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COLLATERAL LIABILITIES UNDER SECTION 77B

Homer Kripke *

THE passage of section 77B of the Bankruptcy Act[1] in 1934 suggested to some lawyers the possibility of using the section as a means of modifying or eliminating the responsibility of persons collaterally liable on obligations for which the corporation to be reorganized or its property was also responsible. The question arose in two common types of situations: (1) guaranties of payment of dividends on capital stock; (2) liability for payment of the bonds or other indebtedness of corporations. In either of these situations, can the liability of persons other than the corporation be discharged or modified by reorganization of the corporation under section 77B of the Bankruptcy Act?

I

Suppose *X* has guaranteed payment of dividends on a class of stock (usually preferred stock) of *Y* corporation. A reorganization of *Y* corporation is effected with the result that the preferred stock is eliminated from the capital structure. What is the effect on *X's* promise?

A carefully drawn guaranty can be conceived under which *X's* obligation to pay dividends if *Y* corporation does not would survive destruction of the stock. Especially might this be so in the case of a guaranty for a definite period of time. Such might be the result, for instance, if the guaranty was in the following form:

> "I, *X*, promise that if *Y* corporation does not pay dividends equal to $6 per share on its preferred stock annually for ten years, then I will pay to the holders of preferred stock certificates a sum equal to the amount of such dividends."

Liability on a guaranty with language only slightly changed, however, would not survive retirement or destruction of the capital stock. *Lorillard v. Clyde*[2] presented the following situation: Plaintiffs and defendants had effected a merger of their competing shipping lines under a contract which vested control in defendants, who guaranteed to plaintiffs dividends on stock of the merged corporation at a fixed rate for seven years. At the instigation of plaintiffs, the corporation was

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[1] 48 Stat. L. 911, 11 U. S. C., § 207.

[2] 142 N. Y. 456, 37 N. E. 489 (1894).

dissolved two years before the end of the seven-year period. Plaintiffs sued on the guaranty for dividends during the two years after dissolution. The court said that the contract contained no explicit statement covering the contingency which had arisen. However, the guaranty was in form a promise that the dividends of the corporation should annually for seven years equal a certain sum, and not a promise for a payment of that sum, and the court therefore concluded that a guaranty of *dividends* implied the existence of a corporation capable of earning and declaring dividends. Accordingly, it held that the guaranty was conditioned on the continued life of the corporation during the seven years. While there are few cases on the point, it is believed that most courts would follow *Lorillard v. Clyde* by reading into the guaranty a condition that the stock remain outstanding.[8]

If *X's* guaranty is expressly conditioned by such language as "so long as said preferred stock shall be outstanding," the obligation will

[8] One method by which it might be held that the obligation of *X* survived destruction of the stock would be a holding that *X's* obligation was one not of guaranty but of insurance. In several English cases a distinction between guaranty and insurance has been made, and in some of these it was held that the undertakings were contracts of insurance and not of guaranty, and, therefore, that they survived the destruction of the principal obligations. Shaw v. Royce, Ltd., [1911] 1 Ch. 138; Finlay v. Mexican Inv. Corp., [1897] 1 Q. B. 517; Dane v. Mortgage Insurance Corp., [1894] 1 Q. B. 54. The undertaking in each of these cases (although in some of them the obligee was referred to as the insured and the contract as a policy of insurance) followed substantially the following type form:

> "The society *guarantees* to the registered holder of the above debenture the payment of the principal moneys and interest to become due under the said debenture in manner following, that is to say: (1) as to interest if and whenever the company makes default in the payment of any interest for more than thirty days the society will pay such interest on demand; (2) As to principal, if the company makes default in the payment of principal moneys or any part thereof, the society will pay any loans upon whichever of the days following shall first happen, namely. . . ."

On the other hand, in another English case, In re Denton's Estate, [1904] 2 Ch. Div. 178, a bank which had loaned £4,000 and then "insured" the indebtedness with the defendant corporation brought suit on the obligation, which provided that upon specified default and after notice the defendant would pay the principal moneys due under the mortgage. This obligation was said to be one of suretyship and not of insurance, the court distinguishing the case from Dane v. Mortgage Insurance Corp., [1894] I Q. B. 54. Certainly it seems that if any distinction should be drawn, the Denton case should be held to be one of insurance, while the first cases cited should be considered cases of guaranty. This at least would conform to the language of the obligations themselves. However, in an American court not habituated to the niceties of distinction taken by English judges, it is questionable whether any of the obligations in these cases would have been construed as contracts of insurance instead of guaranty.

be terminated when the reorganization terminates the existence of the stock. Such an express condition is found in the cases of *Mason v. Standard Distilling & Distributing Co.*[4] and *Bijur v. Standard Distilling & Distributing Co.*,[5] both of which arose out of the same transactions. Each suit was upon a guaranty of the defendant endorsed on each share of preferred stock of another corporation to the effect that defendant guaranteed and agreed to pay specified dividends to the certificate holder of record "so long as said certificate shall be outstanding." In each case the defendant set up in defense the fact that the corporation whose stock was guaranteed had been dissolved. It was held in each case that, since the corporation was dissolved, the certificates were no longer outstanding and the guaranty had terminated.[6]

Suppose *X's* guaranty of dividends on the preferred stock of *Y* corporation does not specify the duration of the guaranty. The guaranty will not survive the termination of the stock itself.[7]

Possible deliberate use of corporate reorganization to eliminate a guaranty of dividends on corporate stock suggests two additional questions.

(1) What if the guarantor is the instigator of the reorganization proceedings? In *Mason v. Standard Distilling & Distributing Company*[8] the court held (this being the only question presented on the pleadings) that the bare fact that the dissolution had been accomplished in part by the action of the defendant guarantor did not estop the defendant from setting up as a defense the fact of the dissolution and the consequent termination of the guaranteed stock. The court intimated that if the act of the defendant was conceived and carried out to relieve it of its guaranty, then such act would amount to a fraud and the holders of the guaranty would have a cause of action for whatever damage they suffered thereby. Probably the court's suggestion should be confined to situations in which guarantors force into dissolution corporations whose financial situation would not otherwise

[4] 85 App. Div. 520, 83 N. Y. S. 343 (1903).

[5] 74 N. J. Eq. 546, 70 A. 934 (1908).

[6] Compare In re Pettingill, (D. C. Mass. 1905) 137 F. 143, in which it was suggested in passing that a guaranty of dividends on preferred stock "until stock is retired" would have been made definite and certain, so as to permit proof of the obligation in bankruptcy proceedings against the guarantor, if the corporation whose stock was guaranteed had gone into bankruptcy first.

[7] See Oppenheimer v. Bobb, 10 La. App. 79, 120 So. 523 (1929); Tilton v. Whittemore, 202 Mass. 39, 88 N. E. 329 (1909); Butterworth v. Tellier, 185 Ark. 357, 47 S. W. (2d) 593 (1932).

[8] 85 App. Div. 520, 83 N. Y. S. 343 (1903).

have warranted dissolution. It should not apply to situations where guarantors in good faith and justifiably under the circumstances inspire dissolution of corporations. In *Bijur v. Standard Distilling & Distributing Co.*[9] it was held that the guarantor might properly exercise its right as a stockholder to vote for dissolution of the corporation, the stock of which it had guaranteed, even though dissolution would terminate liability on the guaranty.

(2) Suppose a stockholder refuses to participate in the reorganization, to accept new securities, or to surrender his old stock certificates, and brings suit on the guaranty. The certificates should be held to be no longer outstanding after the particular class of stock has ceased to exist by virtue of the reorganization.[10]

II

X is jointly liable with *Y* corporation on a bond, or has guaranteed the bond; or *X* is the original obligor on bonds secured by mortgage, and *Y* corporation, either with or without assumption of the debt, is now the owner of the mortgaged property. As to *Y* corporation, the court has jurisdiction to reduce the debt or extend its maturity, or both, or cancel it substituting new securities therefor. Likewise, the lien may be discharged or modified. What effect would a reorganization providing either for cancellation of the original bonds, or for an endorsement therein reducing their amount, have upon the liability of *X*? What would be the effect of an express provision in the plan discharging *X*?

By subdivision (k) of section 77B of the Bankruptcy Act[11] all other provisions of the act except those inconsistent with section 77B are made applicable to proceedings instituted under that section. Section 16 of the act[12] provides that the liability of a codebtor with the bankrupt may not be altered.[13] While these provisions of the statute

[9] 74 N. J. Eq. 546, 70 A. 934 (1908).

[10] Mason v. Standard Distilling & Distributing Co., 85 App. Div. 520, 83 N. Y. S. 343 (1903).

[11] 48 Stat. L. 911 at 921, 11 U. S. C., § 207 (k).

[12] 30 Stat. L. 550, 11 U. S. C., § 34 (1898): "The liability of a person who is a co-debtor with, or guarantor or in any manner a surety for a bankrupt shall not be altered by the discharge of such bankrupt."

[13] Under section 76 of the Bankruptcy Act [48 Stat. L. 925, 11 U. S. C., § 204 (1934)] extensions pursuant to the *foregoing* provisions of the chapter shall extend the obligations of co-debtors. The reference to *foregoing* provisions makes this section inapplicable to section 77B.

Representative Celler introduced into the House of Representatives on May 23,

are admittedly troublesome, some lawyers hoped immediately after the passage of section 77B that the provisions might not be an insuperable obstacle to attempts to affect the liability of codebtors by reorganization of the corporation. The case of *Shaw v. Royce, Ltd.*[14] afforded justification for the hope. The trust deed involved in that case provided that holders of three-fourths of the indebedness secured thereby might assent to any compromise between the mortgagor and the debenture holders which the court would have jurisdiction to sanction under the English Joint Stock Companies Arrangement Act of 1870.[15] In consideration of any annual premium, the trustee under the indenture had guaranteed therein payment of the debentures. Pursuant to the above-mentioned provision of the trust deed an arrangement was worked out between the mortgagor, the trustee, and three-fourths of the debenture holders under which the annual premium was to be discontinued, the trustee released from the guaranty, and unguaranteed new securities with a higher rate of interest issued. A debenture-holder who had not consented to the arrangement brought suit for a declaration that the arrangement did not bind him, or that the trustee was still liable on the guaranty, or for an injunction restraining the mortgagor from consenting to the arrangement. The court held that the contract of the trustee was one of insurance and not of guaranty, so that mere termination of the mortgage debt would not destroy the trustee's liability,[16] but it further held that, since under the trust deed plaintiff was bound by the arrangement, which required acceptance of new unguaranteed securities, the liability of the trustee would be terminated. The court said it would have power under the Arrangement Act to sanction an arrangement of this type.[17]

1935 (74th Cong., 1st sess., H. R. 8179) a bill to amend Section 77B of the Bankruptcy Act so as to provide for release or substitution of existing guarantees on outstanding securities or obligations of the debtor; to authorize the enjoining of suits against persons secondarily liable on obligations of the debtor; to provide for discharge of such persons; and to provide that any extension of obligation of the debtor should extend the obligation of any persons secondarily liable. This bill died in committee.

[14] [1911] 1 Ch. 138.

[15] 33-34 Vict., c. 104 (1870).

[16] See note 3, supra.

[17] [1911] 1 Ch. 138 at 148-150: "That brings me to the real question: Is this transaction, which the debenture-holders have purported to sanction, within the provisions of sub-clause 4 of clause 14 of the fifth schedule; is it one to which the majority can bind the minority; in other words, is that which has been sanctioned an 'arrangement or compromise' to be made between the company and the debenture-holders which the Court would have jurisdiction to sanction under the Joint Stock Companies Arrangement Act, 1870, or any statutory modification thereof, if the company were being wound up? I think it is. The position at the time when this arrangement

So far as the writer knows, there was at the time of the passage of section 77B no other case either supporting or opposing the conclusion that a court had jurisdiction under section 77B, by modifying a corporate liability through reorganization, to alter the liability of someone other than the corporation. Since that time three cases have been decided by the circuit courts of appeals indicating that the im-

was made was this: The company and the debenture-holders had a society in liquidation as their trustee. The debenture-holders had, as their guarantor, a society in liquidation. The company were liable to go on paying the premiums to the liquidating society. I *quite agree that the company might have ceased to pay premiums and the society might have ceased to be trustee and yet the guarantee would have been effective at the suit of a debenture-holder.* But it seems to me that, granting that, we still have a position, not only as between the society and the debenture-holders, but as between the company and the debenture-holders, which was, to use the phrase in the deed, capable of 'arrangement.' Whether the transaction could be called a compromise may be a matter of doubt, but I think on consideration that the position of affairs was one which could properly be said to be the subject of arrangement. *Then is it an arrangement between the company and the debenture-holders? I think plainly, when properly regarded, it is an arrangement between them.* The company give to the debenture-holders something which they did not have before, namely, the extra 10s. per cent, representing the amount of the premium which the company would have had to pay to the society. On the other hand, the company get the advantage of putting an end to the sinking fund. The company and the debenture-holders get as trustees two gentlemen of whom they both approve in place of the liquidating society, and then as a term, without which that arrangement between the company and the debenture-holders cannot be carried out, the company stipulates that the society shall be released from its guarantee. *Now, does the fact that the company stipulates for something which affects an outsider prevent the entire arrangement from being not only an arrangement between the company and the debenture-holders,* but an arrangement arising out of circumstances existing between the company and the debenture-holders which call for arrangement? *I do not think it does.* I think the existence of the guarantee and the fact that without its release the society would not withdraw from their position as trustees, or give up their right to receive the 10s. per cent from the company, was merely one of several incidents in the position which gave rise to the necessity for an arrangement. In my opinion, therefore, assuming that in order that a transaction may be an arrangement or compromise within this clause of the deed it must be something other than a mere agreement for which there was no necessity or occasion, except the desire of the two parties to enter into it, I think in this case there was in the relation between the two parties and in the position in which they were severally placed, sufficient occasion for an arrangement, if not an arrangement and compromise, between those parties. But that is not quite enough. One must go a little further, because there is a proviso in this clause 4: 'Provided that it is one which the Court would have jurisdiction to sanction under the Joint Stock Companies Arrangement Act, 1870, or any statutory modification thereof if this company were being wound up.' *Now, would the Court have had jurisdiction to sanction this agreement? It had been decided over and over again that the Court has power to sanction an arrangement between a company and secured creditors.* That means that it has power to sanction an arrangement which involved the giving up of the existing security and the acceptance of a different one. *Can it have any less jurisdiction—it is not a question of whether it thinks proper to do so, but can it have less jurisdiction to sanction an arrangement because it contains a stipula-*

plications of the *Royce* case will not be followed under section 77B.[18] In *In re 1775 Broadway Corporation*[19] the proposed plan of reorganization provided for release of the trustee under a note issue of the debtor corporation from all liability in tort in connection with the issue. The chief sources of potential liability were charges of misrepresentation in selling the notes, and of mismanagement of the collateral security for the note issue. In consideration of the release the trustee was to make a loan to the debtor. The trial court struck out these provisions of the plan, without prejudice to the right of the noteholders' committee to make a contract to release the trustee as to the deposited notes; but on resettlement of the order the court forbade the committee to give any releases. On appeal, the circuit court of appeals affirmed the order in this form. It held that the trial court did not have jurisdiction over nonassenting noteholders to release tort claims against the seller of the notes; but that the court's control over the committee gave it power to forbid the committee to release the claims. Claims arising from misrepresentation in the sale of notes were said not to be claims against the debtor or its assets nor claims that had to be settled in order to bring property into the reorganized company. Indeed, it was said that the trustee could be compelled to transfer the property, leaving these claims undetermined and outstanding. The court held, however, that the claim against the trustee for mismanagement of the trust could be ordered released if the trial court was satisfied that it was fair to do so, and that sufficient consideration was paid therefor; because such a release pertained to the trust res to be turned over in the reorganization.

Some of these conclusions appear to have been reached without adequate consideration. If there was no jurisdiction to approve a plan providing for release of claims against the trustee for misrepresentation, and if settlement of these claims was unnecessary to reor-

tion which the company think necessary to make, and which the debenture-holders who voted in favor of it think it in the interest of the debenture-holders to accept? *I cannot see why that stipulation should render the agreement one which the court would have no jurisdiction to sanction.*" (Italics added.)

It will be seen from this quotation that the trustee in this case was insolvent. While this fact influenced the determination that the arrangement was advisable, the circumstance could not have conferred jurisdiction where none otherwise existed, although, as the court intimates, it might justify an arrangement which would otherwise be considered improper.

[18] In re 1775 Broadway Corp., (C. C. A. 2d, 1935) 79 F. (2d) 108; In re Nine North Church Street, (C. C. A. 2d, 1936) 82 F. (2d) 186; In re Diversey Bldg. Corp., (C. C. A. 7th, 1936) (not yet reported).

[19] (C. C. A. 2d, 1935) 79 F. (2d) 108.

ganization of the debtor, then the court's jurisdiction of the noteholders' committee ought not to extend so far as to empower the court to forbid the committee to arrange a settlement with the trustee, a matter which likewise could be of no concern in the reorganization. Similarly, so far as the claims against the trustee for mismanagement of the trust res were claims of the noteholders and not of the corporation, the court could not have taken jurisdiction, consistently with the rest of its decision, to settle these claims in the reorganization.

The most important holding in the *1775 Broadway* case, namely, that the court has no jurisdiction in the plan to provide for release of collateral liabilities, was reaffirmed by the same court in *In re Nine North Church Street, Inc.*[20] Simplifying the facts of that case for present purposes, it may be said that it involved a guaranty by the Maryland Casualty Company of payment of a bond secured by a trust mortgage. On default in the payment of the bond, the Maryland Casualty Company caused title to the mortgaged property to be transferred to a wholly-owned subsidiary corporation, which one week later filed a section 77B proceeding. In that proceeding an injunction was issued against prosecution of a pending suit in a state court against the Maryland Casualty Company on its guaranty. A plan of reorganization was confirmed in the section 77B proceeding, providing for an extension of the debt, reduction of the interest, and modification of the guaranty. Appeals were taken from the order granting the injunction and the order confirming the plan of reorganization. Both decrees were reversed. The circuit court of appeals said:

> "By its guaranty, Maryland promised to meet certain obligations and these are not affected by the reorganization of this debtor. Any modification of this contract can only be justified by the bankruptcy power which extends only to the relief of insolvent or hard pressed debtors. If Maryland is in that class, it must come into court and establish the fact. *It cannot modify its obligations by the reorganization of other insolvents.*"[21]

In reversing the injunction decree, the court relied on section 16a of the Bankruptcy Act,[22] as indicating that Congress conceived that the alteration of the guarantor's liability is not necessary to the discharge of the bankrupt; and pointed out that the plaintiffs in the state court action were not interfering with reorganization of the debtor, but were

[20] (C. C. A. 2d, 1936) 82 F. (2d) 186.
[21] (C. C. A. 2d, 1936) 82 F. (2d) 186 at 188 (italics added).
[22] Quoted in note 12, supra.

prosecuting a personal action against the Maryland Casualty Company.

The *Nine North Church* case was recently followed in the seventh circuit by the case of *In re Diversey Building Corporation.*[23] The court there held that the trial court had had no jurisdiction to provide in the plan for release of the guarantor of the debtor's bonds and, therefore, although no appeal had been taken from the order of confirmation, an order enjoining enforcement of a judgment against the guarantor should be reversed. The decision is based not only on the ground that there was no jurisdiction under section 77B to affect the guarantor's liability, but also on the ground that under section 265 of the Judicial Code[24] a federal court may not enjoin proceedings in a state court except as provided in the Bankruptcy Act.

These three cases are the only reported cases found under section 77B which directly pass upon this question. An unreported case arising out of a reorganization in the northern district of Illinois, eastern division, is also of interest. A plan of reorganization under section 77B was confirmed which expressly released the liability of a guarantor of mortgage bonds (an individual) and provided for cancellation of the bonds and an issuance of new certificates of stock in exchange therefor. A bondholder who had knowledge of the proceedings did not participate therein or consent to the plan, nor did he surrender his bonds for cancellation or accept new certificates. On the contrary, he brought suit on his bond against the guarantor in the municipal court of Chicago.[25] An affidavit of merits was filed, which pleaded the section 77B proceedings providing for release of the guaranty as res adjudicata. The court sustained a motion to strike the affidavit of merits and entered judgment for the plaintiff. An appeal to the appellate court of Illinois is pending.

It is believed that the conclusion of these cases is sound.[26] While they indicate the legal rules, much can be accomplished as a practical

[23] (C. C. A. 7th, 1936). Not yet reported.

[24] 36 Stat. L. 1162, 28 U. S. C., § 379 (1911).

[25] Gottlieb v. Crowe and Stoll, Municipal Court of Chicago, First District, No. 2775071 (1936).

[26] It is possible that, because a court in a section 77B proceeding has jurisdiction of a bondholder as a creditor of the debtor or its property, the consummation of the plan, which gives to the bondholders new securities in lieu of the liability of the debtor or its property, is, to the extent of the value of the new securities, a satisfaction of the debt, whether the securities are accepted or not. To the extent of that satisfaction, the claim against the collateral obligor is reduced. Obviously, a holding to this effect would be vastly different from a holding that the new securities must be accepted in complete satisfaction of the creditor's rights against all parties liable for the debt. The point was not raised in any of the cases discussed.

matter. Any bondholder who surrenders his original securities for cancellation under the plan and accepts new securities, possibly also any bondholder who consents to a plan expressly modifying a collateral liability,[27] can no longer enforce the collateral liability. No doubt a federal judge would and should be alert to see that no liabilities are surrendered gratuitously. In many cases in the northern district of Illinois, eastern division, the judges have eliminated provisions for release of trust deeds and discharge of the liability of the debtor on the bonds without cancellation of the bonds themselves, so that the liability of other parties thereon might be preserved. If the party collaterally liable offers to contribute to the reorganized corporation consideration for release of his liability, the court may well be disposed to permit a provision for such release to remain in the plan so as to bind any bondholders who consent and accept the consideration offered. Such arrangements have been worked out in some reorganizations.[28] It should be said again, however, that any such provisions will be binding only on security holders who consent to the plan and to the release. Rights of creditors of the debtor against other parties cannot be impaired in reorganization proceedings without their consent.

[27] At least if the party collaterally liable has offered in the plan consideration for modification of his liability. This qualification is made because, in the absence of consideration, his consent alone will not bind the bondholder on contractual principles, and we are assuming that the court's order is void and is not effective per se as a release.

[28] See Shaw v. Royce Ltd., [1911] 1 Ch. 138, discussed above.