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### BEYOND *YALE EXPRESS*: CORPORATE REORGANIZATION AND THE SECURED CREDITOR'S RIGHTS OF RECLAMATION

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#### I. INTRODUCTION

The advantages of the reorganization of a financially embarrassed corporation, where feasible, over a bankruptcy liquidation were apparent to debtors and creditors and their attorneys long before the initial federal statutory recognition of the procedure in 1934.<sup>1</sup> Through reorganization the going concern value

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<sup>1</sup> In 1934 Congress passed § 77B of the Bankruptcy Act, Act of June 7, 1934, ch. 424, § 1, 48 Stat. 912, a provision covering corporate reorganization. § 77A, 11 U.S.C. § 205 (1970), covering railroad reorganization, had been passed a year earlier. The purpose of these sections was to codify the already well-developed procedure of the federal equity receivership, and to eliminate some of its obvious abuses. Those abuses centered upon the delivery of the benefits from the preservation of the going concern value of the corporation to those groups which were legally and equitably least entitled to them—existing management and, perhaps grudgingly, the stockholders, without whose support management could not survive. This delivery could take place only by ignoring the hierarchy of claims (debt, subordinated debt, equity) as developed under state law and

of the enterprise, often its single most valuable asset but one which upon a distress bankruptcy sale of the real assets would realize nothing for the creditors, is preserved.<sup>2</sup> This preservation becomes possible because "legal failure," the inability of the corporate assets to meet the legally enforceable creditor demands against those assets,<sup>3</sup> can take place independently of, and without being followed by, "economic failure," a permanent inability to earn a reasonable net return on the capital invested commensurate with the risk involved.<sup>4</sup>

Legal failure might result from overcapitalization, an excess of capital in the business which must be paid for even though unused or underused; an unnecessarily topheavy capital structure, where earnings cannot support the debt service; change in public demand for the company's products, which change, though disastrous in the short run, could be coped with over the longer haul; or dishonesty or incompetence of management, which can be replaced. The common theme is that in such situations it is often possible to salvage more for the interested parties<sup>5</sup> through a continuation of an economically sound busi-

the contractual provisions governing the obligations. In 1938, § 77B was pronounced inadequate, and replaced by the current Chapters X, XI, and XII of the Bankruptcy Act; the railroad reorganization provisions remain intact. Chapter X, 11 U.S.C. §§ 501 *et seq.* (1970), the general corporate reorganization chapter, is the focus of this Article.

<sup>2</sup> "Going concern value" in this context means the excess of value in the business enterprise over the liquidation value of the real assets. Such value is generally determined by a capitalization of the earnings of the enterprise. The difference between the two figures represents "good will," a highly valuable asset if the business is continued but typically worthless upon liquidation. Of course, if the business fails to have any net earnings over any substantial period of time there is not even a question of the preservation of going concern value, and litigation is probably the only course. *See generally* 1 A. DEWING, FINANCIAL POLICY OF CORPORATIONS 284-90 & nn.j-o (5th ed. 1953).

<sup>3</sup> This concept of legal failure is written into the bankruptcy definition of "insolvency":

A person shall be deemed insolvent within the provisions of this title whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts . . . .

Bankruptcy Act § 1(19), 11 U.S.C. § 1(19) (1970).

This definition applies in Chapter X reorganization proceedings. Bankruptcy Act § 102, 11 U.S.C. § 502 (1970). The equitable definition of insolvency or the inability to pay debts as they mature, will suffice for the filing of a Chapter X petition. Bankruptcy Act § 130(1), 11 U.S.C. § 530(1) (1970).

<sup>4</sup> For an extensive development of these concepts, see 2 A. DEWING, *supra* note 2, at 1214.

<sup>5</sup> At this point, "interested parties" is used to include only creditors of and holders of equity in the debtor corporation. A broader concept of "interestedness" will be developed later in this Article.

ness with going concern value and a concomitant waiver of some of their rights than through an immediate liquidation of the business' tangible assets at distress prices.

For better or worse, not every insolvent corporation can or should be reorganized. Petitions for reorganization are sometimes filed purely as a dilatory tactic, to buy a little time for management before the inevitable liquidation. The success of some reorganizations will depend upon the infusion of new capital, often in massive doses, which will not be forthcoming. In perhaps the largest number of insolvencies, business failure and economic failure, as defined above, do coincide and there is no possibility of reorganization. Finally, in some cases reorganization, while technically feasible, may be economically unwise, "placing crutches under corporate cripples"<sup>6</sup> and misallocating economic resources which could be more profitably and productively utilized in more viable enterprises. Nevertheless, it can scarcely be doubted that a fair, economically sound reorganization is infinitely preferable to a liquidation for all concerned.

Typically a successful reorganization in lieu of a liquidation operates to the benefit of the junior creditors and, occasionally, the stockholders. To the fully secured creditor, the method of debt adjustment should make little difference, other than with respect to the delay inherent in the reorganization system, for, absent fraud or the most egregious insolvency, he will come out of either type of proceeding reasonably whole, unless he runs afoul of a substantive provision of the Bankruptcy Act avoiding his security interest, which provisions operate in Chapter X and XI proceedings as well as in ordinary bankruptcy.<sup>7</sup> In the case of a successful Chapter X reorganization this result is assured by the absolute priority doctrine engrafted onto such reorganizations by the Supreme Court in the progeny of *Northern Pacific Ry. v. Boyd*.<sup>8</sup>

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<sup>6</sup> *Price v. Spokane Silver & Lead Co.*, 97 F.2d 237, 247 (8th Cir.), cert. denied, 305 U.S. 626 (1938).

<sup>7</sup> Bankruptcy Act §§ 60, 70c, 70e, 102, 302, 11 U.S.C. §§ 96, 110c, 110e, 502, 702 (1970).

<sup>8</sup> 228 U.S. 482 (1913). The progeny include *Kansas City T. Ry. v. Central Union Trust Co.*, 271 U.S. 445 (1926); *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939); and *Consolidated Rock Prods. v. DuBois*, 312 U.S. 510 (1941) (the last two under Bankruptcy Act § 77B, ch. 424, § 1, 48 Stat. 912 (1934)). Lower courts have held that the absolute priority doctrine developed in the earlier cases was carried over to Chapter X of the Bankruptcy Act by the "fair and equitable" standard for approval and confirmation of a plan. Bankruptcy Act §§ 174, 221(2), 11 U.S.C. §§ 574, 621(2) (1970). *E.g.*, *In re General Stores Corp.*, 147 F. Supp. 350, 353 (S.D.N.Y. 1957). Essentially, the absolute

Partially secured and unsecured creditors will fare better or worse in a liquidation depending upon the extent to which unencumbered assets exist. Obviously, if there is more than one class of general unsecured creditors, by agreement of the creditors themselves, the degree of insolvency of the company becomes more important to each group of creditors as one moves down the line. Thus those interested parties who look to the proceeds from liquidation of the debtor's unencumbered assets, and for whom little or nothing would remain because of statutory and contractual priorities, benefit most from a reorganization in which they participate, for they will either receive a larger return than they would have received upon liquidation, retain a claim against a viable entity, or some combination thereof. Extensive possibilities exist, however, for the short circuiting of what may have been a successful reorganization, to the detriment of all those who stand to benefit. These possibilities are inherent in the constitutional and statutory protection afforded secured creditors.<sup>9</sup>

Chapter X and case law evolving from it and its predecessors have attempted to balance the protection of the rights of secured creditors against the interests of other parties in seeking a successful reorganization. The balance reached is such that, to the extent the secured creditor's position is not maintained virtually intact throughout the proceeding, he will often be able to sabotage the reorganization effort through repossession of, or foreclosure upon, his collateral, which may be essential to the continuing operation of the enterprise.<sup>10</sup> If, for example, the collateral is depreciating, the secured creditor can appropriately maintain that the continuing deprivation of his right to repossess

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priority doctrine requires that each class of creditors, in order of seniority, must receive the "indubitable equivalent" of full compensation upon its claims pursuant to the plan before the next junior class of creditors is entitled to receive anything at all upon its claims. See *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935). Thus, a fully secured creditor, the most senior type, must be fully compensated by any plan or there can be no plan, in which case his foreclosure upon his collateral is unaffected by the liquidation of the debtor's estate.

<sup>9</sup> "Secured creditors" in this context refers to holders of consensual security interests in the debtor's real or personal property. The term does not refer to holders of statutory liens or liens obtained through judicial process.

<sup>10</sup> The ultimate success of virtually any Chapter X proceeding will depend upon the continued operation of the business during the course of the proceeding by the trustees (or in some very small cases, by the debtor in possession). A shutdown of the operations even temporarily will have a devastating effect on the chances of rehabilitation, given the loss of workers, cash flow, etc.

or foreclose is doing him irreparable injury, contrary to his constitutional and statutory rights. Accordingly, unless the maintenance of his position can be assured, such as through periodic payment to him of the economic depreciation of the collateral, the secured creditor, with nobody's interest but his own in mind, may be able to force a termination of the reorganization effort.<sup>11</sup>

It is submitted that such a result is indefensible. It is bot-tomed upon a glorification of the expectations of the secured creditor as somehow more sacrosanct than those of other inter-ested parties, too narrow a view as to just who is "interested" in a successful reorganization, and an outmoded philosophy of bankruptcy, and *ergo* reorganization, as a self-contained, self-supporting system of equity for which the immediate partici-pants must pay. Although taking a first step, the proposed Bank-ruptcy Act of 1973<sup>12</sup> does not go far enough in rectifying this unbalance.

With a wider perspective of the interests involved in success-ful corporate reorganization, it is apparent that the public has a sufficiently significant stake in the process to justify some public subsidy in instances where an otherwise viable reorganization effort must be terminated because of the constitutional protec-tion accorded secured creditors. That public subsidy, in the few cases where it was needed, should take the form of a credit against the federal income tax liability of the secured creditor equal to the difference between the recovery the secured credi-tor would have had, had he been allowed immediately to re-claim his collateral upon the filing of the reorganization petition—that is, the fair market value of the collateral less esti-mated costs of repossession and sale—and the ultimate recovery from sale of the depreciated collateral and any other payment in discharge of the secured debt when an unsuccessful reorganiza-tion effort was terminated. Thus only in instances where 1) the position of the secured creditor on the filing date cannot be maintained during the course of the proceeding, and 2) the good faith reorganization effort is unsuccessful, would the pro-posed credit be needed.

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<sup>11</sup> Such a situation was at least partially responsible for the failure of reorganization proceedings in *Detroit Trust Co. v. Campbell River Timber Co.*, 98 F.2d 389 (9th Cir. 1938); *In re Newjer Contracting Co.*, 154 F. Supp. 567 (D.N.J. 1957); *In re Stevens Enterprises*, 148 F. Supp. 12 (E.D. Pa. 1957); *In re Sun Cab Co.*, 67 F. Supp. 137 (D.D.C. 1946).

<sup>12</sup> See notes 81-92 *infra* & accompanying text.

It is submitted that the benefits to be gained by evaluating each reorganization effort on its legal and economic merits rather than permitting prematurely termination because of the private considerations of secured creditors justify the public subsidy, particularly in light of the probable infrequency with which the device will actually be needed.

## II. THE ECONOMIC FUNCTION OF SECURED CREDIT

The primacy of the secured creditor's interests in the bankruptcy context results from the crucial role he plays in the economy as a whole. Typically the secured creditor is a lender of money in some sense, distinguishing him from the trade creditor, the supplier of goods and services.<sup>13</sup> Thus, the mortgagee of real property, the purchase money vendor, the factor or other commercial financier, and the holders of the corporation's mortgage bonds, represented by an indenture trustee, all provide the company, either directly or indirectly, with capital with which to carry on its business. In the context of any particular enterprise it may be difficult to comprehend why such creditors should receive far more protection than the trade creditors, whose goods and services may be just as crucial to the profitability of the enterprise as the capital provided by the secured creditors. Analytically, the trade creditor who refuses to deliver goods or services except for cash can have just as devastating an effect upon the operations of a shaky enterprise as a secured lender who insists upon exercising his rights pursuant to his security agreement. Perhaps the rationale is that upon demand for payment upon delivery by a trade creditor, the secured lender will often be the only source of funds, and thus entitled to the prerogatives of a savior after all.

No such difficulties of analysis are confronted when comparing secured lenders with unsecured lenders to determine the function of secured credit in the economy in general. In this context, the function of the secured loan is clearly to reduce

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<sup>13</sup> This statement is to some extent borne out by the findings of J. Eric Fredland. Fredland, *The Business Bankrupts*, in 3 REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES (1973) [hereinafter cited as *Fredland Study & Commission Report*]. Fredland found that about 75% of both his business failure sample and his going concern sample had secured loans, although there were wide divergences on this figure by industry type. *Id.* 10. The majority in number of creditors of failed firms were unsecured. *Id.* 10 n.19.

substantially the risk of nonpayment. Normally, the interest rate charged upon loans, above the rate charged on perfectly "safe" loans, is the measure of the risk of nonpayment.<sup>14</sup> However, there are practical, economic and sometimes legal limitations on interest rates. At some point a venture becomes so questionable that no rate of interest would be adequate compensation for the risk of nonrepayment; and at some point, presumably reached much sooner, the rate required for adequate compensation to cover the risk is completely unacceptable to the would-be borrower. Thus, the function of secured credit in our economy is to make capital available to those who, for whatever reason, cannot compete for it in a market whose legal tender is the rate of interest. Capital is not, nor can it sensibly be, available to all borrowers on equal terms. To the extent that interest rates fail to serve effectively as a catalyst outside of a fairly narrow range of cases, the security device takes up the slack on the riskier end of the spectrum.<sup>15</sup> Thus the institution of secured credit, which makes capital available to high risk enterprises which could not otherwise obtain it, is making a vital, and perhaps an irreplaceable, contribution toward economic expansion.

The adoption of article nine of the Uniform Commercial Code by forty-nine states and the District of Columbia by the mid-1960's undoubtedly contributed heavily to the growth and popularity of the secured credit device, for pursuant to article nine the reasonably careful secured creditor can very easily obtain a valid and enforceable security interest in personal property with a minimum of technicalities. Gone is the bewildering variety of pre-UCC security devices, each of varying validity

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<sup>14</sup> The rate of interest charged on "safe" loans, in addition to the time preference rate of the lender, reflects two other measures as is painfully apparent in the current climate of skyrocketing rates. First, the interest rate reflects the scarcity of credit as related to the demand for credit, the normal supply and demand function performed by the price level of any commodity. Second, the interest rate acts as a hedge against inflation, to assure the creditor that he will be repaid in real terms at least as much money as he loaned, plus an additional amount as compensation for the transaction. Thus, in this era of both high inflation and high interest rates, a 15% stated interest rate on a transaction may represent only a 3% return to the lender in terms of the buying power of the dollars received.

<sup>15</sup> Fredland provides some corroboration for this hypothesis in his finding that businesses in his failure sample were more likely to have gone to secured lending sources than those in his going concern sample. *Fredland Study, supra* note 13, at 179. From this finding it can be inferred that the security device functions to bring credit into the hands of businesses (and individuals) who could not afford the interest rate which the lender would have to charge to justify the risk taken.

in different states, each with its own technicalities which themselves differed from state to state. The current ease and uniformity surrounding perfection of security interests undoubtedly has contributed to the growth of secured credit and, therefore, the economy. It has also resulted in an unprecedented domination of bankruptcy and reorganization proceedings by this single group of creditors, often to the severe detriment of other interested groups.<sup>16</sup>

To the extent that the creation and enforcement of secured transactions are facilitated by the law, as by article nine, the costs of credit are restrained and its availability will extend deeper into the region in which interest rates cannot compensate the lender for the risk taken, without reaching a level unacceptably high to the would-be borrower. Conversely, to the extent that the legal system restricts the creation and enforcement of security interests, credit becomes less available, and the first to suffer will be those enterprises which could not obtain credit on an unsecured basis. If the bankruptcy laws prevent, impede, or even delay the enforcement of security agreements, the possible bankruptcy of the borrower must be considered as carefully by a secured as by an unsecured lender in determining the price to be charged for his capital. To the extent that such hindrances exist, they act as an upward force on the price of credit, and thus constitute a restraint on the expansive effect of article nine.

Clearly, the marginal cases, those most likely to wind up in a bankruptcy proceeding, will feel the restraint first; the effect will be to deny the possibility of a bailout to a company which might have been saved. However, the economic effect of bankruptcy impediments to the enforcement of secured credit transactions goes well beyond such marginal cases, for the anticipated costs of nonenforcement caused by bankruptcy in any one case must be spread to all other secured lending transactions. While the contingency of nonenforcement will not affect all potential borrowers equally, since the stronger would just have to pay more for their credit, while the weaker would be denied credit altogether, its effect on the cost of credit, and thereby upon economic growth, is undeniable.

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<sup>16</sup> Unfortunately, with the universal adoption of the Uniform Commercial Code, it is often the case that the only function to be performed by a bankruptcy proceeding is the determination of the priority of secured creditors *inter se*; it is already the rare case where there are any substantial assets left for distribution to general unsecured creditors.



### III. THE SECURED CREDITOR AND CHAPTER X

The promotion of economic growth is not the principal, or even a secondary, purpose of the American bankruptcy system. Nevertheless, the bankruptcy system does not operate in a vacuum. Its effect upon other political and economic goals can scarcely be ignored. The present Chapter X of the Bankruptcy Act<sup>17</sup> contains a balance between protection of the debtor and protection of the secured creditor which reflects the policies and assumptions of the era which produced it.

No provision of Chapter X specifically addresses the protection of secured creditors, other than the special-interest protection for aircraft and water carriers provided by sections 116(5)<sup>18</sup> and (6)<sup>19</sup> respectively, and National Housing Act mortgages by section 263.<sup>20</sup> Rather, the general safeguards written into the procedure protect the interests of secured as well as other general creditors. Before a Chapter X reorganization can proceed, the judge must approve the petition as having been filed in good faith.<sup>21</sup> A petition is deemed not to be filed in good faith if, *inter alia*, "adequate relief would be obtainable by a debtor's petition under the provisions of Chapter XI of this Act,"<sup>22</sup> or "it is unreasonable to expect that a plan of reorganization can be effected."<sup>23</sup> Secured creditors are shielded from a Chapter X reorganization, a form of relief which can and probably will alter their rights, when a Chapter XI arrangement of unsecured creditors, a less drastic form of relief which will, at least in theory, leave their rights unaffected, is sufficient to rehabilitate the corporation. All interested parties are protected against a dissipation of the debtor's assets when it is reasonably apparent initially that rehabilitation is a fond, or desperate, figment of management's imagination.<sup>24</sup> The appointment of a disin-

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<sup>17</sup> Bankruptcy Act § 101 *et seq.*, 11 U.S.C. § 501 *et seq.* (1970).

<sup>18</sup> Bankruptcy Act § 116(5), 11 U.S.C. § 516(5) (1970).

<sup>19</sup> Bankruptcy Act § 116(6), 11 U.S.C. § 516(6) (1970).

<sup>20</sup> Bankruptcy Act § 263, 11 U.S.C. § 663 (1970).

<sup>21</sup> Bankruptcy Act § 141, 11 U.S.C. § 541 (1970).

<sup>22</sup> Bankruptcy Act § 146(2), 11 U.S.C. § 546(2) (1970).

<sup>23</sup> Bankruptcy Act § 146(3), 11 U.S.C. § 546(3) (1970).

<sup>24</sup> While purchased time may result in some benefits to the interested parties, such as through collection of accounts receivable or sale of inventory in the ordinary course of business, an ultimately unsuccessful reorganization allowed to proceed too long is more likely to result in a smaller pot of assets available for liquidation and distribution, given the costs of continued operation of the business in Chapter X and the double administra-

terested trustee in virtually all cases<sup>25</sup> is further protection against dissipation of assets by overexuberant management. Since the court must fix a time within which the trustee shall prepare and file a plan,<sup>26</sup> the period of experimentation with other people's property is limited by the court's sense of fair play. In most cases the plan of reorganization must be submitted to the Securities and Exchange Commission for its recommendations,<sup>27</sup> and must be approved by the court before being sent to creditors for their approval.<sup>28</sup> The most important standard for approval by the judge, as well as for confirmation, is that the plan be "fair and equitable, and feasible."<sup>29</sup> Even if the secured creditors' rights are interfered with in accordance with the provisions to be examined below these words of art, with their precisely understood meanings, offer the final compensation to secured creditors for rights postponed or negated.<sup>30</sup>

On the other side of the coin, a plethora of statutory provisions and judicial decisions impede, or prevent, the enforcement of the contractual rights of secured creditors pending the outcome of the proceeding. In 1966, the Second Circuit in *In re Yale Express System, Inc.*<sup>31</sup> overruled a leading case<sup>32</sup> holding that jurisdiction of the reorganization court to stay enforcement of the remedial rights of creditors whose debts were collateralized by the property at issue in the proceeding, depended upon the debtor's possession of title. Under *In re Lake's Laundry*, the reorganization court had jurisdiction to stay reclamation of property on which the creditor held a chattel mortgage, but not the reclamation of property sold pursuant to a conditional sales

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tion expenses (for the Chapter X and the ordinary bankruptcy liquidation proceedings) incurred.

<sup>25</sup> Only in instances where the indebtedness of the debtor, liquidated as to amount and not contingent as to liability, is less than \$250,000 does the judge have discretion not to appoint a trustee. Bankruptcy Act § 156, 11 U.S.C. § 556 (1970).

<sup>26</sup> Bankruptcy Act § 169, 11 U.S.C. § 569 (1970).

<sup>27</sup> Only where the scheduled indebtedness is less than \$3,000,000 may the judge, in his discretion, dispense with submission of the plan to the Securities and Exchange Commission. Bankruptcy Act § 172, 11 U.S.C. § 572 (1970).

<sup>28</sup> Bankruptcy Act § 174, 11 U.S.C. § 574 (1970).

<sup>29</sup> Bankruptcy Act §§ 174, 221(2), 11 U.S.C. §§ 574, 621(2) (1970).

<sup>30</sup> For the meaning of "fair and equitable," see cases cited note 8 *supra*. A plan is "feasible" if "the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities [issued pursuant to the plan]." *Consolidated Rock Prods. v. DuBois*, 312 U.S. 510, 525 (1941).

<sup>31</sup> 250 F. Supp. 249 (S.D.N.Y.), *rev'd* 370 F.2d 433 (2d Cir. 1966).

<sup>32</sup> *In re Lake's Laundry*, 79 F.2d 326 (2d Cir.), *cert. denied*, 296 U.S. 662 (1935).

agreement, since in the latter instance title never passed to the debtor. Passage of the Uniform Commercial Code rendered any such distinction obsolete, since article nine does not distinguish between types of security devices depending upon where title lies. Now, if the debtor has an interest in the asset in question which rises to the level of "property" the reorganization court will have jurisdiction over it, and the assertion of the secured party's rights thereto will have to win the approval of that court.

Several overlapping provisions of Chapter X operate to stay the commencement or continuation of all actions in any court other than the reorganization court, and the enforcement of liens, whether or not with judicial assistance. Section 113<sup>33</sup> provides that prior to the approval of the petition the judge may order temporary stays for cause shown; proposed Bankruptcy Rule 10-601<sup>34</sup> would have the filing of the petition result in an automatic stay. Upon the approval of the petition the judge may stay any such actions until final decree;<sup>35</sup> the approval of the petition operates as an automatic stay of a "prior pending bankruptcy, mortgage foreclosure, or equity receivership proceeding, and of any act or other proceeding to enforce a lien against the debtor's property."<sup>36</sup> Again, the adoption of proposed Bankruptcy Rule 10-601 will move the discretionary stage from the application for the stay, initiated by the debtor, to the application for relief from the stay, initiated by the creditor but with the burden of persuasion remaining on the debtor.

Aside from the stay procedures, the provision most immediately threatening to the secured creditor's margin of safety

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<sup>33</sup> 11 U.S.C. § 513 (1970).

<sup>34</sup> Proposed Bankruptcy Rule 10-601 would have the filing of the petition result in an automatic stay. Rules of Practice and Procedure for bankruptcy have now been adopted, pursuant to authority conferred upon the Judicial Conference of the United States by 28 U.S.C. § 331 (1970), for ordinary bankruptcy, Chapter XI, and Chapter XIII proceedings. Bankruptcy Rules for Chapter X proceedings have, at the time of this writing, not yet been submitted by the Committee on Rules of Practice and Procedure of the Judicial Conference to the Supreme Court for its approval. However, a proposed draft of such rules has been circulating since October 1972. COMM. ON RULES OF PRACTICE & PROCEDURE OF THE JUDICIAL CONFERENCE OF THE UNITED STATES, PRELIMINARY DRAFT OF PROPOSED BANKRUPTCY RULES & OFFICIAL FORMS UNDER CHAPTER X OF THE BANKRUPTCY ACT (1972) [hereinafter cited as PROPOSED BANKRUPTCY RULES].

<sup>35</sup> Bankruptcy Act § 116(4), 11 U.S.C. § 516(4) (1970).

<sup>36</sup> Bankruptcy Act § 148, 11 U.S.C. § 548 (1970). Adoption of proposed Bankruptcy Rule 10-601 would move the judge's discretionary control over the stay from the point of the application to stay, initiated by the debtor, to the point of the petition for relief from the stay, initiated by the creditor. PROPOSED BANKRUPTCY RULES, *supra*, note 34.

is section 116(2) of the Bankruptcy Act,<sup>37</sup> authorizing the judge to approve the issuance by the trustee of certificates of indebtedness "upon such terms and conditions and with such security and priority in payment over existing obligations, secured or unsecured, as in the particular case may be equitable." The potential damage to secured creditors' interests from inequitable application of this power is too obvious to belabor.

Finally, even if two-thirds of a class of creditors, including otherwise fully secured creditors who have been barred from realizing upon their collateral, refuse to accept a plan, the plan may nevertheless be confirmed, provided the plan, or order confirming the plan, provides, *inter alia*, "adequate protection for the realization by them of the value of their claims against the property dealt with by the plan and affected by such claims."<sup>38</sup> Thus, while a plan can be "crammed down" the throats of a class of unwilling creditors, adequate protection, as determined in the sound discretion of the court, must be provided.

This catalogue of restraints upon the ability of the secured creditor to realize upon his collateral becomes meaningful only in the context of the facts and needs of an actual reorganization proceeding. Virtually all of these provisions, which have a significant potential effect on creditors' rights, are precatory, their actual operation resting in the sound discretion of the reorganization court.

Any such discretion, however, is tempered by the protection given creditors against dilution of their collateral in a reorganization proceeding by a thoroughly confusing body of case law, purporting to be bottomed upon the requisites of the fifth amendment and the fair and equitable standard. To the extent that this protection has constitutional underpinnings, any dilution of the interests of secured creditors in order to permit reorganization attempts in more cases becomes impracticable.

#### IV. THE SECURED CREDITOR AND THE CONSTITUTION

The notion that the bankruptcy power of Congress granted by article I, section eight, clause four is limited by the fifth amendment appears to have sprung Athena-like from the brow

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<sup>37</sup> 11 U.S.C. § 516(2) (1970).

<sup>38</sup> Bankruptcy Act § 216(7), 11 U.S.C. § 616(7) (1970). This provision is popularly referred to as the "cram-down" power of the reorganization court.

of Mr. Justice Brandeis.<sup>39</sup> Writing the Court's opinion in *Louisville Joint Stock Bank v. Radford*<sup>40</sup> declaring certain provisions of the Frazier-Lemke Act of 1933<sup>41</sup> unconstitutional, Brandeis listed five crucial rights denied by the statute, leaving the provision fatally infirm as a taking of the secured creditors' property without due process of law: (1) The right to retain the lien until the indebtedness is paid; (2) The right to realize upon the security at a public sale; (3) The right to determine when such sale shall be held, subject only to the discretion of the court; (4) The right to protect its interest in the property by bidding at such sale; and (5) The right to control the property during the period of default, subject only to the discretion of the court, and to have the rents and profits collected by a receiver for satisfaction of the debt.<sup>42</sup> The opinion gave no indication whether these rights were individually or only collectively sacrosanct, or to what extent Congress could affect such rights without constitutional impropriety.<sup>43</sup>

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<sup>39</sup> The early cases involving the definitional problems of the term "bankruptcy" as used in the Constitution were very broad in their approach to the power of Congress in this area. *In re Reiman*, 20 Fed. Cas. 490 (S.D.N.Y. 1874). Surely there is nothing self-evident, or even particularly compelling, about the notion that the exercise of one power of Congress specifically granted by the Constitution is limited by another, seemingly coequal, constitutional provision. That Mr. Justice Brandeis so asserted, without benefit of analysis, is rather extraordinary. In fairness to him, however, the prior case of *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181 (1902), has been cited in support of the proposition that such a limitation allows Congress only to discharge the debtor from future, as opposed to past, encumbrances. *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 451 (1937). *Hanover* itself is not clear. The issue there arose from a contention of the petitioners that the lack of notice to creditors of the filing of a bankruptcy petition was a due process violation. The Court recast the argument in terms of whether the short time between adjudication and discharge was an unreasonable restriction on the right to oppose discharge. The Court held that, in the view of "the plenary power of Congress, the subject-matter of the suit, and the common rights and interests of the creditors," the argument of unreasonableness was untenable. The Court then added: "Congress may prescribe any regulations concerning discharge in bankruptcy that are not so grossly unreasonable as to be incompatible with fundamental law, and we cannot find anything in this act on that subject which would justify us in overthrowing its action." 186 U.S. at 192. Thus, the most that can be said for *Hanover* is that it established that there is a point beyond which Congress could not go, but gave no hint what the limitations are or whether they are defined by the fifth amendment.

<sup>40</sup> 295 U.S. 555 (1935).

<sup>41</sup> Act of June 28, 1934, ch. 869, 48 Stat. 1289. Designed as emergency New Deal legislation to cope with the plight of the farmer, the provisions dealt with agricultural compositions and extensions.

<sup>42</sup> 295 U.S. at 594-95.

<sup>43</sup> It must be kept in mind that the *Radford* opinion came at the height of the "substantive due process" vogue. As will be seen, its basic holding regarding the existence of a limitation has been reaffirmed many times, although the content of the limitation remains very vague.

As amended,<sup>44</sup> the Frazier-Lemke Act was upheld by the Supreme Court two years later,<sup>45</sup> Brandeis writing that rights one, two, and four specified in *Radford* were protected in the new statute. Right number three was deemed protected by the discretion of the court read into the statute, despite the mandatory three-year stay of mortgage foreclosure seemingly mandated by the statute. Although the amended statute did not protect right number five, the Court found no detriment to the creditor therein. While holding that the new statute passed constitutional muster, the Court did not clearly articulate a constitutional standard or clarify the basis of its prior holding. The Court's third opinion on the Frazier-Lemke legislation<sup>46</sup> only further muddied the waters. It upheld an amended version of the act providing that the debtor had a right to buy the property at its mortgaged value, without a judicial sale, at the end of the three year moratorium. Reading the three cases together, it must be concluded that there are fifth amendment limitations on the bankruptcy power, and those limitations come into play where secured creditors' rights are involved. It is very difficult, however, to delimit them precisely.<sup>47</sup>

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<sup>44</sup> Act of Aug. 28, 1935, ch. 792, 49 Stat. 942.

<sup>45</sup> *Wright v. Vinton Branch of the Mt. Trust Bank*, 300 U.S. 440 (1937). The Court here examined the legislative history of the amended bill and concluded that Congress did not intend to grant the farmer-debtor absolute rights, but only a limited right to remain in possession. When one compares the provisions struck down in *Radford* with those upheld in *Wright*, the substantive similarities and merely formal differences are transparent.

<sup>46</sup> *Wright v. Union Cent. Life Ins. Co.*, 304 U.S. 502 (1938). Here Justice Reed wrote that state law creates norms regarding property rights to which Congress must "substantially adhere" and any "serious departure" from the "quality of the property rights created by the state law" has led to finding "a deprivation of property without due process." *Id.* at 517.

<sup>47</sup> That the reorganization court has substantial power to deal with a secured creditor's collateral has never been subject to serious doubt. *Continental Ill. Nat'l Bank & Trust Co. v. Chicago, R.I. & Pac. Ry.*, 294 U.S. 648 (1935). *Radford*, however, has been cited in a number of confusing contexts over the years which indicated that its holding is anything but clear. In *In re Radio-Keith-Orpheum Corp.*, 106 F.2d 22 (2d Cir.), *cert. denied*, 308 U.S. 622 (1939), the court declined to hold that the payment of cash or its readily recognizable equivalent is constitutionally required and found the former Bankruptcy Act § 77B, the predecessor to present Chapter X inapplicable, while in *In re Tennessee Pub. Co.*, 81 F.2d 463 (6th Cir. 1936), *cert. denied*, 306 U.S. 659 (1939), the court held § 77(b)(5), a portion of this same provision, unconstitutional under *Radford*. In other cases the courts cite *Radford* after commenting on the fair and equitable doctrine. *Provident Mut. Life Ins. Co. v. University Evang. Lutheran Ch.*, 90 F.2d 992, 995 (9th Cir. 1937); *Francisco Bldg. Corp. v. Battson*, 83 F.2d 93, 94 (9th Cir. 1936). In *In re Boston & Me. Corp.*, 484 F.2d 369, 374 (1st Cir. 1973), *Radford* is cited in a situation where liquidation would be bad for unsecured creditors, the court stating that they too are entitled to protection of their assets in a § 77 railroad reorganization. (Interestingly,

Some courts have attempted to define the secured creditor's constitutional rights in terms of the substantive-procedural dichotomy: the latter may be affected in a reorganization proceeding while the former may not. The Seventh Circuit, for example, has said that while the reorganization court may regulate the means of enforcing a lien, it cannot destroy its substance except upon the principle of assent.<sup>48</sup> Such a standard is hopelessly circular: if the deprivation results in loss, or a real potential of loss, to the secured creditor, it must be substantive.<sup>49</sup>

Recent controversies in this quasi-constitutional arena have occurred in the context of railroad reorganizations,<sup>50</sup> involving,

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this is the only case found which seems to support the notion that unsecured as well as secured creditors have constitutional rights in property which must be protected in a reorganization proceeding. If the issue is ever definitively litigated, the result could upset entirely the reorganization procedure as it now exists. Accordingly, this discussion must necessarily proceed on the presumption that there are no such rights; were it held otherwise, the whole philosophical foundation of reorganization would crumble, for the absolute priority doctrine could no longer serve as the basis of a "fair and equitable" reorganization.) One court cited *Radford* to support the proposition that interest on a secured claim up to the effective date of the plan has the same priority as the principal itself. *Brooks v. St. Louis-San Francisco Ry.*, 153 F.2d 312, 318 (8th Cir.), *cert. denied*, 328 U.S. 867 (1946). On the other hand, one court has held that *Radford* did not prevent nonassenting creditors from being forced under § 77B to accept preferred and common stock in substitution for first mortgage bonds, despite the absence of a prior determination of solvency. *In re 333 N. Mich. Ave. Bldg. Corp.*, 84 F.2d 936, 940, 942 (7th Cir.), *cert. denied*, 299 U.S. 602 (1936).

<sup>48</sup> *In re Deluxe Court Apartments, Inc.*, 86 F.2d 772, 774 (7th Cir. 1936).

<sup>49</sup> The fate of the secured creditors of the New York, New Haven, and Hartford Railroad is a good illustration of the meaninglessness of this dichotomy. From the inception of the New Haven reorganization in 1961 through 1968, when the railroad merged with the Penn Central, the debtor's estate had amassed more than \$70,000,000 in administrative and postbankruptcy claims that took priority over the bondholders' liens. In 1970, Mr. Justice Stewart wrote that:

[a]lthough the extent to which the ongoing deficit operation has impaired the bondholder's security is unclear, it is undeniable that the continued operation of the railroad into the late 1960's, together with the legal uncertainties engendered by the doubtful future of the company, have greatly depressed the value of the bondholders' interests.

New Haven Inclusion Cases, 399 U.S. 392, 490 (1970). Under such circumstances, it is absurd to argue that the denial of the procedural action of a foreclosure had no effect on the bondholders' substantive rights. This situation moved one court to comment that if the fate of the New Haven bondholders were the touchstone, there was no due process limitation on the bankruptcy power whatsoever. *In re Penn Cent. Transp. Co.*, 494 F.2d 270, 279 (3d Cir. 1974).

<sup>50</sup> To the extent that fifth amendment protection of secured creditors exists in the railroad reorganization context, with its inordinate degree of public interest, it must a fortiori exist to at least the same extent in reorganizations under Chapter X with their lesser public import. In the New Haven Inclusion Cases, 399 U.S. 392, 491-92 (1970), the Supreme Court quoted with approval its earlier observation that security holders cannot be called upon to sacrifice their property so that a depression-proof railroad system might be created. But they invested their capital in a public utility

first, trustees' takedowns of moneys which, pursuant to the terms of various indentures, should have been placed in sinking or mortgage retirement funds or otherwise used to protect the interests of specific classes of bondholders, and, second, the issuance of trustees' certificates with a right of repayment prior to that of the preexisting secured obligations. Two standards had evolved for determining when such takedowns and certificates are permissible, depending upon whether the funds are to be used for general operating expenses<sup>51</sup> or for the maintenance or improvement of property which also represents collateral to the secured parties in question.<sup>52</sup> The courts which evolved these standards did so on equitable grounds, however, the Third Circuit recently seems to have held the standards to be constitutionally required.<sup>53</sup>

Whatever the outer limits of the constitutional protection may be, it would seem that in the usual situation the secured creditor must be assured of ultimately receiving at least the liquidation value of his collateral as of the date of bankruptcy, less

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that does owe an obligation to the public. . . . [B]y their entry into a railroad enterprise, [they] assumed the risk that in any depression or in any reorganization the interests of the public would be considered as well as theirs.

Reconstruction Finance Corp. v. Denver & R.G.W.R.R. Co., 328 U.S. 495, 535-36 (1945).

<sup>51</sup> *In re* Third Ave. Transit Corp., 198 F.2d 703 (2d Cir. 1952) (Ch. X, not Bankruptcy Act § 77 case). The standard requires findings that: (1) it is imperative to obtain the funds; (2) they cannot be obtained through ordinary channels; (3) there is a "high degree of likelihood" that the debtor can be reorganized within a reasonable time; and (4) there is a "high degree of likelihood" that the secured creditor whose security is being disturbed will not be injured thereby. *Id.* at 706, 707. The standard was accepted by the Third Circuit as appropriate for railroad reorganizations as well as Chapter X proceedings. *In re* Penn Cent. Transp. Co., 494 F.2d 270, 279 (3d Cir. 1974).

<sup>52</sup> *Central R.R. v. Manufacturer's Hanover Trust Co.*, 421 F.2d 604, 606 (3d Cir.), *cert. denied*, 398 U.S. 949 (1970) (citing the standard actually devised by Judge Anderson in an unreported opinion, *In re* New York, N.H. & H.R.R., No. 30226 (D.Conn., Dec. 7, 1961)). This lesser burden requires findings that: (1) the funds are presently needed; (2) they cannot be obtained elsewhere; (3) the reorganization is "probably feasible"; (4) the money will "materially contribute" to the possibility of reorganization and to a continuation of the transportation plant or "a substantial portion" thereof; and (5) the interests of the bondholders will not be prejudiced.

<sup>53</sup> *In re* Penn Cent. Transp. Co., 494 F.2d 270, 275 (3d Cir. 1974). The court explained that the main difference between the two tests is in the standards for determining the likelihood of reorganization and the existence of bondholder prejudice. *Id.* at 276. The *Central R.R.* standard, *supra* note 52, looks to the effect of the expenditures on a plant value, while the tougher *Third Avenue* standard requires that the plant value will be at least as much under either a liquidation or a capitalized earnings plan as it would have been without the lien of the trustees' certificates. Under *Central R.R.*, to the extent that expenditure for improvements to collateral accrues to the benefit of the secured creditor, there should be no constitutional problem. The real danger to the position of the secured creditor is in the *Third Avenue* situation; hence the higher standard.



costs of repossession and sale.<sup>54</sup> Any lesser amount would mean that the secured creditor's position had suffered decline because of the attempt to rehabilitate rather than immediately to liquidate the debtor. Since the cases are unclear whether the Constitution prohibits any decline in this position, or merely an unreasonable decline, it is safest to assume the former. What is perfectly clear, however, is that the due process protection of secured creditors in reorganization proceedings, enunciated in the 1930's, is still very much with us, whatever the appropriate formula for its precise measurement may be.<sup>55</sup> Accordingly, any suggested redress of the balance between secured creditors' rights on the one hand and those of all other interested parties on the other must respect this limitation or run the risk of constitutional infirmity, and, for purposes of this analysis, the maximum measurement of constitutional protection will be applied.

## V. THE SECURED CREDITOR AS SABOTEUR

### A. *The Yale Express Resolution*

It is not difficult to imagine situations in which, upon application of the initial "good faith" standard, there is a sufficiently great possibility of a successful reorganization, but in which the required protection of the secured creditors' position cannot be assured. If the collateral is needed for the continued operation of the business, reclamation will assure liquidation, while denial of reclamation, without providing substitute security equal in

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<sup>54</sup> This standard seems appropriate because it is the most a secured creditor could have received if there were no procedural or substantive limitations whatsoever placed upon him. This standard was accepted by the reorganization court in the New Haven-Penn Central merger situation, *In re* New York, N.H. & H.R.R., 289 F. Supp. 451, 453-55 (D. Conn. 1968) (the considered alternative, the going concern value, was rejected for the simple reason that the New Haven was not a going concern), and was also accepted by a three-judge court dealing with the same merger in parallel litigation. *New York, N.H. & H.R.R. Bondholders Comm. v. United States*, 289 F. Supp. 418 (S.D.N.Y. 1968). Furthermore, the Supreme Court affirmed use of that standard. *New Haven Inclusion Cases*, 399 U.S. 392 (1970). The valuation, however, was considered by the Supreme Court to be an equitable one, and whether it was constitutionally mandated was specifically not considered. *Id.* at 489-90. Thus, the parameters of the constitutional protection remain in doubt; that there is some such protection is not in doubt.

<sup>55</sup> Witness the recent decision in *Connecticut Gen. Ins. Corp. v. United States Ry. Ass'n*, 383 F. Supp. 510 (E.D. Pa. 1974), *rev'd sub nom.* *Blanchette v. Conn. Gen. Life Ins. Corps.*, 43 U.S.L.W. 4031 (U.S. Dec. 16, 1974), in which aspects of the Regional Rail Reorganization Act of 1973 were held to be unconstitutional for failure to provide for sufficient reimbursement to secured creditors.

value to the original collateral, will unlawfully<sup>56</sup> damage secured creditors' interests.<sup>57</sup> The fact pattern of *Yale Express*,<sup>58</sup> the case in which some progress toward solving this problem was made, is a good illustration of the manner in which it arises. There, the debtor (Yale) and its wholly owned subsidiaries carried on an integrated motor carrier and freight forwarder business. In March, 1965 Fruehauf Corporation sold trailers and truck bodies to Yale for a total price of \$379,208.50 on an installment basis. Fruehauf retained a security interest in the trailers and truck bodies, which was presumed by the trial and appellate courts to be properly perfected.<sup>59</sup> The agreement provided for monthly payments until 1970.

Less than two months later, Yale filed a Chapter X petition and made no further installment payments. In October, Fruehauf sought reclamation of its collateral under the terms of the security agreement. The district judge denied the petition. He first applied the *Lake's Laundry*<sup>60</sup> distinction based on the passage of title,<sup>61</sup> and determined that reclamation must be denied since title had passed to the debtor. The last sentences of the opinion, however, discuss "cogent equitable reasons why Yale should not be forced to give up possession of its property at this time."<sup>62</sup>

One immediate result of forced dispossession of the Fruehauf manufactured equipment would be the requirement that Yale purchase new replacement units. Its existing older units in storage are obsolescent and

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<sup>56</sup> As the notion of unlawful is developed in text accompanying notes 39-55 *supra*.

<sup>57</sup> This conflict would arise where, for example, the collateral in question was depreciating, as would typically be the case with machinery, or was subject to unpredictably fluctuating market values, as is the case with securities, where inability to time the sale would mean inability to minimize the loss.

<sup>58</sup> 250 F. Supp. 249 (S.D.N.Y.), *rev'd*, 370 F.2d 433 (2d Cir. 1966), *aff'd after remand*, 384 F.2d 990 (2d Cir. 1967).

<sup>59</sup> The facts are actually more complicated. The sales were originally made over several months in 1964, pursuant to an agreement that cash payment was to be made 30 days after delivery of each truck body and 90 days after delivery of each trailer. Fruehauf purported to rely upon favorable Dun & Bradstreet reports in extending the credit. In February 1965, however, Fruehauf was informed by Yale that the 1963 financial data upon which the Dun & Bradstreet report was based were grossly inaccurate, and that the actual situation for 1963 was negative rather than positive. Fruehauf thereupon asserted a right to reclaim the equipment. Negotiations resulted in the installment payment and security agreements which became the subject of the litigation. 250 F. Supp. at 251.

<sup>60</sup> 79 F.2d 326 (2d Cir.), *cert. denied*, 296 U.S. 622 (1935).

<sup>61</sup> *See* text accompanying notes 31-32 *supra*.

<sup>62</sup> 250 F. Supp. at 255.

inefficient. Usage of the latter would mean greater maintenance costs and, more important, loss of customers which cannot effectively be served by such ancient equipment. Any such increased expense with concomitant loss of revenues could well mean the difference between successful reorganization and forced liquidation. The whole objective of Chapter X is "to avoid immediate liquidation of the properties involved in the reorganization of a corporation . . . with a view to rehabilitate rather than to liquidate."<sup>63</sup>

On appeal, the Second Circuit took the opportunity to overrule the chattel mortgage-conditional sale dichotomy of *Lake's Laundry*, stating that henceforth a reorganization court should not look for artificial distinctions based on title in disposing of reclamation petitions, but rather "equitable considerations and the *substance* of the transaction should govern, regardless of the *form* of the security agreement."<sup>64</sup> Since it was not clear whether the district court had rejected the reclamation because of the supposed dictates of *Lake's Laundry* or had reached its decision on an analysis of the equities, the case was remanded for further proceedings below. However, the Second Circuit noted:

Even if Judge Tyler finds that the equities favor Yale's retention of the property, he need not conclude that Fruehauf is entitled to no relief at all. Consideration should be given . . . , for example, to the propriety of requiring Yale to make rental payments for the use of the trucks and trailers during the period of reorganization. It is true, as Judge Lumbard states [in dissent], that in the past bankruptcy courts have been reluctant to award such rental payments; but the considerations underlying this reluctance may well be different now in light of our holding that a creditor cannot assure himself the right to reclaim merely by labeling his security device a conditional sales contract.<sup>65</sup>

The problem with this suggestion, which quickly became apparent upon remand, was that if Fruehauf were to be granted rental payments in lieu of reclamation, the other secured cred-

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<sup>63</sup> *Id.* at 255 (quoting *In re Island Park Associates, Inc.*, 77 F.2d 334 (2d Cir. 1935)).

<sup>64</sup> *In re Yale Express Sys., Inc.* 370 F.2d 433, 438 (2d Cir. 1966) (emphasis in original, footnote omitted).

<sup>65</sup> *Id.* at 439.

itors would demand the same treatment, and the cash flow needed for such payments did not exist. Since the equities in favor of Yale, and the reasonable possibility of successful reorganization, were the same as upon the original decision, the district court denied reclamation and denied rental payments as well.<sup>66</sup>

A new appeal was taken, and the Second Circuit affirmed.<sup>67</sup> The court stated that it was clear that "the prospects of reorganization would be frustrated if the reclamation were granted,"<sup>68</sup> a most undesirable consequence since "the trustee's goal of rehabilitating Yale is not a mere will-o'-the-wisp."<sup>69</sup> It approved the denial of rental payments to Fruehauf on the ground that they too would nullify the reorganization effort if granted to all creditors. The court concluded with an all-important paragraph:

Nor, [sic] have we overlooked Fruehauf's contention that equitable considerations compel a favorable ruling in its behalf because the vehicles in which it claims a security interest are depreciating. But *to such extent as Fruehauf has been damaged by the use of its property pending the reorganization, it is entitled to equitable consideration in the reorganization plan.* . . . Moreover, we note that the trustee has offered to fix the value of the security interest claimed by Fruehauf so that its position in any reorganization will be unaffected by possible depreciation.<sup>70</sup>

The process envisioned by the Court of Appeals is clear. If the liquidation value of the collateral is determined as of the time of the reclamation petition, the creditor will not be hurt by denial of his petition so long as he receives at least the equivalent value (less estimated costs of repossession and sale?) pursuant to the plan of reorganization. This amount, it will be recalled, is, according to the conclusion reached above, the constitutional minimum guaranteed to such a secured creditor.<sup>71</sup>

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<sup>66</sup> See *In re Yale Express Sys., Inc.*, 384 F.2d 990, 991 (2d Cir. 1967) (dist. ct. opinion unreported).

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 991.

<sup>69</sup> *Id.* That the goal was subsequently accomplished, with secured creditors receiving full compensation, lends substantial hindsight support to the conclusion of the Second Circuit. Letter from David W. Bernstein, attorney for Yale Express trustee, to Robert Rosenberg, Nov. 21, 1974.

<sup>70</sup> *Id.* at 992 (emphasis supplied, footnote omitted).

<sup>71</sup> See text accompanying notes 54-55 *supra*.

This is a tidy solution by which the debtor's plans are not frustrated while the creditor is to receive the same recovery as if reclamation had been granted, and possibly more. The only trouble with this solution is that it assumes that a plan of reorganization will unquestionably be successfully completed. Such an assumption does not accord with experience, and does not give due consideration to the legal standards applied at the early stages of a reorganization.

The burden of the debtor to meet the "good faith" test to secure approval of the reorganization petition, specifically the aspect requiring a reasonable expectation that a plan of reorganization can be effected,<sup>72</sup> is necessarily a light one. The standard's purpose is to weed out those cases of obvious hopelessness. Were it otherwise, only those corporations with the most superficial problems would survive the test: the very corporations for which a Chapter XI arrangement would typically be sufficient. Such a result would not do justice to the purposes of the statute,<sup>73</sup> which surely include the revitalization of seriously, though not terminally, ill enterprises. Accordingly, virtually all courts agree that the appropriate burden of persuasion on this initial good faith determination is easily met. The debtor need only demonstrate the reasonable "possibility," not probability, of successful reorganization.<sup>74</sup>

A recent Second Circuit case, *In re Bermec Corporation*,<sup>75</sup> decided after *Yale Express*, involved a reorganization plan which was determined to have met the good faith test despite the secured creditors' concern that rapid depreciation of the collateral was steadily increasing their risk of loss. Bermec was the lessor, at the time the Chapter X petition was filed, of over-the-road tractors, trailers, and heavy duty trucks. One group of creditors, holding security interests on substantially all of Bermec's rolling stock, opposed approval of the petition and sought immediate liquidation. The debtor's liabilities exceeded its assets by about \$4,000,000, and for some time it had been losing approximately \$500,000 each month. Bermec's president, whose earlier earn-

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<sup>72</sup> Bankruptcy Act § 146(3), 11 U.S.C. § 546(3) (1970).

<sup>73</sup> For discussions of the differences of purpose and application between Chapters X and XI, see *SEC v. American Trailer Rentals Co.*, 379 U.S. 594 (1965); *General Stores Corp. v. Shlensky*, 350 U.S. 462 (1956); *SEC v. United States Realty & Improv. Co.*, 310 U.S. 434 (1940).

<sup>74</sup> See cases cited in 6 COLLIER, BANKRUPTCY ¶ 6.09, at 1040 (14th ed. 1972).

<sup>75</sup> 445 F.2d 367 (2d Cir. 1971).

ings projection for the year ending June 20, 1971, was off by a staggering \$4,000,000, testified that the operation could be made profitable within six months if a series of steps were taken and satisfactorily implemented.<sup>76</sup> In the meantime, however, it was questionable whether the debtor could make the depreciation payments to the secured creditors, and meet its payroll. The expert witness for the secured creditors, who had made a thorough study of the debtor's affairs for a competitor firm when Bermec approached the competitor about acquiring Bermec, expressed grave doubt that the program could be carried out, particularly within the time frame proposed by the debtor's president.<sup>77</sup> The special master discounted the testimony of the creditors' witness,<sup>78</sup> declared the credibility as an expert of Bermec's president unaffected by his prior enormous miscalculation, and concluded that:

Given this situation, I cannot say that the financial condition of the debtor, [sic] has so deteriorated that liquidation in bankruptcy is the only proper avenue open to it. I cannot hold that its position is so utterly hopeless that the prospects for reorganization are so remote that it is not worth the few additional months delay to allow a trustee time to attempt to make the necessary repairs and to propose a plan of reorganization.<sup>79</sup>

The district judge adopted the recommendation of the special master that the petition be approved, and the Second Circuit, in a *per curiam* opinion, affirmed, stating:

We are conscious of the deep concern of the manufacturing secured creditors lest their security depreciate beyond adequate salvage, but we must balance that with

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<sup>76</sup> Among these steps were:

(1) the favorable renegotiation of certain unprofitable rental-of-equipment contracts under the threat of rejection by the Trustees; (2) revenue improvement by a substantial seasonal increase in revenues in the ensuing Summer months; (3) the sale of excess equipment which could result in substantial operating savings; (4) savings on revenues arising from escalation clauses; (5) more effective fuel control; and (6) anticipated new business which would produce a large percentage of profit because fixed costs would already have been met.

445 F.2d at 368.

<sup>77</sup> Memorandum Decision and Report of Special Master on Approval of Petition at 16-20, *In re Bermec Corp.*, No. 71-B-291 (S.D.N.Y., May 11, 1971) (unpublished).

<sup>78</sup> As the witness was an officer of a competitor of the debtor, the special master concluded that he "cannot help but be liquidation minded." *Id.* at 20.

<sup>79</sup> *Id.* at 20-21.

the Congressional mandate to encourage attempts at corporate reorganization where there is a reasonable possibility of success. Nor can we find clearly erroneous the finding that the Trustees will be able to pay the 'economic depreciation' on the secured creditors' equipment so as approximately to preserve their *status quo*. In sum, we cannot find the prospect so hopeless as to require setting aside the order below as might have been required in a case where there was, indeed, no reasonable possibility of a successful reorganization.<sup>80</sup>

Thus, it can be seen that the debtor's burden of showing good faith is very easily met. It would seem that any showing of nonhopelessness will suffice for approval of the petition. If that is so, it can be seen that approval of the petition is not equivalent to a showing that secured creditors can be adequately compensated for any risk of loss in the denial of reclamation, through fair treatment in a consummated plan. As a consequence of this nonequivalency, the broad *Yale Express* doctrine—that the reasonable prospect of reorganization is sufficient protection for the rights of the secured creditors—must at some point give way, and the secured creditor must be given assurances that the status quo will be maintained before his right to immediate realization on the secured property is suspended.

Interestingly the court in *Yale Express* proceeded upon equitable considerations and did not even raise the constitutionality of its holding, presumably since it assumed that confirmation of a plan would almost certainly occur in due course. It is most unlikely, given the precedents, that it was concluding that there would be no constitutional problem if a plan were not ultimately confirmed. Nevertheless, the opinion certainly gives a green light to experimentation with the resuscitation of a gravely wounded enterprise, despite its possible adverse effect upon secured creditors, at least at the point where a plan is "no mere will-o'-the-wisp." That the full scope of the *Yale Express* rationale can be applied to other cases at an earlier point in the proceeding is doubtful; if it were, the constitutional due process issue would surely rear its head.

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<sup>80</sup> 445 F.2d at 369. The cautious optimism of the judges at the various levels proved to be well founded; although the reorganization effort was abandoned in early 1973 in favor of liquidation, the secured creditors in question have been made whole, despite the highly inauspicious beginning. This would not have been possible if liquidation had been undertaken immediately. Letter from Everett A. Eisenberg, attorney for Bermec trustee, to Robert Rosenberg, Nov. 20, 1974.

Thus, despite the indisputably pro-debtor holdings of *Yale Express* and *Bermec*, the problem of the unprotectable secured creditor as saboteur of a potentially successful reorganization, particularly in the early stages of the proceeding when it is too early to predict the outcome with any certainty, remains.

### B. *The Bankruptcy Act of 1973 Resolution*

The proposed Bankruptcy Act of 1973<sup>81</sup> contains a single Chapter VII devoted to the subject of reorganizations, eliminating the cumbersome trichotomy of Chapters X, XI and XII<sup>82</sup> of the present Bankruptcy Act. The objective was to retain the protective features of current Chapter X missing in current Chapters XI and XII while allowing greater flexibility where appropriate and in the interests of those concerned. Thus, whether a trustee is appointed or the debtor remains in possession is a matter for the sound discretion of the court.<sup>83</sup> Further, although a version of the absolute priority doctrine is retained,<sup>84</sup> considerable flexibility in its application is written into the statute, and a negotiated composition similar to that in Chapter XI will still be possible under limited circumstances.<sup>85</sup>

<sup>81</sup> The proposed Bankruptcy Act of 1973 is the product of the Commission on the Bankruptcy Laws of the United States, established by 84 Stat. 468 (1970). The Commission authorized a series of studies and reports, and issued its own final report in July 1973. Instead of merely recommending amendments to the present Bankruptcy Act, it proposed and drafted an entirely new statute. The proposed statute was introduced into both houses of Congress, and referred to the Judiciary Committee of each. Some hearings have been held to date, and more have been scheduled. The Commission Report and proposed statute are contained in a three-volume package available from the Government Printing Office. COMMISSION REPORT, note 13 *supra*.

<sup>82</sup> Chapter XII of the Bankruptcy Act, 11 U.S.C. §§ 801-926 (1970), deals with real property arrangements by persons other than corporations. It is seldom used, and, from the modern perspective, it is difficult to understand why it was legislated as a separate type of proceeding in the first place.

<sup>83</sup> If the debtor is a corporation with debts of \$1,000,000 or more and 300 or more security holders, the court must order the appointment of a trustee "unless it finds that the protection afforded by a trustee is unnecessary or that the expense would be disproportionate to the protection afforded." Proposed Bankruptcy Act of 1973 § 7-102(a), 2 COMMISSION REPORT, *supra* note 13, at 221.

<sup>84</sup> See note 8 *supra* & accompanying text.

<sup>85</sup> The relevant provisions are:

#### *Section 7-303. Provisions of Plan.*

A plan of reorganization

...

(3) may include, if the plan is based on an estimated valuation which would preclude other participation by any class of creditors, the partners of a partnership debtor, an individual debtor, or equity security holders of the debtor, provisions for delayed participation rights for such a class or classes, holders, part-



Three sections of the proposed Chapter VII<sup>86</sup> deal specifically with the maintenance of the secured creditor's position in a reorganization proceeding. Section 7-106 deals with the issuance of certificates of indebtedness, including those with priority over existing secured claims. The Commission's note indicates that existing standards are to be applied.<sup>87</sup>

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ners, or individual conditioned on the court's determination within a period specified in the plan but not later than five years from the date of confirmation that the reorganized debtor or the successor under the plan has attained a financial status that warrants such participation;

(4) may provide, if the court finds that, (A) in the case of a partnership debtor, when the partners retain an interest under the plan, (B) in the case of an individual, when he retains an interest under the plan, and (C) in the case of a corporate debtor, when the equity security holders retain an interest under the plan, the individual debtor, certain partners or equity security holders will make a contribution which is important to the operation of the reorganized debtor or the successor under the plan, for participation by the individual debtor, such partners, or such holders under the plan on a basis which reasonably approximates the value, if any, of their interests, and the additional estimated value of such contribution;

...

#### Section 7-310. Confirmation

...

(d) *Confirmation.* The court shall confirm a plan if

(1) it is accepted by a majority in amount of the creditors of each class materially and adversely affected who have accepted or rejected the plan and, if the debtor is not insolvent, by the holders of a majority in number of the equity securities of each class materially and adversely affected who have accepted or rejected the plan, exclusive of those creditors and equity security holders who are provided for pursuant to section 7-303(7) or (8); and

(2) the court makes the following findings or has previously made such findings upon approval of the plan:

(A) The provisions of this chapter have been complied with and the plan is feasible and not likely to be followed by the liquidation of, or a need for further financial reorganization by, the debtor or any successor under the plan.

(B) Subject to the provisions of section 7-303(3) and (4) and the court's making any findings required thereby, there is a reasonable basis for the valuation on which the plan is based and the plan is fair and equitable in that there is a reasonable probability that the securities issued and other consideration distributed under the plan will fully compensate the respective classes of creditors and equity security holders of the debtor for their respective interests in the debtor or his property. If the plan does not materially and adversely affect the claims or interests of holders of publicly held securities, and if the court finds that the plan has been knowingly and voluntarily accepted by all creditors and equity security holders materially and adversely affected by it after full disclosure, the court need not make the findings required by this Clause (B).

...

2 COMMISSION REPORT, *supra* note 13, at 241-42, 251-52.

<sup>86</sup> Proposed Bankruptcy Act of 1973 § 4-501, *id.* 117-18, providing for an automatic stay of all actions and lien enforcement against the debtor for all types of proceedings under the Act, is also relevant in this context. It is analogous to current Bankruptcy Rules 401 and 601, 11-44, 13-401 and proposed Bankruptcy Rule 10-601.

<sup>87</sup> *Id.* 226-27.

During the pendency of the reorganization, section 7-204 stays any right of setoff of mutual debts by a creditor, which would otherwise be available to a creditor, unless relief is specifically granted. If a creditor seeks relief from such stay, however, the trustee or debtor has the burden of proving that the creditor is "adequately protected." Although the note following section 7-204 does not comment upon this notion of "adequate protection," the intended standard seems to be the same as that in a decision whether a repossession or foreclosure should be permitted under section 7-203, which uses the same language.

Section 7-203 relates specifically to the protection of the secured creditor. It provides:

(a) *Use of Property*. Notwithstanding the terms of . . . a security agreement,

(1) the trustee . . . may use property . . . subject to a lien . . . in the operation of the business . . . until termination of the stay prescribed by section 4-501; and

(2) property acquired by the trustee . . . after the date of the petition shall not be subject to any lien resulting from a security agreement entered into by the debtor prior to the date of the petition.

(b) *Relief from or Modification of Stay*. [A] secured party . . . may file a complaint (1) to terminate the stay, or (2) to modify the stay by imposing such conditions on the use of the property . . . as will adequately protect the secured party. The trustee . . . shall have the burden of proving that the value of the secured creditor's interest in the property . . . as of the date of the petition is adequately protected.<sup>88</sup>

Subsection (a)(2) is a limitation which does not currently exist on otherwise valid afteracquired property clauses. The concept is that the filing of the petition should terminate any possible accretion to the secured creditor's position because of the continued operation of the business. This is consistent with the notion that the filing of the petition is the point of cleavage, with a new entity going forward from that time. It supports both the preference and setoff provisions contained elsewhere in the statute.<sup>89</sup>

<sup>88</sup> Proposed Bankruptcy Act of 1973 § 7-203, *id.* 236.

<sup>89</sup> Preferences are dealt with by § 4-607, while setoffs are dealt with by § 5-201 of the Proposed Bankruptcy Act of 1973. *Id.* 166, 188.

Subsections (a)(1) and (b) are of immediate concern here. The operational concept is "adequate protection." Although the final sentence of the provision makes clear that the minimum standard is the liquidation value of the collateral as of the date of the petition, the draftsmen chose not to supply the modes by which that standard could be achieved. The Commission's note does give some suggestions as to "conditions" which might be utilized to "adequately protect the secured party":

Conditions which may be imposed by the court, when appropriate, include (1) requiring other security of an equivalent value; (2) if there is no equity or the equity is marginal, requiring additional security to the extent of the anticipated decrease in the value of collateral as a result of use; and (3) giving a priority if it is clear that the proceeds of the liquidation of the property of the estate available to pay the claim will be sufficient.<sup>90</sup>

It is interesting to note that while section 7-203 is deemed to be "essentially a codification of such cases as *In re Yale Express System, Inc.* . . . and *In re Bermec*,"<sup>91</sup> the three additional assurances to be given the secured creditor suggested in the note are significantly more conservative than the Second Circuit's holding in *Yale Express* would seem to condone. Each of the suggested "conditions" is based on a current finding that alternative property is then available for protection of the secured party and will continue to be available upon the collapse of the reorganization proceeding—that is, a finding either that the corporation owns sufficient nondepreciating, or very slowly depreciating, unencumbered property to which the lien, or part of the lien, can be transferred, or that the insolvency of the corporation is mild enough, and the continuation of the business in the reorganization proceeding is not so costly, that the metamorphosis of the security interest into a "mere" priority will not affect its relative certainty of payment.

It will be recalled that the *Yale Express* court seemed to treat the prospect of reorganization, the fact that such a prospect was not a "will-o'-the-wisp," as adequate protection. That is significantly different from the specific findings which appear to be required by the Commission's proposed conditions. The seem-

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<sup>90</sup> *Id.* 237.

<sup>91</sup> *Id.* 236.

ingly tougher standards proposed in the Commission's note, while citing *Yale Express* as well as *Bermec*, may indicate an unarticulated recognition on the part of the draftsmen that, reading the two cases together, *Yale Express* has more limited application than would appear to be the case on casual reading. The specific suggestions of the draftsmen, protecting the date-of-petition liquidation value of the collateral, recognize the constitutional limitations upon interference with secured creditors' rights, the issue the Second Circuit avoided in *Yale Express* because it saw a fair and equitable plan on the horizon. Presumably the full scope of *Yale Express* would remain good precedent under the proposed Act for another case in the same posture. In a more "will-o'-the-wisp[ish]" situation, however, where there is nevertheless enough prospect to pass muster under the *Bermec* standard for approval of the petition, the constitutional issue will be raised, and the problem under the proposed statute remains as it is currently: unless adequate protection can be internally generated from the debtor's assets, a possibly viable reorganization will be sabotaged to protect a single interest. Despite the much greater governmental role written into the proposed statute,<sup>92</sup> the system is still conceived of as self-contained.

## VI. AN INTEREST ANALYSIS AND PROPOSED RESOLUTION

The *Bermec* opinion must be read as an instruction to the reorganization court that a debtor should, at least in the early stages of a proceeding, be given every reasonable opportunity to reorganize rather than to liquidate.<sup>93</sup> This is entirely appro-

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<sup>92</sup> The administrative system of bankruptcy envisioned by the *Commission Report* would have government employees counsel debtors, administer estates where the creditors do not exercise the right to elect an independent trustee, and continue to advise the court on the propriety of plans of reorganization. *See id.* 117-26.

<sup>93</sup> The Special Master made short shrift of the secured creditors' argument that the petition should not be approved because of their irrevocable opposition to anything less than complete and immediate payment of their claims. He stated:

Experience has shown that not infrequently creditors hostile to the debtor at the outset change their position and vote to accept a plan which they initially rejected. I think that announced opposition by the secured creditors to any plan of reorganization which did not provide for complete and immediate payment of the secured indebtedness is no basis for defeating the Chapter X proceeding at its very inception.

Memorandum Decision and Report of Special Master on Approval of Petition at 15, *In re Bermec Corp.*, No. 71-B-291 (S.D.N.Y., May 11, 1971) (unpublished); *accord*, *Wachovia Bank & Trust Co. v. Dameron*, 406 F.2d 803, 806 (4th Cir. 1969); *Corr v. Flora Sun Corp.*, 317 F.2d 708, 710 (5th Cir. 1963); *York v. Florida Southern Corp.*, 310 F.2d 109,

appropriate, given the economic and social benefits which accompany the successful rehabilitation of a business enterprise. Whether the competing proposition, the importance of maintaining the integrity of secured credit transactions, is equally compelling need not be discussed here, since such maintenance is to a greater or lesser extent a constitutional mandate. Failure to accommodate these conflicting sets of interests, mentioned above, adequately within the bankruptcy system may be the result of a failure to look beyond the assumptions of the early bankruptcy cases and statutes which are probably no longer accurate or desirable. The offending premise in this case is that bankruptcy is a self-contained system of debt readjustment of immediate interest only to creditors, investors, and the debtor. The premise bears reexamination at this time.

Our current bankruptcy system was conceived of as self-supporting. The equitable distribution of losses was to be accomplished, whether via liquidation or reorganization, only with the use of the assets of the insolvent enterprise, or, in the case of a reorganization, perhaps with the infusion of funds from a willing third party. In no event, however, was the government to be involved, except as a creditor or as a friend of the court:<sup>94</sup> the government's normal role was merely to provide a forum for the carrying out of the debt readjustment. Indeed, even the bankruptcy courts were to be self-supporting, unlike the rest of the federal court system which is financed out of general revenues.<sup>95</sup> Court-appointed trustees and receivers and their counsel and accountants, as well as counsel for the debtor and, where man-

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110 (5th Cir. 1962); *In re Plaza Towers, Inc.*, 294 F. Supp. 714, 721-22 (E.D. La. 1967). *But cf.* *Janaf Shopping Ctr., Inc. v. Chase Manhattan Bank*, 282 F.2d 211, 214-15 (4th Cir. 1960), where such opposition was held to be one factor, though not determinative, in the decision to approve a petition.

<sup>94</sup> See note 107 *infra* & accompanying text. No formal role at all for the SEC is provided in Chapter XI, except for the purpose of applying to the court for an order dismissing the proceeding, unless the petition is amended to comply with Chapter X. Bankruptcy Act § 328, 11 U.S.C. § 728 (1970). In practice, however, the SEC often participates in Chapter XI proceedings on an informal basis, sometimes as a *quid pro quo* for not seeking transfer to Chapter X under § 328.

<sup>95</sup> Since 1946 the bankruptcy judges and their clerical staffs are paid from the Referee's Salary and Expense Fund, maintained by filing fees and assessments charged to the debtor's estate. Bankruptcy Act § 40, 11 U.S.C. § 68 (1970). Chapter X proceedings are conducted by federal district judges rather than by referees in bankruptcy and no assessments are charged debtor's estate for services the court may request of a referee. Bankruptcy Act §§ 117, 241, 248, 11 U.S.C. §§ 517, 641, 648 (1970). For a discussion of the policy behind bankruptcy court self-sufficiency, see D. STANLEY & M. GIRTH, *BANKRUPTCY-PROBLEM, PROCESS, REFORM 173-95* (1971).

dated by the statute, counsel for the creditors, are compensated from the estate in an amount determined by the court.<sup>96</sup>

From the modern perspective, it is most difficult to understand why such a different system for bankruptcy, as compared to the rest of the federal judiciary, was devised. Bankruptcy, under the present system, however flawed, is an economical procedure as compared with private litigation, for it permits the resolution of all conflicts and the readjustment of all debts in a single proceeding in a single forum. It is difficult to understand why the general revenues of the United States should be so carefully insulated from use to support this relatively economical system, while they are lavishly used to support the rest of the federal judicial system in which each proceeding typically settles only a single dispute between, more often than not, a single plaintiff and single defendant.<sup>97</sup>

The implication to be drawn is that the creators of the system felt that there was not enough public interest in the bankruptcy and reorganization process to justify public expenditure. Yet a degree of indirect public expenditure has long been available to those creditors whose expectations are foiled by the loss reallocation process, via the federal income tax deduction. The Internal Revenue Code allows a deduction from net income for bad debts<sup>98</sup> and for business related losses;<sup>99</sup> the costs of attempted collection of obligations from which they arise are equally tax deductible for business.<sup>100</sup> Thus, the federal government is already providing indirect subsidies to the "victims" of the bankruptcy process. These subsidies, however, in no way promote the reorganization process because they are not keyed into it in any way. When a loss is "realized,"<sup>101</sup> a deduction is always available if the transaction was one in a "business" con-

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<sup>96</sup> Bankruptcy Act §§ 48a-c, 62a(1), 64a(1), 11 U.S.C. §§ 76a-c, 102a(1), 104a(1) (1970).

<sup>97</sup> That the bankruptcy process involves as many administrative as judicial functions does not seem an adequate distinction, for no effort is made to apportion the two functions and provide "free" judicial services as in virtually all other litigation. Of course, to the extent that the bankruptcy process makes use of the nonbankruptcy federal judicial facilities and personnel, no such charge to the parties is involved. For detailed analysis, see D. STANLEY & M. GIRTH, *supra* note 95, at 173-95.

<sup>98</sup> INT. REV. CODE OF 1954, § 166.

<sup>99</sup> *Id.* § 165.

<sup>100</sup> *Id.* § 162.

<sup>101</sup> The mere filing of a bankruptcy or reorganization petition is not the equivalent of the "realization" of a loss for tax purposes. Each case will turn on its facts. For a discussion of this problem and collection of authorities, see H. SMITH & J. TOVEY, *FEDERAL TAX TREATMENT OF BAD DEBTS AND WORTHLESS SECURITIES* (1964).

text, and may, under limited circumstances, be available in a "nonbusiness" context.<sup>102</sup> The extent of the subsidy thus depends upon the tax bracket of the taxpayer. In the context of the derogation of the rights of secured creditors in bankruptcy proceedings, there has never been any judicial ruling that such subsidy is the "indubitable equivalent"<sup>103</sup> of the secured creditor's claim, and indeed there could not be, inasmuch as the subsidy would be substantially less than such claim under the best circumstances.<sup>104</sup> Nevertheless, federal subsidy of the bankruptcy and reorganization participants does exist to this extent, although it neither promotes nor hinders the process.

In 1950, a leading commentator on reorganization, in analyzing its benefits, wrote: "In the end its most significant aspect for society as a whole may be a negative one: The junior interests who are relieved by it from the judgments of the market are rescued without the direct disbursement of public funds for their benefit."<sup>105</sup> As noted, this observation is only partially correct, since in most instances the junior interests will not be fully compensated even in a successful reorganization, given the absolute priority rule,<sup>106</sup> and will receive an indirect subsidy through a tax deduction to the extent compensation pursuant to the plan falls short of the total due. More importantly, however, this view of the public interest in reorganization is far too limited and is at least partially responsible for the current imbalance in the accommodation of the several competing sets of interests.

A corporation in a Chapter X proceeding will almost always have one or more classes of publicly held securities. Protection of such public security holders was the primary rationale behind the absolute priority doctrine developed by *Boyd* and its progeny.

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<sup>102</sup> Taxpayers other than corporations who incur nonbusiness bad debts are limited to a short term capital loss. INT. REV. CODE of 1954, § 166(d). But, given the Code's definition of "nonbusiness debt" in section 166(d)(2), a secured creditor or unsecured trade creditor should almost always qualify for the more favorable deduction from ordinary income. Nonbusiness "loss" deductions are limited to \$100 against ordinary income. INT. REV. CODE of 1954, § 165(c). The debenture holder, bondholder or stockholder is limited by § 165(g), to a capital loss, which is not available until the security in question becomes "worthless."

<sup>103</sup> The phrase is from *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935).

<sup>104</sup> Because individuals are currently taxed at a maximum rate of 50% of earned income and corporations at a maximum rate of 48%, those figures represent the maximum subsidy available resulting from the allowable deduction. INT. REV. CODE of 1954, §§ 1, 11.

<sup>105</sup> Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 603 (1950).

<sup>106</sup> See note 8 *supra* & accompanying text.

The same rationale accounts for the formal participation of the Securities and Exchange Commission in Chapter X proceedings. The role of the SEC is to assure the public security holder as much of the benefit of his security contract in the reorganized corporation as is commensurate with the absolute priority principle. Maintenance of the integrity of, and public confidence in, the nation's security markets constitutes the fundamental purpose of this huge federal agency. To the extent corporate reorganizations affect public security holders and help protect or preserve their investments, they pursue the same goal. Thus the public interest in successful reorganization is readily apparent and has been recognized throughout this century. Despite this recognition of the public interest, the SEC's role as representative thereof in the reorganization process is merely advisory;<sup>107</sup> thus, even where recognized, the public's voice is muffled.

The public interest in successful reorganizations extends well beyond this facet, however. The number of multimillion dollar bankruptcies has increased enormously in the last few years;<sup>108</sup> the railroad and securities industries alone easily account for several billions of dollars of liabilities.<sup>109</sup> The effect of the liquidation of such enterprises on their employees is obviously devastating.<sup>110</sup> The only bone thrown to employees in ordinary bankruptcy is picked nearly clean—a very limited priority

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<sup>107</sup> Bankruptcy Act § 172, 11 U.S.C. § 572 (1970), makes perfectly clear that the SEC's report on proposed plans submitted to it "shall be advisory only." Although that agency may be deemed to be a party in interest in the proceeding, it "may not appeal or file any petition for appeal in any such proceeding." Bankruptcy Act § 208, 11 U.S.C. § 608 (1970).

<sup>108</sup> DUN & BRADSTREET, *THE FAILURE RECORD THROUGH 1971*, at 2. Fredland determined that after adjustment for price increase due to inflation, average liabilities of bankrupt companies increased four times between 1950 and 1971 (6.5% per year), and more than doubled between 1960 and 1971 (7% per year). Fredland Study, *supra* note 14, at 3. There are indications that this trend may have levelled off, but at a high plateau. See DUN & BRADSTREET, *THE FAILURE RECORD THROUGH 1972*, at 2.

<sup>109</sup> Neither of these industries is subject to Chapter X proceedings. Railroad reorganizations are controlled by Bankruptcy Act § 77, 11 U.S.C. § 205 (1970), and, in at least part of the United States, the new Regional Rail Reorganization Act of 1973, 45 U.S.C. §§ 701 *et seq.* (Supp. III, 1973). Securities brokerage houses with public customers are now liquidated pursuant to the Securities Investors Protection Act of 1970, 15 U.S.C. §§ 78aaa *et seq.* (1970). Both of these procedures are, however, modeled on Chapter X.

<sup>110</sup> It is interesting to note that the original version of that part of the Chandler Bill which eventually became Chapter X included among the "interested persons" entitled to standing to be heard in a reorganization proceeding representatives of employees of the debtor. In testimony before the House of Representatives Judiciary Committee, SEC Chairman William O. Douglas strongly endorsed the provision giving labor a voice in the proceedings as a recognition of "the direct impact of reorganization on labor." *Hearings on H.R. 6439 and 8046 Before the House Comm. on the Judiciary, 75th Cong., 1st Sess., 188-96* (1937). Under the statute as enacted, employees of the debtor may be heard only



claim for back wages owed to them.<sup>111</sup> Otherwise they are thrown to the wolves, left to seek other employment and sharing *pari passu* with trade creditors in the inadequate assets of their bankrupt employer to the extent that they have claims beyond the absurdly inadequate wage priority. Aside from the clear personal hardship, if the economy is not able rapidly to transfer these people to equally gainful employment elsewhere, society as a whole will bear a heavy burden. To the extent that a viable reorganization will obviate this result, the public has a substantial interest in not permitting such reorganization to be sacrificed to the interests of one group of creditors.

Finally, the public at large *qua* consumer has an interest in successful reorganization. The demise of a large enterprise will necessarily lessen competition in the relevant market for the goods or services in question, to the detriment of the consumer. On a more specific level, it is a not infrequent occurrence that the consumer is a creditor of the enterprise.<sup>112</sup> In a bankruptcy liquidation, such a consumer is but a general unsecured creditor; not even the very limited special treatment accorded the employee creditor is available to him, nor will he be subsidized for his loss with a tax deduction. The hardship to this group incumbent in liquidation is clear; yet in most cases the consumer creditor will have neither enough clout nor enough organization to make his interest felt in a bankruptcy proceeding.<sup>113</sup> It is becoming quite common for municipal or state consumer protection agencies to intervene in bankruptcy proceedings on behalf of consumers.<sup>114</sup> The interest of the consumer in a successful reorganization is certainly a "public" concern in this context.

It can thus be concluded that a view of bankruptcy and reorganization as an adversary battle for debt readjustment be-

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by discretion of the court, "for cause shown." Bankruptcy Act § 206, 11 U.S.C. § 606 (1970).

<sup>111</sup> Bankruptcy Act § 64a(2), 11 U.S.C. § 104a(2) (1970). The priorities designated in § 64 do not apply in Chapter X proceedings, where more discretion to do equity is allowed. Bankruptcy Act §§ 102, 197, 11 U.S.C. §§ 502, 597 (1970).

<sup>112</sup> This is the case, for example, with customers of retail outlets with "layaway plans," consumers holding service contracts or warranties on purchased goods, and subscribers to magazines or other publications.

<sup>113</sup> This problem is fully explored in Schrag & Ratner, *Caveat Emptor-Empty Coffers: The Bankruptcy Law Has Nothing to Offer*, 72 COLUM. L. REV. 1147 (1972).

<sup>114</sup> See, for example, the Chapter XI proceedings of Vigilant Protect. Sys., Inc., No. 71-B-723 (S.D.N.Y., petition filed July 27, 1971), in which the Attorneys General of the states of New York and New Jersey, the U.S. Attorney for the S.D.N.Y. and the New York City Dept. of Consumer Affairs all intervened on behalf of low-income consumers who had purchased burglar alarms and service contracts pursuant to installment sales contracts from the debtor's high-pressure, door-to-door salesmen.

tween the debtor, whose interests will typically coincide with those of management to the extent the latter can survive in the reorganization proceeding, on one side and creditors on the other is far too narrow. Were it accurate, the conclusion that the reorganization proceeding should terminate as a direct consequence of any dissipation of the substantive rights of senior creditors is somewhat defensible, since the only sacrifice is placed upon those junior interests who lacked the bargaining strength to obtain comparable senior rights, and upon stockholders who knew they were risking their entire investment.

Even assuming the correctness of this model, the public already does partially bear the cost of the senior creditors' exercise of rights through tax deductions available to the junior interests for losses suffered in the resulting liquidation.<sup>115</sup> However, this model is too narrow, failing to give proper recognition to the public interest in a viable reorganization. Given the model with due recognition of the public interest, the scuttling of a reorganization effort because the debtor cannot internally generate sufficient protection for the rights of one class of creditors is indefensible. That constitutional and judicial protection of those rights is well-established is a given; that liquidation must follow when those rights cannot be protected during the long process of the debtor's rehabilitation is not unalterable.

How, then, to assure that the secured creditor's constitutionally guaranteed recovery is protected, whether or not a successful reorganization is consummated, and also to allow the debtor complete freedom to use the collateral so long as reasonable efforts toward reorganization are being made? The problem can easily be solved through a tax credit. The administration of such a system would be quite simple. Since, as has been concluded, the most the fifth amendment can assure the secured creditor is the liquidation value of the collateral at the date of the petition, that value can be determined by the reorganization court, via either an independent appraiser's decision appealable to the court, an adversary proceeding before the court, or some other equitable method.<sup>116</sup> That amount, less estimated costs of repossession and sale, will be a minimum guarantee to the cred-

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<sup>115</sup> See notes 98-102 *supra* & accompanying text.

<sup>116</sup> It might be objected that the U.S. Treasury should not be deprived of income on a basis which is bottomed upon such an inexact process as valuation through appraisal. As shown in the text, however, the number of situations in which the credit would be

itor. If a reorganization is successful, the secured creditor will receive at least that amount under the plan because of the absolute priority doctrine. If no plan is confirmed and liquidation follows, the difference between the guaranteed amount and the amount realized upon sale of the collateral would be available as a credit against the secured creditor's federal income tax liability, representing a 100% recovery of the guaranteed amount.<sup>117</sup> The credit would be reduced to the extent the secured creditor is made whole through a distribution of the proceeds from the sale of unencumbered assets to unsecured and partially secured claimants. If any such distribution falls short of a one hundred

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needed would be quite small: only those cases in which collateral is depreciating, the secured creditor's position cannot be maintained in another manner, and the reorganization effort is ultimately unsuccessful. Furthermore, the valuation process is virtually built into bankruptcy and reorganization proceedings. In liquidation proceedings, Rule 606(a) provides that: "The court shall appoint one or more competent and disinterested appraisers, unless it determines that such appointment is unnecessary. Unless the court directs otherwise, the appraiser or appraisers shall appraise all the property of the estate and shall prepare and file a report of the appraisal with the court." In Chapter X proceedings, the court has more discretion whether to have any appraisals made. Cf. Bankruptcy Act § 116(3), 11 U.S.C. 22 516(3). To the extent the secured creditor has a constitutionally protected claim for the liquidation value of his collateral as of the date of the filing of the petition, and is entitled to reclamation of that collateral if the value is subject to diminution, valuation of the collateral is unavoidable. The proposal herein simply subjects a minute portion of the revenue-collecting scheme to this valuation process. It is submitted that the public interest in permitting a potentially viable reorganization to proceed, as developed here, far outweighs the danger that an infinitesimally small portion of the public revenues may be lost through overgenerous valuation of collateral in a few cases.

<sup>117</sup> There is one potential exception to the universal viability of this solution: the secured creditor who has no federal income taxes due and owing against which to offset the proposed credit, even given the eight year span of the tax loss carryover provisions. INT. REV. CODE OF 1954, § 172. In such a case, the continued operations of the secured creditor would most likely be at stake. To the extent that that factor is intertwined with the decision to permit or deny reclamation, the balancing of a different set of equities is involved. The tax credit proposal herein will solve neither the practical nor the constitutional issue vis-à-vis this creditor. In such a case, the current standards should serve reasonably well, since the public interest in permitting reorganization of the debtor must be balanced against the public interest in preventing the failure of the secured creditor. If the *Yale Express* standard is applied, reclamation would be denied if the prospects of reorganization were reasonably good, and the secured creditor would then be protected by the absolute priority principle. In such a case, the court should probably bend over backward to offer some protection to the secured creditor—if rental payments as reserved in the lease were impossible, the economic depreciation should be paid, or less if absolutely necessary, even if at some inconvenience to the debtor. If, on the other hand, the prospects of reorganization were less good, the equities would favor the secured creditor, and the judge should be particularly vigilant not to give the debtor so much benefit of the doubt that the likely result is the failure of both the debtor and the creditor. In other words, in the unlikely event that such a case would arise, perceptions of the public interest would shift accordingly, and the premises presented herein would no longer be necessarily controlling.

percent recovery, however, the credit will be available to the extent necessary to produce the equivalent of a 100% recovery of the guaranteed amount; were it otherwise, the secured creditor will have been unconstitutionally penalized by the stay. The credit would foreclose any bad debt, business loss, or worthless security deduction to the extent the credit is taken to prevent duplication of tax benefits. Such deductions would, of course, be allowed for any unpaid excess of the original indebtedness over the guaranteed amount. Business and nonbusiness secured creditors would be treated identically, since there is no difference in the constitutional protection afforded them.

Such a system would, obviously, involve a certain amount of public subsidy of the reorganization effort. However, as noted, public subsidy is already involved in the business failure context, via the federal income deduction.<sup>118</sup> The existing subsidy benefits going concerns or individuals, and in many instances functions to relieve them partially from the consequences of bad business judgment. Yet, as noted, no subsidy is available to aid the financially embarrassed but potentially viable corporation to get on its feet. The reorganization procedure exists, but can be utilized only to the extent the secured creditors' constitutional protection is maintained. The direct subsidy proposed herein would directly benefit the creditor, who is already subsidized to a substantial extent. Only indirectly does the subsidy benefit the debtor: the possibility of reorganization would then be determined upon its own progress and potential and not upon an irrelevant externally imposed condition. As argued above, if a viable corporation is successfully reorganized, the economy and public at large benefit; conversely if a reorganizable corporation is liquidated because it is denied the use of needed encumbered property, the economy and the public suffer. A public expenditure in a small number of cases to promote the substantial public interest involved seems not unreasonable.<sup>119</sup>

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<sup>118</sup> It is not at all clear that such a subsidy would be more expensive than the current tax-deduction subsidy. This is true because to the extent the proposed tax credit promotes successful reorganizations, the tax deduction will not be used, or at least the available deduction will be a smaller, given the larger return on the obligation which a creditor will receive in a reorganization.

<sup>119</sup> It is too late in the day to argue very cogently that public expenditure should not be involved in aiding private enterprises when such aid is seen to be in the public interest. Witness the federal aid to Lockheed Aircraft, the Penn Central Railroad, the recent efforts of the Federal Reserve Board on behalf of the Franklin National Bank, etc.

Several points should be emphasized. First, the proposed subsidy would not be necessary in most cases. Its availability would assure that a reorganization effort is not terminated for extraneous reasons, but it would actually come into play only where the reorganization effort is unsuccessful *and* the collateral is depreciated or depleted. Second, and as a corollary to the first point, no change in the standard for approval of a Chapter X petition or for the granting of an application to replace the reorganization proceeding with a liquidation is proposed. The purpose of this exercise is not to promote economic waste through desperate and hopeless efforts to reorganize, when liquidation is the appropriate legal and economic course. Rather, the purpose is to eliminate irrelevant considerations from any reorganization versus liquidation decision. Undoubtedly, a *viable* reorganization is economically and socially more desirable than a liquidation. This proposal simply assures that the effort can be undertaken in viable cases.

It may be objected that the very secured creditors described herein are the persons most likely to insist that hopeless reorganization efforts be terminated at an early stage and that if they are protected by a tax credit, they will lose the incentive to terminate such proceedings since they stand to lose nothing. The short answer to such an objection is that they will be replaced by the next group of interested parties, the partially secured or unsecured creditors, who will be subsidized only to the extent of presently allowed income tax loss deductions and will therefore lose substantially from a dissipation of assets in a hopeless reorganization effort. Furthermore, the SEC, under the current Chapter X, and the Bankruptcy Administration, under the proposed Bankruptcy Act of 1973, will participate in the proceeding and advise the court with the public's interest in mind. Were the proposal presented herein to be adopted, a formal participating role for the Internal Revenue Service might be appropriate. In any event, it is most unlikely that a vacuum would be created.

Finally, some economists might argue that the suggested tax credit is unnecessary because the market mechanisms will function to produce, at a realistic price, purchasers of the secured creditor's expected recovery when he is unable or unwilling to "wait it out," if viable reorganization is indeed a realistic

possibility.<sup>120</sup> Aside from its glorification of theory over reality, such an argument is inconsistent with the "good faith" standard for approval of the reorganization petition as interpreted by cases such as *Bermec*. If successful reorganization is not a mere "will-o'-the-wisp" the theoretical purchaser from the market place is no longer needed since *Yale Express* permits the secured creditor to be stayed at that point. Rather, at the point where he will be needed, when no more can be said for the prospect of reorganization than that it is not hopeless, the theoretical purchaser, unless he is a speculator of almost irrational proportion, will not be willing to buy at a price acceptable to the secured creditor.<sup>121</sup>

## VII. CONCLUSION

Because federal income tax deductions are allowed for business losses, bad debts, and worthless securities, tax subsidies are already inextricably intertwined with the bankruptcy and reorganization procedure. However, because of the failure to acknowledge the extent of the public interest in successfully consummated reorganization proceedings, legislators have failed to key in tax benefits to the reorganization process in ways which would promote it. The costs of the foregoing proposal in terms of loss of tax revenue would undoubtedly be minimal. Given the current economic climate an upsurge in the number of filed reorganization proceedings can reasonably be expected. To the extent that these enterprises can be successfully rehabilitated rather than liquidated, the public benefits. It is entirely appropriate that the tax laws be utilized to permit the fate of each such enterprise to be decided on its economic and legal merits rather than on the basis of some externally imposed and, for the goals at hand, irrelevant conditions.

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<sup>120</sup> An analogous argument with respect to protection in the market for stockholders whose firm is undervalued in the reorganization proceeding is made by Blum, *Some Marginal Notes on TMT Trailer Ferry Reorganization: The New Math?*, 1968 S. CT. REV. 77, 84-87, reproduced in W. BLUM & S. KAPLAN, MATERIALS ON REORGANIZATION, RECAPITALIZATION AND INSOLVENCY 377-79 (1969). It is certainly true that such a theoretical purchaser can benefit substantially from a successful reorganization, particularly if the plan provides for the replacement of the secured claim with an equity or convertible interest and the corporation is thereafter profitable.

<sup>121</sup> See generally Radner, *Problems in the Theory of Markets under Uncertainty*, 60 AEA PAPERS AND PROC. 454, 457 (1970) ("set up costs").