Chapter 8

The Trust Indenture Act of 1939*

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automatically deemed to provide that all parties agree that the court may discretionarily require a litigant in any suit to file an undertaking to pay the costs of such suit, as assessed at the court's discretion. However, this will not apply to the following: (1) suits instituted by trustee; (2) suits instituted by any indenture security holders with an aggregate holding of more than 10% in principal amount of the securities outstanding; (3) suits instituted by any security holder for the enforcement of the payment of the principal of or interest on any indenture security, on or after the respective due dates expressed in such indenture security.[1]

D. TRUSTEE CLAIMS AGAINST OBLIGOR

§ 8:24 Generally

Section 311 deals with a trustee's claims against an obligor. The situation often arises where the trustee is a creditor of the obligor upon the indenture securities, and upon another claim. Should the obligor default on either, the trustee is found in a conflicting position: it is a creditor competing against the holders of the indenture securities, to whom it owes a duty, for any remaining assets. Worse, where the trustee is well-acquainted with an obligor's finances, it may foresee and pre-empt a default by quickly collecting its own claims first. It may even try to circumvent its duty by resigning as trustee beforehand. Section 311 thus concerns this specific (possible) conflict of interest.[1]

Generally, within three months before a default which has not been cured, the trustee must set aside and hold in a special account, for the benefit of the trustee individually and the indenture holders, an amount equal to all reductions in the amount due and owing upon any claim as creditor, including both principal and interest;[2] and property received in satisfaction or composition of claims as creditor.[3] Here, a default is the failure to pay in full the principal or interest as and when it becomes due and payable.

§ 8:25 Exceptions

Congress recognizes certain instances where the trustee-creditor and obligor-debtor relationship does not warrant doubt over the

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[Section 8:23]

[1] Section 316(e).

[Section 8:24]

[1] See generally Stanley E. Howard, at 172-173.

[2] Section 311(a)(1). This does not include a reduction of amounts owed due to an exercise of any right of set-off.

[3] Section 311(a)(2). However, the trustee must take property subject to the rights of the obligor or fellow creditors therein.

trustee's conduct, or is even beneficial to indenture holders. The TIA thus automatically excludes certain transactions from the operation of Section 311, although parties have the option to expressly agree otherwise.[1] The transactions include acquiring indenture securities with a maturity of one year or more at the time of acquisition;[2] advances authorized by a bankruptcy or receivership court or by indenture, if notice is given to the indenture holders;[3] disbursements made in the ordinary course of business in certain capacities;[4] indebtedness from services rendered, premises rented or goods or securities sold;[5] ownership of securities of a corporation under the Federal Reserve Act, which is a creditor of the obligor;[6] and dealing with self-liquidating paper.[7]

Certain actions also fall outside the rule. A trustee-creditor may retain for its own account payments by persons other than the obligor who are liable on the claim, proceeds from a *bona fide* sale of such claim to a third party, and distributions from claims against the obligor in bankruptcy or receivership.[8] It may also realize, or receive payment against the release of, collaterals taken contemporaneously with claims created after the three-month period began (provided that the trustee had no reasonable cause to believe that the default would subsequently occur),[9] as well as collaterals held before the three-month period began.[10] A substitution or renewal of securities or claims will not subject the newly-substituted property to the three-month countdown; it will have the status of a pre-existing security or claim.[11]

Thus, on one hand, the TIA protects the long-term creditors (*i.e.*,

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[Section 8:25]

[1]Section 311(b).

[2]Section 311(b)(1).

[3]Section 311(b)(2).

[4]Section 311(b)(3).

[5]Section 311(b)(4).

[6]Section 311(b)(5).

[7]Section 311(b)(6). This is defined in rule 17 C.F.R. 260.11b-6 as "any draft, bill of exchange, acceptance or obligation which is made, drawn, negotiated or incurred by the obligor for the purpose of financing the purchase, processing, manufacture, shipment, storage or sale of goods, wares or merchandise and which is secured by documents evidencing title to, possession of or a lien upon the goods, wares or merchandise or the receivables or proceeds arising from the sale of the goods, wares or merchandise previously constituting the security: Provided, The security is received by the trustee simultaneously with the creation of the creditor relationship with the obligor arising from the making, drawing, negotiating or incurring of the draft, bill of exchange, acceptance or obligation."

[8]Section 311(a)(A).

[9]Sections 311(a)(C) and (D).

[10]Sections 311(a)(B) and (D).

[11]Section 311(a).

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indenture holders) against improper abuse by short-term creditors (*i.e.*, the trustee as creditor); on the other hand, by way of exceptions to the rule, the TIA avoids difficulties the trustees may face in advancing funds to the obligor if justified.[12]

§ 8:26 Apportionment

Between the trustee and indenture holders, the proceeds from such special account and dividends on claims against the obligor in bankruptcy or receivership will be apportioned so that they realize the same percentage of their respective claims. The claims are figured before the payment of such proceeds or dividends, but after crediting payments on the claim from other sources. Dividends do not include secured portions of claims.

The court may either apply the statutory formula mechanically, or use this formula as a guide to determine the fairness of distributions to the trustee and indenture holders. In the latter case, liquidating or appraising the value of securities and property, or making specific allocations on secured and unsecured portions of the claim, is not necessary.[1]

§ 8:27 Resigned/removed trustees

Trustees who resign or are removed within the three-month period remain subject to Section 311. Trustees who resign or are removed before that are still subject to Section 311 if the payment in question took place within the three-month period, and such payment took place within three months of resignation or removal.[1] It follows that only trustees who resign or are removed six months before a default are completely immune to the provisions in Section 311.

§ 8:28 Paying agents' duties

Paying agents are defined as persons authorized by an obligor to pay the principal or interest on the security on the obligor's behalf or, if the security is a certificate of interest or participation, on the trustee's behalf.[1] Their duties are twofold. They must hold all sums held for the payment of principal or interest on the securities in trust

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[12] Stanley E. Howard, at 173-174.

[Section 8:26]

[1] Section 311(a).

[Section 8:27]

[1] Section 311(a).

[Section 8:28]

[1] Section 303(13).

for the indenture holders' benefit. They must also give the trustee notice of the obligor's default in making any such payment.[2]

§ 8:29 Indenture holders' duties and powers

Unless expressly stated otherwise, indentures to be qualified are automatically deemed to authorize majority security holders[1] in principal amount of the indenture securities or holders of any specific series of securities at the time outstanding:

a. To direct the time, method and place of conducting any proceeding for any remedy, available to such trustee, under such indenture; or
b. On behalf of all security holders, to consent to waiving any past default and its consequences.

Alternatively, the indenture to be qualified may authorize the security holders of not less than 75% in principal amount, or holders of any specific series of securities at the time outstanding, to consent on behalf of all security holders to the postponement of any interest payment for up to three years from its due date.

While the indenture may bestow a certain degree of power onto the majority security holders, majority action clauses cannot be used to effect changes in payment terms (such as the right to receive payment and interest on or after the respective due dates as expressed in the indenture agreement and the right to institute suit for the enforcement of any such payment).[2] The indenture security holder's absolute right was affirmed by the court in *Great Plains Trust Co. v. Union Pac. R.R. Co.*,[3] when it held that no-action clauses will not override the security holder's absolute right to seek payment of overdue interest. Therefore, in order to modify the payment terms of an entire issue of qualified indenture securities (other than a limited postponement of interest payment authorized under Section 316(a)(1)), every security holder must consent to it.

Some courts have declined to uphold no-action clauses and have allowed direct class action suits in the trustee's right if the trustee acts

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[2]Section 317(b).

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[1]See paragraph 215.01 of the FAQ at http://www.sec.gov/divisions/corpfin/guidance/tiainterp.htm (accessed August 8, 2012). The TIA provides a required procedure for calculating votes for proposals permitted by Section 315(d)(3). In calculating the majority, securities owned by the obligor or an affiliate of the obligor must be disregarded.

[2]Section 316(b).

[3]Great Plains Trust Co. v. Union Pacific R. Co., 492 F.3d 986 (8th Cir. 2007).

fraudulently or has a conflict of interest.[4] For example, in *Rabinowitz* v. *Kaiser-Frazer Corp.*,[5] the clause vested the bondholders' rights to sue the obligor in the trustee, and prohibited bondholders from acting unless the trustee failed to act after holders of at least 25% of securities demanded the trustee in writing to act.[6] To protect bondholders, the indenture required subsequent purchasers of the bonds to assume the extant obligations; however, the purchaser refused to assume a sinking fund obligation. A holder of 0.125% of the bonds brought a class action for the bondholders. The court upheld the complaint, reasoning that the trustee had conflicting interests.[7]

Under Section 319(a) of the TIA, the SEC has authority to make rules and regulations that are necessary and appropriate to carry out the provisions of the act. As a result of the TIA Reform Act, the prohibition on majority action contained in Section 316(b) of the TIA has become an ongoing statutory provision rather than merely a contractual provision. Accordingly, the SEC arguably now has the power to make rules and regulations to determine whether such provision is being carried out after qualification of the indenture and issuance of the debt securities. This suggests that the SEC could, for example, adopt rules requiring that issuers proposing to amend qualified debt securities in a manner that may be subject to the restrictions of Section 316(b) make a filing with the SEC. Such a filing would then be subject to liability for false or misleading statements under Section 323(a) of the TIA.[8]

§ 8:30 Regulations on indenture provisions

Generally, the duties discussed in Sections 311–317 are part of, and govern, every qualified indenture. They operate retrospectively and supersede inconsistent provisions.[1] Where duties are optional, they do

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[4]See Conflict of Interests Between Indenture Trustee and Bondholders: Avoidance of "No Action" Clauses Prohibiting Bondholder Suits Against the Obligor, 62 No. 7 Yale L.J. 1097, 1099 et seq. (n. 14) (Jun. 1953).

[5]Rabinowitz v. Kaiser-Frazer Corp., 111 N.Y.S.2d 539 (Sup 1952).

[6]While this case predates the 1990 Amendment, it is submitted that the changes are not fatal to the applicability of this case. The pre-1990 legislation merely permits the clause now imported by Section 316(a)(1), the 1990 Amendment imports the clause by default unless the indenture expressly provides otherwise; either way, the obligor has the option to include or exclude the clause.

[7]For a detailed analysis, see Conflict of Interests Between Indenture Trustee and Bondholders: Avoidance of "No Action" Clauses Prohibiting Bondholder Suits Against the Obligor, 62 No. 7 Yale L.J. 1097, 1102 et seq. (Jun. 1953).

[8]Edwards and Bancone, Modifying Debt Securities: The Search for the Elusive "New Security" Doctrine, 47 No. 2 Bus. Law. 571, 590 (Feb. 1992).

[Section 8:30]

[1]Section 318(c).

not mandatorily form part of or govern the qualified indenture.[2] Parties may not provide terms to limit, qualify or conflict the duties imposed here,[3] but may provide terms not in contravention of the TIA.[4] Nor may parties contract to waive compliance with the TIA or any rule, regulation or order thereunder; such conditions, stipulations or provisions shall be void.[5]

§ 8:31 Defenses in general

Any liability imposed by the foregoing provisions will not apply to any act done or omitted in good faith, in conformity with any rule, regulation or order of the SEC. This applies even if such rule, regulation, or order is subsequently amended, rescinded or invalidated.[1]

VI. SEC ENFORCEMENT

§ 8:32 Generally

Prior to the TIA Reform Act, the SEC had no civil rights against violators of the indenture agreements. As a third party, it could not enforce the indenture provisions or regulate the relationship between an issuer and the indenture security holders. Rather, once qualified, the indenture becomes a contract. "It is enforceable only by the bondholders, the trustee, and the obligor. The [SEC] cannot intrude, at any point of time thereafter, upon the enforcement of its covenants or the assertion of rights thereunder in any respect whatsoever."[1] This view of the original TIA was supported by the courts[2] as well as Senate[3] and House[4] reports on the bill.

With the TIA Reform Act in 1990, however, the SEC may now enforce the statutory provisions, subjecting wrongdoers to both civil

[2]This is contemplated by Sections 310(b)(1), 311(b), 314(d), 315(a), 315(b), 315(d), 315(e), and 316(a)(1).

[3]Section 318(a).

[4]Section 318(b).

[5]Section 327.

[Section 8:31]

[1]Section 319(c).

[Section 8:32]

[1]Trust Indentures: *Hearings on H.R. 10,292 Before a Subcomm. Of the Comm. On Interstate and Foreign Commerce, House of Representatives*, 75th Cong., 3rd Sess. (April 25, 1938) (statement of William O. Douglas).

[2]Morris v. Cantor, 390 F. Supp. 817, 819-20, Fed. Sec. L. Rep. (CCH) P 94996 (S.D. N.Y. 1975) (". . . the scheme of the Act is to regulate in a limited fashion by taking a type of private contract, requiring that it contain certain terms and be registered with the [SEC], and that the parties disclose certain information, *and precluding the [SEC] from enforcing those terms*") (emphasis added).

[3]Senate Comm. on Banking and Currency, Report on Trust Indenture Act of 1939, S. Rep. No. 248, 76th Cong., 1st Sess. 8 (1939): ". . . it is believed that the

and criminal liability and federal court jurisdiction. Any person who willfully violates any TIA provision (or rule, regulation or order thereunder), or willfully makes a material misstatement or omission in any application, report or document filed pursuant to the TIA is liable to a fine of up to $10,000, and/or imprisonment not exceeding five years.[5]

To facilitate this enforcement, the SEC wields a range of investigative mechanisms. The SEC may administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of documents or records deemed relevant or material to the inquiry.[6] Additionally, the SEC has powers over investigations and hearings provided for by Sections 20, 22(b) and 22(c) of the Securities Act. This affords the SEC powers to award injunctions and various other orders, and some degree of extraterritorial jurisdiction.

Hearings may be public and held before the SEC, and any members or officers thereof. Appropriate records of the hearing shall be kept as well.[7] Testimony given in SEC investigations may be the basis of criminal prosecution for perjury.[8]

Any person aggrieved by an order of the SEC may seek judicial review in the U.S. Court of Appeals, by filing a written petition within 60 days after the entry of such order.[9] In a review, the court must first consider the facts found, and the agency's application of the relevant statute. The construction of the statute by those charged with its execution is accorded deference, unless there are compelling indicators otherwise.[10]

The U.S. District Courts have jurisdiction over violations of the TIA, and/or any rules, regulations or orders promulgated thereunder.[11]

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enforcement of the indenture may appropriately be left to the bondholders themselves, *without continuing supervision by a governmental agency*" (emphasis added).

[4]House Comm. On Interstate and Foreign Commerce, Report on Trust Indenture Act of 1939, H.R. Rep. No. 1016, 76th Cong., 1st Sess. 26 to 27 (1939): "The [SEC's] *only function* will be to see that the terms of each indenture conform to the prescribed standards. . . . The [SEC] will have *no powers* with respect to the enforcement of the provisions of the indenture. After the indenture has been executed it will be *enforceable only by the parties*, like any other contract." (emphasis added).

[5]Section 325.

[6]Section 321(a).

[7]Section 320.

[8]Woolley v. U.S., 97 F.2d 258 (C.C.A. 9th Cir. 1938).

[9]Section 322, referring to Section 9 of the Exchange Act.

[10]E. I. du Pont de Nemours & Co. v. Collins, 432 U.S. 46, 97 S. Ct. 2229, 53 L. Ed. 2d 100, Fed. Sec. L. Rep. (CCH) P 96081 (1977).

[11]Section 322(b), referring to Section 22(a) of the Securities Act.

VII. PRIVATE CAUSE OF ACTION

§ 8:33 Private actions generally

The TIA provides a federal cause of action for breach of terms in the indenture as mandated by the act.[1] It also permits civil action for the violation of the TIA. For instance, a federal private right of action exists under Section 315.[2] The TIA creates substantive liabilities in the areas it addresses, and contemplates that liability may be enforced by private actions.[3]

§ 8:34 Liability for misleading statements

A person who makes a material misstatement or omission in an application, report or document filed with the SEC is liable to another person who, in reliance thereon, purchased or sold a security under the indenture, unless he acted in good faith and had no knowledge of the omission, or that the statement was false or misleading. This private action is in addition to any rights and remedies under the Securities Act or Exchange Act,[1] but it does not give such plaintiff the right to recover more damages than the loss he suffered.[2]

This cause of action is personal to those who relied on the misrepresentation; thus, it does not follow the security to remote purchasers who had no basis for reliance. Accordingly, purchasers who acquired securities from class members after an issuer disclosed his financial embarrassment were not automatically assigned the class members' causes of action when they bought the securities.[3]

Such a suit must be brought within one year of discovery of the facts constituting the cause of action, and within three years after the cause of action accrued.[4] However, this limitation period only applies to actions enforcing liability for material misstatements and omis-

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[Section 8:33]

[1]Zeffiro v. First Pennsylvania Banking and Trust Co., 623 F.2d 290, Fed. Sec. L. Rep. (CCH) P 97514 (3d Cir. 1980).

[2]In re Equity Funding Corp. of America Securities Litigation, 416 F. Supp. 161, 22 Fed. R. Serv. 2d 368 (C.D. Cal. 1976).

[3]Morris v. Cantor, 390 F. Supp. 817, Fed. Sec. L. Rep. (CCH) P 94996 (S.D. N.Y. 1975).

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[1]See also U. S. Trust Co. of New York v. First Nat. City Bank, 57 A.D.2d 285, 394 N.Y.S.2d 653 (1st Dep't 1977).

[2]Section 323(b).

[3]In re Nucorp Energy Securities Litigation, 772 F.2d 1486, Fed. Sec. L. Rep. (CCH) P 92306 (9th Cir. 1985).

[4]Section 323(a).

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sions; it does not apply to actions under theories of breach of contract or express trust.[5]

§ 8:35 Trustees' powers upon obligor's default

Where an obligor defaults on the principal or interest of a security, and such default is continuing, the trustee may sue, in its own name and as trustee of an express trust, the obligor for the whole amount of principal and interest unpaid.[1] It may also file documents and proofs of claim as necessary or advisable to have the claims of the indenture holders and itself allowed in judicial proceedings concerning the obligor's indenture securities, creditors or property.[2]

§ 8:36 Assessment of damages for violations

Materiality and causation feature in a court's assessment of damages. In *Semi-Tech Litig., LLC* v. *Bankers Trust Co*,[1] the trustee had breached its duties to examine the statements furnished to it under Section 314 for conformity to the indenture. The trustee had also failed to give notice of default to the security holders. However, only nominal damages were awarded as the violation was insignificant. The Court founds that, had the trustee examined the certificates and brought the deficiencies to the obligor's attention, the obligor would have provided conforming certificates. Furthermore, the breach of duties was not the cause of losses to the security holders.

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[5]Zeffiro v. First Pennsylvania Banking and Trust Co., 473 F. Supp. 201, Fed. Sec. L. Rep. (CCH) P 96950 (E.D. Pa. 1979).

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[1]Section 317(a)(1).

[2]Section 317(a)(2).

[Section 8:36]

[1]In re Bankers Trust Co., 450 F.3d 121, Fed. Sec. L. Rep. (CCH) P 93874 (2d Cir. 2006).