Updating the Trust Indenture Act

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Holders of publicly distributed debt securities are, in essence, parties to contracts of adhesion. There is no opportunity for a purchaser of a debt security to negotiate the terms of his loan to the issuer. In addition, because there are a large number of geographically scattered small lenders, each of them is placed in a particularly vulnerable position. While lenders traditionally have numerous methods of protecting their interests, creditor protection is ineffective unless responsibility for enforcement is centralized. Widely scattered security holders find it difficult to police compliance with covenants in the loan agreement and to coordinate legal action in case of default. Therefore, the debt holders' interests are generally represented by a trustee who is given the responsibility of enforcing the loan provisions (and any related mortgage provisions) that are embodied in the indenture under which the securities are issued.1

The Trust Indenture Act of 19392 (Act) was directed toward assuring to holders of debt securities the services of a disinterested indenture trustee,3 who would observe high standards of conduct in protecting their interests.4 Without this protection, other creditors and stockholders represented by management often could obtain unfair advantage upon the

1 The earliest function of the trustee under an indenture was that of serving as the transferee of the property conveyed as collateral to secure the rights of scattered bondholders. For a discussion of the trustee's functions and the general development of the trust indenture see AMERICAN BAR FOUNDATION, COMMENTARIES ON IDENTURES 4-10 (1971) [hereinafter cited as ABF COMMENTARIES].
3 While the Act is somewhat awkwardly drafted for this purpose, it presumably requires the use of a trustee whenever bonds, notes, debentures, or other evidences of indebtedness are issued in an amount totaling over $250,000 in any twelve-month period. Trust Indenture Act § 304(a)(8), 15 U.S.C. § 77ddd(a)(8) (1970). Issues over $250,000 must be issued under an indenture. Id. Presumably implicit in the indenture requirement is that the indenture provide for a trustee, although the Act never specifies this, for indentures which need not otherwise comply with the substantive provisions of the Act, even in § 303(7), the definitional provision of "indenture." 15 U.S.C. § 77ccc(7) (1970). If the total amount of securities that may be outstanding under the indenture is more than one million dollars, the indenture must comply with the other provisions of the Act. Trust Indenture Act § 304(a)(9), 15 U.S.C. § 77ddd(a)(9) (1970). One of these provisions specifies that a trustee be used. Trust Indenture Act § 310(a)(1), 15 U.S.C. § 77jjj(a)(1) (1970). See also 2 L. LOSS, SECURITIES REGULATION 746-47 (1961).
4 This purpose was indicated not only in the legislative history, see H.R. REP. No. 1016, 76th Cong., 1st Sess. 25 (1939), but was also spelled out in the Act itself. Trust Indenture Act § 302(a), 15 U.S.C. § 77bbb(a) (1970). See also Note, The Trust Indenture Act of 1939, 25 CORNELL L.Q. 105 (1939).
insolvency of a corporate issuer of debt securities. Creditors junior to the public debt security holders might take steps to collect, or at least to collateralize, their advances. Incumbent management might structure the reorganization, which would occur after a default, so as to retain substantial control. And often, as the history of the early part of the twentieth century shows, the indenture trustee, supposedly acting on behalf of the bondholders, either would itself be a junior creditor or shareholder, or would be allied with other junior creditors or shareholders who were attempting to obtain advantages.

In the wake of the Great Depression, Congress perceived its first problem as one of restoring confidence in the securities industry. It then focused specifically on the problems facing security holders, particularly debt security holders, after the issuer's default. Section 211 of the Securities Exchange Act of 1934 directed the Securities and Exchange Commission (SEC) to make a study of reorganizations and liquidations of insolvent corporations, with particular reference to the activities of protective and reorganization committees. Out of this study came both the Trust Indenture Act, and Chapter X of the Bankruptcy Act, which was added by the Chandler Act in 1938. Both pieces of legislation were largely concerned with post-default problems.

In hindsight, the drafters of the Trust Indenture Act appear to have been wearing blinders. Their concern with protecting bondholders led them to ignore the broader impact of the Act upon the securities markets. Having dealt with the misuse of inside information in 1934, Congress promptly forgot about it in the context of the 1939 Act.


\[\text{1 J. Moore & R. Oglebay, Corporate Reorganization 1973-75 (1948).}\]

\[\text{7 See note 5 supra.}\]

\[\text{8 See V. Carosso, Investment Banking in America 352-53 (1970).}\]


\[\text{11 The work of protective and reorganization committees has been described as follows:}\]

The functions of the bondholders' protective committee in this context are to prepare a plan of reorganization and to obtain the security holders' assents to the plan. When, pursuant to the decree of the court, the foreclosure sale is held, the committee proceeds to bid in the property, applying, in payment of most of the purchase price, the bonds which have been deposited with it. Then, freed of creditors' claims by the sale, the debtor's assets are enveloped in a new corporate shell, and subjected to the new financial structure designated in the reorganization plan; and the securities representative of this new structure are issued to those who have assented to the plan of reorganization.


\[\text{13 See 2 L. Loss, Securities Regulation 719-20 (1961).}\]

Since 1939, however, problems of misuse of inside information have come to the fore, as have related concerns regarding the role of institutional investors in our economy. Despite these changes in attitude, the question of the continuing adequacy of the Trust Indenture Act's provisions has been virtually ignored. The two most ambitious and recent studies that might have explored the question failed to do so. Neither the SEC's Institutional Investor Study,\textsuperscript{15} nor the Report of the President's Commission on Financial Structure and Regulation (the Hunt Commission report)\textsuperscript{16} touched on the problem, even though both extensively discussed bank personal trust departments.\textsuperscript{17} The American Law Institute's project to draft a Federal Securities Code will contain a portion relating to trust indentures; however, a draft of this part has not yet been publicly released. Nevertheless, the Reporter's Introductory Memorandum to Tentative Draft No. 2 of the Federal Securities Code states that "little substantive change is envisaged" with respect to that part of the Federal Securities Code.\textsuperscript{18}

It is difficult to explain the continuing failure to reexamine the Trust Indenture Act. In part, the lack of concern may be due to the general economic prosperity that has existed since World War II. This period of prosperity has minimized the number of situations in which public holders of debt securities have been adversely affected by corporate insolvency.\textsuperscript{19} Since the Act generally is directed toward concerns that arise upon default by the obligor, it is only upon insolvency that the Act's provisions become of crucial importance. Second, the complexity of the Act has led to a channeling of efforts in directions other than toward a wholesale examination of the bases upon which the Act rests. For example, the American Bar Foundation (ABF) has completed its ambitious Corporate Debt Financing Project that prepared model provisions for indentures, including boilerplate developed to comply with the Act's requirements.\textsuperscript{20} While the ABF Project has simplified the drafting of enormously complex documents, it has failed to further any critical evaluation of the adequacy of existing controls.\textsuperscript{21}

\textsuperscript{15} SEC INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971) [hereinafter cited as INSTITUTIONAL INVESTOR STUDY].
\textsuperscript{16} REPORT OF THE PRESIDENT'S COMM'N ON FINANCIAL STRUCTURE AND REGULATION (1971).
\textsuperscript{17} INSTITUTIONAL INVESTOR STUDY, supra note 15, at 413-94; REPORT OF THE PRESIDENT'S COMM'N ON FINANCIAL STRUCTURE AND REGULATION, supra note 16, at 101-06.
\textsuperscript{18} ALI FED. SECURITIES CODE xiii-xv (Tent. Draft No. 2, 1973).
\textsuperscript{20} See ABF COMMENTARIES, supra note 1.
\textsuperscript{21} Indeed, in describing the project, its editors said:

\textit{In order to achieve maximum standardization and general adaptability, the Project sought first to determine what provisions are practically "non-negotiable," not in the sense that they cannot be negotiated, but in the sense that they seldom are in fact negotiated and as a practical matter in most cases ought not to be.}

\textit{Id. at 3 (emphasis added).}
Whatever may be the reasons for the lack of interest in the Trust Indenture Act, the disregard cannot be attributed to the disappearance of the problems that the Act was designed to remedy. Today widely scattered holders of debt securities face the same hurdles in enforcing indenture provisions that existed in 1939. The need for disinterested and responsible indenture trustees is as great as ever, and, as indentures for corporate organizations contain increasingly complex covenants to protect the holders of securities under the indentures, the need for sophisticated and active trustees increases. Moreover, despite the development of other remedial and protective provisions of the federal securities laws in recent years, the kinds of problems at which the Trust Indenture Act was directed have not been adequately treated.

The Trust Indenture Act's thrust, which is largely prophylactic, is to ensure the presence of a trustee with adequate power and responsibility to protect holders of securities under the indenture. Thus, while the recent decision in Lewis v. Marine Midland Grace Trust Co. held that a rule 10b-5 action is available to purchasers and holders of debentures who allege a plan or scheme between the issuer, its accountants, and the indenture trustee to submit false asset valuations in order to satisfy certain covenants in the trust indenture, such an action is at best an after-the-fact remedy. The failure of the Trust Indenture Act to protect against the activities alleged in Lewis and related cases involving Webb & Knapp debentures gives rise to concern that the Act needs reform in order to achieve its purposes.

I. PURPOSES OF THE ACT

A. Conflicts of Interest

One of the important purposes of the Trust Indenture Act was an attempt to eliminate conflicting interests that might lead the trustee to disregard his duty to bond or debenture holders. The history of the Act shows that its drafters were primarily concerned with conflicts of interest existing when the trustee either is allied with junior security holders or is itself a short-term lender. In either case the trustee has incentives to delay notice of defaults by the obligor and to postpone foreclosures on behalf of the bondholders, in order to protect junior or unsecured inter-

22 For an example of early covenants drafted in a manner that permitted easy evasion, see the negative pledge clauses described in VI SEC 1936 REPORT, supra note 5, at 10-16. Compare the clauses in ABF COMMENTARIES, supra note 1, at 349-67.


26 See note 108 and accompanying text infra.

27 VI SEC 1936 REPORT, supra note 5, at 71-109.
ests. Any delay makes it possible for junior creditors, stockholders, and insiders to siphon off assets ahead of senior debt holders or, at a minimum, to form and control the reorganization committee, which dominates reorganization proceedings after insolvency becomes apparent.\(^{28}\)

An example of the problem is the case of R. H. Hoe & Co., Inc., described by the SEC in its 1936 report.\(^{29}\) Guaranty Trust Company was trustee for the bonds of Hoe, a manufacturer of printing presses. Officers of an affiliate of Guaranty Trust knew of an impending default, but did not inform the bondholders even after the default occurred. Guaranty had numerous other relationships with Hoe: it was a creditor of Hoe; its securities affiliate was an underwriter of Hoe securities; and it was in control of Hoe through both common stock ownership and control of the trustees of a voting trust. When it became clear that a default would occur, Guaranty began to take steps to ensure that it would control the reorganization that would certainly follow. Through such control, Guaranty could protect itself from losses due to its other relationships with Hoe.

Even before default, however, Guaranty was in a position to benefit itself at the expense of bondholders. Guaranty earlier had loaned $1,700,000 to Hoe. When it appeared that Hoe was in financial difficulty, Guaranty began to do two things: first, it applied the proceeds of collateral to reduce the amount owed to it by Hoe; second, through its control of Hoe’s board of directors, it modified the loan agreement to increase the collateral pledged to secure the loan by ending Hoe’s right to withdraw collateral in excess of 120 percent of the loan. If Hoe had been able to continue the withdrawal of excess collateral, additional assets would have been available to satisfy bondholders. In addition, Guaranty applied Hoe’s checking account balance to the outstanding loan, and seized funds that Guaranty held as paying agent for the bonds for which it was also trustee.\(^{30}\)

To combat problems such as these, the Act, in Section 310(b),\(^{31}\) sets up elaborate provisions for disqualification of a trustee with conflicting interests. These provisions must be included in all indentures covered by the Act.

1. \textit{In General: Section 310(b)}—If the trustee has or acquires a conflicting interest, he must either eliminate the conflicting interest or resign within ninety days after discovering the conflict. If the trustee fails to take either of these steps, he must notify the bond or debenture holders of his failure to resign, and any person who has been a bona fide holder of the indenture securities for six months may obtain court removal of the trustee and appointment of a successor.\(^{32}\)

In nine paragraphs, the Act specifies in meticulous detail the conditions under which a trustee is deemed to have a conflict of interest.

\(^{28}\) \textit{Id.}
\(^{29}\) \textit{Id. at 39-42, 83-88.}
\(^{30}\) \textit{Id.}
\(^{32}\) \textit{Id.}
a. Dual Trusteeship\textsuperscript{33}—A conflict exists if the indenture trustee is also a trustee under another indenture covering securities of the same obligor. This provision, however, exempts dual trusteeships where no conflict of interest is likely to exist. The first of these exemptions is the situation in which the trusteeship under an indenture for collateral trust notes is coupled with a trusteeship under an indenture for securities that are the only collateral for the collateral trust notes.\textsuperscript{34} Here, presumably, the security holders under both indentures have identical interests, since the value of the collateral trust notes is solely dependent upon the value of the collateral securities.

The second exemption from the dual trusteeship prohibition is for dual indentures covering obligations of real estate companies where the obligor has no substantial unmortgaged assets, and each indenture is secured by wholly separate parcels of real estate. In this case there is presumably no conflict of interest because all of the issues under each indenture are equally and separately secured, and no unsecured assets are available to be siphoned off by one set of creditors.\textsuperscript{35} In addition, any attempts to invade the collateral of other bondholders is prevented by the probable presence of state statutes enabling recordation of mortgage interests in real property.

An exemption may also be obtained if the indenture itself excludes another specifically described indenture from the operation of the disqualification provisions, as long as both indentures are wholly unsecured. However, the SEC may prohibit such a dual trusteeship if it formally finds that the differences between the two indentures make a material conflict of interest likely to exist.

Finally, even if none of the exemptions from the dual trusteeship provisions apply, a dual trusteeship may be permitted if the issuer proves, in proceedings before the SEC, that no material conflict of interest is likely to exist.

b. The Trustee as an Obligor or Underwriter\textsuperscript{36}—The Act specifies that a conflict exists if the trustee or any of its directors or executive officers is either an obligor on the indenture securities or an underwriter for such an obligor. Where the trustee or principals of the trustee are also the obligor, the conflict is clear: the trustee is both a debtor and a trustee of the creditors, who are holders of the securities. Where the trustee is an underwriter, a similar conflict exists. The underwriter generally has close ties to the management of the issuer. Or, the underwriter may be a market maker for the issuer's stock and may desire to reduce its position, by selling off its stock holdings, before defaults by an obligor are disclosed.\textsuperscript{37}

The provisions of the Banking Act of 1933, which require separation of


\textsuperscript{34} Collateral trust notes are debt obligations that are secured by a lien on other securities which have been deposited with a trustee as collateral. See I A. DEWING, \textit{THE FINANCIAL POLICY OF CORPORATIONS} 210-14 (5th ed. 1953).

\textsuperscript{35} Cf. VI SEC 1936 \textit{REPORT}, \textit{supra} note 5, at 32-33, 103-09.


\textsuperscript{37} VI SEC 1936 \textit{REPORT}, \textit{supra} note 5, at 103-07.
commercial and investment banking activities, reduced the number of situations in which the trustee was also an underwriter.

c. The Trustee as an Affiliate of Either the Issuer or Underwriter—For the same reasons that there is a conflict where the trustee is itself an obligor or underwriter, the Act also provides that a conflict exists if the trustee is in control of, is controlled by, or is under common control with the obligor or an underwriter for the obligor.

d. Director or Officer Interlocks—The Act provides that if there are more interlocks between the trustee and the obligor (or underwriter) than one director or executive officer each way, a conflict exists; however, one additional interlock is allowed if the trustee has more than nine directors. More specifically, a conflict is present if the trustee or any of its directors or executive officers is a director, officer, partner, employee, appointee, or representative either of the obligor, or of an underwriter for the obligor who is currently engaged in the business of underwriting. However, one individual may be a director or an executive officer of the trustee, and a director or an executive officer of the obligor, so long as he is not an executive officer of both. Also, if the number of directors of the trustee in office is more than nine, one additional person may be both a director and an executive officer of the trustee and a director of the obligor. The trustee still may serve in such ministerial capacities as transfer agent, registrar, custodian, paying agent, fiscal agent, escrow agent, or depositary, or as a trustee under another indenture or otherwise, unless Section 310(b)(1), relating to dual trusteeships under indentures, is violated. Thus, despite the potential conflicts of interest that may develop, a trustee may have two representatives on the board of the obligor (if the trustee has over nine directors), one of whom could also be an executive officer of the obligor.

The interlock provisions of the Act reflect an ambivalence about the usefulness of interlocks. The SEC's Report on Protective and Reorganization Committees, which led to the Act, stated:

Representation of the issuer on the board of the trustee may give rise to an alliance which is dangerous to the security holders represented by the trustee, since the interests of debtor and creditor are commonly antithetical. This conflict certainly arises where such representation gives the issuer control of the trustee. It may likewise arise where a minority of the board of the trustee is composed of officers or directors of the issuer, especially in times of trouble when the trustee is preparing to take active steps to collect the debt [etc.]. . . . The same considerations apply to allowing a director or officer of the issuer to be an exec-

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43 See note 33 and accompanying text supra.
utive officer of the trustee. . . . [I]t is part of prudence and safety to eliminate the issuer from the councils of the trustee.

The same considerations apply to situations where the trustee owns or represents stock or other junior interests of the issuer. . . .

On the other hand the trustee should not be disqualified from being represented on the board of directors of the issuer. It is frequently the part of prudence and wisdom for creditors to be represented on the board of the debtor. From that vantage point creditors can, through their representative, more adequately protect their interests against improvident or fraudulent acts than if they are debarred from participating in the councils of the debtor . . . . As a matter of fact, since we conclude that the necessary reform is to make these trustees active trustees, such affiliation may at times be almost essential if they are to perform the obligations of that trustership. 44

While the SEC was concerned with the possibility of the obligor thwarting the trustee's efforts to enforce the bondholders' rights, it paid little, if any, attention to the possibility of the trustee misusing inside information received in its capacity as director or officer of the obligor.

e. Ownership of the Trustee's Voting Securities 45—The Act states that there is a conflict if the obligor or any director, partner, or executive officer of the obligor owns 10 percent or more of the trustee's voting securities, or if any combination of such persons owns 20 percent or more of such securities. A conflict also exists if an underwriter for the obligor, or any director, partner, or executive officer of that underwriter, or any combination of these persons owns 10 percent or more of the trustee's voting securities. This status constitutes a conflict even if the proscribed ownership does not constitute control of the trustee.

f. Ownership of the Obligor's Voting Securities 46—A conflict exists if the trustee beneficially owns or holds, as collateral for an obligation that is in default, 5 percent or more of the voting securities of the obligor, 10 percent or more of any other class of the obligor's securities (other than securities issued under indentures under which the trustee serves), or 10 percent or more of any class of securities of an underwriter for the obligor.

g. Ownership of an Affiliate's Voting Securities 47—The trustee has a conflict if it beneficially owns or holds, as collateral for an obligation in default, 5 percent or more of the voting securities of an affiliate (control person) of the obligor. Likewise, there is a conflict if the trustee owns or so holds that same interest in a person who, though not in control of the obligor, holds 10 percent or more of the obligor's voting securities.

h. Ownership of the Securities of the Parent 48—If the trustee bene-

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44 VI SEC 1936 REPORT, supra note 5, at 99-101.
ficially owns or holds, as collateral security for an obligation in default, 10 percent or more of any class of security of a person who owns 50 percent or more of the voting securities of the obligor, a conflict exists.

i. The Holding of Securities in a Trust Capacity—If the indenture trustee holds, either in its capacity as executor, administrator, trustee, guardian, committee, or conservator, or in other similar capacities, 25 percent or more of any class of securities of the obligor or of any other person listed in paragraphs (6), (7), or (8) of Section 310(b), there is a conflict. The indenture may provide, however, that if securities, which bring the trustee's holdings above the 25 percent limit, are acquired as an executor, administrator, or trustee of an estate, and the holdings of the estate itself were less than the limit, the Act's conflict provisions will not be triggered until two years after acquisition of the proscribed holdings. The procedural provisions accompanying this section indicate that this is perhaps the most sensitive of the conflict provisions, even though the chances of a bank's holding such a large block of stock in its trust department seem minimal where the issuing corporation enjoys sufficient investor interest to permit a public floatation of debt securities.

While the Act provides for only a yearly determination by the trustee of its trust department holdings, further obligations are imposed on the trustee when the obligor defaults in the payment of either principal or interest and the default continues for thirty days. In such a case, the trustee must promptly check its trust department holdings, and a conflict exists if its holdings exceed the more constraining percentages specified in paragraphs (6), (7), and (8) of Section 310(b), rather than the less restrictive 25 percent figure specified in paragraph (9). This requirement corresponds to the higher obligation generally placed upon a trustee after default.

In 1939, while discussing this provision of the Act, the Senate Committee stated that ownership of securities in a representational capacity "is given separate and more liberal treatment... on the theory that such ownership does not involve as direct a conflict as beneficial ownership." The absence of concern about the misuse of inside information passing between the corporate trust department and the personal trust department may surprise the present day reader.

2. Misuse of Inside Information—In 1939 the drafters of the Trust Indenture Act had rather narrow objectives. They were almost exclusively concerned with the potential harm arising from the presence of indenture trustees with divided loyalties. Alliances between the trustee and either the management of the obligor or the junior creditors could lessen the

50 See notes 46-48 and accompanying text supra.
51 This conclusion is supported by a recent Senate report. SENATE GOV'T OPERATIONS SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS AND BUDGETING, MANAGEMENT AND EXPENDITURES, DISCLOSURE OF CORPORATE OWNERSHIP (1973), [hereinafter cited as SENATE DISCLOSURE REPORT]. Excerpts from the report are reprinted in 234 BNA SEC. REG. & L. REP. G-1 (Jan. 9, 1974), and in BNA WASH. FINANCIAL REP. No. 3 at p. T-1 (Jan. 21, 1974).
trustee's diligence in enforcing the rights of bondholders. These alliances were the primary evil to be combated.

In order to obtain responsible trustees, the drafters required, in Section 310(a)(1) of the Act, that each indenture covered by the Act be trusted by an institution that is incorporated and authorized to exercise corporate trust powers under federal or state law and is subject to the supervision of or examination by federal or state agencies. In this provision, however, lay the seeds of another kind of conflict, hardly apparent in the 1930's, but of great importance today. State and federal regulatory statutes do not contemplate the existence of separate institutions solely exercising corporate trust powers. Rather, banks and trust companies are generally authorized to offer a broad spectrum of trust services. Thus, the typical indenture trustee will also administer personal trusts, in which it has investment discretion, and act as trustee for pension and employee-benefit plans, in which it has varying degrees of investment discretion. These other trust responsibilities may involve the management of equity portfolios which contain, among other holdings, stock of corporations for which the institution is indenture trustee.

The combining of these different trust functions in a single institution gives rise to a new problem. As indenture trustee, the institution should obtain various types of financial and other information in order to determine whether the corporate issuer has complied with the covenants in the indenture. If the indenture trustee, by virtue of its position, obtains non-public information that would be relevant to the price of the obligor's stock, this information might be used improperly to benefit the institution's interests in its role as manager of equity portfolios. For example, if the trust department learned of an impending default, it might sell off its holding of the corporation's common stock. Recognizing the potential for misuse of inside information in another area, banks recently have established formal procedures in an attempt to prevent the exchange of in-

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53 The Act, in Section 302(a)(3), 15 U.S.C. § 77bb(a)(3) (1970), sets forth the necessity for the statute and states that the public interest and the interest of investors are adversely affected "when the trustee does not have resources commensurate with its responsibilities. . . ." Section 310(a)(2), 15 U.S.C. § 77jjj(a)(2) (1970), also requires the indenture to provide that the institutional trustee have a combined capital and surplus of not less than $150,000. This amount is obviously inadequate by present-day standards, and indentures for sizable issues often require a minimum capital and surplus of $5,000,000. See J. KENNEDY, CORPORATE TRUST ADMINISTRATION 40 (1961).


55 Under 12 U.S.C. § 92(a) (1970), national banks may be given trust powers which state banks and trust companies are permitted to have under applicable state law. An example of the broad powers granted by state law to trust companies is N.Y. BANKING LAW § 100 (McKinney 1971).


57 The potential use of inside information by bank trust departments was highlighted by the STAFF OF HOUSE BANKING AND CURRENCY COMM., 92d Cong., 1st Sess., REPORT ON THE PENN CENTRAL FAILURE AND THE ROLE OF FINANCIAL INSTITUTIONS, pt. V, at 313 (1972) [hereinafter cited as HOUSE BANKING AND CURRENCY COMM. STAFF REPORT].
formation between lending and trust officers. It would also seem appropriate that similar precautions be taken to prevent corporate trust officers from passing on inside information to personal trust officers. However, banks routinely place their corporate trust responsibilities in the same department with other trust activities.

The dangers of misuse of inside information are particularly acute when the trustee holds large amounts of an obligor's stock in its other fiduciary capacities. The larger the trustee's holdings of stock in discretionary trust accounts, the greater will be the institution's temptation to bail out when times are troubled, and the more adverse will be the effect on the market price of the stock. But the extent to which indenture trustees hold equity securities of obligors is largely unknown. Although the Trust Indenture Act limits such ownership to 25 percent of a class of the obligor's securities, the SEC does not require initial or periodic reporting by a trustee of the amounts of an obligor's equity securities held in fiduciary capacities. Under Section 313(a) of the Act, the indenture must require the trustee to transmit annual reports to indenture security holders. The trustee may, however, as to Section 310, merely state that "to the best of its knowledge it has continued to be eligible and qualified." Further, even if reporting were adequate, the 25 percent limitation provides little protection, since much smaller percentage holdings often may give the institution working control of the publicly held company.

Presumably, the use of the word "trust" has papered over the real conflicts that may exist when duties as a corporate trustee and as a trustee for personal and employee trusts holding equity securities are carried out

59 The COMPTROLLER'S MANUAL FOR REPRESENTATIVES IN TRUSTS (1963), which provides directions for examination of the trust departments of national banks to personnel of the Bureau of the Comptroller of the Currency, assumes that the corporate trust division will be part of the bank's trust department. 4 CCH FED. BANKING L. REP. ¶¶ 59,211 et seq., 59,326 et seq. (1963).
60 Cf. the proposal by Senator Lloyd Bentsen to limit bank trust department holdings to 5 or 10 percent of any company's stock. BNA WASH. FINANCIAL REP., Dec. 3, 1973, at A-11.
61 For some recently released figures on bank trust department holdings see SENATE DISCLOSURE REPORT, supra note 51. The report does not relate bank trust department stockholdings to corporate trust functions.
63 The SEC's Form T-1, "Statement of Eligibility and Qualification Under Trust Indenture Act of 1939 of a Corporation Designated to Act as Trustee," does not call for this information, even though it does require information deemed necessary to determine whether the trustee is eligible and qualified under the other provisions of Section 310 of the Act. 3 CCH FED. SEC. L. REP. ¶ 43,103-06 (1968).
simultaneously. For example, the 1972 Annual Report of the Chase Manhattan Corporation makes special mention of "a strict policy of separation between officers and staff members handling trust and fiduciary accounts and those involved in other activities...." But, in discussing its trust activities, it states that

[Int]n addition to its services for individuals, the Trust Department also performs various functions for corporations and institutions.... [It] acts as corporate trustee under some 1,400 bond issues brought out by over 700 public agencies and private business concerns....

Nevertheless, it seems probable that the potential conflicts are generally ignored because indenture trustees, prior to default, receive little nonpublic information as a result of their trusteeships. Indentures may, and generally do, contain provisions stating that prior to default the indenture trustee shall not be liable except for the performance of duties specifically set out in the indenture. Considering the potential conflicts that might arise from an active search for nonpublic information, a prudent trustee is likely to avoid such a search.

This state of affairs should cause dismay among indenture security holders. When banks make direct loans to corporations, it seems implicit that they would insist upon receiving certain kinds of information which must be insulated from the trust department. However, when these banks act as trustee for public lenders under a trust indenture, they apparently do not insist on this type of information. The fact that the Trust Indenture Act does not require them to do so is regrettable.

3. The Trustee as a Lender: Section 311—Even though the Trust Indenture Act requires a trustee to resign if he is a trustee for other lenders whose interests may be adverse, strangely enough, nothing prohibits a trustee which itself is a lender from continuing to serve. In its 1936 Study of Protective and Reorganization Committees, the SEC recommended the following:

Either corporate trusteeships must be divorced from commercial banks and made the exclusive function of trust institutions

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67 For the same observation as to the interchangeability of personal trust and corporate trust personnel, see Phol, The Administration of Trust Indentures by Corporate Trustees, Trust Bull., Apr., 1957, at 81-82.
68 The Chase Manhattan Corp., ANN. REP. 1972, at 45.
69 Id. at 44.
70 Cf. Johnson, supra note 19, at 215-16.
72 See, e.g., ABF, MODEL DEBENTURE INDENTURE PROVISIONS, ALL REGISTERED ISSUES § 601(a) (1967) [hereinafter cited as ABF MODEL PROVISIONS].
74 See notes 99-100 and 105-11 and accompany text infra.
specializing in the business of acting as trustee; or a commercial bank acting as trustee for securities of a corporation should not be permitted to hold a management, ownership or creditor position in that company or have any other interest inconsistent with its fiduciary responsibilities. Nothing short of such measures will insure adequate protection to the bank’s depositors and stockholders, and to the investors for whom they purport to act as trustee. The large number of banks which function as corporate trustees without being short term creditors of the issuer demonstrates that this separation of functions is practical.  

Congress, however, rejected the recommendation that indenture trustees be precluded from being direct creditors. Instead, Section 311 of the Act merely sets up a structure which attempts to prevent the preferential collection of claims by a trustee. The Act generally requires an indenture provision stating that if the trustee becomes or remains a creditor of the obligor within four months prior to or after a default in principal or interest, steps must be taken so that the trustee’s loan is not collected ahead of the obligations to indenture security holders. In order to accomplish this, the trustee, unless and until the default is cured, must set aside in a special account, for the benefit of both the trustee individually and the bondholders, any amounts collected. When the trustee has set aside the amounts collected, it then must account for them in such a way that it and the indenture security holders will realize the same percentage of their respective claims from a combination of these amounts and any dividends on unsecured claims in bankruptcy or receivership proceedings. Section 311 sets out in great detail the operation of the provisions that are aimed at ensuring equality of treatment. Specifically, the trustee must set aside an amount equal to all valid reductions in principal or interest effected during the statutorily defined period, plus all property received either in satisfaction for or as security for obligations to the trustee.  

The trustee, however, is able to exercise some priority over the bondholders under certain conditions. The trustee may retain reductions resulting from any right of setoff which the trustee in bankruptcy could have exercised if a petition had been filed on the date of default; it may retain payments made by persons other than the obligor, proceeds of the sale of a claim to a third person, or distributions received under either the Bankruptcy Act or state receivership laws; it may retain proceeds from the sale of property held as security if such property was held prior to the four-month period; and the trustee may retain the proceeds of property received as a security interest within the four-month period if such security was received simultaneously with the granting of the loan, and if the trustee proves that it had no reasonable cause to believe that a default of principal or interest under the indenture would occur within four months. Thus, a trustee is not discouraged from making a bona fide "rescue" or  

77 VI SEC 1936 REPORT, supra note 5, at 107.
"distress" loan. Likewise, the trustee may receive payment against release of property held as security, to the extent of the fair value of the property, where it could have retained the proceeds from the sale of the collateral.

A leading commentator suggests that the congressional decision, allowing trustees also to be direct creditors, was a wise one:

The more important and experienced trust institutions are also large commercial banks and have important credit arrangements with corporate obligors. If extension of credit were prohibited, these institutions would unquestionably surrender their corporate trust relations with these obligors. Instead of benefiting security holders, such a step would provide them with a less experienced and capable trustee.

The wisdom of this decision, however, is not that clear. While the drafters of Section 311 of the Trust Indenture Act permitted the indenture trustee to lend funds directly to the obligor, they limited the situations in which the trustee could serve as a trustee under another indenture. Certainly the conflicts arising when a bank acts both as a direct lender and as a trustee for public lenders are no less than those arising when a bank acts as a trustee for two sets of public lenders. Rather, Section 311 seems to have been a clear victory for the banking industry, permitting banks to maintain their normal banking relationships with a corporation while simultaneously serving as indenture trustee.

Further, the wisdom embodied in Section 311 distorts the concept that an indenture trustee is a fiduciary. In effect, the section turns a failure by the obligor to pay principal or interest into "constructive bankruptcy" insofar as the trustee's position is concerned. By voiding preferential payments and liens received by the trustee within four months before or subsequent to default in the payment of principal or interest, and by requiring such preferences to be applied pro rata to debts owed to the trustee and to the indenture security holders, the trustee receives essentially the treatment that a creditor would receive if the obligor on the indenture

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78 H.R. REP. No. 1016, 76th Cong., 1st Sess. 48 (1939). See also Note, supra note 4, at 110.

Encouraging the trustee-lender to advance funds at a time of financial difficulty for the obligor is consistent with the trustee's fiduciary duties to bondholders. The "distress" loan may prevent an impending default by the obligor. Courts have generally recognized the value of encouraging a lender to bail out a financially troubled business. See, e.g., Rowan v. United States, 219 F.2d 51 (5th Cir. 1955), Arnold v. Phillips, 117 F.2d 497 (5th Cir.), cert. denied, 313 U.S. 583 (1941).

79 J. KENNEDY, supra note 53, at 54.

80 These comments are strangely reminiscent of the reaction of the banking industry to the proposals to separate commercial banking and investment banking functions which later became part of the Banking Act of 1933. In the early 1930's, one bank official predicted that the proposed requirements would cripple the system of distributing securities. V. CAROSSO, INVESTMENT BANKING IN AMERICA 370 (1970).

81 See notes 33-35 and accompanying text supra.

securities had filed a petition in bankruptcy on the date of default in the payment of principal or interest. This treatment hardly seems consistent with the fiduciary duties placed upon a trustee for public debt holders. It would seem that the trustee's duty to act for the benefit of his cestui que trust ought to require at least that all property in his possession or control be applied first to the claims of the indenture security holders whose claims are not otherwise specifically subordinated to those of the lender-trustee. Further, it should be noted that the "default" which triggers the antipreference provisions of Section 311 is only default in the payment of principal or interest. In contrast, under Section 35(c) of the Act, other events of default as well as these create a higher standard of care which the trustee is required to exercise in default administration.

Illustrative of the dismal position of the holders of indenture securities is the following common situation. Compensating balance arrangements are becoming an increasingly integral part of banks' financing arrangements. A corporation often will be required to maintain a minimum balance in a checking account, or to hold a low-interest certificate of deposit in order to maintain either current borrowing privileges or a line of credit for future borrowing. This compensating balance arrangement can have several adverse effects on indenture security holders under the provisions of the Trust Indenture Act.

First, insofar as these compensating balances are subject to withdrawal restrictions, they decrease the ability of the obligor to meet interest payments on indenture securities. Therefore, the possibility of default is increased.

Second, it appears that the lending bank may retain all amounts in the borrower's compensating balance accounts in payment of its loan. Section 311(a)(1) provides that the trustee need not set apart for pro rata distribution any reduction in liability resulting from any right of setoff which the trustee could have exercised if a petition in bankruptcy had been filed by or against the obligor upon the date of default. Under the Bankruptcy Act, the trustee could have set off the balances in the obligor's accounts in payment of its claim. See text of SEC Draft for Compensating Balances Release, 180 BNA SEC. REG. & L. REP. J-1 (Dec. 6, 1972). See also Securities Act Release No. 5436, Adoption of Amendments to Regulation S-X (Nov. 13, 1973), 3 SEC DOCK. 33 (Nov. 27, 1973), 228 BNA SEC. REG. & L. REP. D-1 (Nov. 21, 1973).

The SEC's new disclosure requirements for compensating balance arrangements consider the effect of such arrangements on liquidity to be the important test of materiality for purposes of disclosure. See Securities Act Release No. 5436, supra note 85.

Cf. the activities of Guaranty Trust Co., described in text accompanying note 29 supra.

gor's other accounts against any loans outstanding. 89

Third, it is not clear that the trustee, in its annual report to indenture security holders, even needs to report the existence of compensating balance arrangements. Section 313(a)(3) requires only that the trustee report with respect to

the amount, interest rate and maturity date of all other indebtedness owing to it in its individual capacity, on the date of such report, by the obligor upon the indenture securities, with a brief description of any property held as collateral security therefore. . . . 90

Is a compensating balance “property held as collateral security”? Perhaps “property” in this context does not include such cash items, since the very next section of the statute refers separately to “property” and “funds” in possession of the indenture trustee. 91 Even if compensating balances are property, it is unclear whether they are “held as collateral security,” although courts occasionally treat the right of setoff as a common law banker’s lien on funds in other accounts of the debtor. 92 Since banks seem primarily interested in the use of compensating balance arrangements to effectively increase interest rates, it may be argued that the funds are held for that purpose, and only serve incidentally as collateral security for outstanding loans, even if the common law banker’s lien does extend to such funds. 93

Thus, the situations that the Act sanctions benefit the banking industry rather than the bondholders under a trust indenture. Not only does the Act fail to achieve its goal of eliminating conflicts of interest, but it also has codified rules which encourage the creation and existence of such conflicts.

B. The Trustee’s Standard of Conduct

A second important purpose of the Trust Indenture Act was to assure that the indenture trustee would observe high standards of conduct while

92 At common law, the banker’s lien extended to securities and valuables in the banker’s possession, while money left on deposit was subject to setoff. See Gunn v. Stockyards State Bank, 97 Kan. 404, 155 P. 796 (1916); Nolting v. National Bank, 99 Va. 54, 37 S.E. 804 (1901); 5 C. Zollman, Banks and Banking § 3051, at 71 (perm. ed. 1936). A few courts, however, have treated the right to set off money left on deposit as a banker’s lien against such funds. See King v. Porter, 230 Ala. 112, 160 So. 101 (1935); First Nat’l Bank v. Coplen, 39 Cal. App. 619, 179 P. 708 (Cal. Dist Ct. App. 1919).
93 Presumably, property may be “held as collateral security” even though it is not subject to a lien. It would seem that the setoff right may be considered as collateral security. Cf. Overcash v. First Nat’l Bank, 115 Ga. App. 499, 501-02, 155 S.E.2d 32, 34 (1967), finding, in another context, that a contract of suretyship was collateral security.
acting on behalf of security holders. As Section 302(a)(2) of the Act recites,

the general and reasonable assumption by . . . investors [is] that
the trustee is under an affirmative duty to take action for the
protection and enforcement of their rights, [but] trust indentures
(A) generally provide that the trustee shall be under no duty to
take any such action, even in the event of default, unless it re-
ceives notice of default, demand for action, and indemnity,
from the holders of substantial percentages of the securities out-
standing thereunder, and (B) generally relieve the trustee from
liability even for its own negligent action or failure to act. . . .

The abuses which prevailed prior to the enactment of the Trust Inden-
ture Act had been well documented. Indicative of the passive stance
that the trustee maintained was the testimony of a leading corporate
trust officer who said that he viewed the indenture trustee as merely a
mechanical bookkeeping agent who took action only when ordered to do
so by the bondholders.

Sections 314 and 315 of the Act were designed to remedy the sit-
tuation. Section 314 requires that the obligor on the indenture securi-
ties file certain reports with the indenture trustee as evidence of compli-
ance with the provisions of the indenture. Section 315 is the key
section defining the trustee's duties and responsibilities. The section
essentially sets up a dual set of criteria, one to guide the trustee prior to
default, and a second for post-default guidance. In all cases, events of
default may be defined by the indenture and are not limited by the
Act.

The provisions of Section 315 were written against the background of
indentures containing broad exculpatory clauses. Section 315(a) sets
out certain permissible exculpatory provisions. The indenture may
provide that, prior to default, the trustee shall be liable only for failure to

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96 See VI SEC 1936 REPORT, supra note 5, at 2-70.
97 VI SEC 1936 REPORT, supra note 5, at 4.
100 See notes 140-43 and 172-73 and accompanying text infra for a discussion of
the adequacy of these provisions.
101 The original proposal submitted to Congress would have given the SEC
authority to establish rules as to what should constitute events of default. See Katz,
which defines "default" for the purposes of that section's antipreference provisions.
The ABF MODEL PROVISIONS, supra note 72, at § 501, provide for the following
as events of default: 1) a default in the payment of interest that continues for thirty
days; 2) a default in the payment of principal; 3) nonperformance or breach of any
cozenant or warranty that continues for thirty days after notice of the default has been
given by the trustee or by 10 percent of the debenture holders; and, 4) bankruptcy,
insolvency or similar proceedings.
perform the duties specifically set out in the indenture. In addition, the indenture may provide that, prior to default, the trustee need not make any independent investigation of statements or opinions furnished in conformity with the requirements of the indenture, so long as the trustee is not acting in "bad faith," and so long as it examines the evidence of compliance furnished pursuant to Section 314103 to determine whether the evidence conforms to the requirements of the indenture.

In case of a default, however, the trustee's duties change. Section 315(c) requires indentures to provide that, in case of default, the trustee exercise "such of the rights and powers vested in it by such indenture, and . . . use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs." Section 315(d) further limits the exculpatory clauses which may be contained in the indenture. The indenture may not contain provisions relieving the trustee from liability for its own negligent action, for negligent failure to act, or for willful misconduct. However, the indenture may contain the provisions permitted by Section 315(a) and provisions protecting the trustee from liability for any error in judgment made in good faith by a responsible officer of the trustee, unless the trustee was negligent in ascertaining the pertinent facts. The indenture may also protect the trustee against liability with respect to action taken or omitted in good faith, in accordance with the directions of the holders of not less than a majority of the principal amount of the indenture securities.

The structure of the Act, which makes a default the triggering device that turns a passive trustee into an active one, creates a significant problem as to the trustee's duty to discover defaults. This problem is illustrated by the alleged facts in the recent litigation relating to the provisions of the indenture of Webb & Knapp. The indenture required the obligor, Webb & Knapp, to certify the absence of defaults to the trustee annually in writing. The indenture prohibited Webb & Knapp from purchasing real property or incurring additional indebtedness unless it maintained a ratio of assets to liabilities of 200 percent. It was claimed that from 1954 to 1964 Webb & Knapp submitted certifications on the basis of inflated appraisals of its assets. The trustee accepted these certifications,

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105 15 U.S.C. § 77ooo(c) (1970). The original bill proposed to Congress would have given the SEC authority to impose predefault duties on the trustee, "consistent with the duties . . . which a prudent man would assume and perform prior to such default if he were trustee under such an indenture." The postdefault standard of care would have been that of a prudent man "if he were a fiduciary and had the degree of skill which the indenture trustee has, or which the indenture trustee . . . represents itself as having whichever is the higher." See Katz, supra note 94, at 291.
even though the appraisals had been accompanied by a note stating that they represented the view of the officers of Webb & Knapp "as to what the properties could be sold for on a cash basis under favorable market conditions after their earning power shall have been clearly established."\textsuperscript{109}

While the merits of the substantive claim have not yet been determined, it seems clear that a problem exists if legislation as comprehensive as the Trust Indenture Act fails to force the trustee to discover such fairly obvious defaults as were allegedly present here. The problem is particularly acute when certain covenants, such as those relating to the maintenance of working capital,\textsuperscript{110} are included as early-warning indicators of financial problems. Nevertheless, Section 315(a) of the Act\textsuperscript{111} permits, and indentures usually include,\textsuperscript{112} provisions stating that prior to default, in the absence of bad faith,\textsuperscript{113} the trustee may conclusively rely upon certificates by officers or others which are in proper form, without having to make its own independent investigation.\textsuperscript{114} Upon default, however, the trustee's duties increase.\textsuperscript{115} Does this mean that the exculpatory provisions permitted by Section 315(a) are of no practical consequence in the context of certification of compliance with covenants in the indenture? Does the trustee become absolutely liable under a higher degree of care immediately upon the occurrence of a default, even if the default is unknown to him?\textsuperscript{116}

As a practical matter, these questions are answered in the negative. While theoretically the trustee becomes liable for a higher standard of care even upon the occurrence of a default not reasonably discoverable, the indenture can easily protect against this higher burden. Since "default" is a term of art, the definition of which is left to the indenture,\textsuperscript{117} a default may be defined as occurring, for example, only after the trustee is notified of the default by the security holders, or after a requisite number of security holders or the trustee notifies the obligor of the default. The American Bar Foundation's Model Debenture Indenture provisions require such notice to trigger an "event of default" in all cases, except for the failure to pay principal or interest, bankruptcy, or a similar proceeding involving the obligor.\textsuperscript{118}

\textsuperscript{110} See ABF Commentaries, supra note 1, at 452-55.
\textsuperscript{112} See ABF Model Provisions, supra note 72, at § 601(a)(2).
\textsuperscript{113} The dissenting opinion of Mr. Justice Douglas in Caplin v. Marine Midland Grace Trust Co. suggests that "bad faith" is shown in relying upon officers' certificates when there is wilful misconduct or gross negligence on the part of the trustee. 406 U.S. at 439 & n.4 (1972).
\textsuperscript{114} See Johnson, supra note 19, at 225-26.
\textsuperscript{116} See Katz, supra note 94, at 291.
\textsuperscript{117} See Johnson, supra note 19, at 223-25.
\textsuperscript{118} ABF Model Provisions, supra note 72, at § 501. See also Johnson, supra note 19, at 227-36.
Thus, breach of most of the indenture covenants that protect indenture security holders is to be discovered by a trustee who is essentially passive. The primary sources of information to which the trustee has access are whatever reports the indenture requires the obligor to furnish. Whether this procedure provides a sufficient basis for detecting defaults can be determined only by examining the types of covenants commonly used today to protect indenture security holders.

The primary problem arises in connection with those covenants which are essentially prophylactic in nature, i.e., those which are intended to prevent the more serious default of failure to pay principal or interest. This general group of prophylactic covenants may be divided into various categories. First, covenants may require the obligor to maintain insurance. The coverage required may be not only against casualty losses on properties, but also against liability for crippling judgments, and key-man life insurance on selected executives.119

A second group of covenants may limit future encumbering of property. These covenants are often referred to as “negative pledge clauses.” They attempt to prevent other creditors from obtaining priority over debentures, either by requiring that the debentures participate ratably with future creditors in the proceeds of any property pledged as security, or by completely prohibiting the creation of liens. These covenants may become long and intricate in attempting to deal with the many business situations which might give rise to claims having priority over the debentures.120

A third type of covenant may impose limits upon the amount of additional debt which the obligor may incur. Here again, the formula utilized for determining the permissible amount of debt may be complex. One example of such a covenant is the prescribed asset to liabilities ratio present in the Webb & Knapp indenture discussed above.121 The covenants may be cast in terms of prescribed ratios between liabilities and net tangible assets, capitalization, or tangible net worth, with each of these terms carefully being defined in the indenture. A number of other variations of debt limitations are also possible.122 Policing compliance with these limitations may require careful auditing in light of each definitional provision.

A fourth type of covenant may limit the payment of dividends and similar distributions, often using a formula pegged to the amount of retained earnings as of the date of the issuance of the debentures.123

Other types of covenants may limit the disposition of assets by the obligor,124 the use of sale-leaseback transactions,125 or may require the maintenance of certain levels of working capital.126

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119 See ABF Commentaries, supra note 1, at 341-48.
120 See id. at 349-67.
121 See notes 108-09 and accompanying text supra.
122 See ABF Commentaries, supra note 1, at 368-400.
123 Id. at 401-21.
124 Id. at 422-31.
125 Id. at 432-49.
126 Id. at 450-56.
How is an essentially passive trustee to police compliance with these complex covenants? The Act contemplates that the trustee will receive reports from the obligor as to compliance with the covenants. However, in its specific terms was drafted largely to confront the problems raised by mortgage bonds or by conditions precedent to action by the trustee. The drafters of Section 314(1) left to the SEC the rule-making authority to deal with the policing of compliance with prophylactic debenture covenants. Thus, Section 314(b)(2) requires an indenture provision compelling the obligor to provide opinions of counsel as to compliance with any recording requirements that are necessary to perfect a lien on the property which serves as security under the indenture. Further, if the indenture contains conditions precedent relating to authentication and delivery of the indenture securities, release or release and substitution of property subject to the lien of the indenture, satisfaction and discharge of the indenture, or any other action to be taken by the trustee at the request of the obligor, then Section 314(c)(1) demands an indenture provision requiring opinions regarding compliance with such conditions precedent by officers of the obligor, counsel, and accountants. Finally, if the indenture is secured by the mortgage of property or securities, Section 314(d)(1) requires indenture provisions calling for an engineer, appraiser, or similar expert to furnish certificates of fair value (1) as to property or securities to be released from the lien of the indenture; and (2) as to property or securities the deposit of which is to be made the basis for (a) authentication and delivery of indenture securities, (b) the withdrawal of cash from the trust estate, or (c) the release of property or securities from the lien of the indenture.

Only Section 314(a)(1) deals with compliance with the type of debenture covenants described above. The section requires that provision be made for the obligor to file with the trustee the periodic reports required by Section 13 of the Securities Exchange Act of 1934. Beyond this, provision must be made for the obligor to file such additional information, documents, and reports as the SEC may require by rule with the trustee and the SEC, and to submit this additional information to holders of the indenture securities. The SEC has not exercised its rule-making authority in this area, despite the widely recognized fact that

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127 See note 100 and accompanying text supra.
129 Id. § 77nnn(b) (1970).
130 Id. § 77nnn(c) (1970).
131 Id. § 77nnn(d) (1970).
135 See notes 118-25 and accompanying text supra.
139 Id. § 77nnn(a)(3) (1970).
the financial statements required to be filed under Section 13 of the Securities Exchange Act often will not disclose defaults on indenture covenants.  

Even without the compulsion of SEC rules, it has become standard practice to include an indenture provision requiring that annual statements of compliance be filed with the trustee. The provision, however, commonly requires compliance certificates only from officers of the obligor. Despite the presence of complex accounting formulas in many of the covenants, often no opinion of independent certified public accountants is required. Some indentures do require certificates of compliance to be issued by independent certified public accountants, but usually these certificates merely provide for a statement that the accountants "obtained no knowledge" of noncompliance during their examination of the corporation's books.

Section 315 of the Act, as has been pointed out, permits indenture provisions which allow the trustee to "conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture." Under these conditions, the holders of indenture securities have little protection against the furnishing of fraudulent or inaccurate certificates. Consequently, defaults may remain undiscovered. Because early discovery of defaults is crucial, and delay often irreparable, there is a definite need for more stringent reporting requirements.

II. SUGGESTIONS FOR CHANGE

A. Misuse of Inside Information

The potential for misuse of inside information by the trustee results from the congressional decision to structure the Trust Indenture Act so as to virtually ensure that indenture trustees will be commercial banks or trust companies engaged in other trust business. While rule 10b-5, under the Securities Exchange Act of 1934, provides a sufficient basis for an after-the-fact remedy for misuse of inside information, there are insufficient provisions in the securities acts to effectively prevent such activities.

It should be noted that the harm resulting from the misuse of inside information available to the corporate trustee probably does not affect the holders of the corporate debt securities. Rather, the purchasers of the

140 ABF COMMENTARIES, supra note 1, at 325.
141 See notes 120-21 and accompany text supra.
142 See ABF MODEL PROVISIONS, supra note 72, at § 1001.
143 ABF COMMENTARIES, supra note 1, at 334.
144 See notes 110-13 and accompanying text supra.
146 See notes 55-59 and accompanying text supra.
147 See generally A. BROMBERG, SECURITIES LAW: FRAUD (1973).
corporation's equity securities in the open market are the victims of the misuse, which may result in tremendous profits being realized by the financial institutions when they sell equity securities. Nevertheless, the Trust Indenture Act should take account of the consequences of the institutional structures that it permits, and should not work against the anti-fraud provisions of the Securities Exchange Act. If the Trust Indenture Act is to require that responsible trustees administer corporate trust indentures, it should also consider the potential for illicit market activities which this requirement creates. The potential for the misuse of information might be controlled in at least two ways: by increased supervision of trustees' activities or by the separation of corporate trust departments from other trust functions. Both of these alternatives were suggested to and rejected by the Congress in 1939.

In discussing the proposal for increased supervision of trustees, the House Report on the Trust Indenture Act stated:

A proposal to amend the Senate bill so as to vest in the Board of Governors of the Federal Reserve System continuing jurisdiction over actual performance by indenture trustees was unfavorably reported by the Board itself and by the Federal Deposit Insurance Corporation, and was rejected by the Senate Committee on Banking and Currency. That proposal was renewed at the hearings on H.R. 5220. The committee does not believe that it would accomplish the desired objectives. It would cover only about 25 percent of the field—trust indentures under which the trustees are national banks. It would require detailed periodic examination of the trustee's actual performance of its obligations. It would come into operation only after the improper action had occurred and the resulting loss had been sustained by the bondholders, a loss which would frequently have been prevented or minimized if the indenture itself had been corrected.

Certainly the Committee's first objection is not well taken. Today, many state-chartered banks and trust companies join the Federal Reserve System, even though they are not required to become members. At the end of 1971, 1,092 state chartered banks belonged to the Federal Reserve System. Although this figure accounted for only 12 percent of all state commercial banks, these member banks accounted for 25 percent of all of the state commercial banking offices and held 50 percent of

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148 Cf. House Banking and Currency Committee Staff Report, supra note 57, passim.
149 Since the institutional trustee requirements of section 310(a)(1), 15 U.S.C. § 77jjj(a)(1) (1970) virtually assure that indenture trustees will serve in various other trust capacities, the Act creates a situation that fosters the dissemination and possible misuse of inside information.
152 Report of the President's Comm'n on Financial Structure and Regulation, supra note 16, at 65, recommends that membership in the Federal Reserve System be required for all state-chartered commercial banks, among others.
the total deposits in state commercial banks. While figures do not appear to be available, it would seem likely that almost all trustees, for debt issues of sufficient size to be subject to the Trust Indenture Act, would be members of the Federal Reserve System.

The second objection raised by the House Committee also seems insubstantial when applied to prevention of misuse of inside information. Increased supervision need not operate only after loss has occurred. Supervision could be directed toward ensuring institutional structures that would minimize the potential for the exchange of inside information.

Ultimately, the misuse of inside information would probably be controlled most effectively through separation of the corporate trust function from other trust activities which might involve trading by the trustee of the obligor’s stock. Several types of separation are possible.

Corporate trust activities could be segregated from other trust activities by the creation of a subsidiary corporation whose activities would be limited to furnishing corporate trust and related servicing functions. At least one Federal Reserve Board Governor has suggested that the general trust departments of banks in bank holding companies be placed in distinct corporate entities. Unfortunately, this type of separation has limited advantages. Even though the directors at the subsidiary level, in theory, do not face conflicting duties, in practice, they are representatives of the parent. The parent, which must select the directors of the subsidiary, continues to face the conflict of duties to the indenture security holders on the one hand, and to beneficiaries of personal trusts on the other. The conflict arises both from selecting the directors, and from the resulting control of the subsidiary.

Perhaps more effective than mere legal separation would be a requirement of physical separation of corporate trust personnel from personnel engaged in other trust activities. Internal rules limiting the transmission of inside information are more easily enforceable if the parties who should not exchange information do not have informal daily contacts over lunch and coffee.

The most effective, but most difficult, type of separation is that which would force corporate trustees to be completely independent from institutions which offer personal trust services. The problem inherent in a complete independence requirement is the same as that in proposals which seek to prohibit direct lending activities by corporate trustees, i.e., the most experienced and qualified institutions may decide to give up their

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155 For a description of the functions involved in servicing debt securities, see J. Kennedy, supra note 53, at 140-74.
157 See Herman & Safanda, supra note 58, at 37.
corporate trust activities rather than limit other services. In fact, there seem to be no existing institutions, other than those handling personal trust business, that are equipped to act as corporate trustees, and it is questionable whether new institutions of comparable quality could be created solely to handle corporate trust functions. Thus the cost of independent trusteeships may be greater than investors are willing to pay.

There is, however, another method of dealing with misuse of inside information through the imposition of additional disclosure requirements upon obligors. The effect of disclosure requirements extends beyond the situation in which a financial institution acts as a corporate trustee. Indeed, the major interest in such requirements has been prompted by problems wholly outside of the realm of corporate trusteeships. Most of the suggestions for increased disclosure are directed primarily at the potential misuse, by bank trust departments, of information received by the bank through its commercial operations. While disclosure may be necessary in lending and interlocking directorate situations, any additional requirements also ought to take account of the problem of the misuse of information acquired by banks as corporate trustees under an indenture.

The President's Commission on Financial Structure & Regulation has recommended that trust institutions be required annually to report (a) their twenty largest stock holdings; (b) holdings constituting 5 percent or more of a corporation's voting stock; (c) interlocks of officers, directors, or senior employees between trust institutions and portfolio companies; and (d) cases in which its shares were voted in opposition to management of portfolio companies. These proposals do not go far enough, since they do not distinguish cases of potential conflict of interest from those in which inside information was probably misused. In order to identify possible misuses of inside information, a trust institution should be required to disclose sales of substantial percentages of its holdings of the securities of any corporation to which it has made direct loans, with which it has executive interlocks, or for which it serves as indenture trustee. Reports should be made within a short time after the occurrence of any such transaction and should be filed with the SEC, so that those who pur-

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158 See notes 79-82 and accompanying text supra; cf. J. Kennedy, supra note 53, at 54.

159 See Lybecker, Regulation of Bank Trust Department Activities: Seven Gaps, Eight Remedies, 90 Banking L.J. 912, 914-15, 923-27 (1973). Lybecker recognizes that potential conflicts may also exist when the bank's trust department holds a corporation's stock and still carries on other banking relationships with the corporation. For Lybecker's allusion to the conflict posed when the bank is an indenture trustee, see id. at 925.

160 The Commission was to "review and study the structure, operation, and regulation of the private financial institutions in the United States, for the purpose of formulating recommendations that would improve the functioning of the private financial system." Report of the President's Comm'n on Financial Structure and Regulation, supra note 16, at 1.

161 Id. at 102.

162 It would not be unreasonable to require reporting of sales of 10 percent of the bank trust department's holdings of a particular corporation. Note that the important figure is the percentage of the bank's holdings, regardless of the relation of this figure to the total outstanding shares of the corporation.
chased the securities may be alerted to the possibility that a seller may have had inside information. In addition, where the institution is an indenture trustee, reports of large-scale sell offs should be transmitted promptly to indenture security holders, along with a statement explaining why the sales were made. Only in this way will indenture security holders be alerted to potential business problems that have been discovered by the trustee. Even if the information in the trustee's explanatory statement falls short of establishing any breach of the indenture covenants, it is important information for debt security holders since it will alert them to watch future events carefully.

Mandatory reporting by trustees to indenture security holders might require amendment of the Trust Indenture Act as it presently stands. Section 315(b) permits the indenture to provide that, in case of default other than in payment of principal, interest, or sinking fund, the directors, executive committee, or responsible trust committee of the trustee may withhold notice of the default from indenture security holders if they determine in good faith that such action is in the interest of such holders. The difficulties encountered in showing a lack of good faith make the possibility of an institution's wrongfully withholding notice, in order to benefit its creditor or portfolio management activities, a real danger. Mandatory disclosure, even in situations short of default, would give protection to the indenture security holders. The disclosures, in all likelihood, would outweigh any benefit derived through the withholding of information in the rare case contemplated by Section 315(b)."
the four month cut-off. If the trustee is to be permitted to maintain lending relationships with the obligor on the debt securities, the trustee's duties should be increased. First, and at the very least, the provisions of Section 311 of the Act,\footnote{168} which prohibit the preferential collection of claims by the lender-trustee only upon default in the payment of principal or interest, ought to be triggered by any default.\footnote{169} Revamping of the trustee's duties, however, should go even further. Once a default of any kind has occurred, the trustee should be required to place the interest of indenture security holders ahead of its own interests. To the extent that holders of indenture securities have a claim on assets equal to that of the lender-trustee (i.e., to the extent the indenture securities are not specifically subordinated to creditors of the same class as the lender-trustee), all assets coming into the hands of the trustee should go first to cover the claims of the indenture security holders. Where a loan by its terms is secured by a lien on the borrower's property, and was so secured before the lender had reason to believe that a default on the indenture securities was likely to occur, it is fair to give the lender-trustee a prior claim to that property. If the secured loan antedated the issuance of the indenture securities, purchasers of these securities would have had notice of the loan in the registration statement of the issuer. Even if the loan was extended while the indenture securities were outstanding, the pledging of collateral presumably resulted in a lower interest rate or other favorable terms to the borrower; all of these favorable terms would inure to the benefit of all security holders. But no such \textit{quid pro quo} is generally given in exchange for the lien that arises by operation of law on particular assets of the debtor. To the extent that compensating balance arrangements are intended to secure repayment of a loan, and thus result in lower interest rates or other favorable terms, the same considerations applicable to security arrangements would apply. It is necessary under this proposal, therefore, that the role of the compensating balance arrangement be made clear in the loan agreement. At present, it seems likely that many compensating balance arrangements are intended solely as indirect methods of increasing the effective rate of interest on the borrower's loan.\footnote{170} If the lender wishes to secure repayment by immobilizing cash reserves of the borrower, the traditional sinking fund is a more effective device for accomplishing this objective.

Thus, under this proposal, the lender-trustee could realize upon any collateral covered by its loan agreement, but not upon other assets to which, by operation of law, the lender-trustee might ordinarily have first claim, e.g., assets reachable through rights of setoff or through the existence of a banker's lien. All assets, including compensating balances, which are not specifically encumbered in the lender-trustee's agreement


\footnote{169}{This requirement can be extended to prohibiting preferential collection upon the occurrence of any "event of default." \textit{See} note 101 and accompanying text \textit{supra}, and notes 174-75 and accompanying text \textit{infra}.}

\footnote{170}{\textit{See} note 93 and accompanying text \textit{supra}.}
with the borrower, would go to the indenture security holders. These assets should probably include not only assets acquired within four months before default and after default, but also those which came into the lender-trustee's control at any time the trustee had reason to believe that a default was likely to occur. The proposed operating procedures and priorities would elevate the actions of the trustee to a standard commensurate with his title.

C. Activating the Passive Trustee

The failure of trustees to promptly discover defaults is a significant problem, particularly as indenture covenants become more complex. Several converging institutional practices discourage the prompt discovery of defaults, and the Trust Indenture Act establishes standards which make such discovery difficult.

First, the Act does not require independent verification of an obligor's compliance with many types of indenture covenants. An annual review by independent certified public accountants, in order to determine whether there has been a breach of any of the indenture covenants, is needed to give adequate protection to the indenture security holders. The SEC has authority under Section 314(a) of the Act to require the issuer of the debt securities to file an audit of this sort with the Commission and the trustee.

Second, the Act should require the trustee to exercise the same degree of care and skill in discovering the existence of a default as a prudent man would exercise in the conduct of his own affairs. This could be accomplished most easily by amending Section 315, which now differentiates between the predefault and postdefault duties of the trustee. Instead of permitting the activation of the trustee to depend entirely upon the indenture definition of default, the section should be recast to impose the higher standard of care upon the occurrence of any "event of default," even if a notice requirement or a grace period has not turned the event into a "default." Thus, while the indenture may still include whatever covenants are desired, the occurrence of events which, except for a grace period, notice requirement, or similar formality, would constitute a default, will impose new duties upon the trustee. Holding the trustee responsible for taking action when such events occur, will cause it to take extra steps to discover defaults. A defense of reasonable reliance upon certificates of compliance issued by independent certified public accountants would alleviate any unfairness and would give adequate pro-

171 While this proposal might lead to encumbering an obligor's assets to a greater extent by creditors, these security arrangements would be disclosed, and holders of securities under the indenture would be more likely to be aware of these arrangements.
172 See notes 108-26 and accompanying text supra.
175 See note 101 and accompanying text supra.
tection to the trustee in cases of collusion or fraud by the issuer and the issuer's accountants. These proposals would do much to improve the protection given to indenture security holders.

III. CONCLUSION

While Congress generally has updated the other federal securities statutes as changing business practices have required statutory modifications, it has studiously avoided the complex Trust Indenture Act. Now the time for a review of this Act has arrived as well. The drafting of the Federal Securities Code by the American Law Institute presents an opportunity to rethink some of the provisions of the Trust Indenture Act, in terms of both the protections afforded to debt security holders, and the relationship of the Act's provisions to other public policies. Congressional hearings or empirical investigations of corporate trust operations may reveal problems beyond those suggested by this article. Whatever may have been the rationale in the past, the Trust Indenture Act can no longer justifiably be ignored.