TRUSTEES FOR DEBENTURE HOLDERS[1]

THE COMPANIES AMENDMENT ACT 1966 SECTIONS 5 TO 8.

The recent failures of a number of Australian companies, notably Reid Murray Acceptance Limited but also Rockmans Limited and Latec Investments Limited, have highlighted the weakness of the position of members of the investing public who become debenture and note holders. This weakness stems from the very nature of the loan.

The borrowing company is usually large; the lenders members of the general public, often lacking in knowledge and ability to determine the true merits of the investment but they are attracted by high or higher than normal interest rates.[2] The terms of the loan are prescribed by the borrowing company which naturally tries to avoid provisions that will unnecessarily restrict its operations. It is frequently good business to give the minimum security for the maximum loan. Most lenders are concerned with the interest rate and whether the loan is secured or not. Few bother to examine the full conditions of the loan or understand them if they do.

With a mortgage the mortgagee can within reason dictate the terms of the loan. With a debenture issue to the public the lender has only the choice to invest or not to invest. With a mortgage the lender is more concerned with the security of his loan than the success or failure of the borrower's business. If he is prudent he will have sufficient security even if the borrower fails. With a debenture the lender's own funds provide, in many cases, the major part of the assets backing the loan. The security for the loan is the assets of the company and the value of these assets is dependent on the success of the company. This makes the debenture holder dependent on the profitability of the borrowing company. If the company fails, heavy losses are likely to result on the forced sales of assets. An example of this is Enzlon Chemical Fibres Ltd where, according to the Statement of Affairs as at 28 April 1966, the date of the appointment of the receiver, the book value of production inventories was $205,694 but their estimated realisable value only $130,000. Freehold properties had a book value of $728,314 but estimated realisable value of $20,000, plant and machinery $2,071,738 against $150,000.

One example of the dependency of the lender on the success of the borrowing company is Finance Corporation of New Zealand Ltd

1. In this article the meaning of the term "debenture" is any loan to a company whether constituting a charge on the assets of the company or not. It is not used in its technical sense of a secured loan as compared with an unsecured loan in the form of a note issue, unless the context requires this. The term "debenture holder" is used to mean a person who holds debenture stock pursuant to a debenture trust deed executed by the borrowing company.
2. This comment does not apply to the financial institutions which are large subscribers to many debenture issues. It has been the practice for the financial institutions to peruse debenture trust deeds before execution by the borrowing company.

where, according to the published balance sheet as at 30 June 1966, over 85% of the tangible assets are financed by an unsecured note issue. Here there was no trustee and no trust deed.

Mainly as a result of the Reid Murray failure, the Victorian Legislature passed the Companies (Public Borrowing) Act 1963 which imposed stringent conditions on companies borrowing money from the public. Similar legislation has been adopted by the other Australian States and following the advice of the Company Law Advisory Committee, a similar though considerably milder Act was passed in New Zealand in 1966.

This Act, the Companies Amendment Act 1966, deals mainly with prospectuses and debenture trust deeds, the former of which is outside the scope of this article. By section 95A of the Act no company[3] shall accept a deposit or loan of money from any person in response to an invitation to the public unless an eligible trustee for the debenture holders has been appointed and this trustee has executed a deed and is satisfied with the prospectus. The trust deed must be filed with the Registrar of Companies so that it is available for public inspection[4].

To decide what is meant by an invitation to the public requires an examination of the circumstances of each case. Such facts as the number of copies of the circular or of the persons who receive it and the character of the document itself have all been considered relevant but the question is not one capable of rigid or exact definition as appears from *Nash* v. *Lynde* [1929] A.C. 158, 170 per Lord Buckmaster. This is recognised by the legislature which has, in section 63 of the Companies Act 1955, prescribed guide lines only for the construction of references in the Act to offers of shares or debentures to the public and invitations to the public.[5]

The test accepted by Wynn-Parry J. in *Governments Stock and Other Securities Investment Co. Ltd* v. *Christopher* [1956] 1 W.L.R. 237, 242 was not who received the offer or invitation but who could accept it. In that case, which concerned a take-over bid, only existing shareholders of given companies could accept the offer and then non-renounceable letters of allotment would issue so it was held that the offer was not made to the public. Professor Gower goes further than Wynn–Parry J. and says that the equivalent English provision to section 63 (s.55) covers an offer of rights which cannot be renounced, if the offer is accompanied by a Stock Exchange advertisement. *The Principles of Modern Company Law (Second Ed. 1957)* 278.

3. This includes overseas companies. S.410A.
4. The right to a copy of the trust deed given by s.95(3) extends only to debenture holders and apparently not to prospective investors.
5. This problem was considered in *Burrows* v. *Matabele Gold Reefs and Estates Co. Ltd* [1901] 2 Ch. 23, 27 per Farwell J. where an offer to debenture and shareholders was not considered an offer to the public. It was also considered in *Booth* v. *New Afrikander Gold Mining Co. Ltd* [1903] 1 Ch. 295, *Sherwell* v. *Combined Incandescent Mantles Syndicate Ltd* (1907) 23 T.L.R. 482 and *re South of England Natural Gas and Petroleum Co. Ltd* [1911] 1 Ch. 573 but all these cases must be considered in the light of s.63 which was enacted in New Zealand for the first time in 1955 and in England in 1948.

Section 95A expressly includes within its scope an invitation to existing debenture holders to renew or vary the terms of any deposit or loan to the borrowing company. It does not appear that an approved trustee need be appointed if the invitation is made by way of non-renounceable rights to subscribe, given to the existing shareholders unaccompanied by advertising. Also it would appear that an offer to existing debenture holders to lend more money rather than to renew or vary the terms of their loan would not require the appointment of a trustee if the offer is not renounceable. It is suggested that the scope of the section should be widened to include offers to shareholders and to debenture holders, provided it is not solely the domestic concern of the persons making and receiving the invitation. (For example see *Lee* v. *Evans* (1964) 112 C.L.R. 276.) Investors of this type need protection as well as persons investing in the company for the first time.

Another type of investor who needs protection is one who lends money to an individual in response to an invitation to the public. The Companies Act as amended applies only to companies[6] so that individuals can raise large sums of money from the public without being required to enter into a trust deed or appoint a trustee unless the individual borrower issues the invitation "on behalf of a company". In addition an individual need not issue a formal prospectus nor is his advertisement required to conform to the provisions of section 48B of the Companies Act.

An illustration of this is an advertisement which appeared in a Wellington newspaper on 3 October 1967. This invited deposits from the public under the "Cornish Lamphouse Investment Plan". It contained application forms for the subscription of money and so would have been a prospectus under section 48B if issued "by or on behalf of a company". However the advertisement states that the investors are creditors of Mr A. S. Cornish although the loans are guaranteed by all the companies in the Lamphouse group except Lamphouse Properties Ltd and the depositors will have first option on any shares offered to the public by the group. In the past loans have been made by Mr A. S. Cornish to the group. It is suggested that where an individual raises large sums of money from the public he should also be required to appoint a trustee and publish a full prospectus. Although there would be the personal liability of such an individual, co-ordinated action by the many creditors would be difficult without a trustee and it is therefore desirable that the legislature should investigate this type of situation.

It is interesting to note that the position of the individual borrower was discussed in the debate on the Companies Amendment Bill but Parliament failed to include any provision in the Bill to cover this type of situation. Dr. Finlay, M.P., in the debate referred to an Auckland accountant who raised $22,000 on unsecured loans from the public

6. It should also be noted that, since the Act applies only to companies, other corporate bodies (e.g. Producer Boards and Local Bodies) are not affected by the provisions of the Act.

within two months. He then went bankrupt with debts of approximately $300,000 and assets of about $40,000.[7]

The mere requirement that a trustee be appointed would not be sufficient to protect lenders. Before a trustee has executed the trust deed he owes no duty to prospective debenture holders and after he has executed it he owes only those duties which he has agreed to accept and a general duty of care and skill. Before the enactment of section 96 of the Companies Act 1955, even the latter duty was commonly excluded by provision in the trust deed.

As acceptance of the position of trustee is a commercial transaction, a trustee who tries to insist on adequate powers may fail to obtain appointment and an unscrupulous company may seek another individual who could be open to influence by the board of the borrowing company. However by section 95A(2) the trustee is required to be a trustee corporation or bank, or insurance company or other body corporate approved by the Minister of Justice, or a subsidiary of any of the foregoing kinds of corporate bodies. A subsidiary can only be appointed if the holding company is liable for all liabilities incurred by the subsidiary as trustee for the debenture holders, or if the holding company beneficially holds shares in the subsidiary company with a liability not less than $400,000 that can only be called up on the winding up of the subsidiary. This last provision was added after representations by the National Mutual Life Nominees Ltd, a subsidiary of an Australian insurance company, to the Statutes Revision Committee as Australian insurance companies are forbidden by legislation from directly guaranteeing liabilities of their subsidiaries.

By section 96A(6) the trustee is prohibited from retiring from office without the consent of the court until another eligible trustee has taken office and no trustee can contract out of this requirement.

Subsection (5) forbids a body corporate from being appointed as trustee if it and the borrowing company are, under section 3 of the Land and Income Tax Act 1954, deemed to be under the control of substantially the same persons or to consist of substantially the same shareholders.

These provisions mean that the trustee to be appointed shall be one with a commercial reputation to maintain. The hope that a reputable trustee will not accept appointment unless adequate safeguards are provided appears to be the reason why the New Zealand Parliament has failed to follow the stringent provisions of the Australian legislation. In view of the memorandum issued in 1965 by the Life Assurance Companies in New Zealand setting out the basic requirements they would expect to find in any trust deed this hope appears to have some justification.

As eligible trustees are restricted to bodies corporate of the kind set out above there will be continuity in the administration of the trust deed. Trustees will have experience in dealing with such trusts and will have experience in evaluating the worth of companies intending to issue

7. N.Z.P.D. 1966 3316.

debentures. As professionals the trustees will be in a better position than most individuals to watch the activities of borrowing companies and to detect breaches of the trust deeds. They should be able quickly and effectively to enforce the trust deeds.

While the requirement of the appointment of a body corporate may be more expensive for the borrowing company than the appointment of an individual, the added protection for the investing public makes this provision a welcome safeguard. However, the provision in the New Zealand Act to prevent conflict of interest does not go as far as the Victorian legislation. Section 74(3) of the Victorian Act forbids a trustee from being a director of, or a beneficial holder of shares with more than one-tenth of the voting power in the borrowing company, or a guarantor, or creditor of the borrowing company for more than one-tenth of moneys secured by the debentures, unless the money advanced is on first mortgage or is held under the trust deed. This section possibly goes too far particularly where it bars trustees from being directors, as a trustee may be appointed to the board under the trust deed to protect the interests of the debenture holders. If, however, a trustee were appointed a director of the company other than solely on behalf of the debenture holders, his duty to the company may be to dissuade debenture holders, as far as possible, from exercising any rights in a manner inconvenient to the company.

Again, if a trustee were a creditor of the company, as a bank could well be, or a shareholder of the borrowing company, a conflict of its interests with its duties may arise as was pointed out by Maugham J. in *Dorman, Long & Co. Ltd* [1934] Ch. 635, 670, 671. A similar conflict of interests could arise if the borrowing company issues a second lower ranking series of debentures or a note issue and the same trustee acts for both issues. A local example is Group Rentals New Zealand Ltd which has issued both debenture stock and convertible notes and the Trustees Executors and Agency Company of New Zealand Ltd is the trustee for both issues. While it is not suggested that trustees knowingly abuse their position in situations outlined above, the timing and use of their powers requires expert judgment which may tend to be clouded by their interest.

It is submitted that provision should be made along the lines of the Victorian legislation but permitting trustees to be appointed as directors on behalf of the debenture holders and banning the appointment of the same trustee for separate issues of debentures and/or notes under different trust deeds. The Victorian legislation avoids difficulties seen by the Cohen Committee (1943; Cmd. 6659) para. 63.[8] The Securities and Exchange Commission in the United States also has an

8. The Committee refrained from recommending legislation on the subject because they thought an absolute ban might interfere unduly with arrangements which though in practice unobjectionable, involve in theory a conflict of interests. They gave the example of a bank being prevented from acting as trustee for the debenture holders of a company in which the bank, as executor of a will, had a small shareholding and they thought it would not be possible to set forth in legislation all the exceptions which would be desirable.

elaborate series of provisions to ensure that trustees are completely independent and even extend these to the officers of trustee corporations.[9] It is to be hoped, in the meantime, that trustees jealously guard their commercial reputation (important in New Zealand's small financial community) and avoid entangling themselves in a situation where a conflict of interest could arise.

Trustees, whoever they are, must be informed about the affairs of the borrowing company if they are to carry out their duties efficiently. Sections 95B and 95C of the Amendment Act are designed to provide this information. Copies of reports required to be furnished by auditors to the borrowing company and its members under the Companies Act must be sent to the trustees. If the auditors as such become aware of any matters which in their opinion are relevant to the exercise or performance of the powers or duties of the trustee, they are required to report the matter to the borrowing company and the trustee. Also trustees have the power to request similar information from the auditors who are then obliged to supply it.

These provisions involve a material departure from the duties auditors were considered to have before the Act. These were expressed to be:—

> An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of the company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that.

per Lindley L. J. *In re London and General Bank (No. 2)* [1895] 2 Ch. 673, 682 cited with approval in *re City and Equitable Fire Insurance Co. Ltd* [1925] Ch. 407, 480 per Romer J. and 519 per Warrington L. J.

These matters which previously the courts considered were of no concern to the auditor are now of vital importance to the trustee in exercising his duties. The inadequacy of the previous situation was disclosed at page 55 of the Interim Report of the Investigators into the affairs of the Reid Murray Group, dated 2 December 1966 and published by the Victorian Government Printer. The auditors of Reid Murray Acceptance Ltd, the borrowing company, in the course of their audit became aware of a number of transactions which were considerably weakening the position of the debenture holders. They took legal advice on whether they should disclose the information to the trustee for the debenture holders and were informed that they were under no duty to do so and were further advised that if they did in fact do so, and the company suffered loss in consequence of this, the auditors might be liable in damages for this loss.

9. For the details of the provisions in U.S.A. see *Loss Securities Regulation* (Second Ed. 1961) 730.

The Investigators also pointed out at page 25 of their Report that the auditors, if they had been responsible to the trustee, should have pointed out to the trustee at an early stage the eventual causes of the heavy losses of Reid Murray Acceptance Ltd—the unsecured loans to other members in the group, and the large investments in land development.

Under section 95C, as enacted by the 1966 Amendment, trustees are entitled to receive all communications that are sent to members regarding general meetings and are entitled to send a representative who may speak at the general meeting. There are also some procedural provisions for the summoning of a meeting of debenture holders. The trustee has the right to inspect all the records of the borrowing company and to be given such information as it requires regarding these records. While these provisions are valuable if the trustee is alert and suspicious, they lay no duty on the borrowing company to publish any extra reports.[10] If the trustee is only a passive recipient of its remuneration rather than an efficient watch dog these provisions are of little use. In contrast, the Victorian legislation requires quarterly reports by directors setting forth in detail matters which adversely affect the security or interests of the debenture holders with particular reference to the limitation on liabilities, the observance of the terms of the deed, any event that may make the debenture enforceable, any substantial change in the nature of the business of the borrowing company and details are required of lending to related companies who are not guarantors. Half-yearly audited accounts are also required although a trustee may now wholly or partially waive the audit requirement—Companies Amendment Act 1965.

In New Zealand it is common to provide in trust deeds for limited reports by the directors. The Cable Price Downer Ltd debenture trust deed for instance, in Clause 21 (d) provides for two directors to report whether or not the register of debenture holders has been maintained, the charged properties insured and the premiums paid, the necessary interest payments made and whether or not any event has occurred which would cause the debenture stock to become immediately repayable.

These reports are only half yearly ones and are of limited value other than for the administrative convenience of the trustee. The Victorian provisions for the directors' report are admittedly little better except for the last two requirements which were enacted to warn trustees of events such as those which were likely to cause losses to the debenture holders in the Reid Murray Group. The necessity for half yearly audited accounts is, however, a big improvement on the present situation. Much can happen in a year to change the financial position of the borrowing company and there is frequently a long delay after the close of the financial year before the annual report is published.

10. Private Companies borrowing from the public are required, since 1960 to appoint auditors and they cannot dispense with this requirement as in the case of other private companies.

In the United States the Securities and Exchange Commission requires considerably more detailed information in the annual reports of companies listed on the Stock Exchange than is required by the eighth schedule of the Companies Act 1955 and, further, requires semi-annual income statements showing sales, operating revenues, profit before and after tax and special and extraordinary items. The New York Stock Exchange goes further and requires quarterly income statements with similar information from all listed companies. It is submitted that there is a very strong case for requiring semi-annual income statements in New Zealand from companies borrowing from the public if not from all companies listed on the Stock Exchange. As long as there is provision for sufficient penalties for negligent or deliberate presentation of misleading information or withholding of material information, audited accounts may not at present be required. Also, provision would probably have to be made to avoid the necessity of a complete stock-taking every six months. The value to investors generally should out-weigh the extra effort required by management. Such a requirement should have the support of the trustees, since in the Life Offices memorandum referred to above it was stated at page 5 that "although most desirable, any attempt to insist on the furnishing of half-yearly accounts would probably fail, unless supported by a statutory requirement."

Section 95D(1) of the Companies Act 1955 lays upon the trustee a general duty to exercise reasonable diligence. This is probably only a restatement of the existing law but it at least sets out clearly the required standard (see also s.95D(6)). Section 95D(2) however, goes further and requires the trustee to use reasonable diligence to ascertain if the assets of the borrowing company are, or are likely to be, sufficient to discharge the amounts of the debentures as they become due. This duty should probably be exercised in conjunction with a trustee's rights under sections 95B(3) and 95C(3) to request information from the auditors and from the company itself.

By section 95D(3) if a trustee is of the opinion that the assets of the borrowing company are insufficient or likely to be insufficient to discharge the debentures as they become due, the trustee, having regard to all relevant circumstances, may apply to the court for an order under subsection (4) which gives the court wide powers including the appointment of a receiver. This provision will enable a trustee to act before a breach of the trust deed occurs if, for instance, interest was being paid out of capital, as was the case with Rockmans Ltd. Again with Reid Murray Acceptance Ltd the trustee had been told some time before the event that the company would default on the next interest payment. Now the trustee could make an application under section 95D and save valuable time. Such an application should not however be made without due regard to all the relevant circumstances as set out in section 95D(3) because an ill-considered and premature application could have disastrous consequences for the borrowing company. However the eligible trustees as set out in the Act should be sufficiently reputable for this danger not to arise.

The provisions of the Act apply to all companies except authorised short-term money market dealers, banks and savings banks and an exception set out in section 8 of the 1966 Amendment Act. This special exemption was inserted after representations by the Equitable Building and Investment Company of Wellington Ltd and is restricted to companies approved by the Minister whose liabilities do not exceed twice the shareholders' funds and in which 75% of the liabilities are represented by liquid funds or are advanced on the security of mortgages over houses. The invitation to deposit money can only be made in publications circulated mainly to members of the accountancy and legal professions. The purpose of the exemption is to make the appointment of a trustee unnecessary if the liabilities of the borrowing company have sufficient backing and where the investment should be made only on professional advice. This exemption is likely to assist only investment and flat owning companies and building societies.

The Amendment Act took effect in New Zealand from 1 January 1967 and is retrospective to the extent that the invitation could be made before the date of commencement of the Act yet it applies to deposits accepted after the commencement. Also sections 95B to 95D apply to all trustees regardless of when they were appointed. However, if the trustee was appointed before 8 July 1966 deposits could be accepted up to the 1 April 1967 before an eligible trustee was required.

The Amendment Act does not go as far as the Victorian Act in that it does not require the deed of trust to state a limit to the amount borrowed nor does it imply a condition that the borrowing company will use its best endeavours to carry on and conduct its business in a proper and efficient manner. It was suggested by the Investigator into the Affairs of Factors Ltd at page 89 of an Interim Report dated 6 May 1966 that the legislature should require a limitation clause that is to be maintained throughout the currency of the note or debenture issue. The Investigator states in his Report that the trustee for the debenture holders of Rockmans Ltd, a subsidiary of Factors Ltd, discovered in February 1961, that the required minimum ratio of assets to liabilities had not been maintained but because the trust deed did not require the ratio to be maintained the trustee was powerless to do anything about it and the company did not go into receivership until nearly two years later after an amendment to the trust deed had been made.

The Life Offices at page 4 of their Memorandum state that acceptable ratios are for secured liabilities not at any time to exceed 40% of total tangible assets and 60% of total liabilities. It may be unwise however for the legislature to specify a set ratio because of widely differing circumstances but it is submitted that there should be a statutory provision for requiring that trust deeds specify a minimum ratio of liabilities to tangible assets which must be maintained. This may be partially covered by section 95D(3) if it could be proved that, as assets had fallen below a certain ratio, the debenture was unlikely to be repaid, but there would be difficulties of proof.

The New Zealand Act is devoid of any provision designed to curb

the lending of money by the borrowing company to associate companies on terms that may be to the detriment of the debenture holders. Such a practice, termed "on-lending" was one of the principal causes of the large losses of Reid Murray Acceptance Ltd. Section 95D(3) may be of some avail to the trustee when on-lending becomes excessive but an application in this respect would involve proving that the loans to the associate companies are not likely to be repaid and this could be a complicated process.

An effective provision specifically designed to curb on-lending which was applicable in all instances would be difficult to frame as it may involve the trustees in becoming too entangled in the day to day operations of the borrowing company. Such a provision is best left to individual negotiation. However a provision that the borrowing company will carry on its business efficiently would apply to the borrowing company as an independent unit and not just as a member of a group of companies, as a company is often regarded to be by its management. Activities like on-lending may be for the advantage of the group but not for the advantage of the lending unit and so the trustee could seek to stop such actions under such a provision.

An avenue not explored by the New Zealand legislature is the possibility of establishing a model trust deed in a manner similar to the Articles of Association contained in Table A of the Third Schedule to the Companies Act 1955. Such a suggestion has been adopted by the Securities and Exchange Commission in the United States with considerable success. It is true that this idea was not approved by the Jenkins Committee (1962; Cmnd. 1749) para. 297 because of the diversity of conditions but it would permit the legislature to express ideas that the legislature may not want to actually enact through a desire not to cause undue interference with commercial practice. It would be an opportunity for the legislature to introduce a clause designed to prevent on-lending, to give the trustees wide powers, to set out a limitation clause, to make provision for detailed three monthly directors' reports and half yearly audited accounts. This model deed should be drawn up in consultation with the Life Offices, trustee corporations and banks and should apply in the absence of provisions to the contrary. The Act could also require the prospectus to state the material deviations in the actual trust deed as compared with the model trust deed. This would be legislation by persuasion rather than coercion. While it may lead to drafting by reference this could be of considerable assistance to draftsmen, who probably use precedents of varying merit and, in the important matter of public borrowing, involving at least two parties with their solicitors, material errors are unlikely to occur.

While the need for stringent regulation may not have been felt in New Zealand to the same degree as it has in Australia it is suggested that, when the Companies Act is eventually revised, further protection to investors should be provided, especially in the form of more frequent accounts, more stringent provisions to prevent conflict of interest and some provision to curb on-lending, if only in the form of a model trust deed.

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