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BANKRUPTCY- MUNICIPAL REORGANIZATION - FAIRNESS OF PLAN

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BANKRUPTCY — MUNICIPAL REORGANIZATION — FAIRNESS OF PLAN — A local government district, finding itself hopelessly in debt, filed a petition for relief under Chapter IX of the Bankruptcy Act as amended.[1] The municipal debt composition plan provided that bondholders would receive eight cents on the dollar. The evidence showed that a considerable quantity of bonds were bought by local landowners at much more than eight cents on the dollar, evidently for the purpose of being used in getting the approval of some such plan as proposed, in the expectation of an increase in value of their lands by improvements to be made by the debtor through a loan from the Reconstruction Finance Corporation. The plaintiff bondholders opposed adoption of the plan on the ground of discrimination in favor of those holders who also owned land in the district. *Held*, the plan discriminated against bondholders not owning land in the district; the landowning bondholders should either have been excluded from participation in determining the requisite percentages of assenting bondholders, or else there should have been a separate classification whereby those creditors owning no lands could have voted and been recorded as such. *Kaufman County Levee Improvement District No. 4 v. Mitchell*, (C. C. A. 5th, 1941) 116 F. (2d) 959.

The approach of the courts to the question of fairness of plan in municipal reorganizations has been greatly influenced by their experience with equity receiverships and reorganization of private corporations under section 77B and now under Chapter X of the present Bankruptcy Act.[2] In the field of corporate reorganization, the question of fairness has resolved itself mainly into one

[1] 50 Stat. L. 654, §§ 81-83 (1937), as amended by 52 Stat. L. 939, § 3 (a) (1938), 11 U. S. C. (Supp. 1939), §§ 401-404. Sec. 83 (e), 11 U. S. C. (Supp. 1939), § 403 (e), provides, in part: "At the conclusion of the hearing, the judge shall make written findings of fact and his conclusions of law thereon, and shall enter an interlocutory decree confirming the plan if satisfied that (1) it is fair, equitable, and for the best interests of the creditors and does not discriminate unfairly in favor of any creditor or class of creditors. . . ." This provision stands in the amendments of 54 Stat. L. 44 and 668 (1941).

[2] 27 CAL. L. REV. 740 at 741 (1939); American United Mutual Life Ins. Co. v. City of Avon Park, (U. S. 1940) 61 S. Ct. 157, noted in 54 HARV. L. REV. 690 (1941); 27 VA. L. REV. 544 (1941); MOORE, BANKRUPTCY MANUAL 437, 578 (1939).

of maintaining "relative" or "absolute" priorities between the various classes of creditors and stockholders.[3] Thus, bankruptcy courts were committed to a strict rule of equality between creditors before the problem arose under the municipal composition section of the act[4] and this principle was adopted by Congress in Chapter IX by the express provision against unfair discrimination.[5] Because there has been very little litigation under Chapter IX or its predecessors[6] on the question what constitutes a "fair and equitable plan" for the protection of the interests of creditors in a composition agreement,[7] the very recent Supreme Court ruling in *American Mutual Life Insurance Co. v. City of Avon Park*[8] and the decision in the principal case are of great importance in indicating the tests for the validity of a municipal debt composition. In the *Avon Park* case, the action of a fiscal agency in securing approval of a municipal composition without disclosing various pecuniary interests of its own[9] was severely criticized by the Supreme Court in reversing the lower court's approval of the plan. The Court made it clear that there is responsibility in a bankruptcy court to scrutinize carefully the circumstances surrounding the acceptances, the special or ulterior motives which may have induced them, the time of acquiring the claims so voting, and the amount paid therefor. "Where such investigation discloses the existence of unfair dealing, a breach of fiduciary obligations, profiting from a trust, special benefits for the reorganizers, or the need for protection of investors against an inside

[3] In the case of Northern Pacific Ry. v. Boyd, 228 U. S. 482, 33 S. Ct. 554 (1913), the Supreme Court adopted a rule to the effect that a reorganization plan was fair if the "relative" priority between the various classes of creditors and stockholders was maintained. Subsequently a stricter "absolute" priority rule appears to be required by the Supreme Court, speaking through Justice Douglas, in Case v. Los Angeles Lumber Products Co., 308 U. S. 106, 60 S. Ct. 1 (1939). The latter rule of strict "absolute" priority was reaffirmed by the Supreme Court in the very recent case of Consolidated Rock Products Co. v. Du Bois, (U. S. 1941) 61 S. Ct. 675, where the Court held that the "absolute" priority rule applies to reorganizations of solvent as well as to insolvent corporations, and protects the interest as well as principal of bonds.

[4] The idea of a fair plan in corporate reorganization as laid down in Northern Pacific Ry. v. Boyd, 228 U. S. 482, 33 S. Ct. 554 (1913), was carried over into the field of bankruptcy reorganization. 27 CAL. L. REV. 740 at 741 (1939).

[5] Quoted in note 1, supra.

[6] Prior to Chapter IX, a similar statute had been declared unconstitutional in Ashton v. Cameron County Water Improvement District No. 1, 298 U. S. 513, 56 S. Ct. 892 (1936), but the immediate predecessor of Chapter IX, called the Municipal Debt Composition Act, 50 Stat. L. 653 at 654 (1937), 11 U. S. C. (Supp. 1939), §§ 401-404, has been sustained by the Supreme Court. United States v. Bekins, 304 U. S. 27, 58 S. Ct. 811 (1938).

[7] American United Mutual Life Ins. Co. v. City of Avon Park, (U. S. 1940) 61 S. Ct. 157. For definitions of "fairness" under a similar provision in the previous act, see In re Merced Irrigation District, (D. C. Cal. 1939) 25 F. Supp. 981; In re Drainage District No. 2 of Ada County, Idaho, (D. C. Idaho, 1939) 28 F. Supp. 84.

[8] (U. S. 1940) 61 S. Ct. 157.

[9] The fiscal agency had three financial stakes in the composition: (1) the fee to be collected from bondholders, (2) speculative position as to interest accruals bought at a discount, (3) speculative profit as a result of refunding of bonds bought at default prices.

few or of one class of investors from the encroachments of another, the court has ample power to adjust the remedy to meet the need." [10] The doctrines so expounded by the Supreme Court were heavily relied upon by the circuit court of appeals in the principal case in adjudging that the landowning bondholders obtained an unfair and inequitable advantage over nonlandholding creditors of the same class. This would seem to be a very justifiable application of general reorganization bankruptcy principles. A composition should not be confirmed where one creditor has obtained some special favor or inducement not accorded to others.[11] In determining whether there is discrimination among creditors, courts of bankruptcy have not hesitated to probe the circumstances surrounding the composition to see if inequality exists.[12] If it be said that there is no express authority for such action, it may be argued that the bankruptcy court is a court of equity,[13] and therefore in the exercise of its jurisdiction may grant or deny relief upon the performance of a condition which will safeguard the public interest.[14] The limitation of the vote to the amount paid for securities,[15] the separate classifications of claimants,[16] the complete subordination of some claims,[17] indicate the range and power which a bankruptcy court may exercise in these proceedings. A review of these cases leads one to the conclusion that municipal reorganizers must look to the principles established for reorganizations under Chapter X as well as to the cases under the municipal composition section in determining "fairness" of a plan thereunder.

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[10] American United Mutual Life Ins. Co. v. City of Avon Park, (U. S. 1940) 61 S. Ct. 157 at 162.

[11] In re Weintrob, (D. C. N. C. 1917) 240 F. 532; In re M. & H. Gordon, Inc., (D. C. N. Y. 1917) 245 F. 905. But a composition of debts of a drainage district is not unfair for failing to give a first in time bond issue priority over subsequent issues where all of the bondholders acquiesced in treating the bonds on a parity. Luehrmann v. Drainage District No. 7 of Poinsett County, Arkansas, (C. C. A. 8th, 1939) 104 F. (2d) 696, cert. denied sub nom. Haverstick v. Drainage District No. 7 of Poinsett County, Arkansas, 308 U. S. 604, 60 S. Ct. 141 (1939).

[12] National Security Co. v. Coriell, 289 U. S. 426, 53 S. Ct. 678 (1933); Case v. Los Angeles Lumber Products Co., 308 U. S. 106, 60 S. Ct. 1 (1939).

[13] 52 Stat. L. 842, § 2 (1938), 11 U. S. C. (Supp. 1939), § 11. See also American United Mutual Life Ins. Co. v. City of Avon Park, (U. S. 1940) 61 S. Ct. 157.

[14] Securities and Exchange Commission v. United States Realty & Improvement Co., 310 U. S. 434, 60 S. Ct. 1044 (1940); Pepper v. Litton, 308 U. S. 295, 60 S. Ct. 238 (1939).

[15] In re McEwen's Laundry, (C. C. A. 6th, 1937) 90 F. (2d) 872.

[16] First National Bank of Herkimer v. Poland Union, (C. C. A. 2d, 1940) 109 F. (2d) 54.

[17] Taylor v. Standard Gas & Electric Co., 306 U. S. 307, 59 S. Ct. 543 (1939); Pepper v. Litton, 308 U. S. 295, 60 S. Ct. 238 (1939).