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RECENT ECONOMIC DEVELOPMENTS IN CORPORATE REORGANIZATIONS

BY STANLEY LAW SABEL*

The general scope of section 77B of the Bankruptcy Act has been widely examined.¹ The present writer is in accord with the conclusion that it "represents substantial advance in the practice of reorganization."² He has viewed it as a procedural reform which does not change greatly the substance of reorganization law.³ The fact that rules of the substantive law of reorganization lend themselves less readily to change seems a tribute to their inherent soundness in relation to economic theories underlying the social structure.⁴ However, the fact remains that either because of or in spite of the Corporate Reorganizations Act,⁵ the theories of reorganization law have not remained static. Indeed, by crystallizing the functions of the court, the Act has served to bring the really vital questions to the fore. These questions—basically economic—are two:

(1) When is it proper to reorganize? How long must a debtor continue to struggle before he may seek the beneficent arm of bankruptcy moratorium? How long must a creditor wait before he can ask for a re-shuffle?

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²Weiner, Corporate Reorganizations: section 77B of the Bankruptcy Act, (1934) 34 Col. L. Rev. 1173.

³Sabel, The Corporate Reorganizations Act, (1934) 19 MINNESOTA LAW REVIEW 34.

⁴"Notwithstanding the somewhat haphazard conditions under which reorganization processes have developed, the precedents and customs, arising outside of formal court procedure, yet acknowledged and approved by court decisions, have withstood changes in financial practice better than many other financial usages developed in the closing decades of the nineteenth century." Dewing, Financial Policy of Corporations, 3d ed., p. 1100.

⁵Bankruptcy Act, sec. 77B, 11 U. S. C. A. sec. 207; Mason's U. S. Code, supp. no. 3, tit. 11, sec. 207; hereinafter reference to portions of section 77B will be by subdivision.
(2) How is a debtor to be reorganized? What is fair and equitable for each class of claimants?

Each of these questions, which, it may be reiterated, are in the last analysis more economic than legal, may arise under the Act in a number of different ways. The answers, however, do not depend upon how the questions arise but tend to be uniform. The important questions remain when and how. The cases answering these questions not only give the crux of the current case law development under section 77B but also give interesting examples of legal rules being moulded by economic needs.

I. When a Corporation May Reorganize

Suppose: (1) A corporation with property worth $1,000,000 is indebted on a single bond issue which greatly exceeds this figure and is secured by a first mortgage on substantially all the corporate property. The bondholders have organized a protective group which (desiring foreclosure) opposes reorganization under section 77B and specifically objects to all plans proposed by the junior-lien or the equity holders.

(2) A corporation with property worth $1,000,000 has no secured debts outstanding. It has, however, unsecured claims against it which greatly exceed the value of its property. The unsecured creditors have organized a protective group which (desiring liquidation) opposes reorganization under section 77B and specifically objects to all plans proposed by the equity holders.

The first situation was never much trouble in receivership reorganizations. Mortgagees could always foreclose their mortgages. Such foreclosure was the normal way in which the old

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8Under sec. 77B the question of when to reorganize may arise under subdivision (a) in connection with a determination of "good faith;" it may arise under subdivision (c) (10) in connection with a determination of whether or not proceedings should be enjoined.

The question of how a corporation should be reorganized is primarily a question which would arise under subdivision (f) in connection with the confirmation of a plan of reorganization. It might, however, arise under subdivision (a) in determining the possibility of reorganization as bearing upon "good faith," or it might arise under subdivision (c) (10). Furthermore, subdivision (f) embodies references to subdivisions (d) and (e).

For example, if the court determines the debtor to be insolvent for the purpose of dispensing with stockholders' assents to a plan of reorganization, it would hardly regard a plan as unfair to stockholders. See, however, In re Reading Hotel Corp., (D.C. Pa. 1935) 10 F. Supp. 470, infra p. 137.

8Cravath, The Reorganization of Corporations; Bondholders' and Stockholders' Protective Committees; and Voluntary Recapitalization of Corporations, in Some Legal Phases of Corporate Financing, Reorganization and Regulation 153, 161.
line reorganizations were carried out. The first mortgagees could foreclose and if their bid was sufficient take over the mortgaged property and not allow other creditors or stockholders to participate with them in such property. Reorganizations, in which the other claimants were allowed to participate, were resorted to where the more spartan procedure was uneconomic.

The second situation was sometimes very troublesome. Where the corporation is insolvent in the bankruptcy sense, the appoint-

9"It rarely happens in the United States that foreclosures of railroad mortgages are anything else than the machinery by which arrangements between creditors and other parties in interest are carried into effect." Canada Southern Ry. v. Gebhard, (1883) 109 U. S. 527, 539, 3 Sup. Ct. 363, 27 L. Ed. 1020.


"In Railways Co. v. Union Trust Co., supra, the Supreme Court said: 'If the bondholder wishes to foreclose, and exclude inferior lienholders or general unsecured creditors and stockholders, he may do so.'

11Various reasons may be suggested: (1) The need for new money, (2) desire to include unmortgaged assets in the reorganization enterprise, (3) desire to avoid expensive and protracted legislation, (4) desire to preserve stockholders' goodwill in cases where stockholders are also customers.
ment of a receiver is an act of bankruptcy.\textsuperscript{12} It was because of the different definitions of insolvency prevailing in bankruptcy and in equity that all receiverships could not be upset in this manner.\textsuperscript{13} It was the danger of such attack that made the careful pleader in his petition for a "consent receivership" add to the statement of inability to meet debts as they matured an allegation of a surplus of assets over liabilities at a fair valuation.\textsuperscript{14} All this is elementary, but the haphazard procedural growth of the law which caused this peculiar situation was probably the outgrowth of economic realities.\textsuperscript{15} That is, if the difficulties which beset a particular business are temporary or due to maladjustments in capital arrangement, they should be adjusted by reorganization; if they are permanent and due to the enterprise being economically unjustifiable, the business should be liquidated asspeedily as

\textsuperscript{12}Bankruptcy Act sec. 3(b) subdivision (5). Prior to the amendment of 1926 this particular "act of bankruptcy" required that a receiver be appointed "because of insolvency." Such was not likely to be the case as equity receivers were not appointed because of insolvency in the bankruptcy sense. The amendment changed this. See National Refining Co. v. Penn Petroleum Co., (C.C.A. 8th Cir. 1933) 66 F. (2d) 914. However, insolvency need only exist at the time the receiver is appointed; in spite of sec. 3(c) of the Bankruptcy Act insolvency need not exist at the time of the filing of the petition. See West Company v. Lea, (1899) 174 U. S. 590, 19 Sup. Ct. 836, 43 L. Ed. 1098 (so holding in respect to a general assignment for the benefit of creditors).

\textsuperscript{13}"When the Bankrupt Act, then, uses the word 'insolvent' in describing an act of bankruptcy, the meaning to be given to the word is obviously the meaning that is demanded by the Bankrupt Act itself. It follows that a consent receivership, although instituted because of the corporation's insolvency as generally understood,—that is, because of the corporation's inability to pay its debts as they will fall due,—is not an act of bankruptcy. Hence the astute pleader who draws the bill of complaint for a consent receivership is careful to allege that the corporation's difficulties are due only to the fact that it is unable to meet its maturities, with the precautionary statement added that the total of the company's assets, at a fair valuation, is in excess of its liabilities. On a bill so drawn the corporation can be adjudged a bankrupt only if it is shown, dehors the record in the equity court, that, when the bill was filed, the corporation in fact was insolvent in the bankruptcy sense, that is, the total of its assets, at a fair valuation, was less than the sum of its debts. In that case, and then only, can it be said that the receiver was appointed 'while (the corporation was) insolvent', and hence an act of bankruptcy was committed." Glenn, The Law Governing Liquidation 278.

\textsuperscript{14}Supra, note 13. "On information and belief, the fair value of the assets of the defendant is in excess of the amount of its outstanding bonds, notes and other obligations and indebtedness, but the defendant has not now on hand sufficient moneys with which to meet its obligations now due and which will shortly become due and can now not realize sufficient money for such purpose through the sale of its properties or by borrowing further moneys." Bill of Complaint in American Steamship Company v. Wickwire Spencer Steel Company (D.C. N.Y. 1927) reprinted in Clark, A Treatise on the Law and Practice of Receivers, 2 ed., p. 1587, quoted portion at 1589.

\textsuperscript{15}See note 4 supra.
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possible. Temporary difficulties or capital maladjustment could usually be remedied before the enterprise became insolvent in the bankruptcy sense. Rarely where bankruptcy was available would all creditors agree not merely to an alternative method of liquidation but also to reorganization. Reorganization was usually limited to the situation where it was, roughly speaking, the best economic solution at hand.

How does section 77B affect these situations? As to the first, the Act provides that suits, pending or otherwise, to foreclose a mortgage may be enjoined and provides that a plan when confirmed is binding upon secured creditors. The alternative of unconditional foreclosure is thus apparently taken away. How does this affect the substantive rights of secured creditors? Where two-thirds of a class of secured creditors assent to a proposed...
plan, the substantive nature of the change depends upon how important one regards the protection given to minorities by the upset price under the old procedure.\textsuperscript{21} Where two-thirds of a class of such creditors have not assented, the situation becomes especially interesting. In the situation first supposed, it seems that the secured creditors are in effect the owners of the mortgaged property. (The value at which they can take it over will, of course, be determinative on the amount of their claim against unsecured assets—that, however, is not of immediate concern here.)\textsuperscript{22} Three of the methods provided in the Act for alternative satisfaction of creditors of a class of which less than two-thirds assent to a plan of reorganization fully recognizes the rights of the secured creditors in our first supposed case as owners.\textsuperscript{23} The fourth, providing satisfaction “by such method as will in the opinion of the judges, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection,”\textsuperscript{24} might mean anything. Viewing the rights in the security as substantive,\textsuperscript{25} it is arguable that this method does not add greatly to the other methods stated in the Act. This problem was before the court in \textit{In re Murel Holding Corporation}.\textsuperscript{26} The case involved an appeal from an order denying a motion to vacate a stay of a foreclosure suit. The order was reversed, the court holding in effect that the stay should have been vacated. The factual setup was very similar to that in our first supposed case with the secured creditors objecting to reorganization and wishing to proceed with foreclosure. It was

\textsuperscript{21} Weiner, \textit{Conflicting Functions of the Upset Price in a Corporate Reorganization}, (1927) 27 Col. L. Rev. 132; Sabel, \textit{The Corporate Reorganization Act}, (1934) 19 \textit{Minnesota Law Review} 34, 43 “... under the old practice a distributive share of the proceeds of a judicial sale was never an alternative in any true sense of the word.”

\textsuperscript{22} Weiner, \textit{Conflicting Functions of the Upset Price in a Corporate Reorganization}, (1927) 27 Col. L. Rev. 132, 147 points out that one function of the upset price is to determine the bondholders’ rights, qua deficiency judgment, against unmortgaged assets.

\textsuperscript{23} Subdivision (b) (5) provides for such alternative satisfaction “… if the property affected by such interests, claims, or liens is dealt with by the plan, either as provided in the plan (a) by the transfer or sale of such property subject to such interests, claims, or liens, or by the retention of such property by the debtor subject to such interests, claims, or liens, or (b) by a sale free of such interests, claims, or liens at not less than a fair upset price and the transfer of such interests, claims, or liens to the proceeds of such sale; or (c) by appraisal and payment either in cash of the value either of such interests, claims, or liens, or, at the objecting creditors’ election, of the securities allotted to such interests, claims, or liens under the plan, if any shall be so allotted. … .”

\textsuperscript{24} Subdivision (b) (5) (d).

\textsuperscript{25} See \textit{Oil Fields Syndicate v. American Improvement Co.}, (C.C.A. 9th Cir. 1919) 260 Fed. 905; note, (1932) 17 \textit{Minnesota Law Review} 47.

\textsuperscript{26} \textit{In re Murel Holding Corp.}, (C.C.A. 2d, Cir. 1935) 75 F. (2d) 941.
apparently urged that the plan favored by stockholders and by unsecured creditors would give "adequate protection" to the secured creditors in that it provided for full payment to them in ten years with interest in the meantime. The court held that such was not the meaning of the "adequate protection" clause, saying:

"In construing so vague a grant, we are to remember not only the underlying purposes of the section, but the constitutional limitation to which it must conform. It is plain that 'adequate protection' must be completely compensatory...."

The Murel Case illustrates the problem which confronts a court in determining whether to restrain foreclosure pending reorganization. It is, of course, always possible that eventually a plan may be proposed to which the requisite number of the class of secured creditors containing the objectors will assent.

How far should a court enjoin or continue an injunction against foreclosure because of this possibility? The courts which have considered this question answer that not for very long should a creditor's right to foreclose be restrained where there is not some showing that an acceptable plan will be forthcoming. Where there is nothing else shown, the situation is summarized very nicely in the language of the court in the Murel Case. "... A stay should never be the automatic result of the petition itself..."

27 In re Murel Holding Corp., (C.C.A. 2nd Cir. 1935) 75 F. (2d) 941, 942.

28 See In re Island Park Associates, Inc., (C.C.A. 2nd Cir. 1935) 77 F. (2d) 334. That case involved an appeal from several orders, one of which enjoined foreclosure. The debtor had proposed a plan which had not been affirmatively rejected by creditors. In affirming the orders below the court stressed this fact. "The class of creditors represented by the appellants can, if they wish, accept or reject it [the plan], but until they have had the opportunity to vote and express their decision, we should not reject the plan in advance of their consideration." In connection with the requirement in subdivision (a) that a petition or answer be filed in "good faith" a similar rationale has been suggested to the effect that a difference exists between non-action and affirmative disapproval. See Gerdes, "Good Faith" in the Initiation of Proceedings Under Section 77B of the Bankruptcy Act, (1935) 23 Geo. L. J. 417, 426-7: "If a petition under section 77B is filed by the required number of creditors holding the necessary amount of provable claims, it can not be said to have been filed in bad faith merely because the claims of the petitioning creditors represent but a small proportion of the total indebtedness of the debtor. The statute has set up definite requirements in this respect and if these requirements are met no valid objection may usually be made. But when the petitioners represent only a small proportion of the total claims against the corporation, and the proceedings are opposed in good faith by a majority of all the creditors, it is apparent that a feasible plan of reorganization will not be adopted and that the proceedings will be futile. In such a case, therefore, the petition should be dismissed."

29 In re Murel Holding Corp., (C.C.A. 2nd Cir. 1935) 75 F. (2d) 941, 943.
the court in *In re Coney Island Hotel Corporation.* In that case the lien holders were resisting 77B proceedings. The lower court had stayed a foreclosure suit. On appeal this order was reversed, the court saying:

"It is conceivable that when the plan of reorganization is submitted it may offer a sufficient substitute for the lien of the mortgage. We leave that question open to the consideration of the district court when the question arises. But as it now stands, the case is in line with *In re Murel Holding Corporation,* except that there is even less reason to grant a stay. The foreclosure was going on for nearly eighteen months before the petition was filed, and it had been possible to file it for nearly six months. No plan has been prepared; the debtor apparently supposed that the mere filing of the petition was enough to stop the foreclosure. This is not so."

This problem has arisen in different ways. In *In re 235 West 46th Street Co. Inc.,* commonly known as the *Paramount Hotel Case,* the first mortgage bondholders succeeded in getting the petition dismissed. Proceedings for reorganization had been brought by the debtor after a receiver of rents and profits had been appointed in a foreclosure proceeding in a state court. The trustee under the mortgage claimed that there was no equity in the property above the mortgage debt. Four plans of reorganization were presented, none of which met the approval of the court. The property had failed to earn taxes and interest on the first mortgage. The court said:

"It was the purpose of section 77B of the Bankruptcy Act to protect creditors and the debtor's equity in its property against possible injury traceable to frozen asset problems. If the owners of such interests are to be protected, it becomes their duty to formulate some plan which would result in the maximum safety and security for lienors and creditors of the debtor. A plan should be forthcoming with reasonable promptness; otherwise the debtor does not bring its case within the section.... We are not warranted in believing that there is a reasonable prospect for a reorganization beneficial to all. To grant more time, there must be a showing that there is a fair opportunity to sustain the appellee's claim that the corporation can be reorganized for the benefit of all. We think the liberal powers conferred by the section and their exercise in enjoining foreclosure of the first mortgage should no longer stay the appellants. It would be an abuse of the powers granted by section 77B, under the circumstances found in this case, to further

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9(C.C.A. 2nd Cir. 1935) 76 F. (2d) 126.
10(C.C.A. 2nd Cir. 1935) 76 F. (2d) 126, 127.
11(C.C.A. 2nd Cir. 1935) 74 F. (2d) 700.
12(C.C.A. 2nd Cir. 1935) 74 F. (2d) 700, 701-702.
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stay the appellants in the hope that eventually some other plan of reorganization might be proposed.”

A petition or answer under section 77B in order to be approved must be filed in “good faith.” 44 It is under this requirement that the remaining authorities are to be found establishing the proposition that in many cases the secured creditor’s right of foreclosure is still available. 45 A number of these “good faith” cases, in their holding that some showing of the possibility of a successful reorganization is necessary, are in point here. 46 They of course do not stand for the proposition that in order to support a petition a plan must already have been formulated. 47 Such is obviously not the spirit of the Act. They do mean, however, that junior creditors (or stockholders acting through the debtor) cannot in situations like the case first supposed, where they have no real equity in the assets, delay the rights of the real owners. 48 Such a holdup game does not constitute “good faith” as the courts view it. 49

44Subdivision (a).

45See note (1934) 48 Harv. L. Rev. 283, 293 reviewing many cases and suggesting that they go too far in allowing dismissal to be granted on a showing that petitioners cannot obtain the requisite percentage of backing to present or formulate a plan of their own. This overlooks the fact that to approve such a petition would serve no useful purpose.

46In re Texas Gas Utilities Co., (D.C. Tex. August 13, 1934) not officially reported, see C. C. H. Bankruptcy Law Service, new ed., par. 2688.01, 3014; In re Mo. Kan. Pipe Line Co., (D.C. Ill. 1934) (report of Special Master) not officially reported; In re Coronado Hotel Co., (D.C. Mo. 1934) not officially reported, see C. C. H. Bankruptcy Law Service, new ed., par. 3002; In re Electric Public Service Co. (D.C. Del. 1934) 9 F. Supp. 128; “A possibility of reorganization must exist to meet the test of good faith”; In re Bush Terminal Co., (D.C. N.Y. 1935) 10 F. Supp. 315; “If it becomes reasonably apparent, after a sufficient time, that no such plan can be presented, then it will be the duty of this court, on due notice, to dismiss the petition and relegate the debtor to such other procedure as may be found to be most applicable for a termination of the controversy in this court.” Manati Sugar Co. v. Mock, (C.C.A. 2nd Cir. 1935) 75 F. (2d) 284: “The question here is whether there may be reasonably applied to the debtor some feasible and practicable plan of reorganization. If not, there is no occasion to invoke the benefits of the Act. We do not mean to say that the petitioners cannot be heard unless they have a reorganization plan fully worked out and ready for immediate consideration, but it is essential to show that one may be forthcoming.” In re Grigsby-Grunow Co., (C.C.A. 7th Cir. 1935) 77 F. (2d) 200.


48The difference in such a situation lies in the affirmative dissent by a dominating class. See cases cited note 36, supra.

49See Judge Mack’s opinion in In re Associated Gas & Electric Co., (D.C. N.Y. 1934) not officially reported, see C. C. H. Bankruptcy Law
In the second supposed situation, where the corporation is insolvent in the bankruptcy sense and thus, theoretically at least, liquidation more fitting, the alternative of old line bankruptcy is limited by section 77B. Petitions or answers under section 77B may be filed in pending bankruptcy proceedings, and if approved the proceedings come under the new Act. Reorganization is now paramount to bankruptcy, and this remains so until the proceedings are dismissed. What of the second supposed situation, especially where the enterprise in question is economically unjustified? Aside from the possibility that creditors may successfully block any reorganization plan, it is obviously highly undesirable to allow reorganization moratoria to delay inevitable liquidation.

The Act provides that a voluntary petition or answer must state facts showing need for relief thereunder. So far the courts, ignoring this, have broadly placed this type of case along with types previously considered and hold that a petition showing no possibility of reorganization is not filed in "good faith." Cases where this reasoning is applied because of the existence of other liquidation or reorganization proceedings which may have continued for some time are especially analogous.

The only recognition which the older law gave to the proposition that an economically unjustifiable enterprise should not be

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Service, new ed., par. 3057, affirmed on reargument, see C. C. H. Bankruptcy Law Service new ed., par. 3085: "But even more than that, I think the requirement of good faith was intended to prevent strike suits against corporations. The requirement of good faith is aimed more than anything else at the racketeers both in and out of the legal profession, or to prevent racketeering through the use of legal process in the case of corporations which have because of the times reached a state of insecurity for the creditors."

Cf. note 16, supra; lack of ability to earn current operating expenses usually accompanies bankruptcy insolvency, see note 92 infra.

Subdivision (a).

Subdivision (b) (8).

Liquidation is inevitable when, as in our supposed case, a dominant class objects and it is not practicable to give such class alternative satisfaction without ending the possibility of reorganization. In re Murel Holding Corp., (C.C.A. 2nd Cir. 1935) 75 F. (2d) 941.

A creditors' petition need not show this; it must, however, show the existence of a pending bankruptcy proceeding or equity receivership or that the debtor has committed an act of bankruptcy, Subdivision (a).

This is probably because in many cases petitions are filed by creditors who, as noted in note 44, supra, need not allege need for relief. Thus in In re Grigsby-Grunow Co., (C.C.A. 7th Cir. 1935) 77 F. (2d) 200, all creditors except the petitioning creditors admitted that reorganization was impossible and that liquidation was inevitable. The court was forced to base its dismissal of the creditors' petition on the fact that it was not filed in good faith. See other cases cited in note 36, supra.

reorganized was in the rule that in certain situations bankruptcy was paramount. Thus it was that where an act of bankruptcy, such as the appointment of a receiver while the corporation was insolvent, had occurred, bankruptcy lay at the election of petitioning creditors. The law as it is developing under section 77B appears to give greater recognition to the economics of the situation. Regardless of insolvency in the bankruptcy sense, reorganization proceedings will only be dismissed where liquidation is the more economic solution.

Suppose: A corporation with property worth $1,000,000 has debts somewhat under this sum which for the most part are not presently due. The corporation has sufficient working capital to meet present interest obligations and current maturities, but the going seems hard from the stockholder's point of view. This may be taken as illustrating a situation not yet ripe for reorganization. Creditors have a right to insist that their debtor continue to struggle up to a certain point. This is illustrated in other fields of creditors' rights. It has until recently been something of an inarticulate premise in receivership cases. It is submitted that it formed part of the background for the early dicta limiting consent receivership. Recently the Supreme Court of the United States has expressed itself more definitely and finally it has made it clear that insolvency in the equity sense whether present or prospective is essential for this type of receivership.

There have been few cases on this under section 77B. Prospective insolvency three months off is apparently sufficient. On the other hand, it has been held that petitioners who bought bonds for the purpose of suit and waived the security thereon were not creditors at all. This is surprising in view of the broad provi-

sions in section 77B as to intervention which would seem greatly to reduce any danger of collusion. One court has said by way of dictum that a petition is not brought in "good faith" when brought against a corporation not in need of reorganization. A similar rule would probably apply to a voluntary petition. About all that can be said in answer to the supposed case is that where a corporation does not need reorganizing it should not be allowed to reorganize.

Under the old procedure the chief danger was thought to be that of collusion resulting in unneeded reorganizations involving unnecessary moratoria. The courts were careful to guard against this. The danger remains under the new procedure but in greatly reduced form. The chief danger now lies not in unnecessary

3rd Cir. 1934) not officially reported, see C. C. H. Bankruptcy Law Service new ed., par. 3024.

66Subdivision (a) and Subdivision (c) (11). Cf. In re Garment Center Capitol, Inc., (D.C. N.Y. 1935) not officially reported, see C. C. H. Bankruptcy Law Service, new ed., par. 3472, where the court denied an individual creditor leave to intervene, saying: "No facts are furnished to sustain an application to intervene. The petitioner, without intervention, is entitled to notice of hearing on any proposed plan of reorganization. The statute so provides. So far as concerns the facts disclosed the petitioner needs nothing but an opportunity to be heard on such a plan."

67In re South Coast Co., (D.C. Del. 1934) 8 F. Supp. 43. However, it is, of course, sufficient that the debtor is unable to meet its debts as they mature. Subdivision (a). Thus need for organization does not require bankruptcy insolvency. An interesting discussion of the economic background for this is found in Judge Chesnut's opinion in In re Kelly-Springfield Tire Co., (D.C. Md. 1935) 10 F. Supp. 414, 417. "The great purpose of the statute is to prevent a sinking corporation from drowning. And it is with that idea that the courts of the United States are instructed to lend their aid to save a financially drowning corporation. If they are dead, then, of course, there is only bankruptcy for them. But while there is life there is always hope, financially as well as physically. So that I do not think it is necessary that a corporation should have no hope whatever of successful financial rehabilitation in order to justify its coming into court. It is an old saying in the law that an ounce of prevention is worth a pound of cure, and I think that was the underlying thought of Congress in passing this legislation—it was to be of help to corporations and endeavor to rehabilitate them, having in mind that the best interests of their creditors lie along that line. Every one knows, of course, that every modern industrial enterprise of any size is of value only as a going concern. Bricks, mortar and machinery are a liability and not an asset unless they can be made productive, productive for the benefit of their wage employees, for the members of society in the community, to keep them off Relief rolls, and productive for the benefit of the proprietors of the business and for the purpose of paying interest on the organization's obligations. So it is very, very clear that in applying the substance or intention of this Act we do not have to wait until a corporation is absolutely insolvent." That a "solvent" corporation may reorganize if unable to meet its debts as they mature was held in In re New Rochelle Coal & Lumber Co. (C.C.A. 2nd Cir. 1935) 77 F. (2d) 881.

68See note 53, supra.

59See note 57, supra, the requirement of "good faith" in the Act pre-
reorganization but at the other end of the scale in reorganization where something more drastic is needed. The courts have made a sensible beginning in their interpretation of the restrictions which section 77B places on both foreclosure and old line bankruptcy liquidation. Several decades of judicial decisions have restricted equity receiverships as steps in reorganizations to situations where reorganization is economically desirable. We are now witnessing the beginning of a similar limitation of statutory reorganizations which would likewise limit such reorganizations to those economically desirable. The difference, of course, as already pointed out, is that the limitations on the new Act are to prevent its being used in place of foreclosure or liquidation where the latter are more desirable. The rules themselves cannot yet be reduced entirely to formula. Broadly speaking, it may be said that reorganizations, as always, should be limited to economically justifiable enterprises which could not get along without such adjustments. Detailed application of this general theory to situations under the new Act has already begun, and it is in such application as in those already examined that we find the beginnings of the answer to the question of when may a corporation reorganize.

II. How a Corporation May Reorganize

This topic includes chiefly a consideration of the fairness of a plan of reorganization in the broadest sense of that term. We have come a long way in reorganization law since it was first said that courts will not write reorganization plans for the parties. Nevertheless, although such plans even before the new

vent approval by the courts of petitions against corporations not in need of reorganization.

See cases cited in note 36, supra.

See discussion of first two supposed cases, pages 118 to 127, supra.

Ibid.

Ibid.

Subdivision (f) of the Act deals with confirmation of the plan. The provisions of this subdivision which are pertinent to our present problem are: "After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible; (2) it complies with the provisions of subdivision (b) of this section; (3) it has been accepted as required by the provisions of subdivision (e), clause (1) of this section; (4) the provisions of subdivision (e), clause (2) of this section have been complied with... (6) the offer of the plan and its acceptance are in good faith and have not been made or procured by any means or promises forbidden by this Act."

In Guaranty Trust Co. v. International Steam Pump Co., (C.C.A. 2nd Cir. 1916) 231 Fed. 594 the court affirmed the decree below and quoted the opinion of Mayer, District Judge, in which he said: "... courts are not
Act were subjected to increasingly close judicial scrutiny, it remained in the main true that courts would not write reorganization plans. The same is true under the new Act. Under a laissez faire economic regime anything else could not be imagined. No one would doubt that in the kindred field of new financing the allocation of securities between promoters, bankers and the ultimate furnishers of the new money is a matter for individual bar-empowered to make contracts for parties in interest, nor can courts adjudge or decree the terms upon which a mortgagee may allow to junior lienors, or others, participation in his mortgaged property when failure to pay the debt due him brings that property under the hammer.

"It is rare that any reorganization is satisfactory to all concerned; for, in the nature of things, when there is not on hand enough to satisfy every obligation in full, some, and perhaps all, must suffer more or less; but, in the absence of fraud in the inception or a fraudulent scheme to which court proceedings are necessary incidents, the field in which the battle for respective adjustments must be fought out is beyond the court room, for the court can only ask whether, without the aid of fraud or unlawful means, the debt is really and justly due.

"It is clear, therefore, that the court cannot directly or indirectly re-write this reorganization agreement and I should not state something so obvious, were it not for the fact that the argument, so urgently pressed, comes down to that. The charges of fraud and collusion are not only not sustained, but are affirmatively disproved, as the record abundantly shows."

Guaranty Trust Co. v. Chicago M. & St. P. Ry. Co., (D.C. Ill. 1926) 15 F. (2d) 434; Swaine, Reorganization of Corporations: Certain Developments of the Last Decade, in Some Legal Phases of Corporate Financing, Reorganization and Regulation, 146; Grange, Corporation Law for Officers and Directors 649-650: "The reorganization plan will usually be worked out either before or after the decree of foreclosure and sale, by the joint efforts of the protective committees representing the different classes of creditors and stockholders whose interests are affected, or by a joint committee made up of members of each of these protective committees. When the plan has been formulated, each protective committee submits it to the security holders whom it represents for approval—usually pursuant to a provision in the deposit agreement that unless notice of dissent is received within a certain time the depositor shall be deemed to have assented—and participation in the plan may also be invited on the part of those creditors and stockholders who have not deposited their securities with any protective committee. If the plan receives substantial support, it will be submitted to the court for its approval, and a hearing will be held at which persons objecting to the plan may present their arguments. If the court approves the plan, the sale is decreed or confirmed, as the case may be, and the property is conveyed to a new corporation formed for that purpose, which then issues its securities to the various parties in accordance with the terms of the plan."

The Act provides for the proposal of plans by creditors, stockholders and the debtor. It contains no provision for the proposal of a plan by the court. See subdivision (d).

That we are still under such a regime is clearly illustrated by the recent decision of the United States Supreme Court in Louisville Joint Stock Land Bank v. Radford, (U.S. 1935) 295 U. S. 555, 589, 55 Sup. Ct. 854, 863, holding unconstitutional the Frazier-Lemke Act, Bankruptcy Act, sec. 75(s), 11 U. S. C. A. sec. 203(s), Mason's U. S. Code, title 11, sec. 203(s) (July 1935 Year Book Vol. 7, No. 4.), as depriving secured creditors of specific property rights; "The bankruptcy power, like the other great substantive powers of Congress, is subject to the fifth amendment."
gaining. We have rules as to watered stock, promoters' liability, fraud, etc., which may affect the ultimate result. New Deal economics may require registration under the Securities Act and with the Securities Exchange Commission in sundry cases. The fact remains that determining the financial structure of the new company is largely a matter of individual initiative. The situation is very much the same in the case of a reorganization plan. The recent emphasis placed by the Supreme Court of the United States on the necessity in receivership reorganizations of considering the course and result of operations under the management of the receiver might suggest that a like reasoning be applied in determining values for purposes of 77B proceedings. In

70Fletcher, Cyclopedia Private Corporations, perm. ed., secs. 5199-5258.
75See note 69, supra. The court, however, in reorganizations under 77B assumed greater control of committees. Thus in In re Rosenbaum Grain Co. (D.C. Ill. May 27, 1935) not officially reported, see C. C. H. Bankruptcy Law Service, new ed., par. 3468, the court granted a petition requesting it to appoint a committee to represent creditors, and a committee to represent stockholders: "The court is generally in the dark as to the method of the organization of the committee and of the manner in which the committee conducts the affairs of the debtor. Likewise it can know little of the real merits of the plan of reorganization presented. The court must rely on the statements of interested parties, on the reports made by the committees, and the statements of creditors in open court. It is exceedingly important therefore that the court have its own representatives on the stockholders' and creditors' committees. Further, it is necessary that the court have control of the committee and have the right to remove any member who either through negligence or dishonesty fails to perform the duties of his office. In this case the court has such a representative on each committee and by the terms of the draft order presented, the creditors' committee as a whole is under the jurisdiction of the court. The order will be signed."
76National Surety Company v. Coriell, (1933) 289 U. S. 426, 53 Sup. Ct. 678, 77 L. Ed. 1300. See, however, In re New Rochelle Coal & Lumber Co., (C.C.A. 2nd Cir. 1935) 77 F. (2d) 881, where the court said: "Our attention is called to National Surety Co. v. Coriell, (1935) 289 U. S. 426, 53 Sup. Ct. 678, 77 L. Ed. 1300, where the court, in an equity receivership case, remanded to the district court for further proceedings the matter of reorganization, and criticized the terms of the reorganization in equity receivership there provided for. A reorganization under sec. 77B is statutory and where there has been compliance with the terms prescribed in the statute, it is sufficient.

"We think here that the determination that the plan was fair, equitable and feasible was reached only after full opportunity was accorded to creditors to voice their objections or suggest some more equitable terms. When that has been done, the statute has been complied with and the court is authorized to approve the plan. Order affirmed."
the main this would seem to be true. The argument that might be
drawn from it to the effect that values based upon earnings may be
determined more definitely in the case of enterprises that are be-
ing reorganized than in the case of new financing is fallacious. It
loses sight of certain types of new financing such as those in-
volved in the merger of several independent plants which have
long been in operation or the financing of certain types of public
utilities where the course of future operations can be forecast
with almost uncanny accuracy.\textsuperscript{77} Even in these situations the
parties write their own financial plans. So it is that under the
present economic regime the rule that \textit{reorganization plans should
be made by the parties} should continue as the cardinal rule of this
aspect of the topic.

The decision of the district court in \textit{In re Alleghany Corpora-
tion}\textsuperscript{78} illustrates this principle. The reorganization plan funded
five years of bond interest and the unsecured claims of certain
bankers with preferred stock, and provided for the paying off of
other unsecured creditors in cash. The court confirmed the plan,
saying it would disregard certain technical objections apparent to
any lawyer:

\begin{quote}
"I think you have to take this plan very largely as it is, by
reason of practical considerations; and I must insist from my
point of view that in a big situation like this you must deal with
the big features of it and not with the mere details. I am quite sure
that any of us that are legally trained would be able to suggest
other objections to this plan, or at least other improvements from
the standpoint of the bondholders, in detail."
\end{quote}

\textsuperscript{77}Dewing, Financial Policy of Corporations, 3rd ed., p. 178 et seq. and
199 et seq.

\textsuperscript{78}(D.C. Md. 1934) oral opinion, not officially reported.

Certain similar situations should be distinguished. Thus weighing
rival plans and determining which is fairest and most feasible as was done
by the Court in \textit{In re McCrory Stores Corp.}, (D.C. N.Y. Nov. 12, 1935)
not yet officially reported, See C. C. H. Bankruptcy Law Service, new ed.
par. 3698, does not amount to judicial plan writing. It might approach
this if a plan could be proposed by a sufficiently small interest. However,
under the act this is not so as only substantial interests can submit plans.
Subdivision (d). It would not seem likely that an alternative plan formally
proposed by the debtor itself would be judicially written. Likewise, modi-
fication of a plan along lines suggested by the court is not judicial plan
writing. Modifications of the plan were suggested by the court in \textit{In re
Middle West Utilities Co.}, (D.C. Ill. Nov. 6, 1935) not yet officially re-
ported, See C. C. H. Bankruptcy Law Service, new ed. par. 3671. Formally
such modifications are by the parties. As a matter of substance the changes
suggested in the case just cited were designed to meet certain specified
objections to the plan. The line is admittedly a hard one to draw, but
it would seem that pointing out how a plan is unfair and can be improved
is not the same as writing a plan. The changes so suggested carry no
judicial mandate.
Plainly the court did not regard the plan it confirmed as the best possible. It probably felt that it could have drawn a better one. The rule, however, is: the parties may reorganize any way they wish to so long as their plan is fair and complies generally with the Act. As to the actual plan in the Alleghany Case, payment of certain unsecured creditors in cash while funding bond interest in preferred stock seems somewhat arbitrary but was probably justified by the circumstances of the particular situation. The court referred to the advantage to the bondholders of not requiring immediate liquidation of their security. That alone would probably not have been sufficient to make the plan fair. The real justification was the comparative size of the respective classes. This practical consideration is doubtless what influenced the court. The situation was not unlike that existing in the case of "six months' claims." The case was affirmed on appeal; however, it is to be regretted that these points apparently were not raised or at least were not considered by the circuit court of appeals when the case came before it. At any rate, the lower court is to be commended for its eminently practical view of what is necessary in a reorganization plan.

Where the debtor is solvent in the bankruptcy sense, or at least has not been affirmatively determined to be insolvent in that sense, a reorganization plan should take some account of whatever equity there is for the stockholders. A plan not doing so would be unfair. This is not a situation where the bondholders may take over the entire property through foreclosure or liquidation. The most they can insist on against the equity holders is alternative satisfaction as provided in the Act. On the other hand, stockholders' assent to a plan of reorganization may be entirely dispensed with if the debtor is insolvent in

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7Spaeth & Friedberg, Early Developments Under Section 77B, (1935) 30 Ill. L. Rev. 137, 158, applies a de minimis theory to explain excessive preferences given in many plans to unsecured governmental claims.


9In re Hopkins Lake Drive Realty Corp. (D.C. Md. 1934) not officially reported, see C. C. H. Bankruptcy Law Service, new ed., par 3276: "Equity and fairness require the debtor corporation to discharge all of its original obligations which were incurred in good faith. The plan should be modified to provide for the payment of cumulative and unpaid interest before the equity in the property is turned over for possible liquidation to the ultimate owner of the equity." Cf. In re Reading Hotel Corp., (D.C. Pa. 1935) 10 F. Supp. 470.

10Cf. note 10, supra; also see discussion of first two suppositional cases in topic 1 supra.

11Subdivision (b) (5).
the bankruptcy sense. This very sensible rule is obviously based on considerations that in such a situation stockholders have no true equity in the property. As might be anticipated, the difficulty lies in determining insolvency. The bankruptcy definition of such insolvency—liabilities exceeding assets at a fair valuation—is not easy of application. Many different tests have been used by the courts in determining fair value. None of them is entirely satisfactory. They all involve an attempt to get a value higher than is obtainable by a forced or distressed sale. Until recently most of them have ignored the phrase “to pay his debts” in the bankruptcy definition of insolvency. The difference in the def-

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The language of the lower court in Stern v. Paper, (D.C. N.D. 1910) 183 Fed. 228, aff'd. (C.C.A. 8th Cir. 1912) 198 Fed. 642 seems susceptible of a construction that might indicate that the court viewed values as taken for the purpose of payment of debts: "'Fair valuation' within the meaning of subdivision 15 of section 1 of the bankruptcy act means a value that can
nitions of insolvency prevailing in equity and in bankruptcy has been noted already. Neither the equity nor the bankruptcy definition of insolvency accurately expresses the popular meaning of that term. To a business man a business has either failed or it has not failed. He is apt to apply either legal test according to which seems appropriate in a given situation. The economist uses the same common sense approach as the business man. To him, too, a business is insolvent when it has failed. Regardless of the cause of the financial difficulty, a business may be said to have failed when it no longer can go on with any chance of success.

The Supreme Court of the United States as far back as 1900 recognized the connection between the two legal tests of insolvency. "Inability to pay debts in the ordinary course of business," the court said, "usually accompanies an insufficiency of assets." By this statement the supreme court clearly showed that lack of working capital (which is really determinative of equity insolvency) was an important factor in determining bankruptcy insolvency. Other federal cases have recognized this.

This type of valuation problem was before the district court of Indiana in In re Studebaker Corporation. The question was the insolvency of the automobile manufacturing company there involved. There was practically no market for its plant as a single unit. A valuation could not be arrived at by capitalizing earnings as the corporation was losing money. Break-up value was clearly less than the outstanding indebtedness. The situation was illus-

be made promptly effective by the owner of the property ‘to pay his debts’.

The fifth circuit definitely adopted this construction in Mitchell v. Investment Securities Co., (C.C.A. 5th Cir. 1933) 67 F. (2d) 669; "Statutory as well as commercial insolvency arises out of, and consists in, inability to pay debts. One is insolvent under the statute when his assets, if converted into cash, at a fair not forced sale will not pay them. In both cases solvency is tested by ability to pay debts, in the one case promptly, in the other, in time. In testing both kinds of insolvency, the realities of the situation control. In both kinds it is the actual, rather than the theoretical, condition of the debtor which determines it." (Italics ours.)

Note 13, supra.


The court took a practical view of the situation and dispensed with stockholders' assent to the plan on the ground that the Studebaker Corporation was insolvent.

"A person or corporation is therefore insolvent when he or it is unable to pay debts, and this inability to pay debts is not temporary, through lack of ready funds, but permanent through lack of assets convertible in a reasonable time, not necessarily at forced sale, but nevertheless within a reasonable period. Insolvency under the statute and from a commercial standpoint results from inability to pay. If the assets will not sell on the market within a reasonable time for enough to liquidate the debts, insolvency exists."06

The test thus applied is close to the economic concept, which likens insolvency to business failure, for a business has certainly failed if it cannot be liquidated within a reasonable time for a sufficient amount to pay its debts.

95 Spaeth & Friedberg, Early Developments Under Section 77B, (1935) 30 Ill. L. Rev. 137, 166, 167: "... it is apparent that the difficulty of proving insolvency will constitute a major obstacle in the path of foreclosing creditors in the reorganization of the utilities and larger industrials." The functional analysis of the Studebaker case suggested by Messrs. Spaeth and Friedberg is broad enough to apply to every reorganization where, broadly speaking, the public has an interest in the continuance of the business: "In the Studebaker case two appraisals were made by the receivers; the first gave Studebaker a going concern value of approximately nineteen and one-half million dollars, the second, based on liquidation value and 'assuming that liquidation would be made under conditions where the receivers would have definite knowledge that it was impending for some time in advance of it being generally known, and that liquidation would be completed within a period of eighteen months,' valued the property at fourteen and three-quarter million dollars. As the liabilities totalled over twenty million dollars, Studebaker was 'obviously insolvent' only by the liquidation test. With out referring to the going concern valuation, the court found the corporation insolvent, stating that when 'the assets will not sell on the market within a reasonable time for enough to liquidate the debts, insolvency exists.' The court was obviously much influenced by the practical consideration that, if shareholders were permitted to vote, further delay and expense would result for an industry which it was in the public interest to restore to normal activities as quickly as possible." Cf. the views expressed infra page 138 as to stockholders coming ahead of outsiders.

96 (D.C. Ind., 1935) 9 F. Supp. 426, 427. See In re Reading Hotel Corp., (D.C. Pa. 1935) 10 F. Supp. 470, 471. The Master's report found debtor insolvent. The court overruled exceptions based upon claims that future potential value should be considered in arriving at insolvency: "The more strongly urged exceptions raise the question that the Master declined to add to the fair value thus found a potential value which is really based upon a guess (perhaps not altogether unjustified) that the hotel, by reason of a past history of wide advertisements, good management, and excellent reputation will, when times improve, make money for its then owners. In effect the exceptant proposes a new definition of insolvency for that term as it is used in section 77B. There is nothing in that amendment however which shows any intention to modify the definition of the original act. Under any rule of statutory interpretation this would be a sufficient answer."
CORPORATE REORGANIZATIONS

It thus seems that concerns which have economically failed as distinguished from those merely in economic difficulties can be reorganized without stockholders' assent. This is the very type of business that, as we have previously seen, should be liquidated rather than reorganized. The real economic need where creditors do not insist on taking the property by foreclosure or otherwise liquidating it is, of course, new money. Stockholders are usually the best and often the only source of new money. The stockholders in such a situation still have some rights. This is illustrated by In re Reading Hotel Corporation. There the court found the debtor to be insolvent but expressly left open the question of whether or not stockholders were entitled to be heard on a question of fairness:

"Although, if the corporation is insolvent, a stockholder should not ordinarily participate in the assets of the reorganized company without a new contribution, it may be that considerations of fairness require stockholders to be given preferential rights (as against outsiders) to come into the new enterprise upon terms. Without attempting to go further into the matter, there may be other points from which stockholders of an insolvent corporation may challenge the fairness of a plan. It is sufficient to say the Act clearly does not intend them to be wholly disregarded for every purpose from the moment a finding of insolvency is made."

The creditors cannot object to this. The situation is really in their control. If enough creditors or classes of creditors had resisted reorganization, they could probably have obtained foreclosure or liquidation as they might desire. That is the purport of the first group of cases considered.

That the doctrine of the Boyd Case is applicable to reorganiza-

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97 See note 84, supra.
98 That is, where a dominating class of creditors are opposing reorganization. See discussion of first two supposititious cases in topic I, supra.
100 See note 98, supra.
101 Ibid.
tion under section 77B is, of course, obvious. This has been recognized clearly by writers on the subject and by case authority. The "fixed principle" of the Boyd Case never went further than preserving a rough semblance of the relative status between the various classes of creditors and stockholders. It never required that anything be given to the lowest class in a particular case. It has been seen that in many cases fairness under section 77B may require that something be given to every class of creditors and stockholders. The amount which would have to be given to stockholders if such a theory should fully develop is, of course, variable. In a sense, such a development would be along the general line of the Boyd Case. Just as creditors come ahead of stockholders, stockholders come ahead of the general public. Like the Boyd Case doctrine, it would not require the impossible. The beginning of the development of such a rule may be one of impelling factors behind the increasingly wide use of warrants in corporate reorganizations. Such warrants when issued to stockholders give them a chance to share in the enterprise if it turns out profitably. Though the use of such warrants cannot entirely displace shorter term rights which must necessarily be used

104In re Hopkins Lake Drive Realty Corp., (D.C. Md. 1934) not officially reported. "Equity and fairness require the debtor corporation to discharge all of its original obligations which were incurred in good faith. The plan should be modified to provide for the payment of cumulative and unpaid interest before the equity in the property is turned over for possible liquidation to the ultimate owner of the equity."
106See note 10, supra.
109The Associated Telephone Utilities Company reorganization is typical of the treatment given security holders in reorganizations of large public utility holding companies. The plan provided for all series of preferred stockholders and common stockholders receiving warrants, in various proportions, which in effect constituted calls for the stock of the new General Telephone Corporation (the Corporation formed to carry out the Plan) good until November 1, 1948. See Petition of Reorganization Committee for confirmation of plan, filed March 15, 1935 (order entered May 13, 1935).
110Ibid.
111Thus the preferred stockholders in the Associated Telephone Utilities Company Reorganization were also given rights, in different proportions...
where immediate new money is needed, they serve in many cases to give the stockholders something more tangible.\footnote{112} They place the stockholder ahead of the outsider for a longer period. Implications from the dicta in the Reading Hotel Case would carry the "fixed principle" in the Boyd Case further than it has been carried hitherto. Still further developments may be expected. Fairness will probably never become an entirely static concept. The yardstick for determining fairness will still continue to be a variable one, depending as it does on the economics of a particular situation.\footnote{113} Perhaps this will always be so. However, as economic requirements develop into rules of law it should at least become possible to formulate the yardstick for the particular situation with greater ease.

\footnote{112}{However, the price should be such as not to prevent new financing by the sale of stock.}

\footnote{113}{The writer has recently expressed it: "We constantly search for some way of formulating a yard stick with which to measure all corporate reorganization plans. We can formulate such a yard stick for a particular situation—a simple plan against which to test all others. As for a general yard stick (and that is what a yard stick should be), it has been aptly said that yard sticks which can now be formulated resemble degrees of latitude which vary with the longitude—in other words, it is the particular situation which governs." Book Review (1935) 30 Ill. L. Rev. 254, 255.}

according to which class of preferred stock they held, to units consisting of one share of new three dollar preferred stock and one share of new common stock. Such rights "to expire sixty days after formal announcement that new securities provided for by the Plan are available for distribution." Petition, id. 10.