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CORPORATIONS

FIDUCIARY DUTY OWED CREDITORS BY DIRECTOR OF INSOLVENT CORPORATION

The Calton Crescent Company had been insolvent since its incorporation in 1933. Between 1942 and 1946 one of the company directors, Becker, purchased debentures of the company from creditors at a discount.¹ In an arrangement proceeding under Chapter XI of the Bankruptcy Act² the referee prorated Becker's claims at face value. This order was affirmed by the district court³ and by the Court of Appeals for the Second Circuit.⁴ The Manufacturer's Trust Company, trustee under the indenture pursuant to which the debentures were issued, was granted certiorari to the Supreme Court. The trustee contended that, because the debentures were purchased during insolvency, Becker had violated a fiduciary duty owed to the creditors, and that his claims should be limited to the price he paid for the debentures. The Court held that there was no evidence of over-reaching by Becker such as would constitute a breach of a fiduciary duty, and affirmed the order. *Manufacturers Trust Co. v. Becker*, 70 Sup. Ct. 127 (1949).

The unusual character of the corporate entity raises many problems as to the relationship of the director to persons interested in the successful operation of the corporation and in its assets after insolvency. Where the corporation is solvent the relation between the director and a creditor is generally regarded non-fiduciary.⁵ Nor is the director a fiduciary to the stockholders under the majority view.⁶ But an increasing minority has, by the "special circumstances" rule, imposed a fiduciary obligation upon the director where his ac-

1. In purchasing the claims Becker acted as agent for his wife and mother. Under these circumstances the court concluded that proofs of debt filed by the Becker women should be treated as if they were proofs of debt filed by Becker. *Manufacturers Trust Co. v. Becker*, 70 Sup. Ct. 127, 131 (1949).

2. 30 Stat. 544 (1898), as amended, 11 U. S. C. § 701 (1938).

3. *Manufacturers Trust Co. v. Becker*, 80 F. Supp. 822 (S. D. N. Y. 1948).

4. *Manufacturers Trust Co. v. Becker*, 173 F. 2d 944 (2d Cir. 1949).

5. *Frost Manufacturing Co. v. Foster*, 76 Iowa 535, 41 N. W. 212 (1889); *Allen v. Cochran*, 160 La. 425, 107 So. 292 (1926); *Young v. Haviland*, 215 Mass. 120, 102 N. E. 339 (1913); *Union National Bank v. Hill*, 148 Mo. 380, 39 S. W. 101 (1899); *Zinn v. Mendel*, 9 W. Va. 580 (1876); *cf. Whitfield v. Kern*, 122 N. J. 332, 192 Atl. 48 (1937). There is an exception to this rule in the case of corporate banking companies. *Delano v. Case*, 121 Ill. 247, 12 N. E. 676 (1887); *Cassidy v. Uhlmann*, 170 N. Y. 505, 63 N. E. 554 (1902); *Marshall v. F. M. Sav. Bank of Alexandria*, 85 Va. 676, 8 S. E. 586 (1889).

6. Indiana follows the majority rule. See *Ryan, Should Tippecanoe County Commissioners v. Reynolds Be Overruled?*, 16 IND. L. J. 563 (1941). Other cases following the majority rule are: *Steinfeld v. Nelson*, 51 Ariz. 242, 139 Pac. 879 (1913); *Hooker v. Midland Steel Co.*, 215 Ill. 444, 74 N. E. 445 (1905); *Seitz v. Frey*, 152 Minn. 170, 188 N. W. 266 (1922); *Crowell v. Jackson*, 53 N. J. 656, 23 Atl. 426 (1891); *Shaw v. Cole Manufacturing Co.*, 132 Tenn. 210, 177 S. W. 479 (1915). Cases following the minority rule imposing a fiduciary relationship between a director and a stockholder are: *Oliver v. Oliver*, 118 Ga. 362, 45 S. E. 232 (1903); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932); *Buckley v. Buckley*, 230 Mich. 504, 202 N. W. 955 (1925).

tions make it inequitable for him to profit at the stockholders' expense.⁷ The director is generally held to be a fiduciary to the corporate entity,⁸ though his duties are not as stringently enforced as are those owed by a trustee to the *cestui que trust*. Thus, a director may purchase discounted claims against a solvent corporation and enforce them at their face value so long as he acts in good faith and is under no present duty to make the purchase for the corporation.⁹

But when a corporation becomes insolvent, creditors are substituted for the corporation and the director becomes a trustee of the corporate assets for their benefit.¹⁰ This is the situation posed by the *Manufacturers Trust* case. The Court, finding no over-reaching by Becker, rejected the trustee's contention that Becker's fiduciary duty should be strictly enforced,¹¹ and utilized a

7. *Strong v. Repide*, 213 U. S. 419 (1909); *Borg v. International Silver Co.*, 11 F.2d 147 (2d Cir. 1925); *Bacon v. Soule*, 19 Cal. App. 428, 126 Pac. 384 (1912); *Agatucci v. Corradi*, 327 Ill. App. 153, 63 N. E.2d 630 (1943), 24 CHI-KENT REV. 272 (1946); *Goodwin v. Agassiz*, 283 Mass. 358, 186 N. E. 659 (1933), 32 MICH. L. REV. 678 (1934). See also *Berle, Publicity of Accounts and Directors' Purchases of Stock*, 25 MICH. L. REV. 827 (1927); *Comment*, 19 So. CALIF. L. REV. 32 (1945); *Notes*, 14 MINN. L. REV. 530 (1930), 4 U. OF NEWARK L. REV. 441 (1939), 11 WIS. L. REV. 547 (1936).

8. *Bates v. Dresser*, 251 U. S. 524 (1920); *Barnes v. Andrews*, 298 Fed. 614 (S. D. N. Y. 1924); *Mobile Land Improvement Co. v. Goss*, 142 Ala. 520, 39 So. 229 (1905); *New Haven Trust Co. v. Doherty*, 75 Conn. 555, 54 Atl. 209 (1903); *Hun v. Cary*, 82 N. Y. 65 (1880); *Dodd, Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?* 2 U. OF CHI. L. REV. 194 (1935); *Fuller, Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors*, 26 WASH. U. L. Q. 189 (1941); *Uhlman, The Legal Status of Corporate Directors*, 19 B. U. L. REV. 12 (1939).

9. *Kroegher v. Calinada Conolization Co.*, 119 Fed. 641 (3d Cir. 1902); *Alexandrine Hotel Co. v. Whaling*, 313 Mich. 15, 20 N. W.2d 793 (1945); *Wabunga Land Co. v. Schwarbeck*, 245 Mich. 505, 222 N. W. 707 (1929); *Punch v. Hipolite Co.*, 340 Mo. 53, 100 S. W.2d 878 (1936); *Glenwood Manufacturing Co. v. Syme*, 109 Wis. 355, 85 N. W. 432 (1901). *Contra*: *Davis v. The Rock Creek L. F. & M. Co.*, 55 Cal. 359 (1880); *Duane v. Merchants Legal Stamp Co.*, 227 Mass. 551, 116 N. E. 875 (1917); *McDonald v. Houghton*, 70 N. C. 316 (1874). See also, 2 THOMPSON, CORPORATIONS § 1343 (3d ed. 1927); *Lake, The Use For Personal Profit of Knowledge Gained While a Director*, 9 MISS. L. J. 427 (1937); *Riley, Corporation's Right to Profits Made by Director*, 4 MINN. L. REV. 513 (1920); *Note*, 26 IOWA L. REV. 334 (1941).

10. *E.g.*, *In re The Van Sweringen Co.*, 119 F.2d 231, 234 (6th Cir. 1941); *Martin v. Chambers*, 214 Fed. 769, 771 (5th Cir. 1914); *In re Los Angeles Lumber Products Co.*, 46 F. Supp. 77, 88 (S. D. Cal. 1941); *Horner v. New South Oilmill*, 130 Ark. 551, 197 S. W. 1163, 1165 (1917); *Bonney v. Tilley*, 109 Cal. 346, 352, 42 Pac. 439, 440 (1896); *Farwell v. Pyle National Electric Co.*, 289 Ill. 157, 164, 124 N. E. 449, 452 (1919); *Powell v. Willamette Val. R. Co.*, 15 Ore. 393, 15 Pac. 663, 666 (1887); 3 FLETCHER, CYC. CORPORATIONS § 869.1 (Perm. ed. 1947); 2 THOMPSON CORPORATIONS § 1344 (3d ed. 1927).

11. The few cases there are that deal with this particular question have all allowed the creditors the benefit of profits made by the director when dealing with other creditors. *Bonney v. Tilley*, 109 Cal. 346, 42 Pac. 439 (1935); *Bulkley v. Whitcomb*, 121 N. Y. 107, 24 N. E. 13 (1890). In *Moulton v. Connell-Hall-McLester Co.*, 93 Tenn. 377, 27 S. W. 672 (1894) the court decided for the director, but this judgment was based on a procedural point inasmuch as plaintiff creditor was suing for himself and not for the benefit of all the creditors. In *Appeal of Hammond*, 123 Pa. 503, 16 Atl. 419 (1889) a director purchased claims after the corporate property was assigned to a trustee in bankruptcy. The

less vigorous rule similar to that applied to the relation between a director and a solvent corporation.¹² The Court conceded that the duty would be strictly enforced if judicial proceedings in bankruptcy were imminent.¹³ Under this reasoning it is possible that Becker violated no duty owing to the creditors, since his purchases did not deplete the fund available for dividends and did not injure the creditors, who received no less than they would have in the absence of the purchase. Nor would the seller-creditors succeed in recovering Becker's profits since it was generally known at the time of the purchase that land values were increasing.¹⁴ As a result of the decision, the director was allowed a profit of \$42,000 on an investment of \$8,000 while the creditors received a dividend of 43.61% on the face value of their claims. Had the director been allowed only the price he paid for the debentures the dividend would have mounted to over 80% of the face value of the creditors' claims.¹⁵

The assumption by the majority opinion that the same rule is applicable to both the solvent and the insolvent corporation is difficult to sustain.¹⁶ When the claim against a solvent corporation is purchased, it is apparent that at the time the debenture was issued the corporation received full value for its obligation to repay.¹⁷ It is, therefore, reasonable to allow the profits to the director because the corporation has incurred no loss. It is felt that the allowance of profits to the director increases his incentive, resulting in better management, and thereby benefiting the stockholders, employees, and the community. But when insolvency occurs, the creditors are substituted for the corporation,¹⁸ and they should be allowed to alleviate some of their losses resulting from the insolvency.¹⁹ Despite the absence of any direct injury, they are equitably entitled to the director's profits. The creditors, of course, are not always in this superior position. Should the director purchase claims in the belief that he can relieve the corporation of its insolvent condition by

court held that inasmuch as the claims were purchased at a time when the defendant was no longer a director of the corporation, the complaining creditors, not having been injured by the transaction, had no standing in court.

12. "That there is no such conflict (between a director's personal interest and his duty to the corporation) in the ordinary case of the purchase by a director in a going corporation of its outstanding obligations would seem true not only of solvent corporations." *Manufacturers Trust Co. v. Becker*, 70 Sup. Ct. 127, 132 (1949).

13. *Manufacturers Trust Co. v. Becker*, 70 Sup. Ct. 127, 133 (1949).

14. The director made his purchase during the years 1942 to 1946.

15. See note 13 *supra*, at 129.

16. *Manufacturers Trust Co. v. Becker*, 173 F.2d 944, 950 (2d Cir. 1949).

17. In the present case the corporation received value in the form of a cancellation of a mortgage by the mortgagees in return for the debenture bonds it issued.

18. See note 10 *supra*.

19. *Cf. Martin v. Chambers*, 214 Fed. 769 (5th Cir. 1904); *Bonney v. Tilley*, 109 Cal. 346, 42 Pac. 439 (1935); *Bramblet v. Commonwealth Land & Lbr. Co.*, 26 Ky. 1176, 83 S. W. 599 (1904); *Bulkley v. Whitcomb*, 121 N. Y. 107, 24 N. E. 13 (1890).

a composition agreement he may share in the corporate assets on the same basis as do the other creditors.²⁰ This result is justified by the same considerations as those allowing the director to speculate in the securities of a solvent corporation; because it increases his incentives, incidentally benefiting other interested parties.²¹ Since the creditors' interests are inferior to the combined interests of others, the director is placed on a par with the creditors. But if the director purchases claims without expectation of composition, the stockholders, employees, and the community are not necessarily the incidental beneficiaries, since the purpose of the transaction is not to alleviate the insolvency.²² Here the creditors' interests outweigh those of the director, and the director's recovery should be limited to the purchase price of the claims.²³

The only limitation imposed upon the director of an insolvent corporation by this latest decision concerns that situation where judicial proceedings in liquidation are imminent. Since directors have some discretion in fixing the time of such proceedings,²⁴ there is a conflict between his personal motives and his fiduciary duty. The director will be inclined to delay judicial proceedings if he knows he can make added profits through subsequent dealings in corporate securities. Such a delay may work to reduce the return to the creditors on their initial loan.²⁵ The imposition of a strict fiduciary obliga-

20. A director will be protected if his sole purpose in purchasing the claims is to enable the corporation to continue in business. *Powell v. Willamette Val. R. Co.*, 15 Ore. 393, 15 Pac. 663 (1887); *accord*, *Alexandrine Hotel Co. v. Whaling*, 313 Mich. 15, 20 N. W.2d 793 (1945); *Punch v. Hipolite Co.*, 340 Mo. 53, 100 S. W.2d 793 (1945); *Glenwood Mfg. Co. v. Syme*, 109 Wis. 355, 85 N. W. 432 (1901). On the other hand if a company is in the act of reorganization, a director is not protected if he purchases claims with a view toward personal profit. *In re Los Angeles Lumber Products Co.*, 46 F. Supp. 77 (S. D. Cal. 1941); *In re McCrary Stores Corp.*, 12 F. Supp. 267 (S. D. N. Y. 1935), 34 MICH. L. REV. 1245 (1935).

21. *See*, *In re Calton Crescent*, 173 F.2d 944, 952 (2d Cir. 1949) (dissenting opinion).

22. A director is allowed to protect his personal investment in an insolvent corporation by purchasing secured claims against the corporation in order to forestall foreclosure proceedings. In such a case he will be allowed his pro rata share at face value since the director's intent was not only to protect his own interests but also the interests of others by relieving the corporation of its insolvent condition. *Monroe v. Scofield*, 135 F.2d 725 (10th Cir. 1943); *Martin v. Chambers*, 214 Fed. 769 (5th Cir. 1914); *Beaumont v. Folsom*, 136 Neb. 235, 285 N. W. 547 (1939). On the question of personal interest versus fiduciary duty see C. and E. Rohrllich, *Psychological Foundations for the Fiduciary Concept in Corporation Law*, 38 COL. L. REV. 432 (1938).

23. *Accord*, *In re The Van Sweringen Co.*, 119 F.2d 231 (6th Cir. 1941); *United States Fidelity & Guaranty Co. v. Eichel*, 219 Fed. 803 (3d Cir. 1915); *In re Jersey Materials Co.*, 50 F. Supp. 428 (D. N. J. 1943); *Bonney v. Tilley*, 109 Cal. 346, 42 Pac. 439 (1895); *Bramblet v. Commonwealth Land & Lbr., Co.*, 26 Ky. 1176, 83 S. W. 599 (1904); *Bulkley v. Whitcomb*, 121 N. Y. 107, 24 N. E. 13 (1890); *Appeal of Hammond*, 123 Pa. 503, 16 Atl. 419 (1889).

24. *Royal Indemnity Co. v. American Bond & Mortgage Co.*, 289 U. S. 165 (1933); *In re De Camp Glass Casket Co.*, 272 Fed. 558 (6th Cir. 1921); *Note*, 50 HARV. L. REV. 662 (1937).

25. *See*, *Manufacturers Trust Co. v. Becker*, 70 Sup. Ct. 127, 133 (1949) (dissenting opinion).