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CORPORATIONS - MODIFICATION PROVISIONS OF CORPORATE MORTGAGES AND TRUST INDENTURES

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CORPORATIONS — MODIFICATION PROVISIONS OF CORPORATE MORTGAGES AND TRUST INDENTURES — As early as the late 1800's it was not uncommon to find included in corporate mortgages and trust indentures provisions looking to the modification of the rights of the bondholders by action of a given majority of such holders. Ordinarily the power conferred could not be exercised by the holders of less than seventy-five per cent in value of the outstanding bonds; the modification authorized might be the alteration of security rights, the de-

ferment of payments of interest or principal, the reduction of interest, or even the reduction of the debt.[1] Inasmuch as the same equitable doctrines limit their use, these four powers may be considered as of one generic type, and for our purposes discussed together as comprising the "modification provisions" of modern trust indentures. These provisions enjoyed little popularity with the draftsmen until the 1920's when, perhaps because of their possible use to obviate the need for, or serve in the place of, reorganizations under receivers, the modification clauses of one type or another became customary in most corporate mortgages.[2] But in spite of wider use, even today the extent to which they may be of aid in establishing a plan of reorganization either with or without judicial proceedings cannot be defined with precision because of the paucity and complexity of litigation directly turning on the force of the provisions.

The extent of the problems involved in the use of modification provisions and the difficulties in analyzing their force are illustrated in *In re Los Angeles Lumber Products Co.*[3] The case involved the fairness of a plan submitted in 77B proceedings calculated to reduce the top-heavy capital structure of a shipbuilding enterprise, so that credit could be obtained to finance large government contracts anticipated in the immediate future. The objection of the minority bondholders was to the preservation of an equity in the stockholders while the bonded

[1] The text of a suggested modification clause is set out in McCLELLAND and FISHER, THE LAW OF CORPORATE MORTGAGE BOND ISSUES 819 (1937). The possibilities for variety in the provisions make it impossible to characterize any text as typical. See also S. E. C. REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES [hereinafter cited Report on Reorganization Committees], Part VI, Appendix (c), p. 135 (1936).

[2] The growth of professional interest in the provisions can be traced by reference to treatises on indenture provisions. As late as 1917 a rather extended treatment of indenture provisions failed to mention modification clauses. Stetson, "Preparation of Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures," in SOME LEGAL PHASES OF CORPORATE FINANCING [1 LECTURES ON LEGAL TOPICS] 1 (1917). In 1927 the modification provisions were noted as a possibly helpful device in reorganizations. Swaine, "Reorganization of Corporations: Certain Developments of the Last Decade," in SOME LEGAL PHASES OF CORPORATE FINANCING [8 LECTURES IN LEGAL TOPICS] 133 at 172 (1926). From reports of the Securities and Exchange Commission it seems that the use of some types of modification clauses became common in the 1930's. S. E. C. REPORT ON REORGANIZATION COMMITTEES, Part VI, pp. 143 ff. (1936). The use of the provisions is indorsed in McCLELLAND and FISHER, THE LAW OF CORPORATE MORTGAGE BOND ISSUES 822 (1937). Probably the power to reduce the principal sum is not included in over 10% of modern indentures. Cf. HEARINGS ON H. R. 5220, 76th Cong., 1st sess., pp. 284-285 (1939). The provisions are common in English indentures. British-American Nickle Corporation, Ltd. v. O'Brien, [1927] A. C. 369.

[3] (D. C. Cal. 1938) 24 F. Supp. 501.

obligation was reduced. The stockholders' justification went to the effectiveness of the modification clause in the bonds. In 1930 by the agreement of a large majority of bondholders under this modification provision, all principal and interest payments had been deferred to 1944, and in consideration thereof the stockholders had put $400,000 into the preservation of the assets. In the 77B hearing the court held the preservation of value to the stockholders was fair because the plan also waived this deferment of payments to 1944 on all bonds. Thus the waiver was good consideration for the equity preserved.[4] The existence of a clause conditioning foreclosure upon a demand of twenty-five per cent of the bondholders, leaving a smaller minority powerless, and the fact that unless the modification agreement were valid the $400,000 was a donation to the interest of the bondholders, may have influenced the court. These factors, together with the nature and condition of the business and the wide discretion of the court, make the determination of the effectiveness of the modification provision in the court's opinion anything but precise. The case serves to illustrate the manner in which the issue is apt to arise and poses four questions for further examination: 1. Is a modification under the provisions per se invalid as against minorities? 2. What is the extent of judicial review of the exercise of the power on motion of the minority? 3. How far will the provisions aid in effectuating a reorganization under a receiver? 4. What are the prospects for future use of modification clauses?

I.

Throughout the study of modification provisions, the recurring basic question is how far a bondholder will be held to an earlier formal agreement that, without his consent at the time, some percentage of his class may grant away his personal and secured rights against the debtor. As a contract there is nothing illusory in such an agreement, but perhaps it is more like a grant of power than an irrevocable assent to a future contract.[5] Nor is there any inconsistency in the instrument that sets up the debt and the pledged security and then provides for the reduction of either or both.[6] Indeed, in view of *Canada Southern Ry. v.*

[4] Ibid. at 513: "In waiving their right to defer any possible foreclosure, these stockholders who are given consideration under the plan are clearly parting with a valuable asset."

[5] Only if the debtor directly controlled the reduction in minority bondholders' rights could the contract be called illusory. 1 WILLISTON, CONTRACTS, rev. ed., 126 (1936). But concepts of consideration and mutual assent from contract law are not readily adaptable to test the establishing of plans for financial readjustment of distressed businesses. In re Georgian Hotel Corp., (C. C. A. 7th, 1936) 82 F. (2d) 917.

[6] Follit v. Eddystone Granite Quarries, [1892] 3 Ch. 75. Cf. Berman v. Consolidated Nevada-Utah Corp., 132 Misc. 462, 230 N. Y. S. 421 (1928).

Gebhard,[7] it can scarcely be argued that one has any vested rights in an obligation or security when he may be deemed to have submitted himself to the operation of a power which may reduce those rights. But nevertheless it is apparent in the cases that the courts are concerned over the position of the investor who buys bonds with good security and then finds that against his consent the character of the investment is to be altered.[8] The solution has been, however, to curtail the exercise of the power rather than attack its essential validity. Whether or not a bona fide purchaser for value of a bond would be bound by the provisions raises questions of negotiability and notice with which we are not concerned here.[9] Where statutory provision has not allowed incorporation of such provisions in negotiable bonds, the result has been reached that the debtor's personal obligation to the dissenters under their bonds remains unimpaired even after the majority agreement has effectively altered the extent of the security rights of all bondholders.[10]

2.

Granted the validity of modification provisions, their exercise by the majority of bondholders is sharply curtailed by the courts when timely application is made by the dissenting minority. When called upon to justify the alteration in the normal rights of the minority, the majority must show explicit authority derived from the indenture, and it is the settled policy of the courts to construe rigidly against the majority the scope of the power conferred.[11] The wisdom of such a rule of construction cannot be questioned, for actually little or no attention is paid to the potentialities of such provisions at the time

[7] 109 U. S. 527, 3 S. Ct. 363 (1883).

[8] Without such provisions no compromise of rights under the indenture could be forced. Heider v. Hermann Sons Hall Assn., 186 Minn. 494, 243 N. W. 699 (1932); cf. Lake Street El. Ry. v. Ziegler, (C. C. A. 7th, 1900) 99 F. 114, which suggests but then rather denies the possibility. Since bonds are ordinarily purchased without actual attention being given to such provisions, it is hard to hold that the purchaser is thereby deemed to have consented to any alteration. Even when the change is beneficial, as in the case of substituting security upon merger, the overruling of the minority is not free from difficulty. Ikelheimer v. Consolidated Tobacco Co., (N. J. Ch. 1904) 59 A. 363.

[9] Enoch v. Brandon, 249 N. Y. 263, 164 N. E. 45 (1928); Hibbs v. Brown, 190 N. Y. 167, 82 N. E. 1108 (1907); Mayo v. Fitchburg & L. St. Ry., 269 Mass. 118, 168 N. E. 405 (1929); 41 YALE L. J. 312 (1931); 33 MICH. L. REV. 1082 (1935).

[10] Mayo v. Fitchburg & L. St. Ry., 269 Mass. 118, 168 N. E. 405 (1929); Manning v. Norfolk Southern Ry., (C. C. Va. 1887) 29 F. 838.

[11] Mercantile Investment & General Trust Co. v. International Company of Mexico, [1893] 1 Ch. 484, note; Re B. C. Portland Cement Co., 22 Dom. L. R. 609 (1915).

of purchase, so that any alteration is a reduction in supposedly secured rights.

But granted an exercise within the explicit power of the majority, still the courts will inquire into the manner and circumstances of its exercise before holding the minority bound by their irrevocable assent to the alterations.[12] The approach of the courts is that the majority are in a fiduciary relationship to the minority, with a power in trust to be used only for the common good of all.[13] It is not altogether clear why the nature of the bondholders' contract or the character of the indenture itself as a trust instrument should require this fiduciary relationship between minority and majority groups any more than stockholders' contracts, where self interest is allowed free rein.[14] But from a business standpoint it is wise to limit the use of a power which may vary the secured obligation the investor apparently purchases. At least it is well settled that "Agreements between bondholders lodging in the majority in interest the power of control over the common fund contemplate that those having the largest interest in its conservation will be the most jealous. They are intended to minimize the power of a factious minority to thwart the general good. But every delegation of power implies that it will be honestly exercised."[15] With this approach to the exercise of the power, the judicial review may turn either to the motive of the majority in the exercise of the power,[16] or to the substantive wisdom of the action taken.[17] The two inquiries will ordinarily overlap at many points. The possibility of litigation on either issue makes the use of the power less certain than is ordinarily desirable in business

[12] "Unquestionably this or any other granted power may be abused. Fraudulent and oppressive invasion of minority rights and equities . . . might be attempted by the majority. But prevention of such inequities is a subjectmatter of the jurisdiction of equity, whose long and strong arm may readily and presumably effectively be invoked against it." In re Georgian Hotel Corporation, (C. C. A. 7th, 1936) 82 F. (2d) 917 at 919.

[13] Mercantile Investment & General Trust Co. v. International Company of Mexico, [1893] 1 Ch. 484, note; Vogelstein v. Athletic Mining Co., (Mo. App. 1917) 192 S. W. 760.

[14] Windmuller v. Standard Distilling & Distributing Co., (C. C. N. J. 1902) 114 F. 491. However, it is possible that the minority may enforce the duty owed by the management to the corporation as such.

[15] Hackettstown National Bank v. Yuengling Brewing Co., (C. C. A. 2d, 1896) 74 F. 110 at 113. Cf. the language of the Supreme Court in Sage v. Central R. R., 99 U. S. 334 at 341 (1878).

[16] Vogelstein v. Athletic Mining Co., (Mo. App. 1917) 192 S. W. 760; Hackettstown National Bank v. Yuengling Brewing Co., (C. C. A. 2d, 1896) 74 F. 110; British-American Nickle Corp., Ltd. v. O'Brien, [1927] A. C. 369.

[17] Ikelheimer v. Consolidated Tobacco Co., (N. J. Ch. 1904) 59 A. 363; Sneath v. Valley Gold, Ltd., [1893] 1 Ch. 477, 68 L. T. 602.

matters, which would tend to make recourse to the use of the power rather a last resort before receivership.

When we turn to the test of the substantive wisdom of the plan, the problems become those generally of censoring the exercise of business discretion by the courts. When the debtor is solvent, changes in rights can be weighed with something of mathematical exactness, and it would be difficult for the majority to argue the common benefit to secured creditors to justify a reduction in secured rights. If the debtor's insolvency makes the value of even the secured claims doubtful, from necessity the courts can halt only the most obviously unwise arrangements as a breach of trust. Further, the very fact that modification provisions must contemplate a more or less serious alteration of rights in case of need may influence the courts to look more to good faith than substantive wisdom.[18] When the bondholders are practically proprietors, as may happen in the case of holding companies, the motive requisite to the good faith of the majority may perhaps be extended to include an advantage to the corporation as a going concern, rather than to the bondholders as a secured class of investors.[19]

Within these limits, when the alteration does not prefer the majority, nor show bad faith, nor appear patently unsound from the selfish view of a secured creditor, modification plans will be upheld. The courts have approved attorneys' liens[20] and other claims allowed ahead of the secured bondholders by the majority;[21] substitutions of stocks for other security has been permissible;[22] deferring of payments is common.[23] To the distressed debtor it is doubtful whether the modification provision is of any more utility in staving off embarrassing foreclosures than the clause requiring a demand of twenty-five per cent of the bonds to initiate foreclosures.[24] But where other means would fail, alterations or extensions under modification clauses can

[18] When there is no hint of collusive action, the self-interest of the majority is regarded as a guarantee of the wise use of the power. Warner Bros. Pictures, Inc. v. Lawton-Byrne-Bruner Ins. Agency Co., (C. C. A. 8th, 1935) 79 F. (2d) 804 at 818: "It is not to be assumed that 75% of bonds (widely held) would agree to release or alteration disadvantageous to themselves; the provision permits elasticity of action for accommodation to future situations as they may develop in the progress of the business."

[19] Ikelheimer v. Consolidated Tobacco Co., (N. J. Ch. 1904) 59 A. 363; Snyder v. Fenner, (C. C. A. 3d, 1939) 101 F. (2d) 736.

[20] Dolph v. Cincinnati, B. & C. Ry., 56 Ind. App. 137, 103 N. E. 13 (1913).

[21] Re B. C. Portland Cement Co., 22 Dom. L. R. 609 (1915); British-American Nickle Corp., Ltd. v. O'Brien, [1927] A. C. 369.

[22] Ikelheimer v. Consolidated Tobacco Co., (N. J. Ch. 1904) 59 A. 363; Sneath v. Valley Gold Ltd., [1893] 1 Ch. 477, 68 L. T. 602.

[23] In re Los Angeles Lumber Products Co., (D. C. Cal. 1938) 24 F. Supp. 501. Cf. Heider v. Hermann Sons Hall Assn., 186 Minn. 494, 243 N. W. 699 (1932).

[24] For a discussion of the rights of bondholders under typical indenture provisions, see comments, 27 COL. L. REV. 443, 579 (1927).

serve to avoid involuntary receiverships and so provide a breathing spell for distressed debtors where otherwise the financial distress would place the minority in an advantageous position. To the prosperous debtor, the uncertainty of modification under the clause impairs the usefulness of the provisions; but here, too, in readjusting the burden of fixed charges the provisions may be helpful.

3.

When the financial difficulty of the debtor has reached the point where judicial reorganization impends, considerations determining the effectiveness of the provisions as an aid in establishing a plan acceptable to the majority are quite different from the considerations which guide the court in reviewing a modification already accomplished. There are two points at which the provisions have significance: first, in making possible the presentation to the court of a plan already approved by the bondholders, thus gaining the advantage of a presumption of fairness and the possibility of a short receivership;[25] second, in giving the court less reason to fear injustices to minorities under the plan.

Whenever the control of the debtor permits it, the reorganization counsel directing reorganization proceedings prefer to formulate the plan, to circularize security holders for assents, and to prepare for the confirmation of the plan before any petition for judicial receivership is moved.[26] This practice makes possible freer dealings with strikers, presentation of the plan to the court as an accomplished fact with all presumptions of fairness in its favor, and a short receivership, serving primarily to furnish the desired finality to the reorganization in fact already accomplished. The practice gives flexibility, speed, and economy. Its dangers lie in unethical maneuverings and coercive use of force against minorities.[27] Under equity receiverships and 77B proceedings, these contract reorganizations with final judicial approval were allowed to a considerable extent. Their efficacy was entirely apart from the existence of modification provisions in indenture or mortgage. The advantages obtained were largely psychological but very real. Because of the dangers in binding the courts by assents secured outside judicial surveillance, the Chandler Act by Chapter X sought to forestall such procedure by requiring assents to any plan to be obtained anew after judicial approval of the plan submitted.[28] The

[25] The best collection of material on this subject is to be found in the S. E. C. REPORT ON REORGANIZATION COMMITTEES, Part I, pp. 312 ff., esp. 328 (1936).

[26] S. E. C. REPORT ON REORGANIZATION COMMITTEES, Part VI, pp. 146 ff. (1936).

[27] Ibid., p. 150.

[28] 52 Stat. L. 840 at 891 (1938), 11 U. S. C. (Supp. 1938), §§ 574-576.

nice question remains for us whether, when the indenture contains modification provisions, the courts would not, even under the Chandler Act, be forced to recognize as conclusive against bondholders their assents to any plan whenever made. There are as yet no cases on the point. There would be no logical difficulty in recognizing that assents so obtained altered the rights of the minority bondholders from that time, so long as the exercise of the power conformed to the tests set out in the last section. But, in view of the discretion resting with the court, it is altogether doubtful whether the distinction would or should be observed between the examination of the fairness of a plan submitted to the court under a receivership, and the examination of an accomplished modification. The purpose of the provisions of the Chandler Act ought not to be thwarted by the device of including modification provisions in the indenture. Nor should such previously obtained assents from bondholders curtail the examination of the Securities and Exchange Commission into the wisdom of the plan as provided under the Chandler Act.[29]

If in fact there has been no alteration in the obligation of the bond at the time of a judicial reorganization under Chapter X of the Chandler Act, it seems very doubtful if the court would consider as a factor in determining the fairness of a plan the fact that the majority could embarrass the dissenting minority under the modification clause.[30] The possibility that a majority of their fellow bondholders could alter their rights against the debtor would not vary the position of the minority at the moment as normally secured bondholders, and the bare existence of the clause should not be the basis of an approval of the plan otherwise unfair as to dissenters. Nevertheless such considerations might be among the imponderables considered within the discretion of the court.

4.

In view of the attitude of the courts and the trend of legislation, it can be said with assurance that modification provisions will not be allowed to influence the court in approving any reorganization plans of a debtor in receivership. Under the rules promulgated by the Securities and Exchange Commission, coercive use of the provisions in

[29] 52 Stat. L. 840 at 890 (1938), 11 U. S. C. (Supp. 1938), §§ 572, 573.

[30] This is the complement of the question in the last paragraph. In view of the attitude of the courts that the power is designed to aid the debtor as a going concern rather than to serve as a bludgeon in the hands of the majority, the provisions should not be a factor in the settlement of rights among competing parties in the estate of the bankrupt debtor. Cf. the attitude of the courts in Vogelstein v. Athletic Mining Co., (Mo. App. 1917) 192 S. W. 760; In re Georgian Hotel Corp., (C. C. A. 7th, 1936) 82 F. (2d) 917.

circularizing the bondholders will be controlled;[31] prior assents by bondholders to any plan will be valueless to establish a presumption of fairness before the court.[32] This conclusion is not to be particularly regretted, as the Chandler Act provides adequate mechanics to bar strikers, and the protection of minorities under the Chandler Act is probably worth the sacrifice of the economy of short receiverships.

When the need of the debtor is for a breathing spell rather than entire reorganization, it is desirable that some technique less costly than receiverships be provided to defer payments. That modification provisions could provide this technique is perhaps their primary value.[33] But whether they will be permitted to be so used depends upon whether Congress deems it necessary for the protection of small bondholders to require judicial supervision of even the deferment of payments. The Trust Indentures Act of 1939 recognizes the value of providing mechanics for inexpensive extensions[34] but limits the scope of extension provisions to three years.[35]

When the problem of the debtor is to readjust the burden of fixed charges so as to avoid impending financial distress, it seems again that indenture provisions to bind strikers may be very desirable, particularly as judicial receiverships may be unavailable to the debtor. How far the Trust Indenture Act of 1939 will be construed to allow provisions looking to the readjustment of the principal debt cannot be forecast.[36] The language of section 316(b) permits limitations on a

[31] S. E. C., GENERAL RULES AND REGULATIONS UNDER THE SECURITIES EXCHANGE ACT OF 1934, Reg. X-14, p. 1401 (1938), pursuant to section 14 of the act. There may be further rules and regulations by the Commission under Section 319 of the Trust Indenture Act of 1939. Pub. No. 253, 76th Cong., 1st sess. (1939).

[32] S. E. C. REPORT ON REORGANIZATION COMMITTEES, Part I, p. 328 (1936), shows the attitude of the authority shaping present legislation: "proponents of voluntary debt readjustments should not be permitted to have the imprimature of federal courts placed on their plans so easily and so expeditiously." At page 900 the recommendation of the S. E. C. is to stop by appropriate legislation the solicitation of assents before judicial scrutiny of every plan has been satisfied. If the Chandler Act by sections 174, 175, and 176 was not sufficiently explicit to halt solicitations under modification clauses, it cannot be doubted that further legislation will remove the possibility.

[33] In Re Georgian Hotel Corporation, (C. C. A. 7th, 1936) 82 F. (2d) 917, the court allowed bonds containing modification provisions to be forced on dissenting bondholders under a reorganization plan. In recognizing the wisdom of including the provisions, the court said (at page 919): "The evident intent of this was to provide power and flexibility for meeting unforeseen contingencies as they might arise, and to provide, so far as might be, against resort to another reorganization proceeding in case this one cannot without alteration be ultimately carried out."

[34] Pub. No. 253, § 316 (a), 76th Cong., 1st sess. (1939).

[35] Ibid., § 316 (a).

[36] Ibid., § 316 (b). See HEARINGS ON H. R. 2191 and H. R. 5220, 76th Cong., 1st sess., pp. 83, 219, 284, 285 (1939).

bondholder's right to sue for his matured principal and interest "if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien." Though this result was to be anticipated from the trend in the limiting of contract reorganization, still it seems unfortunate that the minorities could not be protected without removing the possibility of aid from modification provisions to a far-sighted management. Indeed, the regulations of the Securities and Exchange Commission in controlling the circularizing of security holders[37] seems to be an effective check on the abuse of the modification powers. Out of these increasingly rigid limitations on the use of modification powers the conclusion can be drawn that the future will see them useful only to defer payments in times of stress for relatively short periods (three years from due date) or to alter the security rights of bondholders.

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[37] See note 31, supra.