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CORPORATIONS-TRUST INDENTURE-NOTICE TO SECURITY HOLDERS OF CONTENTS OF INDENTURE

CORPORATIONS — TRUST INDENTURE — NOTICE TO SECURITY HOLDERS OF CONTENTS OF INDENTURE — Ever since corporate bonds made their appearance more than a century ago, there has been a steady increase in difficult problems relating thereto.[1] Not the least interesting of these problems pertains to the matter of notice to holders of the bonds and other securities of the contents of the indenture under which they are generally issued. The question becomes acute when one of these bondholders starts suit in law or in equity, and is met by the proposition that his right to so sue is limited by the trust indenture.[2] There are two aspects to the matter, and it is proposed to take them up in order. First, how far is the bondholder charged with knowledge

[1] STETSON, SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 1-13 (1916). Mr. Stetson discusses the evolution of the bond and indenture to their present involved forms.

[2] A typical provision in an indenture of the sort with which we are principally concerned here is the following:

"the trustee . . . upon being requested in writing by the holders of fifty-one per cent (51%) of the amount of the notes then outstanding hereunder, shall declare . . . the notes . . . as immediately due and collectible. . . .

"Every holder of said notes and coupons accepts them subject to the express agreement that unless and until the Trustee shall have declined to act as herein provided every right of action hereunder by judicial proceedings or otherwise is vested exclusively in the Trustee, and that in no event except in case of such declination by the Trustee, shall any holder . . . have any right to institute any suit or proceeding or take any action hereunder. . . ."

The above provision is taken from the indenture involved in the case of McAdoo v. Oregon City Mfg. Co., (C. C. A. 9th, 1934) 71 F. (2d) 879 at 881. It is fairly typical except that normally the percentage of holders requesting the trustee to sue need not be as high as 51 per cent. The usual percentage is 25 per cent.

of the contents of the trust indenture? [3] Second, admitting that he is charged with knowledge, is he bound by provisions which limit his right to sue?

I

As to our first question, there seems to be a sharp split of authority. Many decisions of the lower courts in New York have quite uniformly held that a reference in a bond to an indenture, by which it is secured, is insufficient to affect the holder with knowledge of the contents of the indenture.[4] The terminology employed in the various reference clauses has been very diverse.[5] Still, except in a few extreme cases where the reference was too definite and positive to warrant any other holding,[6] these courts have steadfastly adhered to the view that there

[3] The term "trust indenture" is used throughout this comment to refer to the document which provides the security for the bonds. The attorneys and parties also use the terms "trust agreement," "indenture" and "trust mortgage," but all mean the same thing. The term "bond" is used broadly to denote any sort of security that may be issued under such "trust indenture." The principles developed are equally applicable to other types of securities such as notes, debentures, etc.

[4] Neivel Realty Corp. v. Prudence Bonds Corp., 151 Misc. 737, 271 N. Y. S. 209 (1934); Cunningham v. Pressed Steel Car Co., 238 App. Div. 624, 265 N. Y. S. 256 (1933); Lubin v. Pressed Steel Car Co., 146 Misc. 462, 263 N. Y. S. 433 (1933); Berman v. Consolidated Nevada-Utah Corp., 132 Misc. 462, 230 N. Y. S. 421 (1928); Brown v. Michigan Ry., 124 Misc. 630, 207 N. Y. S. 630 (1924); General Inv. Co. v. Interborough Rapid Transit Co., 200 App. Div. 794, 193 N. Y. S. 903 (1922); Higgins v. Hocking Valley Ry., 188 App. Div. 684, 177 N. Y. S. 444 (1919); Rothschild v. Rio Grande Western Ry., 164 N. Y. 594, 58 N. E. 1092 (1900), affirming 84 Hun. 103, 32 N. Y. S. 37 (1895) (contains only dicta on this subject).

[5] Some of the typical clauses are:

(a) "Reference is hereby made [to the trust indenture] for the nature of the securities constituting the trust fund, the rights and remedies of the trustee and the respective holders of these bonds" and for "the terms and conditions under which said bonds are . . . issued. . . ." See Neivel Realty Corp. v. Prudence Bonds Corp., 151 Misc. 737, 271 N. Y. S. 209 (1934).

(b) "To which indenture reference is hereby made for a statement of the rights of the holders of said bonds." See Lubin v. Pressed Steel Car Co., 146 Misc. 462, 263 N. Y. S. 433 (1933).

(c) "To which indenture reference is made for a description of the property mortgaged, the nature and extent of the security, and the rights of the corp. and the trustees and the bondholders in respect thereto. . . . In case of default by the corporation . . . the principal may be declared . . . due . . . in the manner provided in the mortgage." See Brown v. Michigan Ry., 124 Misc. 630, 207 N. Y. S. 630 (1924). This provision is the one commonly used today.

[6] See, for example, Mitchell v. Madison Avenue Offices, 147 Misc. 149, 263 N. Y. S. 442 (1933). Here, the reference clause was very much like that set out under (c) in note 5, supra, but in this case there was held to be notice to the bondholder. See also Rudick v. Ulster & Delaware R. R., 147 Misc. 637, 263 N. Y. S. 498 (1928).

was no notice. This position finds support in the decisions of a few other jurisdictions also.[7] The reasons ordinarily given by these courts for their attitude are: (1) To charge the holder with notice of the provisions in the indenture would be to render the bond non-negotiable, a most undesirable result.[8] (2) The conditions in the indenture are inconsistent with the unconditional promise to pay to be found in the bond. That being so, the bond must prevail for that is the instrument on which the holder relies when he is making his purchase.[9] (3) At most the reference imports only a limitation upon the holder's right to sue upon the indenture and none upon his right to sue at law upon his bond.[10]

On the other hand, the federal courts have taken exactly the opposite view. A recent case, arising in the ninth circuit court in California,[11] held that noteholders were charged with notice of all the terms of the trust indenture under which they were issued, where the note referred to this indenture for the conditions of issuance and the rights of the holders. In deciding this way, the court was simply following the well-

[7] Thorpe v. Mindeman, 123 Wis. 149, 101 N. W. 417, 107 Am. St. Rep. 1003, 68 L. R. A. 146 (1904); Guilford v. Minneapolis, S. Ste. M. & A. Ry., 48 Minn. 560, 51 N. W. 658 (1892). See also Enoch v. Brandon, 249 N. Y. 263, 164 N. E. 45 (1928); Sturgis Nat. Bank v. Harris Trust & Sav. Bank, 351 Ill. 465, 184 N. E. 589 (1933); Paepcke v. Paine, 253 Mich. 636, 235 N. W. 871 (1931). In these last three cases, the principal issue concerned the negotiability of the bond, and our problem here was only incidentally involved.

[8] Cunningham v. Pressed Steel Car Co., 238 App. Div. 624, 265 N. Y. S. 256 (1933); Higgins v. Hocking Valley Ry., 188 App. Div. 684, 177 N. Y. S. 444 (1919); Thorpe v. Mindeman, 123 Wis. 149, 101 N. W. 417, 107 Am. St. Rep. 1003, 68 L. R. A. 146 (1904). The result feared may not necessarily follow of course. See 41 YALE L. J. 312 at 313 (1931).

[9] Lubin v. Pressed Steel Car Co., 146 Misc. 462, 263 N. Y. S. 433 (1933); Berman v. Consolidated Nevada-Utah Corp., 132 Misc. 462, 230 N. Y. S. 421 (1928). This reason, which might sufficiently justify the decision of these courts, were other considerations not present, is simply a variation of the modern notion that bond and indenture, though executed simultaneously, are not to be construed together as one instrument, especially if to do so will render the bond non-negotiable. See Aigler, "Conditions in Bills and Notes," 26 MICH. L. REV. 471 at 492 *et seq.* (1928) and cases cited in notes therein. Yet, it is difficult to see any inconsistency if the bond specifically refers to the indenture for the conditions of issuance and the rights of the holders.

[10] Brown v. Michigan Ry., 124 Misc. 630, 207 N. Y. S. 630 (1924); General Inv. Co. v. Int. Rapid Transit, 200 App. Div. 794, 193 N. Y. S. 903 (1922); Rothschild v. Rio Grande Western Ry., 164 N. Y. 594, 58 N. E. 1092 (1900), affirming 84 Hun. 103, 32 N. Y. S. 37 (1895); Bank of California v. Nat. City Co., 138 Wash. 517, 244 Pac. 690 (1926).

[11] McAdoo v. Oregon City Mfg. Co., (C. C. A. 9th, 1934) 71 F. (2d) 879.

settled federal authority.[12] Distinctions might of course be drawn between these two groups of cases. For example, in an attempt to reconcile them it might be argued that the references are not alike, but a careful examination of the cases will reveal that often where the reference is full and complete, the state court will not charge the bondholder with notice; [13] while, on the other hand, there are many cases in which the reference is indefinite and ambiguous,[14] and still the federal court has refused to entertain the bondholder's suit. It would seem that the sounder rule is the one followed in the federal courts. The policy of not letting one disgruntled bondholder start trouble, when the trustee and most of the bondholders see no reason for such action, ought to be sufficient reason for adopting this principle.[15] The courts that go the other way are narrowing the idea of notice a bit too much just for the sake of preserving the negotiability of the bond.[16]

[12] Craig v. Consolidated Cement Corp., (C. C. A. 10th, 1934) 69 F. (2d) 613; Home Mtg. Co. v. Ramsey, (C. C. A. 4th, 1931) 49 F. (2d) 738; Harvey v. Ill. Power & Light Corp., (D. C. E. D. Ill. 1933) 3 F. Supp. 489; Lidgerwood v. Hale & Kilburn, (D. C. S. D. N. Y. 1930) 47 F. (2d) 318; Allan v. Moline Plow Co., (C. C. A. 8th, 1926) 14 F. (2d) 912; Crosthwaite v. Moline Plow Co., (D. C. N. Y. 1924) 298 Fed. 466; McClure v. Twp. of Oxford, 94 U. S. 429, 24 L. ed. 129 (1876). Courts in other jurisdictions also adopt this rule. See St. Louis-Carterville Coal Co. v. So. Coal & Mining Co., 194 Mo. App. 598, 186 S. W. 1152 (1916); Boley v. Lake St. Elevated R. R., 64 Ill. App. 305 (1896); State v. Comer, 176 Wash. 257, 28 Pac. (2d) 1027 (1934); Moody v. Pacific S. S. Co., 174 Wash. 256, 24 Pac. (2d) 609 (1933); Thayer v. South Side Foundry & Machine Works, 112 W. Va. 134, 163 S. E. 821 (1932). The idea in the minds of some of these courts is that proper reference being made by the bond to the indenture, the two must be taken and considered together as forming one contract. See 7 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., c. 39, secs. 3157, 3158 (1931). See also note 9, supra.

[13] See, for instance, the reference in Brown v. Michigan R. R., which is given under (c) in note 5, supra. See also the elaborate reference in Enoch v. Brandon, 249 N. Y. 263, 164 N. E. 45 (1928).

[14] See St. Louis-Carterville Coal Co. v. So. Coal & Mining Co., 194 Mo. App. 598, 186 S. W. 1152 (1916) where (at p. 601) the reference in the coupon was that the coupon represented interest due on the corporation's "first mortgage five per cent gold bond No. 813." This was considered enough to charge the holder with notice of the contents of the mortgage.

[15] Then, too, fairer treatment can be accorded the general body of creditors if there is avoided the multiplicity of suits that would follow from holders racing for preference upon default. Because of these policy considerations it has been said that even recordation of the mortgage gives sufficient notice. See Belleville Savings Bank v. So. Coal & Mining Co., 173 Ill. App. 250 at 253 (1912).

[16] In rebutting the contention that giving effect to the restriction would be incompatible with the negotiability of the instrument, it is argued in 41 YALE L. J. 312 at 313 (1931) that in some states legislation makes all corporate bonds negotiable regardless of the NIL. See N. Y. Personal Property Law, art. 8, secs. 260 and 262, Cahill's Consol. L. of N. Y. (1930), pp. 1760-1761. But see criticism in 26 COL. L. REV.

II

The second half of our problem raises even more difficult questions. Granting that we have sufficient notice to the bondholder, is the latter still bound by limitations upon his right to sue either at law upon the corporation's primary obligation [17] or in equity upon the bond? The answer to this will depend upon the construction which the court gives to the limitation provisions.[18] Various considerations of policy influence

884 (1926). See also Ky. Stat., (Carroll 1930) sec. 3102, and Siebenbauer v. Bank of Cal. Nat. Ass'n, 211 Cal. 239, 294 Pac. 1062 (1930). Furthermore, even under the NIL the instrument could be negotiable to the extent of passing good title to an innocent purchaser. The latter would merely be subjected to terms expressly incorporated by reference to another instrument, which terms would operate not to condition the maker's obligation but to waive certain rights of the individual holders.

See also 29 MICH. L. REV. 1062 at 1065-1066 (1931) where it is suggested that since corporate bonds are long-term obligations and are widely distributed, they should be held negotiable, as long as they do not positively violate any fundamental element of a negotiable instrument. These bonds are investments, and a widespread distribution is necessary to enable the corporation to effectively borrow money. This distribution, as well as the necessary liquidity, can best be secured by holding the bonds negotiable.

[17] By "primary obligation" is meant the corporation's promise to pay at a certain date. This is something apart from the security furnished by the corporation.

[18] Many and different have been the meanings given to these provisions. When the indenture said "no holder of any bond shall have the right to institute any suit, action, or proceeding at law or in equity upon, or in respect of, this indenture . . . to affect, disturb or prejudice the lien of this indenture by his action, or to enforce any right hereunder, except" etc., the court said that the limitation was confined to actions to enforce the security afforded by the indenture, and was not applicable to actions based on the primary promise to pay. Brown v. Michigan R. R., 124 Misc. 630, 207 N. Y. S. 630 (1924). A recent Delaware case held that the provisions in the indenture are to be strictly construed. Hence, if the bondholder is denied the right to sue under the indenture, that does not deny to him the right to have a receiver appointed for the corporation. Noble v. European Mtg. & Investment Corp., 19 Del. Ch. 216, 165 Atl. 157 (1933). When the indenture provided various remedies in case of default, but did not expressly exclude the bondholder's right to sue, nor was such right excluded by necessary implication, then the enumerated remedies were to be considered cumulative only. Manning v. Norfolk Southern R. R., (D. C. E. D. Va. 1887) 29 Fed. 838. The holder of detached coupons may sue to foreclose for overdue interest, despite a provision in the indenture that default in paying interest for a certain time shall mature the debt at the option of the trustee or a certain percentage of the bondholders, since in this action there is no attempt to recover the principal, but only to foreclose for unpaid interest. California Safe Deposit & Trust Co. v. Sierra Valleys Ry., 158 Cal. 690, 112 Pac. 274, Ann. Cas. 1912A 729 (1910); Mack v. American Electric Telephone Co., 79 N. J. L. 109, 74 Atl. 263 (1909) (*semble*, the coupon being detached and therefore not coming within the conditions of the bond). A requirement in the indenture for prosecution of actions by the trustee was held not to preclude action by the individual bondholder for conversion of his bonds into bonds of another class. Brooks v. North Carolina Public Service Co., (D. C. M. D. N. C. 1929) 32 F. (2d)

the court in this construction.[19] A number of early United States Supreme Court [20] and lower federal court decisions [21] have held that regardless of such provision, a single bondholder could foreclose for nonpayment of interest. In none of these cases, however, was there any express prohibition against the suit of a single bondholder. What prohibition there was arose only by implication, and since strict construction [22] is the rule in such cases, the court refused to make the necessary implication. Nevertheless, there are many later cases, federal and state,[23] where an express prohibition was present, with the result that it was given effect and the suit held barred. It should be observed that in all of these cases the suit was at law upon the bond, but the books contain a few decisions [24] in which the bondholder sought to have

800. The court reasoned that the limitation referred simply to those suits affecting the bondholders as a group.

Various other constructions have been placed upon these provisions. See Kimber v. Gunnell Gold Min. & Mill. Co., (C. C. A. 8th, 1903) 126 Fed. 137; Romberg v. Interstate Independent Tel. & Tel. Co., 200 Ill. App. 509 at 513 (1916); 41 YALE L. J. 312 (1931).

In McAdoo v. Oregon Mfg. Co., (C. C. A. 9th, 1934) 71 F. (2d) 879, the provision was that "every right of action hereunder is vested in the trustee" and that was interpreted to bar suit at law as well as suit in equity. All the cases cited in note 12, supra, are in accord with such interpretation.

[19] If most of the bondholders oppose action, their wishes should govern, argue those courts which give a liberal construction to these limitations. On the other hand, if there has been a default, is it fair to make the bondholder stand patiently by, while in his opinion the property securing his bond is being dissipated? See TRACY, CORPORATE FORECLOSURES, RECEIVERSHIPS AND REORGANIZATIONS, sec. 6, p. 6 (1929), for an excellent discussion of both sides of this matter.

[20] Chicago, D. & V. R. R. v. Fosdick, 106 U. S. 47, 1 Sup. Ct. 10 (1882); Morgan's L. & T. R. R. & Steamship Co. v. Texas Central Ry., 137 U. S. 171, 11 Sup. Ct. 61 (1890); Guaranty Trust & Safe Deposit Co. v. Green Cove Springs & M. R. R., 139 U. S. 137, 11 Sup. Ct. 512 (1891).

[21] Farmers' Loan & Trust Co. v. C. & A. Ry., (D. C. Ind. 1886) 27 Fed. 146; Lowenthal v. Georgia Coast & P. R. R., (D. C. S. D. Ga. 1916) 233 Fed. 1010; Brown v. Denver Omnibus & Cab Co., (C. C. A. 8th, 1918) 254 Fed. 560.

[22] See note 18, supra, and especially Manning v. Norfolk Southern R. R., (D. C. Va. 1887) 29 Fed. 838, and Noble v. European Mtg. & Investment Corp., 19 Del. Ch. 216, 165 Atl. 157 (1933).

[23] See the cases cited in note 12, supra.

[24] Home Mortgage Co. v. Ramsey, (C. C. A. 4th, 1931) 49 F. (2d) 738; Harvey v. Ill. Power & Light Corp., (D. C. E. D. Ill. 1933) 3 F. Supp. 489; McGeorge et al. v. Big Stone Gap Imp. Co., (D. C. W. D. Va. 1893) 57 Fed. 262. It should be noted, however, that in these cases the appointment of a receiver was sought not for the sake of foreclosing, but for the sake of securing proper management of the corporation. *Cf.* Noble v. European Mtg. & Investment Corp., 19 Del. Ch. 216, 165 Atl. 157 1933), where the corporation was insolvent, and the receiver was appointed at bondholder's request. See also Reinhardt v. Inter-State Tel. Co., 71 N. J. Eq. 70, 63 Atl. 1097 (1906).

a receiver appointed in equity, and he failed. It has been suggested by a writer [25] on corporate foreclosures that the modern tendency is to observe the wishes of the majority of the bondholders, and therefore even a foreclosure suit brought in equity by one of the bondholders should be barred.[26] Of course, where the restrictions are such as to oust the jurisdiction of the courts, they are universally held void.[27]

III

To sum up, it appears that the better rule is that a reference in a bond to the indenture for the rights of the bondholders is enough to charge the holder with notice of the limitations upon his rights, which are contained in such indenture.[28] Otherwise, one bondholder is allowed to impair the whole security by starting trouble when the others are perfectly satisfied to allow things to go on as in the past. Then also, if it is granted that these restrictions may be imposed, it is difficult to conceive of anything else that the mortgagor might have done to have protected himself. If the argument is advanced that he might have attached a copy of the indenture to the bond, the answer is that it is doubtful if the bondholder would have troubled to read it any more than he did with the indenture kept in a quasi-public place to which all

[25] TRACY, CORPORATE FORECLOSURES, RECEIVERSHIPS AND REORGANIZATIONS, sec. 6, p. 9 (1929).

[26] This suggestion is rebutted, at least inferentially, in those cases where the courts have gone to great lengths to uphold the negotiability of the bond, and have therefore construed the reference clause as affecting the security only. See Enoch v. Brandon, 249 N. Y. 263, 164 N. E. 45 (1928); Paepcke v. Paine, 253 Mich. 636, 235 N. W. 871, 75 A. L. R. 1205 (1931); Pflueger v. Broadway Trust & Sav. Bank, 351 Ill. 170, 184 N. E. 318 (1932). These cases did not expressly hold that the plaintiff might have foreclosed in equity, but such conclusion might be inferred from what was said.

[27] See Brown v. Denver Omnibus & Cab Co., (C. C. A. 8th, 1918) 254 Fed. 560, and Guaranty Trust and Safe Deposit Co. v. Green Cove Springs & M. R. R., 139 U. S. 137, 11 Sup. Ct. 512 (1891). In this latter case the fatal provision said that the mode of sale provided by the indenture shall be exclusive of all others.

[28] It is submitted that even in New York the courts might change their rule without doing violence to precedent. See McClelland v. Norfolk Southern Ry., 110 N. Y. 469, 18 N. E. 237 (1888). In this case the bond recited that it was to become payable upon the terms and with the effect mentioned in the trust mortgage, and the court held that the promise to pay was conditional. Thus, the implied ruling was that the bondholder was charged with knowledge of the contents of the mortgage, and if that is so, the New York lower courts might very well adopt the federal rule without, I repeat, going into the teeth of *stare decisis*. An even clearer New York decision, which gives weight to this contention, is Batchelder v. Council Grove Water Co., 131 N. Y. 42, 29 N. E. 801 (1892), where the court explains the policy underlying the restrictive clause and the enforcement of it. See also Old Colony Trust Co. v. Stumpel, 247 N. Y. 538, 161 N. E. 173 (1928).

bondholders may go in order to read it.[29] Then, having crossed the obstacle of notice, there is left only the question of the binding effect of these provisions. For the reasons of policy and fairness which are advanced above,[30] it would seem sound and proper to enforce them.

M. C. D.

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[29] It is generally provided in the trust indenture that a copy of it is to be kept by the trustee, and is to be open for inspection by any bondholder.

[30] See note 15, supra, in addition to those considerations, which are mentioned in the body of this comment. Other points that might be raised are that it is desirable to establish the trustee as representative of all the bondholders, some of whom might find it more difficult than others to sue individually because of the wide scattering of corporate holdings. Then also, if these restrictions are carried out, that prevents capricious suits which tend to ruin the corporation, when its present shaky condition is only temporary. See TRACY, CORPORATE FORECLOSURES, RECEIVERSHIPS AND REORGANIZATIONS, sec. 6, p. 6 (1929).