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REORGANIZATION WITHOUT CONSENT OF CREDITORS - SECTION 77B (b) (5)

REORGANIZATION WITHOUT CONSENT OF CREDITORS — SECTION 77B (b) (5) — On May 15, 1936, the Circuit Court of Appeals for the Seventh Circuit denied a petition for leave to appeal from an order confirming a plan of reorganization under Section 77B[1] of the Bankruptcy Act in the case of *In re Garfield Arms Hotel Building Corporation.*[2] The property of the debtor, consisting of a furnished hotel building, was encumbered by a first mortgage bond issue of $254,500 with interest at six and one-half per cent in default since October 16, 1929. There was a second mortgage of $50,000 and accrued interest as well as approximately $22,000 in judgments against the debtor. The unpaid taxes exclusive of interest and penalties approximated $30,000. The property was placed in the hands of a receiver under a decree entered in first mortgage foreclosure proceedings on March 31, 1931, but no progress had been made toward a reorganization prior to the filing of a petition under Section 77B. The original plan

[1] 48 Stat. L. 912, 11 U. S. C., § 207 (1934).

[2] (C. C. A. 7th, May 15, 1936) No. 5879, not yet reported. Facts and holding obtained from the attorneys for the bondholders committee.

of reorganization gave the first mortgage bondholders ninety-one per cent of the stock in a new corporation while the remaining nine per cent was to be divided among the junior interests (including stockholders of the debtor). It was accepted by more than two-thirds of the creditors of each class and by all of the stockholders of the debtor. This plan was later amended to eliminate participation by any interests junior to the first mortgage.[3]

After a hearing on the amended plan, the court adjudged the debtor insolvent[4] and the value of all the property to be not in excess of $140,000. At the same time the court ordered that notice should be given to all creditors and stockholders of the debtor to the effect that any creditor or stockholder who had theretofore accepted the plan of reorganization should be deemed to have accepted the plan as modified unless any such creditor should withdraw.[5] The holder of the second mortgage withdrew his acceptance of the original plan. The order of confirmation found that less than two-thirds in amount of the junior lienors had accepted the plan as amended and that the interests, claims and liens of all creditors of the debtor junior to the first mortgage bondholders were valueless. The order provided, however, that upon any party in interest or any third party tendering the principal and interest of the first mortgage as a first bid at a sale of all of the property of the debtor free and clear of liens, a sale would be ordered by the court.

The holder of the second mortgage petitioned for leave to appeal

[3] The available report does not indicate why the original plan of reorganization was never consummated. Since the value of debtors' assets was approximately one-third of the bondholders' claims, it is reasonable to assume that the court opposed any participation by junior creditors and stockholders.

[4] If the debtor is insolvent in the bankruptcy sense, the consent of stockholders to the plan is not required. 48 Stat. L. 918 (1934), as amended by 49 Stat. L. 965, 11 U. S. C., § 207 (e) (Supp. 1935). It is generally conceded that the provisions of Section 77B binding dissenting stockholders are valid. See Kaplan, "Is Section 77B a Proper Part of a Bankruptcy Act?" 21 A. B. A. J. 47 at 49 (1935); Garrison, "The Power of Congress over Corporate Reorganizations," 19 VA. L. REV. 343 (1933). In Campbell v. Alleghany Corp., (C. C. A. 4th, 1935) 75 F. (2d) 947, the court stated that Section 77B was just as valid as applied to stockholders as to creditors.

[5] 48 Stat. L. 919, 11 U. S. C., § 207 (f) (1934), provides that a plan may be modified "subject to the right of any creditor or stockholder who shall previously have accepted the plan to withdraw his acceptance, within a period to be fixed by the judge and after such notice as the judges may direct, if, in the opinion of the judge, the change or modification will be materially adverse to the interest of such creditor or stockholder, and if any creditor or stockholder having such right of withdrawal shall not withdraw within such period, he shall be deemed to have accepted the plan as changed or modified." Where modifications or changes have concerned minor matters the courts have denied second voting privileges, but if there is a change in the security rights of creditors, the plan must be resubmitted. For a collection of cases on this point, see 49 HARV. L. REV. 1111 at 1184 (1936).

from the order of confirmation, relying upon *In re Tennessee Publishing Co.*[6] and *Louisville Joint Stock Land Bank v. Radford.*[7] In a brief memorandum opinion the court dismissed the petition stating in part:

> "In view of the fact that these claims (first mortgage and taxes) are greatly in excess of the debtor's assets, as found by the court on uncontradicted evidence so that there would be nothing to distribute to petitioner and other creditors whose claims are inferior to those mentioned, consent of the junior creditors was not necessary for the confirmation of the plan."

The rulings of the Supreme Court in *Continental Illinois National Bank & Trust Co. v. Chicago, R. I. & P. Ry.*[8] and other decisions[9] clearly indicate that Section 77B will be upheld in so far as it binds creditors who belong to a class two-thirds of which have accepted the plan of reorganization.[10] But more doubtful constitutional questions

[6] (C. C. A. 6th, 1936) 81 F. (2d) 463, noted 84 UNIV. PA. L. REV. 780 (1936).

[7] 295 U. S. 555, 55 S. Ct. 854 (1935), noted 35 COL. L. REV. 1136 (1935).

[8] 294 U. S. 648, 55 S. Ct. 595 (1935).

[9] In In re Central Funding Corp., (C. C. A. 2d, 1935) 75 F. (2d) 256, noted 83 UNIV. PA. L. REV. 914 (1935), the district court approved a plan accepted by 94 per cent of the bondholders and ordered the trustee under the mortgage to turn over the collateral it held to a new corporation organized under the plan. The court ruled that Section 77B was within the power of Congress to enact "uniform Laws on the subject of Bankruptcies." U. S. Constitution, Art. I, § 8, cl. 4. In Campbell v. Alleghany Corp., (C. C. A. 4th, 1935) 75 F. (2d) 947, a plan was proposed for the purpose of readjusting over a five-year period the interest payments on a single issue of collateral trust convertible bonds and was accepted by holders of 77 per cent of the bonds. The court in sustaining the confirmation of the plan upheld the validity of Section 77B. It reasoned that it was not "arbitrary" to compel secured creditors to scale down their debts in proportion to the shrunken value of their securities in accord with the "wishes of the great majority of those who have a common interest" in the property of the debtor. The court further reasoned that this in effect was depriving the objectors merely of their right to hinder the majority. See 49 HARV. L. REV. 1111 at 1185 (1936).

[10] It has not been seriously disputed that Section 77B in its general scope represents a constitutional exercise of the bankruptcy power of Congress. It is essentially the same as Section 77 [47 Stat. L. 1474 (1933), amended by 49 Stat. L. 911, 11 U. S. C., § 205 (Supp. 1935)], which has been approved by the Supreme Court. Continental Illinois Nat. Bank & Trust Co. v. Chicago, R. I. & P. Ry., 294 U. S. 648, 55 S. Ct. 595 (1935). See Swaine, "Federal Legislation for Corporate Reorganization; An Affirmative View," 19 A. B. A. J. 698 (1933); Kaplan, "Is Section 77B a Proper Part of a Bankruptcy Act?" 21 A. B. A. J. 47 (1935); Weiner, "Corporate Reorganization: Section 77B of the Bankruptcy Act," 34 COL. L. REV. 1173 (1934); Gerdes, "Constitutionality of Section 77B of the Bankruptcy Act," 12 N. Y. UNIV. L. Q. REV. 196 (1934).

For the contrary position see Stebbins, "Constitutionality of the Recent Bankruptcy Law," 17 MARQUETTE L. REV. 163 (1933).

present themselves where the consent of two-thirds cannot be obtained.[11] The question arises whether the court under Section 77B can confirm, over the objection of a class of junior creditors, a plan of reorganization which provides for participation only by senior creditors.[12] Under the statute a plan may provide "adequate protection" for a dissenting class of creditors 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; or . . . by such method as will in the opinion of the judge, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection."[13] These provisions had been considered previously,[14] but in *In re Tennessee Publishing Co.*[15] the Circuit Court of Appeals for the Sixth Circuit in sweeping language declared subsection (b) (5) of Section 77B unconstitutional[16] in so far as it attempted to bind a dissenting class of creditors. The decision was based squarely on *Louisville Joint Stock Land Bank* v. *Radford.*[17]

[11] Most authorities have not made any clear distinction between provisions for binding the dissenting minority in a class which has consented and those for binding a class without consent. No previous statutes have attempted to bind creditors without majority assent, except the Frazier-Lemke Act, 48 Stat. L. 1289, 11 U. S. C., § 203 (s) (1934), which was held unconstitutional in Louisville Joint Stock Land Bank v. Radford, 295 U. S. 555, 55 S. Ct. 854 (1935), noted 35 COL. L. REV. 1136 (1935).

[12] See 48 Stat. L. 918 (1934), as amended by 49 Stat. L. 965, 11 U. S. C., § 207 (e) (1) (Supp. 1935), and 48 Stat. L. 920, 11 U. S. C., § 207 (g) (1934).

[13] 48 Stat. L. 914, 11 U. S. C., § 207 (b) (5) (c)-(d) (1934).

[14] In In re Murel Holding Corp., (C. C. A. 2d, 1935) 75 F. (2d) 941, the court disapproved of a plan advanced by the debtor and stockholder-junior mortgagee. The senior lienors were unwilling to accept the proposed moratorium. Judge Learned Hand in dismissing a stay against a foreclosure suit in a state court, ruled that Section 77B was not intended to deprive secured creditors of their rights for the benefit of junior creditors "unless by a substitute of the most indubitable equivalence." Similarly, in the case of In re Preble Corp., (D. C. Maine, 1935) 12 F. Supp. 1002, the court refused to accept a plan which provided that dissenting holders of first mortgage bonds were to receive the appraised value of their claims. The court intimates that Section 77B would be unconstitutional if it provided "a right to arbitrarily appraise a whole class of creditors out of the picture." See Sabel, "Recent Economic Developments in Corporate Reorganizations," 20 MINN. L. REV. 117 (1936).

[15] (C. C. A. 6th, 1936) 81 F. (2d) 463, noted 84 UNIV. PA. L. REV. 780 (1936).

[16] The court declared that the right to file the petition might have been denied on the ground that it was not filed in "good faith" as required by subsection (a), since there was no reasonable expectation of a successful rehabilitation. The court, however, felt obliged to pass on the constitutionality of the section in order to forestall future plans which might satisfy the "good faith" requirements.

[17] 295 U. S. 555, 55 S. Ct. 854 (1935), noted 35 COL. L. REV. 1136 (1935). The parallel between this case in which the Supreme Court held the Frazier-Lemke Act [48 Stat. L. 1289, 11 U. S. C., § 203 (s) (1934)] unconstitutional and In re

The court in the *Tennessee Publishing Company* case[18] seems to ignore the distinction between the two situations which may arise under subsection (b) (5) of Section 77B.[19] In the first class of cases, the shareholders or the minor creditors are seeking to have a plan of reorganization confirmed without the consent of the senior lienors. In the second class, the senior lienor classes have proposed, or at least have accepted, a plan to which the consent of two-thirds of certain subordinate classes cannot be obtained.

The *Tennessee Publishing Co.* case was of the first type. The outstanding bonds alone totalled more than three times the value of the property. Furthermore, the plan presented by the stockholders was not approved by any bondholders, and about fifty per cent of the unsecured creditors affirmatively opposed the plan. To permit stockholders to override the interests of creditors in this manner would involve precisely the sort of unwarranted taking of property which was condemned in the *Radford* case. To permit junior creditors to prevail over senior lienors would be only slightly less obnoxious.

In the second class, no case has been found previous to the decision in the principal case in which a federal circuit court has held that a junior lienor class can be completely eliminated at the request of a senior lienor class without the consent of the former. In the case of *In re Witherbee Court Corp.*,[20] where the property of the debtor was found to be worth $300,000 with a first mortgage indebtedness of $437,000, the District Court for the Southern District of New York confirmed a plan providing for a participation only by first mortgage bondholders and eliminating all junior interests. The language used by the court was:

> "The moment it is proved that the value of the debtor's property is less than the first mortgage, no reorganization can be tolerated that gives an interest to junior parties unless they pay fair value in cash or property. More than two-thirds of the bondholders have accepted the plan. . . . Acceptances of the plan by others than first mortgage bondholders are unnecessary."

The court reached a similar conclusion in the case of *In re William Penn Garage*.[21] It has been suggested that authority for this procedure

Tennessee Publishing Co., (C. C. A. 6th, 1936) 81 F. (2d) 463, is by no means exact. The Frazier-Lemke Act did not provide for a judicial finding of fairness by the court, while Section 77B (b) (5) requires that a plan of reorganization must "equitably and fairly" provide "adequate protection" to creditors.

[18] (C. C. A. 6th, 1936) 81 F. (2d) 463.

[19] 48 Stat. L. 914, 11 U. S. C., § 207 (b) (5) (1934).

[20] (D. C. N. Y. 1935) C. C. H. Bankruptcy Law Service, par. 3727.

[21] (D. C. Pa. 1935) C. C. H. Bankruptcy Law Service, par. 3649. The court confirmed a plan which provided for the elimination of all interests junior to the first

can be found in Section 77B, subsection (e), providing that the assent of creditors whose claims are not affected by the plan is not necessary.[22] Such a solution has not been mentioned in the cases which have considered the point. The court in the principal case seems willing to place the decision on the ground that the junior creditor class has secured "adequate protection" as required by subsection (b) (5).[23] Thus, it was argued that "adequate protection" must be "completely compensatory."[24] Since the district court found the petitioners' claim to be of no value, there was nothing for which he was entitled to compensation.

Furthermore, the court in its order provided for a public sale of the property if any interested party could be found willing to buy the property at a price sufficient to satisfy the claims of the first mortgage bondholders. Where the claims of such prior lienors are far in excess of the value of the property, such a provision for sale seems rather a futile gesture.[25] It seems, however, to give the junior lienors some protection[26] against an erroneous appraisal. If this privilege is limited to a reasonable time[27] it cannot be seriously prejudicial to the prior lienors. But to go further and hold with the *Tennessee* case that the junior creditors can permanently obstruct a reorganization which does not win consent of two-thirds of each class of creditors, without regard to the value of the assets of the debtor, cannot be "fair and equitable." It is, indeed, precisely the sort of thing which, in a different form,

mortgage of $583,000 where the real and personal property of the debtor was found to be worth $206,436.

[22] 48 Stat. L. 918 (1934), as amended by 49 Stat. L. 965, 11 U. S. C., § 207 (e) (Supp. 1935).

> "(e) (1) A plan of reorganization shall not be confirmed until it has been accepted . . . by or on behalf of creditors holding two-thirds in amount of the claims of each class whose claims have been allowed and would be affected by the plan. . . *Provided, however*, That such acceptance shall not be requisite to the confirmation of the plan by any creditor or class of creditors, (a) whose claims are not affected by the plan. . . ."

[23] 48 Stat. L. 914, 11 U. S. C., § 207 (b) (5) (1934).

[24] In re Murel Holding Corp., (C. C. A. 2d, 1935) 75 F. (2d) 941; Francisco Building Corp. v. Battson, (C. C. A. 9th, 1936) 83 F. (2d) 93.

[25] Thus in In re Garfield Arms Hotel Building Corp., (C. C. A. 7th, 1936) No. 5879, not yet reported, the petitioner could hardly contend that the right to redeem was of any value. The property within fifteen months from a sale, if one were presently held, would have almost to treble in value before a redemption would be made.

[26] It is true that such a plan does not offer absolute protection. When property of great value is involved, the inability of dissenters to secure sufficient financial backing might make this a right of little practical worth. But the right may be of great importance in the case of small corporations where the value of the property is not so high as to prevent dissenters from being able as a practical matter to bid.

[27] In the case of In re Garfield Arms Hotel Building Corp., (C. C. A. 7th, 1936) No. 5879, not yet reported, the term was limited to thirty days.

was embodied in the first Frazier-Lemke Act[28] and led to the decision in the *Radford* case invalidating the act for depriving a secured creditor of his substantive rights to control his security.[29]

It would seem better if the court were allowed under the authority which is apparently granted by subsection (b) (5) (d) to consider the special facts and circumstances of each plan and to disapprove of a plan like that in the *Tennessee Publishing Co.* case as not "fair and equitable"[30] and to approve a plan like that in the *Garfield Arms Hotel* case, rather than to base the decision upon a broad ruling as to the constitutionality of Section 77B (b) (5).

In the class of cases where the consent of the senior lienors has been obtained and junior lienors are not likely to get anything from the reorganization, it would seem extremely difficult to get the consent of such junior lienors. It is just at this point that a provision such as that included in subsection (b) (5) is most needed if reorganizations are to be expedited. Thus the decision in *In re Garfield Arms Hotel Building Corporation* is welcomed as an important modification, or at least a clarification, of the sweeping decision in *In re Tennessee Publishing Co.*

P. M. C.

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[28] 48 Stat. L. 1289, 11 U. S. C., § 203 (s) (1934).

[29] The reasoning and language of Louisville Joint Stock Lank Bank v. Radford, 295 U. S. 555, 55 S. Ct. 854 (1935), indicate that a creditor may insist upon eventual realization on his security and cannot, consistently with the due process clause, be forced to accept a substitute. To allow a subordinate class of creditors to hinder the members of other classes from carrying out a reorganization would seem to be contrary to the principle of that case.

[30] The desire on the part of the stockholders who had secured control by purchasing all of the common stock just prior to the filing of the petition to formulate some plan, coupled with the unanimous lack of consent by the bondholders, would tend to indicate that the plan as proposed in In re Tennessee Publishing Co., (C. C. A. 7th, 1936) 81 F. (2d) 463, was not "fair and equitable."