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CORPORATIONS-RIGHT OF DIRECTORS TO ENFORCE AT FACE VALUE CLAIMS AGAINST THE CORPORATION PURCHASED AT A DISCOUNT DURING INSOLVENCY

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CORPORATIONS—RIGHT OF DIRECTORS TO ENFORCE AT FACE VALUE CLAIMS AGAINST THE CORPORATION PURCHASED AT A DISCOUNT DURING INSOLVENCY—From 1942 to the initiation of bankruptcy proceedings the assets of the debtor corporation were insufficient to pay its liabilities, and, with the exception of 1945, it operated at a deficit. In 1946 the assets of the corporation were sold, and the debtor filed a petition under Chapter XI of the Bankruptcy Act.[1] Prior to the filing of the petition, but during the period of insolvency, the respondents, the sister, mother, and a personal friend of a director, acquired debenture bonds of the corporation, primarily from over-the-counter dealers, at 3% to 14% of face value, the aggregate cost being $10,000. The plan of arrangement under Chapter XI provided for a dividend to debenture holders of 43.6% of the face amount, which would return to the respondents a dividend of $64,000. A creditor, and trustee under the bond indenture objected to the respondents' claim on the grounds that the circumstances demanded limiting their claim to the amount paid for the bonds plus interest. The district court approved the arrangement and the circuit court of appeals affirmed, Judge Learned Hand dissenting.[2] On certiorari from the court of appeals, *held,* affirmed. In the absence of overreaching or bad faith, directors

[1] 52 Stat. L. 883 (1938), 11 U.S.C. (1946) §701 et seq.

[2] In re Calton Crescent, Inc., (2d Cir. 1949) 173 F. (2d) 944. Noted 62 HARV. L. REV. 1391 (1949); 59 YALE L. J. 151 (1949); 18 UNIV. CIN. L. REV. 542 (1949).

may profit from the purchase of claims against an insolvent corporation where such purchases are made before proceedings for judicial relief of the debtor are expected or begun. Thus, there can be no objection to purchases by friends and relatives of a director. *Manufacturers Trust Co. v. Becker,* 338 U.S. 304, 70 S.Ct. 127 (1949).

While there is little doubt that a corporate official may purchase claims against the corporation and enforce them at cost plus interest,[3] his right to enforce at face value claims which he has purchased at a discount has been less certain. Although a few courts have denied insiders any right to profit by such purchasers,[4] the modern view has been that in the absence of bad faith or a duty to purchase for the corporation, such claims may be fully enforced.[5] Prior to the principal case, several courts had taken the broad position that purchases made at a discount while the corporation was "insolvent" could not be enforced at face value.[6] The objections to such profits have not been clearly set out in these decisions, the courts contenting themselves with generalized statements of fiduciary duties applicable to express trustees.[7] The Supreme Court in the principal case rejects the theory that an insolvent corporation holds its assets in trust for creditors, and rejects, at least in part, the insolvency restriction. The majority opinion, written by Justice Clark, recognizes three stages on the road to liquidation or reorganization and indicates the director's right to profit may depend largely on which stage the corporation has reached at the time of purchase. Where the corporation is insolvent, but remains a going concern with no expectation of initiating judicial proceedings for relief, the majority is unable to find a probability of conflict between fiduciary duty and personal interest resulting from the purchase. In fact, it is suggested, such purchases may have the effect of bolstering the corporation's failing credit and staving off proceedings for relief. The majority admits that the possibility of conflicting interests increases as it becomes apparent to insiders that the corporation

[3] 3 FLETCHER, CYC. CORP., perm. ed., §868 (1947).

[4] Martin v. Chambers, (C.C.A. 5th, 1914) 214 F. 769; Davis v. Rock Creek Lumber Flume & Mining Co., 55 Cal. 359, 36 Am. Rep. 40 (1880); 3 FLETCHER, CYC. CORP., perm. ed., §869 (1947).

[5] Seymour v. Spring Forest Cemetery Assn., 144 N.Y. 333, 39 N.E. 365 (1895); Fuller, "Restrictions Imposed by the Directorship Status on Personal Business Activities of Directors," 26 WASH. UNIV. L. Q. 189 (1941); BALLANTINE, CORPORATIONS 209 (1946); 3 FLETCHER, CYC. CORP., perm. ed., §869 (1947).

[6] Bonney v. Tilley, 109 Cal. 346, 42 P. 439 (1895); Bramblet v. Commonwealth Land & Lumber Co., 26 Ky. L. Rep. 1176, 83 S.W. 599 (1904); Horner v. New South Oil Mill, 130 Ark. 551, 197 S.W. 1163 (1917). However, where the interests of creditors were not involved, such claims have been permitted. Punch v. Hipolite Co., 340 Mo. 53, 100 S.W. (2d) 878 (1936); Glenwood Manufacturing Co. v. Syme, 109 Wis. 355 (1901). The majority opinion distinguished a line of lower federal court cases in terms laying down a general insolvency restriction, since they dealt in fact only with purchases made after bankruptcy proceedings had begun. Monroe v. Scofield, (C.C.A. 10th, 1943) 135 F. (2d) 725; In re Norcor Mfg. Co., (C.C.A. 7th, 1940) 109 F. (2d) 407; In re Jersey Materials Co., (D.C. N.J. 1943) 50 F. Supp. 428; In re Los Angeles Lumber Products Co., (D.C. Cal. 1941) 46 F. Supp. 77; In re McCrory Stores Corp., (D.C. N.Y. 1935) 12 F. Supp. 267; In re Philadelphia & Western Ry. Co., (D.C. Pa. 1946) 64 F. Supp. 738.

[7] It is well established that an express trustee may not profit by the purchase of claims against the trust estate at a discount. Scott, "The Trustee's Duty of Loyalty," 49 HARV. L. REV. 521 at 557 (1936).

must resort to reorganization or liquidations, but finds that the purchases in the principal case were made prior to that time. As restricted by the majority to the stage of "going concern" insolvency, the decision would appear correct. The rejection of an express trust is consistent with previous Supreme Court decisions[8] and there seems little reason to fear a conflict of interest and duty. Where, however, it becomes apparent that the corporation is not going to be able to continue as a going concern, severe temptations are likely to confront the director who purchases devalued claims. He may wish to postpone proceedings for relief to allow him to continue to purchase the claims at a price lower than the intrinsic value he believes them to have.[9] He may choose liquidation rather than reorganization because of the more certain profits which that course might insure.[10] He might take advantage of the sellers of claims who lack inside information as to possible dividends forthcoming from the adjustment of debts.[11] The objections to the majority opinion raised by Justices Burton and Black, and by Judge Learned Hand in the circuit court, rest not so much on the facts of the principal case as on the extreme difficulty of determining where "going concern" insolvency merges into this second stage. Because of this difficulty, Justices Burton and Black advocate the strict denial of all profits from the purchase of devalued claims by directors without regard to the likelihood of bankruptcy at the time of purchase.[12] Judge Hand's solution is to demand from the purchasing director an affirmative showing that there were well-founded expectations of continuing the business without reorganization and to accept no other excuse.[13] The implication of the majority opinion, coupled with the dissent, is that a strict limitation on insider's profits may at least be imposed where purchases are made at a time when bankruptcy can be shown to be imminent, but the point is left unsettled.[14] The decision also leaves unsettled the effect of purchases after bankruptcy proceedings have begun, although the decision recognizes that the lower federal courts have refused to allow profits from purchases made during this third stage of insolvency.[15] The federal decisions, however, have for the most part involved acts of overreaching or bad faith,[16] and it may well be argued that there is less reason for imposing a strict trust

[8] Hollins v. Brierfield Coal and Iron Co., 150 U.S. 371, 14 S.Ct. 127 (1893); S.E.C. v. Chenery Corp., 318 U.S. 80, 63 S.Ct. 454 (1943).

[9] Suggested by the Securities and Exchange Commission, as *amicus curiae* in the principal case.

[10] Suggested by the dissenting opinion in the principal case at 316.

[11] 62 HARV. L. REV. 1391 (1949). For a more detailed discussion of the possible abuses of the fiduciary duty in this situation see 59 YALE L. J. 151 (1949).

[12] Principal case at 316.

[13] In re Calton Crescent, supra, note 2, at 952.

[14] The majority expressly left the way open for the S.E.C. to raise the problem under Chapter X of the Bankruptcy Act. See the principal case at 313.

[15] Note 6, supra.

[16] In re McCrory Stores, Inc., note 6, supra (corporation was also seeking to purchase claims); In re Jersey Materials Co., note 6, supra (director failed to reveal opportunity for profitable purchase to the corporation); In re Norcor Mfg. Co., note 6, supra (misrepresentation made to sellers of claims). However, Monroe v. Scofield, note 6, supra, appears to rest purely on fiduciary obligation.

duty upon officials who have purchased while corporate affairs are under the control of a trustee in bankruptcy and creditors fully informed of forthcoming arrangements, than where the purchases are made prior to that time.[17]

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[17] Where the debtor is left in possession, however, without the appointment of an independent trustee, there is strong reason for imposing a strict trust duty. Two of the federal "insolvency" cases were concerned with that situation. In re Los Angeles Lumber Products Co., Ltd., note 6, supra; In re Philadelphia and Western R. Co., note 6, supra.