UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 17 | Number 1 Article 13

12-1-1938

Corporate Reorganization -- Bondholders' Committees -- Fiduciary Obligations

Oscar Leak Tyree

harsh. By excluding evidence of any fraudulent representation contradicted by the writing, "clear and convincing" proof of fraud in the inducement may often be prevented from reaching the jury, thus shielding a wrongdoer.

However, consideration of the California rule (excluding evidence of a promise made with intent not to perform where the promise is contradicted by the subsequent writing) might well lead to the conclusion that this more narrow restriction is a desirable one. By reason of the necessarily intangible nature of proof of the promisor's state of mind, *i.e.,* that at the time he made the promise he intended not to keep it, "clear and convincing" proof of this type of fraud can seldom be presented. Often the jury must draw the inference of such an intent from little more than evidence of the making of the promise and the non-performance of it. In this situation the written contradiction of the alleged oral promise would seem the more reliable evidence, where the promisee knew the terms of the writing.[20] In allowing the introduction of only the more reliable evidence, California and Texas make a commendable return to the spirit of the parol evidence rule in the face of modern tendencies[21] to render uncertain the finality of written instruments.

MARGARET CLOYD JOHNSON.

Corporate Reorganization—Bondholders' Committees—Fiduciary Obligations.

T executed a note secured by a pledge of securities, including bonds of the *Y* corporation in the amount of $61,000, to the appellant bank. Subsequently, the *Y* corporation defaulted on its bonds and a bondholders' protective committee was formed to receive bond deposits in order to seek a reorganization. The cashier of the appellant bank became the most active member of this committee.[1] The *Y* bonds held by the bank as collateral security were deposited by agreement between it and *T*, and a certificate of deposit was assigned to the bank. *T* failed to make a payment on the note and all collateral security was sold, being bought by the bank as a sole bidder for $5,000. On an attempt by the bank to prove a claim for the par value of the *Y* bonds in a proceeding in corporate reorganization, *held,* the bank acted under a fiduciary duty to the bondholders and was not entitled to profit from

[20] See (1936) 20 MINN. L. REV. 555.
[21] 3 JONES, COMMENTARIES ON EVIDENCE (2d ed. 1926) §§1487, 1518; 3 WILLISTON, CONTRACTS (rev. ed. 1936) §634.

[1] The bank was treated as a member of the committee by the court in this case. This disregard of the corporate entity in holding that the position of the cashier was the position of the bank seems reasonable on the facts of the case.

the purchase of the bonds but only to have its debt with *T* paid in full, which was done by the other securities furnished by *T*.[2]

One of the unfortunate results of the depression was a widespread default in real estate and corporate bond payments.[3] When bonds are in default protective committees, necessary because investors are so spread out that their interests can only be served by united action,[4] are formed. Bonds are deposited with them, and they seek a reorganization, usually by foreclosure and by setting up a new corporation which takes over the property that secured the bonds. New securities are issued to the old bondholders in exchange for certificates of deposit previously given them on depositing their bonds with the committee.[5] The past history of these committees is replete with abuses of their position by members.[6] The principal source of these abuses has been the broad powers conferred upon the committees by the deposit agreements together with the fact that the committees have usually been formed by the issuing house, as it has been the only one in possession of a list of bondholders.[7] Consequently reorganization is often more in the nature of a promotional scheme than a means for investors to readjust their losses. Aware of this, courts have begun to take a more active interest in the reorganization proceedings,[8] and recent

[2] *In re* Marquette Manor Bld'g Corp., 97 F. (2d) 933 (C. C. A. 7th, 1938).

[3] It was estimated that out of approximately ten billion dollars of outstanding real estate bonds, eight billion were in default. Report of the Sabath Committee, *Investigation of Real-Estate Bondholders' Reorganizations*, H. R. REP. No. 35, 74th Cong., 1st Sess. (1935).

[4] Cary and Brabner-Smith, *Studies in Realty Mortgage Foreclosures: V. Reorganization* (1933) 28 ILL. L. REV. 1.

[5] 2 GERDES, CORPORATE REORGANIZATIONS (1936) §§987-1014; Rohrlich, *Protective Committees* (1932) 80 U. OF PA. L. REV. 670. These committees serve a useful function in reorganizations not only where there has been a default, but also in reorganizations of going concerns. For example, see Dodge v. Commissioner of Corporations and Taxation, 273 Mass. 187, 174 N. E. 109 (1930).

[6] The earlier House of Representatives investigation (*supra*, note 3) was followed by a very comprehensive investigation by the Securities and Exchange Commission which sets out at length the practice of these committees. SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTION OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936-38); note (1935) 35 COL. L. REV. 905. Harigan v. Pound, 239 App. Div. 1, 265 N. Y. Supp. 676 (1st Dep't 1933), presents as an example of one of these issuing houses, the S. W. Straus & Co., and its practices. The opinion develops the interesting history of this company. Note (1933) 43 YALE L. J. 330.

[7] For an account of the practices used to secure deposits, see *Arbitration to the Rescue of the Mortgage Bondholders*, BUSINESS WEEK, Nov. 2, 1932, pp. 10-11. Rights of other committees and bondholders to obtain these lists are treated in *In re* International Match Corp., 59 F. (2d) 1012 (S. D. N. Y. 1932) (holding there is no right to these lists). *Contra:* Bergelt v. Roberts, 144 Misc. 832, 258 N. Y. Supp. 905 (Sup. Ct. 1932), *aff'd*, 236 App. Div. 777, 258 N. Y. Supp. 1086 (1st Dep't 1932).

[8] "Until the last twenty years, the courts, in no uncertain terms, expressed the view that they had no concern with the business of reorganization. . . . In latter years, it has been considered as within the court's jurisdiction to examine the proposed plan and pass upon its fairness." Bethlehem Steel Co. v. International Combustion Engineering Corp., 66 F. (2d) 409, 412 (C. C. A. 2d, 1933). The

legislation has replaced former Section 77 B of the Bankruptcy Act[9] with new Chapter X, which provides *inter alia* that a list of all bondholders of the defaulting company must be filed.[10] The new provisions, however, were not in effect at the time of the principal case.

Abuses of their position by committee members naturally led to the now well-established rule that the relationship between those members and the depositing bondholders is a fiduciary one.[11] There is an indication that the relationship extends to non-depositing as well as to depositing bondholders.[12] Since he is not to participate in the reorganization but to be paid off in cash, the non-depositor's interest is determined by the sale price of the property securing the bonds at foreclosure. As the committee is often the only one in a position to make a bid because of the large cash outlay necessary, it is apparent that important rights of his are subject to the will of the committee.

Once the fiduciary duty has been established, the mere purchase of the corporation's bonds by a member of the committee constitutes a breach thereof.[13] It might appear that it should make no difference to other bondholders whether a committee member or an outside party owned the bonds; and, in fact, such purchase might enhance the value of their interests, as the committee member would then have a greater

---

interest by the courts seems to date back to the period of the great railroad reorganizations, and arose out of the doctrine in Northern Pac. Ry. v. Boyd, 228 U. S. 482, 33 Sup. Ct. 554, 57 L. ed. 931 (1913).

[9] 48 STAT. 912, 11 U. S. C. A. §207 (1934).

[10] Pub. L. No. 696, 75th Cong., 3d Sess. (June 22, 1938), §§164, 165, U. S. C. (Current Service, 1938, No. 4) §§164, 165. There was a provision under 77B for the filing of lists, but it was discretionary and not mandatory, as is the provision under Chapter X. Under Chapter X, however, there is no absolute right to the use of these lists, but only such use as the court prescribes. For reference, in general, to the changes and effect of the new chapter on reorganizations, see SWANSTROM, CHAPTER TEN, CORPORATE REORGANIZATION UNDER THE FEDERAL STATUTE (1938); McCaffrey, *Corporate Reorganization Under the Chandler Bankruptcy Act* (1938) 26 CALIF. L. REV. 643; note (1937) 47 YALE L. J. 229.

[11] Bullard v. Cisco, 290 U. S. 179, 54 Sup. Ct. 177, 78 L. ed. 254 (1933); Parker v. New Eng. Oil Corp., 4 F. (2d) 392 (D. Mass. 1924); Mawhinney v. Canverse, 177 App. Div. 255, 102 N. Y. Supp. 279 (1st Dep't 1907); Bergelt v. Roberts, 144 Misc. 832, 258 N. Y. Supp. 905 (Sup. Ct. 1932), *aff'd*, 236 App. Div. 777, 258 N. Y. Supp. 1086 (1st Dep't 1932); note (1927) 41 HARV. L. REV. 377.

[12] Parker v. New England Oil Corp., 4 F. (2d) 392 (D. Mass. 1924); Bergelt v. Roberts, 144 Misc. 832, 258 N. Y. Supp. 905 (Sup. Ct. 1932), *aff'd*, 236 App. Div. 777, 258 N. Y. Supp. 1086 (1st Dep't 1932); Clinton Trust Co. v. 142-144 Joralemon St. Corp., 237 App. Div. 789, 263 N. Y. Supp. 359 (2d Dep't 1933) *semble*. *Contra:* Bund v. South Carolina Ry., 78 Fed. 49 (C. C. A. 4th, 1897).

[13] Johnson v. Loose, 201 Mich. 259, 167 N. W. 1021 (1918), (1918) 28 YALE L. J. 192; 3 BOGERT, TRUSTS AND TRUSTEES (1935) §§485, 543; Hart, *The Development of the Rule in Keech v. Sandford* (1905) 21 L. Q. REV. 258. The rigidness of the rule is explained by a desire to prevent ". . . the 'disintegrating erosion' of particular exceptions." Cardozo, C. J. in Meinhard v. Salmon, 249 N. Y. 458, 464, 164 N. E. 545, 546 (1928). For a comprehensive exposition of this concept of rigidity, see Newcomb v. Brooks, 16 W. Va. 32 (1879).

interest in the success of the reorganization, which might increase his diligence. Yet this rationale ignores the fact that the rule is one of rigidity, based on the twofold proposition that: (1) the fiduciary must exclude all selfish interest; and (2) act at all times for the benefit of his *cestui.* The committee member is treated as the trustee of an express trust.[14]

Earlier judicial decisions,[15] subsequently incorporated by the Chandler Act,[16] recognize that purchase is a breach of trust and deny the offending committeeman compensation for his services on the committee. To deny him not only compensation for his services but also all profit from the bond purchase seems a fairly infrequent penalty for this breach,[17] though under 77 B,[18] carried forward in the Chandler Act,[19] the trial judge is empowered to limit any claim by the committee member against the debtor to the actual consideration paid therefor, and there are several state statutes relative to ordinary trustees to the same effect.[20] But 77 B and the cases decided independently thereof, as well as the compensation cases and the Chandler Act, fail to distinguish speculative purchases from those made solely to protect the purchaser from loss on a loan on the security of the bonds.[21] To deny the committee member compensation for his services on the committee merely because he seeks to protect his loan is to ignore the reason for holding that purchases are a breach of the fiduciary duty. For this purpose the distinction should be made, although there would seem to be no reason to distinguish the two so as to allow either the speculator or purchaser for protection a profit on the bonds purchased.[22] Even under the present

[14] Bullard v. Cisco, 290 U. S. 179, 54 Sup. Ct. 177, 78 L. ed. 254 (1933). A trustee under an ordinary trust indenture commonly stipulates in that indenture that he may acquire bonds of the issue thereby secured. The trustee is usually allowed to take advantage of these stipulations before foreclosure, though it is possible they may be held to be against public policy. However, after foreclosure has been commenced and the trustee enters upon active duties for the bondholders, he is no longer permitted to exercise his stipulated privilege of purchase. See DOUGLAS AND SHANKS, CASES AND MATERIALS ON THE LAW OF FINANCING BUSINESS UNITS (1931) 137 (h).

[15] *In re* Paramount-Publix Corp., 12 F. Supp. 823 (S. D. N. Y. 1935); *In re* Republic Gas Corp., C. C. H. Decisions ¶4104 (S. D. N. Y. June 10, 1936) (not officially reported).

[16] Pub. L. No. 696, 75th Cong., 3d Sess. (June 22, 1938) §249, U. S. C. (Current Service, 1938, No. 4) p. 721, §249, BANKRUPTCY ACT, ch. X, §249.

[17] *In re* McCrory Stores Corp., 12 F. Supp. 267 (S. D. N. Y. 1935); *In re* McEwen's Laundry, Inc., 90 F. (2d) 872 (C. C. A. 6th, 1937) *semble.*

[18] 48 STAT. 912, 11 U. S. C. A. §207 (b) (10) (1934).

[19] See note 16, *supra.*

[20] CAL. CODE CIV. PROC. (Deering, 1931) §2263; S. D. COMP. LAWS (1929) §1219.

[21] The policy favoring the purchaser for protection as distinguished from the speculative purchaser is not as great where the loan is made *subsequent* to his becoming a member of the committee.

[22] "Claims of stock may, of course, be acquired or disposed of by gift or inheritance, levy of execution under judgments, foreclosure of pledges, or other

state of the law there is an indication in the principal case that the committeeman could have made the purchase and retained all the profits had he given all the other bondholders' notice of his intentions.[23] The giving of such notice is usually impracticable.

That the committee member in most cases may not profit by his purchase of the bonds of the insolvent corporation is admitted. But what may he do? As has been seen, 77 B and the Chandler Act provide that the trial judge "may limit any claim filed by such committee member . . . to the actual consideration paid therefor."[24] This would seem to limit the purchasing committee member to a maximum recovery of his actual outlay, which maximum recovery would occur only where the property securing the bonds was equal in value to their face value, and if this were the case it is almost inconceivable that the corporation itself would be insolvent. Usually, the return on the claim filed would be far below that of the face of the claim[25] with the result that the purchaser not only would make no profit but would lose. A more equitable rule would be one which allowed the purchaser to prove a claim equal to the par value of the bonds which he has bought but limited his return to the consideration that he paid for them. This would deny any profit to the purchaser which is the aim of the rule making purchase a breach of duty. If this result cannot be reached under a reasonable interpretation of the Statute it is suggested that the trial judge exercise the discretion vested in him and not impose the statutory penalty.

In the case of the foreclosure of pledges another question arises. What is meant by "consideration paid therefor"? Where the purchases are speculative the answer is obvious. But where the purchase is made to protect a loan does this phrase mean the amount bid at the sale, often merely nominal, or the amount of the loan? Assuming that only the bonds on sale secure the loan and that there is no possibility of collecting a deficiency judgment against the pledgor, the latter construction seems the more equitable, for, as the bonds represent the full return to the creditor-purchaser from his loan, there is no profit to him from this purchase if he be allowed to collect the amount of the loan. Analogous cases support this view.[26] However, if such a construction

---

methods unlikely to involve a breach of fiduciary duty." McCaffery, *supra* note 10, at 659.

[23] "The least appellant could have done was to notify all members of the committee of the sale, and under the circumstances we think it was obliged to see that all bondholders had notice." *In re* Marquette Manor Bld'g Corp., 97 F. (2d) 733, 735 (C. C. A. 7th, 1938). [24] See note 18, *supra.*

[25] Securities and Exchange Commission Report, *supra* note 6.

[26] McClean v. Bradley, 282 Fed. 1011 (N. D. Ohio 1922); Marr v. Marr, 73 N. J. Eq. 643, 70 Atl. 375 (1908).

is deemed unreasonable[27] it is again suggested under the court's discretion that the statute be not applied. If there are other securities protecting the loan it may well be argued that they must be sold and the funds received therefrom deducted from the amount of the claim of the purchasing committee member before he is allowed to receive more than the sum bid for the bonds at the foreclosure sale. Otherwise he would indirectly profit by the breach of his fiduciary duty not to purchase. An objection to this, however, is the enormous difficulty in accurately ascertaining how much of the sum bid for all the securities was bid for each.

In the principal case it would appear that the party really suffering because of the sale of the bonds was their pledgor, *T*. It has been seen that the purchase by the bank as a committee member is a breach of duty to the depositing bondholders as a group.[28] Is it also a breach as to *T* who is *one* of the depositing bondholders? There seems to be no authority on the precise point. The uniqueness of a situation in which the pledgor of bonds is also a depositing bondholder and the pledgee a member of the bondholders' committee furnishes an adequate explanation for this. There is a strong analogy in the relationship of a corporate director to stockholders in the corporation. In that situation the weight of authority denies that there is a fiduciary duty owed by the director to *individual* shareholders.[29] Yet a growing minority recognize that there is a fiduciary relationship and demand that the director make a full disclosure of all relevant facts known to him before purchasing shares.[30] For breach of this duty the stockholder may maintain a suit against the director for all profits he has made on the purchase.[31] Applying the minority rule to the facts of the principal case, it is evident that if the committee member's purchase was made without a dis-

[27] Strictly speaking "consideration paid" would mean only the sum bid at the foreclosure sale. Helvering v. Midland Mutual Life Ins. Co., 300 U. S. 216, 57 Sup. Ct. 423, 81 L. ed. 612 (1936), furnishes a persuasive analogy to this effect.

[28] See note 11, *supra*.

[29] Cahall v. Lofland, 12 Del. Ch. 299, 114 Atl. 224 (Ch. 1921); Hooker v. Midland Steel Co., 215 Ill. 444, 74 N. E. 445 (1905); Blabon v. Hay, 269 Mass. 401, 169 N. E. 268 (1929); Shaw v. Cole Mfg. Co., 132 Tenn. 210, 177 S. W. 479 (1915); White v. Texas Co., 59 Utah 180, 202 Pac. 826 (1921); O'Neile v. Ternes, 32 Wash. 528, 73 Pac. 692 (1903).

[30] Oliver v. Oliver, 118 Ga. 362, 45 S. E. 232 (1902); Dawson v. National Life Ins. Co. of U. S., 176 Iowa 362, 157 N. W. 929 (1916); Stewart v. Harris, 69 Kan. 498, 77 Pac. 277 (1904); Hotchkiss v. Fischer, 136 Kan. 530, 16 P. (2d) 531 (1932); FLETCHER, CYC. CORP. (Perm. ed. 1931) §1168; Bigelow, *The Relation of Directors of a Corporation to Individual Stockholders* (1915) 81 CENT. L. J. 256; Laylin, *The Duty of a Director Purchasing Shares of Stock* (1918) 27 YALE L. J. 731; Smith, *Purchase of Shares of a Corporation by a Director from a Shareholder* (1921) 19 MICH. L. REV. 698; note (1933) 19 CORN. L. Q. 103.

[31] Saville v. Sweet, 234 App. Div. 236, 254 N. Y. Supp. 768 (1st Dep't 1932); Commonwealth Title Ins. & Trust Co. v. Lettzer, 227 Pa. 410, 76 Atl. 77 (1910); Black v. Simpson, 94 S. C. 312, 77 S. E. 1023 (1913).

closure[32] of all facts which might have enabled T[33] to induce a friendly party to buy the bonds in for it, T has a cause of action against the committee member. This creates the anomalous situation in which the committee member is apparently liable to each of two separate parties for the whole of the profits he has made. However, that there may well be a fiduciary duty to the individual depositing bondholders is indicated in the principal case by its implication that the committee member could have retained the profits had he given adequate notice of his intentions to buy to *all* bondholders. It would seem highly inequitable to allow both of these parties to recover from the committee member, thereby subjecting him to a net loss equal to the profits he would have made but for the fiduciary duties. Indeed, if the member were compelled to surrender to the bondholders' committee all returns on the bonds above the amount he actually paid at the foreclosure sale rather than above the amount of his investment there would be an additional loss. If only one party is to recover the individual bondholder should be preferred as the bond purchase results in a positive loss to him.[34] The bondholders' committee suffers no such loss when it fails to receive the profits made by the committeeman, but remains in as good a position as it was before the purchase. The discipline of the offending committee member which is the object of the rule making him liable to the committee for all profits on his purchases of the insolvent corporation's bonds is effectuated equally well by giving the profits to the individual rather than to the group. Where, as usually will be the case in all probability, the individual bondholder has pledged other securities as well as the bonds for the loan to him, there is a well-nigh insurmountable difficulty in determining how much of the profit of the pledgee-committeeman who buys all the securities at the foreclosure sale may be attributed to the bonds. In speculative transactions where the bonds alone are bought the profit is ultimately ascertainable. A court of equity in the action of the individual bondholder against the offending committee member could retain the cause[35] until the member's claim for the face value of the bonds is realized in the cor-

[32] To make the bank disclose to T would necessitate its giving notice of sale when its pledge agreement allows sale without notice. In any case, *quaere* as to what disclosure would suffice to a pledgor. Of course, where the purchase is made directly from a bondholder who does not have to sell, disclosure could be made more simply.

[33] In speaking of the duty of a committee member to *non-depositing* bondholders, should this duty extend to parties in the position of T, if he were a non-depositing bondholder?

[34] We must not overlook the fact, however, that even if T has no recovery, he will be no worse off than the pledgor ordinarily is following a sale of pledged securities. The fiduciary duty, if it exists, is a coincidence.

[35] A possible alternative, but seemingly an undesirable one, would be to order an appraisal of all securities purchased by the creditor, and to order him to account to the individual bondholder for profits thus determined to have been made.

porate reorganization proceedings. The sum above the amount of the consideration paid for the bonds would then be held in trust for the individual bondholder.

OSCAR LEAK TYREE.

Criminal Law—Grand Juries—Independent Investigations.

Two recently considered legal problems have again brought to the forefront the long unanswered question as to the power of the grand jury to make, of its own motion, without a charge from the court or the solicitor, investigations into violations of the criminal law.

The grand jury of the Guilford Superior Court, serving during the first half of 1938, undertook, of its own motion, but with the knowledge of the judge and solicitor of that district,[1] to conduct an investigation of alleged fraudulent practices in the High Point Democratic primary of June 4, 1938. The probe was carried out through the subpoenaing of witnesses to appear and answer the grand jury's interrogations.[2] This investigation was not completed at the expiration of the jury's service; therefore, it made a report to the court, not based specifically on warrants, and pointed out several particular instances where the election laws had been violated.[3] The newly assigned judge denied the succeeding grand jury authority to proceed with the independent investigation of the alleged offenses before it made a presentment of the facts to the court.[4] This new grand jury was thus restrained from exercising the authority countenanced in its predecessor.

Recently the request of the grand jury of the Durham Superior Court for funds with which to employ special agents to assist it in making an investigation was denied on the ground that it lacked the authority to employ such special investigators, and that the county lacked the authority to supply funds for such a purpose.[5]

These instances raise questions as to: (1) whether the grand jury may, of its own motion, make an investigation of, and a presentment to the court concerning, violations of the criminal law with which it is acquainted through its own knowledge or observation; (2) whether it may so act upon information received from a third party; and if such an investigation is allowed, (3) whether it may subpoena witnesses to

[1] Greensboro Daily News, July 14, 1938, p. 18, col. 6.
[2] Greensboro Daily News, June 23, 1938, p. 1, col. 5; June 24, 1938, p. 22, col. 4.
[3] High Point Enterprise, July 12, 1938, p. 10, col. 1.
[4] *Ibid.*
[5] Durham Morning Herald, Oct. 5, 1938, p. 4, col. 2. In a letter to Hon. Leo Carr, dated Sept. 21, 1938, Assistant Attorney General Wettach expressed the opinion, in behalf of Attorney General McMullan, that there does not appear to be any express provision in the statutes which authorizes a county to employ special investigators to assist the grand jury; and that an outside detective agency could not be employed for this purpose without special legislative authority.