Federal Reserve and Junk Bond Financing: Anomaly Or Inconvenience?

William W. Barker
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THE FEDERAL RESERVE AND JUNK BOND FINANCING: ANOMALY OR INCONVENIENCE?

William W. Barker

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I. JUNK BONDS AND THEIR ROLE AS PART OF A LARGER SCHEME IN INNOVATIVE CORPORATE ACQUISITION FINANCING

A. Introduction—Increase in Corporate Takeovers

The last two decades have seen a dramatic increase in the unsolicited tender offer as an important weapon in the acquisition of corporate control. With this increase has come a notable trend toward “doing bigger and better deals” sometimes involving targets that are significantly larger and that have far greater capital than the acquiring corporation. Transactions now involve billions, instead of millions of dollars. Accordingly, a need has developed to raise

1. Greene, A Reappraisal of Current Regulation of Mergers and Acquisitions, SEC. L. Rev. 297, 300 (1985). In 1960 there were eight tender offers to acquire control of corporations with securities listed on national exchanges. By 1966 the number had increased to more than 100. In 1981 there were 123 such tender offers, and in 1982, 92 were reported. Id. at 300, n.3; see also, H.R. Rep. No. 1711, 90th Cong., 2d Sess. 2 (1968), reprinted in 1968 U.S. CONG. & ADMIN. NEWS 2811, 2812.
2. For example, these mergers occurred in the 1980s: 1984, Gulf/Chevron ($13.3 billion); 1984, Getty/Texaco ($10.1 billion); 1981, Conoco/DuPont ($7.4 billion); 1982, Marathon Oil/U.S. Steel ($6.7 billion); 1984, Superior Oil/Mobil ($5.8 billion); 1985, General Foods/Phillip Morris ($5.8 billion). Wall St. J., Jan. 2, 1986, at 6, col. 1.
3. Id.
4. See, supra note 2 (examples of mergers over a billion dollars include Mesa/Unocal, GAF/Union Carbide, Pantry Pride/Revlon).
large amounts of cash quickly. In response, raiders and others are continually developing new innovative financing techniques equal to the challenge. One device is popularly known as the "junk bond." A "junk bond" is a debt security sold to sophisticated private investors, who, unlike banks, brokers, and dealers, are not traditionally regulated by the Federal margin. The junk bond allows acquisitions to be financed by raiders with a limited capital investment. As a result, many have perceived an increase in corporate takeovers financed by junk bonds. A new interpretive regulation by the Federal Reserve would place junk bond financing under the Federal margin rules used to regulate banks, brokers and dealers.

B. Junk Bond Financing Prior to Federal Reserve Regulation

Prior to the new Federal Reserve regulation 207.112, a raider who had accumulated stock in a target, but did not have the capacity to finance an entire acquisition on its own, could raise capital to finance the prospective tender offer through the sale of high yield, non-investment grade securities, also known as "junk bonds." This type of financing is exemplified by the Mesa/Unocal transaction which is used as an illustration for the new regulation. The technique consists of a tender offer made through a shell corporation capitalized through the sale of junk bonds.

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5. The term "raider" signifies a concept of relative meaning. Some have used the term to create fear; attributing to it a boogie-man quality and suggesting the corporate raider as the individual newly designated to hide in the closets of corporate boardrooms: "Today there are those individuals in our financial community who seek to reduce our proudest businesses into nothing but corporate shells. They seize control of the corporation with unknown resources, sell or trade away the best assets, and later split up the remains among themselves." 113 Cong. Rec. 857-58 (1967) (statement of Senator Kuchel).


9. Typically, this accumulation will stop short of 5% in order to delay application of the Williams Act (15 U.S.C.A. § 78m(d)(1) (West 1982).

10. Regulation section 207.112 provides two examples illustrating the types of tender offers subject to regulation. The Federal Reserve emphasizes the fact that these examples refer to the Mesa/Unocal and Pantry Pride/Revlon tender offers, respectively. Fed. Res. Bd. Release 5-6 (Jan. 10, 1986) (on file at the Pacific Law Journal). The illustration relating to Mesa/Unocal follows:

(b) In the first situation, the acquiring company, Company A, controls a shell corporation that would make a tender offer for the stock of Company B, which is
The junk bonds are issued by a shell corporation, having no assets or business functions, but which serves as an investment vehicle for the takeover attempt. Because the shell has no assets, the bonds are unsecured. However, the risk is made acceptable to the investor primarily by a high interest rate and, to a lesser degree, handsome commitment fees as well as promises by the issuer to effect shelf registration. The securities are sold to sophisticated investors in large denominations through private placements. No equity is involved; therefore, from the perspective of the issuer, junk bond financing is preferable because it leaves a larger share of control and profit in the issuer's hands.

In this manner the raider has been able to raise, at an early stage, all the money needed to finance the tender offer. The advantages over other financing methods were twofold. First, the raider was not "at risk" for any of the amounts raised. Secondly, in contrast to a margin transaction, the raider was not limited to raising an amount which he could match by his own collateral. This resulted in the ability to finance extremely large takeovers. This development led some to question whether takeovers have been made too easy, especially those on a large scale. Certainly it has led management to

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margin stock (as defined in section 207.2(i)). The shell corporation has virtually no operations, has no significant business function other than to acquire, and hold the stock of Company B, and has substantially no assets other than the margin stock to be acquired. To finance the tender offer, the shell corporation would issue debt securities which, by their terms, would be unsecured. If the tender offer is successful, the shell corporation would seek to merge with Company B. However, the tender offer seeks to acquire fewer shares of Company B than is necessary under state law to effect a "short form" merger with Company B, which could be consummated without the approval of shareholders or the board of directors of Company B.

Id. 11. 12 C.F.R. § 207.112(b) (1986). M. Lipton and E. Steinberger, Takeovers and Freezeouts, § 1.0418 (1987) [hereinafter, Lipton]. Shelf registration makes the securities more freely transferable, hence more valuable in the hands of the holder. Id. The topic is developed more fully in later portions of the text.


13. Corporate Acquisition Ideas (P-H) at 1 (August 1986).

14. The SEC's Office of the Chief Economist has completed a study which found that although there are pronounced trends toward the use of junk bonds to finance takeovers, the absolute level of junk bond financing is less than what many believed. The study did confirm, however, that junk bonds are used most often in hostile takeover attempts.

According to the OCE, from 1981 to 1984 the most popular form of tender offer financing continued to be bank borrowing (78.6%), followed by internal funds and equity financing (21.1%). During those same years debt financing accounted for only 0.3% of financing ($200 million out of $65 billion). The OCE found a changing trend during the first half of 1985, however. During this period junk bonds accounted for 13.6% of financing ($2 billion out of
put pressure on Congress and the regulatory agencies to curb takeovers in general.\textsuperscript{15}

\section*{II. THE FEDERAL RESERVES ANTI-TAKEOVER REGULATION: 12 C.F.R. SECTION 207.112}

In response to petitions by entrenched management at Unocal Corporation and Revlon Incorporated, the Federal Reserve promulgated a regulation which, on its face, purports to change the previous regulatory scheme by bringing the Mesa/Unocal type financing transaction within the ambit of the Federal margin rules.\textsuperscript{16} In essence, the Federal Reserve accomplishes this result by considering these investors to be "lenders" and considering debt securities issued by a shell corporation to be "indirectly secured" by the stock of the target company and thus subject to the margin rules.\textsuperscript{17} With this change,

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\item \textsuperscript{14}\textsuperscript{7} billion).
\item Junk bond financing increased as the size of the offer increased. From October 1984 through July 1985, researchers found that junk bonds accounted for none of the 30 smallest offers, 0.6\% of the 30 median-sized offers, and 32.9\% of the 30 largest offers. \textit{See Corporate Acquisition Ideas, (P-H) at 6 (Sept. 1986); see also Fed. Sec. L. Rep. (CCH) [1986-87 Transfer Binder] 84,011 (Junk Bond Study).}
\item \textit{See} 15 U.S.C.A. § 78g-h (West 1982, Supp. 1985). One commentator explains margin trading thusly:
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The word "margin" has been judicially defined as collateral or security used in connection with the purchase of securities. Ordinarily, margin is considered to be the amount deposited by a purchaser of stock with his broker, being a certain percentage of the purchase price of the stock involved, the broker agreeing to advance the balance of the purchase price upon the condition that he be entitled to hold the stock purchased as security for his advance.

Trading on margin is normally accomplished by one of two methods. Using the first method, an investor will deposit a percentage of the purchase price with his broker in a margin account and the broker will lend the investor the remainder of the purchase price. The broker will then retain the purchased stock as collateral. . . .

The amount deposited by the investor at the time of purchase is the "initial margin" and the amount which must be maintained in accordance with a percentage of the market value is the "maintenance margin." Using the second method, an investor will borrow directly from a bank, finance company or other lender with no formal margin account being established.

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\item If not subject to the margin rules, the raider's takeover capacity is limited only by the amount of debt he is able to raise. Under the new rule, the raider must be able to raise from other sources at least 50\% of the funds to serve as margin security. \textit{See} 12 C.F.R. § 207.112 (1986). \textit{Cf. infra} notes 103-04 and accompanying text.
\item Regulation section 207.112 provides in relevant part:
\end{itemize}
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(c) The purchase of the debt securities issued by the shell corporation to finance the
junk bond investors are limited by the margin rules to financing only fifty percent of the tender offer. The remaining fifty percent must be put up, in cash, by the shell corporation as security on the loan. Under the new interpretation, the utility of junk bond financing has potentially been diminished where the tender offeror can not raise an equivalent amount of capital to that which was raised through the sale of junk bonds. If successful the burden would be most pronounced in very large tender offers, since as the size of the debt offering increases so too does the amount of money which must be independently raised by the tender offeror.

The Reagan administration, the Securities and Exchange Commission, and the Justice Department have expressed doubts regarding the validity of this new interpretation of Regulation G. The Securities and Exchange Commission and the Department of Justice have intimated that the new amendment is an indirect regulation of hostile takeovers which in practical effect benefits only the largest corporations. As such, the regulation raises serious legal and policy issues as to whether it exceeds the congressional grant of authority to regulate margin transactions.

A. The Federal Margin Restrictions

Section 7 of the Securities Exchange Act of 1934 sets out the basic statutory guidelines for margin regulation. The purpose of the statute is to prevent the excessive use of credit for the purchase and carrying of securities. The Act prescribes the margin percentages that exchange members, brokers and dealers may extend for the purchase of securities. Currently the Federal Reserve Board has set the margin rate at approximately fifty percent. Section 7(d) of the Exchange

acquisition clearly involves “purpose credit” (as defined in section 207.2(l)).

In addition, such debt securities would be purchased only by sophisticated investors in very large minimum denominations, so that the purchase may be “lenders” for purposes of Regulation G. Sec. 12 C.F.R. 207.2(h). Since the debt securities contain no direct security agreement involving the margin stock, applicability of the lending restrictions of the Regulation turn on whether the arrangement constitutes an extension of credit that is secured indirectly by margin stock.

20. Id.
22. Id. § 78g(b) (West 1982).
23. Id. § 78g(a)(1) (West 1982).
Act additionally authorizes the Federal Reserve Board to adopt similar provisions regarding the extension of credit by persons other than exchange members, brokers and dealers when the credit is extended for the purpose of purchasing securities.24

B. Regulation G

The Federal Reserve is authorized by 15 U.S.C. § 78w to create such regulations as are “necessary or appropriate” to implement the provisions of section 7. Regulation G is one such rule.

Regulation G extends the margin requirements to “lenders (other than exchange members, brokers, and dealers) who, in the ordinary course of their business, extend or maintain, . . . any credit for the purpose of purchasing or carrying any margin security, if such credit is secured directly or indirectly, in whole or in part by collateral that includes any margin security.”25 Once Regulation G applies, no lender falling within its parameters may extend or arrange for credit to purchase securities in an amount exceeding fifty percent of the purchase, or as determined by the lender in good faith.26 Typically, Regulation G has been applied to “mainstream” credit institutions such as banks. Prior to section 207.112, Regulation G had not been expanded to include individual investors purchasing junk bonds.

In concluding that the issuance of junk bonds by a shell corporation is properly regulated under the Federal margin rules, the Federal Reserve Board must have made the following conclusions: (1) that junk bond financing involves the type of credit transaction intended by Congress to be regulated under the margin rules; and, (2) that given the nature of the security, sophistication of the purchaser, and the junk bond market in general, an investor could reasonably expect his investment to be indirectly secured by the stock of the target corporation.

This article examines the validity, application, and scope of Federal Reserve regulation section 207.112, amending Regulation G to prohibit a shell corporation from debt financing more than fifty percent of a hostile corporate takeover. To this end, consideration will first be given to the general application and rationale behind the federal margin requirements. Secondly, the amendment itself will be examined to determine its specific limitations. Finally, consideration will

24. See § 78g(d) (West 1982).
25. 12 C.F.R. § 207.1(b) (1982) (Purpose and Scope).
26. Solomon, supra note 12, at ¶ 77,470.3.
be given to developing ways around the regulation, and the innovative reactions of the securities industry in developing alternatives which do not conflict with the new regulation.

III. CRITICISM OF THE FEDERAL RESERVE BOARD REGULATION

A. Background and Legislative History

1. Pre-margin Regulation Abuses

In the early 1930's, Congress, and a large portion of the rest of the United States, was of the belief that a major cause of the 1929 stock market crash and the ensuing Great Depression was excessive speculation in securities on credit. Prior to the enactment of section 7 of the Exchange Act, an investor with little or no collateral could obtain a large position in margin securities on credit arranged by a broker or third party lender. At any one time, the aggregate amount of credit extended to the market would vary with the volume of margin transactions. Given a fixed money supply, and the fact that the same lenders serviced both the securities market and mainstream loans to businesses, the system was thought to result in less money available for commercial loans and higher interest rates. A slight market downturn resulted in a significant impairment of bank security.

2. Legislative History

Both the statute and the legislative history make it clear that the margin rules were enacted primarily "for the purpose of preventing excessive use of credit in purchasing and carrying securities." A review of the legislative history clearly indicates that Congress was much less concerned with the individual than with the credit market as a whole.

27. S. JAFFE, BROKERS, DEALERS AND SECURITIES MARKETS, 327 (1977). This is so even though commentators have disagreed as to the ultimate cause. Id. (citing GALBRAITH, THE GREAT CRASH OF 1929, 174 (1954)).
29. 15 U.S.C.A. § 78g(a) (West 1982).
30. See id. This is not to say that there was no concern with investor protection but it is apparent that investor protection was not a dominant force. To this effect was a statement by Chairman Rayburn of the House Commerce Committee: "A reasonably high margin requirement is essential so that a person cannot get into the market on a shoestring one day
Because the Federal Reserve Board’s regulating authority is circumscribed by this statutory delegation of power, the new regulation raises two basic questions. The first involves determining whether the word “credit” is all-inclusive, or whether some differentiation between types of lenders is required. The second question relates to which creditors Congress intended to regulate, or whether all creditors were intended to be equally regulated in light of the purposes of the Exchange Act.

Congress seems to have been fairly explicit in its determination that not all credit transactions bear a relationship to the particular abuses to which the margin rules are addressed. The House Reports are particularly clear in addressing this point:

The underlying theory of the bill with respect to credit is as follows:
1. Without adequate control the too strong attraction of a speculative stock market for credit prevents a balanced utilization of the nation’s credit resources in commerce, industry, and agriculture;
2. To effect such better balance, all speculative credit should be subjected to the central control of the Federal Reserve Board...;
3. To achieve that control, the Federal Reserve Board should be vested with the most effectual and direct power over speculative credit, i.e., the power to control margins on the actual ultimate loans themselves.31

The House Report then delineates the purposes which it desired to be achieved by the margin rules:

The main purpose of these margin provisions... is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even the protection of the small speculator by making it impossible for him to spread himself too thinly—although such a result will be achieved as a by-product of the main purpose.

The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation’s credit

and be one of the sheared lambs when he wakes up in the morning.” 78 Cong. Rec. 7700, 8 (1934).

In contrast is a statement by Thomas Cochran, principal draftsman of the Exchange Act: “One [purpose] is to protect the lamb. Another, and probably the more important of the two, although it does not appeal to one’s human instinct as completely, is a protection of the National Business System from the fluctuations that are induced by fluctuations in the market, which in turn stems back to this very exquisite liquidity you get when you have a lot of borrowed money in the market. Hearings on Stock Exchange Practices, 73d Cong. 2d Sess. 6994 (1934) (statement of Thomas Cochran).

resources which can be directed by speculation into the stock market and out of more desirable uses of commerce and industry—to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained by far higher rates into security loans and the New York call market. . . 32

In light of this, Congress concluded that:

When margins are discussed with this main purpose in mind, differences between the collateral value of gilt-edged bonds and speculative stocks, the credit-worthiness of particular borrowers and similar considerations which have been urged as reasons why each loan should be treated as a particular problem in itself—considerations which affect not a general national credit policy, but only the safety of a particular stock transaction from the standpoint of a particular lender and particular borrower—are unimportant. 33

Thus, it is clear that the speculative nature of a particular issue was only intended to be regulated to the extent it impaired the national mainstream credit market.

3. Ultra Vires

In light of this policy, an examination of the credit and junk bond markets should illustrate that because of the bonds’ nature and the market’s definition, these rationales do not apply to the present regulation. The issuance of junk bonds neither affects the availability of credit to commerce and industry nor does it affect interest rates. Thus, the question is raised as to whether the Federal Reserve has acted ultra vires as has been intimated by the Justice Department and the Securities Exchange Commission. 34

In concluding that junk bond investors who buy in large minimum denominations are “lenders,” 35 the Federal Reserve assumes that all credit available either for junk bond purchases or for use in commerce and industry is drawn from the same “pool” of credit, and that it is equally available for either purpose. In fact this is not the case. Two different capital markets are involved, normal business capital and risk capital. These two capital markets are composed of two

32. Id. (emphasis added).
33. Id. (emphasis added); but see supra note 31 and accompanying text.
34. See supra note 19; see also infra note 41 and accompanying text.
35. 12 C.F.R. § 207.2(h); 207.112 (1986). See also id. § 207.3(a) (1982) (provides for registration).
distinct types of lenders, the "risk averse" lender and the "risk taker."\textsuperscript{36}

The junk bond market is composed of "risk takers," investors who are looking to invest only in speculative ventures which because of the higher degree of risk will yield a greater rate of return, i.e., a greater "risk premium." To the extent that these investors are seeking maximum return from their capital, the risk taker's funds are simply not available to the commercial or industrial borrower who will not pay more for the use of the risk taker's funds than for a commercial bank loan. Conversely, because the normal commercial loan venture is not "risky" enough for the borrower to justify the high interest which must be paid for the use of the risk taker's funds, the commercial borrower would not wish to borrow money from the risk taker.\textsuperscript{37}

Bankers, brokers, and dealers on the other hand are "risk averse" lenders. They will not normally wish to engage in risky transactions, and in fact are precluded from doing so by statute.\textsuperscript{38} Consequently, because of the lesser degree of risk, the cost of capital is relatively low in the commercial loan market when compared to the risk capital market. The "consumer" in this market would tend to be a relatively low risk, long range, and growth oriented commercial borrower, who is unwilling to pay an unnecessary risk premium.\textsuperscript{39}

From this it follows that junk bond financing should cause neither more nor less credit to be available for commercial and industrial purposes. Since Congress intended only to regulate mainstream lenders on whom commerce and industry depend for affordably priced capital, it makes little sense for the Federal Reserve to regulate junk bond purchasers as "lenders" simply because debt securities are purchased in large denominations. To the extent that the risk capital market does not overlap with the mainstream commercial lending market, there is no diversion of mainstream credit and Federal

\textsuperscript{36} Stevenson, Fundamentals of Investments 243 (1981).

\textsuperscript{37} Id.

\textsuperscript{38} See 12 U.S.C.A. § 24 (West 1945, Supp. 1987) (corporate powers of associations); 12 C.F.R. § 1.3(b) (1982) (defining "investment security"); see also Cal. Fin. Codes § 1335 (West 1977) (authorized investments), 1369 (West 1977) (legal investments of savings banks). Both state and federal law restrict a bank's purchase of securities to investment grade securities, excluding investments which are predominately speculative in nature. Junk bonds are non-investment grade securities and, consequently, an improper portfolio item for such institutions. See infra notes 50-51 and accompanying text.

\textsuperscript{39} Stevenson, Fundamentals of Investments 243 (1981).
Reserve interference is improper. Thus, the justification proffered by the Federal Reserve is, at best, tenuous.

For similar reasons it does not seem likely that junk bond financing would have an appreciable effect on interest rates. First, the Federal Reserve and the Treasury exert greater direct control over interest rates through their power to control the money supply and regulation of T-Bill sales, respectively, than do private market forces. Secondly, if it is assumed that interest also is a function of market demand for credit, then it must also be assumed that there exist two distinct capital markets. From this it follows that there are two independent demand curves, which again leads to the conclusion that the activities in the junk bond market would have no direct effect on interest rates for mainstream credit.  

B. "Indirectly Secured" by Margin Stock

Notwithstanding the regulation's inadequacy from a purely theoretical and policy perspective, fault may also be found with the conclusion that the bonds are indirectly secured by the margin stock of the target company. A loan is indirectly secured when the borrower's right or ability to dispose of the margin stock owned by the customer is in any way restricted while the credit remains outstanding. However, the loan is not indirectly unsecured where the lender has not relied upon the margin stock as collateral in extending or maintaining the credit.

The position taken by the Board of Governors is that historically "the Board has recognized 'indirect security' can encompass a wide variety of arrangements . . . where lenders do not have a conventional direct security interest in the collateral." The citation provided by the Board in support of this statement refers to a situation where loans were made to an investment company for purchase of securities to hold as part of its business. This reference only muddies already murky water.

40. Without support from either of these two rationales, it may be contended that the Federal Reserve regulation is ultra vires. While this may prove true in theory, the practical difficulty is in hurdling the administrative law barriers, which are beyond the scope of this topic. It might also be noted that an interpretive ruling is an important, but nonbinding agency opinion of how a statute should be viewed. Thus, on review, an interpretive ruling is much more subject to attack on its underlying principles. 3 Mezines, ADMINISTRATIVE LAW, § 15.07[3] (1977).

41. 12 C.F.R. § 207.2(f) (1987).
42. Id. § 207.2(f)(2)(iv) (1987); see also id. § 207.112 (1987).
43. Id. § 207.112(d) (1987).
44. 5 Loss, SECURITIES REGULATION 3276 (2d ed. Supp. 1969).
A review of one commentator's work indicates that the Federal Reserve conclusion on this point would be explainable where the lending institution was a broker, dealer or bank since the question of whether the lender has in good faith not relied upon margin stock is necessarily one of fact. While it would be inconsistent for a risk averse lender, such as a bank, to lend money without security to rely upon, such a result would be entirely consistent with a lower interest rate reflecting less risk in the case of a secured loan to the investment company. The high interest rates paid on junk bonds, on the other hand, are indicia of complete lack of security, direct or indirect, and therefore the same conclusion is not warranted in the case of junk bond financing.

The Federal Reserve's position on this issue ignores the fact that when an investor is a risk taker, it is completely consistent, even necessary, that he not rely upon margin stock as security given the risk premium offered in exchange for accepting unsecured debt. The key feature of the junk bond is in its high degree of risk and superior long term yield. Because of this, and in light of the highly sophisticated nature of the investor, it seems particularly anomalous for the Federal Reserve to take the position that the risk premium involved in a junk bond transaction is not due to the lack of security. This is, after all, why the securities are called "junk" bonds.

1. Technical Description of the Junk Bond Market

A technical description of the junk bond market is an integral part of the facts and circumstances which indicate that an investor may in good faith not rely upon the margin stock as indirect security. Junk bonds are high yield, fixed income debt securities which are rated below investment grade, although the particular characteristics of the bond are not invariable.

45. Id.
46. Id. (citing 54 Fed. Res. Bull. 439 (1968)).
47. 11 LORNE, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS, § 6.05[4] (1985) [hereinafter, LORNE]; Phillips, High-Yield Securities, Seventeenth Annual Institute on Securities Regulation, 85 (Prac. L. Inst. 1986) [hereinafter, Friedman]. This volume examines the full panoply of issues which may arise in a hostile takeover scenario. Written by, and for, investment bankers it presents a detailed and complex analysis of the area.
48. Friedman, supra note 47, at 71.
49. Variations on this scheme may include variable rates, exchangeability options, detachable warrants or other "equity kickers." LITLTON, supra note 11, at § 1.04[8]. See also Friedman, supra note 47, at 72.
Generally, the bonds are sold in minimum denominations of $1 million or more. The noninvestment grade status results from the fact that the bonds are unsecured and would be subordinate to hypothetical equity interests; there would also be no cause of action on the part of the holder in the event of default. As a result, junk bonds receive a rating from Standard & Poors of BB+ or lower, and a rating from Moody's of Bal or lower. Among other things this noninvestment grade status, by statute, precludes junk bonds from being a proper investment for some banks. Since junk bonds are unsecured, it stands to reason that the investors must be primarily interested in the quality and potential of management and the high yield, not the security provisions of the borrowing agreement. With respect to the foregoing, two additional points regarding the sophistication of the investor and the performance of the bonds, are significant.

2. The Junk Bond Investor

The high yield bond market has attracted extremely competent and sophisticated investors, even apart from their willingness to accept risk. One survey indicates that approximately 90%-95% of the purchasers of junk bonds are large institutional investors. Less than 10% of the remaining purchasers are individuals. Of these investors, all possess the requisite financial acumen and net worth to qualify for private placement and, presumably, the ability (either themselves or through their representatives) to understand the relationship between unsecured debt, risk, and the rate of return.

3. Superior Historical Rates of Return

It should now be clear that the nonrecourse nature of the debt is deemed acceptable by the sophisticated investor in light of the attractive rate of return. Over the last ten years junk bonds have enjoyed a cumulative rate of return of almost 250% compared to Fixed Income Funds (175%), Standard & Poors 500 (117%), and the

50. Friedman, supra note 42, at 72.
51. See supra note 38 and accompanying text (supporting the proposition that there are two distinct credit markets).
52. Friedman, supra note 47, at 72.
53. Id. at 83.
54. Id. (Insurance Companies and Pension Funds (65-70%); High Yield Mutual Funds (20%); Savings Institutions (10%); Individuals and Foreign Investors (less than 10%).
55. Id.
Dow Jones Industrial Average (61%). This is so notwithstanding the fact that the default rate of junk bonds (1.6%) is 16 times that of investment grade securities (.01%). Over 95% of this total return on a bond which has a 14% coupon and a twenty year life is provided by the payment and reinvestment of interest, not the return of principal. Thus, the analysis of the junk bond payout indicates that return of principal and security is merely a secondary consideration to the investor because of the extraordinary rate of return.

What little authority there is on this point at the present time has concluded that the situation has been taken out of context. First, given the sophisticated nature of the purchasers and their ability to assess and diversify risk, it would appear highly unlikely that they could reasonably look to anything other than the rate of return when buying the junk bonds. When presented with this argument, however, the Federal Reserve claimed it was unsupported by the introduction of evidence. Instead the Federal Reserve found, without convincing analysis, that there must have been at least partial reliance upon the margin stock. This conclusion is unwarranted since it completely ignores the separate capital markets, the concept of the risk/return trade-off and the lack of legal recourse in the event of default by the issuer.

Secondly, the principal purpose of raising funds from the sale of junk bonds is to acquire companies, not investment positions. The bidders' intent, invariably, is to cause the securities to cease being traded at all. Placed back into the context of a hostile takeover attempt, margin securities are not, therefore, the source to which the lenders are looking for repayment. They are looking to the assets and earning power of the historically undervalued target company.

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56. Id. A detailed financial analysis supporting the superior performance of junk bonds is beyond the scope of this article. The point to be emphasized is that from this performance, regulation by the Federal Reserve Board does not seem justified. Even if it were justified, other agencies are better suited to regulate in this area.

57. Id.

58. Id. (explaining the wider spread).


60. Lorne, supra note 47, at § 6.05[4].


63. See supra notes 35-47 and accompanying text.

64. Lorne, supra note 47, at § 6.05[4]; Friedman, supra note 42, at 85.

65. Lorne, supra note 47, at § 6.05[4].

66. Id.
The Federal Reserve's interpretive regulation, reflecting its belief that junk bond purchasers do rely on margin stock as collateral, does not accurately reflect these underlying considerations.

IV. THE OUTER LIMITS OF JUNK BOND REGULATION

The outer limits of junk bond regulation are circumscribed by self-imposed limitations by the Federal Reserve Board, and efforts by the securities industry to circumvent the Board's regulation.

A. Self-imposed Limitations

In effect, the Federal Reserve's regulation is limited in coverage to large-scale hostile takeover financing schemes involving shell corporations without significant assets and business functions, and without a guaranty from a parent company or other entity. Specifically, in purporting to limit the regulation to clarifying "indirect security" in the Mesa/Unocal type transaction (and thereby causing the margin rules to apply), the regulation sets forth four "safe harbor" transactions in which an investor could in good faith extend credit without looking at the margin stock for security.67

1. Agreed Upon ("Friendly") Mergers and Statutory ("Short Form") Mergers

The margin restrictions will not apply to debt financing of either "friendly" acquisitions or "short form" mergers.68 Of the four limitations, the exclusion of these two transactions appears to be more a matter of theoretical completeness than practical utility.

Part of the Federal Reserve's justification in concluding that the junk bond purchases were indirectly secured appeared in the finding by the Reserve Board that because of potential defensive measures by the target company, the margin stock must be retained by the raider for a "significant and indefinite" period of time depending upon which defensive measures are utilized and to what degree.69 In the Federal Reserve's view this constitutes a "practical" restriction on the ability to dispose of collateral, hence the transaction is

68. 12 C.F.R. § 207.112(f) (1987).
69. Id.
indirectly secured by the target's stock. Where there is an agreement to merge, however, there would presumably be no defensive tactics and, according to the Federal Reserve, no restriction upon disposition. However, in order to rely on this provision the merger agreement must have been concluded, at the latest, by the time the funds are advanced.

For similar reasons the short form merger is excluded from operation of the regulation. The short form merger exemption is even more limited than the exclusion for friendly mergers. First, it only applies where the tender offeror could obtain the statutorily required percentage of shares, up to 90% in some states. Secondly, because of the high percentage of shares required to effect a short form merger, this exemption is almost certainly limited to small or mid-sized companies and would not work well for large tender offers.

2. Operating Companies With Substantial Assets

Debt securities will not be subject to margin requirements when the issuer is an operating company with substantial non-margin stock assets or cash flow. The Pantry Pride/Revlon transaction demonstrates the basic scenario for this safe harbor exclusion. Section 207.112(h) uses the Pantry Pride tender offer as an illustration for this type of exclusion:

(h) In the second situation, Company C, an operating company with substantial assets or cash flow, seeks to acquire Company D, which is significantly larger than Company C. Company C establishes a shell corporation that together with Company C makes a tender offer for the shares of Company D, which is margin stock. To finance the tender offer, the shell corporation would obtain a bank loan which complies with the margin lending restrictions of Regulation U. Company C would issue debt securities that would not be directly secured by any margin stock.

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70. Id.; Fed. Sec. L. Rep. (CCH) ¶ 22,011.35; Loss, supra note 45, at 770 n.52. The point is, of course, debatable. As enacted the regulation applies to a transaction where “disposal of the security is in any manner restricted.” (emphasis added) 12 C.F.R. § 207.112(f) (1985). Here the Federal Reserve views a “practical restriction” as one of the prescribed ways disposition may be restricted. This is erroneous. For the most part a raider is free to sell the security—either back to the company, or to another person.


73. For example, the Mesa or GAF tender offers.

The Board is of the opinion that these debt securities would not be indirectly secured by any margin stock of Company D since, as an operating business Company C has substantial assets or cash flow without regard to the margin stock of Company D.

The rationale of the Board of Governors in excluding the Pantry Pride type transaction is that since the junk bonds are issued by a company with a history of ongoing business operations, it would be unreasonable to conclude that lenders are relying on margin stock of the target company, and not other assets, as the source of repayment. Although the Federal Reserve continues in its reasoning to ignore the indicia of completely unsecured debt the position taken by the Federal Reserve on this point softens the impact on the junk bond market by narrowing the definition of “shell corporation” to encompass only shells which do not have substantial assets and genuine business operations.

The question remains unanswered by the preceding example as to what figures will constitute “substantial assets or cash flow.” Because the Federal Reserve has referred specifically to tender offers by Pantry Pride and the GAF Corporation, some indications of specific parameters are available. Unfortunately, they are unofficial.

Pantry Pride/Revlon is the first example. Pantry Pride was an operating company with existing non-margin assets of approximately $400 million, net worth of $145 million, and annual income of only $110 million. Revlon, on the other hand, was a $2.4 billion company.

Revlon petitioned the Federal Reserve objecting that the $840 million sought to be raised by Pantry Pride could not be supported by their existing assets. This petition was later withdrawn before the Federal Reserve could comment. However, in a later release the Federal Reserve Board commented that a debt/book value ratio of 2:1, based upon the Pantry Pride figures, was thought to be sufficient.

76. See supra note 36 and accompanying text.
78. Id.
80. Id. The relevant portion of the article reads: “The Fed said that Pantry Pride, part owned by MacAndrews, was not a shell even though it had just $10 million in annual revenue when it acquired Revlon, which had $2.4 billion.” Id.
81. Fed. Res. Bd. Release 7, 19 (Jan. 10, 1986) (on file at the Pacific Law Journal). It is not clear as to the relative weight each figure is given. It is assumed that the primary figure would be asset value, given the concern for security.
assets to avoid the margin rules. Lower ratios, illustrated by the GAF/Union Carbide transaction in the next section, have also been held to be sufficient.\textsuperscript{82} 

3. Guarantees by Companies with Substantial Assets or Cash Flow

For the same reasons, a junk bond purchaser may, in good faith, not rely upon the margin stock of the target when the bonds are guaranteed by a company with substantial non-margin assets or cash flow.\textsuperscript{83} As an illustration the Federal Reserve cites the GAF/Union Carbide tender offer.\textsuperscript{84} GAF intended to control a shell acquisition vehicle issuing debt securities totalling $2.3 billion guaranteed by GAF. In this instance, GAF’s total assets and shareholders equity was $1.2 billion. This represented a ratio of 1.92:1, which the Federal Reserve stated was adequate.\textsuperscript{85}

A comparison of the Pantry Pride and GAF tender offers indicates that, at least for the time, a debt to asset ratio of as low as 1.92:1 would be acceptable to the Federal Reserve in avoiding application of the margin rules.

B. Exceptions and Industry Alternatives

The self-imposed limitations placed upon the regulation by the Federal Reserve may prove inadequate in certain situations. For example, in a very large tender offer by a very small company, it is likely that at some point the ratio of debt to security will climb to an unacceptable level. It is also possible that the potential risk involved would make giving a guarantee impractical. Furthermore, the quasi-safe harbor provisions of the preceding section are still somewhat uncertain and subject to change. Consequently, this section develops suggestions intended to facilitate junk bond financing without conflict with regulation section 207.112.

1. “Little Takeovers”

The federal margin rules do not apply when the target company’s stock is not “margin” stock.\textsuperscript{86} “Margin Stock” is not uniformly

\textsuperscript{82} See \textit{infra} note 85 and accompanying text.

\textsuperscript{83} 12 C.F.R. § 207.112(b) (1987).


\textsuperscript{85} \textit{Id.} Further inquiry might be made into what comparable standards of assets to debt are required by industry lenders.

\textsuperscript{86} Fed. Sec. L. Rep. (CCH) ¶ 22,011.35; Loss, \textit{supra} note 45, at 720 n.52.
defined. For Regulation G purposes regulation 207.2(i) defines "margin stock" to mean any registered equity security, OTC margin stock, National Market System security, debt convertible into margin stock, option or warrant to subscribe to margin stock, and certain registered Investment Company Act Securities.\(^{87}\) The purchase of privately held companies which are not traded over the counter and are not listed on the Board's periodically published list of OTC Margin Stocks are not margin stock and are not inhibited by the regulation.\(^{88}\) Thus, it is at least theoretically possible to finance one hundred percent of such takeovers through the sale of junk bonds.

Junk bond financing for takeovers of companies with non-margin stock is not desirable however. The practical reality is that if a security is not traded over the counter the company is probably too small to justify the cost of junk bond financing. Another reason is that due to the absence of a public market the acquisition of non-margin shares could not be accomplished feasibly by means of a conventional tender offer. Such a transaction, if completed, would have more characteristics of a "mugging" than a hostile takeover.

2. Publicly Offered Debt Securities

The margin rules do not apply to securities purchased with funds obtained through the sale of publicly offered debt securities.\(^{89}\) However, as originally proposed, regulation 207.112 did not differentiate between junk bond sales made by the usual private placement and those made through a public offering.\(^{90}\) The Federal Reserve's official policy behind this change of position was that purchasers on the secondary market may not have access to the disclosure statements and thus may not be aware that the proceeds from sale of debt securities would be subject to the margin rules.\(^{91}\)

Another, and perhaps more substantial, criticism of the new interpretation by the Federal Reserve is that it is contrary to the widely different goals of the federal margin rules established by the 1934

\(^{87}\) Id.

\(^{88}\) Under the Exchange Act of 1934, a company is not eligible to be traded over the counter unless it is a section 12 reporting company (15 U.S.C. § 781 (1972)). Registration under section 12(g)(1)(B) is required when there are more than 500 shareholders and assets in excess of $5 million. Registration is discretionary in other cases. 15 U.S.C. § 78l(g)(1)(B) (Section 12 of the Exchange Act of 1934).


\(^{90}\) See supra note 28 and accompanying text.

Exchange Act, and the registration requirements of the 1933 Securities Act.\textsuperscript{92} Whereas, the primary purpose of the margin rules is the protection of the national credit market,\textsuperscript{93} the goal of imposing registration under section 5 of the Securities Act is to insure adequate information in the market regarding the issuer. Since the operative registration and liability sections of the Securities Act\textsuperscript{94} contemplates a “disclosure system” rather than a “merit system,” it would seem that once an issue complied with the registration requirements of the 1933 Act, junk bonds should be subject to no further protective provisions relating to the soundness of the offering. The investor has had adequate information disclosed to him before placing his funds at risk.

According to the Federal Reserve, the proposal as originally conceived was directed at the nominal type of public offering utilized in the Pantry Pride/Revlon transaction.\textsuperscript{95} Pantry Pride had registered the securities with the SEC as a public offering, but sold the securities in minimum denominations of $2.5 million so that the transaction resembled a private placement.\textsuperscript{96} In declining to finally adopt the position that public and private offerings would both be subject to the margin rules, the Board also provided a somewhat ominous caveat. For the purposes of applying the margin requirements, prior staff decisions which stated that publicly offered debt securities are not subject to margin regulations were premised upon the assumption that these were \textit{bona fide} public offerings.\textsuperscript{97} In light of the federal policy behind the securities laws, this caveat by the Federal Reserve seems unwarranted.

Although it is unclear as to whether the Federal Reserve will ultimately have the authority to subject publicly issued debt securities to the margin requirements, the Board claims to have found support for this position in one case.\textsuperscript{98} For the time being however, the Board

\textsuperscript{92} These goals were not addressed by the Federal Reserve Board.
\textsuperscript{96} \textit{Id.}
\textsuperscript{97} \textit{Id.}
is content to place the matter under consideration to be dealt with in the context of a formal amendment to Regulation G.

3. Securities Industry Adaptations

The securities and corporate finance industry has always been very quick to adapt. In January of 1986, when the Board of Governors voted 3 to 2 to adopt the new interpretation, some supporters hailed the regulation as “shutting the door on hostile, junk bond takeovers.”99 Others forecasted a substantial disruption of the market.100 At that time the Justice Department stated that the proposal would lead to higher costs for acquiring firms; unequal treatment of competitors for corporate control; decreased market efficiencies for corporate control; and losses for shareholders of both acquiring and target firms.101

In August of 1986, seven months following the effective date of the interpretation, securities industry specialists were merely inconvenienced by the Federal Reserve’s interpretation. Some had gone so far as to say that the Federal Reserve’s Rule has “no effect” on financing hostile takeovers.102

In adapting to the change in regulatory climate, one response has been to issue half each of equity and debt.103 The equity however is a special type of “boutique” or “designer” stock; stock which looks and acts like debt, but counts as equity. When a merger agreement is reached, most of the equity stock can be converted into debt.104 The “equity” portion of the capital funds the fifty percent margin requirement, thus satisfying the regulation.

Another response has been to avoid regulation section 207.112 entirely by not using a shell corporation at all. Most deals do not utilize shell corporations in any event.105 This approach would be especially appropriate where “designer” equity stock is issued and which, by its terms, forecloses a right to bring a claim in the event of default.

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100. Id.
103. Corporate Acquisition Ideas (P-H), at 8 (Sept. 1986).
104. Id. Conversion is facilitated by the better investment terms of debt over the equity instruments.
Where it is desirable to use a shell corporation, a variety of approaches have been adopted to meet the "substantial assets or cash flow" and "significant business functions" requirements. First, an acquiring corporation may utilize one of its smaller subsidiaries to serve as the shell company. Alternatively, another approach utilized by some firms, such as Triangle Industries and MacAndrews & Forbes, has been to keep small companies at the ready for use as shell corporations in leveraged acquisitions.106

V. CONCLUSION

Federal Reserve regulation section 207.112 has not had the impact upon financing hostile corporate acquisitions which was feared at its inception. By limiting the application of the regulation to shell corporations without substantial assets and significant business functions, the Federal Reserve has foreclosed but one particular type of junk bond financing. Thus, if the Mesa/Unocal takeover attempt were to recur, subject to Regulation G, it could not take the same form, but it would occur nonetheless. Without the use of a shell corporation, issuance of "designer" equity stock would accomplish the same result. Alternatively, it would not be difficult to find a small operating subsidiary to serve, consistently with the new regulation, as the acquisition vehicle. Even assuming that investor protection was a legitimate and desirable objective of the margin rules, neither the equity investors nor the junk bond purchasers will have gained anything by the Federal Reserve's new interpretation, since the issuer and the purchaser remain free to agree that the investment is without recourse upon default. The same should be true where debt securities are sold through a public offering, despite warnings by the Federal Reserve to the contrary.

Notwithstanding the existence of financing alternatives, problems remain both from a statutory and an economic perspective. As envisioned, the Federal margin rules were designed to prevent the excessive diversion of credit, otherwise available for the Nation's commercial, industrial, and agricultural growth. As applied, however, the Federal Reserve's authority is being directed against a capital market which, unlike mainstream commercial banking and lending institutions, has nothing to do with the purpose. Moreover, from an investment analysis perspective, the concept of indirectly securing the

106. Id.
sale of junk bonds, especially in the context of a hostile takeover, is completely antithetical to the risk/return tradeoff. In light of this, perhaps the best approach would be to challenge the interpretive regulation as *ultra vires*.

At best, these inconsistencies in the new regulation give it the qualities of an anomaly. Two inseverable components create the essence of a junk bond: high risk and high yield. To the extent that one is a function of the other, a change to the unsecured nature of the junk bond, without a corresponding expectation of changes in the investment return, is completely irreconcilable. At worst, because innovative financing techniques already exist to circumvent the problem entirely, the regulation may be, for all practical purposes, irrelevant.