available to the justices of the Supreme Court, it is indeed unfortunate that by denying certiorari they failed to publicize it.\textsuperscript{47}

\textbf{DENIAL OF REORGANIZATION PROFITS ON BONDS PURCHASED BY INSIDERS DURING INSOLVENCY*}

Since 1929, opportunities for corporate insiders to exploit innocent security holders and to frustrate the workings of a free and open securities market have been sharply curtailed.\textsuperscript{1} Directors and officers may be stripped of profits earned through short-term speculation in the stock of the companies they manage.\textsuperscript{2} They may be compelled to surrender profits derived from trading

\textsuperscript{47} The Supreme Court will have another opportunity to review §404(c). Lapides has filed a petition for rehearing based primarily upon the discovery of a letter representing as the view of the State Department "that subsection (c) of Section 404 of the Nationality Act does not serve the interests of the United States." Communication to Senator Francis J. Meyers from . . . , Assistant Secretary of State, dated July 15, 1947, according to Petition for Rehearing, p. 7, Lapides v. McGrath, 18 U.S.L. Week 3129 (U.S. Oct. 25, 1949).

Another case contesting the constitutionality of §404(c) has started in the lower courts. Mendelsohn v. Acheson, No. 2390-49, D.D.C. 1949.

\textsuperscript{*1} In re Calton Crescent, 173 F.2d 944 (2d Cir. 1949), aff'd sub nom. Manufacturers Trust Co. v. Becker, 18 U.S.L. Week 4025 (U.S. Nov. 21, 1949).


in the corporation's securities during Chapter X reorganizations. But the Second Circuit decided in the recent Calton Crescent case that speculation by insiders in the securities of an insolvent corporation before reorganization is not similarly proscribed.

Calton Crescent, Inc., a small corporation, was insolvent in the bankruptcy sense: its liabilities exceeded its assets. Since its organization in 1933, it had consistently failed to meet the interest on its obligations. Continual operating deficits led its officers to undertake negotiations for sale of the apartment house which constituted its sole asset. During this period, one of its directors advised his wife, his mother, and a business associate to invest in the corporation's outstanding indebtedness. Altogether these three purchased 60% of the corporation's $250,000 of debenture bonds, many in over-the-counter transactions for about 6% of par. Subsequently, the apartment house was sold, and a petition for a voluntary arrangement under Chapter XI was filed. The ensuing cash settlement at 43.8% of par which was awarded to participating bondholders yielded these insiders a 500% profit. On behalf of other bondholders, the indenture trustee objected to allowance of the insiders' claims, alleging that they had substantial reason to foresee the high sale price ultimately received by the insolvent corporation. Furthermore, he alleged that recognizing speculative profits from bonds purchased during insolvency condoned an intolerable conflict of interest between directors as fiduciaries and directors as speculators. Consequently, he urged the bankruptcy court to invoke its power to subordinate and limit these claims to the actual purchase price of the bonds.


4. In re Calton Crescent, 173 F.2d 944 (2d Cir. 1949).

5. If the insiders had been denied their 500% profit, other bondholders would have received a 94% return on the face value of their claims. 173 F.2d 944, 947 (2d Cir. 1949).

6. 173 F.2d 944, 947-9 (2d Cir. 1949).

7. This argument was actually introduced and developed by the SEC, an amicus curiae in the proceedings. Brief of the SEC, pp. 10-12. The indenture trustee relied heavily upon precedents in the federal courts barring the claims of directors speculating after reorganizations had begun or been authorized, e.g., In re Norcor Mfg. Co., 109 F.2d 407 (7th Cir. 1940), cert. denied, 310 U.S. 625 (1940) (company already in receivership); In re Los Angeles Lumber Products Co., 46 F. Supp. 77 (S.D. Cal. 1941) (reorganization already authorized by directors). The claimants argued that these and other cases cited by the trustee could be distinguished. In all of them, some form of bankruptcy proceedings were already in process at the time of purchase. Apparently, the court was satisfied that this factor made the cases cited by the trustee inapplicable. See 173 F.2d 944, 950 n.11 (2d Cir. 1949).

Judge Swan, speaking for a majority, conceded that a director should not profit at the expense of the corporation from transactions where duty and personal interest conflict. Thus, a director who buys up bonds at a discount without first offering the insolvent corporation an opportunity to purchase them may be compelled to forfeit subsequent profits. In the *Calton Crescent* case, however, the corporation had no funds available for repurchasing its own bonds; hence, the director's activities did not compete with the corporation's attempts to settle its indebtedness. Furthermore, bond purchases by corporate directors during solvency are permissible. The court saw no reason why the mere fact of insolvency warranted judicial interference with this practice. Moreover, since loans by these insiders had staved off bankruptcy until

9. 173 F.2d 944, 949 (2d Cir. 1949). Of course, corporation directors, like trustees, are not supposed to use fiduciary powers to enhance their own profits at the expense of the corporation's welfare. See, e.g., Bosworth v. Allen, 168 N.Y. 157, 165, 61 N.E. 163 (1901).

10. *See, e.g., In re Jersey Materials Co.*, 50 F. Supp. 428, 430 (D.N.J. 1943). Many of the cases cited by the trustee in the *Calton Crescent* case for the proposition that directors may not profit from purchases during insolvency involved situations in which the director competed with the corporation in the purchase of its claims, *e.g.*, *In re McCrory Stores Corp.*, 12 F. Supp. 267 (S.D.N.Y. 1935) (debtor corporation still trying to settle indebtedness at time directors purchased claims).

11. The referee justified this conclusion on the ground that there was no retirement fund or liquidation project for the repurchase of the bonds at the time the insiders purchased. *In re Calton Crescent*, 80 F. Supp. 822, 823 (S.D.N.Y. 1948). When the corporation is unable to repurchase its indebtedness, directors are at liberty to purchase the claims. *See, e.g.*, *Punch v. Hipolite Co.*, 340 Mo. 53, 71, 100 S.W.2d 878, 887 (1936). *But cf. Irving Trust Co. v. Deutsch*, 73 F.2d 121 (2d Cir. 1934), *cert. denid*, 294 U.S. 708 (1934). See generally Fuller, *Restrictions Imposed by the Directorship Status on Personal Business Activities of Directors*, 26 WASH. L. REV. 189 (1941).


Judge Learned Hand, dissenting in the *Calton Crescent* case, argued that courts permit directors to trade in the corporation's securities only because they believe that the personal interest of corporate directors as security holders coincides with the interest of the corporation—both benefit from the corporation's success. This incentive to good management, however, is of little value if the corporation is inevitably headed toward liquidation. Consequently, Judge Hand would allow directors to profit from purchases during insolvency only on a showing that their purchases were motivated by a reasonable confidence in the corporation's ability to recover and remain in business. Even under this test, many of the purchases in the *Calton Crescent* case could not be justified. 173 F.2d. 944, 951–2 (2d Cir. 1949).

But students of business administration question the correlation between incentive and security ownership. They cite the trend in executive compensation away from stock option and purchase plans toward substantial salaries and pensions, and the increasing emphasis upon compensation methods that stress the long-run professional aspects of the job rather than the short-term speculative ones. At least one authority has concluded: "[T]oday under existing corporate organization, there need not be any mutuality of interest between the ownership group—the stockholders—and the management control group—the executives. *Baker, Incentive Compensation Plans for Executives*, 15 HARV. BUS. REV. 44 (1936).

13. Many state courts, however, have reached a different conclusion when matured claims were involved. *See, e.g.*, *Bramblet v. Commonwealth Land & Lumber Co.*, 26 Ky.
the corporation could sell its asset at a more favorable price, the court hesi-
tated to penalize the insiders' actions in buying up the bonds. In the absence
of convincing proof that specific inside information had been used, all claims
were allowed in full.

The opinion in the *Calton Crescent* case, however, fails to assess properly
the impact of insolvency upon a director's responsibilities to the corporation
and to other bondholders. An insolvent corporation finds several avenues of
financial relief available: private negotiations with creditors, repurchase of
debts at a discount, voluntary reorganization or bankruptcy. Directors who
engage in insider trading endanger the possible success of any of these reme-
dies. Creditors are likely to suspect the motives of directors who speculate in
claims against the corporation during negotiations for a general scaling down
of its debts. If opportunities arise for the corporation to repurchase its

Law Rep. 1176, 1179, 83 S.W. 599, 602 (1904) (president's acquisition of corporate prop-
erty at foreclosure sale by use of judgment purchased at discount during insolvency).
Similarly, there is a prevailing belief in the federal courts that such conduct by corporate
fiduciaries is reprehensible. See, e.g., Monroe v. Scofield, 135 F.2d 725, 728 (10th Cir.
1943). But such cases often involve foreclosure on matured obligations, a more obvious
misuse of position than the mere receipt of reorganization dividends.

14. The trustee's allegation of overreaching was based upon the failure of the insiders
to disclose (1) their identity as relatives of the director, and owners of the mortgage on
the corporation's asset and (2) the fact that brokers had been making frequent inquiries
about terms of sale of the property. Though many of the purchases were solicited in the
name of a brother-in-law of one of the claimants, the court hesitated "to lay down the rule
that the purchaser from a broker must make disclosure of why he thinks the purchase a
desirable investment under penalty of being charged with overreaching if he fails to do so."
173 F.2d 944, 949 (2d Cir. 1949). And the referee made a finding of no concealment on
the grounds that no "firm offer" had been received for the property at the time the bonds
were purchased. Id. at 949 n.9. The trustee's failure to prove this allegation of over-
reaching illustrates the difficulties that await exploited sellers trying to recover by suits
for fraudulent misrepresentation. See note 27 infra.  

15. The court then went on to decide that even if they imposed an equitable restriction
on trading activities of directors during insolvency, the restriction would not extend to
members of the directors' families purchasing for themselves with their own funds. 173
F.2d. 944, 950-1 (2d Cir. 1949). Any sanction upon directors so easily by-passed would
be no sanction at all. See Moore & Oglebay, CORPORATE REORGANIZATION § 13.18 (1948),
The authors advocate strict application of the existing sanctions of Chapter X (see note 3
supra) to the confederates of speculating fiduciaries in view of "the rigorous purpose of
the statute, and the realities of life."

17. Some commentators have argued that insolvency only reinforces the desirability
of bond purchases by insiders during insolvency to the extent that these purchases enhance
the credit reputation of the debtor corporation and forestall bankruptcy proceedings. E.g.,

18. Many "friendly adjustments" are made in the case of small corporations through
the intervention of credit bureaus. But reputable credit bureaus will accept only "honest
debtors." Knowledge that directors are speculating in creditors' claims would cast strong
suspicion upon the debtor's honesty, and very likely preclude this form of relief. See
bonds at a discount, directors must pass upon the advisability of using limited corporate resources for this purpose. Here, the fact that insiders too may buy these bonds at a discount and enforce them for their face amount in reorganization may persuade directors to decide that the corporation lacks the necessary funds and to slacken their efforts at raising additional capital for the corporation. Finally, where reorganization or liquidation is necessary, the choice of an appropriate time for filing a petition may materially affect the success of the proceeding and the amount of the settlement. Unwarranted delays only add to mounting deficits and increase dissatisfaction among creditors. Yet the possibility of reorganization or liquidation settlements above existing market prices may cause directors to postpone filing a petition until they have acquired substantial amounts of the bonds.

Individual bondholders, too, become peculiarly vulnerable to exploitation at the hands of an unscrupulous insider during insolvency. Few investors ever share the director's access to the corporation's financial secrets. But at least the value of a solvent corporation's obligation can be largely determined by

Mulder & Solomon, *Effect of the Chandler Act upon General Assignments and Compositions*, 87 U. of P.A. L. Rev. 763 n.1 (1939). It is especially necessary to avoid any suspicion of directors' motives where the debtor corporation seeks an arrangement in state courts. Since state courts cannot constitutionally compel creditors to accept any plan, one disgruntled or suspicious creditor can upset the whole scheme by resorting to other legal processes to collect his claims in full. Moore & Oglebay, *Corporate Reorganization* § 0.02 (1948).

19. See Irving Trust Co. v. Deutsch, 73 F.2d 121, 124 (2d. Cir. 1934). "The defendant's argument that the equitable rule that fiduciaries should not be permitted to assume a position in which their individual interests might be in conflict with those of the corporation can have no application where the corporation is unable to undertake the venture, is not convincing. If directors are permitted to justify their conduct on such a theory, there will be a temptation to refrain from exerting their strongest efforts on behalf of the corporation since, if it does not meet the obligations, an opportunity for profit will be open to them personally." Although the corporation involved in the *Irving* case was solvent, the same reasoning should apply to insolvent corporations. For instance, the directors may be tempted to manipulate financial statements in order to justify their conclusion that the corporation cannot afford the purchases. And courts are familiar with misrepresentation of corporate assets by speculating directors. See, e.g., McDonald v. Haughton, 70 N.C. 393, 399 (1874).


21. "Solvent" in this context assumes that the corporation has a reliable reputation and earnings record.
such matters as security, interest rate, amount of principal, and time of maturity.\textsuperscript{22} A bondholder may judge the adequacy of the price offered for his securities with a fair degree of accuracy.\textsuperscript{23} In contrast, the obligation of an insolvent corporation may be highly speculative. Interest payments are often in default, trading at a minimum, and the sale price of the bonds nominal.\textsuperscript{24} In deciding whether to retain or liquidate his holdings, a bondholder must often rely upon his own judgment concerning the corporation's chances of regaining solvency and the imminence of reorganization or liquidation.\textsuperscript{25} Yet the information necessary for enlightened judgment lies uniquely within the director's knowledge and control. The director decides if bond interest shall be paid or defaulted, whether and when voluntary reorganization or liquidation shall be undertaken. Moreover, he is in the most favored position to estimate the amount of ensuing settlements. He can most easily capitalize on the ignorance and insecurity of his fellow-bondholders.

By refusing to disallow the insiders' claims, the reorganization court in the \textit{Calton Crescent} case relegated bondholders to their traditional remedies in suits for fraudulent misrepresentation, where the road to recovery is strewn with obstacles. Very often the exploited bondholder cannot even identify the purchaser of his securities;\textsuperscript{26} rarely can he prove the use of specific inside information affecting the value of the securities;\textsuperscript{27} seldom can a small investor afford the expenses of a lawsuit.

\begin{itemize}
\item \textsuperscript{22} \textbf{BADGER} \& \textbf{GUTHMANN}, \textit{INVESTMENT PRINCIPLES AND PRACTICE} 912 (1938).
\item \textsuperscript{23} Price fluctuations in high-grade bonds are usually narrow compared with variations in stock prices. Original holders may ordinarily sell their bonds at a later date for approximately what they paid for them. \textit{TWENTIETH CENTURY FUND, THE SECURITY MARKETS} 76 (1935).
\item \textsuperscript{24} \textbf{WARRINGTON}, \textit{NATURE AND EXTENT OF LOSSES TO BONDHOLDERS IN CORPORATE REORGANIZATION AND LIQUIDATION} 164 (1936). Moreover, when a corporation becomes insolvent, its securities are dropped from the Exchanges and traded exclusively on the over-the-counter market. The loss of open market price quotations creates a larger area for unfair use of inside information. See Rubin & Feldman, \textit{Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders}, 95 U. of Pa. L. Rev. 468, 496 (1947).
\item \textsuperscript{25} \textbf{WARRINGTON}, \textit{op. cit. supra} note 24, at 162, concludes from his survey of bondholders' losses that their best chance of recovering investments usually lies in participation in reorganization. Modern specialization of industrial equipment makes liquidation financially disastrous. But, if reorganization is unreasonably delayed or prolonged, the bondholder in need of cash has little choice but to sell his holdings for a small fraction of par.
\item \textsuperscript{26} \textbf{SEC Regulation X-15C-1-4} (SEC Release No. 1330, 1937) requires an over-the-counter dealer acting as broker to disclose to his customers the name of the other party to the security transaction. But fiduciaries may purchase through the accounts of their relative and friends, as some of the insiders did in the \textit{Calton Crescent} case. 173 F.2d 944, 948 (2d Cir. 1949). Moreover, if the transactions are conducted between two over-the-counter dealers, the identities of the ultimate purchaser and seller need not be disclosed at all. Yet complete disclosure of identity and personal interest has been considered a major element of "arm's length bargaining" in security transactions. See \textbf{Strong v. Repide}, 213 U.S. 419, 432-3 (1909); \textbf{American United Mutual Life Ins. Co. v. Avon Park}, 311 U.S. 138, 145 (1940).
\item \textsuperscript{27} Use of inside information can ordinarily be proved only by circumstantial evidence. In reorganizations, however, it is frequently difficult to distinguish between use of inside information and early recognition of economic trends. See \textbf{SEC Report}, pt. II,
If it is a sound proposition that insider trading during insolvency should be discouraged, investors deserve greater protection. Existing regulations already make it unlawful for any person to engage in practices which operate as a fraud or deceit upon any other person in connection with the purchase or sale of any security.28 These might be supplemented by a specific requirement that corporations publish any information affecting the value of their securities before management officials could purchase.29 Courts already demand that a director prove complete disclosure of personal interest and adequate consideration in his dealings with the corporation.30 A similar burden might be imposed on corporate insiders in their dealings with individual bondholders.31 While this burden might pave the way for a myriad of nuisance suits by disgruntled security-holders, it would deter insiders from trading during insolvency when the affairs of the insolvent corporation never come under the surveillance of the bankruptcy court.

Many insolvent corporations, however, like Calton Crescent, Inc., ultimately do succumb to bankruptcy or reorganization. In these proceedings, a simpler and more effective deterrent to insider trading during insolvency is the power of the bankruptcy court, as a court of equity, to limit or subordinate any claim.32 Though the court refused to exercise this power in the Calton Crescent case,33 deprivation of profits is a well-established technique for curbing...

310-21 (1937) and pt. III, 151 (1936). Thus, whether the purchases in the Calton Crescent case were motivated by inside information or anticipation of a post-war inflation of real estate values could not be established.

Moreover, in common law suits for fraudulent misrepresentation most jurisdictions adopt the unpredictable "special circumstances" doctrine laid down by the Supreme Court in Strong v. Repide, 213 U.S. 419 (1909). According to this rule, insiders need disclose inside information only when the court considers the circumstances of the transaction particularly inequitable for the security holder. Such circumstances have included prospective merger, McMynn v. Peterson, 186 Wis. 442, 201 N.W. 272 (1925); assured sale of corporate assets, Gammon v. Dain, 238 Mich. 30, 212 N.W. 957 (1927); impending declaration of dividends, Hotchkins v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932).

28. SEC Regulation X-10-B5 (SEC Release No. 3230, 1942). Although the standards of conduct imposed by this relatively new rule upon parties to a security transaction are as yet unexplored, material omissions would certainly fall within the scope of the rule. For discussions of liability under Rule X-10-B5, see Rubin & Feldman, Statutory Inhibitions Upon Unfair Use of Inside Information by Insiders, 95 U. of Pa. L. Rev. 463 (1947); Note, 59 Harv. L. Rev. 769 (1946).


31. Prevailing doctrine considers the corporate director a fiduciary to stockholders or creditors as a class, but not as individuals. The distinction is unrealistic. See Beale & Means, The Modern Corporation and Private Property, 222-7, 277-87 (1934).


33. In part this reluctance stemmed from a recognition that limitation would not benefit those bondholders from whom the insiders purchased their claims. 173 F.2d 944, 950