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CORPORATE REORGANIZATION—SECTION 77 OF THE BANKRUPTCY ACT—POWER OF COURT TO ENJOIN SALE OF BONDS PLEDGED AS COLLATERAL—The recent *Chicago, Rock Island* case[1] raised an interesting problem[2] under Section 77[3] of the Bankruptcy Act. The Chicago, Rock Island, as parent railroad of a system extending into one-fourth of the states, had pledged large blocks of its own mortgage bonds and those of its subsidiaries,[4] as security for loans made to it by the Reconstruction Finance Corporation and some Chicago, New York, and St. Louis banks, under an agreement whereby the pledgees were given a power of private sale, without notice, upon set contingencies. In addition to the above it had previously pledged with trustees as security for some issues of its funded debt bonds and stocks of the system aggregating over 145 million dollars and also subject to a power of sale. More than four months after giving the security to the Reconstruction Finance Corporation and the banks, it filed a petition for reorganization under Section 77 in the District Court for the Northern District of Illinois. Subsequent to the approval of the petition, it petitioned further that the pledgees be temporarily restrained from foreclosing, even though the contingencies had arisen, on the ground that the sale would hinder the preparation of an acceptable plan of reorganization.[5] The District Court summarily[6] enjoined sale of the collateral. The power and discretion of the court were con-

[1] Continental Illinois Nat. Bank v. Chicago, Rock Island & Pacific Ry., (U. S. 1935) 55 Sup. Ct. 595.

[2] The case also upholds the constitutionality of Section 77. That result seemed fairly certain in view of Canada Southern Ry. v. Gebhard, 109 U. S. 527, 3 Sup. Ct. 363 (1883); and Hanover Nat. Bank v. Moyses, 186 U. S. 181, 22 Sup. Ct. 857 (1902). But the Court was careful to set up a due process *caveat* and this may imply troublesome times for some of the recent amendments. *Cf.* Louisville Joint Stock Land Bank v. Radford, (U. S. 1935) 55 Sup. Ct. 854.

[3] 47 Stat. 1474 (1933); U. S. C. tit. 11, sec. 205 (1934).

[4] The subsidiary bonds were guaranteed by the parent. Nine of the subsidiaries joined in the bankruptcy proceeding.

[5] Foreclosure by the trustees as well as by the pledgees was feared. Had both foreclosed, the capitalization would have increased about $200,000,000.

[6] Summary proceedings present a separate problem. See Taubel-Scott-Kitzmiller Co. v. Fox, 264 U. S. 426, 44 Sup. Ct. 396 (1924).

tested, but both were sustained by the Circuit Court of Appeals and finally by the Supreme Court.

1. *Equity Receivership Practice*

The result reached was expressly forbidden in the traditional equity receivership. Why this should have been so, remains to be seen. It was said that the jurisdiction of the court extended only to properties of the receivee within its possession and that pledgee's collateral simply were elsewhere.[7] This would seem to make the concept of possession the crux of the matter. But intimations are to be found that fear of frustrating the commercial function of the transaction was the real motivating factor.[8] This would mean that a prudent exercise of judicial discretion dictated a policy of noninterference, though power to interfere was not at all lacking. Such a conclusion merely poses the double problem of, first, what purpose is served by a receivership, and second, what is the function of a pledge transaction. The answer to the latter part is less difficult. Generally the hope and aim of the typical banker's pledge agreement is to furnish liquidity.[9] Ultimate security is of course also essential but that factor hovers in the background. This must be said even of cases involving unlisted collateral or of cases involving amounts so large as to make prompt liquidation quite unlikely, whether the collateral be listed or not.[10] Merely to ask the banker to obtain the consent of the court would certainly interfere with the efficacy of his arrangement. But why should the consent of the court be necessary, or, in other words, what is the purpose of the receivership? Consideration on this point is conspicuously lacking in the cases. If the purpose be to secure an orderly liquidation, then one set of factors is involved: a set analogous to those involved in standard bankruptcy, and later to be considered. If the purpose be conservation, the difference is apparent. If the purpose be really a first step on the road to reorganization, as in the typical railroad receivership,[11] then Section 77 presents much the same problem and the receivership results should have approximated those now reached under Section 77. But,

[7] International Banking Corp. v. Lynch, (C. C. A. 9th, 1920) 269 Fed. 242; Rogers Brown & Co. v. Tindel Morris Co., (D. C. E. D. Pa. 1921) 271 Fed. 475; Northern Pacific Ry. v. Frank Waterhouse & Co., (D. C. W. D. Wash. 1922) 279 Fed. 750; Risk v. Kansas Trust & Banking Co., (C. C. Kan. 1893) 58 Fed. 45.

[8] See note 7, supra.

[9] See, generally, McGinnis, "The Sale of Collateral Security by the Pledgee Thereof After the Intervention of the Bankruptcy of the Pledgor," 9 IND. L. J. 195 (1934), where the commercial function is explained.

[10] See, for example, the collateral involved in the instant case. See also, In re Hudson River Navigation Corp., (C. C. A. 2nd, 1932) 57 F. (2d) 175, where Hand, J., realized the inconsistency of arguing liquidity about unliquid collateral.

[11] GLENN, LIQUIDATION, sec. 172 (1935).

as already shown, they did not and the analogist must remain disappointed, with the only consolation that the cases involved no railroads. It made no difference that foreclosure interfered with an orderly administration of the estate.[12] It made no difference that the collateral consisted of the receivee's own bonds and that sale would result in double proof.[13] Oddly enough, there is an intimation that uncertainty of values might furnish a basis for interference.[14] But, in conclusion, it must be noted that Section 77 is really a mixture of receivership and of old fashioned bankruptcy, spiced with some modern innovations. That thought not only helps mollify somewhat the disappointment but also makes quite justifiable the fact that the Supreme Court as well as the Circuit Court of Appeals entirely ignored the receivership cases.

2. *Standard Bankruptcy Practice*

Case law and theory involving old fashioned bankruptcy are really not in point, and accordingly the Circuit Court of Appeals and the Supreme Court could well ignore the precedent. The concepts of liquidation and reorganization are truly at opposite poles. What may be appropriate under one may or may not be appropriate under the other. And yet both are treated under the same statutory scheme, and it must be apparent that the ability to differentiate is crucial. From this point of view, a brief review of precedent may not be amiss; not to mention the additional consideration that some of the comment in the case is enlightening on old problems.

The general proposition is settled that on petition the property of the bankrupt passes into the custody of the court.[15] It follows that liens cannot thereafter be enforced without the consent of the court.[16] Nevertheless, the leading Supreme Court case had upheld a sale after bankruptcy by the pledgee in accordance with the power of sale with-

[12] See Ke-Sun Oil Co. v. Hamilton, (C. C. A. 9th, 1932) 61 F. (2d) 215. No pledgee's lien was involved but undoubtedly the same result would follow in a case involving a pledgee. The case illustrates brilliantly the need for centralized administration. Comity concepts prevailed over the demands of orderly administration.

[13] Guaranty Trust Co. v. Galveston City R. R., (C. C. A. 5th, 1898) 87 Fed. 813; Rogers Brown & Co. v. Tindel Morris Co., (D. C. E. D. Pa. 1921) 271 Fed. 475; Matter of Binghampton General Electric Co., 143 N. Y. 261, 38 N. E. 297 (1894). *Cf.* Mississippi Valley Trust Co. v. Railway Steel Spring Co., (C. C. A. 8th, 1919) 258 Fed. 346.

[14] Guaranty Trust Co. v. Fentress, (C. C. A. 7th, 1932) 61 F. (2d) 329. The statement near the bottom of page 334 is either a consoling comment or an indication that relief would be in order, if only there were jurisdiction.

[15] Mueller v. Nugent, 184 U. S. 1, 22 Sup. Ct. 269 (1902).

[16] Isaacs v. Hobbs Tie & Timber Co., 282 U. S. 734, 51 Sup. Ct. 270 (1931). An exception arises from comity principles. Straton v. New, 283 U. S. 318, 51 Sup. Ct. 465 (1931).

out the consent of the bankruptcy court, limiting the right of interference to cases of fraud and violation of the provisions of sale,[17] and making no distinction in cases where the collateral consisted of the pledgor's own bonds.[18] The reasons given were the same possession and commercial function factors already noticed in the receivership field.[19] Thus construed, sections 57(h)[20] and 67(d)[21] certainly protected a pledgee. Then came the much discussed case of *Isaacs v. Hobbs Tie & Timber Co.*[22] with its implication that foreclosure must be in the bankruptcy court, and the later concession in *Straton v. New* that the court could consent to foreclosure elsewhere.[23] This left the pledgee problem in a confusion, still existant, and whereon the Court in the *Chicago, Rock Island* case was careful not to comment.[24] But it did make the following statement: [25]

> "It may be, as suggested, that during the period of restraint the collateral will decline in value; but the same may be said in respect of an injunction against the sale of real estate upon fore-

[17] Hiscock v. Varick Bank, 206 U. S. 28, 27 Sup. Ct. 681 (1907); Jerome v. McCarter, 94 U. S. 734, 24 L. ed. 136 (1876); In re Hudson River Nav. Corp., (C. C. A. 2d, 1932) 57 F. (2d) 175; In re Ironclad Mfg. Co., (C. C. A. 2nd, 1912) 192 Fed. 318; In re Mayer, (C. C. A. 2nd, 1907) 157 Fed. 836; In re Ward, (D. C. Mass. 1900) 104 Fed. 985; In re Browne, (D. C. E. D. Pa. 1900) 104 Fed. 762.

[18] Jerome v. McCarter, 94 U. S. 734, 24 L. ed. 136 (1876); In re Ironclad Mfg. Co., (C. C. A. 2nd, 1912) 192 Fed. 318.

[19] See cases cited in notes 17 and 18, supra.

[20] U. S. C. tit. 11, sec. 93(h) (1898).

[21] U. S. C. tit. 11, sec. 107(d) (1898).

[22] 282 U. S. 734, 51 Sup. Ct. 270 (1931), commented on in 16 MINN. L. REV. 94 (1931); 80 UNIV. PA. L. REV. 412-420 (1932); 41 YALE L. J. 445-455 (1932); 7 IND. L. J. 502 (1932).

[23] 283 U. S. 318, 51 Sup. Ct. 465 (1931). The recent case of In re Henry, (D. C. E. D. Pa. 1931) 50 F. (2d) 453, expressly extended the implications of the Isaacs case to the pledge transaction. But in another case, Hand, J., believed that no such extension was intended. In re Hudson River Nav. Corp., (C. C. A. 2d, 1932) 57 F. (2d) 175. In the somewhat analogous problem of foreclosure under a mortgage with a power of sale, the cases are in conflict. That no injunction will issue is the holding of In re Smith, (D. C. S. D. Tex. 1924) 3 F. (2d) 40, and of Robinson v. Kay, (C. C. A. 9th, 1925) 7 F. (2d) 576. An opposite conclusion is reached in In re Jersey Island Packing Co., (C. C. A. 9th, 1905) 138 Fed. 625, and in Allebach v. Thomas, (C. C. A. 4th, 1927) 16 F. (2d) 853, on a differentiation between impairing rights and remedies.

A current practice in land mortgage cases is to foreclose in state courts with the trustee in bankruptcy joined as a party defendant. From his failure to interfere, consent is implied. But this practice, even if conceded to be valid, cannot in the nature of things apply to a pledge providing for private sale with no notice.

[24] ". . . we need not inquire whether it [restraint of sale] would be admissible under the act in force prior to the adoption of that section [Section 77]." (U. S. 1935) 55 Sup. Ct. 595 at 606-607.

[25] (U. S. 1935) 55 Sup. Ct. 595 at 606.

> closure of a mortgage; and such an injunction may issue in an ordinary proceeding in bankruptcy. Straton v. New, 283 U. S. 318, 321, 51 S. Ct. 465, 75 L. ed. 1060, and cases cited. A claim that injurious consequences will result to the pledgee or the mortgagee may not, of course, be disregarded by the district court; but it presents a question addressed not to the power of the court but to its discretion—a matter not subject to the interference of an appellate court unless such discretion be improvidently exercised. So far as constitutional power is concerned, there is no difference between an injunction restraining the enforcement of a real estate mortgage and one restraining the enforcement of a pledge by a sale of collateral security. Such differences as exist affect not the power but the propriety of its exercise—that is to say, the discretion of the court."

The effect of this language should certainly be to remove the possession argument once and for all as a matter going to the jurisdiction of the court. But that is not all. The Court was also faced with the usual objection to the effect that the pledgee's contract was being impaired.[26] The answer given, with the particular cases relied on, seems significant. The Court not only adopted the right and remedy differentiation already used by some of the minority courts in old fashioned bankruptcy cases but also cited the cases with apparent approval.[27] This certainly suggests that a literal construction of Section 67(d) is equally improper for old fashioned bankruptcy. The comments in the *Hudson River Navigation Corp.* case [28] begin to look doubtful.

The above intimations should serve to remove some non-essential factors and help enormously by pointing the issue clearly: how can liquidation best be accomplished? The indications are that the matter rests in the sound discretion of the court with the ultimate answer depending on an evaluation of the worth of judicial scrutiny as compared to the inconvenience to the pledgee plus the likelihood that freedom of sale by pledgee redounds to the benefit of the estate.[29]

[26] (U. S. 1935) 55 Sup. Ct. 595 at 608.

[27] The court cited Allebach v. Thomas, (C. C. A. 4th, 1927) 16 F. (2d) 853; In re Purkett, Douglas & Co., (D. C. S. D. Cal. 1931) 50 F. (2d) 435; John Matthews, Inc. v. Knickerbocker Trust Co., (C. C. A. 2d, 1911) 192 Fed. 557.

[28] (C. C. A. 2d, 1932) 57 F. (2d) 175 at 176.

[29] ". . . the interest of the bankrupt's unsecured creditors . . . may be better protected by preservation of the pledgee's freedom to sell under favorable market conditions than by the mythical safeguard of a bankruptcy court's consent." 41 YALE L. J 445 at 454 (1932).

3. *The Rule Under Section 77*

Section 77 presents a distinctly separate problem. This conclusion is best illustrated by a glance at some pertinent reorganization procedure under that Section.

It is necessary to prepare and submit a plan to the Interstate Commerce Commission for consideration and recommendation — a plan assented to by two-thirds of each class of stockholders and creditors; and, finally, to obtain the approval of the district court. No argument is necessary to prove that these steps call for an enormous amount of detailed work and that any sale of collateral during the period would entail some alteration in any plan already considered. But these would seem to be not insuperable and on such an approach, among others, the recent cases construing Section 74 may be sustained.[30] The difficulty really becomes acute when the collateral consists of the pledgor's own bonds. The above-noted plan must give specific consideration to two definite factors: (1) the amount and classes of outstanding indebtedness and capitalization of the system, and (2) the figure taken as the assumed normal earning power of the system which is to support the new capital structure. The specific classes and amounts of securities to be outstanding after the plan is put into effect must be set up in the plan so as to take care of all theretofore outstanding securities of each class, and the new securities must be in such classes and amounts and have such terms that the figure taken as the assumed normal earning power will service them.

When considered on such a background, the sale, or sales from time to time, by a pledgee of the bankrupt's own bonds would likely spell disaster for any plan of reorganization. The usual mechanical difficulties of adjustment to a changing capitalization would of course be presented. More important, the increase in the capitalization which would result from the sale of the collateral at ruinous prices, due to the bankruptcy, would affect adversely the acceptability of any plan to already suffering creditors and stockholders. In addition, if the pledgee

[30] Pledgees were enjoined in In re Delger, (D. C. S. D. N. Y. 1933) 6 F. Supp. 776, and in In re Chaiken, (D. C. M. D. Pa. 1933) 10 A. B. REV. 14 (1933). Emphasis was placed on Section 74(h) [U. S. C. tit. 11, sec. 202(h)] limiting the jurisdiction of the court to extend the time of payment of debts to those "the security for which is in the actual or constructive possession of the debtor or of the custodian or receiver." It should be noted that the "possession" provision does not appear in Section 77—unless it be 77(a)—and thus the court in the Chicago, Rock Island case had less difficulty. The cases also emphasize Section 74(n) which is similar to Section 77(l): both of which give power to restrain judicial but are silent as to non-judicial foreclosures. This reasoning can no longer be sustained in view of Section 2(15) [U. S. C. tit. 11, sec. 11(15)] as construed in the Chicago, Rock Island case. 55 Sup. Ct. 595 at 606. But as already suggested above, the cases may still be sustained on a differentiation between third party and the bankrupt's own collateral.

banks are the purchasers, banker control is again to be faced;[31] if third parties are the purchasers, professional dissenters are likely to be at hand.[32]

The Supreme Court so concluded, though the motivating factors lie buried in generalities. The statement is offered that the sale "well might require such changes of detail in the plan, entailing new and perhaps difficult reconcilements of views among many and conflicting interests as to force an abandonment of the proceeding." [33] The further comments are made to the effect that "without the maintenance of the status quo for a reasonable length of time no satisfactory plan could be worked out" [34] and that "The preparation of any plan the important details of which could survive the changes in, and the consequent fluctuation and the disturbance of, the financial structure, brought about by recurring sales of collateral, would seem to be a practical impossibility." [35]

Without considering the conflicting statutory provisions which the Court was forced to reconcile,[36] it may be said, in conclusion, that the Court avoided the possession concepts so common in the receivership and old fashioned bankruptcy cases. This is highly gratifying in view of the purpose of Section 77. The only lamentation is that the case does not more clearly forecast the results to be expected in the typical problem of collateral consisting of third party obligations. True, the case draws no difference expressly, but a difference does exist. That problem, however, was not involved and those who are curious must await the gospel of future case law.

M. L.

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[31] *Cf.* 76 Cong. Rec. 2926 (1933).

[32] *Cf.* Fribourg, "Reorganization of Our Corporate Structure Under the New Bankruptcy Act," 43 ANNALIST 947 (June 22, 1934).

[33] (U. S. 1935) 55 Sup. Ct. 595 at 607.

[34] (U. S. 1935) 55 Sup. Ct. 595 at 607.

[35] (U. S. 1935) 55 Sup. Ct. 595 at 607-608.

[36] Sections 67(d), 57(h) and 77(l) must be construed in the light of sections 2, 2(15), 77(a), and particularly the underlying purpose of Section 77, as a whole.