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CORPORATIONS-TRUST INDENTURE-BOND AND INDENTURE PROVISIONS GIVING NOTICE TO SECURITY HOLDERS OF LIMITATIONS UPON RIGHT TO SUE

CORPORATIONS—TRUST INDENTURE—BOND AND INDENTURE PROVISIONS GIVING NOTICE TO SECURITY HOLDERS OF LIMITATIONS UPON RIGHT TO SUE — In a recent comment [1] in this Review it was pointed out that many corporate bonds contain a clause referring the bondholder to the trust indenture, under which the bonds are issued, for a description of his rights with respect to the bond. The main purpose of this reference clause is to give the holder notice of the limitations upon his right to sue either at law upon the bond or in equity upon the security. These limitations, whatever they may be, are generally too numerous to reprint on the bond, and hence they are found only in the indenture. One such limitation frequently found provides that the bondholder shall have no right to bring suit, unless and until a certain percentage of bondholders have made a request to the trustee to sue, with a guaranty of the costs, and the latter has refused to do so. As was shown in the earlier comment, many courts are astute to nullify the effect of these reference clauses, and they do it by a construction of the language used.[2] It is the purpose of this comment to supplement what was there said, by suggesting a few reference clauses that would seem to be sufficient to accomplish their intended result. To make the picture complete, there will also be suggested some model "no-action" indenture provisions.

I

The draftsman of the bond and indenture must remember three things. First, he must be certain that the reference clause imports a limitation upon the holder's right to sue upon the bond as well as upon his right to foreclose in equity upon the indenture. Second, if he desires that the bonds be negotiable, he must *not include* such clauses as

[1] 33 MICH. L. REV. 604 (1935).
[2] See 33 MICH. L. REV. 604 at 605 *et seq.* and notes (1935).

will destroy negotiability.[3] Third, he must word the indenture so that it limits the bondholder's right to sue upon the bond, and also provisionally bars suit by him upon the indenture.

The following reference clause embodies in substance and with some additions a clause that has generally been considered ample to give notice to the bondholders. This has been particularly true in the federal courts.

> (1) "This bond is one of an issue of bonds of the corporation .... all issued under and pursuant to a certain indenture, dated _____ ... to which indenture reference is hereby made for a description of the terms under which the said bonds are issued and of the rights and obligations of the corporation, the trustee, and the respective holders of the said bonds under the indenture.
>
> "All rights of action on this bond and the annexed interest coupons, except as otherwise provided by the indenture, are vested in the trustee, and the enforcement thereof is governed by the provisions of the indenture." [4]

A simpler clause dealing only with the matter of suit by the bondholder is the following:

> (2) "To the extent provided in the indenture, all rights of action upon this bond are vested in the trustee." [5]

[3] This requirement, as is pointed out elsewhere in this comment, need not be observed in certain cases, where the negotiability element is not of particular moment.

[4] See Allan v. Moline Plow Co., (C. C. A. 8th, 1926) 14 F. (2d) 912; 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. This clause would probably affect the bondholder with knowledge of the contents of the indenture. Furthermore, it is more than likely that the bond would be held negotiable. The Michigan Supreme Court in Paepcke v. Paine, 253 Mich. 636, 235 N. W. 871, 75 A. L. R. 1205 (1931), held negotiable a debenture which, except for the last sentence here, contained a clause almost identical with this one. The same result has been reached in New York [Enoch v. Brandon, 249 N. Y. 263, 164 N. E. 45 (1928)] and in Illinois [Pflueger v. Broadway Trust and Sav. Bank, 351 Ill. 170, 184 N. E. 318 (1932)]. However, these three courts insisted that the reference clause refers to the security only. They did not decide that point, but the cases contain dicta to that effect. However, the federal courts and many state courts uniformly agree that this clause refers to the primary obligation of the bond as well as to the security. See cases cited above in this note and also those cited in note 12 in 33 MICH. L. REV. 604 at 607 (1935). Any doubt as to this point would seem to be resolved in favor of the holding of the federal courts, in view of the inclusion of the last sentence in this first reference clause. Yet, a similar sentence in the bonds involved in Paepcke v. Paine, supra, was held insufficient to give notice of a limitation to sue upon the corporation's primary obligation. For that reason this clause would not universally accomplish the desired result.

[5] This clause does not qualify the corporation's promise to pay a sum certain at a fixed time. It simply gives notice of a limitation upon the bondholder's right to sue.

Another very common reference clause is this:

(3) "This bond is one of a duly authorized issue of bonds of the corporation equally secured by a trust indenture . . . to which indenture reference is hereby made for a description of the property mortgaged, the nature and extent of the security and the rights of the corporation and the trustees and the holders of said bonds in respect thereto." [6]

Last of all comes a clause about which there can be little doubt. It gives the necessary notice, but its shortcoming lies in that it makes the bond non-negotiable.

(4) "For a description of the mortgaged property, the nature and extent of the security, the rights of the holders of the bonds, and the terms and conditions upon which said bonds are issued, reference is made to the indenture, to all provisions of which this bond and each coupon hereto attached are subject, with the same effect as if the same were herein fully set forth.[7]

"In case of default in the payment of interest or of the principal of any of said bonds or in case of default in the performance of any of the covenants or conditions of the indenture, the principal may become due and payable on the conditions and in the manner and at the time provided in the indenture.

"The holder, by accepting this bond, assents to all the pro-

Hence, there would seem to be no reason why the bond should not be held negotiable. However, here too there is present the difficulty of insufficient notice of conditions attached to the holder's right to bring suit at law.

[6] In New York, to judge by the mass of lower court decisions, this clause would not give the bondholder notice so as to bar his suit at law. See cases cited in note 4 in 33 MICH. L. REV. 604 at 605 (1935). But see other New York cases cited in note 6, *ibid.* In the federal courts it would be sufficient. Harvey v. Illinois Power & Light Corp., (D. C. E. D. Ill. 1933) 3 F. Supp. 489. An even less complete clause has been held sufficient in Washington. See Moody v. Pacific S. S. Co., 174 Wash. 256, 24 Pac. (2d) 609 (1933). Furthermore, in view of the great lengths to which courts go in upholding the negotiability of these instruments, a bond containing a clause such as this would probably be held negotiable.

[7] In a recent Illinois case, the reference clause was "For a description of the mortgaged property and the nature and extent of the security reference is made to said trust deed, to all of the provisions of which this bond and each coupon hereto attached are subject, with the same effect as if said trust deed were herein fully set forth." That was held not to preclude plaintiff's individual suit. Oswianza v. Wengler & Mandell, Inc., (Ill. 1934) 193 N. E. 123. Two judges dissented. The opinion would be more startling were it not for the fact that the Illinois court had shown in some earlier cases how far it would go to prevent incorporation by reference into the bond. See Sturgis Nat. Bank v. Harris Trust & Sav. Bank, 351 Ill. 465, 184 N. E. 589 (1933), and Pflueger v. Broadway Trust & Sav. Bank, 351 Ill. 170, 184 N. E. 318 (1932).

visions of the indenture in like manner as if the same were herein fully set forth.

"All rights of action on this bond and the annexed interest coupons, whether to enforce the corporation's primary indebtedness or to foreclose the security, and except as otherwise provided in the indenture, are vested in said trustee, and the enforcement thereof is governed by the provisions of the indenture.

"The indenture, and this bond, as well as all of the other bonds aforesaid, are to be taken and considered together as parts of one and the same contract." [8]

Of the four clauses thus suggested, it seems that clause (1) is the best. Because of the ruling in *Paepcke v. Paine*,[9] which represents a tendency, the prediction is ventured that the bond would be held negotiable despite the inclusion of the last sentence. Furthermore, there would be present the necessary notice of limitations upon the right to sue either at law or in equity.[10]

[8] As suggested in the body of this comment, this clause is probably enough to make the bond non-negotiable. It requires reference to another document to determine whether in fact the unconditional promise to pay at a future date is modified or subject to some contingency. It makes use of the fatal language "to all provisions of which this bond and each coupon hereto attached are subject," and under the N.I.L., the words "subject to" probably destroy negotiability. At least that can be inferred from the requirement that the instrument contain an unconditional promise to pay a sum certain at a fixed time. See Steffen and Russell, "The Negotiability of Corporate Bonds," 41 YALE L. J. 799 at 812 (1932) for a discussion of the effect of these words upon negotiability. Nevertheless, if the corporation, which is issuing the bonds, is a small one and the issue is itself rather small, the negotiability feature will not be of very great importance. The corporate holdings will not be very widely scattered, and therefore, liquidity may not be as important as notice to the security holders of the contents of the indenture.

[9] 253 Mich. 636, 235 N. W. 871, 75 A. L. R. 1205 (1931). See note 4, supra.

[10] This statement must be taken together with the qualifications made in note 4, supra.

A word about suing upon the coupons would not be amiss here. Generally, if there is notice to the bondholder of the relevant indenture provisions, he would have no greater right to sue upon those than upon the bonds. Of course, if the detached coupons are in the hands of a bona fide holder who has paid value, it might be insufficient for them to simply recite that they represent interest due on a "first mortgage bond of _____corporation. . . . No._____." Yet, some courts might say that that is sufficient to put the holder on inquiry as to the terms of the bond and indenture. See St. Louis-Carterville Coal Co. v. So. Coal & Mining Co., 194 Mo. App. 598, 186 S. W. 1152 (1916); McClelland v. Norfolk Southern Ry., 110 N. Y. 469 at 474, 18 N. E. 237 at 239 (1888); McClure v. Twp. of Oxford, 94 U. S. 429, 24 L. ed. 129 (1876). To be certain, however, that the coupon holders were bound by the provisions in the indenture, it would be necessary to reprint on the coupon the same clauses that the bond contained.

2

Next, there arises the necessity of making the indenture limit the holder's right to sue either at law upon the debt or in equity upon the security. The following three provisions are suggested:

(1) "No holder of any bond issued hereunder shall have the right to institute any suit, action or proceeding, at law or in equity, for the collection of any sum due from the company on such bond, for principal or interest, or upon or in respect of this indenture, or for the execution of any trust or power hereof, or for the appointment of a receiver for the Corporation for any purpose whatsoever,[11] or for any other remedy under or upon this indenture, unless and until such holder shall [here put in the various conditions precedent to the bondholder's suit]."

(2) "This indenture is for the common and equal use, benefit, and security of all and singular the present and future holders or owners of said bonds and/or interest coupons, or any of them, without preference, priority or distinction of any of said bonds and/or interest coupons over any of the others by reason of priority in the issue, authentication, sale or negotiation thereof or otherwise.

"No holder of any bond or coupon issued hereunder and hereby secured shall have any right to institute any suit, action or proceeding at law or in equity or take any other steps or proceedings, for the collection of any sum due from the Corporation on such bond or coupon or for any remedy under this indenture unless and until [here put in the various conditions precedent to bondholder's suit].

"It is understood and intended that no one or more holders of bonds and/or coupons shall have any right in any manner whatsoever by his or their action to affect, disturb, or prejudice the lien of this trust indenture, or to enforce any right hereunder or to obtain the appointment of a receiver for the Corporation for any purpose whatsoever, or to sue at law upon the bond and/or coupon to enforce the Corporation's primary indebtedness, except in the manner herein provided, and that all proceedings at law or in equity shall be instituted, had and maintained in the man-

[11] This stipulation against the bondholder's obtaining the appointment of a receiver is included, in order to prevent the court from so construing the indenture as to allow that. In a recent Delaware case the court pointed out that strict construction is the rule with respect to these "no-action" provisions. Therefore, a limitation upon a bondholder's right to sue upon the security did not bar his asking for and getting the appointment of a receiver. See Noble v. European Mtg. & Investment Co., 19 Del. Ch. 216, 165 Atl. 157 (1933).

ner herein provided, and for the equal benefit of all the bonds outstanding hereunder."

(3) "Every holder of any of the bonds hereby secured accepts the same subject to the express agreement that every right of action, whether at law or in equity, and whether upon the Corporation's primary obligation to pay the principal and interest of the bonds to the respective holders of the bonds and to the respective holders of the coupons appertaining thereto, at the respective due dates in such bonds and coupons stated, or upon the security afforded by this indenture, or for the appointment of a receiver for the Corporation for any purpose whatsoever, is vested exclusively in the trustee, and under no circumstances shall the holder of any bond or coupon, or any number or combination of such holders, have any right to institute any action at law upon any bond or bonds or any coupon or coupons, or otherwise, or any suit or proceeding in equity or otherwise to enforce the lien of this indenture or to foreclose the security afforded by this indenture, or to obtain the appointment of a receiver for the Corporation for any purpose whatsoever except in case [here put in the various conditions precedent to the bondholder's suit].

"No action at law or in equity shall be brought by, or on behalf of, the holder or holders of any bonds or coupons, whether or not the same be past due, except by the trustee or by the requisite number of bondholders acting in concert under the provisions of this section for the benefit of all bondholders; it being the intent hereof that no one or more holders of said bonds shall have the right in any manner whatsoever to sue at law upon his or their bonds or to affect, disturb, or prejudice the lien of this indenture by his or their action, or to obtain the appointment of a receiver for the Corporation for any purpose whatsoever, except in the manner provided in this indenture." [12]

This last provision is probably the most lucid and comprehensive of the three.

M. C. D.

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[12] There remains the question of the binding effect of these provisions. For a discussion of this, see 33 MICH. L. REV. 604 at 608 *et seq.* (1935).