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Bankruptcy -- Receiverships -- Insolvency -- Corporate Reorganization -- Power of Indenture Trustee to Act on Behalf of Bondholders

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The executives for 1939-1940 of the editorial staff of the NORTH CAROLINA LAW REVIEW are: Frank Thomas Miller, Jr., editor-in-chief; Elizabeth Shewmake, associate editor; Nathaniel G. Sims, book review editor. They are likewise the recipients of the faculty research assistantships for the current academic year.

Because they stood among the highest ten per cent of their class in point of scholarship, the following students were elected last spring to the honorary law school society of the Order of the Coif: Robert C. Howison, Jr., Moses B. Gillam, Jr., and Clarence A. Griffin, Jr.

Visiting professors in the 1939 summer session of the Law School included: Breck P. McAllister, of the University of Washington, who gave the course in Administrative Law; Walter Wheeler Cook, of Northwestern University, who taught Conflict of Laws; Alexander H. Frey, of the University of Pennsylvania, who gave the course in Labor Law; and Richard R. B. Powell, of Columbia University, who taught the course in Trusts.

NOTES AND COMMENTS

Bankruptcy—Receiverships—Insolvency—Corporate Reorganization—Power of Indenture Trustee to Act on Behalf of Bondholders.

In a proceeding for corporate reorganization under Section 77B of the Bankruptcy Act,[1] the circuit court of appeals[2] reversed the district court's confirmation of a plan of reorganization which had been approved by a two-thirds majority of those bondholders who had filed and voted their claims individually. The circuit court *held* that under Section 77B in computing the amount of claims, two-thirds of which must be represented by the assenting bondholders, the amount of claims filed by the indenture trustee are included as well as those filed by the individual bondholders, and that for the purpose of filing written acceptances no distinction is made between those claims filed by the indenture trustee, and allowed, and those filed by the individual creditor or someone expressly authorized to file them. On this basis the plan did not have the requisite number of acceptances and could not be confirmed by the court.

The usefulness of the deed of trust in corporation finance lies largely in the concert of action which may be obtained by concentration of power in the trustee to act in preserving the interests of the bondholders as a whole, which at the same time avoids the danger of overwhelming the debtor with a multiplicity of suits.[3] In the usual indenture the

[1] 48 STAT. 912, 11 U. S. C. A. §207 (1934).
[2] *In re* Kenilworth Bldg. Corporation, 105 F. (2d) 673 (C. C. A. 7th, 1939).
[3] Note (1927) 27 COL. L. REV. 443.

bondholder is a secured creditor,[4] recognized as the obligee of the bond which he holds; while the trustee, deriving his powers from the deed of trust, is the party responsible for the protection of the bondholder's interests under the covenants of the indenture. The extent to which a trustee has a right to act in connection with trust property is a problem which presents itself to the courts in varying degrees of complexity, depending upon the particular case and the powers therein sought to be exercised by the trustee.[5] Among the problems most frequently arising are those concerned with the power of the trustee to: (1) file an aggregate claim in reorganization and liquidation proceedings on behalf of the bondholders secured by the indenture, (2) vote on a proposed plan of corporate reorganization, (3) bind the bondholders by his consent to the issuance of prior lien receivership certificates, (4) bid in the property for the benefit of the bondholders. The protection remaining to the bondholders when the trustee exceeds the scope of his authority is likewise closely related to these problems.

Whether or not an indenture trustee holds such title as will permit him to file a claim on behalf of all the creditors secured by the indenture is a question which has caused much confusion. It will be conceded that ordinarily the proper party to file the claim is the individual holder of the bond giving rise to the obligation of the maker. If the indenture expressly authorizes the trustee to file the claims, this provision will be given effect.[6] If the indenture contains no provision which can be interpreted to give the trustee such power, many courts hold that the power will not be implied[7] for the reason that since the debt is evidenced

[4] *In re* U. S. Leatheroid & Rubber Co., 285 Fed. 884 (D. Mass. 1923); *In re* Indiana Flooring Co., 53 F. (2d) 263 (S. D. N. Y. 1931); see note (1927) 27 COL. L. REV. 443, 444.

[5] See Moss Tie Co. v. Wabash Ry., 11 F. Supp. 277, 283 (S. D. N. Y. 1935).

[6] *In re* International Match Corp., 3 F. Supp. 445 (S. D. N. Y. 1932); Spitz v. Fox Metropolitan Playhouses, Inc., 3 F. Supp. 606 (S. D. N. Y. 1933).

[7] United States Trust Co. v. Gordon, 216 Fed. 929 (C. C. A. 6th, 1914) (bankruptcy case which decided only that the trustee was not entitled to file aggregate claims where bondholders had already acted); *In re* U. S. Leatheroid & Rubber Co., 285 Fed. 884 (D. Mass. 1923) (bankruptcy case where the trustee was not permitted to file claims even though bonds were made payable to trustee or holder, the court holding that the debt was represented only by the bond itself); Fitkin v. Century Oil Co., 16 F. (2d) 22 (C. C. A. 2d, 1926) (receivership action in which the mortgage deed giving the trustee power "to take all steps needful for the protection and enforcement of rights of the trustee and holders of the notes hereby secured", was deemed insufficient to allow trustee to file the aggregate of the claims); *In re* Indiana Flooring Co., 53 F. (2d) 263 (S. D. N. Y. 1931) (bankruptcy proceeding in which the court emphasized the clause in the indenture to the effect that nothing contained therein should affect the rights of the bondholders); *In re* Prudence Bonds Corp., 16 F. Supp. 324 (E. D. N. Y. 1936) (a proceeding in bankruptcy in which the court held that the trustee relationship was not sufficient to constitute the trustee a creditor and thus allow him to file the aggregate claim). See Mackey v. Randolph Macon Coal Co., 178 Fed. 881, 884 (C. C. A. 8th, 1910); *In re* A. J. Ellis, Inc., 242 Fed. 156, 158 (D. N. J. 1917); Seaboard Nat. Bank v. Rogers Milk Products Co., 21 F. (2d) 414, 418 (1927).

by the bond itself, an instrument entirely separate and distinct from the deed of trust, and that since the trustee is neither the holder of the bond nor its owner, he is, in the absence of express authority to the contrary, in no position to claim against the corporation as its creditor. For this reason, in the more usual situation there is included in the indenture a clause giving the trustee the express power to prove claims;[8] or a clause to the effect that the interest and principal of the secured indebtedness are payable to the trustee in case of default, thereby implying that power in a manner which the courts will recognize.[9] Where the trustee is allowed to file the claims, then, unless his power is specified in the indenture to be exclusive, the bondholders also have the right to file their own claims. Duplication of claims is avoided by reducing the trustee's claim *pro tanto* as the individual bondholders file their own claims.[10] The inclusion in the indenture of a specific clause allowing the trustee to file a claim on behalf of all the creditors secured by the indenture or a clause from which the courts will imply this power, would seem to be practical, as well as equitable, considering the fact that many individual holders cannot be located or notified in the relatively short time allowed for filing claims in bankruptcy proceedings, equity receiverships, and other forms of reorganizations.

However, where this power to file claims is vested in a trustee it does not imply a like power to vote on a plan of reorganization.[11] In filing claims he has acted as an authorized agent of the bondholders,

[8] See note 6, *supra.*

[9] Continental-Equitable Title & Trust Co. v. National Properties Co., 273 Fed. 967 (D. Del. 1921) (receivership action in which it was held that the title of the bondholders was defeasible and terminated on default, at which time title and right to make demand passed to the trustee); *In re* United Cigar Stores Co., 68 F. (2d) 895 (C. C. A. 2d, 1934) (bankruptcy proceeding in which the deed of trust stipulated that payment shall be made "only" to the trustee); *In re* Paramount Publix Corp., 72 F. (2d) 219 (C. C. A. 2d, 1934) (bankruptcy proceeding where the right of the trustee to file was based on the terms of the indenture which stated that payment should be made to the trustee); *In re* Allied Owners' Corp., 74 F. (2d) 201 (C. C. A. 2d, 1934) (77B proceeding where the trustee under the indenture was given the power, in case of default, to proceed to enforce the rights of the bondholders); National Milling & Chemical Co., Inc. v. Amalgamated Laundries, Inc., 7 F. Supp. 723 (S. D. N. Y. 1934) (receivership proceedings in which the trustee under the covenants of the indenture and in his representative capacity was conceded the right to file claims); *In re* James Butler Grocery Co., 21 F. Supp. 149 (E. D. N. Y. 1937) (bankruptcy proceeding where under the terms of the indenture the trustee was given the right to act upon default); Central Nat. Bank of Philadelphia v. Bateman & Co., Inc., 15 Del. Ch. 31, 131 Atl. 202 (1925).

[10] *In re* United Cigar Stores Co., 68 F. (2d) 895 (C. C. A. 2d, 1934); *In re* Associated Telephone Co., 12 F. Supp. 468 (S. D. N. Y. 1935); Gochenour v. Griever, 295 Ill. App. 366, 15 N. E. (2d) 26 (1938); 2 GERDES, CORPORATE REORGANIZATIONS (1936) §744.

[11] *In re* Allied Owners' Corp., 74 F. (2d) 201 (C. C. A. 2d, 1934); Blumgart v. St. Louis S. F. Ry., 94 F. (2d) 712 (C. C. A. 8th, 1938); *In re* Kenilworth Bldg. Corp., 105 F. (2d) 673 (C. C. A. 7th, 1939); note (1935) 2 U. OF CHI. L. REV. 644.

and at no time has he gained the status of an independent creditor of the company; his position was developed for duties of a fiduciary and administrative nature, and at no time was it within the intent of the parties to place the trustee in a policy-forming position.[12] The courts have refused to allow the contract between the corporation and the bondholders to be impaired or changed materially without their consent.[13] Therefore, this action by the trustee would not bind the bondholders since it exceeds the scope of his authority.[14] It has been suggested,[15] however, that at least a provision in the indenture should be made for allowing the trustee to vote for absent bondholders.

The problem of the respective powers of the trustee or the bondholders to vote on a plan of reorganization arises in reorganizations under the National Bankruptcy Act. Under Section 77B of the Bankruptcy Act[16] it was necessary to have the affirmative acceptance of two-thirds of the claims allowed. In such cases it has been said that it was customary to get the acceptance of two-thirds of the entire issue whether the claims were filed by the bondholders or the trustee.[17] The question would then be important whether the acceptance by the trustee could be counted in making up the two-thirds. The Chandler Act, which replaces Section 77B with Chapter X,[18] makes specific provision for such a situation. It provides that the trustee shall have the power to file claims for all holders who have not acted, but ". . . that in computing the majority necessary for the acceptance of the plan only the claims filed by the holders thereof, and allowed, shall be included." The language of the statute would, therefore, lead us to believe that in the future claims must be filed by the individual bondholder in order to allow his claim to be considered in computing the necessary majorities, or to allow him to vote on the plan of reorganization.[19] The claims filed by the trustee are kept alive by the filing, however, so these holders

[12] Note (1935) 2 U. OF CHI. L. REV. 644; see Bitker v. Hotel Duluth Co., 83 F. (2d) 721, 723 (C. C. A. 8th, 1936).

[13] *In re* Allied Owners' Corp., 74 F. (2d) 201 (C. C. A. 2d, 1934); note (1935) 33 MICH. L. REV. 1101; see Bitker v. Hotel Duluth Co., 83 F. (2d) 721, 723 (C. C. A. 8th, 1936).

[14] Palmer v. Bankers' Trust Co., 12 F. (2d) 747 (C. C. A. 8th, 1926); Hollister v. Stewart, 111 N. Y. 644, 19 N. E. 782 (1889); Sturges v. Knapp, 31 Vt. 1 (1858); see Werner, Harris & Buck v. Equitable Trust Co., 35 F. (2d) 513, 514 (C. C. A. 10th, 1929); Chicago Title & Trust Co. v. Robin, 361 Ill. 261, 267, 198 N. E. 4, 8 (1935). *Cf.* Allen v. Moline Plow Co., 14 F. (2d) 912 (C. C. A. 8th, 1926).

[15] Note (1935) 2 U. OF CHI. L. REV. 644.

[16] 48 STAT. 912, 11 U. S. C. A. §207 (1934).

[17] Brief for Appellants, p. 20, *In re* Kenilworth Bldg. Corp., 105 F. (2d) 673 (C. C. A. 7th, 1939). The phrase relied on in 77B(e) (1), "whose claims have been allowed", would seem to make no distinction in the persons who filed them.

[18] 52 STAT. 893, 11 U. S. C. A. §598 (Supp. 1938).

[19] *In re* Genesse Valley Gas Co., Inc. (S. D. N. Y. 1939), C. C. H. Bankr. Serv. ¶2808 (1939).

have some measure of protection since the court will look to the fairness of the proposed plan to the non-voting security holders before confirming it.[20]

The issuance of prior lien receivership certificates for a private company raises an analogous problem where such an issue requires the consent of the bondholders before the certificates are given priority over the secured bond issue.[21] The great majority of the cases hold that the ordinary deed of trust does not contemplate, under a reasonable construction of the general power to protect the bonds, that the authority to give consent shall vest in the trustee[22] either by direct action on his part,[23] or by his inaction in the face of notice of the receivership proceeding.[24]

Relatively few cases have come to the courts for a consideration of the right of the trustee, in the absence of a governing provision in the instrument, to bid for the property at the foreclosure sale on behalf of the bondholders. These cases show a well divided split of authority with excellent authority on both sides. Led by *Nay Aug Lumber Co. v. Scranton Trust Co.*,[25] some courts hold that the trustee has the implied power to bid for the property for the bondholders as part of his duty to protect the security, bidding for it an amount up to the amount of the bonds, and, if it is thereby bid in for the amount of the bonded indebtedness, giving each bondholder an undivided interest in the property.[26] The principal advantage which the courts recognize in this Pennsylvania rule of implied power of the trustee arises from the well known fact that property sold under a foreclosure seldom brings a price anywhere nearly commensurate with its true value. Therefore, it would seem more in the contemplation of the makers of the instru-

[20] See 3 GERDES, CORPORATE REORGANIZATIONS §1124.

[21] Rhode Island Hospital Trust Co. v. Greene & Sons Corp., 50 R. I. 305, 146 Atl. 765 (1929); Koester v. Citizens' Publishing Co., 154 S. C. 144, 151 S. E. 452 (1930); see Clifford v. West Hartford Creamery Co., 103 Vt. 229, 234, 153 Atl. 205, 211 (1931); note (1926) 40 A. L. R. 244.

[22] Farmers Loan & Trust Co. v. Centralia & C. Ry., 96 Fed. 636 (C. C. A. 7th, 1899); Bernard v. Union Trust Co., 159 Fed. 620 (C. C. A. 4th, 1908); Nowell v. International Trustee Co., 169 Fed. 497 (C. C. A. 9th, 1909); Rhode Island Hospital Trust Co. v. Greene & Sons Corp., 50 R. I. 305, 146 Atl. 765 (1929). *Contra: In re* Quemahoning Creek Coal Co., 15 F. (2d) 58 (W. D. Pa. 1926).

[23] See Koester v. Citizens' Publishing Co., 154 S. C. 154, 197, 151 S. E. 452, 467 (1930).

[24] Farmers Loan & Trust Co. v. Centralia Ry., 96 Fed. 636 (C. C. A. 7th, 1899); Rhode Island Hospital Trust Co. v. Greene & Sons Corp., 50 R. I. 305, 146 Atl. 765 (1929).

[25] 240 Pa. 500, 87 Atl. 843 (1913).

[26] Hoffman v. First Bond & Mortgage Co. of Hartford, 116 Conn. 320, 164 Atl. 656 (1933); First Nat. Bank in Wichita v. Neil, 137 Kan. 436, 20 P. (2d) 528 (1933); Krieger v. Title Ins. & Trust Co., 260 Ky. 1, 83 S. W. (2d) 850 (1935); Rogers v. Wheeler, 2 Lans. 486 (N. Y. 1870); Nay Aug Lumber Co. v. Scranton Trust Co., 240 Pa. 500, 87 Atl. 843 (1913); see Straus v. Chicago Title & Trust Co., 273 Ill. App. 63, 67 (1933); Silver v. Wichfield Farms, 209 Iowa 857, 861, 227 N. W. 97, 99 (1929).

ment that the trustee should continue his protection of the bondholders' interest to save them from severe losses. But other courts[27] are unwilling to impair the rights of the bondholders who, in case of default, are entitled to a foreclosure sale and their *pro rata* share of the proceeds in cash. These courts, following the federal rule, hold that it is impossible, in the absence of authorization in the indenture, to bind unwilling bondholders to the hazards of possible subsequent loss in case it turns out that later the property cannot be sold for as much as it would have brought if sold outright at the time of the foreclosure, instead of being bid in for the bondholders. For this reason, a Michigan statute giving the trustee power to bid in on the trust property was declared unconstitutional.[28] Fortunately, this difficulty is usually avoided by express provisions in the deed of trust giving the trustee the power to bid for the property, which provisions are held to be valid and binding on the bondholders.[29]

Bondholders, as individuals or as a class, are not entirely at the mercy of the trustee where he has authority to represent them. The rule of representation of bondholders by the trustee is a rule of convenience and continues only during the exercise of a fair and just representation.[30] Thus, if the trustee, at any time, refuses to act on behalf of the bondholders, conditions of the trust having been met, or if he proves himself hostile or his conduct proves prejudicial to the interests of the bondholders, the rule is put aside.[31] If such an adverse position of the trustee is proved, the bondholders may then represent themselves in proceedings such as these discussed, regardless of any clause in the deed of trust giving power to the trustee to act on their behalf.[32]

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[27] Werner, Harris & Buck v. Equitable Trust Co., 35 F. (2d) 513 (C. C. A. 10th, 1929); Cosmopolitan Hotel Co. v. Colorado Nat. Bank of Denver, 96 Colo. 62, 40 P. (2d) 245 (1934); Sanxey v. Iowa City Glass Co., 63 Iowa 707, 17 N. W. 429 (1883); Bradley v. Tyson, 33 Mich. 337 (1876); Detroit Trust Co. v. Stormfeltz-Loveley Co., 257 Mich. 655, 242 N. W. 227 (1932); see Chicago Title & Trust Co. v. Robin, 361 Ill. App. 261, 265, 198 N. E. 4, 8 (1935).

[28] Detroit Trust Co. v. Stormfeltz-Loveley Co., 257 Mich. 655, 242 N. W. 227 (1932) (a statute giving court power to authorize trustee to bid in on the trust property where not less than a majority of the bondholders requested it, was declared unconstitutional as impairing the contractual rights of the dissenters). But see Heighe v. Sale of Real Estate, 164 Md. 259, 268, 164 Atl. 671, 676 (1933).

[29] Sage v. Central R. R., 99 U. S. 334, 25 L. ed. 394 (1878); Smith v. Massachusetts Mutual Life Ins. Co., 116 Fla. 390, 156 So. 498 (1934); Kitchen Bros. Hotel Co. v. Omaha Safe Deposit Co., 126 Neb. 744, 254 N. W. 507 (1934).

[30] See Farmers Loan & Trust Co. v. Northern Pac. Ry., 66 Fed. 169, 174 (C. C. E. D. Wis. 1895).

[31] Farmers Loan & Trust Co. v. Northern Pac. Ry., 66 Fed. 169 (C. C. E. D. Wis. 1895); Cochran v. Pittsburg S. & N. Ry., 150 Fed. 682 (W. D. N. Y. 1907); Lowenthal v. Georgia Coast & P. Ry., 233 Fed. 1010 (S. D. Ga. 1916); Brown v. Denver Omnibus Co., 254 Fed. 560 (C. C. A. 8th, 1918).

[32] See note 31, *supra*.