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Canadian Bond Issues

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Although in the United States and Canada ordinary bankruptcy laws apply to corporate as well as individual debtors and make provision for compositions between ordinary creditors and the debtor, it is only comparatively recently that serious attention has been given to providing a cure for sickness among incorporated businesses by means of reorganization procedures. The importance of such reorganizations has been steadily growing as a result of the increasing practice of incorporating businesses. Speaking of the situation in the United States, Thomas K. Finletter says that "the use of corporations for commercial purposes had increased so rapidly that by 1929 practically all the important industrial business of the country was carried on in corporate form. Yet even at this late date there was no adequate statutory procedure for reorganization."[1] Moore and Oglebay also say that "the problem of corporate reorganization is and has always been primarily a problem of how the corporate debtor in failing circumstances can be made economically sound and, at the same time, the legal rights, in so far as they exist, of the creditors and stockholders be preserved or modified under some sort of arrangement fair to all. The growth of the problem has been commensurate with the tremendous expansion in this country of business conducted in the corporate form."[2]

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[1] Principles of Corporate Reorganization (1937), p. 2.

[2] Corporate Reorganization (1948), Vol. 1, p. 2.

This practice of incorporating businesses has led, as was inevitable, to the making of provision for their reorganization in order to provide curative procedures, permitting the salvaging of the going concern value and prospective production and earning power of a business for the benefit not only of its creditors — including bondholders — but also for the benefit of its employees, suppliers and customers, and often in fact for the benefit of the whole community.

The earliest important step in this vital effort was taken in 1867 by the British Parliament through the enactment of statutory provisions for the reorganization of railroads, and this was followed in 1870 by legislation on other companies. In the United Kingdom of course the legislation encountered no constitutional difficulties, such as a federal system of government necessarily creates. Here, as in the United States, federal legislation, unfortunately, can only be supported by the federal body's powers to legislate on bankruptcy and insolvency. Consequently, the epoch-making provisions of the 1933 77B amendment and the later chapter X of the Chandler Act (1938) form part of the United States federal Bankruptcy Act and our own Companies' Creditors Arrangement Act only applies to corporations which can bring themselves within the federal power to legislate on matters of bankruptcy and insolvency. On the other hand, the English provisions for the reorganization of corporations are to be found in the Companies Act, 1948, and no state of insolvency is required to make them applicable.[3]

Corporations having bond issues form a large and important part of the businesses of our country and, in view of the division between the federal and provincial legislatures of statutory authority to deal with their problems, it is important to frame the provisions of a trust deed securing bonds in such a way as to provide maximum possibilities for reorganization outside the statutory provisions. Although the latter have worked very satisfactorily in many cases of openly admitted and serious financial difficulties, there have been other cases where the difficulty was not so acute or of such a character as to make the application of the provisions of the legislation desirable or even possible. Fortunately we have long followed the practice of the English conveyancers of including in trust deeds the so-called "majority clauses", which permit bondholders' meetings to pass resolutions binding on all the bondholders, and both before and since the passing by Parliament of the Companies' Creditors Arrangement Act,[4] important

[3] See sections 206-210 of The Companies Act, 1948, Part IV, and Buckley on The Companies Act (12th ed., 1949), pp. 404 *et seq.*

[4] 23-24 Geo. V, c. 36.

reorganizations have been satisfactorily brought about in our country in this way. Thus, while in England the importance of these majority clauses has been greatly reduced owing to the satisfactory use that can be made of the Companies Act, they remain of outstanding importance to us.

This whole question of the terms of bond issues is thus of real significance from the standpoint of the growth of our productive capacity through the expansion of the volume of business conducted by corporations. It involves the recognition of bond issues as a sound and attractive means of providing capital, ensuring bondholders of the maximum possibility of preserving and, if necessary, realizing upon their basic security—the business of the mortgagor company as a going concern—and at the same time benefiting the interests of all others concerned in the sick business, including the community as a whole, through providing means for its restoration to a condition of health and prosperity.

The legal profession has played an important part from the bench and at the bar, and through its associations, in the development of methods of attaining this objective by means of statutory enactments and the terms of loan contracts as expressed in trust deeds and other instruments, and in their intrepretation and application in the courts. This is one more field in which the lawyer has demonstrated his capacity to serve our economic growth and the preservation of its stability by providing proper protection for the interests of various classes of investors, creditors and shareholders, and giving them the means whereby, through majority class action, they can co-operate to their mutual advantage and the benefit of our economy.

The steadily increasing importance of the financial structure of our corporations from the standpoint of the growth of our economy, and the fact that growing numbers of individuals and corporations may be interested in any particular corporation as investors, creditors, suppliers, customers and employees, and that even taxing authorities may be affected, have doubtless broadened the interest of lawyers generally, and their various associations, in the matters dealt with in this article. These matters can no longer be regarded as the concern of those only who participate directly in specific phases of corporation finance. All persons dealing with corporations are interested and may often be turning to their own lawyers for advice; and there is also the fact that the legal profession as a whole is deeply concerned to see that the contribution it has already made in this field is not impaired by any ill-advised innovations that may be proposed or undertaken,

and that every effort is made to keep our system of corporation finance fully adequate to changing conditions and to improve it wherever possible.

With these thoughts in mind, no attempt will be made in this article to interest the specialists in the field. I will try to indicate the general features of this large subject and to refer to authorities and publications where more detailed information can be found. In order to simplify this task the article will be restricted to the situation of a typical first mortgage bond issue secured in accordance with the provisions of the law of the province of Ontario by both fixed and floating charges on an industrial business. However, the position would be substantially identical in the other provinces of Canada where the English system of law — common law, equity and statutory enactments — prevails. I understand that there is also similarity in the province of Quebec.[5]

The rights and remedies of the holders of industrial bonds are mutually interlocked and it is essential to consider them together if one is to obtain a clear picture. The rights of bondholders include security on the assets of the debtor company and the latter's contractual obligations to the bondholders and the trustee. Their remedies include the enforcement of the security for their benefit, the preservation, pending realization or reorganization, of the value of the assets mortgaged or charged to secure the bonds, and the ultimate procedure in a realization or a reorganization. Various aspects of the bondholders' position may be conveniently dealt with under the headings which follow.

The Security

Broadly speaking there are no characteristics relating to the creation of security which are exclusive to bond issues, although there is special legislation in the case of bond issues regarding registration,[6] and the fact that the security is created in favour of a trustee has no bearing upon the nature of the security created or the method of its creation. It follows, therefore, that in creating security upon such assets as lands, buildings, ships, chattels, bills and accounts receivable, securities and shares, and the undertaking and goodwill of the mortgagor company, the ordinary law as it obtains in transactions between individuals is applicable, subject

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[5] See Winslow Benson, Business Methods of Canadian Trust Companies (1949), for the terminology used to identify various types of bond issues and a description of their characteristics.

[6] For example, the Corporation Securities Registration Act, R.S.O., 1950, c. 71.

to such special legislation as the Corporation Securities Registration Act.

There is however one vitally important feature of the security created for issues of bonds which, while theoretically applicable as between individuals, is practically never used except in the case of bond issues. This feature is the floating charge which covers the whole undertaking and business of the debtor company as a going concern.[7] The existence of a floating charge may add to the tangible security available for the bondholders as its crystallization turns the floating charge into a specific charge ranking ahead of ordinary unsecured creditors[8] but, generally speaking, its importance lies in the fact that it enables a remedy to be applied which will preserve the going concern value of the debtor company's business and its future potential earning power for the benefit of all concerned, including the debtor company and its shareholders, and is also an important factor in making a sound reorganization possible. This important feature will be more fully discussed later.

The Trust Mortgage

Our Canadian forms of trust deed are undoubtedly of English origin. They are reproduced and explained in the various editions of *Palmer's Company Precedents,* the last being Part III of the fifteenth edition published in 1938. In dealing with these English forms of trust deeds there are several points to be borne in mind.

(a) The term "bond" is never used by the English conveyancer in the sense we give to it. "Bond issues" are confined, for example, on the London Stock Exchange, to foreign issues, principally American and Canadian.

(b) English practice makes substantial use of registered debenture stock. In these issues the contractual obligations of the debtor company run solely to the trustee for the issue and there is no privity of contract between the debenture stockholder and the debtor company, but all payments made by the debtor company directly to the debenture stockholders satisfy *pro tanto* its obligation to the trustee. The elimination of this contractual relationship between the debenture stockholder and the debtor company necessarily affects the form of the trust deed.

(c) It is quite usual in England to put out issues of securities secured by a debenture in bearer or registered form which in its

[7] See Masten & Fraser, Company Law of Canada (4th ed., 1941), pp. 347 *et seq.*, and Buckley, *supra,* pp. 225 *et seq.*, for citation of cases on the creation and effect of a floating charge.

[8] *Evans* v. *Rival Granite Quarries,* [1910] 2 K.B. 979.

own terms creates a floating charge on the undertaking of the debtor company, no trustee or trust deed being required.[9]

On account of the large amount of bond issue financing effected by Canadian enterprises in the United States, it was of course inevitable that features of both a business and legal character which were common in the United States would infiltrate into Canadian forms. Some of these features are of fundamental and probably permanent importance and in many cases must be, or should prudently be, adopted in the creation of Canadian issues where sale in the United States to either private investors or the public is contemplated. These features include the following.

(1) The so-called "majority clauses" have been widely used in Canadian trust deeds.[10] Under these provisions bondholders' meetings were given wide powers to agree to modifications and compromises resulting in extensions of time or other concessions and often in complete reorganizations. The conferring of such broad powers on bondholders' meetings was never customary in the United States and today, in respect of securities requiring to be registered under the Trust Indenture Act of 1939, the powers exercisable by bondholders' meetings are limited by the provisions of section 316(a)(1) and (2) to the postponement (by vote of at least 75% of the outstanding securities) of any interest payment for a period not exceeding three years from its due date and the right (by vote of a majority) to waive any past default and its consequence, or to direct the trustee in the enforcement of any remedy, or the exercise of any power conferred upon it under the indenture.

(2) It has long been customary in England and in Canada to confer upon the trustee under a trust deed, by "discretionary release clauses", wide powers to grant releases of properties covered by the security. It was also to a limited extent customary to put provisions in trust deeds giving the debtor company the contractual right as between itself as mortgagor and the trustee as mortgagee to require the release of certain portions of the mortgaged properties on specified terms. A typical Canadian trust deed may therefore include both discretionary and mandatory release provisions.[11] These discretionary powers have, however, never been used in the United States. The granting of releases by trustees

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[9] A common form of trust deed currently used in Canada will be found in Fraser, Canadian Company Forms (3rd ed., 1947) at p. 648.

[10] Canadian Company Forms, *supra*, p. 704, ss. 116 *et seq.*; Palmer's Company Precedents, *supra*, p. 156.

[11] Canadian Company Forms, *supra*, pp. 677 *et seq.*; Palmer's Company Precedents, *supra*, pp. 326 *et seq.*

under the standard forms of American trust deeds have been provided for on what we sometimes call "the pieces of paper" basis: that is to say, the trustee, upon being provided with various documents, such as certified copies of resolutions of the board of the debtor company, certificates of officers of the debtor company and sometimes independent certificates and valuations and legal opinions, is bound to give the release asked for. Therefore, no matter how advisable it may appear to be in the interest of the bondholders that a release of property should be granted, unless it can be brought within the four corners of these mandatory provisions the trustee is powerless to grant the release. Conversely, it must be granted even though the trustee considers the granting of it to be contrary to the bondholders' interest. In many cases, however, the trust deed authorizes the trustee to require further evidence, or make further investigation as to the facts and matters stated in certificates or opinions. And it should also be noted that, as is shown in the preceding paragraph, not even a meeting of bondholders can authorize the release. The mandatory provisions on releases are set out in section 314 (c), (d) and (e) of the Trust Indenture Act.

(3) There are also various specific provisions in the Trust Indenture Act which must be complied with if a registration under it is required. These include such matters as the obtaining of periodical legal opinions by the trustee (section 314 (b) 2), the keeping of a list of the names and addresses of the bondholders by the trustee (section 312 (a)), the giving of information to bondholders by the trustee (section 312 (b)), the giving of certain notices by the trustee to the bondholders (section 313), the imposition of certain duties on the trustee after default (section 315 (b) and (c)), limiting the immunity provisions in regard to the trustee (section 316 (d)) and provisions as to the qualifications of the trustee (section 310 (a) and 2).

Apart from the specific matters just mentioned, the typical American trust deed has had an impact in various individual cases upon the phraseology of Canadian trust deeds, introducing provisions which were often inappropriate or unnecessary. Typical instances of this type of infiltration are to be found in mortgaging clauses which purport to cover chattel properties specified under classifications of wide scope, notwithstanding that these chattel properties are being effectively covered by the floating charge only. It is also important to remember, if the draftsman is dealing partly with American precedents, that the doctrine of "jeopardy" is unknown in the United States and that here the existence of jeopardy

rather than default is nearly always the fundamental reason, whether or not there is default, why proceedings are taken for the enforcement of the security leading to the appointment of a receiver and manager. It is necessary, therefore, to ensure that any provisions incorporated from American precedents are not inconsistent with the application of the doctrine of "jeopardy".

A further development of a business character which is common to Canada and the United States, but seems to have no fully comparable parallel in England, is the practice of including a large body of covenants, known as "restrictive covenants", in trust deeds. These covenants restrict the freedom of action of the debtor company in various ways, such as over the payment of dividends. It is, for example, quite a common practice for the mortgagor company to covenant that it will not pay dividends while its net liquid assets are below a specified figure, or would be reduced below the figure as a result of the payment.

Upon close analysis it will be found that a typical trust deed comprises two principal ingredients: (1) the mortgage and charges created by the mortgagor company in favour of the trustee mortgagee; and (2) a statement of the terms of the trust upon which the trustee mortgagee holds the mortgage and charges for the benefit of the bondholders. Thus it is legally possible for a mortgagee to cause an issue of securities to be created by assigning the mortgage to a trust company on stated trusts, the trust company issuing certificates of beneficial interest to the purchasers of the securities, who thus would have the same position as debenture stockholders. This procedure has, in fact, been used in actual practice.

The provisions creating the mortgage and charges, and the incidental provisions, such as the various covenants entered into by the mortgagor company, logically fall into one distinct category, but in actual practice they are not usually grouped together in one part of the trust deed. For instance, sinking fund provisions are logically part of the mortgaging provisions, since they amount to an agreement to pay the principal of the mortgage indebtedness in specified instalments. Similarly the covenant to insure is an ordinary incident of an ordinary mortgage, as are provisions on the definition of default and the remedies in case of default. Any mandatory release provisions also operate as between mortgagor and mortgagee, and of course the provisions on the terms of the bonds and the conditions under which, and the amounts in which, they can be issued all relate to the mortgage, because it is by these provisions that the amount of the mortgage debt is estab-

lished. If, however, one turns to the index of a typical trust deed, it will be found that these and other provisions of similar character are not grouped together as relating solely to the position between the mortgagor company and the trustee mortgagee, but are distributed throughout the instrument under separate headings, such as "the bonds", "sinking fund", "insurance", "release provisions", "default".

Likewise upon turning to the usual index it will be found that the provisions constituting the declaration of the trust upon which the trustee mortgagee holds the trust assets are not separately grouped. Indeed, instances may arise where it is not perfectly clear whether a particular provision operates solely as between the trustee mortgagee and its cestui que trustent, or whether it also affects the relationship between the mortgagor company and the trustee mortgagee.

Notwithstanding the failure to segregate clearly these two important ingredients in the structure of a trust deed, the common arrangement of the various sections as disclosed by a typical index is convenient in practice.

While precedents are essential to the conveyancer charged with the responsibility of drafting a trust deed, no form can be blindly followed. It is indeed necessary to consider the applicability to the case in hand of every provision in any precedent which is being followed and, of course, some additional provisions may be required. It is always advisable to make sure that any precedents followed are up-to-date because forms of trust deeds are constantly being amended in order to meet situations that have arisen in practice and have not been adequately foreseen and provided for. One of the most important tasks of all concerned in the creation of trust deeds is to use imagination in an endeavour to foresee what situations may arise during the existence of the bond issue they are creating so that adequate provision will be made in the terms of the trust deed for any situation likely to arise. This is not a light burden considering the length of time that bond issues usually run and the kind of situations that may develop in the future.

Besides the two principal ingredients mentioned, the ordinary trust deed contains provisions which do not fall strictly within the scope of mortgage provisions or the statements of the trusts, such as, for example, provisions giving an individual bondholder the right to exchange denominations, to register or de-register, to obtain duplicate bonds in the case of loss or destruction; and in our typical Canadian mortgages there are also the very important

provisions for the holding of meetings of bondholders and the extent of the authority of a meeting to pass resolutions binding on the whole body of bondholders.

The drafting of the mortgaging and charging clauses and the other clauses ancillary to them is of first importance. In our Canadian practice it is usual for the mortgagor company to create specific mortgages and also a floating charge, and this necessitates a definition of "the specifically mortgaged premises", being the property effectively covered by the specific mortgaging and charging clauses. The totality of the property covered by the specific mortgages and charges and the floating charge is defined as "the mortgage premises". It is not usual with us for a specific mortgage or charge to be created on physical assets other than real estate, chattel properties being covered only by the floating charge. These remarks do not apply to trust deeds used in the United States since they do not contain a floating charge.

In addition to creating valid and effective security by way of fixed mortgage and charge and floating charge, care must be taken to see to the proper registration of the mortgages and charges, and this involves the important matter of the covenant for further assurance.

Sometimes the specific mortgage purports to cover after-acquired property and here no difficulty need be anticipated in framing a proper covenant for further assurance. It is different, however, so far as the floating charge is concerned. The mortgagor company may have widely spread assets subject to the terms of the floating charge, such as shipments of goods on consignment and receivables, and in some jurisdictions it may be impossible to register a floating charge, and in others, although registration is possible, the expense and trouble of registration would far exceed any protection it would give to the bondholders.

Defeasance provisions must also be carefully scrutinized. For example, in the case of a trust deed which authorizes the issue of bonds in series under specified conditions as to additional property, earnings, and the like, the payment at maturity or upon redemption of all existing outstanding bonds might result, unless the trust deed is properly drawn, in the automatic discharge and cancellation of the deed, and thus prevent the issue of subsequent series under it.

Special considerations also arise having regard to the nature of the property to be mortgaged, as in the case of ships.

The provisions setting out the statement of the trusts upon which the trustee mortgagee holds the trust estate are pretty well

standardized but nevertheless require detailed consideration on the part of the draftsman. Occasionally one hears criticism of the length of the modern trust deed and the great number of provisions it contains. It should be borne in mind, however, that the standard provisions in use to-day have grown to their present number as the result of practical experience and the effort to provide clearly for what may happen during the currency of the particular issue with which the draftsman is dealing. His aim is to see to it that there is a provision in the trust deed applicable to any situation likely to arise, so that it can be disposed of without doubt or delay. The best road to the achievement of this objective is experience.

The Position of the Trustee

The position of the trustee has received exhaustive consideration in recent years in the United States through the investigations conducted by the Securities and Exchange Commission,[12] and in the lengthy hearings before congressional committees in Washington leading to the passing of the Trust Indenture Act. It has also been dealt with in England in the report of the Cohen Committee,[13] and the voluminous testimony given during the hearings by that Committee. It may now be definitely stated that from the strictly legal standpoint the trustee for a bond issue is a trustee holding the trust assets (that is, the mortgages and charges on the mortgaged premises, but not the mortgaged premises themselves) in trust for the bondholders, its cestui que trustent, with the rights, responsibilities and immunities contained in the trust deed and subject to the duties imposed by, and with the protection of, any applicable general law, statutory or otherwise.

What, however, is the practical position and how far is it sound practice to cut down the duties and responsibilities of the bond issue trustee to a lower level than that of the ordinary trustee in the usual type of personal trust? This matter has been considered fully in the United States and in England.[14] The fundamentally important point is, of course, the extent to which bondholders are entitled to look to the trustee for their protection. The degree of

[12] See particularly Part VI of the Securities and Exchange Commission Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (Government Printing Office, Washington, D.C.).

[13] Report of the Committee on Company Law Amendment (His Majesty's Stationery Office, London, Cmd. 6659).

[14] See particularly Part VI of the Securities and Exchange Commission Report, *supra*, and the proceedings of various Congressional Committees leading up to the enactment of the Trust Indenture Act, 1939, Report of the Cohen Committee, *supra*, and The Companies Act, 1948, s. 88.

responsibility in this respect resting upon the trustee will, of course, primarily depend upon the terms of the trust deed, but it will also depend upon particular situations that may arise, such as "jeopardy", default in payment of interest, breach by the mortgagor company of other important covenants (for example, the restriction on the payment of dividends). Another point to be taken into consideration is the extent to which responsible trust companies will be prepared to undertake the duties, inevitably substantial, involved in acting as a trustee for bondholders unless the extent of their duties is clearly defined in a satisfactory manner.

The views held on this important matter of the degree of responsibility accepted by trustees for bond issues will also depend to some extent upon what one considers the essential nature of the investment by the bond purchaser to be.

When an individual makes a mortgage loan on a dwelling house he has no interest in the business of the mortgagor (if he has one); he is concerned with his financial position only to the extent of the value of his covenant to pay. On the other hand, the investor in corporation bonds is deeply concerned with the business of the mortgagor company, its earning power being his primary security. Inevitably, therefore, his concern will be over the soundness of the business and the character of its management and board of directors. In short, it may be argued that in purchasing bonds of a corporation the purchaser is making an investment in a particular layer of the corporation's capital structure and he may in fact invest in other layers, such as preferred and common stock. Where the trust deed confers the right to exchange his bonds for shares he often attaches substantial value to this privilege, which, in fact, is frequently exercised.

Another important factor is the extent to which purchasers of corporation bonds rely upon the protection of the issuing houses marketing the bonds. It is common knowledge that issuing houses have often gone to great trouble and expense to protect the interests of the holders of the bonds they have placed upon the market. During the depression of the 1930's the importance of issuing houses in meeting difficult situations, or helping the trustee to do so, was clearly brought to light where default had overtaken bond issues that had long been on the market and the original issuing houses had disappeared.

It is also the case that the remuneration trust companies receive for acting as bond issue trustees is so small during the period of the normal operation of the trusteeship that corresponding relief from the full measure of trustee responsibility must be given to

them. This point was recognized in the hearings leading up to the Trust Indenture Act of 1939 and the Cohen Report.[15]

Obviously a default must have an important effect upon the trustee's position. The Trust Indenture Act of 1939 endeavours in section 315 (c) to deal with this problem. This provision requires the trustee to exercise in case of default as defined in the trust deed such of the rights and powers vested in it, and to use the same degree of care and skill in their exercise, as a prudent man would exercise or use in the conduct of his own affairs. The preceding clauses of this section in effect exempt the trustee from all but certain specified duties before default. This attempt to differentiate clearly between pre-default and post-default responsibilities scarcely fits the situation. Some defaults may be relatively unimportant. During the depression of the thirties, for example, defaults in payment of sinking fund were common. They were well known to bondholders and the financial community and pressure to remedy the default on the part of the bondholders, their trustees or the issuing houses would have been foolish because it would have resulted either in grave injury to the mortgagor company's business or, at best, to the increase of bank loans secured in priority to the bonds. Only those whose bonds were taken up in the sinking fund operation would have benefited.

On the other hand, a serious condition of "jeopardy" may arise before default. As a matter of fact it is "jeopardy" and not default which, with us, in the majority of cases has been the cause of enforcement proceedings resulting in the appointment of a receiver and manager. A typical situation of this kind is where the mortgagor company advises the trustee and the issuing houses that its bankers will not advance any further moneys to enable the operation of the business to be continued unless they are provided with receiver's certificates and that, consequently, if proceedings are not immediately taken permitting the issue of certificates, the company will be unable to meet its payrolls. In such circumstances trustees in the past have acted at once by taking proceedings to enforce the security, coupled with the appointment of a receiver and manager who is authorized by the court to issue the necessary receiver's certificates to the company's bankers, thus permitting the company's activities to be continued.

There are other situations which raise doubts of the feasibility of drawing a clear line between pre-default and post-default periods

[15] For fuller discussion of this matter see Business Methods of Canadian Trust Companies, *supra*, at pp. 139 *et seq.*, particularly p. 135 where the three types of provisions on the responsibility of the trustee—"exculpatory", "protective" and "enabling"—are discussed.

in determining the degree of the trustee's responsibility. For example, the mortgagor company may have covenanted that it will not declare or pay dividends when its net liquid assets are below a certain sum or would be reduced below it by the payment. The company then declares a dividend which the trustee believes and is advised constitutes a breach of this covenant. What is the responsibility of the trustee? An injunction will not solve the problem because the mere declaration of the dividend creates a debt and each shareholder is entitled to sue the company for his proportion.[16] Furthermore, the situation may be complicated if the company contends that on the true interpretation of the trust deed it had the right to declare the dividend. It does not seem reasonable in such circumstances to impose the "prudent man" degree of full responsibility upon the trustee.

The service given by the trust companies as bond issue trustees is not however governed solely by the terms of the trust instrument. They frequently are active where no duty is placed upon them or where they are even entitled to immunity, as in seeing to the compliance with the insurance provisions.[17] It is customary also for the trust companies to take great care to see that the terms of the trust deed are in conformity with the prospectus and otherwise proper.[18] Although in the initial issue of bonds under a trust deed no responsibility is placed upon the trustee under the typical instrument regarding the validity of the mortgagor company's title, due registration of the instruments of mortgage and charge, and the like, these matters are in practice carefully checked by the trustee before it will certify and deliver the bonds. But the trustee obviously is in a position of real responsibility when it comes to issuing additional bonds, or paying over proceeds of the sale of bonds for construction or other specified purposes. Provisions on these matters must be very carefully drawn and scrutinized so as, on the one hand, to preserve the proper responsibility of the trustee and, on the other, to make the carrying out of the transaction practicable by enabling the trustee to accept evidence of various kinds, such as certificates of company officers, auditors, engineers and appraisals, establishing the facts which must be proved to enable the additional bonds to be issued, or the proceeds paid out by the trustee.

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[16] See cases collected on page 512 of Masten and Fraser, Company Law of Canada, *supra*.

[17] See Business Methods of Canadian Trust Companies, *supra*, pp. 135 *et seq.*

[18] See Business Methods of Canadian Trust Companies, *supra*, p. 142, and the S.E.C. Report, Part VI, p. 7.

Broadly speaking, although the exculpatory, protective and enabling provisions of trust deed are fairly well standardized, it is of course necessary that they be given careful consideration. Solicitors for the underwriters and the trustee will want to see that the purchasers of the bonds are given proper protection through the services they are entitled to from their trustee. The trustee on its part will want to be sure that it is not subjected to any unreasonable burden. All concerned in the creation of the issue will desire to satisfy themselves that the provisions adopted will not interfere with the efficient administration of the trust.

So far the activities of the trustee considered have been those undertaken by it on its own initiative as duties imposed upon it by the trust deed or undertaken as a matter of recognized practice, or in the exercise of its discretion. There is, however, another aspect from which the trustee's position may be and, indeed, has often been envisaged — where the trustee is an agency that can be put in motion by action on the part of the bondholders. The trustee is, for example, a source from which the bondholders can obtain information upon inquiry. Furthermore, under practically all types of trust deeds, the trustee is an instrumentality which can be put in motion to enforce the security for the bonds, or otherwise protect the bondholders' interest. In these cases it must be furnished with a request and indemnity as provided in the trust deed, the request being evidenced by resolutions of bondholders' meetings or by instruments signed by holders of a specified percentage of the bonds, which sometimes is as low as 10%.

This view of the trustee as a quiescent agency requiring some action by the bondholders to put it in motion was originally the classic view of the trustee's position, and consequently there was no objection to an officer of the mortgagor company or a member of its board of directors acting as trustee.[19] Undoubtedly the trustee continues as part of its functions to constitute an agency which the bondholders may put in motion, but to-day it is fully recognized that the functions of the trustee must go beyond making its services available in this manner. The question of how far beyond they should go is to a considerable extent for determination in each bond issue.

Compromise and Reorganization

Sometimes where there are the usual majority clauses a compromise or arrangement can be very simply and soundly effected

[19] See Business Methods of Canadian Trust Companies, *supra*, at p. 134.

merely by the submission of a proposal to the bondholders which is accepted at a bondholders' meeting. A typical situation of this type is the following.

The mortgagor company has made a serious default through failure to pay its bond interest. But there is no "jeopardy"; apart from bond interest its working capital position is fairly good; there are no subsequent encumbrancers, no accumulation of debt to ordinary creditors, all of whose claims are on current account, and the management is considered to be efficient. In these circumstances it has often been possible to work out a proposal acceptable to the bondholders, and in its formulation the issuing houses, and possibly some large institutional holders of bonds, are quite likely to co-operate with the trustee in an endeavour to produce a satisfactory offer.

In some cases the so-called "two-step method" can be, and has been, satisfactorily applied. This method involves a preliminary bondholders' meeting at which a committee is appointed to co-operate with the trustee in the working out of the plan of compromise or reorganization for later submission to the bondholders at a second meeting. The trustee, with the approval of the committee, is authorized in the meantime to refrain from taking any proceedings to enforce the security, but, on the other hand, with the committee's approval, it may take such action at any time which in the combined discretion of the trustee and the committee seems in the interest of the bondholders. It is common practice now to make special provision in the trust deed authorizing the appointment of such a committee, thus avoiding any difficulty arising as the result of the decision in the *British American Nickel* case.[20]

As a general rule, representatives of the issuing houses and of the large institutional holders, if any, will be elected to the committee, and even junior bond issues may be satisfactorily represented, provided that the trust deeds securing such issues also give the bondholders authority to appoint committees with like powers, in which event the proposal of compromise or reorganization can be worked out by negotiations between the trustees, the committees and the mortgagor company.

This simple and effective means of bringing about a satisfactory compromise or arrangement is not of course available in the United States because of the lack in American trust deeds of "majority

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[20] *O'Brien (M.J.) Limited* v. *British American Nickel Corporation Ltd.*, [1927] A.C. 369; [1927] 1 D.L.R. 1121. And see Fraser's Canadian Company Forms, *supra*, p. 708, clause (m).

provisions" giving bondholders' meetings the necessary powers. Needless to say, the method can be put to good use even if enforcement proceedings have taken place and a receiver and manager has been appointed. It would hardly be appropriate, however, if recourse were to be had to the Companies' Creditors Arrangement Act.

The Function of a Receiver and Manager[21]

In order to obtain a clear picture of the rights of bondholders it is of first importance to determine what they can do if their security becomes enforceable. In the case of industrial issues under the ordinary British type of trust mortgage they have two different types of charges, the fixed and the floating. By reason of the floating charge they have security upon the business as a going concern and can require the business to be carried on through the appointment of a receiver and manager. It is not necessary, however, for the bondholders to avail themselves of their security upon the goodwill or going-concern value of the business, and if they do not choose to do so they can proceed to realize upon the fixed assets and those of the floating assets which are effectively caught through the crystallization of the floating charge, without concerning themselves about or assuming any obligation in carrying on the business which, in such circumstances, in the unlikely event of its being carried on at all, can only be carried on by a trustee-in-bankruptcy or a liquidator under a lease from, or other arrangement with the trustee or receiver for the bondholders. The technical procedure by which this result is brought about is through taking sale or foreclosure proceedings, and either abstaining entirely from receivership proceedings or having a receiver only, instead of a receiver and manager, appointed, the bondholders thus relinquishing their right to have the business continued through a manager appointed at their instance. In actual practice this course is rarely taken, and so far as this writer's knowledge goes it has never been taken unless at the time the trouble arose the company's business had ceased to be carried on or plainly could not be further continued. On the other hand, in the case of the great majority of industrial bond issues it is a matter of vital importance to the bondholders that the business be continued, as otherwise they would be left with plants and equipment on their hands very difficult to realize upon, and which

[21] The topic of this section was previously dealt with by the author in a booklet issued in 1932: Fred R. MacKelcan, K.C., The Position of the Holders of Industrial Bonds.

would involve heavy expense for such items as taxes, insurance and caretaking up to the time of realization. Furthermore, realization would often be found impossible unless the original business could be revived or a purchaser found who was carrying on, or proposed to carry on, the same line of business.

Therefore, it generally happens that when action is necessary on the part of the bondholders it takes the form, as a first step, of having a receiver and manager appointed with power to carry on the business. Such a receiver and manager under our law is entirely different from a receiver appointed in bankruptcy or a liquidator and also from a receiver appointed in the United States, since the American receivers are appointed at the instance of ordinary creditors, while in our proceedings the receiver and manager is appointed at the instance of the bondholders as mortgagees. Contrary to what is probably the general understanding, receivers and managers of a company are rarely appointed merely as a result of default upon its bonds. The primary reason for their appointment is to permit the business of the company to be carried on, the appointment being made on what is technically known as the ground of "jeopardy". In plain English this means that the company gets into such a position that its operations will cease unless a receiver and manager is appointed, thus preventing interruption of the business through action by ordinary creditors, and enabling new moneys to be raised for operating purposes by the issue of receiver's certificates ranking ahead of the bonds. On the other hand, the mere inability of a company to pay interest or sinking fund under its bond mortgage does not necessarily make it desirable in the interests of the bondholders to take proceedings for the appointment of a receiver and manager and the enforcement of the security if the company is able to continue operations, because the result of such proceedings might be to injure the business of the company as a going concern. Therefore, where bondholders are confronted with a situation where there is default under the bond mortgage, but the company is nevertheless able to continue carrying on its business, the very first point to be decided is whether the going concern value and the continuance of operations are of substantial importance to the bondholders, and if so whether operations can be carried on effectively through a receiver and manager without substantial injury to the business. The factors involved in this problem, of course, vary greatly in individual cases. As already indicated, it generally appears highly desirable in the bondholders' interest to continue operations if possible, and in some cases operations can be continued by a receiver and man-

ager as efficiently as if they were carried on by the company's management, or perhaps even more efficiently, while in other instances, owing to the nature of the business, receivership may be harmful.

A further important point which generally arises is over the security held by the company's bankers. In most instances it will be found that the company has given its bankers assignments of inventories under section 88 of the Bank Act and also assignments of receivables, and if it should be found desirable to have a receiver and manager appointed on behalf of the bondholders one of the first things to be done is to make some arrangement with the bank having the security. The receiver and manager, of course, cannot himself carry on operations without obtaining the right to use the inventories belonging to the bank and obtaining sufficient line of credit to take the place of the assigned receivables; on the other hand, the bank cannot itself work up and dispose of its inventories, and sometimes cannot effectively collect the receivables, without carrying on the business, which involves the use of the plant and equipment covered by the security of the bondholders. The kind of arrangement to be made with the bank depends upon the facts of each particular case. If, for example, it should be considered that the bank's security will not realize sufficient to pay off the bank's loans, then the receiver and manager may try to make an arrangement with the bank whereby, with or without rental, the bank is permitted at its own risk and expense to occupy and use the premises so as to work out its security; on the other hand, if there appears to be a large surplus of security above the amount of the bank's loans, the receiver and manager will sometimes endeavour to arrange with the bank to take a receiver's certificate for the amount of its loans, thus freeing the liquid assets and making them available for the operations of the receiver and manager. There are indeed many kinds of arrangements that might be made with the bank depending on the facts of the particular case.

It will be seen therefore that it is quite impossible to obtain a clear understanding of the rights of the holders of bonds of industrial concerns unless one takes fully into account this vitally important question of going concern value, which entirely differentiates such a situation from that of the ordinary mortgage on a piece of real estate. One must bear in mind, however, that the bondholders can always put themselves, if they wish, in the position of an ordinary mortgagee of tangible assets, provided they are willing to abandon the hope of realizing anything upon the business as a going concern.

It seems clear that the appointment of a receiver and manager is an unsurpassed method of preserving, and possibly improving, the going concern character and prospective earning power of the business of the mortgagor company for the benefit of the bondholders pending reorganization or ultimate sale, if reorganization should prove impossible or undesirable from the bondholders' standpoint.

One important privilege a receiver and manager enjoys is that, with the approval of the court, he may either refrain from carrying out pre-receivership contracts, leaving the other party to claim for damages for breach, which if sustained would only make him an ordinary creditor, or he may proceed to carry out the contract, subject to the right of the court at any time to direct otherwise. By fulfilling a contract the receiver and manager may preserve, so long as desired, an asset considered to be valuable, and which, on account of the terms of the contract, might have been lost if the mortgagor company had gone into bankruptcy or liquidation. Of course, the receiver and manager can, with the court's authority, adopt the contract, either with unrestricted personal liability on his part, or with liability restricted to the assets in his hands available for his indemnification; or the contract could be made a charge on the receivership assets, with such status in regard to other charges on the assets as might be agreed upon. In either of these two cases there would be, in effect, a novation, but if neither of these courses is taken the rights of the receiver and manager against the other party cannot rank higher than those of the mortgagor company, and accordingly, if he fulfills the contract in the mortgagor company's name, any claim that could be asserted against the mortgagor company could be asserted against him.[22]

It may be of interest here to compare briefly our receivership practice with federal equity receiverships in the United States, which up until the passing by Congress in 1934 of the famous section 77B of the Bankruptcy Act — now appearing in revised form in chapter X of the Chandler Act, 1938 — provided the chief, and indeed almost the only, means of effecting reorganizations of large American companies having bond issues. With us the standard form of proceeding in which a receiver and manager is appointed is an action by the trustee for the bondholders in which realization by sale of the mortgaged premises is sought. The important matter is, however, the appointment of a receiver and manager who takes possession and control of all the assets covered

[22] See *Parsons* v. *Sovereign Bank of Canada*, [1913] A.C. 160.

by the bond mortgage, which in a standard case includes everything the mortgagor company owns because the trust deed will have included a floating charge. The solicitors for the plaintiff trustee have the "carriage of the order" and normally matters brought before the court for its ruling are submitted on applications made by the plaintiff trustee. An important practical feature is the ability to raise money for the carrying on of the business by the issue of receiver's certificates ranking in priority to the claims of the bondholders. It is common practice to authorize the issue of receiver's certificates with this priority.

In the federal equity receivership in the United States proceedings were commenced by an ordinary creditors' bill and the receiver took possession of all the company's assets, subject to the rights of secured creditors. The equity receivership was, of course, a proceeding aimed at achieving a reorganization. Ultimately the mortgagees (normally the trustees for bondholders) would bring foreclosure actions as dependent bills to the creditors' action, whereupon the actions would be consolidated with the receivership under the creditors' bill and the court thus put in a position to synchronize the two proceedings so as to arrive at the final necessary step in the reorganization, a sale under both bills at the same moment. The sale was generally made to a reorganization committee composed of representatives of the bondholders, or, at all events, including them.[23] Because a sale of all the mortgagor company's assets was the technical device by which reorganization was brought about and as the assets effectively mortgaged would not include all the assets of the mortgagor company, it was essential to give the sale this double-barrelled characteristic.

Chapter X of the Chandler Act adopts the essential characteristics of the equity receivership reorganization but the necessity of having recourse to the technical procedure of a sale is eliminated and the reorganization is based on obtaining the required percentage of consents from the parties affected.

As I have pointed out, with us the issue of receiver's certificates ranking ahead of the bondholders is a normal procedure resulting from the fact that the receivership action has been brought on behalf of all the bondholders, but, under the equity receivership practice or the provisions of the present Chandler Act,[24] the giving of priority is not a clear or simple matter.

[23] See Finletter, *supra*, pp. 12, 13 *et seq.*, and 27 *et seq.*, for the history of section 77B and the Chandler Act, and the defects of the equity receivership procedure; and see Moore and Oglebay, *supra*, Vol. 1, pp. 20 *et seq.*

[24] See chapter X, s. 116, sub-s. 2, and Moore and Oglebay, *supra*, Vol. 1, p. 716. For the provisions of the Chandler Act see Jacob I. Weinstein, The Bankruptcy Law of 1938 (published by the National Association of Creditmen.)

The Companies' Creditors Arrangement Act

Comparable legislation to the Chandler Act is to be found in our Companies' Creditors Arrangement Act, 1933.[25] This legislation does not attempt, however, to set out the detailed procedure contained in chapter X of the Chandler Act; it is founded on the provisions on "Arrangements and Reconstructions" in sections 206 and following in Part IV of the English Companies Act, 1948. Under both out Act and the English Act, however, the sanction of the court to the reorganization plan, after notice to the parties affected, is essential. A broad distinction between the attitudes of our courts and the American courts is that in considering whether they will sanction a plan, our courts merely seek to determine that it has been put before the meetings of various classes with all proper formalities and adequate information, and that each class was fairly represented by those attending the meeting; that the statutory majority acted bona fide and did not coerce the minority in order to promote interests adverse to those of the class they purported to represent; and that the arrangement was such as an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve.[26] On the other hand, the American courts enforce certain strict rules on priorities which must be observed in reorganization plans and they will not permit any class of creditors to be forced to abandon their priority rights by a majority, no matter how large the majority.[27] To-day it seems clear that in reorganizations under chapter X of the Chandler Act the "absolute priority" rule must be applied; that a plan must provide full satisfaction of each class in the descending hierarchy to the extent permitted by the value of the property and may allow participation of the various classes only to the extent the value of the debtor's assets reflects an equity therein for them.[28]

Under our procedure bondholders, by the required majority action, either under the provisions of the trust deed or the Companies' Creditors Arrangement Act, can definitely waive payment of amounts due them for interest or principal without receiving any tangible consideration in return, actuated solely by the desire to assist in placing the reorganized company on a sound basis. In

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[25] 23-24 Geo. V, c. 36.

[26] See Buckley, *supra*, p. 410, and the cases there cited.

[27] See Moore & Oglebay, *supra*, Vol. II, pp. 3860 *et seq.* discussing the "fair and equitable" and "absolute" priority principles flowing from the decision in the *Northern Pacific Railway Co.* v. *Boyd* (1913), 228 U.S. 482, 33 S. Ct. 554.

[28] See Moore & Oglebay, *supra*, Vol. II, p. 3872.

the application of this principle, for example, amounts owing to the bondholders may be cancelled while, at the same time, consideration is given to the shareholders of the mortgagor company for such reasons as that many of them were customers of the company and their elimination from the reorganization would have a serious adverse effect upon the sales of the reorganized company's products. Plans of this nature would not be approved in American courts.

It would be surprising if the Companies' Creditors Arrangement Act, hurriedly passed twenty years ago, did not require amendment. Proposals for amendment have already been advanced and have been considered by several interested organizations, including the Canadian Bar Association, and by the government at Ottawa. In the first place, abuses of the Act have made clear that it should not be available to commercial corporations seeking compositions with their trade creditors. Machinery for compositions, both before and after bankruptcy, is now available in the new Bankruptcy Act. The Companies' Creditors Arrangement Act is totally unsuited to them. A simple amendment restricting the scope of the Companies' Creditors Arrangement Act to this extent is essential.

But, apart from this obvious and urgent need, there is a need for amendments that will standardize practice under the Act, and provide the additional safeguards that twenty years of experience have shown to be advisable. Rules, as contemplated by section 17 of the Act, have never been promulgated and coherent practice throughout the Dominion could hardly be expected. But what is required is more than procedural: substantive legislation is desirable. The amendments proposed also set up other safeguards on such matters as the information furnished to bondholders and other creditors, solicitation of proxies and the conduct of meetings. In the main they are features which found their way into the British and United States legislation as a result of the inquiries of the Cohen Committee and the Securities and Exchange Commission.

The Ontario Judicature Act

The investor in real estate mortgages looks upon the marketability of the mortgaged property as his chief security and he expects to sell it, if the mortgagor defaults, for a cash consideration that will give him back the principal and interest of his loan and his expenses, with as large a down payment as possible and the balance of the price secured by a vendor's lien or a mortgage back. But

he cannot accept a consideration other than one ultimately, if not immediately, wholly payable in cash because there is no way of determining the value of the non-cash portion of the consideration so as to ascertain whether the mortgagee has or has not received on the sale a payment which exceeds the amount of his claim.

This situation was changed to a limited degree in respect of bondholders by the 1917 amendment to the Judicature Act, the provisions of which have since been expanded.[29] Under the expanded provisions, where bondholders at meetings duly called have approved a sale of the mortgaged assets for a consideration wholly or in part other than in cash, the court may appraise the value of the non-cash consideration, which almost always consists of shares of some company existing or to be formed. Usually the bondholders do not give the court carte-blanche but make their approval conditional upon the awarding of a specified amount of the shares as part of the consideration payable to them. The terms of the offer generally make clear what the capital structure of the company, the shares of which are to be received, is or will be, and the situation in respect of its control and other relevant features. This legislation was, of course, brought about by the obvious fact that a sale for cash would rarely be expected in realizing upon the security for bond issues of any size, the security having no marketability even remotely comparable to that of a dwelling house or a moderate-sized apartment or office building.

Although these provisions of the Judicature Act cannot be used to effect a compromise or reorganization within the field covered by federal legislation,[30] they have been satisfactorily used in various cases and may well be resorted to in the future.

Conclusion

Obviously the question of the safety of industrial bond issues as a form of capital investment in our rapidly growing industrial development calls for particular attention. It requires examination of the means of protecting the position of bondholders if the mortgagor company should encounter financial difficulties. Although it would be dangerous to be complacent and ignore possibilities of improvement, there are good grounds for thinking that the means of protection now available are reasonably satisfactory. If a business is hopelessly dead or moribund, there is no other course open but to realize on the mortgaged assets, probably piece-

[29] R.S.O., 1950, c. 190, s. 15, clause (i).

[30] *Montreal Trust Company* v. *Abitibi Power and Paper Co.*, [1938] 1 D.L.R. 548, 4 D.L.R. 529; [1938] O.R. 81 and 589.

meal, with results that experience has shown to be unsatisfactory. This, of course, is to be expected when the security represented by the earning power of the business has gone.

But where the illness of the business is not fatal, there are effective methods available for restoring its health by capital surgery or curative treatment, including the transfusion of new life blood with new capital or new management and control. As I have mentioned, there may be simple cases which can be solved by an arrangement with the mortgagor company approved by the bondholders in accordance with the provisions of the "majority clauses", either under a "one-step" or "two-step" procedure, no recourse to court proceedings or statutory enactments being necessary. If, however, the occurrence of "jeopardy" has rendered receivership unavoidable, then the appointment of a receiver and manager by virtue of "the floating charge" can preserve the vitally important "going concern" element of the bondholders' security while efforts are made to work out the situation in a manner that will protect their interests. In many cases this would mean developing a plan of reorganization and making it effective in one or other of the manners which have previously been discussed. Should all efforts to effect a sound reorganization fail, it would be necessary to bring the business to sale as a going concern, in which case the provisions of the Judicature Act might be found useful.

Society's Responsibility for Automobile Accidents

Another possible scheme is to cast aside entirely the traditional doctrines of negligence law in critical accident areas, and place the problem of injury redress, at least as to automobile accidents, in the administrative realm, by analogy to the Workmen's Compensation statutes which cover industrial accidents. A fairly strong case for this solution can be made. It may be urged that, just as in the industrial field, a certain toll of property damage and human suffering — sometimes because of individual 'fault' and sometimes not — is necessarily concomitant in other areas of a mechanized civilization. Even with vigorous safety campaigns, there will probably always be a reasonably large and comparatively irreducible residuum of accidental damage, and it may be argued that society at large should bear the burden lest it be inflicted ruinously upon the individual. Strict liability of this sort is not necessarily the 'radical' innovation it may at first appear to be. Indeed it may even be said that such a change, rather than introducing a new and strange doctrine, would in some sense be only a return to the strict liability of the writ of trespass in the earlier common law, although the burden of damages would be spread over the public rather than, as under the early law, placed upon the individual. (McNiece and Thornton, Is the Law of Negligence Obsolete? (1952), 26 St. John's L. Rev. 255)