

# COMPETING SYSTEMS OF CORPORATE REORGANIZATION: CHAPTERS X AND XI OF THE BANKRUPTCY ACT

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CORPORATIONS may be reorganized both under Chapter X and Chapter XI of the revised Bankruptcy Act.<sup>1</sup> Chapter X is reorganization in the grand manner. It represents the response of its draftsmen to the great reorganization cases and to the atmosphere of melodrama and importance which colors all discussion of them. The Wabash, the Monon, the St. Paul; Bogert and Furlaud and Boyd — for readers of the law reviews and the United States reports, these are words to conjure up “an alluring picture of shady characters, with diamond rings on their fingers, . . . sitting with lips glued to the telephone and weaving their nefarious webs around the world . . . ”<sup>2</sup> As a device for protecting the participants in reorganization from each other, Chapter X is in every way an improvement upon its predecessors, the equity receivership and the Section 77B proceeding. Its ritual is more complex and impressive, its substance more satisfying, its promise of protection to investors more emphatic. Chapter XI, on the other hand, has about it the grub-biness of bankruptcy. It provides a cheap and practical method of settlement, based on the history of composition in bankruptcy, for poor debtors whose estates cannot afford the expense of an elaborate public ceremonial. No one will look to Chapter XI as a theatre for the glamor and high language expected of spectacular proceedings under Chapter X.

In its large way, Congress intended Chapter X for the reorganization of big corporations, and Chapter XI for the relief of small debtors, incorporated and unincorporated. But the forty-odd experts who worked eight years revising the Act omitted from it any formula for determining which corporate debtors should be rehabilitated under Chapter X and which under Chapter XI. As things stand, Chapter X and Chapter XI

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1. Chapter X, 52 STAT. 883-905, 11 U. S. C. A. §§ 501-676 (Supp. 1938); Chapter XI, 52 STAT. 905-916, 11 U. S. C. A. §§ 702-799 (Supp. 1938). Sections of Chapter X are numbered from 101 to 276; sections of Chapter XI from 301 to 399. Citations to the Bankruptcy Act will hereafter refer to the section number alone.

For an authoritative survey of the revised Act, and its genesis, see McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act* (1937) 4 U. OF CHI. L. REV. 369.

2. D. H. Robertson, *World Finance* (1931) in A. C. PIGOU AND D. H. ROBERTSON, *ECONOMIC ESSAYS AND ADDRESSES* (1931) 182.

offer alternative systems for the reorganization of corporations generally, and it is established practice for similar corporations, in comparable financial difficulties, to be reorganized under either chapter.<sup>3</sup> Yet the two reorganization chapters are violently inconsistent. They provide incompatible procedures and they appear to contemplate opposite results.<sup>4</sup> They were drafted by different groups, with different objects, and according to different models. Unless the courts prove acrobatic in devising machinery omitted from the Act, effective administration of the two chapters will not be possible until the Statute is suitably amended.

### THE COMPARATIVE STRUCTURE OF CHAPTERS X AND XI

Chapter X is principally the work of the Securities and Exchange Commission,<sup>5</sup> and is based on the Commission's already classic Protective

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3. That many corporations which "belong" in proceedings under Chapter XI are being reorganized under Chapter X, see Address of Samuel O. Clark, Director, Reorganization Division, S. E. C. (Jan. 5, 1939) 9. Of 250 corporations for which petitions under Chapter X were filed between September 22, 1938, and March 31, 1939, 173, or 70%, had indebtedness of less than \$250,000. S. E. C. Corp. Reorg. Release No. 12 (May 8, 1939) 10.

The Brooklyn Daily Eagle Corporation, publisher of a newspaper, is being reorganized under Chapter XI in the Eastern District of New York. The petition was filed on April 13, 1939, and on April 14, 1939, an order was signed "accepting" the petition and ordering the management to remain in possession, apparently as trustees. The petition, the debtor stated, was the result of "a friendly understanding" on the part of the newspaper's few large creditors. The first meeting of creditors was held on April 29, and a "plan of reorganization" proposed on May 26, 1939, based on 35% settlement.

"Under the proposed plan a new corporation, to be known as the Brooklyn Eagle, Inc., is to be created. This corporation would issue 7,000 to 8,000 shares of non-cumulative 6 per cent preferred stock of \$10 par value and also 3,000 to 3,500 shares of common stock of \$10 par value.

"The plan seeks also to pay secured and prior claims and to raise working capital for the new corporation by the issuance of \$300,000 to \$350,000 in three-year notes, which would have parity with all future obligations and yield not more than 6 per cent interest.

"For unsecured claims the plan provides for the issuance of \$175,000 to \$275,000 in unsecured, non-interest bearing junior notes to be liquidated from a sinking fund created by setting aside 50 per cent of the annual net earnings of the new corporation."

N. Y. Times, May 27, 1939, p. 19, col. 2; see also N. Y. Times, April 14, 1939, p. 17, col. 5; April 15, 1939, p. 6, col. 8; April 30, 1939, p. 5, col. 2. The publisher of Scribner's Magazine, on the other hand, is being reorganized under Chapter X. N. Y. Times, May 27, 1939, p. 19, col. 3.

4. On the differences between X and XI, see Graham, *Fair Reorganization Plans under Chapter X of the Chandler Act* (1938) 8 BROOKLYN L. REV. 137, 153, 154. Cf. Heuston, *Corporate Reorganizations under the Chandler Act* (1938) 38 COL. L. REV. 1199, 1233-1239.

5. See letter of former Chairman Landis, *Hearings before the Committee on the Judiciary on H. R. 6439* (reintroduced and passed in 1938 as H. R. 8046), 75th Cong., 1st Sess. (1937) 423-426. This source will hereafter be referred to as *House Hearings*.

Committee Study.<sup>6</sup> Despite shortcomings, Chapter X is the most substantial achievement of the new Act, and its innovations of procedure should operate materially to change results in corporate reorganization.<sup>7</sup> The reforms of Chapter X are designed in the first instance to maximize the protection given creditors in the process of reorganization and in the reorganization plan. Public officers and agencies—the judge, the trustee and the Securities and Exchange Commission—are to dominate the proceedings; management and committees controlled either by management or by the house of issue find the area within which they may act to press their interests correspondingly reduced in size and importance. But the chapter promises to do more than restore the balance of bargaining power in reorganization, in favor of creditors as against management. There is a public interest not only in the “fairness” of reorganization plans, but in their financial content. Chapter X represents a vague and feeble effort, but an unmistakable one, to declare an affirmative policy with respect to some of the economic and managerial problems of reorganization.<sup>8</sup>

Chapter XI, on the other hand, is the achievement of a campaign carried on by the National Association of Credit Men and other groups of creditors’ representatives expert in bankruptcy.<sup>9</sup> Their business of representing trade creditors in small and middle-sized commercial failures is an important element in the background of the chapter. Their technique has been to conduct a central information and credit-clearing bureau, from which news of the impending financial difficulty of a debtor is forwarded. Once warned, creditors may either act independently or authorize the credit bureau to act for them. Usually a sufficient number of claims are marshalled to give the creditors’ organization command of any subsequent proceeding. It then takes charge of negotiations for composition, and often runs the business as custodian during the period of settlement. The process of liquidation goes on entirely out of court,

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6. REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936-39). Seven parts have already been published; an eighth is soon to appear. The study will hereafter be cited as S. E. C. REPORT.

7. The provisions of Chapter X have been much discussed. See Dodd, *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations* (1938) 38 COL. L. REV. 223; Swaine, “*Democratization of Corporate Reorganizations*” (1938) 38 COL. L. REV. 256; Weiner, *The Securities Exchange Commission and Corporate Reorganization* (1938) 38 COL. L. REV. 280; Graham, *supra* note 4; Teton, *Reorganization Revised* (1939) 48 YALE L. J. 573; Gerdes, *Corporate Reorganizations—Changes Effected by Chapter X of the Bankruptcy Act* (1938) 52 HARV. L. REV. 1; Heuston, *supra* note 4; Levi, *Corporate Reorganization and a Ministry of Justice* (1938) 23 MINN. L. REV. 3.

8. See Teton, *supra* note 7, at 607; p. 1373, *infra*.

9. Chapter XI was sponsored at the House Hearings by W. Randolph Montgomery, Counsel for the National Association of Credit Men. *House Hearings, supra* note 5, at 31, 35, ff.

though proceedings are initiated by using whatever legal device — common law or statutory assignment for the benefit of creditors, power of attorney, trust mortgage or receivership — is locally most convenient or customary.<sup>10</sup> “Friendly adjustment” is the slogan of such groups. Their interest is in the preservation and protection of informal, inexpensive methods of dealing with the insolvency of smaller enterprises, and they point to dividends higher than in bankruptcy, and to frequent rehabilitation of the debtor business as the advantages of their system. They want to retain a lucrative practice in the administration of debtors’ estates. But their out-of-court procedure possessed two inherent weaknesses. The debtor and his property could never be immunized from the threat of involuntary bankruptcy, and dissenting creditors could rarely be forced to accede to a scheme postponing liquidation in favor of extension and continuation of the business.<sup>11</sup> Chapter XI, created by the spokesmen of the Credit Bureaus in the National Bankruptcy Conference,<sup>12</sup> eliminates both these defects, and it gives the creditors’ representatives almost everything they want.<sup>13</sup> Under Chapter XI a debtor, or the organized creditors’ groups controlling the debtor, should have almost complete autonomy in the administration of the estate, and in the control of negotiations for settlement. Practical, swift and economical relief is provided for small debtors, through a simplified procedure adapted from Sections 12, 74 and 77B.

But if large corporations or corporations with widely held securities can obtain relief under Chapter XI, even in a limited class of situations, the creditors groups who sponsored Chapter XI will have more than they bargained for, and the reformist aims of those who drafted Chapter X will be defeated. The courts and the Securities and Exchange Commission, to say nothing of creditors, will almost surely try to prevent such a use of Chapter XI.<sup>14</sup> For Chapter XI offers tremendous advantages of procedure and of result to corporate management, and to the security interests usually held by management. Those advantages seem specially tempting when contrasted with the closely supervised reorganization system provided by Chapter X.

#### *Reorganization Procedure under Chapter X and Chapter XI*

As applied to larger corporations or corporations with widely held securities, Chapter XI anthologizes the evils of procedure and short-

10. See Comments (1937) 46 YALE L. J. 1177, 1186 *et seq.*; (1938) 47 YALE L. J. 944.

11. See Comment (1938) 47 YALE L. J. 944, 949-950, and cases cited, p. 949.

12. See statements of W. Randolph Montgomery, counsel for National Association of Credit Men, before House Judiciary Committee. *House Hearings, supra* note 5, at 36-38.

13. See Montgomery, *Arrangements* (1938) 13 J. N. A. REF. BANKR. 17; Weinstein, *The Debtor Relief Chapters of the Chandler Act* (1938) 5 U. OF PITTS. L. REV. 1.

14. As to the position taken by the S.E.C., see p. 1363, *infra*.

comings of scope and purpose, long recognized in earlier forms of the reorganization proceeding, which Chapter X is designed to remedy.

It was, for example, a defect of the equity receivership as a vehicle for the reorganization of larger corporations, and to a lesser extent of Section 77B, that the management of a debtor corporation had great power to control the proceedings and to mislead or coerce its creditors and the judge into accepting its plan.<sup>15</sup> Chapter X eliminates or controls, and Chapter XI preserves or ignores, most of the weapons traditionally used for these purposes—the debtor-in-possession, or the friendly receiver or trustee; the protective committee operating under a deposit agreement; the reorganization managers, usually identified with the management or its bankers; the lists of creditors controlled by management or by banking groups friendly to management; the opportunity for soliciting assents before the court passed on the fairness of the plan; the absence of supervision over the representations made by those soliciting deposits or other forms of assent.

*Procedure of Preparing a Plan under Chapter X.* Chapter X requires the appointment of a trustee where the debtor's fixed and liquidated indebtedness is more than \$250,000.<sup>16</sup> The trustee cannot be hand-picked by the debtor; he is to be "independent," and the judge's discretion in choosing him has been enlarged.<sup>17</sup> The trustee under Chapter X is an important functionary, charged with jobs formerly done by reorganization managers, protective committees, private detectives, and the 77B trustee, and with some jobs formerly not done at all. During the first part of the period of administration the trustee, aided by a power of examination,<sup>18</sup> is to investigate and report on the business and financial condition of the debtor, and to express an opinion on the desirability of continuing its business.<sup>19</sup> An effort is thus made to base the plan of reorganization on a thorough and disinterested study of the economic problem presented by the insolvency. Further, the trustee is to report on facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to causes of action available to the estate.<sup>20</sup>

Elaborate provision is made to minimize the influence of management in the drafting of the plan. Plans or proposals for plans may be submitted to the trustee by creditors and stockholders;<sup>21</sup> the trustee then prepares

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15. See S. E. C. REPORT (Part I) 868 *et seq.*

16. § 156.

17. §§ 156, 158.

18. The power to examine officers and directors and other persons cannot be exercised unless "the judge shall so direct." § 167(2).

19. § 167(1) and (5).

20. § 167(3). For the experience with mismanagement investigations under § 77, see (1937) 47 YALE L. J. 285.

21. § 167(6).

a plan, which is considered at a hearing, together with objections, amendments or separate plans proposed by the debtor<sup>22</sup> or by any creditor or stockholder.<sup>23</sup> At this hearing, as at others, the indenture trustee and any creditor or stockholder has a right to be heard.<sup>24</sup> Thus nine-tenths of the complicated drama of intervention in reorganization is avoided, for under Section 206 minority interests may air their objections in court early enough in the proceedings to have a real opportunity to prevent acceptance of the plan either by the judge or by the parties in interest.<sup>25</sup>

In this process of urging plans on the trustee and the court, creditors may act together.<sup>26</sup> The coöperative activity of minority groups is facilitated by the provisions of the Act relating to lists.<sup>27</sup> The court may require third persons, such as paying agents or the house of issue, to disclose lists of a debtor's security holders; it may refuse the inspection of such lists only to creditors or stockholders who have become such within three months of the filing of the petition.<sup>28</sup> But the group activities of creditors or stockholders are subject to strict controls. Deposit agreements and other documents defining the terms of an agency for security holders may be examined; the court may restrain the exercise of any power found to be unfair or inconsistent with public policy.<sup>29</sup> The Securities and Exchange Commission may be allowed to become a party

22. § 169.

23. *Ibid.*

24. § 206. The right to be heard exists as to "all matters arising in a proceeding under this chapter." That the right to be heard under § 206 carries with it the right to appeal, see Report of Special Master, *In re Philadelphia & Reading C. & I. Co.* (E. D. Pa., 1939) C. C. H. Bankr. Serv. ¶ 51,743; Teton, *Reorganization Revised* (1939) 48 YALE L. J. 573, 592. And see *Texas Hotel Securities Corp. v. Waco Developments Co.*, 87 F. (2d) 395, 398 (C. C. A. 5th, 1936). But compare MOORE'S BANKRUPTCY MANUAL (1939) 554-555.

25. In equity the dissenter, in order to get the attention of the court before the confirmation hearing, at which time overwhelming majorities were brought to bear upon the judge, sought to intervene at some earlier stage in the proceedings. If he was a bondholder, he was met with the answer that he was adequately represented by the indenture trustee; if a simple creditor, by the receiver; if a stockholder, by the management. Despite the patent unreality of these contentions, intervention was usually denied, unless some fraud could be shown. See MOORE'S BANKRUPTCY MANUAL (1939) 549-560, and cases cited. Little change in intervention rules followed the passage of Section 77B. Except for the specific issues on which creditors and stockholders were given a right to be heard [§ 77B(c)], intervention was regarded as necessary. It has been argued that intervention under Chapter X should be allowed at least as freely as under Section 77B (See MOORE, *op. cit. supra*, at 561), but the enlarged right to be heard conferred by § 206 will make this issue less important under Chapter X than in the past.

26. § 209 permits creditors to act in person, by an attorney at law, or by a duly authorized agent or committee.

27. §§ 164, 165, 166.

28. § 166.

29. §§ 211, 212.

for all purposes in the proceeding except appeal.<sup>30</sup> It is already clear that as a party the Commission polices the proceeding with some vigor. Its presence should serve negatively as well as affirmatively to reduce the chance that the plan confirmed will be unfair to creditors or defective in the provision it makes for the financial future of the debtor enterprise.

After the hearing on the plan or plans proposed by the trustee and by other parties, and before the judge approves them, he may submit plans which he regards as worthy of consideration to the Securities and Exchange Commission for an advisory report. He must submit plans for such a report if the scheduled indebtedness of the debtor is more than \$3,000,000.<sup>31</sup> After the filing of the Commission's report, the judge shall approve a plan or plans as "fair and equitable, and feasible," and the trustee or the debtor in possession shall submit approved plans to interested creditors and stockholders for acceptance.<sup>32</sup> This submission by the trustee or debtor in possession must be accompanied by a barrage of documents designed to help the creditor or stockholder make up his mind. These documents are required by Section 175:

- "(1) The plan or plans so approved, together with a summary thereof approved by the judge;
- (2) The opinion of the judge, if any, approving the plan, or plans, or a summary thereof approved by the judge;
- (3) The report, if any, filed in the proceeding by the Securities and Exchange Commission, as provided in Section 172 of this Act, or a summary thereof prepared by the Securities and Exchange Commission; and
- (4) Such other matters as the judge may deem necessary or desirable for the information of creditors and stockholders."

Except by express consent of the court, which in all probability will rarely be given, no one other than the trustee or the debtor in possession may solicit acceptances of any plan, or authority in any form to accept any plan, until after the creditors and stockholders have received the envelope contemplated by Section 175; "and any such authority or acceptance given, procured, or received by reason of a solicitation prior to such approval and transmittal shall be invalid . . ."<sup>33</sup>

*Procedure of Preparing an Arrangement under Chapter XI.* The process of formulating an arrangement under Chapter XI, and of soliciting acceptances to such an arrangement, sacrifices to speed and economy every safeguard in the interest of thoroughness and disinterestedness provided by Chapter X.

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30. § 208.

31. § 172.

32. § 174.

33. § 176.

Chapter XI proceedings are voluntary, and the debtor must file a proposed arrangement with his petition. The appointment of a custodian is discouraged. It is provided that upon the application of a party in interest the court may appoint a receiver, if necessary.<sup>34</sup> Presumably the applicant will have to show grounds of necessity comparable to those required under Section 2a(3), governing the appointment of bankruptcy receivers generally.<sup>35</sup> It is significant that Chapter XI, drafted by bankruptcy lawyers, provides for a receiver and not a trustee, for a receiver under the Bankruptcy Act has been an officer of limited authority, with less capacity for initiative than a trustee. The receiver may carry on the business and issue certificates of indebtedness,<sup>36</sup> but he has no functions of inquiry, nor any duties in connection with drafting the arrangement. It is unlikely that receivers under Chapter XI will be appointed as often as trustees under Chapter X. And even where a receiver is appointed, the Act makes no provision for an investigation, a report, or a determination of the economic justification for continuing the business.

Creditors are afforded an extremely limited opportunity to influence the contents of an arrangement. So far as the words of the Act are a guide, they may not propose an arrangement, or alterations or modifications of an arrangement proposed by the debtor.<sup>37</sup> Their role is to vote yes or no, and their choice is influenced by the chances of delay and possible loss which might follow rejection.<sup>38</sup>

Furthermore, acceptances of an arrangement may be obtained by the debtor before the filing of the petition.<sup>39</sup> Creditors are given no protection in their function as voters comparable to the protection afforded them under Chapter X,<sup>40</sup> or even under the former Section 12, governing

34. § 332.

35. Although § 2a(3) has been revised so as to permit more frequent appointment of receivers in bankruptcy, it is still necessary to justify the appointment by showing some special threat of loss to the estate unless receivers take charge. The phrase "if necessary" in § 332 may mean something less than the requirement of § 2a(3), as, for example, if creditors wish suit to be brought in behalf of the estate to set aside a fraudulent conveyance or a preference. Compare §§ 341, 343, 2a(3).

36. §§ 343, 344. These powers may also be exercised by a debtor in possession.

37. See note 114, *infra*. By refusing to confirm any arrangement which does not include suggested modifications, the court should in effect be able to bring about some amendments. If the debtor is still recalcitrant, the judge possesses additional powers, discussed at p. 1361, *infra*. Section 466 of Chapter XII (Real Property Arrangements by Persons other than Corporations) expressly permits creditors to propose arrangements approved by a certain percentage of creditors.

38. The costs of administration of a small estate absorb fantastic percentages of the asset value in short periods. See Billig, *Extra-Judicial Administration of Insolvent Estates: A Study of Recent Cases* (1930) 78 U. of Pa. L. Rev. 293.

39. § 336(4). The similar practice in equity receivership has often been denounced as inimical to the interests of investors. See S. E. C. REPORT (Part I) 900.

40. See §§ 175, 176, discussed *supra* pp. 1339-1340.



compositions.<sup>41</sup> And the creditor's vote is subject to another danger under Chapter XI. An arrangement may be confirmed by the court if accepted "in writing by a majority in number of all creditors or, if the creditors are divided into classes, by a majority in number of all creditors of each class, affected by the arrangement, whose claims have been proved and allowed before the conclusion of the meeting, which number shall represent a majority in amount of such claims generally or of each class of claims, as the case may be."<sup>42</sup> Since the arrangement as proposed or modified may provide differing treatment for different classes of creditors, the debtor apparently has considerable power, subject to the court's control under Section 351, tentatively to fix the division of creditors into classes for the purposes of the arrangement and its acceptance. In the light of Section 362, this grant empowers the debtor to change the political position of a creditor, by putting him into a larger or smaller class. Debtors may conceivably divide their creditors to weaken potential opposition or to bribe it into acquiescence.<sup>43</sup> Since arrangements under Chapter XI directly affect only unsecured debt, the term "classes" may mean something less restricted than the meaning given it under Section 77 or Chapter X. There, seemingly, classes can be recognized only with reference to the place of claims in the hierarchy of priorities.<sup>44</sup> But Chapter XI apparently contemplates that bank creditors and merchandise

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41. *In re Berler Shoe Co.*, 246 Fed. 1018 (S. D. N. Y. 1917). Under § 12a, a bankrupt could not offer a composition until he had been examined in open court or at a meeting of his creditors, and had filed in court a schedule of his property and the list of his creditors required to be filed by bankrupts. The provision was changed in order to allow the participants in an out-of-court adjustment, *e.g.*, by way of an assignment for the benefit of creditors, to forestall creditors who threatened to throw the estate into bankruptcy. If the creditors carry out their threat, the debtor can now counter with a Chapter XI petition, propose the identical plan which had been the basis of the interrupted negotiations, and file the consents that were obtained before bankruptcy intervened. See *House Hearings*, *supra* note 5, at 37, 38.

42. § 362(1). It should be observed further that dissenters and dissenting classes may have greater obstructive power under Chapter XI than under Chapter X. No provisions comparable to those of § 216(7) or (8) appear in Chapter XI.

43. See *In re Burns Bros.*, 14 F. Supp. 910 (S. D. N. Y. 1936), where many creditors contested two large claims on the ground that the claimants had dominated the debtor and brought about its financial ruin. Almost all of the contesting creditors agreed to abandon their objections when a plan was proposed allowing the disputed claims but placing them in a class subordinate to the class in which all other creditors were included. This compromise was approved by the court. Compare *Taylor v. Standard G. & E. Co.*, 59 Sup. Ct. 543 (U. S. 1939); *In re McCrory Stores Corp.*, 12 F. Supp. 267, 268 (S. D. N. Y. 1935); see the cases collected and discussed in FINLETTER, *PRINCIPLES OF CORPORATE REORGANIZATION* (1937) 422-433.

44. *Morgan & Co. v. Missouri Pacific R. R.*, 85 F. (2d) 351 (C. C. A. 8th, 1936), *cert. denied*, 299 U. S. 603 (1936). § 197 of Chapter X authorizes the judge to divide creditors into classes "according to the nature of their respective claims . . ." § 351 of Chapter XI states that "the court may fix the division of creditors into classes . . ." No standards are specified.

creditors, for example, though both unsecured, be treated differently in an arrangement,<sup>45</sup> and vote in separate classes.<sup>46</sup>

It is possible in appropriate cases that protective committees will be used in Chapter XI proceedings;<sup>47</sup> the Act gives the court no authority, save its general equity powers, to control their agreements or activities. Rival groups may take the field. The only express power the court has over creditors' lists is given by Sections 21a and 39a(3).<sup>48</sup> It has so far been held that Section 21a is not enough to justify a bankruptcy court in requiring the disclosure of one committee's lists to a rival creditors' committee, and that the rival committee can derive no benefit from the referee's independent powers under Section 39a(3).<sup>49</sup>

The Court can pass on the fairness of an arrangement only after it has been approved by requisite majorities of creditors. The referee will thus be facing a *fait accompli*, like an equity receivership court passing on a plan at a hearing to confirm the master's report of the sale.<sup>50</sup> Before that point, and even before the filing of the petition, the debtor can solicit acceptances of his arrangement on any kind of representations, safe from the competition of solicitors for rival plans.<sup>51</sup> It is entirely

45. "This (§ 351) permits the division of unsecured debts into classes according to their nature or according to the necessities of the case. It is intended, for example, to allow the payment in full of small claims, or a settlement with a bank on terms different from the settlement with merchandise creditors." *Analysis of H. R. 12839*, 74th Cong., 2d Sess. (1936) 42; MOORE'S BANKRUPTCY MANUAL (1939) 665. But can such treatment, though different, be unequal? If unequal, will such treatment be fair and equitable? And have unsecured creditors a right to vote with all their fellow creditors?

46. §§ 351, 357(1), 362 (1).

47. It is reported that creditors' committees operating under Chapter XI are seeking amendments to provide for the payment of fees to such committees. See (1939) 13 J. N. A. REF. BANKR. 93.

48. For instances of a policy as to creditors' lists in equity receivership, see S. E. C. REPORT (Part III) 252; Comment (1935) 44 YALE L. J. 498; *Bergelt v. Roberts*, 144 Misc. 832, 258 N. Y. Supp. 905 (Sup. Ct. 1932), *aff'd*, 236 App. Div. 777, 258 N. Y. Supp. 1086 (1st Dep't 1932).

49. In the case of *In re International Match Corp.*, 59 F. (2d) 1012 (S. D. N. Y. 1932), a creditors' committee sought to utilize §§ 21a and 39a(3) to compel a rival committee to disclose its lists. The court held § 21a inapplicable on the ground that the lists bore no relation to the "acts, conduct or property of the bankrupt." It was admitted that the referee might have an independent power of compelling disclosure under § 39a(3) but the court refused to place this power at the disposal of one of two rival committees. See (1932) 32 COL. L. REV. 1435; (1932) 46 HARV. L. REV. 309.

50. See S. E. C. REPORT (Part I) 900; *Chicago, Milwaukee & St. Paul Reorganization*, 131 I. C. C. 673, 694-696; LOWENTHAL, *THE INVESTOR PAYS* (1933) 366 ff.; *Foster, Conflicting Ideals for Reorganization* (1935) 44 YALE L. J. 923, 959.

51. There is little reason to anticipate that substitute protection can be given investors by the Securities Act of 1933. § 393a(2) of Chapter XI, and § 204a(2) of Chapter X exempt from the provisions of § 5 of the Securities Act of 1933 "any transaction in any security issued pursuant to a plan [or arrangement] in exchange for securities of or claims against the debtor or partly in such exchange and partly for cash and/or property, or issued upon exercise of any right to subscribe or conversion privilege so issued

possible for a debtor to negotiate a settlement with a suitable majority of his creditors before filing a petition, and then use Chapter XI to obtain confirmation and discharge.

Every phase of the procedure under Chapter XI bearing on the administration of the estate and the development of an arrangement is under the control of the debtor, or those controlling the debtor. Whether Chapter XI is used for large corporations or small ones, the system of reorganization it offers is unsatisfactory to creditors, except on grounds of economy and speed. Insofar as it is or can be used for large corporations, or corporations with publicly held securities, it has all the procedural weaknesses of the equity receivership and the 77B proceeding, and some new ones peculiarly its own.

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. . ." An opinion of the General Counsel of the Securities and Exchange Commission, construing § 77B(h) [in this respect comparable to §§ 393 and 264] took the position that although the exemption applied in terms only after the issuance of the securities, it did not prevent the solicitation of approvals or acceptances (and the issuance of certificates of deposit equivalent to approvals or acceptances) before the court had approved the terms of the plan or the reorganized company had issued the securities. S. E. C. Securities Act of 1933, Release No. 296 (Feb. 15, 1936); Throop and Lane, *Some Problems of Exemption under the Securities Act of 1933* (1937) 4 LAW & CONTEMP. PROB. 89, 102-107. It has been suggested that the Commission might change its construction of the scope of this exemption, in view of the absence under Chapter XI of supervision over the solicitation of acceptances, to require registration of any security to be issued in arrangement proceedings, before acceptances of the arrangement proposing its issuance can be solicited. But acceptances could be solicited under § 77B before a plan was approved or even before a petition was filed. The suggested view would negate the exemption of §§ 393 and 264, and the provisions of both chapters allowing acceptances to be solicited before approval of the plan, §§ 336(4), 176. [Throop and Lane, *supra* at 105: "the exemption from registration afforded" by § 77B(h) to securities issued in reorganization "would be a hollow form if the solicitation of requisite approvals and acceptances could not be engaged in without registration."]

Even if the prevailing construction of §§ 393a(2) and 264a(2) should be changed, the securities to be issued in most cases under Chapter XI will be exempted from the provisions of the Securities Act of 1933 under § 3a(9) of that Act, exempting "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." And in the comparatively rare Chapter XI case which does not fit § 3a(9) of the Securities Act of 1933, [see *Brooklyn Daily Eagle* case, note 3 *supra*], an appropriate interpretation of § 3a(10) may achieve the same result. That section exempts from the provisions of the Securities Act any security which is issued in reorganization proceedings after an open hearing before a court or administrative body upon the fairness of the terms of its issuance. See (1936) 45 YALE L. J. 1050. Where, as in Chapter XI proceedings, the court cannot pass on the fairness of the terms of issuance of the new securities until acceptances are marshalled in proper majorities, the Commission may well view § 3a(10) as applying to the security when finally issued, and as permitting solicitation of acceptances, at least in tentative form, before the issuance and without prior registration. See note 122, *infra*. But see S.E.C. Rule X-14A-7(e), implying that the Commission's rules relating to the solicitation of proxies and consents applied to the solicitation of Chapter XI acceptances with respect to securities listed on national securities exchanges.

*Plans of Reorganization under Chapter X and Chapter XI*

The basic objection to reorganization in equity and under Section 77B was the result reached: plans of reorganization were consistently approved which favored junior interests represented by management at the expense of senior creditors.<sup>52</sup> True, there were decisions by the Supreme Court and by circuit courts of appeals, demanding a better order of things. But these were bolts from the blue, occasionally visited upon a feckless sinner, and without much influence on the daily habits of the reorganization bar.<sup>53</sup> Reorganization plans, like other judicial determinations, are a function of the system of procedure used in framing them, and the procedure in equity receivership (to a lesser extent in 77B proceedings as well) permitted management groups to retain positions of almost irresistible importance. They controlled, or at least contributed decisively to the flow of information into the record, and to the courts' impression of the debtor's business. They had a considerable nuisance value, and material advantages in the competition for creditors' votes.<sup>54</sup> It followed that they were often able to convince creditors and the court that they should be given a larger share in the reorganized enterprise than they deserved in terms of legal rule.

Under Chapter X, all this is to be changed. The revolutionized procedure of Chapter X should take the balance of power in reorganization away from management. The Supreme Court's theory of reorganization is no longer an abstraction to be ignored in the practical confusion of a reorganization case. The Securities and Exchange Commission now stands by to repeat the lessons pronounced by appellate judges in the pre-natal stage of a plan's history. The trustee and the judge are reminded of the rules before the plan can be drafted, approved or submitted to security holders. Reorganizers will be forced at least to bow to orthodoxy throughout the period in which a plan takes form. And trial judges, drilled in the true faith by cases to which the Commission is party, may be expected to preach it fervently to the litigants in lesser proceedings.

52. A number of such cases are listed in Foster, *supra* note 50, at 948, n. 38; Graham, *supra* note 4, at 151, n. 72. One of the plans listed by Foster was unsuccessfully attacked by a creditor in *Lindh v. Booth Fisheries Corp.*, 80 F. (2d) 733 (C. C. A. 9th, 1935), *cert. denied*, 298 U. S. 670 (1936).

53. Foster, *supra* note 50, at 927-8.

54. On the interests and strategic position of management in reorganization, and its activities, normally carried forward with the aid of affiliated banking groups which acted as managers and underwriters of the reorganization transaction, see S. E. C. REPORT (Part I) 868, *et seq.*; Dodd, *supra* note 7, at 254; Cravath, *The Reorganization of Corporations* in 1 SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION (1916) 153. Such groups determined when to initiate the proceedings, controlled the personnel of one or more protective committees, prepared the debtor's plan, did much of the solicitation of deposits and assents. See S.E.C. REPORT (Part I) 874 (control of lists); O'Leary, *The Role of Banking Groups in Corporate Reorganizations* (1939) 29 AM. ECON. REV. 337.

The rules which are thus to be given renewed vitality have been vigorously restated. Reorganization under Chapter X, it is proclaimed, will be reorganization according to a very minatory version of the *Boyd* case gospel.<sup>55</sup> Valuation will be employed to foreclose the interests of junior classes of creditors and stockholders, and no securities are to be given any class unless all prior classes are "fully compensated." In terms of this theory of reorganization, the sacrifice of readjustment to the insolvency must fall first on stockholders, then on the next higher class of claimants, and so on, until capitalization is reduced at least to the value of the enterprise as a going concern.

As a basic canon of reorganization draftsmanship, the Securities and Exchange Commission's construction of the *Boyd* case doctrine has substantial support. The Supreme Court, however, has not discussed the problem intelligibly since 1913,<sup>56</sup> and then its decision was so Delphic, with implications so at variance with habitual practice, that the tea-cups have rocked ever since whenever lawyers tried to explain what the Court said.<sup>57</sup>

*Northern Pacific Railway Company v. Boyd*, like most of the earlier cases, was concerned with the practice in reorganization of leaving smaller unsecured claims out of the plan, to be settled privately, for cash, while

55. The S. E. C. is committed to a "strict priority" view of reorganization draftsmanship. See *In re* Genesee Valley Gas Co., S. E. C. Holding Co. Act Release No. 981 (1938); cf. *In re* West Ohio Gas Co., S. E. C. Holding Co. Act Release No. 1284 (1938).

"I will state at the outset, as to fairness, that I am a firm believer in the so-called 'strict priority' doctrine of the fair plan . . ." Address of Samuel O. Clark, Jr., Director of the Reorganization Division, S. E. C. (Jan. 5, 1939) 11.

"In order to test the fairness of a reorganization plan, it is first necessary to arrive at an estimate of the value of the property. The primary factor, in arriving at this estimate is a capitalization of 'reasonable prospective earnings.' This 'value' is then to be divided among the various classes of security holders and claimants in the order of their priority. Each class must obtain a 'completely compensatory' allotment of securities in the reorganized company before any participation can be allowed to a junior class.

"Some people have called this the logical or mathematical theory of reorganization. I think it can better be referred to as the constitutional theory . . ." Address of Abe Fortas, Former Assistant Director of the Public Utilities Division, S. E. C. (July 14, 1938) 7-8.

56. *Northern Pacific Ry. v. Boyd*, 228 U. S. 482 (1913). The Supreme Court spoke again in *Kansas City So. Ry. v. Guardian Trust Co.*, 240 U. S. 166 (1916) and in *Kansas City Term. Ry. v. Central Union Trust Co.*, 271 U. S. 445 (1926), but not helpfully.

57. The law reviews have waxed fat on the *Boyd* case. See, e.g., Foster, *supra* note 50; Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization* (1933) 19 VA. L. REV. 541; Gerdes, *A Fair and Equitable Plan of Corporate Reorganization Under Section 77B of the Bankruptcy Act* (1934) 12 N. Y. U. L. Q. REV. 1; Graham, *supra* note 4; Rosenberg, *Reorganization—The Next Step* (1922) 22 COL. L. REV. 14; Swaine, *Reorganization—The Next Step: A Reply to Mr. James N. Rosenberg* (1922) 22 COL. L. REV. 121; Spaeth and Winks, *The Boyd Case and Section 77* (1938) 32 ILL. L. REV. 769.

bondholders and stockholders divided the securities of the new company among themselves. The practice was denounced as a fraud on creditors, seemingly because stockholders were given a share in the control or a chance of profit or a claim to the assets of the reorganized enterprise, while some creditors received less than 100% of their claims.<sup>58</sup>

Two themes in the *Boyd* case opinion seem to have contributed most to the contemporary form of the *Boyd* case doctrine.

On the one hand, the Court said that the value of the property had nothing to do with the fixed principle of equity represented by the decision. "The invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property, for in cases like this, the question must be decided according to a fixed principle, not leaving the rights of creditors to depend upon the balancing of evidence as to whether, on the day of sale the property was insufficient to pay prior encumbrances."<sup>59</sup> In that phase of its opinion the Court was concerned with preserving in the plan the relative position of the old securities with respect to each other. The priorities established in the hierarchy of old claims had to be translated faithfully into the capital structure of the new company, although it was clear in the *Boyd* case, and repeated in later ones, that no real simplification of corporate structure could ever be accomplished unless the hierarchy of old claims was modified by giving the holder of the prior claim more of the same class of securities given the holder of a lesser one.<sup>60</sup> In any event, it has been said that no junior class could receive anything until senior classes were "completely compensated"<sup>61</sup> — a phrase which seems to mean at least that the prior class must be given securities equal in face amount, par or stated value to the face amount, par or stated value of its old ones;<sup>62</sup> perhaps the words mean also that an effort will be made to save the priority of claims to income.<sup>63</sup> Market values are not much consulted in these comparisons.

58. *Railroad Co. v. Howard*, 7 Wall. 392 (U. S. 1868); *Louisville Trust Co. v. Louisville, N. A. & C. Ry.*, 174 U. S. 674 (1899); *Chattanooga, R. & C. R. R. v. Evans*, 65 Fed. 809 (C. C. A. 6th, 1895).

59. 228 U. S. 482, 507 (1913).

60. See *Kansas City Term. Ry. v. Central Union Trust Co.*, 271 U. S. 445, 455-6 (1926).

61. *Cf. In re Murel Holding Corp.*, 75 F. (2d) 941, 942 (C. C. A. 2d, 1935).

62. *Kansas City Term. Ry. v. Central Union Trust Co.*, 271 U. S. 445 (1926); *In re New York Railways Corp.*, 82 F. (2d) 739 (C. C. A. 2d, 1936), *cert. denied*, 293 U. S. 687 (1936); *In re Barclay Park Corp.*, 90 F. (2d) 595 (C. C. A. 2d, 1937); *In re Day & Meyer, Murray & Young, Inc.*, 93 F. (2d) 657 (C. C. A. 2d, 1938).

63. See *In re Day & Meyer, Murray & Young, Inc.*, 93 F. (2d) 657 (C. C. A. 2d, 1938); Healy, Commissioner, concurring, in *In re West Ohio Gas Co., S. E. C. Holding Co. Act Release No. 1284* (1938) 12; Graham, *supra* note 4, at 156, n. 90 (discussing fairness of the new plans prepared in the Barclay Park and Day & Meyer reorganizations, after the C. C. A. decisions). But see *Kansas City Term. Ry. v. Central Union Trust Co.*, 271 U. S. 445, 456 (1926) (" . . . circumstances may justify an offer of differing amounts of the same grade of securities to both creditors and stockholders").

Although valuation was expressly discarded in this part of the opinion, in favor of a fixed principle of preserving priorities, it reappeared, a little inarticulately, in later passages. The "fixed principle" of relative priority would have made reorganization impossible, if it had not been coupled with a foreclosure device based on valuation. Since the relative positions of old security holders and other claimants had to be preserved — and "preserved" meant "fully compensated" — capitalization could never have been reduced in reorganization unless some groups of claimants were given no place in the new enterprise. The value of the debtor's assets at the time of reorganization became the fact which was used to accomplish such foreclosures. It was regarded as entirely fair to exclude from reorganization claimants whose interests the court found to be without value at the time of reorganization. Conversely, it was early indicated that it was unfair to exclude a class of claimants from a reorganization plan when the debtor's property was valued at more than the amount due on prior claims. And evidently the junior class could insist not only on being included in the plan, under such circumstances, but on being given the equivalent of everything then available to satisfy its claims.<sup>64</sup> Valuation thus offered a formula for determining which claims against a debtor corporation could be excluded from its reorganization.

The doctrine grew. If it was not unfair to exclude a claim from reorganization as valueless, it became almost compulsory to do so, for reasons that were indicated, if not fully developed, in the *Boyd* case itself. The *Boyd* case was a creditor's bill to reach property unavailable to the levy of execution. Boyd was trying to obtain what was given to stockholders: property interests which should have been given to him as creditor. Those interests consisted of the road itself subject to the mortgages securing the bonds of claimants prior to Boyd.<sup>65</sup> The Court indicated in the *Boyd* case that what the stockholders received was of value, and not a worthless gift of securities,<sup>66</sup> the implication being that if the road had been

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64. *Mountain States Power Co. v. Jordan Lumber Co.*, 286 Fed. 217 (D. Mont. 1923), *aff'd*, 293 Fed. 502 (C. C. A. 9th, 1923), *cert. denied*, 264 U. S. 582 (1924); see *New York Trust Co. v. Continental & Comm. Trust & Sav. Bank*, 26 F. (2d) 872, 876 (C. C. A. 8th, 1928). The *Mountain States* case is discussed in Swaine, *Reorganization of Corporations* in 8 SOME LEGAL PHASES OF CORPORATE FINANCE, REORGANIZATION AND REGULATION (1927) 133, 174-175.

65. *Northern Pacific Ry. v. Boyd*, 228 U. S. 482, 501 (1913).

66. 228 U. S. 482, 507 (1913). In several earlier lower court cases, an opposite view was asserted. Since the liens against the road exceeded its value, the reorganizers argued that there was no equity either for unsecured creditors or for stockholders, and that unsecured creditors could not complain if the former stockholders received a gift from the bondholders in the form of worthless stock in the new company. *Paton v. Northern Pacific Ry.*, 85 Fed. 838 (E. D. Wis. 1896); *Wenger v. Chicago & E. Ry.*, 114 Fed. 34 (C. C. A. 7th, 1902); *Farmers' Loan & T. Co. v. Louisville & C. Ry.*, 103 Fed. 110 (C. C. D. Ind., 1900). For a throwback to these early cases, see *Lindh v. Booth Fisheries Corp.*, 80 F. (2d) 733 (C. C. A. 9th, 1935), *cert. denied*, 298 U. S. 670 (1936).

insolvent<sup>67</sup> the creditor's bill might have been dismissed. The conclusion in the *Boyd* case that the stockholders received property of value was fortified by the fact that after reorganization in that proceeding, but before the appeal was heard, the railroad paid excellent dividends on the stock given the old stockholders. But the Court used significant language in explaining its conclusion:

"It is insisted, however, that not only the bid at public outcry, but the specific finding in the Paton case, established that the property was worth less than the encumbrances of \$157,000,000, and hence that Boyd is no worse off than if the sale had been made without the reorganization agreement. In the last analysis, this means that he cannot complain if worthless stock in the new company was given for worthless stock in the old. *Such contention, if true in fact, would come perilously near proving that the new shares had been issued without the payment of any part of the implied stock subscriptions except the \$10 and \$15 assessments.*"<sup>68</sup>

Thus the court's finding of valuation served another function, the significance of which grew with the development of judicial control in reorganization. In the name of the policy against watered stock, the finding of value limited the total capitalization of the new enterprise. A valueless claim had to be eliminated to prevent the issuance of watered stock, unless its holder paid an assessment.<sup>69</sup> And then the new claim could be represented on the balance sheet only by the amount of the assessment. Even if the use of no-par stock in some states permits reorganizers to avoid the watered-stock phase of the *Boyd* case doctrine, Mr. Justice Lamar's opinion contains another dictum of equivalent effect. "If the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control."<sup>70</sup> Junior claimants cannot even be given stock which is worthless from a balance sheet point of view, so long as prior claimants are not "fully compensated."

If certain claimants cannot be excluded from the reorganization because their claims have value, in terms of a valuation sanctified as a finding; if those claimants have to be "fully compensated," at least as to the face amount of their claims, before junior claims can participate at all; and if the court is vigilant to prevent the issuance of watered stock, the par or stated value of which would force total capitalization

67. At the time of the petition? The confirmation of the plan? The suit?

68. 228 U. S. 482, 507 (1913) (*italics added*).

69. See *In re Barclay Park Corp.*, 90 F. (2d) 595, 598 (C. C. A. 2d, 1937). But cf. *New York Trust Co. v. Continental & Comm. Trust & Sav. Bank*, 26 F. (2d) 872, 876 (C. C. A. 8th, 1928).

70. 228 U. S. 482, 508 (1913).



over the level fixed by the finding of value, it is easy to see how the "strict priority" theory of reorganization emerged, and found support in the uncertain language of the *Boyd* case.

The key place of valuation in the reorganization system provided by Chapter X of the Bankruptcy Act has been acknowledged. It is provided by Chapter X, following Section 77B, that if the debtor is insolvent, stockholders may not participate in the proceeding, nor need they be consulted for their views on the plan; and the plan need make no provision for them.<sup>71</sup> By analogy, the view has been taken that the reorganization court may by valuation also foreclose junior classes of creditors from all participation in the reorganization, and in relatively easy cases this has been done.<sup>72</sup> Valuation for the purposes of excluding classes from a reorganization, however, presents problems of real difficulty, especially for larger corporations, the assets of which cannot be "sold", in any practical sense, except to its creditors. It has been said that estimates of earnings are the proper basis for valuations in reorganization proceedings.<sup>73</sup> But estimating future earnings, and agreeing on an interest rate at which to capitalize them, is no less empirical a process than estimating reproduction cost; so far the use of estimated earnings has been generally approved as the key to valuation for purposes of reorganization, but only in cases which did not venture to rely on earnings as exclusive evidence of value.<sup>74</sup> And so far the courts have been gener-

71. §§ 137, 216(8) and 179.

72. "Here the controlling finding is that not only that there was no equity in the property above the first mortgage, but that petitioners' claims were appraised by the court as having 'no value.' There was no value to be protected. This finding embraces whatever interests petitioners may have as junior lienors under the Illinois law, and, in the same aspect, the constitutional argument is unavailing as petitioners have not shown injury." *In re* 620 Church St. Building Corp., 299 U. S. 24, 27 (1936). *In re* Hotel Governor Clinton, Inc., 96 F. (2d) 50 (C. C. A. 2d, 1938); *In re* Day & Meyer, Murray & Young, Inc., 93 F. (2d) 657 (C. C. A. 2d, 1938); *Providence Mut. Life Ins. Co. v. University Evangelical Lutheran Church*, 90 F. (2d) 992 (C. C. A. 9th, 1937); *In re* Garfield Arms Hotel Corp. (C. C. A. 7th, 1936) C. C. H. Bankr. Serv. ¶4116, (1936) 34 MICH. L. REV. 1201. But see *Farlee & Co. v. Springfield-South Main Realty Co.*, 86 F. (2d) 931 (C. C. A. 1st, 1936).

While Section 77 (e) makes specific provision for the elimination in railroad reorganizations of classes of creditors whose claims have no value [11 U. S. C. §205 (e) at p. 1026 (Supp. 1937)] no such provision appears either in 77B or in Chapter X. But under 77B the courts proceeded as if such a provision were inserted. *In re* Hotel Governor Clinton, *supra*; *In re* 620 Church St. Building Corp., *supra*.

73. See 2 BONBRIGHT, *THE VALUATION OF PROPERTY* (1937) 837 *et seq.*; Spaeth and Windle, *Valuation of Railroads Under Section 77 of the Bankruptcy Act* (1938) 32 ILL. L. REV. 517, 553, and especially the cases cited at 540-541, notes 111-120.

74. The usual procedure is for the court to mention in passing all possible evidence of value, reproduction cost, historical cost, earning power, salvage value, etc., and then to accept a capitalization which compromises with all the figures. The courts say that they regard earning power as the basis of valuation for purposes of reorganization. In fact, however, they have so far generally failed to carry out the implications of that view;

ous in their estimates of value, so that the facts relating to valuation have not often been contested in reorganization cases.<sup>76</sup> None of the decisions now recorded will prevent junior classes from insisting on relatively long and expensive valuation proceedings; they therefore leave to such groups part at least of their traditional nuisance value, which can be asserted by contesting the valuation on which reorganization is to be based.<sup>76</sup>

Whatever the merits or demerits of the doctrine of strict priority,<sup>77</sup> it is simple to administer, save for the basic problem of valuation itself, and will apparently be regarded as implied by, or consistent with, the main judicial precedents.<sup>78</sup> In the hands of energetic judges, it should serve to hasten reorganizations, and to make them more drastic. Both ends are socially useful. Quicker reorganization proceedings would reduce a burdensome and unproductive social expense. More drastic reorganizations, if coupled with a sensible minimization of debt in the

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to our knowledge, no court has chosen an interest rate, used it to capitalize earnings averaged over a given period and established the capitalized figure as the maximum valuation that will be permitted. For cases which consider factors of value in this indecisive way, see *In re* Genesee Valley Gas Co., S. E. C. Holding Co. Act Release No. 981 (1938); *Spokane International Ry. Reorganization*, 228 I. C. C. 387, 403 (1938); *Chicago Great Western R. R. Reorganization*, 228 I. C. C. 585, 610, 611 (1938); *In re* United Railways & Elec. Co., 11 F. Supp. 717, 719-20 (D. Md. 1935); *In re* Pittsburgh Hotels Corp., 17 F. Supp. 949, 950 (W. D. Pa. 1938). In a case typical in result, if not in language, *In re* United Railways & Elec. Co., *supra*, the court declared that there were "three accurate bases" for valuation: the valuation for rate-making purposes, the company's valuations based on a two year study, and earnings. The capitalization accepted seemingly splits the difference between the three figures. And in *In re* New York Railways, 82 F. (2d) 739, 742, 743 (C. C. A. 2d, 1936) the court placed major emphasis on forced sale values rather than on earning power.

75. It has been said that the junior security holders should not be barred unless it is "overwhelmingly clear" that there is no equity in the property. *In re* Hopkins Lake Drive Realty Corp. (D. Md. 1934) C. C. H. Bankr. Serv. ¶ 3276; *In re* Kelly-Springfield Tire Co., 13 F. Supp. 724 (D. Md. 1935).

Nor is this tolerance confined to district judges. In the course of a defense of earning power as the paramount factor in valuation for reorganization purposes, Abe Fortas, formerly Assistant Director of the Public Utilities Division of the S. E. C., declared, "I think that it is only fair to permit a moderate amount of optimism to influence judgments as to earnings for this purpose. That is to say, reasonably prospective earnings are the criterion; and in my experience reasonably prospective earnings are always established at a higher rate than the past record of the company would indicate." Address, *supra* note 55, at 8.

76. On possible complications of valuation in railroad reorganization, and, inferentially, in the reorganization of other large corporations, see the statement of Robert T. Swaine before the Senate Committee on Interstate Commerce. *Additional Report of the Committee on Interstate Commerce pursuant to S. Res. 71 (74th Cong.) 76th Cong.*, 1st Sess. (1939) 24. But cf. Spaeth and Windle, *supra* note 73, at 526, n. 43.

77. See Bonbright and Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization* (1928) 28 COL. L. REV. 127; Moore, *Railroad Fixed Charges in Bankruptcy Proceedings* (1939) 47 J. POL. ECON. 100.

78. See notes 79, 106, *infra*.

new financial structure, should remove a management whose stake in the enterprise had lost all value, and should permit the reorganized enterprise to survive wide fluctuations in income without default.

The new model of fairness in reorganization draftsmanship is illustrated in several recent decisions under Section 77B,<sup>79</sup> in opinions of the Interstate Commerce Commission under Section 77,<sup>80</sup> and of the Securities and Exchange Commission under the Holding Company Act of 1935, and under Chapter X.<sup>81</sup> In all these cases junior interests suffer, and great deference is paid to the priority of creditors' claims. Assets are valued; capitalization is limited to the value of assets; and interests without value, in terms of the valuation, are eliminated, or practically eliminated. The trustees and the Securities and Exchange Commission are pursuing a more rigid policy in drafting and reviewing reorganization plans than that which prevailed in the lower courts under the old dispensation. Although administered with some flexibility, Chapter X has so far been given a gloss more orthodox, from the point of view of the *Boyd* case, than was previously thought "practical."<sup>82</sup>

Chapter XI has very little connection with the *Boyd* case and its progeny. It provides simply that "an arrangement within the meaning of this Chapter shall include provisions modifying or altering the rights of unsecured creditors generally or of some class of them, upon any terms or for any consideration."<sup>83</sup> Clearly enough, a Chapter XI court

79. *In re* 620 Church St. Building Corp., 299 U. S. 24 (1936); *Tellier v. Franks Laundry Co.*, 101 F. (2d) 561 (C. C. A. 8th, 1939); *Sophian v. Congress Realty Co.*, 98 F. (2d) 499 (C. C. A. 8th, 1939); *In re* Day & Meyer, Murray & Young, Inc., 93 F. (2d) 657 (C. C. A. 2d, 1938); *Providence Mut. Life Ins. Co. v. University Evangelical Lutheran Church of Seattle*, 90 F. (2d) 992 (C. C. A. 9th, 1937); *In re* Barclay Park Corp., 90 F. (2d) 595 (C. C. A. 2d, 1937); *In re* Witherbee Court Corp., 88 F. (2d) 251 (C. C. A. 2d, 1937), *cert. denied*, 301 U. S. 701 (1937); *Security-First National Bank v. Rindge Land & Navig. Co.*, 85 F. (2d) 557 (C. C. A. 9th, 1936), *cert. denied*, 300 U. S. 613 (1936); *In re* New York Railways, 82 F. (2d) 739 (C. C. A. 2d, 1936), *cert. denied*, 298 U. S. 687 (1936).

80. See *Spokane International Ry. Reorganization*, 228 I. C. C. 387 (1938); *Chicago Great Western R. R. Reorganization*, 228 I. C. C. 585 (1938); *Akron, C. & Y. Ry. Reorganization*, 228 I. C. C. 645 (1938); *Western Pacific R. R. Reorganization*, I. C. C. Finance Docket 10913 (Oct. 10, 1938). See Moore, *Railroad Fixed Charges in Bankruptcy Proceedings* (1939) 47 J. POL. ECON. 100; Spaeth and Winks, *The Boyd Case and Section 77* (1938) 32 ILL. L. REV. 769; Comment (1937) 47 YALE L. J. 247.

81. *In re* West Ohio Gas Co., S. E. C. Holding Co. Act Release No. 1284 (1938); *In re* Genesee Valley Gas Co., S. E. C. Holding Co. Act Release No. 981 (1938); *In re* Penn Timber Co., S. E. C. Corp. Reorg. Release No. 8 (1939), C. C. H. Bankr. Serv. ¶ 51,710; *In re* Detroit International Bridge Co., S. E. C. Corp. Reorg. Release No. 9 (1939) C. C. H. Bankr. Serv. ¶ 51,709; *In re* National Radiator Corp., S. E. C. Corp. Reorg. Release No. 10 (1939). See Meck and Cary, *Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935* (1938) 52 HARV. L. REV. 216, 249; (1938) 38 COL. L. REV. 680.

82. Dodd, *supra* note 7, at 237.

83. § 356.

cannot under this section modify the rights of secured creditors. It has been assumed or asserted that this provision also denies courts under Chapter XI any authority to deal directly with the interests of stockholders.<sup>84</sup> If the interests of stockholders cannot be altered, except perhaps by dilution (as when stock is given to creditors pursuant to an arrangement), it follows that the sacrifice of readjustment in Chapter XI proceedings must come entirely out of the hides of unsecured creditors. In short, Chapter XI seemingly requires the result prohibited by the prevailing interpretation of Chapter X.

This is hardly a remarkable conclusion. Chapter XI is based mainly on the history of Sections 12 and 74.<sup>85</sup> Its philosophy is that of composition, not equity reorganization, and, as applied to corporations, these are historically distinct points of view about insolvency administration. True, an arrangement must be "fair, equitable and feasible,"<sup>86</sup> words which were held in cases under Sections 77 and 77B to embrace the cluster of ideas associated with the *Boyd* case.<sup>87</sup> But an arrangement must also be "in the best interest of creditors" and that phrase appeared in Section 12, and is found now in all the debtor relief sections and chapters of the Bankruptcy Act, except Section 77 and Chapter X.<sup>88</sup>

The phrase "best interest of creditors" as applied to composition has, it has been suggested, some of the qualities of a term of art; there may be corresponding significance in the fact of its omission from the two real corporate reorganization chapters of the Bankruptcy Act. For seventy years a composition offer has been confirmed, as being in the best interest of creditors, if it offers them a consideration approximately equal to the amount they would realize in straight bankruptcy liquidation.<sup>89</sup> The words

84. "Chapter XI likewise affords no authority to compel changes in a debtor's ownership interest. It authorizes alterations in unsecured debts only . . ." Address of Samuel O. Clark, Jr., Director, Reorganization Division, S. E. C., *supra* note 55, 4; Graham, *supra* note 4, at 154.

85. The chapter also contains elements derived from Section 77B. The legislative history of Chapter XI and the weaknesses of §§ 12 and 74 are thoroughly discussed in MOORE'S BANKRUPTCY MANUAL (1939) 631 *et seq.*

86. § 356(2). "As a further point, if the doctrine of the *Boyd* case and its successors is still applicable to corporate reorganizations, as is commonly believed to be the case, it is inconceivable that such reorganizations can be 'fairly and equitably' consummated under Chapter XI, which as I said makes no provision for the alteration of equity interests as such." Address of Samuel O. Clark, Jr., *supra* note 55, at 4.

87. See the cases cited *supra*, notes 79, 80.

88. § 366(2) (Arrangements—Chapter XI); § 472(2) (Real Property Arrangements by Individuals—Chapter XII); § 656(a)(2) (Wage Earners' Plans—Chapter XIII). All these chapters also require that plans enacted under them be "fair and equitable."

89. *Adler v. Jones*, 109 Fed. 967 (C. C. A. 6th, 1901); *Fleischmann & Devine, Inc. v. Saul Wolfson Dry Goods Co., Inc.*, 299 Fed. 15 (C. C. A. 5th, 1924); *In re H. J. Arrington Co.*, 113 Fed. 498 (E. D. Va. 1902); *In re Griffith Stillings Press*, 244 Fed. 315 (D. Mass. 1917); see *Cumberland Glass Mfg. Co. v. DeWitt*, 237 U. S. 447, 453 (1915).

are read in a practical way; the composition offer may be less even than the liquidation-sale value of the assets, by the putative amount of administrative expenses. If creditors were offered by composition about what they might expect as the net result of bankruptcy, the composition satisfied the test of Section 12.

Compositions in bankruptcy have been effected in many business situations, by individual debtors and by corporations of all sizes.<sup>90</sup> In the most common case, the debtor offered an immediate dividend in cash, furnished either by himself or by some third party who became a creditor of the refinanced enterprise.<sup>91</sup> Where the debtor was a corporation, and the lender the chief stockholder,<sup>92</sup> the money that made up the dividend could be compared to the cash assessment often demanded of stockholders in an equity reorganization. Strict application of the *Boyd* case doctrine would limit the participation of stockholders to the amount of the cash assessment.<sup>93</sup> But in a cash composition a greater interest was retained by stock. After composition, the balance sheet showed no debt at all, or, if the corporation accounted for the transaction as a loan, it showed a debt not greater than the liquidation value of the corporate assets. No matter how the composition was financed, or represented on the corporate books, its result was always to give old stockholders an equity represented by the difference between liquidation and full going concern values of the assets; and usually it did not disturb the old stockholders' control of the management. It was expressly understood that such values were to be preserved for the stockholders: "In the normal case, the bankrupt is impelled by vital interests, not only to make the offer promptly, but to expedite confirmation. Interruption incident to delay necessarily impairs the value of a business as a going concern."<sup>94</sup>

Even more significant for present purposes are those compositions in which creditors were offered securities of the corporation, accompanied by little or no cash. Although the financial circumstances of the debtor companies are comparable to those found in many equity receivership reorganizations or Section 77B cases,<sup>95</sup> the stockholders invariably retain

90. Section 12 as a vehicle of corporate reorganization is criticized at length in MOORE'S BANKRUPTCY MANUAL (1939) 638.

91. See the cases cited *supra* note 89; Comment (1938) 51 HARV. L. REV. 1408, 1414.

92. As in *Fleischmann & Devine v. Saul Wolfson Dry Goods Co.*, 299 Fed. 15 (C. C. A. 5th, 1924); *In re Griffith Stillings Press*, 244 Fed. 315 (D. Mass. 1917); *In re H. J. Arrington Co.*, 113 Fed. 498 (E. D. Va., 1902).

93. See Comment (1938) 51 HARV. L. REV. 1408, 1414.

94. *Nassau Smelting Works, Ltd., v. Brightwood Bronze Foundry Co.*, 265 U. S. 269, 272 (1924).

95. See, e.g., *In re Realty Associates Securities Corp.*, 6 F. Supp. 549 (E. D. N. Y. 1934), where the debtor was a mortgage investment corporation in the Prudence group, owing \$12,000,000 to its bondholders and other creditors, and possessing assets worth about \$10,000,000. The case was carried to the Circuit Court of Appeals and the Supreme Court on another issue. See 74 F. (2d) 61 (C. C. A. 2d, 1934), *rev'd*, 295 U. S. 295 (1935).

more than is permitted them where *Boyd* case principles are applied. Time notes<sup>96</sup> or bonds<sup>97</sup> may be offered to creditors; they may even be given stock in the enterprise,<sup>98</sup> with the old shareholders retaining the balance. While it is not clear that creditors can be offered securities the face value of which approximates a liquidation dividend, compositions are often confirmed though they award to creditors bonds or notes whose face value is less than 100% of their claims.<sup>99</sup> The stockholders do not give up their stock, or exchange it for other stock, or pay an assessment on it. In the run-of-the-mill case involving the composition of an insolvent corporation, the stockholders' control is untouched, their expectation of dividends is immeasurably improved, and they retain from the beginning a balance sheet showing of a claim to assets.<sup>100</sup>

It is apparent, if these cases mean what they seem to say, that any given situation of corporate insolvency looking to a continuance of the business would be resolved in one way—in favor of creditors—if the plan of rehabilitation is drafted in the light of equity precedents, and in another—in favor of stockholders—if a composition is permitted. Every case, arising under either chapter, presents the court with the necessity of a choice between the true faith of equity reorganization, on the one hand, and the equally respectable ideal of composition, on the other.

Yet the conflict may prove to be illusory.

One possible reconciliation, apparently untenable, is the so-called composition theory of reorganization, defended in *Downtown Investment Association v. Boston Metropolitan Buildings, Incorporated*.<sup>101</sup> The adherents of this heresy argue that the way to avoid the supposed differences in result between Chapter X and Chapter XI is to require under Chapter X the kind of plan seemingly contemplated under Chapter XI, *i.e.*, a

96. *In re Reiman*, 20 Fed. Cas. No. 11,673 (S. D. N. Y. 1874), *aff'd*, 20 Fed. Cas. No. 11,675 (C. C. S. D. N. Y. 1875); *In re Hurst*, 12 Fed. Cas. No. 6,925 (C. C. E. D. Mich. 1876). But *cf. In re J. B. & J. M. Cornell Co.*, 186 Fed. 858 (S. D. N. Y. 1911).

97. *In re Realty Associates Securities Corp.*, 6 F. Supp. 549 (E. D. N. Y. 1934).

98. See *Oriole Phonograph Co. v. Kansas City Fabric Products Co.*, 34 F. (2d) 400 (C. C. A. 8th, 1929), *cert. denied*, 280 U. S. 609 (1930); *Kinkead v. J. Bacon & Sons*, 230 Fed. 362, 366 (C. C. A. 6th, 1916), *cert. denied*, 241 U. S. 680 (1916). *Cf. In re Woodend*, 133 Fed. 593 (S. D. N. Y. 1904).

99. *In re Realty Associates Securities Corp.*, 6 F. Supp. 549 (E. D. N. Y. 1934); (interest cancelled); *Oriole Phonograph Co. v. Kansas City Fabric Products Corp.*, 34 F. (2d) 400 (C. C. A. 8th, 1929), *cert. denied*, 280 U. S. 609 (1930); see *Kinkead v. J. Bacon & Sons*, 230 Fed. 362 (C. C. A. 6th, 1916); *In re Berler Shoe Co., Inc.*, 246 Fed. 1018 (S. D. N. Y. 1917). Where stock was offered to creditors, its face value was usually fixed at 100% or more of creditors' claims, but this was far from its real value. See *In re Woodend*, 133 Fed. 593 (S. D. N. Y. 1904).

100. The limits set on the debtor's powers in composition [see (1938) 51 HARV. L. REV. 1408, 1417] do not weaken the contrast in results between composition and equity reorganization.

101. 81 F. (2d) 314 (C. C. A. 1st, 1936).

composition with creditors.<sup>102</sup> As it is most vigorously advanced, however, the "composition theory" is not closely related to the pattern of the composition cases under Section 12; it is, in fact, another name for the long-lived relative priority theory of corporate reorganization in equity.<sup>103</sup> Its proponents do not claim that the interest of stockholders cannot be touched in corporate reorganizations; they do contend, however, that stockholders should not be entirely eliminated from plans of reorganization. Their position is that in the name of debtor relief and sweet charity reorganization plans should give some place in the new company to all members of the community of claimants grouped together in the old one. Standards of fairness are satisfied if the creditors and stockholders of the old company reappear in the new one in the order of their precedence. They do not rely on the thesis — familiar in composition cases — that the stockholders as owners of the enterprise should be allowed in bankruptcy to settle with creditors for the equivalent of what the creditors would have received on liquidation. Their program depends rather on one of the strong traditions of equity, the tradition of mitigating foreclosure devices in favor of the poor debtor.

To some extent the "composition" argument is one of statutory construction. Thus comfort is drawn from the language of Section 216(1) of Chapter X: "A plan of reorganization under this chapter — (1) *shall* include with respect to creditors generally, or some class of them, secured or unsecured, and *may* include in respect to stockholders generally, or some class of them, provisions altering or modifying their rights . . ." The inference sought is that the section contemplates the confirmation of plans which reduce the claims of creditors, but not of stockholders, and there is evidence that a senator or two was vaguely aware of such a possibility.<sup>104</sup> If this were a tenable view, Section 216(8), in connection with Section 179, would mean that a plan need not be approved by stockholders whose interests had no value, and need make no provision for them, but that some recognition might be given such groups, as poor relatives of the debtor, *e.g.*, to prevent litigation. In other words, a plan would not be

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102. The "composition" theory (with reference to §77) has been most vehemently defended by Ernest S. Ballard and Minier Sargent of the Chicago bar, in several briefs filed before the Interstate Commerce Commission in behalf of stock interests in three current railroad reorganizations: Chicago & E. I. Ry. Reorganization, Finance Docket No. 9952 (1937); Missouri Pac. R. R. Reorganization, Finance Docket No. 9918 (1939); Spokane Int. Ry. Reorganization, Finance Docket No. 10131 (1937). And see the testimony of Minier Sargent before the Senate Interstate Commerce Committee. *Senate Report, supra* note 76 at 40. The Ballard-Sargent position is disputed in Spaeth and Winks, *The Boyd Case and Section 77* (1938) 32 ILL. L. REV. 769, 771 *et seq.*; FINLETTER, PRINCIPLES OF CORPORATE REORGANIZATION (1937) 398-400.

103. For discussion of the "relative priority" theory, see Bonbright and Bergerman, *supra* note 77. See also pp. 1347-1349, *supra*.

104. See Graham, *supra* note 4, at 153; Spaeth and Winks, *supra* note 102, at 785.

unfair which gave something to holders of worthless stock, although they could not compel such treatment.

But these ambiguities of the Statute are hardly overwhelming; and the decisions under Section 77B have strongly upheld the priority of creditors. It is too late to contend that the reorganization of corporations can ignore the canons of fairness which have evolved in the shadow of the *Boyd* case.<sup>105</sup> The efforts so far made to distinguish *In re 620 Church Street Building Corporation* are not convincing. The *Church Street* case involved the reorganization of an apartment house. There were \$455,000 in first mortgage bonds, and the property had an appraised value of \$245,000. The plan was not submitted to junior creditors or stockholders, and made no provision for them. The Supreme Court held that there was no need to consult them, or give them new securities, because their interests were without value. One spokesman for the composition party tried to evade the force of the decision by claiming that the petition for *certiorari* presented only the issue of whether junior lien creditors could be excluded from the plan, without their consent, not the principle of composition under Section 77B.<sup>106</sup> But these are not separate problems: a decision on the first decides the second.

There may be a more practicable resolution of the apparent conflict between the composition part of the heritage of Chapter XI, and the notions of fairness expressed in reorganization cases effected through equity receivership and Section 77B.

The premise which underlies all notions of fairness in the administration of insolvent estates is that creditors may have all the non-exempt property of the debtor, or its value. Various metaphors are used to identify and explain the proposition. The property of an insolvent, especially of an insolvent corporation "belongs to" or "should be devoted to," or is a "trust fund for" the creditors, secured or unsecured. It is thought that there is a constitutional sanction which requires the debtor's property, or its value, to be given to the creditors,<sup>107</sup> the idea of valuation of course being the saving ambiguity in the formula.

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105. The long list of recent 77B cases in the circuit courts of appeals, cited *supra* note 79, are committed to the proposition that the equity rules clustering about the *Boyd* case apply in 77B proceedings. While the Supreme Court has not as yet spoken definitely, the *620 Church Street* case is inconsistent with a "composition" theory of reorganization. The identification of § 77 as a "composition" statute in *Continental Illinois Nat. Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry.*, 294 U. S. 648 (1935) referred to the power to bind dissenters and does not make § 77 a "composition" statute for other purposes. *Callaghan v. Reconstruction Finance Corp.*, 297 U. S. 464 (1936).

106. Messrs. Ballard and Sargent, Debtor's Brief in Support of Debtor's Amended Plan, *Chicago & E. I. Ry. Reorganization*, Finance Docket No. 9952 (1937) 47-51.

107. Dodd, *Reorganization Through Bankruptcy: A Remedy for What?* (1935) 43 HARV. L. REV. 1100, 1132; Spaeth and Winks, *supra* note 102, at 781-782; Address of Abe Fortas, quoted *supra* note 55. There is little reason for denying unsecured creditors the assurances given secured creditors by *Louisville Joint Stock Land Bank v. Radford*,



In most cases, this purpose was satisfied by composition in the bankruptcy of small commercial enterprises owned by unincorporated debtors. The only feasible alternative to composition in those cases was a liquidation sale in bankruptcy. It was ordinarily impossible to arrange a sale in which the creditors might realize on the going-concern value of the business, for the simple reason that the going-concern values inhered in the personality, experience and skill of the owner. Unless the order confirming the composition were to be qualified by a restriction binding the debtor not to try to earn a living at his calling, the creditors had to choose between composition and a liquidation sale in bankruptcy. The goodwill of the enterprise had a market price only in a sale made by the debtor, as part of a transaction in which he covenanted not to compete with his purchaser. Such a covenant is beyond the power of the bankruptcy court, and the good will of the business was not an asset available to its creditors in bankruptcy proceedings, or elsewhere. So long, therefore, as the composition yielded approximately what creditors might hope to receive on liquidation, the composition gave them "all the property" of their debtor, although it was expressly understood that the debtor retained the going-concern value of his enterprise. Composition through bankruptcy permitted him to cut down his debts, refinance them if he could, and keep his business. Yet the transaction was "in the best interests of creditors," because it gave them the equivalent of the maximum recovery in fact available to them.<sup>108</sup>

The same premise — that creditors should receive in insolvency proceedings not less than the maximum value of the debtor's property available to them on a sale — animates the equity reorganization cases. There it was required only that the sale device employed by the court realize as much for creditors as was practicable under the circumstances. There was no compulsion to reorganize, or to carry on the business as a unit, save perhaps in public utility cases where the interests of creditors were subordinated to the public interest in continued service. If it was feasible to sell the insolvent business at going-concern values, or to carry it on under a management hired or provided by creditors, then the court would look to a reorganization in which control and the speculative chance of future gains were given to the ranking creditors. On the other

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295 U. S. 555 (1935) and *Wright v. Vipton Branch of the Mountain Trust Bank*, 300 U. S. 440 (1937). What concreteness is offered by these abstractions, however, remains to be seen.

108. There are indications in the composition cases that if a particular creditor thought the debtor's offer of a certain percentage did not yield this maximum recovery, the creditor might offer a larger percentage, and take over the business himself. *In re Lipman*, 50 F. (2d) 948 (D. Conn. 1931); *cf. Matter of Criterion Watch Case Mfg. Co.*, 8 Am. Bankr. Rep. 206 (S. D. N. Y. 1902). If a single creditor may make a larger offer, *a fortiori* a group of creditors may make a higher bid and run the business themselves.

hand, there were equity reorganizations which resulted in liquidation sales at scrap-value prices, and these too were fair and equitable.<sup>109</sup>

Despite the fact that Chapter XI procedure is heavily weighted in favor of the debtor, there is no inherent reason why fair arrangements for corporations under Chapter XI cannot satisfy the test proposed. There is no magic adverse to creditors in the requirement that an arrangement be in their "best interests." If the corporation being rehabilitated in Chapter XI proceedings is peculiarly dependent on the old stockholders for management, good will and a reasonable expectation of survival, and if it is impracticable for the creditors to preserve that going-concern value by hiring the old management,<sup>110</sup> then an arrangement under Chapter XI (or for that matter under Section 77B<sup>111</sup> or Chapter X) might give recognition to the old managerial group, and to that extent approximate the pattern of result in Section 12 compositions. There is little difference between the problem here and that presented by the composition offer of the unincorporated debtor under Section 12. Under such circumstances, the creditors will maximize their recovery, and an arrangement will be "in their best interests," if they acquiesce in a plan which permits the stockholders to retain some or all of their prior holdings. Their control may be diluted by the issuance of new stock to creditors, or by the creation of a voting trust; but they will receive some place in the new corporation by reason of their being stockholders in the old, despite its insolvency. Such a result will permit them in large part to retain the control and the chance of speculative gain — the good will, the going-concern value of the business — which cannot, under the circumstances, be realized upon by creditors.

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109. Historically, receiverships have resulted in liquidation as often as in reorganization. In the *Flershem* case [First Nat. Bank v. Flershem, 290 U. S. 504, 522-528 (1934)] Mr. Justice Brandeis said that in the receivership of non-utility corporations the sale should dispose of the properties in whatever way yielded most, some parcels going for scrap, some as active business units. Occasional liquidations have been effected through the machinery of Section 77B. *In re* Central Funding Corp., 75 F. (2d) 256 (C. C. A. 3d, 1935); *In re* State-Lake Bldg. Corp. (N. D. Ill. 1935) C. C. H. Bankr. Serv. ¶ 3515.

110. This would be the common case where the debtor was a one-man corporation, and the salary of the president was in fact a debit to the profit and loss account.

111. There are 77B cases in which the services of the present management have been considered indispensable to the success of the reorganized enterprise, and in which recognition has consequently been accorded to the old stockholders. *In re* Los Angeles Lumber Products Co., 24 F. Supp. 501 (S. D. Cal. 1938), *aff'd*, 100 F. (2d) 963 (C. C. A. 9th, 1939); *In re* Donahoe's, Inc., 19 F. Supp. 441 (D. Del. 1937); *cf. In re* Willsea Works (W. D. N. Y. 1936) C. C. H. Bankr. Serv. ¶ 4026. But even if such cases will be followed stock should be represented only where the management cannot be otherwise retained and where the management owns the bulk of the outstanding shares. The issue to be proved in these cases is more than usually unsatisfactory and impalpable, and the debtor's evidence especially should be taken with suspicion. *In re* Barclay Park Corp., 90 F. (2d) 595 (C. C. A. 2d, 1937).

But if the insolvent business is of such a character that stock control is a valuable asset to the creditors, no arrangement under Chapter XI should be approved which deprives them of it. Then, as a matter of business fact, the financial condition of the debtor corporation is the same as the condition of insolvency normally expected under Chapter X, and the result indicated as appropriate there should be reached. The criteria of fairness stated in *Northern Pacific Railway Company v. Boyd* and its heirs apply; any other solution would deprive creditors of values which can in fact be made available to them.

The question has been asked: "Is the *Boyd* case to be controlling in corporate reorganization proceedings instituted under Chapter XI?" The answer suggested is Yes and No. Both the typical reorganization plan drafted in conformity with modern versions of the *Boyd* case doctrine, and the typical bankruptcy compositions under Section 12, represent applications to different factual situations of the same underlying proposition: that creditors must be given claims to all the debtor's property which is accessible to them. In order to determine whether stockholders must be eliminated from the reorganization of an insolvent corporation under Chapter XI, it is necessary first to decide whether the corporation can be reorganized, as a practical matter, without them. If the premise of this argument is correct, the issue under Chapter XI of an arrangement's fairness to creditors and stockholders depends on a factual analysis of the debtor's business, not on a supposed principle of composition embedded in the phrase "best interests of creditors." If there is any way, by sale or otherwise, in which creditors can be given the benefit of the going-concern value of the business, they should have such values, whether or not stockholders are eliminated in the process. A reorganization plan *à la Boyd* case should be required for an insolvent corporation under Chapter XI whenever the debtor business might be successfully continued without its old stockholders.

But if Chapter XI courts take this view of their function in passing on arrangements under Section 366, they face a difficult series of decisions. The hearing on the confirmation of an arrangement, under Sections 361 or 362, is the first direct opportunity the Act gives the court to pass on the issue of the arrangement's fairness, feasibility or good faith. The meeting comes after a suitable majority in number and amount of the creditors affected by the arrangement have assented to it. The court therefore is at the disadvantage of facing a *fait accompli*, and may feel some reluctance to upset the proceeding. But courts lately have shown increasing willingness to set plans aside despite the approval of large majorities.<sup>112</sup> And it may be that Chapter XI courts will be strict in their investigation of fairness.

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112. *First National Bank v. Flershem*, 290 U. S. 504 (1932); *In re Barclay Park Corp.*, 90 F. (2d) 595 (C. C. A. 2d, 1937).

The language of the Statute, however, will be of little help. In a situation where creditors are in position to take over or hire suitable management, as with many large corporations, and the debtor corporation is insolvent, the court should refuse to confirm any arrangement which does not eliminate the stockholders. Yet if the debtor refuses to propose a plan compatible with the views of the court,<sup>113</sup> the court evidently cannot force it to do so, since only the debtor may "propose" alterations or modifications of an arrangement.<sup>114</sup> But the court possesses other powers. After refusing confirmation of the plan as unfair, it may either dismiss the petition, or adjudicate the debtor a bankrupt, and direct that bankruptcy be proceeded with, "whichever in the opinion of the court may be in the interest of the creditors."<sup>115</sup> But the latter course does not necessarily involve liquidation, and consequent losses to creditors. The adjudication is certainly sufficient basis for an involuntary proceeding under Chapter X.<sup>116</sup> Or if Chapter X proceedings are thought unnecessary, a reorganization could be effected by creditors through a bankruptcy sale, much like a reorganization in equity receivership based on a foreclosure sale, or a sheriff's sale on a creditor's bill, at not less than a fair upset price. The reorganization could eliminate stockholders, and, as in equity, limit dissenters to a share of the sale price.<sup>117</sup> There never was any inherent reason why reorganization could not be effected through bankruptcy; and in fact several such proceedings occurred.<sup>118</sup>

Whatever the attractions of this view, it is not yet by any means The Law. So far as the cases go, and they are all lower court cases, it seems that creditors of insolvent corporations have been given somewhat

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113. Evidently the readjustment may be effected through the formation of a new corporation (see § 395), as well as by a redistribution of the securities of the old company. See proposed arrangement of Brooklyn Daily Eagle, note 3, *supra*.

114. § 363 permits alterations or modifications of an arrangement to be proposed by the debtor; nothing in the chapter permits the creditors to suggest amendments or the court to adopt such changes against the debtor's will. And since Article VIII, enumerating the permissible provisions of an arrangement, does not authorize the modification of stock interests, it is contended that an "arrangement under Chapter XI" cannot reduce the debtor's equity, despite § 395, unless the debtor consents in concurrent recapitalization proceedings under state law. See notes 84, 86, 113, *supra*.

115. § 376(2).

116. § 131(1).

117. In the case of *In re Witherbee*, 202 Fed. 896 (C. C. A. 1st, 1913) the bankruptcy sale apparently eliminated stockholders, unless they paid an assessment. And see *Schuler v. Hassinger*, 177 Fed. 119 (C. C. A. 5th, 1910), indicating that it is not even necessary to fix an upset price. But *cf. In re Prudential Outfitting Co.*, 250 Fed. 504 (S. D. N. Y. 1918).

118. *Lindh v. Booth Fisheries Corp.*, 80 F. (2d) 733 (C. C. A. 9th, 1935); *In re Witherbee*, 202 Fed. 896 (C. C. A. 1st, 1913); *Schuler v. Hassinger*, 177 Fed. 119 (C. C. A. 5th, 1910); *In re Prudential Outfitting Co.*, 250 Fed. 504 (S. D. N. Y. 1918); *In re Nevada-Utah Mines & Smelters Corp.*, 198 Fed. 497 (S. D. N. Y. 1912); *In re Pittsburg Dick Creek Mining Co. of Alaska*, 197 Fed. 106 (S. D. N. Y. 1912).

more, and stockholders less, under Section 77B than under Section 12. It may be anticipated, absent a development of doctrine along lines not so far clearly indicated in judicial opinions, that arrangements under Chapter XI will differ from plans under Chapter X in something like the same way. In terms at least of their respective histories, Chapter X differs from Chapter XI in the treatment it provides for creditors and stockholders, as well as in procedure and in the extent to which proceedings are controlled by public agents.

#### THE COMPARATIVE SCOPE OF CHAPTERS X AND XI

The differences between the chapters, both in procedure and in resulting treatment of creditors, would be easier to explain or defend if Chapter X were applicable to one class of corporations, or one condition of corporate insolvency, and Chapter XI to another. There is sense in having a dual system of reorganization: a simple scheme of quick relief, based on the formula of composition, for the small corporation whose position in the community approximates that of an individual debtor; and a rigorous, full-dress procedure, designed to protect the parties to the complicated reorganization of a large corporation, or of a corporation with publicly held securities.

If there were a clear rule defining the comparative scope of the two chapters, there would be few conflicts in their administration. They could be enforced side by side, fulfilling inconsistent theories, without causing concern. The draftsmen of the Act were thinking in terms of such a rule, but they fell down badly in stating it. The Act expressly links the two chapters. They are evidently supposed to complement each other, providing related systems of reorganization, applicable to distinctly different circumstances. Thus all petitions under Chapter X must state "specific facts showing the need for relief under this chapter, and why adequate relief cannot be obtained under Chapter XI."<sup>119</sup> No petition under Chapter X is filed in good faith if adequate relief would be obtainable by a debtor's petition under Chapter XI.<sup>120</sup> But in defining the relative scope of the two chapters, the experts responsible for the wording of the Act stopped with this vague declaration: Chapter X applies to the class of situations in which Chapter XI cannot offer adequate relief, and proceedings under Chapter X should be superseded by proceedings under Chapter XI where that chapter does offer adequate

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119. § 130(7).

120. § 146(2). This requirement is a little puzzling as applied to involuntary petitions under Chapter X, in view of the exclusively voluntary character of proceedings under Chapter XI. Even if adequate relief could be obtained under Chapter XI, the creditors cannot obtain it. Debtors should be allowed the advantage of this defensive requirement only if they are willing under § 147 to file a Chapter XI petition.

relief.<sup>121</sup> They omitted to answer any of the questions suggested by their proposition. They did not indicate under what circumstances, or for what corporate debtors, proceedings under Chapter XI would be considered to provide "adequate" relief. They failed to say whether the words "adequate relief" mean relief adequate for the debtor or adequate for its creditors. Most obscurely of all, they put no language in Chapter XI limiting the class of corporations which may seek relief under it, and provided no procedure, comparable to that of Section 147 in Chapter X, for transferring to Chapter X reorganization cases improperly filed under Chapter XI.

The issue of defining the differences in scope between the chapters can arise in two settings: in the hearing under Chapter X looking to the approval of the petition, in which the question is necessarily presented; and in possible proceedings to contest the propriety of a petition filed under Chapter XI.

*Prospective Inadequacy of Relief under Chapter XI as an Issue in Chapter X Proceedings*

Every petitioner under Chapter X must prove "specific facts," Section 130(7) says, showing why adequate relief could not be obtained by a debtor's petition under Chapter XI. What should be alleged to satisfy the requirement?

The Securities and Exchange Commission has taken the view that corporations with publicly held securities cannot be reorganized under Chapter XI; it should follow that a petition satisfies the requirement of Section 138(2) by alleging that the debtor corporation has a publicly-held issue of securities, bonds or stock.<sup>122</sup> The hearings, reports and debates indicate that those who drafted Chapter XI had no thought so tangible. Corporations are included among those who may file Chapter XI petitions, the House Report explains, to permit "a larger number of smaller companies that are now seeking relief under section 77B, but do not require the complex machinery of that section, to resort to the simpler and less expensive, though fully adequate, relief afforded" by

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121. The phrase "adequate relief" was presumably borrowed from subdivision (i) of Bankruptcy Rule 77B-2 of the Southern District of New York, stating that the debtor had to file with its petition or answer under Section 77B an affidavit of "facts showing why relief under § 12 of the Bankruptcy Act is not adequate." Nov. 15, 1935. This rule applied only to voluntary petitions and answers to involuntary petitions under Section 77B in which the debtor joined in the prayer for reorganization.

122. "I consider Chapter X and Chapter XI mutually exclusive as to the types of corporation with which they are intended to deal, and . . . I feel that any corporate debtor with publicly held securities which resorts to Chapter XI runs a grave risk of indulging in an erroneous procedure, rendering invalid its acts under that Chapter and any securities issued as a result of the proceedings thereunder." Address of Samuel O. Clark, Jr., *supra* note 55, at 3. See note 51, *supra*.

Chapter XI.<sup>123</sup> This explanation has no support in the language of the Statute. But it does seem to imply that some small companies may "require the complex machinery" of Chapter X, and perhaps even that some large ones may be able to solve their financial problems under Chapter XI.

That view is buttressed by the only concrete suggestion of the Act itself on the issue: that the scope of Chapter XI is to be defined not by the size of the prospective debtor, but by its fiscal condition. For a Chapter X reorganization plan may modify the rights of secured creditors, while under Chapter XI an arrangement cannot do so.<sup>124</sup> It follows that the adequate relief provisions of Chapter X mean at least this: that a corporation for which no reorganization would be feasible without a modification of secured debt cannot obtain adequate relief by a petition under Chapter XI. Thus jurisdiction under Chapter X should be accepted in cases where present fixed charges on secured debt exceed presently anticipated income, or where the value of the property, and consequently the new capitalization, do not exceed the secured debt by an appropriate amount.<sup>125</sup>

But the possibility of a feasible reorganization without modification of secured debt is hardly a sufficient or exclusive criterion for fixing a jurisdictional boundary between the two chapters. That test would leave big corporations or corporations with publicly held securities to Chapter XI, if the debtor corporation had a relatively small amount of secured debt, which could be left undisturbed, or where its debt consisted of debentures or notes. No such division of reorganization business between the two chapters can be justified, in view of their basic differences in philosophy and method. Although there is no particular authority for the view in the language or the legislative history of the Act, it should be held that a petition is properly filed under Chapter X for a debtor corporation with widely scattered security holders. Should the test go farther and require Chapter X proceedings wherever the debtor has long-term debt, especially debt divided into small units, like bonds or debentures, and involving a trustee? In the interest of protecting investors, such situations might be held to require the policing afforded by a Chapter X proceeding, whether or not the securities of the debtor were pub-

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123. *Report of the House Judiciary Committee on H. R. 8046*, 75th Cong., 1st Sess. (1937) 51.

124. Compare § 216(1) of Chapter X with §§ 356, 357 of Chapter XI.

125. To satisfy requirements of feasibility, a reorganization plan should leave the debtor in position to meet its future financing needs comfortably, by issuing either bonds or stock, as the occasion demands. A large secured debt and high fixed charges will prevent future stock flotations. Bonds will be hard to market in such a case unless secured by a first lien. Since no provision can be made in a Chapter XI arrangement for displacing or reducing the lien of present secured debt to allow for future financing by prior lien bonds, it will be difficult to draft a feasible plan under Chapter XI when the ratio of secured debt to the value of the property is high.

licly held. Should the idea of the potential inadequacy of relief under Chapter XI extend to include any corporation sufficiently large in terms of assets and debts, whether or not its securities are widely distributed? The administrative machinery of Chapter X, with its provisions for reports, investigations, and detailed control by the trustee or trustees, is infinitely more appropriate for the control of large enterprises than that of Chapter XI. Should there be a link between the kind of plan to be confirmed and the proceedings in which it is formulated? It has been suggested that ideas inherited from the *Boyd* case should be applied in drafting reorganization plans in some proceedings instituted by a Chapter XI petition.<sup>126</sup> It would be infinitely simpler, from the administrative point of view, to transfer all such situations to Chapter X. For the procedure provided by Chapter XI is not designed to force the development of a reorganization plan which eliminates or minimizes the participation of stockholders and junior classes. Only the debtor, for example, can propose an arrangement or an alteration or modification of an arrangement. And the interests represented by the management of a corporation will not often propose their own suicide. Where it is in the best interests of creditors to eliminate stockholders, it is also in their best interests that reorganization be conducted according to the rules of Chapter X.

*Prospective Inadequacy of Relief under Chapter XI as an Issue  
in Chapter XI Proceedings*

Amendment or litigation should give some meanings of this order to the requirement that a Chapter X petition be dismissed when adequate relief can be obtained by a debtor's petition under Chapter XI. The obverse problem, of refusing to accept a petition already filed under Chapter XI when adequate relief *cannot* be obtained through such proceedings, presents more difficulties.

So far as the naked words of the Statute go, any person who may become a bankrupt under Section 4 of the Bankruptcy Act may file a petition under Chapter XI.<sup>127</sup> There is no discrimination between corporations in defining the terms of access to Chapter XI. The Act has no test of largeness or smallness, quantitative or otherwise, to justify

126. See pp. 1357-1360, *supra*. Other issues have appeared as part of the denotation of § 130(7). In the *McKesson & Robbins* case, the petition alleges that "adequate relief cannot be obtained under Chapter XI of the Bankruptcy Act for the reason that it is believed that the facts above set forth with respect to falsification of the books of account and records would be a bar to the discharge of petitioner as a bankrupt under Section 14 of the Bankruptcy Act and, accordingly, would prevent the confirmation of an arrangement under Section 366 of Chapter XI . . ." Petition, *In re McKesson & Robbins, Inc.* (S. D. N. Y. 1938) 3.

127. §§ 306(3), 321, 322. Under § 4a, any person except a municipal, railroad, insurance or banking corporation or a building and loan association may file a voluntary petition.



a court in refusing jurisdiction to a small corporation under Chapter X. And it provides no direct procedure by which a court can refuse jurisdiction under Chapter XI to a big corporation or to any other. The Act makes no provision for a preliminary step in a Chapter XI proceeding analogous to the hearing on adjudication in bankruptcy,<sup>128</sup> or the hearing on the approval of a petition under Chapter X, in which the court might consider the propriety of the petition.<sup>129</sup> Upon the filing of a petition under Chapter XI, the jurisdiction, powers and duties of a court are the same as if a decree of adjudication had been entered at the time the petition was filed.<sup>130</sup> On the face of the Statute, the Court has no discretion to refuse a petition under Chapter XI. The Act is drafted as if its theory were that every debtor should have one chance, if he wants it, to solve his financial difficulty by an arrangement under Chapter XI.

But the seeming absolutism of the corporate debtor's privilege of instituting Chapter XI proceedings should be qualified by the existence of Chapter X. No petition can be approved as properly filed under Chapter X until the court has determined that the system of Chapter XI could not provide adequate relief in the situation of the case. This oblique definition of jurisdiction under Chapter X can be evaded at will unless a comparable condition is read into Chapter XI. There are strong reasons of policy for contending that Chapters X and XI should be applied as far as possible to different situations of insolvency. Chapter XI should not be available to all corporate debtors, or in all financial situations. If petitions under Chapter X are accepted when relief under Chapter XI would be inadequate, petitions under Chapter XI should be rejected for the same reason; and the prospective inadequacy of relief under Chapter XI should be the same question when presented as an issue in Chapter XI proceedings as when it arises at the hearing on the approval of the petition, in a Chapter X proceeding. Decisions approving or disapproving petitions under Chapter X will necessarily give concreteness to the proposition that Chapter XI proceedings are inadequate and therefore inappropriate for some debtors and some situations. Those determinations should have a corresponding weight in Chapter XI proceedings.

If the Act provides no way in which these issues can be tested in a Chapter XI proceeding, one should be invented. There are several pro-

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128. "Upon the filing of a voluntary petition . . . the judge shall hear the petition and make the adjudication or dismiss the petition." § 18g.

129. Under § 141 of Chapter X, the judge must enter an order approving the petition, if it is satisfied that it complies with the requirements of the chapter and is filed in good faith, or dismissing it if not so satisfied. Good faith includes the issue of whether adequate relief can be obtained under Chapter XI. § 146(2). On the import of such a hearing under Article VI of Chapter X, see §§ 145, 149. See note 3, *supra*, for an instance in which a Chapter XI court apparently passed on the propriety of the petition soon after it was filed.

130. § 312(2).

cedures more or less implicit in the Act, out of which the courts may, if they wish, devise a method for asserting an attack on the propriety of Chapter XI proceedings.

Creditors, and perhaps other persons, may take advantage of the informal practice, recognized in bankruptcy, of permitting interested persons to move, in the bankruptcy proceedings, that an adjudication be vacated and a petition dismissed. The terms on which this maneuver has been recognized fit without squeezing into the scheme of Chapter XI, where the court's jurisdiction on the filing of the petition is made comparable to that of a bankruptcy court on adjudication. In bankruptcy cases persons who have no express right to file pleadings or otherwise to contest the allegations of a petition have been allowed to move for the vacation of an adjudication, or the dismissal of a petition, on grounds sufficiently important to be labelled jurisdictional or quasi-jurisdictional,<sup>131</sup> and the moving parties have successfully appealed from a denial of their motions.<sup>132</sup> The majority of cases in which this extra-statutory practice was recognized concerned issues like the residence of the bankrupt,<sup>133</sup> or the amenability of the petitioner to bankruptcy.<sup>134</sup> There are cases which go further, evincing a willingness to consider any issue, on this preliminary motion, going to the propriety or potential effectiveness of the court's acceptance of jurisdiction in the particular case.<sup>135</sup>

131. *Royal Indemnity Co. v. American Bond & Mortgage Co.*, 61 F. (2d) 875 (C. C. A. 7th, 1932), *aff'd*, 289 U. S. 165 (1933); *In re Ettinger*, 76 F. (2d) 740 (C. C. A. 2d, 1935); *Chicago Bank of Commerce v. Carter*, 61 F. (2d) 986 (C. C. A. 8th, 1932); *Vassar Foundry Co. v. Whiting Corp.*, 2 F. (2d) 240 (C. C. A. 6th, 1924); *In re Guanacevi Tunnel Co.*, 201 Fed. 316 (C. C. A. 2d, 1912).

132. The denial of such a motion to vacate an adjudication entered upon a voluntary petition was reviewable only by a petition to revise, under § 24b. *In re Ann Arbor Mach. Corp.*, 274 Fed. 24 (C. C. A. 6th, 1921); *In re Lone Star Shipbuilding Co.*, 6 F. (2d) 192 (C. C. A. 2d, 1925). But an occasional circuit court of appeals has accepted an appeal under § 24a, without expressly passing on its propriety. See *Royal Indemnity Co. v. American Bond & Mortgage Co.*, 61 F. (2d) 875 (C. C. A. 7th, 1932), *aff'd*, 289 U. S. 165 (1933). The form of appeal is of limited importance under the revised § 24.

133. *In re Ettinger*, 76 F. (2d) 740 (C. C. A. 2d, 1935); *Chicago Bank of Commerce v. Carter*, 61 F. (2d) 986 (C. C. A. 8th, 1932); *In re Guanacevi Tunnel Co.*, 201 Fed. 316 (C. C. A. 2d, 1912); *In re American & British Mfg. Corp.*, 300 Fed. 839 (D. Conn. 1924).

134. *Vassar Foundry Co. v. Whiting Corp.*, 2 F. (2d) 240 (C. C. A. 6th, 1924) (dissolved corporation).

135. See *Vassar Foundry Co. v. Whiting Corp.*, 2 F. (2d) 240, 241 (C. C. A. 6th, 1924) ("whether or not this objection is called jurisdictional, it is one upon which creditors must have a right to be heard"). In the case of *In re Nash*, 249 Fed. 375 (S. D. W. Va. 1918), the debtor filed a petition for bankruptcy within six years after a prior discharge. The court held that this fact alone would not stop him from filing his petition; since the debtor scheduled no assets, however, and the bankrupt's "only purpose or object" in filing his petition "was to hinder and delay or defraud his creditors," the adjudication was vacated on motion by a creditor. And see *Blackstock v. Blackstock*, 265 Fed. 249 (C. C. A. 8th, 1920).

The impossibility of adequate reorganization under Chapter XI should be a ground for such a motion in Chapter XI proceedings. To support his motion the moving party should show any facts which would be considered germane in a comparable inquiry under Section 146(2) of Chapter X.<sup>136</sup> He may point to the debtor's burden or secured debt, so heavy as to make any Chapter XI arrangement inadequate as an instrument for reestablishing the business' financial structure. The debtor may be a large corporation, in terms of assets, though closely held; or, as with some holding companies and investment companies, small in terms of assets but with widely scattered security holders. Perhaps the possibility of realizing on going-concern values for creditors should be treated as sufficient reason for refusing to continue a Chapter XI proceeding.

It is clear that such a motion would be available to unsecured creditors, who could claim that the relief sought by the debtor would be inadequate as to them. Could a secured creditor appear also, alleging that the approval of an arrangement, necessarily unfeasible under the circumstances, would injure his security, and provoke further default in the near future? Could the Securities and Exchange Commission do so, as proper and perhaps necessary party to a possible Chapter X proceeding,<sup>137</sup> on the ground that a continuance of the Chapter XI proceeding deprives it of an opportunity to fulfill its statutory duties, in a case of insolvency administration in which Congress wanted it to serve?<sup>138</sup>

Motions of this type, if accepted as proper, ask for a dismissal of Chapter XI proceedings, but in fact seek the institution of proceedings under Chapter X. They might serve as makeshift procedure for testing the propriety of Chapter XI petitions; but courts should not let them be used as collection devices for creditors seeking 100% recovery.<sup>139</sup> If a dismissal is granted on such a motion, for the reason that the relief sought under Chapter XI would be inadequate, it should be conditioned on the simultaneous institution of Chapter X proceedings, either by the debtor or by a suitable number of creditors. Only by such precautions can the result comparable to that provided for in Section 147 of Chapter X be attained under Chapter XI.

Perhaps this result — supersession of the Chapter XI proceedings by more appropriate proceedings under Chapter X — could be attained directly by allowing creditors to file an involuntary proceeding under Chapter X.<sup>140</sup> The involuntary petition would have to be based on an act of

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136. See pp. 1363-1365, *supra*.

137. See § 208 of Chapter X.

138. Failing such a move, the S. E. C. would be able to file a motion to vacate as *amicus curiae*.

139. But see *First Nat. Bank v. Flershem*, 290 U. S. 504 (1934), and *Shapiro v. Wilgus*, 287 U. S. 348 (1932). See Comment (1938) 47 YALE L. J. 746, 758 *et seq.*

140. § 126.

bankruptcy,<sup>141</sup> and the debtor's voluntary petition under Chapter XI should constitute a suitable "act." Section 3a(6) declares it to be an act of bankruptcy for the debtor to have "admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt." A debtor must admit his insolvency or inability to pay debts in a Chapter XI petition.<sup>142</sup> And it can with some plausibility be contended that by filing this petition, he has indicated his "willingness to be adjudged a bankrupt." Chapter XI provides that if the judge refuses to confirm the arrangement, or if the judge does confirm but the debtor fails to carry out his part of the bargain, the court may "enter an order adjudging the debtor a bankrupt . . . or dismissing the proceeding under this chapter, whichever in the opinion of the court may be in the interest of the creditors."<sup>143</sup> The argument marches easily from presumption to presumption: the debtor corporation is presumed to know that the judge possesses this power; therefore its petition indicated a "willingness" to accept later adjudication.

The meager case-law<sup>144</sup> under Section 3a(6) neither helps nor harms the creditors' cause, for cognate problems could never have arisen until the new Act was passed in 1938. The debtor relief sections added to the Bankruptcy Act in 1934 present no such issue. Section 74 applied only to individuals, Section 77B to corporations. Proceedings under these two sections could be superseded only by bankruptcy, and then on terms expressly provided.<sup>145</sup> Furthermore, both sections provided for preliminary hearings at which the propriety of petitions under them could be tested. But now liquidation proceedings in bankruptcy can be

141. § 131(5). The creditors' petition may contain any one of five allegations: (1) that the corporation was adjudged a bankrupt in a pending proceeding; (2) that a receiver or trustee has been appointed in a pending equity proceeding; (3) that an indenture trustee or mortgagee is, after a default, in possession of all or the greater portion of the debtor's property; (4) that a proceeding has been commenced to foreclose a lien against all or the greater portion of the debtor's property; (5) that the debtor has committed an act of bankruptcy within four months. Creditors in the situation under discussion would be unable to fit within any of the first four subdivisions of § 131.

142. § 323. Is § 3a(6) satisfied if the debtor has alleged his insolvency, not his inability to pay debts as they mature?

143. §§ 376(2), 377(2). It is assumed throughout this discussion that the Chapter XI petition was filed under § 322 and not under § 321—that is, that the debtor had not been adjudicated a bankrupt before filing the Chapter XI petition. If an adjudication had taken place, involuntary proceedings under Chapter X should be available under §§ 127 and 131(1).

144. The cases primarily concern themselves with such issues as the power of directors to admit a corporation's willingness to be adjudicated; the effect of an equity consent receivership on the questions of (a) willingness to be adjudicated and (b) admission of insolvency; the precise wording of letters written by embarrassed debtors to their creditors. The decisions are collected in the annotation to 11 U. S. C. A. § 21, ¶¶ 131-140 (1934).

145. See old 74f [11 U.S.C. § 202f (Supp. 1937)] and old 77B (k) [11 U.S.C. § 207(k) (Supp. 1937)].

superseded by either Chapter X or Chapter XI proceedings.<sup>146</sup> Presumably reorganization proceedings may not be superseded by bankruptcy except on their dismissal,<sup>147</sup> and Section 147 provides a technique for transferring cases from Chapter X to Chapter XI. But no procedure is provided for transferring cases from Chapter XI to Chapter X. Does the omission mean that proceedings under Chapter XI can be attacked by an involuntary petition under X, or that proceedings under Chapter XI cannot be attacked at all, until the hearing to confirm an arrangement?

An involuntary petition under Chapter X, based on a prior Chapter XI petition as an act of bankruptcy, can superficially be accommodated to the philosophy of acts of bankruptcy.<sup>148</sup> And two sections of the Act indicate that the procedure may be proper. Section 379 of Chapter XI, following the sections permitting the court to adjudicate the petitioner a bankrupt,<sup>149</sup> provides that no such adjudication may be entered against a wage-earner or farmer unless such person shall in writing file with the court consent to the adjudication. Corporations in the same predicament are not afforded this protection. And Section 262 of Chapter X declares that if a proceeding under *that* chapter shall be dismissed, the filing of the petition shall not constitute an act of bankruptcy by the debtor. Chapter XI contains no such limitation. Since in general the two chapters parallel each other in draftsmanship, article headings and many sections being identical,<sup>150</sup> the omission may be regarded as purposive.

There may be some difficulties in the way of thus depriving the Chapter XI court of its powers. Upon the filing of a petition, the Chapter XI court has a prior jurisdiction which, presumably, should not be collaterally disturbed.<sup>151</sup> The procedure here might give rise to a conflict between two courts acting under the Bankruptcy Act, if the Chapter XI proceeding had been instituted at the debtor's domicile<sup>152</sup> and the Chap-

146. A petition under Chapter X or Chapter XI may be filed before or after an adjudication in bankruptcy. §§ 127, 321.

147. See § 236 of Chapter X and §§ 376 and 377 of Chapter XI.

148. See Treiman, *Acts of Bankruptcy: A Medieval Concept in Modern Bankruptcy Law* (1938) 52 HARV. L. REV. 189, 199.

149. §§ 376(2), 377(2).

150. Numerous provisions of the two chapters are in the same words. See, *e.g.*, §§ 101 and 301; 111 and 311; 120 and 315; 121 and 316; 221(2), (3) and 366(2), (4); 261 and 391; 264 and 393, 271 and 397.

151. Upon the filing of a petition under Chapter XI, the jurisdiction of the Chapter XI court is the same as if a decree of an adjudication in bankruptcy had been entered. § 312. "An adjudication of bankruptcy, made by a District Court having jurisdiction of the bankrupt, cannot be impeached collaterally by any person who was a party to the bankruptcy proceedings." *Graham v. Boston, H. & E. R. R.*, 118 U. S. 161, 178 (1886); *Michaels v. Post*, 21 Wall. 398 (U. S. 1874).

152. Chapter XI proceedings may be instituted wherever bankruptcy proceedings would be proper. Under § 2a(1), a debtor may be adjudicated in the district where he has had his principal place of business, or has resided, or has had his domicile.

ter X petition were filed as an original petition at the debtor's principal place of business, pursuant to Section 128. But Section 128 can be rendered inapplicable by giving a broad construction to the preceding Section 127. If a bankruptcy proceeding is pending, then under Section 127 the Chapter X petition must be filed in that pending proceeding.<sup>153</sup> By accepting the proceeding started by the prior Chapter XI petition as a "pending bankruptcy proceeding,"<sup>154</sup> it is possible to force the Chapter X petition to be presented to the court that has jurisdiction over the proposed arrangement under Chapter XI.

In comparable situations, direct action before the court already exercising jurisdiction is required to effect a transfer from one part of the Act to another. Reorganization petitions must be filed in the bankruptcy court if a bankruptcy proceeding is pending,<sup>155</sup> and a transfer from Chapter X to Chapter XI is decided upon by the Chapter X court.<sup>156</sup> Since the problem here is to repair an omission of the Statute, and to devise a method for transforming a Chapter XI proceeding into one under Chapter X, a construction of Section 127 affording the Chapter XI court a chance to pass on the issue seems consistent with conventional notions of orderliness in practice, and with ideas of comity. Whatever violence might be done to the wording of Section 127 is justified by the result achieved: the adequacy of relief under Chapter XI might then be considered in a Chapter XI proceeding, as in a Chapter X proceeding,<sup>157</sup> and by a court possessing unquestioned jurisdiction.

The only occasion provided by Chapter XI at which the propriety of the petition may be considered is the hearing or meeting to confirm the arrangement.<sup>158</sup> One of the issues upon which the court must satisfy itself before confirming the arrangement is that "the proposal and its acceptance are in good faith and have not been made or procured by any means, promises or acts forbidden by this Act."<sup>159</sup> The phrase "good faith" has had an important and elastic history in the administration of

153. "A petition may be filed in a pending bankruptcy proceeding either before or after the adjudication of a corporation." § 127. § 128 does not apply if a "bankruptcy proceeding" is pending.

154. Despite the evidently contrary usage by the draftsmen, there seems to be no reason why a Chapter XI proceeding cannot be called a proceeding in bankruptcy for the purposes of Section 127, in the interest of preventing conflict between courts.

155. §§ 127, 321.

156. § 147.

157. Pursuant to § 146(2) in the hearing on the approval of the Chapter X petition.

158. §§ 361, 362. If the debtor has obtained the consents of 100% of the creditors, the court can proceed to confirm under § 361 at the first meeting. If the consents of 100% are not marshalled at the first meeting, the confirmation hearing takes place at a date set by the judge, after a suitable majority of creditors shall have assented.

159. § 366(5).

Section 77B<sup>160</sup> and should be broad enough, in this context, to require of the court a decision as to whether the forum is appropriate, and whether the relief proffered by the arrangement and the administration is adequate.

But such a hearing comes late in the proceeding, and objectors attacking the propriety of the proceedings as a whole, after the promulgation and acceptance of an arrangement, face a formidable inertia.<sup>161</sup> True, it is the first opportunity more or less directly recognized by the Act at which such objections can be heard. But at this point in the case the objection that adequate relief cannot be obtained under Chapter XI becomes an aspect of the attack on the adequacy of the relief actually offered by Chapter XI: *i.e.*, it is merged with other arguments bearing on the fairness and feasibility of the arrangement as a plan of reorganization.<sup>162</sup> If the result of the proceeding is an arrangement in the best interests of the creditors, the court is unlikely to require the litigants to start over, especially in view of the expense and potential slowness of a Chapter X proceeding.

#### CONCLUSION

Convenience in administration requires some amendments designed to clarify the relationship between Chapter X and Chapter XI. If it is thought undesirable to deny Chapter XI to corporations altogether, a simple and untechnical procedure should be legitimized in Chapter XI proceedings, analogous to that of Section 147 under Chapter X, by which the Chapter XI court may decide whether the Chapter XI proceeding should be superseded by one under Chapter X. Transfer of proceedings from Chapter XI to Chapter X should turn on the same facts, whatever they may be, supposed to control the transfer of proceedings from Chapter X to Chapter XI. And Congress should indicate what those facts are, *i.e.*, say more concretely what is meant by the idea that the prospective adequacy of relief under Chapter XI tests the propriety of a petition under Chapter X, and, conversely, under Chapter XI.

These are minimal amendments. It would be preferable to rewrite the chapters more thoroughly. If it is a good idea to have a separate reorganization system for small corporations, that system should be extensive enough to do the work required of it. The court administering such a system should have power to reach secured debts and stock interests, as well as unsecured debt; and it should have fuller duties of supervision than are prescribed by Chapter XI. The result could be

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160. See FINLETTER, *PRINCIPLES OF CORPORATE REORGANIZATION* (1937) 74; Comment (1939) 37 MICH. L. REV. 912.

161. See note 50, *supra*. A comparable problem may arise on any such motion.

162. See pp. 1345, *et seq.*, *supra*.

achieved either by revising Chapter XI, or by excluding corporations from Chapter XI, and modifying Chapter X to meet the problems of the small corporation. At present some of the more elaborate features of Chapter X — the appointment of a trustee and the supervisory report of the S.E.C., for example — apply only to large debtors. An extension of such limitations in the Chapter X proceeding would meet the needs of the situation and avoid present conflicts altogether.

If so much amendment is undertaken, why not go further, to reconsider the economic policy of the reorganization chapters? Every statute or body of practice defining the scope of an insolvency proceeding makes certain decisions of economic policy. It fixes the occasions in the history of an enterprise when the enterprise should be terminated or subjected to the strain and expense of reorganization proceedings. And insofar as it provides for reorganization, it offers standards for the financial structure of the reorganized enterprise.

Chapters X and XI together purport to offer a new system of corporate reorganization. However, they do not much change the traditional economics of the reorganization process. There is reform in the two chapters. But it is legal reform of the narrower kind: a practice regarded as inequitable is abolished; a conflict of decision over an old Section is resolved in favor of "the sounder view." Both chapters are new, in the sense of having new nomenclature and novelties of detail in rule and procedure. But neither chapter breaks new ground in defining the function of reorganization proceedings. The revisers evidently accepted without radical modification the historical understanding of what reorganization proceedings were supposed to do, and when they should be instituted. Voluntary proceedings may still be begun when debtors want them begun — a good enough rule, in a free society, for liquidation, but not without danger as applied to reorganization. Involuntary proceedings are still visited as punishment on debtors who have become bankrupts, or commit what are still in effect acts of bankruptcy. And there is still little assurance that reorganized corporations will be financed in such a way as to minimize the chance of a second failure. Except for three casual and collateral gestures,<sup>163</sup> the system of corporate reorgan-

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163. Reorganization is fitted to the income tax, not without difficulty, by §§ 268, 270, 395, 396, and to the Securities Act by §§ 393 and 264 (see note 51 *supra*); Chapter X, it has been indicated, favors drastic reorganization plans; and § 216 of Chapter X is a beginning in the direction of a positive policy towards problems of finance. The subdivisions of § 216, however, cover voting rights, the selection of directors, provisions for sinking funds, annual reports and the like. While § 216(12)(b)(1) [a plan of reorganization under this chapter . . . shall provide for the inclusion in the charter of the debtor, or any corporation organized or to be organized for the purposes of carrying out the plan, of—provisions which are fair and equitable and in accordance with sound business and accounting practice, with respect to the terms, position, rights, and privileges of the several classes of securities of the debtor or of such corporation . . .] is broad enough



ization through bankruptcy does not represent or assert a conscious policy towards the financial organization of society.

According to the calculus of the economists, it pays socially for business enterprises to be continued as long as their revenues cover out-of-pocket costs, or their out-of-pocket losses are less than the losses which would be incurred by shutting down.<sup>164</sup> So far as the economics of solvency are concerned, inability to pay interest on capitalized debt is not a useful criterion for determining when the enterprise should be subjected to the expense of insolvency proceedings. In the case at least of larger enterprises, which have no market value in any realistic sense, the capital represented by the debt is irrevocably invested in the enterprise, and will generally continue to be used in it for production, whatever is done by way of insolvency proceeding, as long as revenues equal or exceed the costs which must be incurred in order to continue production.<sup>165</sup> Default in payment of charges on capital might well be the occasion for a visitatorial inquiry into management, and perhaps for a change in voting rights, in effect eliminating common stock by intra-corporate action rather than by judicial proceeding; but it seems wasteful to make such an event alone the occasion for reorganization proceedings on their present scale.

Historically, of course, we are committed to the practice of regarding some part of capital as debt, and correlatively, the holders of that debt have the status of current-account creditors for purposes of creditors' remedies. It is probably impossible to change the deep-seated habit of treating bondholders as creditors for such purposes. And so long as default on capitalized debt is regarded as the occasion of reorganization proceedings, it is desirable that the resulting reorganizations be drastic. If we must have a judicial proceeding after default on capitalized debt, that proceeding should thoroughly purge the finances of the business. And the administration of Chapter X, at least, promises that reorganization will have adequate purgative features.

An acceptable reorganization system should, however, do more than is done by Chapters X and XI to control the future financial structure of reorganized enterprises, in the interest of preventing the recurrence

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to include an adequate policy as to the feasibility of plans, and may become the spring-board for such a policy, it is too vague in its present form to offer much assurance that such a policy will come.

164. Harrod, *The Expansion of Credit in an Advancing Community* (1934) 1 *ECONOMICA* (N.S.) 287, 289 *et seq.*

165. Except in the insolvency of small, marketable business units, default offers bondholders no real opportunity to withdraw their capital. They may normally take over management or accept new securities; whatever their personal decision, the business is most often continued, charged with lower fixed costs, a fact sometimes thought to affect price policies in the industry. See, for a particular example, NATIONAL BUREAU OF ECONOMIC RESEARCH, REPORT OF THE COMMITTEE ON PRICES IN THE BITUMINOUS COAL INDUSTRY (1938) 13-14.

of uneconomic insolvency proceedings. Ideally, such a policy would be expressed by a prohibition in the charter of the new company against any form of capitalization resulting in fixed charges or fixed maturities. All capital returns would be contingent on there being earnings above operating expenses, priority of risk being expressed by priority of claim to income. If habits of finance and of thinking about finance among those who constitute the capital market will keep reorganizers from writing such utopian terms into articles of incorporation, they should at least be required to restrict the quantity or proportion of an enterprise's capital which may be obtained through borrowing. The control of capital structures through reorganization should go further. It is generally regarded as dangerous to have much of the capitalization of a business represented by securities on which a fixed maximum return is payable. Such a financial structure promises a new default with every considerable fluctuation of income, and tempts the directors to speculative managerial policies. If the capitalization of a company carries large fixed or maximum charges, its management, usually holding equities, stands to gain disproportionately from a course of action, however risky, which increases the existing over-all rate of return on capital. And so far no device short of charter restriction has developed for protecting the corporation against its management in this particular of financial policy:

"It must also be doubted that railroad management can in the future be relied upon, without restrictions contained in the capital structure itself, to keep a reorganized capital structure sound. The investments of management are usually in junior securities, indeed usually in stock. This will accentuate management's natural interest to raise money at the lowest cost possible, that is, through the issue of the most senior securities available at the time. Even creditor representatives in management will be inclined to keep the cost of new money down, at the expense of sending the debt ratio up. This is not at all to criticize either equity or creditor management: the inducements referred to are compelling and it would require a far-sightedness beyond the qualities of most human beings to resist them.

"It would therefore seem wise that in setting up capital structures for railroads now undergoing reorganization provisions should be inserted in the new mortgages designed to counteract the inducements referred to, and on the one hand to restrict the creation of additional fixed charges and, on the other hand, to encourage the use of income bonds and stock in future financing."<sup>166</sup>

Any substantial revision of the system of corporate reorganization through bankruptcy should start with a reconsideration of the economic

166. R. T. Swaine and R. L. Gilpatric, *Brief on Behalf of the Debtor, Chicago, Milwaukee, St. Paul and Pacific R. R. Reorganization*, I. C. C. Finance Docket No. 10832 (May 31, 1938) 64.

function of such proceedings, and should serve the definite policy of making them an occasion to rebuild the financial structure of the debtor enterprise. The plan of reorganization should give management all the discretion it needs to meet the future financing requirements of the business; but that discretion should be restricted so as to forestall the danger of over-speculative business policy, and the waste of premature reorganization.

Only after a reform of this order will we begin to get our money's worth from the reorganization system. As it is now conducted, reorganization is expensive without being altogether productive. The elaborate proceeding yields fees to lawyers, but the litigants come out still with little assurance that they won't be back too soon.