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UNAUTHORIZED EXPENDITURES
BY BONDHOLDERS' PROTECTIVE COMMITTEES

By Stanley Law Sabel*

A writer in a recent issue of the Harvard Law Review, in an article entitled The Railroad Reorganization Act, has pointed out that the problem of excessive reorganization expenses is not satisfactorily settled even as to reorganizations of railroads under that act. The act provides that a district court judge may within limits fixed by the Interstate Commerce Commission allow a reasonable compensation for the services rendered and reimbursement for actual and necessary expenses incurred in connection with the proceeding and plan by officers, parties in interest, reorganization managers, and committees or other representatives of creditors and stockholders. As pointed out by Mr. Lowenthal and by other writers on this act, this section does not change the law in relation to compensation of the committee and other expenses of a reorganization from what it was under United States v. Chicago, Milwaukee, St. Paul and Pacific R. R. Co., which held that the deposit contract in relation to assessments was not a contract relating to commerce and hence the Interstate Commerce Commission was without jurisdiction in relation thereto.

It may be true, as Mr. Lowenthal suggests, that "even without the new act, the Supreme Court might conclude that devices such as were employed in that case should not be permitted to defeat commission regulation," or it may be, as suggested by another writer, that the question now becomes one of the fairness

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1Lowenthal, The Railroad Reorganization Act, (1933) 47 Harv. L. Rev. 18.
5Rogers and Groom, Reorganization of R. R. Corporations under Sec. 77 of the Bankruptcy Act, (1933) 33 Col. L. Rev. 571, 587-588.
7Lowenthal, The Railroad Reorganization Act, (1933) 47 Harv. L. Rev. 18, 55.
of the plan.\textsuperscript{8} At any rate, the problem is certainly one of current interest.

Although deposit agreements usually contain every conceivable grant of power,\textsuperscript{9} and although the normal method of enforcement of assessments made by the committee is in rem against the securities deposited,\textsuperscript{10} it is conceivable that certain expenditures of the committee may be totally unauthorized by any construction of the deposit agreement and a depositing bondholder may wish to raise this himself rather than wait and resist an assessment. The bondholder may wish so to raise the issue in order that he himself might select the time and place for the suit. This special aspect of the problem raises the question of what effect such expenditures would have on the relationship between the committee and the depositors inter se. Along with the broader problems, this certainly is not answered by the new act. The whole question will without doubt be revisited in litigation interpreting this act.\textsuperscript{11} In anticipation of such litigation, the present writer wishes to analyze the state of the authorities as to the direct rights of the individual depositors as they are affected by unauthorized expenditures by a protective committee.

\textbf{Analysis and State of Authorities}

There appear to be no cases in which a bondholders’ committee has been held directly liable to depositing members. Cases which may be helpful on our problem fall roughly into two groups: first, the group dealing with the nature of the relationship as it exists between the committee and the depositors; and, second, the group involving equitable actions by the depositors against the committee for an accounting. In this latter group are a few cases dealing with the expenses incurred by the committee. None of these cases are specific or recent enough to

\textsuperscript{8} Weiner, Reorganization under Sec. 77: A Comment, (1933) 33 Col. L. Rev. 834, 844.

\textsuperscript{9} Address by Paul D. Cravath, Reorganization of Corporations, in Some Legal Phases of Corporate Financing, Reorganization and Regulation 153, 164.


\textsuperscript{11} Lowenthal, The Railroad Reorganization Act, (1933) 47 Harv. L. Rev. 18, 55, states, “Whatever the final decision may be, it is apparent that there may be litigation before the provisions of the new Act on the subject of fees can become effective.”
answer alone the problem as herein considered. It is believed, however, that a tracing of the general proposition involved in these two groups of cases will give a pretty close approximation of the answer to our problem.

**NATURE OF THE RELATIONSHIP**

The relationship existing between a depositor and the protective committee has been called one of trust,\(^{12}\) agency,\(^{13}\) syndicate or bailment. The conclusion reached by a recent writer as to the nature of this relationship is that about all that can be said is that it is contractual and fiduciary.\(^{14}\) An examination of the cases is apt to leave one with an equally vague idea of just what this relationship is. It is submitted, however, that a more definite result can be reached. The confusion is due to the fact that the depositing bondholders occupy a dual relationship with respect to the committee, viz., they create the relationship and are, in turn, the beneficiaries thereof. More generally speaking, they are both grantors and cestuis; as grantors they create the relationship, and as cestuis they enforce it.

The contract of deposit in general determines the powers of the protective committee. This is illustrated by *Titus v. U. S. Smelting, Refining and Mining Exploration Co.*,\(^{15}\) where the court examined the deposit agreement in reaching the conclusion that "expenditures incurred to determine the presence or non-presence of ore in paying quantities in a given mining area is [sic] necessary and proper work and within the express authority conferred upon the committee."\(^{16}\)

However, the contract of deposit is not always specific, and in such cases the courts endeavor to construe the agreement. In *United Waterworks Co. v. Stone*\(^{17}\) the court sustained a declaration based upon conversion brought by certain bondholders against a bondholders' committee, on the ground that the reorganization plan alleged to have been adopted by the committee was not in furtherance of the plan as outlined in the deposit agreement.

\(^{12}\)Caldwell v. City Water Supply Co., (1906) 130 Iowa 671, 105 N. W. 1016.


\(^{14}\)Rogers, Rights and Duties of the Committee in Bondholders' Reorganization, (1929) 42 Harv. L. Rev. 899, 928-929. See also, Rohlicn, Protective Committees, (1932) 80 U. of Pa. L. Rev. 670, 682.

\(^{15}\)(C.C.A. 2nd Cir., 1917) 240 Fed. 881.

\(^{16}\)(C.A.A. 2nd Cir., 1917) 240 Fed. 881, 891.

\(^{17}\)(D.C. Mass. 1904) 127 Fed. 587.
This case seems to indicate that the courts will construe deposit agreements according to the purpose behind them. Thus it has been held that where a depositor comes in under a subsequently adopted reorganization plan, he cannot be held liable for expenses incurred under a prior unsuccessful plan in which he had not joined.\textsuperscript{18}

In the case of expenditures by the committee, the usual form of deposit agreement does not contain an express limitation upon these expenditures. In such a case the right to make necessary expenditures will be implied. Thus in \textit{Cowell v. City Water Supply Co.}\textsuperscript{19} the court said that "... any reasonable expenditure necessary to preserve the property is implied in the very nature of the trust." When a court reaches the point of interpreting a deposit contract by the nature of the relationship, it is really dealing with relational rather than contractual law. This fiduciary relationship can be called a trust, at least as far as expenditures by the fiduciary are concerned.\textsuperscript{20} So analyzed, the problem boils down to a consideration of how the beneficiary can protect his rights in the case of unauthorized expenditures by the fiduciary.

\textbf{Rights of the Bondholders}.

Rights and duties are correlative. Thus this topic, in considering the rights of bondholders, must also involve a consideration of the duties or limitations upon rights of the committee. In general, a bondholders' committee has a lien upon the deposited securities for expenses incurred in "good faith."\textsuperscript{21} Ordinarily, a depositor who does not pay his pro rata share of the expenses loses his right under the reorganization agreement and is only entitled to his share of the proceeds from the foreclosure sale.\textsuperscript{22} However, it has been suggested that under the modern type of deposit agreement, providing for an in rem enforcement of the assessment against the securities, such a failure to pay the assessment will not prevent the depositor sharing pro tanto in the new corporation.\textsuperscript{23} Nevertheless, it is generally held that a depositor

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\textsuperscript{19}(1906) 130 Iowa 671, 105 N. W. 1016.
\textsuperscript{21}Coppell v. Hollins, (1895) 91 Hun 570, 36 N. Y. S. 500, aff'd on opinion below, (1899) 159 N. Y. 551, 54 N. E. 1089.
\textsuperscript{22}Appeal of Fidelity Insurance Co., (1884) 106 Pa. St. 144.
\textsuperscript{23}Indiana Ill. & Iowa R. R. Co. v. Swannell, (1895) 157 Ill. 616, 41 N. E. 989.
\end{flushright}
may, prior to the completion of a reorganization, bring an action for an accounting without first paying his share of the reorganization expenses. Thus *Mawhinney v. Bliss*\(^24\) held that a depositor who alleged, among other things, excessive expenditures by the committee as showing bad faith might obtain an accounting. Similarly, the committee may have its accounts approved by a court of equity.\(^25\) This last case approved the expenditures by the committee, although one of the members of the committee was also a member of a firm to which commissions were paid for the sale of bonds in the reorganized company.

From the foregoing it will be seen that a bondholder who does not pay his share of the expenses of the committee will ordinarily lose his rights (or at least pro tanto in the case of in rem enforcement) to share in the reorganized corporation. (The situation where the reorganized company bears the expenses of the reorganization is not dealt with, as that involves more than the relationship between the depositing bondholders and the committee.)\(^26\)

Where the committee incurs excessive or unauthorized expenditures, it would seem that the rights of a bondholder should be somewhat larger. That is, the committee, by over-assessing the bondholder, should not prevent him from sharing in the reorganized company if he does not pay this assessment. As seen in *Mawhinney v. Bliss*,\(^27\) a bondholder may obtain an accounting, by alleging bad faith of the committee, prior to the consummation of the reorganization plan and although the deposit agreement contained a provision limiting the duties of the committee to account. However, the practical advantage of the solution just suggested would be that the bondholder could wait and seek an accounting after the reorganized company is formed, and thus enforce his rights at a time when such a suit would be more fruitful. There seems to be but one case in which a bondholder attempted to enforce his rights in this manner, *Appeal of the Fidelity Insurance Trust and Safe Deposit Co.*\(^28\) This case involved a bill for accounting by certain bondholders against a bond-

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\(^{26}\)See 15 Fletcher, Cyclopedia Private Corporations, rev. ed., 351.


\(^{28}\)(1884) 106 Pa. St. 144.
holders' committee. From a decree ordering an accounting, the defendant bondholders appealed. Although the appeal was sustained, the peculiar set-up of this case involved a lower court holding which is favorable to the view herein contended for, and which was not weakened by the reversal on appeal. The decree in the lower court was based on a master's report which it confirmed without opinion. The master found in favor of the plaintiff under the following set-up: The deposit agreement under which the plaintiff had deposited provided for the plaintiff sharing in a reorganized company to be formed by the committee. A foreclosure sale took place, and the property was bought by an outsider, who later sold it to the persons who had agreed to act as a bondholders' committee. The master found that this purchase was in substance a purchase under the deposit agreement. He next considered the objection urged by the committee that the present plaintiff could not maintain his action because he had not borne his proportionate share of the expenses. The master decided that the action was not barred by the plaintiff's refusal to share in the expenses, as certain expenses were excessive. On this point the report of the case in the supreme court of Pennsylvania contained in its statement of facts the following quotation from the master's report:

"If the case turned upon this simple question [i.e., failure of the plaintiff to share in the expenses], it would doubtless be necessary to dismiss the bill. There were, however, other circumstances to complicate the matter. After the purchase by the defendants, they dealt with the property as their own, without the leave, assistance, or advice of the plaintiffs, or any of them. They did more. They gave away, as a gratuity to Ogden, an integral part of the property purchased for the joint benefit of the plaintiffs and defendants, to wit: that part of the value of the road represented by the shares of stock issued by the reorganized railroad company, being all over $65,000, the amount of the mortgage bonds issued by the company. If, for the sake of the argument, we assume that this conduct was a fair compliance with the terms of the agreement, it is still difficult to see how the defendants could be entitled arbitrarily, and against the wishes of the plaintiffs, to spend $10,000 for improvements, and then to demand a contribution including such expenditure on pain of a forfeiture of the plaintiffs' rights under the agreement. The very foundation of the plaintiffs' duty to contribute was the fact of their being jointly interested with the defendant, and the least right

29(1884) 106 Pa. St. 144.
conferred by such joint interest was to be consulted as to the propriety of spending money in improvements."

As before noted, the master's report was affirmed by the lower court without opinion. Assuming that the reasoning of the master's report was likewise adopted by this affirmance, the case below stands for the proposition that excessive and unauthorized expenses by a bondholders' committee will render the committee liable to account to each bondholder for his pro rata share in the reorganized company, although the bondholder has not yet paid his share of the expenses of the committee. This probably does not mean that the committee is thereby prevented from setting off in such an action proper expenses; but it does mean that where expenses are excessive, a depositing bondholder loses no rights in the property or its proceeds by not paying the excessive assessment, and this although a lesser amount was justly due. The reversal in the upper court was on the ground that the purchase of the property by the bondholders' committee from the intermediate purchaser was not a purchase pursuant to the deposit agreement, which limited the authorized bid to a lesser amount than that paid to the intermediate purchaser. The upper court thus held that the only duty the defendant owed to the plaintiff was that which it owed to non-depositing bondholders, namely, to offer him fair terms on which he could come in, and that having refused such terms, he had no rights to participate in the reorganization other than those of a non-assenting bondholder. It was thus unnecessary for the upper court to consider the propriety of the expenses incurred by the committee.

Although this early holding of the master and the lower Pennsylvania court may be called weak authority, it suggests a simple and practical means by which a bondholder can enforce his rights in the case of excessive expenditures by a protective committee. Yet to the reorganization lawyer it may suggest the necessity of specifying in detail what expenditures may properly be incurred by the committee which he represents. Like exculpatory clauses such specifications are not binding in every case, but like such clauses these stipulations would probably govern in the ordinary borderline case; that is, they would apply in the case in which the principles suggested by the procedure in the lower Pennsylvania Court would open the way for the greatest opportunity for

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30 See Posner, Liability of the Trustee under the Corporate Indenture, (1928) 42 Harv. L. Rev. 198.
holdups. When the cases are viewed in this light, one is less willing to concede the desirability of attack by a single bondholder. Theoretical jurisprudence does not always function so well in these days of obstreperous minorities.\footnote{The very theory underlying modern statutory schemes of reorganization is that of taking away too much power from the dissenter in cases where a substantial majority favor a given plan.}