

March 1939

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Recommended Citation

Luther D. Swanstrom, *Amenability of Newly Formed Corporations to Statutory Reorganization*, 17 Chi.-Kent L. Rev. 101 (1939).

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CHICAGO-KENT LAW REVIEW

VOL. 17

MARCH, 1939

No. 2

AMENABILITY OF NEWLY FORMED CORPORATIONS TO STATUTORY REORGANIZATION

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THE practitioner called upon to direct the reorganization of unwieldy capitalization or of debt structures that have become too burdensome by reason of reduced income of the debtor's business or from any other cause, must often resort to court action to consummate a satisfactory reorganization. If the only practical and efficient forum for reorganization is a bankruptcy court, may the debtor be changed from an individual to a corporation, or vice versa, in order to obtain the relief required? Is the completion of a satisfactory reorganization so important to the private and public interests involved that a corporation organized as a step in the reorganization process, or one organized for the purpose of being reorganized, may be brought into the jurisdiction of the bankruptcy court for reorganization?

Two circuits have had under consideration the question of the amenability of newly formed corporations to Section 77B. The eighth circuit has held that such a corporation is not amenable.² The seventh circuit has approved the petitions of two such debtors.³ From the rationale of the decisions in the two circuits a conflict may be said to exist, though the approval of the petition rests in the sound discretion of the court.

The cases in the seventh circuit proceeded upon the theory that it was the duty of a court of equity to afford relief upon a proper

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² Milwaukee Postal Bldg. Corp. v. McCann, 95 F.(2d) 948 (C.C.A. 8th, 1938).

³ In re Knickerbocker Hotel Co., 81 F.(2d) 981 (C.C.A. 7th, 1936); In re Loeb Apartments, 89 F.(2d) 461 (C.C.A. 7th, 1937).

petition where needed, and that the statute granted such power to the court. The eighth circuit, in the Milwaukee Postal Building Corporation case (cited above), denied the relief on the ground of legal fraud.

The question has not been directly passed upon in other circuits. Petitions of corporations organized for the purpose of filing petitions under Section 77B have been approved in the second and in the seventh circuits without any point, apparently, having been raised on the question.⁴

It is proposed to examine in order the cases sustaining and denying amenability, and those not directly in point but cited in support of amenability; then will be considered the theories of the principal cases in the light of the purposes of the statute. It may be said at the outset that the conclusion reached is in favor of amenability.

CASES SUSTAINING AMENABILITY

In the Knickerbocker case⁵ the corporate debtor seeking reorganization under Section 77B filed its petition immediately after creation and the receipt of a conveyance of the hotel property involved from an individual nominee of the bondholders' committee, who had become the purchaser of the property at a foreclosure sale more than two years previously. Ninety-eight per cent of the first mortgage bonds were deposited with a committee that was the moving spirit behind the reorganization proceedings. Reorganization in the state court in connection with foreclosure proceedings had failed because the state court had refused to approve a plan and to confirm the sale made pursuant thereto, had removed the receiver for breach of duty, and had restrained all parties from taking steps for reorganization in the bankruptcy courts. The 77B petition was approved over the objection of 2 per cent of the bondholders.

The court stressed the point that the indebtedness was not that

⁴ In re Nine North Church Street, 82 F.(2d) 186 (C.C.A. 2d, 1936): "To forestall this [a suit by the trustee on demand of certificate holders against Maryland Casualty Company on its guaranty], Maryland organized the Nine North Church Street Corporation, the debtor, and transferred the property to it, subject to the mortgage. One week later, this petition under Bankruptcy Act § 77B . . . was filed." In re Louis Joliet Garage Corp., 100 F.(2d) 751 (C.C.A. 7th, 1938): "The corporation was organized and on the following day, January 26, 1938, a voluntary petition was filed by the newly organized corporation for relief under section 77B."

⁵ In re Knickerbocker Hotel Co., 81 F.(2d) 981 (C.C.A. 7th, 1936); before Evans, Sparks, and Briggle; opinion by Briggle, D.J.

of an individual, capable of filing under Section 74, but that of a corporation; that the fact that an individual was holding the naked legal title to the property for use of the bondholders did not brand it as individual property; that the same property was being dealt with, the same indebtedness and the same bondholders and the same "receivership spectre that produced thousands for the receiver but not one cent for the actual owners." The court stated that if the debtor had been organized merely for the purpose of incurring debts in order to file a 77B petition without anything further, good faith would have been lacking, and that would have brought an end to the proceeding. The opinion referred to the practice of a court of equity to look through the form to the substance, and having done so the court saw "a bewildered group of bondholders confronted with a condition and not a theory. . . . They had honestly, we believe, taken various steps to bring about a fair adjustment of the unfortunate situation and had been thwarted in their purpose. Ninety-eight per cent of them still had faith that a court of equity somewhere, somehow, would deliver them from bondage." The court held that the intent of Section 77B was to prevent a minority group from defeating a worthy plan of the majority and thus develop a nuisance value for their claims; that the statute contemplated a plan of reorganization; that the statute did not limit its application to corporations in existence at the time of its passage, and that the failure to exclude subsequently organized corporations was in keeping with its general purpose. The court distinguished the North Kenmore Building Corporation case⁶ on the facts.

⁶ In re North Kenmore Bldg. Corp., 81 F.(2d) 656 (C.C.A. 7th, 1936); before Sparks, Alschuler, and Briggie; opinion by Briggie, D.J. In this case an individual owned land, buildings, and furnishings appraised at \$192,203, with first mortgage bonds aggregating \$259,000 and a second mortgage of \$85,000 with accrued interest. A decree of foreclosure and sale was had in the state court on June 10, 1935, pursuant to a bill filed on June 16, 1932. On March 7, 1933, the owner quitclaimed the property to his attorney, who did not assume the indebtedness. On July 2, 1935, the debtor was incorporated and its stock issued to the attorney. On July 3, 1935, the attorney conveyed the property to the debtor corporation, which assumed all the liens, aggregating \$344,000. On July 18, 1935, the debtor filed a petition under Section 77B, which was attacked by a bondholders' committee holding in excess of 82 per cent of the outstanding bonds, on the ground of lack of good faith.

The court, dismissing the petition for lack of good faith, stated that the objection of a large percentage of bondholders to the petition weighed heavily in the determination of the question of good faith.

Thereupon the opinion proceeds with a further argument as to the lack of good faith, in that Section 74 had been enacted to apply to individuals and 77B to corporations, and hence individuals might not clothe themselves "in corporate

In the Loeb Apartment case⁷ a petition under Section 74, filed by Loeb, was dismissed for lack of jurisdiction. Loeb thereupon formed the debtor corporation and conveyed his property to it and caused the debtor to file a petition under Section 77B within a month of its incorporation. The debtor's plan was accepted by holders of more than 66 $\frac{2}{3}$ per cent of the first mortgage bonds. The special master recommended the disapproval of the petition, but Judge Wilkerson, D.J., filed a memorandum overruling the master's recommendation. Two days later, however, the Kenmore Building Corporation decision was handed down and this decision induced Judge Wilkerson to reverse his conclusion. One side therefore relied upon the Kenmore decision and the other on the Knickerbocker decision.

The Circuit Court of Appeals held that the question is one of good faith, or the lack thereof, and finding that the petition was filed in good faith, ordered that it be approved. If, in the opinion of the court, the proceeding is an attempt unreasonably to delay and harass creditors, good faith would be lacking:

No one evidentiary fact can ordinarily be given paramount weight in deciding the question. If it is obvious that a debtor is attempting unreasonably to deter and harass creditors in their bona fide efforts to realize upon their securities, good faith does not exist. But if it is apparent that the purpose is not to delay or defeat creditors but rather to put an end to long delays, administrative expenses, statutory periods of redemption and unreasonable obstruction by minorities, incident too frequently, we are sorry to observe, to mortgage foreclosure, and to invoke the operation of the act in the spirit indicated by Congress in the legislation, namely, to attempt to effect a speedy, efficient reorganization, upon a feasible basis, supported by more than two-thirds of all the creditors, good faith cannot be denied.⁸

The court took occasion to narrow the language in the Kenmore decision as follows:

It was not the intent of this court, in *Re North Kenmore Building Corporation*, supra, to fix as an arbitrary test of good faith the fact that the corporation had or had not been organized for the purpose of invoking jurisdiction. That such is the purpose does not necessarily vitiate a petition

garments for the purpose of taking advantage of the statutes appertaining thereto"; that such was not the legislative intent. In support of this last point the court cited *In re Collins*, 75 F. (2d) 62 (C.C.A. 8th, 1934); *In re Fullagar*, 8 F. Supp. 602 (W.D.N.Y., 1934); *In re Francfair, Inc.*, 13 F. Supp. 513 (S.D.N.Y., 1935); and *In re Philadelphia Rapid Transit Co.*, 8 F. Supp. 51 (E.D.Pa., 1934), approved, *Wilson v. Philadelphia Rapid Transit Co.*, 73 F. (2d) 1022 (C.C.A. 3rd, 1934).

⁷ *In re Loeb Apartments, Inc.*, 89 F. (2d) 461 (C.C.A. 7th, 1937); *Evans, Lindley, and Briggles*; opinion by Lindley, D.J.; *Briggles, D.J.*, dissenting.

⁸ 89 F. (2d) at p. 463.

under section 77B, nor does it always endow such a proceeding with a character negating good faith.⁹

The court held that Congress intended by Section 77B to provide a method for prompt reorganization, saying:

To invoke that jurisdiction and to guide one's steps with that purpose in mind is in accord with the statute and is not opposed to good faith as that term is used in the statute.¹⁰

The dissent by Briggie, D.J. (who wrote the opinion in the Knickerbocker case) is grounded on the fact that the property had been owned by an individual who, having failed for certain reasons in an attempt under Section 74, had caused the debtor to be formed; that the debt having been first incurred by an individual distinguishes the Knickerbocker Hotel decision. The dissenting opinion, however, rested on the lack of good faith but goes on to say that it was not the legislative intent that individuals might create corporations to file under a statute affording greater advantages than the one for individuals, citing in support of such view the cases relied upon in the Kenmore case.¹¹

CASES DENYING AMENABILITY

In the Milwaukee Postal Building case,¹² a corporation sold an issue of bonds executed by it which was secured by a trust deed on its garage property in Milwaukee, Wisconsin, of which issue there were outstanding \$149,500. Later it conveyed the property to a person named Little. About four years' taxes were in default and interest was unpaid since early 1936. A bondholders' committee was formed and 75 per cent of the bonds were deposited with it. When soliciting the deposit of bonds the committee circulated a plan which provided that a new corporation would be formed to be known as the Milwaukee Postal Building Corporation. The capital stock was to be held by voting trustees for a number of years and finally to be distributed to the bondholders; the maturity dates of the old bonds were to be extended and the interest rates were to be reduced. The plan was to be effective upon the acceptance of 95 per cent of the bonds.

To carry out the plan an escrow agreement was entered into

⁹ *Ibid.*, pp. 463-4.

¹⁰ *Ibid.*, p. 464. See *In re South Coast Co.*, 8 F. Supp. 43 (D.Del., 1934): "Bad faith cannot attach to adopting a course afforded by the Congress."

¹¹ See note 6, *supra*.

¹² *Milwaukee Postal Bldg. Corp. v. McCann*, 95 F. (2d) 948 (C.C.A. 8th, 1938); *Stone, Woodrough, and Van Valkenburgh*; opinion by Stone, C.J.

by the committee, Little, and a trust company as escrowee. Into the escrow Little was to deposit \$5,583.33, being the rent collections for the last two months, and a deed conveying the property to the new corporation, and the stock certificates representing the capital stock of the new corporation were to be placed in the escrow. The cash and subsequent rent collections were to be used, first, for committee expenses, and the balance to be paid to the bondholders. If the plan was not accepted by 95 per cent of the bonds by a certain date, then the stock certificates were to be delivered to Little and the cash in the escrow to the indenture trustee under the trust deed securing the bonds. The debtor was organized on July 9, 1936, and began business on July 22, 1936; the trust company collected the rents and made certain expenditures so that it had at the time of the hearing below \$14,624.07. One bondholder filed a foreclosure action on February 13, 1937, in Wisconsin and sought the appointment of a receiver. The directors of the debtor then authorized the filing of the petition under 77B. Little executed an instrument agreeing to such procedure and waiving any interest in the capital stock of the debtor under the escrow agreement. The petition was filed on February 23, 1937.

The court found that the bondholders showed a sincere effort to work out a very difficult situation; that because the trustee under the mortgage had begun no action, the owner had been collecting the rents, and the property was not properly maintained and needed repairs to such an extent that the tenant was threatening to vacate. Under this state of facts the court found further that the corporation was not formed for the specific purpose of taking advantage of Section 77B.

However, the court dismissed the petition, laying down two propositions: (1) that it would be legal fraud upon creditors to approve the petition; (2) that it would be "without the intentment of this section (77B) to construe as within the section a corporation formed to and taking over the property of an individual debtor for the purpose of utilizing the section." The opinion, after stating the facts, contains the following language:

It is confined to instances where the debtor is a corporation. It has nothing to do with the situation where the debtor is an individual or a partnership—sections 74 and 75, as amended, U.S.C.A. title 11, §§ 202 and 203, cover the field as to individuals in so far as Congress deemed it wise so to do. It deals solely with corporate reorganizations. This being true,

it is clear that it would be not only a legal fraud upon creditors, but without the intendment of this section to construe as within the section a corporation formed to and taking over the property of an individual debtor for the purpose of utilizing the section. *Shapiro v. Wilgus*, 287 U.S. 348, 53 S. Ct. 142, 77 L.Ed. 355, 85 A.L.R. 128; *Platt v. Schmitt*, 8 Cir., 87 F.(2d) 437,440; *In re Collins*, 8 Cir., 75 F.(2d) 62; *In re North Kenmore Building Corp.*, 7 Cir., 81 F.(2d) 656, and see *In re Philadelphia Rapid Transit Co.*, D.C. Pa., 8 F. Supp. 51, approved in *Wilson v. Philadelphia Rapid Transit Co.*, 3 Cir., 73 F. (2d) 1022, contra, *In re Loeb Apartments*, 7 Cir., 89 F.(2d) 461. In the *Platt* case, supra, Judge Woodrough, for this court, said: "There is a duty in the courts to see that provisions of the act are not abused and that its privileges are extended only to those who are within the contemplation of the act." 87 F.(2d) 437, at page 440.

CASES CITED AGAINST AMENABILITY

The opinion in the Milwaukee Postal Building Corporation case, does not mention the Knickerbocker Hotel case, but relies upon one equity receivership case and certain bankruptcy reorganization cases. These cases may be summarized as follows:

*Shapiro v. Wilgus*¹³ was an equity receivership case. An apparently solvent individual failed in an attempt to obtain an extension from his creditors because two of his creditors refused. Under the particular state law a receiver could not be appointed for an individual. The debtor therefore organized a Delaware corporation, conveyed all of his assets to the corporation and took all of its capital stock. Three days later, in conjunction with a single contract creditor, he brought suit against the Delaware corporation in the Federal court and prayed for a receiver. The court held that the creation of the corporation and the institution of the receivership were not to administer the assets of the corporation legitimately for normal business purposes, but were to interpose an obstruction to creditors, saying that the conveyance was a mere "scheme whereby the form of a judicial remedy was to supply a protective cover for a fraudulent design."

In the *Collins* case,¹⁴ a corporation conveyed, without consideration, all of its property to Collins, who owned all the capital stock, on February 9, and on February 12 Collins filed a Section 74 petition. Section 77B was not at this time in force. The court found that the purpose of the entire transaction and of every move in it was to hinder and delay creditors. Accordingly, the court held the conveyance fraudulent with respect to corporate debtors, and dissolved an order restraining sale of real estate to

¹³ 287 U.S. 348, 53 S. Ct. 142, 77 L.Ed. 355, 85 A.L.R. 128 (1932).

¹⁴ *In re Collins*, 75 F. (2d) 62 (C.C.A. 8th, 1934).

satisfy a default on a deed of trust covering the property. In the Fullager case,¹⁵ a person owning a considerable amount of real estate deeded a farm to another who owned no other property for the purpose of placing the grantee in a more favorable position by permitting him to come under Section 75 of the Bankruptcy Act.¹⁶ The court, after pointing out that such provision "was passed for the benefit of bona fide farmers," said, "It seems to the court that this petition was not filed in good faith, and that the alleged debtor is not a bona fide farmer within the contemplation of the act."

It is to be noted that in *Platt v. Schmitt*,¹⁷ on the other hand, a father made a gift of the property to his son and the son filed a Section 74¹⁸ petition. The court approved the petition as having been filed in good faith, resting its decision squarely on the ground of good faith, and on that ground distinguished the Fullagar and Collins cases.¹⁹

In the Francfair case,²⁰ a solvent Massachusetts trust conveyed property to a corporation in consideration of all of the capital stock and the corporation's note for \$345,000 and its assumption of the first mortgage. Foreclosure proceedings were pending and a sale was advertised for April 29. The liabilities against the property exceeded its appraised value by \$135,000. The court disapproved the petition for the reason that there was no probability of a successful reorganization, citing as authority *Manati Sugar Co. v. Mock*.²¹ The court went on to say further that a petition filed on January 15 by a debtor incorporated on January 2 for the purpose of acquiring property from a solvent trust and the trust continuing in control of the property could not be considered to have been filed in good faith, and cites by comparison *Shapiro v. Wilgus*.

¹⁵ *In re Fullagar*, 8 F. Supp. 602 (W.D.N.Y., 1934).

¹⁶ 75 (s) (3), 11 U.S.C.A. § 203 (s) (3).

¹⁷ 87 F. (2d) 437 (C.C.A. 8th, 1937).

¹⁸ 11 U.S.C.A. § 202.

¹⁹ The court in *Platt v. Schmitt* was composed of Judges Sanborn, Woodrough, and Booth. The court which decided the *Milwaukee Postal Bldg. Corp.* case in the same circuit was composed of Judges Stone, Woodrough, and Van Valkenburgh.

²⁰ *In re Francfair, Inc.*, 13 F. Supp. 513 (S.D.N.Y., 1935).

²¹ 75 F. (2d) 284 (C.C.A. 2d, 1935). The court affirmed an order dismissing as not filed in good faith a petition under 77B, where the corporation's financial condition was not shown, no reorganization plan was tendered, no facts were pleaded showing that reorganization could be effected, and answer of the corporation and the intervening bondholders' protective committee alleged facts showing that reorganization was impossible.

The Philadelphia Rapid Transit case²² was decided purely on the question of good faith. The court held that a city official who believed that a street car company should be reorganized, could nevertheless not buy claims against the company for the purpose of filing an involuntary petition. The court held that an involuntary petition should be filed by creditors, and that one who buys his way into court is not a creditor within the meaning of the statute.

It is apparent that all the foregoing cases disapproved the petitions for reorganization or composition for lack of good faith in fact and not because of legal fraud. In *Shapiro v. Wilgus*,²³ for example, although the term "legal fraud" was employed, the Supreme Court found that the corporation was formed and the receivership proceedings instituted to hinder and delay creditors. Such a finding in a reorganization case would prevent the approval of a petition.

CONSIDERED IN VIEW OF THE STATUTORY PURPOSES

An equity receivership proceeding is different from a 77B or Chapter X proceeding. The equity receivership theoretically is to be used where the debtor is solvent, for, if it is insolvent, it will be subject to bankruptcy, hence Congress had in mind remedies for a debtor and creditor situation that would apply more universally and could be used for the rehabilitation of an insolvent debtor.

The Milwaukee Postal Building Corporation case and the dictum in the Kenmore case carried over in the dissenting opinion in the Loeb Apartments case rest on the proposition that a petition of a newly formed corporation may be disapproved upon the ground of legal fraud upon creditors and on the ground that Congress did not intend that the statute might be so used. These doctrines indicate that even if creditors and their debtors have attempted to reorganize out of court and have failed, they may not then resort to the bankruptcy reorganization statutes.

Fraud is one of those terms that do not submit readily to defi-

²² In re Philadelphia Rapid Transit Co., 8 F. Supp. 51 (E.D.Pa., 1934), approved, *Wilson v. Philadelphia Rapid Transit Co.*, 73 F. (2d) 1022 (C.C.A. 3rd, 1934). The case was decided in the bankruptcy court by a three judge court, composed of District Judges Dickinson, Kirkpatrick, and Welsh. The last named judge dissented.

²³ 287 U.S. 348, 53 S. Ct. 142, 77 L.Ed. 355, 85 A.L.R. 128 (1932).

nition. The facts of each case determine the question. Statutory definitions of fraud do not seem to illuminate the subject. Fraud is said to be synonymous with bad faith.²⁴ Actual fraud is distinguished from constructive fraud, which is sometimes called legal fraud. Constructive fraud may arise where there is a breach of legal or equitable duty which, irrespective of the moral guilt of the fraud feisor, the law declares fraudulent because of its tendency "to deceive or mislead other persons, or to violate private or public confidence, or to impair or injure the public interests."²⁵ Likewise acts constitute legal fraud which, if generally permitted, would be prejudicial to the public welfare or have a detrimental effect upon public interests and public or private confidence.²⁶ Every reorganization proceeding is a class action. It is not a law suit with victory for one litigant over the other. The bankruptcy reorganization amendments are an expression by Congress of the underlying public policy that reorganization of distressed enterprises should be promoted. The use of the remedies afforded by Congress in reorganization matters, where the public interests are recognized to be more and more present, can not well be said to be such acts as would constitute legal fraud on the ground that, if generally permitted, it would tend "to deceive or mislead other persons, or to violate private or public confidence, or to impair or injure the public interests."

If a 77B court finds that the proceedings are brought with intent to hinder and delay creditors, or if the result of the proceedings would be to hinder and delay creditors, the court should not approve the petition because good faith would then be lacking. A 77B or Chapter X proceeding differs to some extent from an equity receivership proceeding. A 77B or Chapter X proceeding effectually places the assets of the debtor in a position for use by the creditors and stockholders, if they have an interest, to accomplish an equitable distribution in a plan either by cash or securities. A 77B or Chapter X petition, particularly when support-

²⁴ *Stark v. Starr*, Fed. Cas. No. 13,307 (1870); *Hilgenberg v. Northup*, 134 Ind. 92, 33 N.E. 786 (1893); *State ex rel. Millice v. Petersen*, 36 Ind. App. 269, 75 N.E. 602 (1905).

²⁵ 1 Story Equity Jur. (12th ed.) § 258. See also 26 C.J. 1061, and cases cited therein.

²⁶ "Constructive fraud" has been defined as "an act done or omitted, not with an actual design to perpetrate positive fraud or injury upon other persons, but which, nevertheless, amounts to positive fraud, or is construed as a fraud by the court because of its detrimental effect upon public interests and public or private confidence." *Eaton, Equity* (2d ed.), p. 260.

ed by a large number of creditors of a senior class, cannot be said to be brought for the purpose, therefore, of harassing or delaying creditors.

The statute specifically provides that a judge shall approve the petition if it is a proper one and if he believes that it is filed in good faith.²⁷ There was no attempt made in Section 77B to define the term "good faith." The courts, however, established a practical definition of good faith and held that if the interests of the parties would be best served by a proceeding in the bankruptcy courts then good faith would be present.

The approval or disapproval of a petition lies in the sound discretion of the court. Good faith is an ultimate fact to be found by the court from evidential facts. It is the conclusion to be drawn one way or the other from the facts alleged in the petition or elsewhere.²⁸ It connotes honesty, actuality, innocence and the absence of fraud, collusion, or deceit. The court's discretion is exercised as the exigencies of each case demand. Variables present themselves that resist standardization.²⁹ The history and background of the present litigation between the creditors and the debtor—the results obtainable in other forums compared with the likelihood of better results under the Federal reorganization statutes have been considered important elements in the determination of good faith.³⁰

While the elements that make up good faith are vague and uncertain the court has been guided by practical considerations so that where it is apparent that no plan can be worked out and that it would be futile to bring the proceedings, good faith is held

²⁷ 77B, a: "Upon the filing of such a petition or answer the judge shall enter an order either approving it as properly filed under this section if satisfied that such petition or answer complies with this section and has been filed in good faith, or dismissing it."

Ch. 10, § 141: "Upon the filing of a petition by a debtor, the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied." 11 U.S.C.A. § 541.

²⁸ *Hickey v. Ritz-Carlton Restaurant & Hotel Co.*, 96 F. (2d) 748 (1938).

²⁹ The language of *Platt v. Schmitt*, 87 F. (2d) 437 at 440 (C.C.A. 8th, 1937) is typical: "No comprehensive definition of 'good faith' should be attempted, but the circumstances of each case must control according to long-settled principles of law and equity. The purpose and spirit of the act are to be found in the circumstances of its enactment and in all its terms considered together."

³⁰ *R. L. Witters Associates, Inc. v. Ebsary Gypsum Co., Inc.*, 93 F. (2d) 746 (C.C.A. 5th, 1938); *In re Prairie Avenue Building Corp.*, 11 F. Supp. 125 (E.D. Ill., 1935); *In re Loeb Apartments, Inc.*, 89 F. (2d) 461 (C.C.A. 7th, 1937); *In re A. C. Hotel Co.*, 93 F. (2d) 841 (C.C.A. 7th, 1937).

to be not present. A possibility of reorganization should exist.³¹ Some prospect must be shown that the affairs of the debtor may be reorganized—a general showing of circumstances that reasonably indicate the desirability and possibility of reorganization.³²

Such practical considerations have led to the approval of petitions where it is apparent that the plan of reorganization must result in a liquidation, that is, where the senior class of creditors takes all of the property of the debtor.³³

There are further statutory safeguards against harassing or delaying creditors in that the plan must be presented in good faith³⁴ and the acceptances thereto must be obtained without the giving of any promises forbidden by the Act and all charges and expenses in connection with the reorganization must be disclosed and approved by the court.³⁵ A showing is required of the claims or stock purchased or transferred by those accepting the plan in contemplation of the proceedings.³⁶ Furthermore, good faith must continue throughout the proceedings,³⁷ and is required of all concerned, including creditors and stockholders, as well as the debtor.³⁸

The Supreme Court has held that the formation of a corporation to create diversity of citizenship so that the rights of the parties might be determined by a Federal Court is not improper or collusive within the meaning of Section 37 of the Judicial Code, which requires dismissal of a suit where the parties have improperly or collusively joined either as plaintiffs or as defendants for the purpose of creating a case cognizable in such a court. If the succession and transfer to the new corporation are actual,

³¹ *In re South Coast Co.*, 8 F. Supp. 43 (D.Del., 1934); *In re Francair, Inc.*, 13 F. Supp. 513 (S.D.N.Y., 1935); *R. L. Witters Associates, Inc. v. Ebsary Gypsum Co., Inc.*, 93 F. (2d) 746 (C.C.A. 5th, 1938).

³² *In re 2747 Milwaukee Avenue Building Corp.*, 12 F. Supp. 557 (N.D.Ill.E.D., 1935); *Manati Sugar Co. v. Mock*, 75 F. (2d) 284 (C.C.A. 2d, 1935).

³³ *In re Central Funding Corp.*, 75 F. (2d) 256 (C.C.A. 2d, 1935); *R. L. Witters Associates, Inc. v. Ebsary Gypsum Co., Inc.*, 93 F. (2d) 746 (C.C.A. 5th, 1938); *In re A. C. Hotel Co.*, 93 F. (2d) 841 (C.C.A. 7th, 1937); *Re 620 Church Street Bldg. Corp.*, 299 U.S. 24, 57 S.Ct. 88, 81 L.Ed. 16, reh. den. 299 U.S. 623, 57 S.Ct. 229, 81 L.Ed. 458 (1936).

³⁴ *Tennessee Pub. Co. v. American National Bank*, 299 U.S. 18, 57 S.Ct. 85, 81 L.Ed. 13 (1936).

³⁵ Section 77B(f); Ch. 10, § 221.

³⁶ Section 77B(e); Ch. 10, § 203.

³⁷ *In re Dutch Woodcraft Shops*, 14 F. Supp. 467 (W.D.Mich.S.D., 1935).

³⁸ *In re Louisiana Oil Refining Corp.*, 20 F. Supp. 580 (W.D.La., Shreveport D. 1937).

and not feigned or merely colorable, the courts will not inquire into the motives in deciding jurisdiction.³⁹ In the Milwaukee Postal Building Corporation case, the court stated that since Sections 74 and 75 were passed to cover cases where the debtor is an individual and that Section 77B deals solely with corporations, so therefore, it was not the intent of Congress that Section 77B should be construed to apply to a corporation formed to take over property of an individual debtor for the purpose of utilizing the section. The restriction was extended to exclude a debtor not organized specifically to file under Section 77B if it was organized and the property conveyed to it for the purpose of attempting to work out a reorganization, because "the natural and inevitable result thereof would be a reorganization under the section if the out of court reorganization failed. This situation is within the spirit of the above decisions." It further stated that to construe the statute so as to permit relief under such circumstances would open the door to easy evasion either intentionally or unintentionally. It is difficult to understand just what evasion would be made possible by the approval of the petition and the opinion does not throw any light on this speculation. The proceedings at all times are in the control of the court of equity for a new purpose—that of reorganization—and improper evasion would not be permitted.

There is nothing in Section 77B that limits its application to corporations in existence at the date of its passage.⁴⁰ Section 77B expressly applies to any corporation that could become a bankrupt, except one amenable to Section 77.

The limitations in section 77B with respect to venue, do not relate to the period of time of corporate existence.⁴¹ This is made clearer by the comparable provisions of Chapter X, by the addition of the language "or for a longer portion of the preceding six months than in any other jurisdiction."⁴²

³⁹ *Black & White Taxicab & Transfer Co. v. Brown & Yellow Taxicab & Transfer Co.*, 276 U.S. 518, 48 S.Ct. 404, 72 L.Ed. 681 (1928).

⁴⁰ *In re Knickerbocker Hotel Co.*, 81 F. (2d) 981 (C.C.A. 7th, 1936).

⁴¹ Section 77B(a). "The petition shall be filed with the court in whose territorial jurisdiction the corporation, during the preceding six months or the greater portion thereof, has had its principal place of business or its principal assets, or in any territorial jurisdiction in the State in which it was incorporated."

⁴² Ch. 10, § 128. "If no bankruptcy proceeding is pending, an original petition may be filed with the court in whose territorial jurisdiction the corporation has had its principal place of business or its principal assets for the preceding six months or for a longer portion of the preceding six months than in any other jurisdiction."

If the rule laid down by the Milwaukee Postal Building Corporation case is followed, attempts at out-of-court reorganization will be discouraged where it is necessary to form a corporation to carry out the reorganization because, should such attempts fail, the corporation could not complete its reorganization in a court proceeding under the Bankruptcy Act for lack of amenability to the reorganization chapters thereof.

The general purpose of the legislation is expressed in 77A. It has been said that the extent of jurisdiction is significant and distinguishes cases under the old Act.⁴³ It has been said that it has as one of its purposes the creation of a method whereby dehydration of securities may be effected, and gradual deflation from excessive inflation be had, and by orderly processes, to accomplish a reorganization of the financial and economic structure to reach recovery.⁴⁴ Though such proceedings are in bankruptcy,⁴⁵ they differ fundamentally from ordinary bankruptcy.⁴⁶ Such proceedings are not the same as proceedings in equity receivership as to form, practice, or objectives. The reorganization amendments to the Bankruptcy Act authorize the courts to do what they have not been able to do in equity receivership.⁴⁷

The courts have held that the bankruptcy amendments should be liberally construed so far as possible to make the legislation

⁴³ "Likewise, legislation which deals with the subject of bankruptcy, that is, legislation for the benefit and relief of creditors and debtors—is not subject to the same constitutional limitations as legislation which deals with other subjects and which affects contractual rights and obligations of debtors and creditors. The grant of power 'to establish . . . uniform Laws on the subject of Bankruptcies' (Const. art. 1, § 8, subd. 4) was necessarily a grant of power the exercise of which would impair the obligation of contracts. For legislation on the subject of bankruptcy contemplates a discharge of the debtor's debts—which is an impairment of contractual obligations. *Hanover National Bank v. Moyses*, 186 U.S. 181, 22 S.Ct. 857, 46 L.Ed. 1113." *In re Chicago, R. I. & P. Ry. Co.*, 72 F.(2d) 443, 452 (C.C.A. 7th, 1934).

⁴⁴ *Campbell v. Alleghany Corporation*, 75 F.(2d) 947, 951 (C.C.A. 4th, 1935).

⁴⁵ *Meyer v. Kenmore-Granville Hotel Co.*, 297 U.S. 160, 56 S. Ct. 405, 80 L.Ed. 557 (1936); *Schwartz v. Irving Trust Co.*, 299 U.S. 456, 57 S. Ct. 303, 81 L.Ed. 348 (1937).

⁴⁶ *Lowden v. Northwestern National Bank & Trust Co.*, 298 U.S. 160, 56 S. Ct. 696, 80 L.Ed. 1114 (1936); *Continental Ill. Nat. Bank & Trust Co. v. Chicago, R. I. & P. Ry. Co.*, 294 U.S. 648 55 S. Ct. 595, 79 L.Ed. 1110 (1935).

⁴⁷ "*The proceedings under sections 74, 75, 76, and 77 are not the equivalents of equity receivership proceedings. They contemplate a feasible plan, promptly presented, whereby the overburdened debtor may, through creditors' co-operation (though unanimous creditor action is unnecessary) secure a scaling of debt or interest, or an extension of due date of debts.*" [Italics by the court] *In re Sterba*, 74 F.(2d) 413, 417 (C.C.A. 7th, 1935).

effective.⁴⁸ The purpose of the statute should be forwarded by a fair and liberal construction of its provisions and not thwarted by a narrow and technical interpretation "and certainly not by reading into its language conditions and limitations which the law makers did not see fit to express."⁴⁹ The meaning of words and phrases used in equity cases has been broadened to meet the requirements of the reorganization statutes and to carry out the intent and purposes of such statutes, particularly to overcome the emphasis placed by courts of equity on the position of non-assenting minorities.⁵⁰ It is difficult enough for creditors to realize on their claims at best, and especially so when they must act in a class.⁵¹

It is therefore manifestly unfair to creditors to bar them from the newly created remedies of the Bankruptcy Act unless Congress has clearly shut the door to them. Likewise, stockholders are entitled to the fullest use of these remedies to salvage their investments. If the bankruptcy forum is indicated as the best one for readjustment of the claims and stock interests such forum should not be denied by strained legalism which may also tend to place the legislation in a "strait-jacket." This the Supreme Court said should not be done.⁵² General congressional intent is thus recognized and adherence to inappropriate concepts with

⁴⁸ *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 57 S. Ct. 292, 81 L.Ed. 324 (1937); *In re Chicago, R. I. & P. Ry. Co.*, 72 F. (2d) 443 (C.C.A. 7th, 1934), *aff'd*, *Continental Ill. Nat. Bank & Trust Co. v. Chicago, R. I. & P. Ry. Co.*, 294 U.S. 648, 55 S. Ct. 595, 79 L. Ed. 1110 (1935).

⁴⁹ *Campbell v. Alleghany Corporation*, 75 F. (2d) 947, 950 (C.C.A. 4th, 1935).

⁵⁰ *In re Peyton Realty Co.*, 18 F. Supp. 822 (E.D.Pa., 1936). See also: *Downtown Inv. Association v. Boston Metropolitan Bldgs. Inc.*, 81 F. (2d) 314 (C.C.A. 1st, 1936); *Ashton v. Cameron County W.I. Dist. No. One*, 298 U.S. 513, 56 S. Ct. 892; 80 L.Ed. 1309 (1936); *In re Allied Owners' Corp.*, 74 F. (2d) 201 (C.C.A. 2d, 1934).

⁵¹ *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 55 S. Ct. 854, 79 L.Ed. 1593 (1935), cited in the *Milwaukee Postal Building Corporation* case in support of the statement that prior to Section 77B there were only two remedies open to debtors and creditors, viz: liquidation or bargaining for composition. In the *Louisville* case, the court clearly indicated the difference between class action in reorganization and individual action: "In no case of composition is a secured claim affected except when the holder is a member of a class; and then only when the composition is desired by the requisite majority and is approved by the court. Never, so far as appears, has any composition affected a secured claim held by a single creditor."

⁵² *Lowden v. Northwestern Nat. Bank & Trust Co.*, 298 U.S. 160, 56 S. Ct. 696, 80 L. Ed. 1114 (1936). In discussing the applicability or inapplicability of the set-off rule, the court said: "A decision balancing the equities must await the exposure of a concrete situation with all its qualifying incidents. What we disclaim at the moment is a willingness to put the law into a strait-jacket by subjecting it to a pronouncement of needless generality."

the development of unworkable precepts is to be avoided. The concept of legal fraud has no place in the administration of a law where fact controls.

If it is not in harmony with the congressional intent and purpose to deny the facilities of the bankruptcy reorganization statutes to any corporation otherwise qualified if it is in need of reorganization and if the interest of creditors and stockholders, if they have an equity, may be thereby better conserved. In this field of reorganization actuality is the important thing. Potency of fact surmounts authority of theory. In deciding whether 77B petitions for reorganization should or should not be approved, it is improper to resurrect such fiction as legal fraud when interpreting a statute which specifically requires good faith in the presentation of the petition.

EFFECT OF CHAPTER X

The Revised Bankruptcy Act of 1938, including Chapters X and XII, containing reorganization provisions derived principally from Sections 77B and 74, strengthens not only the liquidation provisions in bankruptcy but the reorganization provisions as well. Chapter XII, dealing with arrangements by persons other than corporations, provides that the plan shall modify or alter the rights of secured creditors either through the issuance of securities or otherwise.⁵³ The reorganization of the affairs of an individual debtor, therefore, is not more limited in this respect than that of a corporation under Chapter X or Section 77B. Such reorganization may be by the transfer of its securities to a corporation and issuance of new securities of any character or otherwise.

The provisions of Chapter X respecting the required allegations in a petition have been amplified over those required in Section 77B in that it is specifically provided that a showing of facts must be made concerning the status of any plan of reorganization, readjustment, or liquidation affecting the property of the corporation either in connection with or without any judicial proceeding.⁵⁴ This would indicate that should the court find from

⁵³ Section 461: "An arrangement—(1) shall include provisions modifying or altering the rights of creditors who hold debts secured by real property or a chattel real of the debtor, generally or of a class of them, either through the issuance of new securities of any character or otherwise. . . ." 11 U.S.C.A. § 861.

⁵⁴ Section 130: "Every petition shall state . . . (6) the status of any plan of reorganization, readjustment, or liquidation affecting the property of the corporation, pending either in connection with or without any judicial proceeding. . . ." 11 U.S.C.A. § 530.

the exposition of facts showing that an out of court reorganization has been attempted through the mechanics of a new corporation, as in the Milwaukee Postal Building Corporation case, the petition should be approved if the court believes that to do so would best subserve the interests of the parties.

While no attempt is made in Chapter X to define the term "good faith," Section 146 sets forth certain conditions which if present would negative good faith.⁵⁵ This substantially codifies certain decisions under 77B.⁵⁶ Furthermore, it is expressly provided that if there is a prior proceeding in any court and it appears that the interests of stockholders and creditors would best be served in the prior proceeding, good faith is not present. Conversely, it would follow that, notwithstanding attempts at reorganization in other proceedings, if the court believes that the interests of the creditors and stockholders would be best served under Chapter X, good faith will be present and the petition, if otherwise proper, should be approved.

The provision of 77B⁵⁷ granting jurisdiction in the reorganization court over property of the debtor held by a receiver or trustee appointed in any other court has been strengthened in Chapter X⁵⁸ by the provision that the trustee appointed under the Act shall have the right to immediate possession of the debtor's property which is in possession of a trustee or mortgagee under a mortgage. This provision is undoubtedly inserted to overcome the effect of certain decisions under 77B relating to property in

⁵⁵ Section 146: "Without limiting the generality of the meaning of the term 'good faith,' a petition shall be deemed not to be filed in good faith if—

(1) the petitioning creditors have acquired their claims for the purpose of filing the petition; or

(2) adequate relief would be obtainable by a debtor's petition under the provisions of chapter XI of this title; or

(3) it is unreasonable to expect that a plan of reorganization can be effected; or

(4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding."

11 U.S.C.A. § 546.

⁵⁶ See cases cited in notes 20, and 27 to 30 inclusive.

⁵⁷ 77B(i): "and if such petition or answer is approved, the trustee or trustees appointed under this section, or the debtor if no trustee is appointed, shall be entitled forthwith to possession of and vested with title to such property. . . ."

⁵⁸ Section 257: "The trustee appointed under this chapter, upon his qualification, or if a debtor is continued in possession, the debtor, shall become vested with the rights, if any, of such prior receiver or trustee in such property and with the right to the immediate possession thereof. . . . [and] of all property of the debtor in the possession of a trustee under a trust deed or a mortgagee under a mortgage." 11 U.S.C.A. § 657.

states following the "title" theory instead of the "lien" theory as to the rights of mortgagees after default.⁵⁹

CONCLUSION

If the judge finds that a petition is filed in good faith, such finding is tantamount to a finding that the proceeding would not embarrass or obstruct creditors in the pursuit of their legitimate remedies. The finding of good faith, therefore, and orders based thereon preclude the existence of legal fraud. To afford the remedy under an order of approval after such finding of fact cannot be said to hinder and delay creditors. No legal fraud is perpetrated on creditors by the approval of a petition properly drawn and presented if the judge finds, in the exercise of sound discretion, that the petition is filed in good faith under the practical and comprehensive definition of that term as found in the opinions of the cases.

It is within the "intendment" of the legislation, as shown by its express language and by the construction placed thereon by the courts generally, to hold that a corporation formed as a step in the process of reorganization is amenable to the provisions of Section 77B and Chapter X.

⁵⁹ See, for example, *In re Frances E. Willard National Temperance Hospital*, 82 F.(2d) 804 (C.C.A. 7th, 1936), in which the court quoted the following language from *Tuttle v. Harris*, 297 U.S. 225, 56 S.Ct. 416, 80 L. Ed. 654 (1936): "A mortgagee after condition broken under the law of Illinois is the owner of a legal estate, and as such entitled as of right to the possession of the mortgaged premises. *Wolkenstein v. Slonim*, 355 Ill. 306, 189 N.E. 312. The grantee under the deed of trust was in possession not as receiver, but as owner," and then held: "It follows from this that as owner, he cannot be ousted under proceedings under section 77B, and it was therefore error for the court to order the mortgaged property turned over to the temporary trustee, either by summary or plenary proceedings."