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Mandatory Class Action Lawsuits As a Restructuring Technique

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I. INTRODUCTION

Holders of public debt securities often face a dilemma when a troubled company presents them with a restructuring proposal seeking payment and other concessions. If the proposal is structured as an exchange offer, these bondholders must choose either to accept the terms of the new securities offered in the exchange or to "hold out" of the offer and suffer loss of payment priority, security and covenant protections through punitive "exit" amendments to the securities they hold. In the past several years, bondholders have responded to such exchange offers by organizing themselves and forming unofficial bondholder committees. By unifying a group of bondholders large enough to block such an exchange, bondholder committees have generally neutralized the coercive aspects of exchange offers by forcing issuers to negotiate and reach agreement with them before obtaining the needed financial relief.

However, this procedure has several weaknesses. First, unofficial bondholder committees have no official status or authority. It is often unclear (both to the committee and the issuer) how many bondholders such a committee actually represents and even less clear whether the bondholders it claims to represent will honor the committee's commitments. Thus, while unofficial committees provide a sounding board for bondholder concerns and a procedural mechanism for negotiating the terms of a restructuring, the mechanism is problematic: neither the committee nor the issuer can be entirely sure that the negotiations, even if successful, will yield an agreement that will be accepted by enough bondholders to consummate the exchange.[1] Moreover, even if enough bondholders are inclined to make the financial concessions necessary to provide the issuer with the overall relief it needs, the agreement may still fail because of bondholders' visceral unwillingness to allow their concessions to benefit opportunistic holdouts seeking to profit at the expense of the majority. In the past, unofficial committees have sought to solve the holdout problem by insisting that the issuer implement the restructuring through a "prepackaged" Chapter 11 plan of reorganization,[2] which, unlike an out-of-court exchange offer, binds *all* holders to a plan approved by holders representing sixty-six and two-thirds percent in amount of claims and fifty percent in number of creditors in any class of creditors.[3]

In this article, we suggest that, in certain cases, the filing of a federal class action lawsuit by bondholders and the effectuation of a consensual restructuring through the settlement of the action may provide substantial benefits over the prepackaged plan approach described above. Under the class action approach, representatives of the bondholders would file a lawsuit against the issuer of the bonds following a payment or other default, or in response to a restructuring proposal made by the issuer. Such representatives would then seek to have the lawsuit certified by the court as a mandatory class action—that is, an action binding upon all members of the class, with no right to opt out. These representatives, who would then officially represent the entire class of bondholders in the certified class action, would negotiate a settlement of the lawsuit that provides for a restructuring of the securities. The restructuring settlement, once approved by the court after a fairness hearing, would bind all members of the bondholder class.

While mandatory class action lawsuits have been used rarely in recent years to effectuate binding corporate restructurings,[4] we believe

1. For example, in its October 4, 1990 exchange offers, The Southland Corporation failed to obtain the requisite acceptance levels from four out of six issues of securities even though the terms of the exchange had been agreed to by the informal committees. *See* Memorandum Opinion Invalidating Acceptance of Pre-Packaged Plan of Reorganization at 17, In re Southland Corp., No. 390-37119-HCA-11 (Bankr. N.D. Tex. 1990).

2. In *Southland*, it was the bondholder steering committee—not the issuer—that "suggested a prepackaged plan of reorganization as one way to insure participation by an acceptably high percentage of holders." *See* Memorandum of The Southland Corporation (1) In Support of Confirmation of its Prepackaged Plan of Reorganization and (2) In Response to Objections to Confirmation at 15, *In re* Southland Corp., No. 390-37119-HCA-11 (Bankr. N.D. Tex. Dec. 7, 1990).

3. *See* 11 U.S.C. § 1126(c) (1988) (the "Bankruptcy Code").

4. *See* MBank Dallas v. LaBarge, Inc., No. 86 C 9583 (N.D. Ill. December 29, 1986) (unpublished findings of fact, conclusions of law and final order) and Kemper Investors Life Ins. Co. v. Las Colinas Corp., No. 88 C 9162 (N.D. Ill. July 21, 1989) (unpublished final order). *See also infra* Sections II(A) and IV(B), which discuss the *LaBarge* and *Colinas* cases. In *Las Colinas*, the issuer was able to avoid filing a prepackaged

that this approach has a number of advantages over the prepackaged plan approach. First, the issuer and the representatives of a certified class action can negotiate the terms of a restructuring with the assurance that the class representatives officially represent the class and have the ability to propose a settlement that, when approved by the court after a fairness hearing, will bind all members of the bondholder class. Second, the restructuring can occur without resort to Chapter 11 of the Bankruptcy Code, which may impose significant costs and may present unacceptable risks for both the bondholders and the issuer.

Indeed, the filing for relief under Chapter 11, even briefly to effectuate a prepackaged plan, may damage an issuer's business and reputation and jeopardize its supplier and vendor relationships. Moreover, the filing of a Chapter 11 petition invites to the table another party—a bankruptcy judge vested with extraordinary powers under the Bankruptcy Code and with an agenda that sometimes favors the interests of third parties over the interests of creditholders and shareholders.[5] As the bondholders in the *Eastern Airlines*, *LTV* and numerous other Chapter 11 cases have learned,[6] and as recent scholarship has demonstrated, restructuring under Chapter 11 can be be costly for bondholders.[7] Since the authority of a federal court to approve a class action settlement under Rule 23 is limited to consid-

plan of reorganization under Chapter 11 through the settlement of a mandatory class action lawsuit initiated by one of the bondholders. *Las Colinas*, No. 88 C 9162, at 1.

5. In the Chapter 11 case of *Eastern Airlines*, 134 B.R. 528 (S.D.N.Y. 1991) (memorandum decision), Judge Lifland "expressed strong feelings that, given the nature of Eastern's business, *it shouldn't just look to the preference of creditors but also to the public interest, which is to give consumers a choice of airlines.*" WALL ST. J., Dec. 6, 1990, at C1 (emphasis added). For a criticism of the *Eastern Airlines* case, see Aaron Bernstein et al., *Eastern: On the Wings of Greed*, BUS. WK., Nov. 11, 1991, at 34 (noting that "Early in the bankruptcy, the judge said that getting Eastern flying again was in the 'public interest' and outweighed the 'parochial' concerns of other parties.").

6. *See* Aaron Bernstein et al., *Eastern: On the Wings of Greed*, BUS. WK., Nov. 11, 1991, at 34 (stating that "While this last-gasp step [Chapter 7 liquidation] might help a little, it probably won't prevent Eastern from ending up as one of the few large bankruptcies in history that won't even have enough money left to pay off the lawyers. If that happens, unsecured creditors won't get a penny of the $2.2 billion they're owed."). *See also* WALL ST. J., April 16, 1991, at C1 (stating that "LTV Corp. said it expects to file its first reorganization plan by May 6, setting the stage for negotiations that will allow the company to emerge from bankruptcy court protection."). LTV filed for protection under Chapter 11 on July 16, 1986. The market price of LTV's 15% Senior Notes, which traded at $93 just prior to the bankruptcy filing, have not paid interest for five years and traded at between $12 5/8 and $17 3/8 in 1992. STANDARD & POOR'S BOND GUIDE 113 (May 1992).

7. *See* Michael Bradley & Michael Rosenzwieg, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1049 (1992) ("In sum, our empirical results indicate that both

eration of the specific action before it, we believe that a federal court is more likely to effectuate the agreement between the bondholders and the issuer than is a bankruptcy court under Chapter 11.

Finally, a restructuring implemented through settlement of a class action lawsuit may be accomplished without registration with the Securities and Exchange Commission through use of the exemption provided by Section 3(a)(10) of the Securities Act of 1933,[8] which provides an exemption for the issuance of securities whose terms and conditions have been approved by a court after a fairness hearing.[9] This may be a significant advantage to bondholders. One commentator has stated: "The registration process is time-consuming, particularly in the context of a troubled situation. In that environment, time is frequently a matter of great concern, but the nature of a troubled enterprise is such that the SEC staff is, understandably, likely to require a detailed review which extends the duration of the process."[10]

In a restructuring, investors are directly harmed by delays caused by SEC review and bankruptcy proceedings. New investors are particularly wary of purchasing distressed securities where there is a possibility of significant delays in the completion of the restructuring.[11] The uncertainty regarding the outcome and timing of a restructuring generally causes securities to trade at depressed levels, severely impairing the liquidity of the investment. Since the parties to a class action determine, to a large extent, the terms and timing of the settlement and need only federal court approval of the settlement,[12] the mandatory class action approach should offer bondholders timing advantages over the prepackaged plan approach, which

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stockholders and bondholders of bankrupt firms suffer dramatically greater losses under the 1978 Act than previously.").

8. Securities Act of 1933, § 3(a)(10), 15 U.S.C. § 77c(a)(10) (1988). However, if debt securities are issued in a class action settlement that is exempt from Securities Act registration because of the Section 3(a)(10) exemption, the indenture governing such securities must be qualified with the SEC under the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb (1988). *See infra* Section VI.

9. 15 U.S.C. § 77c(a)(10) (1988).

10. Simon M. Lorne, *Securities and Securities Law Issues in Troubled Debt Situations in High-Yield Bonds, Leveraged Buyouts, and Troubled Debt Financing*, 619, 630-31 (1989).

11. *See, e.g.*, Martin D. Sass, *Distressed Opportunities Plentiful in the 90's*, PENSIONS & INVESTMENTS, March 5, 1990, at 1 (explaining that, "For example, after a mechanical evaluation, a distressed security might appear to have a gross return of 40%. But a review of the dynamics might reveal it will take two years for the return to be realized, thus significantly reducing the annualized return.")

12. Restructurings accomplished through the settlement of mandatory class action lawsuits have been completed very quickly. *See* MBank Dallas v. LaBarge, Inc., No. 86 C 9583 (N.D. Ill. December 29, 1986) (unpublished findings of fact, conclusions of law and final order) (22 days from filing of complaint to entry of final settlement order).

generally requires both preapproval by the SEC and subsequent plan confirmation by a bankruptcy court.

II. Comparison of the Mandatory Class Action Approach to the Prepackaged Plan Approach

A. *Description of the Mandatory Class Action Approach*

1. Background

During the early part of this century, many railroads and other interstate corporations were fully reorganized in the federal courts of the United States through the use of equity receiverships without any resort to the federal bankruptcy laws. In many such reorganizations, federal courts used their inherent equitable powers to effectuate reorganizations that were binding upon nonassenting bondholders.[13]

The equitable remedy that served as the basis for such equitable reorganizations—the bill of peace—also served as the basis for the adoption, in 1938, of the predecessor provisions to the current Rule 23 of the Federal Rules of Civil Procedure that provide for mandatory class action lawsuits.[14] The Supreme Court has stated: "The class suit was an invention of equity to enable it to proceed to a decree in suits where the number of those interested in the subject of the litigation is so great that their joinder as parties in conformity to the usual rules of procedure is impracticable."[15]

The class action lawsuit is a particularly appropriate procedural vehicle for bondholder action. Because the rights of bondholders of a particular issue are defined by a single instrument and governed by the same laws, and because bondholders may be so numerous as to make it impracticable to join them all in a traditional proceeding, the class action suit has been used on many occasions, both prior to and following the promulgation of Rule 23, as a procedure for resolving conflicts between bondholders and issuers.[16]

13. *See infra* Section IV(C).

14. Arthur R. Miller & David Crump, *Jurisdiction and Choice of Law in Multistate Class Actions After* Phillips Petroleum Co. v. Shutts, 96 YALE L.J. 1, 39 (1986) (stating that "Mandatory classes find historical precedent in the equitable bill of peace").

15. Hansberry v. Lee, 311 U.S. 32, 41 (1940).

16. *See infra* Section III(A).

2. Mandatory Class Actions by Bondholders

Class actions by bondholders seeking to implement a restructuring of their debt securities are generally categorized as actions under Rule 23(b)(1) or (b)(2)—the Rule 23 class action classifications that provide for certifications of mandatory classes with no right to opt out.[17] Bondholders seeking to use a Rule 23 class action lawsuit as a restructuring technique may commence the class action at various times in the restructuring process. In *Continental Assurance Co. v. MacLeod-Stedman, Inc.*[18] and in *MBank Dallas v. LaBarge, Inc.*,[19] the bondholder representatives filed the class action lawsuits after reaching an agreement with the issuer and before any public offer from the issuer[20]—therefore permitting the issuer to avoid the delay and expense of filing a registration statement with the SEC. On the other hand, in *Las Colinas*, one of the bondholders filed the class action complaint shortly after the filing with the SEC of a registration statement for a registered exchange offer and prepackaged plan solicitation.[21] Although the issuer proceeded with the exchange offer and the prepackaged plan solicitation, the issuer eventually relied upon the settlement of the mandatory class action as a procedure for making the exchange offer binding upon all bondholders without the use of the prepackaged plan under Chapter 11.[22]

After the filing of a Rule 23 class action lawsuit, Rule 23(c)(1) requires the court to hold a hearing to determine whether the class action may be maintained. Among issues typically considered at such hearings are the adequacy of representative plaintiffs to represent the interests of the class, the scope and definition of the plaintiff class and the nature of any notice that will be required to be given.[23]

In addition, Rule 23(c)(4) provides that, when appropriate, a class may be divided into subclasses and each subclass treated as a class.[24] Such subclasses would be particularly appropriate in a restructuring which includes several different issues of debt or other securities of a single issuer. While there is benefit in having all of the claims resolved in a single proceeding, the different issues of securities may

17. *See infra* Sections III(C), (D) and (E).

18. 694 F. Supp. 449 (N.D. Ill. 1988).

19. No. 86 C 9583 (N.D. Ill. December 29, 1986) (unpublished findings of fact, conclusions of law and final order).

20. *Id.* at 6 (the terms of the tentative settlement were described in a term sheet attached to the complaint); *see also* 694 F. Supp. at 453-54.

21. Las Colinas Corporation filed its Registration Statement on Form S-4 (No. 33-24488) with the SEC on October 4, 1988. The class action lawsuit was filed on October 27, 1988. *See* Kemper Investors Life Ins. Co. v. Las Colinas Corp., No. 88 C 9162 (N.D. Ill. 1988) (complaint).

22. *See Las Colinas*, No. 88 C 9162 (N.D. Ill. July 21, 1989) (unpublished final order).

23. *See infra* Section III(A).

24. FED. R. CIV. PROC. 23(c)(4).

have different contractual rights that will require separate class representatives and different settlements. The settlement of the class action will incorporate the terms of the restructuring. In *Continental Assurance*, for example, the settlement agreement provided for the issuance of $18 million of increasing rate Restructure Notes and $12 million of exchangeable preferred stock in exchange for the existing $30 million of mortgage notes.[25] In *Las Colinas*, the settlement agreement provided for the receipt, at the holder's option, of either new "Adjustable Rate Conduit Mortgage 'Pass Through' Certificates" or cash (at a discount to principal) in exchange for the issuer's outstanding twelve and a half percent First Mortgage Notes.[26]

Rule 23(e) requires court approval for all compromises of Rule 23 class action lawsuits,[27] and Section 3(a)(10) requires that the court conduct a fairness hearing in order to provide for the Section 3(a)(10) exemption from SEC registration.[28]

3. Dissident Strategy: The Threat of an Involuntary Petition

As discussed above, in an out-of-court restructuring, bondholders often have a significant financial incentive to try to hold out of the issuer's offer. A successful holdout retains its bonds with their original payment terms. Moreover, the holdout's prospects for payment may have been enhanced by the financial concessions made by the other bondholders who participated in the restructuring. On the other hand, since the settlement of a mandatory class action lawsuit binds all class members, there are fewer incentives for such dissident strategies in restructurings effected through mandatory class action lawsuits.

Nevertheless, holders who oppose the class action settlement have several options. First, they may appear at the fairness hearing, express their views and attempt to derail the settlement, and they may appeal the settlement order. Second, they may file an involuntary petition against the issuer under Chapter 11.[29] However, only in rare

25. 694 F. Supp. at 455.

26. *Las Colinas Corp.*, No. 88 C 9162, at 3-6 (N.D. Ill. June 6, 1989)(Exhibit A to Order Approving Notice).

27. FED. R. CIV. PROC. 23(e).

28. 15 U.S.C. § 77c(a)(10) (1988).

29. Under Section 303(b)(1) of the Bankruptcy Code, an involuntary petition may be filed by three or more entities with aggregate bona fide claims in excess of $5,000 more than the value of any lien. 11 U.S.C. § 303(b)(1) (1988). Under Section 303(e), the petitioners may be required to indemnify the debtor for its expenses if the petition is later dismissed under Section 303(i), and they may be required to pay punitive dam-

situations would the filing of an involuntary Chapter 11 petition constitute rational wealth maximization for a particular bondholder.[30] Since a bondholder's prospects under a traditional Chapter 11 case will in all likelihood be worse than its prospects in a consensual restructuring effectuated through settlement of the class action, bondholders are less likely to pursue this dissident strategy.

B. Class Representatives and Unofficial Committees

One experienced observer noted that most restructurings of public debt securities now "involve a process of negotiation."[31] In order to effectively participate in and protect their rights in such negotiations, holders of bonds of a troubled issuer will often attempt to form an unofficial bondholders committee in anticipation of or in response to an issuer's restructuring proposal.[32] Such committees may adopt bylaws and other procedures and hire financial advisors and legal counsel. In some cases, the issuer will agree to indemnify and pay the expenses of these advisors.[33]

Although unofficial committees can be useful in arriving at a fair, negotiated restructuring plan with the issuer, these committees have significant limitations. Unlike a traditional proceeding under Chapter 11, where the United States Trustee selects an official creditors committee,[34] an unofficial committee in an out-of-court restructuring has no such official sanction. It represents only those bondholders who agree to be represented, and even then, there is no legal mechanism for holding these bondholders to positions taken or agreements made by the committee. Moreover, the unofficial committee does not represent bondholders who choose not to be represented, and a re-

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ages if the petition is dismissed because it was filed in bad faith. 11 U.S.C. § 303(e) (1988).

30. Among other things, the direct costs of bankruptcy reorganization are significantly greater than the direct costs of consensual debt restructuring. *Compare* Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 291 (1990) (mean direct costs of bankruptcy measured at 2.8% of the book value of assets) *with* Stuart Gilson, Kose John & Larry H.P. Lang, *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 337 (1990) (mean direct costs of a private debt restructuring measured at .65% of book value of assets). In addition, bondholders fare poorly in Chapter 11 reorganizations in comparison to corporate managers, bankruptcy lawyers and financial advisors. *See* Bradley & Rosenzwieg, *supra* note 7, at 1072 (losses suffered by bondholders of issuers who filed for protection under the 1978 Bankruptcy Act are more than 28 percentage points greater than the losses suffered by bondholders prior to the adoption of such Act).

31. Nicholas P. Saggese, et al., *A Practioner's Guide to Exchange Offers and Consent Solicitations*, 24 LOY. L.A. L. REV. 527, 541 (1991).

32. Allen L. Weingarten, *Consensual Non-Bankruptcy Restructuring of Public Debt Securities*, 23 SEC. & COMMODITIES REG. 159, 160 (1990).

33. *Id.*

34. 11 U.S.C. § 1102(a)(1)(1988).

structuring agreed to by a committee representing a majority of bondholders may be attacked, in some cases successfully, by dissident bondholders.[35] In negotiating with an unofficial committee, therefore, an issuer has no assurance that the committee can deliver the participation of the bondholders it claims to represent, let alone protect the negotiation against future attacks by bondholders that it does not represent.

The class action approach provides a more satisfactory framework for negotiating a debt restructuring. Once a class action is certified under Rule 23(c)(1), the issuer can negotiate with the class representatives with the assurance that they represent and speak for the entire class and that the settlement, when approved, binds all class members.

C. *The Holdout Problem in Public Debt Restructurings*

1. The Plague of Section 316(b) of the Trust Indenture Act

Holders and issuers of public debt securities continue to be plagued by Section 316(b) of the Trust Indenture Act,[36] which restricts the freedom of an issuer and its bondholders to agree to a majority action provision by limiting the ability of issuers to amend fundamental payment terms of public debt securities without the consent of *each* affected bondholder.[37] Because it is often impossible to obtain unani-

35. For example, in the Chapter 11 case of *In re Southland Corporation*, a group of minority investors, dissatisfied with the voting process and with the representation provided by the unofficial committee which had negotiated with and agreed to a "prepackaged" restructuring plan with Southland, filed objections to the prepackaged plan after the filing of the Chapter 11 petition. *See* Unofficial Committee of Debenture Holders' Objection to Confirmation of Debtor's Plan and the Adequacy of Disclosure and Solicitation, dated November 20, 1990, and the Objection of Certain Preferred Stockholders to Confirmation of Plan of Reorganization, dated November 21, 1990, *In re* Southland Corp., No. 390-37119-HCA-11 (Bankr. N.D. Tex. Nov. 1990). Largely on the basis of the objections filed by the dissident security holders, Judge Abramson invalidated the solicitation and ordered a resolicitation. *In re Southland Corp.*, 124 B.R. 211, 227 (N.D. Tex. 1991).

36. 15 U.S.C. § 77ppp(b) (1988).

37. It is evident from a review of the statements and writings of the architects of the Trust Indenture Act that they not only recognized that Section 316(b) would frustrate the ability of issuers to adjust their debt outside of bankruptcy, but that they actually favored the supervision of debt reorganizations by federal judges. *See* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 234, 250-52 (1987) (asserting that "Douglas and his colleagues at the SEC were not only aware that requiring near unanimity would help induce bankruptcy, they welcomed the prospect. They were convinced that insider machinations would damage bondholders and that the only cure was a bankruptcy proceeding in which the judge scrutinized the recapitalization").

mous consent to payment concessions from a body of diverse and dispersed bondholders, financially troubled issuers in the past have used exchange offers to restructure their debt without resort to bankruptcy. By offering to issue new debt securities with needed payment modifications in exchange for the old debt securities (and often soliciting "exit" amendments that deprive the old debt securities of priority and covenant protections), a number of issuers have succeeded in restructuring their public debt.[38]

Exchange offers, however, suffer a serious defect. A bondholder who can successfully "hold out" of an exchange offer by a troubled issuer often stands to reap a windfall at the expense of bondholders who tender in the exchange. The successful holdout, who has made no financial concessions, retains a bond with original payment terms whose prospects for payment, even after the loss or modification of financial covenants, may have improved because of the financial concessions made by bondholders who exchange. The exchange offer, in effect, results in a transfer of value from exchanging to nonexchanging bondholders.

Even more important than the financial windfall conferred upon holdouts, however, is the vulnerability of exchange offers to opportunistic behavior by minority holders. An exchange offer seeking significant financial concessions will typically be conditioned upon a high level of acceptance, usually eighty-five to ninety-five percent. While a financially troubled issuer often needs substantial participation in the exchange in order to obtain the overall financial relief it seeks, the primary impetus for such high acceptance levels comes directly from the bondholders, who will object to the windfall conferred upon fellow bondholders that refuse to participate.[39] As a result of such acceptance levels, a holder or group of holders who own or control just five to fifteen percent of an issue of securities can effectively hold up an entire exchange offer. If the restructuring involves concurrent exchange offers for multiple issues of debt securities, each offer conditioned upon the others, an effective blocking position may consist of securities representing only a small fraction

38. Since 1985, there have been over 100 exchange offers for high-yield securities that were characterized as "distressed"—that is, exchanges in which holders receive a lower coupon or less than their original principal amount. *See* THE FIRST BOSTON CORP. HIGH YIELD HANDBOOK 34 (Jan. 1990); THE FIRST BOSTON CORP. HIGH YIELD HANDBOOK 17 (Jan. 1991).

39. In *Southland*, it was the bondholder steering committee—not the issuer—that insisted upon a nonwaiveable 95% tender condition and "suggested a prepackaged plan of reorganization as one way to insure participation by an acceptably high percentage of holders." *See* Memorandum of The Southland Corporation (1) In Support of Confirmation of its Prepackaged Plan of Reorganization and (2) In Response to Objections to Confirmation at 25, *In re* Southland Corp., No. 390-37119-HCA-11 (Bankr. N.D. Tex. Dec. 7, 1990).

of the company's capitalization—yet powerful enough to jeopardize a restructuring proposal acceptable to the overwhelming majority of securityholders.[40]

2. Prepackaged Bankruptcies as a Solution to the Holdout Problem

In order to solve the holdout problem, a number of issuers have proposed "prepackaged" plans of reorganization under Chapter 11, either as alternatives to out-of-court exchange offers[41] or as "straight" plans.[42] In a "prepackaged" bankruptcy, an issuer obtains the acceptance of its creditors to a plan of reorganization before it files for relief under Chapter 11 of the Bankruptcy Code. The principal advantage of a prepackaged bankruptcy is that it enables issuers to make use of rules under Chapter 11 that eliminate the "holdout" problem and that foster negotiated restructurings, without incurring the disruption and the costs of a traditional Chapter 11 proceeding. Under Section 1126(c) of the Bankruptcy Code, a plan of reorganization that impairs the claims of *all* holders of a class of claims requires

40. Even though Southland obtained the minimum 95% tender levels for four out of its six issues of debt securities and preferred stock, it had to resort to Chapter 11 bankruptcy because it obtained the acceptances of only 91% of the holders of its junior subordinated debentures and only 82% of the holders of its subordinated debentures. *See In re* Southland Corp., 124 B.R. 211, 219 (N.D. Tex. 1991).

41. In addition to Southland, combined exchange offer/prepackaged plans have included: Sunshine Mining Co.; Sunshine Precious Metals, Inc., Preliminary Prospectus (May 22, 1991) (SEC File No. 33-40783); Munsingwear, Inc., Preliminary Prospectus (January 17, 1991) (SEC File No. 33-38565); Price Communications Corp., Preliminary Prospectus (October 4, 1990) (SEC File No. 33-37190); Westmark Sys., Inc., Tracor Aviation, Inc. and TDH, Inc., Preliminary Prospectus (August 27, 1990) (SEC File No. 33-36576) (prepackaged solicitation failed; issuer filed for Chapter 11); Interco Inc., Preliminary Prospectus, (May 17, 1990) (SEC File No. 33-34965); NBI, Inc., Preliminary Prospectus (May 11, 1990) (SEC File No. 33-34861); Republic Health Corp., Prospectus (November 13, 1989) (SEC File No. 33-19544) (filed prepackaged plan in December 1989 and emerged on May 11, 1990); Las Colinas Corp., Prospectus, (May 23, 1989) (SEC File No. 33-24488).

42. In the straight prepackaged Chapter 11 case of JPS Textile Group, Inc., the issuer restructured approximately $600 million of debt, classified in five classes, through a plan that was confirmed on March 21, 1991, just 40 days after it filed its Chapter 11 petition. John J. Huber, Bryant B. Edwards & Jeffrey C. Soza, *Restructuring High-Yield Securities Through Prepackaged Bankruptcies*, INSIGHTS, May 1991, at 3. *See also* Charter Medical Corp., Prospectus (April 24, 1992) (straight prepackaged plan of reorganization); Intermark, Inc., Preliminary Prospectus (March 31, 1992) (SEC File No. 33-46885) (straight prepackaged Chapter 11 plan of reorganization; Memorex Telex N.V. and Memorex Telex Corp., Prospectus (November 21, 1991) (straight prepackaged plan of reorganization); MB Holdings, Inc., Disclosure Statement (Oct. 16, 1991) (straight prepackaged plan of reorganization); Trump Taj Mahal, Disclosure Statement (June 5, 1990); Vyquest, Disclosure Statement (August 8, 1989).

acceptance by only two-thirds in amount and a majority in number of the claims of the class that vote on the plan.[43]

3. Mandatory Class Action Lawsuits as a Solution to the Holdout Problem

Class action lawsuits brought by a class of bondholders for the purpose of effectuating a restructuring should normally be categorized under either Rule 23(b)(1) or Rule 23(b)(2) of the Federal Rules of Civil Procedure. As such, the outcome will be binding upon all members of the class without any right on the part of individual class members to opt out.[44] A restructuring effected through the settlement of such a class action, including a restructuring that impairs the principal or interest or other payment terms of debt securities, will bind all members of a class of bondholders. This ability to bind nonassenting bondholders to a settlement arises out of the fundamental equitable powers of a federal court and is not affected by contractual provisions to the contrary, including provisions required by Section 316(b) of the Trust Indenture Act.[45] In addition, such a settlement is not affected by the contract impairment clause of the United States Constitution, which restricts state but not federal action. Furthermore, if the settlement satisfies the procedural requirements of Rule 23, it should also satisfy the due process clause of the Constitution.[46]

D. Risks of Prepackaged Plans

The filing of a petition for relief under Chapter 11, even pursuant to a prepackaged plan, is a heavy-handed solution to the holdout problem that presents a number of risks. In determining whether to insist upon a prepackaged plan as a solution to the holdout problem, bondholders should determine whether the mandatory class action approach is not a kinder, gentler alternative with fewer negative effects on the underlying business of the issuer.

1. Effects on Business and Trade Credit

In a service or consumer products business, a bankruptcy—including a prepackaged bankruptcy—can diminish consumer confidence, reducing revenues and affecting the core business. Even short bankruptcies divert management's attention and, because of the need to apply for court approval of many decisions,[47] impair management's

43. 11 U.S.C. § 1126(c) (1988).

44. *See infra* Section III.

45. *See infra* Sections IV(A) and (B).

46. *See infra* Section IV(D).

47. For example, Section 363 of the Bankruptcy Code requires the debtor to obtain court approval to use, sell or lease property of the estate other than in the ordinary course of business. 11 U.S.C. § 363 (1988). Section 364 of the Bankruptcy Code re-

ability to take advantage of business opportunities and to respond to competitive threats.

Once a petition under Chapter 11 is filed, the debtor is generally prohibited from paying claims that arose prior to the filing of the petition until the consummation of the plan of reorganization.[48] As a result, even if the issuer proposes a prepackaged plan that does not impair trade credit, parties that supply goods or services on credit may tighten their credit terms, or stop shipments of goods or the provision of services, in anticipation of the automatic deferral of such payments upon a Chapter 11 filing.[49]

In contrast, while resolution of a mandatory class action may divert management's attention, it is less likely to be viewed by the public as a threat to the issuer's survival and may have a more benign effect on the issuer's business. Moreover, because the mandatory class action approach does not involve an automatic cessation of payment of prepetition debt, it is less threatening to trade creditors and other suppliers of goods and services.

2. Restrictions on Use of Professionals

In a Chapter 11 proceeding, the employment and compensation of financial advisors is governed by sections 327, 328, 330 and 1103 of the Bankruptcy Code. Among other things, these provisions permit a bankruptcy judge to determine whether the proposed compensation is "reasonable" based upon the "nature, the extent, and the value of such services, the time spent on such services and the cost of compa-

quires the debtor to obtain court approval in order to obtain credit, other than unsecured credit incurred in the normal course of business. 11 U.S.C. §§ 364(a)-(e) (1988). Also, the bankruptcy court must generally approve payments to the debtor's attorneys and advisors under Sections 327 through 330 of the Bankruptcy Code. 11 U.S.C. §§ 327-330 (1988).

48. 11 U.S.C. § 362(a)(6) (1988). *See, e.g.,* Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987), *cert. denied,* 485 U.S. 962 (1988); *In re* FCX, Inc., 60 B.R. 405, 410 (E.D.N.C. 1986).

49. Southland, which had extensive trade credit, managed its trade credit problem by (a) proposing a plan that did not impair its existing trade credit and (b) obtaining a court order upon filing a petition that permitted Southland to continue to pay trade credit in the normal course of business, including credit extended prior to the filing of the petition. *See* Emergency Order Granting and Modifying Authorization to Pay Prepetition Claims of Trade Creditors Who Consent to Continue to Reinstate Customary Trade Terms, *In re* Southland Corp., No. 390-37119-HCA-11 (Bankr. N.D. Tex. October 24, 1990). As a result of these actions, Southland avoided having to identify and solicit the acceptances of its trade creditors, and it was able generally to maintain its trade credit on existing terms. Southland's approach, however, depended upon its ability to obtain a court order permitting payment of prepetition trade credit; such relief may not be obtainable in all cases.

rable services . . . ."[50] However, these sections, by their terms, do not govern arrangements entered into, and services performed, *prior* to the commencement of a Chapter 11 case because all these sections contemplate employment of professionals "with the court's approval."[51] This was not an oversight. Section 329 of the Bankruptcy Code specifically provides for ex post facto review of compensation paid or agreed to be paid to a debtor's *attorney* within "one year before the date of the filing of the petition."[52] Even though compensation of financial advisors is addressed and governed by the sections mentioned above, there is a conspicuous absence in the Bankruptcy Code of a provision comparable to Section 329 that provides for review of prepetition services performed by financial advisors.

Nevertheless, bankruptcy courts have strongly challenged debtors' obligations to honor prepetition commitments to financial advisors and have even been willing to dishonor previously approved fee arrangements.[53] As a result of this and other restrictions on the payment of investment professionals in Chapter 11 cases, many investment banking firms have questioned their continued interest in Chapter 11 cases.[54]

These restrictions, which could limit the ability of the bondholders and the issuer to employ the most talented investment banking pro-

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50. 11 U.S.C. § 330(a) (1988).

51. Section 327(a) of the Bankruptcy Code provides that the trustee, "with the court's approval," may employ professionals "that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties . . . ." 11 U.S.C. § 327(a) (1988). Similarly, Section 1103(a) provides that a creditors' committee, "with the court's approval," may employ professionals. 11 U.S.C. § 1103(a) (1988). Section 328(a) provides that a trustee or a creditors' committee, "with the court's approval," may employ professionals on "any reasonable terms and conditions" and may later change such terms and conditions if they have proved "improvident" in light of later developments. 11 U.S.C. § 328(a) (1988). Finally, Section 330(a) provides for payment of "reasonable compensation" to professionals employed under Sections 327 or 1103. 11 U.S.C. § 330(a) (1988).

52. 11 U.S.C. § 329 (1988).

53. *See, e.g.,* Michele Galen & Tim Smart, *Legal Affairs*, BUS. WK., Sept. 30, 1991, at 60 (noting that the court in the *Gillett Holdings* Chapter 11 case rejected the debtor's preexisting agreement to pay financial advisors a success fee upon successful completion of the case). For a particularly egregious example of the willingness of bankruptcy courts to dishonor previously agreed and approved fee arrangements for investment bankers, see *In re* Gillett Holdings, Inc., 137 B.R. 475 (D. Colo. 1992) (court slashed the fees of the financial advisor for the applicable period from $800,000 to $298,343—a reduction of $501,343, or almost 63% of the amount agreed to by the debtor and approved in an earlier order by the court).

54. *See, e.g.,* Barbara Franklin, *Accounting Angst; Controversy Around New Bankruptcy Fee Rules*, 206 N.Y.L.J. 5 (1991) (reporting that, as a result of new fee reimbursement guidelines adopted in the Southern District of New York for Chapter 11 cases, Norman Brown, a managing director for Donaldson, Lufkin & Jenrette, stated: "Every firm involved in this business is going to have to reconsider whether they continue in the business and how they do it").

fessionals, would not apply to a restructuring accomplished through a class action settlement.

3. Risk of Resolicitation and Loss of Control

One of the principal advantages of prepackaged plans over traditional reorganization proceedings is that they permit corporate managers to stay in control of the reorganization process. In a prepackaged plan, a corporation does not submit to the jurisdiction of a bankruptcy court until negotiations with creditors have been completed and all necessary creditor approvals to the plan have been obtained. In theory, once a prepackaged plan of reorganization is filed, there is little to do but confirm and consummate the plan.

In practice, however, it appears that there are substantial risks that a prepackaged plan may run into legal difficulties after a Chapter 11 petition has been filed. One commentator stated:

> Because much of the work in a prepackaged bankruptcy case is done prior to the Chapter 11 filing and outside the purview and control of the bankruptcy court, there is significantly less certainty than in a traditional Chapter 11 as to how the court will deal with critical legal issues that may arise in the case.[55]

In *Southland*, for example, the issuer filed its petition for reorganization on October 24, 1990, after it believed that it had received sufficient acceptances of the plan to obtain confirmation of the plan by the bankruptcy court.[56] Once Southland submitted itself to jurisdiction of the bankruptcy court, a number of dissident security holders filed objections challenging the adequacy of a number of disclosures in the prospectus and challenging Southland's procedure for counting votes for purposes of the numerosity requirement—*i.e.*, the requirement that a plan of reorganization be approved by fifty percent of the holders of claims of each class.[57] In addition, the SEC, which had made over 400 comments to Southland's registration statement before it was declared effective, filed an objection to provisions of the plan which attempted to release, pursuant to Section 524 of the

55. Alesia Ranney-Marinelli, et al., *Prepackaged Plans of Reorganization*, *in* A PRACTICAL GUIDE TO OUT-OF-COURT RESTRUCTURINGS AND PREPACKAGED PLANS OF REORGANIZATION 4-1, 4-55 (Nicholas P. Saggese & Alesia Ranney-Marinelli eds., 1991).

56. *In re* Southland Corp., 124 B.R. at 219.

57. *See generally* Unofficial Committee of Debenture Holders' Objection to Confirmation of Debtor's Plan and the Adequacy of Disclosure and Solicitation, dated November 20, 1990, and the Objection of Certain Preferred Shareholders to Confirmation of Plan of Reorganization, dated November 21, 1990, *In re* Southland Corp., No. 390-37119-HCA-11 (Bankr. N.D. Tex. 1990).

Bankruptcy Code, certain nondebtor third parties.[58]

As a result of the objections, the bankruptcy court invalidated the original solicitation and ordered Southland to resolicit votes for Southland's plan of reorganization from all holders of claims and interests, including those that were beneficial owners as of December 13, 1990, some seven weeks after the completion of the original solicitation.[59] A number of substantive economic changes were made to the plan prior to the resolicitation, including the percentage of equity retained by the former owners, the provisions for release of claims, and alternative security packages for certain classes of creditors.[60] The revised plan was eventually approved by the necessary classes of creditors and was confirmed by Judge Abramson on February 21, 1991, 120 days after the original Chapter 11 petition was filed.[61]

While Southland eventually succeeded in confirming a plan substantially similar to the original plan, Southland's difficulties illustrate some of the risks inherent in using Chapter 11 of the Bankruptcy Code. Judge Abramson himself stated that the provisions of Section 1126(b) "amount to a form of 'Russian Roulette' for the proponent of a prepetition plan."[62] Once a debtor has filed a plan and submitted to the jurisdiction of a bankruptcy court, a number of events might occur that could derail the prepackaged plan process.

For example, there is considerable doubt about what law constitutes "applicable nonbankruptcy law" for purposes of Section 1126(b) of the Bankruptcy Code.[63] If the law or regulation under which the plan acceptance was solicited is determined by the bankruptcy judge *not* to constitute applicable nonbankruptcy law, the judge must then consider whether it was solicited after disclosure of "adequate information."[64] Because the definition of "adequate information" is vague and subjective, an inquiry into the adequacy of disclosure at the plan confirmation stage is fraught with the danger that a bankruptcy court may second-guess the disclosure in an issuer's solicitation documents and invalidate a plan already approved by the creditors. Simi-

58. *See generally* Objection of the SEC to Confirmation of Debtors' Plan, *In re* Southland Corp., No. 390-37119-HCA-11 (Bankr. N.D. Tex. Dec. 27, 1990).

59. *In re* Southland Corp., 124 B.R. at 227.

60. *See generally* Disclosure Statement and Summary of Plan, approved January 23, 1991, *In re* Southland Corp., No. 390-37119-HCA-11 (Bankr. N.D. Tex. 1991).

61. Huber, Edwards & Soza, *supra* note 43, at 3.

62. *In re* Southland Corp., 124 B.R. at 225-26.

63. Huber, Edwards & Soza, *supra* note 42, at 6.

64. Section 1125(a) of the Bankruptcy Code states that "adequate information" is "information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable the hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan. . . ." 11 U.S.C. § 1125(a) (1988).

lar challenges could be mounted based upon the feasibility[65] of, and the classification of claims[66] in, a prepackaged plan.

If there have been sufficient transfers of securities to investors with different investment strategies, a resolicitation based upon one of these challenges may yield a different result. Even without such transfers, there is no assurance that security holders will vote the same way twice. As *Southland* illustrates, a number of events might occur that could cause a prepetition compromise to break down completely after the filing of the petition, resulting in resort to a traditional Chapter 11 process that may take months and even years to complete.

On the other hand, a mandatory class action lawsuit presents considerably more manageable risks for bondholders and the issuer. Under Rule 23, a federal judge is empowered only to approve the terms of the settlement reached by opposing parties to the action; he has no general powers to appoint a trustee or an examiner, to approve corporate transactions, or to exercise the other considerable powers enjoyed by a bankruptcy judge with respect to a debtor in possession.

4. Mandatory Appointment of an Examiner

In *In re Revco, D.S., Inc.*,[67] the Sixth Circuit held that the appointment of an examiner is mandatory upon the request of a party in interest or the United States Trustee in cases where certain of the debtor's fixed, liquidated, unsecured debts exceed $5 million.[68] Although the granting of a motion for appointment of an examiner in and of itself should not affect the validity of a prepetition solicitation, it could significantly delay the confirmation and consummation of a plan and burden the estate with considerable costs and expenses.[69] In addition, the mandatory nature of the appointment pro-

65. Section 1129(a)(11) of the Bankruptcy Code requires the court to determine that confirmation of the plan is not likely to be followed by liquidation or the need for further financial reorganization. 11 U.S.C. § 1129(a)(11) (1988).

66. One commentator stated: "Bondholders may vehemently object to being singled out for reductions in their claims while other unsecured creditors 'ride through' the bankruptcy unimpaired." Ranney-Marinelli, *supra* note 55, at 4-58, § 4.03[c].

67. 898 F.2d 498 (6th Cir. 1990).

68. *Id.* at 500-01.

69. The examiner's report in the Chapter 11 case of Interco, Inc. reportedly cost the bankruptcy estate more than $3.7 million in legal and financial consulting fees. Alison Frankel, *Reorganizing Interco: What Did It Take?*, AM. LAW., May 1992, at 25.

vides a dissident bondholder with a weapon through which additional leverage can be exerted.

In comparison, the class action approach is not subject to an equivalent provision that could delay completion of the settlement. The only related threat that a bondholder could make is the filing of an involuntary bankruptcy petition, which as described above, would not normally constitute rational bondholder behavior.[70]

E. SEC Registration and Review

Section 1145(a) of the Bankruptcy Code exempts from registration under the Securities Act securities offered or sold "under a plan."[71] While Section 1145(a) would thus exempt the sale of securities issued in a prepackaged plan, it does not provide an exemption for "offers" of securities which may be deemed to be made by soliciting acceptances of the plan, because there *is* no Chapter 11 case pending at the time the offers are made.

As a result, "offers" made in connection with the solicitation of acceptances must be made pursuant to a prospectus filed as part of a registration statement,[72] or pursuant to an exemption from registration under the Securities Act. To date, most prepackaged bankruptcies have been solicited in connection with alternative exchange offers. Because issuers are simultaneously offering to exchange securities, issuers may use the prospectus or exemption relied upon for the exchange offers in order to cover the prepetition plan solicitations. However, issuers soliciting acceptances to a "straight" prepackaged plan, such as *JPS Textile*,[73] do not have a concurrent exchange offer on which to rely. Such issuers must register the prepetition offers or comply with an applicable Securities Act exemption, such as Section 3(a)(9) (which exempts certain issuer exchanges),[74] Section 4(2) (which exempts transactions not involving a "public offering"),[75] or Regulation D (which provides a safe harbor for certain private placements).[76]

On the other hand, the class action approach can avoid SEC review altogether, since the securities issued in connection with a settlement of a lawsuit may be offered and sold under the exemption provided

70. *See supra* Section II(A)(3).

71. 11 U.S.C. § 1145(a) (1988).

72. Securities Act of 1933, § 5(c), 15 U.S.C. § 77e(c) (1988).

73. *See supra* note 42.

74. Securities Act of 1933, § 3(a)(9), 15 U.S.C. § 77c(a)(9) (1988). The Disclosure Statement in *JPS Textile* revealed the issuer's reliance upon Section 3(a)(9) of the Securities Act to exempt "the offer of new securities which may be deemed to be made pursuant to the solicitation." JPS Textile Group, Inc., Disclosure Statement, December 21, 1990, at 2.

75. Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1988).

76. 17 C.F.R. §§ 230.501-.508 (1991).

by Section 3(a)(10).[77] This is a significant advantage, since review by the SEC staff has been particularly grueling in restructuring situations. For example, in the *Southland* restructuring, Southland received *sixteen sets* of SEC staff comments (totaling more than 400) over an eleven-month period before the SEC declared the registration statement effective.[78] In another example, the SEC staff did not declare the registration statement in the recent Western Union Corporation restructuring effective until *thirteen months* after it was initially filed.[79] While such delays may cause frustration for an issuer attempting to restructure its securities, it is the bondholders who are particularly harmed by regulatory delays. The uncertainty regarding the outcome and timing of a restructuring generally causes securities to trade at depressed levels, severely impairing the liquidity of the investment.[80]

III. Mandatory Bondholder Class Actions Under Rule 23

A. *General Requirements*

A federal class action may be certified if the prerequisites specified in Rule 23(a) and Rule 23(b) of the Federal Rules of Civil Procedure are satisfied. The burden is upon the party seeking certification of the class to show that those prerequisites exist.[81] According to Rule

77. *See infra* Section V.

78. In its "prepackaged bankruptcy" case, The Southland Corporation described the comments it received from the SEC staff:

> Between November 9, 1989, when Southland made its first filing with the SEC, and October 4, 1990, when the SEC declared effective Southland's post-effective amendment relating to its restructuring, Southland received and responded to over 400 comments from the SEC on virtually every aspect of its proposed restructuring. The SEC's comments were received over a long period of time and dealt with a panoply of disclosure and substantive issues, ranging from general conceptual comments to suggestions for specific language. Between September 12, 1990, and October 3, 1990, Southland received four different requests from the SEC, containing approximately 100 comments, on what eventually became the October Prospectus. These comments addressed, *inter alia*, the liquidation analysis, forecasts, debtor-in-possession financing, voting and other issues.

Memorandum of The Southland Corporation (1) In Support of Confirmation of its Prepackaged Plan of Reorganization and (2) In Response to Objections to Confirmation at 25, *In re* Southland Corp., No. 390-37119-HCA-11 (Bankr. N.D. Tex. Dec. 7, 1990).

79. *See* Western Union Corp., S-4 Registration Statement (File No. 33-28883), filed May 31, 1989 and declared effective on June 14, 1990. The Western Union restructuring was not completed until 1991.

80. *See supra* note 11 and accompanying text.

81. Doninger v. Pacific Northwest Bell, Inc., 564 F.2d 1304, 1308-09 (9th Cir. 1977). Either the plaintiff or the defendant in an action may move for class certification. *In*

23(a), four general requirements must be met:

> (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the representative parties are typical of the claims or "defenses of the class," and (4) the representative parties will fairly and adequately protect the interests of the class.[82]

These requirements are generally satisfied when bondholders of the same issue of bonds sue an issuer.[83] Typically, a class of bondholders consists of so many members that joinder of each member is impracticable[84] and any issues affecting the terms of the bonds will be common to all members of the class.[85] Further, any bondholder who chooses to represent the class will have claims against the corporation that are typical of the claims or defenses of the class.[86] Finally, the interests of the class will be adequately protected as long as the class representative is represented by competent counsel, does not possess antagonism toward other members of the class, shares in-

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re Northern Dist. of Cal. "Dalkon Shield" IUD Prod. Liab. Litig., 526 F. Supp. 887, 895 (N.D. Cal. 1981), *vacated on other grounds*, 693 F.2d 847 (9th Cir. 1982), *cert. denied*, 459 U.S. 1171 (1985). In any event, the party requesting certification must allege the facts necessary to bring the proposed class action in the pleadings. Weathers v. Peters Realty Corp., 499 F.2d 1197, 1200 (6th Cir. 1974). Despite the existence of the necessary prerequisites, the trial court retains discretion over whether to certify the class. City of New York v. International Pipe & Ceramics Corp., 410 F.2d 295, 298 (2d Cir. 1969). Thus, the trial judge's determination will be reversed only upon a showing of abuse of discretion. Gay v. Waiters' & Dairy Lunchmen's Union, 549 F.2d 1330, 1332 (9th Cir. 1977).

82. FED. R. CIV. P. 23(a).

83. There are at least two common grounds upon which bondholders might wish to sue a corporation. First, if a corporation defaults on principal or interest payments to bondholders, the bondholders might bring an action to compel payment of the principal or interest due them. *See, e.g.*, Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039 (2d Cir. 1982), *cert. denied*, 460 U.S. 1012 (1983). Second, if the corporation, upon foreseeing an impending liquidity crisis, proposed a debt restructuring plan that affected the bondholders, the bondholders might sue to attack the proposed plan. *See, e.g.*, Eliasen v. Green Bay & W. R.R. Co., 93 F.R.D. 408 (E.D. Wis. 1982), *cert. denied*, 464 U.S. 874 (1983).

84. *See, e.g.*, Rievman v. Burlington N. R.R. Co., 618 F. Supp. 592 (S.D.N.Y 1985) (more than 1,000 bondholders nationwide); Zeffiro v. First Pa. Banking & Trust Co., 96 F.R.D. 567, *aff'd*, 705 F.2d 461 (7th Cir.), *cert. denied*, 464 U.S. 874 (E.D.Pa. 1983) (requirement "undoubtedly" met where more than 300 debenture holders); Citizens Banking Co. v. Monticello State Bank, 143 F.2d 261, (8th Cir. 1944) (class of 40 note holders held sufficiently numerous); Fidelis Corp. v. Litton Indus., 293 F.Supp. 164 (S.D.N.Y. 1968) (holding that 35 stockholders constitute a class in a securities fraud case).

85. *See, e.g., Zeffiro*, 96 F.R.D. at 569 (stating that "The acts or omissions of defendants raise several legal and factual questions which will necessarily be answered in the same way for each class member. Defendants' responsibilities were the same with respect to each debenture holder, and defendants' actions affected all class members in the same manner.").

86. *See, e.g.*, Eliasen v. Green Bay & W. R. R. Co., 93 F.R.D. 408 (E.D. Wis. 1982) (noting that a representative holder of the same class of bonds as class members would have claims typical of the claims or defenses of the class); *Zeffiro*, 96 F.R.D. 567 (stating that "the alignment of interests between named plaintiffs' claims and those of other [debenture holders] is obvious").

terests with absent class members, and is not in collusion with the party opposing the class.[87]

In order for the court to certify a mandatory class action, at least one of the parties must move for a determination by the court that the action may be maintained as a class action.[88] Ordinarily, the party advocating for class certification alleges the facts necessary to satisfy the prerequisites specified in Rule 23.[89] In a bondholder lawsuit, the issuer would allege facts that provide support for certification under Rule 23(b)(1) or Rule 23(b)(2) so that a mandatory class may be certified.

Determinations as to whether a class will be certified can be made on the basis of the pleadings alone where sufficient facts are alleged.[90] However, in some cases, discovery or other precertification proceedings are conducted in order to gather additional facts necessary to the certification issue.[91] The final determination as to class certification rests within the discretion of the trial judge[92] and usually depends upon two factors: "the convenience of maintaining [the action] as a class action [balanced against] the need to guarantee adequate representation of class members."[93] Generally, however, the certification of a class action is favored in doubtful cases.[94]

87. *Zeffiro*, 96 F.R.D. 567 (holding that plaintiff adequately represented class of debenture holders even though plaintiff had sold debentures and had chosen to sue the issuer rather than accept the exchange offer accepted by other debenture holders); *"Dalkon Shield" IUD Prod. Liab. Litig.*, 693 F.2d 847 (discussing requirements for adequacy of representation). *See infra* Section III(I) regarding possible challenges to the certification of the class on grounds of collusion.

88. Huff v. N.D. Cass Co., 485 F.2d 710, 712 (5th Cir. 1973). The court may also certify the class on its own motion. *Id.* In any event, both parties to the action have an equal duty to raise the class certification issue as soon as is practicable after the commencement of the litigation. Fujita v. Sumitomo Bank, 70 F.R.D. 406, 411 (N.D. Cal. 1975). However, practicality has an elastic meaning in this context, and classes have been certified following settlement negotiations. *See, e.g.*, Philadelphia Hous. Auth. v. American Radiator & Standard Sanitary Corp., 323 F. Supp. 364, 373 (E.D. Pa. 1970).

89. *See, e.g.*, Valentino v. Howlett, 528 F.2d 975, 978 (7th Cir. 1976). In fact, the burden of proof of showing that the prerequisites are satisfied falls on the party seeking class certification. *Id.*

90. Huff v. N.D. Cass Co., 485 F.2d 710, 713 (5th Cir. 1973).

91. Zeidman v. J. Ray McDermott & Co., 651 F.2d 1030, 1037-38 (5th Cir. 1981).

92. Hornreich v. Plant Indus., 535 F.2d 550, 552 (9th Cir. 1976). The determination will be reversed only if there was an abuse of discretion. *Id.*

93. Wright v. Stone Container Corp., 524 F.2d 1058, 1061 (8th Cir. 1975). *See generally* 21 Am. Jur. Trials 678 (1984) (detailing the factors normally taken into account by trial judges in class certification decisions).

94. Eisenberg v. Gagnon, 766 F.2d 770, 785 (3d Cir. 1985), *cert. denied*, 474 U.S. 946 (1985). The class certification may be conditional in doubtful cases. Thus, the certification can be revoked where problems later present themselves and militate against certification. *In re* Hotel Tel. Charges, 500 F.2d 86, 90 (9th Cir. 1974).

B. *Types of Class Actions Under Rule 23*

The potential class action must also fall into one of the categories specified in Rule 23(b). According to Rule 23(b), four types of actions are properly certifiable as class actions: actions under Rules 23(b)(1)(A), 23(b)(1)(B), 23(b)(2) and 23(b)(3).

C. *Rule 23(b)(1)(A) Actions: Avoiding Inconsistent or Varying Adjudications for the Opposing Party*

Actions certified under Rule 23(b)(1)(A) are maintained as class actions, rather than as individual lawsuits, to avoid the risk of "inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class."[95] Simply put, if there is a risk that individual lawsuits might result in incompatible judgments, such that the defendant opposing the class could not comply with one judgment without violating the terms of another, the proposed action is properly certifiable as a class action.[96]

The possibility of incompatible judgments is a particular risk when individual security holders under the same instrument are permitted to pursue their claims individually. For example, the Rules Advisory Committee, which drafted Rule 23, illustrated a Rule 23(b)(1)(A) class action by describing a suit brought by municipal bondholders concerning the validity of a municipal bond issue.[97] Under separate actions, one bondholder might receive a judgment which declares the bond issue invalid, while a different bondholder might receive a judgment which merely limits or conditions the future issuance of the bonds.[98] The two inconsistent judgments would establish incompatible courses of conduct for the municipality—the municipality could not stop issuance of the bonds at the same time it continued to issue bonds subject to the required conditions.[99] In contrast, a class action would result in a uniform adjudication of the issue.[100]

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95. FED. R. CIV. PROC. 23(b)(1)(A).

96. 6A FEDERAL PROCEDURE, L. ED. § 12:175 (1989). However, the risk of incompatible adjudications must be real. Eisen v. Carlisle & Jacquelin, 391 F.2d 555, 564 (2d. Cir. 1968). In *Eisen*, the court held that where individual claims were so small that there was little risk that individual claims would be pursued outside of the class action, certification under Rule 23(b)(1)(A) would be denied. *Id.*

97. Advisory Committee's Note to Amendment to Fed. R. Civ. P. 23, 39 F.R.D. 98, 100 (1966) [hereinafter Advisory Note]. *See also* Norman C. Sabbey, Comment, *Rule 23: Categories of Subsection (b)* 10 B.C. INDUS. & COM. L. REV. 539, 540 (1969).

98. *Id.*

99. *Id. See also* Supreme Tribe of Ben Hur v. Cauble, 255 U.S. 356 (1921) (holding that under former Equity Rule 38, a suit by policyholders attacking a reorganization of an insurance company was properly brought as a mandatory class action in order to avoid "conflicting judgments").

100. It is important to note that Rule 23(b)(1)(A) actions do not apply to situations where class members seek primarily money damages from the party opposing the

Likewise, in *Rievman v. Burlington Northern Railroad Company*,[101] the court certified a bondholder action under Rule 23(b)(1)(A) because of the "risk of inconsistent or varying adjudications."[102] The issuer, by offering to substitute government securities as collateral, had attempted to get indenture trustees to release property worth "billions of dollars" that secured only $117 million of railroad bonds issued in 1896.[103] The risk of incompatible adjudications existed because, if separate suits were brought, some judgments might allow for the substitution of securities while other judgments might prohibit the substitution. The subsequent history of the case illustrates the risk. After entry of the preliminary injunction and certification of the class, the class representatives reached a settlement with the issuer valued at approximately $45 million more to the bondholders than the original agreement, which was intended to be equivalent to market value.[104] Even so, the settlement, which was binding upon all bondholders, was opposed by holders of approximately six percent of the bonds.[105]

Prior to the United States Supreme Court decision in *Phillips Petroleum Co. v. Shutts*,[106] Rule 23(b)(1)(A) actions were generally considered *mandatory* class actions[107]—that is, the judgment rendered in

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class. Sabbey, *supra* note 97, at 540. This is because the purpose behind Rule 23(b)(1)(A) is to prevent situations where the party opposing the class is faced with incompatible standards of *conduct*. *Id.* "Rule 23(b)(1)(A) is not meant to apply, however, where the risk of inconsistent results in individual actions is merely the possibility that the defendants will prevail in some cases and not in others, thereby paying damages to some claimants and not others." *In re* "Agent Orange" Prod. Liab. Litig., 506 F. Supp. 762, 789 (E.D.N.Y. 1980) (emphasis omitted). *See also In re* Dennis Greenman Sec. Litig., 829 F.2d 1539 (11th Cir. 1987); *In re* Bendectin Prod. Liab. Litig., 749 F.2d 300 (6th Cir. 1984); and McDonnell Douglas Corp. v. United States Dist. Ct., 523 F.2d 1083 (9th Cir. 1975), *cert. denied*, 425 U.S. 911 (1976). *But see* 1 HERBERT B. NEWBERG, NEWBERG ON CLASS ACTIONS § 4.05, at 279 (2d ed. 1985) (citing cases certified under Rule 23(b)(1)(A) where the major, if not predominant, remedy sought was money damages).

101. 618 F. Supp. 592 (S.D.N.Y. 1985).

102. *Id.* at 595.

103. *Id.* at 594.

104. Rievman v. Burlington N.R.R. Co., 118 F.R.D. 29, 35 (S.D.N.Y. 1987).

105. *Id.* at 34. *See also* Van Gemert v. Boeing Co., 259 F. Supp. 125 (S.D.N.Y. 1966) (holding that an action by debenture holders to compel conversion was properly classified as a Rule 23(b)(1)(A) class action).

106. 472 U.S. 797 (1985). *See infra* Section III(G) for a discussion of the effect of *Shutts*.

107. The trial court retains discretion to require notice to all class members in Rule 23(b)(1)(A) actions. FED. R. CIV. P. 23(d)(2). In addition, a minority of federal courts require an opt out provision if it is determined that due process concerns mandate such a provision. Bauman v. United States Dist. Ct., 557 F.2d 650, 659 (9th Cir. 1977).

those cases bound all members of the class, whether or not they wished to participate in the action.[108] This conclusion is derived from the express terms of Rule 23, which require notice and the right to opt out only from Rule 23(b)(3) class actions.[109] Additionally, there is an implicit preference for unified treatment in class actions in which equitable relief is sought.[110]

Further, aggregation of claims is permitted under Rule 23(b)(1)(A).[111] Accordingly, the class members in a Rule 23(b)(1)(A) action may combine the dollar amounts of their claims to satisfy the $50,000 amount in controversy requirement imposed in federal diversity suits.[112] The ability to aggregate claims in a federal class action is significant, since aggregation generally is not permitted in a Rule 23(b)(3) class action, and each class member must individually satisfy the minimum amount in controversy requirement.[113]

D. *Rule 23(b)(1)(B) Actions: Avoiding Adverse Effects on Class Members*

While Rule 23(b)(1)(A) actions prevent adverse effects upon parties opposing the class, the purpose of Rule 23(b)(1)(B) actions is to prevent adverse effects upon class members.[114] Rule 23(b)(1)(B) actions prevent situations where individual actions are adjudicated "which would as a practical matter be dispositive of the interest of the other [class] members not parties to the adjudications or substan-

108. Johnson v. City of Baton Rouge, 50 F.R.D. 295, 300 (E.D. La. 1970). The only qualification is that the court must describe those persons whom it deems included in the class. *Id.*

109. FED. R. CIV. P. 23(b)(3), (c)(2).

110. Miller & Crump, *supra* note 14, at 38.

111. Aggregation of claims is allowed because the class members in a Rule 23(b)(1)(A) action unite to enforce a single claim in which they have a common and undivided interest. Snyder v. Harris, 394 U.S. 332, 341 (1969). Aggregation is permitted in most Rule 23(b)(1) actions. 6A FEDERAL PROCEDURE, L. ED. § 12:20 (1989). *See generally* S.R. Shapiro, Annotation, *Right, in Suit Brought as Class Action, to Aggregate Claims or Interests of Members of Class in Order to Satisfy Minimum Jurisdictional Amount Requirement in Federal District Court*, 3 A.L.R. FED. 372 (1970 & Supp. 1991).

112. Gallagher v. Continental Ins. Co., 502 F.2d 827, 831 (10th Cir. 1974). In any event, if the issue in the action involves the alleged violation of federal securities laws, federal question jurisdiction would exist. *See* 28 U.S.C. § 1331 (Supp. 1991) (conferring jurisdiction upon federal courts in civil actions where the matter in controversy arises under the Constitution, laws, or treaties of the United States). *See also* Continental Assurance Co. v. Macleod-Stedman, Inc., 694 F. Supp. 449 (N.D. Ill. 1988) (where a corporation sought a court's approval to undertake a section 3(a)(10) exchange, and the court exercised its jurisdiction based upon 28 U.S.C. § 1331).

113. Zahn v. International Paper Co., 414 U.S. 291 (1973).

114. Sabbey, *supra* note 97, at 540-41. "[T]he focus of the Rule [is] on the effect of an individual action on the interests of those who have rights similar to those of the individual bringing suit, rather than on the danger of imposing incompatible standards of conduct on the defendant." 6A FEDERAL PROCEDURE, L.ED. § 12:181 (1989) (footnote omitted).

tially impair or impede their ability to protect their interests."[115]

Professor Miller has written: "The paradigm Rule 23(b)(1)(B) case is one in which there are multiple claimants to a limited fund . . . . There is a risk, if litigants are allowed to proceed on an individual basis, that those who sue first will deplete the fund and leave nothing for the latecomers."[116] By definition, it is impossible to resolve separately individual claims involving common rights or limited funds.[117] For instance, if several persons have a claim against a fund which is insufficient to satisfy all of the claims, a separate action brought by an individual against the fund might, as a practical matter, foreclose actions by the other persons. That is, the fund might be exhausted before all members of the class were able to protect their interests. However, if the action were brought as a class action, all of the claims could be finally determined, and each class member could receive his or her pro rata share of the fund.[118] Similarly, cases involving a breach of trust by an indenture trustee or other fiduciary are appropriately brought under Rule 23(b)(1)(B).[119]

A bondholder suit that attacks a corporate reorganization has been

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115. FED. R. CIV. P. 23(b)(1)(B). The absent class members need only be practically foreclosed from pursuing a separate action. 6A FEDERAL PROCEDURE, L. ED. § 12:181 (1989). However, the fact that an action will have only a precedential or stare decisis effect on later cases is not sufficient to satisfy Rule 23(b)(1)(B). Larionoff v. United States, 533 F.2d 1167, 1181 n.36 (D.C. Cir. 1976), *aff'd* 431 U.S. 864 (1977).

116. Arthur R. Miller, *An Overview of Federal Class Actions: Past, Present, and Future*, 4 JUST. SYS. J. 197, 211 (1978). *See also* Advisory Note, *supra* note 97, at 101. However, where the fund was not limited, certification under Rule 23(b)(1)(B) was not warranted. Zimmerman v. Bell, 800 F.2d 386, 389 (4th Cir. 1986).

117. Miller & Crump, *supra* note 14, at 40. *See, e.g.,* Bush v. Rewald, [1986-87 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,999 (D. Haw. 1986) (mandatory settlement classes confirmed under Rule 23(b)(1)(A) and 23(b)(1)(B) where, because of limited fund of insurance proceeds, "only a settlement which includes, on a mandatory basis, all potential claimants with similar claims, and provides for an overall system of allocation, can be fair.").

118. *See, e.g.,* Hartford Life Ins. Co. v. Ibs, 237 U.S. 662 (1915) (holding that insurer's contingency fund was treated appropriately as a unit in which all policyholders were joined). For other examples of limited fund cases in a reorganization context, see Dickinson v. Burnham, 197 F.2d 973 (2d Cir. 1952) (where disposition of fund by court in class action was held binding on absent class members); Heffernan v. Bennett & Armour, 243 P.2d 846 (Cal. Ct. App. 1952) (ruling that a class action consisting of the creditors of a debtor who made fraudulent transfers will be binding against all those creditors who present claims or those creditors who, after notice, fail to do so.)

119. *See, e.g., Zeffiro*, 96 F.R.D. 567 (E.D. Pa. 1983) (where plaintiffs alleged the violation of indenture provisions). The Advisory Committee Notes suggest that Rule 23(b)(1)(B) certification is appropriate in "an action which charges a breach of trust by an indenture trustee or other fiduciary similarly affecting the members of a large class of security holders or other beneficiaries, and which requires an accounting or like measures to restore the subject of the trust." Advisory Note, *supra* note 97, at 98.

held to qualify as a Rule 23(b)(1)(B) action.[120] In *Eliasen v. Green Bay & Western Railroad Company*,[121] a representative bondholder attacked a merger and reorganization of a railroad company on behalf of a class of bondholders. Under the terms of the related indenture, the representative claimed that the class was entitled to a pro rata distribution of the proceeds flowing from the merger and reorganization. The class representative requested liquidation of the railroad company, if necessary, to satisfy the claims of the bondholders.

The trial court ruled that the action was certifiable as a Rule 23(b)(1)(B) class action because there was a risk that adjudications with respect to individual members of the class would practically impair the rights of absent class members.[122] The court reasoned that if a liquidation of the company became necessary, absent class members might be foreclosed from making future claims against the assets of the company.[123] Further, the court pointed out that the construction which it gave to the related bond indenture would be adhered to in any subsequent suits by absent class members.[124] As such, the court believed that all of the bondholders should be represented in the initial action.[125]

Rule 23(b)(1)(B) actions are usually certified as mandatory class actions.[126] Additionally, just as aggregation of claims is allowed in Rule 23(b)(1)(A) actions, each individual class member in a Rule 23(b)(1)(B) action need not meet the amount in controversy requirements normally imposed in federal diversity suits.[127]

E. Rule 23(b)(2) Actions: Actions for Injunctive or Declaratory Relief

If "the party opposing the class has acted or refused to act on grounds generally applicable to the class" such that final injunctive or declaratory relief would be an appropriate request, the action can be maintained as a Rule 23(b)(2) class action.[128] This type of class action generally involves broad constitutional, statutory, or public pol-

120. Eliasen v. Green Bay & W.R.R. Co., 93 F.R.D. 408, 413 (E.D. Wis. 1982). *See also* Supreme Tribe of Ben Hur v. Cauble, 255 U.S. 356 (1921) (described by the Rules Advisory Committee as an action by policyholders against a fraternal benefit association attacking a financial reorganization where "it would hardly have been practical, if indeed it would have been possible, to confine the effects of a validation of the reorganization to the individual plaintiffs." Advisory Note, *supra* note 97, at 101.)

121. 93 F.R.D. 408 (E.D. Wis. 1982).

122. *Id.* at 412.

123. *Id.*

124. *Id.* at 413. This is because, as the court noted, corporations have a duty to treat all members of a class of bondholders equally. *Id.*

125. *Id.*

126. Johnson v. City of Baton Rouge, 50 F.R.D. 295, 300 (E.D. La. 1970).

127. Gallagher v. Continental Ins. Co., 502 F.2d 827, 831 (10th Cir. 1974).

128. FED. R. CIV. P. 23(b)(2).

icy issues[129] and is particularly suited to civil rights cases.[130] For example, a typical Rule 23(b)(2) action might involve allegations of classwide discrimination that would be subject to a single injunctive remedy.[131]

However, Rule 23(b)(2) actions are not limited to civil rights cases.[132] Rule 23(b)(2) is applicable in any action where the party opposing the class has acted or refused to act on grounds generally applicable to the class and, therefore, is particularly applicable to actions by security holders that seek injunctive or declaratory relief. Accordingly, in *Sharon Steel Corporation v. Chase Manhattan Bank, N.A.*,[133] the Second Circuit Court of Appeals approved the certification of an action involving the default of a class of bonds as a Rule 23(b)(2) class action.[134] In that case, two corporations merged, and the debenture holders sought a ruling to declare that the liquidating corporation was in default on the bonds and that it remained responsible for their payment.[135]

As with actions brought under Rule 23(b)(1), Rule 23(b)(2) actions are typically certified as mandatory class actions.[136] Likewise, aggregation of claims to satisfy federal jurisdictional requirements is normally permitted in Rule 23(b)(2) actions since class members in those actions unite to enforce a single claim against the party opposing the class, and the opposing party's conduct relates to the class as a whole.[137] For example, in an action where a bondholder brought suit

129. 6A FEDERAL PROCEDURE, L. ED. § 12:191 (1989). Rule 23(b)(2) actions can be distinguished from Rule 23(b)(3) actions in that the latter usually involve common damage claims or other property interests, which is typical of mass tort cases. *Id.* Additionally, Rule 23(b)(2) is inapplicable to suits where money damages are the primary relief requested. Doninger v. Pacific Northwest Bell, Inc., 564 F.2d 1304, 1314 (9th Cir. 1977).

130. Redhail v. Zablocki, 418 F. Supp. 1061, 1066 (E.D. Wis. 1976), *aff'd*, 434 U.S. 374 (1978).

131. Senter v. General Motors Corp., 532 F.2d 511, 524 (6th Cir. 1976); *cert. denied*, 429 U.S. 870 (1976).

132. Advisory Note, *supra* note 97, at 102. *See also* Brandt v. Owens-Illinois, Inc., 62 F.R.D. 160, 168 (S.D.N.Y. 1973) (stating that there is "nothing in the language or the use of the rule that suggests its utility is limited to [civil rights actions]").

133. 691 F.2d 1039 (2d Cir. 1982), *cert. denied*, 460 U.S. 1012 (1983).

134. *Id.* at 1047.

135. *Id. See also Brandt*, 62 F.R.D. 160 (class action by holders of preferred stock); Broenen v. Beaunit Corp., 305 F. Supp. 688, *aff'd*, 440 F.2d 1244 (7th Cir. 1970) (class action by holders of bonds).

136. Wetzel v. Liberty Mut. Ins. Co., 508 F.2d 239, 248 (3d Cir. 1975), *cert. denied*, 421 U.S. 1011 (1975).

137. *See* Snyder v. Harris, 394 U.S. 332, 341 (1969) (holding that when claims are "joint and common," they are entitled to aggregation).

over amounts due under a class of delinquent paving bonds, the court permitted aggregation of the bondholder class members' claims.[138] Similarly, another court allowed aggregation of the claims of a corporation's preferred shareholders under a Rule 10b-5 claim brought as a Rule 23(b)(2) class action because any decision on the issue of the corporation's liability would affect all preferred shareholders equally.[139]

Where an action qualifies as a Rule 23(b)(1)(B) or a Rule 23(b)(2) action, it will also qualify for certification under Rule 23(b)(3), which has less rigorous standards for qualification.[140] Initially, this fact may seem to pose an obstacle to the certification of a mandatory class action, since Rule 23(b)(3) actions must include a provision which allows class members to opt out of the action.[141] However, it is an established principle that when an action qualifies under either Rule 23(b)(1) or (2) and Rule 23(b)(3), the action should always be certified under 23(b)(1) or (2).[142] The reason is that the binding effect of a judgment or settlement rendered in a Rule 23(b)(1) or (2) action is preferable to the optionally binding effect rendered in a Rule 23(b)(3) action.[143] Further, in order to support the policies behind the class action rule, separate lawsuits are to be avoided whenever possible, and opt out provisions under Rule 23(b)(3) allow for the undesirable result of multiple suits.[144]

F. Rule 23(b)(3) Actions: Common Questions of Law or Fact

Class actions are commonly certified as Rule 23(b)(3) actions when "class action treatment is not as clearly called for as in [Rule] 23(b)(1) or [Rule] 23(b)(2)" situations, but the facts of the case still support maintaining a class action rather than individual lawsuits.[145] Rule 23(b)(3) prevents multiple litigation of similar factual and legal issues and, therefore, saves judicial time and legal expenses.[146]

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138. Cahill v. Hovenden, 132 F.2d 422, 425 (10th Cir. 1942).

139. *Brandt*, 62 F.R.D. at 169. *See also Broenen*, 305 F. Supp. at 692 (where suit was brought by a class of bondholders, and the court allowed aggregation, noting that "[e]ach member of the proposed class claims all his rights in the debentures through the same trust indenture. Allegedly, a single transaction involving all of the defendants to this action violated the term of the trust indenture, thereby damaging all members of the proposed class equally . . . .").

140. Van Gemert v. Boeing Co., 259 F. Supp. 125, 130 (S.D.N.Y. 1966).

141. FED. R. CIV. P. 23(c)(2).

142. *Van Gemert*, 259 F. Supp. at 130.

143. *Wetzel*, 508 F.2d at 253.

144. *Van Gemert*, 259 F. Supp. at 130-31.

145. 6A FEDERAL PROCEDURE, L. ED. § 12:207 (1989); Advisory Note, *supra* note 97, at 102. The courts give preference to certification under Rule 23(b)(1) or Rule 23(b)(2) where the requirements of those subdivisions are met, even though the requirements specified in Rule 23(b)(3) are also met. *Wetzel*, 508 F.2d at 253.

146. Advisory Note, *supra* note 97, at 102-03.

In order to certify an action under Rule 23(b)(3), the court must find that "the questions of law or fact common to the members of the class predominate over any questions affecting individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy."[147] Since Rule 23(b)(3) actions are particularly appropriate when the action is brought exclusively or primarily to recover money damages,[148] circumstances supporting a certification under Rule 23(b)(3) often exist in mass tort cases.[149] For instance, a district court certified a class under Rule 23(b)(3) for purposes of determining liability in a massive class action against the manufacturer of "Agent Orange."[150]

Class actions pursuant to Rule 23(b)(3) must provide notice containing an opt out provision to all potential class members, thus allowing members to choose whether they want to be bound by the subsequent judgment or settlement.[151] Due to this this opt out requirement, certification under Rule 23(b)(3) would not benefit bondholders using the class action device as a restructuring technique, since individual bondholders could choose whether they wished to be bound by the settlement. Also, the corporation would be open to separate suits by individual bondholders who chose not to participate in the initial action.

Further, aggregation of claims is not allowed under Rule 23(b)(3) and each class member must individually satisfy the $50,000 amount

147. FED. R. CIV. P. 23(b)(3). Four factors are important in making this finding:

> (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; [and] (D) the difficulties likely to be encountered in the management of a class action.

Id.

148. Eley v. Morris, 390 F. Supp. 913, 918 (N.D. Ga. 1975). "Thus, a suit is maintainable as a class action under FRCP 23(b)(3), rather than FRCP 23(b)(1) or FRCP 23(b)(2), where the recovery of damages appears to be the predominant consideration, even though injunctive relief is also sought." 6A FEDERAL PROCEDURE, L. ED. § 12:209 (1989). *Cf. supra* sections III(C), III(D) and III(E) regarding Rule 23(b)(1) and Rule 23(b)(2) actions.

149. *In re* Tetracycline Cases, 107 F.R.D. 719, 724 (W.D. Mo. 1985). Liability and causation are common issues in Rule 23(b)(3) actions based on tort claims. Sterling v. Velsicol Chemical Corp., 855 F.2d 1188, 1197 (6th Cir. 1988). The individual issues of damages as to each class member are reserved for treatment following the class action on the liability issue. *See id.*

150. *See In re* "Agent Orange" Prod. Liab. Litig., 818 F.2d 145, 166-67 (2d Cir. 1987), *cert. denied*, 484 U.S. 1004 (1988).

151. FED. R. CIV. P. 23(c)(2). *Cf. supra* sections III(C), III(D) and III(E) regarding actions brought under Rule 23(b)(1) and Rule 23(b)(2).

in controversy requirement.[152] This is because Rule 23(b)(3) actions commonly involve plaintiffs with separate and distinct claims.[153]

G. *Mandatory Class Actions After Shutts*

In *Shutts*,[154] the United States Supreme Court ruled on a number of personal jurisdiction and choice of law issues in a multistate class action commenced in Kansas state court where the plaintiff sought to recover interest on delayed royalty payments.[155] The Supreme Court held that the application of Kansas substantive law to all claims, when ninety-nine percent of the underlying gas leases and ninety-seven percent of the class members had no connection to Kansas, was "sufficiently arbitrary and unfair as to exceed constitutional limits."[156] The Supreme Court also held that, in addition to receiving proper notice[157] and adequate representation by the named parties,[158] minimum due process requires that absent class members be afforded the right to exclude themselves from the suit in a multistate class action seeking predominately money damages.[159]

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152. Zahn v. International Paper Co., 414 U.S. 291, 292 (1973). Of course, the amount in controversy requirements imposed by 28 U.S.C., section 1332, would not be a bar to federal court access where jurisdiction was based upon a federal question, such as a violation of federal securities laws. *See* 28 U.S.C. § 1331 (Supp. 1991).

153. *See Zahn*, 414 U.S. at 296, 301.

154. Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985).

155. *See* John E. Kennedy, *The Supreme Court Meets the Bride of Frankenstein:* Phillips Petroleum Co. v. Shutts *and the State Multistate Class Action*, 34 KAN. L. REV. 255 (1985).

156. *Shutts*, 472 U.S. at 822.

157. *Id.* at 812. (stating that "[t]he notice must be the best practicable, 'reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.' ") (quoting Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314-15 (1950)).

158. *Id.* (holding that "the Due Process Clause of course requires that the named plaintiff at all times adequately represent the interests of the absent class members") (citing Hansberry v. Lee, 311 U.S. 32, 42-43 (1940)).

159. *Id.* "Additionally, we hold that due process requires at a minimum that an absent plaintiff be provided with an opportunity to remove himself from the class by executing and returning an 'opt out' or 'request for exclusion' form to the court." *Id.* However, the Supreme Court specifically held that due process does not require that nonresident claimants "opt in" to the class. *Id.*

Shutts is significant because it is the first Supreme Court pronouncement concerning the effect of due process requirements on mandatory class actions. Prior to *Shutts*, a majority of federal courts accepted the principle that class members in Rule 23(b)(1) or Rule 23(b)(2) actions cannot opt out. Wetzel v. Liberty Mut. Ins. Co., 508 F.2d 239 (3d Cir. 1975), *cert. denied*, 421 U.S. 1011 (1975); Air Line Stewards & Stewardesses Ass'n v. American Airlines, Inc., 490 F.2d 636, 642 (7th Cir. 1973), *cert. denied*, 416 U.S. 993 (1974). However, a minority of federal courts believed that it was within their discretion to permit members of such classes to opt out. *See, e.g.*, Bauman v. United States Dist. Ct., 557 F.2d 650, 659 (9th Cir. 1977) (ruling that order requiring that notice of right to opt out be sent to members of a Rule 23(b)(2) class is not "clearly erroneous"); Elliott v. Weinberger, 564 F.2d 1219 (9th Cir. 1977), *cert. granted*, 413 U.S. 816 (1978), *aff'd in part and rev'd in part*, 422 U.S. 682 (1979) (holding that Rule 23(d)(2) makes notice discretionary with the court in Rule 23(b)(2) actions). While the Ninth

The *Shutts* court specifically limited its holding to class actions wholly or predominately for money damages. The Supreme Court stated: "Our holding today is limited to those class actions which seek to bind known plaintiffs concerning claims wholly or predominately for money judgements. We intimate no view concerning other types of class actions, such as those seeking equitable relief."[160]

While this language is consistent with the well-accepted position that Rule 23(b)(2) actions, which by definition are actions primarily for equitable relief, do not require opt-out rights, there is considerable controversy regarding the effect of *Shutts* on mandatory class actions under Rule 23(b)(1), which may involve claims for monetary damages. Professor Miller, who argued the case on behalf of Phillips Petroleum, stated that one way to view *Shutts* is as a case concerned primarily with distant forum abuse.[161] Viewed as such, the right to opt out is essential to the validation of jurisdiction over class members who have no affiliation with the distant forum.[162] In cases where there are no concerns over the reach of a distant court or the application of inapplicable law, *Shutts* does not require that class members be permitted to opt out.[163]

Another leading commentator believes that most actions under Rule 23(b)(1) are excluded from the reach of *Shutts* because such suits "predominately (but not exclusively) involve suits seeking equitable relief."[164] According to Mr. Newberg:

> Classes certified under Rule 23(b)(1)(A) seek to have unitary adjudication of

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Circuit Court of Appeals adhered to this minority view, district courts within the Ninth Circuit held that the right to opt out is not "a requirement of due process" in class actions other than under Rule 23(b)(3). *See, e.g.,* Wofford v. Safeway Stores, Inc., 78 F.R.D. 460, 493 (N.D. Cal. 1978).

160. *Phillips*, 472 U.S. at 811 n.3.

161. Miller & Crump, *supra* note 14, at 38, 52.

162. *Id.*

163. To illustrate this point, Professor Miller contrasted the "unified mass disaster" in the Kansas City Hyatt Hotel that was the basis for the class action in *In re* Federal Skywalk Cases, 680 F.2d 1175 (8th Cir. 1982), *cert. denied*, 459 U.S. 988 (1982) (mandatory certification upheld) with the nationwide product liability claims of *In re* Northern Dist. of Cal. "Dalkon Shield" IUD Prod. Liab. Litig. 693 F.2d 847 (9th Cir. 1982), *cert. denied*, 459 U.S. 1171 (1983) (mandatory certification denied). According to Professor Miller, a unified mass disaster, such as in *Skywalk* probably "has the requisite nexus to support mandatory certification at the site of the disaster" after *Shutts*, but mandatory certification may not be appropriate in a "nationwide product[s] liability action for claims for other dispersed torts" such as in *Dalkon Shield.* Miller & Crump, *supra* note 14, at 38, 52-53. *But see In re* "Agent Orange" Prod. Liab. Litig., 100 F.R.D. 718 (E.D.N.Y. 1983) (mandatory certification upheld in nationwide products liability action).

164. 1 NEWBERG, *supra* note 100, § 1.14, at 9-10 (Supp. 1991).

> the controversy affecting a class in order to avoid the risk of incompatible standards of conduct for the party opposing the class. This subsection, which normally deals with a joint right or obligation, includes equitable class actions for mandatory injunctive or declaratory relief such as suits to declare a corporate dividend, or to define riparian rights . . . . Finally, actions by or against similarly-situated persons to allocate pro rata an available fund that is insufficient to pay all claims, such as those found with respect to interpleader suits, creditor claims in bankruptcy, or actions under Rule 23(b)(1)(B), are equitable in nature, although they involve money claims individually.[165]

Although *Shutts* has left open "fascinating and knotty questions"[166] about mandatory class actions, most actions brought by security holders to restructure debt securities should be unaffected by *Shutts*. First, most of these class actions involve claims arising under an indenture or other instrument governed by the laws of a single state or are brought pursuant to the federal securities laws. As a result, such actions are unlikely to raise the troubling questions of personal jurisdiction considered in *Shutts*. Second, these actions, which would most likely seek to require the issuer to issue a new package of securities in exchange for the existing securities, would be actions for injunctive or declaratory relief, rather than for monetary damages, and would not be affected by *Shutts's* opt-out requirements.

H. Class Action Settlements

1. In General

A class action under Rule 23 cannot be dismissed or compromised without the approval of the court.[167] This requirement protects absent class members in mandatory class actions and in permissive class actions where a class member has not exercised his right to opt out.[168]

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165. *Id.* at 10. (footnotes omitted.)

166. Miller & Crump, *supra* note 14, at 57.

167. FED. R. CIV. P. 23(e). Court approval of a class action settlement will be reversed on appeal only upon a showing of abuse of discretion by the trial judge. Girsch v. Jepson, 521 F.2d 153, 156 (3d Cir. 1975).

168. Jenson v. Continental Fin. Corp., 591 F.2d 477, 482 n.7 (8th Cir. 1979). Absent class members' interests need protection because it is very possible, within the dynamics of class action litigation, that the interests of the absent class members and the class representatives will conflict during settlement negotiations. Sylvia R. Lazos, Note, *Abuse in Plaintiff Class Action Settlements: The Need for a Guardian During Pretrial Settlement Negotiations*, 84 MICH. L. REV. 308, 312-14 (1985). This is because the class representatives have a strong incentive to settle to avoid the burdensome costs of litigation which are imposed upon them, while the absent class members' interests are to recover the largest award possible, which may only be attainable after a trial. *Id.* At the same time, the party opposing the class will possess a strong motivation to settle in order to avoid adverse publicity and a potentially high damage award. J. Spencer Schuster, *Precertification Settlement of Class Actions: Will California Follow the Federal Lead?*, 40 HASTINGS L.J. 863, 865 (1989). Thus, the approval of the trial court is necessary to avoid the impairment of the absent class members' interests. *Id.* at 871.

2. Classwide Settlement Reached Prior to Filing Class Action Suit

Rule 23 does not prohibit the certification of a class action filed after a settlement agreement has been reached between putative class representatives and the defendant.[169] One commentator has stated: "Settlement agreements between parties with adverse interests concluded before the the initiation of a lawsuit may consitute the basis of a classwide judicial decree after legal proceedings have begun."[170] In *Continental Assurance Co. v. Macleod-Stedman, Inc.*,[171] the financially troubled issuer of $30 million of mortgage notes notified the registered holders of its failure to make an interest payment on the notes and of its efforts to improve its business prospects.[172] Some months later, "after extensive and complicated negotiations," the issuer and representatives of the holders of the notes reached an agreement, which was submitted to all registered noteholders for their consent.[173] After the agreement was approved by a "substantial majority" of the note holders, the representatives of the holders filed a class action lawsuit seeking certification of a mandatory class in order to obtain unanimous participation in the settlement.[174] While the court declined to certify the class because of concerns that such a certification would violate provisions of the related indenture and the Trust Indenture Act,[175] it did not indicate that this procedure violated the provisions of Rule 23. A similar procedure was followed in *MBank Dallas v. LaBarge, Inc.*,[176] in which a proposed settlement between the issuer and the indenture trustee (on behalf of the bondholders) was reached prior to the filing of the class action lawsuit.[177]

3. Classwide Settlement Reached After Class Action Filing But Before Certification of Class

When a settlement is reached after the class action complaint has

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169. Such a procedure is likely to result in a greater degree of scrutiny for collusion. *See infra* Section III(I).
170. 2 HERBERT B. NEWBERG, NEWBERG ON CLASS ACTIONS § 11.21, at 417 (2d ed. 1985).
171. 449 F. Supp. 449 (N.D. Ill. 1988).
172. *Id.* at 452.
173. *Id.* at 453-54.
174. *Id.* at 454.
175. We believe that this conclusion was not warranted. *See infra* Section IV.
176. No. 86 C 9583 (N.D. Ill. December 29, 1986) (unpublished findings of fact, conclusions of law and final order).
177. *Id.* at 6.

been filed but before the class has been certified by the court, the settlement is treated like a class action settlement in a majority of federal courts—that is, notice and court approval are required.[178] However, since notice cannot normally be given until the class members are determined and the class is certified, the strategic and timing advantages of this approach are diminished unless the court permits the certification of a temporary settlement class in order to facilitate notice requirement.[179] Under this procedure, the settlement fairness hearing may occur prior to the actual certification, which may occur simultaneously with approval of the settlement.[180]

Generally, a court will pay special attention to whether a precertification settlement might have been influenced by fraud or collusion and whether the settlement is fair, adequate, and reasonable[181] in light of all the class members' interests.[182]

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178. *See, e.g.*, Philadelphia Elec. Co. v. Anaconda Am. Brass Co., 42 F.R.D. 324, 326 (E.D. Pa. 1967). The primary concerns are with precertification settlements made on an *individual*, as opposed to a *classwide*, basis. In the case of individual settlements, the putative class members, relying upon the filing of the class action, may forfeit their rights by foregoing individual actions and such settlements may be "an impermissible abuse of the class action device . . . [since] the defendants might well be willing to pay the named plaintiffs a premium for the elimination of the class, a premium to which they are, of course, not entitled." Yaffe v. Detroit Steel Corp., 50 F.R.D. 481, 483 (N.D. Ill. 1970).

There is a split of authority on this point, however. Some federal courts take the view that Federal Rule 23(e) is inapplicable to precertification settlements. *See, e.g.*, Weight Watchers of Phila., Inc. v. Weight Watchers Int'l Inc., 455 F.2d 770, 775 (2d Cir. 1972) (holding that Rule 23(e) "does not bar non-approved settlements with individual members [of the putative class] which have no effect upon the rights of others"). A separate, emerging minority of federal courts requires judicial approval of class action settlements, but does not require notice of the settlement to go out to all class members. Schuster, *supra* note 168, at 873.

179. 2 NEWBERG, *supra* note 170, § 11.27, at 425. This procedure is controversial and was criticized in the MANUAL FOR COMPLEX LITIGATION § 1.46 (5th ed. 1982). However, the MANUAL FOR COMPLEX LITIGATION SECOND § 30.45 (1985) recognizes that courts have permitted the use of settlement classes, although it suggests that this has occurred "with great caution." *Id.*

180. County of Suffolk v. Long Island Lighting Co., 710 F. Supp. 1422 (E.D.N.Y. 1989), *aff'd in part*, 907 F.2d 1295 (2d Cir. 1990).

181. This determination requires the trial court to decide "whether the interests of the class as a whole are better served if the litigation is resolved by the settlement rather than pursued." 6A FEDERAL PROCEDURE, L. ED. § 12:359 (1989) (footnote omitted). *See, e.g.*, Weinberg v. Lear Fan Corp., 627 F. Supp. 719 (S.D.N.Y. 1986) (stating that where a settlement has been negotiated before the class has been certified, the court should scrutinize the fairness of the settlement with even more care than usual).

182. Greenfield v. Villager Indus., Inc., 483 F.2d 824, 833 (3d Cir. 1973). Generally, the fact that the settlement was reached prior to class certification is only one factor weighing against approval of the settlement, and the court will normally approve the settlement where there are other factors indicating that the settlement is fair, adequate, and reasonable. Plummer v. Chemical Bank, 91 F.R.D. 434, 440 (S.D.N.Y. 1981), *aff'd*, 688 F.2d 654 (2d Cir. 1982).

4. Criteria for Court Approval of a Settlement

When a proposed classwide settlement is reached, it must be submitted to the court for approval.[183] Then, the court must notify the class of the proposed settlement and afford absent class members an opportunity to object at a scheduled hearing.[184] Although Rule 23 does not specify what criteria a court should employ to approve a settlement, commentators agree that a settlement should be approved if it is "fair, adequate and reasonable."[185]

With respect to this determination of fairness, the United States Supreme Court has stated: "Courts judge the fairness of a proposed compromise by weighing the plaintiff's likelihood of success on the merits against the amount and form of the relief offered in the settlement . . . . They do not decide the merits of the case or resolve unsettled legal questions."[186]

After surveying numerous cases describing different factors considered by courts in approving class action settlements, one commentor attempted to list them:

> For example, the following all have been viewed as relevant to approving a dismissal or compromise: the likelihood of the class being successful in the litigation, the points of law on which the settlement is based, the amount proposed as compared to the amount that might be recovered, less litigation costs if the action went forward, the plan for distributing the settlement, whether proper procedures were adopted for giving notice to members of the class, and whether the settlement would waive other viable claims.[187]

I. Challenge to Settlement of Class Actions on Grounds of Collusion

Under certain circumstances, a bondholder class action brought to

183. FED. R. CIV. P. 23(e) provides: "A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs."

184. Advisory Note, *supra* note 97, at 104.

185. *See, e.g.*, 3B JAMES MOORE, MOORE'S FEDERAL PRACTICE ¶ 23.80[4], at 23-488 (2d ed. 1991) (stating that "The burden is on the proponents of a settlement to persuade the court that it is fair, adequate and reasonable."); 2 NEWBERG, *supra* note 170, § 11.40, at 452 (stating that "[o]verall, the court has the duty to determine whether the settlement is fair, reasonable and adequate."); 7B CHARLES A. WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE: CIVIL 2D § 1797.1, at 378 (1986) (stating that "[i]n general, the standard used by the courts in evaluating a compromise is that the proposal must be fair and reasonable and in the best interests of all those who will be affected by it.").

186. Carson v. American Brands, Inc., 450 U.S. 79, 88 n.14 (1981) (citation omitted).

187. 7B CHARLES A. WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE: CIVIL 2D § 1797.1, at 395-404 (1986).

restructure debt securities may be subject to scrutiny on the grounds that it is collusive. This challenge would be based upon the fourth prerequisite to class action certification contained in Rule 23(a)—that the representative party must adequately protect the interests of the class.[188] For example, the payment by one side in an action of an opposing counsel's legal fees is generally an indicator of collusion.[189] However, while such payments may be indicators of collusion, they are not always regarded as conclusive. For example, in *Cranston v. Freeman*,[190] a group of dairy farmers brought a class action against the U.S. Secretary of Agriculture and other dairy farmers seeking relief from certain milk pricing differentials.[191] The Consolidated Milk Producers Association solicited the plaintiffs who brought the action and agreed to pay their counsel fees. Significantly, a majority of the Association's members belonged to the group of dairy farmers which made up the defendant class in the suit. The Association's interest in encouraging the suit was to clear up the uncertainty regarding the validity of the pricing differentials which benefitted the defendant class.

Following a motion by certain members of the plaintiffs' class to dismiss the suit because of alleged collusion between the defendants and representatives of the plaintiff class, the District Court in *Cranston* reaffirmed the certification of the class action and refused to dismiss the suit.[192] The court reasoned that, although the Association had contributed to the plaintiffs' counsel fees, neither the Association nor the defendants ever attempted to control the plaintiffs' conduct during the suit.[193] Further, the court noted that the plaintiffs' attorney had vigorously advocated on behalf of the plaintiff class.[194] Since there had been no attempt by the Association to control the plaintiffs' prosecution of the suit and because the proceedings were conducted in "an adversary nature on the highest level," the class certification was upheld.[195]

Likewise, in *Wiley v. Western Airlines*,[196] the court upheld a settlement agreement between two opposing parties to a class action despite allegations of collusion.[197] In that case, certain plaintiffs who

188. *See supra* Section III(A).

189. United States v. Johnson, 319 U.S. 302, 305 (1943) (dismissing a suit on collusion grounds where defendant paid plaintiff's counsel fees and where plaintiff exercised no control over the suit).

190. 290 F. Supp. 785 (N.D.N.Y. 1968), *rev'd on other grounds sub nom.*, Cranston v. Hardin, 428 F.2d 822 (2d Cir. 1970), *cert. denied*, 401 U.S. 949 (1971).

191. *Id.* at 786-87.

192. *Id.* at 788.

193. *Id.* at 789.

194. *Id.*

195. *Id.*

196. Nos. 89-16141, 89-16142, 1991 U.S. App. LEXIS 8239 (9th Cir. Apr. 15, 1991).

197. *Id.* at *16.

opposed the settlement agreement alleged that counsel for the plaintiff class had reached a collusive agreement with the defendant. The court in *Wiley* stated that, in order to overcome a collusion challenge to the class action settlement, the settlement must appear "fair, reasonable, and adequate to all concerned."[198] As in *Cranston*, the court noted that the plaintiffs' attorney had "competently and vigorously" advocated on behalf of the plaintiffs during settlement negotiations and that anything the plaintiffs had conceded was "done 'in the spirit of compromise that is necessary to achieve any settlement.' "[199] The court also concluded that the agreement was "adequate and fair" to all parties concerned, even though a minority of the class members did not approve of the settlement.[200]

Based upon the above analysis, it appears that bondholders seeking to restructure their bonds through bondholder litigation and settlement may seek reimbrusement of the representatives' litigation expenses and still avoid a potential collusion challenge. So long as the interests of the plaintiff class are vigorously advocated, an allegation of collusion is not likely to succeed. Further, if the settlement involves a Section 3(a)(10)[201] exchange of securities, the court must necessarily determine in a fairness hearing that the settlement is fair to all members of the class of bondholders.[202]

IV. DOES THE TRUST INDENTURE ACT PERMIT A MANDATORY CLASS ACTION SETTLEMENT?

A. *Background of Section 316(b) of the Trust Indenture Act*

Section 316(b) of the Trust Indenture Act, originally enacted in 1939, prohibits the impairment of the right of a bondholder to receive payment of the principal and interest on a debt security issued under a qualified indenture without the consent of the bondholder.[203] Sec-

198. *Id.* at *11.
199. *Id.* at *13-14 (citing the district court's order).
200. *Id.* at *9.
201. *See infra* Section V regarding the use of the Section (3)(a)(10) exchange exemption in conjunction with the issuance of securities in the settlement of bondholder litigation.
202. *See infra* Section V(B)(3).
203. The text of Section 316(b) provides:

> Notwithstanding any other provision thereof, the indenture to be qualified shall provide that, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security . . . or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder, except as to a postponement of an interest payment consented to as

tion 316(b) effectively prohibits modification of fundamental payment terms through the use of majority action provisions—provisions which, though rare in 1939 in American indentures because of concerns about their effect on negotiability, were quite common in Canadian and English indentures.[204]

The legislative history of the Trust Indenture Act indicates that Congress enacted Section 316(b)'s prohibition to avoid "[e]vasion of *judicial* scrutiny of the fairness of debt-readjustment plans . . . ,"[205] to preserve negotiability and to assure that such securities were legal investments for certain financial institutions.[206] In his testimony before Congress on the bill, William O. Douglas, then Chairman of the SEC, downplayed the effect of Section 316(b), characterizing criticism of the prohibition as "somewhat of a bogey" and stating that the prohibition "*merely* restricts the power of the majority to change . . . particular phases of the contract."[207]

In fact, the prohibition against majority action was a deliberate strategy by Douglas and others at the SEC to compel judicial supervision of workouts and reorganizations. The SEC's extensive 5000-page study of corporate reorganizations,[208] which served as the legislative basis for the Trust Indenture Act, contained numerous examples of the dangers of out-of-court reorganizations and judicially-supervised reorganizations that did not provide adequate protection for minority security holders. While the majority action prohibition was clearly

> provided in paragraph (2) of subsection (a) and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under the applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien.

15 U.S.C. § 77ppp(b) (1988). It is important to note that the requirements of Section 316(b) do not apply to bond issuances where the indenture limits the aggregate principal amount to $10,000,000. 15 U.S.C. § 77ddd(a)(9) (1988).

204. Francis L. Stetson et al., *Preparation of Corporate Bonds, Mortgages, Collateral Trusts and Debenture Indentures*, *in* SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 1, 68 (1922); De Forest Billyou, *Corporate Mortgage Bonds and Majority Clauses*, 57 YALE L.J. 595, 595-97 (1948).

205. SENATE COMM. ON BANKING AND CURRENCY, REPORT ON TRUST INDENTURE ACT OF 1939, S. REP. NO. 248, 76th Cong. 1st Sess. 26 (1939) (emphasis added) [hereinafter SENATE REPORT]; HEARINGS BEFORE A SUBCOMMITTEE OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES, 75th Cong., 3rd Sess. 35 (1938) (testimony of William O. Douglas).

206. SENATE REPORT, *supra* note 205, at 27 (reporting that "[i]n many States it is necessary in order to preserve the negotiability of the notes or bonds; in others it is necessary if the notes or bonds are to be legal investments for insurance companies, savings banks, and the like.").

207. *Hearings Before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives*, 75th Cong., 3rd Sess. 35 (1938) (emphasis added).

208. SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937).

intended to foster judicial supervision of corporate reorganizations, the SEC report, like the congressional reports, did not necessarily favor bankruptcy courts over other courts or agencies. For example, after surveying a number of contractual approaches, such as majority action provisions that facilitated "voluntary reorganizations," the SEC study concluded: "The risk is that if these provisions come into vogue and no controls are set up over them, the next cycle of reorganizations will take place on a voluntary basis without supervision of *any court or administrative agency*."[209] Similarly, the SEC study acknowledged that until the then-recent revisions of the Bankruptcy Act, "the favored method for effecting a corporate reorganization was through the federal consent receivership."[210] In fact, the SEC report noted that bankruptcy proceedings are more susceptible than receivership proceedings to manipulation by "management and its bankers."[211]

Thus, while the background and the legislative history of the majority action prohibition in Section 316(b) of the Trust Indenture Act indicate legislative intent to promote judicial supervision of corporate restructurings, there is no evidence that the judicial supervision intended was to be provided by a bankruptcy court instead of any other court or adminstrative agency.

B. Recent Cases

Recent courts have puzzled over the question of whether they have the judicial power, through use of a mandatory class action lawsuit, to require nonassenting bondholders to participate in a lawsuit settlement that compromises the original payment terms of the bonds. For example, in the *Continental Assurance* case,[212] the financially troubled issuer of $30 million of mortgage notes, after defaulting on an interest payment, sent a notice to all noteholders inviting them to meet with the issuer for the purpose of discussing various restructuring proposals.

After an initial meeting on April 8, 1987, a preliminary agreement regarding the terms of a restructuring was reached on April 15, 1987 and was reflected in a "term sheet."[213] On September 8, 1987, the is-

209. *Id.* at 150 (emphasis added).
210. *Id.* at 869.
211. *Id.* at 871.
212. Continental Assurance Co. v. MacLeod-Stedman, Inc., 694 F. Supp. 449 (N.D. Ill. 1988).
213. *Id.* at 453.

suer, the indenture trustee and certain noteholders signed a definitive settlement agreement, which was then submitted to noteholders.[214] On November 16, 1987, after holders of eighty-nine percent of noteholders had agreed in principle to the settlement, a representative of the noteholders filed a class action lawsuit against the issuer in federal district court. The representative sought a fairness hearing in order to perfect the exemption under Section 3(a)(10) of the Securities Act and certification of a "no opt out class as a means of avoiding any requirement of consent mandated by the Indenture or the [Trust Indenture Act]."[215]

In its subsequent recitation of facts, the court stated: "*Without issuing an opinion or ruling on class certification*, [this] court indicated its conclusion that the Indenture and the TIA required that any Noteholder who was part of the settlement had to consent to it and that class certification could not be used to avoid this requirement."[216] As a result of this conclusion, the legal issue presented was never pursued; plaintiff withdrew its request for class certification and was able to obtain 100% participation in the restructuring agreement by arranging for one of the participating noteholders to buy the notes of the holdout noteholders.[217]

The court's hesitation in *Continental Assurance* seems unfounded in light of earlier and later cases in the same federal district in which courts certified mandatory classes in similar situations. In *MBank Dallas v. LaBarge, Inc.*,[218] the issuer of $10 million of debentures defaulted on an interest payment due on October 15, 1986.[219] The trustee held a bondholders meeting on November 6, 1986 and by December 7, 1986 had reached a tentative agreement with the issuer with respect to terms of a restructuring of the debentures.[220] Thereafter, the trustee filed the class action, attaching the settlement agreement to the complaint.[221] On December 12, 1986, the court certified the action as a mandatory class action under Rules 23(b)(1)(A) and (B) and (b)(2), approved a notice to class members and scheduled a fairness hearing, which was held on December 29, 1986.[222] Among other things, the notice stated that the settlement order "will be a final and binding resolution of all rights and interests of all Deben-

214. *Id.* at 453-54.

215. *Id.* at 455.

216. *Id.* (emphasis added).

217. *Id.* at 456.

218. No. 86 C 9583 (N.D. Ill. December 29, 1986) (unpublished findings of fact, conclusions of law and final order).

219. *Id.* at 3.

220. *Id.* at 6.

221. *Id.*

222. *Id.* at 3.

tureholders."[223] At such hearing, the court approved the restructuring embodied in the class action settlement and ruled specifically that the holders of the debentures "have not been deprived of their right to sue for principal and interest on the Debentures within the meaning of Section 316(b) of the Trust Indenture Act."[224]

Similarly, a court in a later case in the same federal district certified a mandatory class in a debt restructuring. After experiencing severe financial difficulties starting in the mid-1980s because of deteriorating real estate values in Texas, Las Colinas Corporation, a land development company, began a protracted effort to restructure its debt, culminating in a registered exchange offer and prepackaged Chapter 11 plan solicitation that was launched on May 23, 1989 and completed on June 22, 1989.[225]

In October 1988, Kemper Investors Life Insurance Company, one of the holders of the $200 million of twelve and a half percent First Mortgage Notes that was subject to the exchange offer, had filed a class action lawsuit in the Northern District of Illinois alleging, among other things, breach of provisions of the indenture. Prior to the commencement of the exchange offer, the court certified the lawsuit as a mandatory class action.[226] On June 5, 1989, Kemper and the issuer filed a joint motion for approval of the class action settlement, and the court thereafter directed that Kemper provide notice of the proposed settlement to all noteholders.[227] The settlement provided for the exchange of the notes for the same consideration and on the same terms as provided in the simultaneous exchange offer, except for certain minor changes to the new master note to be issued in exchange. However, because the exchange was to be effectuated as a settlement of a mandatory class action lawsuit, noteholders effectively lost their right *not* to participate in the exchange. In a Prospectus Supplement dated June 7, 1989, the issuer warned:

> Holders of Subordinated Notes should carefully review the Notice because the Settlement, if approved by the Court, will require all holders of Subordinated Notes to, among other things, accept the Exchange Offer, consent to the Indenture/Mortgage Amendments and accept the Prepackaged Plan on terms

223. MBank Dallas v. LaBarge, Inc., No. 86 C 9583 at 9 (N.D. Ill. December 12, 1986) (unpublished notice to debentureholders).

224. MBank Dallas v. LaBarge, Inc., No. 86 C 9583 at 13 (N.D. Ill. December 29, 1986) (unpublished findings of fact, conclusions of law and final order).

225. *See* Prospectus filed on May 25, 1989 under Rule 424(b)(3) of the Securities Act (SEC File No. 33-24488).

226. *See Las Colinas*, No. 88 C 9162 (N.D. Ill. June 6, 1989) (Exhibit A to Order Approving Notice, at 2).

227. *Id.* (Order Approving Notice).

described in the Prospectus and Prospectus Supplement.[228]

The court held a hearing on the settlement on June 22, 1989, issued findings of fact, conclusions of law and an order on June 27, 1989 that approved the proposed settlement and issued a final order on July 24, 1989 that made the settlement binding upon all holders of the notes.[229]

An interesting aspect of the class action settlement was its effect on the prepackaged plan solicitation. Las Colinas solicited approvals of a prepackaged plan simultaneously with its exchange offer as a method of discouraging holdouts: if it received exchange offer tenders and prepackaged plan acceptances that were less than its ninety-five percent minimum exchange offer condition, but greater than the sixty-six and two-thirds percent acceptance level required to approve a prepackaged plan, it would file for Chapter 11 bankruptcy and seek to confirm the preapproved Chapter 11 plan that bound *all* noteholders to the economic terms of the restructuring. Kemper preempted this chancy strategy by having a federal district court assist the parties in implementing a consensual restructuring without risking the delay, expense and risk to the business that accompanies any Chapter 11 filing.

C. *The Equitable Powers of a Federal Court in a Restructuring*

1. Implementation by Federal Courts of Mandatory Reorganizations Through Equity Receiverships

During the end of the last century and the beginning of this century, many of this country's railroads and other corporations were reorganized through the use of equitable receivers appointed by federal courts without any resort to the federal bankruptcy statute.[230] This was due in part to the inadequacy of the federal bankruptcy laws, which then "did not even attempt to deal with corporate reorganizations" and excluded railroads, banks, municipal corporations and insurance corporations.[231]

228. Las Colinas Corp., Prospectus Supplement to Prospectus, dated June 7, 1989, and Solicitation of Indenture/Mortgage Amendment Consents and Prepackaged Plan Acceptances, dated May 23, 1989, at 2 (SEC File No. 33-24488).

229. Kemper Inv. Life Ins. Co. v. Las Colinas Corp., No. 88 C 9162 (N.D. Ill. July 21, 1989) (order approving mandatory class action settlement that incorporated issuer's exchange offer).

230. For example, in 1916, receivers operated over 80 railroad corporations owning 42,000 miles of railroad, or about 16% of the total U.S. mileage. By 1925, 48 railroads with over 18,000 miles of track were operated by receivers. *See* Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901, 901 (1927).

231. James N. Rosenberg, *An Open Letter Containing Proposals for Amendment of the Bankruptcy Act so as to Aid in Combating the Depression*, 19 VA. L. REV. 333, 338 (1933).

Equity receiverships, which were "largely judge-made, or, more accurately, lawyer-made"[232] legal creations, were designed to provide financially troubled companies with sufficient time and protection from their creditors so that they could reorganize in an orderly manner. In a typical equity receivership, a financially troubled company, in order to avoid a multiplicity of foreclosure actions and lawsuits by creditors, arranged for a friendly creditor located in a different jurisdiction to file a creditor's bill in federal court in the jurisdiction of the company's operations.[233] This equitable action, which was called a bill of peace—the forerunner to the modern class action lawsuit[234]—sought relief in the form of equitable execution of the company's assets on behalf of all creditors similarly situated.[235] After the bill was filed, the corporation would answer, admit the allegations of the bill, and consent to the appointment of receivers.[236]

This procedure was cumbersome and expensive in situations where the corporation's property was located in a number of different federal districts or circuits. In fact, in order to provide for an orderly reorganization of a large corporation through equity receivers, it was sometimes necessary to file "ancillary bills" in each federal district in which a corporation's property was located.[237] In one case involving a chain store, some fifty local or ancillary receivers were appointed.[238] In order to provide for coordination of these complex legal proceedings, federal courts adopted the practice of designating the initial court in which a creditor's bill was filed as the " 'court of primary jurisdiction' "[239] However, this designation depended wholly upon the "comity" or courtesy of the ancillary federal district courts.[240]

From this procedural "horror,"[241] a series of judicial decisions were delivered that defined the ability of a federal court, in the exercise of

232. Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 739 (1988).

233. Robert T. Swaine, *Corporate Reorganization Under the Federal Bankruptcy Power*, 19 VA. L. REV. 317, 318-19 (1933). *See also* John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 970 (1989).

234. Miller & Crump, *supra* note 14, at 39 (stating that "[m]andatory classes find historical precedent in the equitable bill of peace").

235. Swaine, *supra* note 233, at 319.

236. *Id.*

237. *Id.* at 320.

238. Rosenberg, *supra* note 231, at 338. *See* May Hosiery Mills, Inc. v. F. & W. Grand 5-10-25 Cent Stores, Inc., 59 F.2d 218 (D. Mont. 1932).

239. Swaine, *supra* note 233, at 320.

240. *Id.* at 320.

241. Rosenberg, *supra* note 231, at 338 (stating that "[t]his horror—it is nothing

its equity powers, to bind nonassenting creditors to a reorganization plan that impaired or compromised the debtor's obligations. The development and recognition of this power is worth considering.

In the early cases, receivers were considered to have only the power to hold and operate property and to sell it at the the most advantageous price. For example, in 1890, the Supreme Court in *Kneeland v. The American Loan & Trust Co.*,[242] expressed the narrow view that "the appointment of a receiver vests in the court no absolute control over the property, and no general authority to displace vested contract liens."[243]

However, the power to enforce a creditor's bill through the conduct of a judicial sale necessarily vested in federal judges considerable power over the reorganization of insolvent entities. As one leading commentator noted:

> [A]ll these proceedings looking toward an ultimate sale of the property must proceed through determination of the validity and extent of each of the liens, the identification of the property which it covers, the setting of a day for the sale to occur, the determination whether there shall be an upset price and, if so, in what amounts, the sale itself, and the ultimate confirmation of the sale involving, under the present generally adopted practice, a judicial determination as to the equity of the plan pursuant to which the property has been purchased.[244]

Most importantly, the power to conduct a judicial sale forced federal judges to administer the distribution of sale proceeds. In the famous reorganization case of *Northern Pacific Railway Co. v. Boyd*,[245] the United States Supreme Court, in a 5-4 decision, struck down a reorganization conducted through a judicial sale that froze out an intermediate class of creditors, while granting continued equity ownership to preferred and common shareholders who contributed additional money to the company.[246] The decision strongly affirmed the "absolute priority" rule. Notwithstanding its conclusion that such a plan was invalid, the Supreme Court—in a famous dictum—noted:

> This conclusion does not, as claimed, require the impossible, and make it necessary to pay an unsecured crditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer, he is left to protect himself as any other creditor of a judgment debtor; and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it.[247]

This dictum paved the way for a series of decisions in which federal courts dispensed with the requirement that creditors are entitled

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less—of the ancillary receivership eats into the very vitals of reorganization of our nationwide enterprises, chain stores, railroads, etc. It must be stopped.").

242. 136 U.S. 89 (1890).

243. *Id.* at 97.

244. Swaine, *supra* note 233, at 323.

245. 228 U.S. 482 (1913).

246. *Id.* at 508.

247. *Id.*

to the cash value of their interest in the debtor's property and the requirement that there be a judicial sale at all.[248] Some commentators noted that the latter requirement had become "more of a fiction than a fact"[249] since the sale was often not made to a real third party, but, rather, to a group of existing creditors who bid their claims as consideration and used the judicial sale as a method of eliminating or compromising the debt of other, more junior creditors.[250]

In *Phipps v. Chicago, Rock Island & Pacific Railway*,[251] for example, the Eighth Circuit confirmed the decree of a federal district court in a receivership proceeding, not involving a sale, in which all creditors, including nonassenting creditors, were required to accept new securities in the reorganized entity in exchange for their claims.[252] Citing the above-quoted dictum in *Boyd*, the Eighth Circuit denied the right of nonassenting holders to receive the cash value of their claims:

> Mr. Phipps has been and still is offered the equivalent in the stock of the reorganized company of his just share of the property of the insolvent company. To sustain the contention of his counsel would result in his receiving the whole amount of his claim against the insolvent company and interest upon it in cash, while other creditors in his rank received only their just shares of property in the stock of the reorganized company. The courts that administered and distributed that property had and still have the same jurisdiction and power to prevent so inequitable a result . . . .[253]

In addition, the Eighth Circuit in *Phipps* dispensed with the requirement of a judicial sale: "That in the foreclosure cases the courts proceeded by sales . . . added nothing to the validity of or effect of their decrees, or of the title they transferred to the purchasers."[254] Thus, in *Phipps*, the Eighth Circuit affirmed the power of a federal district court, relying upon its equitable power of injunction, rather than on the equitable doctrine of receivership and its "fiction" of judicial sale, to effectuate a nonbankruptcy reorganization in which nonassenting creditors were compelled to relinquish their claims and accept in exchange new equity securities in the reorganized entity.

The decision in *Phipps*, although controversial at the time,[255] be-

248. *See Swaine, supra* note 233, at 324-27 (discussing decisions which dispensed with these requirements).

249. *Id.* at 324.

250. *Id.*

251. 284 F. 945 (8th Cir. 1922), *cert. denied*, 262 U.S. 762 (1923).

252. *Id.* at 953.

253. *Id.*

254. *Id.*

255. For a contemporaneous criticism of the *Phipps* case, see Swaine, *supra* note 230, at 924-27.

came generally accepted. In *Kansas City Terminal Railway v. Central Union Trust Co.*,[256] for instance, the United States Supreme Court affirmed a reorganization plan in a railroad receivership which provided that all unsecured creditors would receive a package consisting either of common and preferred stock or, for an additional payment, mortgage bonds and common stock.[257] In so doing, the Supreme Court stated:

> This doctrine [the absolute priority rule] is the "fixed principle" according to which [*Boyd*] declares the character of reorganization agreements must be determined, and to it there should be rigid adherence. But, as that opinion states, this does not require the impossible, and make it necessary always to pay unsecured creditors in cash before stockholders may retain any interest whatever in the reorganized company. By way of illustration it further pointed out, that such creditors can be protected "by the issuance, on equitable terms, of income bonds or preferred stock." And we now add that, when necessary, they may be protected through other arrangements, which distinctly recognize their equitable right to be preferred to stockholders . . . .[258]

In 1934, Congress and the President enacted a bill that added Section 77B to the Bankruptcy Act.[259] Section 77B specifically provided for corporate reorganizations and contained provisions permitting the compromise of an entire class of claims with the assent of creditors holding two-thirds in amount and a majority in number of the claims if such reorganizations were determined to be "fair and equitable."[260] The usefulness of these provisions was considerably reduced by Justice Douglas's ruling in *Case v. Los Angeles Lumber Products Co.*[261] that the words "fair and equitable" required the individual consent of each affected creditor to any deviations from the absolute priority rule.[262] Nevertheless, the new corporate reorganization provisions reduced the need for the cumbersome and expensive receivership procedures, and the elaborate judicially constructed receivership procedures fell into disuse. Even though dormant, however, no legislative action or other action was taken that affected or reduced the scope of the equitable powers of federal courts charted during the heyday of equity receiverships.

2. The Equitable Power of a Federal Court to Impair Claims of Creditors Under Rule 23

Mandatory class action lawsuits under Rule 23 have their historical origins in the same equitable bills of peace that served as the basis

256. 271 U.S. 445 (1926).

257. *Id.* at 454.

258. *Id.*

259. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911 (repealed by the Chandler Act, ch. 575, 52 Stat. 840 (1938)).

260. § 77B; 48 Stat. at 918-19.

261. 308 U.S. 106 (1939).

262. *Id.* at 114-18. For a criticism of this case, see Roe, *supra* note 37, at 253-56.

for the equity receiverships in the early part of this century.[263] In a bill of peace, one person, called the *adversary*, might bring suit in equity against several persons, called the "*multitude*, with separate but similar interests . . . ."[264] Alternatively, representatives of "the multitude might sue to resolve in a single action common questions of law or fact between the adversary and each member of the multitude."[265] Bills of peace were "especially desirable when the multitude [was] seeking to divide a fund or a limited liability" where it was "impossible to make a fair distribution of the fund or limited liability to all members of the multitude except in a single proceeding where the claim of each [could] be adjudicated with due reference to the claims of the rest."[266] Professor Chafee stated:

> The fund or limited liability is like a mince pie, which can not be satisfactorily divided until the carver counts the number of persons at the table . . . . The problem is exactly like the distribution of the estate of a bankrupt, or an insolvent decedent or corporation, and similar to the administration in admiralty of the limited liability of the owner of a lost vessel.[267]

Because of the equitable origins of class actions, class actions for damages at law were not permitted in England until the merger of law and equity in 1873[268] and were not permitted in the United States until 1938, when law and equity were merged through the promulgation of the Federal Rules of Civil Procedure.[269] The Rules Enabling Act, under which the Federal Rules of Civil Procedure were promulgated, specifically provides that "such rules shall not abridge, enlarge or modify any substantive right . . . ."[270]

In *Brucker v. Thyssen-Bornemisza Europe N.V.*,[271] the plaintiffs, dissenting members of a mandatory Rule 23 class action who alleged that the conversion rights for an issue of convertible debentures had been improperly destroyed in a merger, attacked a proposed class action settlement as an improper use of Rule 23 since the settlement

263. 1 NEWBERG, *supra* note 100, § 1.10; Swaine, *supra* note 233, at 319 (remarking that the creditor's bill brought to initiate an equity receivership "seeks such relief on behalf of all creditors similarly situated, in the nature of a bill of peace to avoid multiplicity of actions.").

264. 1 NEWBERG, *supra* note 100, § 1.10 n.88.

265. *Id. See generally*, Zecharia Chafee, Jr., *Bills of Peace with Multiple Parties*, 45 HARV. L. REV. 1297 (1932); 1 JOHN N. POMEROY, EQUITY JURISPRUDENCE § 246, at 467 (5th ed. 1941).

266. Chafee, *supra* note 265, at 1311.

267. *Id.* 1311-12.

268. 1 NEWBERG, *supra* note 100 § 1.10, at 17.

269. *Id.*

270. 28 U.S.C. § 2072(b) (Supp. 1991).

271. 424 F. Supp. 679 (S.D.N.Y. 1976), *aff'd sub nom.* Brucker v. Indian Head, 559 F.2d 1202 (2d Cir. 1977), *cert. denied*, 434 U.S. 897 (1977).

abridged substantive contractual rights. In dismissing the claim, the court in *Brucker* determined that the plaintiffs' substantive contractual rights had not been abridged and concluded that "the Rule 23 procedures have protected the substantive rights of the individual debenture holders."[272] Nevertheless, the question remains whether a Rule 23 mandatory class action in which nonassenting bondholders are bound to a class-wide settlement providing for impairment of their claims constitutes an abridgment of the holders' substantive rights not to have their payment terms impaired without their individual consent, as provided by Section 316(b) of the Trust Indenture Act.[273]

The impairment of creditor claims through settlement of a Rule 23 mandatory class action is an exercise of the equitable powers of a federal court that is conceptually and substantively indistinguishable from the impairment of creditor claims in the *Phipps* equity receivership[274] or the impairment of contractual insurance claims through an equitable bill of peace in *Ben-Hur*.[275] All three actions derive from the inherent equitable powers of a federal court—substantive powers that were not meant to be affected or limited through promulgation of the Federal Rules of Civil Procedure.[276] The *Phipps* and *Ben Hur* decisions demonstrate that federal courts possessed the inherent equitable power to compromise or impair claims of creditors prior to the promulgation of the Federal Rules of Civil Procedure. There is no basis for concluding that the exercise by a federal court of the same remedy through the vehicle of a mandatory Rule 23 class action settlement is limited in any way by the Federal Rules of Civil Procedure.

Moreover, the right of a creditor not to have its claim impaired was not abridged by the promulgation of Rule 23 of the Federal Rules of Civil Procedure or its use in effecting a binding settlement that impairs the claims of nonassenting creditors; as *Phipps* demonstrates, the rights of such creditors have *always* been subject to the equitable remedies of a federal court, including the judicially enjoined restructuring plans that impair the claims of nonassenting creditors.

Finally, the fact that the impairment prohibition is legally required by the Trust Indenture Act, a statute enacted in 1939 following most of the receivership cases, should not affect these conclusions. Section

272. *Id.* at 688.

273. Trust Indenture Act of 1939, § 316(b), 15 U.S.C. § 777ppp(b) (1988).

274. *See supra* notes 251-54 and accompanying text.

275. *See supra* notes 99 & 120.

276. Fitzpatrick v. Sun Life Assur. Co. of Canada, 1 F.R.D. 713 (D. N.J. 1941) (ruling that while the Federal Rules of Civil Procedure abolish the procedural distinction between actions at law and suits in equity, such rules are not meant to change or affect the exercise of equitable remedies).

316(b) of the Trust Indenture Act requires that a prohibition on impairment without individual consent be part of every qualified indenture.[277] However, due to concerns about the effect of majority action provisions on the negotiability of bonds, these prohibitions were a part of almost all United States indentures prior to the enactment of the Trust Indenture Act[278]—and such provisions did not limit the equitable powers of federal courts to bind nonassenting bondholders to reorganization plans that impaired fundamental payment terms.

D. *Constitutional Considerations*

1. Contract Impairment Clause

Article I, section 10 of the United States Constitution commands that "No State shall . . . pass any . . . Law impairing the Obligation of Contracts."[279] The clause, which was a response to state debtor relief laws enacted to combat the economic depression that preceded the adoption of the Constitution, was "included primarily to protect private contracts from improvident majoritarian impairment."[280] Thus, in *Sturges v. Crowninshield*,[281] the Supreme Court struck down New York's insolvency law that discharged debtors of their obligations upon surrender of their property.[282] Likewise, in *Green v. Biddle*,[283] the Supreme Court invalidated a Kentucky law that impaired the ability of landowners to eject squatters.[284]

277. 15 U.S.C. § 777ppp(b) (1988).

278. Prior to the enactment of the Trust Indenture Act, majority action clauses were common in English and Canadian indentures, but relatively rare in American indentures. Francis L. Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts and Debenture Indentures*, *in* SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 1, 68 (1927) (stating that "[t]he object of conferring this power on the majority [in English indentures] is to protect it against unreasonable conduct on the part of the minority and to prevent a defeat of a beneficial arrangement because unanimity cannot be obtained." (footnote omitted)); De Forest Billyou, *Corporate Mortgage Bonds and Majority Clauses*, 57 YALE L.J. 595, 595-97 (1948). The reluctance to use majority action clauses in American indentures resulted primarily from the uncertainty concerning the negotiability of bearer bonds with such clauses under the laws of each of the 48 states—a concern that is not valid today. *Id.* at 597. *See also* Howard J. Kashner, *Majority Clauses and Non-Bankruptcy Corporate Reorganizations—Contractual and Statutory Alternatives*, 44 BUS. LAW. 123, 127-31 (Nov. 1988).

279. U.S. CONST. art. I, § 10.

280. LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 9-8, at 613 (2d. ed. 1988) (footnote omitted).

281. 17 U.S. (4 Wheat.) 122 (1819).

282. *Id.* at 207.

283. 21 U.S. (8 Wheat.) 1 (1821).

284. *Id.* at 92.

Significantly, the contract impairment clause protects private contracts against state, but not federal, action.[285] In *Gilfillan v. Union Canal Co.*,[286] the Supreme Court upheld a Pennsylvania statute which provided that creditors who failed affirmatively to opt out of a "an agreement of settlement" would have their secured and unsecured debt converted into income bonds.[287] In so doing, the Supreme Court discussed the holdout problem in restructurings and stated that the contract impairment clause serves only as a restriction on state legislation.[288]

> As in the present case, a very large majority of the bondholders sometimes think it is for their own interest as well as that of their associates to surrender a part of their rights and accept others instead, and they prepare and submit for execution an agreement, the object of which is to carry their plan into effect. No majority, however large, can compel a minority, small though it be, to enter into such an agreement against their will, and, under the Constitution of the United States, it is probable that no statute of a *State*, passed after the bonds were issued, subjecting the minority to the provisions of the agreement without their consent, would be valid.[289]

In a later case during the same term, the Supreme Court affirmatively stated that action by a governmental entity—such as a foreign government or the federal government—that was not restricted by the contract impairment clause could impair the obligations of the contracts of minority holdouts in a nonbankruptcy debt reorganization.[290] In *Canada Southern Railway v. Gebhard*,[291] the Supreme Court upheld a reorganization plan under Canadian law that permitted minority creditors to be bound by a plan approved by a specified majority.[292] After again discussing the problems created by minority holdouts in a reorganization, the Supreme Court stated:

> Hence it seems to be eminently proper that where the legislative power exists some statutory provision should be made for binding the minority in a reasonable way to the will of the majority; and unless, as is the case in the States of the United States, the passage of laws impairing the obligation of contracts is forbidden, we see no good reason why such provision may not be made in respect to existing as well as prospective obligations. The nature of securities of this class is such that the right of legislative supervision for the good of all, unless restrained by some constitutional prohibition, seems almost necessarily to form one of their ingredients, and when insolvency is threatened, and the interests of the public, as well as creditors, are imperiled by the financial embarassments of the corporation, a reasonable "scheme of arrangement" may, in our opinion, as well be legalized as an ordinary "composition in bankruptcy."[293]

The foregoing cases demonstrate that the contract impairment

285. *Gilfillan v. Union Canal Co.*, 109 U.S. 401, 404 (1883).
286. 109 U.S. 401 (1883).
287. *Id.* at 407.
288. *Id.* at 404.
289. *Id.*
290. Canada S. Ry. v. Gebhard, 109 U.S. 527, 532, 535-36 (1883).
291. 109 U.S. 527 (1883).
292. *Id.* at 539.
293. *Id.* at 535.

clause of the United States Constitution acts only as a limitation on state legislation and state action. Thus, while the contract impairment clause may serve as a restriction on the ability of a state court to effectuate a reorganization through a mandatory class action brought under state laws, it should not restrict the ability of a federal court to effectuate a debt restructuring through a mandatory class action under Rule 23 of the Federal Rules of Civil Procedure.

2. Due Process Clause

While federal courts are not bound by the contract impairment clause, they are bound by the due process clause of the Fifth Amendment, which provides that no person shall be "deprived of life, liberty, or property, without due process of law."[294] In *Gebhard*, the Supreme Court considered whether a "scheme of arrangment" under Canadian law that bound nonassenting bondholders to an impairment of their contract violated the due process clause.[295] It stated:

> The confirmation and legalization of a "scheme of arrangement" under such circumstances is no more than is done in bankruptcy when a "composition" agreement with the bankrupt debtor, if assented to by the required majority of creditors, is made binding on the non-assenting minority. In no just sense do such governmental regulations deprive a person of his property without due process of law. They simply require each individual to so conduct himself for the general good as not unnecessarily to injure another.[296]

In the context of a plan effectuated through settlement of a mandatory class action lawsuit, the Supreme Court has imposed additional due process requirements. As discussed above, the Supreme Court in *Shutts* held that due process requires the right to opt out in certain class actions seeking money damages.[297] However, that holding specifically did *not* apply to class actions that primarily seek equitable relief, such as one effectuating a corporate reorganization.[298]

Since a class action lawsuit is, by definition, a representative action, the due process clause requires that the representative of the class be a person who will fairly insure the adequate representation of the class.[299] In *Hansberry v. Lee*,[300] the Supreme Court held that parties who were determined in a state court to be bound as members of a "class" by a judgment rendered in an earlier class suit were not so

294. U.S. CONST. amend V.
295. *Gebhard*, 109 U.S. at 537.
296. *Id.*
297. *Shutts*, 472 U.S. at 812.
298. *See supra* Section III(G).
299. Hansberry v. Lee, 311 U.S. 32, 41-42 (1940).
300. 311 U.S. 32 (1940).

bound because the representatives of the class did not adequately represent the members' interests.[301]

V. EXEMPT SETTLEMENT EXCHANGES UNDER SECTION 3(a)(10) OF THE SECURITIES ACT

A. *Background of Section 3(a)(10)*

Securities distributed in connection with the settlement of litigation can often be issued without registration under the Securities Act by relying on Section 3(a)(10) thereof, which provides an exemption, among other things, for the issuance of securities whose term and conditions have been approved by a court after a fairness hearing.[302] The Section 3(a)(10) exemption represents a signficant departure from the Security Act's "basic philosophy" of providing full and fair disclosure in connection with the offer and sale of securities.[303] The "whole justification" for the Section 3(a)(10) exemption is that "the examination and approval by the body in question of the fairness of the issue in question is a substitute for the protection afforded to the investor by the information which would otherwise be made available to him through registration."[304]

The legislative history of Section 3(a)(10) indicates that its primary purpose was to "offer financially troubled corporations an alternative to the virtually impossible burdens of registration."[305] The use of the Section 3(a)(10) exemption for financial restructurings accomplished

301. *Id.* at 46.

302. 15 U.S.C. § 77c(a)(10) (1988). Section 3(a)(10) exempts from the registration provisions of the Securities Act the following:

> Except with respect to a security exchanged in a case under title 11 [of the United States Code], any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing on the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.

Id.

303. 11 H. SOWARDS, BUSINESS ORGANIZATIONS, SECURITIES REGULATION, THE FEDERAL SECURITIES ACT AND THE TRUST INDENTURE ACT OF 1939, § 1.02, at 1-6.1 (1990).

304. SEC Securities Act Release No. 33-312, 1 FED. SEC. L REP. (CCH) ¶ 2181, 2183 (March 15, 1935) (letter of SEC General Counsel). *See also* Memorandum of James M. Landis to Senator D. Fletcher, *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 8669, at 8715 (1934) (stating that "[t]he entire basis of the exemption of the second clause of section 4(3) [the predecessor to Section 3(a)(10)] rests upon the assumption that court supervision will be an adequate protection for investors in substitution for the registration requirements of the act.").

305. Barbara A. Ash, *Reorganizations and Other Exchanges Under Section 3(a)(10) of the Securities Act of 1933*, 75 N.W. U. L. REV. 1, 9 (1980) (footnote omitted). *See also* 7 J. HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, § 3.01[2], at 3-12 (1984) (noting that "the legislative history of Section 3(a)(10) indicates legislative

through mandatory class action settlements is consistent with this original legislative purpose.

B. Elements of the Section 3(a)(10) Exchange Exemption

Section 3(a)(10) specifies four basic requirements that must be met to qualify for exemption from the registration requirements of the Securities Act. These requirements include: (1) the issuance of a security; (2) an exchange for one or more bona fide outstanding securities, claims, or property interests; (3) a hearing on the fairness of the terms and conditions of the exchange; and (4) court, agency, or official approval.[306]

1. The Issuance of a Security

Section 3(a)(10) states that its provisions apply to the issuance of "any security."[307] The SEC staff has interpreted this phrase literally and shown a willingness to allow any instrument qualifying as a "security" under the definition in Section 2(1)[308] to be issued in connection with a Section 3(a)(10) settlement exchange. For example, the SEC has taken no-action positions with respect to Section 3(a)(10) settlements involving the issuance of common stock,[309] preferred stock,[310] corporate debt securities,[311] warrants to purchase stock,[312]

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concern for only one type of transaction—the reorganization of a financially troubled business.").

306. Ash, *supra* note 305, at 10-13 (citing 15 U.S.C. § 77c(a)(10) (1988)).

307. 15 U.S.C. § 77c(a)(10) (1988).

308. 15 U.S.C. § 77b(1) (1988).

309. *See* Riverbend International Corp., SEC No-Action Letter *available in* LEXIS, Fedsec Library, Noact File (Mar. 30, 1990); Memory Metals, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Dec. 9, 1988); Cavanagh Communities Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (July 22, 1987); Paradyne Corp., SEC No-Action Letter, LEXIS, Fedsec Library, Noact File (July 20, 1987); Ideal Basic Indus., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Jan. 30, 1987); Anacomp, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (July 24, 1985); Swanton Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Nov. 26, 1984) (stock of third party); AES Technology Sys., Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (June 22, 1984); Allied Leisure Indus. Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Oct. 4, 1979); Sequoyah Indus., Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Sept. 6, 1973).

310. *See* Pacific Scientific Co., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (July 31, 1989); Iomega Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Dec. 29, 1988) (stating that common stock was issuable upon conversion of preferred stock in reliance on Section 3(a)(9)); Endotronics, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Oct. 11, 1988) (distribution of third party stock); Northwest Indus.; Philadelphia and Reading

limited partnership interests or units,[313] depositary receipts[314] and "put" rights.[315] However, the Section 3(a)(10) exemption does not cover securities issuable upon a subsequent conversion of securities which were previously issued in a Section 3(a)(10) transaction[316] or securities issuable upon a subsequent exercise of warrants.[317]

2. An Exchange for One or More Bona Fide Outstanding Securities, Claims, or Property Interests

Section 3(a)(10) provides that the exemption is applicable to the issuance of a security "in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash."[318] The flexibility provided by this broad language is illustrated by comparing it to the much stricter requirements of the Section 3(a)(9) exemption.

Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Aug. 10, 1973).

311. *See* Macleod-Stedman, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (March 3, 1989) (old mortgage notes exchanged for new corporate notes; redeemable, exchangeable preferred stock; and common stock); Mattel, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Jan. 14, 1976) (debentures).

312. Warrants: Dynamic Sciences Int'l, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Dec. 30, 1988); Elscint Ltd., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (May 13, 1988); Allied Leisure Indus., Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Oct. 4, 1979); Builders Inv. Group, SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Dec. 15, 1978), Standard Prudential Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Sept. 6, 1973); LIN Broadcasting Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Dec. 8, 1972).

313. Limited Partnership Units: RRP-DGT GP Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec library, Noact File (Sept. 25, 1989); C. Andrew Russell, MLP, SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Aug. 24, 1989).

314. Gambro AB, SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Oct. 19, 1987).

315. Carolco Pictures, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Jan. 23, 1991).

316. *See, e.g.*, Iomega Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Dec. 29, 1988) (common stock issuable upon conversion of such preferred stock cannot be issued under the Section 3(a)(10) exemption; Section 3(a)(9) may be available).

317. *See, e.g.*, Allied Leisure Indus., SEC No-Action Letter, LEXIS, Fedsec Library, Noact File (Oct. 4, 1979) (warrants); Builder Inv. Group, SEC No-Action Letter, LEXIS, Fedsec Library, Noact File (December 15, 1978) (stating that, with respect to warrants, "the underlying shares must be registered absent the availability of Regulation A or an applicable exemption."); LIN Broadcasting Co., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (December 8, 1972) (stating that "[r]egistration is mandatory if the warrants are to be converted into the underlying stock of the company.").

318. 15 U.S.C. § 77c(a)(10) (1988).

a. No Same Issuer Requirement

Section 3(a)(9) exempts securities exchanged by the issuer with "its" security holders.[319] This means that the securities issued in the exchange must be securities of the same entity that issued the securities sought in the exchange.[320] In the past, the SEC staff has construed this requirement strictly.[321] For example, the SEC has denied no-action relief simply because an issuer changed its form of ownership from a general partnership to a limited partnership,[322] from a corporation to a limited partnership,[323]from a corporation to a liquidating trust[324] or from a corporation to a liquidating partnership.[325]

Conversely, Section 3(a)(10) imposes no such requirement. First, parties in a Section 3(a)(10) settlement exchange are not required to tender securities at all: they may exchange any "claims, or property interests."[326] Second, the transferor of the securities need not be the issuer of the securities: a settling defendant may use the Section 3(a)(10) exemption to distribute securities of another issuer.[327]

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319. 15 U.S.C. § 77c(a)(9) (1988).

320. Hendry County Bank, SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File) (May 28, 1982) (stating that Section 3(a)(9) is not available for a proposed issuance of shares by a holding company to the shareholders of its subsidiary in exchange for the stock of the subsidiary because the transaction involves securities of two different issuers).

321. O'Neill Bondholders Comm., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (July 10, 1974) (stating that issuer in an exchange transaction must be the same entity which originally issued the securities to be surrendered).

322. NEOKA Group 1987-I, SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Jan. 19, 1990) (where no-action relief refused even though the amendment of the partnership into a limited partnership did not cause a dissolution of the partnership under state law or pursuant to the partnership agreement).

323. Kanawha Cauley Coal & Coke Co., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Aug. 5, 1974); Recreation Ventures, SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Mar. 14, 1973).

324. Niagara Frontier Transit Sys., Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Dec. 11, 1974).

325. Mission Mart, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (May 13, 1981).

326. 15 U.S.C. § 77c(a)(10) (1988). *See, e.g.*, S.E.C. v. Blinder Robinson & Co., 511 F. Supp. 799 (D. Colo. 1981) (settlement agreement involving the issuance of common stock and promissory notes to shareholders in exchange for a release of claims); Ideal Basic Indus., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Jan. 30, 1987) (common stock issued to plaintiffs in exchange for a release of claims and covenant not to sue).

327. *See, e.g.*, Endotronics, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Oct. 11, 1988) (where Hoechst Celanese Corp. distributed the common and preferred stock of Endotronics, Inc., in a Section 3(a)(10) settlement exchange); Swanton Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Nov. 26, 1984) (stock of Swanton Corp. issued by Swanton in exchange for

b. *Partly for Cash*

Section 3(a)(9) exempts securities issued by an issuer in exchange with its security holders "exclusively,"[328] which has been interpreted not only to require that the exchange be exclusively with security holders, but also that the transaction be exclusively an exchange transaction—that is, security holders must not be required to contribute anything other than their securities.[329] This requirement permits convertible securities to be converted pursuant to Section 3(a)(9), since all that is being tendered is the security. However, that does not generally permit warrants to be exercised, because to exercise warrants a holder must pay a cash exercise price.[330]

On the other hand, Section 3(a)(10) provides that the securities may be issued partly in exchange for an existing interest and partly for cash.[331] This feature permits a settling issuer to receive cash from plaintiffs in connection with a settlement exchange. However, there is little guidance concerning how substantial the cash portion may be before the Section 3(a)(10) exemption is lost.[332]

c. *Payment to Third Parties*

Section 3(a)(9) requires that "no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."[333] The restriction is not on solicitation in general, but rather on payment of compensation for soliciting activities.

Section 3(a)(10) has no such restriction. The SEC staff has permitted payments of cash and issuances of securities under the Section 3(a)(10) exemption to attorneys, expert witness and other professionals involved in the transaction.[334] While the SEC staff has not specif-

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the stock of Friendly Frost, Inc., to settle lawsuit by Friendly Frost stockholders over a third-party exchange offer).

328. 15 U.S.C. § 77c(a)(9) (1988).

329. *See infra* note 333 and accompanying text.

330. Landmark Oil & Gas, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Sept. 22, 1983) (stating that an exchange of new warrants for old warrants is permitted under Section 3(a)(9), but the warrants may not be exercised unless the registration statement is effective, and a current prospectus is delivered); *see also* Chemfix Technologies, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Oct. 10, 1985).

331. 15 U.S.C. § 77c(a)(9) (1988).

332. 1 SECURITIES LAW TECHNIQUES § 6.02[1][d] (A. Sommer, Jr., ed. 1991). Clearly, Section 3(a)(10) is inapplicable where only cash and no securities are tendered in an exchange. S.E.C. v. Century Inv. Transfer Corp., [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,232 (S.D.N.Y. 1971); S.E.C. v. Philip S. Budin & Co., [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,088 (D.N.J. 1971).

333. 15 U.S.C. § 77c(a)(10) (1988).

334. *See, e.g.*, Riverbend Int'l Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (July 24, 1985) (allowing plaintiffs' counsel fees up to 33⅓% of shares distributed out of settlement fund, plus accrued interest on the value of the shares); Elscint Ltd., SEC No-Action Letter, *available in* LEXIS, Fedsec Library,

ically allowed such payments in connection with soliciting activities, Section 3(a)(10) by its terms does not restrict such payments or activities.

The thrust of the exchange requirement is that the securities be issued to an existing security holder or other party with a valuable and bona fide interest in the issuer; an anticipated claim or unrelated property interest is not sufficient.[335] Otherwise, a spurious exchange could be used as a way to raise capital without registration. For example, if a property interest or security to be exchanged is acquired specifically for the purpose of effectuating an exchange, the proposed exchange would not be considered bona fide.[336]

So long as the security, claim or interest to be exchanged is bona fide, settling defendants have considerable flexibility in structuring the terms of a settlement package. For example, the SEC staff has approved settlement exchanges where plaintiffs are offered their choice of securities or cash.[337] In fact, the "size of the cash component in the transferor's settlement package should be irrelevant for purposes of the exemption."[338]

3. The Fairness Hearing

The key substantive requirement of Section 3(a)(10) is that "the terms and conditions of such issuance and exchange are approved, af-

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Noact File (July 24, 1985) (allowing plaintiff counsel's fees up to 25% of the cash to be paid out of the cash settlement fund); Anacomp, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (July 24, 1985) (stating that plaintiff counsel's fees to be paid out of cash settlement fund); AES Technology Sys., Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (June 22, 1984) (where plaintiffs' counsel to receive 12% of shares issued in settlement fund); Standard Prudential Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Aug. 17, 1973) (expert witnesses).

335. *See, e.g.*, Cavanagh Communities Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (July 18, 1977) (stating that Section 3(a)(10) is not available where the consideration exchanged is an unpaid future interest); Carex Int'l, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Oct. 20, 1975) (asserting that Section 3(a)(10) is not available where the interest exchanged is credit for future rental payments).

336. *See, e.g.*, Osias Org., Inc. SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Apr. 2, 1971) (stating that unregistered short-term receiver certificates issued for cash under Section 3(a)(7) may not be subsequently exchanged for common stock and convertible debentures under Section 3(a)(10)).

337. *See, e.g.*, Iomega Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Dec. 29, 1988) (stating that plaintiffs have the option to take preferred stock or cash); Elgin Nat'l Indus., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (May 9, 1975).

338. 7 J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 3.02[2][b], at 3-17 (1984).

ter a hearing upon the fairness of such terms and condition, at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court . . . ."[339]

a. *Notice*

Since any resolution of a class action lawsuit affects the rights and claims of all members of the class, the SEC has stressed the importance of providing proper notice to class members of the hearing to approve the transactions.[340] This is the case even though Rule 23(c)(2) does not require notice to class members in certain mandatory class actions.[341] In a number of instances, the SEC has conditioned its Section 3(a)(10) no-action positions upon the requirement that "all persons to whom stock is to be issued receive notification of the hearing and of entitlement to be heard."[342] In the case of security holders, this requirement is satisfied when notice is mailed to all registered "and known beneficial holders" detailing the time and place of the hearing with a summary of the proposed settlement.[343] In *Securities and Exchange Commission v. Blinder Robinson & Co.*,[344] which involved the issuance of securities under Section 3(a)(10) in connection with the settlement of an SEC enforcement action, the court described the mailed notice thus:

> After preliminary approval of the settlement, a hearing was set to consider the fairness of the agreement and notice of that hearing was mailed to all persons to whom the settling parties proposed to issue securities. That notice included a summary of the terms and conditions of the settlement agreement and invited the appearance at the hearing by all affected persons, with or without counsel, and also provided for the submission of written objections prior to the hearing.[345]

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339. 15 U.S.C. § 77c(a)(10) (1988).

340. *See infra* notes 342-43 and accompanying text.

341. *See* FED. R. CIV. PROC. R. 23(c)(2) (mandating notice in Rule 23(b)(3) actions only).

342. *See, e.g.*, Cavanagh Communities Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (July 22, 1987); Cavanagh Communities Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Mar. 4, 1985).

343. Macleod-Stedman, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Mar. 3, 1989).

344. 511 F. Supp. 799 (1981).

345. *Id.* at 800. *See also* Securities Act Release No. 33,312, Fed. Sec. L. Rep. (CCH) ¶ 2181, at 2590 (Mar. 15, 1935) (stating that "[a]lthough the wording of section 3(a)(10) does not demand such notice, in my opinion this requirement is to be implied . . . ."). Professor Hicks has written:

> [A]t a minimum, the notice should clearly advise the prospective recipients of the nature of the pending action, the terms of the settlement (including the fact that unregistered securities will be issued), the location of more detailed information about the litigation and settlement that is available for inspection, the date, time, and place of the fairness hearing, and the fact that they have a right to appear and object.

7 J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, § 3.02 [4][b], at 3-37 (1984).

As noted above, under Rule 23(e) of the Federal Rules of Civil Procedure, a dismissal or compromise of a class action may not occur without court approval, which must be preceded by notice to interested parties "in such manner as the court directs."[346] Even though this notice procedure is less defined than under Section 3(a)(10), the SEC has acknowledged that a notice procedure which satisfies Rule 23(e) is sufficient for the Section 3(a)(10) exemption.[347]

Because holders of registered securities, unlike certain classes of plaintiffs, are relatively easy to identify and locate, an issuer proposing a class action settlement should have little difficulty providing notice that satisfies the requirements of Section 3(a)(10).

b. Hearing and Approval

While Rule 23(e) does not specifically require that a hearing occur in connection with the dismissal or compromise of a class action lawsuit, it is clear under Section 3(a)(10) that a fairness hearing must be held in order to satisfy the requirements for the exemption.[348] In *Blinder Robinson*, the court noted that "[t]here is no statutory definition of 'fairness' as used in section 3(a)(10) and there is no general guidance suggesting the criteria for the court to consider in determining the question of approval."[349] In that case, the court determined the fairness issue by focusing upon the procedural aspects of the settlement.[350] According to the court, the key factors were:

> (1) the recommendations of counsel; (2) the scope of the discovery record as an indicator of the adequacy of the investigation into the facts; (3) the apparent alternatives to the settlement; (4) the nature and volume of responses from those receiving notice of the hearing; and (5) the opportunity for direct participation in the process of obtaining full disclosure.[351]

After analyzing these factors and concluding that they had been satisfied, the court stated:

> Those receiving the offer under the terms of the settlement agreement have had a full and fair opportunity to learn everything required to make their decision. Accordingly, it must be concluded that they will act in awareness of the risks involved in acceptance and the alternatives attendant upon a decision to decline the offer. Nothing more could be accomplished by registration and nothing more is required in the determination that this settlement should

346. FED. R. CIV. PROC. 23(e).

347. Mackey Int'l, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Feb. 25, 1974).

348. *Compare* FED. R. CIV. PROC. 23(e) *with* 15 U.S.C. § 77c(a)(10) (1988).

349. *Blinder Robinson*, 511 F. Supp. at 801.

350. *Id.* at 801.

351. *Id.*

be approved.[352]

The *Blinder Robinson* approach, which seeks to assure procedural fairness and adequate disclosure and relies upon fully informed parties to arrive at a fair settlement, has been criticized as overly passive. Professor Hicks stated that "it is reasonable for a claimant to assume that judicial approval of an offer of settlement carries with it a judgment that the court has found the value of the securities offered to be roughly equivalent to the value of the claim of loss."[353] The court in *Continental Assurance*[354] referred to this criticism and stated that this "reading seems more consistent with the plain language of the statute and its purposes."[355]

To be fair, however, the *Blinder Robinson* court distinguished the case before it, which was an SEC enforcement action, from a class action by pointing to the fact that "the SEC is not here as the representative of a class of investors claiming relief."[356] The *Blinder Robinson* court suggested that in a class action it would be confronted with "measuring the adequacy of the relief obtained by comparing the value of the securities to be issued with the claims of loss . . . ."[357]

A review of the cases which discuss the factors to be considered in determing fairness in the context of a Section 3(a)(10) settlement exchange indicates that the articulated factors are substantively identical to the determination that a class action settlement is fair, adequate and reasonable. Additionally, one commentator has suggested that, at least where Section 3(a)(10) is used in the settlement of litigation, courts should follow the fairness standard used in class action settlements by giving approval to the exchange transaction if the "settlement . . . offered is 'fair,' 'reasonable,' and 'adequate.' "[358]

While the SEC has not attempted to define what a fairness determination entails in the context of a Section 3(a)(10) determination, it has required that courts making such determinations be advised of the consequences.[359] Furthermore, the SEC's no-action letters pro-

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352. *Id.* at 802.

353. 7 J. Hicks, Exempted Transactions Under the Securities Act of 1933, § 3.02[4][c], at 3-46.7 (1984).

354. 694 F. Supp. 449 (N.D. Ill. 1988).

355. *Id.* at 468.

356. *Blinder Robinson*, 511 F. Supp. at 801.

357. *Id.*

358. J. Hicks, Exempted Transactions under the Securities Act of 1933 § 3.02[2][a] n.5 (rev. ed. 1981). For a discussion of the fairness standard used to evaluate class action settlements, see *supra* Section III(H)(4).

359. *See, e.g.,* Cavanagh Communities Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (July 22, 1987) (where a no-action position was conditioned upon the court being advised "prior to the hearing that if the terms and conditions of the transaction are approved, registration of the securities issued by the Company would not be required under the 1933 Act by virtue of the Court's ap-

vide useful guidance regarding the definition of the term "fairness." For example, in *Churubusco Bancorp*,[360] the staff upheld the use of a "not unfair and unreasonable to . . . shareholders" standard of review by the Indiana Department of Financial Institutions.[361]

4. Court, Agency, or Official Approval

The final requirement for perfection of the Section 3(a)(10) exemption is the approval of the transaction or settlement "by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval."[362] The SEC staff has interpreted the term "any court" quite liberally to include any federal[363] or state[364] court, unless jurisdiction is clearly lacking.[365]

C. *Use of Section 3(a)(10) in Conjunction with Class Action Settlements*

Section 3(a)(10) is often used to accomplish an exchange pursuant to the settlement of litigation.[366] Further,

> [n]o-action letters indicate that section 3(a)(10) is quite often useful to the settlement of litigation arising from . . . various . . . insolvency-related issuances of securities not pursuant to the Federal Bankruptcy Act . . . . [T]here appears to be no limitation, even in the Commission's view, on the availability of the Exchange Exemption because of the nature of the litigation proposed to be settled.[367]

Hence, Section 3(a)(10) should be a viable exemption to pursue when settling with a group of bondholders who sue a corporation because of its default on a class of bonds or because they oppose a proposed corporate debt restructuring.

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proval.") *Accord* RRP DGT GP Corp., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File) (Sept. 25, 1989).

360. SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File (Jan. 13, 1984).

361. *Id.*

362. 15 U.S.C. § 77c(a)(10) (1988).

363. *See, e.g.*, Geotek Resources Fund, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File) (May 5, 1982).

364. *See, e.g.*, Benson Mines, Inc., SEC No-Action Letter, *available in* LEXIS, Fedsec Library, Noact File) (June 29, 1979).

365. *See* O'Neill Bondholders Comm., SEC No-Action Letter [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,947, at 84,438 (July 10, 1974) (asserting that a bankruptcy court lacks jurisdiction to pass upon a Section 3(a)(10) transaction).

366. Ash, *supra* note 305, at 37.

367. *Id.* at 39.

VI. Qualification of New Indentures Under the Trust Indenture Act

Section 304(a)(4)(A) of the Trust Indenture Act exempts from the Trust Indenture Act any security exempted under Section 3(a) of the Securities Act, except for securities exempted under Sections 3(a)(9) or 3(a)(10) thereof.[368] Accordingly, if debt securities are to be issued in a Section 3(a)(10) settlement exchange, the indenture under which such securities will be issued must be qualified under the Trust Indenture Act.

Section 307 of the Trust Indenture Act governs the qualification of indentures covering securities not required to be registered under the Securities Act.[369] Form T-3 is the appropriate form for qualification of indentures governing securities not required to be registered.[370] In addition, the indenture trustee must file a statement of eligibility qualification on Form T-1.[371] Form T-3 application must be filed in time to have the indenture qualified prior to the issuance of the debt securities in the settlement. Unless a delaying amendment is filed, the T-3 becomes effective on the 20th day (including Saturdays, Sundays and holidays) after the date of filing.[372]

VII. Conclusion

Mandatory class action lawsuits brought by bondholders to initiate corporate restructurings have a number of advantages over prepackaged plans and other restructuring techniques. Among other things, the mandatory class action technique permits bondholders to consummate a consensual restructuring that is binding upon minority holdouts without the need to resort to Chapter 11 of the Bankruptcy Code and without the need for registration with the SEC. Although this technique has been used only rarely and has received little attention, its merits should command greater attention in the future.

368. Trust Indenture Act of 1939, § 304(a)(4)(A), 15 U.S.C. § 77ddd(a)(4)(A) (1988).
369. *See* Trust Indenture Act of 1939, § 307, 15 U.S.C. § 77ggg (1988).
370. 17 C.F.R. § 260.7a-1 (1991).
371. *Id.* § 260.5a-1.
372. *Id.* § 260.7a-9.