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## WHO ARE CREDITORS IN A REORGANIZATION PROCEEDING?

F. J. MOREAU†

### *A. Creditors entitled to join in a petition for the reorganization of a debtor corporation*

The word "creditor" is specifically defined in the very first section of the Bankruptcy Act. A creditor is a person owning a debt, demand, or claim provable in bankruptcy.<sup>1</sup> Accordingly, a complete knowledge of the term as defined can be obtained only by getting a thorough understanding of the nature of provable claims as provided by Congress.<sup>2</sup> Gradually, the number of provable claims has been increased both by amendment of the act,<sup>3</sup> and judicial interpretation.<sup>4</sup> Still a creditor remains under the statute a person having a provable claim.<sup>5</sup>

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1. 11 U. S. C. A. (1927) sec. 1 (9). Now (1938) 52 Stat. 841, c. 575, 11 U. S. C. A. (1939) sec. 1 (11).

2. Bankruptcy Act (1898) 30 Stat. 562, c. 541, sec. 63, 11 U. S. C. A. (1927) sec. 103.

3. Subdivisions 6, 6½, and 7 were added to this section by Congress, June 7, 1934, 48 Stat. 923, c. 424, and June 18, 1934, 48 Stat. 991, c. 580.

4. *Maynard v. Elliott* (1931) 283 U. S. 273; *Williams v. United States Fidelity & Guaranty Co.* (1915) 236 U. S. 549; *Central Trust Co. v. Chicago Auditorium Ass'n* (1916) 240 U. S. 581; *Irving Trust Co. v. A. W. Perry, Inc.* (1934) 293 U. S. 307.

5. *American Surety Co. v. Marotta* (1933) 287 U. S. 513. Lawyers argued that the word "creditor" had the meaning given it by statute throughout bankruptcy proceedings, wherever used. This argument was overthrown when the Supreme Court of the United States held that the word "creditor" as used in relation to the Acts of Bankruptcy (1898) 30 Stat. 544, c. 541, in sec. 3 A (1), should be given the meaning usually attributed to it in the law of fraudulent conveyances, rather than the meaning given to it by specific statutory definition. The net result is that the term as used in sec. 3 A (1) has a broader meaning than as defined in sec. 1 (9). (Now sec. 1 (11) of the Chandler Act (1938) 52 Stat. 841, c. 575, 11 U. S. C. A. (1939) sec. 1 (11)). The case involved the question whether a debtor had committed an act of bankruptcy in transferring property with intent to hinder or delay creditors if such creditors did not have provable claims. The Court answered the question affirmatively. This reasoning in departing from what may be termed the "letter" of the statute is a fine example of purposive interpretation. Congress must have intended to give a "creditor" as recognized in the law of fraudulent conveyances the additional remedy of filing an involuntary petition in bankruptcy upon making his claim provable, even though not provable at the time of the fraudulent conveyance. It refused to say that the statutory word "include" in the definition of creditor also meant "exclude." In other words the Court

Section 77B defined the term "creditors" more broadly.<sup>6</sup> The concept therein was much more inclusive than its meaning in a regular proceeding in bankruptcy. It included claimants having claims against the debtor or *its property*. Holders of vested interests in the debtor's property are not affected by regular bankruptcy proceedings. But in a reorganization proceeding which aims to preserve the debtor's property intact instead of liquidating it, a different technique is essential.<sup>7</sup> All claimants should be

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refused to follow the rule of interpretation which says that if the legislature enumerates, it thereby excludes all things not included. To apply such rule would have defeated the Congressional purpose.

6. Bankruptcy Act (1934) 48 Stat. 911, c. 424, sec. 77 B (b) (10), 11 U. S. C. A. (1937) sec. 207 (b) 10. "The term 'creditors' shall include for all purposes of this section and of the reorganization plan, its acceptance and confirmation, all holders of claims of whatever character against the debtor or its property, including claims under executory contracts, whether or not such claims would otherwise constitute provable claims under this Act. The term 'claims' includes debts, securities, other than stock, liens, or other interests of whatever character. For all purposes of this section unsecured claims which would have been entitled to priority over existing mortgages if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition or answer under this section, shall be entitled to such priority, and the holders of such claims, and of other claims, if any, of equal rank, shall be treated as a separate class of creditors. In case an executory contract or unexpired lease of real estate shall be rejected pursuant to direction of the judge given in a proceeding instituted under this section, or shall have been rejected by a trustee or receiver in bankruptcy or receiver in equity, in a proceeding pending prior to the institution of a proceeding under this section any person injured by such rejection shall, for all purposes of this section and of the reorganization plan, its acceptance and confirmation, be deemed to be a creditor. The claim of a landlord for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall be treated as a claim ranking on a parity with debts which would be provable under section 63 (a) of this Act, but shall be limited to an amount not to exceed the rent, without acceleration, reserved by said lease for the three years next succeeding the date of surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after the filing of the petition, plus unpaid rent accrued up to such date of surrender or reentry: *Provided*, That the court shall scrutinize the circumstances of an assignment of future rent claims and the amount of the consideration paid for such assignment in determining the amount of damages allowed assignee hereunder. In the case of secured claims entitled to the provisions of clause (5) of this subdivision (b), the value of the security shall be determined in the manner provided in section 57, clause (h) of this Act, and if the amount of such value shall be less than the amount of the claim, the excess may be classified as an unsecured claim. The provisions of section 60 of this Act shall apply to claims against the debtor in a proceeding under this Section." *Foust v. Munson S. S. Lines* (1936) 299 U. S. 77.

7. *In re Draco Realty Corp.* (D. C. S. D. N. Y. 1935) 11 F. Supp. 405. For such purposes as filing claims, voting on plans, and sharing in the newly organized company, a right *in rem*, an interest in the property of the debtor, is sufficient to give the claimant the status of a creditor.

harmonized to the purpose. Unsympathetic claimants are inclined to embarrass those seeking to stabilize the slipping structure and within Constitutional limitations should not be permitted to do so.

The portion of section 77B cited above stated that the word was to have this broad meaning "for all the purposes of this section." But the Chandler Act adds, "when not inconsistent with the context." The question arises whether any creditor within the language quoted is qualified to join in the filing of a creditors' petition. Section 77B (a) provided that such creditors must have provable claims.<sup>8</sup> The Chandler Act however allows "creditors" having claims aggregating \$5000 or over, liquidated as to amount and not contingent as to liability, to file petitions.

The exercise of the judicial function in the interpretation of this portion of section 77B caused the courts some difficulties.<sup>9</sup> The problem was always to ascertain what was the necessary relation between debtor and claimant. Necessarily the cases available construe the provisions of section 77B. The Chandler Act, obviously, further limits the right to file petitions.

The status of a mortgagee of property in relation to a purchaser (debtor in reorganization) of the equity of redemption

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8. Bankruptcy Act (1934) 48 Stat. 913, c. 424, sec. 77B (a), 11 U. S. C. A. (1937) sec. 207 (a) provided " \* \* \* Three or more creditors who have provable claims against any corporation which amount in the aggregate, in excess of the value of securities held by them, if any, to \$1,000 or over may, if such corporation has not filed a petition or answer under this section, file with the court in which such corporation might file a petition under this section, a petition stating that such corporation is insolvent or unable to meet its debts as they mature and, if a prior proceeding in bankruptcy or equity receivership is not pending, that it has committed an act of bankruptcy within four months, that such creditors propose that it shall effect a reorganization; \* \* \* " Cf. sec. 1 (9) of the Bankruptcy Act, 11 U. S. C. A. (1927) sec. 1 (9). "'Creditor' shall include anyone who owns a demand or claim provable in bankruptcy, and may include his duly authorized agent, attorney, or proxy." Examine sec. 63 of the Bankruptcy Act, which defines provable claims. Does it limit the meaning of subdivision (a) of sec. 77B? See *Mount Forest Fur Farms of America v. Farnsworth* (C. C. A. 6, 1937) 92 F. (2d) 342, for a literal application of the statute, and a holding that a provable claim is necessary. See also *In re Draco Realty Corp.* (D. C. S. D. N. Y. 1935) 11 F. Supp. 405, in which the court contrasts the two types of creditors. A mortgagee of property is not a creditor of the mortgagor's grantee so as to be able to file a petition against him.

9. *Bryan v. Welsh* (C. C. A. 10, 1934) 72 F. (2d) 618, (C. C. A. 10, 1935) 74 F. (2d) 964. In this opinion, the court quotes *Bogert, Trusts* (1921) 16, distinguishing a debt from a trust. *Guardian Trust Co. v. Studdert* (Tex. Civ. App. 1931) 36 S. W. (2d) 578, 582; *Thornburg v. Buck* (1895) 13 Ind. App. 446, 41 N. E. 85, 86.

from the mortgagor where such buyer has not assumed the debt, presents one manifestation of the problem squarely. In *In re Draco Realty Corporation*,<sup>10</sup> the Winfred Realty Corporation, owning the Drake Hotel in New York City, mortgaged it to the Chase National Bank for the sum of \$3,750,000. A few months later the mortgagor corporation conveyed to the Draco Realty Corporation, debtor, all of this real property, the purchaser not assuming the payment of the bond. Subsequently the debtor filed a petition for reorganization. The court pointed out that the statute describes two types of creditors: those with provable claims, and those having mere interests in the property of the debtor. For the purpose of joining in the filing of petitions creditors must have provable claims against the debtor, and it is not enough that they have an interest in its property. In order to qualify as a creditor for this purpose the mortgagee must be entitled to a deficiency judgment against the debtor. A creditor for this purpose, then, is one who could qualify as such within the meaning of the old bankruptcy act. He must have a provable claim. The mortgagee in the *Draco* case was not such a creditor.

Not long after the enactment of section 77B, in *Bryan v. Welsh*,<sup>11</sup> some holders of certificates of beneficial interest in a business trust sought to file a petition as creditors under the statute. Viewing the relationship of these certificate holders to the business as analogous to the relationship between stockholders and their corporation, the court held that they were equitable owners of the property, proprietors, and not creditors, and therefore not entitled to file an involuntary petition against the debtor. The fact that some of the certificates of interest provided for preferences both as to income payments and as to assets in case of dissolution did not suffice to raise the relationship to that of debtor-creditor. It seems unnecessary to cite cases in support of the well-established doctrine that a stockholder of a corporation is not a creditor thereof.<sup>12</sup> The rule applies to preferred stock as well as to common.<sup>13</sup> Even where preferred

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10. (D. C. S. D. N. Y. 1935) 11 F. Supp. 405.

11. (C. C. A. 10, 1935) 74 F. (2d) 964, 971.

12. 13 Fletcher, *Cyclopedia of Corporations* (1932) sec. 5755; *Bryan v. Welsh* (C. C. A. 10, 1935) 964, 970.

13. *Inscho v. Mid-continent Development Co.* (1915) 94 Kan. 370, 383, 385, Ann. Cas. 1917B 588; *Miller v. Ratterman* (1890) 47 Ohio St. 141, 24 N. E. 496; Note (1894) 27 L. R. A. 136; Note (1899) 73 Am. St. Rep. 227.

stock has matured and is due and payable several months prior to the date of the filing of a petition for a reorganization, it is improper to allow such stockholders to share in the assets of the debtor as creditors.<sup>14</sup> The courts support this conclusion by giving emphasis to the Congressional intent clearly appearing from the fact that the word "stock" is excluded from the statutory definition of "claims." Yet under the statutes of the State of Michigan, where the debtor in the *Bryan* case had been organized, it was legal for the stockholder to demand and receive full payment on such claims. Hence the federal courts have been severe in denying strict legal rights in the interest of equities arising out of the circumstances. This probably amounts to more than a mere disregard of form. Strong support for this view was available from a decision of the judges of the Seventh Circuit. In *In re Piccadilly Realty Co.*,<sup>15</sup> the holders of matured preferred stock, entitled to dividends past-due thereon, sought to file a petition as creditors under section 77B. They were not permitted to do so, the court holding that the stock ownership in a corporation cannot be said to create a creditor-debtor arrangement, regardless of the statutory or stipulated rights or privileges provided for in the stock certificate. Probably this is too careless a reliance upon the mere word "stock." Mere language can lead to erroneous results. The court's language was broader than the facts called for. The case is not authority for the proposition that dividends declared out of existing surplus may not give rise to a valid debtor-creditor relationship, for the facts show that there was no surplus nor profits out of which dividends might have been paid, and accordingly the promise to pay them was unenforceable.<sup>16</sup> Had there been such a surplus available at the time of the declaration a different result might have been proper. In fact, this proposition was upheld in a subsequent case.<sup>17</sup>

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14. *In re Arcadia Furniture Co.* (D. C. W. D. Mich. 1935) 12 F. Supp. 477. The corporate debtor was a Michigan corporation, and under the Michigan statutes it was lawful for the holder of such shares of stock as were involved in this case to demand payment in full of the stock and accumulated dividends at maturity.

15. (C. C. A. 7, 1935) 78 F. (2d) 257.

16. *In re Piccadilly Realty Co.* (C. C. A. 7, 1935) 78 F. (2d) 257, it was held that a stockholder to whom a dividend was declared when no earnings were available is neither a creditor nor an owner to that extent. Such a declaration of dividends is of no legal significance.

17. *Bryan v. Welsh* (C. C. A. 10, 1935) 74 F. (2d) 964, 970, and cases there cited; 11 Fletcher, *Cyclopedia of Corporations* (1932) sec. 5324.

A more difficult situation arises where the stock is convertible into bonds or other securities. Conversion privileges enable stockholders to change rather easily their relationship to the debtor. The change from the status of proprietor to that of creditor can be effected with little effort. The coat of a different color is easy to put on. And if the debtor is a failure, the new coat is much more comfortable. In a federal case arising in Kentucky,<sup>18</sup> it was held that such a conversion would not protect holders of such bonds as against the claims of unsecured creditors. The decision was rested upon the Kentucky statutes and upon general equitable limitations upon statutory rights and powers. The underlying thought or policy was to protect true creditors as against claimants, who, having begun as true stockholders, then decided to become creditors when the unsecured claims had increased in amount to a point at which the equity of proprietorship seemed to be vanishing. They had detected the handwriting on the wall. It is possible, however, that a contrary *logical* decision could be arrived at in other jurisdictions. Care must be exercised to distinguish cases in which only stockholders are involved from those in which creditors are injured by the conversion. One thing is certain; attempts to shift from the status of proprietor to that of creditor should be carefully scrutinized.

The freedom with which courts have exercised their judicial function in this respect is well brought out in *In re Philadelphia Rapid Transit Co.*<sup>19</sup> The court looked through form to reality in

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18. *In re Phoenix Hotel Co.* (D. C. E. D. Ky. 1935) 13 F. Supp. 229, aff'd (C. C. A. 6, 1936) 83 F. (2d) 724. In this case the certificates of preferred stock specifically provided that the shares of stock might be converted at the election of the holder into first refunding and improvement bonds secured by a first mortgage. In 1932 the company became heavily indebted, and in 1933 and 1934 many holders of both first and second preferred stock exchanged their stock for bonds according to the terms of their respective certificates. Holders of unsecured notes naturally objected to the alleged prior liens of these old stockholders. The judge handled the question solely as one involving the Kentucky laws and the public policy of that state, finding no federal question involved. Accordingly, the judge analyzed the Kentucky statutes and the Kentucky decisions and arrived at the conclusion that while the statute permitted a corporation the right to arrange for the conversion of stocks into bonds or other obligations of the corporation, such power is limited by other statutes with respect to the reduction of capital and by the general policy of the state as revealed by the judicial opinions of such state; that before a corporation may be generous to its stockholders it must first be just to its creditors.

19. (D. C. E. D. Pa. 1934) 8 F. Supp. 51.

deciding that holders of bonds could not file a petition, because they had purchased their bonds, and filed their petition, not in "good faith," as required by the statute, but for the purpose of effecting a change in the debtor's management. The decision has not been commented upon, nor has a similar situation arisen since. The case shows how far the statute authorizes the courts to probe into the petitioners' frame of mind.

*B. Creditors entitled to participate in reorganizations.*

We pass now to the consideration of the more important phase of our problem. What persons are entitled to share in the reorganized business? Who can be compelled to participate? The statute, at this point, is a great leveller. It lumps into one group all persons having claims against the debtor or its property except stockholders. All are creditors. In a regular bankruptcy proceeding, persons having valid claims on the debtor's property are not disturbed. Section 67d of the old Act provided for such security. Likewise, in compositions under the old section 12, the agreement involved only the unsecured claimants. The new provisions of the Act designed for the relief of debtors are more inclusive and bring together all persons who in some manner or other are associated in a business unit which is financially embarrassed. It is not uncommon for some persons to oppose the levelling process. Some claimants desire to free themselves from the statutory grouping. The judicial function must resolve these conflicting claims.

The statutory policy is similar to the English practice of recognizing the interests of all types of claimants. It is true that for many years the English courts placed reorganization burdens upon investors, insisting that the utmost damage that could be done to the claims of true creditors was their postponement. But today they permit all claimants to participate fully. They have given the word "creditor" a very broad meaning solely by judicial interpretation.<sup>20</sup> Similarly, the Supreme Court of the United States<sup>21</sup> has given full force and effect to the broad, all-inclusive language of section 77B. After restating the object of

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20. *In re Midland Coal and Iron Co.* [1895] 1 Ch. 267; *Sovereign Life Assur. Co. v. Dodd* [1892] 2 Q. B. 573.

21. *City Bank Farmers' Trust Co. v. Irving Trust Co.* (1937) 299 U. S. 433.



the statute as including a purpose to discharge all demands, executory and contingent, as well as presently due or to mature in the future, the Court went on to emphasize the Congressional language, and held that all claims for damages or indemnities arising out of the termination of a lease after initiation of proceedings for reorganization are provable.<sup>22</sup> The statute calls for full participation by all persons having claims against either the debtor or its property.

The reorganization statute provides for creditor control too, an idea not new to courts of the United States. Creditors have controlled regular bankruptcy proceedings and have always taken an active part in the liquidation process. They examine the debtor and elect the trustee.<sup>23</sup> Moreover, the rule of *Northern Pacific Ry. v. Boyd*<sup>24</sup> is thoroughly imbedded in our thinking. Under this decision a reorganization plan that fails to give creditors a position superior to stockholders is unfair and should not be confirmed. And it is now fairly clear that in most situations, the rule of that case will be applied to a considerable degree in reorganization cases under the new statutes.<sup>25</sup> Both the American and English practices reveal an underlying desire to protect the creditor. In England, originally, he was protected by the court's refusing to tamper with his claims except to the extent of their postponement. In the United States the courts tamper with the claims and alter them, but aim to give the creditor control over the property of the debtor. At all events, the status of a creditor in the American courts is far superior to that of a proprietor. The rights of the latter may be eliminated entirely, and should be eliminated upon a finding of insolvency. In fact

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22. Many other judicial opinions have emphasized the willingness of the courts to admit claimants with great freedom.

23. See secs. 7, 44, 21, of the Bankruptcy Act.

24. (1913) 228 U. S. 482.

25. *The Downtown Inv. Ass'n v. Boston Metropolitan Bldgs.* (C. C. A. 1, 1936) 81 F. (2d) 314; *In re New York Rys.* (C. C. A. 2, 1936) 82 F. (2d) 739, cert. den. (1936) 298 U. S. 687; *In re Peyton Realty Co.* (D. C. E. D. Pa. 1936) 18 F. Supp. 822, 824; *In re Witherbee Court Corp.* (C. C. A. 2, 1937) 88 F. (2d) 251, 254. The net result of these decisions is that the *Boyd* case will not be followed rigidly, but it will nevertheless furnish a rough rule of thumb or pattern by which to determine whether a plan is proper. See also *In re Barclay Park Corp.* (C. C. A. 2, 1937) 90 F. (2d) 595; *Wayne United Gas Co. v. Owens-Ill. Glass Co.* (C. C. A. 4, 1937) 91 F. (2d) 827; *In re Day & Meyer, Murray & Young* (C. C. A. 2, 1938) 93 F. (2d) 657. The leading case is the recent Supreme Court decision of *Case v. Los Angeles Lumber Co.* (1939) 308 U. S. 106.

he may be eliminated so completely that he may not even complain of the objectionable features of proposed plans.<sup>26</sup>

Creditors are not proprietors in the strict sense. Their position is adverse to those whose interests are limited to what remains after creditors' claims have been satisfied. Like proprietors, however, bondholders are investors<sup>27</sup> who have linked themselves to a business concern. The assumed risks may be different. The secured creditor is an investor who was careful enough to reduce his risk of loss by taking a lien upon his debtor's property. He has less to worry about than the general unsecured creditor. Normally what the secured claimant desires is freedom of action in respect to his security and the right to dispose of it to the best possible advantage to himself. In general, the holder of a valid lien has such a right. Under the common law title theory the lienholder becomes the absolute owner of the property on default, and even under the lien theory he can take the property subject, perhaps, to the equities of the debtor, but nevertheless free to secure to himself the payment of his claim.<sup>28</sup> This is permitted in a regular bankruptcy proceeding. Liens are given full recognition and claims are paid in the order of their priorities. Throughout the American experience in reorganizations pursuant to the equity receivership, the courts were constantly confronted with the absolute right of the lienholders to have the value of their rights determined by a judicial sale of the property.<sup>29</sup> Thus, until the passage of legislation for the relief of debtors in 1933 and 1934, vested property rights were never altered without the consent of the owners of such property. There could be compositions in bankruptcy, regular bankruptcy proceedings, and receivership proceedings aimed at reorganizations, but these were mere harmless storms or gentle winds over the stable vested rights. The new legislation, in providing for the alteration of the rights of secured creditors, has ushered in a new principle. It cuts across a large number of

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26. *In re New York Rys.* (C. C. A. 2, 1936) 82 F. (2d) 739, comment (1936) 36 Col. L. Rev. 1166.

27. The early English practice was to look to both bond and shareholders as investors to charge with the responsibility of effecting successful reorganizations.

28. The first Frazier-Lemke Act was declared unconstitutional because it denied the mortgagee the right to the property without providing for full payment of the debt. *Louisville Bank v. Radford* (1935) 295 U. S. 555.

29. *First Nat'l Bank v. Flershem* (1934) 290 U. S. 504.

our common law doctrines. Secured creditors are less free to act with reference to their liens than heretofore. Some of their rights must yield if the paramount purpose of Congress to preserve the economic benefits which inhere in going-concern values is to be realized. To permit secured creditors to take away their properties would be destructive of those very values which a reorganization aims to preserve. The broad statutory definition of the term "creditor" evinces a clear Congressional intent to gather and hold together persons interested in the property of the debtor.

It seems logical here to consider how a court is to determine what types of interests in the debtor's property, if any, are severable from the rest of its property, notwithstanding the broad statutory purposes. What property rights will entitle their owner to free himself completely from the risks of a reorganization? Not long after section 77B had been passed the question arose whether a conditional seller of machinery which became part and parcel of the assets of a corporate debtor as a going concern should be entitled to take possession of such equipment and dispose of it according to the regular procedure evolved under the recognized legal principles pursuant to which conditional sales are made. It is well settled that a conditional seller may repossess himself of the subject of the contract upon default, even against a buyer who has filed a petition in bankruptcy.<sup>30</sup> So the question arose whether these accepted rules of law should be discarded in favor of a ruling more consistent with the Congressional intent and purpose to maintain the going concern values of a failing corporate debtor. It would not be difficult to contend that, within the meaning of the act, assets obtained by conditional sale, if used by a corporate debtor, are "property of the debtor." The risk of loss of such property is on the buyer,<sup>31</sup> and the promise to pay for the property is absolute in the sense that it is not cancelled merely because the property is returned.<sup>32</sup> In case such property is damaged, converted, or otherwise subjected to tortious acts, the buyer is a

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30. 5 Remington, *Bankruptcy* (4th ed. 1936) sec. 2455.

31. Uniform Conditional Sales Act, sec. 27; 2 Uniform Laws Ann. 40, and cases cited; 2A Uniform Laws Ann. 196-199; O'Neil-Adams Co. v. Eklund (1915) 89 Conn. 232, 93 Atl. 524, Ann. Cas. 1918D 379.

32. 2A Uniform Laws Ann. 196; La Valley v. Ravenna (1905) 78 Vt. 152, 155, 62 Atl. 47, 6 Ann. Cas. 684, 2 L. R. A. (N. S.) 97.

real party in interest entitled to maintain an action.<sup>33</sup> The title of the seller is said to be retained solely for security purposes.<sup>34</sup> A conditional seller's frame of mind is that of a seller rather than an owner. He hopes that he will never see the property sold again, and if he does repossess the article, it will be solely for the purpose of enforcing the payment of the debt, to secure which he retained legal title. Accordingly, when the earmarks of a contract of conditional sale are noted it can be assimilated well, if not exactly, to the chattel mortgage. Yet the chattel mortgagee must stay with the business ship even though it is on the verge of sinking. He is not entitled to destroy the going-concern values by foreclosure proceedings. What should a court do in the exercise of its judicial function in passing upon a conditional seller's petition for reclamation of property as to which he has retained the legal title, upon the default of the buyer? Should the rules of law with reference to conditional sales as administered in state courts and in regular bankruptcy proceedings prevail against the above analysis so as to prevent the Congressional purposes from being realized?

The problem has been carefully studied in a few cases. Of four District Judges who have written opinions upon the question, two<sup>35</sup> have permitted the seller to retake his property while the two others<sup>36</sup> took the opposite view. One of the decisions in favor of the seller was appealed and the judgment was affirmed.<sup>37</sup> Moreover, the Supreme Court of the United States denied a writ of certiorari.<sup>38</sup> It appears as if the rules of law relative to con-

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33. *Stotts v. Puget Sound Traction, Light & Power Co.* (1917) 94 Wash. 339, 162 Pac. 519, L. R. A. 1917D 214.

34. *Ibid.* See also *Osborn v. South Shore Lumber Co.* (1895) 91 Wis. 526, 65 N. W. 184.

35. In *In re Ideal Laundry, Inc.* (D. C. N. D. Cal. 1935) 10 F. Supp. 719, the judge said the seller was an owner rather than a creditor. In *re Lake's Laundry, Inc.* (D. C. S. D. N. Y. 1935) 11 F. Supp. 237, *aff'd* (C. C. A. 2, 1935) 79 F. (2d) 326, 102 A. L. R. 247 (Learned Hand dissenting), *cert. den.* (1935) 296 U. S. 622. See also *In re Pointer Brewing Co.* (C. C. A. 8, 1939) 105 F. (2d) 478, giving the seller the right to reclaim even though his conditional sales contract was not recorded as required by state law.

36. In *re Burgmeister Brewing Co.* (D. C. S. D. Ill. 1935) 11 F. Supp. 902; In *re Brown* (D. C. D. Me. 1936) 14 F. Supp. 251. The court relied on two grounds: (1) Lack of record; (2) The theory that debtor's right to redeem is a property right.

37. In *re Lake's Laundry, Inc.* (C. C. A. 2, 1935) 79 F. (2d) 326 (L. Hand dissenting).

38. *Ibid.*, *cert. den.* (1935) 296 U. S. 622.

ditional sales are being carried bodily into reorganization proceedings. These regular rules are evolved from two factual situations. In one of these, only the rights of the vendor and vendee are involved. In the other, the rival claimants are the bona fide purchaser from the vendee and the conditional seller. A *bona fide* purchaser occupies a favored position in the legal tradition and of course, if a seller prevails over such a favored claimant, his position is extremely desirable. It is hardly necessary to call attention to the fact that the situation in reorganizations is very different from the usual situation in conditional sale transactions. Numerous claimants, stockholders, and even the public are vitally interested in reorganizations. The Congressional purpose in passing the reorganization statute evidences the public need for rehabilitating financially embarrassed debtor-corporations. It is significant that the Second Circuit Court of Appeals divided on the issue.<sup>39</sup> The majority were restrained by the words "legal title" and the fact that Congress made no mention of conditional sales. Having found that the claimant had this magic thing, all its usual incidents were held to follow as a matter of course. The reasoning appears a bit mechanical.

Fortunately, Judge Learned Hand filed a forceful dissent from his brethren. He refused to be governed by mere words, and ridiculed the thought that anyone knows what "legal title" means. Assimilating the relations resulting from conditional sales contracts to those existing between chattel mortgagors and mortgagees, he saw no reason for treating conditional sellers and mortgagagees differently.<sup>40</sup> They are, he reasoned, all persons who have interests in the "property of the debtor" and therefore are creditors within the meaning of the reorganization statute. Judge Hand's realism may bear fruit eventually. At least it will pave the way for legislation which will specifically enact the meaning of his dissent into law. Indeed, such legislation has already been recommended to Congress.<sup>41</sup>

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39. See *In re Lake's Laundry, Inc.* (C. C. A. 2, 1935) 79 F. (2d) 326.

40. See the dissenting opinion of Bell, J. in *In re Pointer Brewing Co.* (C. C. A. 8, 1939) 105 F. (2d) 478.

41. Report of the counsel to the chairman of the special committee to investigate receivership and bankruptcy proceedings and administration of justice in United States Courts, Sen. Doc. No. 268, 56. The Chandler Act is silent on the matter, however. In railroad reorganizations the right of the conditional seller to reclaim the property is expressly recognized. See sec. 77 (j) of the Bankruptcy Act, 11 U. S. C. A. (1937) sec. 205 (j).

One more recent decision<sup>42</sup> seems to follow the rule that a seller is entitled to reclaim, but it should be noted that the court in this case ordered the trustee to liquidate the debtor pursuant to subdivision (k) of section 77B, 11 U. S. C. A (1937) section 207 (k).<sup>43</sup> Given the fact that the court properly ordered a liquidation, no objection can be made to the decision. When a liquidation is ordered, the proceeding becomes in substance a regular bankruptcy proceeding rather than one for the reorganization of the debtor. The going values are properly disregarded, for it is not proposed to keep the business functioning.

The recent case of *In re Pointer Brewing Co.*<sup>44</sup> deserves special mention. In the cases discussed above there was no question as to the validity of the contract, the priority of the seller, and his right to repossess the property in case of a straight bankruptcy proceeding. The problem was whether a different holding should be made in the event the proceeding was to effectuate a reorganization. In the *Pointer* case, however, the contract of conditional sale had not been recorded as required by the laws of Iowa. The court apparently assumed that the seller was a creditor, and passed upon the problem of whether or not the creditor was secured. In the cases involving valid conditional sales contracts, those who feel that the seller should not be permitted to repossess the property no doubt would have no objection to the seller being entitled to the status of a secured creditor. The holder of a valid chattel mortgage is not entitled to foreclose his lien and purchase the property, but he is entitled to the status of a secured creditor. That is a problem in classification of claims, which is beyond the scope of this paper. The court in the *Pointer* case, having held the contract of sale valid as against the

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42. *In re Collins Hosiery Mills, Inc.* (D. C. E. D. Pa. 1937) 19 F. Supp. 500.

43. Bankruptcy Act (1934) 48 Stat. 917, c. 424, sec. 77B, 11 U. S. C. A. (1937) 207 (c) provides: "[The judge] if a plan of reorganization is not proposed or accepted within such reasonable period as the judge may fix, or, if proposed and accepted, is not confirmed, may, after hearing, whether the proceeding be voluntary or involuntary, either extend such period or dismiss the proceeding under this section or, except in the case of a railroad or other public utility or of a debtor which has not been found by the judge to be insolvent, direct the estate to be liquidated, or direct the trustee or trustees to liquidate the estate, appointing a trustee or trustees if none shall previously have been appointed, as the interests of the creditors and stockholders may equitably require; \* \* \*." See also clause (k). See Chandler Act, secs. 236-238.

44. (C. C. A. 8, 1939) 105 F. (2d) 478.

trustee, then gave the seller the status of a secured creditor. Is this holding contrary to the other cases in which the seller was held entitled to repossess the property? There is no showing that the seller asked for such relief. Apparently he was satisfied to leave his property in the reorganized business upon being recognized as a secured claimant. The court arrived at its conclusion through an analysis of section 67a of the Bankruptcy Act (11 U. S. C. A. (1937) section 107 (a)) prior to the enactment of the Chandler Act. It emphasized that under Iowa law the "want of record" referred to in the statute did not render the lien invalid.

Since the enactment of the Chandler Act, the decision would probably have to be otherwise. The provisions in sections 60a and 67d (5), relating to the perfection of transfers, evince a purpose to give the trustee the status of a *bona fide* purchaser for value. Under the present statute the trustee prevails so long as the transferee could convey rights to a *bona fide* purchaser superior to the rights of the transferor. In the instant case, so long as the contract remained unrecorded the buyer could convey rights to a *bona fide* purchaser superior to those of the seller. So the trustee should prevail.<sup>45</sup>

Frequently, a debtor in failing circumstances continues to add to its stock of goods, knowing its desperate financial condition. The debtor under such circumstances knows that its promise to pay is not likely to be fulfilled. When such situations occur in regular bankruptcy proceedings, the seller is entitled to reclaim the property as owner, instead of being required to share in the assets as a mere creditor.<sup>46</sup> The theory is that the goods have been tortiously obtained, and that as against the vendee the vendor is entitled to insist that the title did not pass.<sup>47</sup> If the goods are mere additions to the debtor's stock in trade and the same are clearly identifiable, the seller should be entitled likewise to reclaim the goods in a reorganization proceeding.<sup>48</sup> If

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45. Cf. *Magnolia Petroleum Co. v. Thompson* (C. C. A. 8, 1939) 106 F. (2d) 217, rev'd (1940) 309 U. S. 478.

46. *California Conserving Co. v. D'Avanzo* (C. C. A. 2, 1933) 62 F. (2d) 528, 530; *In re Henry Siegel Co.* (D. C. D. Mass. 1915) 223 Fed. 369. See Hanna, *Cases on Creditors' Rights* (2d. ed. 1935) 1061, 1074, on reclamation proceedings, especially *In re P. H. Krauss & Co.* (D. C. W. D. Tenn. 1924) 2 F. (2d) 999.

47. *Thurston v. Blanchard* (1839) 39 Mass. 18, 33 Am. Dec. 700, allowed the seller to maintain trover.

48. *In re James Butler Grocery Co.* (D. C. E. D. N. Y. 1935) 10 F. Supp. 809.

the property is in the nature of fixed capital and in use as an integral part of the debtor's business the problem becomes more difficult. Its withdrawal might prove embarrassing to the reorganizers, for the lack of a machine might stop production entirely.

It is not uncommon for financially embarrassed business corporations to borrow necessary capital by pledging some assets as security. The relation of the pledgees to reorganization proceedings presents some knotty problems. Pledgees naturally desire to withdraw the pledged property entirely so as to insure their reimbursement for the money advanced when it becomes due and payable. While the pledgee has possession and the right to sell the pledged assets on default of the borrower, the pledgor has the legal title, and the right to redeem the pledge. The debtor's interest is somewhat different from that which he has in conditional sales contracts, for the possession passes from the debtor to the pledgee in cases of pledge. But in both situations the debtor is entitled to redeem the property.<sup>49</sup> It has a real interest in that property. And it can be argued logically that the pledgee has an interest in the "property of the debtor." It should follow that he is a creditor within the statutory language. In *Weisstein Bros. & Survol v. Laugharn*,<sup>50</sup> the debtor had sold some canned fruit to the claimant, which at the time of the contract of sale was in possession of a warehouse company. The latter company held as agent for a bank which was pledgee, to secure a debt of the debtor to the bank. The court decided that the purchaser was not entitled to the fruit which had been validly pledged, but was only entitled to file a general claim for its value. The bank's lien was perfectly good, and it was immaterial that the claimant had bought without notice that the property was the subject of a prior pledge. Of course, the decision merely involves the rights of the purchaser as against the trustee. The rights of the trustee (and the debtor) as against the pledgee are not discussed, yet the opinion represents a tacit recognition of the pledgee's rights.

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49. In re Brown (D. C. D. Me. 1936) 14 F. Supp. 251. One of the two reasons given by the judge for holding that the seller could not reclaim goods sold on a conditional sales contract was that the right of redemption of the debtor was property that passed to the trustee in a reorganization proceeding.

50. (C. C. A. 9, 1936) 84 F. (2d) 419.



A clash between two groups of beneficiaries of a pledge developed in *In re National Public Service Corporation*.<sup>51</sup> The debtor had deposited stock as collateral to secure debentures which the court found to be much greater in amount than the value of the collateral. A regular bankruptcy proceeding was instituted and the court entered an order terminating the rights of the debtor and its trustee in the pledged property. The trustee of the pledged stock then proceeded to try to sell the stock. Eight months later some of the debenture holders filed an involuntary petition to reorganize the debtor. The court, by Judges Chase and A. Hand, ruled that the prior order relative to the pledged collateral was final notwithstanding that 66 per cent of the debenture holders voted in favor of the proposed reorganization plan. The clash was thus between the trustee of the pledged property and one-third of the beneficiaries on one hand and two-thirds of the beneficiaries on the other. The dissenting judge believed that the will of the larger number of the real parties in interest should have the controlling voice. He emphasized several basic considerations. He called attention to the peculiar nature of the court's jurisdiction under the statute, pointing out that it is given full control "of the debtor and its property wherever located." He reasoned that the debtor's interest in the pledged collateral gave the court jurisdiction and the power to restrain the enforcement of foreclosure rights over the debtor's property. He examined the fundamental purposes of the statute and concluded that there was ample power to be exercised in the conservation of assets for the continuation of the business, and that even the lienholders, those whose claims were secured by the pledge, were entitled under the statute to vote to stay with the business and take their chances on the future instead of facing the immediate dismemberment and liquidation of their interests. We still have to wait for the case in which all the beneficiaries seek to keep the property for themselves.

The cases involving conditional sales,<sup>52</sup> reservations of unexercised options,<sup>53</sup> the properties of subsidiaries of debtors,<sup>54</sup> as

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51. (D. C. S. D. N. Y. 1936) 18 F. Supp. 293, aff'd (C. C. A. 2, 1937) 88 F. (2d) 19, cert. den. (1937) 301 U. S. 697.

52. *In re Lake's Laundry, Inc.* (C. C. A. 2, 1935) 79 F. (2d) 326, 102 A. L. R. 247.

53. *In re Prudence Bonds Corp.* (C. C. A. 2, 1935) 79 F. (2d) 212.

54. *In re Adolf Gobel, Inc.* (C. C. A. 2, 1936) 80 F. (2d) 849.

well as pledged collateral,<sup>55</sup> all indicate a willingness to permit claimants to take away from the debtor concern, some assets which under a more purposive interpretation of the statute could be said to be "property of the debtor." The dissenting judge in the last case cited referred to the property interests involved as too remote. Other cases point in the same direction. Thus, where a claimant has contracted to purchase land from a debtor, the reorganization proceeding will not defeat the claimant's right to specific performance of the contract.<sup>56</sup> It is conceivable that a decree of specific performance against a debtor in process of reorganization may hamper such process seriously. Likewise, where the debtor had deposited a sum of money to abide the result of an arbitration proceeding, such fund could not be disturbed. It had to remain intact pending the arbitration.<sup>57</sup> The deposit had been made more than a year before the filing of the reorganization petition, and the court treated the situation as analogous to an attachment of the debtor's property which is made more than four months prior to the institution of bankruptcy proceedings. No emphasis was placed upon the provision in the statute for the disturbance and alteration of valid liens. It seems too that in case the debtor has received an amount of money to be refunded to a buyer on the happening of a contingency, the buyer is entitled to the refund on the happening of the event.<sup>58</sup>

Not all efforts to take away property from the debtor succeed, however. Where a debtor was under contract to sell some sardine oil and meal, and disaffirmed the contract, the buyer sought to obtain possession of oil and meal in the debtor's possession which the debtor was threatening to sell to others. The buyer claimed an equitable interest in the property. The court denied the claim and held that the mere showing of a refusal to perform an executory contract for the sale of some unidentified meal and oil could not be made the basis of a separable interest in that property.<sup>59</sup>

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55. *In re Nat'l Public Service Corp.* (C. C. A. 2, 1937) 88 F. (2d) 19.

56. *Rowan v. Harburney Oil Co.* (C. C. A. 10, 1937) 91 F. (2d) 122.

57. *In re Grain Producers Corp.* (D. C. S. D. N. Y. 1937) 20 F. Supp. 134.

58. *Casey Jones, Inc. v. Texas Textile Mills* (C. C. A. 5, 1937) 87 F. (2d) 434.

59. *Globe Grain & Milling Co. v. American Marine Products Co.* (C. C. A. 9, 1937) 91 F. (2d) 380.

Prior to the passage of the reorganization statute, the Bankruptcy Act preserved to the lienor all rights which he had under state law,<sup>60</sup> but it was generally understood that the bankruptcy court had the power to restrain the lienor in the enforcement of his rights. For example, the holder of a lien has been denied the right to start a foreclosure suit in a state court after bankruptcy proceedings have been instituted.<sup>61</sup> The reasoning by which this disturbance of vested rights was explained emphasized the exclusive jurisdiction of the bankruptcy court to act in the interest of all the parties and for the better preservation of the rights of both the unsecured and secured creditors. Moreover, the general equity jurisdiction of bankruptcy courts, it was said, gave them such powers.<sup>62</sup> Upon the same basis, they have ordered the sale of property subject to liens free and clear of such liens.<sup>63</sup> These powers were always exercised within a very narrow compass, however. The power to sell free and clear of liens can be exercised only when there is a reasonable prospect that a surplus will be available for general creditors.<sup>64</sup> Foreclosure suits which have been started prior to the filing of the petition in bankruptcy may be continued, and if the mortgagee has been in possession for four months prior to the beginning of the bankruptcy proceeding, such possession may not be disturbed. In like manner, the court lacks the power to restrain the sale of pledged property by the pledgee.<sup>65</sup>

The reorganization statute gives the courts additional powers with reference to liens.<sup>66</sup> The claims of secured creditors may

60. *Hiscock v. Varick Bank of New York* (1906) 206 U. S. 28.

61. *Straton v. New* (1931) 283 U. S. 318; *Isaacs v. Hobbs Tie & Timber Co.* (1931) 282 U. S. 734; Note (1932) 80 U. of Pa. L. Rev. 412; Note (1932) 41 Yale L. J. 445; Comment (1931) 16 Minn. L. Rev. 94; Comment (1932) 7 Ind. L. J. 502; Comment (1931) 31 Col. L. Rev. 1036.

62. *Continental Bank v. Rock Island Ry.* (1935) 294 U. S. 648. See *Securities & Exchange Comm. v. United States Realty & Improvement Co.* (1940) 60 S. Ct. 1044.

63. *Seaboard Nat'l Bank v. Rogers Milk Products Co.* (C. C. A. 2, 1927) 21 F. (2d) 414. The proceeds of the sale remained subject to the lien, of course.

64. *Ibid.* See *In re Nat'l Grain Corp.* (C. C. A. 2, 1926) 9 F. (2d) 802, 803; *In re Harralson* (C. C. A. 8, 1910) 179 Fed. 490, 492, 29 L. R. A. (N. S.) 737; Remington, *Bankruptcy* (3d ed. 1923) sec. 3583.

65. *Hiscock v. Varick Bank* (1906) 206 U. S. 28; *Taubel-Scott-Kitzmiller Co. v. Fox* (1924) 264 U. S. 426, 433, 434; *In re Prudence Bonds Corp.* (C. C. A. 2, 1935) 75 F. (2d) 262, 263: "A pledgee in possession of the pledge may stand aside from the ordinary bankruptcy proceeding;" per L. Hand, J.

66. (1935) 294 U. S. 648. *In Grand Boul. Inv. Co. v. Strauss* (C. C. A.

be modified or altered. The Supreme Court of the United States has given effect to the statutory power several times, *e. g.*, in *Continental Bank v. Rock Island Ry.*<sup>67</sup> Several decisions in the lower federal courts shed considerable light on the problem. In *Grand Boulevard Investment Co. v. Strauss*,<sup>68</sup> the court ordered the transfer of possession of mortgaged property from the mortgagee to the debtor, although the mortgagee had been in possession over two years. The court applied the reasoning of the *Rock Island* case, in which the sale of pledged collateral was restrained. In *In re Prudence Bonds Corporation*,<sup>69</sup> the debtor corporation had pledged some bonds and mortgages to a trustee to secure its collateral bonds. The holders of some of the debtor's bonds brought suit against the trustee of the collateral for an accounting of the income from the bonds and mortgages which were the subject of the pledge, and further sought to protect his possession of the bonds. The bankruptcy court restrained the prosecution of the suit on the theory that its continuance might impede the progress of the reorganization, or prevent it entirely.<sup>70</sup> It also held that the pledgee was a creditor of the pledgor within the language of the statute. Judge Learned Hand in the course of the opinion pointed out that the plaintiffs who were restrained were merely asserting the rights of the beneficiaries of the trust in accordance with the deed, and that

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8, 1935) 78 F. (2d) 180, it is said at page 184: "The same [power with reference to liens] is shown, we think, by such provisions in Section 77B as the following:" (see section 216 of the Chandler Act). The opinion continues at length upon the special powers conferred by the reorganization statute.

67. (1935) 294 U. S. 648, 676, 683 (case involved section 77, but same reasoning applies to section 77B). *Foust v. Munson S. S. Lines* (1936) 299 U. S. 77.

68. (C. C. A. 8, 1935) 78 F. (2d) 180, 185, it was said: "Our conclusions are that the jurisdiction of the bankruptcy court in proceedings under section 77B has been extended by sections 77A and 77B so that it includes all of the property of the debtor, wherever located, even if such property is in the possession of a lienholder, and even if such possession has continued for more than four months prior to the initial petition of the debtor under section 77B; and that the trial court had jurisdiction to entertain the petition here in controversy; and in the exercise of its discretion, to grant or deny the prayer of said petition upon the merits thereof.

"We think the views expressed in the foregoing opinion find support in the *Rock Island* Case heretofore cited; and also in the case of *In re Greyling Realty Corporation* (C. C. A.) 74 F. (2d) 734. See also, *In re Nineteenth & Walnut Streets Corp.* (D. C.) 9 F. Supp. 625."

69. (C. C. A. 2, 1935) 75 F. (2d) 262.

70. *In re Adolf Gobel, Inc.* (C. C. A. 2, 1936) 80 F. (2d) 849.

the trustee of the pledged property was trying to pave the way for its surrender. If the property had not been involved in a reorganization proceeding, the plaintiff should have prevailed against the trustee. However, section 77B contemplated the repudiation of old arrangements. This was so, the judge pointed out, by virtue of the provision which permitted a two-thirds majority to coerce the minority and force a new arrangement upon it. Hence it was necessary to preserve the pledge so that in case a reorganization plan was accepted the property would be available for use in the new corporate life. The decision preserves the rights of a statutory majority who prefer to remain with the concern and look to the future. Dissenting minorities must submit to the will of the greater number. The case is not authority for the proposition that a debtor corporation is entitled to retain pledged assets as a matter of right. In such cases the assets will be retained in the business only if in the future the requisite number of those beneficially interested therein decide to leave them there.

The power to stay creditors,<sup>71</sup> while broadly given to the federal courts under section 77B(c) of the Bankruptcy Act, and sections 115 and 116(4) of the Chandler Act, is largely within the discretion of the court and must be exercised in relation to the particular circumstances in each case so as to do justice to the claimants, the debtor, and the estate.<sup>72</sup> In such cases the burden is upon the debtor and trustees in reorganization to prove that the estate would be affected unjustly, and in the absence of such a showing the injunction should be denied. It should be granted to facilitate reorganizations, fulfilling the underlying congressional purpose.<sup>73</sup> A majority of the persons interested in the pledged property are entitled to vote on proposed plans and determine for themselves whether they will continue with the concern or take the "adequate protection" granted them by the statute. Another phase of this problem can only be mentioned in this paper. The rights of the pledgees are dependent on what classification of claims the court makes. If pledgees are placed in a separate class, by themselves, they can proceed under the

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71. The power to stay creditors' suits is referred to here because it is closely related to the power of the court over the debtor's property. See cases cited *supra* note 67.

72. *Foust v. Munson S. S. Lines* (1936) 299 U. S. 77, 83.

73. *Continental Bank v. Rock Island Ry.* (1935) 294 U. S. 648, 676.

broad principle of self-determination. Should they, by any chance, be linked with other claimants whose interests are different, even adverse, their rights as pledgees could very well be dissipated.<sup>74</sup>

Parties having claims against a debtor occasionally seek to protect themselves by urging that the debtor stands in the relation of trustee to them; that the property involved really belongs to them. If they can identify the trust property they thereby make themselves clear outsiders. If the relationship is truly of a fiduciary nature, the beneficiaries should prevail. Sometimes the distinction between the debtor-creditor relationship and the fiduciary one is very slight. Where a claimant arranged with a debtor to conduct a fur department in the debtor's place of business, and the debtor collected money which really belonged to the claimant, the court arrived at the conclusion that the relationship was that of debtor-creditor by noting that the agreement of the parties did not provide for the segregation of the amount collected, that the cash sales and the charge accounts involved credit periods, and that the money went into a general fund.<sup>75</sup> A very interesting similar situation is presented through the complicated relationships found in the *Prudence Bond Corporation* cases.<sup>76</sup> The Prudence Bond Corporation was engaged in purchasing bond issues of corporations which subsequently became debtors in reorganization proceedings. The issues were secured by deeds of trust. After such purchases the Prudence Bond Corporation would issue its own participation certificates, which entitled the holders to proportionate shares in the whole number of bonds so purchased. The question presented in *In re The Westover* was whether the holders of these participation certificates issued by the Prudence Bond Corporation, a separate entity, were creditors of the debtors who had issued the original bonds. The courts answered it affirmatively. The underlying reasons for such holding, however, were not carefully analyzed. The decision in the

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74. The matter of classification of claims presents a most important study in itself.

75. *In re Martin's* (D. C. E. D. N. Y. 1935) 11 F. Supp. 99, citing: *Isaac McLean Sons Co. v. William S. Butler & Co.* (D. C. D. Mass. 1913) 208 Fed. 730; *Harvey Brokerage Co. v. Ambassador Hotel Corp.* (D. C. S. D. N. Y. 1932) 1 F. Supp. 660, 57 F. (2d) 727.

76. *In re The Westover* (C. C. A. 2, 1936) 82 F. (2d) 177; *In re Prudence Bonds Corp.* (C. C. A. 2, 1935) 79 F. (2d) 212. The *Westover* case was held to be ruled by the *Prudence Bond* case.

*Westover* case was rested upon an earlier *Prudence Bond Corporation* case.<sup>77</sup> In the latter case, however, the debtor was not the original issuer of the bonds, but rather the purchaser and guarantor of those bonds. Accordingly, the certificate holders had no claim based on any original obligation of the debtor to pay the principal of the certificates, or interest thereon. The debtor was only secondarily liable and any interest in the security would probably have to be worked out on the theory of subrogation. Under section 77B, "securities" were defined as including certificates of beneficial interest in the property of the debtor. This is still true under section 106 (1) and (11) of the Chandler Act. Hence the problem is to find whether the debtor has any property interest in the mortgage which is security for the beneficial certificates. In the *Westover* case the debtor undoubtedly had an interest in the property because it was the mortgagor, and the holders of the certificates could readily trace their interest in that same property to the extent that such certificates represented fractional ownership in the mortgage.

The status of landlord's claims for future rent, the rent to become due for the unexpired, executory residue of leases at the time of the filing of the petition, has received the attention of judges, legal critics and legislators for some years.<sup>78</sup> Under section 63 of the regular Bankruptcy Act (prior to the amendments of 1933 and 1934), enumerating provable debts, as interpreted by the Supreme Court of the United States in *Manhattan Properties Inc. v. Irving Trust Co.*,<sup>79</sup> such claims were not provable

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77. *In re Prudence Bonds Corp.* (C. C. A. 2, 1935) 79 F. (2d) 212.

78. *Manhattan Properties, Inc. v. Irving Trust Co.* (1934) 291 U. S. 320, comment (1934) 28 Ill. L. Rev. 963, comment (1934) 34 Col. L. Rev. 554; Schwabacher and Weinstein, *Rent Claims in Bankruptcy* (1934) 33 Col. L. Rev. 213; Note (1934) 34 Col. L. Rev. 143; Note (1932) 41 Yale L. J. 894; Note (1934) 32 Mich. L. Rev. 664; Douglas and Frank, *Landlords' Claims in Reorganizations* (1933) 42 Yale L. J. 1003-1007.

79. (1934) 291 U. S. 320. In this case the lease still had five years to run, the total rent reserved for the unexpired part was \$58,000, and the claimant asserted that the present rental value for the remainder of the term was \$33,000. He accordingly filed a claim for \$25,000, the difference between the rent reserved and the present rental value. The lease contained a covenant that upon certain contingencies, one of which was the institution of bankruptcy proceedings, the landlord might re-enter the premises without notice, obtain possession, and re-let as agent for the tenant, and the tenant agreed specifically to pay the deficit accruing each month. In *In re Roth & Appel* (C. C. A. 2, 1910) 181 Fed. 667, a landlord was denied the right to prove a claim for future rent on the ground that it was contingent, but the reasoning on this theory was held faulty in the case of *Maynard v. Elliott* (1931) 283 U. S. 273. Supporting the

*Auditorium Association*.<sup>85</sup> The difference may be great enough to prevent that decision from controlling the cases involving unaccrued rent. The same differences would justify Congress in limiting landlords to a mere three years' rent. It has been suggested that if land values should rise immediately following a depression and before the end of a long term lease, the landlord might make a new lease advantageously after having filed his claim for a large amount in the bankruptcy proceeding.<sup>86</sup> It must also be noted that if the landlord is enriched it is usually at the expense of other creditors. Landlord's claims usually exceed the claims of all other creditors.<sup>87</sup> The great danger of having a landlord's claim dominate the creditors' was obvious in a recent case involving a railroad lease for 999 years.<sup>88</sup> The judge in this case emphasized the underlying policy so noticeably lacking in the Supreme Court's decision in the *Manhattan Properties* case.<sup>89</sup>

The depression flooded the bankruptcy courts with cases involving this problem. Large corporations operating in many states under numerous leases found themselves tied up with long term leases and unable to pay rent. Their bankruptcy left property owners with claims for future rent which were not provable and lessees with debts which were not dischargeable. Lessors realized that their long term lease at high rentals were valuable only so long as the lessees remained solvent and prosperous. The *United Cigar Stores* cases<sup>90</sup> furnish ample evidence of the extent

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85. (1916) 240 U. S. 581.

86. Note (1934) 32 Mich. L. Rev. 664, 670: "The mechanical rationalizations of the cases suggest that certain unexpressed but none the less motivating considerations of policy underlie the decisions."

87. Suppose a lease still has fifty years to run at a rental of \$10,000 and that in depression times the rental value of the property is \$2,000 per year. In this situation the landlord could file for the difference between the present worth of the contract rentals and the discounted value of the term at depression prices. It is obvious that if land values rise sometime during the fifty year period, the landlord will be able to make a new lease at higher prices and make a substantial profit at the expense of other creditors. See Note (1934) 32 Mich. L. Rev. 664, at 670: "The size of his [landlord's] demand plus its speculative aspect might well prompt a court to refuse proof."

88. *In re New York, N. H. & H. R. R.* (C. C. A. 2, 1938) 95 F. (2d) 483, 486, rev'd (1939) 305 U. S. 493.

89. *Manhattan Properties, Inc. v. Irving Trust Co.* (1934) 291 U. S. 320.

90. *Schwartz v. Irving Trust Co.* (1937) 299 U. S. 456, 458. The court points out that in August, 1932, when the *United Cigar Stores Co.* was adjudicated a voluntary bankrupt there were in force about 1,000 leases



to which these difficulties permeated the country. It was desirable to settle these claims all at once. The result was the passage of an amendment to section 63 of the Bankruptcy Act in June, 1934.<sup>91</sup> The Chandler Act retains this provision.

The seriousness of the problem is evidenced by the fact that the new provisions were made applicable to cases pending when the amendment was passed. It provided in ordinary bankruptcy cases for the proof of claims for damages arising out of executory contracts for future rents, but only to the extent of an amount not exceeding the rent reserved by the lease without acceleration for *the year* next succeeding the date of the surrender of the premises plus the unpaid rent up to such date. This legislation settled all related matters. It discharged the debtor entirely, while granting the lessor a very limited proof. Long term leases are not much more valuable than under the rule of the *Manhattan Properties* case denying their proof for any amount. Such legislation seems to favor the debtor. The property owner must still carry the burden of the business dangers which lurk in the uncertain future.

The reorganization provisions of the bankruptcy act were passed at about the same time as the amendment to section 63 which we have just discussed, and the provision with reference to future rents appearing in section 77B is similar to the amend-

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under which it held real estate. The following are just a few of the cases involving this same corporate debtor all before the Circuit Court of Appeals, second circuit: (1934) 70 F. (2d) 263; (1934) 70 F. (2d) 313; (1934) 71 F. (2d) 1018; (1934) 72 F. (2d) 673; (1934) 73 F. (2d) 296; (1935) 78 F. (2d) 691; (1936) 82 F. (2d) 744; (1936) 82 F. (2d) 247; (1936) 83 F. (2d) 202; (1936) 83 F. (2d) 207; (1936) 83 F. (2d) 209; (1936) 83 F. (2d) 1019; (1936) 85 F. (2d) 11; (1936) 85 F. (2d) 94; (1936) 85 F. (2d) 134; (1936) 86 F. (2d) 629; (1937) 89 F. (2d) 3.

91. "(a) Debts of the bankrupt may be proved and allowed against his estate which are \* \* \* (7) Claims for damages respecting executory contracts including future rents whether the bankrupt be an individual or a corporation, but the claim of a landlord for injury resulting from the rejection by the trustee of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises plus an amount equal to the unpaid rent accrued up to said date: *Provided*, That the court shall scrutinize the circumstances of an assignment of future rent claims and the amount of the consideration paid for such assignment in determining the amount of damages allowed assignee hereunder: *Provided further*, That the provisions of this clause (7) shall apply to estates pending at the time of the enactment of this amendatory Act in which the time for filing such claims has not expired." (1934) 48 Stat. 923, c. 424, 11 U. S. C. A. (1937) sec. 103.

ment of section 63 in this regard, except for the fact that the maximum amount recoverable is set at the amount reserved by the terms of the lease for *three* years succeeding the date of surrender of the premises or of the landlord's re-entry, instead of one year.<sup>92</sup> In railroad reorganization cases, section 77 allows damages according to equitable principles.<sup>93</sup>

Several decisions involving the construction of this provision of section 77B have reached the Supreme Court of the United States. Its constitutionality has been sustained.<sup>94</sup> In *City Bank Farmers' Trust Co. v. Irving Trust Co.*,<sup>95</sup> it was held that the language of section 77B gave a landlord a provable claim even though the lease contained no covenant making the bankruptcy of the lessee an anticipatory breach of the contract. The purpose of the statute was to give the landlord a provable claim whether the instrument contained such a covenant of indemnity or not. Moreover, the right to prove such a claim was held un-

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92. (1934) 48 Stat. 915, c. 424. "The claim of a landlord for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall be treated as a claim ranking on a parity with debts which would be provable under section 63 (a) of this Act, but shall be limited to an amount not to exceed the rent, without acceleration, reserved by said lease for the three years next succeeding the date of surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after the filing of the petition, plus unpaid rent accrued up to such date of surrender or reentry: *Provided*, That the court shall scrutinize the circumstances of an assignment of future rent claims and the amount of the consideration paid for such assignment in determining the amount of damages allowed assignee hereunder."

93. See sec. 77 of the Bankruptcy Act (1934) 48 Stat. 911, c. 424 prior to the passage of the Chandler Act. *Connecticut Ry. & Lighting Co. v. Palmer* (1939) 305 U. S. 493, rev'g *In re New York, N. H. & H. R. R.* (C. C. A. 2, 1938) 95 F. (2d) 483.

94. *Kuehner v. Irving Trust Co.* (1937) 299 U. S. 445, comment (1937) 4 U. of Chi. L. Rev. 493. The constitutionality was questioned upon several grounds: (1) It was an unreasonable classification, limiting a landlord's recovery below that of other creditors similarly injured; and provided for equal recovery to landlords unequally injured. (2) It involved a denial of due process, since it denied full satisfaction of a landlord's claim while preserving an interest in the stockholders of the debtor. All these arguments were disposed of. There was a major objection to putting landlords on equal footing with other creditors, because their interest was usually speculative. The proper measure of damages is the difference between the fair rental value of the premises for the term remaining and the discounted value of the rent reserved. See *Leo v. Pearce Stores Co.* (D. C. E. D. Mich. 1932) 57 F. (2d) 340. The longer the term, the greater the difficulty of estimating the damages accruing. This is even worse in times of depression. All in all, the three year rule of thumb is not unreasonable. The due process argument was more difficult to overcome.

95. (1937) 299 U. S. 433.

affected by the fact that the leasehold was terminated after the lease had been rejected by the trustee. Hence even though the leasehold estate has been merged pursuant to a surrender under state law, or otherwise terminated, the landlord may nevertheless prove his claim. The amount for which the landlord may prove is again stated to be the "difference between the rental value of the remainder of the term and the rent reserved, both discounted to present worth."<sup>96</sup> That is the general rule of the measure of damages, which must always be read in connection with the statutory limit.<sup>97</sup> Therefore, the lack of a covenant of indemnity, the effective termination of the lease by its surrender, a re-entry of the lessor, and even a reletting by the lessor, will not prevent him from filing his claim. Is there any way in which he may lose his claim? We proceed to consider that problem.

In *Schwartz v. Irving Trust Co.*,<sup>98</sup> it was held that if a landlord takes a release for adequate consideration, he thereby precludes himself from filing any claim. The landlord had entered into an agreement with the debtor and his trustee by which he released the trustee from all liability with respect to the lease and such sub-leases as might have been made by the lessee, including all claims in respect of rent and use or occupation. Such a release by itself would have operated to prevent the landlord from proving the claims, but for the fact that in the instant case, the releases contained reservations of the right to file proof of claim pursuant to the statute. Similarly, it was held in *Meadows v. Irving Trust Co.*<sup>99</sup> that if a lease contains definite stipulations setting forth what shall be deemed full compensation for losses due to the termination of the leasehold, and such conditions are fulfilled, the landlord's claim is barred. In that case the lease provided that if default should occur and the lessee transferred his interest in the demised premises with all improvements thereon, together with all rents, issues, and profits accrued or to accrue, and all insurance policies upon the buildings or improvements, without compensation therefor to the lessor, such transfer should constitute full satisfaction of the lessor's right under the

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96. This is in accord with the holding in *Kuehner v. Irving Trust Co.* (1937) 299 U. S. 445.

97. See (1934) 48 Stat. 915, c. 424.

98. (1937) 299 U. S. 456.

99. (1937) 299 U. S. 464.

lease. It specifically stated that such transfer was not a penalty, but amounted to a liquidation of the damages suffered by the termination of the lease. The lessee having complied with that condition and having transferred all his interests under the lease, it was held that such fulfillment of the condition operated to terminate the tenant's liability, and to remove any possible claim which might have been asserted by the landlord. Claims for unaccrued rent, then, may be effectively released, or they may be reserved. In each case the problem becomes one of examining what the parties have done. Where the bankrupt assigned his rights to the lessor, it was held that the right to file a claim was not released,<sup>100</sup> as it would have been if the bankrupt had assigned to a third person with the assent of the lessor. A re-entry coupled with a reletting may be such a termination of the lease as to amount to a release and leave nothing for the trustee to reject.<sup>101</sup> The acceptance of money by the lessor from the lessee as rent may be deemed a waiver of a prior forfeiture, preventing the lessor from re-entering, but what constitutes a waiver is a question of fact in each case.<sup>102</sup> It is a matter of intent. And though the lessor accepts rent as such in full after breach of the conditions, it will not amount to a waiver if the lease provides that rent may be received without prejudice.<sup>103</sup> The lessors' rights are limited usually by the terms of the lease. If the lessee sublets, the right of the original lessor against the sub-lessee can rise no higher than the right of the sub-lessor against him.<sup>104</sup>

It frequently occurs that a debtor in reorganization has guaranteed the rent obligations of other debtors. In such cases two questions arise in relation to the liability of the guarantor. What is the extent of his liability and to whom does it extend? In

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100. In re United Cigar Stores Co. (C. C. A. 2, 1937) 88 F. (2d) 621. See also (C. C. A. 2, 1937) 89 F. (2d) 3, in which a sublessee was to be liable to the lessor in case of bankruptcy, but this agreement did not operate as a release.

101. In re Radio-Keith-Orpheum Corp. (C. C. A. 2, 1937) 91 F. (2d) 938.

102. In re Walker (C. C. A. 2, 1937) 93 F. (2d) 281. Here the debtor had paid \$1300 to the lessor after a default which entitled the lessor to re-enter. It was held not a waiver of the forfeiture. L. Hand wrote the opinion, emphasizing that the payment was not rent, or money due under the lease.

103. In re Wil-Low Cafeterias (C. C. A. 2, 1938) 95 F. (2d) 306.

104. In re Connecticut Co. (C. C. A. 2, 1938) 95 F. (2d) 311.

*Hippodrome Building Co. v. Irving Trust Co.*,<sup>105</sup> the lessor leased a theatre to a subsidiary of the debtor for a term of 17 years at \$150,000 per year. The debtor guaranteed the payment of the rent. The debtor's trustee rejected the lease. The lessor sub-let under the provisions of the lease granting him the right to do so, but he did not terminate the lease. The court permitted proof only to the extent of three years' rent. The basic principle was that a guarantor could not be held liable for a greater amount than his principal.<sup>108</sup>

The lessor may find himself a creditor of a guarantor who has promised a sub-lessor to discharge the rent specifications on behalf of the sub-lessee. Thus where the debtor had guaranteed to discharge the rental obligations of a sub-lessee which was a wholly owned subsidiary of the debtor-guarantor, the original lessor was held entitled to file its claim against the debtor. This was true even though the promise was not intended to be for the claimant's benefit.<sup>107</sup> The situation was deemed analogous to that in which a grantee of land subject to a mortgage assumes the mortgage and promises to the mortgagor to pay the obligation which it secures. In such a situation the mortgagee may in most states sue the grantee directly. The theory of subrogation is also mentioned. The reasoning is that if the party to whom the promise is made is liable to the original lessor, the latter may reach and enforce the promise to his own debtor. Moreover, even though the promisee of the guarantor has not covenanted to pay rent to the original lessor, the existing privity of estate should be sufficient to entitle the latter to obtain the benefit of the promise. The privity of estate would arise from the fact that the sub-lessor remained a lessee after it sub-let and was bound as an assignee of a lessee in possession.

The status of tort claims in bankruptcy proceedings was shrouded in uncertainty for many years. The problem necessarily centered around section 63 of the Bankruptcy Act.<sup>108</sup> Fol-

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105. (C. C. A. 2, 1937) 91 F. (2d) 753.

106. *In re Radio-Keith-Orpheum Corp.* (C. C. A. 2, 1937) 91 F. (2d) 938.

107. *In re Radio-Keith-Orpheum Corp.* (C. C. A. 2, 1937) 91 F. (2d) 1004.

108. Section 63 of the Chandler Act clarifies the problem of the provability of tort claims. All tort claims which are reduced to judgment at the time of the filing of the petition are provable, and, with reference to claims for damages resulting from negligent conduct of the bankrupt, sec-

lowing the passage of the Bankruptcy Act of 1898, numerous efforts were made to establish the provability of tort claims. These efforts were made along two lines of thought. In the first place it was argued that section b of section 63, providing for the liquidation of unliquidated claims, operated to enlarge the list of provable claims enumerated in part a of section 63. Secondly, lawyers contended that the language of section 17 of the Bankruptcy Act, listing claims which are non-dischargeable, clearly showed that Congress intended to make tort claims provable.<sup>109</sup> Both of these arguments were set at rest by the Supreme Court of the United States, the first one in *Dunbar v. Dunbar*,<sup>110</sup> the second in *Schall v. Camors*.<sup>111</sup> In the latter case the Court settled the controversial issue and held that a claim for fraud was not provable. Other tort claims which bankruptcy courts refused to admit were as follows: claims for the infringement of a patent,<sup>112</sup> and negligence claims not reduced to judgment at the time of filing of the petition.<sup>113</sup> If the tort claim had been reduced to judgment at the time of the filing of the petition it was provable,<sup>114</sup> but the mere fact that a verdict had been rendered was insufficient.<sup>115</sup>

The strict rule of the *Schall* case can be avoided if a contract implied in fact or law can be found and the tort is waived. If the wrongdoer has obtained something of value for which an equivalent price should be paid and on account of which the law would imply a promise to pay, the claim is provable.<sup>116</sup>

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tion 63a, 11 U. S. C. A. (Supp. 1939) sec. 103a provides: "Debts of the bankrupt may be proved and allowed against his estate which are founded upon \* \* \* (7) the right to recover damages in any action for negligence instituted prior to and pending at the time of the filing of the petition in bankruptcy."

109. *Schall v. Camors* (1920) 251 U. S. 239; *Crawford v. Burke* (1904) 195 U. S. 176; *Brown & Adams Co. v. United Button Co.* (C. C. A. 3, 1906) 149 Fed. 48; *Comment* (1920) 15 Ill. L. Rev. 220.

110. (1903) 190 U. S. 340, 350.

111. (1920) 251 U. S. 239.

112. *In re Paramount Publix Corp.* (D. C. S. D. N. Y. 1934) 8 F. Supp. 644.

113. *In re Kroeger Bros. Co.* (D. C. E. D. Wis. 1920) 262 Fed. 463, *comment* (1922) 1 Wis. L. Rev. 369.

114. *Lewis v. Roberts* (1925) 267 U. S. 467; *Moore v. Douglas* (C. C. A. 9, 1916) 230 Fed. 399.

115. *In re Ostrom* (D. C. D. Miss. 1911) 185 Fed. 988.

116. *Clarke v. Rogers* (1913) 228 U. S. 534; *Schall v. Camors* (1920) 251 U. S. 239; *Lane v. Industrial Comr.* (C. C. A. 2, 1931) 54 F. (2d) 338, 341, 86 A. L. R. 765; *Cunningham v. Feinsilver* (D. C. D. Mass. 1925) 6

In June, 1934, sub-section 6½ was added to section 63a.<sup>117</sup> The amendment rendered it no longer necessary for a negligence claim to be reduced to judgment as a condition precedent to provability, provided the action had been instituted prior to the adjudication and was pending at the time of the filing of the petition. The amendment applies only to negligence claims, however. As to all other torts the case of *Schall v. Camors* still controls. The act as amended and as interpreted does not favor the unliquidated tort claim.

The underlying policies which induced the courts and Congress to do nothing about the unliquidated claims are not easy to isolate. This is especially true since the mere fact that a judgment has been entered, or a suit for negligence has been started renders the claim provable. The real nature of the claim is not changed simply because a judgment has been entered. It is suggested in the *Schall* case that bankruptcy laws have dealt primarily with traders and that pure tort claims are excluded as not involved in trading. That may be true, but if that is a real reason, it should make no difference that a judgment has been entered, for if a creditor holding a judgment for pure fraud files his claim, and shares in the assets, he is taking money supposedly belonging to the traders. Again it has been stated that time is of the essence in bankruptcy administration, and that the handling of unliquidated claims would delay the distribution of assets among creditors.<sup>118</sup> That may be a very practical consideration. Yet courts agree that doubts should be resolved in favor of provability.<sup>119</sup>

The rule in reorganization proceedings has been quite different from the practice in regular bankruptcy cases. Judges have admitted tort claimants to the full status of creditors with great freedom. Claims for false arrest and slander, and willful and

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F. (2d) 92; In re Paramount Publix Corp. (D. C. S. D. N. Y. 1934) 8 F. Supp. 644. See also *Stipp v. Doran* (C. C. A. 3, 1927) 18 F. (2d) 83; *Johnson v. Barney* (C. C. A. 8, 1931) 53 F. (2d) 770; In re S. W. Strauss & Co. (C. C. A. 2, 1933) 67 F. (2d) 605; In re Internat'l Match Corp. (C. C. A. 2, 1934) 69 F. (2d) 73; *Cawthon v. Bankokentucky Co.* (D. C. W. D. Ky. 1931) 52 F. (2d) 850.

117. 48 Stat. 923, c. 424, sec. 4(a), 11 U. S. C. A. (1937) sec. 103(6½).

118. In re Paramount Publix Corp. (D. C. S. D. N. Y. 1934) 8 F. Supp. 644.

119. *Williams v. United States Fidelity & Guaranty Co.* (1915) 236 U. S. 549; *Maynard v. Elliott* (1931) 283 U. S. 273.

malicious injury to the person have been held to be both provable and dischargeable.<sup>120</sup> A claim against a steamship corporation under section 33 of the Merchant Marine Act for the wrongful death of an employee by the alleged negligence of the company is both provable and dischargeable.<sup>121</sup>

The liberality of the courts in allowing these claims is explained by the broad language of section 77B, defining creditors to include holders of claims of whatever character, whether or not such claims would otherwise have constituted provable claims under the Bankruptcy Act. The courts accept the statement that the statutory language in this respect is far more comprehensive than the corresponding section of the old Act.<sup>122</sup>

The courts have also shown themselves very lenient in permitting tort claimants to liquidate their claims in state courts without losing their right to file in the reorganization proceeding.<sup>123</sup> Though the courts possess full power to control such suits,<sup>124</sup> it is settled that they may be enjoined only upon a showing by the debtor that their prosecution will hinder, burden or delay reorganization. In the absence of such a showing, the enjoining of a suit constitutes an abuse of discretion.<sup>125</sup> The power under subsection c (10) of section 77B or section 116 (4) of the Chandler Act must be exercised "according to the particular circumstances" of the case and is to be guided by considerations of what is just to the claimants, the debtor, and the estate.<sup>126</sup> The fact that the debtor carried insurance against the liabilities involved is also of great importance. If the claimant needs a judgment to be entitled to such insurance it is an abuse of judicial discretion to enjoin him from obtaining such a judg-

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120. *In re McCrory Stores Corp.* (D. C. S. D. N. Y. 1937) 19 F. Supp. 367; *In re B. M. O. Corp.* (D. C. S. D. N. Y. 1938) 24 F. Supp. 652; *Small v. Kiel* (C. C. A. 8, 1939) 101 F. (2d) 444.

121. *Foust v. Munson* S. S. Lines (1936) 299 U. S. 77; *In re Adolf Gobel, Inc.* (C. C. A. 2, 1937) 89 F. (2d) 171.

122. *In Foust v. Munson* S. S. Lines (1936) 299 U. S. 77, the claim was for the wrongful death of claimant's father, caused by the negligence of the debtor. The court said, "Undoubtedly, 'creditors', 'claims', and 'liabilities' to be dealt with in the reorganization proceeding include petitioner, the cause of action he asserts and the judgment he seeks to recover."

123. *In re Missouri Gas and Electric Service Co.* (D. C. W. D. Mo. 1935) 11 F. Supp. 434.

124. *Foust v. Munson* S. S. Lines (1936) 299 U. S. 77.

125. *Ibid.*

126. *Id.* at p. 83; *In re Adolf Gobel, Inc.* (C. C. A. 2, 1937) 89 F. (2d) 171.



ment.<sup>127</sup> The claimant should be entitled to file,<sup>128</sup> unless the delay is unreasonable.<sup>129</sup>

In railroad reorganizations under section 77, tort claims have been given priority over mortgages and other claims. Full recovery has been allowed both in receivership proceedings, and under the words of the Act treating such claims as operating expenses entitled to be paid in full ahead of the funded debts.<sup>130</sup> Moreover, in case a state statute gives a prior lien upon the property of a railroad in favor of persons suffering damages as a result of its wrongdoing, such lien is given full recognition over other liens.<sup>131</sup> The present policy of allowing liberal proof of tort claims in reorganizations is undoubtedly essential. All claimants have a legal right to sue their debtor and levy execution upon his property, and if all claimants were not brought in and put under control a reorganized business would not have a very peaceful existence. Hence the handling of claims in such a proceeding must be more realistic than in ordinary bankruptcy.

The passage of the Chandler Act has not changed materially the problem analyzed in these pages. A few minor changes have been mentioned, but essentially the decisions under section 77B are still excellent guide posts. In fact they may well be of controlling importance. The effect of having new legislation cutting across well settled rules of law is uncertainty. Those whose rights depend upon the sanctity of old rules, hold them up as immutable, and opponents favor their abrogation. The position of the conditional seller in a reorganization proceeding is illustrative. Purposive interpretation of the statutes requires the denial of some well established rights. Gradually, the practice will evolve fairly clear notions as to what constitutes an interest in the property of the debtor. It is hoped that this study indicates that certain trends are already discernible. It seems too early to draw positive conclusions.

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127. *In re Adolf Gobel, Inc.* (C. C. A. 2, 1937) 89 F. (2d) 171.

128. *Mack v. Pacific S. S. Lines* (C. C. A. 9, 1938) 94 F. (2d) 95.

129. *In re McCrory Stores Corp.* (D. C. S. D. N. Y. 1937) 19 F. Supp. 367.

130. *Central Hanover Bank v. Williams* (C. C. A. 8, 1938) 95 F. (2d) 210; *In re Chicago, etc. Ry.* (C. C. A. 7, 1937) 90 F. (2d) 312, 113 A. L. R. 487; *Thompson v. Siratt* (C. C. A. 8, 1938) 95 F. (2d) 214.

131. *Thompson v. Glover* (C. C. A. 8, 1938) 94 F. (2d) 544.