DEBT BUYBACKS AND THE MYTH OF CREDITOR POWER

YESHA YADAV†

This Article argues that regulation fails to protect bondholders in the context of a debt buyback – when an issuer repurchases its debt with a view to extinguishing the claim. Scholars have developed an expansive body of research examining share buybacks and debated their significance for policy and economic welfare. Little attention, however, has focused on debt buybacks despite their ability to rewrite bargains and strip away creditor control rights in the process. Between 2004-2017, approximately $1.9 trillion worth of corporate debt was subject to a buyback, highlighting the importance of this technique for redefining issuer-bondholder relations and corporate capital structure.

To show how regulation systematically under-protects creditors, this Article makes three points. First bondholders confront information asymmetries that enable issuers to buy back creditor claims cheaply. While disclosure accompanies the extension of debt, buybacks are much less revelatory, with regulation imposing negligible requirements on issuers to provide information. Lacking fiduciary protection, creditors also become vulnerable to being short-changed by issuers in the interests of securing gains for shareholders and managers. Second, buybacks diminish the power of creditor control rights, recently enjoying prominence owing to the emergence of bondholder activists. Alongside limited disclosure, bondholders confront coordination challenges and tight deadlines within which to evaluate a buyback. This difficulty gives issuers scope to underprice creditor controls. Bondholders will not agitate where the gains will be less than the cost of information gathering, coordination, valuation and action. By strategically underpricing a buyback by an amount approximating these transaction costs, an issuer can pocket the difference between the price paid for the claim and that which should have been paid to bondholders in recognition of their bargain. Third, debt buybacks open up the possibility of one set of creditors (notably, banks) extracting value from bondholders. By pushing a borrower to buy back bond claims cheaply, banks (usually with greater individual exposure through their loans) can increase their chances of being repaid. They can also acquire a more powerful voice for themselves in the borrower's internal governance

† Professor of Law, Chancellor Faculty Fellow, Vanderbilt Law School. My sincere thanks to Margaret Blair, Chris Brummer, Barry Friedman, Kose John, Elizabeth Pollman, Kevin Stack, Danny Sokol and Pradeep Yadav for most helpful conversations and comments in the preparation of this Article. All errors are my own.

by muting that of bondholder activists. In concluding, this Article offers proposals to bolster bondholder protection, advocating for greater disclosure and a discrete fiduciary duty to be imposed on managers in the context of debt buybacks. These steps help to more fully realize the goals of investor welfare and reduce the cost of capital in securities markets.

TABLE OF CONTENTS

I. INTRODUCTION

In the summer of 2018, Albertsons – the Idaho-based grocery chain – was celebrating its first set of profitable results following a $9 billion merger with rival Safeway more than three years earlier.[1] As it looked forward to making a splashy bid for retail pharmacy giant Rite Aid later that year, Albertsons plans hit a snag.[2] Bondholders holding around $270 million of Safeway debt began a high-profile campaign to argue that the terms of the 2015 takeover had violated promises made to them in the bond contract. The financing arrangements put in place by Albertsons, they argued, had worked to strip bond investors of their rights as secured creditors to assert a claim against Safeway's assets.[3] The complaint could not have come at a worse moment for the company as Albertsons was just a few weeks away from its bid for Rite Aid. Decrying the move as a hold-up, it sued the bondholders and berated them for wastefully waiting four years to allege a default in the bond contract.[4] As the dispute threatened to escalate, however, the grocery chain eventually resolved to pursue a more pragmatic strategy. Instead of skirmishing, Albertsons paid $330 million to buy back the debt from agitating bondholders and ensure that they dropped their claim. By November 2018, Albertsons had repurchased and retired the debt.[5] While reducing its leverage in the process, it had – crucially – deployed the buyback to neutralize tricky bond covenants and remove troublesome investors from its capital structure.[6]

Debt buybacks allow borrowers to repurchase outstanding debt (usually bonds) as a step towards extinguishing this liability from their books.[7] Through a buyback, corporate debtors can rewrite the bargain with

[1] David Staats, *Albertson's Has Lost Money for Years: This Is What It Says about Its Finances*, IDAHO STATESMAN, April 11, 2018. On the Safeway takeover, *Albertson's and Safeway Complete Merger Transaction*, PMS NEWSWIRE, Jan. 30, 2015; Brian Solomon, *Cerberus Buys Safeway, Merges It With Albertsons For Over $9 Billion*, FORBES, MAR. 6, 2014.

[2] It should be noted that the Albertson's Rite Aid merger was called off, Michael Corkery, *Rite Aid and Albertsons Agree to Call Off Merger in Face of Opposition*, N.Y. TIMES, Aug. 8, 2018.

[3] Alexandra Scaggs, *Schroedinger's Default (Updated)*, FIN. TIMES (ALPHAVILLE), Aug. 8, 2018; Lawrence Lee, Letter from Paul Weiss (Counsel for Bondholders) to Counsel for Safeway Re Safeway Inc. 7.25% Debentures due 2031, Jul. 19, 2018.

[4] Katherine Doherty, *Albertson's Scuffles with Safeway Bondholders Over 2015 Default Claim*, BLOOMBERG, Jul. 24, 2018. On bondholders and class actions, James Park, *Bondholders and Securities Class Actions*, 99 MINN. L. REV. 585 (2014) (noting the rising instances of bondholders initiating class actions).

[5] Katherine Doherty, *Albertsons' Safeway Buys Back Notes to End Default Claim*, BLOOMBERG, Nov. 29, 2018.

[6] Doherty, *supra* note [5].

[7] *See discussion infra* Part II(I)(A). For a discussion on bank loan repurchases, see, Smita Madhur, *Loan Buyback-Related Ratings Action Stir Debate*, REUTERS, May 22, 2009. In this Article, the term "debt

their creditors by buying them out early and – very often – removing their ability to wield the power formalized in covenants and events of default in the loan or bond agreement.[8] The technique enables debtors to accomplish a variety of aims: (i) reducing the amount of debt on their books; (ii) strategically eliminating sources of creditor power; and (iii) facilitating a restructuring of a distressed borrower's finances by simplifying its capital structure.[9] If a company can repurchase its debt when it is trading at a discount – in other words, if a bond representing a debt of $100 is trading for less – the borrower can achieve its goals while recording a notional windfall on its books.[10] Between 2004-17, approximately $1.89 trillion worth of corporate debt was subject to a buy back.[11]

Share buybacks – when companies repurchase equity claims from existing shareholders – have generated an extensive, often charged body of scholarly and popular literature documenting their impact.[12] Debt buybacks, by contrast, have attracted only sparing interest despite their ability to quickly and thoroughly reshape a company's capital structure.[13] This Article fills this gap by developing an account of debt buybacks to show that current regulatory design systematically underprotects bondholders and weakens the exercise of creditor power. In allowing bondholder rights to be cheaply bought out, regulatory policy forces creditors to internalize high costs for safeguarding their interests and extracting fair value for their claims.

To make this argument, this Article highlights three factors that serve to create a structurally unequal playing field in favor of debtors (i) deep information deficits for bondholders; (ii) the high coordination and negotiation costs involved in protecting creditor control rights; and (iii) bondholder vulnerability to opportunistic behavior by more powerful (likely bank) creditors within the capital structure.

---

buyback" refers broadly to buying back debt both in the open market and using a debt tender offer. The Article later distinguishes and discusses the implications of each method.

[8] *See discussion infra* Part II(I)(A).

[9] *See discussion infra* Part II(I)(A).

[10] *See discussion infra* Part II(I)(A). See also, Ng, *infra* note [106].

[11] This figure is based on data from the Fixed Income Securities Database, and on an approximate read of both open market and tender repurchases conducted by non-governmental corporations between 2004-2017.

[12] *See sources cited infra* note [109].

[13] In the legal literature, however a handful of Articles have examined buybacks in the context of the leveraged buyout-out boom in the 1980s. Victor Brudney, *Corporate Bondholders and Debtor Opportunism*, 105 HARV. L. REV. 1821 (1992); Coffee & Klein, *supra* note [159]; Bab, *infra* note [159]; Peterson, *infra* note 159]. On distressed debt exchanges, Bratton & Levitin, *infra* note [149]. On the limited literature in finance scholarship, see, Julio, *infra* note [106].

First bondholders confront steep information asymmetries that are not mitigated by substantive mandatory disclosure.[14] Investors lack a basic set of data regarding the circumstances governing the buyback unless they are first willing to privately spend on research and analysis.

Scholars are familiar with the challenge of putting a price on a loan and estimating how likely a debtor is to default. An exercise in forecasting, lenders must guesstimate factors such as the borrower's cash flows for the life of the loan, the quality of its management, hazards that will imperil its operations, the worth of its assets and so on. To fix a rate reflecting the default risk, they need to come up with hard numbers to reflect their view of what is essentially a nebulous and probabilistic set of dangers that will affect the business far into the future.[15] It follows that extending a loan is routinely preceded by detailed transfers of information from the borrower to the lender as a way to facilitate a more accurate reading of the borrower's credit risk. In the case of bank loans, such flows of data can afford lenders extraordinarily precise access into a borrower's affairs.[16] Public bondholders, while being at greater remove from a company's inner workings, still receive a thick bundle of disclosures when the bonds are first issued and also regular reporting afterwards.[17]

This easing of information costs when debt is originated stands in stark contrast to the paucity of disclosure when it is repurchased. Regulation governing the large-scale repurchase of a bond-issue (done using a tender offer) imposes only minimal requirements – confined to providing a notice and ensuring that any information issuers do convey is not fraudulent or misleading.[18] Unlike equity tender offers that require a fuller and more standardized set of disclosures, debt buybacks take place with little formal transparency and no need for the issuer to make a public filing with the Securities and Exchange Commission (SEC).[19] Indeed debt repurchases can avoid even these mild prescriptions. By choosing to repurchase slivers of their own debt on the open market (i.e. like any other investor), borrowers are absolved from making any prior notification to the market or following up with specific disclosure outside of what must be provided as part the usual periodic regulatory filings and annual report.[20]

---

[14] On the longstanding debate regarding the benefits of mandatory disclosure, see sources cited *infra* note [216]. On the systematic informational disadvantage faced by bondholders, see generally, Brudney, *supra* note [13].

[15] That is to say, lenders need to fix the risk-adjusted "discount rate" to capture the future riskiness of the borrower. *See discussion infra* Part II(I)(A) and (B).

[16] Tung, *infra* note [34]. See discussion *infra* Part I(A)(I)-(II).

[17] See discussion *infra* Part I(A)(I)-(II). On private bondholders and their relatively greater negotiating power than public bondholders, see, Kahan & Tuckman, *infra* note [58]; Michael Bradley & Michael Roberts, *The Structure and Pricing of Corporate Debt Covenants*, 5 Q. J. FIN. 1 (2015).

[18] SEC Regulation 14(E). See discussion *infra* Part II.

[19] SEC Regulation 14(E). See discussion *infra* Part II.

[20] See discussion *infra* Part II.

This lack of information transfer is striking given what is at stake for lenders in a buy back. For one, they lose out on the expected bargain of receiving regular future cash flows (interest and principal payments) and, often, control rights attached to the debt. Importantly borrowers are ideally placed to utilize their information advantage to optimally time a buy-back in ways that systematically undercompensate investors. Jesse Fried advances a similar argument in the context of equity repurchases.[21] However, its applicability to debt is even more pernicious. Unlike equity, managers do not owe a fiduciary duty to their bondholders. Not only does this reduce the need to take lender interests into account, it encourages managers to extract gains from bondholders in favor of shareholders as a matter of corporate duty. Lacking fiduciary protection, bondholders become more vulnerable to insiders trading against them in possession of confidential information.[22] As a result, unless they are willing to spend resources on information gathering, analysis, coordination with other investors and lobbying, bondholders face the risk of being pervasively short-changed during a debt buyback. In the case of a debt tender offer, borrowers have every incentive to low-ball any tender premium offered to nudge investors to surrender their claims. In situations where the possible gains to bondholders are lower than the costs of research and negotiation, added to the uncertainty surrounding the valuation of the claim post-tender, they have little reason to protest the tender offer. If these investors refrain from contesting the buyback, issuers pocket the difference between the amount actually paid to investors by way of premium and the likely optimal premium that should have been paid for relinquishing the bargain.

Secondly debt buybacks risk undermining creditor governance by encouraging issuers to strategically and cheaply repurchase the debt of creditor activists. Per theory, lenders impose covenants to discipline borrowers as a way to reduce the agency costs of debt: the risk that managers and shareholders use lender money self-interestedly to take excessive risks.[23] Scholarship has begun to more fully draw out the significance of creditor power in corporate governance, underscoring its influence, granularity and effectiveness. This increasingly includes activist

[21] Fried, *infra* note [71]. See also, John Core et al. *What Can We Learn from Stock Market Anomalies*, 11 REV. ACC. STUD. 49(2006),

[22] In the context of open market repurchases, Hagit Levy and Ron Shalev find that managers exploit their insider information and time the market, diverting value to bondholders. See discussion, Levy & Shalev, *infra* note [160].

[23] *See for example*, Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure*, 3 J. FIN. ECON. 305 (1976); Stewart Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 145 (1977).

bondholder governance that has, historically, long languished in a state of atrophy owing to the coordination challenges involved in its exercise.[24]

Debt repurchases are often accompanied by "consent solicitations" that ask bondholders to agree to amendments of bond covenants and events of default. For all non-payment-related terms, the law allows the terms of the bond to be changed if the borrower can secure the consent of a majority (or sometimes 3/4ths) of bondholders.[25] Investors are under heavy pressure to accept: if over 50% of them agree to changes (e.g. to permit more borrowing, sell assets, conclude a takeover) within a tight deadline (usually 20 business days), the terms of the bond are permanently altered and holdouts are left without a premium and possessing a claim that has been emptied of power. Bondholders must wager whether or not others will accept. Without information sharing and coordination, uncertainties create coercive pressure on investors to relent and give up control.[26]

As Marcel Kahan and Bruce Tuckman observe, it is often perfectly sensible for borrowers to buy back their debt as a way to lighten creditor oversight.[27] Covenants that might have been appropriate at debt's origination may no longer be useful as the company evolves and grows less risky. Nevertheless, it is equally plausible that borrowers will rationally want to overcorrect and to strip out as many contractual fetters as they can. In other words, to maximally benefit, borrowers will wish to pay as low a premium as they can while removing as many covenants as possible to restore control to shareholders and managers.

Creditors confront structural deficits when seeking to oppose consent solicitations and secure value for their governance rights. A lack of real disclosure impedes a collective understanding of what these rights are worth and what the borrower should pay to have them amended. Working out whether the borrower is likely to violate covenants (e.g. by taking on more debt or becoming a target for a takeover) requires investigation, analysis and coordination as well as a negotiation strategy with which to confront the borrower. More to the point, governance rights present especially thorny questions for valuation, requiring consensus on how bondholders might use them, with what effectiveness and overall outcome. This all raises the transaction costs of investor action and gives borrowers a cushion by which to underpay for bondholder consent. Perhaps more importantly, the ability of a debtor to cheaply buy out future creditor activism raises the risk that debt contracts lose their disciplinary edge –

[24] *See discussion infra* Part I(B). As discussed in this section, Marcel Kahan and Edward Rock describe the rise of hedge fund driven bondholder activism.

[25] *See discussion infra* Part (II)(B)(2).

[26] SEC Regulation 14(E). See discussion *infra* Part II. Sris Chatterjee et al., *infra* note [132]; Kahan & Tuckman, *infra* note [132].

[27] Kahan & Tuckman, *infra* note [132].

prompting lenders to be more circumspect in agitating if the consequence is that their claims become subject to a coercive buyback.

Third debt repurchases open the door for certain creditors within a borrower's capital structure to extract value from others. In particular, they provide an ideal mechanism by which bank creditors can buttress their own position by pushing borrowers to repurchase bonds cheaply. Where certain bonds can be purchased at low cost, banks – usually carrying greater individual exposure on their loans – can enhance their own power and economic standing in the process.[28] Following the repurchase, the borrower's healthier balance sheet can result in a bank having greater chance of being repaid. The quality of collateral may improve. Crucially the bank can gain a stronger voice in borrower governance without facing frictions from competing bondholders also looking to press their influence on management. This may be salient for firms facing financial distress where reducing the number of bondholders – and potentially removing noisy activists – offers a way to facilitate an informal restructuring. Banks possess unique structural advantages by which to persuade a borrower. For one, they are generally better informed. Unlike bondholders – reliant on public filings for disclosure – banks routinely enjoy deep access to a borrower's inner workings and its C-Suite.[29] In addition, they bear only light coordination costs. Unlike dispersed bondholders, banks can organize more easily and wield negotiating leverage a result. While banks may be loath to pay-off bondholders before themselves, the ability to repurchase this debt at low cost allows them to extract value whose long-term significance can exceed the near-term outlay of cash.

In concluding, the Article sets out policy ideas to level the playing field for bondholders whose debt is subject to repurchase. First, empirical attention is needed from regulators and researchers to document the costs and benefits of debt repurchases. To be sure, finance scholars have produced a few empirical studies on the trade-offs involved – and the season of leveraged buy-outs in the 1980s gave rise to a handful of influential legal analyses on the topic.[30] But attention from policymakers has been scant. Given the significance of debt repurchases for remaking firm capital structure – and the opportunities for bondholder abuse – the relative absence of empirical research is startling. Secondly, at a minimum,

[28] *See discussion infra* Part II(B)(1). The literature on the differences between bank and bond debt is extensive. For discussion, see, for example, Stuart Gilson & Gerald Warner, *Private v. Public Debt, Evidence from Firms that Replace Bank Debt with Junk Bonds*, Working Paper (1998). While this Article uses bank debt as convenient shorthand to refer to providers of loans, increasingly numerous types of firm can function as loan providers, such as hedge funds. See e.g., Hannah George & Kelsey Butler, *Who Needs a Bank? Why Direct Lending Is Surging*, BLOOMBERG, MAR. 6, 2019.

[29] *See discussion infra* Part II(B)(1).

[30] But see, Bratton & Levitin, *infra* note [149] (on bond workouts in distressed informal debt workouts). See sources cited *infra* note [159].

this Article suggests equalizing the regulatory disclosure requirements for equity and bond buybacks to require prior notification, more systematized disclosure and a regulatory filing. However, this is insufficient. While there are good reasons for not imposing a general fiduciary duty in favor of bondholders, the Article concludes by raising the possibility of imposing a discrete duty in the context of repurchases. Such a duty should encourage greater disclosure to bondholders as well as create a cost on managers looking to exploit bondholder vulnerability to rework creditor bargains in favor of shareholders and themselves.

This Article analyzes themes crucial to the $9.2 trillion market for U.S. corporate debt, whose growth over the last decade reflects a surge of easy credit owing to low interest rates after the Crisis. Around $3 trillion of this debt is held by companies whose risk is rated as "BBB," hovering just above "junk" status.[31] This loose availability of credit, often with fewer covenants, encourages companies to repurchase old debt and to refinance it more cheaply.[32] Looking forward, as rates increase, the fear of rising debt servicing costs especially for companies with too much leverage, creates incentives for them to buy it back.[33] Fundamentally, the systematic under-protection of bondholders should worry policymakers. If bondholders lose repeatedly, they may end up pricing information asymmetries, weakened creditor governance and inter-creditor opportunism into the cost of capital. Ultimately, this hints at a failure in regulatory policy that causes borrowers and powerful creditors (i.e. banks) to put short-term wins against the larger loss of long-term capital efficiency.

This Article proceeds as follows. Part II outlines the challenges of contracting in debt capital markets, requiring heavy transfers of information and control to lenders. In Part III, the Article describes the goals and regulation of debt buybacks, with Part IV analyzing the implications of their design for bondholder rights and Part V outlining pathways for reform. Part VI concludes.

II. DEBT AND CORPORATE CAPITAL STRUCTURE

Debt is essential to corporate life. While equity attracts the lion's share of attention from scholars, the inclusion of debt within a company's

[31] This means that around $3 trillion is held by companies with a credit rating of BBB, the highest grade above "junk" status. Diane Vazza et al., *The 'BBB' U.S. Bond Market Exceeds $3 Trillion*, S&P Global, https://www.spglobal.com/en/research-insights/articles/the-bbb-u-s-bond-market-exceeds-3-trillion.

[32] Ng, *infra* note [106].

[33] Ng, *infra* note [106].

capital structure radically re-shapes its chances for success as well as its internal governance.[34] By taking on debt, businesses can amplify their returns.[35] They also become subject to a variety of constraints. For one, this debt must be repaid. In addition, lenders routinely impose a slew of restrictions on a company's activities – ostensibly to ensure repayment – but with the result that a business is curtailed in how it conducts operations.[36] In the worst case, failure to comply with lender stipulations pushes a debtor towards financial distress, bankruptcy and liquidation.[37]

This Part outlines the significance of debt for a company's capital structure and governance. It makes three points. First, borrowers and lenders must overcome uncertainties to determine what an optimal balance sheet ought to look like and how best to calibrate the debtor's cost of capital. If a debtor can comfortably repay its debt, it can look forward to returns higher than what it might have achieved by relying on its cash reserves alone. On the other hand, the cost of failure can be catastrophic. Both the debtor and lender face financial and reputational losses; crucially, a debtor risks ruin if the company assumes too much debt, at too high a cost and is ultimately unable to repay. Secondly, these difficulties set the stage for a complex and long-term negotiation between borrowers and lenders where both sides tussle over how much information and power a debtor must concede to a creditor.[38] Creditors need information to decide how risky a borrower is and how much it needs to pay. Assuming a role in corporate governance also gives lenders tools with which to prevent the debtor from taking outsize risks.[39] Thirdly, these dynamics help explain the

[34] *See generally*, Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211-1220 (2006) (examining the impact of creditors as decision-makers in corporations, highlighting that the literature has failed to offer an account of their role); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073 (1995) (noting the significance of debt in corporate governance); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115 (2009) (analyzing the impact of lenders in corporate decision-making). On the effect of financial engineering, see generally, Henry T.C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. 663 (2008); Yesha Yadav, *The Case for a Market in Debt Governance*, 67 VAND. L. REV. 101 (2014) (proposing a market in debt governance to overcome the empty credit problem). On the rise of bondholder governance, see generally, Marcel Kahan & Edward Rock, *infra* note [84], 284–92.

[35] The literature in this area is extensive. See, for example, Shourun Guo et al., *Do Buyouts Still Create Value*, 66 J. FIN. 479 (2011) (noting the potential for leveraged buy outs to enhance value by improving returns and reducing (somewhat) operating costs). On the significance of debt in corporate capital structure, see, for example, Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1, 2-3 (1996)("Thus if one wants a theory of the composition of external financing, it may be more important to understand the structure of debt financing than the choice between debt and equity.").

[36] Baird & Rasmussen, *supra* note [34], 1209-1215; Tung, *supra* note [34], .

[37] Tung, *supra* note [34], 156-60; Bolton & Scharfstein, *supra* note [35], 2-3 (analyzing optimal contracting conditions to discourage default); George G. Triantis, *The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines*, 16 INT'L REV. L. ECON. 101, 104-10 (1996) (discussing the intensity of lender power over debtors in the event of covenant breaches).

[38] Tung, *supra* note [34] (highlighting a transfer of power from borrower to lender in the event the former violates a loan covenant).

[39] Tung, *supra* note [34], 157-160.

importance of debt buybacks. If a company feels more comfortable financially, it may be less willing to cede control and information to creditors, necessitating a mechanism that can help extinguish the company's debt quickly and cheaply from its books.[40]

A. Debt in Capital Structure

Debt can be difficult to define. Broadly, however, it describes arrangements where one party with capital allows another to borrow this money for a period of time on the understanding that these sums will be repaid. In return for the temporary use of its cash, a lender requires that the borrower pay interest – set at a level high enough to compensate the lender for the risk that the borrower fails to pay, lost opportunities to invest in other ventures as well as larger macroeconomic worries like inflation.[41] Usually the lender does not acquire ownership rights, nor does it care about the company for a period longer than the maturity of its loan.[42]

The familiarity of debt's basic design obscures its significance for reshaping a company's performance and how it behaves. At its best, the decision to borrow can jump-start a firm's returns and enhance value for shareholders. Rather than use $200 of equity to invest in a new venture, a company could borrow $100 and use $100 of its own money. Assuming a 10% annual rate of return from this endeavor and a 5% interest rate on the loan, the ability to borrow allows shareholders to reap greater returns when borrowing rather than relying on equity alone. By using only equity, the company enjoys a straight 10% gain on its investment ($220). However, when using a mix of debt and equity, the shareholders deal in a different calculus: a liability of $105 at the end of the year on total wealth of $220, creating $115 worth of equity value. In other words, by using both debt and equity for this transaction, shareholders see a gain of 15% rather than just 10% on what they invest. Provided management is capable of choosing projects that are value-generating over and above what needs to be paid out in the form of repayment to creditors, debt can help promote faster growth than what might have been possible otherwise.

[40] This Part provides an outline of these issues. It does not purport to offer a detailed account of the literature and debates that have shaped discussion of debt governance and optimal capital structure.

[41] For bonds, this is commonly called the "coupon rate." RICHARD BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE (11TH ED), 585-639 (describing the centrality of debt in corporate finance, various types of debt and key features); Financial Industry Regulatory Authority, Bond Basics, https://www.finra.org/investors/bond-basics.

[42] *Id.*

Unsurprisingly, theory highlights the risk of shareholders seeking out debt as a means of supercharging the value of equity.[43]

Lenders, too, benefit from the expansive potential of debt. A central function of debt markets lies enabling those with surplus cash to entrust it to firms looking for capital.[44] In facilitating this transfer from passive savers to productive entrepreneurs, well-functioning debt markets promote an efficient use of surplus capital. They can help encourage wealth creation if lenders make profitable allocative choices that result in growth for firms as well as in steady cash flows for themselves (e.g. in the form of interest payments and fees). These markets thus offer a means by which lenders can plan for their own financial futures by strategically investing in claims that pay out at given dates at given points in time. By deferring their immediate consumption of capital, lenders can use debt markets as a vehicle for assuring themselves of steady future cash flows and a reliable financial safety-net.[45]

Indeed it can often make more sense for someone with surplus capital to invest it in debt rather than equity. As a major theme in corporate finance, understanding the differences between debt and equity has produced an extensive literature whose discussion is outside the scope of this Article. However, broadly seen, the promise of predictable cash-flows in debt (rather than uncertain dividends), higher priority in bankruptcy (rather than no priority at all), as well as the ability to carefully choose maturities, price terms and risk mitigation devices (e.g. taking security over a company's assets) can confer considerable gain for a lender over-and-above what a shareholder might be able to achieve.[46]

At its worst, however, debt can irreparably damage the company by forcing it into distress, asset-sales and, possibly, liquidation. The downside risk of a failed lending relationship carries an asymmetrically heavy burden for shareholders relative to any loss of value they might suffer were they to only use the company's own equity. Recall the earlier example of a company with $100 loan on its books and $100 in available equity. Here rather than seeing 10% returns, the company suffers a 10% end-of-year loss on its projects. As before, the company confronts a

[43] Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1182-1185 (2010); Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605 (2011) (describing the tendency of shareholders to exhibit opportunistic risk taking at the expense of creditors); Clifford Smith & Jerold Warner, *On Financial Contracting*, 7 J. FIN. ECON. 117 (1979) (noting the agency costs of debt and the role of contractual restrictions to reduce the chances of shareholder and managerial risk-taking at creditor expense.

[44] BREALEY ET AL., *supra* note [41], 46-50; 160-167; 427-445. On the allocative and monitoring roles of capital markets, Solomon Tadesse, *the Allocation and Monitoring Role of Capital Markets*, 39 J. FIN. QUAN. A. 701(2004).

[45] BREALEY ET AL., *supra* note [41], 585-605

[46] BREALEY ET AL., *supra* note [41], 218-226; 351-359; Eugene Fama & Kenneth *French, Capital Structure Choices*, Working Paper (2011).

liability of $105 on the loan. However, instead of $220 in overall wealth, the company now has only $180 in value at the end-of-year. As a result, shareholder equity is worth just $75 ($180-$105) – a percentage drop of 25%, rather than the 10% that would have been lost had management relied on equity alone for financing. This illustration may be simplistic. But it serves to highlight the existential burden facing companies that suffer multiple years of incremental losses, or a single year of large losses, when carrying debt on their books. Imagine that the company's project delivered losses of 30% over the year. Under such conditions, shareholder equity ends up being worth a meagre $35 ($140-$105), a percentage drop of 65%. If its assets lose 47.5% in value, the company's shareholders are effectively wiped out as their interest winds up being worth nothing.

The promise and perils of debt underscore the significance to lenders and management of determining what constitutes the company's most optimal capital structure. Where this task is successfully performed – and the company can pay its debt – the gains to shareholder value can be exponential. By contrast, mistakes in this calculus can be extremely costly, as illustrated above. Not only do shareholders suffer losses on the value of their own equity, but they also face the prospect of paying repeat and regular principal and interest on an ever-dwindling surplus. Put more simply, the impact of everyday losses can rapidly magnify when a company decides to introduce debt into its capital structure.

Lenders, too, confront high costs if borrowers fail. Where the company takes on losses, it might never be able to pay. Its secured assets may waste away.[47] Lenders thus lose on two fronts: (i) they may never recover their principal; and (ii) they also miss out on the stream of interest and fees that their capital was supposed to generate, waylaying investment plans and possibly casting doubt on their own solvency following the economic and reputational shock of bad decision-making. To recoup these losses, lenders may engage in costly negotiations with a borrower and other creditors to work out an alternative payment plan. They may end up in messy Chapter 11 bankruptcy proceedings where their ability to act in their own best interests can be curtailed for long periods of time.

As Aswath Damodaran observes, it is all too easy for lenders and borrowers to arrive at dubious calculations of how best to calibrate a company's capital structure.[48] In other words, mistakes will be made. Crucially, parties must provide answers to questions that require consensus on states of future existence whose exact permutations can be near-impossible to gauge accurately. For example, a bank and a company seeking to arrange a $10 million dollar loan, designed to be repaid over 10-

[47] BREALEY ET AL., *supra* note [41], 218-226

[48] Ashwath Damodaran, *Valuing Declining and Distressed Companies*, Working Paper (2009).

years, must work out whether the company will, in fact, be able to pay back this money over the specified period of time. This transaction demands that parties be able to predict factors such as the cash flows the company is likely to produce a decade into the future, what these cash flows are worth in the present, sources of risk that might threaten them, the changing value of the company's assets, and how easily this value can be liquidated for cash. In negotiations, parties may be too optimistic in the assumptions they make. They may over-estimate the durability of the debtor's successes or fail to take into account the slate of possible risks that could disrupt its business. Alternatively, lenders may be overly cautious when provisioning for future risks and put an unduly high price on the loan. While valuation experts can offer intelligent guesstimates, the forward-looking, predictive nature of the exercise imports a high likelihood that parties will vary in their thinking and that "right" answers will ultimately prove elusive.[49]

Indeed the chances of miscalculation are likely to be greatest just when parties can afford it the least – that is, for companies that are faltering. When a company gets into a distressed state during the term of the loan, estimating the value of a company and its risk of missing payments can become particularly pernicious. Under such conditions, Damodoran notes, conventional strategies for arriving at answers break down. Evidence of past performance no longer offers a reliable guide to future operations. Loss-making assets falter in their ability to produce the economic value they might have once done. The common practice of looking to similar businesses for guidance on what the borrower's assets are worth can lack usefulness where the debtor's business is beset with unusual, idiosyncratic problems. Management may be minded to behave unpredictably or even maliciously in seeking to salvage what they can of a struggling business.[50] It is well-recognized in the literature that valuing the debtor's assets, represents a singularly thorny issue. The real-world consequences of this difficulty manifest in the heightened uncertainty it creates and the need for parties to craft measures that can help increase control, constraint and predictability.[51]

B. Information Transfer

[49] For further discussion on the difficulties of valuation in Chapter 11, Anthony Casey & Julia Ann Simon-Kerr, *A Simple Theory of Complex Valuation*, 113 MICH. L. REV.1175(2015).

[50] See generally, Damodaran, *supra* note [48].

[51] See for example, Casey & Kerr-Simon, *supra* note [49]. On the valuation heuristics commonly deployed by managers, see, John Graham & Campbell Harvey, *The Theory and Practice of Corporate Finance: Evidence from the Field*, Working Paper (2000).

To state the obvious, lenders need information about a borrower in order to put a price on its riskiness. When compared with dealings in tangible assets (e.g. a car or a house) that usually carry some inherent value (e.g. parts and fittings), pricing the riskiness of ephemeral prospective cash flows poses special problems. Corporate finance scholarship has developed an extensive body of scholarship designed to clarify best methods and models for pricing risk. Still the fundamental task of estimating future performance means that lenders must ascribe hard values to what is essentially a highly predictive exercise.[52]

As Fred Tung observes, lending relationships especially entail a particularly intensive transfer of information between the borrower and lender.[53] In their substance, such disclosures tend to be far more invasive, granular and continuous than what shareholders conventionally receive by way of routine securities disclosures and as part of the company's corporate governance obligations.[54] Indeed, the depth and access to data that lenders are permitted – particularly in the context of bank loans – can sometimes rival that of a borrower's own board members.[55] Scholars note that these deep information transfers can come out of formal as well as informal dealings between borrower and lender. Loan agreements offer the most obvious mechanism by which lenders demand data about a debtor's business, its management, financial statements, assets, existing borrowing, expenses, prospective investments, dividend declarations and other types of information that offer insight into its propensity towards default.[56] However, lenders can also lean on softer relationships, interpersonal dealings or board seats as a way to glean information that might not be readily obvious on paper. In one study, Randall Kroszner and Philip Strahan found that banks possess an extensive network of linkages into the boardroom of non-financial companies, with bank executives being prolific in securing corporate board seats. The practice of bank executives holding such directorships, as well as executives at non-financials taking on board positions at banks, offers a means for bank lenders to build relationships and to actively engage in on-the-ground monitoring.[57]

---

[52] Damodaran, *supra* note [48].

[53] Frederick Tung, *supra* note [34], 125-131 (2009)

[54] Securities Act 1933 §§ 5(a); 5(b)(2); 77e(c) (necessitating production of a detailed disclosure document – registration statement – that must be in place before a company can issue and effect sales in securities to the public). Securities Act 1933 Pub. L. No. 112-106, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a et seq.); Securities Exchange Act 1934 §13. Securities Exchange Act of 1934, Pub. L. No. 112-158, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a et seq.).

[55] Tung, *supra* note [34], 125-131.

[56] Tung, *supra* note [34], 135-140.

[57] Randall Kroszner & Phillip E. Strahan, *Throwing Good Money after Bad*, John M. Olin Law & Economics Working Paper No. 139 (Aug. 2001) (the authors question whether the closeness created by board relationships can give rise to troubling conflicts of interest that allow companies to gain preferential

These intensive transfers of information are more attenuated in bond markets, especially where bonds are issued publicly.[58] However, they are still important and valued. As Bill Bratton observes, bondholders have come to place heavy reliance on the bond indenture – the contract governing the relation between bondholder and issuer – as a means of self-protection, enforcement and monitoring.[59] In addition, bond investors count on a regular supply of mandatory periodic reporting under securities laws.[60] With more activist bondholders gaining influence, Ed Rock and Marcel Kahan highlight violations of financial reporting obligations as a critical trigger for bondholder scrutiny and action.[61]

Scholars have underscored the significance of disclosure as a mechanism by which those looking for funds can reduce their cost of capital.[62] Examining the impact of accounting disclosures, Richard Lambert et al. observe that companies providing richer disclosure enjoy a lower cost of capital relative to those that do not.[63] Transparent capital-seekers help investors to close the gap between expectations and the reality a company's cash flows. By equipping investors to arrive at more nuanced

access to credit. The authors noted that, while board relationships do not appear to give rise to preferential lending and conflicts of interest, banks do appear to worry about the appearance of conflicts and legal liability that might arise in the event that a debtor ends up in distress and bankruptcy. They note that banks tend to reduce their board engagements with those companies that fall into distress and display volatility, suggesting concerns about legal liability and conflicts). In addition, banks are subject to regulatory restrictions that require them to restrict lending to their bank executives, director, or company controlled by a bank official. A full discussion of these issues is outside the scope of this Article, Board of Governors of the Federal Reserve System, Regulation O: Compliance Guide to Small Entities, https://www.federalreserve.gov/supervisionreg/regocg.htm. See also, Tung, *supra* note [34], 139-140.

[58] Brudney, *infra* note [13](discussing the informational disadvantages for bondholders relative to bank creditors). On the greater influence of bondholders in private markets, Marcel Kahan & Bruce Tuckman, *Private vs. Public Lending: Evidence from Covenants* 11–13 (UCLA Anderson Grad. Sch. Mgmt., Paper No. 13-93, 1993).

[59] William Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process* 3–7 (noting that the protectiveness of the indenture tends to vary by the riskiness of the borrower). See also, Yakov Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 469–70 (1999) (proposing the creation of a supertrustee for bond indentures that can intensively monitor and enforce covenant breaches on behalf of dispersed bondholders).

[60] Securities Exchange Act 1934 §13. Securities Exchange Act of 1934, Pub. L. No. 112-158, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a et seq.). For a review of the literature on mandatory disclosure, For a review of the arguments and literature, Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. 123, 133-143 (2004).

[61] See generally, Marcel Kahan & Edward Rock, *infra* note [84]; See also, Yu Gao et al., *Hedge Fund Activism in the Corporate Bond Market: Evidence from Bondholders' Responses to Delay in Financial Reporting*, Working Paper (Apr. 2018).

[62] Remarks by Arthur Levitt, former Chair of the Securities and Exchange Commission, Inter-American Development Bank, September 29, 1997 ("high quality accounting standards . . . improve liquidity [and] reduce capital costs.")

[63] Richard Lambert et al., *Accounting Information, Disclosure & the Cost of Capital*, Working Paper (2006). See also, Mary E. Barth et al., *Cost of Capital and Earnings Transparency*, Working Paper (2013) (showing that firms with better earnings transparency enjoy a lower cost of capital).

estimations about the company's worth, transparent issuers become more attractive than those that are less open.[64]

Additionally, disclosure can also nudge management towards better behavior.[65] In the case of debt, knowing that they are being watched closely by lenders, a debtor's management comes under pressure to take sounder business decisions, forgo the temptation to cook the books or to hide instances of risk-taking. An expansive framework for disclosure between lender and borrower imposes constraints that motivate management towards behavior that meets with the approval of company lenders. As Lambert et al., note, while the effects are indirect, disclosure pushes the company towards improved, less wasteful managerial performance, resulting in a reduced cost of capital for the firm overall.[66]

The significance of disclosure as a means of reducing capital costs takes on added meaning in the context of debt, particularly for companies that find themselves in distress.[67] The ability of debt to trigger an effective death spiral for companies elevates the importance of information as a protective tool for lenders to more accurately gauge the company's riskiness.[68] Moreover, differences of opinion on valuation between lenders as well as between lenders and (potentially risk-seeking) shareholders puts disclosure at the heart of negotiations designed to clarify the uncertainty.[69] This is especially relevant for struggling companies that face the added complication that conventional valuation methodologies are vulnerable to misfiring in this context.[70] Ensuring that lenders have high-quality disclosure in such circumstances can offer assurance to the borrower that lenders will apply a more accurate risk premium to the debt.

But such information transfers can also be viewed unfavorably by debtor companies and their management. As much as transparency offers lenders a way to price a loan and perhaps reduce capital costs, it can also encourage over-active policing and excessive caution on the part of

64 See also Robert E. Verrechia & Wayne Guay, *Conservative Disclosure*, Working Paper (2017) (noting that firms that commit to "conservative disclosure," in other words, disclosing negative news, experience higher firm prices); Robert E. Verrechia & Joseph Weber, *Redacted Disclosure*, Working Paper (2005) (showing that firms that engaged in more redaction of proprietary terms in filings experienced deterioration on certain liquidity measures - e.g. a higher bid-ask spread).

65 Lambert et al., *supra* note [63]; Gerald J. Lobo & Jian Zhou, *Disclosure Quality and Earnings Management*, 8 ASIA PACIFIC J. ACC'G & ECON. 1 (2001).

66 Lambert et al., *supra* note [63].

67 Stuart Gilson et al., *Valuation of Bankrupt Firms*, 13 REV. FIN. STUD. 43, 44-45 (2000) ("One explanation for the imprecision of the cash flow-based valuations is that the administrative bankruptcy process may limit the amount and quality of available information. With the inability to capitalize on superior information about future cash flows…potential market participants have substantially less incentive to collect information about the bankrupt firm or reality test management forecasts.")

68 Gilson et al., *supra* note [67], 55.

69 Gilson et al., *supra* note [67], 44-45 (discussing the importance of information for creditors during valuation battles); On voluntary disclosure, cost of capital and capital structure choices, *Jeremy Bertomeu et al., Capital Structure, Cost of Capital and Voluntary Disclosures*, 86 ACC. REV. 857 (2011).

70 Damodaran, *supra* note [48].

lenders. In addition, from the standpoint of managerial self-interest, disclosure to lenders blunts some of the entrenched informational advantages traditionally enjoyed by insider-executives. Theory has long recognized the pernicious play of managerial agency costs that can manifest in executives using their informational access to engage in insider trading and self-enrichment to the detriment of company stakeholders.[71] A rich literature has suggested that entrenched informational imbalances in favor of managers can negatively affect a company's capital costs, particularly where investors cannot easily diversify their exposure.[72] That shareholders might value lender monitoring as a way to reduce information asymmetries and the risk of managerial misbehavior is hinted at by studies that show that share prices tend to go up when a company announces that it has procured bank (but not bond) debt.[73]

C. Creditor Power and Activism

[71] William Wang, *Trading on Material Non-Public Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV.1217, 1227–30 (1981); Victor Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); ROBERT CLARK, CORPORATE LAW (1986) (noting that "blanket permission of insider trading" would increase "the price of capital," resulting in "less investment and less capital formation"); James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L. J. 628, 638–39 ("The presence of abusive insider-trading practices increases each firm's cost of capital because investors discount all firm securities by the average risk of abusive trading practices."); A. C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13 (1998) ("[I]nvestors will discount the amount that they are willing to pay for shares to reflect the risk of insider trading, thus impairing capital formation); Jesse Fried, *Insider Trading via the Corporation*, 162 U. PA L. REV. 801 (2014) (noting that "diversion of value" from insider trading "increases firms" cost of capital").

[72] David Easley & Maureen O'Hara, *Information and the Cost of Capital,* 59 J. FIN. 1553 (2004); David Easley, Soeren Hvidkjaer & Maureen O'Hara, *Factoring Information into Returns*, EFA 2004 Maastricht Meetings Paper No. 4118 (2005) (noting abnormal returns for portfolios of stocks with high degree of private information). John Hughes et al., *Information Asymmetry, Diversification & Cost of Capital*, 82 ACC. REV.705 (2007). Richard Lambert et al., argue that information precision, rather than information asymmetry, constitutes the salient factor in determining cost of capital. Richard Lambert et al., *Information Asymmetry, Information Precision and the Cost of Capital*, Working Paper (2010); For skepticism on the impact of information asymmetry on cost of capital, Wayne Guay et al., *Properties of Implied Cost of Capital Using Analysts' Forecasts*, Working Paper (2006).

[73] Christopher James, *Some Evidence on the Uniqueness of Bank Loans*, 19 J. FIN. ECON. 217 (1987) (suggesting that bank lending results in a boost to share prices, whereas private placements can produce negative returns); Steven Ongena et al., *Banks and Bonds: The Impact of Bank Loan Announcements on Bond and Equity Prices*, Working Paper (2007), https://ideas.repec.org/a/mul/jdp901/doi10.12831-78756y2014i2p131-156.html (noting that bond credit spreads showed a marked decrease in risk following the announcement of a bank loan); Steven Ongena & Viorel Roscovan, *Bank Loan Announcements and Borrower Stock Returns: Do Origins Matter*, European Central Bank Working Paper No. 1023 (2009)(noting that stock returns vary depending on the kind of bank that lends to a borrower, with higher stock returns where lending is undertaken by foreign banks and local banks). But see, Matthew Billett et al., *Are Bank Loans Special? Evidence on the Post-Announcement Performance of Bank Borrowers*, 41 J. FIN. QUAN. A. 733 (2006) (suggesting that a boost to equity returns may be very short-term in nature. Long term, borrowers showed negative abnormal stock returns over the next three years). The literature on this topic is extensive.

Information transfer sets the stage for lenders to engage in expansive intervention in a borrower's governance as a way to safeguard their exposure and advance their own commercial interests.[74] Creditor power has long come in second place when compared with the literature that has grown around the role of shareholders in corporate governance. As Baird and Rasmussen note, however, the role of lenders in governance can be impactful in ways that far exceed the influence of shareholders on a company's day-to-day decision-making and performance.[75]

Creditor governance, particularly in the context of bank debt, can be enormously influential. Formally, bank lenders look to the loan agreement to craft contractual levers that can severely limit a borrower's room to maneuver and take independent decisions.[76] As Tung notes, with detailed information transfers and access to the boardroom, lenders are able to surveil a borrower to limit its capital expenditures, investments, dividend declarations, mergers and additional debt.[77] Violations can result in harsh consequences, with lenders dictating firings of C-suite personnel, ensuring creditor-approved replacements, and appointing turnaround specialists to re-shape the running of the business.[78] Lenders routinely charge fees to waive covenant violations and may renegotiate terms to take extra interest or additional security.[79] Management might well feel hamstrung in their ability to exercise business judgment and run the company day-to-day. Indeed, scholars note that the loan agreement constitutes an organic document that is under constant renegotiation and updating.[80] Terms and conditions are drafted precisely in order to be breached, designed to trigger periodic scrutiny and opportunities for lenders to impose discipline as well as to extract lucrative private gains in the form of fees and products sold to the borrower.[81] According to a study

74 *See sources cited supra* note [34].

75 Baird & Rasmussen, *supra* note [34], 1212-1220; Tung, *supra* note [34], 117-130. But see, in the context of Chapter 11 proceedings, see however, Jared Elias & Robert Stark, *Bankruptcy Hardball*, CA. L. REV *(forthcoming)* (an important argument showing the increasingly opportunistic behavior by debtors against creditors in situations of financial stress, designed to help certain stakeholders over others).

76 *See e.g.*, Baird & Rasmussen, *supra* note [34], 1212-1220; Tung, *supra* note [34], 117-130.

77 Baird & Rasmussen, *supra* note [34], 1212-1220; Tung, *supra* note [34], 117-130.

78 Tung, *supra* note [34], 117-130.

79 Tung, *supra* note [34], 117-130.

80 George T. Triantis, *Exploring the Limits of Contract Design in Debt Financing*, 161 U. PA. L. REV. 2041, 2047-2048 (2013)(noting the shift of power to creditors); George G. Triantis, *Debt Financing, Corporate Decision Making, and Security Design*, 26 CAN. BUS. L.J. 93, 101–04 (1996) (analyzing the importance of default as a trigger for re-negotiation). Barry Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 U. PA. L. REV. 1773, 1778-9 (2013); Charles Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 650–54 (2009) (analyzing the varying intensity of covenants); George G. Triantis & Albert Choi, *Market Conditions and Contract Design: Variations in Debt Covenants and Collateral*, 88 N.Y.U. L. REV. 52, 61 (2013) (noting the capacity of covenant adjustment in response to changes to shifts in credit availability). Where borrowers violate loans in a past lending, it can lead to higher spreads in a new loan, see, Felix Freudenberg et al., *Covenant Violations and Dynamic Loan Contracting*, Working Paper (2017).

81 Triantis, *supra* note [80].

on covenant violations by Michael Roberts and Amir Sufi, only about four percent of all covenant violations led to a lender ending its relationship with the borrower. Rather the default opened the door to a renegotiation between the parties on revised, creditor-approved terms.[82]

These instances of lender engagement are not limited to bank lenders. Increasingly bondholders have shown themselves to be active in pursuing violations of indenture terms – despite the conventional wisdom that dispersed bondholders have few means (or interest) to effectively police borrowers.[83] That bondholders would be passive actors in debt governance – leaving indenture terms to go underenforced – makes sense given collective action costs and the relatively weaker covenants usually contained in public bond debt.[84] However, as Ed Rock and Marcel Kahan have documented, activist hedge funds have steadily made their mark in bond markets, reviving neglected covenants by organizing and agitating against issuers, deploying sophistication, resources and regulatory flexibility to pursue actions and punish indenture defaults.[85] They have identified several key targets for bondholder action: challenging interpretative discrepancies, opposing changes of control and punishing failures to file timely reports with the Securities and Exchange Commission (SEC).[86] On account of this agitation, activists have been able to extract value in the form of fees for waiving default violations, securing full (or more) payment on the bonds, tighter covenants and a subsequent increase in the market price of the traded bonds.[87] Their incentives to act have also enjoyed a boost through recent judicial decision-making.

[82] Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation*, 4 J. FIN. 1657, 1660 (2009). See also, Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 537–39 (2009) (on the significance of creditor control in the periods preceding and during bankruptcy).

[83] Kahan & Rock, *infra* note [84], 282-283 (the authors also note limited incentives for indenture trustees to monitor and action violations of the indenture agreement). It is worth noting that in public markets, bond issues are administered by an indenture trustee, designated, in theory, to protect bondholder interests. However, it is well recognized in the literature that trustees are poorly incentivized and can lack authority and duty to protect bondholders. Their role has come to be more ministerial (e.g. processing payments). For discussion see generally, Steven Schwarcz & Gregory Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 ALABAMA R. REV. 1037 (2008)(noting that trustees are not subject to a stringent standard of care in protecting bondholders); Amihud, *supra* note [59] (describing the need for a "supertrustee" to enhance bondholder discipline);

[84] Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U. L. REV. 281, 284–285 (2009). In the context of private debt markets, see, Kahan & Tuckman, *Private vs. supra* note [58]; 11–13 (UCLA Anderson Grad. Sch. Mgmt., Paper No. 13-93, 1993); Bratton, *supra* note [59], 18-20; Amihud et al., *supra* note [59], 457-465.

[85] Kahan & Rock, *supra* note [84], 284-285.

[86] Kahan & Rock, *supra* note [84], 284-292; Gao et al., *supra* note [61] (analyzing the characteristics of hedge fund versus non-hedge fund driven enforcement).

[87] Kahan & Rock, *supra* note [84], 284-292.

Approving generous remedies for bond defaults, courts have crafted lucrative carrots for bondholders who can successfully press their claim. [88]

Default activism has reverberated across major Main Street, motivating issuers to seek settlements with agitators.[89] Recall Albertsons, paying $330 million to Safeway bondholders to deal with accusations that Albertsons then 4-year old takeover of Safeway had violated a number of indenture terms. Albertsons used this $330 million to buy back certain bonds at par as well as to pay unpaid and accrued interest on this debt with the understanding that doing so would free the company to move forward.[90] Similarly PetSmart, the pet-supplies company and owner of Chewy.com, has been embroiled in litigation with creditors holding PetSmart loans and bonds. Per the complaint, PetSmart transferred Chewy's equity to its parent company and a subsidiary, putting this asset of reach of creditors and violating terms of loan and bond agreements. Though PetSmart managed to settle the dispute with some creditors, it has not satisfied all of its bondholders. One firm, holding $80 million in loan exposure and $600 million of bond debt, has continued to litigate the transfer, prompting other bondholders to consider taking similar action.[91]

Bondholder governance can impact a company outside of covenant violations. As Sandrine Docgne shows, indenture terms exert a heavy impact on firm management independently of enforcement by bondholders. In her study of public bonds, restrictions on investment in indentures resulted in a fall in investment in the two years following the bond issue.[92] Such firms undertook fewer capital expenditures relative to

[88] Wilmington Savings Fund Society, FSB v. Cash America International, Inc., No. 1:2015cv05027 - Document 49 (S.D.N.Y. 2016). In this case, the court allowed the payment of an "make-whole" premium to investors alleging a default of indenture terms, in addition to the amount that the issuer would have owed them had it chosen to redeem early. The case centered around a violation of indenture terms after Cash America spun out a subsidiary. When lawyers sought to change the language in covenants to limit awards of the "make-whole" premium, investors rebelled and organized to roll-back the change. For discussion, Marcel Kahan & Mitu Gulati, *Cash America and the Structure of Bondholder Remedies*, CAP. MKTS. L. J. (*forthcoming*); Matt Levine, *Bond Covenants and Skeptic Skepticism*, BLOOMBERG, JAN. 12, 2017.

[89] Cohen, *supra* note [132].

[90] Doherty, *supra* note [5].

[91] Eliza Ronalds-Hannan & Katherine Doherty, *CapRe Seeks to Take Over PetSmart Lawsuit That Lenders Dropped*, BLOOMBERG, Apr. 5, 2019, https://www.bloomberg.com/news/articles/2019-04-05/capre-seeks-to-take-over-petsmart-lawsuit-that-lenders-dropped. For a discussion of the circumstances giving rise to the litigation as well as discussions of noteholder agitation against J.Crew , iHeart and Claire's see, for example, David W. Morse, *Lenders Beware: Expectations and Unintended Consequences — It's Not Just Financial Covenants!*, THE SECURED LENDER, http://www.thesecuredlender-digital.com/thesecuredlender/november_2018/MobilePagedArticle.action?articleId=1437588#articleId1437588. In the distressed debt context, see, Michelle Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69, 84–90 (2008) (detailing the strategies commonly used by distressed debt investor specialists to take over control); *The Corporate Governance and Public Policy Implications of Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 725–30 (2008) (on the potential for success in so-called "loan-to-own" strategies).

[92] Sandrine Docgne, *Bond Covenants and Investment Policy*, Working Paper (2019).

those that were not subject to such covenants. This trend was especially true for firms that were financially distressed.[93]

For the most part, debt governance can be a boon for efficient capital allocation. It provides a check on agency costs – or the risk that managers and shareholders will be careless and greedy in looking after creditor money.[94] Manager-creditor agency conflicts can be mitigated by lenders paying attention to the quality of executive decision-making. Where covenants end up breached, lenders can take action to punish a bad manager. That lenders are ruthlessly efficient at accomplishing this is suggested by Greg Nini et al. that show that forced manager turnover is 60% higher than usual in the quarter following a covenant violation.[95] Indeed, work by Sadi Ozelge and Anthony Saunders shows this figure to be much higher, with underperforming firms in violation of loan terms experiencing a 68-92% higher probability of forced manager change.[96] Additionally, lender vigilance can help cure distortions in shareholder incentives that might lead equity-holders to unduly enrich themselves. Loan and indenture agreements, therefore, explicitly scrutinize dividend declarations.[97] In the PetSmart litigation for example, creditors sued alleging that value was unfairly diverted to its parent, effectively declaring a dividend for the parent and depriving creditors of a critical source of collateral.[98] Unsurprisingly, Linda Allen et al. find that dividend payouts decline under bank monitoring, attenuating this potential source of agency cost.[99] That lender oversight can yield real economic gains overall is made clear by the benefits that can accrue to companies following a default. In a study of 3500 covenant violations, Nini et al. show that companies see gains in their equity valuation, reduced expenditure, fewer dividends, better performance and abnormal returns of around 5% afterwards.[100]

But just as with information transfers, lender governance is not always welcomed by managers and shareholders. While offering lenders a

[93] Docgne, *supra* note [92] (this study also found that those firms with financing constraints were able to spend more, suggesting that these restrictions lowered their cost of capital and allowed additional borrowing).

[94] *See for example*, Triantis, *supra* note [80]. Clifford Smith & Jerold Warner, *On Financial Contracting*, 7 J. FIN. ECON. 117 (1979); Michael Jensen, *The Agency Costs of Free Cash Flow, Corporate Finance & Takeovers*, 76 AMER. ECON. REV. 323 (1986).

[95] Greg Nini et al., *Creditor Control Rights, Corporate Governance, and Firm Value*, (Dec. 2011) (unpublished manuscript) (showing that CEO turnover is 60% higher following a covenant violation); Sadi Ozelge & Anthony Saunders, *The Role of Lending Banks in Forced CEO Turnovers*, Working Paper (2005) (noting higher CEO turnover where companies are more dependent on debt).

[96] Ozelge & Saunders, *supra* note [96].

[97] Tung, *supra* note [34].

[98] *See sources cited* note [91].

[99] Linda Allen et al., *The Role of Banks in Dividend Policy*, Working Paper (2009), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1446808.

[100] Nini et al., supra note 37, at 2–4. See also, Victoria Ivashina et al., *Bank Debt and Corporate Governance*, 22 REV. FIN. STUD. 41 (2009)(showing that lenders governance can contribute to making borrowers more attractive takeover targets).

tool to reduce uncertainties by applying constraint over a borrower, creditor oversight comes with costs. For one, the borrower must pay regularly to service its debt. Failure to do so results in default and a cascade of disciplinary measures.[101] To make payment, companies might not be able to afford to invest in risky projects or ones that only generate cash far into the future.[102] Secondly, lenders may focus only on monitoring their own interest even if it conflicts with other creditors.[103] They may take poor decisions and fail to consider the effect of their efforts on other stakeholders.[104] Thirdly, lender monitoring can be a nuisance, resulting in expensive negotiations and litigation, without always benefiting the company economically. In one empirical study of bondholder activism by hedge funds, the authors find that interventions can result in wealth transfers from shareholders and non-intervening bondholders to hedge fund activists. The authors note that such intervention is motivated primarily by short-term profit-based considerations.[105]

To summarize, debt requires parties to estimate the debtor's chances of meeting its payment obligations. The uncertainty of this task means that lenders need tools that can help them to properly price the risk of failure and to develop techniques (e.g. taking security over a borrower's assets) that can cushion its impact. Importantly, lenders and borrowers conflict over transfers of information and control from borrower to lender, especially following violations of loan and indenture terms. Ceding information and control to lenders can vastly ease a borrower's path to obtaining credit. But is also problematic. Managers and shareholders can face severe limits on their decision-making. Scrutiny prevents self-interested insiders from extracting maximum advantage from their position. Lenders can become a costly nuisance, locking borrowers into a long-term system of formal and softer constraints that can seem excessively limiting and damaging.

III. DEBT BUYBACKS IN CAPITAL MARKETS

[101] *See generally,* Freudenberg et al., *supra* note [80].

[102] Baird & Rasmussen, *supra* note [34], 1245-1246.

[103] Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 761–62 (2011) (describing tensions between junior and senior creditors and impact on creditor incentives); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225, 240-247 (1992).

[104] Baird & Rasmussen, *supra* note [34], 1209-1213 .

[105] Gao et al., *supra* note [61]; See also, Kahan & Rock, *supra* note [84] (observing that hedge funds are strategic and tactical in pursuing only those covenant violations that result in actual profit for the hedge fund, justifying the cost of action).

Debt buybacks involve borrowers using available cash to effectively reduce or extinguish some of their debt by buying back their own debt claims on the open market or through a tender offer.[106] Buybacks constitute a powerful tool for borrowers, giving them a mechanism by which to use surplus cash to recalibrate their capital structure and, in doing so, to reset the balance of control between themselves and lenders.[107] Buybacks are also significant for inter-creditor relationships. Those whose debt is bought back lose their standing within the hierarchy of lenders. For some, this might be welcome, allowing them to recover (some of) their money and to end their relationship with a faltering, risky company. For others, however, debt buybacks can result in lenders unwillingly losing a source of future cash flows and the possibility of exercising debt governance over a company.[108] Where a company buys back its debt, it can provide creditors that are left behind with advantages. They may see an improvement in the company's default risk. Creditors that remain may also enjoy enhanced power and prestige within the firm.

This Part introduces debt buybacks, their purpose, regulation and impact on capital structure. Scholarship has devoted extensive study to share buybacks, where companies purchase their own shares from existing shareholders.[109] Through this literature, commentators have debated a host of concerns about the legal and normative justifications for share buybacks in the economy. By contrast, the literature on debt buybacks is surprisingly spare.[110] To be sure, debt buybacks and share buybacks represent two economically distinct financing strategies with varied purposes, though using superficially similar mechanisms (open market repurchases or tender offers) to effect the transactions. In setting out their features, this Part

[106] Here the word "buyback" is used broadly to refer to both open market repurchases and tender orders. Brandon Julio, *Corporate Investment and the Option to Repurchase Debt*, Working Paper (2013)("Although debt retirement by open market repurchases and tender offers are rather common, very little is understood about the market for debt repurchases and the motives behind these financing activities."); *Serena Ng, Firms Move to Scoop Up Own Debt*, WALL ST. J. Aug. 24, 2009; Alexandra Scaggs, *Debt Buybacks Could Be the New Stock Buybacks*, BARRON'S, Jan. 8, 2019.

[107] *See for example*, Julio, *supra* note [106]; Julio Rotemberg, *Sovereign Debt Buybacks Can Lower Bargaining Costs*, NBER Working Paper 2767 (1988).

[108] See e.g., Morse, *supra* note [91] (noting the reliance by PetSmart on repurchasing debt held by activists seeking to litigate its transfer of Chewy.com assets into a parent company and subsidiary).

[109] *See for example*, Jesse Fried & Charles Wang, *Short-Termism and Capital Flows*, 8 REV. CORP. FIN. STUD. 207 (2019) (noting that concerns about excessive reliance on share buybacks are overblown and that firm's use of share buybacks does not indicate short-termism and a lack of interest in investment and growth); Jesse Fried, *supra* note [71] (showing that lesser-regulated company purchases of shares enables indirect insider trading by insiders); Alberto Manconi et al., *Are Buybacks Good for Long-Term Shareholder Value? Evidence from Buybacks around the World*, European Corporate Governance Institute (ECGI) - Finance Working Paper No. 436/2014 (2014)(noting a positive effect of buybacks on short-term and long-term excess returns). Literature and commentary on this topic is extensive.

[110] Julio, *infra* note [106], 4 ("The literature on debt repurchases is surprisingly fairly small and young.")

situates debt buybacks within current theory on creditor power in capital allocation to outline the implications for policy and regulation.

A. Rationales for Buying Back Debt

Debt buybacks provide borrowers with a means to adjust their balance sheet by repurchasing outstanding debt claims (generally, bonds),[111] sometimes accompanied by amendments to their terms and conditions.[112] By way of comparison, share buybacks function as a channel to compensate shareholders. In addition to dividends, equity buybacks constitute a form of payout to shareholders.[113] Such buybacks leave shareholders, whose securities are not repurchased, with a proportionately larger claim to the remaining pie. As Jesse Fried and Charles Wang write, equity buybacks are usually viewed favorably by investors.[114] And activist campaigns by hedge funds routinely seek to pressure management to return value to shareholders by declaring dividends and using equity repurchases.[115] In all, Fried and Yang observe that between 2007-2016, S&P 500 firms distributed around $7 trillion to shareholders in the form of either dividends or buybacks.[116] Per finance theory, such buybacks help reduce managerial agency costs by limiting the amount of free cash left in the hands of incompetent or greedy managers. Such payouts are also necessary for capital markets to function. If shareholders cannot count on regular returns, whether these occur by way of buybacks or dividends, there is little reason for them to bother investing.[117]

---

[111] Loans can also be repurchased by a company in the open market. However this is less common and also does not implicate securities regulation because loans are not generally included as "securities" within the definition of Section 2(a)(1) of the Securities Act 1933. For discussion of loan buybacks and their intersection with securities markets, see, Smita Madhur, *infra* note [7].

[112] Brudney, *supra* note [13]. It should be noted that this paper does not examine callable bonds that expressly provide provisions for the debt to be "called" or pre-paid in advance of the maturity date. On a discussion of callable bonds, Qiping Xu, *Kicking the Maturity Down the Road: Early Refinancing and Maturity Management in the Corporate Bond Market*, REV. FIN. STUD. (*forthcoming*) (describing the tendency for issuers to be sensitive to macroeconomic shifts).

[113] William Maxwell & Clifford Stephens, *The Wealth Effects of Repurchases on Bondholders*, 58 J. FIN. 895, 897-898 (2003.

[114] Fried & Wang, *supra* note [109], 209-210; Gustavo Grullon & Roni Michaely, *The Information Content of Share Repurchase Programs*, 59 J. FIN. 651 (2004) (noting that news of share repurchases tends to point to a reducing in systematic risk and a lowering of cost of capital relative to firms that are non-repurchasing).

[115] Erin McCarthy, *Icahn Letter Pushes Apple to Buy Back More Shares*, WALL. ST. J., Oct. 9, 2014.

[116] Fried & Wang, *supra* note [109], 207. William Lazonick, *Profits Without Prosperity*, 92 HARV. BUS. REV. 46 (2014)(suggesting that share buybacks increase short-termism). Fried and Yang offer a rebuttal to this thesis by arguing that companies continue to invest and increase their cash holdings.

[117] For the classic account, see, Michael Jensen, *The Agency Costs of Free Cash Flow, Corporate Finance & Takeovers*, 76 AMER. ECON. REV. 323 (1986).

But the purpose of buying back debt has little to do with winning selling creditors' approval and returning value to them. Despite a shared nomenclature, in other words, debt buybacks serve a distinct economic purpose from equity repurchases. Whereas shareholders depend on stock buybacks as a source of returns on investment, debt repurchases seek to extinguish the bargain originally reached with a creditor. Debt repurchases can thus work to deprive creditors of the full, expected value of their investment and cut off or limit the cash flows and contractual rights.[118] Between 2004-2017, companies have repurchased approximately $1.89 trillion worth of debt in the open market and through tender offers.[119]

Broadly, debt buybacks are carried out to satisfy three major purposes for borrowers: (i) moving the company towards a more optimal balance between debt and equity; (ii) amending or eliminating covenants in the credit agreement; and (iii) informally restructuring bondholder claims during periods of financial distress.

1. Cleaning Up the Balance Sheet

A common rationale for a debt buyback lies in reducing the level of interest and principal payments, as well as the leverage, on company books. In other words, it can bring the company's capital structure closer to an optimal mix of debt and equity.[120]

It makes sense that companies would want to buy back their own debt for this purpose. For a start, lenders and borrowers might have misjudged the company's default risk at origination resulting in the debt-burden becoming overly high to be tenable. Alternatively, lenders may have locked a borrower into an expensive set of payment obligations relative to its riskiness or what is available in the market, causing it to divert unnecessarily large amounts of cash to service its debt.[121] For example, shifting macroeconomic conditions can mean that debt terms that are acceptable in one year become too burdensome in another. [122] This has

[118] This is especially the case for debt tender offers. In the case of open-market repurchases, bondholders can gain liquidity by being able to sell their debt back to an issuer. On the opportunistic aspects of debt repurchases, see Brudney, *supra* note [13] (critiquing the practice as debtor opportunism).

[119] *See discussion supra* note [11].

[120] Timothy Kruse et al., *the Decision to Repurchase Debt*, 26 J. APP. CORP. FIN. 8 (2013)(discussing reasons for buying back debt, including deleveraging); Julio, supra note [106] (showing that debt repurchase decisions are driven by the need to address distortions from optimal capital structure); Ng, *supra* note [106].

[121] Julio, *supra* note [106] (noting that debt buybacks offer a form of debt renegotiation). On covenants, discussed below, see also Kahan & Tuckman, *supra* note [ ] (highlighting that covenants may not always be optimal for the length of the loan).

[122] Sam Goldfarb & Avantika Chilkoti, *Regulators, Investors Zero In on Corporate Debt Market*, WALL ST. J., MAY 28, 2019.

become apparent in the years following the Crisis and the availability of cheap debt prompted by the Federal Reserve's lowering of interest rates.[123] In response, the corporate bond has grown in size by about $4 trillion dollars over the decade, from around $5.5 trillion to $9.2 trillion.[124] Buybacks took off and, in 2010, reached $88 billion in repurchased publicly issued debt.[125] Unsurprisingly, empirical study shows that issuers are sensitive to shifting macroeconomic climates when deciding to prepay or refinance their debt.[126] Debt repurchases thus allow borrowers to buy back expensive debt and take out cheaper credit in response to favorable economic conditions.

This rationale is especially powerful in the case of smaller, less creditworthy companies. Such businesses have little slack, riskier cash flows and a possible history of past defaults. Debt repurchases offer these borrowers an opportunity to use resources to strategically buyback and refinance their debt as a way to avoid expensive violations and the risk of bankruptcy. As discussed in Part I, companies experiencing losses risk rapidly putting the value of their equity in jeopardy. Struggling companies are closer to the precipice and likely to have a higher debt burden than they can effectively service.

Commentators note that debt repurchases are particularly popular with riskier companies, such as those with credit rating of BBB or below.[127] In his study, Brandon Julio observes that companies conducting buybacks in his sample were highly indebted, both in absolute terms as well as relative to competitors. These high levels of debt placed heavy constraints on investment choices, reducing firm capacity to respond to new opportunities and to regain profitability. In addition, repurchasing companies showed vulnerability to default. In the two months preceding the repurchase, bond credit ratings fell sharply following a period of decline in company finances. Further underscoring this point, Julio reports that surveyed companies saw an average drop of 55% in their cash flows over the three years preceding the buyback transaction.[128]

Anecdotally at least, a slew of investment grade (or thereabouts) Main Street companies have bought back their debt in recent years in a bid

[123] For explanation of the Federal Reserve's approach to lowering interest rates and the impact on the corporate bond market, see William Cohan, *The Big Dangerous Bubble in Corporate Debt*, N.Y. TIMES, AUG. 9, 2018. .

[124] SIFMA, Fixed Income Outstanding, https://www.sifma.org/resources/research/fixed-income-chart/.

[125] Julio, *supra* note [106].

[126] Xu, *supra* note [112].

[127] Kruse et al., *supra* note [120](In their study of 208 debt repurchase transactions by 189 companies, Kruse et al., observed that their subjects were more likely to have weak operating returns, less cash, more long-term debt trade at a discount and also more assets).

[128] Julio, *supra* note [106], 16-17.

to reinvigorate their balance sheets. Macy's and Kohl's, the retail giants, both repurchased their debt in an effort to improve their leverage ratio. Similarly, BBB- rated companies like Verizon and Viacom have also resorted to repurchasing their debt to reduce high debt servicing costs. By improving the look of their books, reducing leverage and repayment expenses, this strategy is tipped to help BBB-rated companies see improved performance relative to more creditworthy peers.[129]

It is debatable whether buybacks are an unquestioned positive. Recall that debt reduces agency costs. Lenders scrutinize managers and shareholders and prevent them from using company resources for wasteful self-enrichment. Repurchases by debtors, particularly those with a propensity towards riskiness, might hint at bad news for capital allocation in the long-term. Ultimately judgments on the rightness or otherwise of buybacks for debt reduction turn on determinations of what constitutes an optimal capital structure for a particular company.[130] The "correct" amount and composition of debt can provide a boost for firm value by offering cost-effective investment capital and sound monitoring. Broadly, studies show that equity value rises, albeit quite modestly, in the wake of a repurchase. In their study of 208 buybacks by 189 companies, Kruse et al., noted that the transactions studied yielded average cumulative equity returns of 1.47%. Repurchases funded by equity failed to generate any gains. Those that were financed using asset sales were more successful, increasing cumulative equity gains by 3.44%.

2. Re-calibrating Creditor Power

Debt buybacks provide a way for borrowers to recalibrate the intensity of creditor power. In repurchasing their own debt, borrowers can reduce or eliminate debt instruments whose covenants are problematic or likely to trigger activist agitation.[131]

That companies might look for a way to do away with tough covenants is understandable. As Marcel Kahan and Bruce Tuckman point out, a fixed set of covenants can be ill-adapted to the evolving riskiness of a long-term lending relationship. Restrictions on borrowing, capital expenditure or dividend declarations may be unduly stifling for a company

[129] Scaggs, *supra* note [106].

[130] *See for example*, Patrick Bolton and David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1(1996).

[131] Jamie Anderson-Parson, *Bond Indenture Consent Solicitations as a Debt Management Tool*, 3 INT'L J. FIN STUD. 230, 231-233 (2015).

whose riskiness has changed since origination.[132] Restrictions will be inefficient and likely to hamper companies from pursuing profitable investment opportunities. Viewed differently, an overly constraining set of covenants can work to transfer value from a company's shareholders to its creditors.[133] Where creditors enforce too-tight covenants, demanding fees or payments for waivers for example, their discipline becomes costly and not especially useful as a way to reduce riskiness.

Under the Trust Indenture Act, modifying terms relating to payment demands essentially unanimous consent from bondholders – rendering such amendments impossible practically.[134] But companies routinely buy back their debt to modify the intensity of non-payment related covenants and events of default to which they are subject. Here, changes can be achieved by securing the consent of the majority (or sometimes 3/4ths) of all bondholders.[135] In one study, covenant relaxation was cited as the reason for conducting almost 20% of the buybacks in the sample.[136] In 2008, for example, Rite Aid, the pharmacy giant, sought to buy back its bonds and to remove or modify "substantially all" of its restrictive covenants and some of its events of default.[137] In 2017, Verizon, the telecoms company, paid $1 billion to buy back bonds on behalf of itself and numerous subsidiaries while also removing various limiting covenants.[138] Albertsons handed over $330 million to repurchase bond debt from investors contesting its takeover of Safeway's, effectively blunting the power of activists looking to enforce indenture terms.[139]

As discussed earlier, issuers can also buyback restrictive debt to take advantage of a permissive lending environment. The availability of cheap credit – amply in evidence post-2008 – has helped issuers to bargain

[132] Marcel Kahan & Bruce Tuckman, *Do Bondholders Lose from Junk Bond Covenant Changes,* 66 J. BUS. LAW, 499 (1993), 499-503. See also, Sris Chatterjee et al., *Coercive Tender and Exchange Offers in Distressed High- Yield Debt Restructurings: An Empirical Analysis*, 38 J. FIN ECON. 333 (1995)(noting the benefits for lenders of covenant alterations to enable workouts). Steven Cohen et al., *Default Activism in the Debt Market*, Harvard Law School Forum on Corporate Governance and Financial Regulation, Dec. 4, 2018.

[133] Anderson-Parson, *supra* note [131].

[134] The Trust Indenture Act 1939 mandates that amendments to payment terms receive unanimous consent, effectively precluding any realistic chance of an informal bond workout. Section 319(b), 15 U.S.C. § 77bbb (1939).

[135] Kahan & Tuckman, *supra* note [132], 503-504.

[136] Kruse et al., *supra* note [120], 20.

[137] Rite Aid, *Rite Aid Announces Debt Tender Offer and Consent Solicitation*, Jun. 4, 2008, https://www.riteaid.com/corporate/news/-/pressreleases/news-room/2008/rite-aid-announces-debt-tender-offer-and-consent-solicitation.

[138] Verizon, *Verizon Announces Tender Offers/Consent Solicitations for 31 Series of Verizon And Certain of its Subsidiaries' Notes*, Nov. 15, 2017, https://www.prnewswire.com/news-releases/verizon-announces-tender-offers--consent-solicitations-for-31-series-of-verizon-and-certain-of-its-subsidiaries-notes-300557404.html.

[139] Doherty, *supra* note [5].

for lighter loan and indenture terms.[140] With issuers able to raise capital inexpensively – and investors competing to offer credit as a result – market conditions can encourage latitude in how strictly covenants are drafted. In such circumstances, it makes little sense for issuers to be hamstrung by debt carrying restrictive covenants. Instead, they can use debt repurchases as a way to relieve their compliance burden, prior to refinancing on more relaxed terms. This approach has many advantages. A borrower should face fewer costs from covenant violations (e.g. a ratings downgrade).[141] Activist debtholders also end up with a more limited arsenal of levers with which to agitate against a company. According to one view, more relaxed debt terms mean fewer defaults precisely because management has greater leeway to act and is not impacted by aggressive investors. According to supporting research by Standard and Poor's, "cov-lite" loans rated BB- showed a default rate of zero, compared with 6.7% for similarly-rated debt that contained the usual set of covenants.[142] With fewer covenant violations and defaults, the issuer can delay/minimize negotiations with its lenders where routine defaults do not occur as regularly as they would otherwise. In other words, on account of more limited covenants, shareholders and managers can maintain greater control and transfer value from lenders to themselves.

The steady weakening of covenant strength post-Crisis provides compelling incentives for issuers to consider repurchases. According to Moody's Investors Service, the covenant strength for high-yield bonds fell to a record low in July 2015. In their measure for covenant quality, where a grade of "1" signals highest protection and "5" the lowest, average covenant quality for such bonds stood at 4.6.[143] In mid-2018, its quality score for the North American bond market as a whole stood at 4.41, with the "best" scoring bond issues achieving grades of just 3.65-3.99 (considered to be weak by Moody's standards).[144] Commentators have

[140] The term "cov-lite" is usually applied to bank loans. However, there has been a deterioration in covenant quality for bonds as well as loans. In addition to the credit crisis, the debt market has undergone structural changes, that has resulted in difficulties for investors, even those within the loan market, to enforce covenants. For discussion on the increasing "bond-like quality" of the leveraged loan market, see generally, Maura O'Sullivan & Benjamin Cheng, *Term Loans and High-Yield Bonds: Tracking the Convergence*, PRACTICAL LAW, July-August 2012; Alexandra Scaggs, *Hope Floats*, FIN. TIMES, MAY. 16, 2018.

[141] Michael N. Reczek, *An Examination of the Value of Covenant Lite Debt to Issuing Companies*, Working Paper (2010), http://web-docs.stern.nyu.edu/glucksman/docs/Reczek2010.pdf.

[142] Stephen Foley, *Cov-Lite Loans Lose Their Stigma in Search for Yield*, FIN TIMES, MAY 31, 2013. On the Standard and Poor's study, see discussion in, Kadhim Shubber, *Concern Over Waning Use of Covenants in Debt Markets*, FIN TIMES, AUG 27, 2013. According to this study, the sample of cov-lite loans rated B- had a default rate of 13%, 5.4% lower than comparable debt with normal covenants. This view, that cov-lite loans are less likely to default, is not shared universally. The fact of limited default, they suggest, is a matter of contractual luck, rather than a sign of a sounder credit profile.

[143] Shubber, *supra* note [142].

[144] Moody's Investors Service, *Bond Covenant Protections Weaken as Private Equity Scores hit Record-Worst*, Jun. 12, 2018, https://www.moodys.com/research/Moodys-Bond-covenant-protections-weaken-as-private-equity-scores-hit--PR_385129; On rock bottom scores for loan covenants, see, Moody's Investors

observed that indentures are being drafted to be more permissive in their financial covenants – increasing, for example, the amount of debt a company can incur relative to its earnings. In addition, generous carve-outs, opaque drafting and contractual "loopholes" all give issuers plenty of wiggle-room where they would likely not have enjoyed it beforehand.[145]

The utility of debt repurchases as a means of recovering managerial control for borrowers raises questions. Flexibility in shrugging off covenants – while beneficial where these have been outgrown – can be costly in cases where borrowers are overly opportunistic and tactical in pursuing well-timed buybacks. Fewer covenants, lower monitoring, limited activist attention and delayed negotiations might encourage managerial risk-taking and shareholder greed. Where managers take on leverage in excess of what is optimal – without the protection of covenants to keep agency costs in check – lenders bear the risk of fallout.[146]

3. Resolving Financial Distress

For completeness, it is worth briefly noting that debt repurchases, specifically debt exchanges, play an important role in helping distressed companies in their effort to restructure their business, especially outside of the court-controlled Chapter 11 process.[147] Companies that have taken on bond debt can find themselves in a tough position when it comes to dealing with an inability to pay off their liabilities. To avoid a potentially drawn-out Chapter 11, privately-negotiated debt "workouts" can offer a preferred first option for debtors.[148] A dispersed set of bondholders in a complex capital structure create long odds for a workout to succeed. Where the debtor must re-work its payment schedule, secure write-offs, lower the interest rate on the debt or offer a debt-for-equity swap, dealing with an enormous multitude of bond creditors imposes transaction costs and gives holdouts enormous power. As Adam Levitin and Bill Bratton observe,

---

Service, *Weak Covenant Protections Persist as Demand for Leveraged Loans Soars*, Jan. 24, 2019, https://www.moodys.com/research/Moodys-North-American-loan-covenant-quality-hits-new-record-worst--PR_394213.

[145] Scaggs, *Hope Floats*, *supra* note [140]; Alexandra Scaggs, *Some of the Worst Loan Covenants that We've Ever Seen*, FIN TIMES, MAY 22, 2018. However, as the articles note, investors are pushing back, particularly in egregious cases.

[146] On bondholder activism, see, Kahan & Rock, *supra* note [84]; Gao et al., *supra* note [61]. On valuation questions in the context of covenants in junk-bonds, see, Kahan & Tuckman, *supra* note [132].

[147] Chapter 11 of the United States Bankruptcy Code §11 U.S.C.

[148] On the tradeoffs underlying workouts versus formal proceedings, Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J. L. ECON. 595 (1993).

bond workouts have long been rife with dysfunction, opportunism and game-playing, impeding successful outcomes.[149]

Debt buybacks provide a mechanism to facilitate an out-of-court restructuring by allowing selected bond issues to be repurchased, removing them from the borrower's capital structure and easing the negotiating process. Much more often in such contexts, rather than an outright repurchase, existing bonds can be exchanged as part of an offer to swap the old debt for new credit but on revised terms. Because the Trust Indenture Act requires unanimous consent to amend a bond, workouts require the original bonds to be exchanged for new ones that reflect an amended bargain on repayment.[150]

Exchanging old bonds for new ones provides debtors with a route out of situations that would most likely end up in Chapter 11 otherwise.[151] Successful exchange offers can offer real economic gains. According to Edward Altman and Brenda Karlin, exchanges have yielded stronger recoveries for bondholders when compared with a formal restructuring. Looking at exchange offers occurring between 1984-2009, Altman and Karlin show that exchanges produced an average recovery of 50.9 cents compared to just 37.5 cents for other kinds of default.[152] They also tend to be much cheaper than formal bankruptcies.[153]

Nevertheless, exchange offers are also beset by failure and riven by conflict, opportunism and rent-seeking, encouraging collapse.[154] Creditors hold out. Dissenting creditors can see the value of their bonds increase by being uncooperative.[155] Issuers, too, will often behave destructively, seeking to strong-arm creditors into accepting deals.[156] This dynamic can blunt the appeal and workability of exchange offers even if they offer the most likely avenue for a bond workout.

---

[149] Brudney, *supra* note[13], 1834-1938; William Bratton & Adam Levitin, *The New Bond Workouts*, 166 PA. L. REV. 1597, 1597-1598 (2018).

[150] Trust Indenture Act 1939, Section 319(b), 15 U.S.C. § 77bbb (1939). In response, industry has developed exchange offers as a means to progress out-of-court bond workouts. Bratton & Levitin, *supra* note [149], 1600-1602, 1631-1632 (describing the history and real-life effects of the TIA). For seminal treatment on Section 316(b) of the TIA, making a case for removing the section, Mark Roe, *The Voting Prohibition in Bond Workouts,* 97 YALE. L. J. 232, 234-245 (1987) (arguing that Section 316(b) promoted wasteful negotiation and minimized the chances for successful exchange-offer based workouts). See also, Brudney, *supra* note [13], 1875-1880..

[151] Bratton & Levitin, *supra* note [149], 1600-1601.

[152] Edward Altman & Brenda Karlin, *The Re-Emergence of Corporate Exchanges in Corporate Restructurings*, 5 J. CREDIT RISK 43, 50. TBL.2 (2009).

[153] *See discussion*, Bratton & Levitin, *supra* note [149], 1629-1630.

[154] Scholars have developed a thoughtful literature into the issues surrounded Section 316(b). See, for example, Roe, *supra* note [150]; Brudney, *supra* note [13], Bratton & Levitin, *supra* note [149].

[155] This can happen because uncooperative creditors retain the "old" bond with the original terms (e.g. a high interest rate), whereas those that agree to an exchange receive a bond that carries a lower rate. After the exchange is completed, holdouts profit instead of those that worked with the debtor as the value of their bond increases. Bratton & Levitin, 1606-1611.

[156] Bratton & Levitin, *supra* note [149], 1606-1611.

A full discussion of bond workouts and debt exchanges is outside the scope of this Article. Still they sit along the spectrum of strategies enabled by the basic theory and economics of a debt repurchase.[157] That this technique can facilitate progress in situations of financial distress is reflected in the positive note sounded by Bill Bratton and Adam Levitin in their study of post-Crisis exchange-based bond workouts. While underscoring the inherent difficulty, this last decade has seen workouts become more successful. The authors show that around 20% of all restructurings have moved from bankruptcy courts to workouts facilitated by bond exchange offers.[158] With institutional investors warming to exchanges and working efficiently to enable them, repurchases and exchanges are further showing their usefulness in the marketplace.

B. Mechanisms and Regulation

Debt buybacks can proceed using varying degrees of formality. If companies wish to discard problem covenants, debt buybacks can be combined with a process motivating creditors to consent to their rights being modified. A full discussion of the nuances underlying these processes is outside the scope of this Article. Scholars have opined on key aspects, as discussed below.[159] In focusing on the core design of the buyback mechanism and consent solicitation, however, this section highlights the much lighter regulatory oversight involved for debt buybacks when compared to similar transactions in equity markets.

1. Open Market Repurchases v. Tender Offers

Open Market Repurchases: The most straight-forward way to conduct is a buyback is for the company to simply go out and repurchase

[157] Debt Repurchases & Exchanges, Morrison Foerster Guide (Nov. 8, 2012).

[158] Bratton & Levitin, *supra* note [149], 1601.

[159] See e.g., Andrew L. Bab, Note, *Debt Tender Offer Techniques and the Problem of Coercion*, 91 COLUM. L. REV. 846 (1991); *Brudney*, supra note [13]; John Coffee & William Klein, *Bondholder Coercion: the Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207(1991)(noting that issuers conducting bond repurchases and exchanges can put bondholders in a coercive "prisoner's dilemma"); Schwartz, *supra* note [148](highlighting the capacity of bondholders to coordinate and avoid oppressive behavior by creditors); Ford Lacy & David M. Dolan, *Legal Aspects of Public Debt Restructurings: Exchange Offers, Consent Solicitations and Tender Offers*, 4 DEPAUL BUS. L. J. 49 (1991) (noting distortions in the bargaining process for debt tender offers); Kahan & Tuckman, *supra* note [132]; Lewis Peterson, *Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers*, Note, 103 YALE L. J. 505(1993) (arguing that debtor coercion can push for "good" choices).

its own debt on the open market or through a private negotiation with select bondholders.[160] Just like another investor, the company contacts a broker and seeks out to buy back its own debt at the prevailing market price. The advantage of this approach lies in its simplicity, speed and stealth. The company does not need to disclose its intention to purchase its debt in these circumstances.[161] This secrecy means that the company can keep news of the buyback to itself.[162] It can also prevent other investors from jumping into the market to opportunistically buy this debt with a view to reselling it back to the company at a higher price.[163]

The logical time for a company to undertake a transaction like this is when its debt is trading at a discount to its real value.[164] In the aftermath of the 2008 Crisis, for example, a number of companies sought to buy their own debt in this way when it was trading for pennies on the dollar. In 2009, chemical producer, Hexion spent $26 million to repurchase bonds with a face value of $196 million, paying the bargain sum of 13 cents on the dollar. Rather than owe a liability of $196 million, the company spent $26 million to retire it, thus booking a gain of $170 million.[165]

Helpfully the regulatory constraints attaching to such an informal repurchase are minimal. Whereas equity open market buybacks are preceded by an announcement as well as post-acquisition disclosure, open market debt buybacks are only disclosed indirectly as part of the company's annual report and periodic regulatory filings. Pre-sale disclosure is not required.[166]

---

[160] Hagit Levy & Ron Shalev, *Bond Repurchase Objectives and the Repurchase Method Choice*, Working Paper (2011)(noting the "stealthy" nature of open market repurchases).

[161] In theory, the company would be mindful of ensuring that it does not trade in possession of material non-public information, triggering scrutiny under the prohibition against insider trading, promulgated under Rule 10b-5 of the Exchange Act 1934. But see discussion, *infra* Part [III(A)], regarding the applicability to bond purchases. Eric Sibbitt & Adam Ajlouni, *Opportunities for Strategic Debt Disclosures*, O'Melveny & Myers Alerts & Publications, Feb. 15, 2017, https://www.omm.com/resources/alerts-and-publications/alerts/opportunities-for-strategic-debt-repurchases2/; On insider trading and stock repurchases, see generally, Fried, *Insider Trading via The Corporation, supra* note [71].

[162] The company can successfully undertake a privately negotiated or open market purchase if it does not trigger a "creeping tender," a tender offer in substance. Guidance on what constitutes a possible tender offer is set out in Wellman v. Dickinson, 475 F. Supp. 783, 823-824 (S.D.N.Y. 1979). This balancing test looks for a tender offer where some of the following factors are present: (i) the offer is disseminated in a public manner; (ii) the offer provides a premium to the market price; (iii) the company offers no opportunity to negotiate; (iv) the offer extends to a substantial portion of the issue; (v) the offer is time-limited; (vi) there is pressure on offer recipients to respond to the offer; (vii) the company rapidly acquires bonds after the announcement. See also, SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945, 950 (9th Cir. 1985).

[163] Ng, *supra* note [106]. Arguably, financial strain post-Crisis probably meant that bondholders were looking for high premia to compensate them for the risk, overly depressing bond prices.

[164] Ng, *supra* note [106].

[165] Ng, *supra* note [106].

[166] Equity repurchases are generally preceded and followed by an announcement of the proposed buyback under exchange rules as well as under the safe-harbor Rule 10b-18 and Rule 10b-5. In addition, Item 703 of Regulation S-K and Forms 10Q, 10-K and 20-F stipulate disclosure of equity repurchases. Item 703 of Regulation S-K, 17 C.F.R. §229.703(2013); Securities and Exchange Commission 17 CFR Parts 228, 229, 240, 249, 270, and 274, Purchases of Certain Equity Securities by the Issuer and

The major purpose of the open-market buyback lies in helping borrowers pay down a small portion of their debt cheaply. This strategy can slightly clean up the company's balance sheet. But it cannot retire a major portion of an outstanding bond issue. Crucially it does not strip away difficult covenants that may be limiting a company's ability to maneuver. While easy and convenient, its utility is generally limited.

Tender offers: a more public and comprehensive approach looks to the company making a tender offer to repurchase certain bonds.[167] If successful, the tender can result in substantially reducing the amount of debt attaching to a particular bond issue.

Just as before, the company is seeking to take advantage of its bonds trading at a discount.[168] Unlike the open market repurchase, however, the company has to persuade a swath of bondholders to tender their bonds by offering them a premium on the prevailing market price. That means that the issuer needs to convince a set of dispersed bondholders to accept its offer by paying a sufficiently high amount of money to compensate them for their loss of future cash flow and contractual power. To do this, it needs to work out how much it will gain in the longer-term through the tender, relative to the expenses it incurs through paying the premium as well as various legal and advisory costs.

In turn bondholders need to bet on whether accepting the offer – and premium – serves them better than waiting out for repayment. More to the point, they wager on whether fellow bondholders will be tempted to agree. If a sufficient number of investors sign-on, then those that fail to accept will lose the premium and may be left holding onto bonds that are not especially easy to trade and may no longer enjoy the same contractual rights they did previously (on which, more below). In their empirical study, Steven Mann and Eric Powers find that, for the average tender offer, the tender price is 4.75% greater than the market price and the percentage of bonds tendered is 82.3%.[169] Unsurprisingly the more the borrower is willing to pay by way of tender premium, the greater the number of bonds tendered. According to Mann and Powers, a 1% increase in the tender premium resulted in a 10% rise in the number of bonds tendered.[170]

Others. For debt repurchases, such specific obligatory requirements are missing, though issuers will most likely provide disclosure under Regulation Fair Disclosure (to avoid giving non-public information to select investors) as well as under regulatory filings like the Form 8-K, 10-K and annual report. For further discussion on the regulatory reporting obligations for equity buybacks, Fried, *supra* note [71], 814-815.

[167] Sibbit & Ajlouni, *supra* note [161]; Coffee & Klein, *supra* note [159], 1208-1209.

[168] Kruse, *supra* note [120] (noting that debt usually trades at a discount prior to a debt tender).

[169] *See generally*, Brudney, *supra* note [13]; Coffee & Klein, *supra* note [159]; Peterson, *supra* note [159]. On the determinants of the tender premium, see, Steven Mann & Eric Powers, *Determinants of Bond Tender Premiums and the Percentage Tendered*, Working Paper (2005).

[170] Mann & Powers, *supra* note [169].

The choice between whether to do a tender offer or an open market repurchase buyback can depend on a firm's specific objectives (e.g. whether or not to remove covenants) as well as prevailing market conditions. In their study, Hagit Levy and Ron Shalev report that tender offers tend to be more common during normal economic conditions – with around one open market purchase for four tender offers. During more turbulent conditions, however, when investors may be more likely to demand a higher premium for surrendering their bond, the ratios are exactly reversed. Open market repurchases become more popular, with four such buybacks for every tender.[171] Often borrowers can deploy both open market and tenders to soak up as much of their own debt as possible. For example, Kohl's undertook a series of debt buybacks in 2018-2019 to reduce its leverage. Beginning with a tender offer for $500 million in mid-2018, it followed up with a $28 million open market repurchase.[172] A mixed strategy can allow the debtor to use open market repurchases to buy back scraps of debt that did not get tendered by recalcitrant investors.[173]

Tender offers are undertaken through a formal process that is governed by a specific regulatory framework for buying back a large segment of outstanding securities from investors.[174] Under Regulation 14(E), issuers must give notice of the offer and ensure that investors have (generally) 20 business days to consider and accept it.[175] The rules that apply to debt tender offers are more permissive than those that those affecting equity buybacks done through a tender offer. While both equity and debt tenders are subject to the usual antifraud and anti-manipulation protections, equity tender offers must include form disclosure, a post-tender regulatory filing with the SEC, dissemination and limited freedom

[171] Hagit Levy & Ron Shalev, *The Decision between Tender Offers and Open Market Bond Repurchases: Do Bond Issuers Time the Market?*, https://en-coller.tau.ac.il/sites/nihul_en.tau.ac.il/files/media_server/Recanati/management/seminars/account/hagit.pdf.

[172] Adam Levine-Weinberg, *Kohl's Debt is Disappearing Quickly*, *The Motley Fool*, Jan. 3, 2019, https://www.fool.com/investing/2019/01/03/kohls-debt-is-disappearing-quickly.aspx.

[173] Coffee & Klein, *supra* note [159].

[174] 15 U.S.C. § 240.14d-1(a) (2008) (subjecting debt tenders to Regulation 14E). The main regulation applicable to all tender offers, including debt tenders is Section 14(e) of the Exchange Act 1934 and SEC Regulation 14(E). It requires, among other things, to keep an offer open for 20 business days (Rule 14(e)-1(a). In addition issuers are subject to antifraud rules under Rule 10b-5 and anti-manipulation provisions of Rule 102 of SEC Regulation M. Equity buybacks require compliance with Regulation 14E as well as Rule 13(e)-4 and other regulations such as Rule 10b-5. Regulation limits the ability of equity issuers to "sweeten" the offer, but debt issuers are free do to so. It should be noted that exchange offers for cash consideration and offers for debt convertible to equity are subject to the more stringent set of rules that apply for equity buybacks. For fuller details, Tender Offer Considerations for Cash Repurchases and Exchange Offers, Jul.1, 2009, https://media2.mofo.com/documents/090701tenderoffers.pdf; David Baxter et al., *Restructuring Debt Securities*, Pillsbury Winthrop Shaw Pittman LLP (Sept. 2017). Kahan & Tuckman, *supra* note [132], 502-503 (on the mechanics of tenders and consent solicitations).

[175] 15 U.S.C. § 240.14e-1(a) (2008).

to amend offers.[176] By contrast, debt tender offers do not stipulate any specific form disclosure, allow room to amend an offer and do not require a post-tender public filing with the SEC (on which more below).[177]

2. Relaxing Creditor Oversight

Tender offers are routinely combined with efforts by issuers to either scrap or amend covenants and events of default. When a company makes an offer to buy back its debt, it can also ask its bondholders to append their consent to changes in certain constraining terms attaching to the debt.[178] These "consent solicitations" can only target terms of the indenture that do not relate to payment. More than 60% of tender offers include a consent solicitation.[179] The Trust Indenture Act forces unanimous consent to be provided when it comes to changing "sacred" aspects as the bond as its interest rate or maturity. On the other hand, a tender looking to amend a bond's less sacred parts – restrictions on dividends or asset sales, for example – can be altered by obtaining consent from the majority or 2/3rds holders of the face value of the bond.[180]

It might appear strange that an issuer would seek to amend the terms of a bond it wishes to buy back. Why make the effort when the borrower wishes to take back the bond and retire it? But consent solicitations are essential to the process of securing widespread bondholder approval to the tender and covenant changes. If a majority of the bondholders can be persuaded to tender their bonds and consent to amendments – the bonds that are left untendered end up carrying much weaker terms. While the payment terms will remain, protective covenants as well as definitions of default will lose their bite.

In this way, issuers can assert considerable persuasive power over their bondholders to accept the terms of the tender and consent solicitation.[181] Cooperative creditors receive tender premium – sometimes higher if they tender earlier than the deadline. Those that do not tender their bonds miss out. Tendering creditors can avoid future negotiation

[176] For a detailed description and discussion of the tender-offer process, Charles Haag & Zachary Keller, *Honored in the Breach: Issues in the Regulation of Tender Offers for Debt Securities*, 9 NYU J. L. BUS. 199(2012); 17 CFR § 240.14d-100 - Schedule TO.

[177] 17 CFR § 240.14e-1.

[178] Baxter et al., *supra* note [174], 32-33.

[179] Kruse et al., *supra* note [120], 10.

[180] Baxter et al., *supra* note [174], 32-33; Kahan & Tuckman, *supra* note [132], 502.

[181] Case law holds that the contractual tender process is subject to the duty of good faith. However, by itself, seeking a consent solicitation and an exit consent by bondholders agreeing to the tender and consenting to any covenant changes, Katz v. Oak Industries Inc., 508 A.2d 873 (Del. Ch. 1986).

costs, distress and bankruptcy. Those that fail to do so get stuck in lengthy court processes if the debtor cannot make good on bond payments.[182] Importantly the bonds left behind become undesirable. They may have trouble finding an easy market for trading – and their contractual terms are stripped of power.[183] Perhaps understandably, most consent solicitations are successful given these pressures.[184]

Scholars have led a lively debate into whether the consent solicitation process is unduly coercive on bondholders. Kahan and Tuckman, for example, show that the consent solicitation process can be problematic for bondholders particularly if they are unable to coordinate.[185] But they also show that bondholders experience positive abnormal returns around the time of solicitation, suggesting that perhaps issuers do appear to take investor interests into account.[186] Others, however, are less sanguine. Chatterjee et al. observe coercion and that bondholders give up considerable value to shareholders. Still they underscore gains for bondholders in avoiding bankruptcies and workouts, offsetting losses suffered through coercion.[187] In a recent study of 50 companies pursuing consent solicitations, Anderson-Parson et al., find that shareholders experience strong returns around the announcement. Bondholders, however, take just a "token" payment for agreeing to the deal.[188] In short, the jury is out on conclusive answers on the question of coercion. Past work has examined small data sets of around 60 companies or fewer Moreover they do not take into account the impact on bondholders in an age of greater activism by hedge funds in bond markets.

3. Information Production

While information transfer is essential to extending credit, debtors are much less revelatory in the context of debt repurchases. Bondholders and bankers receive a detailed bundle of data when supplying credit. By

[182] Chatterjee et al., *supra* note [132] (noting the value to creditors of avoiding workouts and insolvency proceedings).

[183] Kahan & Tuckman, *supra* note [132], 502-504; Royce de R. Barondes, *An Economic Analysis of the Potential for Coercion in Consent Solicitations for Bonds*, 63 FORDHAM L. REV. 749 (1993), 767-768.

[184] Kahan & Tuckman, *supra* note [132], 502-504.

[185] Kahan & Tuckman, *supra* note [132] ("…with a game-theoretic analysis of consent solicitations and concludes that there exists a trembling hand perfect (THP) Nash equilibrium in which bondholders who cannot coordinate their actions will consent to covenant changes even when it is not in their collective interest to do so.").

[186] Kahan & Tuckman, *supra* note [132], 502-504.

[187] Chatterjee et al., *supra* note [132]; Barondes et al., *supra* note [183]; Anderson-Parson, *supra* note [131].

[188] *See generally*, Anderson-Parson, *supra* note [131].

contrast, the rules governing debt buybacks require much less formalized disclosure. To determine whether the tender premium represents a good deal, dispersed investors face information deficits that they need time and money to mitigate. As Kahan and Tuckman write, bondholders commonly negotiate with issuers, pushing for changes to a debtor's tender offer and consent solicitation.[189] But get to this stage, they first need to understand the debtor's proposal, its rationales and the appropriateness of the tender premium. This necessitates expenditure on information, analysis, advice and outreach to other bondholders. In situations where the debtor's changes are considered small, bondholders do not rate their chances of convincing others, or if efforts will be too expensive and the returns too uncertain, they may not wish to take the trouble of coordinating and overcoming coercion.[190]

Debt repurchases are subject to SEC Regulation 14E. It asks the borrower to supply a basic notice of the tender, its key terms and deadlines for submitting to the deal. Unlike equity buybacks undertaken through a tender that must be accompanied by a more substantial and formal filing, debt repurchases can be undertaken with limited fanfare that requires no form disclosure during a tender and no post-tender filing with the SEC.[191]

To be sure, the debtor is subject to the anti-fraud protections of Rule 10b-5 and Regulation 14(E). The tender offer cannot contain untruths, omissions and distortions of fact that render it false and misleading.[192] Commentators suggest that the chance of creating a fraudulent notice can prompt companies to disclose more fully.[193] But enforcing violations can be costly and small falsehoods may fail to attract attention where the cost of enforcement exceeds the damage to investors and the marketplace. Further, limited post-tender disclosure and filing limit detection and enforcement of fraudulent tenders, incentivizing secrecy.

Finally, it is worth highlighting the limited practical reach of the prohibition against insider trading to debt repurchases.[194] For bonds that are securities – in contrast to bank loan interests that are (arguably) not[195] –

[189] Kahan & Tuckman, *supra* note [132], 502-504.

[190] *See for example*, Barondes, *supra* note [183], 749-750 (noting the costs of negotiation entailed in avoiding coercion).

[191] *See sources cited supra* note [174].

[192] Rule 10b-5.

[193] Haag & Keller, *supra* note [176], 222-233.

[194] A full discussion on this issue is outside the scope of this Article, which merits separate examination as a question in its own right.

[195] Banco Espanol de Credito v. Security Pacific National Bank, 973 F.2d 51, 55–57 (2d Cir. 1992)(on loan interests not falling within the definition of a security under the Securities Act 1933). There has been debate regarding the line between loans and notes, particularly in the context of syndicated loans. See, for example, J. Thomas Cookson, *Loan Participation Agreements as Securities: Judicial Interpretations of the Securities Act of 1933 and the Securities Exchange Act of 1934*, Note, 24 WM. & MARY L. REV. 295 (1983) (discussing whether loan participation interests are securities).

the prohibition against insider trading should prevent those in possession of material non-public information from trading without disclosure. This means that the company should be wary of undertaking a bond repurchase when it is in possession of material, secret knowledge that might impact the future price of securities. This might include information about prospective value-enhancing projects, better cash flows or a takeover that could increase the price of the bond and make it more expensive to buy back.[196] The law's classical account prohibits insiders (in this case, the issuer)[197] from trading unless they first disclose this information to those to whom they owe a fiduciary duty.[198]

But as Jesse Fried argues in the case of equity repurchases by a company, the prohibition against insider trading is only weakly protective in this context. For one, companies can always trade on confidential information whose significance falls below the threshold of materiality.[199] Secondly, Fried notes, in the context of equities, delayed disclosure of repurchase transactions limits the extent to which violations can be detected.[200] For bonds repurchases, this difficulty is magnified further given the limited disclosure and procedural requirements of the bond tender offer - and no prior disclosure at all where repurchases are undertaken in the open market. Information on why a borrower conducted a debt repurchase and its anticipated economic effects usually only emerge later through its periodic disclosures and annual report, leaving regulators with the burden of piecing together a complex causal account about what happened, how and why.[201] Crucially, companies do not owe fiduciary duties to their bondholders. Unlike the protective obligations owed by managers (and arguably the company) to its shareholders, no equivalent extends to banks or bondholders.[202] Creditor-borrower relationships are judged to be founded on contract and do not rise to fiduciary status.[203]

---

[196] Navigating Debt Repurchases, Latham & Watkins Client Alert, 4-5 (March 31, 2008).

[197] The literature and the SEC note that the issuer itself (rather than just the insider managers) can be liable for trading unlawfully on material insider information. Mark J. Loewenstein & William K.S. Wang, *The Corporation as Insider Trader*, 30 DEL. J. CORP. L. 45, 47-58; 70-80(2005).

[198] Dirks v. SEC, 463 U.S. 646, 654, 659, 662 (1983); Chiarella v. United States, 445 U.S. 222, 226–29 (1980).

[199] Fried, *supra* note [71], 823-824.

[200] Fried, *supra* note [71], 814-817.

[201] It is worth noting that Rule 14e-3 prohibits insider trading by persons in possession of information related to a tender offer obtained from, *inter alia*, the issuer of the securities that are subject to the tender. § 240.14e-3

[202] Some have argued for the creation of a protective fiduciary duty towards creditors and bondholders. See for example discussion in, William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, DUKE L. J. 92, 150-152 (1989)(noting that advocates do not see covenants as sufficiently protective); *Bab*, supra note [159], 855-867; Brudney, *supra* note [13], 1835-45.

[203] Fraud or insolvency can give rise to a fiduciary duty, that creditors acquire fiduciary protections. For an important early decisions, see for example, Parkinson v. West End St. Ry., 173 Mass. 446, 53 N.E. 891 (1899) (Holmes, J.) (noting the contractual nature of convertible bonds), Harff.v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974), re'd, 347 A.2d 133 Del. 1975) (holding that convertible

In summary, debt buybacks accomplish critical goals: lowering leverage; re-calibrating the intensity of creditor control; and managing financial distress. Despite their significance for capital markets, however, the workings of debt repurchases have received limited attention in scholarship and policy. Through a buyback, issuers can quickly and quietly re-shape their relationship with a swath of creditors with minimal disclosure and procedural safeguards. Scholars remain conflicted on the question of whether bondholders face undue pressure, resulting in systematic harm. This limited clarity on the impact of debt buybacks – and their ability to fundamentally rewire a debtor's capital structure – raise a number of implications for scholarship and policy.

IV. DEBT BUYBACKS AND CREDITOR DISEMPOWERMENT

Debt buybacks serve an array of functions for borrowers and represent a mainstay of capital markets. Yet their workings reveal dynamics whose fuller implications for information asymmetries, creditor governance and regulation in securities markets remain underexplored. This Part takes a first step in providing an account of some of these implications, situating debt buybacks within the context of scholarly debates on how lenders deploy power and information to control risk.

It connects the mechanisms of debt buybacks to the common conditions that support the extension of credit (e.g. information transfer and creditor governance). In doing so, this Part makes the claim that debt buybacks offer a low-cost way for issuers to extract value from creditors (bondholders especially) by reducing their power and access to information. Creditors do, of course, also gain in many ways. For example, as scholars suggest, those selling their debt to the company can avoid the time and expense of a workout.[204] But current scholarship undervalues the significance of lost creditor power and continued access to bargained-for information through the debt buyback process. It also fails to recognize ancillary gains for an issuer. Though buybacks may be coercive to bondholders, they can boost the prospect for more powerful creditors – like

bondholders did not enjoy fiduciary protection); Katz v. Oak Indus., 508 A.2d 873 (Del. Ch. 1986); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989). However, the Delaware Supreme Court, in its famous *Gheewala decision*, radically restricted fiduciary protections owed to creditors on the eve of bankruptcy owing to the perceived sophisticated nature of bond investors. N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007). For discussion, Elias & Stark, *supra* note [75]. On debt repurchases and insider trading, Hagit Levy & Ron Shalev, *Bond Repurchase Objectives and the Repurchase Method Choice*, Working Paper (2011), 26.

[204] *See e.g.*, Chatterjee et al., *supra* note [132].

banks – to get repaid. In this way, the buyback can provide a negotiating tool for borrowers seeking to curry favor with more influential lenders and avoid trickier covenant violations that result from breaching loan terms. Finally, this Part highlights the regulatory "subsidy" offered to debtors conducting debt buybacks. In contrast to equity, limited disclosure, filing, and procedural protections require bondholders to internalize the cost of investigation and coordination. These costs are especially salient in the absence of fiduciary duties that limit the flow of information and bolster information asymmetries between bondholders and the issuer.

A. Information Asymmetries

While information transfers are critical to the business of bank and bond lending, institutionalized information asymmetries in the context of debt buybacks create systematic and unaddressed costs for bondholders.[205]

A lack of disclosure constitutes a pervasive feature of debt repurchases. As noted above, open market buybacks require no affirmative revelation of a debtor's decision to repurchase. Indeed, they are intended to camouflage its efforts to repurchase debt, enabling transactions to occur without the debtor showing its hand and increasing the market price.[206] The more formal tender and consent solicitation process also fails to inform substantively. For debt – in contrast to a fuller equity tender buyback process – a brief notice of the tender and its key terms suffices.[207] Rule 10b-5 and Regulation 14-E seek to prevent bondholders from being defrauded and manipulated. Short of omissions that might render a notice misleading, regulation mandates only a light set of information transfers from debtor to lender prior to a formal debt repurchase.[208]

This limited transparency makes it harder and costlier for bondholders to price the claim. In case of tender offers, this represents the premium they are willing to accept in return for giving up the debt and attached covenants. The need to calibrate the premium – and decide on whether to accept the offer – requires bondholders to analyze a complex set of trade-offs.[209] Most importantly, does the tender offer (market price +

[205] Brudney, for example, questions the sufficiency of disclosure for bondholders in debt repurchases. Brudney, *supra* note, 1836 [13]("However, the adequacy of the information required to be disclosed and of the choice thus offered is problematic."). See also, Coffee & Klein, *supra* note [159].

[206] Ng, *supra* note [106].

[207] SEC Rules 14-e1(a)-(4). But see, Fried, *supra* note [71](arguing that buybacks by companies are still subject to delayed post-transaction disclosure limiting detection of insider trading).

[208] But see, Haag & Keller, *supra* note [176], 222-233.

[209] Mann & Powers, *supra* note [169] (on the factors constituting the tender premium.

premium) give the bondholder acceptable present value compared to what could be earned from the originally promised set of cash flows? Where the debtor also proposes removing covenants and events of default, a bondholder might imagine that she could have extracted profitable gains through activism, rallying the price of the bond from its present discounted trading price.[210] How might other bondholders view the offer? How much of a discount on any optimal premium would a bondholder be willing to take to avoid being left stuck with a bond post-tender that is stripped of its core covenants? In other words, what is the cost of being a holdout?

While information transfers (e.g. bond offering documents) help bondholders to navigate uncertainties at the time that credit is first extended, the same cannot be said for when this debt is to be repurchased. Yet in both cases, bondholders are being asked to make hard choices concerning the valuation of a debtor's business, its future default risk and the present value of what promised cash flows are worth. Where the debtor is experiencing distress, the challenge of putting a price on a debtor's claims becomes harder still.[211] As Kruse et al., and Julio highlight, companies wishing to put their bonds to tender are often firms that have taken on high leverage, experienced a drop in performance and expect lower future cash flows.[212] Certainly bondholders are probably better informed about a debtor's business at the time of a repurchase than they when the bond was initially issued. At the time of the buyback, bondholders should have received years' worth of periodic disclosures and perhaps engaged with the issuer directly on occasion. Despite this greater information, however, bondholders still confront deep uncertainty regarding the buyback and the trade-offs concerning whether to accept and at what price. As tenders propose to repay an entire class of bonds – impacting a swath of investors – limited information to assist in valuation shifts burden to the creditors to pay for the information and analysis.

This absence of real information regarding a debtor's rationales for the buyback and the terms of the offer reveal the systematic information asymmetries embedded into the transaction. As Brudney notes, bondholders are especially badly affected by this disparity, relative to a bank creditors that are better placed to negotiate privately for insights.[213]

Given the limited information disclosure, buybacks institutionalize deep information asymmetries between bondholders and issuers, allowing the latter to take maximum advantage of its own insider information. Put simply, managers can conduct bond repurchases strategically to reap

[210] *For discussion*, Kahan & Rock, *supra* note [84].
[211] Damodaran, *supra* note [48].
[212] Kruse et al., *supra* note [120]; Julio et al., *supra* note [106].
[213] Brudney, *supra* note [13].

private benefits that can help promote issuer and management gains at the expense of bondholders.

As noted, per the classical doctrine, managers are more insulated from charges of insider trading when transacting in the bond market relative to equities.[214] Though hotly debated as a normative question, case-law has refrained from creating a fiduciary duty owed by managers/issuers to their bondholders – a precondition for classic liability under Rule 10b-5.[215] In this absence, there is little need for the issuer/managers to affirmatively disclose their confidential insights to explain the buyback.[216] This affords managers opportunity to devise strategies designed to repurchase this debt when it is cheapest and bondholders possess fewest alternatives by which to oppose the deal.[217] In other words, structural information asymmetries can leave bondholders systematically vulnerable to being shortchanged by strategically savvy issuers and managers.[218]

Debt buybacks thus create built-in informational deficits for bondholders that they must pay to cure. In addition, investors need to know how others will vote in order to coordinate and bargain. The costs of information gathering, investigation, coordination and negotiation can also shift the balance of interests in favor of the debtor. Where bondholders face high research and coordination costs – for example, where a company

[214] For equity buybacks conducted by the company, Fried, *supra* note [71]. On insider trading in the corporate bond market, Simi Kedia and Xing Zhou, *Insider Trading and Conflicts of Interest: Evidence from Corporate Bonds*, Working Paper (2009), 3-4 (noting the "scant" attention paid to insider trading in corporate bond markets). Several academic studies have empirically observed trading on insider information in the bond market. *Insider Trading In Junk Bonds*, 105 HARV. L. REV. 1720 (1992) (advocating for liability for insider trading in junk bond markets); Laurie P. Cohen & Kevin G. Salwen, *SEC Starts Insider-Trading Probe In Junk- Bond Market*, WALL ST. J., Apr. 10, 1991; See SEC v. Rorech, 673 F. Supp. 2d 217, 227-28 (S.D.N.Y. 2009) (examining insider trading in bond and credit default swap markets); Securities and Exchange Commission, *Barclays Bank Pays $10.9 Million to Settle Charges of Insider Trading on Bankruptcy Creditor Committee Information*, SEC Litigation Release No. 20132 (May 30, 2007) (charges by a bank on a creditor committee using its position to transact in securities). Yesha Yadav, *Insider Trading in the Derivatives Markets*, 103 GEO. L.J..381 (2015) (detailing the propensity for insider trading in the market for credit derivatives).

[215] *See sources and discussion cited supra* notes [202]-[204].

[216] Scholars have debated the incentives of capital-seeking firms to disclose information. For those opposing mandatory disclosure, regulations requiring disclosure are unnecessary because issuers have incentives to provide information. This view has been challenged as issuers also have incentive to be strategic about how they disclose and present information, justifying regulation.. This debate is extensive. *See generally*, Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999); Merritt B. Fox et al., *Law, Share Price Accuracy and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 339–41 (2003) (noting the significance of mandatory disclosure for risk assessment and share pricing) (hereinafter, *Share Price Accuracy*). See also, Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1490-95 (1992); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673-77 (1984) (but concluding that they could not find either benefit or detriment to disclosure); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722–730 (1984).

[217] In the case of loan buybacks, Madhur, *supra* note [7].

[218] On the theories justifying the prohibition against insider trading in bond markets, Brudney, *supra* note [13](highlighting the justifying rationales for imposing liability for insider trading); Wang, *supra* note [71], 1220–30 (1981) (describing the harms when informed insiders can systematically win against investors).

is in distress – they will only be motivated to lobby hard when the tender premium offered meaningfully undervalues their interest. Where they cannot be certain that the debtor is likely to recover (and the price of the bond will go up), they may instead choose to remain rationally apathetic and cut their losses. Or they may only take those actions that only require cursory investment in information acquisition and bargaining.

It is not obvious that coordination between bondholders necessarily re-sets the balance. As Kahan and Tuckman write, coordination between bondholders can be protective against coercion by an issuer.[219] However, it represents only an imperfect safeguard. Coordination can reduce bargaining costs and also information expenses if bondholders can pool resources. However, such coordination only reduces the threshold at which a bondholder will be motivated to act – but does not entirely eliminate the cushion a debtor enjoys to underprice the tender-premium. Even with proper coordination, bondholders still need to pay-to-play. Unless the pay-off clearly exceeds these expenses, there is little economic motivation to act. To the extent that bondholders have imperfect levels of information – and the issuer possesses the richest understanding of its own future – the issuer is well placed to set the tender premium at a level that is likely to disincentivize action. That is, the debtor can low-ball the tender-premium by a sum that reflects: (i) uncertainty in valuing the present and future value of the claim; and (ii) a base level of investigative and coordination costs needed to cure this uncertainty and negotiate for a higher premium. The issuer can thus deploy its informational advantage to set the premium at a level that underprices the debt but not to such a degree that the bondholders are incentivized to contest it actively.

To illustrate, an issuer wishes to buy back its bonds that are trading at a discount. After the repurchase, with a cleaner balance sheet, the issuer expects to receive a takeover offer from a top-rated company. The tender offer proposes a takeover premium of $1.25 per bond, knowing that the "right" premium should be around $3.00 per bond. If it costs bondholders $1.00 per bond in investigation, coordination and negotiation costs, it is less likely that they will act against the debtor. Instead, they will most likely accept the tender. The issuer is unlikely to voluntarily reveal news of the prospective takeover. Bondholders will lack information and face uncertainty about the issuer's true prospects. With base transaction costs ($1.00 per bond), combined with uncertainty about what the bonds are worth given the absence of full information (perhaps the premium should be set to $1.50 or $3.00?), creditors have reason to be risk averse and avoid

[219] Kahan & Tuckman, *supra* note [132].

action. If they do, an issuer (and its shareholders) can enjoy a $2 per bond windfall at the expense of bondholders.

Additionally coordination between creditors is costly and far from certain in its chances of success. Such endeavors are beset with the problem of free-riders.[220] First-movers seeking to bring a group of dispersed actors together will internalize a higher cost relative to other bondholders. Those able to freeride will experience fewer transaction costs while still reaping the benefits of a possible increase in the premium. If a similarly situated group of investors each look to the other to move first, it is possible that passivity prevails. If bondholders do not succeed in coordinating and pooling their resources, then the base transaction costs involved in an intervention go up. In the illustration above, each bondholder ends up paying $1.25 in costs per bond, rather than a $1.00.

These dynamics may not always be adversarial. Issuers may be cooperative and open to offering investors greater disclosure voluntarily. For example, a debtor may worry about acquiring a bad reputation for hurting bondholders, jeopardizing sources of future capital. It may wish to proceed quickly with the tender and willing to pay a higher premium as a result – following a change in control, for example.[221] Institutional investors that are repeat players in bond markets may also be used to cooperating, sharing resources and bargaining efficiently. In the context of workouts, for example, Bratton and Levitin have remarked on the increasing ability shown by institutional investors and issuers to cooperate in exchanging one set of bonds for another.[222] In their 1988-1989 study of 58 consent solicitations, Kahan and Tuckman noted significant abnormal gains for bondholders, suggesting a lack of deliberate oppression by issuers.[223] This being said, limited disclosure and uncertainty about bond premia creates a default whereby bondholders face high transaction and information costs. The expenditure involved provides issuers an opportunity to underprice the premium by a level reflecting these costs and uncertainty, dissuading bondholders from agitating for a higher premium.

B. Cost of Amending Covenants

[220] *See for example*, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 866–80 (2013) (highlighting passivity common to mutual funds that look to activist hedge funds to lead governance interventions).

[221] Mann & Powers, *supra* note [169].

[222] *See generally*, Bratton & Levitin, *supra* note [149].

[223] Kahan & Tuckman, *supra* note [132], 503.

As Mann and Powers note, amending covenants represents a major reason for debtors to seek to go through a debt buyback.[224] That borrowers should seek to re-align relationships with their lenders through time makes practical sense.[225] Kahan and Tuckman underscore the logic of covenant changes to account for normal, expected changes to a borrower's circumstances. Original contractual terms lose utility. They may be economically harmful if they prevent a borrower from pursuing profitable projects or opportunities (e.g. a change of control). As such, re-working these terms through a buyback reduces the potentially wasteful effects of unnecessary contractual constraint.[226]

But buybacks also raise concerns about whether their ability to impact covenant design creates a mechanism for the debtor to relax restrictions on itself at relatively little cost. In so doing, the decision to repurchase debt can revive sources of agency risk as between the creditors and the issuer's managers and shareholders.

1. Underpricing Bondholder Discipline

Regulation creates conditions that encourage issuers to underprice what they pay bondholders to remove covenant protection through a consent solicitation.[227] Importantly, undercompensating bondholders can provide some immediate, near-term pay-offs to issuers. As Mann and Powers note, tender premia tend to be higher when there are more restrictive covenants.[228] Logically, issuers must to pay more to remove a stricter set of covenants. That an issuer has to pay more to reduce a heavier contractual burden, however, is not the same thing as saying that the price needs to be a fair reflection of the value lost by bondholders.

Indeed issuers have every reason to underprice the tender premium beyond simply saving themselves some cash. For a start, paying a lower-than-optimal tender premium helps the issuer appear less risky. Where the tender premium is high, the market should conclude that restrictive covenants hold out enormous value to bondholders, presumably because bondholders wish to use them as a disciplinary device against the issuer. Noting the increase in bondholder activism, reinvigorating long-neglected

[224] Mann & Powers, *supra* note [169], 3-4; See also, Kahan & Tuckman, *supra* note [132]; Chatterjee, *supra* note [132].

[225] Kahan & Tuckman, *supra* note [132].

[226] Kahan & Tuckman, *supra* note [132].

[227] On coercion see, Coffee & Klein, *supra* note [159]; Bab, *supra* note [159]; Brudney, *supra* note [13]; Kahan & Tuckman, *supra* note [132].

[228] Mann & Powers, *supra* note [169].

bond covenant protections, a lower tender premium offers an optimistic signal that even newly empowered activists see little value in enforcement.

Secondly a lower tender premium can provide evidence of an issuer's negotiating power. If the issuer can buy its debt back relatively cheaply, its ability to lower its governance costs can bode well for future extensions of credit that may be less negotiated as a result. In other words, if an issuer can cheaply buy back debt with limits on large asset purchases, borrowing or change of control removed, prospective creditors may be willing to extend debt without these usual contractual safeguards.

Thirdly a low-ball tender premium can help the issuer to buy out future violations of its indenture provisions cheaply. By paying to reduce or eliminate a series of restrictive covenants, the issuer is able to avoid falling foul of prospective violations. It buys itself immunity from the chance that it might default on the indenture and have to confront activists, litigation and high-profile interventions designed to challenge management and corporate decision-making. Particularly with recent case-law and investor interest in favor of generous remedies for covenant defaults, this represents a valuable strategy.[229] By reducing future litigation risk, issuers can divert present-day financial and managerial resources to risky ventures that would otherwise have provoked the ire of bondholders. As Gao et al., have highlighted, bondholder activism can sometimes be short-term and opportunistic in nature.[230] While helping to enforce once-defunct indenture terms, activists may be buying debt in order to make a quick buck at shareholder expense by creating a nuisance for the issuer.[231] If a tender premium can be used to buy-out on the uncertain future risk of high-ticket disruptive litigation, the debtor can make economically worthy gains. On the other hand, where the issuer can cheaply neutralize productive bondholder scrutiny and discipline for the foreseeable future, it can extract value for itself and shareholders at the expense of bondholders. In turn, this increases agency costs for the company.

Regulation offers issuers advantage in seeking to underpay bondholders for covenants and to look for maximum gain for themselves. As noted above, disclosure of information during a tender is limited – requiring bondholders to take the lead in investigation and analysis. Owing to information deficits about the buyback, investors can possess only patchy data by which to gauge the future economic usefulness of their covenants. Where a debtor envisions of change of control, for example, indenture covenants may end up acquiring considerable value as tools to

[229] Kahan & Gulati, *supra* note [88] (on Cash America and "make whole" remedies for bond defaults).

[230] Gao et al., *supra* note [61]; Kahan & Rock, *supra* note [84].

[231] Gao et al., *supra* note [61] (noting that bondholder activism can be short-term in nature).

lever for agitation, settlement and higher repayment. On the other hand, if the debtor is headed for prosperous times, opportunities for unearthing defaults could end up becoming more scarce.

Moreover legal protections to safeguard the value of bondholder governance rights are few and far between. The absence of a fiduciary duty for bondholders eliminates the obligation managers might have to act in their best interests. While a duty of good faith nominally applies, courts have blessed the process for gathering consent solicitations as being in compliance with this duty.[232] As a result, it makes sense for managers to adopt an adversarial posture in supporting the acquisition of shareholder power at the expense of bondholders. The former constitute a source of long-established legal obligation, the latter only exercise dominion by dint of their contract with the issuer. If this contract can be disposed-off cheaply, managers are arguably in closer compliance with their fiduciary obligation to promote shareholder interests.

Scholars have offered in-depth analyses of why fiduciary duties for bondholders make little sense within the overall architecture of corporate law.[233] This Article does not revisit these debates. However, one critical rationale justifying this absence lies in the protection offered to creditors *via* contract. As Brudney argues, bondholders have enjoyed protection through the framework of covenants established by the bond indenture, reducing the urgency to establish some form of fiduciary protection as safeguard against managerial and shareholder risk-seeking. To the extent that the consent solicitation and debt buyback processes allows these contractual rights to be altered without meaningful regulatory scrutiny, it raises the question whether the law undervalues and under-protects bondholder contractual control rights. [234]

With few legal safeguards, bondholders are under pressure to coordinate privately in order to achieve the most optimal price for their contractual covenants. But the limited legal tools available reduce the chances of coordinating effectively. Scholars have routinely billed the consent solicitation process as a prisoner's dilemma that rewards those that

[232] Katz v. Oak Industries Inc., 508 A.2d 873 (Del. Ch. 1986). In addition, the notion of "good faith" is inherently prone to varying understanding and interpretations, creating limited clarity for the market. Brudney, *supra* note [13], 1869-1870.

[233] Brudney, *supra* note [13]; Coffee & Klein, *supra* note [159]; Lawrence Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 HARV. L. REV. 1165 (1990).

[234] On the importance of contract as a prophylactic against the need for fiduciary protection, see for example, Brudney, *supra* note [13], 1836-1845; Henry Hu & Jay Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1330-1336 (discussing the rationales for contractual rather than fiduciary protection for creditors), Fred Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L. J. 809, 860-70 (2008)(highlighting the protections offered by contract for sophisticated creditors); But see, Elias & Stark, *supra* note 75 (noting the insufficiency of contract to safeguard creditor protections on the eve of insolvency). See also, Smith & Warner, *supra* note [43] (on the role of contracting to reduce agency costs of debt).

accept the issuer's terms – and punishes investors that fail to cooperate.[235] However, in game theoretic terms, consent solicitation also requires bondholders to engage in a "coordination game" that promises greatest gain for those that can work together to pursue a collective good. Where participants peel off to follow smaller private victories, opportunities for coordination disappear and so does the possibility of the bigger prize.[236] Critical to such cooperation is, unsurprisingly, the availability of information and channels of communication that can enable investors to arrive at a consensus regarding what their rights are worth.[237] In debt buybacks, this kind of assistance is in short supply. Investors need to work to undertake research and analysis – and quickly in order to meet deadlines for the tender. The lack of fiduciary protection imposes additional difficulty. Investors cannot count on the fact that managers will act in their best interests, requiring them to internalize further costs to verify the quality of the offer from a more adversarial standpoint.

This accretion of costs can increase the odds that bondholders might pursue a cheap exit that limits the accumulation of additional expenses. Moreover, consensus may be especially hard to achieve in the context of bondholder rights. As Kahan and Rock write, these contractual levers have long gone underenforced. Not until the emergence of hedge fund activists have these rights assumed serious significance.[238] Understandably, investors may diverge on how they value contractual levers. Traditional players may lack the appetite, resources and time needed to excavate indenture agreements for possible defaults and to use this understanding to propose an optimal tender premium.[239] Where building consensus takes time, necessitates discussion and lobbying between investors, bondholders may be reasonably persuaded to agree to the consent, especially in light of tight deadlines imposed by the process.

2. Impact on Agency Costs

Conditions that encourage underpricing of bond covenants and enable these to be cheaply bought out raise the risk that issuer companies

[235] *See for example*, Coffee & Klein, *supra* note [159], 1212-1213. While not a subject of this Article, the weak status of the indenture trustee also contributes to bondholder under-protection. On the indenture trustee and its traditional weaknesses, see sources cited *supra* note [83].

[236] DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 35–37 (1994). *See generally*, BRIAN SKYRMS, THE STAG HUNT AND THE EVOLUTION OF SOCIAL STRUCTURE (2004).

[237] BAIRD ET AL., *supra* note [ ], 35–37. On the need to ensure greater effectiveness for the indenture supertrustee, see, Amihud et al., *supra* note [59].

[238] Kahan & Rock, *supra* note [84].

[239] Steven Cohen et al., *supra* note [132] (describing default activism as "default archaeology")

become more vulnerable to the play of agency costs. The ability of issuers to inexpensively repurchase debt can result in bondholder rights becoming less valued as a means of controlling agency costs. Just as recent years have witnessed an uptick in hedge-fund led bondholder activism, opportunistic repurchases may turn the tide in favor of issuers by allowing preemptive buyouts of those issues that are most likely to attract activist advances. In situations where bondholder activists are merely creating a nuisance, buyouts offer a productive mechanism to blunt the impact of a disruptive activist campaign. However, where bondholders are enforcing covenants designed to prevent excessive risk-taking and rent-seeking, an issuer's ability to deploy a repurchase strategically can reduce the effectiveness of bondholder action and the fear it creates in boardrooms.

Recall the argument, advanced by Kahan and Tuckman, that reviewing and removing covenants through buybacks makes sense as a reasonable reaction to changing conditions.[240] Equally it is arguable that the end result – a bond stripped of some or all of its restrictive covenants – represents an overcorrection to the problem of overly rigid contract provisions. That is, in removing or amending covenants through a consent solicitation, the new calibration of governance rights provides an excessively weak check on managerial and shareholder agency costs.

That debt repurchases might result in such an outcome is made possible by the limited opportunities for coordination and negotiation between issuer and bondholders. As argued in this Part, limited disclosure, an absence of fiduciary obligation, coordination problems – and tight deadlines within which to accept the deal – affords negotiation advantages to the issuer. Scholars have also recognized the problem of bondholder coercion as being a live concern within the consent solicitation process.[241]

This upper hand can help issuers and shareholders to ease contractual restrictions and extract value for themselves at the expense of bondholders. If covenants can be released cheaply through a buyback, it makes sense for issuers to push for an expansive relaxation of applicable covenants when the opportunity arises. This allows issuers and shareholders to divert resources to themselves, for example, to pay dividends, transact with major shareholders or borrow more to finance risky projects.[242] Indeed if bondholders are willing to accept the deal – in return for a premium and a quick exit – they may have little interest to negotiate with the issuer to keep protections in place. If bondholders know

[240] Kahan & Tuckman, *supra* note [132], 502.

[241] *See for example*, Brudney, *supra* note [13]; Barondes, *supra* note [183]; Coffee & Klein, *supra* note [159]; Kahan & Tuckman, *supra* note [132]; Chatterjee, *supra* note [132].

[242] Anderson-Parson, *supra* note [131].

that they will no longer be involved in a company's capital structure, they are unlikely to spend money to agitate for keeping tight covenants.

This remains theoretical and empirical testing is needed. The handful of studies on tender offers and consent solicitations show abnormal gains for shareholders on multiple measures. In many ways, this is unsurprising. Managers have a systematic informational advantage. They owe no fiduciary duty to the bondholder. As Julio notes, it would be strange indeed if managers were to lavish cash on bondholders to buy back debt without a strong expectation that shareholders would enjoy a greater gain following the transaction. As noted earlier, shareholders reap the rewards promised by a cleaner balance sheet. Julio reports that companies see leverage ratios decrease by almost 16%, improved access to external funding and reduced frictions caused by high levels of lingering debt on the balance sheet. Kruse et al. also point to shareholders being rewarded by the market with a post-tender premium, an increase in the company's asset base and better performance overall.[243] News of a possible debt buy-back routinely sends share prices soaring.[244] But scholarship has so far failed to empirically address whether - longer term - the episodic elimination of bondholder oversight can also lead to problems as shareholders and managers are less fettered in their ability to pay themselves, borrow more, and to spend the money on riskier investments. Put simply, do attempts to rework covenants through buybacks end up hurting companies in the long run by relaxing covenants too much relative to the firm's agency costs?

Although buybacks can encourage the cheap removal of covenants, studies still point to gains for bondholders. The picture, however, is complicated.[245] As discussed, Kahan and Tuckman observe that bondholders make major gains from the buyback, suggesting that issuers might be more sensitive to bondholder interests than first meets the eye. On the other hand, Chatterjee at al., note that, while they are often pressured into accepting less-than-great deals, bondholders can still get indirect benefits from avoiding protracted workouts and bankruptcies.[246] Despite these equivocal conclusions, however, the key question lies in understanding whether bondholders receive sufficient value for giving up their governance rights.[247] This inquiry is not simply a matter of ensuring

[243] Anderson-Parson, *supra* note [131]; Julio et al., *supra* note [106]; Kruse et al., *supra* note [120].

[244] *See for example*, James Shotter & Thomas Hale, *Deutsche Bank to Launch Buyback of its Bonds*, FIN. TIMES, Feb. 12, 2016.

[245] Anderson-Parson, *supra* note [131] (noting that studies show diverging results on bondholder coercion and gains).

[246] Chatterjee et al., *supra* note [132]; Kahan & Tuckman, *supra* note [132]. See also, Julio, *supra* note [106].

[247] Paul Asquith & Thierry Wizman, *Event Risk, Covenants, and Bondholder Returns in Leveraged Buyouts*, 27 J. FIN. 195 (1990) (finding that bonds with heavy covenant protection are more likely to see covenants removed though a tender offer following a leveraged buy-out).

that investors receive a "fair" deal in relation to the rights that are attached to their claims. Rather it speaks to the incentives regulation creates to encourage bondholders to invest in contracting for and exercising governance power. If buybacks facilitate a quick-and-convenient stripping of bondholder rights – without adequate compensation – rational bondholders might be reluctant to invest in negotiating for useful governance levers *ex ante*. They may choose to be apathetic in exercising creditor discipline. At worst, the costs of such action will be borne by issuers, bondholders as well as markets as a whole. Slack monitoring results in the heightened risk of wasted or misused capital, rent-seeking by managers and shareholders and inefficient allocations of credit.[248] Credit-providers may be drawn only to companies that are do not need much active governance – larger, safer firms that are publicly traded, rather than smaller opaque ones that might benefit from creditor monitoring.

With this in mind, one might expect that the market should systematically punish an issuer's decision to strip away bondholder oversight by imposing a higher cost for future capital. In other words, companies that opportunistically buy out activist bondholders on oppressive terms should see their debt become more restrictive going forward. So even if regulation gives issuers leeway, the expectation of blowback from market might cause managers to be more circumspect about picking which bonds to buy back and covenants to remove.

But relying on fear of market discipline as a means of pushing issuers to consider the consequences of lost bondholder discipline represents, at best, an imperfect strategy. For a start, the market faces serious challenges in putting a price on governance rights and the value of creditor activism. By how much should the issuer's cost of capital increase if it decides to remove its main restrictive covenants? To answer this, investors must first determine whether removing these constraints reflects an appropriate reaction to the debtor becoming less risky than when it took on the bond debt. As per Kahan and Tuckman, if an issuer's business has changed sufficiently that it no longer needs the same intensity of bondholder control, it should be rewarded with debt that comes with fewer conditions. However, if it has not and consent solicitation is deployed to cheaply reduce monitoring intensity to an excessive degree, the issuer represents a future credit risk whose cost of capital ought to increase in lockstep with its over-confident maneuvering.

The market must also consider a complex counterfactual: what would creditors have achieved with the benefit of their governance powers in the absence of the consent solicitation? How might they have acted to

[248] Jensen & Meckling, *supra* note [23], 308-309.

protect and enhance the value of their interest by harnessing the contractual levers at their disposal? In seeking to analyze this question, it is arguably not enough to just examine the power that creditors possess on paper.[249] Rather a debate about valuing bondholder governance must also include some discussion about how investors would seek to actually wield these covenants in practice. On this last question, it is also worth reflecting on the outcomes likely to be generated by bondholder intervention. Default activism by bondholders can sometimes be highly opportunistic, focused on creating short-term pay-offs for activist hedge funds.[250] Where an issuer buys out such opportunistic creditors, its repurchase may have only a limited effect on its long-term financial health given that such bondholders are essentially trying to make a quick buck from litigating technical defaults.[251] On the other side, as detailed by Sandrine Docgne in her study, contractual restrictions can have a more substantive impact on an issuer's decision-making in serving to shape an issuer's investment policies and spending choices to the benefit of agency risks and cost of capital.[252]

Neither of these questions can be answered easily, if they can be answered at all. Bondholders are on the back-foot structurally on account of systematic information asymmetries, less exacting disclosure standards and limited compulsion on managers to provide material non-public information to bondholders. ln determining what kind of value is lost though a consent solicitation, creditors lack the advantage of readily available data to dissect an issuer's motivations and why managers choose to undertake a buyback at particular moments. This endemic informational disadvantage renders assessments of an issuer's changing risk profile almost impossible. Whether releasing contractual fetters makes sense as a practical matter or whether it simply represents a borrower's attempt to dislodge creditor power opportunistically cannot be easily assessed in the absence of real disclosure and data.[253]

Moreover answering hypothetical counterfactuals further complicates the already-steep challenge of valuing and pricing bondholder governance. In seeking to decide how creditors might have used their power, creditors must reckon with a hodge-podge of essentially unanswerable inquiries. Would bondholders have been able to coordinate to push an issuer towards covenant compliance? Would activist

[249] Mariosa Verde, *Loan Preserver: the Value of Covenants*, FITCHIBCA Loan Products Special Report (1999)(noting that bond indentures are lacking real value owing to their broad drafting and weak enforcement). Sabrina Docgne, *supra* note [92]).

[250] Gao et al., *supra* note [61].

[251] Kahan & Rock, *supra* note [84].

[252] Docgne, *supra* note [92].

[253] Asquith & Wizman, *supra* note [247] (noting that consent solicitations occur after LBOs to remove tough covenants). .

bondholders have succeeded? If so, by what measure would this success have been measured? More particularly, in seeking to calibrate the harm to bondholders and to the company's vulnerability to agency costs, the market must come to some consensus on how to attach a price to these abstract questions about alternative states of the world.

Secondly, imposing market discipline confronts a further hurdle in assessing the complicated trade-offs presented by a debt repurchase. As Chatterjee et al. observe, the gains and losses are often hard to parse, muddying judgments about the longer-term impact of a buyback.[254] Bondholders might win by being freed from their investment *via* the repurchase, allowing them to put their capital to work in a more profitable investment. In a tender, they can enjoy the benefit of a premium to the market price while also being freed from future conflicts during workouts and bankruptcies. More philosophically, the financial consequences of a repurchase can be complex and fully grasping the long-term ramifications presents uncertainties. Scholars have demonstrated benefits for a company's balance sheet. With reduced leverage, it often lowers its cost of financing, improves performance and delivers enhanced returns for shareholders.[255] Indeed a company can create greater gains where it succeeds in buying bondholders out most cheaply. The deeper the discount on the bond debt, the better the gain for a company's balance sheet.[256]

At the same time, the longer-term consequences can also end up being more equivocal. A company may face rising agency risks reflecting weaker bondholder monitoring, leading managers to pursue ill-advised projects and excessive leverage. With overly loose restrictions, relative to the risks it poses, an issuer can end up back in financial distress. In short, assessing the overall impact of a debt repurchase requires balancing a multiplicity of costs and benefits that may not always lead to firm conclusions about how best to price the risks of debtor opportunism and bondholder oppression. Limited disclosure does not help. And unlike more efficient and transparent equity markets where prices can more easily reflect heterogenous views on a company's fortunes, credit markets are too fragmented, opaque and lacking liquidity to deliver reliable insights.[257]

[254] Chatterjee et al., *supra* note [132].

[255] See for example, Julio et al., *supra* note [106]; Kruse et al., *supra* note [120]; Kahan & Tuckman, *supra* note [132].

[256] Julio et al., *supra* note [106]; Mann & Powers, *supra* note [169] (noting that issuers can book a profit where debt can be repurchased at a discount). See also, Ng, *supra* note [106] (noting the gains for companies able to buy back debt for pennies on the dollar). In general, the gain is recorded as the difference between the price at which the debt is purchased and retired and the book value of the debt.

[257] Bond market structure remains a complex topic on which an extensive literature has been written. A full discussion is outside the scope of this Article. For discussion, Hagit Levy & Ron Shalev, *Bond Repurchase Objectives and the Repurchase Method Choice*, Working Paper (2011).

Finally even if the market is able to put a price on bondholders seeing systematic losses in both money and power, issuers might nevertheless decide that this price is worth paying. Issuers may determine that any reputational damage and increase in the cost of capital is worth less than the gains likely to be made through the buyback. The superior informational advantages enjoyed by an issuer's management, possible enhancements to a company's balance sheet as well as reduced bondholder monitoring might, together, hold out sufficient motivation for issuers to accept any resulting friction in the credit markets. Where mangers wish to take on risky projects, divert resources to themselves and shareholders or otherwise to shed problematic scrutiny into their activities, engaging in strategic repurchases may seem compelling, despite any added costs in the future to a company's debt. Stated bluntly, the prospect of debt markets being able to price the risk of buybacks into the cost of credit is not a panacea against bondholder coercion, especially if shareholders and managers envision high returns through the buyback.

C. Buybacks and Inter-Creditor Games

As much as buybacks can offer issuers a way of diverting value from creditors to shareholders, they can also provide a mechanism for one set of creditors to seek out advantage at the expense of another. By pushing for certain debt to be repurchased at a discount and for its covenants to be scrapped, remaining influential creditors can achieve multiple aims.

Perhaps most importantly, they can help to improve their odds of being repaid. Rather than diverting cash flow to pay off several sets of creditors, a buyback can ensure that whatever cash that does come in goes to pay-off a smaller number of outstanding claims. Indeed, a buyback can boost the chances that a debtor achieves greater financial security to repay its remaining liabilities.[258] A healthier balance sheet, with better operating performance, more valuable equity and cheaper financing can permit an issuer to boost cash flows and reassure lenders of future performance. According to one model, debt buybacks reduce the overall default risk attaching to a company and improve its credit rating.[259] And anecdotally at least, buying back one set of loans can often impact the outlook for another. When Deutsche Bank announced that it would buy back $5.4 billion worth of senior-ranked, unsecured bonds to shore up its shaky

[258] Julio, *supra* note [106]; Kruse et al., *supra* note [120].

[259] Hui Xu, *Scooping Up Own Debt On the Cheap: The Effect Of Corporate Bonds Buyback on Firm's Credit Condition*, Working Paper.

balance sheet – the news was designed to offer reassurance that it could pay its more junior debt. Promising a sounder balance sheet following the buy back, the price of Deutsche Bank's junior unsecured bonds immediately rallied by 2.6%.[260]

While Deutsche Bank bought back one set of bonds to improve the creditworthiness of another, it is easy to imagine bank loan providers having an outsize voice in suggesting strategic buy back of bond debt. Just as with issuers, loan creditors might seek out opportunistic bond buybacks, where the bonds are transacting at a heavy discount. By repurchasing them at a bargain price, the gains for the company's balance sheet can be appealing for providers of large loans. Those extending loans are likely hold a greater single exposure to the borrower relative to more dispersed bondholders.[261] This loan debt is harder to sell, making its risk stickier on a creditor's balance sheet.[262] Banks may have repeat relationships with a borrower as well as lucrative side deals to provide an array of financial products and services.[263] In short, bank lenders can have a great deal at stake – and as such, a lot to gain if the borrower can more easily fund its future repayments.

In addition, removal of problematic bondholders can enlarge the power and governance reach of bank creditors. Repurchases – combined with consent solicitations can neutralize the ability of bondholder activists to assert themselves in a company's governance. Where such activists can create a nuisance value – by opportunistically targeting firms in technical default of their indentures, for example – their interference might be viewed as a drag on others in the capital structure. In the case of its takeover of Safeway for example, Albertsons paid over $300 million dollars to settle claims with bondholders in order to move on with other projects. If large bondholders can deploy their governance power in such a way that may be prevent a company from taking on value-generating activities (e.g. a profitable merger), bank lenders may have cause to worry about the nuisance risk that noteholders pose to a borrower's creditworthiness. In situations where a company is in distress, negotiating with bondholders to achieve a workout can seem daunting and liable to add time and expense to the restructuring process. Even where the bondholders

[260] Shotter & Hale, *supra* note [244]; Buy analysts were skeptical that the buyback could achieve its aims of improving the credit risk of lower ranked Additional Tier 1 bonds, which had been crashing in value prior to the buyback announcement. For discussion, Alex Chambers & Helene Durand, *Market Questions Long-Term Impact of Deutsche Buy Back*, REUTERS, FEB 13, 2016; Paul Davies, *Why a Deutsche Buyback Would Help*, WALL ST. J., FEB 10, 2016.

[261] Kroszner & Strahan, *supra* note [57].

[262] Edward Altman et al., *Bank Debt versus Bond Debt: Evidence from Secondary Market Prices*, Working Paper (2006), 2-3 (noting the recent development of the bank loan markets).

[263] Sreedhar Bharath et al., *Lending Relationships and Loan Contract Terms,* 24 REV. FIN. STUD. 1141 (2009); Tung, *supra* note [34].

rank junior to a loan creditor, buying back the bond debt cheaply can allow senior lenders to more expansively assert their authority without facing pushback and costly frictions with assertive junior bondholders.[264]

Banks possess special advantages in deploying their creditor power to push for strategic buybacks of creditors. First, they are likely to be better informed than bondholders. Usually enjoying thick information transfers and access to boardrooms, bankers garner detailed insider insights into the company's workings – enabling a finer assessment of when bond debt might be most undervalued.[265] They may have a firmer handle on prospective projects, be available to offer additional credit as well as to advise on restructuring the business. With this depth of insight, banks are well suited to evaluate the trade-offs involved in a potential buyback and to push management to take it on at a moment that might best transfer value from bondholders to themselves. The relative superiority of information enjoyed by banks relative to bondholders is made clear by a study comparing the intensity of price changes for loans compared to bonds in response to news of default and bankruptcy. Examining a data set of loans versus bonds issued by the same company, Edward Altman et al., observe that loan prices fall much more prior to a default or bankruptcy relative to bonds – and much less after this news announced. The inference is clear. Owing to the better monitoring and access available to banks, loan prices fell much earlier. Bondholders, by contrast, reliant on public information reflect the news much later after it becomes public.[266]

In addition, bank lenders – likely much fewer in number than the bondholders – will confront lower coordination costs. Unlike the difficulties affecting bondholders, banks can more easily share information, develop a strategy and press their influence with issuers.[267]

Whether banks, in fact, play a active role in promoting buybacks – potentially to the detriment of other creditors in the capital structure – remains a question requiring empirical analysis. That they have compelling incentives to do would suggest that this inquiry is one worth pursuing. Not only can loan providers benefit from a company's reduced default risk, they can expand their own sphere of influence by removing those of other creditors under the buy back. Inter-creditor machinations can thus work to keep dispersed, lesser informed lenders at a systematic disadvantage to banks holding a fuller panoply of governance levers.

---

[264] On conflict between senior and junior bondholders, Anthony Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011).

[265] Altman et al., *supra* note [262] (noting the monitoring advantages of bank creditors relative to bondholders); See generally, Brudney, *supra* note [13] (analyzing the informational disadvantages of bondholders).

[266] Altman et al., *supra* note [262].

[267] Kroszner & Strahan, *supra* note [57].

In summary, this Article makes the argument that debt repurchases systematically undercompensate bondholders and also allow borrowers to cheaply buy out activists. Information asymmetries are codified as a matter of regulatory policy, requiring investors to internalize the costs of investigation, analysis and coordination. In pricing the tender premium, borrowers have every incentive to push for a maximal easing of covenants and events of default. Information deficits create barriers for investors to negotiate and valuation of governance rights presents an especially costly and complicated analytical task. Finally, debt buybacks open the door for dispersed, lesser informed bondholders to be outmaneuvered by more unified bank lenders looking to improve their changes of repayment and expansion of control. This structurally uneven playing field between issuers and creditors and issuers and bondholders in particular raises numerous implications for policy. If bondholders always lose out, the current design of regulatory policy has arguably failed to create a transactional framework that protects investors and ensures an efficient transfer of capital between issuer and bondholder.

V. IMPLICATIONS FOR REGULATION AND POLICY

This Part outlines ideas for policy reform to address the structural deficits faced by creditors – especially public bondholders. The arguments advanced here are significant for the U.S. corporate debt market that has, in the last decade, witnessed a rapid expansion to create around $9 trillion in bond debt. With over $3 trillion of this debt held by BBB-rated companies that may be vulnerable to distress, the appeal of debt buybacks is clear. So long as credit conditions are expansive, companies can buy back old, expensive, covenant-heavy claims and replace them with those offering a lighter burden. However, fearing expensive credit down the line, companies also have an incentive to buy back debt that may prove expensive to roll-over or whose interest rate floats to peg itself to the prevailing benchmark. These rational moves, however, risk saddling an enormous swath of bondholders with costs that regulatory policy is presently ill-equipped to mitigate. This absence of protection also raises questions about how bondholders might respond in the long-term – in other words, will they ask for higher returns and charge borrowers more because they may see their claims cheaply extinguished?

As a first step, this Part proposes pathways for policy to diagnose the trade-offs underlying debt repurchases – and then suggestions to help even the playing field between borrower and lender. It outlines: (i) the

need for empirical research; (ii) the creation of greater equality in regulatory treatment between debt and equity buybacks; and (iii) the imposition of a discrete fiduciary duty in the context of a repurchase.

A. Bridging the Gap in Empirical Research

Despite their practical significance, debt buybacks have attracted relatively little scholarly and policy attention, leaving a lightly populated slate for future research. Crucially the absence of extensive examination into the reasons and effects of debt repurchases has left policymakers with few insights into the theory and real-world impact of this transaction.

Equity buybacks, by contrast, though clearly fulfilling different economic purposes, have proven a great deal more popular, dominating headlines, scholarly debates and policy agendas in Washington D.C. This effort has yielded a deep bench of ideas, empirical findings and hotly contested debates into the place of equity buybacks in capital allocation, short-termism and investor protection.[268] It has offered clarity on the trade-offs between the gains of share buybacks in limiting agency costs (e.g. by reducing the cash in managerial hands) and the harms to investors where managers exploit insider information to time the market.[269] Moreover, this study has provided insight into the economic productivity of equity buybacks, whether conveyances of cash to shareholders take away from corporate expenditure on investments, research and overall wealth creation.[270] Dialogue on the issue has fed into congressional and SEC thinking.[271] For example, responding to research, SEC Commissioner Robert Jackson proposed increasing the compliance burden on companies where executives cash out after a stock buyback – reflecting concerns about managers using insider access to optimally time repurchases.[272]

As a first step, then, more research is needed to fill the gaps and to develop greater empirical insight into debt repurchases. This Article has raised a number of issues for study. For example, it suggests that bondholders are systematically short-changed by borrowers, owing to

[268] *See sources cited supra* note [109]; On policy, see for example, Letter by SEC Cmmr. Robert Jackson to Sen. Van Hollen, Mar. 6, 2019, https://www.vanhollen.senate.gov/imo/media/doc/20190305%20Response%20(Senator%20Van%20Hollen).pdf (discussing research and data on stock buybacks, insider trades and corporate cash outs).

[269] *Id.* Fried, *supra* note [71]; Fried & Yang, *supra* note [109].

[270] *See sources cited supra* note [109]

[271] Jay Sykes, *Stock Buybacks: Background and Reform Proposals*, Congressional Research Service Legal Sidebar, Feb. 27, 2019.

[272] SEC Commissioner Robert Jackson Jnr., Stock Buybacks and Corporate Cashouts, Speech, Jun. 11, 2018, https://www.sec.gov/news/speech/speech-jackson-061118#_ftnref25 (denying use of Rule 10b-18 safe harbors to companies with executives that cash out after a buyback). .

information asymmetries and the coordination costs involved in bondholder action. It also posits that bondholders see their governance rights being cheaply bought out, with borrowers incentivized to push for the maximum relaxation of covenants. To demonstrate the impact of inter-creditor game-playing, empirical study can help clarify whether banks use their influence to push for repurchases – and if so, why?

The impact of debt buybacks on the economy and the cost of capital remains unclear. Just as research has delved into the question of whether share buybacks might be excessively short-term in nature and harmful to real investment, debt repurchases raise important policy inquiries about their overall effectiveness. Do companies that undertake debt buybacks perform better relative to those that do not? Put differently, are they more skilled at calibrating their capital structure to an optimal level, adapting better to economic conditions? Or, are they more vulnerable to failure, showcasing a proclivity for distress and a ratings downgrade? Where companies introduce consent solicitations to limit bondholder governance, are they more likely to engage in destructive conduct afterwards, for example, by borrowing excessively or taking on expensive projects? Indeed, do debt repurchases foster incentives for managers to privately transact in a company's bonds or stock around the time of the event, extracting gains for themselves using their special access to company information? Where bank lenders are also in the picture, are they more influential in the wake of a repurchase by asserting more events of default, offering further credit, or investment advice to a borrower? Does the price of their debt improve following a bond repurchase? While such questions are difficult and complex to answer, especially given the opacity and lack of liquidity in the debt market, gleaning nuance about the effects of debt buybacks helps develop some ideas about who bears the cost of the transactions and who wins. Perhaps most fundamentally, policy can be better informed on the issue of whether endemic information asymmetries and bargaining frictions result in credit markets punishing those that behave coercively. If bondholders are repeatedly harmed, they ought to respond by charging companies more for capital, adding covenants to debt and attracting aggressive activists that can punish a company. If bondholders do not charge more, it is worth asking why not. Does the lack of reporting impact an attenuated bondholder response? Or, does the tendency towards passivity, despite the rise of hedge funds in bond markets, dampen efforts to rationally increase cost of capital for those issuers that systematically undercompensate bondholders.

B. Mandating Better Disclosure and Reporting

At a minimum, debt buybacks need better disclosure to (at the very least) bring their regulation into basic alignment with the rules applicable to equity repurchases. The present discrepancy between equity and debt remains difficult to justify. To be clear, debt markets have long been infamous for their opacity – perhaps explaining the absence of formal reporting for debt repurchases. But this posture has changed markedly over the last decade. Most notably, since 2002, transactions in public and private corporate bonds must be reported and prices disseminated to the marketplace.[273] The SEC has devoted resources to enhancing transparency as a means of improving the transaction costs involved in trading bonds.[274]

Recall that debt repurchases lack formal *ex ante* and *ex post* reporting requirements. In the case of equity, open-market repurchases require a prior notification and (since 2003) specific post-trade disclosure in the company's regulatory filings.[275] Tender offers for equity mandate form disclosures and a public following after the tender is completed.[276] By contrast, debt repurchases impose near negligible formal transparency requirements, short of mandating that information not be misleading.[277] Prior notification is not needed and even tender offer rules do not stipulate a post-offering filing to confirm its details. For completeness, in the absence of a fiduciary duty for bondholders, the application of the prohibition against insider trading is much weaker than in equity markets.

Greater transparency in debt repurchases constitute a minimal first step towards equalizing the playing field between issuers and investors. Prior notification before open market debt repurchases alert investors to the possibility that their securities may be trading at a discount to real value.[278] At least, notice allows investors to prepare for the possibility that they may be trading their claims with a counterparty that is, by definition, best informed about its own affairs. This can trigger research, investigation and coordination. It might also force investors to reflect on the governance

[273] Financial Industry Regulatory Authority, About Trace, https://www.finra.org/sites/default/files/TRACE_Enhanced_Historical_Data.pdf.

[274] *See for example*, Securities and Exchange Commission, Fixed Income Market Structure Advisory Committee, Recommendation for the SEC to Establish a New Issue Reference Data Service for Corporate Bonds, Oct. 29, 2018.

[275] *See for example*, NASDAQ RULE 5250(b)(1); Michael Simkovic, *The Effect of Mandatory Disclosure on Open-Market Stock Repurchases*, 6 BERKELEY BUS. L. J. 96, 102-110 (2009); Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 CALIF. L. REV. 1323, 1340-1342 (describing varying post-trade disclosure regimes and the Rule 10b-18 regime, as well as the rationales for introducing specific disclosure in 2003).

[276] 17 CFR § 240.14d-100 - Schedule TO.

[277] *See discussion supra* Part [II(B)(3)].

[278] This is a well-known issue in equity markets. See Fried, *supra* note [71].

levers available to them in order to more closely examine the company's financial condition and decision-making. That prior notice constitutes a most minimal policy response to systematic information imbalances is reinforced by the absence of fiduciary protection that might otherwise prompt fuller disclosure from a company. With only contractual safeguards at their disposal, a prior notice allows bondholders to seek out private solutions to mitigate their informational deficit. Hagit Levy and Ron Shalev hint at the potential usefulness of prior disclosure in helping investors extract more value from the sale. Comparing tender offers with open market debt repurchases, they show that claims acquired through open market trades increase more in price than those bought through a tender offer. This suggests that bondholders that sell their claims in the open market may be losing out more heavily.[279]

Ex post reporting by way of a specific notice or filing also offers benefits for investors and regulatory policy. For a start, clearer disclosure can promote a more thorough collation of market activity. How much debt has been bought back, which companies are engaging in these transactions, how often, whether their debt buybacks track closely to trades in stock or derivatives markets – constitute questions for which *ex post* disclosure can help develop a more nuanced picture. To state the obvious, this data can be fuel for researchers (see above). But perhaps more immediately, it assists regulators with developing an idea about whether companies are behaving themselves. Regulators can more easily detect fraud, misleading statements and their impact on markets through greater, quicker and fuller transaction disclosure. Moreover, knowing that they will be disclosing information and becoming subject to market scrutiny might nudge companies towards sounder behavior. In the context of debt repurchases, this may push borrowers to consider offering a more optimal tender premium or seeking to remove covenants that are more optimally reflective of their enterprise condition. Obviously, this argument is speculative. However, the near negligible formal information transfers from borrowers to investors in debt repurchases heighten the costs involved in understanding market activity and monitoring misconduct.

Disclosure is not a panacea. Also, the regulatory regime governing equity buybacks is deficient in many respects. As Jesse Fried writes, the regime for prior notification can seem incredibly flimsy, with companies offering only generalized notices of their *possible* intent to do a buyback. *Ex post* disclosure can also be ineffective, owing to lengthy delays between concluding a repurchase and reporting it. He recommends shortening the *ex post* reporting regime to require disclosure within days,

[279] Levy & Shalev, *supra* note [160].

not months.[280] Perhaps most fundamentally, disclosure cannot fix the structural deficiencies that affect bondholders. Managers can time buybacks to most optimally divert value to themselves. Coordination and information sharing is difficult. Tenders can be coercive. Bondholders can be systematically out-gunned as a result. However, while limited in its efficacy, it can provide a first step that simply introduces a similar level of transparency to bond markets as exists in equity with the expectation that this transparency will be refined and enlarged in due course.

C. Exploring Discrete Fiduciary Protection

The structural imbalances between borrowers and investors revive the question of whether there ought to be greater fiduciary protection for bondholders. This constitutes a well-worn debate in legal scholarship and one whose full discussion is outside the scope of this Article. Importantly, there exist very good reasons for *not* imposing such a duty. As Brudney writes, bondholders and shareholder interests can often diverge, creating confusion and incoherence in corporate law. Crucially, the interests of bondholders are fundamentally at odds with the property-based paradigm underlying equity ownership relative to the time-limited, contractual nature of bond claims. Shareholders must look to fiduciary duties to guard themselves against managerial misfeasance. Bond investors, by contrast, deploy contract as their sword against agency costs.

For this reasons and others, a general fiduciary duty in favor of bondholders seems impractical. But it is worth asking whether a discrete duty may be imposed in the context of debt repurchases as a means of leveling the playing field and imposing affirmative obligations on managers to take bondholder interests more fully into account.

It is worth re-emphasizing that scholars have long resisted the incremental expansion of fiduciary protection into credit markets. Fred Tung, for example, has offered a persuasive argument for private contracting between shareholders and creditors as a more effective means to bargain around the various risks of opportunism. Particularly, given the sophisticated nature of bondholders, imposing fiduciary protections can represent an attempt at undue meddling into private bargains. While this faith in contracting has justified a resistance to fiduciary duties in some quarters, others note an increasingly troubled reality for creditors on the ground. Jared Elias and Robert Stark highlight a growing enthusiasm on

[280] Fried, *supra* note [71], 834-836 (recommending a 2-day reporting time requirement).

the part of debtors to deliberately extract value from creditors for the benefit of shareholders (and others) during periods of financial distress. Following the decision of the Delaware Supreme Court in *Gheewala*, curtailing the application of a fiduciary duty owed to creditors around insolvency, Elias and Stark point to unraveling of norms precluding debtors from seeking to hurt creditors whenever possible. Managers and shareholders, they argue, are now engaged in costly games of "bankruptcy hardball" with creditors, who seem ill-placed to protect themselves using the usual contractual bargains and the benefit of sophistication.[281]

This Article shows that contractual levers similarly fall flat in their ability to protect creditors in the context of a debt buyback, anchoring several rationales to ground a discrete fiduciary duty. First, bondholders risk losing their entire bargain with the borrower – and at the latter's discretion. This makes bondholder interests adverse to those of managers and shareholders that seek to buy out the debt and its covenants at the cheapest possible price and with fewest transaction costs to themselves. Secondly, it is not obvious that relying on contract alone in this context is even practicable, without investors having to spend heavily on information, coordination and lobbying. Dispersed bondholders already face high hurdles in organizing. Hedge fund activists offer some antidote to this difficulty, but it is far from a complete one. In debt buybacks and consent solicitations, bondholders face the added difficulty of tight deadlines – usually 20 business days – that create fierce urgency to contest the tender. Scholars have pointed to the coercive nature of solicitations. Added to limited information and inertia prompted by collective action costs, relying on simple contract for protection seems overly optimistic. Thirdly, the law has historically been willing to impose discrete fiduciary protections for creditors in certain cases. Where a debtor is in insolvency or commits fraud against a creditor, its fiduciary burden shifts towards those that have lent it capital.[282] With this precedent in mind, it is not a stretch to imagine that in similarly adversarial circumstances, where contractual protections are costly to enforce, offer a model for shaping a limited, bespoke fiduciary protection in favor of bondholders.

This idea is not problem-free. It forces borrowers to internalize compliance costs at a time when they may be struggling financially. Fuller disclosure may result in them paying more for the debt claims. The need to act in bondholder interests may limit their negotiating power in discussions surrounding the tender premium. From the standpoint of bondholders,

[281] *See generally*, Elias & Stark, *supra* note [75].

[282] But, the Delaware Supreme Court and the Delaware Court of Chancery have, in recent years, sharply revised and limited the bite of fiduciary protection owed by managers to creditors around insolvency. North American Catholic Education Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007); Quadrant Structured Products Co. v. Vertin, 2015 WL 2062115 (Del. Ch. May 4, 2015).

fiduciary protections may also lack real power. How should the standard be defined in the context of debt buybacks? What kinds of behaviors might trigger a breach of the duty? Can the wide latitude traditionally encapsulated within the concept of business judgment essentially inoculate managers against a bondholder claim?

While difficult and complex, these problems are not intractable and courts have long confronted demands to give substantive form to diffuse legal standards in corporate governance. Its goal, however, lies in offering a deeper and more structural fix to the inherent vulnerability of bondholders – representing an enormous constituency within capital markets – to systematic and costly under-protection of their interests.

VI. CONCLUSIONS

Debt buybacks constitute an ever-present yet understudied phenomenon in capital markets. With the expansion of corporate credit over the last decade, the urgency of unraveling their workings, the trade-offs and bargains underlying these transactions has become pressing. This Article takes a first step to do so, situating debt repurchases within the context of theories exploring the role and power of debt. While highlighting debt's significance, it shows how buybacks represent a potent tool in the hands of borrowers, capable of entirely re-writing the bargain between debtor and creditor. For bond markets, endemic information asymmetries and structural barriers to coordination systematically penalize bondholders. Traditionally protective tools like information sharing and fiduciary protections have long received short shrift in bond markets and, unsurprisingly, are lacking in the regulatory framework. To mitigate the harm to bondholders and level the playing field, this Article sets out initial pathways for reform, focusing on mandating more research, disclosure and discrete fiduciary protection for bondholders. In doing so, it recognizes the need for ongoing study of this phenomenon to more fully decode its meaning for capital allocation, investor welfare and the economy.