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BANKRUPTCY - CORPORATE REORGANIZATION - EFFECT OF RELEASE OF COLLATERAL OBLIGOR ON DISSENTING CREDITORS

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RECENT DECISIONS

BANKRUPTCY — CORPORATE REORGANIZATION — EFFECT OF RELEASE OF COLLATERAL OBLIGOR ON DISSENTING CREDITORS — The federal district court confirmed a plan of reorganization of debtor corporation, under section 77B of the Bankruptcy Act,[1] which expressly released defendant from liability as guarantor of bonds of the corporation and provided for cancellation of the bonds and substitution of new certificates of stock. The plaintiff, a bondholder, made no objection when the plan was submitted to the court; objection by other bondholders was overruled. The plaintiff brought suit in municipal court on the defendant's guaranty. Defendant pleaded the confirmation of the plan by the district court as res adjudicata. The trial court denied the plea and entered judgment for the plaintiff. *Held*, trial court reversed and plea of res adjudicata allowed, it not appearing that the federal district court was wholly without jurisdiction to cancel the guaranty and release the defendant. *Gottlieb v. Crowe*, 289 Ill. App. 595, 7 N. E. (2d) 469 (1937).

A surety is not released by a discharge of the principal debtor in the ordinary bankruptcy proceeding.[2] Nor does the majority rule release the surety from liability to creditors who have entered into a composition with the debtor, if such action is reasonable.[3] But under a reorganization of a debtor corporation in a 77B proceeding, a bondholder who surrenders his original securities for cancellation or consents (for a valid consideration) to a plan which expressly modifies a collateral liability cannot enforce his rights against the surety.[4] The same is true where the creditor consents to a plan which materially alters the obligation of the debtor corporation to the creditor. The surety is released on the theory of the new contract abrogating the old.[5] The situation with regard to dissenting creditors is decidedly different. Previous to the decision in the instant case,[6] the United States circuit courts of appeals had passed on the

[1] 48 Stat. L. 911 (1934), 11 U. S. C., § 207 (1935).

[2] Under section 16 of the Bankruptcy Act, 30 Stat. L. 544 (1899), 11 U. S. C., § 34 (1935): "the liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of the bankrupt." This provision has been thought to be incorporated into § 77B, since § 77B (k) states that all provisions of the act not inconsistent with § 77B are made applicable to that section.

[3] ARANT, SURETYSHIP AND GUARANTY, § 54 (1931).

[4] Kripke, "Collateral Liabilities Under Section 77B," 35 MICH. L. REV. 432 (1937). After an examination of the cases thus far decided on the question, the author concluded (35 MICH. L. REV. at 441): (1) that if a bondholder gives up his guaranteed security and accepts an unguaranteed security, the liability on the guarantee will be gone, simply because the creditor no longer holds the obligation of the guarantor; (2) if, without giving up the guaranteed security, the creditor consents to a plan of reorganization which releases the guarantor, then the guarantee will be released, at least if the release of the obligation is supported by consideration.

[5] ARANT, SURETYSHIP AND GUARANTY, § 67 (1931).

[6] The same result as that of the principal case was reached in an even more recent Illinois case, Barnett v. Gitlitz, 290 Ill. App. 212, 8 N. E. (2d) 517 (1937). The plaintiff got a judgment against the defendant as surety on bonds of the debtor cor-

question and consistently held that the district courts under a 77B proceeding have no jurisdiction to provide for release of a surety's liability to dissenting creditors.[7] The following arguments have been advanced to support this position. The dissenters to the plan make no agreement with the surety and consequently are not precluded from bringing a personal action against the solvent surety.[8] The prosecution of their claims would not interfere with the reorganization of the debtor corporation. Section 77B (f) contemplates that the judge must not confirm the plan unless he is satisfied that it is "fair and equitable." [9] Consequently, the court in *In re 1775 Broadway Corp.*[10] held that a plan which provided for the release of those collaterally liable was not "fair" to non-assenting creditors and the court had no jurisdiction to confirm such a plan. The Bankruptcy Act was intended for relief of insolvents, and the surety in these cases is apparently perfectly solvent.[11] Even if he were shown to be insolvent he would have to seek relief under other sections of the Bankruptcy Act.[12] The purpose of a guaranty is protection against the principal's inability to pay. If we allowed the collateral obligation to be released on reorganization of the debtor corporation, it would make the guarantor's obligation nominal only, since he would merely have to see that the debtor was reorganized.[13] Although section 77B forces dissenters to come under the plan as to

poration. The corporation submitted a plan of reorganization under § 77B. The United States District Court confirmed the plan and, as an incident to it, ordered satisfaction of the judgment against the defendant as surety. The defendant sued out execution on the judgment. The plaintiff appealed to the Illinois appellate court. The court held the judgment had been satisfied, saying (290 Ill. App. 212 at 218): "To sustain the position of the plaintiff it would be necessary to ignore the provisions of the law of the United States. . . . If the plaintiff is right, a minority of bondholders can prevent the United States District Court from functioning under section 77B." It is submitted that the court erred in failing to ascertain whether the district court was "functioning" properly under § 77B when it released the collateral obligation.

[7] In re 1775 Broadway Corp., (C. C. A. 2d, 1935) 79 F. (2d) 108; In re Nine North Church Street, (C. C. A. 2d, 1936) 82 F. (2d) 186; In re Diversey Bldg. Corp., (C. C. A. 7th, 1936) 86 F. (2d) 456.

[8] This observation was made in 23 VA. L. REV. 601 at 602 (1937) and in Kripke, "Collateral Liabilities under Section 77B," 35 MICH. L. REV. 432 at 441 (1937).

[9] In 48 Stat. L. 911, § 77B (f) (1934), 11 U. S. C., § 207 (f) (1935), are set forth the final prerequisites before the plan is confirmed. Having already heard objections, "the judge shall confirm the plan if satisfied that it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible."

[10] (C. C. A. 2d, 1935) 79 F. (2d) 108.

[11] In re Diversey Bldg. Corp., (C. C. A. 7th, 1936) 86 F. (2d) 456 at 458.

[12] Either under ordinary bankruptcy procedure or under 47 Stat. L. 1467, § 1 [§ 74] (1933) [as amended by 48 Stat. L. 911, § 2 (1934)], 11 U. S. C., § 202 (e) (1935). See Maynard v. Elliott, 283 U. S. 273, 51 S. Ct. 390 (1931), to the effect that the liability of a guarantor, even on an unmatured claim, while his liability is contingent, is provable and dischargeable.

[13] In In re Nine North Church Street, (C. C. A. 2d, 1936) 82 F. (2d) 186 at 188, such a plan was attempted by a guarantor to absolve itself from liability.

their rights against the principal,[14] nothing is said concerning their rights against the surety. Moreover, since section 76 [15] of the Bankruptcy Act, as amended in 1934, expressly provides that those secondarily liable shall be bound by the plan of extension of obligations of individuals under section 74,[16] the natural implication of the failure to mention, in section 77B, the rights against the one collaterally liable is that no jurisdiction of the court over rights against sureties was intended. An argument in support of the principal case may be found on the grounds of expediency in administering the act. If the dissenters are allowed to enforce their rights against the surety they would have a material advantage over assenting creditors who lose such rights. A general knowledge of this superior position would make it difficult to obtain acceptance of a plan involving reorganization of a guaranteed issue. However, it would seem that the arguments propounded for the other view are compelling and the court in the instant case might better have followed the decisions of the United States circuit courts of appeals.[17]

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[14] See 48 Stat. L. 911, § 77B (g) (1934), 11 U. S. C., § 207 (g) (1935). On the constitutionality of this provision, see Alley, "An Appraisal of Some Phases of the Corporate Reorganization Statute," 23 VA. L. REV. 503 (1937).

[15] 48 Stat. L. 911, § 10 (1934), 11 U. S. C., § 204 (1935).

[16] 47 Stat. L. 1467, § 1 (1933) [as amended by 48 Stat. L. 911, § 2 (1934)], 11 U. S. C., § 202 (e) (1935). An excellent discussion of this statutory argument may be found in 3 UNIV. CHI. L. REV. 661 (1936).

[17] The way in which the instant case arose placed the court in an embarrassing position, since the United States District Court had twice passed on the particular question concerning the release of the collateral obligation. The court was, therefore, reluctant to say that the district court had acted wholly without jurisdiction. A dissenting judge, however, expressed the view that the court had no choice but to follow the decisions of the circuit courts of appeals.