1937

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THE TRUSTEE AND THE TRUST INDENTURE: A FURTHER STUDY *

LOUIS S. POSNER†

The multiplication of court decisions and other legal literature dealing with the corporate trust deed attests the importance of the subject. In the past decade alone there have been more than twice as many decisions in this field than in the preceding half century. The cases deal in the main with the duties of trustees named in indentures and with the extent of the protection they derive from the exculpatory clauses normally included in such instruments. The extent of those duties and immunities has now been the subject of an elaborate investigation authorized by Congress, and of a considerable volume of public debate. The trust indenture has ceased to be altogether a matter of private contract; and a growing public concern in its content and structure may soon result in federal and state statutes regulating the process of draftsmanship.

The device of using a trustee under an indenture as part of the machinery for financing by widely held loans is comparatively new, though its lineage is ancient. Perhaps the earliest instance of its use is that

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* The author's earlier study, Liability of the Trustee Under the Corporate Indenture, was published in (1928) 42 HARV. L. REV. 198.
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1. The term “trustee under the indenture” is used synonymously with “trustee,” and “corporate trustee.” “Indenture” is used synonymously with “corporate indenture,” “trust indenture.” “trust deed” and “corporate trust indenture.”
2. SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE COMMISSIONS, PART VI, TRUSTEES UNDER INDENTURES (1936). The Commission is hereafter referred to as the “S. E. C.” and the report as “S. E. C. REPORT.”
of the Morris Canal Company deed of trust in 1830 to one Willink, a merchant of Amsterdam, to secure an issue of corporate bonds. It was not until fifty years later that trust companies generally entered the field, replacing the individual trustees, one or more in number, theretofore usually selected. But despite the relative recency of the device, the security issues represented in the United States by such trustees at the close of the year 1934 are estimated to have reached the huge total of $37,000,000,000.

In earlier days it was common practice to name an individual, at times an officer of the mortgagor, as the trustee to whom property was transferred to secure the corporate obligation; and this despite the fact that the interests of the officer-trustee were obviously adverse to those of the investor. In no sense was he regarded as more than a stakeholder or agent for the purpose of holding title. The device was then intended to serve only the convenience of the mortgagor who, seeking to satisfy his money needs out of the resources of investors at large, found it impracticable to transfer the security to numerous scattered and changing bodies of purchasers and thereupon adapted to that end the familiar device of transfer to a third person of property to be held for the benefit of others. But for the convenience thus afforded the mortgage might have been executed directly to all the bondholders, as was done in one case. Though denominated "trustee", the transferee was not regarded as such in the usual sense of the private trust relationship, with its high measure of devotion. His powers were few, as were his duties. When additional safeguard was sought beyond that effected by the officer-trustee there arose the practice of naming third parties who bore reputations for integrity and sound financial standing, and, judging by the frequency with which the same individual or individuals were so named, it may be assumed that for a time it was the vogue to choose them from an accepted group which enjoyed public esteem. But even then no duties were imposed beyond those of stakeholder.

4. See Smith, supra note 3, at 904.
5. For an analysis of the increased use of the corporate trustee in America, see J. G. Smith, The Development of Trust Companies in the United States (1928) Pt. II. In 1870, 28 out of 40 trustees were individuals, and 20 years later all but 2 out of 89 were corporations. Id. at 299-306.
6. 1936 Moody's Industrial, p. a 38 (Estimates of Securities Outstanding in U. S.) U. S. Treasury Dept., Statistics of Income (1933). This includes the outstanding corporate debt of railroad, utilities, industrials, financial and real estate (excluding non-corporate urban, real estate and farm mortgages) and federal land bank. In the 7 years, 1926-1933, there has been an increase in the corporate debt outstanding in U. S. of $14,095,000,000. See also N. Y. Times, Feb. 15, 1937, p. 27, col. 1.
7. Stetson, Preparation of Corporate Bonds, Mortgages, etc., in Some Legal Phases of Corporate Financing, Reorganization and Regulation (1917) 7.
With the growth in complexities of finance, and the inclusion of bankers, underwriters and security dealers in the transaction, indenture provisions were correspondingly multiplied until the instrument grew to be "the largest of all legal documents." With this development, the powers of the trustee grew, and its duties increased also, but not commensurably. To a great extent this limitation of the trustee's duties was the result of the inclusion in the indenture of exculpatory clauses, general and specific. Considerable impetus to the inclusion of such clauses is undoubtedly due to an early case which, in sweeping language, placed upon such trustees the full measure of fiduciary liability. In passing upon the nature of the trusteeship created by a deed of trust securing a railroad issue, the court in 1850 observed that "trusts of this complicated and public character" are "so entirely new that very little light can be gained from any analogy to other trusts"; and concluded that it was a trusteeship in the full sense of the private trust, so that fiduciary responsibility by judicial implication is "no less a part of the contract than its most express provisions."

The corporate trust indenture became a familiar instrument in the financial community without much judicial clarification of its various provisions. Business had outstripped the decisions. Then, suddenly, the courts were inundated with cases touching every function of the trustee and every part of the indenture. The law had not undergone a long, slow growth in the field, and there had been no legislation to mould the law to fit this widespread financial reality, no "adjustment of the legal system to the newer demands of a modern industrial state." The result was confusion. Courts utilized old concepts which did not fit and invented new methods of approach which in too many instances were fashioned for the particular case only. It was inevitable that the law should become in many aspects unpredictable and also that when decisions were reached the courts should be found to be in conflict. As a result, the indenture trustee has been treated to every variety of judicial description; some courts have viewed it as a full fiduciary; others have taken the position that the letter of the contract is the law of the trust; and indeed, even that a provision against liability for any act except wilful or gross negligence "merely expressed what a court of equity would hold in the absence of such a provision." In this conflict among rival legal theories the central figure remains the indenture trustee. It is of the essence of the device. The courts

9. See Draper, supra note 3 at 79.
are trying to describe the place of the trustee, in view of their recognition that even if its functions as stakeholder have been largely outgrown, the imposition upon it of the full fiduciary responsibilities of a private trustee cannot, under present indenture provisions nor in the light of the requirements of finance, be deemed practicable. As our discussion of the law proceeds, significant and realistic decisions will be noted on many phases of the subject. But these are far too few, and the need for clear definition, for change, is obvious if investments of the public at large are to be safeguarded. Legislation is essential at many points. The ensuing study is a necessary background to any discussion as to the character and scope of that legislation.

AUTHENTICATION

Authentication of bonds by the trustee is the invariable preliminary to issue. Its essential purpose is to protect bondholders against the contingency of over-issue. The trustee certifies or authenticates upon the bond that it is "one of the bonds described in the within-mentioned indenture." The indenture usually provides that authentication by the trustee shall be the conclusive and the only evidence that the bonds have been issued thereunder. Courts hold such a certification to import nothing more than that the bonds are those embraced within the transaction and are not counterfeit or issued in an amount in excess of that contemplated by the indenture. The trustee's certificate does not in any way concern the priority or quality of the security for, despite close proximity in space, the certificate is held not to relate in any way to any statements in the bonds with respect to the nature of the security, and no burden of investigation is imposed on the trustee. The legal effect of certification is merely an attestation of genuineness; so that even where it is provided that bonds are not to be valid until certified, they are nevertheless held to be obligations of the company where in fact they are genuine, although not certified. The negligible scope of liability arising from certification is illustrated in a Massachusetts case, where the trustee's certification incorrectly stated the date of the deed.

13. The Securities and Exchange Commission has made certain recommendations for appropriate legislative action. S. E. C. Report at 70. These are discussed at various points in the article.
14. The term "certification" is herein used synonymously with "authentication."
15. The accepted statement of the rule is to be found in Tschetinian v. City Trust Co., 186 N. Y. 432, 436, 79 N. E. 401, 402 (1906).
If the trustee drafts the instrument, it is liable only to the obligor, for its capacity as draftsman is held entirely distinct from that of trustee under the indenture. Green v. Title Guarantee & Trust Co., 223 App. Div. 12, 227 N. Y. Supp. 252 (1st Dep't 1928), aff'd 298 N. Y. 627, 162 N. E. 552 (1928).
of trust, and where the security consisted of an unrecorded chattel mortgage, incorrectly described in the bond as a First Mortgage. The trustee was held not liable. The discrepancy in date afforded no basis of recovery since no damage was thought to result from it. The court indicated that this result would have been the same whether the trustee did or did not have knowledge of these inaccuracies.

When specific facts are certified by the trustee, however, liability is clear if inaccuracy causes damage.\(^\text{18}\) It has been indicated that a trustee would be liable in fraud where its certificate included a statement setting forth the securities and mortgages and it knew that such securities had not been deposited.\(^\text{19}\) But even in the absence of such knowledge liability would follow as for negligence or breach of warranty, since the trustee is responsible to bondholders at least for the truth of what it specifically certifies. Hence, where the bond was certified as "one of a series of first mortgage bonds . . . secured by the deed of trust or mortgage within mentioned, executed and delivered by the Florida Railroad Company to . . . trustee" and no mortgage was ever recorded, the court declared the certification to be a warranty that the mortgage was a first mortgage, and liability was imposed.\(^\text{20}\) Present day certifications are more carefully worded.

If, as is usually the case, specified prerequisites to authentication are listed, the trustee has authority to certify only upon fulfillment of these prerequisites. Their absence places authentication beyond the range of the trustee's authority and subjects it to liability. The most recent instance of such liability is the New York case of Doyle v. Chatham & Phenix National Bank.\(^\text{21}\) Bonds had been issued which stated that they were secured by specified collateral. The indenture required the trustee to comply with the issuer's demand for certification if specified collateral were pledged with it. The trustee was authorized to require the obligor to furnish a certificate containing names and addresses of the makers of the collateral and other pertinent data, the certificate to be conclusive evidence to the trustee of all statements therein contained, and full warrant and protection to it for all action taken on the faith thereof.

Without having obtained such certificate, the trustee proceeded with the certification of the bonds and declared upon each that it was "one of the series described in the Collateral Trust Indenture mentioned therein." The collateral deposited was not of the character specified,

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\(^{18}\) Any ambiguity in additional matter included in the certification may be resolved by looking to the terms of the indenture. Cf. Walker v. Howell, 209 Iowa 823, 226 N. W. 85 (1929).

\(^{19}\) Sullivan v. Arkansas Valley Bank, 176 Ark. 278, 2 S. W. (2d) 1096 (1928).

\(^{20}\) Miles v. Roberts, 76 Fed. 919 (S. D. N. Y. 1896). The holding is weakened by the presence of conflicting interests of the trustee and by the palpable fraud involved.

\(^{21}\) 253 N. Y. 359, 171 N. E. 574 (1930).
and upon default and the subsequent insolvency of the obligor the trustee was held liable to the bondholders who had in good faith relied on the certification. The court indicated that the trustee had acted "beyond the scope of its authority,"22 that it therefore could not claim the benefit of the general immunity clause of the indenture, and that, having failed to obtain the stipulated certificate from the obligor, it must be taken to have assumed the risk that the collateral actually deposited was in fact of the character called for by the indenture.

Hence, there is in this formulation of the "beyond the scope of powers" doctrine, an indication that, even where a trustee has been prudent in investigating the character of the required collateral, when it departs from the indenture prerequisites of conformity it is liable as warrantor of such conformity to those who purchased in reliance on its certification.23 This implication of the doctrine, however, is limited by the court's use of the theory of negligent misrepresentation in justifying recovery.24 The doctrine, novel in New York in such a case, is that the trustee as one in a position of special responsibility, owed potential investors a duty of care in its conduct with respect to them,25 which was breached by the representation in the certification that the prerequisite conditions had been fulfilled.26 The court may have chosen to rely on this theory to avoid the apparent difficulty of spelling out a contract or trust relationship which existed at the time of certification between a trustee and unascertained cestuis,27 and which could be


24. "In not ascertaining that the securities deposited were not securities of the character named in the indenture, the defendant was guilty of negligence. In certifying the bonds as issued under the terms of the indenture it was guilty of negligently making a misrepresentation of fact." Doyle v. Chatham-Phenix Nat. Bk., 253 N. Y. 369, 380, 171 N. E. 574, 578 (1930).


27. "... It is obvious that a trustee, in wrongly certifying bonds to prospective takers, in order that they may become cestuis que trustent, cannot at that moment and before the relationship is established, have violated a trust duty owed to them." See Doyle v. Chatham & Phenix Nat. Bank, 253 N. Y. 369, 376, 171 N. E. 574, 577 (1930).
breached by unauthorized certification. Its use of that theory makes
the case indeterminate on the question of the degree of responsibility
attaching to the acts of a trustee outside the scope of his authority.
Since the recovery is for negligent misrepresentation, the duty being one
of due diligence rather than of warranty, the basis of liability may be
stated in the proposition that when conditions preliminary to certifica-
tion exist, the trustee by its certification represents that it has exercised
due care in ascertaining that these conditions have been fulfilled. How-
ever, the court undoubtedly recognized that liability on this latter theory
alone would have been precluded by the exculpatory clause had the acts
complained of not been found, additionally, to be "beyond the scope"
of the trustee's powers.

RECORDATION

The view that a trustee who certifies bonds secured by an unrecorded
mortgage is guilty of misrepresentation analogous to that in the Doyle
case has not been accepted by most courts, and a New York decision subsequent to the Doyle case indicates that the trustee may exonerate
itself from any such duty. The trustee's certificate in that instance read
"This is one of the notes secured by the within mentioned Collateral
Trust Agreement". The notes contained a recital that they were issued
under a collateral trust agreement "to which reference is hereby made
with the same effect as if herein fully set forth, which collateral trust
agreement is duly recorded and is a lien on all the property, plant, equip-
ment, and other assets of the company . . ." The agreement con-
tained the clause: "It shall be no part of the duty of the trustee to
record this instrument as a mortgage or conveyance of real or personal
property, or to file or record the same as a chattel mortgage, to refile
or renew the same, or to procure any further, other or additional in-
struments of further assurance, or to do any other act for the con-
tinuance of the lien of this indenture."

The bondholder sued the trustee alleging negligence in failing to
record. Although the narrow holding of the case is that the law of
Pennsylvania, which governed the transaction, imposed no liability in
such a case, the language of the court makes it clear that such also
is the New York rule. Apparently, then, in New York, recordation of
the trust instrument is not a duty implicit in the relationship, and the
obligation may be avoided by a clause specifically directed toward that
end. Possibly a more effective theory of the suit might have been mis-
representation in the trustee's certificate, rather than negligence in fail-
ing to record, for the trustee had certified the notes as being secured

v. Title & Guarantee Co., 292 Pa. 228, 140 Atl. 909 (1928).
by the "within mentioned" trust agreement, and the "within mentioned"
trust agreement recited that it was a duly recorded instrument, whereas
in fact no such recorded agreement existed. But it may well be doubted
whether, in view of the court's general language, such a theory would
have succeeded.29

In the exceptional cases where liability has been imposed for non-
recordation, the basis has been an inherent duty to record, viewed as
arising out of the trust relationship30 — either because the trustee was
the grantee in the trust deed31 or was the only one who could file the
mortgage.32 In the case last cited, the court declared that even the
exculpatory clause could not avail the trustee for failing to give the
bondholders this elementary protection.33

Comparable "inherent" duties, not set out in the indenture, are fre-
quently invoked to explain liability for "conduct of the trustee so
repugnant to the trust as to defeat its very purpose."34 The diversity of
situations in which an inherent duty to protect the trust has been en-
forced does not permit a generalized description of the concept. But
however uncertain the process of implying other inherent duties may
be, certainly failure to record a mortgage appears to be within every
test suggested for identifying such duties; if so fundamental an obli-
gation as a duty to record can be avoided by specific exemption, there
seem to be few activities which may not be similarly disclaimed.35

It is the importance of the subject in the light of the New York
decision, rather than the frequency of the problem, which explains the
recommendation of the Securities and Exchange Commission that the
trustee be made expressly responsible for failure properly to record
the instrument;36 for the question itself has come before the courts
in barely a half dozen instances during the past half century. There
will be little dissent from the Commission's recommendation that trustees
be given the duty to record, although it may be qualified by permitting the
trustee to rely on a certificate from an attorney of good standing

29. It may be that the court felt that absence of recordation affects only the quality
of the security and hence, the doctrine that the trustee's certificate does not vouch for
the quality of the security is applicable in this situation.
30. But cf. the doctrinal obstacle expressed in the Doyle case (note 27 supra) with
respect to inherent duties owed unascertained cestuiss.
252 (1st Dep't 1928), aff'd, 248 N. Y. 627, 162 N. E. 552 (1928).
33. Id. at 16, 227 N. Y. Supp. at 257. This dictum may, however, well be considered
disapproved by the Doyle case, or at least strictly limited to chattel mortgages.
34. See Harvey v. Guarantee Trust Co., 134 Misc. 417, 426, 236 N. Y. Supp. 37, 51
(Sup. Ct. 1926).
35. See p. 788, infra.
36. S. E. C. REPORT, at 70.
and of its own choosing, stating the place and date of each recordation and his opinion that the same is due compliance with the recordation statutes affecting the property embraced in the indenture.

APPLICATION OF PROCEEDS

The flotation process of which the corporate trust indenture is part contemplates that the borrower will absorb the proceeds of bond sales for its special needs, which are usually set out in the circular inviting investment; and the inclusion of such a specification of purpose is mandatory under the Securities Act of 1933. That the borrowed money should actually be used in the way indicated in the indenture is plainly of utmost importance to the investor.

The provision, common to corporate indentures, that the trustee is under no obligation to look to the application of proceeds, is enforced by the courts, unwilling to require trustees to supervise the internal affairs of the issuer; nor has the trustee any responsibility in the absence of such a provision, for it is under no obligations except those expressly assumed as to the manner in which the proceeds are applied. The usual provision directs the trustee not to certify or issue bonds either to the public or to the obligor except on receipt of a specified certificate. This may, for example, be the certificate of an accountant, engineer, architect or lawyer, or the written request by the obligor specifying the proposed use of the proceeds to be received — the proposed use being in the class sanctioned by the indenture; or it may be, as condition precedent to the issuance of new bonds, a certificate by the Board of Directors that an amount equal to the proceeds of new bonds has been actually expended by the obligor for extensions and permanent improvements; or that other bonds have been retired.

41. Where there is doubt as to the exact requirements with respect to prerequisite conditions, the most reasonable construction consonant with adequate protection of the security should be adopted. Thus where an engineer’s certificate that ten miles of road had been completed was necessary, this was held to mean ten miles in total, and not a continuous stretch. The bondholders would be as adequately protected whether there was one continuous line of twenty miles or two lines of fifteen and five miles. Denver & Rio Grande Ry. v. United States Trust Co., 41 Fed. 720 (S. D. N. Y. 1890).
42. See Polhemus v. Holland Trust Co., 61 N. J. Eq. 654, 656, 47 Atl. 417 (1900).
When the proceeds are to be employed to remove a prior incumbrance and the trustee is the direct recipient of these proceeds, its duty is interpreted by many courts to be as highly fiduciary as consistency with the words of the indenture will permit. Thus, for example, a trustee who had charge of the sale of the bonds and the application of proceeds was held negligent in adopting a plan of paying off the prior indebtedness piecemeal when the condition of the plant did not justify such a procedure and the final result was loss of the proceeds because of foreclosure of the unpaid balance of the prior lien. Here, in a decision strikingly unlike those reached in certification cases, the heading on the bond and statements contained therein were considered of importance. It is clear that in refunding prior liens or discharging other specified indebtedness, or applying proceeds toward the acquisition of specific property, the trustee should be under a duty to investigate and ascertain the facts. These are matters easily found out and the trustee's duty should be one of maximum protection.

Where, however, the proceeds are applicable to the construction of railroads, buildings, plant improvements, and the like, certificates in the usual manner, authenticated by architects, engineers, accountants and others possessed of the required knowledge should suffice. In construction work the architect's certificate may require a showing of the amount due contractors for labor and materials, the statement that the balance on hand is sufficient to complete the building, a sworn statement by the contractors in compliance with the lien law and an agreement by them to release liens upon the payment of the balance due on their contracts. Courts are alert in protecting bondholders in this situation. But it cannot be expected, and the courts have recognized this fact, that the trustee shall enter into the business affairs and detailed operations of the obligor to the extent that would otherwise be necessary, and reliance upon such certificates is the customary and practical procedure in such cases. Nevertheless, in instances where such certificates are to be submitted only by regular employees or officers of the obligor corporation, indentures should require the additional protection, not always provided for, that confirmatory certificates be furnished to the trustee by independent sources acceptable to it.

The trustee's liability for issuing bonds without receipt of the required certificate or upon a non-conforming certificate seems clear. Such liability could be based upon the ground that the trustee had acted

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44. Stuhr v. Yakima Valley Bank & Trust Co., 149 Wash. 400, 271 Pac. 82 (1928).
46. See Union Indemnity Co. v. Aeolian Co., 153 Miss 339, 346, 121 So. 123, 125 (1929).
"beyond the scope of its authority," conduct deemed inaccessible to the exculpatory clause, or had been guilty of gross negligence, or negligent misrepresentation.

In Rhinelander v. Farmer's Loan and Trust Co., the required certificate was said to be a covenant only between the mortgagor and the bondholders so that the trustee assumed no contractual duty to bondholders, express or implied, with respect to this phase of the transaction. Nevertheless, in that case and in Frishmuth v. Farmer's Loan and Trust Co., involving similar facts, the court indicated that the trustee might be held liable to bondholders on a different theory. In authenticating and issuing the bonds with knowledge that the funds previously turned over in the same transaction had been misapplied the trustee was said to have violated an implied duty, inherent in the relationship between trustee and bondholders, to see that the only assets then available to protect the security should be acquired, or failing that, to refuse to issue bonds unless ordered to do so by the court.

"... The duties assumed by one to whom a railroad mortgage is made for the benefit of bondholders are not those only which are defined by the terms of the instrument. Others are superimposed upon the trustee, created by the relation of the parties and the situation of the trust fund. ... When the mortgage debt is amply secured, the duties of a trustee are ordinarily merely nominal until a default occurs in complying with the conditions of the mortgage. In this case, however, the security was practically in nubibus at the inception of the trust, and was to be created by the cooperation of the defendant and the Oregon Company. ... While its terms exonerate the trustee for a misapplication after it has delivered the bonds or proceeds to the Oregon Company upon orders of the requisite character, they do not absolve it further. They certainly do not protect the trustee in delivering bonds or proceeds which it knows, or has reason to believe, are not to be applied properly."

These two cases have often been taken to support the view that there are inherent fiduciary duties, implicit in the relationship of trustee and bondholder, and distinct from the duties covered by the indenture. But such duties have rarely been enforced in cases where the trustee has conducted itself in a manner not otherwise violative of the provisions

49. 172 N. Y. 519, 65 N. E., 499 (1902).
50. 95 Fed. 5 (S. D. N. Y. 1899).
51. Id. at 89.
of the indenture.\textsuperscript{52} And in these two cases the trustee authenticated and issued bonds without obtaining the certificate conforming to indenture requirements. Liability could well have been based upon the narrower negligent misrepresentation and "beyond the scope of powers" theories of the Doyle case, if not upon gross negligence alone.

But the language of the court in the Frishmuth case is none the less significant in that it indicates that the receipt of a proper certificate may not avail the trustee where it knows that the certificate does not attest a true state of facts. Apparently, express permission to the trustee to act upon a certificate of compliance with specified conditions as to application will not suffice where it knows the proceeds have been misapplied and that future application in the proper manner has been made impossible, or, at least, highly improbable.\textsuperscript{53}

\textbf{RELEASE AND SUBSTITUTION OF SECURITY}

When the trustee is called upon to release or permit substitution of collateral, it is again confronted with the problem of determining whether the letter of the indenture is the limit of its duties or whether, as in some instances, the fact that it is a fiduciary imposes duties beyond the contract and unqualified by its exculpatory clauses.

When the bonds are paid in full the trustee must, of course, return the collateral to the obligor.\textsuperscript{54} It would, however, be a violation of elementary duty to allow such a return of collateral before payment, and the trustee's liability to bondholders for resulting damages would be clear.\textsuperscript{55} Indentures not infrequently provide that the obligor shall

\textsuperscript{52} See p. 788, infra.
\textsuperscript{53} Cf. Patterson v. Guardian Trust Co., 144 App. Div. 863, 129 N. Y. Supp. 807 (3d Dep't 1911), (perhaps the furthest step taken by a court in denying the protection of a certificate as to application of proceeds).

\textsuperscript{54} There may be some collateral consequences of the trustee having power to return collateral after satisfaction of the obligation. Thus in Hall v. Goldsworthy, 136 Kans. 247, 14 Pac. (2d) 659 (1932), it was an element tending to show that payment to the trustee discharged the obligor. And see Harvey v. Guaranty Trust Co., 134 Misc. 417, 236 N. Y. Supp. 37 (Sup. Ct. 1929), aff'd without opinion, 229 App. Div. 774, 242 N. Y. Supp. 920 (1930), aff'd per curiam, Crane, J., dissenting, 256 N. Y. 526, 177 N. E. 125 (1931).

\textsuperscript{55} Lennartz v. Estate of Peter Popp, 118 Ill. App. 31 (1905); cf. Adler v. Interstate Trust & Banking Co., 166 Miss. 215, 146 So. 107 (1933). Where some of the bonds cannot be located, the trustee is not justified in releasing the security unless payment of such bonds is provided for, (Harvey v. Guaranty Trust Co., 134 Misc. 417, 236 N. Y. Supp. 37 (1929)), or unless a new mortgage is executed to secure their payment. (Lehman Mfg. Co. v. Jewett, 90 Ind. App. 12, 168 N. E. 46 (1929). Good faith on the part of the trustee is not material in this connection. But cf. Browning v. Fidelity Trust Co., 230 Fed. 321 (C. C. A. 3rd, 1918), where the indenture expressly prohibited a release during default, the exculpatory clause limiting the liability to gross negligence enabled
have the right, before maturity, to withdraw part of the collateral on specified conditions, with or without replacement or substitution. Replacement or substitution is common when the business of the obligor consists of buying and selling the precise type of property which constitutes the collateral,69 or where, as a concomitant of the obligor's duty to maintain the collateral at a minimum total value, obsolescence or decrease in value make substitution essential, or where there is a provision for withdrawal of defaulted securities.68 It must be apparent that such provisions are avenues through which the interests of bondholders may be seriously jeopardized.69

The trustee's liability is clear even in the absence of gross negligence, fraud or conspiracy where withdrawal or substitution is permitted without indenture authorization.66 Nor may trustee waive any of the protective features of the indenture and thus effect an indirect release of the security.67 On the other hand, where protection of the bondholder's interests requires it, equity may step in and permit a trustee to take such action as the exigencies demand, although that action is not sanctioned by the

the trustee to escape liability for permitting such withdrawal. The result is questionable.

Even if the security remains intact after release, the rights of intervening parties will oust the bondholder. In Brooks v. Hudson, 175 Wash. 246, 27 P. (2d) 111 (1933), the court pointed out that although the recorded trust deed put third parties on notice, it also informed them that the trustee was the accredited representative of the bondholders and was empowered by the trust deed to satisfy the lien of the indenture without the production or cancellation of the bonds. In Harvey v. Guaranty Trust Co., 134 Misc. 417, 236 N. Y. Supp. 37 (1929), the court held that the bondholder's rights were lost where the property released was sold and thereafter made subject to a new mortgage securing an issue of bonds bought up by innocent purchasers.

56. Similarly, it may be a single rather than a continuing business need. Thus, it may be necessary to execute the release of certain of the mortgaged property in order to lease the same. Cf. Lehman v. First National Bank, 189 Ark. 604, 74 S. W. (2d) 773 (1934), where such a release was cancelled and the land was again made subject to the deed of trust, because the release was induced by the fraudulent misrepresentation of the mortgagor.


59. See, e.g., the provisions of the Krueger & Toll Indenture (International Match Co.), which led to such serious losses to bondholders. The certificate of the obligor as to eligibility of substituted securities was sufficient; equality in par value was sufficient to permit substitution, the 120% ratio of security to indebtedness was required to exist only at the time of substitution and at no period thereafter, and there was no limitation upon the identity of the Government whose securities were substituted, except that the population it governed had to exceed 300,000. See S. E. C. Report at 17 and Hazard v. Chase National Bank, 159 Misc. 57, 287 N. Y. Supp. 541 (Sup. Ct. 1936).

60. Richardson v. Union Mortgage Co., 210 Ia. 346, 228 N. W. 103 (1929).

61. In Guaranty Trust Co. of N. Y. v. Minneapolis & St. Louis R. R., 36 F. (2d) 747 (C. C. A. 8th, 1929) the trustee was said to have no power to enter into a closure
strict terms of the agreement. Thus, where the indenture required that the mortgages deposited with the trustee should be whole mortgages not exceeding 60% of the appraised value of the underlying security, equity permitted the trustee to accept senior participating shares in any mortgage owned by the obligor to the extent of 60% of the appraised value of the property, regardless of the relationship between that value and the amount of the debt secured by such mortgage. Likewise, where the terms of a trust agreement called for a sale of the securities in the event of a default, and the distribution of the proceeds to participating certificate holders, the court permitted, instead, a pledge of the securities with the Reconstruction Finance Corporation—the latter having agreed to grant a loan which would make possible a substantial distribution to the security holders, on condition that it be given full control of the liquidation and handling of the securities.

Distinction must be drawn between cases imposing liability upon a trustee for permitting withdrawal or substitution without indenture authorization and those refusing to compel a trustee to permit a requested substitution or withdrawal even though in the form sanctioned by the indenture; a case of the latter type is by no means authority for a statement that the trustee in like circumstances would have been liable to the security holders if it had acquiesced in the obligor's demand. In a New York case, Prudence Co. v. Central Hanover Bank & Trust

agreement which would have the effect of depriving the bondholders of the benefit of an after-acquired property clause in a mortgage which contained a provision that property, acquired after all bonds were sold or disposed of, should not come within the lien of the mortgage. A closure agreement, intended to close the issue of bonds under the mortgage and to cancel the unissued bonds was held not to create a situation in which all the bonds were “sold or disposed of.” But the court indicated that if it had, the bondholders would not have been bound by the agreement—for the trustee's acts in this respect were ultra vires. Thus, this was a case of action beyond the scope of powers in the very strictest sense, for here the trustee had no power to change the legal relationships of the bondholders and third parties with respect to the security.


63. New Jersey National Bank & Trust Co. v. Lincoln Mortgage & T. G. Co., 105 N. J. Eq. 557, 149 Atl. 713 (1930). See also New York State Rys. v. Security Trust Co. of Rochester, 135 Misc. 456, 238 N. Y. Supp. 354 (Sup. Ct. 1929), aff'd without opinion, 228 App. Div. 750, 238 N. Y. Supp. 887 (1930), where the court said that even if the trust agreement could be construed as prohibiting the mortgagor from discontinuing an unprofitable branch of the system, it would be so useless and oppressive a construction as to constitute a proper basis for the application of the equitable powers of the court, for a court of equity will not enforce an agreement where the conditions have changed so as to frustrate its purposes.

64. Seigle v. First National Co., 90 S. W. (2d) 776 (Mo. 1936).

65. A release of collateral may not be insisted upon by the obligor while it is in default, even though this limitation does not expressly appear in the indenture. First Trust Savings Bank v. Bitter Valley Root Irrigation Co., 251 Fed. 320 (D. Mont. 1918).
the trustee insisted that the protective purposes of the security required it so to interpret the indenture prerequisites of withdrawal as to take into account the actual value of the collateral regardless of the express indenture provision that the collateral was to be valued, for purposes of withdrawal, at a stipulated percentage of its face value. Original deposits of securities, consisting of mortgages on real estate, were to be acceptable provided their principal amount did not exceed 75% of the actual value of the underlying realty. Presumably such values originally existed. In the determination of value for purposes of withdrawal, however, such mortgages and other securities of the type designated were to be taken at 83-1/3% of the face or principal amount thereof due and unpaid, all excess of deposits and accumulations beyond the percentage thus calculated being subject to withdrawal. The obligor conceded at the time of the requested withdrawal that the serious general decline in realty values had so affected the deposited mortgages as considerably to reduce their original 25% margin of security; nevertheless, it sought withdrawal of the surplus calculated on the basis of 83-1/3% of face value. The court in substance held, though this was expressly provided for nowhere in the indenture, that the original 75% ratio of value must continue in fact, if withdrawal was to be permitted, else the security would be seriously impaired. The court in effect disregarded the arbitrary standards of the indenture in arriving at its result, although it did rely on ambiguities found in that instrument. Whether the trustee in the Prudence case would have been held liable if, knowing of the destruction of the original actual value ratio, it had nevertheless released in conformity with the indenture provisions, is a question upon which no court has directly passed; manifestly the trustee’s awareness avoided serious embarrassment.

In perspective, the Prudence case may properly be considered a stepping-stone to the later decision in Hazzard v. Chase National Bank. In the former case the court refused to accept an arbitrary definition contained in the indenture of a criterion of action for the trustee; in the Hazzard case any criterion short of reasonable prudence was challenged. The court indicated that a release by a trustee, though in accordance with the indenture criterion, would be held negligent if the trustee knew that the substitution was such as prudence would not countenance; but it did refuse to hold the trustee in that case liable, on the ground that his conduct was not so grossly negligent as to overcome the force of the exculpatory clause.

66. 261 N. Y. 420, 185 N. E. 687 (1933).
As is the case with the performance of other of the trustee's functions, indentures usually provide that the trustee shall be protected in releases or substitutions if certain conditions prerequisite thereto are shown by a certificate, filed with it, which sets forth that these conditions exist. The certificate may refer to some past or presently existing state of things, or may vouch for the obligor's intention to apply the proceeds of released security, cash or property, as the case may be, either to some specified purpose or to acquire other property to be turned back to the trustee as part of the security.

In general, the receipt of the prerequisite certificate serves to protect the trustee. The result is to the contrary, however, if it releases upon a certificate which on its face shows that the prescribed conditions do not in fact exist. And while it is not clear that a trustee is required to go behind the declarations of such a certificate if its knowledge of facts merely raises doubt of the accuracy of such declarations, actual knowledge of the non-existence of the certified conditions should certainly preclude the trustee from releasing property.

A preferable statement of the rule would seem to be that the trustee is empowered to act on the happening of certain contingencies of which the certification is, in the absence of actual knowledge to the contrary, conclusive evidence, rather than that the certificates themselves are the sole prerequisites. For, the latter view would, if there were a conforming certificate, exonerate the trustee even though it acted with reckless indifference to a contrary state of affairs known to it.

A closely related issue considered in the cases on withdrawal of security concerns the trustee's obligations in respect of withdrawal of security in situations in which the specific conditions precedent are in fact present, but where other factors, known to the trustee, also exist, and indicate that the proposed withdrawal or substitution of security will be destructive of the bondholders' protection. If these other factors are so compelling as completely to overcome the importance of compliance with the specified criterion, reliance upon the latter is unlikely to save the trustee from liability. Thus in the Hazzard case, the court stated that despite actual existence of the conditions set forth in the conforming certificate, if the trustee knew that the security sought to

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68. Query whether the trustee is under a duty to follow proceeds of the sale of security released on such a certificate and which the obligor does not employ according to his voucher. Though there is no conclusive holding on the subject, analogous cases would seem to indicate that in not taking action against the obligor it is not violating a duty to the bondholder. Cf. Central Hanover Bank & Trust Co. v. Ulster & Delaware Ry. Co., 153 Misc. 612, 275 N. Y. Supp. 524 (Sup. Ct. 1934).

be substituted had no value at all, an inference of gross negligence might have been drawn.

This view seems unexceptionable. While, in the usual situation, the trustee should be permitted, as heretofore, to rely upon strictly con-
forming certificates, protection of the security in cases of release and substitution must be recognized as one of the primary purposes which indenture provisions should serve. So far as may be, appropriate criteria in this respect should be prescribed by law or regulations under S. E. C. and perhaps also state auspices. To the usual certificates of compliance should be added supporting certificates of disinterested experts. Such certificates should be filed with the S. E. C. as public documents, as well as with the trustee. Bondholders can thus be protected to a reasonably adequate extent, and to the full extent consonant with the continued existence of the trustee device in its contemporary form. It may be that situations will arise where the prescribed criteria prove inadequate. Such situations are not likely to occur frequently; when they do arise, further regulations may be indicated. When the trustee is in doubt as to the propriety of the action requested by the obligor, and there are no applicable regulations, it should be required to refuse the substitution or withdrawal, thus, in effect, allowing the court to decide the propriety of the release requested, as in the *Prudence* case.

**PRESERVATION OF SECURITY AND REIMBURSEMENT FOR EXPENDITURES THUS INCURRED**

But even the most conscientious observance by the trustee of its duties, express and implied, with respect to release and substitution of collateral may not of itself maintain the integrity of the lien throughout the life of the transaction. Total or partial destruction of the mortgaged property, if uninsured, or the interposition of a prior lien for unpaid taxes, assessments, ground rent, necessary repairs, and the like may menace the protective value of the security. It is common, therefore, to find the trustee empowered, expressly or impliedly, to take appropriate steps in such cases to preserve the value of the security. For expenditures thus incurred the trustee is entitled to reimbursement. Whether a particular expenditure is an expenditure necessary to protect the security is sometimes doubtful. It is clear that trustee's advances for taxes and insurance are within the category, while advances to

70. See p. 797, infra.

meet payments of principal and interest due from the obligor are not. 72
Reimbursement for expenditures incurred in protecting the security is
usually assured by permitting the trustee a lien prior to or coextensive
with that of the mortgage. 73

The indenture is rare that does not expressly authorize advances by
the trustee upon failure of the obligor to pay taxes and insurance, or
other sums necessary for the preservation of the estate, with the right
of the trustee to a lien therefor. 74 Two recent cases handed down by the
same court in the same day have, however, indicated that the trustee
may find itself an unsecured creditor of the obligor notwithstanding strict
compliance with the specific powers granted. The defendant executed
a trust deed which permitted, but did not require the trustee to advance
money, in the one case 75 for taxes and ground rent, and in the other 76
for taxes and insurance. To secure reimbursement the trustee was to
have a lien, in the former case prior to, and in the latter on a parity
with, the lien of the trust deed. In all material respects the relationship

72. First Trust Co. v. Ricketts; Marshall & Ilsley Bank v. Hackett, Hoff & Thier-
man, Inc., both supra note 71. Such advances are considered simply as loans by the
trustee to the mortgagor unless there can be found in the transaction an intention on the
part of the bondholder to sell, and on the part of the trustee to purchase, the bond or
coupon so paid by the advances. Ketchum v. Duncan, 96 U. S. 659 (1877); Wood v.
Guaranty Trust Co., 128 U. S. 416 (1888); First Trust Co. of Lincoln v. Carlsen,

73. Taylor v. Davis' Admx, 110 U. S. 330 (1884); Hadley Bros.-Uhl Co. v. Scott,
93 S. W. (2d) 276 (Mo. App. 1936). In American Security & Trust Co. v. Hardee, 77
F. (2d) 382 (App. D. C. 1935) and First National Bank of Boston v. Proctor, 40 F.
(2d) 841 (C. C. A. 1st, 1930), it was held that for advances made to pay taxes the
trustee is subrogated to the prior lien of the taxing authority. And see New York

Where a receiver of the obligor is in possession and collects rents while failing to pay
taxes, the trustee is entitled to a prior lien against such rents to the extent necessary to
reimburse the trustee for taxes paid by it and which accrued during the period of re-
ceivership; the taxes are a charge against the receivership. The lien on rents and
profits is not properly applicable to any other charges, nor to taxes which accrued prior
to the receiver's possession. American Security & Trust Co. v. Hardee, 77 F. (2d)
382 (App. D. C. 1935); Dick & Reuteman Co. v. Hunholz, 213 Wis. 499, 252 N. W. 180
(1934).

74. E.g., Hadley Bros.-Uhl Co. v. Scott, 93 S. W. (2d) 276 (Mo. App. 1936); Fleener v.
Omaha National Co., 267 N. W. 462 (Nebr. 1936); Smith v. Massachusetts
Mutual Life Ins. Co., 116 Fla. 390, 156 So. 498 (1934); McManus v. Temple Estate

75. Marshall & Ilsley Bank v. Guaranty Investment Co., 213 Wis. 415, 250 N. W.
862 (1933).

76. Marshall & Ilsley Bank v. Hackett, Hoff & Thierman, Inc., 213 Wis. 426, 250
N. W. 866 (1933).
and conduct of the obligor and trustee was the same in both cases. In each the original indenture trustee, without at any time notifying the bondholders, exercised its privilege to make the specified advances, and in a foreclosure action brought by the successor indenture trustee, liens for these advances were claimed by the trustee in bankruptcy of the original indenture trustee. The claim for the prior lien was disallowed and the trustee held to be a general creditor in bankruptcy on the ground that since a prior lien created an adverse interest in the trustee it should have fulfilled an "implied duty" to notify the bondholders within a reasonable time after the event that such advances had been made and that their security was thus being impaired. On the other hand, the parity lien was allowed in the other case on the theory that since it was only on a parity with the bondholders' lien, it did not set up an adverse interest and, moreover, that the advances were beneficial to the bondholders in avoiding the creation of a prior lien in the form of unpaid taxes. In theory, the cases are not to be reconciled. The creation of a lien, whether equal or prior to that of the mortgage, has the practical effect of diminishing or diluting the bondholders' security. In either case, the very act of making the advances had the effect of lulling the bondholders into a sense of security and the belief that the enterprise was in fact meeting its obligations, thus preventing them until too late from taking protective action.

Advances in themselves do not necessarily imperil the dignity or security of the bondholders' lien; such advances are usually of protective importance. The trustee's disability to recover arises from concealment of the fact of such advances for so unreasonably long a time as to create peril against which bondholders, without notice, are unable adequately to protect themselves. A duty to give notice has consequently been implied. Such duty has been compared with an agent's duty fully to inform his principal of all facts material to the protection of the principal's interests and within the scope of the agency.

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77. Although there is some discussion in the opinion in the Guaranty Investment case regarding the trustee's intimate alliance with the obligor, nevertheless it appears that the court would have ruled the same way even had the trustee been disinterested.

78. For this reason, had the indenture not authorized the advances the concealment of the fact that they had been made might well have resulted in the denial of the lien in both cases, even though the payment of taxes and insurance is essential to the preservation of the lien. Cf. (1934) 47 Hunc. L. Rev. 882.


Thus far the trustee's power to make advances for the payment of taxes and insurance has not been transformed into a duty. The trustee can neither be compelled to use its own funds for this purpose nor to use moneys in its hands representing sinking fund payments or funds otherwise held by it as security. Such moneys constitute a trust fund whose diversion to any other purpose not consented to by the security holders is unauthorized. In one instance, where it was sought to apply sinking fund payments to the discharge of taxes in order to preserve the security, it was held that to do so would be a conversion, and that a trustee could not be compelled to make such advances even in order to preserve security, the value of which is problematical and speculative, at the expense of security whose value is certain and liquid.

If, in its individual capacity, the trustee makes a loan secured by a lien on property subject to an after-acquired property clause in the indenture, the lien will be held subordinate to that of the bondholders on the ground that in such a case the trustee is bound to know that the mortgage to itself as trustee already covered the property in question. "A court of equity cannot countenance such a discrimination by a trustee between property of a mortgagor which it holds in trust and property of the same mortgagor which it claims to hold in its individual capacity."

NEGATIVE PLEDGE COVENANTS AND MAINTENANCE OF CAPITAL RATIO

Corporations desirous of obtaining capital, but wishing to retain more freedom in handling their assets than is the case where the loan is secured by a mortgage indenture, employ the debenture device. This is commonly a loan on the general credit of the corporation. In order to attract or reassure the investor it is usual to include either in the debenture itself or in an accompanying agreement certain covenants which to some degree restrict the obligor's freedom in the disposition of its assets. Among the more important of these are the so-called "negative pledge" covenants, involving a promise by the obligor either not to create a subsequent lien on its assets at all, or not to create such a lien unless the debentures are equally and ratably secured therewith, and the so-called "debt-asset ratio" covenant, by which the obligor pledges itself not to assume liabilities exceeding a specified percentage of its assets.

The protective efficacy of these clauses must be seriously questioned. The complicated corporate structure and finances of modern industrial enterprises often make it almost impossible to prove a violation of these covenants, and make them easy to avoid. Kelly v. Central Hanover Bank & Trust Co., and other recent cases have aroused a considerable volume of speculation as to what the law of such restrictive provisions is.

In view of the fullness of recent discussion of the issues presented by that litigation, extended analysis of doctrinal problems is unnecessary here. What the cases and the comment on them show is that a debenture holder has difficulties in establishing a breach of the pledge clauses, and even greater difficulties in establishing a right to recover against one to whom assets covered by such clauses were conveyed or pledged. Thus the bondholder to regain his assets must show that the restrictive clauses are to be interpreted broadly; that so interpreted they have been violated; that for such violation there is no adequate remedy at law.

88. Most striking is the history of debentures issued by the Paramount-Publix Corporation. S. E. C. REPORT, at 10-13.
90. The cases are collected and discussed in Comments (1936) 46 YALE L. J. 97, (1936) 49 HARV. L. REV. 620; S. E. C. REPORT at 10-16.
To prove violation of some clauses, valuation of assets is required—an obviously herculean task.
that there being no adequate remedy at law, the metaphysical confusion in the books as to equitable liens should be construed in his favor, to permit such a lien to be recognized, and that the equitable lien survived the transfer or pledge of a legal interest because the transferees had knowledge of the restrictive covenants, a fact which the bondholder may perhaps be enabled to establish by circumstantial evidence. Forging each link in this chain of legal technicalities is, in the present state of the law, a forbidding task.

And the trustee provided for in the debenture indenture apparently need do nothing to make the task easier. It is generally the repository of the power to accelerate and is in a far better position than the bondholder to catch a default at its inception. But as a rule, the trustee has neither the duty to accelerate, nor, in general, any obligation to assume the burdensome task of investigating whether or not such a default exists. Even though it knows of default and is before a progressive court willing, in the presence of actual knowledge, to override the common provision that the trustee may conclusively presume that there is no default until it is notified to that effect by a certain percentage of bondholders, the trustee nevertheless is under no compulsion to act until such action is demanded by a specified percentage of the bondholders and sufficient indemnity is furnished.

It is to be noted that where debentures are issued under an indenture appointing a trustee, and the trustee itself makes loans to the company in violation of restrictive provisions of the indenture, the debenture holders may share equally and ratably with the trustee. The trustee, presumed to have knowledge of the restrictive provision, cannot act in violation thereof.

Legislation and administrative regulations requiring such clauses to be effectively drawn or so drafted as to avoid "negative" wording — such wording as permitted the device in the Paramount situation — of

93. For difficulties here involved see Comments (1936) 49 Harv. L. Rev. 620, (1936)
46 Yale L. J. 97, 104-105.

94. E.g., the criterion of knowledge of a bank being the sum total of the knowledge of its officers in their official capacities. Rosenman, J., in Hazzard v. Chase National Bank, 159 Misc. 57, 287 N. Y. Supp. 541 (1936).

The suggestion in Comment (1936) 46 Yale L. J. 97, 106, that a bank which makes such a loan should be presumed to have knowledge of its customer's outstanding debentures and the restrictive clauses protecting them, is not likely to be adopted by the courts.

95. See p. 766, infra.


98. See note 88, supra.
transfer of assets to a subsidiary—are essential.\(^9\) And, if the reasoning of the district court in the *Kelly* case is to prevail, it may well be that such clauses should be prohibited in order to avoid their deceptive effect. Indenture provisions requiring periodic reports in such detail as shall reveal whether or not these restrictive conditions are violated will serve appreciably to strengthen bondholder protection; especially if joined to this there be a duty of reasonable care and prudence on the part of the trustee when violation of such provisions is disclosed.

**INTEREST AND SINKING FUND PAYMENTS AND REDEMPTION**

Has the obligor fulfilled its duty to make periodic payments of interest and principal under the indenture when he makes such payments to the trustee? The answer has been held to depend on whether the payment is an "irrevocable release of control"\(^10\) operating as a *pro tanto* satisfaction of the issuer's obligation, or whether it is merely an ordinary deposit creating the relationship of debtor and creditor between trustee and obligor. The alternative is said to be resolved by a determination of the intention of the parties, to be inferred from the pertinent documentary language and the course of dealing between them.\(^11\) The express recognition that these payments are held in trust for the bondholders is obviously decisive,\(^12\) but such unambiguous language is only occasionally found, and the courts have, with some degree of unanimity, accepted the onus of interpreting each case on its own facts, exhibiting in the process the tendency to favor the view that the funds are held in trust for the bondholders and the obligor accordingly discharged, *pro tanto*.

In the absence of special provisions to the contrary, a requirement in the indenture that payments of principal and interest be made to the trustee is held to evidence an intention to discharge the obligor to the

\(^9\) See the suggestions for federal legislation, Comment (1936) 46 Yale L. J., 97, 112.


extent of such payments. The same result follows, a fortiori, where the indenture expressly provides that to the extent of payments made to the trustee the obligor's liability shall cease and that the bondholders shall look solely to the trustee for sums due them. Equally controlling, even in the absence of such indenture provisions, is an express declaration by the trustee that it holds such funds in trust for the bondholders. Additional factors sometimes utilized by the courts to strengthen the case for this view are the trustee's powers to accelerate upon default and to accept and enforce payment without producing the bonds, and the nature of the book entries of the obligor and the trustee.

Where, however, the indenture contains neither a covenant requiring payment to the trustee, nor a provision discharging the obligor as to such payments, and where there is no express declaration of trust, voluntary payments of principal and interest by the obligor to the trustee have been held to constitute the trustee merely a fiscal agent of the obligor. The bondholders are then not chargeable with any loss if such funds are dissipated either through improper conduct or insolvency of the trustee. In such cases, additional indications rebutting any inference that the funds are held in trust for the holders have been found in the requirement that payments be made directly to the beneficiaries and credited only after actual receipt, or in permission to the trustee to mingle such payments with its own funds. The courts of New

103. See Fidelity & Columbia Trust Co. v. Schmidt, 245 Ky. 432, 433, 58 S. W. (2d) 713, 714 (1932). The bonds not ever having been negotiable, it was not here decided whether such a particular method of payment impairs negotiability. Although the trustee acts as the holders' agent in receiving sinking fund and interest payments, such an agency is not equivalent to restricting payment of the notes to a particular fund within the objection of § 1 of the Negotiable Instruments Law. See Morley v. University of Detroit, 269 Mich. 216, 218, 256 N. W. 861, 862 (1934).


107. In re National Public Service Corp., 3 F. Supp. 362 (S. D. N. Y. 1933) (at no time were the funds entered on the obligor's books either on the asset side, as a deposit with the New York Trust Company, trustee, or on the liability side as an obligation to coupon holders; nor did the Trust Company treat the funds as a general deposit to the account of the obligor, nor was the obligor permitted in any way to draw upon those funds.)


York have held the trustee merely a fiscal agent of the obligor even
where voluntary annual remittances to the trustee had continued for
many years and been deposited in special accounts with a direction that
payment be made to coupon holders by cashier's check. In the same juris-
diction it has been held that such payments constitute the trustee merely
the agent of the obligor to distribute the latter's money as he directs;
and in view of the nature of the agency thus created, the obligor has
the power to revoke the authority given and demand that the money be
returned.1 Such a holding was criticized by one federal court which,
however, in the interests of commercial certainty, felt constrained to
follow it. The court pointed out that an intention irrevocably to release
control can as well be found in the course of dealing between the parties
as within the four corners of the indenture, and that such intention is
sufficiently indicated where deposits and directions were made as in the
New York case which it followed.112

The amount of the periodic sinking fund payments may be either a
stipulated sum or a proportion of the obligor's income. Upon failure
to make a required payment, the trustee's rights are the same as on any
other default. Where the measure of payment is a proportion of income
the trustee may properly sue for an accounting to determine the amount
due, and in such a suit it is no defense that all income has gone into the
improvement of the mortgaged property, thereby making the holders'
lien more secure, for, the duty of the obligor is to maintain the property
so as not to impair the security as well as to pay the stipulated percentage
of his income into the sinking fund.113

Where the trustee holds sinking fund and interest payments in trust
for bondholders, it may not divert them to other purposes.114 Indeed, so
insistent are the courts that these payments, when considered a pro tonto
discharge of the obligor, are held as trust funds that even an immunity
clause attempting to restrict the depositary's liability to that of an
ordinary debtor was denied effect;115 the bondholders could not in this

Div. 162, 167 N. Y. Supp. 288 (1st Dep't, 1917); cf. Guidise v. Island Refining Corp.,
(1859) is held inapplicable on the ground that there is no promise
by

Sinclair Cuba Oil Co. v. Manati Sugar Co.; In re National Public Service Co.; Hall v.
Goldsworthy, all supra, note 101; Cherry v. Howell, 66 F. (2d) 713 (C. C. A. 2d, 1933).

1912).

114. First Union Trust & Savings Bank v. Bernadin, 60 F. (2d) 419 (C. C. A. 8th,
1932); Tennessee Bond Cases, 114 U. S. 663, 698 (1885).

115. State v. Comer, 176 Wash. 257, 28 P. (2d) 1027 (1934). The immunity clause
read: "... no depositary shall be required to hold any deposits in specie or cur-
way be compelled to substitute for their security merely a credit account with the depositary. Obviously, the trustee cannot use such funds for its own profit and the courts will not permit any corporate fiction to be utilized toward that end. Due care must be exercised in banking these funds, and upon the slightest indication of danger they must be withdrawn; any less measure of the trustee's responsibility will not be countenanced.

Redemption by the application of sinking fund payments must follow the strict terms of the indenture. Often the trustee is permitted to redeem bonds by lot or at the lowest prices obtainable below the fixed redemption figure, in which case its only obligation is to exercise reasonable business discretion in making the most of the fund. Where a choice exists between long term bonds at a premium and serial bonds at par, a sound discretion will sustain the purchase and redemption of the latter class. If the obligor becomes insolvent and is unable to continue the required sinking fund payments, ultimate distribution of such moneys then in the hands of the trustee must be made pro rata to the holders of all outstanding bonds regardless of differing maturities, unless contrary provisions appear in the indenture. Where, however, the agreement designates the specific class of bonds to which sinking funds are to be

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119. See Hall v. Nassau Consumers Ice Co., 260 N. Y. 417, 183 N. E. 903 (1933), where failure to choose bonds for redemption by lot was not excused on the plea that the complaining holder's particular bond may not have been so chosen. (followed in Fortunato v. Banco de Columbia, N. Y. L. J., Nov. 10, 1936, (Sup. Ct.).


123. Masonic Widows & Orphans H. & I. v. Title Ins. & Trust Co., 248 Ky. 787, 59 S. W. (2d) 987 (1933); In re Prudence Bonds Corp., C. C. H., Bkcty. Serv. ¶ 3474 (D. C. N. Y. 1935) (where the obligor is in a 77B proceeding the court has jurisdiction to compel distribution of such funds, but the manner of distribution will be controlled by the law of the state). And see In re Prudence Bonds Corp., C. C. H., Bkcty. Serv. ¶ 3440 (C. C. A. 2d, 1935).
applicable, distribution must be made accordingly. Such provisions are held to create a vested right which arises immediately upon deposit of the funds, and the right is not subject to change by events succeeding the deposit.

In this group of cases the indenture is apparently the measure of the trustee's rights and liabilities and there is no case in this field in which the courts looked to the trust relation between bondholder and trustee as a source of duties discrete from the indenture. The only opportunity which the court here takes to expand or to contract the rights and duties of the trustee is by determining the "intention of the parties" with respect to the disposition of the funds deposited with the trustee by the obligor.

NOTIFICATION OF DEFAULT

In the usual situation the trustee learns of a default before the bondholders. In general, however, decisive action is not then incumbent upon it, for it is commonly stipulated in the indenture that the trustee shall be conclusively deemed to have no knowledge of default until notified of the existence thereof by a specified percentage of the bondholders. Even then it is usually under no duty to take any action until there has been a demand in writing by a specified percentage of holders and tender of indemnity. Manifestly, notice from bondholders is impossible unless they know of the default, and the usual indenture provisions impose upon the trustee no duty to impart such knowledge. The absurd result reached is that the trustee is conclusively presumed not to know of a condition which in most situations it is the first to learn. It by no means follows, however, that the trustee in the absence of such a duty may safely remain quiescent; for the very necessity for notice and demand implies that at some point in the course of the transaction there will be imposed upon the trustee, as an inherent incident of its relationship, the implied duty to notify bondholders in order that they may act for their own protection if the trustee does not.

Necessarily, the trustee must be allowed a wide and often delicate discretion in determining when to notify; the limits of that discretion cannot, of course, be readily stated. At the one end, where the trustee takes every step for the protection of the security that the holders could have taken had they been notified, clearly no liability can be imposed.

But equally clearly, liability attaches when such failure is part of a fraudulent scheme whereby the trustee profits at the expense of the holders, or where it is motivated by concealment, misrepresentation or bad faith.  

The area of difficulty lies between these extremes.

However, liability is not founded alone upon failure to notify, but upon that in conjunction with other circumstances resulting in damage.  

It may be doubted whether it is to the best interests of the bondholders that in this middle ground the trustee be subjected to the pressure of liability for ordinary negligence, whatever may be said as to the appropriate standards that should apply to its other activities after default.

I agree with the opinion of the S. E. C. that publicizing defaults, technical in their nature, and threatening no immediate serious consequence, may result in severe injury to bondholders.  

Hurried sales of securities usually follow notification, with immediate loss to the investors; public confidence is lost; obstacles to the obligor's emergence from what may be but a transient embarrassment are greatly increased. Not infrequently, the discretion of the trustee in withholding notification and granting to the obligor a reasonable period of grace within which to repair default has been a valuable safeguard for the investor, even where defaults went beyond apparently technical matters. Trustees shielded by the general immunity clause have ventured to grant such indulgences. In the presence of a stricter standard of duty, however, the trustee, properly avoiding a course entailing risk to itself, would, in the presence of any doubt, give early notification of default without regard to the immediate effect upon security holdings or the ultimate effect upon the security itself. Hence, the general immunity clause now commonly in use should continue to operate in respect of the trustee's duty to notify of default. At the same time, even this protection is of uncertain value to the trustee if in other respects its duties upon default are to be governed by a stricter standard; for that measure of duty would necessarily tend to circumscribe and penetrate the effect of the former standard.

We may consider a further and different result of its failure to notify, where the trustee seeks reimbursement for advances it has made upon the obligor's default. The problem arises when the trustee claims for such advances a lien prior to or co-equal with that of the mortgage. As indicated, advances for taxes and insurance premiums are held to relate to the preservation of the security and the trustee is entitled, therefore, to the stipulated lien. A federal court, recognizing the lien for such


130. S. E. C. Report at 42.
advances even in the face of the trustee’s failure to notify has declared that there is “no impropriety in requiring the trust estate to reimburse the trustee for such expenditures as would have been necessary had the trust been executed with the greatest fidelity.”\textsuperscript{131} Of course, where such failure to notify is found joined with a fraudulent plan by which the trustee seeks to advantage itself at the expense of the holders, or where such failure is one of the elements evidencing bad faith, the lien will not be permitted.\textsuperscript{132}

Where funds, however, are volunteered by the trustee to meet principal and interest payments, the indenture not providing therefor, it would appear that if the trustee intends to assert a lien it is incumbent upon it, if such payments be made in the usual course, to notify the holders accordingly at the time the advances are made. Such advances are neither commonly authorized by the indenture nor related to the protection of the security, and the right to a lien for them co-equal with that of the holders usually depends on proof that in advancing such funds it is not doing so on behalf of the obligor but is making a purchase of the particular bonds or coupons. Implicit in such proof is the intention on the part of the holder to sell his bond or coupons. When notice of the obligor’s default has not been given and bondholders receive payments of principal or interest in the usual manner so that there is nothing to characterize them as advances by the trustee rather than as required payments by the obligor, the courts have refused to spell out of the transaction such a requisite intention\textsuperscript{133} and have held that to the extent of such advances the trustee is simply an unsecured creditor of the obligor. Aiding the courts in reaching this result is the fact that the very making of the advances has prevented the holders from acquiring knowledge of default which might have enabled them to take appropriate protective steps.

\textbf{TRUSTEE POWERS AND DUTIES OF ENFORCEMENT}

The trustee’s inactivity upon default in any given case is not due to lack of power, for by the usual indenture it is expressly authorized to take all necessary protective steps. A duty fully coextensive with the powers thus conferred, however, is ordinarily avoided by the familiar language of the indenture, by which the trustee’s obligation to act is conditioned upon its receipt of the specified notice of default, demand

\begin{itemize}
  \item \textsuperscript{131} First Trust Co. of Lincoln v. Ricketts, 75 F. (2d) 309 (C. C. A. 8th, 1934).
  \item \textsuperscript{132} First Trust Co. v. Carlsen, 129 Neb. 118, 261 N. W. 333 (1933); Marshall & Ilsley Bank v. Guaranty Investment Co., 213 Wis. 415, 250 N. W. 862 (1933).
  \item \textsuperscript{133} Ketchum v. Duncan; Wood v. Guaranty Trust & Safe Deposit Co.; First Trust Co. v. Ricketts; First Trust Co. v. Carlsen; Marshall & Ilsley Bank v. Hackett, Hoff & Thierman, Inc., all \textit{supra} note 72; Continental Nat. Bank & Trust Co. v. Chicago Bldg. Corp., 283 Ill. App. 64 (1936).
\end{itemize}
for action and indemnity. Even then it ordinarily retains, by the terms of the indenture, the right to choose the specific activity to be undertaken unless also a named percentage of holders, usually larger than that required for notification of default, is authorized to and does dictate the course to be pursued.\footnote{134}

The obligor's default may occasion the trustee's exercise of various powers, among them the following:

\textit{Acceleration.} Ordinarily the trustee is specifically empowered to declare the entire principal immediately due and payable upon default. In the absence of such authorization the power will not be implied.\footnote{135} Where the indenture authorizes the holders of a stipulated percentage to require the trustee to accelerate, it must be strictly followed, else acceleration by the trustee is ineffectual.\footnote{136} Acceleration by the trustee matures the debt solely to enable enforcement by the trustee of its rights under the indenture; and unless a contrary interpretation is made mandatory by that instrument, it does not enable a holder to sue at law for recovery of the principal of his bond.\footnote{137}

\textit{Foreclosure and Entry of Deficiency Judgment.} Since it holds legal title, the trustee, not the bondholders, is patently the proper party to institute foreclosure proceedings.\footnote{138} Ordinarily, it is in the trustee's discretion to determine when it shall do so.\footnote{139} Such discretion may be controlled, however, by the bondholders, even though only a minority, if the indenture so provides.\footnote{140}

\begin{itemize}
\item \footnote{134} S. E. C. Report at 43.
\item \footnote{136} \textit{Ibid.}, Batchelder v. Council Grove Water Co., 131 N. Y. 42, 29 N. E. 801 (1892).
\item \footnote{139} Pearlman & Co. v. Lincoln Belmont Bldg. Corp., 251 Ill. App. 135 (1929); Fleener v. Omaha National Co., 267 N. W. 462 (Neb. 1936).
\end{itemize}
The usual indenture provisions which pledge the income of the mortgaged property as part of the security for the mortgage debt and entitle the mortgagor to take possession upon default give the mortgagor no greater right than that of perfecting the pledge by entering into possession, actually, or constructively through the appointment of a receiver. Until then the mortgagor is entitled to rents and profits; hence, in any contest between a mortgagee-trustee who has not yet taken possession and a judgment creditor who has, the latter, having exercised greater diligence, will prevail. The indenture may provide, however, that that instrument shall operate upon default as an assignment of rents and that the mortgagee shall be entitled to rents and profits, notwithstanding the continued possession of the mortgagor. Such a provision has been held to be effective. The pertinent indenture provision employed, therefore, should be an important guide to the trustee in determining whether or not to foreclose upon default.

Even after foreclosure proceedings have been instituted, they may be enjoined at the suit of dissenting bondholders on a plea of fraud or collusion, or for time to investigate a reorganization plan pursuant to which the foreclosure was instituted. They will not be enjoined on application of the mortgagor on the ground that there is no market for the property, nor for some such special reason as the pendency of an action at law by the individual holder of a duly matured bond will not be enjoined at the request of the trustee who has begun foreclosure, unless such action is prohibited by the terms of the indenture and the language of reference to the indenture appearing on the bonds indicates the inclusion of such prohibition. Continental National Bank v. Chicago Corp., 283 Ill. App. 64 (1935); cf. Oster v. Building Development Co., 213 Wis. 481, 252 N. W. 168 (1934).

A suit at law by the individual holder of a duly matured bond will not be enjoined at the request of the trustee who has begun foreclosure, unless such action is prohibited by the terms of the indenture and the language of reference to the indenture appearing on the bonds indicates the inclusion of such prohibition. Continental National Bank v. Chicago Corp., 283 Ill. App. 64 (1935); cf. Oster v. Building Development Co., 213 Wis. 481, 252 N. W. 168 (1934).


143. Stanton v. Metropolitan Lumber Co., 107 N. J. Eq. 345, 152 Atl. 653 (Ch. 1930); see Paramount B. & L. v. Sacks, 107 N. J. Eq. 328, 152 Atl. 457 (Ch. 1933).

144. See Leesman, Corporate Trusteeship and Receivership (1933) 28 Ill. L. Rev. 238.

145. Clinton Trust Co. v. 142-144 Loralemon St. Corp., 237 App. Div. 789, 263 N. Y. Supp. 359 (2d Dep't 1933); rearg. denied, 238 App. Div. 858, 263 N. Y. Supp. 366 (2d Dep't, 1933) (the allegation of fraud or collusion will justify the issuance of a temporary restraining order pending the trial on the merits).


action by the obligor for specific performance of a refinancing contract against the original trustee,\textsuperscript{148} or that the indenture, by granting the trustee a voluntary right of entry twelve months after default, created a period of grace for that time.\textsuperscript{149}

The trustee's power to enter a deficiency judgment must find express recognition in the indenture.\textsuperscript{150} This result is based on the theory that the bonds and mortgages, though evidencing but one debt, nevertheless constitute two distinct promises giving rise to two separate causes of action, and that the trustee, whose legal relations are held to be confined to the mortgage, has no enforceable rights at law on the indebtedness.\textsuperscript{151} However, when empowered by a specific provision of the trust deed, the trustee may enter the judgment, it being then sufficiently the trustee of the indebtedness to come within Federal Equity Rule 10 allowing a deficiency judgment to a trustee,\textsuperscript{152} and also, it would seem, within the exception to the real party in interest section of the New York Civil Practice Act.\textsuperscript{153}

It is to be hoped that the course of judicial construction of trust mortgages under which the trustee may foreclose and enforce payment of principal will ultimately recognize the trustee's power to enter a judgment for any deficiency that might arise after sale, despite the absence of specific authorization. Such a construction would preclude the necessity for a multiplicity of suits and avoid a race of diligence by individual holders.\textsuperscript{154}

\textit{Purchase at Forclosure.} The familiar provision authorizing the trustee to bid for and purchase the property on foreclosure in behalf of all bondholders is in furtherance of the desire for unity and equality; not in-

\textsuperscript{148} Detroit Trust Co. v. Manilow, 272 Mich. 211, 261 N. W. 303 (1935).
\textsuperscript{150} Lane v. Equitable Trust Co. of N. Y., 262 Fed. 918 (1919); Continental Equitable Title & Trust Co., 273 Fed. 967 (D. Ill. 1921); Grant v. Winona & S. W. Ry. Co., 85 Minn. 422, 89 N. W. 60, (1902); Laing v. Queen City Ry., 49 S. W. 136 (Tex. Civ. App. 1898); Brant Independent Mining Co. v. Palmer, 262 Fed. 370 (C. C. A. 8th, 1919).
\textsuperscript{154} See Grant v. Winona & S. W. Ry. Co., Laing v. Queen City Ry., both supra note 150; Shaw v. Railroad Co., 100 U. S. 605 (1879).
frequently it affords protection against losses consequent upon sale in a depressed market. In these circumstances, courts have translated such power into a duty, often quoting with approval the statement of the Pennsylvania Supreme Court that a trustee empowered to buy in at foreclosure who nevertheless stands by and allows the property to be sold for a fraction of its value is guilty of “supine negligence or wilful default.”

There is a sharp division among the courts, however, where express authority to buy in at foreclosure is lacking. Those adhering to the so-called Pennsylvania rule find in the trustee’s power to take general protective steps the authority for the specific protective step of purchase when necessary to prevent sacrifice at foreclosure. In this line of cases the courts have even extended such implied power into a duty. On the other hand, the federal and Michigan courts in particular insist that “each bondholder has the absolute right to determine for himself, in case of default, whether he shall take his loss and quit, or continue to gamble.” Should he adopt the former alternative, he has the absolute right to his proportionate share in cash of the highest bid and cannot be compelled to become the owner of an undivided interest in the property. Hence, the trustee who purchases on behalf of assenting holders must pay in cash at least a sum sufficient to give dissenters their proportionate amount of the net proceeds of sale. One court declared that it would impair the obligation of contract if a statute granting

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a trustee power to buy in on behalf of all holders irrespective of the indenture were to be given retroactive effect.  \(^{162}\)

Obviously, the trustee's authority to purchase at foreclosure is meaningless unless it acquires thereby the essential incidents of ownership; such incidents have been characterized as "a necessary corollary and consequence of the right to bid and buy." \(^{163}\) In such cases the trustee may hold and operate the property until it can be disposed of without unnecessary loss to bondholders. To preserve the property in the interim it has been held that the trustee may raise a mortgage to pay past due taxes and the expenses of foreclosure. \(^{164}\)

Bankruptcy. Despite the difficulty of giving notice to a large and scattered group of bondholders in sufficient time to allow them to file their claims in bankruptcy, \(^{165}\) the trustee has not been permitted in the absence of specific indenture authorization to file a claim in their behalf. \(^{166}\) The objections to granting the trustee such a right have been that the trustee's rights are derived from the indenture and relate only to the security. \(^{167}\)

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162. Detroit Trust Co. v. Stormfeltz-Loveley Co., 257 Mich. 655, 242 N. W. 227 (1932). From the trustee's point of view, the safer procedure, when in the absence of the express indenture authorization it proposes to buy in at foreclosure, would be to obtain before the sale the permission of the foreclosure court to bid. See Hoffman v. First Bond & Mortgage Co., 116 Conn. 320, 164 Atl. 656 (1933); First National Bank of Wichita v. Peel, 137 Kan. 436, 20 P. (2d) 528 (1933); Nay Aug. v. Scranton Trust Co., 240 Pa. 500, 87 Atl. 843 (1913). If the trustee's bid is made pursuant to a reorganization plan approved by a majority of the holders, it is not liable to a dissenting holder for failure to bid up to the fair value. Herzog v. Chicago Title & Trust Co., 284 Ill. App. 653, 2 N. E. (2d) 385 (1936).


164. Smith v. Massachusetts Mutual Life Ins. Co., 116 Fla. 390, 156 So. 498 (1934), where the court relied on the following clause in the mortgage: "to buy in at foreclosure, manage and sell the property or take such other steps as may be necessary and legal for the protection of said bondholders."


167 In re Indiana Flooring Co., 53 F. (2d) 263 (S. D. N. Y. 1931). (The trustee's rights were held to be confined to the security despite the following: The trustee was given power to accelerate, to recover judgment for the whole amount due and unpaid "before, after or during the pendency of any action for the enforcement of the lien . . . . All rights of action under the indenture or under any of the bonds" may be enforced by the trustee. See also Fitkin v. Century Oil Co., 16 F. (2d) 22 (C. C. A. 2d, 1926); In re Amalgamated Silk Corp. (unreported, S. D. N. Y. Nov. 9, 1931, Caffey, J.).
that the trustee is not the real party in interest, that to permit it to prove would result in an impairment of the bondholders' rights, and that even if granted such a right the trustee would be unable to comply with Section 57b of the Bankruptcy Act, which requires the filing of the instrument on which the claim is based, since it is not the owner or holder of the bonds. Hence, it has become the practice in drafting indentures expressly to authorize the trustee to prove on behalf of all bondholders.

But a solution to the difficulties in this field and a technique for permitting the trustee to prove a claim in the bankruptcy of the issuer despite the absence of an express provision in the indenture is suggested by the reasoning of Judge Mack in In re International Match Corp., although that case involved debentures and an indenture which specifically granted to the trustee the authority to file. The covenant in the indenture to pay to the trustee the full amount of the issue in the event of default was held to give the trustee power to claim as creditor for that amount. For purposes of Section 57b, the indenture was regarded as the instrument on which the trustee's claim was based, a view which not only meets the requirement of Section 57b but further gives substance to the trustee's claim as real party in interest. And the adoption of this theory does not mean that the bondholders are precluded from proving on their bonds, for, as the court reasoned, the obligation in the bond running to the holders, and that contained in the indenture running to the trustee, though evidencing a single debt, are separate obligations. The trustee's claim on the indenture is subject to reduction pro tanto by the amount of claims filed by individual holders. So long as the indenture contains, as it usually does, a promise to pay the full amount of the debt to the trustee upon default, this approach promises to avoid these objections and to facilitate the administration in bankruptcy of the interests of those bondholders for the proof of whose claims the indenture does not expressly make the trustee agent. The protection thus afforded the holders and the fact that bankruptcy pro-


169. See In re U. S. Leatheroid & Rubber Co., 285 Fed. 884 (D. Mass. 1923), where the clause relied on by the court was the usual one to the effect that nothing contained in the indenture was to impair or affect the holders' rights on the bonds. See also In re Ellis, 242 Fed. 156 (D. N. J. 1917).


171. See comment (1933) 46 Harv. L. Rev. 309.

ceedings will be expedited by permitting the trustee to prove, would appear to outweigh any difficulties that may attach to finding an effective way to distribute the amount awarded the trustee.\textsuperscript{173}

Whether the trustee should be permitted to vote as representative of the security holders on a plan of reorganization under Section 77B of the Bankruptcy Act is a mooted question. Long delays in reorganization proceedings pending the receipt of the required percentage of votes from a widely scattered group of security holders is a condition which may require appropriate legislation. Two main objections have been advanced against allowing the trustee such a vote. Both the rules and impulses of equity seem to require express consent by the security holder before equity will approve a plan rearranging and modifying his rights, and we have already noted the well established rule denying the trustee such power. Furthermore Section 77B(g)(h)\textsuperscript{174} requires that a plan of reorganization be affirmatively accepted by two-thirds of each class of creditors. Referring to this requirement in \textit{In re Allied Owners Corporation},\textsuperscript{175} Judge Manton said: “If the trustee of a mortgage were to vote for all the bondholders on every plan which affected the security distinguishing its bond issue and making it a separate class, the two-thirds requirement would be meaningless and one of the purposes of the law would be defeated . . . The trustee’s judgment should not be substituted for that of the real creditors who are to be safeguarded in passing upon the question of whether a plan is fair and equitable.”

The court went further, however, to indicate that a trustee may not attack a plan of reorganization as inequitable; and that if a trustee is to be allowed that privilege, the indenture must duly authorize it, as suggested in subdivision (b), Section 77B.\textsuperscript{176} While the court’s attitude is entirely consistent with present practice, it has been pointed out that on questions relating to the merits of a plan the trustee might well per-

\textsuperscript{173} Any unclaimed dividends which may result from failure of the holders to claim from the trustee should not be treated in the ordinary routine under the \textsc{Bankruptcy Act} \textsection{66}, 30 Stat. 564 (1898), 11 U. S. C. \textsection{106} (1934), because in the trustee's hands they are more likely ultimately to reach the holders, than if they were in the hands of the obligor's trustee in bankruptcy. Furthermore, no time restriction other than the statute of limitations is applicable to the holder's right to compel payment by the trustee; on the other hand, claim against the trustee in bankruptcy must be made within one year. See \textit{In re Paramount-Publix Corp.}, 72 F. (2d) 219 (C. C. A. 2d, 1934); cf. comment (1933) 46 \textsc{Harv. L. Rev.} 309. The dividends are in no proper sense unclaimed if the trustee is permitted to prove for them, hence \textsection{66} is inapplicable. It has been suggested that such dividends be paid into U. S. Treasury and there held subject to the claims of the holders—but the suggestion has not been adopted. See National Milling & Chemical Co. v. Amalgamated Laundries, Inc., 7 F. Supp. 723 (S. D. N. Y. 1934) (points of counsel).

\textsuperscript{174} \textsc{Bankruptcy Act}, \textsection{77B} (h), 48 Stat. 920, 11 U. S. C. \textsection{207} (h) (1934).

\textsuperscript{175} 74 F. (2d) 201 (C. C. A. 2d, 1934). Whether or not the trustee is to be permitted to vote as the representative of absent bondholders was not here decided.

\textsuperscript{176} See also Bitker v. Hotel Duluth Co., 83 F. (2d) 721 (C. C. A. 8th, 1936).
form a more active function, either supplementing, or conceivably replacing, the traditional protective committee. Section 77 of the Bankruptcy Act sets off the view of *In re Allied Owners Corporation*. Although here too prohibited from voting, the trustee is expressly granted by the statute the right to be heard on all questions arising in the proceedings, and may be permitted to intervene. And it has been held that the latter privilege is to be freely granted in such reorganizations to mortgage trustees "because they represent thousands of security holders, whose interests they are not only empowered, but required, to protect in any legal proceedings affecting them, and in the absence of allegations of fraud, refusal of the trustee to act, or other good cause, bondholders may, in the discretion of the court, be refused permission to become parties." This reasoning would appear to apply with equal force to reorganizations under Section 77B; and if it is persuasive, the statute should be amended to adopt the procedure of Section 77, so that the trustee may take an active part in the reorganization process both in formulating and criticizing plans.

**RIGHTS AND REMEDIES OF BONDHOLDERS**

Subject to the comprehensive limitations of the indenture, and those which the courts impose, the bondholder, whether to prevent possible injury to his interests or to recover damages already sustained, before or after default, finds in general four avenues of action open to him: he may seek to stir the trustee to action, according to the procedure stipulated in the indenture; he may sue in his own behalf, or as representative of his class; or he may intervene in proceedings already initiated by the trustee. The S. E. C. report is a sufficient chronicle of the ineffectiveness of these remedies.

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180. Bankruptcy Act §77B (c) (9), 48 Stat. 914, 11 U. S. C. § 207 (c) (a) (1934), would seem to be inclusive enough to provide for trustee compensation for its activity in actual reorganization.
181. There is also another group of preliminary procedural remedies: e.g., right to list of security holders, Bergelt v. Roberts, 236 App. Div. 777, 238 N. Y. Supp. 1035 (1st Dept 1932); right to accounting, Myers v. American National Bank & Trust Co. of Chicago, 277 Ill. App. 378 (1934)—which is very limited because it is available only when the trustee is in actual possession of some piece of property, Harrison v. Union Trust Co., 144 N. Y. 326, 39 N. E. 353 (1895); Trust Co. of Fla. v. Gault, 69 F. (2d) 133 (C. C. A. 5th, 1934).
182. S. E. C. Report, at 128. Of actions by security holders against trustees reported in response to the Commission's questionnaire, about 37% were still pending. Among those which have been carried to a conclusion, however, the Commission lists
The primary obligation assumed by the obligor in an issue of bonds secured by a trust deed is contained in the bond itself; the obligations contained in the indenture, relating to the security, are distinct and secondary. Remedies peculiar to each co-exist. The bondholder, though in one sense the true owner of both obligations, may find restrictions on his power to enforce either.

The bondholder's rights against the security, and his right to sue for the principal debt upon acceleration of its maturity, derive solely from the trust indenture, and the limitations expressed or implied therein are generally enforced. Such restrictions limit the discretion of single bond holders, whose suits might jeopardize the common security, and tend also to prevent multiplicity of suits. In the presence of the typical reference clause directing the holder to the indenture for a description of the security and his rights with respect to it, the cases leave no doubt that a bondholder cannot institute a foreclosure action until there has been strict compliance with the precedent requirements of the indenture and wrongful refusal by the trustee to proceed after action has been duly demanded, nor may the bondholder sue for the appointment of a receiver of the mortgaged premises, nor, in the absence of express authority to that effect, may he accelerate the principal.

about 27.8% as "dismissed or stayed," 57.4% as having resulted in judgment for the trustee, and 14.8% in judgment for the plaintiff. Six of the seven suits represented by the last percentage were merely actions to compel the distribution of moneys. The seventh sought to restrain a reorganization plan.

184. See cases cited note 189 infra.
The power to enforce the security thus reposed in the trustee has its counterpart in the bondholder’s rights on the bond. His right to sue at law on the obligation at its maturity in due course, exists unless there is express provision to the contrary; the right is said to be of too basic a character to be taken away by implication. Nevertheless, for reasons similar to those advanced as justification for restricting his rights against the security, the bondholder’s power to sue at law on his matured bond, as well as upon his matured interest coupons, is at times nullified by references to the indenture made in the bond. In such cases, the reference clauses must be explicit and the restrictive clauses are generally scrutinized much more strictly by the courts than when their purpose is merely to limit the exercise of bondholder’s rights with respect to the mortgage security; for the latter purpose it is sufficient that the bond contain merely a general reference to the indenture. The distinction is based on a reluctance to qualify the bonds’ direct and unconditional promise to pay at maturity, on which purchasers are considered to rely.

Where the reference clauses in the bond relate solely to the description of the security and the rights of the holders with respect to it, the weight

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188. See (1931) 41 YALE L. J. 312.


In determining whether the restriction is sufficiently evidenced in the bond, any ambiguity or inconsistency will be construed in favor of the bondholder. See Rothschild v. Rio Grande Western Ry. Co., 84 Hun 103, 32 N. Y. Supp. 37 (1895), aff’d without opinion, 164 N. Y. 594, 58 N. E. 1092 (1900); Goodjon v. United Bond & Bldg. Corp., 226 App. Div. 137, 234 N. Y. Supp. 522 (1929). It seems clear that where the right of conversion or to exercise purchase options or similar privileges exists by virtue of the terms of the bond, the holder has the right to proceed directly against the obligor for their enforcement. Brooks and Co. v. North Carolina Public Service Co., 32 F. (2d) 800 (M. D. N. C. 1929).
of authority supports the action at law on the bond.\textsuperscript{190} If the reference incorporates the provisions of the indenture for a description not only of the security, but also of all other rights of the holder, at law and in equity the right of action at law is governed (and restricted) by the terms of the indenture.\textsuperscript{191}

These restrictive provisions do not apply, however, where in special circumstances the bondholder seeks to take action manifestly intended to prevent impairment of the common security. Here action appears to lie directly against the obligor corporation, or the trustee, or both, as where the holder seeks to enjoin the issuance of additional bonds which would have impaired security already inadequate;\textsuperscript{192} or to restrain the obligor from disposing of assets to the holders' injury;\textsuperscript{193} or to enjoin threatened damage to the security.\textsuperscript{194} A recent Florida case has in dictum carried this approach to a further point.\textsuperscript{195} The court denied to a bondholder the right to foreclose, but it indicated that in the event of threatened waste or destruction of the property by the mortgagor, independent action by the bondholder would be permitted without resort to the trustee. Distinction was drawn between enforcement of the security contract — the exclusive function of the trustee — and protection of the security. Thus in McDougall \textit{v. Huntington & Broadtop R. & C. Co.},\textsuperscript{196} the court, while refusing the relief sought by the bondholders, announced in dictum that if after request the trustee should decline to fulfill its fiduciary obligations and should persist in its refusal to compel equal and impartial payments equity might intervene to protect the bondholders. In another case, the Court of Appeals of the District of Columbia affirmed an


Although the cases often refer to negotiability as the decisive criterion of the holder's right to sue, obviously, such a right may exist regardless of the negotiable or non-negotiable character of the bond.


\textsuperscript{192} Whitemore \textit{v.} International Fruit \& Sugar Co., 214 Mass. 525, 102 N. E. 59 (1913).

\textsuperscript{193} Hoyt \textit{v.} E. I. duPont de Nemours Powder Co., 88 N. J. Eq. 196, 102 Atl. 666 (Ch. 1917).

\textsuperscript{194} Fortney \textit{v.} Carter, 203 Fed. 454 (C. C. A. 4th, 1913).


\textsuperscript{196} 294 Pa. 108, 143 Atl. 574 (1928). See also Hadley Bros.-Uhl Co. \textit{v.} Scott, 93 S. W. (2d) 276 (Mo. App. 1936).
order preventing trustees from taking possession of property which they were alleged to have sold to themselves at an inadequate price. The sale of the property at the suit of the trustee was enjoined, in one case, to permit intervention and objection by bondholder groups to proposed reorganization plans; while, in another case, the court granted to a minority group an injunction temporarily restraining further reorganization proceedings, but refused to restrain the foreclosure suit properly instituted by the trustee. In at least one instance a group of bondholders was granted not merely an injunction restraining threatened injurious acts by the trustee, but a mandatory injunction compelling affirmative action by the trustee in order to avoid injury.

The remedy of injunction against wrongful or unwarranted action of the trustee is, of course, not inconsistent with the right of the bondholder to self-help. Frequently, in fact, the two forms of remedy are necessarily concurrent. The argument that unhampered action by a representative of the bondholders is necessary is clearly inapplicable where the bondholder seeks not to interfere with the trustee's action, but merely to act against third parties so as to assert rights of his own in no way connected with the indenture or the trustee.

Probably the most drastic preventive remedy available to the bondholder is removal of the trustee. A priori it would seem that this remedy should require a greater degree of misconduct than any of the remedies thus far discussed, and such in general is the rule. But this view is qualified by a recent Florida case. The court, when enforcing the express indenture limitations of the bondholders' right to commence foreclosure, asserted that for the trustee's unjust neglect or refusal to take appropriate action the bondholder's only remedy was ouster of the trustee for faithlessness. If both parts of this ruling are followed, removal will apparently be necessary to give the bondholder any protection against an inactive trustee, in view of the bondholder's incapacity under the trust deed to bring other suits.

201. Cf. Bergelt v. Roberts, 144 Misc. 832, 258 N. Y. Supp. 905 (Sup. Ct. 1932), aff'd, 236 App. Div. 777, 258 N. Y. Supp. 1036 (1st Dep't 1932), where because of condemnation by the intervening bondholders of the reorganization plan intervention by bondholders and injunction against further proceedings were granted, but the trustee was not removed on the ground that the facts failed to disclose any violation of the trust obligation.
203. See Rodman v. Richfield Oil Co., 65 F. (2d) 244 (C. C. A. 9th, 1935), where a similar doctrine was announced by the court by way of dictum.
The usual basis for removal of a trustee is willful disregard of fiduciary duty, whether the source of the duty be the indenture or a court order.\textsuperscript{204} The additional factor of conflicting or adverse interests may often be persuasive evidence of such a breach of trust.\textsuperscript{205} But the mere possibility that the trustee’s conduct will injure bondholders, without evidence of some direct violation of the trust obligation, is not enough to make out a case for this drastic relief.\textsuperscript{206} The remedy is not exclusive. It may be coupled with a demand for restoration for damage inflicted, either specifically, such as by setting aside a decree of foreclosure,\textsuperscript{207} or by way of compensation for damages suffered.\textsuperscript{208}

In an extraordinary case, the Supreme Court of Georgia doubted whether the equity powers which its courts are considered to have inherited from England in 1784 include the power to oust a trustee for violating its trust obligations under a bond indenture.\textsuperscript{209} The proceedings for ouster were brought by the holders of some 92\% of the outstanding bonds. Accused of the most flagrant misconduct, and shown to have been unfaithful to the trust,\textsuperscript{210} the trustee was not removed for the reason, among others, that trusteeships for bondholders, being of too recent origin, and being \textit{sui generis}, were not within the class of fiduciaries to whose control the English equity rules of 1784 were addressed. The more prevalent view is illustrated in \textit{White v. MacQueen},\textsuperscript{211} which held that notwithstanding a provision of the indenture permitting removal on the petition of two-thirds of the outstanding bonds, equity none the less had such inherent power over the administration of trusts as enabled it to remove the trustee when misconduct was shown, without compliance by the complainant with the terms of the indenture.\textsuperscript{212}

\textsuperscript{204} In the Matter of Mechanics Bank, 2 Barb. 466 (N. Y. 1848); Harrison \textit{v. Union Trust Co.}, 144 N. Y. 326, 39 N. E. 353 (1895).
\textsuperscript{205} Myers \textit{v. American National Bank & Trust Co.}, 277 Ill. App. 378 (1934).
\textsuperscript{209} Another possible preventive remedy would be an action for a declaratory judgment. Masonic Widows & Orphans H. & I. \textit{v. Title Ins. & Trust Co.}, 248 Ky. 787, 59 S. W. (2d) 987 (1933).
\textsuperscript{210} 360 Ill. 236, 195 N. E. 832 (1936).
\textsuperscript{211} Not only that he was insolvent, but had improperly caused deposits in banking institutions controlled by him of moneys paid to him as trustee which had been lost due to bank failures, had been been convicted of fraudulent breach of trust in Tennessee, misappropriated funds for his alleged fee, had acted contrary to the wishes of the bondholders and had refused to resign after request by majority of them.
Another group of remedies available to the bondholder is that directed toward recoupment for injury already inflicted. Frequently such recoupment may be possible in the form not only of monetary compensation but also of specific recovery. Thus in one case a bondholder was able to follow and impress a lien upon security sold improvidently and in bad faith by the trustee.\textsuperscript{213} In the \textit{Hazzard} case\textsuperscript{214} the relief sought by the plaintiffs was in the alternative, for damages or to compel the trustee to replace the securities surrendered. In a recent Illinois case a foreclosure decree was set aside at the behest of a group of bondholders because the trustee represented adverse interests.\textsuperscript{215} And, in those instances where the litigation centers about the rights of the trustee by virtue of its acquisition of a part of the bond issue, or of other obligations of the debtor, the bondholder, claiming irregularity or fraud in the acquisition, may seek, usually by intervention,\textsuperscript{216} to subordinate to his own the claims asserted by the trustee.\textsuperscript{217}

By far the largest number of actions seeking recovery for loss caused by the trustee are actions for monetary recovery. The remedy of monetary recovery is more likely to be held subject to the limitation of the general exculpatory clause than any other remedy available to the bondholder for the trustee's misconduct.\textsuperscript{218} The right to intervene, the right to restrain, even the right to oust the trustee, all preventive in their nature, afford no room to the trustee for the protective application of the exculpatory clause. It should be noted, in connection with this remedy for tort damages, that if the bondholder asserting such a claim finds the corporate trustee to be insolvent it seems quite possible for him to sue also those officers of the trustee who directly participated in the transaction and who are alleged to have been guilty of willful default.\textsuperscript{219}

Creating no liability and affording only an opportunity for hearing, it might well be expected that the right to intervene in suits brought by the trustee would be the one most readily available to the bondholder. Countervailing considerations are primarily those of convenience; fur-
ther, the trustee is theoretically the representative of all the bondholders.\footnote{220}

In general, the bondholder is permitted to intervene where the facts indicate a likelihood, or often even a possibility, that his interests will not be adequately served by the trustee. Such a likelihood is deemed to exist, even in the absence of actual misfeasance, where the trustee represents conflicting interests.\footnote{221} The possibility of favor to one group, though a majority, over another group, may ground a right to intervention,\footnote{222} although the mere fact that the trustee advocates one plan of reorganization rather than that advocated by another group is not usually sufficient.\footnote{223} In one case, a circuit court of appeals indicated unwillingness to supplant or allow interference with the trustee so long as there was no claim of bad faith or fraud, despite the trustee's personal interest in the subject matter of the foreclosure.\footnote{224} At the opposite extreme is a decision of the Illinois Court of Appeals. Intervention was permitted solely on the ground that the intervenors disagreed with the judgment of the trustee in not exercising its power to bid at foreclosure although no claim was made that the trustee was unfit or prejudiced in its management of the interests of the bondholders.\footnote{225}

EXCULPATORY PROVISIONS

The study thus far has concerned the rules operative in corporate trusteeships without particular reference to exculpatory provisions. But immunity clauses are universal,\footnote{226} and it is necessary to measure their effect in connection with the functioning of almost every part of the indenture machinery. The result is that the rules alone are not a suffi-


\footnotetext[223]{223}{See note 201, supra.}

\footnotetext[224]{224}{Rodman v. Richfield Oil Co., 66 F. (2d) 244 (C. C. A. 9th, 1933).}

\footnotetext[225]{225}{Strauss v. Chicago Title & Trust Co., 273 Ill. App. 63 (1933).}

\footnotetext[226]{226}{In the S. E. C. REPORT at 124, a tabulation of data from the returns to a corporate trustee questionnaire showed that an exculpatory clause, expressly exempting the trustee from liability except for gross negligence or willful misconduct, appeared in 388 indentures out of a total of 424. Id. at 125. Of these indentures 372 were executed since 1921, and 200 since 1927.}
cient basis for predicting the legal consequences of a specific fact situation. Few express duties are written into the current trust indenture, and the central problem in the application of exculpatory provisions is the extent to which the immunity clause qualifies, distorts or abrogates those duties of the trustee which are implied as terms of the indenture or are regarded, without reference to the indenture, as inherent in a trust relationship established, but not altogether limited, by the written documents.

The General Immunity Clause

Gross Negligence. The orthodox exculpatory clause exempts the trustee from liability arising upon any fault other than gross negligence, willful default or bad faith; indeed, public policy is said to draw the limit of permissible immunization at this line. Normally, the trustee would be held to a standard of ordinary care in the performance of its duties under the indenture. The difficulty in defining ordinary negligence increases that of defining negligence which is gross; obviously the latter looks towards a much less exacting standard of care than that of the prudent man. The various descriptive phrases employed by the courts point the difficulty—gross negligence has been described as an act or omission to act characterized by "recklessness," "indifference," "reckless indifference," "supine negligence," "willful neglect," 


"willful passivity," or as involving besides the creation of an unreasonable risk the "additional and affirmative element of intent to do or willfulness with which is done the negligent act"; or, "including a mental attitude of reckless and wanton disregard of the rights of others." The standard cannot be drawn with precision; it varies in each case with the ideas of judges and juries; at most it can be said that the term must denote some middle ground between ordinary negligence and intentional harm.

In most definitions of gross negligence, there is envisaged a course of action so liable to injure as to spell an intent to risk the harm. It is evident, therefore, that the actor must have knowledge of the existing circumstances and their potentialities of harm, to permit the inference of such "intent". The Browning case indicates the importance of this element of willfulness in gross negligence. Trust property was released by the trustee's officers under authorization to release "while there shall be no existing default to the knowledge of the trustee in respect to the payment of principal or interest." The paying teller in the trustee's banking department knew of two interest defaults, although the trust department had no such knowledge. It was held that, in view of the exculpatory clause, imputed knowledge was an insufficient basis for liability on the ground of gross negligence, though it thoroughly justified a conclusion of ordinary negligence. Although the court remarked that corporate trustees cannot consider their departments as separate entities yet the composite information of the trustee is not to be taken as the actual knowledge of the officers of its corporate trust department, and such actual knowledge in the officers who release the trust property was held necessary to supply the element of intent involved in gross negligence.

The Hazzard case, however, although reaffirming the proposition of the Browning case, and likewise reaching a result favorable to the trustee on a closely similar argument, warns that the imputation of knowledge from one department to another may of itself suffice to

238. The court observed that the institution itself, rather than just one of its departments, is the trustee. Id. at 324. See also Richardson v. Union Mortgage Co., 210 Iowa 346, 228 N. W. 103 (1929).
charge a corporate trustee with gross negligence. While this cannot yet be taken to mean that the trustee will be considered to have all of the knowledge of its officers in their individual capacities nor the knowledge possessed by subordinate officials in their official capacities, nor all of the information in the files of the bank, it may well include that knowledge which is possessed by responsible officers of the bank and the information in its credit files.

The knowledge requisite to action may be acquired by the trustee through a certificate. A trustee may apparently rely, short of the conditions indicated below, upon any certificate which the indenture provides may be accepted as conclusive,\(^\text{240}\) and there is no duty, ordinarily, to make further inquiry even though the power to demand further proof be given by the indenture. But since the provision is intended merely to facilitate the acquisition by the trustee of that knowledge which will enable it to carry out its duty both to the obligor and to the bondholders, the trustee should not be permitted to rely on the certificate as conclusive when it has actual knowledge to the contrary.

Knowledge of a default is usually the initial lever of trustee activity. Of some breaches the trustee may in fact remain uninformed until they are called to its attention; of others, usually denominated events of default, it ordinarily has knowledge, at times inescapable, as when interest, principal installments and sinking fund payments are not made to it at the specified time. It may be doubted whether the "ostrich" clause\(^\text{241}\) will protect the trustee in the presence of actual knowledge of default, where inaction results in loss to the bondholder. The point has not been directly passed upon by the courts.\(^\text{242}\) In a recent decision, however, expressive of judicial tendency, where the indenture contained this clause and provided that the obligor should deliver "after-acquired" property to the trustee as additional security, though there was no corresponding duty on the trustee to enforce delivery, leave was granted to amend the complaint apparently in order to permit an allegation that the trustee had received either the documentary notice prescribed in the indenture or any notice of the obligor's possession of such property.\(^\text{243}\)


\(^{241}\) I.e., the common indenture provision that until notice of default, signed by the holders of a specified amount of outstanding bonds has been received by it, the trustee may conclusively presume that no default has occurred. See p. 763, supra.


Though "gross negligence" looks to a standard less exacting than that of the reasonable man, some standard, however tenuous, must be used in determining liability. Commonly the indenture attempts to prescribe the criteria for trustee action and thus, in effect, to define this standard. The extent to which such prescribed criteria are to be exclusive is a problem of importance to the bondholder, especially in such matters as substitution and withdrawal of security. This consideration is posed in the *Hazard* case and may be a foreshadowing of judicial legislation. There the trustee bank was to permit substitution of the stock held as collateral security provided the obligor furnished an "earnings certificate" showing specified prerequisites, which was to be "received by the trustee as conclusive evidence of any fact or matter therein set forth." One of the many vice-presidents of the defendant trustee was also a director of the holding company whose stock comprised the substituted collateral. He therefore knew something of the value of such securities. Justice Rosenman said:

"Even though value was not the criterion set up in the trust indenture for the propriety of substitution, if it can be said that (the vice-president of the trustee) knew there was no value at all to the common stock of National Public Service Corporation, and if that knowledge is imputed to the defendant, inference might well be drawn of gross negligence in permitting the substitution of such patently and obviously worthless collateral."\(^{244}\)

Important implications may be drawn from these words as to the exclusive character of the criteria prescribed in the indenture. The specified criteria confer, generally, a privilege upon the trustee to exercise a power without consulting all the factors reasonably bearing on risk. But where other factors known to the trustee are so compelling as to demand the use of other than the specified criteria, reliance on the indenture provision alone may well fail to prevent a finding of gross negligence.\(^{245}\) In such cases, the reasonableness of the specified criteria\(^{246}\) and the countervailing quality of the other factors known to the trustee may play their part.

\(^{244}\) *Hazard* v. Chase National Bank, 159 Misc. 57 at 76, 287 N. Y. Supp. 541 at 562 (Sup. Ct. 1936). Although the court ultimately did not hold the trustee liable (see p. 751, supra), this statement is significant especially in view of the fact that the indenture in this case purported to impose the duty as well as the power of allowing the substitution of collateral.

\(^{245}\) Prudence Co. v. Central Hanover Bank & Trust Co., 261 N. Y. 420, 185 N. E. 637 (1933), discussed supra, p 751, is not without direct implications on this aspect.

\(^{246}\) Cf. the essential reasonableness of the "earnings" criterion of the *Hazard* case, with the meaningless "face-value" criterion of the *Prudence* case.
Bad Faith. The presence of bad faith will deny the trustee the full benefit of the other provisions of the exculpatory clause. Where that element is present the defense that its conduct was not grossly negligent will not save the trustee from liability. In Starr v. Chase National Bank the defendant trustee, even after it knew of defaults, had received substantial sums of money from the obligor which it applied on account of an indebtedness due from the latter to it, but it had made no portion of these moneys available for the holders of the defaulted notes. The trustee had also claimed a banker's lien on certain "free assets" of the debtor, but had been compelled by court order, in an earlier suit brought by a noteholder who had obtained an attachment, to turn these assets over to the sheriff. Subsequently the obligor paid off the notes of attaching noteholders, the attachments were vacated, and the property returned to the obligor. In a class action brought by noteholders to compel the trustee to account for alleged malfeasance and nonfeasance, the court held that the facts required a finding of bad faith and that the trustee, in failing to attach the property for the benefit of non-attaching noteholders either when the assets were in its custody or the custody of the sheriff, was guilty of a breach of trust. The trustee claimed a privilege to remain inactive. It had, however, actual knowledge of default in the trust obligation, and it knew where there were substantial assets of the obligor. The striking step was taken of implying a duty to attach such property. Since no clause of the indenture expressly negatived such a duty, it was argued that such action was necessary for the protection of bondholders and was, therefore, within the range of trust duty inherent in the relationship, without reference to the indenture.

If generalization is permissible from this case, it would seem that though the trustee may ordinarily have the choice of remaining inactive or of exercising a power, that privilege will not avail when there has been bad faith. And such "bad faith" may be found where the trustee takes advantage either of its knowledge or of its position to further its private ends at the expense of bondholders; no type of immunity clause, whether general or specific, can avoid the imposition of liability for such misconduct.

247. Preliminary to the finding of bad faith, there is, of course, the necessity for a finding that the trustee knew of the circumstances; and the determination of whether the trustee had "knowledge" should be based upon the same criteria as those applied to determine the existence of gross negligence. Cf. Browning v. Fidelity Trust Co., 230 Fed. 321 (C. C. A. 3d, 1918), cert. denied, 248 U. S. 564 (1918); Starr v. Chase National Bank, N. Y. L. J., Sept. 21, 1936, (Sup. Ct.), p. 771, col. 6.


249. I.e., upon which there was no lien, either under the indenture or otherwise.

As in gross negligence, the determination of whether the acts of the trustee constitute bad faith, is, as a rule, a finding based upon the facts of the particular case. Sale of trust property for a grossly inadequate price, even though it occur at public auction on notice to bondholders, is a circumstance which itself casts suspicion on the fairness of the transaction and will justify the inference that the trustee did not exercise that degree of good faith to which it was bound. Similarly, gross negligence may be evidence to support a finding of bad faith.

And, again, as with gross negligence, certain recurring situations have become crystallized as instances of bad faith. Bad faith will be inferred from the use of trust funds by the trustee in its own business or for speculation. And in State v. Comer, the court went so far as to impose a criminal liability upon a trustee who used for his own purposes funds deposited for principal and interest payments. Though expressly stated in the indenture not to be trust funds, this was held not to over-ride the fact that the whole instrument "carries the idea of a trust."

Willful Default. The cases which turn on "bad faith" seem to involve a willful default coupled with a motive to benefit the wrongdoer or those acting with him. Willful default alone, on the other hand, has been said to be merely "an unauthorized and wrongful act, deliberately and intentionally done . . . ." and without the necessity of a purpose to cause injury. While, in one instance, a trustee has been exonerated

251. Campbell v. Anthony, 112 Fed. 212 (C. C. A. 8th, 1901) (securities of a market value of $175,000 sold for $16,500, of which only $612 was paid in cash); Minneapolis Trust Co. v. Menage, 73 Minn. 411, 76 N. W. 195 (1898) (collateral sold at 10c. on the dollar); cf. Brown v. Oriental University, 44 App. D. C. 414 (1916).

252. First Trust Co. of Lincoln v. Carlsen, 129 Neb. 118, 261 N. W. 333 (1933). The slightest investigation would have revealed that the borrower's only interest in the property securing the bonds was a leasehold. Nevertheless, the trustee allowed the bonds to be sold as real estate mortgage bonds, which ordinarily purport to be secured by a fee. It is noteworthy that here, as in so many cases where bad faith was inferred from gross negligence, the element of dual capacity was present, the officers of the lending and trustee corporations being the same.


254. 176 Wash. 257, 28 P. (2d) 1027 (1934); and see Brown v. Oriental University, 44 App. D. C. 414 (1916).


on the ground that mistake or misconception of its obligations does not amount to willful and intentional breach of trust, it is doubtful whether such a subjective standard would be generally applied today.

No discussion of willful default is complete without a review of the so-called "beyond the scope of powers" doctrine. The concept of "willful default" includes liability both for affirmative acts and for wrongful failure to act. Liability for an affirmative act said to constitute willful default could probably also be rested on the theory that the trustee had transcended its powers under the indenture, so that the general exculpatory clauses, which are part of the indenture, and can apply only to acts done under it, would be unavailable for its defense. The functional similarities of "willful default" (as applied to affirmative acts of the trustee) and "beyond the scope of power" are typically illustrated in Harvey v. Guarantee Trust Co., involving a trustee's irregular satisfaction of the trust deed, where Mr. Justice Frankenthaler placed liability upon both grounds. Since no element of conscious wrongdoing seems necessary in transcending the scope of powers, it would appear probable that the doctrine has gained its increasingly wide acceptance because it at once dispenses with the difficulties of subjective inquiry or fictions of implication and imputation. And its acceptance by the courts has not been retarded by criticism based upon uncertainty in its application.

It is clear that the theory permits the court to classify any departure from the trustee's duties under the indenture as being beyond its scope, so as to lead to liability, despite the general immunity clause, even where only ordinary negligence is found or, indeed, where there is none. It is at least doubtful whether the courts of many jurisdictions will go so far. As far as the cases go, action beyond the scope of authority seems to mean action beyond the scope of authority as defined by the indenture, exclusive of the exculpatory clause.

The doctrine operates to add a flexibility and range scarcely to be expected of the limitations imposed by willful default; it allows the courts to disregard the general immunity clause when that is believed desirable. Whatever its virtues of adaptability, the doctrine and its uses add further elements of uncertainty to the position of the trustee.

258. 134 Misc. 417, 236 N. Y. Supp. 37 (Sup. Ct. 1929). In Richardson v. Union Mortgage Co., 210 Iowa 346, 228 N. W. 103 (1930) the liability imposed upon the trustee was based upon both theories. In Conover v. Guarantee Trust Co., 88 N. J. Eq. 450, 102 Atl. 844 (Ch. 1917), although the express ground of liability was action beyond authority given, in view of the facts of the case and the opinion of the court, the case may be said to involve willful default as well.

The Specific Immunity Clause

The decreasing effectiveness of the general exculpatory clause as a shield for the trustee is dramatized in the growth of the concepts used to evade it—gross negligence, bad faith, willful default and especially in the "beyond the scope" doctrine. To achieve the measure of protection formerly provided by the general exculpatory clause the trustee must place increasing reliance upon the presence of specific disavowals in trust indentures. The central problem is whether the courts will deny effect even to a specific exculpation by imposing upon the trustee a duty arising from the inherently fiduciary nature of its relationship with the bondholders. The rationale of implied duties is simply an alternative for gross negligence, "beyond-the-powers", willful default, and bad faith, in the process of explaining why general exculpatory clauses do not apply to specific fact situations. But it is hard to see how any of these latter concepts except "bad faith" can be applied to overcome the effect of a specific exculpatory clause, exempting the trustee from a named duty.

It is clear that whatever the quantum of disavowal set out in the indenture, the trustee may not in bad faith profit from the trust at the expense of its beneficiary.

It is the general rule that the duty of the trustee is measured and limited by its agreement. Although cases speak of the trustee's implied duties not to conduct itself in a manner repugnant to the existence of the trust, such cases almost invariably concern conduct otherwise in violation of indenture provisions. This was so in the Harvey case,260 in the Starr case,261 in the Rhinelander262 and Frishmuth cases,263 and even in Marshall & Ilsley Bank v. Guaranty Investment, Co.,264 which has been cited265 as indicating a contrary holding in Wisconsin. They are therefore either inapplicable or not directly in point upon the problem of whether the specific disavowal of a duty will fail of effect in the face of an obligation regarded as inherent in the relationship between trustee and bondholders. The specific disavowal of a duty to record the trust instrument—a duty seemingly implicit in the trust relationship—has been given effect in the Benton case266 and in Bell v. Title & Guar-
The language of Mr. Justice McAvoy to the contrary in
the Green case is dictum, however sound from the viewpoint of equity.

The decision of the Washington court in State v. Comer seems to stand quite alone. There it was held that despite a specific clause in
the indenture which named, for redemption funds, a depositary con-
trolled by the trustee and which provided that the funds were not to be
held as trust funds but as a credit in a simple debtor relationship, the
defendant as dominant force in both trustee and depositary was guilty
of embezzlement in dissipating the funds from the trustee's general
account with the depositary. "Aside from this one immunity clause,"
the court said, "the instrument from its beginning to end, carried the
idea of a trust, . . ." The conflicting interests of the trustee there
present, however, makes it inadvisable to rely too strongly on the language
of this case.

But New York and other jurisdictions may yet find inherent duties
which rise beyond their specific disavowal. Perhaps the opening wedge
will occur where an affirmative destruction of the bondholders' security
is made possible by arbitrary immunizations unnecessary to protect
trustees from burdensome duties. Public policy might well be invoked
to deny effect to a clause which renders an indenture "an instrument of public deception." The public interest and the very utility of the
trust indenture as an instrument of finance demand the recognition of
certain pivotal duties as unavoidable by contract. The duties falling into
this category are those that do not involve an unreasonable burden upon
the trustee for their discharge, but which, nevertheless, are of vital
importance for the direct protection of bondholders. Necessarily in-
definite, such a standard allows the courts sufficient freedom to weigh
new and complex situations. It is quite clear, in view of the inevitable
limitations of usage on the case-law in this field that statutes are needed

267. 292 Pa. 228, 140 Atl. 900 (1928).
(1st Dep't 1928), aff'd without opinion, 248 N. Y. 627, 162 N. E. 552 (1928).
269. 176 Wash. 257, 28 P. (2d) 1027 (1934). See also Rhinelander v. Farmers
Loan & Trust Co., 172 N. Y. 519, 65 N. E. 499 (1902).
270. 176 Wash. 257, 262-263, 28 P. (2d) 1027, 1029. It was further stated "and if
the immunity clause is to be given the effect which is claimed for it, we see no reason
why such elaborate provisions for the creation and carrying out of a trust would be
necessary . . . The general purpose and design of a contract will not be permitted to
be frustrated by allowing too much force to be given to single words or clauses . . .
Trust deeds executed to sustain corporate securities do not depend upon the express
terms of the deed alone. The implications which arise from the relations of the
parties are as much a part of the deed as if they were written into it."
(Sup. Ct. 1929).
to clarify standards of trustee behavior.\textsuperscript{272} In New York the Streit Bill looks to such reform but its application is limited.\textsuperscript{273}

Immunity clauses occasionally attempt a different technique, but without conspicuous success. Thus a clause purporting to relieve the trustee from liability for all acts of its regular agents or employees, "providing they are selected with reasonable care," was in effect dismissed in \textit{Richardson v. Union Mortgage Co}. "Surely," said the court, "the trustee was something more than an employment agency."\textsuperscript{274} Analogously, one of several co-trustees was held unprotected by a clause purporting to relieve him from liability for the misconduct of his associates where in joining with them in their disposition of trust property he neglected "to ascertain whether the act he was about to perform might be prejudicial to any of the \textit{cestuis que trustent} whom he represented."\textsuperscript{275}

CONFLICTING INTERESTS OF THE TRUSTEE

Some conflicts of interest cannot be avoided in financial and related enterprises; and the commercial banks which undertake trusteeships may be represented in banker, creditor, financial adviser, bondholder, stockholder, or the directorate of the company for which it acts as indenture trustee under one or more security issues.\textsuperscript{276} The subject has been one

\textsuperscript{272} Significant is the recent step taken by the New York State Legislature declaring invalid, as contrary to public policy, any grant to an executor or testamentary trustee of exoneration "from liability for failure to exercise reasonable care, diligence and prudence." \textit{N. Y. Decedent Estate Law}, § 125.

\textsuperscript{273} \textit{N. Y. Real Property Law}, § 124-130 (as amended by L. 1936, c. 900).

\textsuperscript{274} 210 Iowa 346, 228 N. W. 103 (1933). See also Minnesota Trust Co. \textit{v. Menage}, 73 Minn. 441, 76 N. W. 195 (1898).

\textsuperscript{275} Riker v. Alsop, 27 Fed. 251, 259 (S. D. N. Y. 1886).


This does not by any means exhaust the possible additional relationships which the trustee may assume. See \textit{e.g.}, Fidelity Trust Co. \textit{v. Washington-Oregon Corp}, 217 Fed. 588, 602 (W. D. Wash. 1914) (trustee becoming depositary for protective committee); McCauley \textit{v. Ridgewood Trust Co}, \textit{supra}, (trustee guaranteed the bonds); Nash \textit{v. Minnesota Title Ins. Trust Co}, 159 Mass. 437, 34 N. E. 625 (1893) (trustee
of vigorous study, leading to highly caustic comment in the Report of
the S. E. C. The disclosures of this Report touch situations which arise
when the trustee joins one or more of these capacities with its trustee-
ship, or when there is affiliation with the owners of junior or senior
securities, or with stock interests of the obligor, or with management,
or by means of interlocking directorates; or when it participates actively
in protective committees by representation thereon directly or through
counsel common to it and to such committee. The evils to which this
usage may be put are trenchantly described in the Report, and tables
compiled from questionnaires prepared by the Commission tend to indi-
cate the prevalence of these practices.277

Affiliation of trustees with protective committees seems always un-
fortunate. Such committees represent only those holders who have
deposited their bonds with it. Hence, in aligning itself with the com-
mittee the trustee is no longer an effective advocate of the cause of the
non-depositing holders, whom it is equally bound to protect, and whose
need for such representation is the greater because of their very lack
of organization. Non-depositing minorities who oppose majority action
claimed to be oppressive and unreasonable, or who stand silent, are
entitled to look to the trustee for impartial protection of their rights in
the security held by it for the benefit of all alike.

These considerations are receiving the awakened attention of legis-
latures, courts and administrative bodies. That trust companies them-
selves have become sensitive to situations of conflict was recently evi-
denced by the resignation of the Bankers Trust Company of New York
as indenture trustee of an issue of a corporation controlled by a company
of which it was the largest single stockholder. The stock had come into
its ownership as a result of the reorganization of a predecessor company.
While the trust company declared its belief that there was no impro-
priety in accepting the trusteeship, it decided, in view of the opinion
of the Securities and Exchange Commission to the contrary,278 to resign
also from all other trusteeships of security issues of all the companies
subsidiary to that in which it held stock.279 Relevant in this connection
is the position of the usual investment trust, with its varied holdings,
activities and interlocking interests. The recent declaration of the Leh-
man Corporation at a hearing before the S. E. C. recognized the danger
of improper benefits arising from the positions of conflict incident to
the normal and efficient operation of an investment trust. Its president suggested that the remedy lay in requiring full and open revelation by means of periodic reports of all transactions of the trust, including underwriting activities, brokerage commissions, interlocking directorates and the like. It may well be that similar publicity in respect of the other capacities and interests of the indenture trustee may, in like manner, serve to reduce if not dispel criticisms otherwise justifiable.

Theoretically the trustee is in a position of even greater conflict when it accepts trusteeship under more than one security issue of the same company, or where it becomes a creditor of the obligor. Multiple trusteeships was an early practice under railroad mortgages, and was regarded as of benefit, before default, to the several bondholding groups; much may be found in favor of this practice from the standpoint of saving to the obligor because of the trustee's familiarity with its often complicated financial and corporate structure and the detailed and interrelated rights of the several corporate issues. Upon the occurrence of a default under any of the issues, however, it is customary for the corporate trustee to resign from all but one of the trusteeships. In the occasional instance where the trustee represents two or more series of obligations under a single issue, conflict may arise upon default; in the circumstances, the solution, since the indenture must continue to be administered under the single trusteeship, would appear to be the retention of separate counsel in respect of each series.

It is to be expected that the indenture trustee will be a banking creditor of the issuer. The objection of the S. E. C. to the creditor-trustee relation is not persuasive. Important enterprises are in constant need of short term financing for seasonal or other requirements, and may most readily procure such financing from banking institutions informed of the general and special conditions governing the business. Such ready access, afforded by the trustee's special knowledge, is of definite value to security holders themselves in various ways, particularly in times of stress. Indeed, a creditor-trustee's special knowledge of the obligor's financial affairs may constitute an additional safeguard to bondholders in that a claim of preferential payment to the trustee may be sustained


281. One court has decided that a trustee who holds as collateral the shares of stock of the mortgagor's subsidiary, commits no breach of trust if later it becomes trustee also under a mortgage of the subsidiary itself. Gasquet v. Fidelity Trust & Safety Vault Co., 75 Fed. 343 (C. C. A. 5th, 1896).

in some instances, where a like contention would be difficult or impossible to support as against third party creditors ignorant of the obligor's true condition.\textsuperscript{283}

It is usual for enterprises whose financial needs are large to make banking arrangements in advance with several lending institutions. If such institutions were disenabled from lending to enterprises for which they act as indenture trustees, many would be immediately excluded from this capacity by foresighted management which anticipated later application to them for monetary needs. It is not likely, moreover, that trusteeehipd would be accepted by responsible banks if the resulting penalty was the prohibition of loans to the obligor. Banks of sufficient financial responsibility to undertake trusteeehips of large issues are not numerous; and the difficulty would be aggravated if those to whom the obligor intends later to look to for funds are precluded from becoming trustees. As a consequence, such trusteeehips would inevitably be forced into hands of questionable responsibility. Impecunious trustees would raise far more serious problems than those which arise when the indenture trustee becomes banking creditor of the obligor.\textsuperscript{284}

In the absence of other factors pointing to fraud, courts have not generally forbidden antithetic loyalties.\textsuperscript{285} A safeguard is found in those cases which indicate that an action involving a trustee with adverse interests will be more readily open to intervention.\textsuperscript{286} While these conflicts, without more, have not been actionable, courts have accorded them

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\textsuperscript{283} In New York, for instance, it is essential, in the recovery of a preferential payment, that the recipient have knowledge of the insolvency, at the time of the transfer, actual or threatened, of the corporate debtor. \textit{N. Y. STOCK CORP. LAW, § 15}; Miceli v. Morgano, 36 F. (2d) 507 (S. D. N. Y. 1929); 15 \textit{FLETCHER, CYC. CORP.}, (1931) § 7453. Prior to the 1929 amendment, the debtor's financial condition was, ipso facto, sufficient to identify the payment as a preference, regardless of the creditor's knowledge. Davis v. Senaca Falls Mfg. Co., 17 F. (2d) 546 (C. C. A. 2d, 1927).

\textsuperscript{284} Financial responsibility is recommended by the S. E. C. as a prerequisite to trusteeship. \textit{S. E. C. REPORT} at 111.

\textsuperscript{285} Cf. Monticello Building Corp. v. Investment Co., 330 Mo. 1128, 52 S. W. (2d) 545 (1932) (trustees were also officers of the defendant obligor, which in turn dominated a bondholders protective committee); First Trust Co. of Lincoln, Neb., v. Ricketts, 75 F. (2d) 309, (C. C. A. 8th, 1934) (issuer was trustee); Marshall & Ilsley Bank v. Hackett, Hoff & Thierman, Inc., 213 Wis. 426, 250 N. W. 866 (1933) (trustee promoter and part owner of enterprise). In Stuhr v. Yakima Valley Bank & Trust Co., 149 Wash. 400, 271 Pac. 82 (1928), and in Masonic Widows & Orphans Home & Inf. v. Title Insurance & Trust Co., 248 Ky. 787, 59 S. W. (2d) 987 (1933), no stress was laid upon the fact that the trustee acted as a syndicate to sell the issue. In the latter case, the trustee also guaranteed the issue.


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increasing weight in determining whether the trustee has been guilty of bad faith or willful default. 287

Nevertheless, the result is clearly inadequate for bondholder protection. The general immunity clause, however effective in other situations, should not be available when default occurs. "In the critical times of default and reorganization, it is absolutely essential that the bondholders be represented. The trustee should be by law transformed into an active trustee, receiving compensation commensurate with the increased responsibilities which that entails." 288 And whether or not trustees have heretofore generally failed to observe these standards, the time is opportune to remove any doubt on the subject by making these standards compulsory rather than optional. It must be borne in mind, however, that a responsible and acceptable institution which serves as trustee of a corporate issue in the due course of its multifarious activities acquires individually or in testamentary or like capacities, and either directly or through substitution of investments, or in the processes of corporate consolidation and exchange, the possession of securities which are, at least, theoretically in conflict with the securities of which it is the corporate trustee. Unless the trustee's acquisitions of this type are substantial it is believed that the imposition of a duty of reasonable care when default occurs under the trust indenture, will afford a ready safeguard against inadequate protection. The corporate trustee should be required to resign only when its acquisitions are substantial.

There are various phases of the subject which the limits of a law review article must leave untouched. Clearly, much confusion has been caused by the failure of the courts to recognize that the corporate trustee is something sui generis, and that it cannot be labelled satisfactorily either a stakeholder or a fiduciary trustee. It must also be abundantly clear that whatever may be the emphasis which this study has given to the relations between trustee and bondholder, other aspects of the problem — the functions of the obligor, the underwriter and the banker — require at least equal emphasis and consideration. The Streit Act, in New York, which regulates but a single type of corporate trust indenture, indicates some of these other aspects in its inclusion of "Trustees, bondholders, protective committees, depositaries, management companies, voting trustees and other persons administering, holding in custody or otherwise concerned with real estate and interests therein." 289


288. S. E. C. REPORT, at 47.

289. N. Y. REAL PROPERTY LAW, § 124-130 (as amended by L. 1936, c. 900).
That indenture provisions have been at times found “utterly unjust to the investing public” expresses not so much an arraignment of any one of these aspects as the necessity in general for legislative or regulative control which shall compel fixed minima of protection in consonance with current conditions. In this direction, however, great care is imperative to prevent the swing of the pendulum too far toward restrictive regulation. The concept of the modern trust required centuries to achieve its present state of development; the mortgage idea has an even longer history; it is not too much to say that the corporate trust indenture, an offspring of both, cannot be brought to perfection at one stroke by governmental fiat. It must be conceded that thrusts at the security of the bondholder have been frequently successful because of trustee inertia or indifference; nevertheless, the trustee presents but one part of the larger problem of protecting investors, and legislative or regulative focus upon it alone may unduly interfere with the practicability of the trustee-device, a vital instrument of present-day finance, while leaving unguarded other avenues of attack upon the security of the bondholder.

This said, I find myself in accord with many of the criticisms expressed in the thoughtful and comprehensive, if at times academic, Report of the S. E. C., and with several of its important recommendations.

The effective point of regulation is the trust indenture. It is highly probable that trustee institutions would welcome regulatory control of indenture provisions that have been found to jeopardize the rights of investors, if thereby advisable and practicable minimum standards were to prevail for all the parties to the financing transaction, including certainly the obligor and underwriter no less than the trustee. A heavy responsibility rests directly upon the issuer and the underwriter, who reap the rewards of the transaction, and who are directly concerned with the marketing of the securities; and the trustee, which has no financial stake in the transaction, and whose compensation is fixed and moderate, cannot be expected to conduct or even to participate in the trading between issuer and underwriter, including the concessions which the one may require and to which the other may yield in order to arrive at their bargain.

Consider, for example, the need for reform in the negative pledge clause, which receives the Commission's strong censure. Pointing out that such clauses have proved illusory because of "the cavalier manner in which they have been circumvented or nullified by issuers," the Report declares "there can be no doubt that the problem is primarily one of

control over the issuer rather than the trustee.” It appears something of a non-sequitur, therefore, to say further “that the trustee should take more definite responsibility for the adequacy of these protective features” and that trustees “should require that they be drafted so as to prevent easy circumvention such as in the Insull and Paramount cases.” It would seem that the remedy should be addressed rather toward “control over the issuer” and banker and the provisions which they may insert in the indenture.

The usual condition precedent to the certification of bonds relates to the deposit with the trustee “of a certain quantity or quality of security; the existence of specified earnings of the issuer; and the like.” Compliance with these conditions is usually established by certificates furnished to the trustee. The Report suggests that protection to investors requires that the trustee shall be under a duty in such cases to “investigate the adequacy of such statements” and make “careful inquiry and analysis.” To do this would in most cases impose an impracticable duty upon the trustee, it would involve large and needless expense upon the obligor, and would afford little added benefit to the security holder. Whether a trustee of standing would be willing to assume such onerous responsibilities may well be doubted. In order to comply, the trustee would be compelled to maintain a staff of experts — engineers, accountants, appraisers, lawyers — at heavy cost to the obligor, and the end result would be largely a duplication of the task already performed by the experts and accountants of the obligor corporation and the underwriters of its security issues. Detailed analysis and investigations are the rule in connection with underwritings, usually entailing much expense and time, the results of which are required to be submitted to the Securities and Exchange Commission prior to the original or subsequent issues of securities.

Regulative control should recognize the fundamental difference between conditions which precede default and those which follow. Though the general immunity clause be permitted to remain operative before default, indenture provisions can be strengthened adequately to cover conditions until then; after default a duty of reasonable care unqualified by exculpatory clauses should afford adequate protection. Such readjustment will tend greatly to resolve many existing problems, especially if supplemented by increased use of adequate obligor certificates attesting due performance of conditions or conduct required of the obligor, or the existence of prescribed status. Such certificates, revealing whether or not indenture violations have occurred, will afford basis for

291. S. E. C. REPORT, at 11.
292. Id. at 16.
293. Id. at 26.
294. Ibid.
trustee action or inaction; and, if default be thus disclosed, the impetus of a duty of reasonable care imposed upon the trustee will, it is believed, afford the bondholder the protection to which he is entitled.

Certificates of compliance are common in the business world, and no practices have been disclosed by the S. E. C. which demand departure from the usual procedure in this respect. The Report suggests the wisdom of requiring that certificates of appropriate application of proceeds be filed as supplement to registration under the Securities Act of 1933 as amended and the Securities Exchange Act of 1934. Similarly, other required certificates of compliance or cf status might be so filed. For an appreciable period, railroad securities have been passed upon by the Interstate Commerce Commission and utility securities by the Public Utility Commissions of the various states. Registration requirements under the Securities Act affect substantially all issues of industrials and utilities and enforce submission of fullest information concerning the business, assets, earnings, and pledged property of the issuer as well as of the terms of the trust indenture. In such instances, and in general, the S. E. C. may deem it advisable to require that, in appropriate cases, if certificates of compliance be submitted by regular employees or officers of the obligor corporation, confirmatory certificates shall be furnished to the trustee by independent sources acceptable to it, and filed also with the Commission.

There remains, however, a phase as to compliance certificates which should at all times continue to be clear, namely, that it is the prescribed state of facts itself which is made precedent to action or inaction of the trustee; that the certificate is merely evidence of the existence of such state of facts; and that the certificate is accepted as sole evidence of such state of facts because it is the only practicable and reasonable method for its establishment; from all of which it follows that when the trustee knows that the state of facts attested by the certificate does not exist, it should be held to the strictest accountability despite receipt of the formally correct certificate.

Thus, appropriate certificates will disclose relevant conditions throughout the period prior to default, and will be sufficient ordinarily to indicate compliance or non-compliance of the obligor with the requirements of the indenture. For the rest, and prior to default, the trustee must continue clothed with the immunity it now enjoys; other conditions of default not thus disclosed are unlikely to be of moment and, in any event, not being obvious, would require for discovery a degree of par-

295. Id. at 31.
icipation in the detailed affairs of the obligor coextensive with its business, a duty hardly to be demanded of the trustee, and normally needless.

But once a condition of actual default comes to the knowledge of the trustee, what shall be the measure of its duty? The views of the S. E. C. in this regard, as expressed in its Report, are sound and in consonance with present day conditions. Whether the default be technical or otherwise, the general immunity clause should disappear at this point and reasonable care and prudence become at once the measure of the trustee's duty—it is the touchstone of the "positive action" required for the protection of the investor and demanded by the Commission. The general boundaries of such a duty, while never sharply defined, are not unfamiliar to the trustee. Conditions of the past decade have all too considerably widened the trustee's knowledge and experience in this field. Such a course will impose no undue hardship upon the trustee, particularly in the presence of the right of ready appeal to the courts. It may be added that the stringency of the provison that when default occurs the trustee need take action only upon demand of a prescribed percentage of bondholders, and specific action only upon demand of a higher percentage, will be appreciably modified and certainly relieved by the impulse of this suggested higher standard of duty.

Greater duties imply greater risks, and for this the trustee should be more adequately compensated. In general its duties have been few and its fees moderate. The increased responsibilities consequent upon the application of a standard of reasonable care after default demands increase in compensation.

Reorganization is one of the major fields in which such a change in standards may be expected to induce improvement. The problem may best be summarized by saying that there is lack of democratic procedure in reorganization. The need for such procedure is pressing; the difficulties many in the way of achieving it. Bondholders without means and without organization are unable to take decisive steps, and as a consequence the well-organized, well-financed bondholder group is in a position of advantage over unorganized or weakly organized bondholders. The way must be open to the trustee, whenever in its judgment it is necessary or desirable, for prompt assembly of the security holders to whom the trustee may present the facts. This will afford oppor-

300. At present, the trustee, when a reorganization is in process, is under no duty other than to refrain from acting in bad faith or as the representative of the selfish interests of one competing group. Cf. United States & Mexican Trust Co. v. United States & Mexican Trust Co., 250 Fed. 377, 382 (C. C. A. 8th, 1918); Commonwealth v.
tunity for instructions to the trustee, with resulting protection to it where the indenture provisions permit such direction by a specified percentage of holdings, and for such indemnification as the trustee is entitled to receive. While the desires of a substantial number and amount of holders, in the absence of indenture specifications, cannot remove the trustee's duty to protect the absent minority, the trustee may, if so advised, proceed upon the assurance that if the suggested procedure be fair it will receive judicial support and safeguard itself against the animadversions and charges which a defeated minority are prone to voice.

As the S. E. C. Report concludes, "It may, however, be essential for the trustee to be the focal point for organizations of bondholders in times of trouble and for formation of a protective committee. This may mean that the trustee should act as chairman of a bondholders' meeting where a committee is selected or that it should undertake directly to have a committee formed." If the rule of reasonable care after default be adopted, there is no reason why the trustee should not precipitate itself wholly into the reorganization process and assume a leading role therein, acting in cooperation with all committees, however formed, as far as it may do so consistently with the primary interests it represents. It should be adequately compensated for its labors in reorganization, even though such services be not comprehended in the express terms of the indenture. Recognition in law of the trustee's right to such compensation should clear the way for its effective participation in reorganization activity.

To effectuate these purposes, regulations should require that lists of all bondholders so far as reasonably ascertainable, shall always be lodged with the trustee and be made available to the bondholders. Bondholders in a defaulted issue, the first concerned for protection, should not be the last called for consultation. Indenture provisions governing the method of call and procedure at bondholder meetings are common in other countries, notably in Canada, and have come into increased use in the United States.

Upon bondholders the burden of ultimate loss must fall and to them should be given earliest opportunity, in cooperation with the trustee, to preserve the status, conserve the assets, and reduce the loss. The reverse has usually been true; and by the time the bondholder is at last fully


301. S. E. C. REPORT at 151. See also id. at 62, et seq. Significant is the proposed intervention by the Central Hanover Bank & Trust Co. as trustee for bondholders in the reorganization of the Denver & R. G. R. R. (N. Y. Times, Mar. 6, 1937, p. 21, col. 4), and the recent action of the Guaranty Trust Co. of N. Y. in calling meetings of bondholders in four instances of railroad default.
advised of the situation, conditions have so shaped themselves and plans
have been so moulded that he finds himself restricted to an acceptance
of what he is offered, rather than to what he may be entitled, and in
any case deprived of the opportunity of free decision after full knowl-
edge and discussion. By the time he is vouchsafed opportunity for
decision, various committees, usually self appointed, have maneuvered
for position in the exciting, strategic game of reorganization. The
"independent" committee at times is found to be on intimate and co-
operative terms with the corporate management; notably in real estate
issues the committee is openly designated and controlled by the under-
writers and serves the additional purpose of blocking the way to a full
disclosure of any irregularities in the methods by which the issue was
marketed. And when the bondholder at last learns, as is not infre-
quently the case, that the good faith of the committee with which he
may have deposited is open to question, and thereupon seeks to with-
draw his securities, he finds either that he cannot do so or can succeed
only upon compliance with conditions that are prohibitive; and he learns,
too, to his chagrin and cost, the truth of the maxim "once a depositor
always a depositor." The picture is not overdrawn. It has been common
knowledge for many years and in the last half decade it has grown to
scandalous proportions. One has but to read the powerful arraignment
of these facts in various parts of the S. E. C.'s Report on its study of
the activities of protective and reorganization committees to realize the
amazing extent to which the security holder has been victimized.

In this situation, the active and vigilant protection of an informed
trustee is imperative. Indeed, it is not too much to say that the proper
performance of this function is as vital to bondholder protection as is
the very device of an adequate corporate indenture.

The current revival in finance makes the present an appropriate time
to adopt changes and procedures which will improve corporate indentures
and increase trustee duties upon default so as more effectively to afford
the safeguards which economic conditions and the public need alike
require. In the face of profound social and economic change this im-
portant instrument of finance cannot remain unchanged and unyielding.
To this end legislation or regulation must be broad in scope and recog-
nize that responsibility rests not less on corporate obligors and under-
writing bankers than upon corporate trustees.

302. In view of the situation which now confronts corporate trusteeships, the estab-
ishment of a bureau to advise as to standards, uniform practices, indenture clauses,
and the like, may serve a highly useful purpose without interference with the competitive
character of the business. This procedure as to investment trusts of the management
type in Great Britain has been so successful in establishing satisfactory standards and
habits under the direction of the Association of Investment Trusts as to have obviated
all legislative and governmental regulation. See report of Stayman L. Reed, The N. Y.