ANTITAKEOVER PROVISIONS IN BONDS: BONDHOLDER PROTECTION OR MANAGEMENT ENTREECHMENT?

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INTRODUCTION

On October 20, 1988, senior executives of RJR Nabisco announced that they were considering a leveraged buyout of the company. Overnight, the prices of RJR Nabisco bonds dropped by about 20%, leaving its bondholders with $1 billion in losses.1 The RJR buyout was neither the first nor the last acquisition in which

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bond values plummeted. Rather, beginning in the 1980s, leveraged acquisitions and recapitalizations transformed blue-chip bonds valued in the tens of billions of dollars into speculative-grade "junk." Since then, the plight of bondholders has received widespread popular and academic attention.

In response, several scholars have argued that the law should protect bondholders from takeover-related losses. The reform pro-

2. From 1984 through 1988, the bonds of 183 companies, in addition to RJR Nabisco, lost value as a result of mergers, acquisitions, or leveraged buyouts. Of the 183 companies whose bonds lost value, 45, with $16.2 billion in investment-grade bonds, had their bonds downgraded by Moody's Investors Service from investment grade to speculative grade. Recapitalizations, which often occurred in the face of a takeover threat, adversely affected the bonds of another 90 companies. Moody's downgraded the bonds of 23 of these companies from investment to speculative grade. In the industrial bond sector, these transactions affected approximately 9% of the market annually. MOODY'S SPECIAL REPORT, SPECIAL EVENT RISK IN THE U.S. AND EUROBOND MARKETS 1984-1988, at 9, 10, 21 (1989). In 1989, the bonds of 27 companies were downgraded as a result of acquisitions, leveraged buyouts, and recapitalizations. Of these, 12 were downgraded either from investment grade to speculative grade by either Moody's or Standard & Poor's or were downgraded a full letter grade within the investment grade categories by both. SALOMON BROTHERS, QUANTIFYING EVENT RISK AND ITS EFFECTS: 1986-89, at 3, 9 (1990). For an explanation of a bond rating, see infra notes 96-97 and accompanying text. Moreover, one study found that takeover-related risk increased interest rates on corporate bonds generally by 15 basis points. Steven A. Zimmer, Event Risk Premia and Bond Market Incentives for Corporate Leverage, FRBNY Q. REV., Spring 1990, at 15, 20.

posals that these commentators have advocated include establishing variously defined fiduciary duties to bondholders, finding "implied" protective covenants in bond indentures that lack express protection, and amending state corporation laws to provide a remedy for bondholders that suffer takeover-related losses. Although their positions differ in many details, these scholars base their arguments on the proposition that bondholders cannot obtain effective contractual protection against takeover-related losses and therefore need extrां-\textsuperscript{contractual support.}

While these scholars were developing the case for extra-\textsuperscript{contractual protection, many corporations began to extend to bondholders contractual rights that at least purport to shield bondholders from takeover-related losses. This Article analyzes these novel contractual provisions, which are generally referred to as "change of control covenants" (or "event risk covenants" or "poison puts"). These covenants essentially provide that if a specified takeover-related event occurs, bondholders will either have the right to put their bonds back to the company or to have the interest rate on their bonds increased to reflect the additional risk associated with the takeover-related event.

Although these covenants purport to protect bondholders, some commentators have viewed them as antitakeover devices designed and implemented by managers without shareholder approval to protect management from hostile control changes.\footnote{See, e.g., Richard G. Clemens, Poison Debt: The New Takeover Defense, 42 BUS. LAW. 747, 750 (1987); Daniel Hertzberg, "Poison-Put" Bonds Are Latest Weapon in Companies' Anti-Takeover Strategy, WALL ST. J., Feb. 13, 1986, at 5.} Professor Coffee has taken this claim a step further. He argues that the interests of managers and bondholders with regard to control changes actually coincide, and that management's interest in deterring hostile acquisitions motivates it to provide bondholders with effective contractual protection against takeover-related losses. Ac-
cording to Coffee, this "coalition" of management and bondholders creates protection at shareholder expense.\(^7\)

In this Article, we explore the interaction of interests among bondholders, shareholders, and managers as they relate to contractual bondholder protection.\(^8\) In doing so, we initially focus on two theoretical questions. First, we analyze whether bondholder protection through a change of control covenant can enhance firm value.\(^9\) Second, we examine management's interests in these covenants. We conclude that a bondholder-protective covenant can enhance firm value. To the extent that bondholders pay for this protection by accepting a lower interest rate, this increased value accrues to the benefit of the firm's shareholders. Contrary to Coffee, however, we find that, although managers have an interest in using change of control covenants to ward off hostile suitors, managers' interests are substantially incompatible with providing bondholders with full protection. Moreover, managers have an interest in using these covenants to protect themselves in ways unrelated to bondholder protection.

We then investigate change of control covenants empirically. Consistent with our theoretical analysis, we find that these covenants in fact reflect the parochial interests of managers and fail to provide full protection to bondholders against takeover-related losses. We further find, however, that the extent to which management's interests have influenced the terms of change of control covenants has varied over time. Prior to the RJR Nabisco acquisition, managerial interests dominated the terms of change of control covenants and substantially undermined the protection provided to bondholders. Covenants drafted after that transaction continued to reflect managerial interests, but to a lesser extent. Finally, when takeover activity declined in 1991, the use of change of control cov-

\(^7\) John C. Coffee, Jr., Unstable Coalitions: Corporate Governance as a Multi-Player Game, 78 GEO. L.J. 1495, 1519-21 (1990).

\(^8\) Traditional bond covenants limiting dividends, debt, liens, and mergers and acquisitions can also provide protection against takeover-related risk. See, e.g., Paul Asquith & Thierry Wizman, Event Risk; Covenants, and Bondholder Returns in Leveraged Buyouts, 26 J. FIN. ECON. 195 (1990); Moody's Special Report, Indenture Protection for the 1990s 3-6 (1991). Beginning in the late 1970s, however, these covenants, which restrict corporate operations outside the takeover context as well, have often been omitted from bond indentures or included in a much weakened form. Id. at 3; Bratton, Corporate Debt Relationships, supra note 3, at 139-42; McDaniel, Bondholder and Corporate Governance, supra note 3, at 424-26.

\(^9\) Lehn and Poulsen suggest a negative answer to this question. Lehn & Poulsen, Economics of Event Risk, supra note 3, at 214 (in the context of mandatory bondholder compensation).
enants declined dramatically, despite the potential attractiveness of these covenants to shareholders and despite the fact that industrial bonds have maturities of up to thirty years. We explain these patterns largely by reference to the parochial interests of management.

Although the use of change of control covenants has declined recently, this inquiry is of more than historical interest. If takeover and proxy activity increase in the future, the use of these covenants is likely to increase again and their design may become an important issue. Furthermore, many bonds that are currently traded on the secondary market contain change of control covenants. This Article refocuses the debate over extra-contractual bondholder protection. Until now that debate has proceeded without any systematic inquiry into the extent to which bondholder protection can be, or has been, provided by contract, and little attention has been paid to how the conflict between managerial and shareholder interests affects the level of contractual protection that is given to bondholders. Finally, the terms of these covenants provide a useful window through which to examine how the interaction among shareholder, bondholder, and management interests may implicate corporate governance issues in general. Indeed, as we suggest below, the absence of change of control covenants from the vast majority of bonds issued after 1990 may reflect a dynamic among these interests that reduces firm values.

Part I of this Article examines the potential of a bondholder-protective change of control covenant to enhance the value of a firm, and the conflicting interests of shareholders, bondholders, and managers in the design of these covenants. Part II examines the extent to which the various types of covenants found in our sample increase firm value by protecting bondholders and the extent to which they decrease firm value by insulating management from the market for corporate control. Part III then analyzes a sample of change of control covenants to determine the extent to which managerial interests have actually influenced the terms of these covenants. Part IV concludes with a discussion of the implications of our findings.

I. THE EFFICIENCY OF CHANGE OF CONTROL COVENANTS

A change of control covenant consists of two parts: a set of triggering events, and a remedy that becomes available to bondholders upon the occurrence of a triggering event. The set of triggers
includes one or more takeover-related events\(^\text{10}\) (such as the acquisition of twenty percent of the corporation's shares), or a downgrading in the bond's credit rating,\(^\text{11}\) or both. A bond's credit rating, most commonly provided by Standard & Poor's Corporation or Moody's Investors' Service, measures the ability of an issuing corporation to repay a bond. A downgrading indicates an increased probability of default. The remedy available to bondholders under a change of control covenant is either a put—a right to sell the bonds to the company at a predetermined price—or an increase in the interest rate payable on the bonds. The terms of these covenants are examined in detail in Part II, below.

Depending upon its terms, a change of control covenant can serve two functions: it can protect bondholders from takeover-related losses, and it can insulate management from the threat of a hostile control change. This Part analyzes how a change of control covenant can either increase the value of a firm by protecting bondholders, or decrease the value of a firm by entrenching management.

### A. Change of Control Covenants and Bondholder Protection

A change of control covenant can reduce the risk that a bond will lose value as a result of a takeover-related event. This reduction in the risk facing bondholders may enable a company to issue bonds at an interest rate that is lower than the market would otherwise demand.\(^\text{12}\) Thus, these covenants reflect, at least in part, a simple exchange of less risk to the bondholder for lower interest

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10. Consistent with the terms of change of control covenants generally, we use the term "takeover-related event" to include two sets of transactions: (1) the acquisition of a large block of a corporation's shares, and the replacement of a majority of the members of a corporation's board of directors through a proxy challenge, both of which relate to a change in control of a corporation; and (2) leveraged recapitalizations, which may involve a corporation paying a large dividend or repurchasing a large percentage of its own outstanding shares, both of which are means by which a corporation can avoid an undesired change in control.

11. Technically, bonds for which a rating decline in itself constitutes a trigger are not change of control covenants. Bonds containing these provisions, known as "credit sensitive notes," typically provide that the interest rate payable on a bond will be reset either upward or downward to reflect changes in the credit rating of the bond. Although their risk-shifting quality extends beyond the takeover context, they provide substantial protection against takeover-related events. We therefore have included them in this study.

12. See Leland Crabbe, Event Risk: An Analysis of Losses to Bondholders and "Super Poison Put" Bond Covenants, 46 J. FIN. 689, 701–05 (1991) (finding that bondholder-protective change of control covenants reduced interest expense to corporate borrowers by 24 basis points); see also Matthew Winkler & Randall Smith, Sore Junk-Bond Holders Form Rights Group but Say They Aren't Looking for a Free Ride, WALL
payments by the corporation. Their more important quality, however, which we address below, is their capacity to increase the value of a firm as a whole (that is, the aggregate value of the firm's stocks and bonds).

1. The Agency Cost of Debt

The starting point in analyzing the impact of any bond covenant on firm value is the agency cost framework developed by Jensen and Meckling.13 The agency cost of debt is a product of the conflicting interests of shareholders and bondholders once bonds have been issued. A corporation's bondholders prefer that a company retain earnings and pursue a conservative business strategy, which would maximize the likelihood that the corporation will have sufficient funds to repay its debts. In contrast, because their claims are unlimited on the upside and limited on the downside, shareholders prefer higher dividends and riskier strategies.14

This divergence of interests between bondholders and shareholders creates incentives for a company to engage in transactions that lower the value of the firm but nevertheless increase shareholder wealth by shifting wealth from bondholders to shareholders. For example, a company may implement a leveraged recapitalization in which it borrows money to pay out a large dividend to shareholders. As a result, the firm's value may decline.15 The company, encumbered with a high debt burden, may fail to finance all beneficial investments and may face a high likelihood of bankruptcy in a business downturn.16 Nevertheless, shareholders might gain from

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14. As Jensen and Meckling point out, this dynamic follows directly from the Black-Scholes option pricing model. Shareholders' interests are equivalent to a call option on the total value of the corporation with an exercise price equal to the face value of the corporation's debt. Bondholders are the sellers of that call option. As is true of any call option, the value of the shareholders' interest increases as the risk of the underlying asset—the corporation in this case—increases. Consequently, share values increase and bond values decline as the corporation's risk increases. Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. POL. ECON. 637 (1973).

15. This, of course, is not necessarily the case. Greater leverage could increase the value of the firm by reducing management's control over free cash flow. Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323 (1986).

16. See Nevins D. Baxter, Leverage, Risk of Ruin and the Cost of Capital, 22 J. FIN. 395, 396–97 (1967) (bankruptcy costs cause firm value to decline as amount of debt increases); Stewart C. Myers, Determinants of Corporate Borrowing, 5 J. FIN. ECON.
such a transaction. They would receive a large payment of cash, and they would retain a valuable equity interest in the company. Bondholders, however, would certainly lose. As a result of the increased debt, they would bear a large part of the company's risk of failure, but they would receive no additional benefit if the company succeeds. The present value of the contingent losses in aggregate firm value attributable to such potential actions is referred to as an agency cost of debt.\(^\text{17}\)

In the Jensen and Meckling framework, shareholders bear the agency cost of debt. Bondholders are aware that companies may take actions that shift wealth to shareholders, and they demand a higher interest rate as \textit{ex ante} compensation for that possibility. Because shareholders bear the cost of the higher interest rate, they have an interest in reducing the agency cost of debt by denying themselves the option of taking a wealth-reducing, risk-shifting action. One way a firm can do this is to commit itself, through a covenant in a bond indenture, to refrain from taking certain actions that reduce bond values.\(^\text{18}\) Such a commitment would enable the company to issue bonds at lower interest rates. To the extent such a commitment precludes wealth-reducing actions, the commitment would increase share values and increase the value of the firm as a whole.

So long as bondholders are paid interest rates that reflect the presence or absence of covenant protection, they are indifferent to the extent of protection they are given. If a high degree of covenant protection is present, bondholders will accept a lower interest rate that corresponds to the lower risk they will bear. Conversely, if covenant protection is low or absent, bondholders will demand a higher interest rate that corresponds to the greater risk they will bear.\(^\text{19}\) On the other hand, if covenant protection is not priced in the bond market—that is, if interest rates do not reflect the presence

147, 149 (1977) (debt may induce companies to pass up valuable investment opportunities).

17. Jensen & Meckling, \textit{supra} note 13, at 334–37. There may be an element of adverse selection involved in this process as well. Failure to include a covenant may signal a higher likelihood that management intends to take risks that reduce firm value.


19. Jensen & Meckling, \textit{supra} note 13. Obviously, the risk preference and portfolio of an individual investor may lead her to prefer more or less risk. For bondholders in the aggregate, however, an efficient market will equalize the risk-adjusted returns.
of a covenant—bondholders would reap a windfall at the shareholders' expense from the inclusion of a covenant in a bond indenture.\(^2\)

2. Change of Control Covenants and the Agency Cost of Debt

Heightened takeover activity, which began in the early 1980s, presented bondholders with a source of risk they may not have fully anticipated: dramatic increases in leverage associated with an acquisition or a recapitalization.\(^2\) Recent empirical studies have found that, on average, the values of outstanding bonds declined by 5% to 7% as a result of leveraged acquisitions during the 1980s.\(^2\) Other studies have identified almost 300 companies whose bonds lost value in the wake of leveraged acquisitions or recapitalizations.\(^2\)

Bondholder losses that occur in the takeover context are commonly accompanied by shareholder gains. Studies show that the gains to shareholders from both hostile and friendly acquisitions, on average, far exceed losses to bondholders.\(^2\) Thus, in the aggregate,

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21. The risk of bondholder expropriation in the takeover context is often inadequately protected against in traditional bond covenants. Lehn & Poulsen, Contractual Resolution, supra note 3, at 658; MOODY'S SPECIAL COMMENT, EVENT RISK: MOODY'S AMPLIFIES ITS VIEWS ON INDENTURE PROTECTION ISSUES 1 (1989).

22. See Arthur Warga & Ivo Welch, Bondholder Losses in Leveraged Buyouts 19 (1990) (working paper) (between 1985 and 1988, bond values declined, on average, by approximately 7%); Asquith & Wizman, supra note 8, at 203 (between 1980 and 1988 bondholders that were not protected by traditional bond covenants suffered abnormal returns of −5.3%). The extent of bondholder losses varied depending on the degree of traditional covenant protection against increases in leverage, payment of dividends, and restrictions on mergers. Id. at 212. Earlier studies found only minimal negative effects on bond values. Kenneth Lehn & Annette Poulsen, Leveraged Buyouts: Wealth Created or Wealth Redistributed, in PUBLIC POLICY TOWARD CORPORATE TAKEOVERS 46 (Murray L. Weidenbaum & Kenneth W. Chilton eds., 1988); Laurentius Marais et al., Wealth Effects of Going Private for Senior Securities, 23 J. FIN. ECON. 155 (1989). Warga and Welch explain these results as reflecting flaws in the data available to earlier authors. Warga & Welch, supra.

23. See MOODY'S SPECIAL REPORT, supra note 2 (between 1984 and 1988, bonds of 273 companies were negatively affected by leveraged acquisitions or recapitalizations); SALOMON BROTHERS, supra note 2 (in 1989, bonds of 25 companies were negatively affected by leveraged acquisitions or recapitalizations); see also Zimmer, supra note 2, at 20 (15 basis point event-risk premium in the corporate bond market generally).

24. Asquith & Wizman, supra note 8, at 212 (losses to bondholders in sample were approximately 3% of shareholder gains when bonds with and without traditional covenant protection are taken into account); Warga & Welch, supra note 22, at 2 (order of
takeovers have resulted in a wealth transfer from bondholders to shareholders, but they have also increased firm values. Scholars have concluded, therefore, that the protection of bondholders from takeover-related losses cannot increase a firm’s aggregate value.  

Change of control covenants, however, may enhance efficiency even with respect to wealth-increasing acquisitions. The observed increases in firm value may be due to changes in management, new management compensation schemes, operating efficiencies, and other changes in the company’s business that often accompany an acquisition. The leverage element of the acquisition, however, may have a negative impact on firm value. This could result, for example, from inefficient investment policies that a high debt burden could cause. Nonetheless, because leverage can transfer wealth from a target firm’s existing bondholders to its shareholders and to the acquiror, these parties may support a leveraged acquisition. By promising to compensate bondholders for their losses, a change of control covenant eliminates this incentive to adopt an inefficiently high degree of leverage, and thereby encourages an acquisition structure that maximizes firm value.

Assume, for example, that Better Management Inc. ("BMI") acquires Targetcorp in a leveraged acquisition and that BMI can manage Targetcorp more efficiently than can Targetcorp’s current management. As a result of the acquisition, BMI and Targetcorp’s shareholders gain a total of $50 million and Targetcorp bondholders lose $20 million. The leveraged acquisition thus increases the value of Targetcorp by $30 million. But further assume that BMI could have acquired Targetcorp in an equity-financed acquisition, which would have produced aggregate gains to BMI and Targetcorp shareholders of $40 million and had no effect on bond values. In that case, even though an acquisition increases Targetcorp’s value regardless of how it is financed, the leverage reduces the firm’s value by $10 million. Because the leverage component allowed BMI and Targetcorp shareholders to extract $20 magnitude difference). The fact that acquisitions, on average, do not reduce firm value, does not mean that shareholder gains in all acquisitions exceed bondholder losses. Given the large average discrepancy between shareholder gains and bondholder losses, however, it is likely that few acquisitions decrease the value of a firm.

25. Lehn & Poulsen, Economics of Event Risk, supra note 3, at 214. It is also possible, of course, that the increases in share value reflect incorrect pricing prior to a takeover. See, e.g., Martin Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. PA. L. REV. 1 (1987).

26. See supra text accompanying note 16.

27. We use the term "inefficient" to refer to actions that fail to maximize firm value, i.e., the sum of shareholders’ and creditors’ claims.
million in value from Targetcorp's existing bondholders, shareholders would favor the leveraged structure. If, however, Targetcorp's bonds were protected by a change of control covenant, and Targetcorp therefore had to compensate its bondholders for their $20 million in losses, BMI would have structured the transaction as an equity-financed acquisition, and an additional $10 million in firm value would have been created.  

Thus, by creating incentives to structure this transaction efficiently, the change of control covenant would have increased the firm's *ex ante* value.

Change of control covenants may be especially effective in deterring inefficient leveraged recapitalizations. Because these transactions do not involve changes in management, ownership, or operations, they may be less likely to increase firm value than are leveraged acquisitions. On the other hand, even absent a change in management, a leveraged recapitalization can increase firm value by enhancing managerial incentives, reducing management's control over free cash flow, or lowering the firm's tax burden. A change of control covenant would remove shareholders' incentives to favor a wealth-reducing recapitalization, while preserving their incentives to approve a wealth-increasing recapitalization. In this respect, again, the covenant would increase a firm's *ex ante* value.

Furthermore, a change of control covenant may increase firm value for two reasons related to institutional features of the bond market. The first of these reasons concerns liquidity. Certain institutional investors are restricted in their authority to hold bonds with high risk, and other investors may simply have a preference for low-risk bonds. If such investors hold the bonds of a company that undergoes a leveraged acquisition or recapitalization, they may have to, or want to, sell their bonds. Many bonds, however, trade in a relatively illiquid market. A bondholder may incur high transaction costs or may receive less than the fair market value when she sells her bonds in such a market. This may be particularly true in

28. If BMI had taken the leveraged option, bondholders would have been paid $20 million, and the remaining gains available to BMI and Targetcorp shareholders would have been only $30 million, compared to the $40 million available under the equity-financed option. The change of control covenant would have the same effect if there were two or more actual or potential bidders for a company. In such a case, the covenant would ensure that the bidder who expected to increase firm value the most would succeed in acquiring the company.

29. See Jensen, supra note 15.


31. See Kahan, supra note 20, at 1017–25 (discussing costs of selling in illiquid markets).
the immediate aftermath of a leveraged buyout when many bondholders may want to sell.32 Having a change of control covenant that gives bondholders the right to sell their bonds to the issuing corporation at a predetermined price can provide bondholders with assurance that they will avoid these costs.33

A change of control covenant may also cause a firm’s bonds to appeal to a segment of the investor market interested in obtaining low-risk corporate securities. Some investors may have a special preference for low-risk corporate bonds.34 During periods of high takeover volume, however, the potential for takeover-related losses reduces the supply of low-risk bonds.35 Even bonds of blue-chip companies with high credit ratings (such as the RJR Nabisco bonds) could become “junk” overnight.36 Change of control covenants can remove the risk of such losses and thus satisfy the demand of these investors. If there is a shortage of low-risk bonds at a given time, and there are significant transaction costs of synthesizing portfolios with similar attributes, a firm can increase in value by issuing bonds with change of control covenants.

B. Change of Control Covenants and Management Entrenchment

Apart from providing bondholder protection, a change of control covenant can also be designed to deter control transactions that management opposes. In this section, we examine how a change of

32. Dramatic evidence of this possibility appeared immediately following the announcement of the RJR Nabisco buyout, when it was reported that “no bids [were] placed for most industrial issues.” Tom Herman & Rick Stine, Bonds Stage Rebound Amid Declining Oil Prices and a Hint that the Fed Isn’t Tightening Credit, WALL ST. J., Oct. 21, 1988, at C21.

33. The issuing corporation is not likely to face equivalent liquidity problems redeeming the bonds. It needs only to increase its borrowing from the primary bond market or commercial lenders beyond what is needed to finance the leveraged buyout or recapitalization. The extent to which a put eliminates liquidity risk depends upon the terms of the put. If the put is at par, as is often the case, when market interest rates decline and the market value of the bonds rises, some risk of illiquidity remains. If, however, the put price is adjusted to take account of changes in market interest rates, this risk is eliminated. See infra text accompanying notes 99–100.

34. For example, some investors may want both the combination of the risk and the tax attributes of low-risk corporate bonds and would be unable to create a portfolio with equivalent attributes using junk bonds and governmental bonds. Cf. Kenneth N. Gilpin, Huge Phillip Morris Revenues Aid Kraft Deal, N.Y. TIMES, Nov. 1, 1988, at D6.

35. See Salomon Brothers, supra note 2, at 2–4; Zimmer, supra note 2, at 20.

control covenant may be drafted to provide management with such insulation from hostile control changes, thereby reducing firm value.

1. The Agency Cost of Equity

The shareholder-manager relationship, like the shareholder-bondholder relationship, involves conflicting interests. Whereas shareholders are interested solely in the maximization of share values, managers are concerned with issues such as compensation, work conditions, job security, reputation, and power, which may or may not be closely related to share values. As a result, managers may often find it in their personal interest to take actions that are not in the best interest of shareholders. The present value of the losses the firm incurs as a result of such actions is termed the agency cost of equity.37

The market for corporate control provides an important mechanism for reducing the agency cost of equity. Hostile takeovers and proxy contests create mechanisms for removing managers that fail to maximize share values and replacing them with more effective managers. Moreover, the mere threat of a hostile takeover or a proxy contest provides an incentive for managers to act more in the interest of shareholders from the outset. To the extent the market for corporate control promotes efficient management and moves corporate assets to their highest-value uses, the exposure of a corporation to the threat of hostile control changes enhances its value.38

Many corporate managers have responded to the threat of hostile control changes by seeking shelter. Devices created to ward off unwanted suitors include poison pills, greenmail, the "Pac Man" defense, white knights, and golden parachutes.39 Although these devices may sometimes benefit shareholders, they can all be used to insulate managers from the market for corporate control and can thereby increase the agency cost of equity.40

40. Some antitakeover devices allow management to protect shareholders from underpriced or coercive tender offers, or help create an auction among potential acquirors that may increase the price received by target shareholders. See Lucian A. Bebchuk, The Case for Facilitating Competing Tender Offers, 95 HARV. L. REV. 1028, 1054–56.
2. Change of Control Covenants and the Agency Cost of Equity

By providing a remedy to bondholders in the event of certain control changes, a change of control covenant increases the costs of effecting such control changes. As other commentators have noted, change of control covenants can thus be similar to poison pills and other antitakeover devices in that they may provide management with insulation from the takeover threat—hence the term “poison put.” The extent to which a covenant deters wealth-increasing hostile control changes, and the extent to which it thereby reduces firm value, depends on the magnitude of these additional costs compared to the magnitude of the potential gains from a control change.

To the extent that a change of control covenant forces a company simply to compensate its bondholders for takeover-related losses, it increases the cost of an acquisition. As discussed above, however, while bondholders often incur substantial losses as a result of takeovers, those losses are much smaller than the gains target shareholders typically reap in a hostile takeover. Thus, even if target shareholders had to bear the costs of compensating bondholders, most takeovers would still leave them with gains. This has led some commentators to conclude that a change of control covenant does not significantly deter hostile takeovers.

But even though target shareholder gains from a hostile takeover exceed bondholder losses, a change of control covenant may nonetheless provide significant insulation to managers. As discussed below, the remedy provided by many change of control covenants can impose costs on an acquisition that exceed the losses suffered by bondholders. Indeed, a covenant may provide a remedy to bondholders, and thus impose costs, even if bond values are unaffected by the acquisition. As a result of these costs, a change of

(1982); Lipton, supra note 25, at 26 (takeover defenses benefit target shareholders). But see Easterbrook & Fischel, supra note 38 (arguing that such tactics are not in the ex ante interest of shareholders or society).

41. See, e.g., Clemens, supra note 6; Hertzberg, supra note 6.

42. A change of control covenant has an advantage over a poison pill as a defensive device in that covenants can be drafted to eliminate managerial discretion to unburden an acquisition. In addition, unlike poison pills, change of control covenants are contractual provisions between a corporation and its bondholders and may therefore be more insulated from challenge by shareholders for breach of the fiduciary duty rules of corporate law.

43. See supra text accompanying notes 21–25.

44. Lehn & Poulsen, Contractual Resolution, supra note 3, at 659; Lehn & Poulsen, Economics of Event Risk, supra note 3, at 212–15 (drawing this conclusion).

45. See infra text accompanying notes 99–102.
control covenant can deter some wealth-increasing takeovers and thereby increase a firm's agency cost of equity.46

A change of control covenant can be especially effective in insulating managers against proxy contests. Shareholder gains in proxy contests are much smaller than their gains in hostile acquisitions.47 Hence, even a covenant that creates only modest costs in the event of a successful proxy challenge may be sufficient to induce shareholders to vote in favor of incumbent management and ward off some would-be challengers from the outset.48

Moreover, although shareholders of target companies reap large gains from acquisitions, shareholders of acquiring companies on average earn small or no gains.49 Consequently, to the extent that any acquirer must bear the cost of the remedy given to bondholders, a change of control covenant that imposes even small costs could deter wealth-increasing acquisitions. Acquirors may be unable to shift the additional costs created by change of control covenants to target shareholders. Poison pills and other antitakeover devices enable managers to resist takeover attempts at prices that do not reflect large premiums to target shareholders; and shareholder expectations about takeover premiums, coupled with uncertainty regarding the value of companies to other potential acquirors may lead shareholders to reject low-premium bids. Evidence of this friction in the market for corporate control lies in the fact that raiders rarely even try to acquire a company with a low-premium bid. As a result of this friction, even a covenant that merely compensates bondholders for their actual losses may deter some wealth-increasing takeovers.50

46. Because the threat of a control change provides an incentive to managers to run a company in the interest of shareholders, there is a theoretical possibility that even control changes that lower the value of the company may be desirable.


49. Gregg A. Jarrell et al., The Market for Corporate Control: The Empirical Evidence Since 1980, J. ECON. PERSP., Winter 1988, at 49, 51-53 (various studies find average gains to target shareholders between 16% and 53%; average gains to shareholders of acquiring companies were 1%-2% for the period 1962 to 1985, but in the 1980s, shareholders of acquiring companies suffered statistically insignificant losses).

50. The extent to which the market for corporate control is imperfect in this manner is an empirical question upon which we can only speculate. The validity of our analysis, however, does not hinge on the inability of acquirors to shift the cost of these covenants to target shareholders.
Finally, even purely compensatory covenants that apply selectively to hostile acquisitions and not to management-approved transactions deter wealth-increasing control changes and thereby insulate management. Such a covenant could require a hostile bidder to compete at a disadvantage with a bid by management itself or by a friendly bidder, neither of which would be burdened with the obligation to compensate bondholders. The same would be true of a covenant that does not cover defensive recapitalizations. Hostile acquirors would have to compete at a disadvantage with management-proposed recapitalizations. This disparate treatment not only favors management once a hostile bid is made, but it also deters hostile bidders from making a bid from the outset.

C. Managerial Interests and Bondholder Protection

Managers have substantial control over the terms of change of control covenants. They do not need to obtain shareholder approval, and the complexity of the covenants may make it difficult for shareholders to assess the degree to which the covenants serve management's parochial interests. Thus, a firm's management may have ample opportunity to design a change of control covenant in a self-serving manner. This section completes our theoretical analysis by identifying how management interests in change of control covenants converge with, and diverge from, the goal of providing bondholder protection efficiently—that is, in a manner that minimizes a firm's agency costs and thereby increases its value.

Professor Coffee has argued that manager and bondholder interests in control changes coincide, and that a change of control covenant can serve as the basis for a “coalition” of managers and

51. In Delaware, a covenant that applies only to hostile bids may not give a preference to a friendly bidder over a hostile one. Once management decides to accept a friendly bid, it may be required to “approve” any competing hostile bids. See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182–84 (Del. 1986) (once sale of company has become inevitable, management’s duties are to maximize sale price). But see Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990) (suggesting the possibility that the Revlon rule may not apply in certain circumstances even if sale of company is inevitable). However in jurisdictions that do not follow this aspect of Delaware law—in particular jurisdictions that have enacted non-shareholder constituency statutes permitting directors to take interests of constituents other than shareholders into account—such a covenant may impose greater burdens on a hostile bidder than on a friendly bidder.

52. In Delaware, defensive recapitalization proposals, which can be used to defend against hostile takeovers, do not trigger a duty to “approve” a hostile bid. See City Capital Assocs. v. Interco Inc., 551 A.2d 787, 803 (Del. Ch. 1988) (use of management-proposed internal recapitalization as defense against hostile takeover does not necessarily trigger Revlon duties).
bondholders that extracts value from a firm at the expense of shareholders. In his view, prior to the takeover wave of the 1980s, bondholders implicitly relied on managers' personal incentives to retain earnings and maintain low levels of leverage. In the 1980s, however, management's control over a firm's capital structure declined significantly. A firm might be subject to a leveraged buyout by a hostile third party, or management itself might be pressured to increase the firm's leverage as a defense against a hostile bid. Coffee argues that change of control covenants reflect the joint interest of bondholders and managers to resist such transactions.53

Our analysis demonstrates that the relationship between management and bondholder interests in change of control covenants is more complex. If bond yields reflect the presence or absence of a bondholder-protective covenant, bondholders will be indifferent as to a lower-interest bond with a change of control covenant or a higher-interest bond without one.54 To the extent that a bondholder-protective covenant would reduce the agency cost of debt, it is shareholders who would gain from the covenant. The underlying conflict regarding the terms of a change of control covenant is thus the familiar one between managers and shareholders. This conflict is intensified by the fact that management may not only refrain from providing valuable bondholder protection in a change of control covenant, but may also include in a covenant terms that increase the agency cost of equity and have no effect on bondholder interests.55

Moreover, the developments of the 1980s drove a wedge between the respective interests of shareholders and bondholders that a change of control covenant cannot remove. The relationship between management interests and bondholder protection stems from managers' and bondholders' respective interests regarding acquisitions and other control changes. A bondholder is primarily concerned with the increased leverage that often accompanies an acquisition. A bondholder-protective covenant that minimizes the

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53. Coffee, supra note 7, at 1520 (Change of control covenants allowed "bondholders and management [to] link arms to reestablish their relative control over the firm's free cash flow.").

54. Although an individual investor may have a preference for a high-risk or low-risk bond, each type of bond will find its way into the portfolios of investors with appropriate risk preferences. If the bond market is efficient, it will establish a risk premium for the high-risk bond that makes it as valuable as the low-risk bond.

55. Even if the interest rate payable on a bond does not reflect bondholder protection, bondholder and management interests would not fully coincide as bondholders would want protection against takeover-related events that managers would prefer to leave unencumbered.
agency cost of debt would thus provide full compensation for any loss that occurs as a result of an acquisition or reorganization that reduces bond values, including leveraged acquisitions, whether hostile or friendly, and internal leveraged recapitalizations. In contrast, a manager’s concern with control changes stems primarily from the possibility of the loss of employment as a result of a hostile control change. Acquisitions and recapitalizations that do not involve the involuntary loss of control do not threaten managers. Indeed, managers commonly initiate such transactions. Although management generally disfavors high levels of leverage, when faced with a hostile bid, management may well increase leverage as a defensive measure, either through a management buyout, a friendly acquisition, or an internal recapitalization.56

Management may thus influence the terms of a change of control covenant in any of three ways. First, management may restrict a covenant’s coverage to leave unburdened, and hence to leave bondholders at risk for, transactions that management favors. Such a covenant would omit coverage for management buyouts, other acquisitions by friendly parties, and leveraged recapitalizations. Managers obviously have a strong self-interest in retaining an unencumbered opportunity to acquire a company themselves if they choose to do so. In addition, management values the flexibility to engage in any of these transactions in order both to preserve its managerial prerogatives and to fend off a hostile takeover bid.

Excluding these management-favored transactions from the scope of a change of control covenant, however, would lower the value of a firm for two reasons. It would achieve a smaller reduction in the agency cost of debt than would a more inclusive covenant; and the uneven playing field created by these exclusions could deter a potential hostile acquiror from making a bid for a company, which would increase the company’s agency cost of equity.

Second, management may design a covenant to increase the cost of control changes that threaten its job security but that do not threaten bond values. To do so, it would extend coverage to nonleveraged hostile acquisitions and to proxy contests, neither of which typically reduces bond values, and provide a remedy to bond-

holders regardless of whether bond values actually decline. Such a covenant would increase the firm's agency cost of equity.

Finally, management interests conflict with the goal of providing efficient bondholder protection even with respect to control changes that threaten both management and bondholders, such as hostile leveraged acquisitions. To exploit fully the deterrent effect of a covenant, management would ideally want to create sufficiently high costs to be certain to ward off unwanted acquirors. Thus, management would have an interest in providing bondholders with a supra-compensatory remedy in the event that one of these transactions occurs. This additional deterrence of wealth-increasing control changes, however, would increase a firm's agency cost of equity without reducing its agency cost of debt.

In sum, the bondholder-protective covenant that minimizes the agency cost of debt and equity would cover all leveraged acquisitions and recapitalizations and would provide compensation for no more than the actual loss in bond values that occurs as a result of the transaction. The ideal management-protective covenant, in contrast, would cover only hostile acquisitions and proxy challenges, and it would provide for a supra-compensatory remedy in the event that either of these control changes occurs. This covenant would both increase the firm's agency cost of equity and fail to achieve potential reductions in the agency cost of debt. From the perspective of efficiency, a pure management-protective covenant is thus far inferior to the bondholder-protective covenant, and may be worse than no covenant at all.

II. AN EXAMINATION OF THE TERMS OF CHANGE OF CONTROL COVENANTS

The fact that parochial managerial interests diverge from shareholder interests regarding the terms of a change of control covenant raises the possibility that managers will actually pursue

57. Bondholders actually may favor these transactions if, for example, the new management may improve the performance of the firm without increasing bondholder risk.

58. Full compensation is sufficient to minimize the agency cost of debt that takeover-related risk creates. Any further payment to bondholders would be an even exchange between shareholders and bondholders.

It is possible that full compensation may deter wealth-increasing control changes and thereby increase the agency cost of equity. That is, perhaps providing a subsidy to acquisitions would reduce the agency cost of equity. Providing less than full compensation to bondholders would be one way of creating such a subsidy. If this is true, the amount of compensation that would minimize a firm's total agency costs (that is, the agency costs of debt and equity) may be somewhat less than full compensation.
their own interests in designing these covenants. Whether managers actually behave in this manner is a question we begin to address in this Part by analyzing the terms of change of control covenants included in a sample of indentures for bonds issued between 1986 and 1991.59

Our sample consists of 122 bond issues that Standard & Poor’s rated for “event risk” and includes nearly all publicly-issued bonds with change of control covenants.60 The covenants included in our sample fall into three broad categories, each providing different degrees of bondholder protection and managerial insulation from the threat of a hostile control change. One type of covenant is triggered only by takeover-related events that occur without the approval of management. We term these covenants “Hostile Control Change Covenants.” A second type of covenant is triggered by a bond rating decline alone, regardless of whether a takeover-related event occurs. We term these covenants “Pure Rating Decline Covenants.” Finally, a third group of covenants, which we term “Dual Trigger

59. The year 1986 was the first year in which change of control covenants appeared in publicly traded bonds.


In total, S&P’s rated 147 nonconvertible bond issues of 81 different companies for event risk. Out of these 147 issues, we eliminated 2 because we were unable to obtain information about the terms of their event-risk protection, and 22 that either did not contain change of control covenants, related to privately placed bonds, or duplicated other bond issues in the sample. As explained below, we further eliminated the notes issued by Weyerhaeuser Co. from the sample. See infra.

S&P’s also rated 13 convertible bonds for event risk. The change of control provision in these covenants differed markedly from the provisions found in nonconvertible bonds. As discussed in Part II, with only a single exception, nonconvertible bonds condition bondholder protection on either a rating decline, a change of control event followed by a rating decline, or a change of control event that is not approved by the incumbent directors. By contrast, in all 13 convertible bonds, bondholder protection was conditioned upon change of control events, whether or not they were approved by incumbent directors, and whether or not they were followed by a rating decline. This type of provision serves more to protect the conversion feature of the bonds (similar to an antidilution device) than to protect bondholders from default risk. We therefore excluded convertible bonds from our sample. Finally, we excluded one covenant from the sample because its terms were very different from any other covenant. WIEYERHAEUSER CO., PROSPECTUS SUPPLEMENT, Nov. 8, 1990, at S-6. This left us with a sample of 122 bonds issued by 74 companies. Traditional debt and dividend covenants can also constrain change of control transactions. Those covenants are not covered in this analysis.
Covenants, is triggered by a set of takeover-related events only if they coincide with a bond rating decline.

Table 1 shows the frequency of the three basic types of change of control covenants over the period 1986 to 1991. As is evident from Table 1, Dual Trigger Covenants dominate the picture: they account for 72% of all change of control covenants. Hostile Control Change Covenants, however, which we will show primarily reflect managerial interest, also exhibit a strong presence with a 22% share in the sample. Pure Rating Decline Covenants, on the other hand, which we will show reflect almost no managerial interest, are used much less frequently.

### Table 1: Frequency of Covenant Types

<table>
<thead>
<tr>
<th></th>
<th>Hostile Control Change</th>
<th>Dual Trigger Covenants</th>
<th>Pure Rating Decline</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Issues</td>
<td>27 (22%)</td>
<td>88 (72%)</td>
<td>7 (6%)</td>
<td>122</td>
</tr>
<tr>
<td>Number of Companies</td>
<td>17 (23%)</td>
<td>56 (76%)</td>
<td>6 (8%)</td>
<td>74*</td>
</tr>
</tbody>
</table>

* Numbers add up to more than 74, and percentages to more than 100, because five companies issued some bonds with Hostile Control Change and others with Dual Trigger Covenants.

In the discussion below, we analyze the triggering events provided for in each of these three types of covenants, focusing on the bondholder protection they provide and on the extent to which they reflect managerial interests. Following the analysis of the triggers, we analyze the two alternative remedies included in these covenants—puts and interest-rate adjustments—and the extent to which those remedies protect bondholders or insulate management.

A. An Analysis of the Triggers: Hostile Control Change, Dual Trigger, and Pure Rating Decline Covenants

1. Hostile Control Change Covenants

   a. Description of Trigger

   In the typical Hostile Control Change Covenant, bondholder rights are triggered under two circumstances: a "hostile" acquisition of a specified percentage of the company's stock (usually 20% or 30%), which is defined as an acquisition that is not approved by the directors in office at the time the bonds were issued or successors they have chosen; or a proxy challenge resulting in the replace-
ment of a majority of the firm’s directors.\textsuperscript{61} Some Hostile Control Change Covenants provide bondholders with rights only in the first of these two circumstances;\textsuperscript{62} some also provide bondholders with rights when a company engages in a merger or sale of substantially all its assets, and the merger or sale has not been approved by its incumbent directors.\textsuperscript{63} A few require a decline in the rating of the bonds to coincide with the specified takeover-related event.\textsuperscript{64}

\textit{b. Analysis of Trigger}

The triggering events included in Hostile Control Change Covenants reflect an intent to protect management, not bondholders. Indeed, the triggering events are very similar to those in the ideal management-protective covenants described in Part I. Because Hostile Control Change Covenants apply only to transactions not approved by management, they give management nearly full control over the availability of rights to bondholders. If an acquiror offers management a sufficient inducement to approve an acquisition, bondholders are left with no protection. On the other hand, if management declines to approve a transaction, the covenant increases the cost to the acquiror of pursuing its bid without management approval. Although managers must fulfill their fiduciary duties to shareholders in defending against hostile takeovers, and may thus be forced to “approve” certain unfriendly bids, managers generally retain broad discretion to withhold this approval.\textsuperscript{65} In addition,

\begin{itemize}
  \item See, e.g., \textit{Becton, Dickinson and Co.}, \textit{Prospectus Supplement}, May 27, 1986, at S-3. An unapproved share acquisition constitutes a triggering event in all Hostile Control Change Covenants included in our sample; a replacement of a majority of directors constitutes a triggering event in 56\% of the Hostile Control Change Covenants included in the sample.
  \item See, e.g., \textit{Borden, Inc.}, \textit{Prospectus Supplement}, Apr. 17, 1986, at S-4. In 33\% of the Hostile Control Change Covenants, an unapproved share acquisition is the only triggering event.
  \item See, e.g., \textit{Kerr-McGee Corp.}, \textit{Prospectus Supplement}, Apr. 1, 1986, at S-3 to S-4. Similar provisions are found in about 15\% of the Hostile Control Change Covenants. Incumbent directors are typically defined as directors at the time the bonds are issued and directors nominated or elected by incumbent directors.
  \item See, e.g., \textit{id}. A contemporaneous rating decline is required in 26\% of the Hostile Control Change Covenants. These covenants were classified as Hostile Control Change Covenants, rather than as Dual Trigger Covenants, because only events not approved by incumbent managers are included in the trigger.
  \item See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985) (managers’ duties when faced with hostile takeover attempts); Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986) (managers’ duties when sale of company has become inevitable); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990) (managers do not have a per se duty to maximize short term shareholder value); see also McMahan & Co. v. Wherehouse Entertainment, Inc.,
\end{itemize}
Hostile Control Change Covenants omit leveraged recapitalizations from their coverage. The scope of bondholder protection is thus narrowly limited to hostile acquisitions and proxy challenges, the two ways in which stockholders can wrest control from management.

Furthermore, the trigger in Hostile Control Change Covenants fails to take account of whether bond values are adversely affected by a change of control. For example, an acquisition of a company by a financially strong acquiror or a replacement of an inefficient management team in a proxy contest—two events that would tend to increase bond values—can trigger a Hostile Control Change Covenant. As discussed below, the rights provided by Hostile Control Change Covenants can impose costs on a company even if bondholders do not suffer losses. Consequently, the effect of the covenant is to deter wealth-increasing control changes that threaten management rather than bondholders.

In sum, the scope of the triggering events in Hostile Control Change Covenants reflects an unabashed pursuit of management's parochial interests. These interests take the form of both a failure to cover takeover-related events that management favors but that tend to reduce bond values, and coverage of events that management opposes but that do not generally reduce bond values. These covenants offer little bondholder protection and serve to entrench management. They thus fail to achieve potential savings in a firm's agency cost of debt, and they increase its agency cost of equity.

Standard & Poor's rating of these covenants conforms with our

900 F.2d 576 (2nd Cir. 1990) (language in prospectus describing bonds with Hostile Control Change Covenant implying that "independent directors" would consider interest of bondholders in deciding whether to "approve" tender offer held to be misleading), cert. denied, 111 S. Ct. 2887 (1991).

66. See, e.g., S&P Upgrades California First, Union Bancorp, Reuters, Nov. 1, 1988, available in LEXIS, Nexis Library, Wires File (S&P upgraded Union Bancorp bonds from A- to AA- as a result of its acquisition by a Bank of Tokyo subsidiary.); S&P Cuts Comcast, Raises SCI Holdings, Reuters, Sept. 7, 1988, available in LEXIS, Nexis Library, Wires File (S&P upgraded bonds of SCI and SCI Holdings from respectively, B to B+ and CCC+ to B- as a result of SCI's acquisition by Comcast Corp. and Tele-Communications Inc.); Preferreds Mystified by Kyoei Bid for Florida Steel, Mergers & Acquisitions Rep., July 6, 1992, at 1 (Bonds of FLS Holdings Inc. increased by almost 20 points upon news that the company may be acquired by Kyoei Steel Ltd.).

67. Cf. Dodd & Warner, supra note 47, at 434–35 (reporting that stock prices increase as a result of proxy contests).

68. The remedy provided by these covenants—a put at or above par—is not contingent on the existence of bondholder losses and may be valuable to bondholders even if they have not suffered losses. See infra text accompanying notes 98–100.

69. At the time of the RJR Nabisco buyout, a bond analyst remarked that these covenants "haven't been worth a bucket of warm spit." Winkler, supra note 1.
analysis of these covenants' bondholder-protective qualities. All Hostile Control Change Covenants received an E-5 event risk rating, the lowest available rating, signifying "insignificant or no protection" to bondholders.\(^{70}\)

2. Dual Trigger Covenants

   a. Description of Trigger

   In Dual Trigger Covenants, bondholder protection is triggered only when a takeover-related event is accompanied by a decline in a bond's credit rating. The vast majority of Dual Trigger Covenants cover the following takeover-related events:

   1. the acquisition of a specified percentage of the corporation's stock (most frequently 20% or 30%), whether or not incumbent management approves the acquisition;
   2. a successful proxy challenge in which a majority of the corporation's board of directors is replaced by persons management has not nominated;
   3. the sale of substantially all the corporation's assets or a merger or consolidation; and
   4. the payment of dividends or the repurchase of shares amounting, over the course of one year, to more than a specified percentage of the company's equity (most frequently 30%) or both.\(^{71}\)

   In a few instances, the second of these triggers is not included,\(^{72}\) or a major asset acquisition by the company is included as a triggering event.\(^{73}\)

   To satisfy the rating decline component of the trigger, a bond's rating must fall from investment grade\(^{74}\) to below investment

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\(^{70}\) Hessol, supra note 60.

\(^{71}\) See, e.g., MONSANTO CO., PROSPECTUS SUPPLEMENT, Dec. 6, 1989, at S-3 to S-4. These triggering events are included in 91% of the Dual Trigger Covenants. Most covenants contain exceptions for certain non-takeover-related transactions that would technically fit within one of these descriptions. For example, re-incorporation mergers are often excepted from the third triggering event even though they involve a merger. See id.

\(^{72}\) See, e.g., NORTHWEST PIPELINE CORP., PROSPECTUS, Nov. 22, 1988, at S-15 to S-16. About 9% of the Dual Trigger Covenants do not include the second trigger. In about 6%, the second trigger is the only one that is omitted. In the remaining 3%, only a share acquisition constitutes an event trigger. Although these latter covenants are technically Dual Trigger Covenants, they offer significantly less protection than the standard Dual Trigger Covenant.

\(^{73}\) See, e.g., GENERAL AMERICAN TRANSPORTATION CORP., PROSPECTUS SUPPLEMENT, Mar. 15, 1990, at S-15. About 16% of the Dual Trigger Covenants include asset acquisitions as event triggers.

\(^{74}\) Investment grade is a rating in the four highest rating categories (i.e., AAA, AA, A, and BBB for S&P's and Aaa, Aa, A, and Baa for Moody's).
grade. If the bonds are rated below investment grade prior to the occurrence of the event, a rating decline by a full rating category (e.g., from BB to B for a Moody’s rating) is often sufficient. Most commonly, this rating decline must occur during a time period beginning 121 days prior to takeover-related event and ending 90 days after its occurrence.

b. Analysis of Trigger

Dual Trigger Covenants differ from Hostile Control Change Covenants in two ways that evidence less intrusion of management interest into their design. First, Dual Trigger Covenants cover, at least to some extent, all common takeover-related events, including those that managers favor—friendly mergers, management buyouts, defensive recapitalizations and, in some cases, asset acquisitions. Thus, these covenants offer substantially more complete coverage to bondholders than do Hostile Control Change Covenants. Bondholder protection, however, remains less than complete because the covenant omits from coverage certain takeover-related events that can lower bond values substantially, such as 29% share repurchases in each of two consecutive years.

Second, by requiring a contemporaneous rating decline, Dual Trigger Covenants relate the availability of a remedy more closely to transactions that actually cause a reduction in bond values, as opposed to transactions that solely involve management’s loss of control (for instance, a non-leveraged hostile acquisition). This relationship, however, is not perfect. An unrelated development may

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75. See, e.g., MONSANTO Co., supra note 71, at S-4. This provision is contained in all but one of the Dual Trigger Covenants. Dual Trigger Covenants differ, however, in what happens if both of the major rating agencies (Moody’s and S&P’s) had rated a company’s bonds as investment grade. For some covenants, it is sufficient if one of the agencies drops the rating to below investment grade. See id. For others, both must drop the rating below investment grade. See, e.g., CONSOLIDATED FREIGHTWAYS INC., PROSPECTUS SUPPLEMENT, Sept. 18, 1989, at S-14 to S-15.

76. This provision is found in 76% of the Dual Trigger Covenants. See, e.g., CONSOLIDATED FREIGHTWAYS INC., supra note 75, at S-14 to S-15. Both S&P and Moody’s divide each of their rating categories (e.g., AAA and BB for S&P or Aaa and Ba for Moody’s) into three gradations (e.g., BB+, BB and BB- for S&P and Ba1, Ba2 and Ba3 for Moody’s). A rating decline by one full rating category means a decline to at least the equivalent gradation in the next lower category. Frequently, a withdrawal of a credit rating by a rating agency is also regarded as equivalent to the requisite rating decline. See, e.g., ANHEUSER-BUSCH COS., INC., PROSPECTUS SUPPLEMENT, Dec. 6, 1989, at S-2 to S-3.

77. See, e.g., MONSANTO Co., supra note 71, at S-4. About 52% of the Dual Trigger Covenants contain this provision. The period for a rating decline is commonly extended if the bonds are under review for possible downgrade at the end of the ordinary expiration of the period. See id.
cause a rating decline to coincide with a takeover-related event. In addition, a causally related rating decline may occur outside the specified time window or it may be insufficient in degree to trigger the covenant.

Even though Dual Trigger Covenants provide significantly more protection to bondholders than do Hostile Control Change Covenants, they still reflect some managerial interests. The most significant instance of this is their inclusion of a successful proxy contest as an event trigger. Proxy contests are obviously a substantial threat to management. Unlike acquisitions, however, they are not generally associated with increased leverage or bondholder losses. To be sure, some successful proxy contests may result in bondholder losses. For example, a proxy challenger may campaign on a promise to pay out a large dividend if she succeeds (a payment that is, that falls short of triggering the covenant in itself). Management, however, could take the same action in a defense against a proxy challenge. Yet the covenant would be triggered only if the challenger succeeds.

Moreover, in the case of a proxy challenge, the rating decline component of the trigger is especially ineffective in limiting the covenant's protection to challenges that reduce bond values. A proxy contest is particularly likely to occur contemporaneously with a rating decline unrelated to the prospect of a control change, because the same performance factors that can lead to a rating decline can also lead to a proxy contest. Furthermore, negative information that may come to light in the course of a proxy contest may lead to a downgrading of a company's credit rating, and, an unrelated

78. In the case of a proxy fight coupled with a debt-financed tender offer—a sequence of events that would be likely to impair bond values—the tender offer, if successful, would constitute an event trigger. Coverage of proxy challenges in the trigger would not be necessary to protect bondholder interests.

79. One might argue that in purchasing a bond, the bondholder is making an investment in current management, and that inclusion of proxy challenges in the trigger of these covenants is therefore in the interest of bondholders. This argument, however, has little merit. First, to the extent that bondholders are concerned that less competent management will be voted into office, they should be willing to rely on shareholders' interest in preventing this from occurring. Shareholders have at least as great an interest in managerial competence. Second, from an ex ante perspective, it is more likely that a proxy challenger will enhance rather than reduce managerial effectiveness. Finally, the Dual Trigger Covenant would probably not be triggered by a successful proxy challenge by an incompetent managerial team. The necessary rating decline would probably have to await actual mismanagement, which is unlikely to occur in time to meet the covenant's timing requirement.

80. Richard M. Duvall & Douglas V. Austin, Predicting the Results of Proxy Contests, 20 J. Fin. 464 (1965) (proxy contests are initiated in firms with comparatively low rates of return).
downgrading in a company's credit rating can increase the chance that a proxy challenger will succeed and thus trigger the covenant. It is instructive to note, in this respect, that in the only reported case in which a proxy contest triggered a Dual Trigger Covenant, increased competition in the company's product market was the primary cause of the rating decline.81

In sum, Dual Trigger Covenants in principle cover all common control change transactions that threaten bond values. Thus, they have the potential to reduce the agency cost of debt and enhance the value of a firm. However, protection is less than complete because certain takeover-related transactions may fall outside the scope of the event trigger or cause a rating decline that does not satisfy the rating decline component of the trigger. Both Standard & Poor's assessment of these covenants and a recent empirical study are consistent with our analysis. Standard & Poor's has rated most Dual Trigger Covenants as E-3, indicating "some protection" against event risks.82 In addition, an empirical study found that these covenants reduced interest rates on bonds by an average of twenty-four basis points between 1988 and 1989.83 Nonetheless, the inclusion of proxy challenges in the trigger reflects the parochial interests of management and increases the firm's agency cost of equity.

3. Pure Rating Decline Covenants

a. Description of Trigger

In Pure Rating Decline Covenants, a remedy is triggered solely by a decline in a bond's credit rating, regardless of whether the decline is associated with a takeover-related event.84 Furthermore, even small rating declines are included in the trigger of these coven-

81. See S&P Rated Covenants Tested By Xtra, BONDWEEK, Aug. 6, 1990, at 2, available in LEXIS, Nexis Library, II NEWS File (proxy contest over Xtra was first test of event-risk covenant); Moody's Lowers Ratings of Xtra and Unit, REUTERS, June 22, 1990, available in LEXIS, Nexis Library, Wires File (downgrading reflected "competitive conditions in [Xtra's] core business and that its debt-protection measures will remain modest" but was also affected by possibility that "shareholder-driven restructuring measures may be enacted").

82. See Hessol, supra note 60.

83. Crabbe, supra note 12. Interestingly, before these covenants were developed, bond analysts estimated that the value of protection against takeover-related losses would be 25 basis points. Winkler & Smith, supra note 12.

84. See, e.g., POTLATCH CORP., PROSPECTUS SUPPLEMENT, Dec. 6, 1989, at S-3 to S-4 (describing interest rate adjustment mechanism).
nants. Most Pure Rating Decline Covenants also contain provisions for a decrease in a bond's interest rate in case of a rating upgrade. These covenants thus compensate either bondholders or the company for any change in the company's credit risk in either direction.

b. Analysis of Trigger

Pure Rating Decline Covenants offer substantially more protection to bondholders against takeover-related losses than Dual Trigger Covenants. Pure Rating Decline Covenants protect bondholders from takeover-related losses regardless of when in relation to the takeover-related event a rating decline occurs. Dual Trigger Covenants, in contrast, protect bondholders only if the rating decline occurs within a specified period surrounding the event. Pure Rating Decline Covenants also provide protection against takeover-related events that fall short of satisfying the definition of a requisite trigger in the Dual Trigger Covenants. For example, a company's repurchase of 29% of its outstanding stock would not trigger a Dual Trigger Covenant that requires a 30% purchase, whereas a smaller repurchase could trigger a Pure Rating Decline Covenant.

Pure Rating Decline Covenants reflect no influence of parochial management interests. They contain the most direct link between the remedy and losses in bond values, provide the broadest scope of protection and entail no discrimination between actions that management favors and disfavors. Consistent with our analysis, bonds with Pure Rating Decline Covenants have received E-1 ratings from Standard & Poor's, the strongest event risk rating available.

Although Pure Rating Decline Covenants seem ideally designed to offer protection to bondholders, the breadth of the protection they offer may carry other disadvantages which may, for some companies, outweigh its benefits in the control change context and therefore reduce firm values. Pure Rating Decline Covenants impose on a corporation the risk of credit quality deterioration that is completely outside the control of corporate management, such as problems attributable to increased competition. These covenants

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85. For example, the interest rate of the Credit Sensitive Debentures of Potlatch is 9.425% if the credit rating by Moody's is Baa3, 12.5% if the rating is Ba1, 13% if the rating is Ba2, and 13.5% if the rating is Ba3. See id. at S-4.
86. In addition, Pure Rating Decline Covenants also offer protection against declines in credit quality not caused by takeover-related events.
87. See Hessol, supra note 60.
magnify the effect of bad times on the corporation and could create management inflexibility that is not in the interest of either shareholders or bondholders. The rarity of these covenants may reflect the market's recognition of these potential problems.

4. Summary of the Analysis of the Triggers

The analysis of the triggering events provided for in the three types of change of control covenants yields the following picture. Hostile Control Change Covenants reflect the greatest dominance of management interests, both by excluding from coverage events that threaten bondholders but not managers and by covering events that threaten managers but not bondholders. Pure Rating Decline Covenants provide the most complete coverage of events that threaten bondholders and reflect no intrusion of managerial self-interest, although they may have other inefficient features. Dual Trigger Covenants provide substantial, though incomplete, coverage, but also reflect management interests by covering successful proxy contests.

B. An Analysis of the Remedies: Puts and Interest Rate Adjustments

1. Description of the Remedies

In contrast to violations of traditional bond covenants, the occurrence of a triggering event does not constitute an event of default. Thus, instead of the standard default remedies (which include the rights to accelerate the maturity of a bond, to sue for damages and, in some cases, to demand specific performance), bondholders obtain one of two special remedies expressly provided for in the covenant: a put or an interest rate adjustment.

A put gives each bondholder the opportunity to decide whether to continue to hold a bond or to sell it back to the company at a predetermined price. The most important feature of the put is the price at which it can be exercised. Most Hostile Control Change Covenants give bondholders the right to put their bonds to the company at par (i.e., at their face value). Some issues provide

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88. See, e.g., BECTON, DICKINSON and Co., supra note 61, at S-4. About 78% of the Hostile Control Change Covenants provide for a put at par.
bondholders with a put at a premium above par. The size of that premium ranges from 1% to 10.5%.

In most Dual Trigger Covenants the remedy also consists of a put at par, but in a few cases they provide instead for an interest rate adjustment. Covenants that provide for an interest rate adjustment offer a risk premium corresponding to the increase in default risk that accompanies a triggering event. These covenants contain a schedule relating specific interest rates to changes in credit ratings. The schedule for United Technologies 8-7/8% Debentures issued in 1989, for example, provides that the interest rate on the debentures will increase to 12.5% if their Standard & Poor’s rating drops from AA to BB- in conjunction with any specified takeover-related event. The adjustments provided by these covenants are intended to reflect risk premiums prevailing in the market for bonds of similar duration as of the time of issuance. No Dual Trigger Covenant gives bondholders a put at a premium above par.

Most Pure Rating Decline Covenants provide bondholders with an interest rate adjustment. This remedy is similar to the interest rate adjustment provided by some Dual Trigger Covenants in all but two respects. First, Pure Rating Decline Covenants are more sensitive to small rating declines than are Dual Trigger Covenants. And second, Pure Rating Decline Covenants permit a reduc-


90. The premium is either fixed or varies with the premium the company would have had to pay under a separate call provision. See id. Such call provisions are often contained in bonds with or without change of control covenants. Under these traditional call provisions, the issuer has the right to call the bonds at a specified price. That call price declines over time as the redemption date approaches the maturity date of the bonds. See American Bar Foundation, Commentaries on Model Debenture Indenture Provisions 477-78 (1971).

91. See, e.g., Monsanto Co., supra note 71. About 84% of the Dual Trigger Covenants provide for a put at par, and about 16% provide for an interest rate adjustment.


93. Interest rate adjustments are designed to reflect risk premiums prevailing in the bond market at the time of issuance. Telephone Interview with Gail I. Hessol, Managing Director, S&P’s (Sept. 10, 1992).

94. Six of the seven Pure Rating Decline Covenants provide for an interest rate adjustment. The other covenant provides for a put at a yield-maintenance premium. See infra note 100 and accompanying text.
tion in the bond’s interest rate if the bond’s credit rating increases above its initial rating.\textsuperscript{95}

2. Analysis of the Remedies

The analysis in Part I demonstrated that, from the standpoint of the agency costs of debt and equity, the most efficient remedy for a takeover-related loss is to provide bondholders with an amount that is no greater than full compensation for the losses they actually suffer. Full compensation would allow most wealth-increasing control changes to occur while deterring wealth-decreasing transactions. The easiest way to provide full compensation to bondholders is to adjust the interest rate payable on their bonds in a manner that reflects the increased default risk as measured by the company’s credit rating.\textsuperscript{96}

Other factors being equal, a bond with a lower credit rating carries a higher yield than does a bond with a higher rating. For example, a 10-year bond with rating of Ba may have a yield of 12%, while a 10-year bond with an A rating may have a yield of 10%. If, as a result of a takeover-related event, the credit rating of XYZ Corporation’s 10-year bonds drops from A to Ba, full compensation would require that the interest rate on the bonds be increased to 12%.\textsuperscript{97} This is the remedy provided by the interest rate adjustment contained in most Pure Rating Decline Covenants and in some Dual Trigger Covenants.\textsuperscript{98}

\textsuperscript{95} For example, both upward or downward changes of only one gradation may result in adjustments to the interest rate of the Credit Sensitive Debentures of Potlatch. See Potlatch Corp., supra note 84, at S-4.

\textsuperscript{96} A Moody’s rating of A, for example, denotes “adequate security,” but “susceptibility to impairment sometime in the future;” a Ba rating denotes “moderate protection” that is “not well safeguarded;” and a Caa rating denotes “poor standing” and “elements of danger.” Moody’s Rating Definitions: Long-Term (1991). S&P’s, the other major credit rating agency, employs an essentially identical rating system with slightly different notations.

The effectiveness of the interest-rate adjustment as a remedy depends on the accuracy of credit ratings. Several commentators have argued that changes in credit ratings lag behind fundamental changes in credit risk. See generally Thomas E. Copeland & J. Fred Weston, Financial Theory and Corporate Policy 514–16 (1988) (reviewing literature). The several-month window during which a rating decline can trigger a change of control covenant significantly reduces the risk of a slow adjustment in the credit rating to a change in fundamental risk.

\textsuperscript{97} If less than full compensation is optimal, it can be easily achieved by a smaller interest rate increase, for example to 11.5%.

\textsuperscript{98} Four bonds included in our sample contain interest rate “reset” provisions as optional remedies. Under these provisions, upon the occurrence of a triggering event, a “reset advisor” would be asked to reset a bond’s interest rate to a rate that is sufficiently high to cause the bonds to trade at par or slightly above par. See, e.g., Northwest
In contrast, a put at par, or at a fixed premium over par, offers very ineffective protection. If market interest rates decline after the issuance of a bond, thus causing an increase in its market value, such a put will undercompensate bondholders for takeover-related losses. Indeed, a put may offer no protection whatsoever if interest rates have fallen enough so that the value of the bonds, after accounting for the takeover-related losses, has risen so far as to exceed the put price. Consider, for example, a bond issued at a par value of $100 that three years later has risen in value to $115 as a result of falling interest rates. If a takeover-related event then causes a decline in the value of the bond to $105 and triggers a put at par, the bondholder would not exercise the put and instead suffer the $10 takeover-related loss.

On the other hand, if market interest rates have increased, this type of put overcompensates bondholders. They would be compensated not only for the decline in bond value attributable to the takeover-related event, but also for the decline in value that has occurred since the date of issuance as a result of rising market interest rates. Consider again a bond issued at a par value of $100, but this time consider the case in which market interest rates have risen and the market value of the bond has consequently fallen to $90. If a takeover-related event then causes a decline in the value of the bond to $80 and triggers a put at par, the bondholder will not only be made whole for her $10 takeover-related loss, she will receive an additional $10.

It is possible, however, to structure a put in a manner that provides compensation independent of intervening changes in the bond's market value. To provide full compensation, for example, the put price would be calculated by discounting all future interest and principal payments at a rate that reflects the risk-free market interest rate at the time of the put, plus a risk premium corresponding to the bond's default risk before the occurrence of a takeover-related event. Such a "yield-maintenance put" would provide not only an efficient remedy from the agency cost perspective, it would also assure investors of liquidity after a triggering event. Curiously,
only one bond issue in our sample, which contained a Pure Rating Decline Covenant, provided for this remedy.100

The prevalence of the put at par or at a premium, as opposed to the more efficient interest rate adjustment or yield-maintenance put, cannot readily be explained by the interests of bondholders or shareholders. These inefficient remedies, however, may be explained by management's interest. A put at par is a subtle (and a put at a premium above par a not-so-subtle) means of deterring wealth-increasing control changes and insulating management from the market for corporate control.

Although a put at par in principle allows for both undercompensation and overcompensation, it will on average result in overcompensation. The reason is that any increase in market interest rates that occurs between the time of issuance and the time the put is triggered lowers bond values and thus raises the amount by which a put at par will overcompensate bondholders. A decline in interest rates would correspondingly increase a bond's value above par and thereby cause the covenant to undercompensate the bondholder if a triggering event occurs. This undercompensation, however, can never exceed the amount of the bondholder's takeover-related losses. Once interest rates have declined to such an extent that a triggering event fails to bring a bond's value below par, any additional decline in market interest rates will have no marginal effect on the bondholder's compensation. In other words, zero compensation is the least a bondholder can receive.

For example, consider again the bond that has declined in value from $100 to $90 since its issuance. If a triggering event further reduces the bond's value to $80, a put at par would then allow the bondholder to recoup $20—$10 in excess of her takeover-related losses. A greater increase in interest rates would have further increased the bondholder's gain. In contrast, consider the possibility that market interest rates have fallen since the date of issuance, and the value of the bond has increased from $100 to $110. If the same triggering event occurs, and the value of the bond falls by $10 to $100, the bondholder will not exercise the put and will not receive compensation for the takeover-related loss. The bondholder

will thus be undercompensated by $10. But any additional decline in market interest rates, which would push the bond value above $110, would not reduce bondholder compensation any further. If, for instance, the bond's value were $115 and the takeover-related event drove its value down to $105, bondholder losses would remain at $10 and compensation would remain at zero, and the bondholders would still be undercompensated by $10. Consequently, from an ex ante perspective the effect of the put is supracompensatory.

This skewing of compensation under a put at par is particularly evident in the case of a proxy challenge or a hostile acquisition by a financially strong acquiror—two transactions that are unlikely to reduce bond values substantially, if at all. Because bondholders rarely suffer losses as a result of these transactions, the predominant potential impact of a put at par is to provide overcompensation (that is, if market interest rates have risen). In the case of a put at a premium above par, of course, the likelihood that the put will overcompensate bondholders is even greater than in the case of a put at par. This general tendency of a put to impose costs in excess of bondholder losses may help management to deter hostile control changes even if the changes are wealth-increasing.

There is an additional reason why a put at par serves management's interests. As discussed above, a full compensation remedy may offer management only negligible insulation from the threat of a control change. Thus, during periods in which falling market interest rates cause a put to undercompensate bondholders, managers lose little. If a put overcompensates bondholders because interest rates have risen, however, it may attain significant deterrent effect. Therefore, from the perspective of management, a full compensation remedy, which rarely deters hostile control changes, is inferior to a put, which at times will have a similarly weak deterrent effect, but at other times will have a stronger deterrent effect.

101. The bondholder would have a loss of $10 and no compensation.
102. If a bond is callable at the option of the corporation, one would not expect bonds to remain outstanding after market interest rates cause their values to rise significantly above the call price. As a result, a put at par would have even less of a potential to undercompensate bondholders significantly. Thus, if the bonds are callable at the option of a corporation, a put at par would, on average, result in overcompensation to an even greater extent.
103. See supra text accompanying notes 43-44.
104. Consider the following simplified example. Hostile takeovers generate gains to bidders (prior to payments to bondholders) in amounts between $20 million and $50 million. A bidder knows the gains a particular takeover would generate and the amount of compensation payable to bondholders. A bidder will undertake a takeover only if her
In sum, even though this type of put creates liquidity, which may be of concern to some investors, it is generally an inefficient remedy. It may substantially undercompensate bondholders and thus fail to address adequately the agency cost of debt. Or it may overcompensate bondholders and thereby deter wealth-increasing control changes and increase the agency cost of equity.

A picture thus emerges from the analysis of the remedies provided by change of control covenants that is similar to the picture that emerged from the analysis of the trigger. Pure Rating Decline Covenants, which generally provide for an interest rate adjustment according to a predetermined schedule, offer the best bondholder protection. Dual Trigger Covenants, because they generally provide for a put at par, offer less bondholder protection and more management entrenchment. Hostile Control Change Covenants, which most often provide for a put at par and sometimes a put at a premium above par, offer even more management entrenchment.

III. AN EMPIRICAL ANALYSIS OF THE USE OF CHANGE OF CONTROL COVENANTS

This Part provides an empirical analysis of the extent to which managerial interests influenced the terms of change of control covenants between 1986 and 1991. We begin by examining the frequency with which managers have used these covenants to pursue their parochial interests. We then examine how and why the terms of these covenants changed between 1986 and 1991.

A. The Use of Change of Control Covenants to Pursue Management Interests

Between 1986 and 1991, a substantial number of publicly issued investment-grade industrial bonds with maturities of seven years or more were covered by change of control covenants. See supra text accompanying notes 30-33. Between 1986 and 1991, at least one-tenth of publicly issued investment-grade industrial bond issues with maturities of seven years or more were covered by change of
enty-two percent of these covenants were Dual Trigger Covenants, 22% were Hostile Control Change Covenants, and 6% were Pure Rating Decline Covenants. As the analysis in Part II demonstrates, this rough breakdown indicates that over one-fifth of the covenants reflect a dominance of management interest (the Hostile Control Change Covenants), and that more than nine out of ten covenants (all but the Pure Rating Decline Covenants) reflect some degree of management interest at the expense of shareholders.

In order to obtain a more refined estimate of the extent to which managerial self-interest has influenced change of control covenants, we analyzed the terms of each covenant in our sample to determine the extent to which they reflect managerial interests of either of the two types discussed in Part II. We thus asked two questions with respect to each covenant. First, we asked whether a covenant covers all common transactions that management favors but that threaten bond values—management buyouts, leveraged friendly acquisitions, and leveraged recapitalizations. To the extent that any of these transactions is excluded from a covenant's coverage, the opportunity to reduce a firm's agency cost of debt is sacrificed for the benefit of management.

Second, we asked whether a covenant covers at least one type of common transaction that threatens management but that does
not threaten bond values—non-leveraged hostile acquisitions\textsuperscript{108} or proxy contests. Coverage of these transactions would not affect bondholder protection significantly, but it would insulate management from hostile control changes. Consequently, it would increase the firm's agency cost of equity.

Table 2 presents the results of this analysis. The four rows reflect the four possible combinations of answers to the two questions posed above. The first row contains covenants that reflect both types of managerial interests—a failure to cover all common transactions that threaten bond values and coverage of transactions that threaten management alone. The second row contains covenants that fail to cover all common transactions that threaten bondholders, but that do not cover transactions that threaten only management. The third row contains covenants that cover all common transactions that threaten bond values but also cover transactions that threaten management without affecting bond values. Finally, the fourth row contains covenants that are purely bondholder protective. These covenants cover all common transactions that threaten bond values and no transactions that threaten management alone.

<table>
<thead>
<tr>
<th>Type of Covenant</th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fail to Protect Bondholders Fully and Insulate Managers</td>
<td>23</td>
<td>19%</td>
</tr>
<tr>
<td>Fail to Protect Bondholders Fully but Do Not Insulate Managers</td>
<td>7</td>
<td>6%</td>
</tr>
<tr>
<td>Protect Bondholders Fully but also Insulate Managers</td>
<td>80</td>
<td>66%</td>
</tr>
<tr>
<td>Protect Bondholders Fully and Do Not Insulate Managers</td>
<td>12</td>
<td>10%</td>
</tr>
<tr>
<td>Total Number of Bonds With Change of Control Covenants</td>
<td>122</td>
<td>100%</td>
</tr>
</tbody>
</table>

In 19% of all covenants, both types of managerial interests are present, and in 90% of the covenants one or the other type of managerial interest is present. Thus, only 10% of the covenants are ori-\textsuperscript{108} We counted covenants that include hostile acquisitions in their trigger without including a rating decline as covering non-leveraged hostile acquisitions. Each of these covenants provides for a put at par or at a premium above par and therefore, from an ex ante perspective, deters wealth-increasing transactions of this type. See supra text accompanying notes 99–104.
ent solely toward bondholder protection. The intrusion of managerial interests into the design of these covenants most commonly has taken the form of extending coverage to transactions that management disfavors (85%) rather than restricting coverage to facilitate transactions that management favors (25%).

The conflict between management interests and bondholder protection in the design of a change of control covenant is thus more than a theoretical problem. The terms of these covenants demonstrate that management has in fact frequently allowed its own interests to displace the interests of shareholders in designing these covenants. It has most commonly used change of control covenants to protect itself from hostile control changes regardless of their effect on bond values. In addition, however, management has frequently failed to provide value-increasing protection to bondholders against management buyouts, friendly acquisitions, and leveraged recapitalizations—transactions that management tends to favor.109

B. Shifts in the Terms of Change of Control Covenants

1. Time Trend Data

Another interesting picture emerges when one examines time trends in the use of each type of change of control covenant. As Table 3 shows, Hostile Control Change Covenants were dominant through mid-1988, during which time Dual Trigger Covenants were almost unknown. By 1989, however, Hostile Control Change Covenants essentially disappeared, and Dual Trigger Covenants dominated. Then in 1991, the number of Dual Trigger Covenants dropped dramatically. Moreover, our data reveal that of the sixteen companies that issued bonds with a Hostile Control Change Covenant before July 1988, six returned to the bond market in 1989 or 1990. Of these companies, five issued bonds with Dual Trigger Covenants, and only one issued bonds with a Hostile Control Change Covenant.110

109. An interesting study might be performed to determine whether there is any relationship between the quality of a change of control covenant and variables related to firm governance. For instance, one would expect more bondholder protection and less managerial insulation among firms that have substantial shareholder control or other devices to protect management. We made a preliminary attempt to use our data to identify such a relationship and found none. This issue, however, may warrant further research.

110. Moody's Bond Record, Dec. 1991. For purposes of these data, we excluded bonds issued in 1989 and 1990 with a maturity of less than 5 years.
The rise and fall in Dual Trigger Covenants cannot be explained by changes in the total number of investment-grade industrial bond issues. Between 1987 and 1990, the number of such bond issues dropped from 97 to 72. Then in 1991, the number of issues shot up to 163.\textsuperscript{111}

**Table 3: Frequency of Covenant Types over Time**

<table>
<thead>
<tr>
<th></th>
<th>Total Change of Control Covenants</th>
<th>Dual Trigger Covenants</th>
<th>Hostile Control Change Covenants</th>
<th>Pure Rating Decline Covenants</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/86-12/86</td>
<td>13</td>
<td>1*</td>
<td>12</td>
<td>—</td>
</tr>
<tr>
<td>1/87-12/87</td>
<td>6</td>
<td>0</td>
<td>6</td>
<td>—</td>
</tr>
<tr>
<td>1/88-6/88</td>
<td>6</td>
<td>0</td>
<td>6</td>
<td>—</td>
</tr>
<tr>
<td>7/88-12/88</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>—</td>
</tr>
<tr>
<td>1/89-6/89</td>
<td>15</td>
<td>14</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>7/89-12/89</td>
<td>37</td>
<td>34</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>1/90-6/90</td>
<td>27</td>
<td>23</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>7/90-12/90</td>
<td>11</td>
<td>10</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>1/91-12/91</td>
<td>4</td>
<td>4</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>122</strong></td>
<td><strong>88</strong></td>
<td><strong>27</strong></td>
<td><strong>7</strong></td>
</tr>
</tbody>
</table>

* Though formally a Dual Trigger Covenant, this covenant contains substantially fewer event triggers and different rating decline triggers than do the later Dual Trigger Covenants.

As Table 4 shows, an examination of the covenants over time on an element-by-element basis yields similar results. Throughout the period analyzed, most covenants reflect the influence of management interests to some degree. In the period prior to June 1988, this influence generally took both forms identified in Part I: the covenants failed to provide protection against transactions that tend to reduce bond values but that management favors—management buyouts, other friendly acquisitions, and leveraged recapitalizations; and they deterred wealth-increasing hostile control changes that tend not to reduce bond values—proxy challenges and non-leveraged hostile acquisitions. After 1988, however, the pursuit of managerial interests primarily took the latter form—inhibiting wealth-increasing hostile control changes—while generally covering all common takeover-related transactions that reduce bond values.\textsuperscript{112}

\textsuperscript{111} See supra note 106 (change of control covenants are generally used in investment-grade industrial bond issues).

\textsuperscript{112} Even after 1988, the most common remedy was a put at par, which weakened bondholder protection and, on balance, increased managerial entrenchment.
### Table 4: Frequency and Nature of Managerial Influences over Time

<table>
<thead>
<tr>
<th></th>
<th>Fail to Protect Bondholders Fully and Insulate Managers</th>
<th>Fail to Protect Bondholders Fully but Do Not Insulate Managers</th>
<th>Protect Bondholders Fully but also Do Not Insulate Managers</th>
<th>Protect Bondholders Fully and Do Not Insulate Managers</th>
<th>Total Bonds with Change of Control Covenants</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1/86-12/86</strong></td>
<td>9</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>13</td>
</tr>
<tr>
<td><strong>1/87-12/87</strong></td>
<td>5</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td><strong>1/88-6/88</strong></td>
<td>6</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td><strong>7/88-12/88</strong></td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>67%</td>
</tr>
<tr>
<td><strong>1/89-6/89</strong></td>
<td>0</td>
<td>0</td>
<td>13</td>
<td>2</td>
<td>13%</td>
</tr>
<tr>
<td><strong>7/89-12/89</strong></td>
<td>1</td>
<td>0</td>
<td>31</td>
<td>4</td>
<td>11%</td>
</tr>
<tr>
<td><strong>1/90-6/90</strong></td>
<td>0</td>
<td>1</td>
<td>22</td>
<td>4</td>
<td>15%</td>
</tr>
<tr>
<td><strong>7/90-12/90</strong></td>
<td>1</td>
<td>0</td>
<td>10</td>
<td>0</td>
<td>11%</td>
</tr>
<tr>
<td><strong>1/91-12/91</strong></td>
<td>0</td>
<td>0</td>
<td>4</td>
<td>0</td>
<td>4</td>
</tr>
</tbody>
</table>

2. The Advent of Bondholder Protection: The RJR Nabisco Buyout

The apparent catalyst for the increase in bondholder-protective covenants was the leveraged acquisition of RJR Nabisco. On October 20, 1988, RJR's management announced its intent to carry out a leveraged buyout of RJR, causing an immediate decline in the value of the company's investment-grade bonds by about $1 billion. For five weeks following the RJR announcement, no investment-grade bonds were issued. Then, in November 1988, the first two Dual Trigger Covenants appeared. In the following

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113. See, e.g., Winkler, supra note 1.
114. See sources cited supra note 1.
115. Crabbe, supra note 12, at 696–97. In the year preceding the buyout announcement, an average of 8 investment-grade, nonconvertible, industrial bond issues were offered each month. Id. at 697.
116. Our sample contains one Dual Trigger Covenant in a 1986 bond issue. See supra Table 3. That covenant, however, included only a 50% share acquisition as a triggering event and thus is significantly narrower in scope than the later Dual Trigger Covenants, which include lesser share acquisitions as well as mergers, asset sales, dividends, and share repurchases as event triggers. That covenant is also the only one in
year, 48 bond issues contained Dual Trigger Covenants, and three contained Pure Rating Decline Covenants. Moreover, 43% of all investment-grade industrial bond issues of 1989 were covered by one of these types of covenant.\textsuperscript{117}

The RJR buyout was by far the largest acquisition ever, almost twice as large as the largest prior acquisition, and the losses of RJR’s bondholders received wide press attention.\textsuperscript{118} Although the ease with which firms can become involved in takeovers and related transactions depends on a wide range of factors, the RJR buyout demonstrated the capacity of the credit markets to finance a large leveraged transaction. The demonstration of this capacity apparently provided new information to the market regarding the possibility that other firms, previously thought to be immune to the leveraged acquisition wave because of their size, could become parties to similar transactions. Following the RJR announcement, risk premiums throughout the industrial bond market increased, reflecting the market’s increased estimate of the risk of takeover-related events for industrial firms in general.\textsuperscript{119} This increase was greatest for large blue-chip companies, whose bonds account for most of the Dual Trigger and Pure Rating Decline Covenants.\textsuperscript{120} As a result,

\begin{itemize}
  \item which a rating decline from investment grade to below investment grade does not satisfy the rating decline component of the trigger. STRAWBRIDGE & CLOTHIER, PROSPECTUS, Nov. 18, 1986, at 15. Thus, the Dual Trigger Covenants that appeared in November 1988 differ materially from this earlier Dual Trigger Covenant.
  \item See supra note 106 (change of control covenants are generally used in investment-grade industrial bond issues).
  \item MERGERSTAT REVIEW 1991, at 26 (price paid in RJR buyout was about $25 billion; price in next largest transaction was about $16 billion; price paid in largest transaction prior to RJR buyout was about $13 billion); see, e.g., Winkler, supra note 1 (describing the RJR Nabisco acquisition as a “watershed”); Jerry Knight, Raids Put New Risks Into Bonds, WASH. POST, Oct. 27, 1988, Pt. IV, at D9, D11 (investors worry that what happened to RJR bondholders could happen to anyone); Bill Sing, Mega-Mergers Leave Bondholders Counting Their Losses, L.A. TIMES, Nov. 9, 1988, Pt. IV, at 1 (major bondholder describing buyout as “galvanizing event”).
  \item One study found that “the RJR Nabisco transaction fundamentally changed the industrial bond marketplace . . . [F]or the first time, the market reflected an expectation of continuing event risk activity, requiring higher yields in the [investment-grade industrial, transportation, and natural gas pipeline sectors].” SALOMON BROTHERS, supra note 2, at 4.
  \item See, e.g., Michael Quint, U.S. Bonds Drop as Dollar’s Fall Continues, N.Y. TIMES, Oct. 22, 1988, at 36 (quoting analysts stating that prior to RJR buyout, large companies were regarded as above the level of takeover risk); Susan Kelly, Mortgage and Corporate Securities: Investors are Still Reeling from Size of RJR Offers, AM. BANKER, Nov. 14, 1988, at 15 (RJR buyout “shatter[ed] . . . assumption that some companies were just too big to be taken over.”). The 53 unaffiliated companies whose bonds are subject to Dual Trigger Covenants include nine of the 1989 Fortune 100 companies (Anheuser-Busch, Borden, Caterpillar, Coastal, International Paper, Monsanto, Ralston Purina, Reynolds Metal, and United Technologies) and 33 Fortune 500
\end{itemize}
substantial gains in firm value became available to firms that protected bondholders against takeover-related losses.\textsuperscript{121}

The RJR buyout, however, does not explain why these bondholder-protective covenants were not used at all prior to October 1988. Even before the RJR buyout, bond values declined as a result of leveraged acquisitions.\textsuperscript{122} Thus, promising compensation to bondholders should have enhanced firm values before the buyout, albeit by a lesser amount than after the buyout. So the question remains why companies failed to include such value increasing, bondholder-protective covenants in their bond indentures prior to the RJR buyout.

One answer may be that prior to the buyout, the perceived gains that a corporation could achieve by providing bondholder protection may have been too small to stimulate the development and use of this novel contractual device.\textsuperscript{123} Two factors may have been responsible for these relatively low potential gains. First, the bond market's estimation of the probability and extent of potential takeover-related losses was apparently low compared to its estimate after the transaction. Second, the bond market may have failed to price this protection accurately. As long as takeover-related losses were perceived as remote or small, even rational investors may not have assessed the impact of a protective covenant.\textsuperscript{124} This would be particularly true for a novel and rare covenant. The cost of assessing the value of a novel covenant is relatively high because of securities analysts' lack of familiarity; and the benefit of assessing its value is relatively low because an analysis could apply to only a few bond companies. The six companies that had issued bonds with Pure Rating Decline Covenants include three Fortune 100 (CPC International, Georgia Pacific, and Unysys) and four Fortune 500 companies. See The Fortune 500, FORTUNE, Apr. 24, 1989, at 354, 354–57.

\textsuperscript{121} See Crabbe, supra note 12, at 697 (reporting a 40 basis point yield spread between industrial bonds, which are subject to takeover risk, and otherwise comparable utility bonds, which for regulatory reasons are not subject to this risk).

\textsuperscript{122} See supra note 2.

\textsuperscript{123} The single Dual Trigger Covenant that predated the RJR buyout involved substantially narrower bondholder protection than the covenants that followed the buyout. See supra note 116.

issues. Consequently, bondholders may have failed to make interest rate concessions commensurate with the value of a protective covenant. If so, the use of such a covenant would not have been in the interest of a firm's shareholders.

By increasing its value and raising expectations of more accurate pricing of bondholder protection, the RJR buyout seems to have served as a catalyst for the development and use of the relatively protective Dual Trigger Covenant. Widespread publicity of the RJR bondholders' losses and of the need for bondholder protection raised the market's estimate of takeover-related losses and hence raised the value of protection from such losses. Moreover, the prospect that bondholder protection would become common increased the returns available to underwriters and lawyers to develop new covenants and to securities analysts to measure their value.

3. The Decline of Management Intrusion: The Self-Selection Hypothesis

The preceding analysis does not fully explain why managers became willing to forgo the protection of Hostile Control Change Covenants and to accept the constraints on friendly mergers, management buyouts, and defensive recapitalizations that Dual Trigger Covenants and Pure Rating Decline Covenants impose. One explanation may be that the increased prices that bondholder-protective covenants commanded induced managers to accept Dual Trigger Covenants. Managers do, after all, have an interest in a lower cost of debt and the resulting higher share values. This interest may have outweighed their interest in insulation from hostile control changes.

Moreover, self-selection by management in employing Dual Trigger Covenants may have resulted in these covenants being used

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125. In secondary markets, traders frequently possess only information that is in their computer data base. Such information does not include all details regarding a bond's covenants. It includes only the information that traders deem, ex ante, to be most important.

126. Even if bondholders in the primary market could have priced these covenants, they may have been concerned that the covenants would not be priced in the secondary market, in which case the initial buyers would be unable to recoup their investments in the covenants.

127. Crabbe, supra note 12, at 696–97. For bonds issued between November 1988 and December 1989, Crabbe found that issuers saved an average of 24 basis points by providing bondholders with the protection of a Dual Trigger Covenant. He further found that for bonds trading in the secondary market at year-end 1989, the market valued these covenants at 32 basis points. Id. at 701.

128. Cf. sources cited supra note 124 (pricing imperfections).
disproportionately more by companies that are relatively unlikely to be subject to a friendly acquisition, management buyout, or leveraged recapitalization. Management of such companies may have viewed a Dual Trigger Covenant primarily as a means to protect itself against hostile acquisitions or proxy challenges. Thus, such a self-selected group of managers would have been highly receptive to the idea of including Dual Trigger Covenants in the bond indentures of their companies.

In this respect, it is instructive to take a closer look at the 53 unaffiliated corporations that issued bonds with Dual Trigger Covenants. One of these companies was rumored to be a likely target for a hostile takeover shortly after the issuance of the bonds. A second company became the object of two proxy contests in the following two years. Another was threatened with a proxy challenge. Still another company issued its protected bonds shortly after a hostile raider had taken initial steps towards a takeover attempt. And, finally, one company experienced the replacement of its board through a proxy contest, which triggered the change of control covenant. A total of five out of 53 companies with Dual Trigger Covenants thus became targets of actual or attempted hos-

129. Indeed, management that is not interested in a friendly acquisition, a management buyout, or a leveraged recapitalization may, in certain respects, even prefer a Dual Trigger Covenant over an Hostile Control Change Covenant. Hostile Control Change Covenants suffer from the deficiency that courts may force management to "approve" a hostile bid, thereby eliminating the protection the covenant affords management. See Revlon, Inc. v. McAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (holding that if sale of the company has become inevitable, the court will set aside antitakeover defense if it is not designed to maximize sale price received by shareholders); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (holding that the court will set aside an antitakeover defense if the defense is unreasonable in relation to threat posed). By contrast, even if a court were to force management to approve a hostile bid, the deterrent effect of a Dual Trigger Covenant would still remain in force.

130. This number differs from the total of 56 different companies that had issued bonds with Dual Trigger Covenants because, in three instances, both the parent company and a subsidiary had issued such bonds.


tile control changes. Over the same time period, January 1989 to June 1992, none of the 53 companies became the object of an actual or attempted friendly acquisition or management buyout. In contrast, the overall number of attempted friendly tender offers during the period 1989 to 1991 was 170, and the total number of actual or attempted hostile offers and proxy contests was 129. Thus, though there were 30% more friendly advances than hostile ones overall, the count among companies with Dual Trigger Covenants is five hostile advances to zero friendly ones. This finding supports the self-selection hypothesis.

The self-selection hypothesis is also consistent with the actions of the companies that had issued bonds with Hostile Control Change Covenants prior to July 1988. The fact that these companies had issued bonds with Hostile Control Change Covenants indicates that their managers were particularly concerned with the possibility of a hostile control change. As discussed above, when six of these companies returned to the market to issue bonds again in 1989 or 1990, five issued bonds with Dual Trigger Covenants; one issued bonds with a Hostile Control Change Covenant; and not one

136. These figures are based on several term searches in the Nexis/Wall Street Journal Abstract database, followed up by searches in the Nexis/Bus and Nexis/Wires databases.

137. MERGERSTAT REVIEW 1991, Figure 31, at 69 (takeover data). Hostile or contested tender offers are offers in which an initial bid is rejected by the target company. Other tender offers are friendly or uncontested. The data on proxy contests include only those announced by May 1991. However, because most shareholder meetings are scheduled in the first half of the calendar year, the total number of proxy contests in 1991 should not be significantly greater. See With M&A in the Doldrums, Proxy Fights Plummet, CORPORATE CONTROL ALERT, May 1991, at 1 (proxy contest data).

138. To determine the statistical significance of these results, we tested the null hypothesis that companies with Dual Trigger Covenants are as likely to become the object of a hostile takeover attempt or a proxy contest as of a friendly acquisition or management buyout attempt. Given the higher number of friendly tender offers, this null hypothesis is conservative.

The null hypothesis permits us to use a common “pooled variance” \( s_p^2 \) with

\[
s_p^2 = \frac{1}{(n_1 + n_2 - 2)} \left[ \sum_{i=1}^{n_1} (X_i - \bar{X}_1)^2 + \sum_{j=1}^{n_2} (X_j - \bar{X}_2)^2 \right]
\]

where \( n_1 \) and \( n_2 \) are each 53; \( X_i \) is 0 if the company has not become the object of a hostile takeover attempt or proxy contest and 1 if it has; \( X_j \) is 0 if the company has not become the object of a friendly tender offer or management buyout attempt and 1 if it has; and \( \bar{X}_1 \) and \( \bar{X}_2 \) are the respective sample means, i.e., 0.094339 and 0. This yields \( s_p^2 = 0.043541 \).

Using this pooled variance, the null hypothesis that companies with Dual Trigger Covenants are as likely to become the object of a hostile takeover attempt or a proxy contest as of a friendly acquisition or management buyout attempt can be rejected at a 95% level.
issued a bond without any change of control covenant. In contrast, during 1989 and 1990, 35% of investment-grade industrial bonds contained change of control covenants. Thus, companies that had evidenced particular concern with hostile control changes were substantially more likely to issue bonds with Dual Trigger Covenants than were other companies. This finding provides additional support for the self-selection hypothesis.

4. The Improvement of Bondholder Protection: Event-Risk Rating Service

In July 1989, Standard & Poor's initiated its event-risk rating service. Although the advent of Dual Trigger Covenants predates this service, Standard & Poor's event-risk rating service may have improved the pricing of bondholder protection, and thereby provided firms with incentives to strengthen the protective quality of Dual Trigger Covenants.

As Table 5 shows, prior to July 1989, no bonds with Dual Trigger Covenants covered asset acquisitions, which are often accompanied by an increase in leverage. In addition, all Dual Trigger Covenants had previously provided for a put at par as a remedy, which as discussed above, provides incomplete protection. Beginning in July 1989, however, an increasing proportion of these covenants included “major asset acquisitions” as triggering events and interest rate adjustments as remedies. This increased protection is generally reflected in E-2 event-risk ratings by Standard & Poor's (indicating “significant protection”) as opposed to the lower

139. See supra text accompanying notes 110–11.
140. See supra note 106 (change of control covenants are generally used in investment-grade industrial bond issues).
141. With a 35% overall probability that any bond issued in 1989 or 1990 contains a Dual Trigger Covenant, the hypothesis that companies with pre-July 1988 Hostile Control Change Covenants are not more likely than other companies to issue bonds with Dual Trigger Covenants can be rejected at a 95% significance level.
142. A remaining puzzle is why Hostile Control Change Covenants essentially vanished. Although the self-selection hypothesis explains why some managers would accede to the use of Dual Control Trigger Covenants, it does not explain the near disappearance of management's earlier favorite. One explanation may be that when participants in the bond market focused on change of control covenants and realized how little protection the Hostile Control Change Covenants offered, managers were concerned about the reputational effects the use of those covenants might have. This concern could well have been heightened when S&P's began its event-risk rating service and assigned the lowest rating to Hostile Control Change Covenants. See infra text accompanying notes 143–44.
144. See supra text accompanying notes 99–104.
E-3 rating (indicating "some protection") awarded retroactively to most earlier Dual Trigger Covenants. Indeed, all change of control covenants that received an E-2 or the even stronger E-1 rating ("strong protection") were issued after July 1989.

**Table 5: Extent of Protection Provided by Dual Trigger Covenants over Time**

<table>
<thead>
<tr>
<th>Date</th>
<th>All Dual Trigger Covenants</th>
<th>Asset Acquisition Trigger</th>
<th>Interest Rate Adjustment Remedy</th>
<th>Either Asset Acquisition or Interest Rate Adjustment</th>
<th>Bonds that Received E-2 Rating</th>
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<tr>
<td>1/86-12/86</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1/87-12/87</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1/88-6/88</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>7/88-12/88</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1/89-6/89</td>
<td>14</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>7/89-12/89</td>
<td>34</td>
<td>2 (6%)</td>
<td>2 (6%)</td>
<td>4 (12%)</td>
<td>1 (3%)</td>
</tr>
<tr>
<td>1/90-6/90</td>
<td>23</td>
<td>7 (30%)</td>
<td>7 (30%)</td>
<td>7 (30%)</td>
<td>7 (30%)</td>
</tr>
<tr>
<td>7/90-12/90</td>
<td>10</td>
<td>5 (50%)</td>
<td>5 (50%)</td>
<td>5 (50%)</td>
<td>5 (50%)</td>
</tr>
<tr>
<td>1/91-12/91</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>0</td>
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</tr>
</tbody>
</table>

5. The Decline in Dual Trigger Covenants: Falling Hostile Takeover Activity

If the RJR Nabisco buyout created conditions sufficient for the advent of Dual Trigger Covenants, the drop in merger and hostile takeover activity appears to have caused the dramatic decline in their use in 1991. The number of Dual Trigger Covenants used in new bond indentures decreased from 48 in 1989, to 33 in 1990, and to 4 in 1991. In 1991, these covenants covered approximately one percent of investment-grade industrial bond issues. This compares to a figure of 43% for the peak period of January 1989 through June 1990.

This decline mirrored the decline in takeover volume during that period. From a peak of $156 billion in 1988, the total dollar value paid in acquisitions of publicly traded companies fell to $122 billion in 1989, to $48 billion in 1990, and to $32 billion in 1991—
approximately 20% of the 1988 high. The decline in hostile takeovers was even steeper. The year 1991 witnessed only two hostile takeover attempts, less than 5% of the 1988 high of 46. And while hostile takeover attempts constituted 21% of all tender offers in 1988 and 29% in 1989, they constituted 14% in 1990 and only 10% in 1991. The number of proxy contests took a similar dip, from 112 in the 1988-to-1990 period, to fifteen in 1991.

Nonetheless, just as bondholder protection would have increased firm value before the RJR Nabisco buyout, so too would it have increased firm value when takeover activity was relatively low—though not by as much as it did in the year or so after the RJR transaction. Again, the interesting question is why the bondholder-protective covenants nearly disappeared.

Prior to the RJR transaction, the complete absence of protective covenants may have caused a pricing problem that could have impeded their development. This explanation does not apply, however, to the decline in the use of these covenants in 1991. By that time, the covenants had been developed, they were widely used in bonds traded in the secondary market, and market participants had experience valuing them.

The explanation for the decreased use of Dual Trigger Covenants seems to lie, once again, in managerial attitudes toward change of control covenants. The reduced market values of these covenants allowed managers to pursue their parochial interests with less sacrifice of share values than was possible immediately after the RJR transaction. In 1991, the perceived threat of hostile takeovers virtually disappeared, at least in the short run. Consequently, the management entrenchment features of Dual Trigger Covenants lost appeal to management, and the encumbrance of managerial discretion apparently became too high a burden for managers to carry.

145. Mergerstat Review 1991, Figure 34, at 72.
146. Id., Figure 31, at 69.
147. Id.
148. See With M&A in the Doldrums, Proxy Fights Plummet, supra note 137.
150. See supra text accompanying notes 124–28.
151. In the first half of 1990, Dual Trigger Covenants were valued at about 15 basis points. Crabbe, supra note 12, at 703–04.
IV. IMPLICATIONS AND CONCLUSION

Change of control covenants implicate the interests of shareholders, bondholders, and managers. Bondholders value protection against the increased leverage that often accompanies an acquisition or recapitalization. By providing bondholders with such protection, a change of control covenant can reduce a firm's agency cost of debt and thereby increase its value. To the extent that a covenant's protection is reflected in the price of a bond, shareholders reap the benefit of this increased value.

Managers, however, have parochial interests in change of control covenants and substantial control over their terms. Consequently, a corporation's managers may omit management buyouts, other friendly acquisitions and recapitalizations from the scope of a covenant, even though coverage of these transactions would reduce the firm's agency cost of debt. Furthermore, managers may use a change of control covenant to impede hostile control changes, even though these control changes would increase firm value. This overbroad and selective coverage would help insulate managers from the threat of a hostile control change and thereby increase their firm's agency cost of equity.

Empirically, we find that change of control covenants reflect both of these managerial interests. Substantially all bonds issued prior to October 1988—the date the RJR Nabisco buyout was announced—contain Hostile Control Change Covenants, which encumber only hostile takeovers and proxy contests, usually without regard of their effect on bond values. These covenants combine incomplete bondholder protection with strong management entrenchment features. On the other hand, most bonds issued after October 1988 contain Dual Trigger Covenants. These covenants provide significantly more, though incomplete, protection to bondholders, but still contain some management entrenchment features.

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152. Change of control covenants are usually included in bonds with a maturity of 7 to 30 years. The major credit rating agencies have stated that it is shortsighted to exclude change of control covenants from bond indentures. See Hessol, supra note 60, at 42; MOODY'S SPECIAL REPORT, supra note 8, at 9. Moody's reports that the factors that fueled the takeover market of the 1980s "either remain in place today or could recur in the future." Id. at 2. Ironically, in recently upgrading RJR Nabisco's senior debt, Moody's states that it limited its upgrade to "one notch" because of "the lack of meaningful indenture protection in any of RJR's outstanding indentures in combination with the possibility of releveraging." Id. at 8.
We explain this improved protection by factors related to the leveraged buyout of RJR Nabisco. Both before and after the buyout, providing takeover protection to bondholders would have increased firm value. The buyout, however, served as a catalyst for the development of a novel contractual provision. It increased the magnitude of the gains to be derived from such a provision and may have enhanced the pricing of bondholder protection. These two effects increased the benefits to shareholders of including protective covenants in bond indentures.

Managers may have accepted the restrictions imposed by Dual Trigger Covenants for two reasons. First, the gains in share value achieved with these covenants may have outweighed management’s parochial interest. Second, as our data suggest, these covenants were used predominantly by managers apparently concerned more with becoming targets of hostile takeovers or proxy contests than with the possibility of a management buyout, friendly acquisition, or recapitalization.

The same two factors may also have contributed to the infrequent use of Dual Trigger Covenants in 1991. The decline in takeover activity reduced the gains to be derived from such covenants. Also, the virtual disappearance of hostile acquisitions and the drop in proxy contests reduced managers’ interest in fending off hostile control changes relative to their interest in retaining unencumbered discretion to engage in transactions they favor.

Our findings are inconsistent with those commentators who claim that bondholders cannot obtain effective contractual protection. These commentators argue that, because bondholders do not negotiate the contractual terms of a bond, they need extra-contractual protection. We find, however, that bondholders did obtain substantial contractual protection in the wake of the RJR buyout. At that time, the requisite conditions for the inclusion of such protection were present: bondholders were willing to accept lower interest rates in return for protection; protection of bondholders increased share values; and managers were willing to tolerate restrictions on their discretion.

Instead, our analysis identifies two different market failures, the costs of which are borne by shareholders, rather than bondholders. First, parochial managerial interests have led to underinclusive change of control covenants: they fail to cover transactions that management favors. As a result, the agency cost of debt is higher than necessary. Second, parochial managerial interests have caused change of control covenants to be overinclusive: they impede hostile
control changes that do not harm bondholders, and they tend to
overcompensate bondholders. As a result, the agency cost of equity
is higher than necessary. Whether these market failures justify legal
intervention, however, is a more complex question that lies beyond
the scope of this Article.