Some Aspects of the Trust Indenture Act of 1939 - Duties and Responsibilities of Indenture Trustees

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NOTES AND COMMENTS

SOME ASPECTS OF THE TRUST INDENTURE ACT OF 1939

Duties and Responsibilities of Indenture Trustees

Introductory

By the Trust Indenture Act of 1939\(^1\) Congress took another step in providing for protection of security investors, in addition to those already taken by means of the Securities Act of 1933,\(^2\) which required disclosure through registration statements of fact data material to prospective investors regarding the financial condition of the issuer of securities, and by means of the Securities Exchange Act of 1934,\(^3\) which regulated the security exchanges. In general a familiar method of compelling the disclosure of information to prospective investors has been resorted to in the new act, in the requirement that certain securities be registered and qualified. The securities covered by the act may be said, at this preliminary stage, to be those involved in the usual types of corporate financing through the use of trust deeds to secure notes, bonds, etc.

A novel type of protection has been provided by the Trust Indenture Act, however, in the requirement of disclosure of facts regarding the relation of the trustee, under the trust indenture, to the obligor, and by the imposition of duties and the prohibition of exemptions of the trustee from liabilities, rather than as in the previous legislation above referred to, by requiring disclosure of information regarding the obligor or issuer of the securities.

It is widely known that the experience during the early depression years following 1929 with various kinds of trust indenture securities has been an unhappy and often a disastrous one; and that the difficulties of scattered and unorganized security holders have been considerably added to because of conflicts of interest on the part of the trustees who in these situations have often times occupied not only a dual- but a several-sided relationship to the issues secured by the indentures under which they were trustees. For example, it was not impossible to find situations where the trustee largely constituted or controlled the obligor, was trustee under the indenture, was itself a holder of more or less of the securities issued, was interested in or controlled other holders, and was interested in or controlled the so-called protective committees that were formed when default occurred and liquidation or reorganization was undertaken. Too often no one had much of a voice in such liquidation or reorganization except the trustee; and too often the interests, direct or indirect, of such trustee were opposed to those of

all who in theory, if not in fact, were supposed to be the beneficiaries of the trust.

Aside from the matter of conflicts of interest between the trustee and the beneficiaries, there were also other difficulties. One of the important ones was that it was often impossible for security holders to get information through either the trustee or the issuer as to the identity of other security holders, in order that concerted action by such security holders could be taken. Another difficulty was that under the theory of freedom of contract, obligors were allowed both to exempt the trustee from what might ordinarily be considered some of the most important of trust duties and obligations, so that the trustee was usually only a little, if at all, obligated to take action in behalf of the security holder-beneficiaries, particularly in the event of default; and other provisions often made it next to impossible for the individual security holders to act for their own protection.

The liquidation and reorganization work following depression defaults brought it forcefully to public attention that regardless of the theory that issuers, trustees and security holders dealt at arms' length so that each should look out for itself, in practice the investing public had the idea that a trust indenture was an effective security device from the point of view of the investor, and that the trustee was in fact a trustee for them. This conflict between legal theory and investment practice resulted, among other things, in various investigations; and the outcome was congressional resolution of the conflict, largely by accepting the investor's point of view, and rejecting the freedom of contract principle, operation under which had led to the practice of so drawing trust security instruments and of so limiting the powers and duties of trustees and of so limiting the effective rights of investors, that, in the opinion of many, freedom had been turned into abuse.

It is not intended herein to review in any detail the requirements of registration of securities generally, or of securities under trust indentures in particular, but rather to confine the discussion to requirements as to disclosure of relationships between the trustee and the obligor, and as to requirements in the way of affirmative duties imposed upon trustees, and to prohibitions against resort to previous practices. Accordingly, with regard to the kinds of securities coming under the Trust Indenture Act of 1939, it will only be said, generally and without strict accuracy as to matters of detail, that such securities are those in the form of "a note, bond, debenture, or evidence of indebtedness, whether or not secured," or a certificate of interest or participation in such note, bond, etc., or a temporary certificate for or a guaranty of such note, bond, etc., when the amount of the securities is over $1,000,000. There

5 Ibid., §77ddd(a)(1).
6 See ibid., §77ddd(a)(9) for matters of detail regarding the amount of the issue.
are a number of other exemptions from the operation of the act, as for example, securities exempt from the provisions of the Securities Act of 1933.\(^7\) However, the general situation is at least indicated by the requirements that the issue by one in the form of notes, bonds, etc., secured by a trust deed or mortgage, and that the amount of the issue be $1,000,000 or over.

It might be said in passing, that while the issues must be larger than those likely to be offered in the smaller communities, and so from the point of view of the practising lawyer, perhaps, a matter of no great interest insofar as his practice is concerned with the issue of securities in such communities, still the law is important in any community because of the protections it affords to investors, for they may be found anywhere. In the main, however, the law will be of principal original concern to those involved in the issuance of such securities, either on behalf of the obligor or the trustee, for, generally speaking, the steps taken to prevent use of former practices involve the denial of registration of securities when the provisions of the law in regard to their issue are not complied with, rather than remedial relief after an issue has been improperly marketed and the harm, if any, is done. This is illustrated by the provisions, frequently found in the act, that "the indenture to be qualified shall require" certain things to be done,\(^8\) or that "if the indenture to be qualified" is to require or permit certain things, "such indenture shall contain provisions. . . ."\(^9\) In other words, considerable reliance is placed on preventing the marketing of the issue, in the beginning, if the law is not complied with.

**Eligibility of Trustee**

There are certain initial restraints or limitations upon trustees under such indentures, and eligibility requirements are set out in the act.\(^10\) In the usual way of providing what the indenture to be qualified shall contain, rather than by stating directly eligibility requirements, the act provides that the indenture shall provide that at least one of the trustees be "a corporation organized and doing business under the laws of the United States, or of any state or territory or of the District of Columbia . . . which (A) is authorized under such laws to exercise corporate trust powers, and (B) is subject to supervision or examination by Federal, State, Territorial or District of Columbia authority." This trustee is called an "institutional trustee."

Subdivision 2 of the same section provides that the indenture to be qualified shall require that the institutional trustee shall have as a minimum a combined capital and surplus of not less than $150,000. Provision is made in subdivision 3 for the appointment of one or more

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\(^7\) See ibid., §77ddd(a)(4).

\(^8\) E.g., ibid., §77jjj(a)(1).

\(^9\) E.g., ibid., §77nnn(d).

\(^10\) Ibid., §77jjj.
cotrustees with the institutional trustee, but if the indenture requires
or permits that, it is also required to provide, in substance, that such
cotrustees shall be burdened with the same obligations and responsibili-
ties as the institutional trustee. It is further required that such addi-
tional trustees shall act in any jurisdictions where the institutional
trustee may not be qualified to do particular acts.

Disqualification of Trustee

In subdivision (b) of section 77jjj are found many of the most
important safeguards provided for investors by way of prohibition of too
close a relationship between the obligor and the trustee, and by way
of requirements of disclosure of such relationships and common interests.

The indenture cannot be qualified unless it provides that if a trustee
has or acquires any conflicting interest, as defined in the act, such
trustee shall within ninety days either "eliminate such conflicting inter-
est or resign." A duty is also imposed upon the obligor to take "prompt
steps" to have a successor trustee appointed. This latter provision
obviously places the duty to take the initiative in providing a successor
trustee where it properly belongs, for otherwise, due to the lack of
means or of interest, or of ability to act in concert, a forbidden situation
might last indefinitely if the security holders were left to look out for
themselves in the matter of appointing promptly the required successor
trustee. But as an alternative, provision is also made whereby the
security holders, through a suit by one on behalf of all, may take the
initiative in the matter of securing the removal of the disqualified trustee
and the appointment of a successor. This alternative will probably be
of some practical importance, for the disqualified trustee is to be re-
quired, within ten days after the above mentioned ninety-day period
after it learns of the grounds for disqualification, to give notice to the
security holders of its failure either to eliminate the conflicting interest
or to resign. This burden of disclosure, of course, is important, for the
effect is that the security holders must be advised of the existence of
facts which may lead them to take action.

Conflicting Interests

Detailed and far reaching provisions are contained in the definition
in the act of what is a disqualifying conflicting interest on the part of
the indenture trustee. With certain exceptions, there is a conflict of
interest as defined by the act if the indenture trustee is "trustee under
another indenture under which any other securities, or certificates of
interest or participation in any other securities, of an obligor upon the
indenture securities are outstanding." In some of the excepted or except-
able cases, the matter is left to the Securities and Exchange Commis-

11 Ibid., §77jjj(b)(1) et seq.
sion to determine whether or not there is such a conflict of interest as is material and sufficient to disqualify the trustee.

The trustee is absolutely prohibited, however, from occupying directly a dual role as trustee and obligor, for it is provided that an indenture trustee shall be deemed to have a conflicting interest if "such trustee or any of its directors or executive officers is an obligor upon the indenture securities." A similar conflict of interest is deemed to exist if the trustee or any of its directors or executive officers is an underwriter for such obligor. The purpose of such prohibition of these two kinds of dual interests should be obvious.

Much more far-reaching prohibitions also exist. In addition to the prohibition of a conflict of interest in cases where the "trustee directly or indirectly controls or is directly or indirectly controlled by or is under direct or indirect common control" with an obligor or underwriter for such obligor, there are also safeguards against other less direct and obvious instances of inter-relation of control and interest. It may be sufficiently suggestive of the nature of these prohibitions, without reviewing them in detail, to call attention to the fact that there is deemed to be a disqualifying conflict of interest if as small a percentage as 10 per cent of the voting control in the indenture trustee is held by the obligor, or an underwriter for such obligor, or by any director, partner or executive officer of either. Circumvention of this provision, through acquisition of less than 10 per cent each, by a number of such directors, etc., of the voting control over the trustee is prohibited by setting a total limit of such acquisitions or holdings below 20 per cent. When the trustee, on the other hand, holds obligations of the obligor constituting 5 per cent of the voting control or 10 per cent of any other class of security, where there is a default the same disqualifying conflict of interest is deemed to occur. In general, it may be said that the provisions against hidden control, identity of interest and like matters are both comprehensive and adequate to serve the end of preventing the trustee, either directly or indirectly, from having a substantial interest in the obligor, or being subject in a substantial degree to the control, direct or indirect of the obligor, or of those who have identical or similar interests to those of the obligor. And while larger holdings of the indenture securities are permitted to the trustee when they are held nonbeneficially, as when they are held in other fiduciary capacities under guardianships, trusts, executorships, etc., in which cases it may be supposed that the trustee will have no self interest to serve and so no temptation to make improper use of such securities not held by it beneficially, there are even safeguards against improper manipulation of such nonbeneficially held holdings. The aggregate of such holdings must not equal 25 per cent or more of the voting securities of the obligor; and even then after a default has occurred for a specified time, the trustee is deemed to hold such securities beneficially and to be disqualified thereby, if it would have been disqualified had it in fact held them in title or beneficially. Furthermore, the trustee is required.
indirectly, through the requirement that the indenture to be qualified shall so provide, to check its holdings of indenture securities each year, so that there will hardly be any excuse for ignorance on the part of the trustee as to what its holdings actually are, even in the case of non-beneficially held securities.

And finally, it is worth noticing that the foregoing provisions as to percentage of control "shall not be construed as indicating that the ownership of such percentages . . . is or is not necessary or sufficient to constitute direct or indirect control" in certain cases. In other words, while the mere holding of certain small percentages is not deemed to result in a conflict of interest in and of itself, such as will disqualify the indenture trustee, it seems that the matter may be examined into as a matter of fact in particular cases, and the inference is that even those small percentages of control not in themselves deemed to involve a conflict of interest, may be prohibited because in fact they may be sufficient to provide control. It might be suggested that the familiar holding company pyramiding, to secure by small holdings at the top substantial control of corporations several layers down, seems to be safeguarded against.

**Preferential Collection of Claims**

A matter of some difficulty is involved when a trustee individually competes with its beneficiary in the collection of claims against a common obligor. The problem has been before the courts, for example, in cases where the trustee has kept for itself part of a larger purchase of a security and has disposed of the rest to various trust portfolios. When the obligor is in failing circumstances, there is an inevitable conflict of interest between the trustee as such and as an individual in the effort to realize what may be possible from the obligor. As an original proposition it would seem that the duty of fidelity should not bar a trustee from investing in the same issue in which the trust funds are invested. On the other hand, when collection or liquidation is involved, it seems that the trustee at that stage should not be allowed to put its own individual interests completely ahead of those of its beneficiaries, and at the same time those of the beneficiaries should not be so predominant as to require a trustee to take a complete personal loss if there is not enough to satisfy the claims of the beneficiary and of the trustee too. A rule permitting and requiring a prorating of the amounts recovered would seem to do substantial justice to all interests.

The same problem can arise when an indenture trustee holds part of the indenture securities. The act\(^{12}\) contains detailed and elaborate provisions for prorating in these cases. In general, the trust deed is to provide that if the trustee becomes a creditor of the obligor, etc., within four months of default, a special account must be set up to which the

\(^{12}\) Ibid., §77kktk.
trustee must allocate collections made or other reductions affected in the trust deed indebtedness (except by the trustee's right of set off in certain cases). There are exceptions, as when the reduction in indebtedness results from collection from others than the obligor, and when the trustee without reasonable cause to believe that a default was likely to occur took a security for its own individual claims. Avoidance of these provisions by resignation on the part of the trustee is not permitted. It is permissible, however, for the indenture to be qualified to except from the proration requirements advances authorized in receivership or bankruptcy proceedings, and to pay off tax liens and otherwise to protect the security, provided that notice of such advances be given as provided in the indenture. Other so-called "proper" exceptions may be provided for in the trust instrument.\textsuperscript{13}

\textit{Bondholders Lists}

One of the sorest spots in the liquidation and reorganization history of recent years, has been the obstacle to co-operative effort on the part of security holders furnished by their inability to locate each other. Neither the obligor nor the indenture trustee was, as a rule, considered to have any duty to disclose information as to who the other holders of an issue were, although in the field of general trust law the trustee has a broad and substantial duty to disclose information relevant to the trust estate to the beneficiary. The consequence in the trust indenture field was that "insiders," namely the obligor and trustee, and in aggravated cases, the obligor-trustee, were able to control pretty much as they desired the course of liquidation or of reorganization. The use of the so-called "protective committee," often became what has been called a "racket," and was not infrequently used to protect the obligor or the trustee or both, rather than the purported objects of solicitude, the holders of the defaulted issues.

The act\textsuperscript{14} has provided substantial protection against the evils to security holders due to retention of information as to bondholders or other security holders for the exclusive use of the obligor, the trustee or their dominated protective committees. The obligor is to be required by the indenture to give full and complete information to the trustee regarding the holdings of the issue, and the trustee is to be required to preserve such information. The burden is therefore placed upon both of those who are in a position to supply, preserve, and disclose information, to compile and preserve such information as to who the security holders are.

There is not, however, a complete and unqualified duty upon the part of the trustee to disclose the names of security holders, even to other bona fide holders of part of the same issue. Rather, an alternative is required to be provided for in the indenture to be qualified, whereby

\textsuperscript{13} Ibid., \$77kkk(b).
\textsuperscript{14} Ibid., \$77lll.
NOTES AND COMMENTS

on application of three or more security holders, they shall be allowed access to the information held by the trustee in order to facilitate communication by such three with other holders of the issue; but if the trustee elects not to allow such access, the trustee must forward the communication to the other holders of the issue. This would seem to afford a reasonably adequate opportunity for those interested in instituting co-operative measures, to reach others who might be interested in such measures. It may be presumed that if the matter communicated about is meritorious, responses will be received which will make it possible for security holders to form, for example, their own protective committees. If on the other hand the matter is not meritorious, the lack of response to the communication may leave the three applicants in a situation where they can cause no further trouble. And meanwhile the failure of the trustee to disclose the desired information will result in a denial to them of ammunition that might be used improperly for mere trouble making, or for the purpose of bringing in others through various high-pressure tactics, solicitation, or even fraud and coercion.

Provision is also made for the case where the trustee may feel that the position of the applicants for information is so unmeritorious that they should be denied both of the above mentioned opportunities. In that case the trustee may refuse to act on either alternative, but must promptly present to the Securities and Exchange Commission the matter of the propriety of its action for the determination of the commission.

Reports by Trustees

Elaborate provision is made for the periodic and recurrent disclosure by the trustee to the holders of the issue, of matters arising subsequent to the original issue which may be considered material to the security holders, regarding the continued eligibility of the trustee to act as such, its claims and advances if any to the obligor, and particularly its holdings in its individual capacity of the indenture securities, together with any security it may have therefor. There must be disclosure, under the provisions of the indenture, if it is to be qualified, of other matters as well, such as those relating to the release and substitution of properties and securities subject to the indenture lien, and as to action taken by the trustee in the performance of its duties. There is, therefore, provision for a constant letting-in of the light of day upon transactions which under former practice were often regarded as the special and peculiar concern of trustee and obligor, rather than of the trust beneficiaries.

These requirements in regard to what the trust indenture shall require the trustee to do are supplemented by other requirements which the indenture shall impose upon the obligor, in the way of reports of information to be transmitted to the trustee.\textsuperscript{15} Information to be filed with the

\textsuperscript{15} Ibid., §77nnn.
trustee includes annual reports by the obligor and other information required to be filed with the commission. The commission is also given authority to prescribe by rule the disclosure of other information. Such reports should enable security holders to keep in touch with the financial condition of their obligors, and of the resulting or corresponding value of their securities; and they likewise serve to provide the trustee with information needed if it is effectively to perform its trust duties. Other provisions require the obligor to report what it has done in the way of meeting its own obligations under the trust indenture, so that all concerned may readily know if default in any undertaking has occurred and the nature and extent thereof. In proper cases such reports of the obligor must be supported by or supplemented by reports of accountants, engineers or appraisers, and in some instances by opinions of counsel. In the main, those familiar with the disclosure provisions of the Securities Act of 1933\textsuperscript{16} will find about the same provisions here as are to be found in that act, together with substantially similar safeguards through the requirement of such independent reports, appraisals and legal opinions. Such reports are particularly required for the information of the trustee in connection, for example, with such matters as release of liens on part of the secured property, substitution of securities, and so on. It is also provided that the indenture to be qualified shall provide that the trustee shall be entitled to rely upon such reports and legal opinions when the facts contained in them bear on the performance of particular duties by the trustee; and, while it is said that the trustee may "conclusively rely" on such reports, it is also provided that the trustee is not absolved from the duty of examining the evidence reported to it to see if it conforms to the requirements of the indenture.\textsuperscript{17}

\textit{Exculpatory Clauses}

While in general, independently of statute, exculpatory clauses have been given a narrow construction, so that the result in practice is not to relieve the trustee from liability for breach of trust in many cases that would seem to come within the provisions of such clauses, still they have been given some effect to protect the trustee from the consequences of its negligence. The act, however, seems to carry on the process of eroding away the protection intended by such provisions even more than the courts have done. In effect the act provides that the trust indenture to be qualified shall not contain any provisions excusing the trustee for negligence; and it appears that the very limited immunity that may be given the trustee from liability for "any error of judgment made in good faith by a responsible officer or officers of such trustee" is itself limited by the further requirement that such error of judgment be not in itself negligent.\textsuperscript{18} It is provided, however, that the trustee may act in good faith

\textsuperscript{16} 15 U.S.C.A. 77aa et seq.
\textsuperscript{17} 15 U.S.C.A. 77ooo(a)(2).
\textsuperscript{18} See ibid., §77ooo(d)(2).
without liability, in accordance with the directions of the holders of the majority in principal amount of the indenture securities, in certain instances.\(^{19}\)

**Suits and Proceedings by Trustee**

It has been said regarding former practice in the security field, that the ideal arrangement from the point of view of the obligor is to have a security instrument that will sell, but one that will not be enforceable. The act departs from this "ideal" in providing that the indenture to be qualified must provide for authority in the trustee in case of certain defaults, including default in the payment of principal (but not necessarily in the case of an interest default) to recover judgment in its own name as trustee of an express trust, against the obligor. Similar provisions must be inserted in the instrument allowing the trustee to file proofs of claim in order to have claims allowed against the obligor in any judicial proceedings.\(^{20}\) It is also provided that the indenture must provide that in case of default the trustee must exercise such of the rights and powers vested in it by the indenture and, in their exercise, use the care and skill which would be used by a reasonable man.\(^{21}\)

**Summary**

It would appear that the Trust Indenture Act is a logical and necessary development of the policy first made effective by the Securities Act of 1933, that the investor should have at least an opportunity to learn what it is that he is buying. For although disclosure by the obligor at the time of the offering of the security, and even at times subsequent thereto, of information relating to the nature of the business, its history, and its financial condition was an important step in the protection of the investor, it did not go far enough: The act under discussion makes numerous and important provisions for protection of another kind, by reaching the person who in the last analysis was often in the most important and strategic position of all concerned in a security transaction, namely the trustee. The liquidation and reorganization experience of the last ten years speaks eloquently of the need for recognizing and regulating the activities of the trustee as the "key man" in many of the critical or at least important situations that develop from the time of the original offering until the payment thereof or until the liquidation or reorganization of the obligor.

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19 Ibid., §77000(d)(3). See also for majority direction and control, §77ppp. Three-quarters control is required in one instance by subdivision (a)(2). Without discussing these provisions in detail, it should be noticed that control by less than all is provided for only in particular instances.

20 Ibid., §77qqq.

21 Ibid., §77000(c).

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