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Some Practical Aspects of Section 77-B of the Bankruptcy Act

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Section 77-B, an amendment to the National Bankruptcy Act, was enacted in 1934, by a New Deal Congress, but contrary to general belief, it is not a New Deal measure. The first act providing for corporate reorganization was proposed by the Hastings Bill (S B 3866) in 1932. While the depression was the immediate cause for the enactment of the measure, yet it is not temporary in nature, but is a permanent part of the Bankruptcy Act.

Generally speaking, 77-B provides that a corporation which is insolvent or unable to meet its debts as they mature, may file a petition for reorganization under the provisions of the Amendment, and may propose a Plan of Reorganization. The Plan must include provisions modifying or altering the rights of creditors generally, or of any class of them, and may include provisions modifying or altering the rights of stockholders generally. To make the Plan effective, 66⅔% of each class of creditors affected by the Plan must file acceptances of the Plan, and if the corporation is not insolvent, 51% of each class of stockholders must file acceptances. The Judge before whom the proceedings are pending must also find that the Plan is fair and equitable, and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible. If the Plan is confirmed by the Court, it becomes binding upon all creditors and stockholders, whether or not they have filed claims in the proceedings, and whether or not they have accepted the Plan of Reorganization.

Constitutionality of the Act

Many lawyers have entertained the opinion that the amendment is unconstitutional. That question, however, has been foreclosed, at least as to the broad scope and purpose of the section, by the decision of The United States Supreme Court in *Continental Illinois National Bank and Trust Company vs. Chicago, Rock Island and Pacific Railway Company*, 294 U. S. 648, 55 Sup. Ct. 595, 70 L. Ed. 1110. While this case arose under Section 77 of the Bankruptcy Act, yet the constitutional question involved in the two sections is the same. In this connection, it is interesting to note that The United States Supreme Court refused certiorari in the case of *Campbell vs. Allegheny Corporation*, 56 S. Ct. 92, 296 U. S. 581, 80 L. Ed. 411, where the question of the constitutionality of Section 77-B was squarely involved.

While constitutionality has thus been determined, it must be recognized that both lawyers and judges have encountered a great deal of difficulty in interpreting the intricate provisions of the Section. The purpose of this comment is to point out some of the practical problems which arise in administering the Act and to call attention to some specific rules and principles which the Courts have recognized and applied.

Circumstances Where Reorganization Is Practicable

Lawyers of the State of Washington have made extensive use of Section 77-B. Some of the local corporations reorganized under its provisions are: Olympic Hotel Company, Seattle Gas Company, Columbia River Longview Bridge Company, Carlisle Lumber Company, United Exchange Building, Inc., and Dexter Horton Estate, Inc.

In practically all of the cases where successful reorganizations have been accomplished, bonds were outstanding in the hands of the public. Owing to the depression, Debtors have been unable to meet interest payments and sinking fund requirements in full. If relief is obtained on sinking fund payments, in many situations the company can continue to pay its interest. In other cases, temporary relief is needed in connection with interest payments. Where the need is real, it has not been difficult to get creditors and stockholders to consent to a Plan of Reorganization. However, in drafting a Plan, the psychological attitude of bondholders must be kept in mind. Bondholders who paid par for their bonds are opposed to accepting new securities of a face value less than their old bonds. They will submit, if shown the need, to a reduction in the interest rate, and to a reduction in the sinking fund payments, but to attempt to reduce the principal of the debt is to create an almost unsurmountable obstacle to the consummation of the Plan.

In some instances, corporations having no funded indebtedness, but owing substantial sums to unsecured creditors, have filed Petitions under Section 77-B. The author does not know of a reorganization that has been successfully accomplished where all of the indebtedness was unsecured. Generally, such proceedings are filed merely to hold creditors at bay. Heretofore, Courts have approved of Petitions as being filed in good faith almost without exception. Judge Bowen, of the United States District Court for the Western District of Washington, Northern Division, now requires that an affidavit of facts, complying with Rule 77-B 2 of the United States District Court for the Southern District of New York, be filed with the Petition. One of the requirements is a statement of reasons why Section 12 of the Bankruptcy Act (the Composition Section) would not give adequate relief. The purpose of the affidavit is to give the Judge an opportunity to exercise mature judgment as to whether a reorganization can be successfully accomplished under Section 77-B. Undoubtedly, where all the indebtedness is unsecured, the Courts will hereafter have a tendency to disapprove of the filing as not being in good faith, on the theory that the corporation is attempting to accomplish a composition with its creditors, which could be successfully consummated under Section 12 of the Bankruptcy Act. Indeed, an amendment to the Bankruptcy Act has been suggested by Counsel for the Senate Bankruptcy Committee, whereby only corporations with funded indebtedness outstanding in the hands of the public would be eligible for relief under Section 77-B. All other corporations would be relegated to relief under the Composition Provisions of the Bankruptcy Act.

Generally speaking, the current unsecured creditors are opposed to any plan which provides for the funding over a long period of time of the indebtedness owing to them. Commercial firms, as a matter of practical necessity, are required to turn over their money many times during a year, and they dislike "freezing" their money. Such creditors would much rather accept a certain percentage of their indebtedness in full satisfaction under a composition arrangement or, if that cannot be arranged, they prefer liquidation. Whatever they receive under either arrangement is money in hand which they can use in their business operations.

In all reorganizations there is a certain amount of unsecured indebtedness owing to current creditors. A plan of reorganization will ordinarily provide for the payment of the current unsecured creditors in full. While on the face of it this would seem to give unsecured creditors preference over secured creditors, yet the courts recognize the practical necessities of the situation where the current unsecured indebtedness is small. If the courts refused to allow prompt payment of current unsecured indebtedness in full, the consummation of a Plan of Reorganization would be effectually blocked. The current unsecured creditors would ordinarily constitute a separate class and it would be necessary to get acceptances of the Plan from two-thirds in amount of this class in order to have the Plan confirmed. For the reasons indicated this would ordinarily be impossible. Moreover, if current unsecured creditors are not paid in full promptly, the credit of the debtor corporation would be ruined and it could not conduct its operations in the usual manner. One of the advantages of 77-B is that the Debtor may be left in possession of its property and assets with the right to conduct its business in the same manner as it operated prior to the inception of the proceedings, with the result that the good will of the corporation is preserved.

The Position of the Debtor and Junior Creditors in the Proceedings

Debtors generally overestimate their bargaining position in 77-B proceedings. They take literally the title of Chapter 8, "Provisions for the Relief of Debtors." It is true that in 1934 and the first part of 1935, the courts had a tendency to construe the Act in favor of the Debtor rather than creditors. Moreover, bondholders at that time were inclined to agree to almost any Plan of Reorganization, particularly in real estate organizations. Most real estate bond issues had been in default for a number of years and the bondholders were willing to agree to any Plan that might give them the opportunity of securing some income. With the return of prosperity, both the attitude of the courts and the secured creditors has materially changed. Bondholders know that properties are earning substantially greater returns and they see no reason why they should yield to junior creditors.

The status of junior creditors has been clarified by a recent decision of the United States Supreme Court, in the case of *Re 620 Church Street Corporation,* 299 U. S. 24, 57 S. Ct. 88, 81 L. Ed. 58. It was held that where the value of the property is less

than the amount of the first mortgage, there being no equity for junior creditors and stockholders, their consent to a Plan is not required.

Prior to the decision of the United States Supreme Court on this point, most corporation lawyers felt that under the provisions of the Act the consent of two-thirds in amount of each class of creditors was necessary in order that a Plan might be confirmed, even though there was no equity in the property for junior creditors. Undoubtedly the bargaining position of senior secured creditors is much stronger since this decision. However, it should be noted that creditors can only institute the proceedings under very limited circumstances. Sub-section "A" of Section 77-B provides as follows:

"Three or more creditors who have provable claims against any corporation which amount in the aggregate, in excess of the value of securities held by them, if any, to $1,000 or over may, if such corporation has not filed a petition or answer under this section, file with the Court in which such corporation might file a petition under this section, a petition stating that such corporation is insolvent or unable to meet its debts as they mature and, if a prior proceeding in bankruptcy or equity receivership is not pending, that it has committed an act of bankruptcy within four months, that such creditors propose that it shall effect a reorganization; and such corporation shall, within ten days after the service of a copy of such petition upon it, answer such petition."

The United States Supreme Court has held that receivership in aid of foreclosure is not an equity receivership. See *Duparquet Huot & Moneuse Company vs. Frysinger Evans*, 297 U. S. 216, 56 S. Ct. 412, 80 L. Ed. 591. Unless a prior proceeding in bankruptcy or an equity receivership is pending, the creditors must show that the corporation has committed an act of bankruptcy. Ordinarily an act of bankruptcy would be very difficult to prove.

However, after the Debtor has filed its petition, the holders of claims "being not less than 25% in amount of any class of creditors and not less than 10% in amount of all the claims against the debtor" may propose a Plan. If the Debtor proposes a Plan which fails to receive the requisite amount of acceptances from the creditors then the creditors may propose a Plan of their own, and if there is no equity for stockholders over and above creditors' claims, the stockholders need not be considered in the Plan. Therefore, it is incumbent upon the Debtor to propose a Plan that is fair and reasonable. If the Debtor attempts to gain too much at the expense of creditors, the result may be that the interests of stockholders of the Debtor will be eliminated.

Interesting Problems Which May Arise in Connection With Washington Corporations

While the decision in 620 *Church Street Corporation, supra,* is sound on the facts, it will be interesting to see if the Courts distinguish this case when a similar situation arises in the State of Washington. Under the decisions of our Supreme Court, mortgage creditors have no lien on the income from the property, even after default, and are not entitled to possession or the rents until

the certificate of sale is issued, unless waste has been committed. See *Western Loan & Building Co. v. Mifflin,* 162 Wash. 33, 297 Pac. 743; *State ex rel. Gwinn v. Superior Court,* 170 Wash. 463, 16 P. (2d) 831, 19 P. (2d) 1119, 87 A. L. R. 620; *Clise v Burns,* 175 Wash. 133, 26 P. (2d) 627, 29 P. (2d) 1119.

With these decisions in mind, let us suppose a case where a corporation has outstanding a first mortgage bond issue of $500,000 and a second mortgage bond issue of $200,000, both secured by a lien on the same property. The fair market value of the property is $400,000. The corporation has $30,000 in cash on hand at the inception of the proceedings. The cash on hand is as equally available to the satisfaction of the second mortgage debt as it is to the first mortgage debt. The secured creditors would be required to exhaust their security and then would have a claim against the corporation for any deficiency. Moreover, the second mortgage bondholders would have an equity of redemption which might or might not have any real value. Under the circumstances, it could hardly be considered that the junior creditors have no interest in the corporation or its assets. Therefore, it would seem that their consent to a Plan of Reorganization would be necessary, as the Act requires that their rights be protected, at least to the extent of their interests in the property.

Another very interesting question may arise in connection with real estate reorganizations in this state, under the provisions of Section 77-B. Let us suppose that in the hypothetical case just cited, the Debtor is left in possession with full authority to collect the rents, issues, and profits during the pendency of the proceedings. While the proceedings are pending, the secured creditors cannot institute foreclosure, at least without permission of the Court. After a year, no Plan of Reorganization having been approved, an order of liquidation is entered. Thereafter, the usual provisions of the Bankruptcy Act govern. While the 77-B proceedings were pending, the Debtor collected $40,000 from the mortgaged property, over and above expenses. To whom does this money belong? If the decisions of our Supreme Court are literally applied to these facts, the monies collected during the pendency of the proceedings, together with cash on hand at the inception of the proceedings would be available for general creditors. To the extent that the first mortgage bond indebtedness exceeds the value of the security therefor, the first mortgage bondholders would be entitled to share in these funds. The second mortgage bondholders would undoubtedly abandon their security, in which case they would be entitled to share in the funds to the full pro-rata extent of their claim, in the sum of $200,000. As the indebtedness on the first mortgage bonds, (disregarding the interest) exceeds the value of the security by $100,000, the second mortgage bondholders would get two-thirds of the cash and the first mortgage bondholders one-third of the cash. This result seems inequitable, because if the 77-B proceedings had not intervened, the Trustee for the first mortgage bondholders could have foreclosed on the property, and it is probable that the Trustee would have been let into possession, by reason of the foreclosure,

long before the year had elapsed. It is probable that when this situation arises the Courts will apply equitable principles, and protect the interest of the First Mortgage Bondholders as to the cash collected from the mortgaged property during the pendency of the 77-B proceedings.

Practical Aspects in Proposing the Plan and Obtaining Acceptances

From what has been said, it is apparent that usually, it is to the best interests of all classes of creditors and stockholders that a Plan of Reorganization be consummated. This is particularly true where the Debtor has been operating its business efficiently and its financial troubles have been caused by circumstances beyond its control. A reorganization effected under Section 77-B will enable creditors to retain their status as such, and also allows the stockholders of the Debtor to retain an interest in the business. The creditors may, if they so desire, retain a measure of control over the business through representation on the Board of Directors or by way of a voting trust agreement, until their indebtedness is retired in whole or in part. Experience has shown no class of creditors or stockholders can afford to stand on their strict legal rights in 77-B proceedings. It is necessary that each class compromise its position to some extent.

Where the Debtor has an opportunity to work out a Plan with its creditors prior to the inception of the proceedings, no substantial difficulties are usually encountered, but where bonds are outstanding, unless they are under the control of Committees, the Debtor would not ordinarily know who its creditors are, at least insofar as the bondholders are concerned. Most bonds are bearer bonds, and pass readily from hand to hand without the knowledge of the Debtor corporation. This being the case, the Debtor corporation will file its Petition and then will submit its Plan to stockholders and creditors. A substantial group of creditors may disagree with the terms of the Plan, and if they represent more than one-third of the claims in their particular class, they are in a position to block the Plan. When this situation arises, a compromise is inevitable. Where there are several classes of creditors, serious conflicts in interests may arise not only as between the stockholders and creditors, but between classes of creditors.

Section 77-B provides that in addition to the approval of a Plan by two-thirds of each class of creditors and 51% of each class of stockholders, the Plan must be approved by the Judge as being fair and feasible and not discriminating against any class of creditors or stockholders. The Act does not indicate at what stage of the proceedings the Judge shall give his approval. In most of the cases in the United States District Courts in the State of Washington, approval of the Plan by the Judge has been had after the requisite amount of acceptances by creditors and stockholders has been filed in the proceedings. As a matter of fact, the Courts have approved of the Plan almost as a matter of form after the requisite acceptances have been obtained.

Much difficulty might be avoided if the District Courts would consent to pass upon the fairness and feasibility of the Plan prior to its approval by creditors and stockholders. Judge Cushman of the United States District Court for the Western District of Washington, Southern Division, adopted this procedure in the matter of Columbia River Longview Bridge Company (Unreported). By direction of the Court, a copy of the Plan as filed was mailed to all creditors and stockholders, together with a notice stating that the court would consider the Plan, as to its fairness and feasibility, on a certain date, at which time any creditor or stockholder might be heard on the question. After the hearing, the Judge entered an order finding that "the Plan . . . is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible." This procedure enables the Debtor to find out what objections, if any, creditors or stockholders may have to the Plan, and perhaps to meet such objections prior to requesting acceptances of the Plan. The creditors and stockholders feel more confidence in the Plan after the Judge has declared it to be fair and feasible. It should be noted that Judge Cushman by his order reserved the right to reconsider the matter. Evidently he felt that anyone later voicing an objection to the Plan should not be precluded. Judge J. Stanley Webster of the United States District Court for the Eastern District of Washington indicated, in a case before him, that he would follow the same procedure. The case never reached a stage in the proceedings where such action became necessary. This procedure was approved by District Judge Otis in *re Long-Bell Lumber Company,* C. C. H. 3607, but the United States Circuit Court of Appeals for the First Circuit frowned on the practice in the case of *Downtown Investment Association vs. Boston Metropolitan Buildings, Inc.,* 81 Fed. (2nd) 314. It is submitted, however, that the practice is sound and in accordance with the spirit of the Act. A Judge, in adopting this procedure, may perform a very great service in composing differences between various interested parties, thus enabling a Plan to be consummated.

As was pointed out earlier in this comment, there remains much room for construction and development of the working principles of Section 77-B. The author has dealt with some established principles and has suggested problems awaiting determination. At the present time, the Courts are rapidly building up a body of precedents which will help to point the way in the future in the conduct of proceedings under the Section. The amendment in its practical operation has justified its existence and will, in its general scope, undoubtedly remain a permanent part of the Bankruptcy Act.