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COMMENTS

BANKRUPTCY — CORPORATE REORGANIZATION — "GOOD FAITH" IN PRESENTING PETITIONS FOR REORGANIZATION PROCEEDINGS — Reorganization proceedings for corporations are now provided for in chapter ten of the recently enacted Chandler Act,[1] which supersedes the provisions of 77B.[2] This legislation, designed to aid corporations which are insolvent or unable to meet their debts as they mature,[3] is available to all commercial corporations except municipal, insurance, and banking corporations and railroad corporations authorized to file a petition under section 77 upon the proper showing.[4] Sections 130 and 131 enumerate the necessary requirements of any petition filed for the purpose of obtaining reorganization. However, the most important prerequisite to this relief, from the standpoint of difficulty in compliance, is found in sections 141 to 144 of the act, requiring the court to find that the petition was filed in "good faith" or dismiss it. This question lies at the threshold of the case and must be clearly shown before the court will interfere with the affairs of the corporation.[5]

Thus, the petitioner's principal problem is in determining what is meant by the requirement of "good faith." The only provision in the act which furnishes any light on this question is section 146, which prescribes four situations when a petition will be deemed not to have been filed in good faith, as follows:

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

[1] 52 Stat. L. 883 (1938), 11 U. S. C. (Supp. 1938), § 501 et seq. Effective June 22, 1938.

[2] 48 Stat. L. 912 (1934), 11 U. S. C. (1934), § 207 et seq.

[3] 52 Stat. L. 886 (1938), 11 U. S. C. (Supp. 1938), § 530 (1).

[4] Section 106 (3) provides that a "corporation shall mean a corporation, as defined in this title, which could be adjudged a bankrupt under this title, and any railroad corporation, excepting a railroad corporation authorized to file a petition under section 205 of this title." And 52 Stat. L. 845 (1938), 11 U. S. C. (Supp. 1938), § 22, provides that any commercial corporation except a municipal, railroad, insurance, or banking corporation, or a building and loan association, can be adjudged a bankrupt under this title.

[5] In re Hudson Coal Co., (D. C. Pa. 1928) 22 F. Supp. 768.

"(1) the petitioning creditors have acquired their claims for the purpose of filing the petition; or
"(2) adequate relief would be obtainable by a debtor's petition under the provisions of chapter 11 of this title; or
"(3) it is unreasonable to expect that a plan of reorganization can be effected; or
"(4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding."

Like public policy, good faith is difficult to define, and it is probably not desirable to do so. Certainly, any general definition must be as vague as the term itself and would prove to be of very little aid in a practical sense. While the meaning in the minds of the legislative proponents of this provision[6] is of some assistance, the only satisfactory solution of the problem is to examine the numerous cases construing the term "good faith" as related to reorganization proceedings.

Since the good faith requirement is the same under the present act as under 77B, all the decisions on that point under 77B should still be authority. For the purpose of a more convenient examination of the many cases on this subject, they may be classified under the following divisions: (1) bona fides of the petitioner, including in its scope the judicial constructions of good faith in reference to the intent, purpose, and motive of the petitioner; (2) the need of reorganization; (3) the feasibility of reorganization; (4) the judicial process of determining the existence or non-existence of good faith.

I.

First of all the petition must be filed honestly.[7] Good faith implies honesty of purpose to save the corporation and its creditors, particularly the latter.[8] Thus, any plan which benefits lower ranking groups and excludes those with superior rights lacks good faith. For the same

[6] The following statement by the Honorable T. D. McKeown, chairman of the Subcommittee on Bankruptcy of the House Judiciary Committee, expresses what the proponents of the good faith requirement of 77B intended: "If there was a *bona fide* desire on the part of the corporation to reorganize for the benefit of all of its creditors, as well as stockholders, the filing of the petition is in good faith. If, on the other hand, consent prior to filing of this petition has been obtained to a plan of reorganization from creditors by any unfair means, the petition by the corporation has been for the purpose of obtaining some undue advantage for the stockholders in general, or particular stockholders, or particular creditors represented in the management of the corporation, the petition should be held to have been filed not in good faith." Atlas, "'Good Faith' in the Filing of a Petition Under Section 77B," 2 CORP. REORG. 506 at 507 (1936).

[7] In re South Coach Co., (D. C. Del. 1934) 8 F. Supp. 43.

[8] In re Dutch Woodcraft Shops, (D. C. Mich. 1935) 14 F. Supp. 467.

reasons a controversy must involve substantial claims of creditors and not be just between preferred and common stockholders.[9] Likewise a debtor who hides assets and attempts reorganization without disclosure is guilty of bad faith.[10] However, merely consulting with and acting on the advice of counsel will not be enough to satisfy the good faith requirement in this respect.[11]

It is essential that the petition be presented with the actual intent and purpose to use the act to effect a plan of reorganization.[12] If it is brought for any other purpose than reorganization, it is not in good faith.[13] It was early apparent that corporations with no intent to reorganize would take advantage of the act as a temporary shelter against creditors, and also that it offered a possible source of nuisance suits by creditors. The courts soon eliminated this danger, however, by holding that any such petition was not filed in good faith. Consequently, a creditor's petition if in the nature of a strike suit was deemed bad faith, as was a debtor's petition filed for the purpose of delay or to use the act as a storm cellar from creditors.[14] As a further prevention of such abuse, good faith requires prompt submission of a reorganization plan.[15] However, it is not necessary that a plan be formed when the petition is filed if it is expected that one can and will be presented promptly.[16]

The clause of section 146 providing that a petition is not filed in good faith if "creditors have acquired their claims for the purpose of filing the petition" merely restates the rule already announced by the courts. Good faith requires that the petitioner must be speaking for the corporation or its "real" creditors.[17] The fact that the petition was signed by three persons having the technical status of creditors is not sufficient.[18] Thus, purchasing bonds for the purpose of instituting reorganization proceedings shows lack of good faith.[19] Obviously such

[9] Atlas, " 'Good Faith' in the Filing of a Petition under Section 77B," 2 CORP. REORG. 506 (1936).

[10] In re Wisun & Golub, Inc., (C. C. A. 2d, 1936) 84 F. (2d) 1 (dress manufacturer failed to account for dresses sent to contractor for completion before petition).

[11] Atlas, " 'Good Faith' in the Filing of a Petition under Section 77B," 2 CORP. REORG. 506 (1936); Gregg, "The Trend," 9 ROCKY MT. L. REV. 359 (1937).

[12] In re South Coach Co., (D. C. Del. 1934) 8 F. Supp. 43.

[13] In re South Coach Co., (D. C. Del. 1934) 8 F. Supp. 43; In re Bush Terminal Co., (D. C. N. Y. 1935) 10 F. Supp. 315.

[14] Gregg, "The Trend," 9 ROCKY MT. L. REV. 359 (1937); Atlas, " 'Good Faith' in the Filing of a Petition under Section 77B," 2 CORP. REORG. 506 (1936); and In re Francfair, Inc., (D. C. N. Y. 1935) 13 F. Supp. 513.

[15] In re Philadelphia Rapid Transit Co., (D. C. Pa. 1936) 16 F. Supp. 941.

[16] In re Kelly-Springfield Tire Co., (D. C. Md. 1935) 10 F. Supp. 414.

[17] In re Philadelphia Rapid Transit Co., (D. C. Pa. 1936) 16 F. Supp. 941.

[18] Ibid.

[19] In re Hudson Coal Co., (D. C. Pa. 1938) 22 F. Supp. 768.

purchasers do not have the same interests as actual creditors and cannot properly be said to be speaking on their behalf. Furthermore, in any proceeding of an equitable nature where good faith is required, parties may not purchase themselves into court.[20] For similar reasons there is no good faith where a reorganization promoter procured the filing of a petition by creditors.[21] On the other hand, creditors solicited by another creditor to lend their names to a petition do not violate this provision of the act.[22]

Another problem which was solved by the use of this good faith requirement was that of individuals incorporating so as to obtain the benefits of reorganization procedure. While no statutory provision expressly forbids this, the courts skillfully used the concept of good faith as a judicial axe to prevent that result. An individual cannot incorporate for the sole purpose of taking advantage of the reorganization provisions of the Chandler Act.[23] Since chapter ten is obviously intended to aid the large corporation with assets frozen in several jurisdictions and whose liabilities are divided into bonded debts and capital stock scattered all over, the soundness of this view seems unquestionable. More especially is this true in view of the fact that an arrangement under chapter eleven will for most cases be adequate for the smaller business of an individual.[24] However, such a transfer was all right where the individual held hotel property as trustee after foreclosure on another corporation and the creditors blocked state reorganization proceedings.[25] Likewise, there is good faith where the corporation is formed for the purpose of filing a petition after foreclosure had been pending for three years and the plan was the creditor's.[26]

[20] Ibid.

[21] Gregg, "The Trend," 9 ROCKY MT. L. REV. 359 (1937), citing In re Grandeur Bldg. Corp., (D. C. Ill. 1935), CCH BANKRUPTCY SERVICE, ¶ 3471.

[22] Atlas, "'Good Faith' in the Filing of a Petition under Section 77B," 2 CORP. REORG. 506 (1936); Humphrey v. Bankers Mortgage Co., (C. C. A. 10th, 1935) 79 F. (2d) 345.

[23] See In re North Kenmore Bldg. Corp., (C. C. A. 7th, 1936) 81 F. (2d) 656; Atlas, "'Good Faith' in the Filing of a Petition under Section 77B," 2 CORP. REORG. 506 (1936).

[24] The statute provides that petitioner must show why adequate relief cannot be obtained under chapter 11 [11 U. S. C. (Supp. 1938), § 530] and if obtainable the petition is not in good faith [11 U. S. C. (Supp. 1938), § 546]. Thus a small corporation's petition would in most cases lack good faith.

[25] In re Knickerbocker Hotel Co., (C. C. A. 7th, 1936) 81 F. (2d) 981. Bondholders through trustee foreclosed and then organized a corporation to hold the property and go into bankruptcy and reorganize.

[26] In re Loeb Apartments, (C. C. A. 7th, 1937) 89 F. (2d) 461. Organization of corporation for purpose of reorganization under the bankruptcy act may be in good faith if debtor's purpose is to end delays, administrative expenses, statutory periods of redemption and unreasonable obstruction by minorities.

2.

It is not enough, however, for the petitioner to show honest intentions, a sincere purpose, and proper motives.[27] Before the court will find that a petition is filed in good faith it must be shown that the corporation is in need of reorganization.[28] This is the basis for section 146 providing that if chapter eleven affords adequate relief the petition is not filed in good faith.[29] While it is clear that good faith means there must be a need for reorganization, that still leaves the problem of determining when there is such a need. Certainly there is no need for reorganization if a prior proceeding will best serve the interests of all the parties,[30] and the statute expressly provides that such a petition lacks good faith. Consequently, a petition will be dismissed where an equity receivership is about to be successfully completed,[31] and especially where it has been completed.[32] But it would seem that no court would hold "that interests of all would be best subserved" in a prior state proceeding where little had been accomplished after several years.[33] Further, a petition shows good faith in respect to a need for reorganization where all parties affected agree that reorganization is essential and cannot be obtained in equity.[34]

However, while good faith requires that there be a need for reorganization, this has not been construed so as to permit a corporation which is solvent but losing money to petition in good faith for reorganization. Such a corporation certainly might be found to "need" reorganization, but not in the sense that such need has been interpreted in these decisions. Thus a petition by any solvent corporation lacks good faith in this respect.[35] Furthermore, such a corporation would be unable to show the jurisdictional fact that it was insolvent or unable to meet its debts as they mature as required by the statute. However, a petition has been allowed when it was clearly shown that insolvency was only a few

[27] In re R. L. Witters Associates, Inc., (D. C. Fla. 1937) 19 F. Supp. 648; Atlas, " 'Good Faith' in the Filing of a Petition under Section 77B," 2 CORP. REORG. 506 (1936).

[28] In re South Coach Co., (D. C. Del. 1934) 8 F. Supp. 43.

[29] If chapter 11 affords adequate relief, then there is no need for reorganization under chapter 10 and the petition lacks "good faith."

[30] 11 U. S. C. (Supp. 1938), § 546(4).

[31] In re Williamsport Wire Rope Co., (D. C. Pa. 1935) 10 F. Supp. 481; Atlas, " 'Good Faith' in the Filing of a Petition under Section 77B," 2 CORP. REORG. 506 at 509, note 39 (1936).

[32] In re Phelps Manor Realty Co., (C. C. A. 3d, 1934) 73 F. (2d) 1010.

[33] In re Prairie Avenue Bldg. Corp., (D. C. Ill. 1935) 11 F. Supp. 125; In re New York Title & Mortgage Co., (D. C. N. Y. 1934) 9 F. Supp. 319.

[34] In re South Coach Co., (D. C. Del. 1934) 8 F. Supp. 43.

[35] In re Piccadilly Realty Co., (C. C. A. 7th, 1935) 78 F. (2d) 257.

months away.[36] This failure to provide relief for a solvent and liquid corporation under proper circumstances seems to leave the reorganization procedure incomplete. The desirability of preventing insolvency of a going corporation would seem to be equally as great as that of rejuvenating corporations which are insolvent and perhaps have doubtful prospects of future success.

3.

Good faith also requires a showing that reorganization of the corporation is feasible. As has already been seen, section 146 (3) expresses the legislative intent to this effect. Thus it is clear that the petitioner must show a reasonable expectation of the continued useful existence of the debtor corporation and a reasonable prospect of successful rehabilitation.[37] This, however, is no answer to our original question. It only raises new questions: when is there a reasonable possibility of successful rehabilitation, or when is reorganization feasible. Again the only answer is in the cases where this point has been raised and decided. It is clear that reorganization would not be feasible where a receiver, appointed by a state court, had sold all the assets.[38] The same is true where a large portion of the debtor's assets had been conveyed for a small present and a doubtful future consideration, and business activities were reduced to such an extent that it had gone a long way toward liquidation.[39] Failure of prior successive plans would also be reason to dismiss the petition for lack of good faith,[40] as reorganization would probably be unsuccessful again.

To satisfy good faith in this respect, the debtor must show some going concern value to be protected from the losses resulting from breaking up.[41] Preservation of a going business is one of the principal aims of reorganization proceedings. A substantial equity is not necessary, but existence of no equity shows a lack of good faith.[42] If the debtor has no equity or prospect of future profits, reorganization is not feasible. Such a case is treated as an attempt to hinder and delay creditors and must be dismissed.[43] However, the public interest in the em-

[36] In re Kelly-Springfield Tire Co., (D. C. Md. 1935) 10 F. Supp. 414.

[37] In re R. L. Witters Associates, Inc., (D. C. Fla. 1937) 19 F. Supp. 648; In re Tennessee Pub. Co., (C. C. A. 6th, 1936) 81 F. (2d) 463, affd. 299 U. S. 18, 57 S. Ct. 85 (1936); In re Electric Pub. Serv. Co., (D. C. Del. 1934) 9 F. Supp. 128.

[38] In re Electric Pub. Serv. Co., (D. C. Del. 1934) 9 F. Supp. 128.

[39] In re R. L. Witters Associates, Inc., (D. C. Fla. 1937) 19 F. Supp. 648.

[40] In re Grigsby-Grunow Co., (C. C. A. 7th, 1935) 77 F. (2d) 200.

[41] Gregg, "The Trend," 9 ROCKY MT. L. REV. 359 (1937); In re Dutch Woodcraft Shops, (D. C. Mich. 1935) 14 F. Supp. 467.

[42] In re North Kenmore Bldg. Corp., (C. C. A. 7th, 1936) 81 F. (2d) 656.

[43] In re Tennessee Pub. Co., (C. C. A. 6th, 1936) 85 F. (2d) 463, where

ployment of thousands of workers has been reason for a contrary result even where the prospect of future profits was very remote.[44]

Another important factor as to whether reorganization is feasible or not is the possibility of securing the consent of the interested creditors and stockholders to the plan proposed.[45] If the required majorities are not likely to consent to the plan, the petition will be dismissed.[46] Thus, where the plan at its inception has the approval of most of the creditors there is good faith in this respect.[47] Especially would this be true where two-thirds of all the creditors had adopted the plan offered by the debtor corporation.[48] The fact that the petitioning creditors hold only a small part of the claims is not in itself important.[49] The statute allows them to file a petition if their claims aggregate $5,000. But such a petition is likely to be dismissed because of the opposition. Similarly, when a corporation files a petition it is no lack of good faith that many stockholders are opposed to the management.[50] However, if the stockholders must approve the plan, the petition may be dismissed on the ground that reorganization is not feasible. This does not mean, though, that a petitioner must present a fully worked out plan with his petition.[51] It only requires a probability of acceptance of some plan.[52]

Good faith in respect to the need and feasibility of reorganization is not lacking where the corporation has been ousted from its franchise by the state of its incorporation.[53] A state can do nothing to prevent a corporation from resorting to the Bankruptcy Act.[54] Likewise, the fact that the debtor corporation is in the custody of the state superintendent of insurance is no reason to dismiss a petition for reorganization.[55]

financial condition of debtor makes immediate liquidation the only possible expedient from a business standpoint, a petition for reorganization lacks good faith.

[44] In re Studebaker Corp., (D. C. Ind. 1935) 9 F. Supp. 426.

[45] In re Loeb Apartments, (C. C. A. 7th, 1937) 89 F. (2d) 461. That two-thirds of the creditors favored the debtor's plan was material in determining the good faith of the petition for reorganization.

[46] If the plan is not likely to be accepted, it is not feasible and thus lacks good faith. Gregg, "The Trend," 9 ROCKY MT. L. REV. 359 (1937).

[47] Union Nat. Bank v. Lehmann-Higginson Grocer Co., (C. C. A. 10th, 1936) 82 F. (2d) 969.

[48] In re Loeb Apartments, (C. C. A. 7th, 1937) 89 F. (2d) 461.

[49] Manati Sugar Co. v. Mock, (C. C. A. 2d, 1935) 75 F. (2d) 284.

[50] In re Kelly-Springfield Tire Co., (D. C. Md. 1935) 10 F. Supp. 414.

[51] In re Prairie Avenue Bldg. Corp., (D. C. Ill. 1935) 11 F. Supp. 125.

[52] If a reasonable possibility to reorganize a tentative plan is sufficient, but if acceptance of any plan is improbable, there is no good faith. Atlas, "'Good Faith' in the Filing of a Petition under Section 77B," 2 CORP. REORG. 506 at 510, notes 44-46 (1936).

[53] Capital Endowment Co. v. Kroeger, (C. C. A. 6th, 1936) 86 F. (2d) 976.

[54] Gregg, "The Trend," 9 ROCKY MT. L. REV. 359 at 364, note 33 (1937).

[55] In re New York Title & Mortgage Co., (D. C. N. Y. 1934) 9 F. Supp. 319.

4.

Reorganization proceedings may be instituted by the filing of a petition by the corporation, or by three of its creditors or an indenture trustee if they meet the conditions prescribed in section 126.[56] Likewise, sections 136 and 137 provide for the filing of an answer by either the debtor corporation, a creditor, or an indenture trustee, and if the corporation is not insolvent, by a stockholder. Whether the answer denies or admits jurisdiction and the allegations of the petition, the judge must still find that the petition has been filed in good faith or dismiss it. The determination of the existence or non-existence of good faith is committed to the unlimited discretion of the court,[57] except, if one of the situations described in section 146 exists, the court must find that the petition lacks good faith.

When the answer denies the allegations of the petition, the judge's task of deciding this question is relatively easy. In such case the opposing party will see that all facts showing bad faith are brought to the attention of the court. While the answer is for the purpose of controverting the allegations of the petition, it may be used to raise this issue as to good faith.[58] On the other hand, where the petition is not controverted, the judge will have considerable difficulty in discovering the facts, if any, showing bad faith. The petition may disclose some facts on this question, but not generally. When desirable the judge may order a hearing, upon notice to designated interested parties, and he is free to inquire into facts which are collateral to the issues presented by the pleading if they afford any light.[59] In all cases the burden of proving good faith is on the petitioners. The burden of discovering bad faith, however, rests primarily on the judge, and whether this provision of the statute is successful in barring petitions filed in bad faith depends on the diligence of the judge in requiring a full disclosure of all surrounding circumstances.

It is apparent from the foregoing that whether a petition is filed in "good faith" or not depends upon the peculiar facts of each case. Each

[56] Section 126: "A corporation, or three or more creditors who have claims against a corporation or its property amounting in the aggregate to $5,000 or over, liquidated as to amount and not contingent as to liability, or an indenture trustee where the securities outstanding under the indenture are liquidated as to amount and not contingent as to liability, may, if no other petition by or against such corporation is pending under this chapter, file a petition under this chapter." 11 U. S. C. (Supp. 1938), § 526.

[57] O'Conner v. Mills, (C. C. A. 8th, 1937) 90 F. (2d) 665.

[58] Gerdes, "'Good Faith' in the Initiation of Proceedings under Section 77B of the Bankruptcy Acts," 23 GEORGETOWN L. J. 418 (1935).

[59] Ibid. at 430, 431 (1935).

new fact situation may give the term an added meaning. The decided cases answer the question as to their particular fact situations, but as to future cases, the answer rests on something similar to the broad principles of equity and natural justice. Furthermore, any crystallization of the meaning of good faith would defeat its whole purpose. To enable the court to prevent abuse of the reorganization proceedings under this chapter, it is essential that the generality of the term "good faith" be carefully preserved.[60]

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[60] By the "good faith" requirement the judge is clothed with wide discretionary powers to prevent unjust injury to corporations and their creditors and to preserve and continue a going business if possible. Ibid.