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CLASSIFICATION OF CLAIMS IN DEBTOR PROCEEDINGS

A BANKRUPTCY court sits as a court of equity with full power to administer assets according to the "principles and rules of equity jurisprudence."[1] In straight bankruptcy proceedings this power is exercised by allowance or disallowance or by subordination of claims against the bankrupt estate;[2] in reorganizations and arrangements, by confirming or refusing to confirm a plan, depending upon whether or not it is "fair, equitable and feasible."[3] The respective economic interests of the claimants have been the dominant consideration in equitable distribution of the debtor's assets. Creditors have usually participated according to their priority, which is ascertained by their

1. Pepper v. Litton, 60 Sup. Ct. 238, 244 (U. S. 1939).

2. BANKRUPTCY ACT, § 57. The Bankruptcy Act is found in 52 STAT. 840, 11 U. S. C. §§ 1-1103 (Supp. 1938). The Act will be cited hereafter only by section number.

3. This standard, developed in reorganization through equity receivership, is applied in such proceedings, both state and federal, and in reorganization proceedings under the Bankruptcy Act. It appears, for railroad reorganization, in § 77(e)(1); under Chapter X for corporate reorganization, § 221(2); under Chapter XI for arrangements, § 366(3). Similar provisions appear in § 75 and Chapters IX, XII and XIII. This Comment, however, will consider only § 77 and Chapters X and XI as representative of the problem of classification in reorganization proceedings.

economic status as measured in terms of their security or the preferential treatment accorded them by law. In reorganization, the economic basis of classification was written into the terms "fair and equitable" by the doctrine of the *Boyd* case that junior economic interests cannot, ordinarily, participate unless senior claims are satisfied.[4] As a seldom-tested corollary to this strict priority rule, there is the proposition that claims of the same economic status should be treated equally.[5]

Equity has long recognized exceptions to the theory of strict economic classification of claims. Such classification will be disregarded when fraud is present.[6] And creditors' claims have been disapproved or subordinated on the ground that the relationship of debtor and claimant made it inequitable to apply the usual rule. This reason is invoked most frequently in the case of dominant stockholders proving against their debtor corporations[7] or parent corporations claiming against bankrupt subsidiaries.[8] Recently, there has been a tendency to broaden these exceptions with resulting breaches in the rule that claims of the same economic class should be treated equally.

The importance of the power to classify interests can hardly be overemphasized. Subordination in the hierarchy of priorities may mean the difference between payment and non-payment. Discrimination as to treatment within one class may vitally affect the strategy of bargaining in the reorganization process, or the distribution of political power in a reorganized company. Discrimination in favor of certain groups may also expedite consummation of a plan. And inasmuch as each class votes separately, the classification for voting purposes may mean the difference between success and failure of proposed reorganizations or arrangements.

The nature of classification differs somewhat in each branch of insolvency law. In a straight bankruptcy proceeding, classification is a question only of order of payment from the bankrupt estate, and action against a claim will take either the form of disallowance or subordination. The latter is a form of classification, accomplished by placing a secured claim in the status of an unsecured claim, or by placing a claim, secured or unsecured, in a separate class to receive payment only after other creditors have been satis-

4. Northern P. Ry. v. Boyd, 228 U. S. 482 (1913), reaffirmed recently in Case v. Los Angeles Lumber Products Co., 60 Sup. Ct. 1 (U. S. 1939).

5. See 2 GERDES, CORPORATE REORGANIZATIONS (1936) 1682; FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION (1939) 465; MOORE'S BANKRUPTCY MANUAL (1939) 584. *Cf.* Southern Pac. Co. v. Bogert, 250 U. S. 483 (1919).

6. See Pepper v. Litton, 60 Sup. Ct. 238 (U. S. 1939) for an example of disallowance because of pronouncedly fraudulent circumstances. See GILBERT'S COLLIER ON BANKRUPTCY (1937) 963.

7. *In re* Kentucky Wagon Mfg. Co., 71 F. (2d) 802 (C. C. A. 6th, 1934), *cert. denied,* 293 U. S. 612 (1934); Alexander v. Theleman, 69 F. (2d) 610 (C. C. A. 10th, 1934), *cert. denied,* 293 U. S. 581 (1934); *In re* Chas. K. Horton, Inc., 22 F. Supp. 905 (S. D. Tex. 1938).

8. See Rembar, *Claims Against Affiliated Companies in Reorganization* (1939) 39 COL. L. REV. 907; Comment (1936) 45 YALE L. J. 1471.

fied.[9] Inasmuch as this latter type of subordination has occurred principally where the creditor was a proprietor of the debtor,[10] the difference between subordination and disallowance has been slight. A principal stockholder who must wait until other creditors are paid receives any residue either as creditor or, assuming practically complete ownership, as debtor receiving the unclaimed balance.[11] And if there is no balance after payment of all other creditors, the subordinated claimant might just as well have had his claim disallowed. Subordination may, however, make a considerable difference if the equitable power of classification is expanded to permit discrimination against claimants other than the dominating proprietor of the bankrupt. Suppose, for example, that a bank creditor in an effort to protect its advances forced a debtor into unwise business practices resulting in diminution of assets. A bankruptcy court might well subordinate the bank's claims on the theory that equity should not protect a creditor who has jeopardized the interests of other creditors.[12] If this were done, there would be a marked departure from the usual order of strict economic priority.

In corporate reorganization under Chapter X of the Bankruptcy Act, the power to classify is specifically granted by the statute. Section 197 provides that "for the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock." Some commentators have expressed the opinion that classification under this section should be purely on grounds of economic priority.[13] There are indications, however, that courts may be willing, at the time of classification, to go much further, and alter economic precedence by exercising their equitable power of subordination. In *Taylor v. Standard Gas and Electric Company*,[14] the Supreme Court rejected a proposed plan under Section 77B[15] because the unsecured claim of Standard,

9. For a case in which both secured and unsecured claims were subordinated, see *In re* Chas. K. Horton, Inc., 22 F. Supp. 905 (S. D. Tex. 1938). For subordination of unsecured claims, see Henry v. Dolley, 99 F. (2d) 94 (C. C. A. 10th, 1938); *In re* Otsego Waxed Paper Co., 14 F. Supp. 15 (W. D. Mich. 1935).

10. Henry v. Dolley, 99 F. (2d) 94 (C. C. A. 10th, 1938) (parent and subsidiary); *In re* Otsego Waxed Paper Co., 14 F. Supp. 15 (W. D. Mich. 1935) (same); *In re* Chas. K. Horton, Inc., 22 F. Supp. 905 (S. D. Tex. 1938) (president and principal stockholder).

11. See § 66(b). Whether or not a subordinated creditor could vote under § 56, which provides that creditors shall vote on matters submitted to them, is apparently an unanswered question. Equitable grounds for subordination might equally be considered grounds for forbidding voting at creditors' meetings.

12. This does not seem to be a very great step beyond Taylor v. Standard Gas & Electric Co., 306 U. S. 307 (1939), where the parent's claim was subordinated partly because of mismanagement of its subsidiary.

13. See 2 GERDES, CORPORATE REORGANIZATIONS (1936) 1682; FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION (1939) 465. *Cf.* Friendly, *Some Comments on the Corporate Reorganizations Act* (1934) 48 HARV. L. REV. 39, 70-74.

14. 306 U. S. 307 (1939).

15. Chapter X which supersedes § 77B does not differ materially so far as classification is concerned.

parent of the debtor subsidiary, should have been subordinated to the rights of the preferred stockholders of the subsidiary. The Court's reasoning has been characterized as based upon "the equities of the case — the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary . . . to the detriment of the public investors [of the subsidiary];"[16] upon these grounds the Court decreed subordination, though expressly declining to disallow the claim altogether. While the disapproval of the classification appeared only at the stage of confirmation of the plan, there is no apparent reason for not determining the equities of the case at the earlier stage when classification takes place.[17] If this can be done, then clearly the power to classify includes the power to subordinate.[18]

Even within a single group having like economic standing, there are indications that by classification separate interests may be placed in two or more classes for different treatment. In In re *Burns Brothers*,[19] a district court confirmed a plan under Section 77B which provided that unsecured creditors should be divided into two classes, one consisting of two very large creditors who had exercised considerable control over the debtor, the other consisting of small creditors whose total claims amounted to only slightly more than five per cent of the total unsecured claims. Prior to drafting of the plan there had been a heated contest as to the liability of the dominant creditors for alleged mismanagement of the debtor. The contest ended in a compromise plan in which preferred treatment was given to the smaller claims. There may be other ways in which a single economic group can be divided into classes, and the resulting classes treated differently. Sometimes the treatment of such groups is meant to be comparable, or "equal," though different, as where holders of debentures, as investors, are given debts of longer maturity than the claims given merchandise creditors;[20] on other occasions the treatment afforded such classes is discriminatory,[21] and various reasons are suggested to explain the fairness of the result. Thus, a court would appear

16. See Pepper v. Litton, 60 Sup. Ct. 238, 246 (U. S. 1939). The Court in the *Pepper* case was emphasizing one aspect of the case. It should also be pointed out that the debtor, almost wholly owned by Standard, was insufficiently capitalized. The parent's claim was one on open account, accumulated over a period of ten years of very close supervision and control which involved large management fees, a one-sided lease forced on the debtor, and other transactions mainly in the interests of the parent. See Rembar, *supra* note 8, at 923 *et seq.*

17. But *cf. In re* Philadelphia Rapid Transit Co., 11 F. Supp. 865 (E. D. Pa. 1935), where the court refused to consider preliminary objections to the size of a claim and tentatively allowed it for voting purposes.

18. See Pepper v. Litton, 60 Sup. Ct. 238, 246 (U. S. 1939) (". . . the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done . . .").

19. 14 F. Supp. 910 (S. D. N. Y. 1936).

20. *Cf. In re* Celotex Co., 12 F. Supp. 1 (D. Del. 1935).

21. See Continental Ins. Co. v. Louisiana Oil Ref. Corp., 89 F. (2d) 333 (C. C. A. 5th, 1937).

justified in permitting discrimination, either because on the facts of the case the group receiving less is not equitably entitled to more,[22] or because the differential is not sufficiently unfair to offset the advantages of effectuating a plan based on a compromise.[23] These settlements may not often be contested. Splitting off a group of claims in one class is usually dictated by a desire to placate a dissentient minority by favored treatment. As a practical matter, the remaining members of the class will probably not object.

A situation the converse of separation within a single economic group is one where technically separate classes are combined. Each creditor with a distinct security ordinarily forms a separate class.[24] But in In re *Palisades-on-the-Desplaines*,[25] the court placed all certificate holders in one class despite the fact that each one was secured by a separate mortgage on a specific piece of land. The fact that differences in the securities were not considered substantial led the court to exercise what it deemed a broad discretion conferred by the classification provision.[26] Combination of substantially similar though technically different claims seems quite advisable where separation would greatly increase the number of classes.[27]

In addition to classification as to treatment, claimants must be grouped for voting purposes. Obviously, each economic group votes separately,[28] subject to the qualification discussed under the *Palisades* case, where the combined secured creditors would vote as one class.[29] On the other hand, where creditors of the same economic status are classified separately for treatment in the plan, separate voting is in order.[30] An interesting question might arise in this latter situation. In a case where the classification is to favor a minority by special treatment, the favored minority might seek to

22. *Cf.* Taylor v. Standard Gas & Electric Co., 306 U. S. 307 (1939). The plan in *In re* Burns Bros., 14 F. Supp. 910 (S. D. N. Y. 1936) appears partly to have depended on equities, partly on compromise.

23. See *In re* Burns Bros., 14 F. Supp. 910 (S. D. N. Y. 1936).

24. See 2 GERDES, CORPORATE REORGANIZATIONS (1936) 1682.

25. 89 F. (2d) 214 (C. C. A. 7th, 1937). The case arose under § 77B, but differences are not material.

26. The court also considered important the fact that the one objecting creditor who appealed stood to gain from the plan because the value of his security was considerably less than the probable value of the payments received under the plan. Briggle, D. J. dissented on the grounds that the classification was unconstitutional. *Id.* at 218.

27. *Cf.* J. P. Morgan & Co. v. Missouri P. R. R., 85 F. (2d) 351 (C. C. A. 8th, 1936), *cert. denied*, 299 U. S. 604 (1936) (See notes 45 and 46 *infra* and accompanying text).

28. See § 197, quoted *supra* p. 883.

29. In *In re* Palisades-on-the-Desplaines, 89 F. (2d) 214 (C. C. A. 7th, 1937), the voting was by the certificate holders acting as a unit.

30. Separate voting occurred in *In re* Burns Bros., 14 F. Supp. 910 (S. D. N. Y. 1936) discussed *supra* p. 884. See also Continental Ins. Co. v. Louisiana Oil Ref. Corp., 89 F. (2d) 333, 338 (C. C. A. 5th, 1937), where the court affirmed a plan providing different treatment for two different groups of common stockholders but noted that the stockholders should have voted separately.

increase its advantage by threatening to block the plan. In that event, the court could either fall back on Section 197, relying on the "nature" of the claims to put them into one class,[31] or disfranchise the minority under Section 203[32] on the ground that its refusal to accept was not in good faith.[33]

A cognate problem may arise where for equitable reasons the court either subordinates as to priority or classifies specifically for discriminatory treatment. The interests thus affected may well be opposed to all plans. In the *Taylor* case,[34] for example, the parent corporation might well attempt to block any plan drawn in conformity with the opinion of the Supreme Court.[35] But if the plan proposed is clearly fair on the basis of the holding of the prior case, the judge might disfranchise the objecting parent.[36] Or he might under Section 179[37] force the plan on the dissenting class. Obstructionist tactics arising out of classification can thus undoubtedly be forestalled.

Another problem of classification for voting purposes remains. In an English case, under a reorganization comparable to one which might arise under Chapter X, unsecured creditors receiving equal treatment were classified separately for voting purposes on the ground that one group of creditors, by virtue of a special guarantee of full payment by directors of the debtor, had a different interest in the outcome of the reorganization.[38] It seems probable that such a situation, were it to come up under Chapter X, might

31. There is an apparent conceptual difficulty in permitting classification of unsecured claims for purposes of treatment but denying it for voting. In the absence of objection by creditors who stand to lose by the paradoxical treatment, however, there is no difficulty in sustaining the action on equitable grounds. Objection by the losing group is not, as pointed out in the text, a likely event.

32. Section 203 provides: "If the acceptance or failure to accept a plan by the holder of any claim or stock is not in good faith, in the light of or irrespective of the time of acquisition thereof, the judge may, . . . direct that such claim or stock be disqualified for the purpose of determining the requisite majority for the acceptance of a plan."

33. In view of the wording to the effect that good faith is to be considered "in the light of . . . [the] acquisition" it may be that good faith is limited to the mode and purpose of acquisition. *Cf.* Texas Hotel Securities Corp. v. Waco Development Co., 87 F. (2d) 395 (C. C. A. 5th, 1936), *cert. denied,* 300 U. S. 679 (1937). But according to the authors of Chapter X, such a strict interpretation was probably not intended. See MOORE'S BANKRUPTCY MANUAL (1939) 532.

34. Taylor v. Standard Gas & Electric Co., 306 U. S. 307 (1939). See p. 883 *supra.*

35. In a situation where the debtor was insolvent in the bankruptcy sense, possibly not the fact in the *Taylor* case, the controlling parent probably would not obstruct the plan because in bankruptcy he might find his claim disallowed or subordinated for the same reason it was subordinated by the Court in the *Taylor* case. See Pepper v. Litton, 60 Sup. Ct. 238, 246 (U. S. 1939).

36. See § 203, note 32 *supra.*

37. Briefly, § 179 permits the judge to confirm a plan either upon the assent of suitable majorities or upon provision for dissenting classes of creditors and stockholders under § 216(7), (8). Under § 216(7)(d), and § 216(8)(c), any method which, under the circumstances of the case, "equitably and fairly" protects the dissenting group is acceptable. See Comment (1936) 46 YALE L. J. 116.

38. La Lainière de Roubaix v. Glen Glove & Hosiery Co., [1926] Sess. Cas. 91.

be similarly treated for purposes of classification. This could be done in either of two ways. The court might urge, under the classification section,[39] that the creditors protected by the suretyship obligations should be required to vote separately whether or not they were treated differently, on the ground that their economic stake in the reorganization differed from that of other unsecured creditors, and that they would be more willing than other creditors to accept a sacrifice under the plan. This position has been contested, apparently on the theory that the scheme of the Bankruptcy Act requires equal treatment for all persons classed by the Act as creditors of equal rank.[40] But equality of treatment should not necessarily imply equality of voting rights. The court should, in the exercise of its equitable powers, be able to assure itself that the vote on any plan reflects the judgment of the parties, based on full disclosure of the facts.[41] The same result might also be reached under the section allowing disfranchisement,[42] on the ground that a vote in favor of a plan by one whose financial interest in the outcome was augmented by the appeal of additional surety is a vote "not in good faith." Even if the court fails to do this, it is always empowered to disapprove the plan because it is not "fair and equitable," in that too little is given the non-guaranteed class, perhaps because of an inequitable distribution of voting power.

In other fields of bankruptcy, the statutory authority of the court to classify claims differs somewhat from that conferred by Chapter X. In railroad reorganization, the division of creditors and stockholders "shall not provide for separate classification unless there be substantial differences in priorities, claims, or interests."[43] This qualification was added to obviate the difficulty of handling the large number of classes created by the complicated debt structures of large railroads.[44] The limitation has been construed to require creditors with short-term promissory notes, each secured by different collateral, to be combined in one class.[45] There are dicta in the same case seemingly outlawing classification on the basis of bias or difference of interest in the outcome.[46]

The provision probably does not, however, preclude the court from altering relationships by classification where equity seems to demand discrimination.

39. Section 197. See p. 883 *supra*.

40. See FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION (1939) 466. *Cf.* Friendly, *Some Comments on the Corporate Reorganizations Act* (1934) 48 HARV. L. REV. 39, 71, n. 123.

41. See Kullman v. Greenebaum, 92 Cal. 403, 28 Pac. 674 (1891). *Cf.* National Surety Co. v. Coriell, 289 U. S. 426, 437 (1933).

42. Section 203. See note 32 *supra*.

43. Section 77(c)(7).

44. See Craven and Fuller, *The 1935 Amendments of the Railroad Bankruptcy Law* (1936) 49 HARV. L. REV. 1254, 1265-67.

45. J. P. Morgan & Co. v. Missouri P. R. R., 85 F. (2d) 351 (C. C. A. 8th, 1936), *cert. denied*, 299 U. S. 604 (1936).

46. *Id.* at 352.

Unconscionable participation by a parent railroad in its mismanaged subsidiary seems subject to equity's scrutiny regardless of the extent of the judge's statutory power to classify.[47] Nor is it probable that the provision precludes subdivision of one economic group for purposes of different treatment. If a proposed plan meets the required test of being "fair and equitable,"[48] the fact that within one class different treatment is given should not void the plan. Otherwise, consummation of the plan, the primary objective of a reorganization, might be delayed because such a strict interpretation of the classification provision would preclude compromises. Furthermore, the need for permitting different treatment becomes greater when, by virtue of the classification provision, classes must be decreased in number and increased in size, thus throwing together what may be substantially similar economic claims but substantially dissimilar interests. Harmony within a class may be possible only by subdivision under the proposed plan.

Once separate treatment is accorded, separate voting would in all likelihood follow. But the judge could probably refuse to do so, and require all "classes" of the same economic interest to vote as a unit if there were indications that a separate group within one economic class might, were it allowed to vote separately, try to block the plan.[49] In any event, the judge has power, as under Chapter X, to force a plan on a dissenting class.[50]

Under Chapter XI, which provides for both individual and corporate arrangements, classification is within one single economic group, owing to the fact that neither secured claims nor perhaps equities in the debtor are affected.[51] But within the class of unsecured claims, classification is contemplated. Section 351 provides that "for the purposes of the arrangement and its acceptance, the court may fix the division of creditors into classes." There is obviously no question of the court's power to classify under Chapter XI. Rather the question is what limitations the court can impose on division into classes. In one of the first cases arising under this chapter, In re *United States Realty and Improvement Company*,[52] the proposed plan divided unsecured claims into two "classes,"[53] claims to be modified, and claims to be left unchanged. On the facts of the case, doubts exist whether the plan could

47. There is no reason to believe that the *Taylor* case [see p. 883 *supra*] would have been differently decided had it involved the reorganization of a railroad.

48. Section 77(e)(1).

49. The situation would be identical with that presented under Chapter X. See p. 885 *supra*.

50. Section 77(e). For a discussion of the problems related to this power, see MOORE'S BANKRUPTCY MANUAL (1939) 371-385.

51. Section 356. With reference to stock equities under Chapter XI, see the dissent of Judge Clark in *In re* United States Realty & Improvement Co., C. C. A. 2d, Jan. 15, 1940.

52. C. C. A. 2d, Jan. 15, 1940. See (1940) 49 YALE L. J. 927.

53. Quotation marks are used because for the purposes of the plan and voting, there is only one class, the affected group. Actually, there has been a division into "classes."

be confirmed as one which was "fair and equitable and feasible."[54] But that question was left until the plan should come up for confirmation.[55] In view of the fact that a plan might be discriminatory and therefore "unfair" to the creditors in the affected class,[56] it might seem appropriate to question and correct the classification immediately as an unreasonable one.[57] Under ordinary circumstances "equality is equity,"[58] and good reasons should exist for disregarding equal status. Power to do equity by classifying would seem to encompass refusal to divide as well as authority to divide.[59]

The preceding example is undoubtedly an extreme one of discrimination among unsecured creditors. The more likely classification under Chapter XI would be division into large and small creditors, the latter to be paid off in full in order to save the administrative costs of keeping them in the proceeding as claimants.[60] Compromise of disputed claims may appear by different treatment under a plan.[61] It is also quite possible for the court to admit a claim as bona fide but inequitable — for example, the claim of an overreaching dominant stockholder — and to announce that no plan would be approved which did not discriminate against the inequitable claim.[62] Any

54. Controversy exists over the import of these words in Chapter XI. See Rostow and Cutler, *Competing Systems of Reorganization: Chapters X and XI of the Bankruptcy Act* (1939) 48 YALE L. J. 1334, 1352–1362; (1940) 49 YALE L. J. 927, 930.

55. Perhaps the question must be left until confirmation. Under § 363 it appears that only the debtor can propose a modification of a plan. If re-classification under § 351 is a modification, then the judge might have to exercise his power by refusing confirmation.

56. See (1940) 49 YALE L. J. 927, 931.

57. It was assumed by the authors of the bill that the classification would have to be reasonable. See MOORE'S BANKRUPTCY MANUAL (1939) 665.

58. See note 5 *supra*.

59. *Cf. In re* Ogden Apartment Bldg. Corp., 90 F. (2d) 712, 715 (C. C. A. 7th, 1937), where the court held that a holder of a claim based on a void tax deed should be classed with holders of first mortgage bonds, saying: "Appellant cannot object to this classification rather than a separate classification since if it were allowed the latter, it would have to be in subordination to the bondholders, and . . . subordination of its claim would render its consent to the plan unnecessary. . . ."

60. *Cf.* Brockett v. Winkle Terra Cotta Co., 81 F. (2d) 949 (C. C. A. 8th, 1936), where the court did not object to having unsecured creditors paid in full and secured creditors take a loss. The reason given was that unsecured claims formed a small fraction of the total debt.

In addition to the small-large classification, the draftsmen of the bill suggested classifying bank creditors and merchandise creditors separately for different treatment. See MOORE'S BANKRUPTCY MANUAL (1939) 665. If by different treatment is meant only the method in which the two classes are satisfied, and not unequal treatment, the draftsmen were undoubtedly right. *Cf.* § 357(1). But in the absence of a dispute over the size of a claim or some inequity in equal treatment [see bank creditor example, *supra* p. 883], it is difficult to see how one group could be given less in amount than the other.

61. *In re* Burns Bros., 14 F. Supp. 910 (S. D. N. Y. 1936) is a § 77B case involving a compromise among unsecured creditors resulting in unequal treatment.

62. If no satisfactory plan is accepted, the court apparently must dismiss the proceedings because there is no provision allowing him to force a plan on dissenters. See

other inequitable situation, such as one where the arrangement leaves mismanaging stock interests in control or does not affect a disputed secured claim, manifestly cannot be rectified by classification under Chapter XI. Correction must depend on the effect to be given the power of the court to refuse confirmation because the plan is not "fair and equitable and feasible."[63]

The power to effect equitable distribution of assets in debtor proceedings through classification, though not yet greatly developed, gives every indication of becoming a strong weapon in the hands of bankruptcy courts. Although the practice of classification on all sorts of grounds which may be deemed equitable violates the mechanical terms of the rule of strict contractual priority represented by the *Boyd* case, in fact it complements that rule. Both the rule of the *Boyd* case and the body of cases concerned with classification are attempts to settle the sometimes complicated claims and counterclaims of a debtor proceeding in a manner which judges regard as equitable. In the absence of special, ad hoc factors of over-reaching or fraud, the rule-of-thumb stated in the *Boyd* case and its successors works well enough — claims are met in the order of their contractual priority, and within each level of the hierarchy, equal "pro rata" distribution obtains. But when rigid adherence is unjust, either because it restricts unduly the give-and-take of compromise or unjustly favors those whose actions do not entitle them to equality, the discretionary power of classification can smooth out inequities. In the last analysis, the priority rule and its corollary of equal treatment within a single economic group are based on the doctrine that to enforce contract rights is to do equity. Deference to contract rights when the result is manifestly unfair to some junior interest or unfairly distributes political power in the reorganization process would make the conduct of reorganization proceedings too mechanical. The power to classify will, in many instances, afford a flexible method by which a court can, when necessary, accommodate the priority rule to the practical considerations of reorganization.

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note 37 *supra*. Under § 361 the court can disqualify votes for acceptance which are not in good faith. *Cf. In re* Weintrob, 240 Fed. 532 (E. D. N. C. 1917) (under old § 12). But it does not appear to be given authority to disqualify dissenters.

63. See § 366(3). For the difficulties connected with making "fair and equitable" the same powerful weapon in the hands of a judge that it is under Chapter X, see Rostow and Cutler, *supra* note 54, at 1352-1362.