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NOTES AND RECENT CASES

STOCK PURCHASES BY DIRECTORS DURING VOLUNTARY REORGANIZATION*

Courts, legislative bodies, and commissions have all contributed in recent years to the clarification and expansion of the fiduciary duties of corporate officers and directors. Nowhere in this field has controversy been hotter and changes more striking than in connection with restrictions on the power of these fiduciaries to deal in securities of their own corporations. The latest effort of the Securities and Exchange Commission to check abuses in this field has been directed to purchases of securities of utility corporations registered under the Public Utility Holding Company Act of 1935[1] made by "insiders" while plans for readjustment of the securities are pending before the commission.[2] In a test case involving Federal Water Service Corporation, the commission's action has been set aside by the Court of Appeals of the District of Columbia.[3]

* Chenery Corp. v. Securities and Exchange Com'n, 128 F. (2d) 303 (App. D.C. 1942).

[1] 49 Stat. 803 (1935), 15 U.S.C.A. § 79 (1941).

[2] Conflicts of interest which may arise in reorganization committees as the result of trading in the securities or certificates of deposit have been discussed in S.E.C., Report on the Study and Investigation of the Work, Activities, Personnel and Function of Protective and Reorganization Committees, pt. 2, at 315–51 (1937). A general discussion of the problems is also found in ibid., pt. 8, at 196–204, 221–31 (1940).

[3] Chenery Corp. v. Securities and Exchange Com'n, 128 F. (2d) 303 (App. D.C. 1942). Miller, J., dissented.

The corporation had outstanding several series of preferred stocks with heavy arrearages of dividends. There were also outstanding Class A common shares, subordinate to the preferred stock, but preferred over the Class B common shares. The Class B shares were all owned by Utility Operators Company in which the controlling interests were held by officers and directors of Federal. The entire voting power had been vested in the Class B shares, but defaults on the preferred and Class A dividends had reduced the voting strength of the Class B to about 43 per cent of the total. A large deficit prevented the declaration of dividends.[4]

In this situation, especially in view of the preferred dividend arrearages, and the necessity of conforming to the standards for capital structures prescribed by the Holding Company Act,[5] reorganization of some sort was imperative.

The corporation registered under the Holding Company Act in November, 1937, and immediately filed a plan of reorganization. In this plan, despite the admitted deficit, the Class B stockholder was given a participation in the reorganized company. On this ground members of the commission's staff expressed opposition to the plan and to several amended plans which had a similar feature.[6] In this situation, Mr. C. T. Chenery, the president, realized that if the commission persisted in this stand, "The officers and employees of Federal . . . . would find themselves without either a stake or influence in the company they had helped create and by which they were employed."[7] Mr. Chenery therefore suggested that they buy preferred shares. Some of them followed this suggestion and Mr. Chenery himself made purchases through a "family corporation" controlled by him. Between November, 1937, and June, 1940, about 8 per cent of the preferred shares were thus purchased, many at prices in the low twenties and very few shares at over $30.[8]

In March, 1940, the corporation filed an amended plan which took the form of a plan of merger between Federal, Utility Operators Company, and a wholly owned subsidiary of Federal. The plan embodied a concession that the Class B shares were not entitled to any participation. It reflected, however, continued efforts to provide for maintenance of the existing management. Thus there was a provision for a "staggered" board of directors under which the stockholders of the reorganized corporation would not be able to replace the entire board until the third annual meeting after the reorganization. The commission disapproved this feature of the plan and also the treatment of the preferred shares purchased by Mr. Chenery and his associates on a parity with other shares of the same class. The commission stated: "We believe that a formula should be

[4] In the matter of Federal Water Service Corp., 8 S.E.C. 893 (1941). The corporate structure is described in detail in this opinion.

[5] One of the apparent purposes of the proposed voluntary reorganization was to avoid the compulsory simplification of complicated capital structure provided by the Act. 49 Stat. 821 (1935), 15 U.S.C.A. § 79k(b)(2) (1941).

[6] In the matter of Federal Water Service Corp., 8 S.E.C. 893 (1941).

[7] Chenery Corp. v. Securities and Exchange Com'n, 128 F. (2d) 303, 306 (App. D.C. 1942).

[8] In the matter of Federal Water Service Corp., 8 S.E.C. 893, 915 (1941).

devised which will limit the participation of the preferred stock purchased by the management to an amount which takes into account the purchase prices paid, plus accumulated dividends since the dates of the respective purchases."[9] The entry of an order was withheld, however, and amendments to the plan were filed. In these amendments, the corporation eliminated the provision for a "staggered" board. It was apparently desired, however, both to test the legality of the commission's ruling as to the management's stock purchases and, in the meantime, to consummate the merger. Accordingly, the company's amended plan provided that the shares so acquired should be purchased for cancellation by the reorganized corporation at cost plus interest at four per cent.[10] The Chenery Corporation and individual directors intervened and opposed the amended plan as not "fair and equitable" unless modified so as to restore them to equal treatment with other preferred stockholders. These objections were overruled and the plan approved. The intervening stockholders filed a petition for review of this order in the Court of Appeals of the District of Columbia and the order was reversed.[11] A petition for certiorari has been granted by the United States Supreme Court.[12]

All parties have apparently wished to have a decision of the question as it would have been presented on review of an order approving the 1940 plan only on condition that the preferred shares acquired by the management be recognized in the plan only to the extent of their cost plus accrued dividends. Such a condition would have been rested on the commission's power under Section 7(f) to attach to an order permitting a declaration to become effective such "conditions as the Commission finds necessary to assure compliance with the condition specified in this section."[13] And the relevant condition specified in the section is that the terms of issue of the new securities shall not be found "detrimental to the public interest or the interest of investors or consumers."[14] The court of appeals treated the case as though it presented such an order for review. No such order, however, had ever been entered.[15] The actual order was one approving the amended plan filed by the company over objection of intervening stockholders.[16] The commission's decision was that the company's plan was not unfair or inequitable to the management stockholders. But, in order to secure an authoritative decision on the merits of its general policy, the commission was apparently willing to support the limited recognition of shares purchased by the management as not merely proper and not unfair but necessary

[9] Ibid., at 920.

[10] In the matter of Federal Water Service Corp., Hold. Co. Act Rel. No. 3023 (1941).

[11] Chenery Corp. v. Securities and Exchange Com'n, 128 F. (2d) 303 (App. D.C. 1942).

[12] Securities & Exchange Com'n v. Chenery Corp., 63 S. Ct. 52 (1942).

[13] 49 Stat. 817 (1935), 15 U.S.C.A. § 79g(f) (1941).

[14] 49 Stat. 816 (1935), 15 U.S.C.A. § 79g(d)(6) (1941).

[15] In the matter of Federal Water Service Corp., 8 S.E.C. 893 (1941).

[16] In the matter of Federal Water Service Corp., Hold. Co. Act Rel. No. 3023 (1941).

to make the plan "not detrimental to the public interest or the interest of investors or consumers."[17]

Two principal points were made in the majority opinion reversing the commission's order. In the first place, the court viewed the action of the commission as establishing—retroactively—a rule for directors much stricter than any rule applied by courts in comparable situations. The commission was charged with "adventuring with uncertain steps into a brand new field in which there was neither guide nor compass. . . . ."[18] In the second place, the court found in the Holding Company Act no warrant for such action, particularly in view of the provisions of Section 17. This section, patterned after Section 16 of the Securities Exchange Act of 1934,[19] requires directors of registered corporations to report their transactions in the company's securities and provides for recapture of profits where directors purchased and then sold within six months. It was argued that this treatment of the problem of purchases by directors was intended to leave the commission with no power to prescribe stricter standards. Both of these points reflect a failure to give sufficient effect to the distinction between purchases made under ordinary circumstances and those made while the directors are active in arranging a reorganization. The commission's strict rule for purchases made under the latter circumstances is not without support in judicial decisions in similar situations. Section 17, furthermore, applies to all purchases by directors, and when adequate recognition is given to the peculiar dangers in permitting purchases while reorganization is pending, the inclusion of Section 17 affords little basis for an inference of congressional intent that the commission should have no authority to adopt a stricter rule for purchases during the critical reorganization period.

The commission conceded that the directors' purchases were made in good faith, at a fair price, and after full disclosure. It is obvious that such purchases should not be penalized if made under ordinary circumstances. So strict a rule would make it practically impossible for directors to increase their investment in the shares of their corporations. It has always been assumed that it is desirable to have ownership as closely identified with control as possible in order that the directors' pecuniary interests may promote the responsible exercise of their management powers. The danger in connection with purchase made under ordinary circumstances is that directors may be tempted to take advantage of inside information or to manipulate corporate action, such as dividend declarations, so as to influence market prices. Under ordinary circumstances, many courts hold that a director, though a fiduciary toward the corporation and with respect to its management, owes no fiduciary duties to stockholders per-

[17] 49 Stat. 816 (1935), 15 U.S.C.A. § 79g(d)(6) (1941).

[18] Chenery Corp. v. Securities and Exchange Com'n, 128 F. (2d) 303, 307 (App. D.C. 1942).

[19] 48 Stat. 896 (1934), 15 U.S.C.A. § 78p (1941).

sonally and may deal with them at arm's length in the purchase of their shares.[20] Some courts have taken a contrary view, but only with the result of imposing a duty of full disclosure and fair dealing.[21] The enforcement of such a rule of disclosure presents an insoluble problem in connection with purchases made through brokers on a securities exchange. In the Securities Exchange Act and the Holding Company Act, Congress has accordingly resorted to a different type of rule. As already stated, it has sought to prevent improper purchases by publicity and by making all short-term speculation unprofitable.

Purchases made during the pendency of a reorganization program involve much more serious dangers. Market prices are typically depressed and often fluctuate widely during the critical pre-reorganization period. If the individuals in charge of the reorganization are free to take advantage of market swings, there will be grave dangers that in negotiations over the plan and in the timing of the reorganization they will be primarily influenced by the desire for profits through security purchases. Large profits may be made during such a period by taking advantage of market reactions to proposals of plans, amendments, withdrawals, delays, and other well-timed announcements concerning the prospects for the corporation. The amount of such profits may bulk large in comparison with the directors' existing stake in the enterprise and will usually be much greater than the profits available to insiders by trading during ordinary periods.

Such considerations have influenced courts in cases decided during the last decade in reorganization proceedings in bankruptcy. It has become settled that members of bondholders' committees will not be awarded allowances for their services if they have purchased securities of the debtor corporation during the pendency of the proceedings.[22] This rule is now made explicit in Section 249 of Chapter X of the Bankruptcy Act,[23] but it had been applied in cases under Section 77B which contained no express provision to this effect,[24] and the new Section 249 has been regarded as merely a codification of the pre-existing rule.[25] Fees have been denied when committee members merely purchased for invest-

[20] Deaderick v. Wilson, 8 Baxt. (Tenn.) 108 (1874); Bd. of County Com'rs v. Reynolds, 44 Ind. 509 (1873); Carpenter v. Danford, 52 Barb. (N.Y.) 581 (1868). On the general problem see 11 Wis. L. Rev. 547 (1936); 46 Yale L. J. 143 (1936).

[21] Steward v. Harris, 69 Kan. 498, 77 Pac. 277 (1904); Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903). For a further discussion see Yourd, Trading in Securities by Directors, Officers, and Stockholders: Section 16 of the Securities Act, 38 Mich. L. Rev. 133 (1939).

[22] Otis & Co. v. Insurance Bldg. Corp., 110 F. (2d) 333 (C.C.A. 1st 1940); In re Mountain States Power Co., 35 F. Supp. 307 (Del. 1940); In re Paramount-Publix Corp., 12 F. Supp. 823 (N.Y. 1935), rev'd on other grounds, 83 F. (2d) 408 (C.C.A. 2d 1936); In re Republic Gas Corp., 35 F. Supp. 300 (N.Y. 1936).

[23] 52 Stat. 901 (1938), 11 U.S.C.A. § 649 (1941).

[24] See cases cited in note 22 supra.

[25] In re Brown Co., 36 F. Supp. 275 (Me. 1941); see In re Consolidated Rock Products Co., 36 F. Supp. 912 (Cal. 1941); Otis & Co. v. Insurance Bldg. Corp., 110 F. (2d) 333, 335 (C.C.A. 1st 1940).

ment and did not engage in trading.[26] The rule has been the same whether the securities were purchased on an exchange or through personal transactions.[27] It has not been limited to purchases from persons who have deposited their securities with the committee.[28] Good faith has been held not to affect the result, and the rule has been applied in the case of small purchases made for the accommodation of its customers by an investment banking firm which was acting as bondholders' representative in working out a reorganization.[29] In these cases various reasons are given in support of so strict a rule, but they all reflect a conviction that there is serious danger that persons representing security holders in working out the problems of the reorganization may not give "loyal and disinterested service" if they are free to make purchases during the critical period.[30]

The rule has been applied not only to committee members but also to counsel for the debtor corporation.[31] In one of these cases, *In re Los Angeles Lumber Products Company*,[32] counsel who had been denied compensation for extensive legal services also had his claim as a bondholder reduced to an amount representing the cost of the bonds plus interest. This result is the more striking in view of the fact that some of the purchases were made before the formal commencement of the reorganization proceeding.

In the *Federal Water Service* case, the commission insisted that in a readjustment of stock interests the functions of the directors and officers in connection with the plan are analogous to those of protective committees in a reorganization involving bonds or other debt securities. The majority of the court of appeals, however, distinguished the bondholders' committee cases as involving an "express trust."[33] The decisions concerning counsel for the debtor,[34] however, show that the rule is not thus limited and, in any event, the fiduciary duties of committee members should be recognized as flowing not from any position as technical trustee of deposited securities but from the position of influence which they occupy in the formulation of the reorganization plan. If it is important that committee members be disqualified from market transactions,

[26] In re Mountain States Power Co., 35 F. Supp. 307 (Del. 1940); In re Republic Gas Corp., 35 F. Supp. 300 (N.Y. 1936).

[27] In re Republic Gas Corp., 35 F. Supp. 300 (N.Y. 1936).

[28] In re Republic Gas Corp., 35 F. Supp. 300 (N.Y. 1936); In re Paramount-Publix Corp., 12 F. Supp. 823 (N.Y. 1935), rev'd on other grounds, 83 F. (2d) 408 (C.C.A. 2d 1936).

[29] Otis & Co. v. Insurance Bldg. Corp., 110 F. (2d) 333 (C.C.A. 1st 1940).

[30] In re Paramount-Publix Corp., 12 F. Supp. 823, 828 (N.Y. 1935), rev'd on other grounds, 83 F. (2d) 408 (C.C.A. 2d 1936).

[31] Otis & Co. v. Insurance Bldg. Corp., 110 F. (2d) 333 (C.C.A. 1st 1940); In re Los Angeles Lumber Products Co., 46 F. Supp. 77 (Cal. 1941); In re Consolidated Rock Products Co., 36 F. Supp. 912 (Cal. 1941); In re Los Angeles Lumber Products Co., 37 F. Supp. 708 (Cal. 1941); In re Arcade Malleable Iron Co., 35 F. Supp. 461 (Mass. 1940).

[32] 46 F. Supp. 77 (Cal. 1941).

[33] Chenery Corp. v. Security and Exchange Com'n, 128 F. (2d) 303, 309 (App. D.C. 1942).

[34] Cases cited in note 31 supra.

the same would seem true of directors in cases of stock readjustment proceedings.

Further support for the commission's action is found in the cases dealing with the status of claims against a corporation purchased by directors at a discount when the corporation was insolvent. It has often been held that such claims may be enforced only to the extent of the price paid.[35] Sometimes this result is required because the purchase by the director diverted from the corporation the opportunity to retire its indebtedness at a discount.[36] In other cases, however, no such showing is made and the rule is usually stated broadly.[37] The rule has even been applied when the purchaser did not become a director until after the assignment of the claim,[38] or, on the other hand, when the purchase occurred after the severance of any relationship with the company.[39] The basis of the rule is clearly apparent in a case where the director was permitted to enforce claims for the face amount because they were acquired after the corporate affairs had been taken over by a receiver in a dissolution proceedings.[40] The court stated flatly that the result would have been otherwise had the purchases been made while the corporate business was being conducted and indicated that the directors would be similarly restricted if the liquidation of the corporation had been left in their hands, presumably because they could not be expected to prosecute the liquidation wisely and diligently if their efforts were also devoted to the purchase of claims at a discount. The same principle was applied in a reorganization case in which claims purchased by the attorney for the principal stockholder, who was also a director and president, were held entitled to participate in the plan only to the extent of the amount paid.[41]

It must be conceded that no case has been found in which shares of stock, as contrasted with bonds, purchased by a director have been denied full participation in a reorganization plan. Indeed, there is one decision which must be regarded as in conflict with the commission's ruling.[42] It involved purchases of shares by trustees of an unincorporated holding company at a time when they were engaged in formulating plans of liquidation. In such a case, just as in the stock readjustment situations not under the jurisdiction of a court, the considerations underlying the bankruptcy reorganization cases would seem to apply

[35] Bramblet v. Commonwealth Land Co., 26 Ky. L. 1176, 83 S.W. 599 (1904); Bonney v. Tilley, 109 Cal. 346, 42 Pac. 439 (1895); In re Imperial Land Co., [1877] 4 Ch. D. 566.

[36] See Rupperger v. Allyn, 25 F. Supp. 554 (N.Y. 1938); Wabunga Land Co. v. Schwanbeck, 245 Mich. 505, 222 N.W. 707 (1929); cf. Horner v. New South Oilmill, 130 Ark. 551, 197 S.W. 1163 (1917).

[37] See 2 Thompson, Corporations 838 (3d ed. 1927); 3 Fletcher, Cyc. Corp. 184–89 (1931); 3 Cook, Corporations 2525 (8th ed. 1923).

[38] Bonney v. Tilley, 109 Cal. 346, 42 Pac. 439 (1895).

[39] In re McCrory Stores Corp., 12 F. Supp. 267 (S.D. 1935), noted in 34 Mich. L. Rev. 1245 (1936); cf. In re Imperial Land Co., [1877] 4 Ch. D. 566.

[40] Allen-Foster-Willett Company's Petition, 227 Mass. 551, 116 N.E. 875 (1917).

[41] In re Norcor Mfg. Co., 109 F. (2d) 407 (C.C.A. 7th 1940).

[42] Donnelly v. Consolidated Investment Trust, 99 F. (2d) 185 (C.C.A. 1st 1938).

with added force. In bankruptcy cases involving large corporations, the court must appoint an independent trustee charged with the preparation of the plan. Furthermore, the plan and activities of committee members are directly under the court's control. Under these circumstances the danger from speculative purchases by insiders would seem much less serious than in cases of extra-judicial liquidation or reorganization. In reorganizations involving debt securities, moreover, security-holders of various classes are typically represented in the negotiations concerning the plan by separate committees or agents. In a stock readjustment, however, the plan is often prepared by corporate officers and directors who are interested in the junior shares. Where the plan is neither the product of adversary negotiations nor subject to direct judicial control, there would seem special need to protect the directors from the temptations of the market.

DISSOLUTION OF A SUBSIDIARY CORPORATION A TRAP FOR THE UNWARY PARENT*

A prolific source of litigation has been the existence of a minority stock interest in a subsidiary managed by officers of its parent corporation. Dissolution of the subsidiary is often resorted to as a means of terminating the troublesome situation.[1] The difficulties inherent in the dissolution device, however, are strikingly illustrated in recent litigation involving the Inland Steel Company and its ore-carrying subsidiary incorporated in West Virginia.[2] In each of its two opinions, the Circuit Court of Appeals for the Seventh Circuit enunciated two propositions: 1) that, under the West Virginia statute providing for dissolution upon the vote of holders of sixty per cent of the shares of capital stock, a prosperous corporation may be dissolved regardless of motive and expediency; and 2) that, in the event of such a dissolution, if the majority stock holder purchase the corporate assets, the minority have a cause of action unless the majority pays the fair value of the assets, including the going concern value of the business. The situation to which these principles were applied was analyzed by the court, as one in which the majority stockholder brought about the dissolution of the corporation and the sale of its assets in order to get rid of the minority. Although the price paid was conceded to have been a fair price for the physical assets, nothing had been added for intangibles, and the majority stockholder was held to have improperly appropriated the going concern value of a prosperous business.

At common law most courts have held that neither the dissolution nor the sale of the entire assets of a prosperous corporation can be accomplished without

* Lebold v. Inland Steel Co., 125 F. (2d) 369 (C.C.A. 7th 1941), cert. den. 62 S. Ct. 1045 (1942).

[1] Hornstein, Voluntary Dissolution—A New Development in Intracorporate Abuse, 51 Yale L. J. 64 (1941).

[2] Lebold v. Inland S. S. Co., 82 F. (2d) 351 (C.C.A. 7th 1936); Lebold v. Inland Steel Co., 125 F. (2d) 369 (C.C.A. 7th 1941), cert. den. 62 S. Ct. 1045 (1942).