

Article

Bondholders and Securities Class Actions

James J. Park[†]

INTRODUCTION

Securities class actions are typically brought by shareholders of the corporation who allege they purchased stock at a price inflated by fraud. Yet a company's common stock is not the only type of security protected by the securities laws. Bond investors may also bring suit for securities fraud and are increasingly asserting claims through bondholder class actions.¹ Drawing upon a data set of 1660 securities class actions filed from 1996 through 2005, this Article argues that bondholders are playing a greater role in securities class actions than previously recognized and that this role is likely to grow.² Securities class actions have evolved so that they not only protect shareholders, but address fraud that benefits shareholders at the expense of bondholders.

[†] Professor of Law, UCLA School of Law. For helpful comments, thanks to Stephen Bainbridge, Stanislav Dolgoplov, George Georgiev, Maria Loumiti, Urska Velikonja, and workshop participants at the American Association of Law Schools 2014 Annual Meeting (Section on Securities Regulation), American Law and Economics Association 2014 Annual Meeting, Brooklyn Law School Junior Faculty Forum, 2013 Corporate and Securities Litigation Workshop, UCLA School of Law Junior Business Law Faculty Forum, and the UCLA School of Law Faculty Workshop. For helpful research assistance, thanks to Thomas Fuell, Alex Nguyen, and Andrew Lee. Copyright © 2014 by James J. Park.

1. When referring to "bonds," this Article means non-convertible debt securities with a maturity of one year or more.

2. A number of articles by business school professors have inquired into related issues. See, e.g., Michael Hartzmark et al., *Fraud on the Market: Analysis of the Efficiency of the Corporate Bond Market*, 2011 COLUM. BUS. L. REV. 654 (discussing efficiency of bond markets); Mary Billings et al., *Shareholder Class Action Suits and the Bond Market* (May 2011) (unpublished manuscript), available at <http://ssrn.com/abstracts=1984666> (examining whether bond prices react to the filing of securities class actions). No such study focuses on the frequency and characteristics of bondholder class actions.

At first glance, it seems unlikely that bondholder involvement in securities class actions would be of much importance. Because they have priority over shareholders in the firm's capital structure, bondholders are less likely to suffer losses from fraud than shareholders. In any case where bondholders are the victim of securities fraud, shareholders will suffer much greater losses. When bondholders assert claims alongside shareholders, their claims might be perceived as insignificant and redundant. Bondholder recoveries in securities class actions could be explained as the result of opportunistic rent-seeking by class action attorneys seeking to obtain part of a securities class action settlement.

Even if bondholders recover less frequently and in smaller amounts than shareholders, bondholder class actions may still be of importance because bondholders are most likely to obtain damages in the most serious cases of fraud. For example, the most prominent case where bondholders achieved a recovery through the securities laws involved WorldCom, the telecomm company that collapsed in the wake of accounting fraud in 2002, where bondholders recovered about \$5 billion.³ The WorldCom settlement was for a fraud that resulted in the bankruptcy of a major public company. The fraud was so significant that in a rare event, board members were required to personally contribute to the settlement.⁴ While the WorldCom fraud had social implications in its own right, the involvement of bondholders highlighted how the worst frauds do more than cause shareholder losses.

Moreover, if bondholders suffer distinct injury from securities fraud, their claims are not simply redundant with shareholder actions. In many cases, companies commit securities fraud in the hope they will increase shareholder wealth by taking on additional risk that is not disclosed. Bondholders do not benefit from such a course of action and can be harmed when such risk is hidden. In such cases, securities fraud essentially distributes wealth from bondholders to shareholders. Even if

3. Gretchen Morgenson, *Bank to Pay \$2 Billion To Settle WorldCom Claims*, N.Y. TIMES (Mar. 17, 2005), http://www.nytimes.com/2005/03/17/business/17worldcom.html?_r=1& ("The bondholders in the case had sought a total of \$9 billion in damages. Of the \$6 billion recovered from the banks, \$5 billion will go to bond investors and \$1 billion will go to holders of WorldCom stock. The \$5 billion recovered for bondholders is 56 percent of the amount sought by the plaintiffs in the case.").

4. See Brooke A. Masters & Kathleen Day, *10 Ex-WorldCom Directors Agree to Settlement*, WASH. POST, Jan. 6, 2005, at E1.

some bondholder involvement in securities class actions is the result of rent-seeking, to the extent that unique arguments can be asserted by bondholders, a role for bondholders in securities class actions is justified.

This Article is the first to present extensive data on bondholder actions. The evidence from 1996 through 2005 provides support for the view that bondholder involvement in securities class actions is increasing. Bondholder recoveries were rare for the first five years covered by the data set, averaging about 3% of settlements from 1996 through 2000. The rate of bondholder recoveries increased to an average of 8% of settlements from 2001 through 2005. Bondholder recoveries have not only become more frequent, they are disproportionately represented in the largest settlements of securities class actions. For the period covered by the data set, bondholders recovered in 4 of the 5 largest settlements and 19 of the 30 largest settlements.

Many of these bondholder class actions raise allegations of distinct harm to bondholders. A significant number of bondholder class actions are associated with a downgrade of the company's credit rating, an event signaling a substantial increase in the credit risk of a company. Bondholder class actions also often arise out of bond sales where risks were not adequately disclosed to bond purchasers. Both situations can involve transfers of wealth from bondholders to shareholders.

The growing involvement of bondholders in securities class actions is likely to continue. In the first year of the data set, 1996, less than 10% of securities class actions sought recovery for non-shareholder plaintiffs. Over the next decade, plaintiffs began certifying broader classes that included bondholders. It has now become routine for a securities class action to allege claims on behalf of all investors of the issuer's publicly traded securities. By 2005, close to half of securities class actions brought claims on behalf of such a broader class.

The increase in bondholder recoveries illustrates how the nature of securities fraud can change over time. There is a tendency in the literature to assume that securities class actions have a fixed essence. The reality is far more complex. In some periods, cries of securities fraud appear to be opportunistic attempts to recover losses from temporary stock price fluctuations. In more recent times, frauds have been associated with serious declines in the fortune of public companies. Securities class actions are evolving as the nature of securities fraud changes. For example, in earlier years, suits alleging fraudu-

lent securities offerings primarily targeted emerging companies selling stock in an initial public offering (IPO). Now, the most significant recoveries arising out of securities offerings involve bond sales by seasoned public companies.

Bondholder class actions also have implications for corporate governance. Corporate law has traditionally focused on the rights of shareholders, who are protected by fiduciary duties, and not bondholders, whose rights are defined by contract.⁵ With bondholder class actions, an investor who purchases a bond at a price that does not reflect the true risk of a corporation's insolvency can recover damages. A recovery by bondholders typically shifts funds from shareholders to bondholders, providing a remedy for reckless decisions meant to benefit shareholders. Bondholder class actions highlight how fraud harms non-shareholder constituencies, while respecting the traditional corporate law distinction between shareholders and bondholders.

Given the unique position of bondholder plaintiffs, in some circumstances, courts should treat bondholder class actions differently from shareholder class actions. The fraud-on-the-market presumption,⁶ which facilitates certification of a class by assuming that all investors uniformly rely upon the integrity of the market price for a security, should be modified for bondholders.⁷ Investors rely more on credit rating agencies

5. See, e.g., *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988) (holding that a bondholder “acquires no equitable interest, and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture”); *Mann v. Oppenheimer & Co.*, 517 A.2d 1056, 1061 (Del. 1986) (“The rights of debenture holders are controlled by the terms of the indenture under which the securities are issued.”); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (noting that rights of bondholders are “fixed by agreement”); *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) (“The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation’s obligation to its bondholders.”); see also Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1167 (1990) (“For bondholders, this has meant that the bond contract, typically negotiated and drafted by corporate management, serves as the font of all bondholder rights and duties.”).

6. The U.S. Supreme Court recently rejected an attempt to overrule the decision establishing this presumption. See *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2408–11 (2014).

7. Because bond markets are less developed than stock markets, one commentator predicts that bondholders are less likely to satisfy various class certification hurdles. See John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 328 (2010) (“Because the debt markets are normally not considered to be efficient . . . plaintiffs in cases

than markets in assessing the risk of corporate bonds. To the extent that a fraud substantially distorts a credit rating, courts ought to presume that bondholders uniformly relied on such credit rating. In addition, to the extent that bondholder class actions raise distinct theories of harm, bondholders should be represented in a separate sub-class from shareholders by independent counsel. Such representation could enhance the ability of bondholders to assert their interests in securities class actions.

Part I of this Article discusses bond valuation and the particular way in which securities fraud impacts bonds. Part II discusses two possible hypotheses with respect to the importance of bondholder class actions. Part III presents evidence on bondholder recoveries and their characteristics from a data set of securities class actions filed from 1996 through 2005. Part IV contends that increasing bondholder recoveries are evidence of the changing nature of securities fraud. Part V discusses the role bondholder class actions play in corporate governance. Part VI argues that courts should recognize the differences between bondholders and shareholders in adjudicating securities class actions.

I. BOND INVESTORS AND SECURITIES FRAUD

Compared to shareholders, bondholders have less reason to be concerned about securities fraud. This is because, as will be discussed in Section A, bonds are valued differently than stocks. Bond prices are not as vulnerable as stock prices to changes in the company's expected profitability. Section B describes how securities fraud can affect bondholders. Certain frauds can result in the inflation of bond prices, resulting in losses when the fraud is revealed. Bondholders are most concerned about frauds that obscure the risk that a company will default on its debt obligations.

A. BOND VALUATION

The value of any security should approximate the net present value of the expected cash flows the owner of that security expects to receive.⁸ For the bond investor, those cash flows in-

involving debt securities need to sue on an individual or consolidated basis, thereby again downsizing the role of the opt-out class action.”).

8. See, e.g., Hartzmark et al., *supra* note 2, at 669 (“The price of bonds is calculated as the present value of the expected future cash flows they generate.”).

clude all of the expected interest payments from the issuer as well as the return of principal at the end of the bond's maturity.⁹ These values can change.¹⁰ Over time, the value of the bond can fluctuate so that when traded in the secondary market, a bond initially purchased for \$1000 will trade at a discount, say \$900, or a premium, say \$1100.

A bond's price depends much less on the future growth of a company's earnings than the price of a stock. The value of a stock depends on the market's assessment of whether the underlying corporation will be profitable. Unlike the shareholder, the bondholder has a contractual right to receive interest payments and the return of principal, regardless of whether the firm has earnings. This fixed return is safer than the residual return captured by shareholders. Bondholders have priority over shareholders in bankruptcy, and thus they benefit from an equity cushion that absorbs most fluctuations in firm value. New information should only affect bond valuations if it changes the investor's assessment that the bond issuer will fulfill its obligation to pay interest and return the principal when the bond matures.¹¹

Corporate bondholders will thus assess the risk of default of the particular issuer,¹² that is, credit risk, when calculating

9. See, e.g., *In re HealthSouth Corp. Sec. Litig.*, 261 F.R.D. 616, 631 (N.D. Ala. 2009) ("A corporate bond reflects a debt owed by the borrower/corporation to the bondholder that calls for periodic payments of interest at a specified rate, as well as a lump sum payment of the principal amount at a designated maturity date.").

10. A variety of factors affect a bond's valuation. See, e.g., Robert C. Merton, *On the Pricing of Corporate Debt: The Risk Structure of Interest Rates*, 29 J. FIN. 449, 449 (1974) (noting that the primary risks affecting bond prices are interest rate risk and credit risk); see also Mark S. Klock et al., *Does Corporate Governance Matter to Bondholders?*, 40 J. FIN. & QUANTITATIVE ANALYSIS 693, 695-96 (2005) (finding that antitakeover governance provisions reduce the cost of debt).

11. See, e.g., William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1541 (1982) ("The fixed return of the debt claim is designed to appeal to an investor whose aversion to risk is higher than that of a residual claimant in the same firm or to an investor who does not want to be concerned with the profit-maximization decisions of the firm.").

12. The risk of default translates into a higher interest rate for corporate bonds relative to risk-free U.S. government bonds. See, e.g., Francis A. Longstaff et al., *Corporate Yield Spreads: Default Risk or Liquidity? New Evidence from the Credit Default Swap Market*, 60 J. FIN. 2213, 2214 (2005) (finding that the risk of default "accounts for the majority of the corporate spread across all credit ratings"). Studies differ in the influence of default risk on the premium paid by corporate issuers. See, e.g., Edwin J. Elton et al., *Explaining*

the price they will pay for a bond issued by that company.¹³ If a corporation becomes insolvent, a bond investor could lose part or all of its investment.¹⁴ While bondholders can expect to recover more than shareholders in bankruptcy, they often suffer substantial losses.¹⁵ Corporate bond prices will thus fluctuate based on the market's assessment of the safety of the corporate issuer relative to other corporate issuers.¹⁶ As the risk of default grows higher, the price of a corporate bond will fall.

Bond investors rely on both credit ratings and bond covenants to reduce the cost of calculating the risk of default. Rating agencies assess the creditworthiness of an issuer's bonds for a fee, essentially grading a bond based on a number of different criteria. The highest rating, AAA, would indicate that the issuer is very unlikely to default.¹⁷ Lower ratings, such as BBB, can mean there is a non-trivial risk of default.¹⁸ The interest rate paid for a bond rated AAA will be lower than the interest rate paid for a bond rated BBB because investors will accept a lower

the Rate Spread on Corporate Bonds, 56 J. FIN. 247, 249 (2001) (finding that default risk only explains 25% of corporate spread).

13. See, e.g., *Newby v. Enron Corp. (In re Enron Corp. Sec. Deriv. & "ERISA" Litig.)*, 529 F. Supp. 2d 644, 755 (S.D. Tex. 2006) (noting that bond prices depend on factors including "the likelihood of default, the most critical factor").

14. See, e.g., *Pierre Collin-Dufresne et al., The Determinants of Credit Spread Changes*, 56 J. FIN. 2177, 2178 (2001) ("[C]redit spreads obtain for two fundamental reasons: (1) there is a risk of default, and (2) in the event of default, the bondholder receives only a portion of the promised payments.").

15. See, e.g., *Lynn M. LoPucki & William C. Whitford, Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 142 (1990) (reporting that bondholders recover between 0.5% to 81.6% of unsecured claims); see also *Kenneth M. Ayotte & Edward R. Morrison, Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 518 (2009) ("[I]n 22 percent of the cases, secured claims exceeded the value of the company.").

16. Corporate bond prices will fluctuate in response to changes in interest rates and changes relating to credit risk. See, e.g., *Hartzmark et al., supra* note 2, at 670 ("[D]aily changes in corporate bond prices and yields are most often a function of only three of these factors: changes in risk-free Treasury rates of interest, changes in risk premiums for similar-risk corporate bonds, and changes in the company's likelihood of default on its obligations.").

17. Historically, only 1% of AAA bond issuers default over a ten-year period. See S&P, *2011 Annual U.S. Corporate Default Study and Rating Transitions*, tbl.13 (Mar. 23, 2012), available at <https://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245331026864>.

18. Historically, about 5% of issuers of BBB bonds default over a ten-year period. See *id.*

rate of return for a bond with a lower risk of default.¹⁹ A bond's rating can be downgraded as a company's risk of default increases, which adversely affects the price of the bond.²⁰ Bondholders will also typically be protected by contractual provisions, or covenants, that prohibit certain conduct that would increase the risk of default.²¹

While ratings and bond covenants reduce the cost of monitoring, they are not completely effective in protecting bondholders from losses. Much has been written about the deficiencies of credit rating agencies and the unreliability of their ratings.²² Bondholder covenants are rarely enforced because bond trustees have insufficient incentive to monitor for breaches.²³ Moreover, bondholder covenants and ratings tend not to be effective

19. The credit rating is especially influential in the initial pricing of a corporate bond. *See, e.g.*, Martin S. Fridson & M. Christopher Garman, *Determinants of Spreads on New High-Yield Bonds*, 54 FIN. ANALYSTS J. 28, 34 (1998) ("Ratings . . . have by far the highest correlation of any variable with new-issue spreads.").

20. *See, e.g.*, Elton et al., *supra* note 12, at 258 ("[S]ome of the bonds originally rated AAA have migrated to lower-rated categories where there is some probability of default."); *see also* Newby v. Enron Corp. (*In re* Enron Corp. Sec. Deriv. & "ERISA" Litig.), 529 F. Supp. 2d 644, 757 (S.D. Tex. 2006) (noting that Enron's credit rating was downgraded after it announced write-downs).

21. *See* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 125-46 (1979) (describing various bond covenants). Bondholder covenants tend to offer less protection than covenants for bank loans. *See, e.g.*, Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1931 (2013) ("[P]rivate debt contains far more covenants than public debt."); Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 651 (2009) (noting that public bonds have "typically less restrictive covenants in light of greater publicly available information about those borrowers, the higher cost to monitor and enforce compliance, and a decline in the ability to mitigate credit risk through contract" (footnotes omitted)).

22. *See, e.g.*, Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L. Q. 619, 623-24 (1999) (concluding that credit rating agencies have thrived because of the sale of regulatory licenses rather than the accuracy of their ratings).

23. *See, e.g.*, Yakov Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 470 (1999) ("[T]he indenture trustee is not obliged to engage in active monitoring, its compensation creates no incentive to expend effort, and it does not have the authority to renegotiate covenants."); *see also* Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 150 (2009) (noting that bank loan covenant violations are common). However, the rise of active investors has resulted in more aggressive enforcement of bond covenants. *See* Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U. L. REV. 281, 283 (2009).

in preventing fraud.²⁴ If a company is committed to manipulating the price of its securities, it is unlikely that it will carefully follow the mandates of covenants or rating agencies.²⁵ Bondholders thus remain vulnerable to securities fraud despite these protections.

B. THE IMPACT OF SECURITIES FRAUD ON BONDS

When a company commits securities fraud, it generally makes a misstatement relating to its past, present, or future performance. A material misstatement might affirmatively inflate the price of the company's stock, or it might prevent a stock price decline. Investors who purchased stock at the inflated price will suffer losses when the truth is revealed and the stock price moves to its appropriate value.

Like stock investors, bond investors rely on the company's disclosures in making an investment and monitoring it.²⁶ However, because of the characteristics of bonds discussed earlier, bondholders are less vulnerable than shareholders to securities

24. Broadly worded contractual provisions are limited in their ability to prohibit fraudulent conduct. *See, e.g.*, Amihud et al., *supra* note 23, at 464 ("Some corporate actions that harm creditors—for example, actions that increase the business risk associated with the company's operations—are difficult to specify contractually . . ."). Rating agencies generally rely upon the issuer's representations in computing ratings, and thus are limited in their ability to detect fraud. *See, e.g.*, Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 6 (noting that because "rating agencies make their rating determination, based primarily on information provided by the issuer of securities, a rating is no more reliable than that information" and therefore "[r]atings do not cover the risk of fraud").

25. Indeed, securities fraud is a way to circumvent bond covenants. *See, e.g.*, Baruch Lev, *Corporate Earnings: Facts and Fiction*, 17 J. ECON. PERSP. 27, 36 (2003) (observing that firms manipulate accounting to avoid violation of contractual commitments with bondholders and other lenders); Smith & Warner, *supra* note 21, at 144 ("Restrictions on the shareholders' behavior can be relaxed by manipulating the accounting numbers which define the constraints.").

26. *See, e.g.*, Leland E. Crabbe & Christopher M. Turner, *Does the Liquidity of a Debt Issue Increase with Its Size? Evidence from the Corporate Bond and Medium-Term Note Markets*, 50 J. FIN. 1719, 1721 (1995) ("Investors analyze a variety of types of information about a borrower, such as its leverage ratios, cash flow, management expertise, litigation risk, credit ratings, cyclical risk, and industry risk."); Smith & Warner, *supra* note 21, at 143 ("[B]ondholders find financial statements to be useful in ascertaining whether the provisions of the contract have been (or are about to be) violated."); *see also* Peter D. Easton et al., *Initial Evidence on the Role of Accounting Earnings in the Bond Market*, 47 J. ACCT. RES. 721, 739–45 (2009) (finding that bonds trade more around earnings announcements).

fraud.²⁷ While changes in a company's stock price are common, so long as the fraud does not impact the perception of the bond market that the company will remain solvent, bond prices should not be affected by the fraud.²⁸

The situation can change if the securities fraud hides information that significantly affects the probability of corporate default.²⁹ A fraud may hide information that would fundamentally change the market's assessment of whether a company is in danger of insolvency. For example, a number of studies have found that bond markets respond to accounting restatements, which cast doubt on the reliability of the company's financial statements.³⁰ Without trust in the company's financials, the bond market may perceive that the risk of default has increased. Moreover, credit rating agencies can respond to fraud by downgrading the company's debt, signaling to the market that the debt is riskier.

A bond investor who purchased the bond on the assumption that the company had a certain credit risk will see the value of that investment decline. The bondholder would have to discount the price of the bond to sell it to another investor. In some cases, a company may find that its credibility is so dam-

27. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1085 (1990) ("Debt securities will be more insulated from the shocks associated with bad news than will equity securities.").

28. The price of bonds with higher credit ratings will fluctuate less than lower rated bonds. Because the risk of default for an AAA bond has historically been low, only the most extreme developments will affect the market's assessment of the price of an AAA bond. In contrast, high yield or junk bonds with lower credit ratings are at greater risk of default. Lower rated bonds will move more like stocks in response to negative information than higher rated bonds. See, e.g., Simon H. Kwan, *Firm-Specific Information and the Correlation Between Individual Stocks and Bonds*, 40 J. FIN. ECON. 63, 65 (1996) ("AAA-rated bonds are insensitive to firm-specific information, thus they resemble riskless bonds more than they do risky bonds.").

29. See, e.g., *In re HealthSouth Corp. Sec. Litig.*, 261 F.R.D. 616, 635–36 (N.D. Ala. 2009) ("[M]aterial new unexpected information concerning the creditworthiness of the issuer or the prospect of default on bond obligations would be of interest to bondholders and affect the price.").

30. See, e.g., Anneleen Cornil, *The Impact of Accounting Restatements on a Firm's Cost of Public Debt*, 2009 REV. BUS. & ECON. 147, 148 (2009) (finding that restatements increase cost of debt by 6.2%); Charles Shi & Sanjian William Zhang, *Accounting Restatements and the Cost of Debt Capital* (Chinese Accounting Professors' Assoc. of N. Am., Working Paper 2008), available at <http://www.capana.net/download/confpaper1.pdf> (finding negative return for bonds of restating companies). In addition, bond prices tend to react negatively to the filing of a shareholder class action. See Billings et al., *supra* note 2, at 3.

aged that it cannot access capital markets. Without liquidity, the company could be forced to file for bankruptcy, and bondholders may suffer losses in the reorganization or liquidation if the company's assets do not cover all of its liabilities.

II. BOND INVESTORS AND SECURITIES CLASS ACTIONS

As with shareholders, bondholders can bring suit under the federal securities laws if they suffer damages from securities fraud. Given that bondholders are generally shielded from fraud, one might predict that bondholder class actions will not play a significant role relative to shareholder class actions. Section A briefly describes the two major causes of action for securities fraud, focusing on the particular issues raised when bondholders are the plaintiffs. Section B then describes two hypotheses concerning the importance of bondholder involvement in securities class actions.

A. BONDHOLDER CAUSES OF ACTION

As with shareholder class actions, there are two major types of securities fraud claims that can be pursued through bondholder class actions. The first requires an offering of bonds by an issuer to public investors. The second relates to trading of bonds on the secondary market. The first type of claim, if available, offers a more favorable liability standard than the second.

1. Section 11

As they do with stock, companies periodically sell bonds to investors through public offerings. Investors who purchase bonds in such offerings are protected by section 11 of the Securities Act of 1933, which provides a damages remedy for fraud in the registration statement filed by the issuer with the Securities and Exchange Commission (SEC).³¹ Liability for a section 11 claim does not require any showing of fraudulent intent.³² The issuer is strictly liable for any decline in value of the bonds if there is a material misrepresentation in the registration statement.³³ Third parties such as underwriters and auditors are also liable though they have a due diligence defense if they

31. See 15 U.S.C. § 77k (2012).

32. See *id.*

33. There is a presumption that any decline in the value of the security was caused by the material misrepresentation, but that presumption can be overcome if the defendant proves some other cause for the decline. See 15 U.S.C. § 77k(e)(3).

performed a “reasonable investigation,” had “reasonable ground to believe,” and “did believe” that the registration statement was not materially misleading.³⁴

There are at least two reasons why a section 11 claim is more easily asserted by a bondholder than a shareholder. First, the courts require an investor to trace their purchase of a security to a particular offering in order to bring suit under section 11.³⁵ This tracing requirement can be more difficult to satisfy for a purchaser of common stock. If a company makes more than one offering of common stock, it can be impossible for an investor to identify which offering the stock he purchased came from, as one share of common stock has the same characteristics as any other share of common stock.³⁶ In contrast, bonds are easier to trace because bonds issued at different times have differing terms that facilitate identification. Second, issuers tend to issue bonds more than stock because a stock offering will dilute the stake of existing shareholders. It is thus more likely that a fraud will coincide with a bond offering than a stock offering.

2. Rule 10b-5

As with stocks, bonds often trade among investors in a secondary market. The price of the bond will be determined in part by the market’s assessment of the issuer’s disclosures. If those disclosures materially inflate the price of a bond in the secondary market, a damaged purchaser of the bond can bring suit under SEC Rule 10b-5 (Rule 10b-5),³⁷ which was enacted pursuant to section 10(b) of the Securities Exchange Act of 1934.³⁸ A Rule 10b-5 action may be a bondholder’s only remedy if the fraud occurs long after a public bond offering.³⁹

34. See 15 U.S.C. § 77k(b)(3)(A).

35. See, e.g., *DeMaria v. Andersen*, 318 F.3d 170, 176–78 (2d Cir. 2003) (discussing tracing requirement).

36. See Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429, 465–67 (2000).

37. 17 C.F.R. § 240.10b-5 (2014).

38. See 15 U.S.C. § 78j(b).

39. The statute of limitations for a section 11 claim is one year. See 15 U.S.C. § 77k. Though its most important application is to secondary market fraud, Rule 10b-5 is often the basis for claims arising out of offering fraud. If the offering is exempt from registration, section 11 will not apply, and the plaintiff must proceed under Rule 10b-5. Moreover, even when section 11 applies to an offering, the plaintiffs will typically also assert concurrent Rule 10b-5 claims.

To prevail on a Rule 10b-5 action, the plaintiff must prove that a fraudulent misstatement was made with scienter, or fraudulent intent.⁴⁰ At the pleading stage, this scienter must be pleaded with sufficient specificity so the court can conclude that there is a strong inference of fraud.⁴¹ The plaintiff must also establish other elements of a Rule 10b-5 cause of action such as materiality (the importance of the misstatement to a reasonable investor), and causation (whether the investor suffered a loss because of the misstatement).⁴²

In contrast to section 11 suits, bondholders will usually find it more difficult to bring Rule 10b-5 suits than shareholders. As a general matter, even though they involve investments with a greater aggregate value than stock markets,⁴³ bond markets tend to be less liquid and efficient. While bonds of large issuers trade frequently,⁴⁴ most bonds do not trade as often as stocks, trade over-the-counter rather than on exchanges, and are not followed as closely by research analysts.⁴⁵ As a re-

40. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976).

41. See 15 U.S.C. § 78u-4(b)(2)(A).

42. See, e.g., *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005) (listing elements of 10b-5 claim).

43. See, e.g., *In re HealthSouth Corp. Sec. Litig.*, 261 F.R.D. 616, 632 (N.D. Ala. 2009) (“The size of the bond market also dwarfs the stock markets; roughly \$880 billion in bonds trade a day, as compared with \$85.5 billion in stocks.”).

44. See, e.g., Gordon J. Alexander et al., *The Determinants of Trading Volume of High-Yield Corporate Bonds*, 3 J. FIN. MARKETS 177, 179 (2000) (“[O]ur sample of bonds exceeded the anecdotal benchmark and . . . their dollar volume is comparable to the medium to high volume NYSE and Nasdaq stocks. This volume suggests that these bonds are not simply held to maturity, but that some portion of the public float is traded actively.”). There is evidence that bond markets can be informationally efficient. See Edith S. Hotchkiss & Tavy Ronen, *The Informational Efficiency of the Corporate Bond Market: An Intraday Analysis*, 15 REV. FIN. STUD. 1325, 1328 (2002) (finding in study of fifty-five corporate bonds “that information is impounded quickly into both bond and stock prices, despite the lesser transparency for the bonds”).

45. See, e.g., Amy K. Edwards et al., *Corporate Bond Market Transaction Costs and Transparency*, 62 J. FIN. 1421, 1427 (2007) (finding that corporate bonds on average only trade 2.4 times per day); Michael A. Goldstein et al., *Transparency and Liquidity: A Controlled Experiment on Corporate Bonds*, 20 REV. FIN. STUD. 235, 235 (2007) (“[T]he corporate bond market historically has been one of the least transparent securities markets in the United States, with neither pretrade nor posttrade transparency. Corporate bonds trade primarily over-the-counter, and until recently, no centralized mechanism existed to collect and disseminate posttransaction information.”); Sriketan Mahanti et al., *Latent Liquidity: A New Measure of Liquidity, with an Application to Corporate Bonds*, 88 J. FIN. ECON. 272, 278 (2008) (finding that very few bonds trade every day and over 40% of corporate bonds do not trade even once a year);

sult, it is less common for a bond to trade in an efficient market than a stock.⁴⁶

In cases where a security trades in an efficient market, courts presume that investors uniformly relied upon the integrity of the market in purchasing the security.⁴⁷ This fraud-on-the-market presumption provides the commonality necessary to certify a class action. If a bond market is not efficient, that presumption will not apply and bondholders will not be able to proceed as a class.⁴⁸ Indeed, as will be discussed later in this Article, certification of a bond class has been denied in one major case,⁴⁹ though in many cases courts have found that bonds do trade in efficient markets.⁵⁰

Paul Schultz, *Corporate Bond Trading Costs: A Peek Behind the Curtain*, 56 J. FIN. 677, 678 (2001) (“Most bonds trade infrequently.”).

Some factors that influence the amount of trades include the size of the issue and age of the bond. *See, e.g.*, Edwards et al., *supra*, at 1431 (“[C]orporate bonds take about 2 years to settle into institutional portfolios, after which point the secondary market is thinner but still alive.”); Goldstein et al., *supra*, at 249 (finding that bonds from larger issues trade more frequently and that bonds trade less frequently as they age).

46. Indeed, there may not even be market prices for illiquid bonds. *See* Oded Sarig & Arthur Warga, *Bond Price Data and Bond Market Liquidity*, 24 J. FIN. & QUANTITATIVE ANALYSIS 367, 369 (1989) (“For illiquid bonds, which do not trade as often as other bonds, month-end actual trade prices need not exist. In these cases, traders have to guess the price that would have cleared an active market, had one existed.”).

47. *See* Basic Inc. v. Levinson, 485 U.S. 224, 246–47 (1988) (“[W]here materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market may be presumed.”).

48. *See, e.g.*, Coffee, *supra* note 7, at 328.

49. *See, e.g.*, *In re* Am. Int’l Grp. Sec. Litig., 265 F.R.D. 157, 181 (S.D.N.Y. 2010) (finding that plaintiffs failed to show that AIG bonds “traded in an efficient market”), *vacated and remanded by* 689 F.3d 229 (2d Cir. 2012).

50. *See, e.g.*, *In re* HealthSouth Corp. Sec. Litig., 261 F.R.D. 616, 639 (N.D. Ala. 2009) (“[T]he HealthSouth bond market traded on all the publicly available information and thus meets the test for informational efficiency.”); *In re* DVI, Inc. Sec. Litig., 249 F.R.D. 196, 207–08 (E.D. Pa. 2008), *aff’d*, 639 F.3d 623 (3d Cir. 2011) (“[T]he weight of the various factors discussed above leads us to conclude that DVI’s Senior Notes traded in an efficient market during the Class Period.”); *Newby v. Enron Corp. (In re Enron Corp. Sec. Deriv. & “ERISA” Litig.)*, 529 F. Supp. 2d 644, 768 (S.D. Tex. 2006) (“The Court finds that [plaintiff’s expert] has made a *prima facie* showing that Enron’s Registered Bonds and Preferred Securities did trade in an efficient secondary market.”).

B. TWO HYPOTHESES RELATING TO BONDHOLDER CLASS ACTIONS

This Section presents two hypotheses to frame the empirical analysis of bondholder class actions. The first sets forth reasons why bondholder involvement in securities class actions may be insignificant. The second sets forth the opposite view, that bondholder involvement is significant.

1. Hypothesis 1: The Insignificance of Bondholder Class Actions

Bondholder class actions may seem to be of little importance because bondholder losses from fraud are smaller and less frequent than shareholder losses. If bondholders simply make the same arguments as shareholders, their presence adds little to the litigation. Bondholder recoveries might only reflect rent-seeking by opportunistic class action attorneys.

a. Less Frequent and Smaller Losses

As noted earlier, bondholders are shielded from most securities frauds.⁵¹ It is only when a fraud threatens the firm's solvency that bondholders will be affected. Shareholders will suffer losses from securities fraud more frequently than bondholders and those losses will be much larger than bondholder losses. To the extent that compensation is a goal of securities class actions, shareholders will recover more than bondholders. To the extent that deterrence is a goal of securities class actions, the bulk of the deterrent effect will be generated by shareholder recoveries.

b. Similar Interests as Shareholders

Given that bondholders suffer smaller losses than shareholders, one might argue that shareholders will adequately represent bondholder interests in any securities class action. In some situations bondholder and shareholder interests are aligned.⁵² Many securities frauds will harm investors in similar

51. See, e.g., Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 273 (2009) ("Public debt offerings provide a lower chance of liability and smaller potential damages because debt is paid back first in preference to distributions to equity.").

52. See, e.g., Barry E. Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 U. PA. L. REV. 1773, 1777–78 (2013) ("[I]t is important not to forget that shareholder and creditor interests are broadly aligned with respect to a wide set of decisions; both shareholders and creditors want the company

ways. A misstatement that hides a sharp decline in earnings will distort both the shareholder's prediction of future earnings and the bondholder's assessment of the credit risk associated with the company. All investors have an interest in minimizing fraud, and it may not be clear why bondholders have distinct interests in a securities class action. If bondholders are affected by fraud in similar ways as shareholders, they would make identical arguments as shareholders in litigating a securities class action.

c. Opportunistic Recoveries

In light of the infrequency and redundancy arguments, when bondholders receive part of a securities fraud recovery, such recovery might be written off as opportunistic. As noted earlier, bondholders are more likely to have access to the lenient liability standard of section 11, which does not require proof of fraudulent intent, because they find it easier to meet the tracing requirement.⁵³ To the extent that a bond offering happens to coincide with a fraudulent misstatement, bondholders will have a strong case for recovery. Indeed, the issuer will often have little defense so long as there is a material misrepresentation in its SEC filings. Because bond offerings are relatively frequent, the offering may have nothing to do with any fraudulent scheme, but will subject the issuer to a heightened liability standard. A section 11 recovery by a bondholder may reflect nothing more than being in the right place at the right time.

Class action attorneys have incentives to represent bondholders to siphon off part of the settlement obtained by shareholders. Bondholder recoveries could reflect nothing more than aggressive attempts to carve out a role in a securities class action. For example, in the *WorldCom* case, some bondholders were recruited to opt out of a settlement by an attorney who

to be well run and profitable.”); William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 113 (1989) (“The investment conception emphasizes the shared characteristics of debt and equity – debt and equity investments differ only in degree; they are not fundamentally different forms of participation.”). For financial economists, shareholders and bondholders are simply different sources of funding for the corporation who have rights to the corporation's cash flows. See Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 737 (1997) (defining corporate governance as measures that ensure investors receive a return on their investment).

53. See *supra* Part II.A.1.

failed in his attempt to be appointed lead counsel.⁵⁴ Bondholder recoveries might simply reflect a struggle over rents generated by the class action settlement process.

2. Hypothesis 2: The Significance of Bondholder Class Actions

Though bondholders suffer smaller and less frequent losses from fraud, they tend to recover in cases involving the most significant frauds. Moreover, bondholders do not always have identical interests as shareholders. Securities fraud can transfer wealth from bondholders to shareholders. Bondholders thus can make unique arguments about a fraud that would not be raised by shareholders.

a. *The Most Important Frauds*

Bondholders will be involved in a smaller percentage of class actions, but bondholder class actions often target frauds with the greatest societal impact. Some of these frauds will involve bankruptcies of large public companies.⁵⁵ To the extent that a securities class action targets a temporary fluctuation in the stock price, it will be difficult for bondholders to claim injury. Thus, bondholder recoveries are less likely to reflect nuisance settlements of strike suits against healthy companies.

b. *Divergence of Bondholder and Shareholder Interests*

Even though bondholders may recover relatively small amounts in many cases, if bondholder interests differ from shareholder interests with respect to certain securities frauds, their recoveries will not just be redundant and opportunistic. Rather, bondholder plaintiffs can add a perspective to a securities class action that is not present when there are only shareholder plaintiffs. Indeed, in certain circumstances, securities

54. Coffee, *supra* note 7, at 311.

55. See James J. Park, *Securities Class Actions and Bankrupt Companies*, 111 MICH. L. REV. 547 (2013). When bondholders suffer losses in a bankruptcy associated with a securities fraud, they can recover some of their losses by bringing a securities class action. Though the issuer usually cannot contribute to any recovery for securities fraud, insurance policies that cover the liability of directors and officers for securities fraud are typically not subject to the bankruptcy stay and are often a source of recovery. See, e.g., Gillman v. Cont'l Airlines (*In re* Cont'l Airlines), 203 F.3d 203, 216–17 (3d Cir. 2000); La. World Exposition, Inc. v. Fed. Ins. Co. (*In re* La. World Exposition, Inc.), 832 F.2d 1391, 1400–01 (5th Cir. 1987). Moreover, third parties such as underwriters and auditors who are not subject to the bankruptcy stay are also potential sources of damages.

fraud can be motivated by a desire to further the interests of shareholders at the expense of bondholders.

The interests of shareholders and bondholders can diverge with respect to fraud because shareholders generally prefer that the corporation take on more risk than do bondholders. Shareholders get the upside from risky projects that can increase the value of the corporation but only have limited liability for the corporation's debts.⁵⁶ Shareholders are thus often said to have a call option on the corporation's assets that pays off when the assets are greater than the liabilities.⁵⁷ In contrast, bondholders who receive a fixed rate of return share in none of the upside of a risky project, but can suffer losses if the project fails. Bondholders thus prefer that the corporation avoid excessive risk, while shareholders want the company to take on risk to grow its earnings.⁵⁸

In light of these different risk preferences, there are two contexts relating to bondholder class actions where bondholder and shareholder interests can conflict. When fraud relates to a bond offering, the fraud is a way of directly extracting value from bondholders to shareholders. Fraud relating to secondary markets can reflect risk-taking that benefits shareholders without benefiting bondholders.

i. Bond Offering Fraud

When a company sells bonds to the public, securities law requires it to make disclosures to investors who rely upon those representations in purchasing the bond.⁵⁹ To the extent that such statements are false, the fraud can enable the company to borrow funds at more favorable terms than without the fraud.⁶⁰

56. See, e.g., John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 66 (1986) ("As the residual claimant, the shareholders receive all the upside return, but, because they have limited liability, they can avoid downside loss, except to the extent their capital is invested in the firm.")

57. See Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 649–50 (1973) ("In effect, the bond holders own the company's assets, but they have given options to the stockholders to buy the assets back.")

58. See, e.g., Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1491 (1993) ("Unlike shareholders, creditors prefer management to risk as little as possible because they have little to gain if risky ventures succeed and will suffer further loss should these projects fail.")

59. See 15 U.S.C. § 77g (2012).

60. Cf. Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L.

The expected gains from any projects made possible with these funds will primarily benefit shareholders.

Professors Michael Jensen and William Meckling observed in their seminal article on agency costs in public corporations that when a company has two projects with differing risks, management can benefit shareholders at the expense of bondholders by promising to take on the low-risk project, selling bonds at a price that assumes the company will take on the low-risk project, and taking on the high-risk project instead.⁶¹ The fraud enables shareholders to take value from the bondholders because: (1) if the company had revealed that it would take on the riskier project, the bondholder would have charged a higher interest rate to take into account the additional risk of default (interest savings translate into higher earnings that benefit shareholders); and (2) if the riskier project has a higher expected value than the low-risk project, taking on the high-risk project would increase the company's stock price. Fraud hiding the risk of a project thus benefits risk-preferring shareholders at the expense of risk-averse bondholders.

Jensen and Meckling's point can be generalized to misrepresentations relating to the credit risk of a firm. If a company's risk of default is 50% and its public disclosures wrongly convey that the risk is 0%, a bondholder who buys bonds assuming that the risk is 0% will charge a lower price than if he knew that the risk was 50%. If the bondholder knew the truth, the price of the bond would be discounted by taking into account the risk of default along with the bondholder's expected recovery in bankruptcy. Thus, if the bondholder expects to recover 50% of his investment in bankruptcy, revelation that the true default risk is 50% would result in a discounting of the value of the bond by 25%.⁶² A bond with a face value of \$100 would thus

479, 503 (2001) ("If the shareholder in some way deceived the creditor into believing that the corporation had adequate assets to cover its obligations and the creditor, relying on that misstatement, failed to demand a personal guarantee, the shareholder ought to end up being held liable.").

61. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 335 (1976); see also Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1149 (1979) ("Because the interest rate is fixed, the debtor has an incentive to increase the riskiness of the loan, since, by doing so, he effectively obtains a higher-risk loan at an interest rate reflecting the lower risk level anticipated by the creditor when the loan was made.").

62. The risk of default (0.5) times the expected recovery in bankruptcy (0.5) would equal 0.25.

really be worth \$75. The bondholder's damage from the fraud, \$25, is the amount extracted from the bondholders by the shareholders, who were essentially able to sell a \$75 bond to investors for \$100.

To concretely illustrate how securities fraud can benefit shareholders at the expense of bondholders, consider the case of WorldCom. WorldCom operated in the highly competitive telecommunications industry where high capital expenditures were necessary.⁶³ As industry conditions declined, WorldCom needed additional funds to continue its operations.⁶⁴ In a series of two public bond offerings, WorldCom raised \$16.8 billion by selling bonds that paid about an 8% interest rate.⁶⁵ The registration statements for those offerings incorporated statements from periodic disclosures that inflated the company's earnings by understating its expenses.⁶⁶ In doing so, WorldCom created the impression it was "successfully managing industry trends that were hurting all of its competitors."⁶⁷

If the truth had been known, WorldCom would not have been able to issue bonds without paying higher rates, and perhaps would not have been successful at raising billions of dollars to fund its operations. If WorldCom had succeeded in using the funds to turn around the company, the shareholders would have benefited much more than the bondholders who receive a fixed return. In fact, WorldCom filed for bankruptcy and WorldCom bondholders saw their investment fall from a high of \$106 in the secondary market to \$11.⁶⁸ The bond offerings allowed WorldCom to raise funds to benefit shareholders at the expense of bondholders.

63. See DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLD.COM, INC. 44 (2003).

64. WorldCom had previously funded its daily operations through short-term commercial paper, but found at some point it was not able to raise additional funds through that market. First Amended Complaint ¶ 197, *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (S.D.N.Y. Dec. 1, 2003) [hereinafter *WorldCom Compl.*].

65. *Id.* ¶¶ 199, 218, 220.

66. *Id.* ¶¶ 206, 230.

67. BERESFORD ET AL., *supra* note 63, at 13.

68. *WorldCom Compl.*, *supra* note 64, ¶ 6. One named plaintiff alleged losses of over \$28 million. *Id.* ¶ 30.

ii. Secondary Market Fraud

Securities fraud can also harm bondholders by inflating the price they pay for bonds in the secondary market. Such fraud typically inflates the price all investors, shareholders and bondholders, pay for securities. In some circumstances, secondary market fraud can benefit shareholders at the expense of bondholders. For example, when a company takes on additional risk but hides it to maintain its credit rating, the fraud can be understood as a transfer from bondholders to shareholders.

Consider a case where a company wants to borrow money to invest in a risky project but doing so will endanger its credit rating. Also assume that a lower credit rating would materially reduce its ability to conduct its business. The company commits accounting fraud, characterizing what are in substance loans as asset sales. By doing so, the company essentially borrows additional funds without affecting its credit rating.

The fraud would benefit shareholders more than bondholders. If the risky project succeeds, shareholders will capture the gains. If the risky project fails, both shareholders and bondholders would suffer losses. So long as the expected gain from the fraud is greater than the expected losses, shareholders would seek to go forward with the fraud.⁶⁹ Bondholders, in contrast, do not have expected gains to weigh against expected losses and would prefer the company not take on the risky course of conduct. Without the fraud, the company would not be able to take on additional debt, would not be able to take on the risky project, and bondholders would be safe.

The fraud is essentially a transfer from bondholders to shareholders. Bondholders who purchase bonds on the secondary market relying on the company's credit rating have purchased bonds that are worth less than the market price because

69. See, e.g., Lawrence E. Mitchell, *The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243, 290–91 (noting that the innocence of shareholders "diminishes further if one treats the class of shareholders as the primary, if not the sole, beneficiaries of managerial profit maximizing, the sole class of actors legally empowered to determine the composition of corporate boards and, through them, the sole class of actors that can select the management of the most powerful private actors in our society"); James C. Spindler, *Vicarious Liability for Bad Corporate Governance: Are We Wrong About 10b-5?*, 13 AM. L. & ECON. REV. 359, 378 (2011) ("[S]hareholders are no different from the seller in any sort of commercial transaction, who prefers a higher price to a lower one. Given a manager who maximizes aggregate shareholder payoffs, firms will tend to commit fraud.").

of the added risk assumed with the help of the fraud.⁷⁰ The shareholders reap the gains of the fraud because the company can conduct business with a higher credit rating while taking on greater risk than reflected by that rating.

Enron is an example of a company that defrauded bondholders to take on risks for shareholders. Enron was an energy trader that relied upon its credit rating to do business.⁷¹ Without a strong credit rating, it could not trade without posting significant collateral.⁷² At the same time, Enron was aggressively investing in new businesses to increase its stock price, and needed funds to make such investments. If it sold addi-

70. Securities fraud relating to secondary markets tends to directly benefit selling investors. For example, suppose an issuer discloses information that indicates there is a 0% chance of insolvency when in fact there is a 50% chance of insolvency. The stock trades at \$100 a share based on this false disclosure and would trade at \$50 if the truth were known. Because there is a 50% chance the stock is worth \$0, the market might discount a \$100 stock price by 50%. The secondary market fraud thus inflates the stock by \$50 a share. A shareholder who sells at \$100 a share captures a gain from the fraud of \$50 a share, while the shareholder who purchases at \$100 a share will suffer a loss of \$50 a share.

Selling bondholders can also capture gains from securities fraud, but their gains tend to be less than selling shareholders. Bond prices fluctuate less than stock prices because bondholders can expect some recovery even in insolvency. Consider how bonds might react to the example above where the disclosed risk of insolvency is 0% while the true risk of insolvency is 50%. A bond would trade at its par value (assume that is \$100) when the risk of insolvency is 0%. Unlike the stock, the bond price would not be discounted fully by 50% if the true risk of insolvency were known. The market would take into account the fact that bondholders would recover some of their investment even in insolvency. Suppose bondholders could expect to recover 50% of their investment in bankruptcy. A 50% chance of a 50% recovery would mean that the market would discount the bond price by 25%, meaning the bond's price absent the fraud would be \$75. A bondholder who sells at the inflated price of \$100 would capture a \$25 gain, while the bondholder who purchases at the inflated price would suffer a loss of \$25 a bond when the true risk of insolvency is revealed.

In the example just described, selling shareholders benefit from secondary market fraud by \$50 a share (or 50% of their investment) while bondholders benefit by \$25 a bond (or 25% of their investment). Selling bondholders benefit from secondary fraud just as selling shareholders do, though we can expect that selling shareholders have a greater incentive to push issuers to commit secondary market fraud because they gain more from such fraud.

71. See, e.g., WILLIAM C. POWERS, JR. ET AL., REPORT OF THE INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 36 (2002) ("Maintaining Enron's credit rating at investment grade was vital to the conduct of its energy trading business.").

72. See Second Interim Report of Neal Batson, Court-Appointed Examiner at 18-19, *In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y. Jan. 21, 2003).

tional debt, Enron's credit rating might have fallen.⁷³ Instead, Enron entered into transactions it characterized as sales with various special purpose entities it controlled. In fact, the sales were loans because Enron was ultimately responsible for the liabilities of the special purpose entities.⁷⁴ These transactions allowed Enron to raise funds without putting additional debt on its balance sheet. If the truth were known, Enron's debt would have been \$22.1 billion rather than the reported \$10.2 billion.⁷⁵ Enron's credit rating would have plummeted, preventing it from taking on risky projects for its shareholders. Enron's bondholders were harmed because they paid prices for debt on the secondary market that did not reflect the additional risk that Enron had taken on.

III. EVIDENCE OF BONDHOLDER RECOVERIES

This Part builds upon the earlier theoretical discussion and presents empirical evidence relating to bondholder involvement in securities class actions. Based on examination of a data set of 1660 securities class actions filed from 1996 through 2005,⁷⁶ this study finds that bondholders are part of an increasing number of cases. As predicted by the significance hypothesis, bondholders recover in the largest settlements and often assert distinct claims of harm from shareholders. On the other hand, as predicted by the insignificance hypothesis, bondholder re-

73. See, e.g., *id.* at 15 (noting that Enron "was reluctant to incur debt because of a possible adverse effect on its credit ratings"); John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 68 (2005) ("Enron needed to raise billions of dollars to meet its costs, but it needed to do so in a manner that would not spook capital markets and jeopardize its trading business.").

74. See, e.g., Second Interim Report of Neal Batson, *supra* note 72, at 37–38 ("Although it treated these transactions as sales for accounting purposes, Enron (i) had the obligation to repay substantially all of the financing regardless of the value of the underlying assets and (ii) retained substantially all of the future appreciation in value and cash flows from the underlying asset.").

75. See *id.* at 3.

76. Part of this data set was collected for a prior study. See Park, *supra* note 55. The data set was compiled primarily using documents posted on the Stanford Securities Class Action Clearinghouse and was supplemented with data from PACER, the LoPucki Bankruptcy Research Database, Westlaw, Lexis, and internet sources. The data set only includes cases where the primary allegation is that the issuer or its agents inflated the issuer's stock price through fraud. It thus excludes cases that involve allegations of fraud relating to IPO allocations, investment adviser fraud, mutual fund market timing, and proxy fraud.

coveries tend to be relatively small compared to shareholder recoveries.

Initially, the study sought to identify all complaints with bondholder plaintiffs. A problem with this approach was that in many cases, it was difficult to identify *ex ante* whether bondholders were part of the class. Bondholders were specifically identified as plaintiffs in the complaint in only a small number of cases. One prior study found only 24 securities class action cases filed from 1996 to 2008, a period three years longer than the data set for this study, where bondholders were named as plaintiffs.⁷⁷ However, counting only cases where bondholders are explicitly named as plaintiffs underestimates the number of bondholder plaintiffs because some classes are defined in a way that could include bondholders though specific bondholders are not named as plaintiffs.

The most accurate way of measuring bondholder involvement in securities class actions was to search for bondholder recoveries. Bondholders indisputably take part in cases where they receive part of a recovery.⁷⁸ Bondholder recoveries can be identified by looking at the notice of settlement filed with the court after the parties agree to settle a case. Such notices specify when a bondholder was allocated a portion of the settlement. This study found many more cases where bondholders recovered than cases where bondholders were named as plaintiffs.

Table 1 summarizes the number of bondholder recoveries by filing year.⁷⁹ Of the 1660 securities class actions in the data set, 1152 settled for some amount. Of those 1152 settled cases, 64 involved a bondholder recovery, a substantially higher number than cases where bondholders were specifically named as plaintiffs.⁸⁰ Bondholder recoveries were rare for cases filed from

77. See Billings et al., *supra* note 2, at 45.

78. On the other hand, this method would not include cases where bondholders are named as plaintiffs but bondholders do not recover because the case is unsuccessful.

79. In other words, a bondholder recovery in 2003 means that the original securities class action was filed in 2003, not that the case settled in 2003.

80. This figure is a conservative one. The total of 64 bondholder recoveries does not include cases where bondholders were plaintiffs and the case did not result in a recovery. Moreover, in the data set, there were about 15 to 20 cases where convertible bondholders received a recovery but investors in nonconvertible bonds did not. These cases were not classified as bondholder recoveries. While they are technically bonds, the interests of convertible bondholders are more closely aligned with shareholders than the interests of the typical bondholder. See, e.g., John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81

2014]

BONDHOLDER CLASS ACTIONS

609

1996 through 2000, averaging about 3% of the 542 securities class that were settled. The period from 2001 through 2005 saw a significant increase in bondholder recoveries, averaging 8% of the 610 securities class actions that were settled.⁸¹

Table 1. Summary Data on Number of Bondholder Recoveries in Data Set by Year (1996-2005).

Year	Number of Securities Class Action Settlements	Number of Bondholder Recoveries	% of Securities Class Action Settlements with Bondholder Recoveries
1996	63	2	3.2
1997	105	2	1.9
1998	139	3	2.1
1999	113	4	3.5
2000	122	5	4.1
1996-2000	542	16	3.0
2001	117	10	8.5
2002	129	15	11.6
2003	106	8	7.5
2004	127	8	6.2
2005	131	7	5.3
2001-2005	610	48	7.9

Supporting the significance hypothesis, bondholder recoveries are present in the majority of the largest settlements of securities class actions. Table 2 lists the 30 largest securities class action settlements in the data set (the “Top 30 Settlements”) and identifies whether they involve a bondholder recovery. Four of the top 5 settlements had bondholder recoveries. Seven of the top 10 and 19 of the top 30 settlements also resulted in bondholder recoveries. This article will refer to the-

COLUM. L. REV. 261, 313 (1981) (noting with respect to convertible bonds: “the principal value of such a security will come from its convertibility into equity”).

81. This difference is statistically significant at $p < 0.01$.

se 19 bondholder settlements as the “Largest Bondholder Settlements.”⁸²

**Table 2. Top 30 Settlements by Size (1996-2005)
(Bondholder Recoveries in Bold).**

Issuer Name	Filing Year	Approximate Total Settlement Amount	Bondholder Recovery	Credit Down grade	Bankruptcy Filing
Enron Corp.	2001	\$7.2 billion	Yes	Yes	Yes
WorldCom, Inc.	2002	\$6.2 billion	Yes	Yes	Yes
Tyco International Ltd.	2002	\$3.2 billion	Yes	Yes	No
Cendant Corp.	1998	\$3.2 billion	Yes	No	No
AOL Time Warner, Inc.	2002	\$2.7 billion	Yes	No	No
Nortel Networks Corp.	2001	\$2.5 billion	No	No	No
Royal Ahold Corp.	2003	\$1.1 billion	No	Yes	No
American International Group Inc.	2004	\$1 billion	Yes	Yes	No
McKesson HBOC, Inc.	1999	\$1 billion	Yes	No	No

82. It is unclear whether there is any causal relationship between bondholder recoveries and the size of securities class action settlements. Bondholder recoveries may occur because large settlements are more likely to involve large companies whose bonds trade in liquid markets. On the other hand, perhaps the possibility of a bondholder recovery leads to higher recoveries to take into account the fact that the class of recovering plaintiffs is larger. When a section 11 claim is asserted by a bondholder, there may be pressure to pay substantial amounts to cover what is likely to be a claim with a lower threshold of proof. Resolving whether there is a causal link between bondholder recoveries and the size of securities class actions is a question to be left for another time.

2014]

BONDHOLDER CLASS ACTIONS

611

Health-South Corp.	1998	\$778 million	Yes	Yes	No
Xerox Corp.	2000	\$750 million	Yes	Yes	No
Cardinal Health, Inc.	2004	\$600 million	No	Yes	No
Lucent Technologies, Inc.	2000	\$568 million	Yes	Yes	No
BankAmerica Corp.	1998	\$490 million	No	No	No
Dynegy, Inc.	2002	\$468 million	No	Yes	No
Raytheon Company	1999	\$460 million	No	No	No
Adelphia Communications Corp.	2002	\$460 million	Yes	Yes	Yes
Waste Management, Inc.	1999	\$457 million	Yes	Yes	No
Qwest Communications International Inc.	2001	\$451 million	Yes	No	Yes
Federal Home Loan Mortgage Corp.	2003	\$410 million	No	No	No
Marsh & McLennan Companies, Inc.	2004	\$400 million	Yes	Yes	No
Global Crossing, Ltd.	2002	\$343 million	Yes	No	Yes
Rite Aid Corp.	1999	\$334 million	Yes	Yes	No
Delphi Corp.	2005	\$333 million	Yes	Yes	Yes

Sunbeam Corp.	1998	\$330 million	No	No	Yes
Williams Companies, Inc.	2002	\$311 million	Yes	Yes	Yes
General Motors Corp.	2005	\$303 million	Yes	Yes	No
Oxford Health Plans, Inc.	1997	\$300 million	No	No	No
Bristol-Myers Squibb Co.	2002	\$300 million	No	No	No
El Paso Corp.	2002	\$285 million	Yes	Yes	No

For the largest settlements, bondholder recoveries are primarily driven by credit downgrades, where a rating agency concludes that the issuer is at greater risk of defaulting on its debt. For the Top 30 settlements, the presence of a credit downgrade was associated with a bondholder recovery. Fifteen of the 19 Largest Bondholder Settlements (79%) involved a credit downgrade.⁸³ Only 3 of the 11 cases (27%) where bondholders did not recover involved a credit downgrade. This difference was statistically significant at the 1% level.⁸⁴ In 6 of the 19 Largest Bondholder Settlements (32%), the issuer filed for bankruptcy while the securities class action was pending.⁸⁵ Only 1 of the 11 cases (9%) without bondholder recoveries involved a bankruptcy filing. However, this difference was not statistically significant.⁸⁶ In all but 2 of the 19 Largest Bondholder Settlements, there was either a credit downgrade or bankruptcy.

Consistent with the hypothesis that bondholders assert distinct arguments, many of the complaints associated with the

83. For the sample of bondholder recoveries as a whole, about half of the cases with bondholder recoveries involved a credit downgrade. *See infra* Appendix, Table A2.

84. $p=0.0086$.

85. For the sample of bondholder recoveries as a whole, about half of the cases with bondholder recoveries involved a bankrupt company. *See infra* Appendix, Table A2.

86. $p=0.2146$.

19 Largest Bondholder Settlements make allegations consistent with conduct that would benefit shareholders at the expense of bondholders. The *HealthSouth* complaint alleged that fraudulent bond offerings were used to raise fresh capital to keep HealthSouth afloat.⁸⁷ The complaint in *General Motors* alleged that the company saved \$520 million in interest costs by fraudulently issuing bonds.⁸⁸ The *Adelphia, Delphi, and Williams Companies* complaints all alleged that the fraud hid debt from the markets.⁸⁹

The data set is consistent with the hypothesis that bondholders are often in a position to assert section 11 claims. Bondholders brought section 11 claims in a substantial percentage of cases where they received part of a recovery. Of the 19 Largest Bondholder Settlements, as shown in Table A1 of the Appendix, 13 (68%) involved section 11 claims arising out of a bond offering. Additionally, Table A2 of the Appendix shows that 46.9% of all bondholder recoveries in the data set involved a section 11 claim. Thus, many, but not all, bondholder recoveries were in cases where bond offerings coincide with an alleged fraud.

In terms of the size of bondholder recoveries, as predicted by the insignificance hypothesis, bondholders usually recover smaller amounts than shareholders, though many of the recoveries are quantitatively large. Determining the amount of actual recoveries was challenging because it is not always clear from the notice of settlement how much bondholders actually recover.⁹⁰ While an average recovery per share is almost always calculated for shareholder recoveries, that is not the case for bondholder recoveries. For example, the notice of settlement in

87. See Joint Second Amended Consolidated Class Action Complaint for Violations of the Federal Securities Laws [Factual Basis] ¶¶ 12–15, *In re HealthSouth Corp. Sec. Litig.*, No. CV-03-BE-1500-S (N.D. Ala. Jan. 8, 2004).

88. Third Amended Complaint for Violation of the Federal Securities Laws ¶ 590, *In re General Motors Corp. Sec. Litig.*, No. 06-md-1749 (E.D. Mich. Aug. 15, 2006).

89. See Consolidated Class Action Complaint ¶¶ 42–53, *In re Delphi Corp. Sec. Litig.*, No. 1:05-CV-2637 (NRB) (S.D.N.Y. Sept. 30, 2005); Consolidated Class Action Complaint ¶ 1, *In re Adelphia Comm. Corp. Sec. & Deriv. Litig.*, No. 03-MD-1529 (LMM) (S.D.N.Y. Dec. 22, 2003); Consolidated Amended Complaint ¶¶ 15, 16, 227, *In re Williams Sec. Litig.*, No. 02-CV-72-H(M) (N.D. Okla. Oct. 7, 2002).

90. Moreover, information about actual settlement distributions is often confidential. See, e.g., Elliott J. Weiss, *The Lead Plaintiff Provisions of the PSLRA After a Decade, or “Look What’s Happened to My Baby,”* 61 VAND. L. REV. 543, 576 (2008) (reporting that settlement administrators would not disclose information about distributions).

a securities class action against Xerox stated: “There were approximately thirty-six different individual issues of Xerox bonds outstanding during the Class Period, each of which is subject to differing potential loss amounts . . . estimating an average recovery per bond is not meaningful.”⁹¹ However, in some cases, it is possible to identify how much of the settlement was allocated to bondholders.

In section 11 cases, it was easiest to determine the amount recovered by bondholders. Of the 19 Largest Bondholder Settlements, there were 6 cases where the size of the section 11 recovery was specified:

In the *WorldCom* class action, bondholders recovered \$5 billion,⁹² an average recovery of about \$400 per \$1000 bond.⁹³

In the *Tyco* class action, bondholders recovered 8% of a \$3.2 billion settlement, or about \$250 million.⁹⁴

In the *HealthSouth* class action, about \$230 million,⁹⁵ or \$64 per \$1000 bond, was allocated to bondholders.⁹⁶

In the *Delphi* class action, up to 18% of a \$300 million settlement was allocated to Delphi bondholders, a total of about \$54 million.⁹⁷

In the *American International Group (AIG)* class action, the settlement allocated 5% of the \$1 billion recovery to bondholders, a total of \$50 million.⁹⁸

In the *Adelphia* class action, the “average recovery for Adelphia debt securities” was “\$30.52 per [\$1000] bond.”⁹⁹

As summarized in Table A3 of the Appendix, the amount of

91. Notice of Pendency of Class Action and Proposed Settlement, Motion for Attorneys’ Fees and Settlement Fairness Hearing at 2, *Carlson v. Xerox Corp.*, No. 3:00-CV-1621 (AWT) (D. Conn. Mar. 27, 2008).

92. Notice of Proposed Settlements of Class Action with Settling Defendants and Bar Order Notice at 11, *In re WorldCom, Inc. Sec. Litig.*, Master File No. 02 Civ. 3288 (DLC) (S.D.N.Y. July 1, 2005).

93. *Id.* at 2.

94. Notice of Proposed Settlement, Motion for Attorneys’ Fees and Fairness Hearing at 1–2, *In re Tyco Int’l Sec. Litig.*, MDL Docket No. 02-1335-PB (D.N.H. 2006).

95. Notice of Pendency of Class Action at 2, *In re HealthSouth Corp. Sec. Litig.*, Master File No. CV-03-BE-1500-S (N.D. Ala. Apr. 22, 2010).

96. *Id.* at 5.

97. Notice of Proposed Settlement with Certain Defendants, Motion for Attorneys’ Fees and Reimbursement Hearing at 2, *In re Delphi Corp. Sec., Deriv. & “ERISA” Litig.*, MDL No. 1725 (E.D. Mich. 2007).

98. *See, e.g.*, Notice of Proposed Settlement, Motion for Attorneys’ Fees and Expenses Award and Fairness Hearing at 1, *In re Am. Int’l Group, Inc. Sec. Litig.*, Master File No. 04 Civ. 8141 (DAB)(AJP) (S.D.N.Y. Oct. 14, 2011).

99. Notice of Pendency and Proposed Partial Settlements of Class Action at 2, *In re Adelphia Comm. Corp. Sec. and Deriv. Litig.*, No. 03-MD-1529 (LMM) (S.D.N.Y. 2006).

the section 11 bondholder recovery was identified for a total of 22 cases in the data set.¹⁰⁰

In many cases where bondholders recovered for section 11 claims, a portion of the bondholder recovery also went to bondholders asserting fraud relating to trading in secondary markets. For some cases, this made it difficult to determine how the recovery was allocated between section 11 and Rule 10b-5 claimants. In 2 of the 19 Largest Bondholder Settlements, part of the settlement was divided between Rule 10b-5 and section 11 plaintiffs:

In the *WorldCom* class action, \$1 billion “was allocated to purchasers of WorldCom stock and other pre-existing bonds on the open market throughout the Class Period.”¹⁰¹

In the *Enron* class action, where the total recovery was \$7 billion, the court “commingled the settlement funds into a single pool, rather than allocating them into different pools with distribution dependent on the particular claims (§ 10(b) or § 11) asserted against a particular defendant.”¹⁰² The bondholders with section 11 claims were entitled to recover either the amount of their 10b-5 measure of loss or three times their section 11 measure of loss.¹⁰³

There were not many identifiable bondholder recoveries in cases where only Rule 10b-5 claims were asserted. In 3 of the 19 Largest Bondholder Settlements, it was possible to identify the amount of the secondary market recovery for bondholders:

In the *Waste Management* class action, about \$10.2 million of a \$457 million settlement was allocated to bondholders.¹⁰⁴

In the *Lucent* class action, about \$3.75 million of a \$600 million settlement was allocated to bondholders.¹⁰⁵ Bondholders also received an additional \$4.6 million in settlement of related suit alleging common law claims.¹⁰⁶

100. Among the most significant of these settlements (outside of the 19 Largest Bondholder Settlements) was the *Conseco* settlement where bondholders recovered \$81 million and the *Refco* settlement where bondholders recovered \$221.09 per \$1,000 bond.

101. Notice of Proposed Settlements of Class Action with Settling Defendants and Bar Order Notice, *supra* note 92.

102. Conclusions of Law, Findings of Fact, and Order Re Final Approval of Plan of Allocation at 13, *In re Enron Corp. Sec., Deriv. & “ERISA” Litig.*, MDL-1446 (S.D. Tex. Sept. 8, 2008).

103. *Id.* at 14 n.12.

104. Notice of Proposed Class Action Settlement, Right to Exclusion, and Hearing at 1, *In re Waste Mgmt., Inc. Sec. Litig.*, Master File No. H-99-2183 (MH) (S.D. Tex. 2002).

105. Notice of Pendency of Class Action, Settlement, and Hearing Thereon at 5, *Balaban v. Schacht*, Civil Action No. 02-4805 (D.N.J. 2003).

106. *Id.* at 3.

In the *Global Crossing* class action, bondholders on average recovered about \$13 per \$1000 bond.

As recorded in Table A4 of the Appendix, the amount of a Rule 10b-5 settlement was identified for 15 cases in the data set.

The relatively small size of bondholder recoveries in most cases provides some support for the insignificance view of bondholder class actions. However, smaller settlements do not necessarily mean that bondholders recover trivial amounts. Since bonds tend to be concentrated in the hands of a smaller number of investors than stocks,¹⁰⁷ the average recovery for each bondholder can be substantial even if the total settlement amount is lower.¹⁰⁸ Moreover, because bond losses are usually smaller than stock losses, even with smaller recoveries, bondholders may be compensated for a significant percentage of their losses.

Bondholders are likely to continue recovering in securities class actions. The traditional securities class action sought to bring claims solely on behalf of shareholders. In the earlier years of the data set, plaintiffs rarely purported to bring claims on behalf of non-shareholder investors. After 2002, there has been a significant shift where complaints seek to represent the investors of all publicly traded securities, a broader class that includes bondholders. Table 3 presents data on the number of class actions with the broader class of all publicly traded securities. While in 1996 only 7 complaints alleged a class of all publicly traded securities, by 2003, close to half of all complaints made such an allegation.

107. See Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 584 (1995). Even in shareholder cases, losses tend to be concentrated among the largest investors. See Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2056 (1995).

108. Cf. James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail To File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 878 (2002) (noting that average recoveries fall as more investors make claims).

2014]

BONDHOLDER CLASS ACTIONS

617

Table 3. Summary Data on Number of Cases in Data Set where the Class Included Purchasers of “All Publicly Traded Securities” (1996-2005).

Year	Number of Securities Class Actions	Number of “All Publicly Traded Securities” Cases	% of Securities Class Actions that were “All Publicly Traded Securities” Cases
1996	84	7	8.3
1997	139	13	3.3
1998	198	16	8.0
1999	173	24	13.9
2000	184	36	19.6
2001	156	45	28.8
2002	188	55	29.3
2003	164	80	48.8
2004	187	104	55.6
2005	187	75	40.1
Total	1660	455	27.4

As should be evident from reading Tables 1 and 3 together, the number of bondholder recoveries has risen as the number of complaints alleging classes of “All Publicly Traded Securities” has increased. The emergence of broader certified classes has likely been spurred by spectacularly successful bondholder cases such as the class action on behalf of WorldCom investors. Moreover, plaintiffs’ attorneys are wary of the possibility that bondholders will opt out of the class and retain separate counsel. Class action counsel may respond to this problem by seeking certification of broader classes that include bondholders. At the same time, bondholder settlements cannot be solely explained by the increase in complaints alleging broader classes. The severity of recent securities frauds also created the conditions necessary for increasing bondholder recoveries.

The data set shows that bondholders are increasingly recovering through securities class actions and are likely to continue doing so. As theory would predict, bondholders tend to recover less than shareholders, but recover disproportionately in

cases with the largest settlements. The presence of a credit downgrade appears to be driving bondholder recoveries.

IV. BONDHOLDER CLASS ACTIONS AND SECURITIES FRAUD

The rise in bondholder recoveries reflects a change in the nature of securities fraud. Section A describes this evolution of fraud. In an earlier period, the typical securities fraud involved stock price fluctuations that solely affected shareholders. More recently, major securities class actions have involved losses so substantial that they affect corporate stakeholders such as bondholders. Section B then explains how bondholder class actions are a response to the changing nature of securities fraud. The rise in bondholder recoveries demonstrates that securities fraud and the class actions targeting such fraud are not static in nature. Both securities fraud and securities class actions can evolve.

A. THE EVOLUTION OF SECURITIES FRAUD

Part of the difficulty of defining the concept of securities fraud is that such fraud does not have a fixed essence. The reach of the prohibition against fraud is deliberately broad and captures a wide range of conduct. In some periods, the targeted conduct is less egregious in its harm to society than at other times. The spike in bondholder recoveries from 2001 through 2005 is consistent with a significant change in the nature of securities fraud from prior years.

Early studies of securities class actions focused on emerging technology companies. For example, Professor Janet Cooper Alexander in a seminal 1991 article assessing the merit of securities class actions, looked at a small sample of “initial public offerings (“IPOs”) of computer and computer-related companies during the first half of 1983.”¹⁰⁹ The concern with such offerings is that the promoter of the company might overstate the prospects of the company to investors.¹¹⁰ On the other hand, investing in emerging start-up companies is generally risky, and investors should be well-aware of those risks. Complaints of deception by investors in fledgling companies may seem like

109. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 507 (1991).

110. Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1057–59 (1995).

self-serving attempts to recover losses from a speculative investment.

Another early type of securities fraud case targeted the failure of a company to meet earnings projections. The stock market can relentlessly focus on the immediate concern of whether a company has met its numbers for the quarter. When a company fails to meet its projections, the stock price can plummet, and some investors might complain that those projections were made with knowledge that they were false.¹¹¹ The problem with this argument is that projections are inherently speculative, and the failure to meet a projection often reflects nothing more than the difficulty of predicting the future. If incorrect projections routinely trigger a securities class action, companies will simply stop making such projections, cutting off information that could be useful to investors. Congress thus exempted projections from securities fraud liability in the Private Securities Litigation Reform Act of 1995 (PSLRA).¹¹²

After the passage of the PSLRA, attention shifted to questionable accounting with respect to earnings. Under scrutiny by the SEC,¹¹³ dozens of companies admitted to false accounting and restated their earnings.¹¹⁴ Misstatements of earnings can lead to significant mistakes by investors who rely on accounting statements in valuing securities. At least initially, such earnings restatements were relatively minor, and would not have affected bondholders.

Later, major earnings misstatements were associated with the collapse of large public companies. In the early 2000s, companies such as Enron and WorldCom filed for bankruptcy in the wake of substantial accounting frauds. In addition to these two companies, there were many cases where the harm of secu-

111. See, e.g., H.R. REP. NO. 104-369, at 43 (1995) (“If a company fails to satisfy its announced earnings projections—perhaps because of changes in the economy or the timing of an order or new product—the company is likely to face a lawsuit.”).

112. See 15 U.S.C. §§ 77z-2, 78u-5 (2012).

113. The problem was highlighted by SEC Chairman Arthur Levitt in a 1998 speech called *The Numbers Game*. Arthur Levitt, Chairman, Sec. & Exch. Comm’n, *The Numbers Game* (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>.

114. U.S. GOV’T ACCOUNTABILITY OFFICE, FINANCIAL RESTATEMENTS UPDATE OF PUBLIC COMPANY TRENDS, MARKET IMPACTS, AND REGULATORY ENFORCEMENT ACTIVITIES 11 (2006) (“The number of annual announcements of financial restatements generally increased, from 314 in 2002 to 523 in 2005 . . . an increase of approximately 67 percent This constituted a nearly five-fold increase from 92 in 1997 to 523 in 2005.”).

rities fraud extended beyond shareholders to affect stakeholders such as bondholders.

In some eras, cries of securities fraud sound like sour-grapes complaints from investors. Because share prices tend to fluctuate, investors should be well-aware of the potential for losses as the market reassesses the future prospects of a company. In other periods, frauds are more severe and involve misstatements that result in a permanent decline in the company's prospects.

B. THE EVOLUTION OF THE SECURITIES CLASS ACTION

As securities fraud evolves over time, so do the securities class actions that target such fraud. Causes of actions are adapted to new circumstances. Securities class actions seem meritless in some periods, but in others they help address substantial fraud. With bondholder class actions, there has been significant change in the typical section 11 cause of action. There is also potential for evolution with respect to the Rule 10b-5 cause of action.

1. Section 11 and Bondholder Class Actions

When bondholders assert section 11 claims, they raise different concerns than posed by the traditional shareholder action arising out of an IPO. In a substantial shift, the most significant section 11 cases now assert claims on behalf of bondholders rather than shareholders.

Section 11 suits originally focused on IPOs by start-up companies. The Securities Act of 1933 was directed at the problem of unscrupulous promoters who raised funds for new companies of questionable value.¹¹⁵ The main concern with section 11 has been its potential to raise the costs of going public.¹¹⁶ When section 11 was enacted, there were concerns that the fear of liability would make it too expensive to raise capital through stock offerings.¹¹⁷ As noted earlier, criticisms of securities class actions were directed at the use of section 11 against speculative technology companies. Section 11 has more recently been

115. Mahoney, *supra* note 110, at 1068–69.

116. See, e.g., James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 908 (1996) (“The cost of strike suits is especially burdensome for companies going public for the first time.”).

117. See Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 776 (1972).

described as a put option that provides costly insurance to investors for declines in new public issues,¹¹⁸ potentially raising the costs of innovative companies seeking to raise money through the public markets.¹¹⁹

Bondholder class actions have introduced section 11 suits in a different context, the seasoned company selling debt to investors. Bondholders of large public companies affected by fraud have increasingly asserted section 11 claims. As noted earlier, 13 of the 19 Largest Bondholder Settlements were in cases with section 11 claims arising out of a bond offering, meaning that close to half of the Top 30 securities class action settlements involved fraud by a seasoned issuer selling bonds. Far from just regulating initial sales of stock, section 11 is being used to target frauds that occur years after a company goes public.

Section 11 claims by bondholders are a way of remedying fraudulent sales of bonds that transfer value from bondholders to shareholders. Companies raising funds in the capital markets face liability if bond sales coincide with misrepresentations that hide facts indicating a significant risk of insolvency. Absent such fraud, bondholders would have charged more for investing in the offering, and shareholders would not have benefited from the lower cost of debt. Bondholder recoveries can be understood as transferring wealth from shareholders back to bondholders. Far from just protecting shareholders investing in risky IPOs, section 11 is playing a role in maintaining the integrity of bond sales by established companies.

As noted earlier, because of the frequency of bond offerings, bondholders are more likely to have access to the lenient liabil-

118. See James C. Spindler, *IPO Liability and Entrepreneurial Response*, 155 U. PA. L. REV. 1187, 1190 (2007) (“[B]ecause the shareholder purchases not just the firm’s equity but also a ‘put option’ exercisable in the bad state of the world, the shareholder pays more for the share-cum-option than she would have paid for just the share.”).

119. It is important to acknowledge that of the two types of securities class actions that plaintiffs can bring, cases brought under section 11 have been the less controversial. Because section 11 is limited to the particular situation where a company is selling securities to investors, there are fewer opportunities to use or abuse section 11. Moreover, unlike secondary market transactions where the issuer does not trade, the context of a direct sale is one where the issuer directly benefits from the fraud at the expense of investors. Criticisms of securities class actions have thus generally observed that section 11 is not as great an area of concern as Rule 10b-5. See, e.g., John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1556–57 (2006).

ity standard of section 11 than shareholders. When a bond offering coincides with a fraud, bondholders need not prove *scienter* to recover, raising the possibility that recoveries result from a lower liability standard rather than greater merit. It would be troubling if bondholder recoveries under section 11 simply reflected the accident that a bond offering occurred during the period of the fraud. There is evidence, though, that bondholder recoveries are driven by more than the mere presence of a bond offering. While it is a small sample, 11 of the 13 Largest Bondholder Settlements with section 11 claims also involved a credit downgrade, indicating that there was an external event causing particular harm to bondholders. So long as bondholder class actions are driven by events of specific concern to bondholders, there is some assurance that the presence of a bond offering during the class period is a necessary but not sufficient condition for a bondholder recovery.

As many commentators have observed, section 11 claims involving seasoned issuers raise issues of special concern relating to the liability of third parties such as underwriters.¹²⁰ In contrast to the new company that takes months to prepare a securities offering, the securities laws allow seasoned public issuers to execute an offering within a matter of days through what is called a shelf offering.¹²¹ Unlike the extensive disclosure prepared for an IPO, the disclosure relating to such an offering simply incorporates earlier periodic disclosures filed with the SEC.¹²² With a shelf offering, underwriters, who face liability under section 11, do not have as much time to perform due dili-

120. See, e.g., John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1168–71 (1995); Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1025–32 (1984); Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 62 (2000).

121. For a discussion of the policy reasons behind integrated disclosure and shelf registration, see Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984).

122. Indeed, investors often rely mainly on the credit rating and characteristics of the bond rather than extensively assess the issuer's disclosures. See, e.g., Committee on Federal Regulation of Securities, *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, 48 BUS. LAW 1185, 1233 (1993) ("Debt securities involved in rule 415 shelf takedowns . . . are sold to institutional investors on the basis of rating, name, and yield.").

gence as they do with respect to an IPO.¹²³ Because bondholder section 11 claims typically involve such seasoned companies, they pose the risk of imposing excessive liability on underwriters.¹²⁴

The data set shows that underwriters are held liable in some but not all cases where bondholders bring section 11 claims. Of the 13 Largest Bondholder Settlements with section 11 claims, underwriters contributed to the settlement in 5 of the 13 cases.¹²⁵ These cases included notorious frauds such as Enron, WorldCom, HealthSouth, Adelphia, and Global Crossing. With the exception of HealthSouth, all of these companies filed for bankruptcy.¹²⁶ In the other 8 cases, though there was a bond offering and section 11 claims were asserted, underwriters did not contribute to the settlement. Only 2 of these companies, Delphi and the Williams Companies, filed for bankruptcy.¹²⁷

Resolving the fairness of underwriter liability for shelf offerings is beyond the scope of this article. However, the data provides support for the proposition that bondholders tend to recover meaningful amounts in a section 11 suit only when the offering is linked to a substantial fraud that dramatically changes the market's assessment of a public company's solvency. Underwriters are not always found liable simply because a bond offering happens to coincide with a misleading disclosure. While there will be circumstances where it is unfair to hold underwriters responsible for the failure of a company, there are circumstances where underwriters should be accountable for failing to detect the largest frauds.

123. See, e.g., Coffee, *supra* note 120, at 1168 (“In a compressed time period, the underwriter cannot conduct the same ‘due diligence’ investigation that the ‘33 Act intended in its provisions for a ‘due diligence’ affirmative defense to civil liability under Sections 11 and 12(a).”); Fox, *supra* note 120, at 1006 (“A major criticism of Rule 415 is that this speed and flexibility impede an underwriter’s ability to perform ‘due diligence,’ its statutorily induced investigation of the accuracy of the information contained in the registration statement.”); Langevoort, *supra* note 120, at 62 (“There may be no time for serious due diligence between the decision to proceed, at which point the underwriters are selected and notified, and the sales.”).

124. In the *WorldCom* case, a court held the underwriters to a high standard, requiring that they follow up on red flags and do more than a cursory investigation to take advantage of the due diligence defense. See *In re WorldCom Sec. Litig.*, 346 F. Supp. 2d 628, 685 (S.D.N.Y. 2004).

125. See *infra* Appendix, Table A1.

126. See *supra* Table 2.

127. See *id.*

Bondholder recoveries in section 11 cases illustrate how the securities fraud statutes adapt over time. It is doubtful that the legislative drafters of section 11 anticipated that the statute would be used so frequently by investors to recover damages for fraud relating to some of the largest public companies. Just a few years prior to the collapse of Enron and WorldCom, the most extensive and sophisticated study of section 11 suits involving IPOs concluded that most of the suits were without merit.¹²⁸ Though there is controversy surrounding securities class actions, very few commentators would deny that a significant number of the cases in the early 2000s have targeted real cases of fraud. At the very least, the issues raised by the new bondholder section 11 cases differ from those raised by the traditional shareholder section 11 cases. The securities class action has evolved with the times, and efforts to reform the securities class action should take into account the possibility that a remedy that seems wasteful in one period may be useful in another.

2. Rule 10b-5 and Bondholder Class Actions

Bondholder class actions could potentially add another dimension to the controversial Rule 10b-5 action for secondary market fraud. When a fraud affects investors purchasing older bonds in the secondary market, investors will not be able to meet the one-year statute of limitations governing section 11 claims.¹²⁹ Such bondholders can use Rule 10b-5 to recover when a fraud hides credit risk at the time the bond was purchased. Rule 10b-5 recoveries have tended to be smaller than section 11 recoveries, but with the rise in bondholder class actions, it is possible that an increasing portion of 10b-5 recoveries will go to bondholders.

Fraud-on-the-market claims have been criticized as resulting in useless transfers among shareholders. The main version of this critique argues that compensation for Rule 10b-5 claims is a circular shifting of losses from shareholders to themselves.¹³⁰ Put another way, when shareholders suffer losses

128. Bohn & Choi, *supra* note 116, at 979 (“This Article’s empirical results show that most securities-fraud class actions are, in fact, frivolous.”).

129. 15 U.S.C. § 77(k) (2012).

130. See, e.g., James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 509 (1997) (“[A] circularity problem arises for settlements of securities class actions . . . [T]he plaintiffs necessarily provide, albeit indirectly, some portion of their own settlement recovery.”); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L.

from fraud in secondary markets, any recovery they obtain comes from corporate revenue, reducing shareholder earnings, or from an insurance policy that is funded by the shareholders. Though this transfer is no worse than a dividend,¹³¹ the circularity of shareholder compensation reduces the loss spreading function of securities class actions.¹³²

In contrast, successful bondholder class actions result in a non-circular transfer from shareholders to bondholders. When a bondholder recovers from an issuer under Rule 10b-5, that

REV. 639, 649 (1996) (“[M]oney paid out by the issuer itself is essentially taken from the company’s shareholders . . .”).

131. James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 325 (2009).

132. A second version of the circularity problem argues that because most investors are diversified, they are just as likely to be beneficiaries of securities fraud as victims. *See, e.g.*, Amanda Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1688 (2011) (“[D]iversified investors both buy and sell shares on the stock market . . . [And] are just as likely to benefit from fraud that inflates stock prices as they are to be injured by it, and these gains and losses are likely to net out over time.”). While investors who buy a security at an inflated price lose from the transaction, investors who sell the security at an inflated price win from the transaction. Over time, an investor with a diversified portfolio should not suffer significant losses from fraud on the market.

Put more concretely, consider a situation where an investor has a portfolio of two stocks—Stock A and Stock B. Suppose the investor purchases Stock A for \$5 a share, but it turns out that Stock A is inflated by fraud and only worth \$4 a share. The transaction results in a \$1 loss for the investor from securities fraud. In a different transaction, the investor sells Stock B for \$5 a share, though in reality Stock B is inflated by fraud and only worth \$4 a share. This transaction results in a \$1 gain for the investor from securities fraud. Assuming these are the only two stocks in the investor’s portfolio, the gain from fraud exactly offsets the loss from fraud.

In some cases, the circularity-diversification argument will apply to bondholders just as much as it does to shareholders. Bondholders might benefit from securities fraud in some transactions even while being harmed in others. But there is reason to believe that for the largest frauds, the circularity-diversification argument is less likely to protect bondholders from fraud. Because bondholders have limited upside to their investment, it will be more difficult for significant losses to be offset by significant gains in the bondholder’s portfolio.

Another concrete example illustrates this point. Suppose a bondholder owns two bonds—Bond A and Bond B. The bondholder purchases Bond A for a \$100 par value investment, but it turns out that Bond A is inflated by fraud and is only worth \$75. The transaction results in a \$25 loss for the bondholder. To offset that loss, the bondholder would have to have a transaction in his portfolio where he sells a bond inflated by \$25. For conservative investors who purchase bonds at par value, such transactions will be unlikely because bonds do not participate in earnings growth and have a limited upside. In contrast, it is more likely that an investor would have a stock in his portfolio that is inflated by significant amounts because of the greater volatility of stocks.

payment essentially comes from shareholders. Any bondholder recovery that comes directly from the company is an expense that reduces shareholder earnings. Or, the payment comes from an insurance policy that was essentially funded by shareholders over time. Because bondholder compensation is a transfer from shareholders to bondholders, bondholder securities class actions avoid the problem of circular loss shifting from shareholder to shareholder.

Bondholder compensation for fraud is attractive not only because it avoids the problem of circularity, but because as noted earlier, shareholders tend to benefit more from securities fraud than bondholders. Circular loss shifting seems especially unwarranted when shareholders are compensating themselves for risks that might have benefitted them if successful. On the other hand, compensating bondholders for losses caused by risks that they would not have preferred is more consistent with a just policy of compensation.

Most significant bondholder recoveries occur in the context of bond offerings, but bondholders do at times recover for secondary market fraud. Indeed, more than half of all bondholder recoveries involve cases with only Rule 10b-5 claims. Even when section 11 claims are asserted, complaints typically also allege Rule 10b-5 claims. For example, as noted earlier, in the *Enron* and *WorldCom* cases, where bondholders recovered under section 11, a significant portion of the recovery also went to bondholders who purchased in secondary markets.¹³³

Bondholders can protect themselves from the effects of secondary market fraud in various ways, but such protection does not eliminate the need for a remedy. First, like shareholders, a bondholder can diversify, which would mean that a smaller portion of its portfolio would be exposed to fraud losses.¹³⁴ However, even when diversified, bond holdings in a particular issuer tend to be quite large,¹³⁵ meaning that even diversified bond-

133. See *supra* Part III.

134. See, e.g., Amihud et al., *supra* note 23, at 461 (“An investor can thus diversify away the firm-specific, or idiosyncratic, risk associated with the bonds of any single company.”).

Investors might also be diversified across asset classes, meaning that they hold not only bonds but stocks. Gains from one part of the portfolio could offset losses from another part of the portfolio.

135. Bond transactions are generally much larger than stock transactions. *In re HealthSouth Corp. Sec. Litig.*, 261 F.R.D. 616, 632 (N.D. Ala. 2009) (“When bonds do trade, however, the trades tend to be at least fifty times as large as typical stock exchange transactions.”). Most corporate bonds are held

holders can suffer meaningful losses from fraud. Second, bondholders can protect themselves by hedging. An investor can enter into a credit default swap, which insures against losses caused by bond defaults.¹³⁶ The obvious cost to hedging is that returns from investing in the bond will be reduced by the price of the hedge. To the extent that securities fraud is deterred, investors will need to spend less to hedge against the risk of fraud.

Protecting bondholders from secondary market fraud could be criticized on the ground that doing so would primarily protect speculators rather than long-term investors.¹³⁷ Consider a case where the price of a company's bonds has fallen from \$1000 to \$800 based on fears of the company's solvency. A speculator purchases bonds for \$800, betting that the company will recover. Later, the market learns that the company failed to reveal facts indicating that its condition is much worse, and when the truth comes out, the bond prices plummet to \$500 a share. Should the speculator be permitted to bring a claim under Rule 10b-5 for securities fraud to recover its losses? On the one hand, offering such a remedy rewards speculators who should know they are taking on significant risk. On the other hand, the availability of such a remedy provides speculators with greater incentive to purchase bonds in secondary markets, which could benefit bondholders who want to exit a volatile investment. Especially as bond markets become more efficient,¹³⁸ a Rule 10b-5 remedy can provide modest assurance for inves-

by institutions. *See, e.g.*, Schultz, *supra* note 45 ("The corporate bond market is primarily an institutional market."). As a result, "ownership of bonds of any particular issue tends to be highly concentrated, that is, a relatively small number of investors generally owns a high fraction of the bonds of a single issue." Kahan, *supra* note 107, at 584; *see also* Schultz, *supra* note 45, at 679 ("Also contributing to the lack of volume is the fact that institutions buy bonds in sufficiently large quantities that even the largest issues can be held entirely by 200 or fewer institutions.").

136. *See, e.g.*, Longstaff et al., *supra* note 12, at 2216 ("Credit derivatives are contingent claims with payoffs that are linked to the creditworthiness of a given firm or sovereign entity."); Partnoy, *supra* note 22, at 678.

137. Bondholders vary in the amount of trading they do. *See, e.g.*, Sugato Chakravarty & Asani Sarkar, *Trading Costs in Three U.S. Bond Markets*, 13 J. FIXED INCOME 39, 40–41 (2003) (noting that insurance companies tend to be "buy and hold" investors in bonds while pension funds and hedge funds "are reputed to trade more frequently").

138. In the future, bond markets may become more efficient. Efforts are being made to create new platforms for bond trading. *See* Serena Ng & Kirsten Grind, *Firms in Talks on Bond Trading*, WALL ST. J., June 14, 2012, at C1.

tors that they can rely upon market prices, increasing liquidity in those markets.

Bondholder class actions asserting Rule 10b-5 claims for secondary market fraud are not vulnerable to some of the criticisms of similar shareholder class actions. The recovery for such claims have been relatively small, but such claims could increase in importance as bond markets become more liquid and bondholders continue to assert claims.

V. BONDHOLDER CLASS ACTIONS AND CORPORATE GOVERNANCE

Bondholders generally cannot bring suit against directors and officers under state corporate law, but with bondholder class actions they are not completely without recourse when managers secretly take on excessive risk to benefit shareholders. To the extent that bondholders increasingly recover for securities fraud, the prevailing view that the interests of bondholders have no place in corporate governance will be modified. Section A describes the absence of bondholder rights under state corporate law. Section B examines how securities class actions can address corporate governance issues. Section C argues that bondholder class actions address a particular governance concern, excessive risk-taking on behalf of shareholders that impacts corporate stakeholders.

A. THE LACK OF BONDHOLDER RIGHTS UNDER CORPORATE LAW

In corporate law, an important distinction between shareholders and bondholders is that shareholders are protected by fiduciary duties, enforceable through derivative suits, while bondholders are not.¹³⁹ A basic reason for the differing treatment of shareholders and bondholders is that shareholders are essentially owners of the corporation,¹⁴⁰ while bondholders are outside creditors who are dealt with at arms-length. Fiduciary

139. See *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (“When a corporation is *solvent*, those [fiduciary] duties may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation’s growth and increased value.”).

140. See, e.g., *Brooks v. Weiser*, 57 F.R.D. 491, 494 (S.D.N.Y. 1972) (“The fact that among the plethora of derivative suits brought over the generations none even discuss the issue reflects the obviousness of the proposition that the right to sue derivatively is an attribute of ownership, justified on the theory that the plaintiff in such a suit seeks to recover what belongs to the corporation, because as a co-owner, it also belongs to him.”).

duties are triggered by the special relationship directors and officers have with the shareholders,¹⁴¹ who appoint directors to serve their interests. In contrast, bondholders have no voting rights or fiduciary relationship with corporate managers. Attempts by bond investors to bring derivative suits with respect to solvent companies have thus largely failed,¹⁴² with the courts holding that bondholder rights are limited to the contractual provisions negotiated with corporate issuers.¹⁴³

A drawback of the traditional focus on shareholder rights is that the interests of stakeholders essential to the functioning of the corporation will not be considered when they conflict with the interests of shareholders. Corporate law scholars have often observed that the goals of shareholders and bondholders can diverge.¹⁴⁴ Corporate managers who seek to maximize

141. See, e.g., *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998) (noting that directors have “the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners”).

142. See, e.g., *Harff v. Kerkorian*, 347 A.2d 133, 134 (Del. 1975) (per curiam) (affirming a ruling that “debenture holders lack standing under Delaware law to sue derivatively because they are not ‘stockholders’”); *Brooks v. Weiser*, 57 F.R.D. 491, 494 (S.D.N.Y. 1972). State law does provide bondholders with a cause of action for fraud, see, e.g., *Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988), but class actions asserting state fraud claims relating to securities are likely preempted by federal law. See Securities Litigation Uniform Standards Act of 1998, Pub. L. 105-353, 112 Stat. 3227.

143. See cases cited *supra* note 5. Bondholders can bring derivative actions alleging a breach of fiduciary duty when the company has filed for bankruptcy, see, e.g., *Gheewalla*, 930 A.2d at 101 (“[T]he creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.”), but such suits are rare. See Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 720 (1993) (“Neither creditors nor shareholders are likely to take formal legal action against managers for perceived breaches of the managers’ fiduciary duty of loyalty.”); see also Kahan & Rock, *supra* note 23, at 302 (noting that bondholders rarely sue for breach of covenant). Such suits would also be limited by the business judgment rule. See Stephen M. Bainbridge, *Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 336, 368 (2007).

144. See, e.g., Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1288 (2008) (“Even when a company issues only two kinds of securities—say, common stock and debt—options theory predicts an inevitable conflict of interest between the debtholders (who want to preserve the company’s ‘equity cushion’ and avoid risk) and the stockholders (who favor risk because they enjoy all the upside while sharing the burden of the downside with the debtholders).”); LoPucki & Whitford, *supra* note 143, at 684 (footnote omitted) (“[W]hen a marginally solvent company engages in high risk investment, the risks are borne primarily by creditors while the benefits accrue primarily to shareholders.”).

shareholder wealth can do so in a way that undermines the interests of bondholders. Some scholars have therefore argued that corporate law should take into account bondholder concerns. For example, reacting largely to the financing in the 1980s of takeovers with the issuance of additional debt that increased risk for corporate bondholders, a number of commentators argued that corporate law fiduciary duties should be extended to bondholders.¹⁴⁵

Proposals to directly enhance the corporate law rights of bondholders have not gained much traction, in part because bondholder abuse in hostile takeovers and buyouts declined substantially in the 1990s.¹⁴⁶ Another reason might be that bondholders are less concerned than shareholders about corporate governance except in times when a company is close to insolvency. So long as there is a substantial equity cushion, bonds will retain their value and bondholders have little incentive to be concerned with corporate governance. As a result, the traditional conception of limited rights for bondholders still dominates corporate law.¹⁴⁷

145. See, e.g., Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 206 (1988) (“[C]ourts should declare that directors have a fiduciary duty to deal fairly with *all* of the investors in a corporation—bondholders as well as stockholders.”); Mitchell, *supra* note 5, at 1168 (arguing that extending “additional rights to bondholders promotes corporate social responsibility”); Note, *Creditors’ Derivative Suits on Behalf of Solvent Corporations*, 88 YALE L.J. 1299, 1301 (1979) (“This Note argues that creditors of a solvent corporation should have a statutory right to bring suit in the name of the corporation against its directors for breaching the trust of their office.”); Note, *Public Creditors of Financial Institutions: The Case for a Derivative Right of Action*, 86 YALE L.J. 1422, 1456 (1977) (“[O]fficers and directors of financial intermediaries owe a fiduciary duty to their public creditors not to deal with their institutions for their own accounts or derive personal profit from transactions in which their institutions engage.”).

146. See, e.g., Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 226 (2009) (“The mid-to-late part of the 1980s was an active period for LBOs, before market conditions changed and LBO activity declined rather sharply in the early 1990s.”).

147. See, e.g., Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440–41 (2001) (“The principal elements of this emerging consensus are that ultimate control over the corporation should rest with the shareholder class; the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders; other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance . . .”).

B. SECURITIES FRAUD AS CORPORATE GOVERNANCE FAILURE

Unlike corporate law, the securities laws provide bondholders with essentially the same causes of action as shareholders. To the extent that securities class actions can be used to challenge corporate misconduct, they provide bondholders with a mechanism for asserting their interests that is not provided by corporate law.

Securities fraud is perhaps the most visible result of poor corporate governance. Inactive and captured boards, imperial CEOs, self-dealing managers, unfair compensation structures, and other corporate governance failures can contribute to an environment where securities fraud is more likely. The cases where investors suffer the greatest losses often coincide with the worst breaches of fiduciary duties by management.

If securities fraud is one result of corporate governance failure, securities class actions inevitably address issues relating to corporate law.¹⁴⁸ Professors Robert Thompson and Hillary Sale go so far as to say that “federal securities law and enforcement via securities fraud class actions today have become the most visible means of regulating corporate governance.”¹⁴⁹ Indeed, there can be overlap between the typical securities fraud claim and corporate law duty of care violations.¹⁵⁰ A failure to act with care can result in conditions conducive to securities fraud. For example, a corporation may take on ill-advised risk that causes poor economic performance and then take steps to hide those mistakes. Punishing the failure to disclose risk would indirectly hold the corporation accountable for the lack of care that resulted in the fraud. If a corporation knows it cannot hide incompetent conduct without the possibility of pun-

148. In addition, corporate derivative suits appear to be addressing issues relating to securities fraud. One study of 160 derivative suits filed in 2005 and 2006 found that “more than 90% included allegations of false or misleading statements, the same allegations that are the cornerstone of fraud claims.” Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49, 70 (2011).

149. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 860 (2003).

150. See, e.g., Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 58 (1993) (“A duty of care suit can also arise under the federal securities laws for such ‘plain vanilla’ accounting misconduct as inventory deficiency fraud, improper income recognition or improper accounting for goodwill.”); Thompson & Sale, *supra* note 149, at 889 (noting that securities class actions can target earnings management cases where “the managers have caused the corporation to do something that has made the corporation’s shares less valuable and, thereby, harmed the shareholders”).

ishment, there will be additional incentives to avoid such conduct in the first place.

Some commentators have been skeptical that securities fraud class actions have a meaningful and desirable impact on corporate governance. In a thoughtful article, Professors William Bratton and Michael Wachter express doubt that securities class actions can be justified on the grounds that they promote better corporate governance.¹⁵¹ Bratton and Wachter observe, as others have, that there are questions as to whether securities class actions do much to deter misconduct because they rarely hold individuals personally liable for securities fraud.¹⁵² Additionally, they argue that to the extent they affect corporate behavior, securities class actions are an end-run around the choice of many companies in Delaware to essentially opt out of the duty of care.¹⁵³

There is a tension between these two arguments. On the one hand, securities class actions are criticized for not doing enough to directly deter corporate misconduct by individuals. On the other hand, securities class actions are criticized for second-guessing the decision of many corporations to opt out of individual liability for corporate wrongdoing. Much of the perceived dysfunction of securities class actions stems from the difficulty of reconciling such competing considerations.

Indeed, any corporate litigation regime must find a balance between the policy goal of deterring corporate misconduct and the policy goal of minimizing the costs of such liability. The current state of securities class actions reflects a compromise between these two goals. Corporations are potentially liable for securities fraud, but individual managers are shielded except in the most egregious cases. Deterrence is not completely eliminated under this balance. In some cases, individuals are required to contribute to securities class action settlements.¹⁵⁴ The system deters the worst cases of fraud while protecting individuals from liability in most cases.

151. William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 118–33 (2011).

152. *Id.* at 124 (“[A securities class action] almost never holds anyone to an individual admission of liability, much less individual accountability . . .”).

153. *Id.* at 128 (observing that “corporations—with their shareholders’ approval—have decided that the benefits of care-based litigation are not worth the costs” and that shareholders might opt out of securities class actions).

154. In the *Enron*, *WorldCom*, *Global Crossing*, and *Rite Aid* settlements, directors and officers personally contributed to the settlement. See *infra* Appendix, Table A1.

Securities class actions are not substantially in conflict with the corporate law regime of Delaware. As noted earlier, individuals rarely personally contribute to securities class actions, making the system similar to the Delaware system, which has virtually eliminated personal liability for the duty of care through section 102(b)(7) of the Delaware General Corporate Law.¹⁵⁵ Moreover, residual liability for the worst forms of securities fraud is not inconsistent with Delaware law. Section 102(b)(7) does not allow corporations to eliminate liability for breaches of the duty of loyalty and duty of good faith.¹⁵⁶ Some securities class actions raise issues relating to loyalty when the fraud is motivated by a desire to personally enrich management. Moreover, because the conduct targeted by the securities laws requires a showing of scienter, or fraudulent intent,¹⁵⁷ the worst cases of securities fraud will likely involve the sort of conscious disregard of duty that violates Delaware's duty of good faith.¹⁵⁸ Delaware does not permit companies to opt out of these duties, and it is far from clear that corporations would opt out of liability for the worst forms of misconduct by management.¹⁵⁹

C. SECURITIES CLASS ACTIONS AND BONDHOLDER INTERESTS

The rise of bondholder class actions adds a new dimension to the influence of securities class actions on corporate governance. Securities class actions do more than create additional corporate law for shareholders. Bondholder class actions address fraud that seeks to benefit shareholders at the expense of bondholders.

Securities class actions allow bondholders to assert claims when corporations take on excessive risk for shareholders without disclosing such risk. While the harm from fraud affects

155. Bratton & Wachter, *supra* note 151, at 127.

156. *Id.*

157. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

158. See *In re The Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 62–68 (Del. 2006) (discussing several definitions of the duty of good faith and noting that “a conscious disregard for one’s responsibilities” can violate the duty); Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456, 493 (2004) (likening the duty of good faith to a scienter standard).

159. To the extent that duty of care claims are intertwined with duty of loyalty or duty of good faith claims, derivative claims may proceed without running afoul of 102(b)(7). See *McMullin v. Beran*, 765 A.2d 910, 926 (Del. 2000) (noting that affirmative defenses under 102(b)(7) “cannot provide protection for directors who breach their duty of loyalty”).

both shareholders and bondholders, many bondholder class actions have alleged distinct harm to bondholders. In the section 11 context, bondholders can obtain relief when firms misrepresent their condition to sell debt, a fraud which transfers wealth from bondholders to shareholders. As noted earlier, 13 of the 19 Largest Bondholder Settlements include section 11 claims alleging that the corporation defrauded bondholders so it could raise funds for shareholders. In the Rule 10b-5 context, bondholders can obtain relief when firms endanger their credit ratings by taking on undisclosed risk to inflate a company's stock price. Fifteen of the 19 Largest Bondholder Settlements involved a credit downgrade, an event that has particular implications for bondholders.

Bondholder class actions address the most egregious abuses by corporate managers while respecting the basic corporate law distinction between shareholders and bondholders.¹⁶⁰ In normal periods, the interests of bondholders are not a major concern of corporate governance, and managers should rightly focus on the interests of shareholders. But when there is a temptation to gamble with bondholder funds on behalf of shareholders, or a temptation to inflate the company's stock price by taking on hidden risks that threaten the company's credit rating, the securities laws require consideration of bondholder interests because such laws provide a remedy for such misconduct.

The fact that bondholder recoveries come from funds originating from shareholders distinguishes the corporate governance impact of bondholder class actions from shareholder class actions where funds are transferred between shareholders. To the extent that bondholder recoveries are transfers from shareholders to bondholders, they are a modest check on the tendency to favor shareholders in all aspects of corporate governance. Such transfers are appropriate given that shareholders tend to benefit from successful frauds, while bondholders do not.

When directors and officers face personal liability for corporate misconduct, it is likely that the source of that liability will be a securities class action involving bondholder interests. Though in most cases, the liability of individuals is covered by D&O insurance, in a few notable cases with bondholder recoveries—*Enron*, *WorldCom*, *Global Crossing*, and *Rite Aid*—

160. See, e.g., William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 734 (1984) (noting that federal securities laws are evidence that bondholders deserve protection).

directors and officers personally contributed to the settlement.¹⁶¹ It is possible that managers would have personally contributed even if only shareholders were bringing claims, but the case for personal liability is strongest for the most severe frauds that cause significant harm to stakeholders.¹⁶²

Personal liability is a rare occurrence, but even a few cases of such liability could create a deterrent effect. Counsel briefing a new director about the potential for personal liability should discuss federal securities law cases such as *WorldCom*, cautioning the director that personal liability is possible under the securities laws when securities fraud hides information that would lead to credit downgrades, bankruptcy, and harm to stakeholders such as bondholders. Given the frequency of debt offerings in large public corporations, an informed board of directors will know they will face the highest risk of liability when fraud significantly harms the interests of those bondholders. The current system of limiting personal liability to the worst cases of fraud perhaps strikes the right balance by minimizing the possibility that managers will be chilled from active decision-making. Securities class actions create normative outer boundaries that should not unduly burden law-abiding corporations.

While the use of the federal securities laws to influence state corporate governance could have federalism implications, in the case of bondholder class actions, the tension between federal and state interests is likely to be low. Unlike one-size-fit-all mandatory rules, securities class actions tend to raise corporate governance issues on a case-by-case basis. Moreover, as noted earlier, bondholders recover for securities fraud less frequently than shareholders. Only exceptional frauds will

161. See *infra* Appendix, Table A1. In the *Enron* case, the outside directors contributed \$13 million. Kurt Eichenwald, *Ex-Directors of Enron To Chip in on Settlement*, N.Y. TIMES, Jan. 8, 2005, at C1. In the *WorldCom* case, the outside directors contributed \$24.5 million and a number of executives also made personal contributions. Masters & Day, *supra* note 4. In the *Global Crossing* case, the Chairman contributed \$30 million. Gretchen Morgenson, *Global Crossing Settles Suit on Losses*, N.Y. TIMES, Mar. 20, 2004, at C1. In the *Rite Aid* case, the CEO contributed \$1,450,000. *Rite Aid's Ex-CEO Settles Lawsuit*, L.A. TIMES (Apr. 10, 2003), <http://articles.latimes.com/2003/apr/10/business/fi-rup10.1>. It is important to note that these payments are still the exception rather than the rule. See Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1063 (2006) ("Outside directors make personal payments in a tiny percentage of cases.").

162. For an analysis of how securities fraud affects stakeholders, see Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887 (2013).

trigger scrutiny of managers through bondholder litigation. Finally, if bondholder class actions encourage more effective risk-management, such a norm is not inconsistent with Delaware law.¹⁶³

Bondholder class actions fit within a broader trend of corporate governance scholarship encouraging consideration of the interests of stakeholders such as bondholders. Professors Lucian Bebchuk and Holger Spamann argue that banks, which tend to have significant amounts of debt, should link executive pay packages to a “broader basket of securities than common shares and preferred shares,” including “all outstanding bonds.”¹⁶⁴ In doing so, managers would have more incentive to rein in outsized risks that threaten the solvency of the corporation. On the other hand, compensation linked to debt would move corporate law from its traditional focus on shareholders and perhaps make executives too risk-averse.

Bondholder class actions are a less intrusive way of dealing with the worst forms of managerial misconduct than creating obligations to stakeholders, either through fiduciary duties or compensation structures. Rather than controlling management ex ante through measures that blur the line between shareholders and bondholders, bondholder class actions provide a remedy ex post that provides bondholders with relief for the worst forms of corporate misconduct.

VI. THE FUTURE OF BONDHOLDER CLASS ACTIONS

This Part considers some practical implications of this Article’s findings. Courts should take into account the distinct situation of bondholders when adjudicating securities class actions. Section A proposes that courts could modify the fraud-on-the-market presumption when considering whether a class of bondholders should be certified so that it focuses on the reli-

163. See, e.g., *In re Caremark Int’l Inc. Deriv. Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (“[A] director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system . . . exists, and that failure to do so . . . may, in theory at least, render a director liable for losses . . .”).

164. Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers’ Pay*, 98 GEO. L.J. 247, 284 (2010). Bankruptcy, where bondholders are essentially the residual claimant, is another context where debt might make sense as a form of executive compensation. See Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV. 777, 800 (2007) (“To improve managerial performance, I propose that the committee be granted the right to award managers a percentage of the unsecured debt of the insolvent firm.”).

ance of bondholders on credit ratings. Section B contends that when there is tension between bondholder and shareholder interests in a securities class action, bondholders should be represented by independent counsel.

A. THE FRAUD-ON-THE-CREDIT-RATING-AGENCY PRESUMPTION

There is significant uncertainty in the law governing whether a class of bondholders can be certified in Rule 10b-5 cases. Part of the problem is that some courts have not recognized that bond markets operate differently than stock markets. While shareholders mainly rely on the integrity of efficient markets, bondholders mainly rely on the integrity of credit ratings.

For bondholders to be certified as a class, they must establish commonality.¹⁶⁵ For Rule 10b-5 cases, the main element where commonality among investors is in question is reliance.¹⁶⁶ As noted earlier, many shareholders do not actually rely on a particular misstatement, making it difficult to establish common reliance. Instead, they can be certified as a class through the fraud-on-the-market presumption, which presumes that shareholders relied upon the integrity of market prices when a stock trades in an efficient market.¹⁶⁷ Many courts have found that bonds of large public companies trade in efficient markets and have permitted bondholders to use the fraud-on-the-market presumption.¹⁶⁸ In a 2010 decision, though, a district court in the Southern District of New York found that the bonds of AIG, one of the largest public companies at the time, did not trade in an efficient market.¹⁶⁹ In reaching its decision, the court relied partly on the fact that the bonds did not trade on a number of days when bad news about AIG was disclosed.¹⁷⁰

165. FED. R. CIV. P. 23(b)(3).

166. In contrast, section 11 does not have a reliance requirement. 15 U.S.C. § 77k (2012).

167. See *Basic Inc. v. Levinson*, 485 U.S. 224, 246–47 (1988).

168. See cases cited *supra* note 50.

169. *In re Am. Int'l Grp. Sec. Litig.*, 265 F.R.D. 157, 181 (S.D.N.Y. 2010), *vacated and remanded by* 689 F.3d 229 (2d Cir. 2012).

170. *Id.* at 180. Even though the plaintiff's expert showed that AIG bonds traded in greater volume and amount than average bonds, the court found that this was not sufficient to establish market efficiency. *Id.* at 177. At least one group of commentators has been critical of the court's findings. See, e.g., Hartzmark, *supra* note 2 (criticizing failure of court to certify class of bondholders in securities class action against AIG). It may be that not much should be made of the AIG decision as it partly rests on failures by the plaintiff's expert to offer sufficient proof. In future cases, experts could offer proof of effi-

The AIG opinion highlights the potential problem bondholders have with relying on the fraud-on-the-market presumption.¹⁷¹ Because bonds trade less frequently than stocks, bond prices do not fluctuate as much as stock prices, suggesting that bond markets are less likely to be efficient than stock markets.¹⁷² The AIG opinion attempted to formulate a general prerequisite for bondholders to invoke the fraud-on-the-market presumption. It noted the absence of “any court in this jurisdiction that has found debt securities to trade in an efficient market without first having found that the price of those bonds is responsive to company-specific news at a statistically significant level.”¹⁷³ If this test for efficiency is read as encompassing all “company-specific” news, very few bond markets will qualify as efficient.

Applying the efficient markets hypothesis to bond investors is problematic because bond markets are concerned with a narrower range of information than stock markets. The focus on bond markets is on information that substantially changes the risk of an issuer’s insolvency. For example, a company that goes from a 1% risk of insolvency to a 50% risk of insolvency will see its bond prices plummet. Even smaller increases can affect bond prices depending on the expectations of bond investors. An increase in the risk of insolvency from 1% to 5% may

ciency that would be sufficient.

171. After the district court’s decision, various defendants agreed to settlements where about 5% of the recovery was allocated to bondholders. Notice of Proposed Settlement, Motion for Attorneys’ Fees and Expenses Award and Fairness Hearing, *supra* note 98.

172. Moreover, a distinct test for judging whether bondholders can rely on the fraud-on-the-market presumption has not yet emerged. *See, e.g., In re Enron Corp.*, 529 F. Supp. 2d at 748 (“[N]o standard at all appears to have been established for measuring market efficiency for debt securities.”). In the absence of such a standard, courts have generally applied the *Cammer* test, which sets forth a number of criteria used to determine whether a market for an issuer’s stock is efficient. *See, e.g., In re Am. Int’l Grp.*, 265 F.R.D. at 175–76 (noting the lack of a clear standard and applying the *Cammer* test). In assessing whether a security trades in an efficient market, the *Cammer* test looks at whether there is: “(1) a large weekly trading volume; (2) a significant number of securities analysts following and reporting on a company’s stock; (3) the presence of market makers and arbitrageurs who are able to react swiftly to company news and drive the stock price; (4) the eligibility of the company to file an S-3 Registration Statement for its public offerings; and (5) empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price.” *Id.* at 176 (quoting *In re SCOR Holding AG Litig.*, 537 F. Supp. 2d 556, 574 (S.D.N.Y. 2006)).

173. *In re Am. Int’l Grp.*, 265 F.R.D. at 180–81.

be a significant development for an investor in AAA bonds. In contrast, an increase in the risk of insolvency of a similar magnitude—say from 30% to 35%—may not be as important for a holder of a junk bond, where there is already a substantial risk of insolvency.

To the extent that investors uniformly focus on the credit risk of a bond, it is likely they will rely in part on credit ratings in their decision to purchase a bond. When such a rating is based on fraudulent disclosures, bondholders can argue they all relied on a rating that was obtained or maintained through fraud.¹⁷⁴ Indeed, in the *AIG* case, credit rating agencies downgraded *AIG*'s credit rating in the wake of the events at issue,¹⁷⁵ a fact not emphasized by the court in its decision.

Rather than judge bondholder class actions based on a mechanical application of the various factors relevant to stock market efficiency, courts could allow bondholders to meet their burden of establishing uniform reliance by showing they relied upon a credit rating that was based on fraudulent disclosures.¹⁷⁶ Put another way, instead of utilizing a fraud-on-the-market presumption, bondholders could use a fraud-on-the-credit-rating-agency presumption.¹⁷⁷ Alternatively, courts should focus not on whether bond markets react to all information, but on whether they react to information that significantly affects the credit risk of the issuer.¹⁷⁸ Such modifications

174. See, e.g., *In re HealthSouth Corp. Sec. Litig.*, 261 F.R.D. 616, 638 (N.D. Ala. 2009) (“The publicly available financial information affected the credit rating for HealthSouth bonds in much the same way information affects the price of stock in an efficient market for stock; and the credit ratings—along with other publicly available information—likewise affected the price of the HealthSouth bonds.”).

175. Consolidated Third Amended Class Action Complaint ¶¶ 765–73, *In re Am. Int'l Grp., Inc. Sec. Litig.*, Master File No. 04 Civ. 8141 (JES)(AJP) (S.D.N.Y. Dec. 15, 2006).

176. In *Halliburton Co. v. Erica P. John Fund, Inc.*, the U.S. Supreme Court held that a defendant could rebut the fraud-on-the-market presumption “through evidence that an alleged misrepresentation did not actually affect the market price of the stock.” 134 S. Ct. 2398, 2417 (2014). Similarly, in a bondholder class action, a defendant could provide evidence that the misrepresentation had no impact on the company's credit rating.

177. Thanks to Jeff Manns for suggesting this phrase.

178. A separate but related issue is that of loss causation. To establish a Rule 10b-5 claim, the plaintiff must show that the alleged fraud caused the alleged loss. See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005). Because bonds respond to many factors, such as interest rate fluctuations, it might be difficult to isolate what part of the bond's price decline can be attributed to the revelation of the fraud. In cases where the issue of causation is difficult to resolve, a court might adjust the recovery of bondholders to take

to the fraud-on-the-market test for bondholders would more fairly reflect the contexts where bondholders are uniformly defrauded.

B. REPRESENTING BONDHOLDER INTERESTS

As bondholder involvement in securities class actions increases, courts should do more to ensure that the distinct interests of bond investors are adequately represented. As this study has shown, the current trend has been to merge bondholders and shareholders into one class of publicly traded securities.¹⁷⁹ Only 1 of the 19 Largest Bondholder Settlements had a class of bondholders represented by separate counsel.¹⁸⁰ While certifying one class of all investors may be appropriate in many cases, it is problematic when there is conflict between bondholder and shareholder interests.

The trend of defining a broad class at the outset is partly motivated by the desire of plaintiffs' attorneys to control the class action. If there is separate counsel for bondholders, the division of attorney fees might be affected as well as other issues relating to settlement negotiations. When the interests of bondholders and shareholders are similar, having one class counsel for all publicly traded securities would be appropriate. Indeed, if the claims asserted by bondholders and shareholders are essentially the same, separate class counsel would create unnecessary costs.

When a class of publicly traded securities is certified, a shareholder is usually appointed as the lead plaintiff. Bond-

into account this uncertainty. In the *Xerox* class action, the court discounted the bondholder recovery for secondary market fraud by 25%. It explained that the discount "is intended to recognize the somewhat greater difficulty a Bond purchaser faces compared to a purchaser of an equity security in showing the causal relationship between the allegedly misleading information and the claimed loss." Preliminary Order for Notice and Hearing in Connection with Settlement Proceedings at 21 n.3, *Carlson v. Xerox Corp.*, No. 3:00-CV-1621 (AWT) (D. Conn. Mar. 27, 2008). In the *Qwest* class action, the recovery discount for some bonds was even greater, 90%, again reflecting the difficulty of proving reliance. Notice of Pendency and Partial Settlement of Class Action at 8, *In re Qwest Commc'ns Int'l Inter. Inc. Sec. Litig.*, Civil Action No. 01-cv-1451-REB-CBS (D. Colo. Jan. 5, 2006). The point is that rather than completely denying the claim, adjustments can be made to take into account the greater uncertainty with respect to damages suffered by bondholders.

179. As noted earlier, about half of securities class actions now allege such a class.

180. The court in the *HealthSouth* case certified a separate class of bondholders. *In re HealthSouth Corp. Sec. Litig.*, 261 F.R.D. 616, 621 (N.D. Ala. 2009).

holders tend to take on a lesser role as representative plaintiffs who are named in the complaint but have less control of the litigation than the lead plaintiff.¹⁸¹ Shareholder dominance of the lead plaintiff position should not be surprising because as noted earlier, shareholders suffer greater losses from securities fraud than bondholders.¹⁸² Pursuant to the PSLRA, there is a presumption that the plaintiff with the largest loss should be the lead plaintiff.¹⁸³

Though the law is somewhat unclear,¹⁸⁴ courts have allowed a lead plaintiff to represent bondholders even when they have not bought the bonds at issue. For example, in the *World-Com* case, the lead plaintiff was permitted to represent bondholders asserting section 11 claims though it had not purchased bonds in any primary offering.¹⁸⁵ The court reasoned that the addition of representative plaintiffs who had invested in bonds in the relevant offerings ensured that the interest of such bondholders would be adequately represented.¹⁸⁶

In some cases, shareholders and bondholders have similar interests, but this Article has argued that in other cases shareholders and bondholders are in different positions with respect to a securities fraud. When there is such a conflict, a shareholder will not be an adequate representative of bondholder interests as required by Rule 23 of the Federal Rules of Civil Procedure.¹⁸⁷ While the inclusion of bondholders as named

181. Of the 19 Largest Bondholder Settlements, there were 6 cases where the lead plaintiff was a shareholder and there were also bondholders appointed as representative plaintiffs. These cases included *Enron*, *Xerox*, *Adelphia*, *Global Crossing*, *Delphi*, and *Williams Companies*.

182. See *supra* notes 27–28 and accompanying text. Another reason may be that some bondholders are reluctant to become involved in securities class actions. For example, insurance companies are significant holders of corporate bonds but tend not to become involved in securities class actions as lead plaintiffs. See James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1609 (2006).

183. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (setting forth the rebuttable presumption that plaintiff with “largest financial interest in the relief sought” should be the lead plaintiff).

184. See, e.g., *In re Am. Int’l Grp. Sec. Litig.*, 265 F.R.D. 157, 165 (S.D.N.Y. 2010) (“There is conflicting case law in the Second Circuit on whether a court may certify a class of purchasers of a security or fund that was not also purchased by Lead Plaintiffs.”), *vacated and remanded by* 689 F.3d 229 (2d Cir. 2012).

185. *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267, 280–81 (S.D.N.Y. 2003).

186. *Id.* at 281.

187. See FED. R. CIV. P. 23(a)(4).

plaintiffs might lessen this concern, the reality is that the lead plaintiff has the power to dictate the terms of the settlement. The appropriate response would be to create a subclass of bondholders represented by their own counsel.¹⁸⁸

Bondholders should be part of their own subclass when there are particular allegations of conduct that defrauds bondholders. When it is clear that a complaint alleges claims that specifically affect bondholders, such as the fraudulent sale of bonds to perpetuate a fraud, or the concealment of debt to maintain a credit rating, it would not be appropriate for bondholders to be represented by a shareholder.¹⁸⁹ Such a shareholder is arguably a beneficiary of a fraud that transferred value from bondholders to shareholders.

If bondholder interests are better represented in the settlement process, bondholder recoveries would likely increase. As noted earlier, bondholders tend to recover less than shareholders. The relatively low recoveries likely reflect the fact that bondholders are harmed less by fraud. However, it is also possible that the lower recoveries are partly a result of inadequate representation of bondholder interests in the settlement process. If a shareholder is appointed as lead plaintiff, he has little incentive to allocate significant amounts to bondholders. Creating a subclass for bondholders would help ensure that bondholders recover appropriate amounts when the fraud transfers their wealth to shareholders.¹⁹⁰

188. See FED. R. CIV. P. 23(c)(5) (“When appropriate, an action may be brought or maintained as a class action with respect to particular issues.”). Though the rules are unclear as to when a subclass should be created, subclasses are meant to address concerns relating to adequacy of representation. See Scott Dodson, *Subclassing*, 27 CARDOZO L. REV. 2351, 2382–83 (2006).

189. A number of commentators have raised concern that class representatives may not adequately represent the interests of other shareholders. See, e.g., Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109 (2011) (arguing that courts should appoint diverse groups of securities plaintiffs); David H. Webber, *The Plight of the Individual Investor in Securities Class Actions*, 106 NW. U. L. REV. 157 (2012) (arguing that interests of institutional investors may conflict with interests of individual investors). Institutional investors, for example, can have different interests than retail investors. If institutional investors are typically chosen as the class representative of securities class actions because they suffer the largest losses, they might resolve cases in a way inconsistent with other investors who tend to suffer smaller losses. The potential conflict between bondholders and shareholders is likely even greater than between institutional and retail investors.

190. Larger recoveries by bondholders could lead to opportunistic behavior by class action attorneys. Counsel might claim that bondholders deserve recovery even when they do not in order to extract part of the settlement. Courts should scrutinize settlements closely to determine whether bondholders did in

A more radical way of assuring adequate representation of bondholder interests in securities class actions might be to prioritize their recovery over shareholders in certain cases. If bondholder actions are a vehicle for checking excessive risk-taking by shareholders, a case can be made that bondholders should be compensated for all of their damages before shareholders receive any compensation, much as bondholders are paid before shareholders in bankruptcy.¹⁹¹ In particular, when the factual allegations establish that a fraud was driven by a desire to distribute wealth from bondholders to shareholders, one can argue that shareholders should not have the same claim to recovery as bondholders. If they receive priority over shareholders in certain cases, bondholders would have greater incentives to become involved in securities class actions, and such cases would be more potent in policing the conflict between shareholders and bondholders. Further development of this possibility might be appropriate for a future Article.

CONCLUSION

Securities class actions are no longer just for shareholders. Bondholder class actions represent an important evolution of the traditional securities class action. The significance of bondholder class actions has implications for the way academics, policymakers, and judges think about securities class actions as well as the role of bondholders in corporate governance. The rise of the bondholder class action reflects the significant societal implications of securities fraud during certain periods. A vibrant bondholder class action can provide a remedy for the worst shareholder excesses that harm the interests of corporate stakeholders. More should be done to ensure that the interests of bondholders are represented adequately in securities class actions, especially in cases where bondholders are the victims of a fraud that advances shareholder interests.

fact suffer losses from the fraud.

191. See 11 U.S.C. § 510(b) (2012).

Appendix:**Table A1. Characteristics of 19 Largest Bondholder Recoveries**

Issuer Name	Section 11 claims	Settling Defendants
Enron Corp.	Yes	Auditors; Underwriters; Directors
WorldCom, Inc.	Yes	Auditors; Underwriters; Directors Officers
Tyco International Ltd.	Yes	Issuer, Auditor, Officers
AOL Time Warner, Inc.	Yes	Issuer, Auditor
American International Group Inc.	Yes	Issuer, Auditor, Starr Defendants
McKesson HBOC, Inc.	No	Issuer, Auditor
Xerox Corp.	No	Issuer, Auditor
Lucent Technologies, Inc.	No	Issuer
HealthSouth Corp.	Yes	Issuer, Auditor, Underwriter
Adelphia Communications Corp.	Yes	Auditor, Underwriter
Waste Management, Inc.	No	Issuer
Qwest Communications International Inc.	No	Issuer, Auditor
Marsh & McLennan Companies, Inc.	Yes	Issuer
Global Crossing, Ltd.	Yes	Auditor, Underwriter, Chairman

2014]

BONDHOLDER CLASS ACTIONS

645

Delphi Corp.	Yes	Issuer, Auditor
Rite Aid Corp.	No	Auditor, CEO
General Motors Corp.	Yes	Issuer, Auditor
Williams Companies, Inc.	Yes	Issuer, Auditor
El Paso Corp.	Yes	Issuer, Auditor

Table A2. Various Summary Statistics for Cases Involving Bondholder Recoveries (1996-2005).

Characteristic	Number of Cases	% of Bondholder Recoveries (64 observations)
Section 11 Claim	30	46.9
Bankruptcy	30	46.9
Credit Downgrade	32	50.0

2014]

BONDHOLDER CLASS ACTIONS

647

Table A3. Identifiable Section 11 Bondholder Average Recoveries (not including attorney fees)

Issuer	Section 11 Recovery
WorldCom, Inc.	\$5,000,000,000
Tyco International Ltd.	\$250,000,000
HealthSouth Corp.	\$230,000,000
Conseco, Inc.	\$81,000,000
Delphi Corp.	\$54,000,000
American International Group, Inc.	\$50,000,000
Safety-Kleen Corp.	\$45,000,000
Livent, Inc.	\$33,000,000
Owens Corning, Inc.	\$20,000,000
Just for Feet, Inc.	\$17,750,000
Hayes Lemmerz International, Inc.	\$15,000,000
Thaxton Entities	\$9,500,000
Levi Strauss & Co.	\$5,000,000
MobileMedia Communications, Inc.	\$4,950,000
First Merchants Acceptance Corp.	\$3,000,000
Fleming Companies, Inc. (1996)	\$2,500,000
Refco, Inc.	\$221.09 per \$1000 bond
Fleming Companies, Inc. (2002)	\$35.61 per \$1000 bond
PMA Capital Corp.	\$20 per \$1000 bond
First Merchants Acceptance Corp.	\$18.90 per \$1000 bond
FirstEnergy Corp.	\$8.62 per \$1000 bond
Exodus Communications, Inc.	\$5.60 per \$1000 bond
Boston Chicken, Inc.	\$2 per \$1000 bond

**Table A4. Identifiable Rule 10b-5 Average Recoveries
(not including attorney fees)**

Issuer	Rule 10b-5 Recovery
TXU Corp.	\$15,000,000
Waste Management, Inc.	\$10,200,000
Hayes Lemmerz International, Inc.	\$10,000,000
Sears Roebuck & Co.	\$10,000,000
Motorola, Inc.	\$9,500,000
Lucent Technologies, Inc.	\$3,750,000 (plus \$4.6 million from common law claims)
Reliance Group Holdings, Inc.	\$33.25 per \$1000 bond
Northpoint Communications Group, Inc.	\$31.60 per \$1000 bond
Global Crossing, Ltd.	\$13 per \$1000 bond
Globix Corp.	\$8.29 per \$1000 bond
Winstar Communications, Inc.	\$7.85 per \$1000 bond
Collins & Aikman Corp.	\$6.50 per \$1000 bond
ViroPharma, Inc.	\$5.95 per \$1000 bond
Salton, Inc.	\$1.63 per \$1000 bond
Dollar General Corp.	\$1.07 per \$1000 bond