

THE ENFORCEMENT OF SECURED CREDITORS' CLAIMS UNDER 77 AND 77B: A FUNCTIONAL ANALYSIS

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INTRODUCTORY NOTE

The outstanding quality in John Howland's mind was integrity. He thought slowly, even painfully, assimilating his experience almost inch by inch. What he learned from it became an essential part of himself. He was one of those men who find themselves late and are almost compelled to force themselves to look at life. But in the process of self-discovery there developed in him an awareness of purpose, a resolution, and a courage that made certain for him a career of real distinction. For he had the type of character that never deserts an objective that it is determined to gain. He wrestled with his difficulties like a swimmer who battles with a heavy sea; but, when they were overcome, their defeat came to mean for him a mastery and definition of ends which gave him an inner assurance certainly destined to make him a man of significance. His early death was more than a loss to us who cared for him. It deprived the law of one who had come to see in its service the opportunity of a public devotion which illuminated his whole life. This paper is but a fragment of the purpose he had shaped for himself. It is yet, his friends believe, sufficient in its penetration and care, to make it clear why those who loved him recognized in his personality a promise destined to a high fulfilment.

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THE INSTITUTION of reorganization proceedings under the Bankruptcy Act invariably precipitates a conflict between secured creditors on the one hand, and the debtor, its stockholders and subordinate creditors on

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the other. Secured creditors desire to convert their collateral into cash at the earliest opportunity consistent with a maximum return on their investment; while the other interests prefer to maintain the collateral *in statu quo*, in the hope that the security will eventually be included in the property of the reorganized company. This latter purpose can be achieved only by enjoining the secured creditors from enforcing their claims, on the authority of the *Rock Island* case.¹ To the unwilling secured creditor this infringement of contract rights causes grave concern,² but to the other interests postponement represents a fair measure necessary to the success of the cooperative effort to reorganize. These conflicting desires must be reconciled by the reorganization courts with negligible assistance from the decided cases, for the applicable rules are still being formulated. In order to obtain some practical basis for these rules it is necessary to understand fully the effects of an order restraining secured creditors upon the business of banking and finance, and the practice of corporate reorganizations.

I.

For the purposes of this study, a primary distinction should be made between long and short term debts. A long term debt of a railroad or industrial corporation is usually evidenced by a bond or other instrument secured by a mortgage or deed of trust covering specific physical property; a short term debt, on the other hand, is generally evidenced by a collateral note or trust bond secured by a pledge of specific securities owned by the debtor.³ Although the difference in the form of the security device is not without legal import, the significance of the discrimination lies in the diversity in commercial function between long and short term secured credits and in the degree of liquidity of the collateral securing the debts.

Long term borrowing has become the recognized and orthodox method of obtaining capital for industrial development.⁴ This form of borrowing is characterized by the ultimate security of the collateral rather than

1. *Continental Ill. Nat. Bank & Trust Co. v. Chicago, R. I. & Pac. Ry.*, 294 U. S. 648 (1935), (1935) 48 HARV. L. REV. 1430, (1935) 30 ILL. L. REV. 240, (1935) 83 U. OF PA. L. REV. 913; Comment (1935) 33 MICH. L. REV. 1225.

2. See Paton, *Collateral as Affected by the Borrower's Bankruptcy* (1931) 24 AM. BANKERS A. J. 125.

3. Although the pledge device is typically associated with that form of financing, it is not necessarily restricted to short term credits; collateral trust bonds may be secured by a pledge of securities or other choses in action, and in the guaranteed mortgage field it was common to issue bonds secured by a pledge of mortgages. Cf. *In re Prudence Bonds Corp.*, 75 F. (2d) 262, 263 (C. C. A. 2d, 1935).

4. DEWING, *FINANCIAL POLICY OF CORPORATIONS* (3d ed. 1934) 82-97, 931-53, esp. at 940. The policy of issuing short term obligations in anticipation of the issue of long term bonds, on the assumption that interest rates are declining, is of comparatively recent origin; it is based similarly on the principle of liquidity.

by immediate liquidity. Experience has demonstrated that even in the absence of judicial restraint the collateral securing a long term debt cannot ordinarily be reduced to cash. Theoretically the bondholder or his representative has the power to foreclose and sell the collateral upon default and to apply the proceeds toward the payment of principal or interest. In practice, however, this power rarely—if ever—can result in the conversion of collateral into cash. The size and complexity of modern industrial enterprise make real liquidation of large mortgage debts impossible; an independent buyer who is prepared to pay a fair price can seldom be found in times of economic stress, and consequently a forced sale would be ruinous to creditors and debtors alike. For these reasons foreclosures of railroad or industrial mortgages have not resulted in sales in the ordinary business sense, but in reorganizations.⁵ Briefly, the procedure is that mortgage assets are bid in at a nominal price by a representative of the bondholders, and the property is transferred to a new company in which the bondholders receive in exchange for the old bonds a fractional interest as provided by the plan of reorganization.⁶ After the payment of all the foreclosure expenses from the small amount realized from the sale, whatever cash remains is made available to dissenters exclusively. These well-known infirmities, immanent in collateral securing long term obligations, apparently have never presented any serious impediment to the sale of long term bonds. Nor, presumably, where the debtor is undergoing reorganization pursuant to Section 77 or Section 77B of the Bankruptcy Act, will a restraint of the right of foreclosure have a disturbing effect on the long term money market.

The situation in the case of short term credits, however, is directly the contrary.⁷ Short term credits are usually provided by commercial banks, by investment bankers or others interested in the preservation of the debtor corporation, and, in some cases, by government agencies or by the public through its subscription to issues of short term notes. These short term credits owe their existence to the exigencies of temporary financing; they constitute a type of emergency security which comes

5. See Craven and Fuller, *The 1935 Amendments of the Railroad Bankruptcy Law* (1936) 49 HARV. L. REV. 1254, 1269; Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganizations* (1933) 19 VA. L. REV. 541, 554; 1 GERDES, CORPORATE REORGANIZATIONS (1936) 110.

6. In cases where the mortgage is owned by a single creditor the problem is not quite so complex, but liquidation of the security is rarely attained. The mortgagee will usually buy in the property, in many instances only after a protracted and expensive foreclosure proceeding, and he will probably be required to hold the property indefinitely for a rise in the market. See Oppenheim, *Sales of Property in Bankruptcy* (1934) 29 ILL. L. REV. 67.

7. On the subject of short term financing see DEWING, *op. cit. supra* note 4, at 937; Hatch, *A Form of Depression Finance—Corporations Pledging Their Own Bonds* (1934) 47 HARV. L. REV. 1093.

into popular use during periods of acute economic depression.⁸ Railroads and industries unable to meet fixed charges and operating expenses must resort to borrowing in order to escape the waste and expense incident to bankruptcy or reorganization.⁹ But at these times the stringent money market makes it impossible to borrow long term funds by the sale of bonds at reasonable rates in the open market.¹⁰ It becomes essential, therefore, to borrow from the banker on short term paper secured by collateral of a more fluid nature. Demand for collateral is particularly apparent in periods of banking difficulties, when the volume of frozen bank loans is mounting in proportion to threatened extraordinary demands by depositors. In the usual case, the collateral will consist chiefly of securities owned by the debtor, including securities of the debtor or its affiliated companies.¹¹ Liquidity is insured by the terms of pledge agreements, which ordinarily provide that collateral may be sold by the pledgee immediately upon default. In actual practice this ideal—rapid conversion of collateral into cash—is not always attained in cases involving sales of a considerable amount of collateral. In these instances collateral is frequently bought in by the creditor who may dispose of the securities on the open market from time to time.¹² Despite the imperfections of the pledge device in that regard, however, this characteristic—liquidity—is so fundamental that any restriction upon the exercise of the power of sale results in serious apprehension in banking circles and brings forth the prediction that short term credit may not be available in the future.¹³ As one court said, "Nothing would be more disturbing to transactions of that kind . . ." ¹⁴

Prior to the adoption of Sections 77 and 77B of the Bankruptcy Act, the distinction between long and short term credit was recognized by

8. DEWING, *op. cit. supra* note 4, at 939.

9. In the single year 1932, the railroads issued over \$1,000,000,000 in mortgage bonds; the bulk of these bonds were issued as collateral securing short term loans of approximately \$650,000,000. U. S. Daily, Jan. 18, 1933, p. 2005, col. 4. An examination of the Interstate Commerce Commission finance dockets covering approvals of Reconstruction Finance Corporation loans indicates that probably 90% of the issues were typical of the kind under discussion. *E.g.*, Chicago & N. W. Ry., 180 I. C. C. 533 (1932); Missouri Pac. R. R., 184 I. C. C. 3 (1932); New York Cent. R. R., 184 I. C. C. 737 (1932); Southern Ry., 187 I. C. C. 331 (1932); Baltimore & Ohio R. R., 187 I. C. C. 323 (1932).

10. DEWING, *op. cit. supra* note 4, at 940, n. e., 941, n. f.

11. On the pledge of the debtor's own bonds see Hatch, *loc. cit. supra* note 7.

12. *E.g.*, collateral held by short term bank creditors of Insull Utilities, Inc., was bought in by the creditors when sold pursuant to the pledge agreement in August, 1935. See STANDARD BOND DESCRIPTIONS, Bond Bulletin Section, p. 1146 (1937).

13. See McGinnis, *The Sale of Collateral Security by the Pledgee Thereof After the Intervention of the Bankruptcy of the Pledgor* (1934) 9 IND. L. J. 195, 219; Paton, *loc. cit. supra* note 2. And see note 43, *infra*.

14. *In re Hudson River Navigation Corp.*, 57 F. (2d) 175, 176 (C. C. A. 2d, 1932).

bankruptcy and reorganization courts, though in most cases not for the reasons here presented. In bankruptcy it was generally held that the court had jurisdiction to enjoin the foreclosure of a mortgage¹⁵ if the necessary conditions were present¹⁶ but had no jurisdiction to forbid the sale of pledged securities in accordance with the terms of the pledge contract.¹⁷ A similar rule prevailed in equity reorganization practice.¹⁸ Since the pledge contract is characteristic of short term financing, the rule against restraining foreclosure sales in effect recognized the difference between long and short term credits in the need for liquidity. But, except for isolated cases¹⁹ the distinction between foreclosure of mortgages and pledges was placed not upon that ground, but upon the theory that summary bankruptcy power depended upon actual or constructive possession of the assets by the debtor at the time of the petition.²⁰ That the distinction is legalistic rather than functional is apparent from statements that the sale of pledged property could not be enjoined even in

15. See *Isaacs v. Hobbs Tie & Timber Co.*, 282 U. S. 734, 738 (1931); *Straton v. New*, 283 U. S. 318, 321 (1931); Comment (1932) 41 YALE L. J. 445.

16. A sale of mortgaged property was enjoined in bankruptcy only if there was an actual or potential equity in the property which would be sacrificed by a foreclosure sale. *In re Morris White Holding Co.*, 52 F. (2d) 499 (S. D. N. Y. 1931); see *Central States Life Ins. Co. v. Kopljar*, 80 F. (2d) 754, 757 (C. C. A. 8th, 1935); cf. *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555, 584 (1935); *In re Schulte United, Inc.*, 49 F. (2d) 264 (C. C. A. 2d, 1931).

17. *Jerome v. McCarter*, 94 U. S. 734 (1876); *Hiscock v. Varick Bank*, 206 U. S. 23 (1907); *In re Hudson River Nav. Corp.*, 57 F. (2d) 175 (C. C. A. 2d, 1932). *Contra*: *In re Henry*, 50 F. (2d) 453 (E. D. Pa. 1931). But see criticism of the decision in Paton, *supra* note 2, at 126. A permanent restraint against the sale of collateral has been issued where the collateral consisted of unsecured obligations of the debtor. *John Matthews, Inc. v. Knickerbocker Trust Co.*, 192 Fed. 557 (C. C. A. 2d, 1911).

18. *Guaranty Trust Co. v. Galveston City R. R.*, 87 Fed. 813 (C. C. A. 5th, 1893); *International Banking Corp. v. Lynch*, 269 Fed. 242 (C. C. A. 9th, 1920); *Northern Pac. Ry. v. Frank Waterhouse & Co.*, 279 Fed. 750 (W. D. Wash. 1922). *Contra*: *Cherry v. Insull Utility Investments, Inc.*, 58 F. (2d) 1022 (N. D. Ill. 1932), *rev'd on other grounds, sub nom. Guaranty Trust Co. v. Fentress*, 61 F. (2d) 329 (C. C. A. 7th, 1932).

19. *In re Hudson River Nav. Corp.*, 57 F. (2d) 175 (C. C. A. 2d, 1932); *Rogers Brown & Co. v. Tindell Morris Co.*, 271 Fed. 475 (E. D. Pa. 1921); *In re Chaiken*, M. D. Pa. 1933, (1933) 10 AM. BANKR. REV. 14. This functional approach is expressed in *In re Hudson River Nav. Corp.*, *supra*, at 176:

"Millions of dollars are daily lent upon like collateral, which fluctuates from hour to hour; unless the pledgee is free to choose his time to sell, his security may disappear. The same is not indeed true of shares like those at bar, or of notes, neither of which vary rapidly in value; but the same legal reasons exist as to them also. The pledgee, having taken possession of the documents, supposes himself for just that reason to be the sole judge of his necessities, and lends on that understanding. So long as he keeps within the terms of the agreement, he need not concern himself with the pledgor's fate, or that of his creditors, who must stand in his shoes . . ."

20. See cases in notes 17 and 18, *supra*.

cases where the pledge device had been used to secure long term debts.²¹ Although based on principles of property rather than commercial practice, the discrimination in favor of pledge contracts as distinguished from mortgage contracts undoubtedly afforded a desirable means of insuring liquidity in short term financing. It is probably true that "business has adapted its transactions to this line"²² by using the pledge device in short term loans. Thus, prior to the enactment of Sections 77 and 77B of the Bankruptcy Act, business needs and legal concepts had attained a position of approximate assimilation.

II.

From the creditor's point of view the enactment of Sections 77 and 77B of the Bankruptcy Act accentuated the desire for an unrestricted right to foreclose, particularly in the case of short term debts. Under these amendments it became possible for two-thirds of a class to bind the remainder to any plan of reorganization²³ found by the court²⁴ to be fair and equitable.²⁵ As applied to long term creditors this provision is not a radical innovation; it is merely an improved method of accomplishing the same result as the sale in an equity reorganization.²⁶ But, as applied to short term creditors such as commercial banks, the provision carries a definite threat. A single short term creditor might be compelled to accept a plan of reorganization which involved a drastic change in his status, such as the surrender of all collateral in exchange for stock. This was not the case in equity reorganizations. While the plan must be found to be fair and equitable, the sharp change from previous reorganization practice in this regard and the different concepts of an impartial plan naturally breed distrust among short term creditors and increase their desire to escape, if possible, from the threat of coercion.²⁷

21. See, e.g., *In re Prudence Bonds Corp.*, 75 F. (2d) 262, 263 (C. C. A. 2d, 1935).

22. *Rogers Brown & Co. v. Tindell Morris Co.*, 271 Fed. 475, 476 (E. D. Pa. 1921).

23. BANKRUPTCY ACT § 77 (e), 49 STAT. 1969, 11 U. S. C. § 205 (e) (Supp. 1936); § 77 B (b), 48 STAT. 913, 11 U. S. C. § 207 (b) (1934).

24. In railroad reorganization the plan must be approved by the Interstate Commerce Commission [BANKRUPTCY ACT § 77 (d), 49 STAT. 917 (1935), 11 U. S. C. § 205 (d) (Supp. 1936)] as well as by the court [BANKRUPTCY ACT § 77 (e), 49 STAT. 1969, 11 U. S. C. § 205 (e) (Supp. 1936)].

25. Although doubts have been expressed, the provision is generally believed to be constitutional. *Campbell v. Alleghany Corp.*, 75 F. (2d) 947 (C. C. A. 4th, 1935), *crt. denied*, 296 U. S. 581 (1936); see 1 GERDES, CORPORATE REORGANIZATIONS § 32; 2 *id.* § 1038.

26. 1 GERDES, CORPORATE REORGANIZATIONS § 17; Frank, *supra* note 5, at 709; Friendly, *Some Comments on the Corporate Reorganizations Act (1934)* 48 HARV. L. REV. 39, 48.

27. Note the strenuous efforts of J. P. Morgan & Company to avoid being placed in the same class as the Reconstruction Finance Corporation in the Missouri Pacific

Under Section 77B(b)(5)²⁸ a plan may be imposed on an entire class despite unanimous opposition by the members of the class. This can be accomplished in any of four ways:²⁹ first, by transfer, sale, or retention of the property subject to existing liens; second, by sale of the property at a fair upset price with a transfer of the liens to the proceeds of the sale; third, by appraisal and payment in cash of the value of these liens or, at the creditors' election, of the value of the securities awarded to these liens under the plan; or finally, by any method which will afford adequate protection under the circumstances of the particular case.³⁰

With the possible exception of the fourth alternative, the Act probably insures long term creditors a degree of protection at least as effective as that offered them in equity reorganizations.³¹ But as applied to short term secured creditors the Act has again somewhat drastically changed reorganization practice. Before these amendments the short term pledgee-creditor could always sell his collateral at public sale and, if necessary, bid it in himself to hold for a possible rise in price; but he is now faced with the threat that his collateral may be valued during a period of rock-bottom prices and the cash equivalent paid to him in lieu of it.³² Furthermore, under the fourth alternative the court apparently has broad and discretionary power to force upon an entire class of short or long term creditors any plan which it thinks will "equitably and fairly protect

reorganization. *In re Missouri Pac. R. R.*, 13 F. Supp. 888 (E. D. Mo. 1935), *aff'd*, 85 F. (2d) 351 (C. C. A. 8th, 1936), *cert. denied*, 57 Sup. Ct. 230 (1936).

28. BANKRUPTCY ACT § 77B (b) (5), 48 STAT. 913, 11 U. S. C. 207 (b) (5) (1934). For the corresponding sections of the Railroad Reorganization Act see BANKRUPTCY ACT § 77 (e), 49 STAT. 1969, 11 U. S. C. § 205 (e) (Supp. 1936).

29. As Frank points out, where several alternatives are available, the tendency will be to select the one which is least favorable to the class or interest involved. Frank, *supra* note 5, at 708.

30. In view of the Supreme Court's decision in *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555 (1935), the constitutionality of the third and fourth alternative methods presented by the statute is open to serious doubt. The fourth alternative was in fact found unconstitutional in *In re Tennessee Pub. Co.*, 81 F. (2d) 462 (C. C. A. 6th, 1936). *aff'd on other grounds, sub nom. Tennessee Pub. Co. v. American Nat. Bank*, 299 U. S. 18 (1936). Friendly [*Amendment of the Railroad Reorganization Act* (1936) 36 COL. L. REV. 27, 35] takes the position that no creditor may be deprived of his collateral, without sale, in the absence of the consent of a majority of his class, however reasonable the substitute may be. To the contrary see Craven and Fuller, *supra* note 5, at 1276; Frank, *supra* note 5, at 708-10.

31. 2 GERDES, CORPORATE REORGANIZATIONS § 1067. This generalization may be inapplicable to the single mortgage creditor. Under equity and bankruptcy practice, he might be enjoined from collecting his debt if the debtor's estate had a potential equity in the property, but he was not reorganized out of his collateral against his will. See note 16, *supra*.

32. The short term bank creditor is thus placed in a position analogous to that of the dissenter in equity reorganizations.

the creditor under all the circumstances of the particular case." While experience acquired since the enactment of those amendments does not indicate that their coercive provisions often result in serious injury to the secured creditors,³³ the possibility of loss is sufficient to cause secured creditors to try to withdraw from the reorganization tribunal by the foreclosure route.

Thus, at the inception of a 77B proceeding the secured creditor may adopt one of several courses: he may decide to participate in the reorganization, despite the risk that an unfavorable plan may be imposed upon him and that he may be injured by the delay inherent in all reorganizations, or he may choose to take no chances and decide to escape, if possible, from this threat of coercive action by foreclosing on his collateral. That the short term creditor will choose the second alternative, if it is available, goes without saying. This decision raises two problems: first, whether the reorganization court may enjoin both the long and short term creditor classes from foreclosing on their collateral; and second, if such power exists, when it may be exercised. The Supreme Court decision in the *Rock Island* case³⁴ definitely answers the first question but leaves the second in a state of doubt and ambiguity.

Shortly after filing a petition under Section 77 of the Bankruptcy Act, the Rock Island Railway moved for an injunction restraining five bank creditors and the Reconstruction Finance Corporation from selling the securities pledged to secure their claims. The railroad owed these short term creditors in the aggregate less than \$18,500,000, and as security for these obligations had deposited collateral of an aggregate par value of over \$54,000,000. Except for one item of \$1,400,000, the collateral was of three kinds: bonds of the debtor railroad, bonds of subsidiaries which the debtor had guaranteed, and bonds of subsidiaries which the debtor had not guaranteed. The District Court and the Circuit Court of Appeals had found that the sale of this system collateral would completely prevent the preparation and consummation of a plan of reorganization. This conclusion, which the Supreme Court accepted largely upon the findings of the lower courts,³⁵ was based on the contentions that the

33. In fact, the courts seem to have indicated an extremely conservative approach to this question, and have been reluctant to approve any plan unless all classes of secured creditors consent to it. *In re Murel Holding Corp.*, 75 F. (2d) 941 (C. C. A. 2d, 1935); *In re Tennessee Pub. Co.*, 81 F. (2d) 462 (C. C. A. 6th, 1936); *Preble Corp. v. Wentworth*, 84 F. (2d) 73 (C. C. A. 1st, 1936); *Francisco Building Corp. v. Battson*, 83 F. (2d) 93 (C. C. A. 9th, 1936).

34. *Continental Ill. Nat. Bank & Trust Co. v. Chicago, R. I. & Pac. Ry.*, 294 U. S. 648 (1935).

35. *Id.* at 678. "These concurrent findings of the two courts, as this court has often held, should be accepted as conclusive unless clearly erroneous. *United States v. Commercial Credit Co.*, 286 U. S. 63, 67 [1932]; *Stuart v. Hayden*, 169 U. S. 1, 14 [1898]; *Dun v. Lumbermen's Credit Ass'n.*, 209 U. S. 20, 23, 24 [1908]."

sale of the collateral might precipitate similar action by creditors holding \$145,000,000 of additional system collateral, and that the sale of this collateral from time to time during the reorganization proceedings might require changes in details of the plan which would involve new and, perhaps, difficult reconciliations of the views of many essentially diverse interests and might force an abandonment of the proceedings.³⁶

Upon considering all the factors, the Supreme Court held that under Section 77 of the Bankruptcy Act³⁷ a reorganization court had power to enjoin a short term creditor secured by a pledge of the debtor's securities. This involved an abandonment of the long established theory that a bankruptcy court had jurisdiction only over property *in custodia legis*,³⁸ such as mortgages held by long term creditors, and that in the absence of possession, as in cases where securities were held in pledge by short term creditors, no injunction could be issued.³⁹ There was no express provision in Section 77 upon which this result could be founded. But in its desire to uphold Section 77 and promote its operation and effectiveness, the Court found sufficient basis for the new rule in the fact that a bankruptcy court is "a virtual court of equity," and further in the general provisions of Section 2(15) of the Bankruptcy Act and Section 262 of the Judicial Code — neither of which had theretofore been considered available for this purpose.⁴⁰

This decision enables the reorganization court to cut off the escape of both long and short term creditors from the delays and dangers inevitable in reorganization proceedings. It is a powerful weapon. If

36. It was contended that since a substantial amount of the collateral consisted of bonds of the debtor, or bonds of the debtor's subsidiaries which the debtor had guaranteed, the sale of these securities would have disturbed the mechanics of the reorganization by creating new classes of creditors and increasing the amount of claims outstanding in existing classes.

37. Although the decision was based on the BANKRUPTCY ACT § 77, the principle is applicable to 77B proceedings generally. *In re Prudence Co., Inc.*, 82 F. (2d) 755 (C. C. A. 2d, 1936), *cert. denied*, 298 U. S. 685 (1936).

38. Despite the Court's holding that physical possession was unnecessary, the old theory of *custodia legis* still perseveres. See *In re Lake's Laundry, Inc.*, 79 F. (2d) 326, 328 (C. C. A. 2d, 1936), *cert. denied*, 296 U. S. 622 (1936), where the court refused to enjoin conditional vendors from repossessing equipment sold to the debtor. *Cf. In re Adolph Gobel, Inc.*, 80 F. (2d) 849 (C. C. A. 2d, 1936); *In re Prudence Co., Inc.*, 82 F. (2d) 755 (C. C. A. 2d, 1936).

39. The reasoning of the Court seems to cast great doubt on existing bankruptcy and equity reorganization precedents. If under § 77 a bankruptcy court may enjoin a pledgee where a foreclosure threatens the success of a reorganization, why cannot the same court enjoin a pledgee where a sale would hinder successful liquidation? That question was specifically reserved by the Court for future determination.

40. It should also be noted that the Court considered constitutional objections to the exercise of the power to restrain and overruled them on the ground that the remedy, not the contract right, was being impaired. Realistic bankers may disagree. See Paton, *supra* note 2, at 127.

hastily and improvidently used, this power is capable of inflicting injurious consequences upon both creditor and debtor interests, particularly in the field of short term finance.

As already pointed out, liquidity is the essential and predominant characteristic of short term finance. If the use of injunctions becomes widespread, banks and other sources of short term credit,⁴¹ faced with the delay,⁴² expense and dangers of a reorganization proceeding, will avoid making loans which may sustain a hard-hit company long enough for it to survive a depression.⁴³ It follows that large railroad and industrial corporations may be compelled to issue long term bonds during periods of unfavorable markets at excessive discounts.⁴⁴ In that case, the effect would be to swell the debt structure and perhaps permanently burden the debtor with greater fixed charges. If this avenue of temporary financing is not available, bankruptcy would seem the only other course.

And if creditor interests become fearful of the dangers of promiscuous injunctions, foreclosures will become more frequent during the crucial period in which the debtor is striving to escape bankruptcy. Short term creditors who might otherwise be inclined to grant debtors reasonable indulgence, apprehensive of an unreasonable delay, will naturally rush to foreclose whenever it becomes fairly evident that resort to the reorganization or bankruptcy statutes will be made. The close relationship that often exists between the borrowing corporations and their

41. Banks have been the principal source of short term credit during the depression years. HARDY AND VINER, REPORT ON THE AVAILABILITY OF BANK CREDIT IN THE SEVENTH FEDERAL RESERVE DISTRICT (Treas. Dep't 1935).

42. Protracted delay has been especially characteristic of the reorganization of American railroads. Between 1894 and 1931 the average duration of the railroad receiverships of roads operating more than 100 miles was in excess of 4 years, and apparently there is not much promise that proceedings under §77 will be materially expedited. Many have been pending for over three years and none has been completed; one has been dismissed. See 49 I. C. C., STATISTICS OF RAILWAYS IN THE UNITED STATES (1937) S-9.

43. It seems agreed that the danger that short term creditors may not be permitted to sell their collateral has a direct and adverse effect on the short term credit market. Paton, *supra* note 2, at 126. For this reason Congress amended §77 (j) of the Bankruptcy Act to deprive the court of power to enjoin the enforcement of equipment trust obligations, which are essentially of a short term nature. The principal argument in favor of the amendment was that it was necessary to restore the confidence of the market in obligations of that kind. Further, in enacting §74 of the Bankruptcy Act, Congress limited jurisdiction to enjoin the enforcement of debts to cases where the court had actual or constructive possession of the property because any other rule would "further restrict credit." SEN. REP. NO. 1215, 72d Cong., 2d Sess. (1933) 5.

In *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555, 595 (1935) Mr. Justice Brandeis pointed out that the Frazier-Lemke Act was made inapplicable to future mortgages for fear that the farmers' credit facilities would be destroyed. See REPORT OF NATIONAL BANKRUPTCY CONFERENCE (1935) 35 (tentative draft).

44. DEWING, *op. cit. supra* note 4, at 940.

bankers will insure the bankers of timely warning of the impending event.

In addition, the participation of short term creditors in the reorganization will result in increased bankers' domination. During the reorganization process this may be manifested by banker control over reorganization committees⁴⁵—with a resulting increase in reorganization fees and expenses.⁴⁶ After reorganization this mastery may appear through bank ownership of a majority⁴⁷ or a controlling minority of the voting stock.⁴⁸ In cases where creditors receive a controlling share of the stock of the reorganized company, their desire for liquidity will create conflicts as to the policies of the new company. A conservative policy of quick realization of assets might fit the desires of bank creditors, but other interests which have sustained a much greater loss as a result of the failure of the enterprise, hoping for larger future gains, will prefer to keep the corporation's property intact.⁴⁹

The banker is likely to sell his block of stock in the new company at the first favorable opportunity. This may result in a transfer of control from the commercial banker to the investment banker and a resultant uncertainty of policy during the early and delicate period of the new company's existence, a development which may not be to the best interests of the minority shareholders.⁵⁰

45. See Lowenthal, *The Railroad Reorganization Act (1933)* 47 HARV. L. REV. 18; Lowenthal, *The Stock Exchange and Protective Committee Securities (1933)* 33 COL. L. REV. 1293.

46. Under §77B (c) (9) the district court has discretionary power to make an allowance out of the estate to creditors' attorneys for services rendered in the reorganization. The inclusion of pledged property in the estate undergoing reorganization increases administrative costs.

47. An instance where secured bank creditors were awarded voting control of a reorganized corporation is presented in *In re Middle West Utilities Co.*, N. D. Ill., Nov. 27, 1935; in that case the bank creditors received 51.65% of the stock in the new company.

48. See generally BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

49. This problem worried the unsecured creditors and shareholders in *In re Middle West Utilities Co.*, N. D. Ill., Nov. 27, 1935. It was finally solved when the bank creditors agreed to name only four of the nine directors during the initial term of office and to include in the by-laws a provision that no asset having a book value in excess of \$500,000 could be sold without consent of two-thirds of the entire board; the controlling directors were named by the court. In this manner it was hoped that the danger of an immediate liquidation of the new company by the banking interests would be avoided.

50. An illustration of this point is also presented by the Middle West Utilities reorganization. Recently two investment bankers announced that they had purchased from the Continental Illinois Bank & Trust Company 475,000 shares, constituting 14.3% of all outstanding shares, which the bank held in the reorganized company. See N. Y. Times, Aug. 19, 1936, p. 31, col. 5.

Eliminating the threat of a sale of the collateral likewise removes a powerful incentive for consummating and completing a plan. Within the sheltering haven of an injunction, the debtor may simply wait—at the expense of the creditor. If waiting proves the wrong policy, the creditor loses. If conditions change for the better, the creditor is paid off or a compromise reached—all, apparently, at the option of the debtor. This situation results from the change in bargaining power incident to the injunction. A reorganization is essentially a bargaining process between creditors and security holders; the final plan turns largely on the position of the respective parties. A creditor able to foreclose has one position. A creditor unable to foreclose has another; separated by injunction from mortgage collateral, he has almost no bargaining power at all, and may be dealt with lightly in the timing of the reorganization.

In short, if exercised without discrimination, the power to restrain the enforcement of secured creditors' claims may destroy the sources of short term credit and thereby force needy borrowers into bankruptcy; it may precipitate foreclosures by secured creditors upon the first indication that their debtors contemplate resorting to the reorganization statutes; it may increase reorganization costs and expenses; it may enhance banker-control of the reorganization and the new company; and finally, it may remove an effective stimulus to speedy reorganization. To avoid these consequences, it is essential that the power be sparingly exercised.

Once it is recognized that the power to restrain the sale of collateral should be employed with caution, the limitations beyond which the *Rock Island* case should not be applied appear with greater clarity.

First, under the *Rock Island* case, secured creditors may be restrained from selling their collateral "if a sale would so hinder, obstruct and delay the preparation and consummation of a plan of reorganization as probably to prevent it."⁵¹ Whether an injunction will be granted even in such cases rests in the court's discretion. No distinction was made in this respect between short term (pledgee) and long term (mortgagee) creditors. But the Court did point out that "A claim that injurious consequences will result to the pledgee or the mortgagee may not, of course, be disregarded by the district court; but it presents a question addressed not to the power of the court but to its discretion . . ." ⁵² Thus, the district court may take into consideration the fact that an injunction restraining the sale of collateral securing short term debts constitutes a much greater destruction of the creditors' expectations than an in-

51. *Continental Ill. Nat. Bank & Trust Co. v. Chicago, R. I. & Pac. Ry.*, 294 U. S. 648, 675 (1935).

52. *Id.* at 677.

junction restraining the sale of collateral securing long term indebtedness. Because of this and the other considerations already mentioned, a stronger showing may be required before the court will exercise its discretion in the case of short term debts. While the powers of the court are the same, whether long or short term creditors are involved, the considerations controlling the exercise of the discretionary power are different. And the burden of proving that the power should be exercised clearly rests with those who desire that a restraining order be issued or maintained.⁵³

Second, injunctions should be granted only when the threatened sale may reasonably be expected seriously to impede or destroy the effort to reorganize. The *Rock Island* case presented such a situation. The collateral, which was worth more than the outstanding debts, consisted almost entirely of bonds issued by the debtor or bonds of debtor's subsidiaries, many of which had been guaranteed by the debtor. The sale of this collateral might well have precipitated sales by other creditors, and a resultant continuing fluctuation of outstanding claims. As the court pointed out, that, in turn, "might require such change of detail in the plan, entailing new and perhaps different reconcilements of views among many and conflicting interests, as to force an abandonment of the proceeding."⁵⁴ A similar determination may be expected where the collateral held by secured creditors constitutes an integral and necessary part of the debtor's property without which the debtor cannot continue in business; where the sale of the collateral would destroy a valuable equity of the debtor;⁵⁵ or where because of abnormal market conditions the sale might result in an unreasonably large deficiency claim which would overbalance the claims of other interests and threaten the success of the reorganization proceedings.⁵⁶

Third, an injunction should not be granted unless it appears that the debtor will be reorganized within a reasonable time. Reorganization proceedings have in many cases become a haven of refuge for well-meaning but deluded debtors for whom there is no hope of salvation. Without any real equity in their properties, most of which are pledged or encumbered by mortgages, and without profitable sources of income, they cling to their corporate lives, hoping that a miracle may rescue them from disaster. In other cases, the rehabilitation of the debtor can be

53. *Foust v. Munson Steamship Lines*, 299 U. S. 77 (1936); *Guaranty Trust Co. v. Henwood*, 86 F. (2d) 347, 354 (C. C. A. 8th, 1936); *In re Murel Holding Corp.*, 75 F. (2d) 941 (C. C. A. 2d, 1935) *semble*; *In re Coney Island Hotel Corp.*, 76 F. (2d) 126 (C. C. A. 2d, 1935) *semble*.

54. *Continental Ill. Nat. Bank & Trust Co. v. Chicago, R. I. & Pac. Ry.*, 294 U. S. 648, 679 (1935).

55. *In re Prudence Bonds Corp.*, 77 F. (2d) 328, 331 (C. C. A. 2d, 1935).

56. *Central States Ins. Co. v. Kopljar*, 80 F. (2d) 754 (C. C. A. 8th, 1935) *semble*.

accomplished only with material concessions by shareholders or creditors — concessions which they emphatically refuse to make.⁵⁷ In such instances it seems clear that secured creditors should not be restrained from disposing of their collateral. The debtor and subordinate interests may be willing "to stay under the umbrella" indefinitely, and the court, sympathizing with the debtor's predicament, may wait patiently for better days before terminating the reorganization proceedings and directing a liquidation. But these visionary expectations do not furnish the basis for an injunction restraining the enforcement of secured creditors' claims.⁵⁸ A mere flicker of hope may be sufficient to justify the continuation of reorganization proceedings, but it hardly sustains the imposition of a restraint upon the rights of secured creditors.

Fourth, where the pledged or mortgaged property is worth less than the amount of the liens on it, the sale of the property should not be restrained unless the property is essential for the continued operation of the debtor's business. In many cases, particularly those involving short term creditors, the collateral consists of property which is not an integral part of the debtor's business, such as stocks, bonds, accounts receivable, or other choses in action acquired during the course of the debtor's operations. Where the debtor has no equity in it, the sale of the collateral would not retard or hamper the reorganization. Consequently there would seem to be no basis for enjoining the sale of the security.

Fifth, the sale of collateral should not be enjoined in cases where the security cannot be brought within the plan of reorganization. In many instances, secured creditors constituting more than one-third of a class will accept a plan of reorganization deemed fair by the court only if the collateral is surrendered to them. In these cases the court is powerless to include the collateral in the property to be held by the reorganized company unless the debtor or other parties to the reorganization are willing to adopt one of the alternatives provided in Sections 77(e) or 77B(b)(5)—the transfer of the property to the reorganized company subject to existing liens or an appraisal and payment in cash of the value of the liens. But in most instances reorganizations cannot succeed unless the amount of outstanding claims is reduced; retention of existing liens would frustrate the major purpose of the reorganization. Further, generally no cash is available for the purpose of paying creditors the full value of their liens. Thus, the alternatives presented by Section

57. Cf. *In re* 235 W. 46th St. Co., Inc., 74 F. (2d) 700 (C. C. A. 2d, 1935); *Manati Sugar Co. v. Mock*, 75 F. (2d) 284 (C. C. A. 2d, 1935); *In re* Murel Holding Corp., 75 F. (2d) 941 (C. C. A. 2d, 1935); *In re* Coney Island Hotel Corp., 76 F. (2d) 126 (C. C. A. 2d, 1935); *In re* Island Park Associates, 77 F. (2d) 334 (C. C. A. 2d, 1935).

58. *In re* Murel Holding Corp., 75 F. (2d) 941 (C. C. A. 2d, 1935).

77B(b)(5) often will not provide a satisfactory solution where more than one-third of a creditor class is unwilling to accept any plan of reorganization which does not provide for the surrender of the collateral.⁵⁹

When an impasse develops from which the provisions of Sections 77(e) or 77B(b)(5) afford no escape, it would seem useless to restrain creditors from enforcing their claims, for ultimately the collateral will have to be surrendered to them. Power to restrain creditors is necessarily founded upon the possibility of bringing the security within the plan of reorganization. When that is impossible in these cases, the stay serves a useful purpose no longer and its continuation can hardly be justified.⁶⁰

It is apparent that promiscuous injunctions restraining the sale of collateral held by short term creditors may have widespread and harmful repercussions on the business of banking and finance and on sound reorganization practice. The power should be sparingly exercised and limited to reorganizations in which injunctions are clearly necessary to promote the common good. Each case must stand on its own bottom; but certain general rules and principles suggest themselves. If adapted to the special needs of the individual reorganization, the rules should result in a satisfactory adjustment of the conflicting interests of secured creditors on the one hand, and the debtor, its shareholders and subordinate creditors on the other.

59. A third alternative may be presented by §§ 77 (e) and 77B (b) (5) (d); under these sections it can be argued that the reorganization court may impose a fair and equitable plan upon an entire dissenting class. But there is considerable doubt whether this power exists and whether it is constitutional. See note 28, *supra*.

60. Cf. *In re Coney Island Hotel Corp.*, 76 F. (2d) 126 (C. C. A. 2d, 1935); *In re Commonwealth Bond Corp.*, 77 F. (2d) 308, 309 (C. C. A. 2d, 1935).