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## CORPORATE REORGANIZATION AND A MINISTRY OF JUSTICE

By EDWARD H. LEVI\*

OF the corporate reorganization chapter of the recently amended bankruptcy act,<sup>1</sup> it may be said in brief that it contributes generally to reorganization practice, makes numerous minor changes which will be of practical significance in particular cases, and leaves many problems untouched or further complicated. The chapter is important in the history of corporate reorganizations, but it is also important as an example of legislative draftsmanship.

We have seen many changes in the formalities of corporate reorganization in the past few years.<sup>2</sup> No longer is it necessary

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<sup>1</sup>Chapter X of the now amended bankruptcy act. The amendments comprise the "Chandler Bill," sponsored by Congressman Walter Chandler. The bill was first introduced on May 28, 1936; it was finally introduced on July 28, 1937, as H. R. 8046. It was signed by the president on June 22, 1938. The National Bankruptcy Conference did considerable work on the bill, but chapter X, which concerns us here, went through much revision in the later forms of the bill, as an analysis of H. R. 12889, introduced on May 28, 1936, will show (see subsection II of section 12 of that bill) and its preparation would seem to have been in a more hurried atmosphere. For the background of the Chandler Bill, see McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, (1937) 4 U. Chi. L. Rev. 369. Professor McLaughlin's valiant fight to change the set-off provisions of the act failed. The setting for chapter X is shown by the hearings on the bills to establish a conservator in bankruptcy, hearings before the Committee on the Judiciary, House of Representatives on H. R. 9 and H. R. 6963, serial 10, March 30, 1937, as well as by the hearings on the Chandler Bill itself. The following articles have recently appeared on Chapter X: Gerdes, *Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act*, (1938) 52 Harv. L. Rev. 1; Douglas, *Improvement in Federal Procedure for Corporate Reorganizations* (1938) 24 A. B. A. J. 875; McCaffery, *Corporate Reorganization under the Chandler Bankruptcy Act*, (1938) 26 Cal. L. Rev. 643; Heuston, *Corporate Reorganizations under the Chandler Act*, (1938) 38 Col. L. Rev. 1199.

<sup>2</sup>The articles by Levi and Moore on *Bankruptcy and Reorganization in (1937-1938)* 5 U. Chi. L. Rev. 1, 219, 398 at least do show some of the changes.

to talk about a fair sale when a fair plan is meant.<sup>3</sup> In order to obtain federal and equity receivership jurisdiction, it is no longer necessary to employ the fiction of the consent receivership which was so annoying to Judge Bourquin.<sup>4</sup> Three creditors of the debtor may now file the petition directly in the federal court. In order to satisfy the demands of dissenters, it is, in the main, no longer necessary to resort to upset price devices, or possibly trustee-purchase.<sup>5</sup> Today if the requisite majority of a class of creditors or stockholders approve a plan of reorganization, the dissenters are forced in directly. The question of fees for committees has come, without constitutional difficulties,<sup>6</sup> under the control of the court. And the duty and ability of a court to make a binding adjudication that a plan is fair has been enacted into law. These were the main changes accomplished by section 77B of the bankruptcy Act. Now that section 77B has been superseded by chapter X, we can say that despite all the changes and problems which section 77B brought in its wake, the most important contribution of the section was its treatment of the dissenter problem. In the main the section aided reorganizers who could not raise money to pay off dissenters. Thus undoubtedly the most pressing problem of corporate reorganization during the depression, the problem which had kept reorganizations from moving, was met and solved.

Looked upon in this light, section 77B was one step in the attempt "to introduce democracy into reorganization practice."<sup>7</sup> It

<sup>3</sup>For the older view, see *Bowling Green Trust Co. v. Virginia P. and P. Co.*, 164 Fed. 753, 755, (C.C. Va. 1908) and see Swaine, *Reorganization of Corporations: Certain Developments of the Past Decade*, (1927) 27 Col. L. Rev. 901. A milepost along the way was *Phipps v. Chicago Rock Island & Pacific Ry. Co.*, (C.C.A. 8th Cir. 1922) 284 Fed. 945, 28 A. L. R. 1184, where it was felt that there need be no sale at all since the plan was fair. For the history of the development, the essays in Rosenberg, Swaine, Walker, *Corporate Reorganization and the Federal Court* (1924) are invaluable.

<sup>4</sup>His language in *May Hosiery Mills v. F. W. Grand 5-10-25 Cent Stores*, (D. Mont. 1932) 59 F. (2d) 218, 222, is revealing as to the temper of the times. In connection with the temper of the remarks it is pleasant to read Radin, *The Good Judge of Chateau-Thierry and His American Counterpart*, (1922) 10 Cal. L. Rev. 300. Cf. *State ex rel. Merriam v. Ross*, (1894) 122 Mo. 435, 25 S. W. 947.

<sup>5</sup>Katz, *Protection of Minority Bondholders*, (1936) 3 U. Chi. L. Rev. 517, gives the best demonstration of these devices. There is an excellent discussion in Weiner, *Conflicting Functions of the Upset Price in Corporate Reorganization*, (1927) 27 Col. L. Rev. 132.

<sup>6</sup>Cf. *United States v. Chicago, M. & St. P. R. Co.*, (1931) 282 U. S. 311, 51 Sup. Ct. 159, 75 L. Ed. 359, and note Rodgers and Groom, *Reorganization of Railroad Corporations under section 77 of the Bankruptcy Act*, (1933) 33 Col. L. Rev. 571, 587.

<sup>7</sup>See Foster, (1933) 43 Yale L. J. 352 (Book Review), but Mr. Foster

recognized the rights of a majority of a class. But an ill informed, unorganized and possibly frightened majority may in turn be led by a powerful and organized minority.<sup>8</sup> Under such conditions the real democrats might be dissenters—or at least so some may say. The next step “in making democracy work” is to see to it that the majority of the voters are informed, and to set up various constitutional controls whereby no organized minority may run the show for itself. Since informing the voters may be propagandizing them, and controlling the minority presupposes some person or group which will hold the controls, the charge will then be made, and often correctly, that we have not more but less democracy. And the next charge will be that we have hamstrung the competent, which is not to the best interests of the majority. This leads to the proposition that we should not have democracy, or that true democracy is the rule of the competent. The new chapter is an attempt to provide the means of informing the voters and to provide controls against an organized minority. We may expect further attempt to do this in the future. The charges already have been made that all of this leads to less democracy, and the question is implicit whether we really want democracy in our industrial and investment order.<sup>9</sup>

## I

As against the standard of a democratic industrial and investment order, section 77B appears to have been inadequate in at least two general ways. Of course, the dissenters were only to be forced into a plan which the court found to be “fair and equitable.”<sup>10</sup> Adequate protection for all classes of investors requires that these words have definite content. The problem concerns not only investors whose rights as to debtors are being modified through reorganizations. Of course these investors do not have

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rather abandons his democratic notions to some extent in Foster, *Conflicting Ideals for Reorganization*, (1935) 44 Yale L. J. 923.

<sup>8</sup>“It is therefore essential, if the general will is to be able to express itself, that there should be no partial society within the state and that each citizen should think only his own thoughts . . .,” Rousseau, *The Social Contract*, Book II, chapter III.

<sup>9</sup>Thus the article by Swaine, “Democratization” of Corporate Reorganizations, (1938) 38 Col. L. Rev. 256. See also the discussions by Professor Dodd, *The Securities and Exchange Commission’s Reform Program for Bankruptcy Reorganizations*, (1938) 38 Col. L. Rev. 223; Weiner, *The Securities and Exchange Commission and Corporate Reorganization*, (1938) 38 Col. L. Rev. 280; Laporte, *Changes in Corporate Procedure Proposed by the Chandler and Lea Bills*, (1938) 51 Harv. L. Rev. 672.

<sup>10</sup>77B(f) (1) “it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible.”

necessary information as to their rights if their rights are vague and changing. But the problem concerns the whole investment market. Securities are not bought intelligently if the position of these securities in the event of liquidation or reorganization is hidden. It was somewhat unfortunate for the dissenting class in particular that under section 77B, unlike the railroad reorganization act, the court did not pass upon the fairness of the plan until majority assents had been secured. The dice were then somewhat loaded not only against dissenters in a class but against whole dissenting classes. But more important, there was no clear statement in the act, nor any clearly applicable rule in the cases, that set forth the minimum requirements of a fair plan. To be sure there was some development in the cases as to what constituted a fair plan. But only two things were really made definite. It was unnecessary to include stockholders or even creditors in the plan of reorganization if it could be clearly shown that there was no equity left for them,<sup>11</sup> and a plan would be unfair if it were forced upon the top class of secured creditors who did not approve the plan by the two-thirds majority.<sup>12</sup>

It would be a gross exaggeration to say that plans of reorganization varied enormously because of uncertainty as to legal rights. Nevertheless it is not clear what treatment an intermediate class may demand in a reorganization. This is another way of saying that the application of the *Boyd Case*<sup>13</sup> in section 77B, even assuming that the principle of the case applies,<sup>14</sup> was uncertain. In the first place there is the still remaining argument as to whether the *Boyd Case* applies as among classes of creditors where the lowest class allowed in the plan is not a class of stockholders but of creditors.<sup>15</sup> In the second place there is the un-

<sup>11</sup>In re 620 Church Street Bldg. Corp., (1936) 299 U. S. 24, 57 Sup. Ct. 88, 81 L. Ed. 16.

<sup>12</sup>Tennessee Publishing Co. v. American National Bank, (1936) 299 U. S. 18, 57 Sup. Ct. 85, 81 L. Ed. 13. The district court had refused to confirm the plan and had dismissed the proceedings. The Supreme Court in affirming refused to discuss the question as to the constitutionality of 77B (b) (5). The plan was "impracticable;" it was also unfair. Certain provisions were "wholly incomprehensible." But the precedent of a case is one thing, and the rule of law which it establishes another. We may limit the Tennessee case to its facts, but the rule of law which it gives effect to today is much broader.

<sup>13</sup>Northern Pacific R. Co. v. Boyd, (1913) 228 U. S. 482, 33 Sup. Ct. 554, 57 L. Ed. 931.

<sup>14</sup>Cf. Matter of New York Railways Corp., (1936) 82 F. (2d) 739 (C.C.A. 2d); Downtown Investment Ass'n v. Boston Metropolitan Buildings, (C.C.A. 1st Cir. 1936) 81 F. (2d) 314; In re Watco Corporation, (C.C.A. 7th Cir. 1938) 95 F. (2d) 245.

<sup>15</sup>Frank, Some Realistic Reflections on Some Aspects of Corporate Re-

certainly as to how much the intermediate class may demand, assuming it may demand something more than the lower class. Here there is the widest divergence of views ranging from the notion of merely something more than lower classes get to the position that the intermediate class is entitled to payment in full as on liquidation before the lower class is admitted.<sup>16</sup> The argument is colored by the confusion as to whether the *Boyd Case* really ought to apply at all where it is fairly certain that there is no equity for the intermediate class anyway,<sup>17</sup> as was the situation in the *Boyd Case* itself.<sup>18</sup> Another way of stating the problem of the *Boyd Case* in regard to section 77B is in terms of the *Tennessee Publishing Co. Case*.<sup>19</sup> Will the principle of that case apply to an intermediate class so that such a class may not be appraised out if it fails to accept the plan by the two-thirds majority?

Less serious than the problem of the intermediate class are problems concerning the rights of dissenters within a class. Despite the provisions for rule of the two-thirds majority under section 77B, might dissenters defeat a plan of reorganization on the ground that their class of securities was not sufficiently compensated? Thus may a minority of the class of preferred stockholders defeat a plan because common stockholders are to receive stock of the same priority as preferred stockholders are receiving—and a majority are willing to receive—for 75 per cent of their old preferred stock?<sup>20</sup> Or may a minority of bondholders or note

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organization, (1933) 19 Va. L. Rev. 698; Swaine, Reorganization of Corporations: Certain Developments of the Last Decade, (1927) 27 Col. L. Rev. 901.

<sup>16</sup>Bonbright and Bergerman, Two Rival Theories of Priority Rights of Security Holders on Reorganization, (1928) 28 Col. L. Rev. 127; see Buschek, A Formula for the Judicial Reorganization of Public Service Corp., (1935) 32 Col. L. Rev. 964.

<sup>17</sup>New York Trust Co. v. Continental & Commercial Trust & Savings Bank, (C.C.A. 8th Cir. 1928) 26 F. (2d) 872.

<sup>18</sup>This was the reason that Paton's plea had been previously denied when he attacked the plan. Paton v. Northern Pacific R. R. Co. (E.D. Wis. 1896) 85 Fed. 838. "Such contention, if true in fact, would come perilously near proving that the new shares had been issued without the payment of any part of the implied stock subscriptions except the \$10 and \$15 assessments. But there was an entirely different estimate of the value of the road when the reorganization contract was made" (1912) 228 U. S. 482, 507, 33 Sup. Ct. 554, 57 L. Ed. 931. The *Boyd Case* is more than twenty-five years old now, and if we had well drawn reorganization acts, it would be high time to forget about it.

<sup>19</sup>(1936) 299 U. S. 18, 57 Sup. Ct. 85, 81 L. Ed. 13.

<sup>20</sup>It has been held they may not. In re Donahoe's, Inc., (D.C.D. Del. 1937) 19 F. Supp. 441, 443. "The bankers who are furnishing the new money insist that 135,000 shares be given to the present holders of common stock, those holders including the new management. The success of the company and the value of the preferred stock will depend upon the efforts of the new management." Cf. In re Parker-Young Co., (D.C. N.H. 1936) 15 F. Supp. 965.

holders defeat a plan of reorganization because their interest is reduced, while stock is given to stockholders no longer having any equity?<sup>21</sup> May a minority of any higher class object to giving stock anticipation warrants to stockholders?<sup>22</sup> Even the problem of the dissenting first mortgage lien holder causes difficulty where separate liens are classified together and over the objection of the individual lien holder, who is not allowed to foreclose but is forced into a plan recognizing both unsecured creditors and stockholders without paying the claim of the dissenter in full.<sup>23</sup>

If confusion as to the standards of a fair plan was the first serious defect of section 77B, the second defect was the failure of the section to provide adequate means of informing the security holders as to the plan of reorganization on which they were to vote, and inadequate devices for controlling the strong minority which might lead a disorganized, uninformed, and possibly frightened majority. Studies of corporate reorganization have supplied documentation for facts which have been known for some time.<sup>24</sup> The house of issue through its control over the trustee under the indenture and its control over the formation of committees may dominate a reorganization so that it emerges again as underwriter or protects its rights as creditor through control over the new management or through recognition as a creditor in the plan in a way denied ordinary mortals. It may be that all this leads to efficient management, but it is not democracy in the usual sense. The possibility of committee members who own conflicting interests, of trustees under indentures who will enforce their own claims first, and of insiders speculating in the securities of the debtor, who will be in a position to control publicity, is usually defended only as a necessary evil. Section 77B did not compel the house of issue, if it were not the trustee, to disclose its list of security holders. It did not prevent the court appointed trustee from being in effect the friendly receiver in a new guise

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<sup>21</sup>It has been held they may. *In re Barclay Park Corp.*, (C.C.A. 2d Cir. 1937) 90 F. (2d) 595. In support of the plan it was argued that the landlord, who could evict the debtor, would not accept a plan which would exclude the holders of junior securities, and that the stockholders represented the management which was necessary to the enterprise and which would "walk out" if the proposed plan did not go through.

<sup>22</sup>See *In re Middle West Utilities Co.*, (N.D. Ill. 1935) C. C. H. Bank. Dec. 3671. and *In re New York Railways Corporation*, (C.C.A. 2d Cir. 1936) 82 F. (2d) 739, 744.

<sup>23</sup>*In re Palisades on the Desplaines*, (C.C.A. 7th Cir. 1937) 89 F. (2d) 214.

<sup>24</sup>Particularly the studies of the Securities and Exchange Commission on Protective and Reorganization Committees.

with affiliations close to one of the reorganization protagonists; in fact it allowed the debtor to remain in possession. It did not require committee members either to own the securities they represented or at least to refrain from owning securities in adversary positions. It did not prevent the trustee under the indenture from becoming a creditor of the debtor and then enforcing that claim of its own prior to or at least on a par with the claims it represented. While solution to these problems is not easy, it may be thought that reasonable safeguards might be attempted at least.

The contribution which chapter X of the amended bankruptcy act makes to the general outline of reorganization practice is chiefly in an attempt to control the inner processes of reorganization by devices for informing security holders and for depriving minority groups of the overwhelming power they might have to lead majorities. The basic changes made by chapter X may be classified under four headings: (1) the trustee, (2) the court, (3) committees, and (4) the Securities and Exchange Commission. As to the trustee, the first thing to be noted is that a trustee must be appointed where the liquidated and noncontingent indebtedness of the debtor is \$250,000 or over.<sup>25</sup> If the indebtedness is less than \$250,000, the debtor may be allowed to remain in possession. Second, when a trustee is appointed under the new chapter, the trustee must be "disinterested" unless there are at least two trustees, in which case one of them may be a director, officer, or employee of the debtor with authority to operate the business during the period fixed by the judge and to file with the court reports concerning the operation at such intervals as the court may designate.<sup>26</sup>

"Disinterested" is a word of art under the chapter;<sup>27</sup> it is only defined negatively, however, and presumably the court might add to its meaning from time to time. Under the act a person is not disinterested if (1) he is a creditor or stockholder of the debtor, or (2) is or was an underwriter of any of the outstanding securities of the debtor, or within five years prior to the date of the filing of the petition was the underwriter of any securities of the debtor, or (3) is, or was, within two years prior to the date of the filing of the petition, a director, officer, or employee of the debtor or any such underwriter, or an attorney for the debtor or

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<sup>25</sup>Sec. 156.

<sup>26</sup>Secs. 156 and 189.

<sup>27</sup>Sec. 158.



such underwriter, or (4) it appears that he has, by reason of any other direct or indirect relationship to, connection with, or interest in the debtor or such underwriter, or for any reason, an interest materially adverse to the interests of any class of creditors or stockholder. The attorney appointed to represent the trustee must also be disinterested, except for a specified purpose other than representing the trustee in conducting the proceedings under the chapter, when the judge has given his approval.<sup>28</sup>

Now three objections have been made to the mandatory appointment of a disinterested trustee. It has been urged that the disinterested trustee will not be sufficiently well acquainted with the debtor's business—that only an interested trustee, presumably an officer of the debtor corporation, will be sufficiently well acquainted to conduct the debtor's business efficiently and retain the good will that the debtor may have. This argument overlooks the fact that the section specifically provides that "a trustee or debtor in possession may employ officers of the debtor at rates of compensation to be approved by the court."<sup>29</sup> There is no reason to believe that the officers will not be retained, and if they are retained, and if the trustee is competent, the fact that the trustee is an outsider may well be of definite advantage. The second argument seems to have more validity. It is argued that in many cases the expense of a disinterested trustee will not be warranted. This is somewhat answered by the provision that there need be no trustee if the indebtedness is not \$250,000. It must be admitted that there probably will be cases where an independent trustee is appointed where his services to this debtor corporation do not warrant the expense to the creditors. The justification for this must be that it is salutary for reorganizations by and large to have independent trustees.

There should be some provision therefore whereby in a given case the court ought to be allowed to pay the expense of the trustee from a general fund, collected either from court costs or appropriated for that purpose by the legislature, with the recognition that the purpose of the trustee requirement is to raise the level of reorganization practices in general, and the expense in a given case should not be carried by the estate. In fact one of the main purposes of bankruptcy legislation is to raise the economic morality of the community. General provisions are therefore required, but

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<sup>28</sup>Sec. 157.

<sup>29</sup>Sec. 191.

their expense should not always be carried by the particular litigants.

A third argument against the mandatory appointment of a disinterested trustee has to do both with the general competence of the trustee appointed and the requirement that the trustee "shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement, and irregularities, and to any causes of action available to the estate."<sup>30</sup> It is thought that the trustee will be vindictive, make unfounded charges of fraud, and will further the assumption that the debtor was always negligent or worse. There is little to justify this assumption. Trustees in the past, possibly because they were interested, have been if anything too lax. And a competent trustee might well insulate the management from unfounded attacks. The problem is to obtain competent trustees, and this is a problem which it is the duty of the federal courts to solve. The arguments against having one competent group of trustees to which all cases are referred never have seemed convincing.<sup>31</sup>

It should be noted that the mandatory appointment of a somewhat disinterested trustee is not a new step in reorganization law. Under section 77, the railroad reorganization act, the appointment of a trustee is mandatory, and the selection of the trustee is subject to the approval of the Interstate Commerce Commission. There the trustee must not have been connected with the debtor during the past year, unless there is an additional trustee who was not so connected, or the operating revenues of the road during the past year were under \$1,000,000.<sup>32</sup> In addition the trustee under section 77, as under chapter X, is directed to report charges of misconduct which may give the debtor a cause of action.<sup>33</sup>

Not only is the trustee mandatory in many cases under chapter X, and required to be disinterested in most, but the position of the trustee is radically changed. The trustee is to prepare the plan of reorganization or to report to the court why a plan cannot be effected.<sup>34</sup> This a radical change. Creditors and stockholders

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<sup>30</sup>Sec. 167.

<sup>31</sup>See the testimony of David Teitelbaum, Hearings before the Committee on the Judiciary, June, 1937, p. 105, on H. R. 6439 and H. R. 8046. This is really the main problem. We will have to develop a class of professional and competent trustees. It is unfortunate that the act against a person or firm having a monopoly on the trustee appointments has not been repealed. 11 U. S. C. A. S. 76a.

<sup>32</sup>Sec. 77 (c) (1).

<sup>33</sup>Sec. 77 (c) (9).

<sup>34</sup>Sec. 169. In the hearings referred to in note 31, Congressman Celler stated: "Between you and me, it does not make a bit of difference who proposes the plan . . ." (p. 173).

may submit suggestions or plans to the trustee,<sup>35</sup> but the trustee must actively prepare the plan. Apparently on the hearing of the plan, any debtor, creditor, or stockholder may propose amendments or may offer other plans, but it is clear that the act contemplates that the trustee will occupy the central position. The advantage of this method of preparation of the plan is that the court ought to be able to be informed of what is actually going on, and the inclusion of provisions unduly favorable to some special interest may not go unseen so frequently. The disadvantage is that security holders are partially removed from the struggle and compromise which would seem to be the only way that parties may feel satisfied with the ultimate result. A wise trustee, however, through consultation with the parties in interest, may at times merely act as an arbitrator allowing the parties to fight their own battles. The danger of this, of course, is that the trading will go on just as before without anything gained by the presence of an inactive trustee.

Where the debtor is allowed to remain in possession, the court may appoint a special examiner to prepare the plan, and plans may be filed by creditors, stockholders if the debtor is not insolvent, and by the debtor.<sup>36</sup> Since the debtor in possession is to perform the functions of the trustee, save for the preparation of the plan, it would appear that the debtor is also under obligations to investigate itself.

The position of the court has been changed under chapter X by placing more responsibility on the court, and by an attempt to make it more likely that the court will be more aware of the mind of the ordinary creditor. The most important change is the adoption of the practice utilized in section 77<sup>37</sup> of having the court pass on the fairness of the plan prior to any vote by security holders.<sup>38</sup> In practice, however, this may only operate to substitute for the feeling that the plan is presumptively fair because approved by a majority the feeling that the plan is probably fair if it has been drawn up by the trustee.

The power of committees to dominate the proceedings is greatly reduced. Committees may not solicit acceptances to a plan of reorganization until after an order approving the plan and the transmittal of the plan to creditors and stockholders.<sup>39</sup> This does not

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<sup>35</sup>Sec. 167.

<sup>36</sup>Sec. 168.

<sup>37</sup>Sec. 77 (e).

<sup>38</sup>Sec. 174.

<sup>39</sup>Sec. 176. They may do so before the order approving the plan if the court gives its consent.

mean that committees must be inactive during the earlier stages. Section 209 explicitly provides that a creditor or stockholder may act in a proceeding under this chapter in person, by an attorney at law, or by a duly authorized agent or committee. But before a committee may represent more than twelve stockholders or creditors, a statement must be filed with the court giving information about the membership of the committee, the claims owned by them and when they were acquired, and a copy of the instrument of authority.<sup>40</sup> In so far as these requirements may be burdensome, they favor the large institutional investor who will be able to make his influence felt without a committee representing twelve creditors.<sup>41</sup> Under the provisions of section 213, no agent, indenture trustee or committee will be allowed to intervene or to be heard until they have "satisfied the court that they have complied with all applicable laws regulating the activities and personnel of such persons." This may have reference to state regulatory acts, such as in New York, Michigan and California,<sup>42</sup> but it also leaves the way open for further federal legislation.<sup>43</sup>

The power of one committee to dominate the entire proceedings is also reduced through the increase in the importance of the court appointed trustee. Nevertheless, the committee may be of great utility. It may advise the court on the selection of a trustee; it may supervise the management of the estate, and in this respect the committee will be aided by the reports which the trustee must submit. The form of these reports may be "recommended" by the Securities and Exchange Commission.<sup>44</sup>

Speculation by members of committees will be curbed by section 249, which legalizes the practice of some courts under section 77B.<sup>45</sup>

"No compensation shall be allowed to any committee or attorney or any other person acting in the proceeding in a representative or fiduciary capacity, who at any time after assuming to act in such a capacity has purchased or sold such claims or stock, or by whom or for whose account such claims or stock have without the prior consent or subsequent approval of the court, been otherwise acquired or transferred."

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<sup>40</sup>Sec. 211. The provisions are also applicable to indenture trustees.

<sup>41</sup>See Brandeis, *Other People's Money*.

<sup>42</sup>These acts are discussed in Levi and Moore, *Bankruptcy and Reorganization*, (1938) 5 U. Chi. L. Rev. 236.

<sup>43</sup>Such as the Lea Bill, H. R. 6968, which would regulate committees, and the Barkley Bill, H. R. 2344, which would regulate trustees under indentures.

<sup>44</sup>Sec. 190.

<sup>45</sup>In *re Paramount Publix Corp.*, (C.C.A. 2d Cir. 1936) C. C. H. Dec. 3987; In *re Republic Gas Corp.*, (S.D. N.Y. 1936) C. C. H. 4104.

In line with reducing the power of committees, is the broad right to be heard which is granted under chapter X. The right to be heard is now clearly distinguished from the right to intervene. "The debtor, the indenture trustees, and any creditor or stockholders of the debtor" now has the right to be heard on all matters arising in the proceeding.<sup>46</sup> The inclusion of the indenture trustee is to be noted. The right to intervene itself is only stated in permissive terms,<sup>47</sup> but it may be interpreted to give an absolute right to intervene in certain instances in accordance with rule 24 of the federal rules of civil procedure.

The organization of security holders among themselves is made easier by the requirement that the trustee prepare a list of security holders and requiring anyone having such a list to produce it.<sup>48</sup>

The position of the Securities and Exchange Commission with respect to the proceedings is the fourth great change wrought by the new chapter. After a plan has been proposed by the trustee or by other permissible parties where the debtor is left in possession, and there has been a hearing on the plan, the judge must, if the indebtedness of the debtor exceeds \$3,000,000, and may if the indebtedness is less, decide what plan or plans are worthy of consideration and report this plan or plans to the Securities and Exchange Commission for "examination and report."<sup>49</sup> In the event of such a submission of a plan to the Commission, the court cannot proceed further until there has been a report by the commission, or notification to the effect that there will be no report, or reasonable time has elapsed after the submission to the commission,<sup>50</sup> even though the debtor's indebtedness was less than \$3,000,000, and the submission to the commission was therefore voluntary. The report of the commission is only advisory, and the plan is not to be submitted to security holders until approved

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<sup>46</sup>Sec. 206. During the hearings there was a great deal of conversation concerning the provision that "The Judge may, for cause shown, permit a labor union, or employees' association, representative of employees of the debtor, to be heard on the economic soundness of the plan affecting the interests of the employees." But the provision is unimportant, although it is as Mr. Douglas said, "A modest beginning." Mr. Michener was considerably troubled by the idea. Hearings, 191.

<sup>47</sup>Sec. 207. The subject of intervention in proceedings in the federal courts is supposed to be covered in the articles in (1936) 45 Yale L. J. 565 and (1938) 47 Yale L. J. 898. The absolute right to intervene is granted a trustee under an indenture in *Central Hanover Bank and Trust Co. v. Philadelphia and Reading Coal and Iron Co.* (C.C.A. 3d Cir. Oct. 14, 1935) C. C. A. 51, 404.

<sup>48</sup>Sec. 165.

<sup>49</sup>Sec. 172.

<sup>50</sup>Sec. 173.

by the court.<sup>51</sup> On the other hand whatever report is made by the commission, or a summary of the report prepared by the commission itself, must be submitted to the security holders along with the plan when the plan is submitted to the security holders for their vote.<sup>52</sup>

The potential effect of such a report is obvious. It may be supposed that as a practical matter the commission ordinarily will only submit a report which points out possible advantages and disadvantages in proposed plans as various security holders are affected.<sup>53</sup> But the ability of the commission to damn a plan effectively will be such that reorganizers may well be more wary as to the plans which they will attempt to get the trustee to submit. The limits of the powers of the commission in making its "examination and report" is open to question. A previous draft of the chapter had allowed the commission to make an "investigation, examination, and report."<sup>54</sup> May the commission subpoena witnesses and books in its efforts to gain the facts? It seems probable that it may not. Its activities probably are limited to indicating in its report the want of sufficient facts for it or security holders to make an intelligent appraisal of the submitted plan.

The power of the commission in reorganizations is also enhanced because not only must it be given notice of all steps taken in connection with the proceedings, together with copies of most of the important orders entered or papers filed,<sup>55</sup> but it must appear in the proceedings if requested to do so by the judge and it may on its own motion if approved by the judge.<sup>56</sup> It apparently has no absolute right to intervene, and even when admitted though deemed to be an intervener, it does not have the right to appeal—which is somewhat anomalous.<sup>57</sup>

It is theoretically possible but beyond all probability that the court might see fit to disregard not only an unfavorable report by the commission but also a resulting failure to secure the required majority of votes from security holders. The revised

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<sup>51</sup>Sec. 174. A possible interpretation, however, is that the judge must approve at least one plan. It does not say "if any."

<sup>52</sup>Sec. 175.

<sup>53</sup>In the manner of the majority report of the Commission on the Reorganization Plan for International Paper and Power Co., Holding Company Act Release No. 641, May 5, 1937.

<sup>54</sup>H. R. 6439, sec. 12, subsec. 11 (d) (7).

<sup>55</sup>Sec. 265a.

<sup>56</sup>Sec. 208.

<sup>57</sup>And note the limitation as to fees. Sec. 242 (3).

act includes the ambiguous provision of the present act, which never has been successfully used, that the plan "shall provide for any class of creditors which is affected by and does not accept the plan by the two-thirds majority in amount required under this chapter, 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, either, as provided in the plan or in the order confirming the plan . . . (d) by such method as will, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection."<sup>58</sup> The provision in the present section 77 which allows the plan to be confirmed by the court where the plan has not secured the required two-thirds majority but the court finds that the plan treats fairly those who have rejected it and the rejection was not reasonably justified is also present in a modified form under the proposed act.<sup>59</sup> Acceptance or failure to accept when not in "good faith" may be disregarded "for the purpose of determining the requisite majority for the acceptance of a plan."<sup>60</sup>

Thus it may be said that chapter X looks towards an improved reorganization practice by requiring the appointment of an independent trustee, by placing the responsibility for the plan somewhat more directly on the court, by reducing the power of committees somewhat and making it easier for security holders to know each other and appear in the proceedings, and by giving the court and creditors and stockholders the advice of the Securities and Exchange Commission.

The minor changes made by the chapter are numerous, and to the practitioner they may at times seem more important. Some of these may be enumerated.

Petitioning creditors must now have claims of \$5,000 in amount rather than only \$1,000, although there is no longer any requirement that the amount be above the security held by them or that their claims be provable.<sup>61</sup> In addition the trustee under the indenture may file. The creditors need not have claims against the debtor itself, but may have claims against the debtor's property only; this was somewhat doubtful under 77B.<sup>62</sup> It is now

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<sup>58</sup>Sec. 216 (7). But they may not longer elect to take the value of the securities allotted to them—at least it is no longer so specifically provided. Thus the end of the dictum in *Coriell v. White* (C.C.A. 2d Cir. 1931) 54 F. (2d) 255.

<sup>59</sup>Sec. 77 (e).

<sup>60</sup>Sec. 203.

<sup>61</sup>Sec.126.

<sup>62</sup>See *Matter of Draco Realty Co.*, (D.C. N.Y. 1935) 11 F. Supp. 405.

clear that the provisions of the bankruptcy act apply, for instance as to a 21a examination, prior to the approval of the petition.<sup>63</sup> This, too, was somewhat doubtful under the peculiar and conflicting wording of subsections (k) and (o) of 77B. The power to extend time limits under the act<sup>64</sup> and to determine the manner of giving notice has been made explicit.<sup>65</sup> The judge now is given the power to refer matters not expressly requiring his action to a referee where a final determination may be made, rather than only to a referee as special master whose report would have to be confirmed.<sup>66</sup> The exemption granted under 77B to municipally owned corporations has been removed.

The place of incorporation is omitted as sufficient venue, but the power of the court to transfer the proceedings to any district regardless of whether that might have been the place of original venue is made clear.<sup>67</sup> The idea of the supremacy of the debtor's petition is removed with the provision that a petition may be filed only if no other petition by or against the corporation has been filed; the first petition thus prevails.<sup>68</sup> The requirement that a creditors' petition show an act of bankruptcy or a pending bankruptcy or equity receivership pending has been expanded.<sup>69</sup> Prior bankruptcy proceeding has been made more definite so that there must already have been an adjudication in bankruptcy. "Prior equity receivership pending," in order to avoid the *Duparquet*<sup>70</sup> and *Tuttle*<sup>71</sup> Cases, has been expanded to include the case where a receiver or trustee has been appointed in equity proceedings to take over at least the greater portion of the property, or where there has been a foreclosure proceeding to enforce a lien against at least the greater portion of the property, or where an indenture trustee or a mortgagee is in possession of at least the greater portion of the property by reason of default. The right to immediate possession is given to the trustee or the debtor in possession as against trustees under a trust deed or under a mortgage.<sup>72</sup>

<sup>63</sup>Sec. 112. See *Matter of Fox Metropolitan Playhouses, Inc.*, (C.C.A. 2d Cir. 1935) 74 F. (2d) 722.

<sup>64</sup>Sec. 119.

<sup>65</sup>Sec. 120. Why does not the act require special notice as to the hearing on fees?

<sup>66</sup>Sec. 117.

<sup>67</sup>Sec. 118.

<sup>68</sup>Sec. 126.

<sup>69</sup>Sec. 131.

<sup>70</sup>*Duparquet, Huot & Moneuse v. Evans*, (1936) 297 U. S. 216, 56 Sup. Ct. 412, 80 L. Ed. 591.

<sup>71</sup>*Tuttle v. Harris*, (1936) 297 U. S. 225, 56 Sup. Ct. 416, 80 L. Ed. 654.

<sup>72</sup>*Cf. In re Francis Willard*, (C.C.A. 7th Cir. 1936) 82 F. (2d) 804.



Any creditor, indenture trustee or stockholder if the debtor is not insolvent may controvert the allegations of the petition.<sup>73</sup> The requirement of good faith is negatively defined in accordance with the cases under 77B.<sup>74</sup> We may note particularly that the petition is not in good faith if it is unreasonable to expect that a plan of reorganization be effected, or if a prior proceeding is pending and it appears that the interests of the creditors and stockholders would be best subserved in that prior proceeding.<sup>75</sup> It is now expressly provided that the trustee under the indenture may file claims for his security holders who have not already filed, but these claims are not to be counted in order to determine the majority necessary for acceptance of a plan.<sup>76</sup>

## II

At the outset it was said that section 77B was defective in two general ways. The second way had to do with the failure of the section to provide adequate means for informing the security holders as to the plan of reorganization, and the inadequacy of devices for controlling a strong minority which might lead a disorganized, uninformed and possibly frightened majority. To a large extent chapter X has cured this defect. But the first way in which section 77B was inadequate was in its treatment of the fair plan. The lack of statutory standards as to what constitutes a fair plan had led to a good deal of confusion as to what treatment an intermediate class could demand, and some confusion as to what objections a minority could raise where the majority had approved the plan of reorganization. Now contrary to what may be thought to be the implications of Justice Brandeis' dissenting opinion in the *International News Service Case*,<sup>77</sup> some persons might believe that, rather than statutory standards, it would be better to have the courts work out the appropriate standard from case to case. But over a period of years this has not been done. The failure of chapter X further to elaborate the standards for a

<sup>73</sup>Sec. 137. Cf. *In re 1030 North Dearborn Bldg. Corp.*, (E.D. Ill. 1934) 7 F. Supp. 896.

<sup>74</sup>Sec. 146.

<sup>75</sup>The petition is not in good faith if "the petitioning creditors have acquired their claims for the purpose of filing the petition." Thus the adoption of *In re Philadelphia Rapid Transit Co.*, (D.C. Pa. 1934) 8 F. Supp. 51, affd. in *Wilson v. Philadelphia Rapid Transit Co.*, (C.C.A. 3d Cir. 1934) 73 F. (2d) 1022. But why?

<sup>76</sup>Sec. 198. Cf. *Matter of Allied Owners Corp.*, (C.C.A. 2d Cir. 1934) 74 F. (2d) 201.

<sup>77</sup>*International News Service v. Associated Press*, (1918) 248 U. S. 215, 248, 267, 39 Sup. Ct. 68, 63 L. Ed. 211, 2 A. L. R. 293.

"fair and equitable" plan seems to be a mistake. It may be thought that the Securities and Exchange Commission may do the elaborating in the series of reports which it may issue. If so this puts an unnecessary burden on the Commission.

In the eminently commercial matter of what constitutes the minimum standards for a fair plan in reorganization, it is more important that the law be certain than which way it be decided. If the law is certain, security holders may know the attributes of the securities which they are buying. The fact that stocks and bonds are today treated very much alike in the investment market<sup>78</sup> is probably not so much a reason for confusing the two in reorganization as the result of years of indifferent treatment in reorganizations. Unsound financing through second mortgages again probably has been furthered by the lack of a clear position as to the treatment of subordinate securities in reorganizations. In arriving at the standard which the legislature should set, reasoning based upon the rights of security holders upon bankruptcy or foreclosure if they should insist upon their rights is again somewhat beside the point.<sup>79</sup> That kind of argument opens the way to the discussion of what kind of right it is which in most cases the individual security holder in a large reorganization can never insist upon. The history is interesting, but what we need is a definite standard.

Since one thesis of this article is the need for a ministry of justice to aid in the draftsmanship of statutes, it must recognize the great and peculiar difficulties which the creation of statutory rules presents. It is only in the most tentative way, therefore, and merely to present something concrete, that the following amendment is proposed to chapter X, section 221(2):

"(2) The plan is fair and equitable, and feasible. Without limiting the generality of the foregoing, no subordinate class of security holders shall be allowed participation if prior classes have not received full recognition of the value of their interests in the assets. 'Full recognition' shall be determined with reference to the going concern value of the enterprise. Interest or dividend payments may be modified with reference to the current return on investments. Participation of a subordinate class will not make a plan unfair, however, if the prior class not receiving full recognition has voted to accept the plan by the majority required under this act."

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<sup>78</sup>See Isaacs, *Business Security and Legal Security*, (1923) 37 *Harv. L. Rev.* 201.

<sup>79</sup>Levi and Moore were guilty of this kind of discussion in their articles in (1938) 5 *Univ. Chi. L. Rev.*

This suggested amendment would enact into law the *Boyd Case*, applying it to the cases where creditors are the most subordinate class permitted entrance as well as where stockholders are in the bottom class. It would apply the *Boyd Case* even when there is no equity for the intermediate class. It makes it clear that the intermediate class may insist upon payment in full before any subordinate class may receive anything, but it also makes it clear that the wishes of the required majority of the class are to prevail. The amendment does not insist upon absolute priority as upon liquidation; it does permit reference to the going concern value of the enterprise, which in turn must take into consideration the possibility of future earnings. Thus it does allow for something of a moratorium as to principal, with interest rate modified with reference to the current return on investments.

Probably the chief reason for desiring a clear statement as to what the positions of securities in reorganizations is to be is that security holders may know the kind of securities which they are purchasing. An additional reason is the desire for simplicity in handling reorganizations. Both knowledge on the part of security holders and simplicity in handling reorganizations is impossible, however, if the varied types of hybrid securities is permitted to continue. It is unfortunate that state corporation or security regulation laws have not seen fit to limit the types of securities which may be issued, more than they have. Possibly the only solution will be through some kind of federal incorporation act.<sup>80</sup> Meanwhile, however, hybrid securities are matters of real concern so far as the bankruptcy law is concerned.

A fair plan should mean one under which no securities are issued as to which the knowledge of security holders as to their future rights is of necessity vague. Chapter X has made some progress in handling this portion of the fair plan problem. The charter of the reorganized corporation must now include

“provisions which are fair and equitable and in accordance with sound business and accounting practice, with respect to the terms, positions, rights and privileges of the several classes of securities of the debtor or of such corporation, including, without limiting the generality of the foregoing, provisions with respect to the issuance, acquisition, purchase retirement, or redemption of any such securities, and the declaration and payment of dividends thereon. . . .”<sup>81</sup>

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<sup>80</sup>The Public Utility Holding Company Act has done more for outlining the proper corporate structure. See (1937) 15 U. S. C. A. 79g.

<sup>81</sup>Sec. 216 (12).

It is suggested in Chapter X that for obligations of more than five years provisions be made for the retirement of the debt out of a sinking fund or otherwise, (a) if secured, within the expected useful life of the security therefor, or (b) if unsecured, or if the expected useful life of the security is not fairly ascertainable, then within a specified reasonable time, not to exceed forty years."<sup>82</sup>

It is required that the plan

"shall include provisions which are equitable, compatible with the interests of creditors and stockholders, and consistent with public policy, with respect to the manner of selection of the persons who are to be directors, officers, or voting trustees, if any, upon the consummation of the plan and their respective successors."<sup>83</sup>

It is required that the new charter have provisions prohibiting the debtor from issuing non-voting stock, and providing protection for the preferred stockholders in the event of default.<sup>84</sup> And it is also required that the charter of the new corporation have provisions for the making of periodic reports—at least annually—which will include profit and loss statements and balance sheets "prepared in accordance with sound business and accounting practice whenever the indebtedness of the debtor is \$250,000 or over."<sup>85</sup>

While these provisions constitute a step forward, again the objection which must be made to them is that they are too vague. It is again true that the Securities and Exchange Commission through its reports may mold future corporation practices into something more definite. If so, however, we may expect an era of somewhat increased irritation between business men and the administrative commission.<sup>86</sup> For the sake of the life of the commission itself it is important to minimize such irritations when it is possible to set up certain standards and thus avoid putting the commission in the position of bargaining. Therefore again in the most tentative manner, a suggested amendment is offered to chapter X, section 216 (12) (a):

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<sup>82</sup>Sec. 216 (9).

<sup>83</sup>Sec. 216 (11). See also sec. 221 (5).

<sup>84</sup>Sec. 216 (12) (a).

<sup>85</sup>Sec. 216 (12) (b) (2).

<sup>86</sup>"... the most important point in the development of administrative law is the reduction of discretion," Freund, *Historical Survey, in The Growth of American Administrative Law* 24. But one need not take that somewhat unpopular position in order to argue for standards when the very purpose of the regulation is to educate the community to have higher standards. The position taken in the above proposed amendment so far as the Boyd case is concerned is similar to that outlined by Mr. Abe Fortas, assistant director of the Public Utilities Division of the Securities and Exchange Commission, in his address at the Hotel Astor, July 14, 1938.

"Provisions which limit the securities of the corporation to (1) common stock with voting rights; (2) non-participating preferred stock with cumulative dividends whether or not earned, with the right to elect at least the majority of directors in the event that preferred dividends are unpaid and at least until accrued dividends are paid, unsecured obligations, (3) unsecured obligations, and (4) secured first lien obligations. Income bonds not making provisions for interest to be cumulative if earned shall be prohibited. The public offering of unsecured obligations shall be prohibited if secured obligations are outstanding, and secured obligations shall be prohibited if there has been a public offering of unsecured obligations."

This suggested and tentative amendment would simplify the capital structure of companies in general. It may be that particular types of companies should have their capital structures further simplified, but that would involve special problems which a general bankruptcy act could not hope to handle. The amendment would do much to solve the difficulties of at least peculiar treatment of the preferred stock at the hands of the common. It would wipe out second mortgages. Through its treatment of income bonds it would do much to simplify for the ordinary investor the difference between bonds and stocks. If the suggested amendment seems too rigid, it might be wise to permit exceptions where the need for them is shown.

### III

It is undoubtedly ungracious in the case of a chapter such as the one with which we are dealing to say that in places it is poorly drafted. The poor draftsmanship in most cases is the direct result of strenuous efforts to improve the law, and it may be suspected that without certain ambiguities some improvements would fail of passage by the legislature. Nevertheless, it is important that statute law be consistent and understandable.<sup>87</sup> Chapter X is an example of quick draftsmanship which in many cases could have been improved if persons removed from the struggle to gain the substantive changes in the law effected by the statute and concerned only with its technical aspect had been required to pass upon it. Such would be one of the duties of a federal ministry of justice, a proposal which might be thought somewhat timely after almost a decade of extensive revision of our statutory law in a somewhat haphazard manner. Such a ministry would be a fitting memorial to Mr. Justice Cardozo.<sup>88</sup>

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<sup>87</sup>See Freund, *Standards of American Legislation*, (1917) ch. VI.

<sup>88</sup>See Cardozo, *Law and Literature*, the chapter, *A Ministry of Justice*.

Meanwhile it must be admitted that chapter X has many ambiguities and defects. In the first place it is not even known when the chapter takes effect. Section 7 of the amendatory act states that the amendments shall take effect three months from the date of approval of the act. The act was approved on June 22, 1938. But section 276c of chapter X provides for the application of the chapter to proceedings before the effective date of the act. Where the petition was filed within three months prior to the effective date then "the provisions of this chapter shall apply in their entirety to such proceedings." If the petition in the proceedings was approved more than three months prior to the effective date, then "the provisions of this chapter shall apply to such proceedings to the extent that the judge shall deem their application practicable." Two interpretations are possible. Perhaps the simplest interpretation would be that the chapter does not apply at all until after the effective date. After the effective date, it applies to proceedings which were commenced previously—the application is compulsory to those begun within three months, discretionary with proceedings begun more than three months before.

A more complicated interpretation is that since the act applies in its "entirety" to proceedings begun within three months—the chapter becomes effective as to them as to procedure and substantive law during those three months as well as later. This more complicated interpretation was rejected by the United States district court of the southern district, California, in *In re Consolidated National Corporation*.<sup>89</sup> The court pointed out that such an interpretation would require the application of the act if the petition was approved within the three months period, but the proceedings were no longer pending before the effective date of the Act. The difficulties and confusion that the second method of interpretation would entail caused it to be rejected. But the circuit court in the third circuit in *Bankers Securities Corp. v. Ritz Carlton Restaurant and Hotel Co.*<sup>90</sup> has adopted the more complicated view that the section was immediately applicable to proceedings begun during the three month period. Thus in the hearing on the petition, notices would have to be sent to the Securities and Exchange Commission and a disinterested trustee would have to be appointed.

Somewhat similar difficulties apply to section 276c (3) which

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<sup>89</sup>C. C. H. Bankr. Serv. Dec. 51,365.

<sup>90</sup>C. C. H. Bank. Serv. Dec. 51,367. Cf. *In re Old Algiers, Inc.* (U.S. D.C. N.Y. Sept. 30, 1938). C. C. H. 51,387.

makes the tax exemption provision applicable to reorganizations where plans have been "confirmed under section 77B before the effective date of this amendatory act." How retroactive is that provision supposed to be?

The provisions for process are not as clear as they might be. Under section 77, process runs throughout the country.<sup>91</sup> It had been thought that the same might well be true of section 77B. The present chapter does not specify. It is possible to argue that process does run throughout the country, but if it does it is because of the vague provisions of section 2(15), present in the old bankruptcy act as well, which gives the court power to ". . . issue such process . . . as may be necessary for the enforcement of this act." The necessity for a plenary proceeding, as opposed to summary jurisdiction, and the powers of the reorganization court in a plenary proceeding are still vague. The courts have denied the reorganization court the right to exercise jurisdiction in actions in personam where hardship against individual defendants would be great, but chapter X does nothing to clarify the rules.<sup>92</sup> Similarly just when it will be an abuse of discretion for the reorganization court to stay state court proceedings for the liquidation of individual claims is not made clear under the amended act.<sup>93</sup>

The United States Supreme Court held, in the *Chicago Title and Trust Company Case*, that a dissolved corporation might not file a voluntary petition under section 77B.<sup>94</sup> The court expressly refused to rule on the question of whether an involuntary petition could be filed against such a corporation. That a distinction might be made in this connection between voluntary and involuntary petitions had been indicated in some of the cases, and the seventh circuit, which had previously allowed creditors to file against a dissolved corporation, has, since the *Chicago Title and Trust Company Case*, reaffirmed its position.<sup>95</sup> And the federal district court in Minnesota has allowed a corporation to file where

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<sup>91</sup>Sec. 77 (a).

<sup>92</sup>There is *Thomas v. Winslow*, (D.C. N.Y. 1935) 11 F. Supp. 839, where extraterritorial jurisdiction was held good, and *Bovay v. Byllsby*, (C.C.A. 5th Cir. 1937) 88 F. (2d) 990, and *United States v. Tacoma Oriental S. S. Co.*, (C.C.A. 9th Cir. 1936) 86 F. (2d) 363 where it was not. Note the discussion in *In re Prima Co.* (C.C.A. 7th Cir. Aug. 26, 1938) C. C. H. Bankr. Serv. Dec. 51,323.

<sup>93</sup>See *Foust v. Munson Steamship Lines*, (1936) 299 U. S. 77, 56 Sup. Ct. 751, 80 L. Ed. 1378.

<sup>94</sup>*Chicago Title & Trust Co. v. 4136 Wilcox Bldg. Corp.*, (1937) 302 U. S. 120.

<sup>95</sup>*In re Park Beach Hotel Corp.*, (C.C.A. 7th Cir. 1938) 96 F. (2d) 886.

its charter was allowed to lapse, but where, unlike the *Chicago Title and Trust Company Case*, the period allowed for corporate powers to be utilized for winding up the corporation's affairs had not elapsed.<sup>96</sup> In the absence of any clarifying words in the present chapter, litigation on both of these points will continue. The same must be said for eleemosynary corporations.<sup>97</sup> It is still not clear whether an involuntary petition may be filed against them.

The relationship between chapter X and chapter XI of the present act is not well thought out. Chapter XI is a combination of the old composition section of the bankruptcy act, section 12, and of the special section for the relief of unincorporated debtors, section 74. Chapter XI is now open to both incorporated and unincorporated debtors; the theory of the chapter seems to be that it will take care of the milder forms of readjustments, since under the chapter secured claims may not even be extended. Before a petition may be filed in good faith under chapter X, it must be shown that adequate relief could not be obtained under chapter XI.<sup>98</sup> But if creditors can be denied relief for this reason under chapter X, they are left in a peculiar position if their petition is really dismissed for this reason, for they may not then proceed to file under chapter XI. Only voluntary petitions are allowed under chapter XI. Further, if the theory is that chapter XI is to take care of the milder readjustments, it is strange that the chapter makes no provisions for the modification of the rights of stockholders. In other ways the policy of chapter XI cannot be called consistent with that expressed in chapter X. The appointment of a trustee is not mandatory, nor need the trustee be disinterested. Committees or trustees under indentures are not even mentioned. The good faith requirement for petitions is omitted. Only the debtor may propose a plan. In other respects chapter XI is confusing. Class voting is authorized, but the division into classes is possibly to be determined only by the treatment of the classes under the plan.<sup>99</sup> Only claims provided for in the plan are to be discharged,<sup>100</sup> but it is also provided that the plan is to be binding on all claims whether they are provided for in the plan or not.<sup>101</sup>

<sup>96</sup>In the Matter of International Sugar Feed Co., (D.C. Minn. 1938) 23 F. Supp. 197.

<sup>97</sup>In re Michigan Sanitarium & Benevolent Ass'n, (D.C. Mich. 1937) 20 F. Supp. 979.

<sup>98</sup>Sec. 146 (2).

<sup>99</sup>Sec. 351.

<sup>100</sup>Sec. 371.

<sup>101</sup>Sec. 367.



In one respect the good faith requirements under chapter X are somewhat unfortunate. It may be expected that because of the prohibition against assents procured before a plan of reorganization has been approved by the court, some reorganizers will prefer state court proceedings. Unless what goes on under state court proceedings is a matter of no concern to federal legislators, it is not particularly wise to set up requirements which are higher than those in the state courts, and then provide a means whereby reorganizers can keep their proceedings from the federal courts. But the requirement that it be reasonable to expect that a plan can be effected, and that the interests of creditors and stockholders be not best subserved by continuing in proceedings pending in another court, may leave the door open to the claim of committees representing large numbers of the depositors that they will not consent to a plan of reorganization in the federal court, and that the petition is therefore filed in bad faith.

The uncertainty as to the proper division for class voting which has existed ever since section 77B was enacted has not been clarified. The standards for a fair plan which the chapter enacts already have been mentioned. The requirement that the new corporation have in its charter provisions against non-voting stock is not clear, however. After the provision against non-voting stock, section 216 (12) (a) goes on to say that the voting power shall be equitably distributed so as to give preferred stockholders the right to elect directors in the case of default. The section is open to the interpretation that the right to vote on default makes a stock voting stock, and that no other voting rights need be given. Further the right to elect directors does not necessarily mean the right to elect the majority of the directors. The position of six months claims is highly uncertain under the chapter as it now stands. Unsecured claims are no longer specifically entitled to the priority which they would have had under equity receiverships, and the provisions of section 64, relating to priorities in ordinary bankruptcy, are specifically made inapplicable. The priority which may be given to receiver's certificates or trustee's certificates, which was held by the seventh circuit to be extended under section 77B,<sup>102</sup> is not clarified either.

It is to be regretted that the amended bankruptcy act does nothing about the position of the guarantor where the debtor is in reorganization. Section 16 of the act, which prevents the discharge of a guarantor or surety because the principal debtor is discharged

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<sup>102</sup>In re Prima Co., (C.C.A. 7th Cir. 1937) 88 F. (2d) 785.

in bankruptcy remains unchanged. It has been held that the guarantor is not discharged as against creditors who have been forced into the reorganization.<sup>103</sup> Presumably the guarantor is discharged as against creditors who voluntarily accept a plan of reorganization which provides for release of the surety, although it has also been held that such creditors may preserve their rights by specifically reserving their rights against an indorser.<sup>104</sup> The present situation is no more unfair to the guarantor than it is to unsuspecting creditors.<sup>105</sup> Creditors who accept a plan of reorganization thinking that all creditors of their class will be bound by the provisions of an accepted plan are being misled.

An attempt has been made through chapter X to relieve reorganizations from the threat of taxation upon income which appears as a result of debts being wiped out.<sup>106</sup> This was the case for some reorganizations prior to chapter X. It is further understandable that together with the exemption of such reorganizations from taxation on income resulting from the reorganization itself, an attempt should be made to make it clear that income made after the reorganization should not be exempt. Section 270 therefore states that "in determining the basis of property for any purpose . . . the basis of the debtor's property . . . shall be decreased by the amount . . . by which the indebtedness of the debtor . . . has been cancelled or reduced." If giving bondholders stock cancels or re-

<sup>103</sup>In re Diversey Bldg. Corp. (C.C.A. 7th Cir. 1936) 86 F. (2d) 456 and Matter of Nine North Church Street (C.C.A. 2d Cir. 1936) 82 F. (2d) 186. In (1937) 23 Va. L. Rev. 601, 602, it is stated that "Being dissenters, they certainly have no agreement with the surety which might preclude a personal action by them against the solvent surety." Note Seixas v. Hege-man, (1935) 158 Misc. Rep. 560, 285 N. Y. S. 838, affd. in (1936) 285 N. Y. S. 840. The Illinois appellate court in Gottlieb v. Crowe, (1937) 289 Ill. App. 595, 7 N. E. (2d) 469, held that the cancellation of the guarantor's obligation by the federal court in reorganization proceedings was res adjudicata and no separate action could be maintained in the state court. But the Illinois supreme court reversed the decision. Gottlieb v. Crowe, (1938) 308 Ill. 88, 12 N. E. (2d) 881. The plaintiff had filed a petition in the district court asking that the cancellation order be modified. The United States Supreme Court has just held that the order of the federal court was binding on the state court, even though "we express no opinion as to whether the Bankruptcy Court did or did not have jurisdiction of the subject matter." Stoll v. Gottlieb (U.S. Sup. Ct. Nov. 21, 1938) C. C. H. Bankr. Serv. Dec. 51,466.

<sup>104</sup>Durfee Trust Co. v. Steiger, (Mass. 1936) 4 N. E. (2d) 1014.

<sup>105</sup>The guarantor may have subrogation in order to avoid difficulties of valuation. Thus Union Trust Co. of Rochester v. Willsea, (1937) 275 N. Y. 164, 9 N. E. (2d) 820, 112 A. L. R. 1175, where the guarantor remained liable although the plan "provided for payment in full to its creditors by the issuance of 5,000 shares of a new first preferred class A, 5 per cent cumulative stock," because "for all that appears it may have no value." The court said subrogation would be allowed the guarantor to the stock when he paid.

<sup>106</sup>Sec. 268.

duces the indebtedness of the debtor," then under this provision a corporation owning real estate once worth a million dollars, and now only worth one half a million, will discover itself in a peculiar position if it reorganizes by giving the bondholders stock. A later sale of the property for one fourth of a million only will result in income. This may be avoided by the argument that there is no cancellation, for stock was given, and that a reduction can only be determined by a valuation of the property. The provision that the Commissioner of Internal Revenue is to prescribe regulations to carry "into effect the purposes of this section" may also be the means of rectifying the defect.<sup>106a</sup>

One of the troublesome matters under section 77B was the need for determining for the purposes of appeal whether the order appealed from was an order given in a "proceeding" or in a "controversy" in bankruptcy. It has been said that the need for the distinction is done away with under the amended act. This is not the case. While appeals are as of right where more than \$500 is involved in both proceedings and in controversies, where interlocutory decrees are concerned appeal is of right under the present act only when the interlocutory decree is in a controversy, but not where it is in a proceeding.<sup>107</sup>

Finally it is to be regretted that while the fee provisions have been considerably expanded, the bothersome question as to the powers of the reorganization court over fees set in prior proceedings is not clarified. The case law seems to be moving to the position that the reorganization court may modify the allowed fees if a direction to pay was not given in the prior proceeding, but this is a matter that could be taken care of easily in a reorganization statute.<sup>108</sup>

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<sup>106a</sup>But the regulation of the Commissioner, T. D. 4871, Nov. 9, 1938, Art. 113(b)-2, C. C. H. Fed. Tax Serv. 802A, does not seem to clarify matters, although by failing to make an exception for the case where bondholders take stock, it may be thought that the Commissioner will not remedy the defect in the statute. The regulations under section 112(b) (8) of the Revenue Act of 1938, T. D. 4874, Nov. 16, 1938, C. C. H. Fed. Tax Serv. 6624 are of some weight in favor of strict construction, although these regulations apply to exchanges and distributions made in obedience to orders of the Securities and Exchange Commission in connection with holding companies. The attempts which must follow to remedy this defect in draftsmanship illustrate the theme of this article. Spurious interpretation or unsound financing will be the children of this defect if the legislature does not remedy it.

<sup>107</sup>Weinstein recognizes this to be the case in his book on *The Bankruptcy Law of 1938*, and in Report No. 1409, July 29, 1937, on the Revision of the National Bankruptcy Act. See also the discussion in the Hearings on H. R. 6439 and H. R. 8046, 78.

<sup>108</sup>Thus *In re Shorewater Corporation*, (C.C.A. 7th Cir. 1938) 94 F.

It is obvious that the defects of chapter X do not nullify its merits. The attempt which the chapter makes to control the inner practices of reorganizations is an achievement against which criticism of the defects of the chapter are petty. The statute however stands in need of amendment. Poor draftsmanship in numerous cases will be inevitable until some practical attention is given to the need for a federal ministry of justice which will study proposed federal bills for the discovery of technical errors, lack of uniformity, and will report to the legislature gaps and ambiguities in statutes revealed by the interpretations of courts. When the recommendations of Professor Freund and Mr. Justice Cardozo are followed in this respect, we may expect an improvement in our statutes. It is true, of course, that to deprive some provisions of their ambiguities would result in their defeat, but against that must be set the doubtful character of the victory which the proponents of a statute achieve when its provisions are capable of emasculating interpretations. The confusion of issues and tremendous waste in litigation is the result of the practices now pursued. It goes without saying that proper statutory draftsmanship would also be easier if cooperation between the bar and the law schools were better established, and if the bar itself took its duties somewhat more seriously. The reports of bar association committees have not always showed an acquaintanceship with the legislative bills which they criticize.

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(2d) 261, 262: “. . . where the state court has entertained a final judgment in a foreclosure proceeding, with a direction as to the payment of the same, a federal court is bound by such judgment.” This was not a holding because the court felt that the district court in denying the fee had acted arbitrarily anyway.