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Corporate Reorganization under the Chandler Bankruptcy Act

NONE of the important changes in the Bankruptcy Act made by the so-called Chandler Act¹ has excited greater controversy than the complete revision of the provisions relating to corporate reorganizations. In addition to the recasting of former section 77B, with numerous amendments both clarifying and of substance, as new chapter X of the Bankruptcy Act, the provisions compelling the appointment of a trustee in the case of larger corporations and with respect to the new roles in reorganization proceedings of the trustee and the Securities and Exchange Commission, introduce important practical changes, and to some extent an entirely new philosophy, in the readjustment of financially distressed corporations.

The new provisions are the outgrowth of the study of protective and reorganization committees by the Securities and Exchange Commission,²

¹ Pub. L. No. 696, 75th Cong., 3d sess. (approved by the President June 22, 1938). Except as otherwise specified the amendments become effective three months from the date of approval, but the new provisions as to corporate reorganizations are applicable in their entirety to cases where the petition under former section 77B [48 STAT. (1934) 911] was approved within three months of the effective date of the Chandler Act, and to the extent the judge shall deem their application practicable where the petition was approved prior to that period. §§7, 276c (Chandler Act). In the Matter of the Ritz-Carlton Restaurant & Hotel Co., decided July 14, 1938, by the United States District Court for the District of New Jersey, held none of the new amendments applicable for three months after the approval of the Act, though presumably the corporate reorganization provisions would become at that time applicable as stated above to proceedings then pending under former section 77B.

References herein, unless otherwise specified, are to sections of the Bankruptcy Act as amended by the Chandler Act.

² Provided for under section 211 of the Securities Exchange Act of 1934, 48 STAT. (1934) 831, 15 U.S.C. (1934) §78. See SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936-38). The parts of this report, and the dates of their presentation to Congress, are as follows: PART I. STRATEGY AND TECHNIQUES OF PROTECTIVE AND REORGANIZATION COMMITTEES, May 10, 1937; PART II. COMMITTEES AND CONFLICTS OF INTEREST, June 21, 1937; PART III. COMMITTEES FOR THE HOLDERS OF REAL ESTATE BONDS, June 3, 1936; PART IV. COMMITTEES FOR THE HOLDERS OF MUNICIPAL AND QUASI-MUNICIPAL OBLIGATIONS, April 30, 1936; PART V. PROTECTIVE COMMITTEES AND AGENCIES FOR HOLDERS OF DEFAULTED FOREIGN GOVERNMENTAL BONDS, May 14, 1937; PART VI. TRUSTEES UNDER INDENTURES, June 18, 1936; and PART VII. MANAGEMENT PLANS WITHOUT AID OF COMMITTEES, May 10, 1938.

and are based largely on the suggestions made by the Commission in Part I of its report thereon.³ The scope of the Commission's investigation and report was broad, and the resulting proposed legislation included, in addition to the corporate reorganization provisions of the Chandler Bill, the complementary provisions of the Lea Bill,⁴ dealing with the solicitation of proxies, deposits and assents by committees and others; and the Barkley Bill,⁵ dealing with the qualifications of indenture trustees and the provisions of trust indentures. While neither of the latter two measures reached the point of enactment during the Seventy-fifth Congress, the proposed revisions of section 77B have been enacted, in somewhat modified form, as part of the general revision of the Bankruptcy Act made by the Chandler Bill.

Amendments of the utmost practical importance to the reorganization practitioner and to all those involved in corporate reorganizations have been made with respect to the initiation of the reorganization proceedings, the appointment and duties of the trustee, the proposal, confirmation and consummation of the plan of reorganization and the allowance of compensation and expenses. New provisions, particularly with respect to income taxes, have been added, and innumerable clarifying amendments made. Within the limits of the present article, only the most important of the new provisions can be discussed.⁶

INITIATION OF THE PROCEEDINGS

The provision of former section 77B permitting proceedings to be filed in the state of incorporation of the debtor had resulted in a substantial

³ 1 SECURITIES AND EXCHANGE COMMISSION, *op. cit. supra* note 2, at 897-907. For discussion of the changes as proposed by the Commission, see Dodd, Swaine, and Weiner, *A Symposium: Recommendations of the Securities and Exchange Commission* (1938) 38 COL. L. REV. 223; Gerdes, *Section 77B, the Chandler Bill and Other Proposed Revisions* (1937) 35 MICH. L. REV. 361; and Laporte, *Changes in Corporate Reorganization Procedure Proposed by the Chandler and Lea Bills* (1938) 51 HARV. L. REV. 672.

⁴ H. R. 6968, 75th Cong., 1st sess. (1937). Hearings were held before the House Committee on Interstate and Foreign Commerce, but the bill was not reported out.

⁵ S. 2344, 75th Cong., 1st sess. (1937). The bill was referred to the Senate Banking and Currency Committee and favorably reported [Senate Rep. No. 1619, 75th Cong., 3d sess. (1938)] but was not acted upon by the Senate.

⁶ Since the provisions of the chapters of the Bankruptcy Act dealing with strict bankruptcy liquidation are, except as expressly provided or inconsistent, applicable also in corporate reorganizations, various of the important amendments to the Bankruptcy Act proper may also be applicable in reorganization proceedings. §102.

Thus under section 24 the former confusing distinctions between orders appealable as of right and those requiring leave of the appellate court are abolished. Appeals are now discretionary only when less than \$500 is involved, all other matters being appealable as of right. Query as to orders for examinations under section 21a, or directing a trustee to furnish certain information or investigate particular matters, and similar administrative orders. Appeals from such orders presumably will remain discretionary.

concentration in certain jurisdictions, such as Delaware, of proceedings relating to corporations whose actual business, properties and creditors were elsewhere. This has been eliminated by the new provisions, and petitions may now be filed only in a pending bankruptcy proceeding or in the jurisdiction in which for the preceding six months or the larger portion thereof the corporation has had its principal place of business or principal assets.⁷

Involuntary petitions may be filed by three or more creditors having claims against the debtor or its property aggregating \$5,000 or over, or by an indenture trustee.⁸ In addition to allegations generally similar to those now required, all petitions, whether voluntary or involuntary, must show why relief cannot be obtained under the provisions of the Act for the arrangement of unsecured indebtedness.⁹ Under this provision and the corresponding clause with respect to "good faith" mentioned below, it is anticipated that a large number of the smaller corporations whose indebtedness is of an unsecured character will be readjusted under the simpler and probably speedier provisions relating to arrangements. Specific provision is made for answer to petitions, whether voluntary or involuntary, and answers may now be filed by the debtor, any creditor or indenture trustee or, if the debtor is not insolvent, by any stockholder of the debtor.¹⁰

Under section 77B where a prior proceeding in bankruptcy or an equity receivership was not pending, a creditor's petition was required to allege the commission of an act of bankruptcy within four months; and in *Duparquet Huot & Moneuse Co. v. Evans*¹¹ the Supreme Court held a receivership for the collection of rents and profits in a mortgage foreclosure not an "equity receivership" within this requirement. Yet, particularly in the case of corporations dealing in real estate, reorganization proceedings may under these circumstances be highly desirable. Under the new provisions this ruling, and the companion decision of *Tuttle v.*

⁷ §§127, 128. See discussion in the Senate by Senator Hastings of Delaware and others, CONG. REC., June 10, 1938, p. 11531 (temporary paging). A petition by or against a subsidiary corporation may be filed either as stated in the text, or in the court which has approved the petition by or against its parent corporation. §§106(13), 129.

⁸ §126. The claims must be liquidated in amount and not contingent as to liability, but may be secured or unsecured. No petition may be filed if another is already pending by or against the same debtor, although as under section 77B the proceedings may be transferred to any jurisdiction where the interests of the parties will be best served. §118.

⁹ §130(7). The provisions as to arrangements of unsecured indebtedness, derived from former sections 12, 13 and 74, now constitute Chapter XI (§§301-399) of the Bankruptcy Act as amended.

¹⁰ §§136, 137.

¹¹ (1936) 297 U. S. 216.

Harris,¹² are met by the provision that in lieu of the allegations above mentioned the creditors or indenture trustee may allege alternatively either the existence of a pending proceeding to foreclose a mortgage or enforce a lien against all or the greater portion of the property of the corporation, or that such property is by reason of a default in the possession of an indenture trustee or mortgagee.¹³

In their application of the provision that the petition must be filed in good faith the courts under section 77B have gone far beyond the mere subjective requirement of honesty of motive and purpose, and have required that objective standards, not always clearly defined, be fulfilled.¹⁴ Under the new amendments the requirement of good faith in the institution of the proceedings is continued, and some of the interpretations given to this vague phrase under section 77B are specifically codified. Good faith is not to be deemed to exist if the petitioning creditors have acquired their claims for the purpose of filing the petition;¹⁵ if adequate relief would be obtainable under the provisions relating to arrangements of unsecured indebtedness;¹⁶ if it is unreasonable to expect that a reorganization can be effected;¹⁷ or if a prior proceeding is pending in any court

¹² (1936) 297 U. S. 225.

¹³ §131(3), (4).

¹⁴ For general discussion of "good faith" under section 77B, see 1 GORDON, CORPORATE REORGANIZATIONS (1936) §§323-324; FINLETTER, PRINCIPLES OF CORPORATE REORGANIZATION (1937) 63-86; Note: *Developments in the Law—Reorganization Under Section 77B of the Bankruptcy Act—1934-1936*, (1936) 49 HARV. L. REV. 1111, 1123-1128.

¹⁵ §146 (1). Cf. *In re Philadelphia Rapid Transit Co.* (E. D. Pa. 1934) 8 F. Supp. 51, *aff'd*, *Wilson v. Philadelphia Rapid Transit Co.* (C. C. A. 3d, 1934) 73 F. (2d) 1022; *Humphrey v. Bankers Mortgage Co.* (C. C. A. 10th, 1935) 79 F. (2d) 345. The effect of incorporation for the purpose of proceeding under the corporate reorganization provisions is not specifically settled. Cf. *In re Loeb Apartments, Inc.* (C. C. A. 7th, 1937) 89 F. (2d) 461; *Milwaukee Postal Bldg. Corporation v. McCann* (C. C. A. 8th, 1938) 95 F. (2d) 948. Cf. also *Shapiro v. Wilgus* (1932) 287 U. S. 348.

¹⁶ §146(2). Cf. *In re Wisun & Golub, Inc.* (S. D. N. Y. 1936) C. C. H. BANKR. SERV., par. 3830, *rev'd*, on other grounds, (C. C. A. 2d, 1936) 84 F. (2d) 1. A petition improperly filed as one for corporate reorganization because adequate relief could be obtained under chapter XI may upon application by the debtor be amended and the proceedings continue under that chapter. §147.

¹⁷ §146(3). The financial situation of the debtor may be such that liquidation is the only solution. *In re Grigsby-Grunow Co.* (C. C. A. 7th, 1935) 77 F. (2d) 200; *O'Connor v. Mills* (C. C. A. 8th, 1937) 90 F. (2d) 665; *Price v. Spokane Silver & Lead Co.* (C. C. A. 8th, 1938) 97 F. (2d) 237. Cf. *Provident Mut. Life Ins. Co. v. University Ev. Lutheran Church* (C. C. A. 9th, 1937) 90 F. (2d) 992; *First National Bank v. Conway Road Estates Co.* (C. C. A. 8th, 1938) 94 F. (2d) 736. But a fully worked out plan need not be presented at the outset; it is sufficient that one may reasonably be expected to be forthcoming. *Manati Sugar Co. v. Mock* (C. C. A. 2d, 1935) 75 F. (2d) 284; *R. L. Witters Associates v. Ebsary Gypsum Co.* (C. C. A. 5th, 1938) 93 F. (2d) 746; *In re Associated Gas and Electric Company* (S. D. N. Y. 1934, 1936) C. C. H. BANKR. SERV., par. 3057, *ibid.*, par. 3085, *ibid.*, par. 3992. Cf. *Hickey v. Ritz-Carlton Restaurant & Hotel Co.* (C. C. A. 3d, 1938) 96 F. (2d) 748. Where

and the interests of creditors and stockholders would be best subserved in such prior proceeding.¹⁸ By express non-limitation of the generality of the meaning of "good faith," however, the general requirement of an honest purpose and motive, and the application of the term to other and new situations as they arise, are carefully preserved.

APPOINTMENT AND DUTIES OF TRUSTEES

Whether the debtor should be left in possession or a trustee appointed was under section 77B wholly within the discretion of the court, and in a substantial majority of cases trustees were not appointed.¹⁹ Around this situation and the related problem of whether a person affiliated with the management of the debtor might properly be designated as trustee or co-trustee, a violent controversy raged. The strategic power of the debtor in possession or interested trustee was used, it was contended, to perpetuate unsound managements and to suppress the investigation and enforcement of claims against the corporate management and affiliated interests for dishonest and incompetent administration of the corporate affairs. These contentions, in the opinion of many, were strongly supported by the results of the Securities and Exchange Commission investigations.²⁰ Meanwhile new theories of the function of the trustee in reorganization proceedings were being developed, and if these theories were to be adopted it was obvious that a trustee would be required to perform the new and important duties which they contemplated. On the other hand it was contended that the cases of corporate mismanagement were few and could be dealt with under the existing powers of the courts, the old management most familiar with the debtor's business and best able to guide it through the stress and strain of reorganization proceedings, and that the compul-

the great majority of the real parties in interest are opposed to the proposed procedure the improbability of success has resulted in dismissal of the petition on the ground of lack of good faith. *E.g., In re North Kenmore Bldg. Corporation* (C. C. A. 7th, 1936) 81 F. (2d) 656.

¹⁸ 146(4). *Cf. In re South Coast Co.* (D. Del. 1934) 8 F. Supp. 43; *In re Electric Pub. Serv. Co.* (D. Del. 1934) 9 F. Supp. 128; *In re Prairie Avenue Bldg. Corporation* (E. D. Ill. 1935) 11 F. Supp. 125; *In re Surf Bldg. Corporation* (E. D. Ill. 1934) 11 F. Supp. 295. *Cf. also* *Reighard v. Higgins Enterprises, Inc.* (C. C. A. 3d, 1937) 90 F. (2d) 569.

¹⁹ Statistics furnished the House Judiciary Committee by the Securities and Exchange Commission showed that in 955 proceedings instituted under section 77B during 1936, the debtor was continued in possession in 545 cases and trustees (including officers of the debtor appointed as trustee or co-trustee) designated in 269. Sixteen cases were otherwise disposed of, and no information was secured as to the remaining 125. See *HEARINGS BEFORE COMMITTEE ON THE JUDICIARY ON H. R. 6439 (AMENDED, REINTRODUCED AND REPORTED AS H. R. 8046), 75th Cong., 1st sess. (1937) 421. See also 1 SECURITIES AND EXCHANGE COMMISSION, op. cit. supra note 2, at 305-308; 2 ibid. at 523, n. 4.*

²⁰ See 1 SECURITIES AND EXCHANGE COMMISSION, *op. cit. supra* note 2, at 290-312, 899-900. See also Dodd, *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations* (1938) 38 COL. L. REV. 225-230.

sory appointment of an independent trustee would ordinarily result only in undue complication and expense.²¹ Several federal judges, in connection with the hearings before the House Judiciary Committee on the Chandler Bill, expressed the belief that the discretionary provisions of section 77B should be retained.²²

Under the new provisions these controversies have been settled by the compulsory requirement that a disinterested trustee be appointed where the liquidated indebtedness of the debtor equals or exceeds \$250,000.²³ Interest is defined in detail, and the proposed appointee is disqualified if he is a creditor or stockholder of the debtor, an underwriter of its outstanding securities or within five years the underwriter of any of its securities, if he is or within two years has been a director, officer or employee of the debtor or any such underwriter or counsel for either of them, or if he has for any reason an interest materially adverse to the interests of any class of creditors or stockholders.²⁴ In partial concession, however, to the contention that this may deprive the estate of the services of the persons most familiar with the debtor's business and best qualified to act as trustees, two qualifications are made. Where the operation and management of the business of the debtor is authorized by the court, an additional trustee may be appointed for this purpose who is a director, officer or employee of the debtor; and the trustee may employ officers of the debtor at rates of compensation to be approved by the court.²⁵ Generally speaking, these provisions probably represent a reasonable adjustment of

²¹ See Swaine, "Democratization" of Corporate Reorganizations (1938) 38 COL. L. REV. 256, 263-265; Laporte, *op. cit. supra* note 3, at 677-679.

²² See HEARINGS, *op. cit. supra* note 19, at 343 (statement of Representative Celler as to views of Judges Coxe, Goddard, Knox and Bondy of the Southern District of New York, Judges Galston and Moscowitz of the Eastern District of New York and Judges Swan and Hand of the Circuit Court of Appeals for the Second Circuit), 367-373, 383-384 (testimony of Judge Knox) and 175, 371-372 (statements of Chairman Douglas of the Securities and Exchange Commission, Representative Celler and Judge Knox as to views of Judge Patterson of the Southern District of New York). It should be noted that these opinions were expressed with respect to the provision of the bill as originally drafted that an independent trustee should be appointed in all cases, regardless of the size of the estate.

²³ §156. Where the indebtedness is less than \$250,000 the court may either appoint a disinterested trustee or continue the debtor in possession.

²⁴ §158. The requirement of disinterestedness applies also to the counsel for the trustee, except that with the approval of the judge the trustee may employ an attorney who is not disinterested, for any specific purposes other than to represent the trustee in conducting the reorganization proceeding. §157. *Cf.* United States Supreme Court, General Order in Bankruptcy, No. XLIV; *In re Chicago Rapid Transit Co.* (C. C. A. 7th, 1937) 93 F. (2d) 832.

The trustee must also possess the other qualifications required of trustees under the Bankruptcy Act proper by section 45, except that he need not reside or have an office within the district. §156. The latter requirement has often been disregarded under section 77B. See 1 GERDES, *op. cit. supra* note 14 at §350.

²⁵ §§156, 191. Apparently the authority of an additional trustee appointed for the purpose of running the business of the debtor is limited to that purpose.

the conflicting contentions. It would appear, however, that the line between the important reorganizations where the designation of a trustee is to be required and the smaller situations where appointment is to remain optional, might well have been fixed at a substantially higher point.

New and important duties are placed upon the disinterested trustee thus appointed. The provisions of section 77B with respect to his filing of lists of creditors and stockholders, schedules and other information "necessary to disclose the conduct of the debtor's affairs and the fairness of any proposed plan"²⁶ are greatly strengthened and welded into a new procedure the intent of which is to make the trustee the key figure in the conduct of the reorganization and in the development of the reorganization plan. The filing of lists of creditors and stockholders by the trustee is made mandatory, and where lists of security holders are in the possession of third persons the court may direct them to be made available to the trustee.²⁷ If the judge shall so direct, the trustee shall "forthwith investigate the acts, conduct, property, liabilities and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge."²⁸ A statement of his findings is to be submitted to creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and such other persons as the court may direct.²⁹ Most important of all, however, the new provisions place upon the disinterested trustee the burden of the preparation and proposal in the first instance of the plan of reorganization.³⁰ This fundamental change requires separate consideration.

THE PLAN OF REORGANIZATION

Under section 77B the initial plan of reorganization has ordinarily been proposed by the debtor. Due in part to the debtor's greater famili-

²⁶ §77B (c) (4).

²⁷ §§164, 165. The lists filed may be impounded, but their inspection or use by the trustee, any indenture trustee or any creditor or stockholder must be permitted upon such terms as the court may prescribe. Inspection may, however, be refused to a creditor or stockholder who acquired his claim or stock within three months prior to the filing of the reorganization petition or during the pendency of the proceeding. §166.

²⁸ §167(1). Where the debtor is continued in possession the court may appoint a disinterested person as examiner to perform this or other functions of the trustee with regard to investigation of the debtor's affairs or the plan. §168. *Cf. In re Utilities Power & Light Corporation* (C. C. A. 7th, 1937) 90 F. (2d) 798.

²⁹ §167 (5). "Subsection (5) is not limited by subsection (1) above, though the duties of the trustee under subsection (5) are more restricted as respects subject matter. Subsection (5) places upon the trustee the duty in every case of preparing a statement (based upon such examinations as he has made in the performance of his functions) of the property, liabilities and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof." SEN. REP. No. 1916, 75th Cong., 3d sess. (1938) 30.

³⁰ §169.

arity with the situation and perhaps foreknowledge of approaching reorganization, this has been also to a considerable extent the result of the requirement of section 77B(d) that a creditors' plan be accepted before proposal by twenty-five per cent of the proposing class and ten per cent of the total amount of creditors. Obviously this provision gave to the debtor at the outset a strategic advantage. But graver charges were being brought against reorganization procedure. In many cases, it was charged, the committees or others purportedly representing the bondholders, general creditors and stockholders in the informal negotiations resulting in the final plan, were not actually effective and independent representatives of the interests they purported to serve. In some cases, the report of the Securities and Exchange Commission indicated, such committees or other representatives were in fact affiliated with or even designated by the old management or other "inside" interests, whose real purpose might be to perpetuate existing control and cover up possible past mismanagement. In others they really represented outside interests seeking control of the situation for themselves rather than the benefit of existing securityholders. Acceptances of the plan thus developed, or perhaps authorizations to accept plans before any plan had in fact been developed, were secured prior to objective judicial scrutiny of the plan and perhaps without full disclosure; yet the effect of these acceptances when the plan was submitted for confirmation was often to present the court with a *fait accompli* which it might dislike but would be reluctant to upset.³¹

Whether the evils undoubtedly disclosed by the Securities and Exchange Commission report were as widespread as the framers of the report believed may be doubted, but that a need for requiring at least full disclosure to security holders of the possible conflicting interests of persons seeking to represent them seems undeniable. The Commission's legislative proposals, however, went much further, including in addition to the provisions herein discussed the unenacted provisions of the Lea and Barkley Bills; and fundamental changes are made by the Chandler Act in the procedure above described. It is the trustee who is to prepare and propose in the first instance the plan of reorganization or to report his conclusion that no plan can be effected; in the larger reorganizations the plan must be submitted to the Securities and Exchange Commission for advisory report; and preliminary approval of the plan by the court is required before acceptance or authority to accept may be solicited from creditors or stockholders. That these provisions will lead to additional complexities and delay in the reorganization procedure is denied,

³¹ See 1 SECURITIES AND EXCHANGE COMMISSION, *op. cit. supra* note 2, at 243 *et seq.*, 873-896, 900; Dodd, *op. cit. supra* note 20, at 231-238. Cf. Laporte, *op. cit. supra* note 3, at 688-690; Swaine, *op. cit. supra* note 21, at 265-272.

and it is anticipated that the practical administration of the new provisions in reorganization proceedings will demonstrate that such considerations, if not wholly without foundation, are substantially outweighed by the actual benefits derived by investors.

In the preparation of the plan the trustee will have available, in addition to his own general experience, the results of the investigations of the debtor and its affairs, required, as noted above, by the new provisions. And the plan is not to be prepared in cloistered quiet without regard to the claims of contending factions, for the trustee "shall give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan, or proposals in the form of plans, within a time therein named."³² "The trustee," it was contemplated, "as a representative of the court, plays an active role in the formulation and negotiation of plans, and supplies scrutiny and control thereof in the interest of creditors and stockholders. In handling the suggestions of proposals of plans, the independent trustee would act in an informal administrative manner. He is made the active head of the reorganization process; he would provide an intermediate forum and round table where creditors and stockholders could be heard and could negotiate. In short, vital functions which in the past have been performed by inside groups or by protective committees seeking personal profit, will be vested in the trustee—with the advice and consent of creditors and stockholders and subject to court supervision."³³ Obviously the personality and competence of the trustee will be of fundamental importance in such a process. Only if the central figure be designated not by reason of any personal or political considerations but solely because of his experience and capabilities, can the new and onerous responsibilities imposed upon the trustee be adequately performed.

When the plan or the report that no reorganization can be effected has been filed by the trustee, a hearing is to be held thereon, and it is at this stage that other formal proposals may be made. Amendments to the plan proposed by the trustee, or new plans, or objections to a conclusion that reorganization is impracticable, may be filed by the debtor or by any creditor or stockholder, the requirement of section 77B(d) that twenty-five per cent of the class and ten per cent of the total amount of creditors join in the proposal of a plan having been removed.³⁴

Reference to the Securities and Exchange Commission is optional if the scheduled indebtedness of the debtor does not exceed \$3,000,000.

³² §167(6).

³³ H. R. REP. NO. 1409, 75th Cong., 1st sess. (1937) 44.

³⁴ §169. Where the debtor is continued in possession, plans may be filed (within a time fixed by the judge) by the debtor, any creditor or indenture trustees, any stockholder (if the debtor is found to be solvent) or by the examiner, if one has been appointed for the purpose. §§170, 168.

Where the indebtedness exceeds that amount, however, the judge must, after the hearing on proposed plans, submit to the Securities and Exchange Commission for examination and report the plan or plans which he regards as worthy of consideration.³⁵ This report, while carefully specified to be advisory only, is to be transmitted with the approved plan or plans to the creditors and stockholders,³⁶ and will undoubtedly have great practical effect both upon the court in determining its approval of the plan and upon creditors and stockholders in considering the plan's acceptance or rejection. Its requirement, together with the provision that the Securities and Exchange Commission may upon the request of the judge or on its own motion with his approval become a party to the proceedings with the right to be heard on all questions,³⁷ has been vigorously denounced as an unwarranted intrusion by a governmental body in private litigation between private parties involving no public question.³⁸ Analogy has also been drawn to the unsuccessful operation of the provisions of section 77 requiring the approval of plans of railroad reorganization by the Interstate Commerce Commission; and the distinction between the Interstate Commerce Commission's approval as required and the Securities and Exchange Commission report as merely advisory may be rather more formal than real.³⁹ But while some revision of section 77 may be desirable, the reasons for the failure of any substantial railroad reorganization to be thus far completed should be sought in the magnitude of railroad reorganizations and the present unfortunate economic situation of the railroads, rather than in the provisions of section 77. Given proper administration of the new provision from the standpoint both of the Securities and Exchange Commission and the court, the familiarity with reorganization problems which has been acquired by the Commission through the exercise of its existing functions under the Securities Act, the Securities Exchange Act, and more recently the Public Utility Holding Company Act, and through its investigation of reorganization procedure, should render the Commission's participation in reorganization proceedings of substantial value to investors and to the general public.⁴⁰

Section 77B is silent as to the propriety of the court giving tentative approval to a plan of reorganization before its submission to creditors

³⁵ §§172, 173.

³⁶ §175(3).

³⁷ §208. The Commission, however, is to have no right of appeal; and no allowance of compensation or expenses is to be made to it or its counsel. §§208, 242.

³⁸ Swaine, *op. cit. supra* note 21, at 265 *et seq.*

³⁹ *Ibid.* at 273-274. No specific provision is made as to whether hearings on the plan shall be held before the Commission.

⁴⁰ Laporte, *op. cit. supra* note 3, at 675-677; see Dodd, *op. cit. supra* note 20, at 238-239.

and stockholders, and there is authority both for and against such a practice.⁴¹ Under the new provisions the judge is not only permitted but required, after hearing (and, if required, reference to the Securities and Exchange Commission), to approve the plan or plans which in his opinion comply with the provisions of the Act and are fair, equitable and feasible. Any opinion rendered in connection with such approval is also transmitted to the creditors and stockholders with the plan.⁴² In addition, section 176 expressly provides that without the consent of the court no acceptance, conditional or unconditional, of any plan, nor any authority to accept a plan, shall be solicited until after the entry of an order approving such plan and its transmittal to the creditors and stockholders; and any consent or authority given or received by reason of such prior solicitation is expressly invalidated.⁴³ Literally construed, this provision might be considered, unless judicial consent were secured, to prevent even endeavors to secure support for and acquiescence in a particular plan during the preliminary negotiations, since a subsequent formal acceptance by the creditor or stockholder might be invalidated. Such a result, however, would be unreasonable, and might constitute an effective bar to the joint expression by creditors and stockholders of their desires with regard to the plan. Only the solicitation and receipt of acceptances having legal effect as such, or of authority to give such an acceptance, should be considered as within the ban of the statute.

⁴¹ For: *In re Long-Bell Lumber Co.* (W.D. Mo. 1935) C. C. H. BANKR. SERV., par. 3607; *In re Prudence-Bonds Corporation* (E. D. N. Y. 1935) 16 F. Supp. 324; *In re Pressed Steel Car Co.* (W. D. Pa. 1936) 16 F. Supp. 325, 329. Against: *Downtown Investment Ass'n v. Boston Metropolitan Bldgs., Inc.* (C. C. A. 1st, 1936) 81 F. (2d) 314; *In re Baldwin Locomotive Works* (E. D. Pa. 1937) 21 F. Supp. 94, 105-106. The provision of section 77B(d) that a plan may be proposed "at a hearing duly noticed for its consideration" has been suggested as lending statutory support to the procedure of tentative approval. See Note: *Developments in the Law—Reorganization under Section 77B of the Bankruptcy Act—1934-1936* (1936) 49 HARV. L. REV. 1111, 1194-1196.

⁴² §174.

⁴³ §77(e) [47 STAT. (1933) 1467 at 1478] as originally enacted contained the requirement (deleted in the 1935 revision) that an attorney or committee accepting a plan of railroad reorganization on behalf of a creditor or stockholder must be "acting under authority executed by him subsequent to the recommendation of the plan by the Commission." Where the deposit agreement or power of attorney authorized consent to a plan subject to a right of withdrawal, it was argued under this provision that "a failure on the part of assenters to withdraw their deposited securities or written authority within a reasonable period of time after notice that failure to withdraw within such period would be deemed to constitute execution of authority to the committee, should constitute 'authority executed'." See Rodgers and Groom, *Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act* (1933) 33 COL. L. REV. 571, 611. But see Lowenthal, *The Railroad Reorganization Act* (1933) 47 HARV. L. REV. 18, 43-46. Doubtful even under the original language of section 77(e), this argument seems entirely untenable under section 176. Cf., however, section 223.

Although subject to the "scrutiny" clause, so-called negative assents were gen-

If the acceptance or failure to accept a plan by the holder of any claim or stock is not in good faith, such claim or stock may be disqualified in determining the majority requisite for the acceptance of a plan. Aside from the provision that such good faith may be determined in the light of or irrespective of the time of acquisition of the claim or stock, no specification is given as to the meaning of this elusive phrase.⁴⁴ An indenture trustee, apparently regardless of whether the provisions of the indenture specifically authorize such action, may file claims for all holders of securities issued under the indenture, but in computing the majority necessary for the acceptance of the plan only the claims filed by holders, and allowed, are to be included.⁴⁵ The requirement of acceptance by the Secretary of the Treasury (or his failure to reject within ninety days) as a condition to the confirmation of a plan not providing for the payment in full of federal taxes or customs duties, is retained without substantial change.⁴⁶

Only minor changes are made in the provisions of section 77B with respect to the confirmation and consummation of the plan of reorganization. In confirming the plan the judge must now find that the identity, qualifications, and affiliations of the proposed directors, officers, or voting trustees have been fully disclosed and that their designation as such is equitable, compatible with the interests of creditors and stockholders and consistent with public policy.⁴⁷ Creditors or stockholders may share in the distribution even though they have filed no claim in the proceedings, provided such claims or stock have been listed by the trustee or debtor in possession as fixed, liquidated in amount, and undisputed.⁴⁸ On the other hand upon distribution a time may be fixed, expiring not

erally valid under section 77B. See *In re* 333 North Michigan Ave. Bldg. Corporation (C. C. A. 7th, 1936) 84 F. (2d) 936; *In re* Witherbee Court Corporation (C. C. A. 2d, 1937) 88 F. (2d) 251. Specific language of the unenacted Lea Bill as originally introduced, and general provisions of its later form authorized the Securities and Exchange Commission to prohibit such provisions in deposit agreements. H. R. 6968, 75th Cong., 1st sess. (1937) §10(b)(2); *ibid.* (Committee print No. 2, July 29, 1937) §§307(a)(6), 311(b)(2).

⁴⁴ §203. Cf. *Security-First National Bank v. Rindge Land & Navigation Co.* (C. C. A. 9th, 1936) 85 F. (2d) 557, *rel'g den.*, (C. C. A. 9th, 1936), 86 F. (2d) 3; *Texas Hotel Securities Corporation v. Waco Development Co.* (C. C. A. 5th, 1936) 87 F. (2d) 395. See also *HEARINGS, op. cit. supra* note 19, at 179-182, 244-245.

⁴⁵ §198. Under section 77B claims by the indenture trustee were allowed if under the provisions of the indenture there was a direct promise running to him or language indicating an agency on his part for the bondholders. *In re* Paramount Publix Corporation (C. C. A. 2d, 1934) 72 F. (2d) 219; *In re* United Cigar Stores Co., 68 F. (2d) 895 (C. C. A. 2d, 1934); *In re* Paramount Publix Corporation (C. C. A. 2d, 1934) 72 F. (2d) 219; *In re* International Match Corporation (S. D. N. Y. 1932) 3 F. Supp. 445. Cf. *In re* Allied Owners' Corporation (C. C. A. 2d, 1934) 74 F. (2d) 201.

⁴⁶ §199.

⁴⁷ §221(5).

⁴⁸ §224(4).

earlier than five years after the final decree closing the estate, within which creditors and stockholders must collect the money or new securities distributable to them under the plan or final decree, or forfeit their rights thereto. Securities or cash remaining unclaimed at the expiration of this period become the property of the debtor or of the new corporation which has acquired its assets.⁴⁹

Securities issued pursuant to the plan in exchange for securities of or claims against the debtor or partly in such exchange and partly for cash or property, or issued upon exercise of a right to subscribe or conversion privilege so issued, are as heretofore exempt from registration under the Securities Act of 1933.⁵⁰ Restricting the provisions of section 77B, however, securities publicly issued under the plan for other purposes, such as to provide working capital or funds for the payment of creditors, are no longer exempt. In line with the interpretation given by the Securities and Exchange Commission to section 77B(1) the exemption is also specifically rendered inapplicable to a distribution by an issuer or underwriter, or a participating dealer as to his unsold allotment or subscription, otherwise than pursuant to the plan. Even though the original transactions pursuant to the plan may have been exempt, the subsequent public redistribution by such persons of securities issued under a plan of reorganization is thus not exempt from registration by the new provisions.⁵¹

In order to present a connected picture of the reorganization process, discussion of the contents of the reorganization plan itself has been postponed to this point. Subject to some broadening and clarification, the provisions of section 77B in this respect are substantially unchanged. The charter of the debtor or the new corporation must prohibit the issuance of non-voting stock and provide for "the fair and equitable distribution" of voting power among the various classes of stock, including adequate provisions for the election, in the event of dividend default, of directors representing preferred stockholders.⁵² Where the liquidated indebtedness of the debtor equals or exceeds \$250,000 the charter must also provide for the making, at least annually, of periodic reports to se-

⁴⁹ §§204, 205. Similar provisions have been contained in some plans under section 77B without express statutory authority, and are common in recent years in corporate mortgages with respect to moneys deposited for the redemption or payment at maturity of the bonds.

⁵⁰ §264. Cf. Securities Act §3(a)(10), 48 STAT. (1934) 881 at 906, 15 U.S.C. §77c(a)(10). The exemption is also applicable to so-called "receiver's certificates" issued by the trustee or debtor in possession.

⁵¹ *Ibid.* See SEN. REP. NO. 1916, 75th Cong., 3d sess. (1938) 38-39. Cf. SECURITIES AND EXCHANGE COMMISSION, RELEASE NO. 646 (Securities Act of 1933). "Security", "issuer", "underwriter" and "dealer", as used in section 264, have the technical meanings defined in section 2 of the Securities Act, 48 STAT. (1933-34) 74, 881 at 905, 15 U.S.C. §77.

⁵² §216(12)(a).

curity holders, which are to include profit and loss statements and balance sheets prepared in accordance with sound business and accounting practice.⁵³ The procedure adopted in the *Paramount* case is given statutory recognition by the requirement that the plan shall provide, as to claims of the debtor or its estate not settled or adjusted in the plan, for their retention and enforcement by the trustee or, if the debtor has been continued in possession, by an examiner appointed for that purpose.⁵⁴ In *In re Paramount-Publix Corporation*, however, the occasion for the retention of the causes of action against the old management was the fact that some of the defendants in the suit were to be officers and directors of the reorganized corporation. Where such a conflict did not exist as to a management suit, or in the case of claims which arose in the ordinary course of business, a provision of the plan that the cause of action should pass to the new corporation or be returned to the reorganized debtor might be considered to have "settled" or "adjusted" the claim for the purposes of the plan of reorganization and within the meaning of the statutory provision.

PARTICIPATION IN THE PROCEEDINGS—ALLOWANCE OF COMPENSATION AND EXPENSES

Broadening the provisions of section 77B, the debtor, indenture trustees and any creditor or stockholder are entitled to be heard on all matters arising in the reorganization proceeding; and any party in interest, as well as, as above noted, the Securities and Exchange Commission, may be permitted to intervene generally or with regard to any specified matter.⁵⁵ Before being heard, however, an attorney for creditors or stockholders must file with the court a statement disclosing his clients, with the nature, amounts and (except as to claims or stock acquired more than a year prior to the proceeding) the time of acquisition of their claims or stock. A more detailed statement must be filed by a person or committee representing more than twelve creditors or stockholders, or an indenture trustee.⁵⁶ The provisions of section 77B empowering the

⁵³ §216(12) (b) (2).

⁵⁴ §216(13). See *In re Paramount Publix Corporation* (C. C. A. 2d, 1936) 82 F. (2d) 230.

⁵⁵ §§206, 207. For cause shown, a labor union or employees' association, representative of employees of the debtor, may be heard on the economic soundness of the plan affecting the interests of the employees. §206. "This will constitute solely a right to be heard thereon; and does not in any way make such organizations a party to the proceedings." SEN. REP. No. 1916, 75th Cong., 3d sess. (1938) 6.

⁵⁶ §§210, 211. The statement filed by a person or committee representing over twelve creditors or stockholders must include "the pertinent facts and circumstances in connection with the employment of such person or indenture trustee" and in the case of a committee disclose at whose instance the employment was arranged or the committee organized; the claims or stock owned by such person at the time of employment, the committee at its formation or the indenture trustee at its appear-

court to scrutinize and disregard the provisions of deposit agreements, powers of attorney, indentures or other authorizations, and to limit the claims of persons or committees acting thereunder to the actual consideration paid for such claims, are incorporated in the new provisions in substantially similar form.⁵⁷

The expense of reorganization through equity receivership, coupled with doubt as to the extent of the power of the court to limit allowances therein, was one of the principal objections raised to the old equity procedure; and under section 77B the discretionary authority of the court to make allowances for services "in connection with the proceeding and the plan"⁵⁸ was properly exercised in the direction of economy. But despite the obvious importance of restricting the reorganization expenses to the minimum reasonable amount, doubts were raised whether considerations of even more fundamental importance did not justify relaxation of the strict rules sometimes adopted. Although benefit to the estate was recognized by most courts as the basic principle involved, its application was in various cases narrowly restricted. Services by committees or other creditor representatives merely in connection with the administration of the estate were ordinarily not compensated, on the ground that this function was adequately performed by the trustee or debtor in possession;⁵⁹ yet such activities by creditor representatives might at times prove a valuable check upon the trustee or debtor. Where a substantial committee representing a particular class of security holders was already in the field, subsequently developing committees or individual intervenors have been denied compensation on the basis that their activities constituted an unnecessary duplication.⁶⁰ Yet granting the objections to compensa-

ance in the proceedings, with the cost and date of acquisition and a statement of any sales or other dispositions thereof; and the amount of claims or stock represented by such person or committee and the times of acquisition thereof by the holders, unless acquired at least a year prior to the filing of the petition. In addition a copy of the instrument, if any, authorizing such representation must be filed.

⁵⁷ §212. Apparently envisaging the enactment of the Lea and Barkley Bills, an agent, indenture trustee or committee must also satisfy the court that they have "complied with all applicable laws regulating the activities and personnel of such persons." §213.

⁵⁸ §77B(c)(9); see also §77B(b)(3), (f)(5) and (k). See generally 3 GERDES, *op. cit. supra* note 14, at c. 25; Medill, *Fees and Expenses in a Corporate Reorganization under Section 77B* (1936) 34 MICH. L. REV. 331; Note: *Developments in the Law—Reorganization under Section 77B of the Bankruptcy Act—1934-1936* (1936). 49 HARV. L. REV. 1111, 1199-1206.

⁵⁹ *In re Paramount Publix Corporation* (C. C. A. 2d, 1936) 85 F. (2d) 588; *Sartorius v. Bardo* (C. C. A. 2d, 1938) 95 F. (2d) 387; *In re United Cigar Stores Co. of America* (S. D. N. Y. 1937) 21 F. Supp. 869.

⁶⁰ *In re Paramount Publix Corporation* cases, *supra* note 59, at 588, *et seq.*; *West v. Fradenburg* (C. C. A. 8th, 1936) 86 F. (2d) 318; *Straus v. Baker Co.* (C. C. A. 5th, 1937) 87 F. (2d) 401, *modified* (C. C. A. 5th, 1937) 89 F. (2d) 322. See Note: *Developments in the Law—Reorganization under Section 77B of the Bankruptcy Act—1934-1936* (1936) 49 HARV. L. REV. 1111, 1201, n. 636.

tion of strike suitors or nuisance claimants, important contributions to the reorganization might be made by independent committees or individual intervenors, particularly where the committees originally formed were suspect of affiliation with the debtor or other "inside interests." Objection to or the defeat of a plan of reorganization has been held not compensable. So also, often as a matter of statutory construction, have attempts to develop a plan where none was formally proposed or the proceeding dismissed.⁶¹ Yet opposition to the proposed plan may be the most valuable contribution to the reorganization that could be made, and even where the proceeding is ultimately dismissed substantial time and effort may have been spent in an honest endeavor to understand and develop a solution of the situation.

In short, it was urged, "the principle governing allowances should recognize the value of constructive ideas, whether they are in support of or in opposition to favored plans, and whether advanced by groups or by individuals."⁶² In the application of this principle the provisions of section 77B have been broadened and made more comprehensive. Allowances may of course be made to the officers of the court, the trustee and his counsel, and the attorneys for the debtor and the petitioning creditors.⁶³ Reasonable compensation and expenses may be allowed to all parties in interest, and their counsel, with respect to services in connection with the administration of the estate, or in connection with a plan approved by the judge, whether or not the plan is accepted by the creditors and stockholders or is finally confirmed. No compensation or expenses, however, may be allowed the Securities and Exchange Commission or its counsel.⁶⁴ In addition, creditors and stockholders who submit plans or suggestions for plans or objections to the confirmation of a plan may, with their counsel, be allowed reasonable compensation and expenses if such services actually contribute to the plan confirmed or the refusal to confirm one. Allowances may be made even though the proceeding is ultimately dismissed or an order that bankruptcy be proceeded with is entered.⁶⁵

Neither under the new provisions nor under section 77B, however, is the mere rendition of services by a member of an eligible class a guarantee of a substantial allowance. Under the new provisions, as under section 77B, the reorganization court has broad discretionary authority as

⁶¹ Opposition: *In re Nine North Church St.* (C. C. A. 2d, 1937) 89 F. (2d) 13. But cf. *In re Consolidated Motor Parts* (C. C. A. 2d, 1936) 85 F. (2d) 579. No plan presented or proceeding dismissed: *Sartorius v. Bardo* (C. C. A. 2d, 1938) 95 F. (2d) 387. But see *Oakland Hotel Co. v. Crocker First National Bank* (C. C. A. 9th, 1936) 85 F. (2d) 959.

⁶² 1 SECURITIES AND EXCHANGE COMMISSION, *op. cit. supra* note 2, at 902.

⁶³ §241.

⁶⁴ §242.

⁶⁵ §§243, 246. See also §§216(3), 221(4).

to the persons to whom allowances are to be made and the compensation to be regarded as reasonable. And giving statutory recognition to the practice adopted by some courts under section 77B,⁶⁶ the new amendments expressly deny any compensation or reimbursement for expenses to a committee, attorney or other person acting in the proceedings in a fiduciary capacity who, after commencing to act in such capacity, has purchased or sold claims against, or stock of, the debtor. Where such claims or stock have been otherwise acquired or transferred by one acting in a fiduciary capacity, compensation and expenses are not to be allowed unless approval of the transaction by the judge is secured.⁶⁷ Claims or stock may, of course, be acquired or disposed of by gift or inheritance, levy of execution under judgments, foreclosure of pledges, or other methods unlikely to involve a breach of fiduciary duty. Nevertheless even a direct purchase or sale need not necessarily involve a violation of fiduciary obligation, and the absolute requirement that committee members freeze their own interests throughout the proceeding or lose all compensation and even reimbursement for expenses incurred may well deter substantial investors from active participation in the reorganization. It is submitted that the allowance or denial of compensation and expenses should in all situations have been left within the discretion of the court. It may be noted that in no case do these provisions apparently apply to the purchase or sale, or other acquisition or disposal, of securities of or stock in a subsidiary or affiliated corporation of the debtor.

TAX PROVISIONS

As has been noted, the new amendments incorporate without substantial change the requirement that where a plan provides for less than full payment of federal taxes or customs duties, the acceptance of such lesser amount by the Secretary of the Treasury, or his non-objection for more than ninety days after formal submission of the plan to him, is a condition precedent to confirmation.⁶⁸ This provision renders largely moot the question, much discussed prior to its inclusion in section 77B in 1935, whether the priority given the United States under section 3466

⁶⁶ See *In re Paramount Publix Corporation* (S. D. N. Y. 1935) 12 F. Supp. 823; *In re Republic Gas Corporation* (S. D. N. Y. 1936) C. C. H. BANKR. SERV., par. 4104.

⁶⁷ §249. The provisions of the so-called Borah Act [50 STAT. (1937) 810, 28 U. S. C. (1937) §572a] prohibiting fee-fixing agreements between parties and counsel in bankruptcy and reorganization proceedings as to compensation to be paid from the estate, and rendering unlawful from the allowance of compensation so fixed, are apparently unaffected by the new amendments.

⁶⁸ §199. See Hill, *The Problems and Interests of the Treasury Department in Corporate Reorganizations* (1936) 2 CORP. REORG. 464.

of the Revised Statutes is applicable in reorganization proceedings.⁶⁹ In addition, where it appears that a plan has for one of its principal purposes the avoidance of taxes, objection to its confirmation may be made upon that ground by the Secretary of the Treasury or, in the case of a state, by its authorized representative; and if the judge be satisfied that such purpose exists, the plan shall not be confirmed.⁷⁰

Numerous tax problems arise in connection with the administration of the estate in reorganization proceedings, but with few exceptions the questions presented are similar to those arising in ordinary corporate operations. In the preparation and consummation of the plan of reorganization, however, important specialized tax problems arise from several angles. Whether the proposed plan will result in taxable gain or an allowable loss to the corporation or its security holders; whether the modification or cancellation of indebtedness probably resulting from the plan will involve taxable income to the debtor; the extent to which stamp taxes will be applicable to the issues or transfers of securities or conveyances of property contemplated under the plan; the incidence of liability for past taxes of the debtor or taxes arising during the reorganization proceedings—careful consideration of these and perhaps other tax problems may be vital to the proper drafting and carrying out of the reorganization plan. Whether a disposition of capital assets resulting in allowable gain or loss will result from the plan is to be determined under complex provisions of the Revenue Acts unaffected by the new bankruptcy provisions;⁷¹ but as to each of the other problems mentioned the new amendments may prove of fundamental importance.

In *United States v. Kirby Lumber Company*,⁷² a corporation which had purchased and retired its own bonds at less than their face value, for which they had been issued, was held to have thereby made available for its general purposes assets previously offset by the obligation of the now extinct bonds, and accordingly to have realized taxable income in the amount of the difference between the face value and the purchase price of the bonds retired. Difficulties both of constitutional and statutory construction and of sound fiscal policy arose, however, in the appli-

⁶⁹ See 2 GERDES, *op. cit. supra* note 14, at §643; Friendly, *Some Comments on the Corporate Reorganizations Act* (1934) 48 HARV. L. REV. 39, 59-62; Logan, *Priorities and Lien Preferences Accorded Federal and State Claims in Corporate Reorganizations* (1938) 16 TAX MAG. 201, 202-206.

⁷⁰ §269. Under section 276c(3) this provision may apply "where practicable and expedient" to plans confirmed under section 77B after the effective date of the new provisions.

⁷¹ Revenue Act (1938) PUB. L. NO. 554, 75th Cong., 3d sess. (May 28, 1938) §112. See Regulations 94, arts. 112(a)-1-112(i)-1; FINLETTER, *op. cit. supra* note 14 at 466-486, 490-493; 2 PAUL AND MERTENS, *LAW OF FEDERAL INCOME TAXATION* (1934) §§17.33-17.113.

⁷² (1931) 284 U. S. 1. See REGULATIONS 94, arts. 22(a)-14, 22(a)-18.

cation of this principle to financially embarrassed corporations. Where by reason of insolvency or otherwise, free assets were not in fact made available to the corporation, it was generally held that no taxable income resulted.⁷³ Whether the transaction was entered into purely from the profit motive or as part of a *bona fide* plan to restore a financially embarrassed or insolvent taxpayer to a reasonably sound financial position, might also be of importance.⁷⁴ And where, as in the case of accrued interest unpaid with the taxpayer on an accrual basis, the taxpayer had in a previous tax year received a benefit through the deduction of indebtedness later cancelled, an additional complicating factor was involved.

In order to resolve these problems and to mitigate the hardship which might otherwise result from the full application of the *Kirby Lumber Company* case to such situations, specific provision is made under the new amendments as to the effect for income tax purposes of the modification, or cancellation in whole or in part, of any of the indebtedness of a debtor in corporate reorganization proceedings. No income or profit taxable under any present or future law of the United States or of any state is to be deemed to have been realized by the debtor, a trustee provided for under the plan, or the new corporation organized or made use of under the plan, by reason of such cancellation or modification; but the basis of the debtor's property (other than money) in his hands or in the hands of any person required to use his basis in whole or in part, is to be decreased for future tax purposes by the amount by which his indebtedness has been reduced or cancelled under the plan.⁷⁵ To this latter provision there is a further qualification where the indebtedness can-

⁷³ Commissioner of Internal Revenue v. Simmons Gin Co. (C. C. A. 10th, 1930) 43 F. (2d) 327; Burnet v. John F. Campbell Co. (App. D. C. 1931) 50 F. (2d) 487; Dallas Transfer & Terminal Warehouse Co. v. Commissioner (C. C. A. 5th, 1934) 70 F. (2d) 95; Madison Railways Company v. Commissioner (1937) 36 B. T. A. 1106, non-acq., Int. Rev. Bull., 1938-20-9339. Cf. Lakeland Grocery Co. v. Commissioner (1937) 36 B. T. A. 289. See 1 PAUL AND MERTENS, *op. cit. supra* note 71, at §7.43; FINLETTER, *op. cit. supra* note 14, at 486-490.

⁷⁴ Cf. Dallas Transfer & Terminal Warehouse Co. v. Commissioner (C. C. A. 5th, 1935) 70 F. (2d) 95; Auto Strop Safety Razor Co., Inc. v. Commissioner (1933) 28 B. T. A. 621, *aff'd*, Commissioner v. Auto Strop Safety Razor Co., Inc. (C. C. A. 2d, 1934) 74 F. (2d) 226.

⁷⁵ §§268, 270. These sections apply to plans confirmed under section 77B, whether before or after the effective date of the new provisions, provided that the exemption given by section 268 may be disallowed if the plan has for one of its principal purposes the avoidance of income taxes. And as stated in note 70 *supra*, the provisions of section 269 may also be applicable where the plan is confirmed after the effective date of the new provisions. §276c(3).

Although going substantially beyond the question of sharing in the assets of the estate, as to which federal power as against a state was upheld in *New York v. Irving Trust Co.* (1933) 288 U. S. 329, the application of these provisions and of section 267 to state tax laws will probably be upheld under the federal bankruptcy power.

celled or reduced consisted of unpaid accrued interest which had not resulted in a tax benefit on any income tax return; in such a case no reduction of basis is to be made. With this exception the reduction of basis takes place wherever indebtedness of a debtor has been reduced or cancelled under a reorganization plan, and whether such reduction or cancellation would have resulted in taxable income but for the exemption previously referred to is apparently immaterial. On the other hand it should be noted that the provision has no application to the property in the hands of a person not required to use the debtor's basis therefor for income tax purposes.

Under the new provisions also, the issuance, transfer or exchange of securities, or the making or delivery of instruments of transfer under any plan of corporate reorganization is exempt from any stamp taxes now or hereafter imposed under the laws of the United States or of any state.⁷⁶ Except as to the inclusion of state stamp taxes, this is substantially similar in effect to the provision of former section 77B.

While under other chapters of the Bankruptcy Act federal and state taxes are not discharged, the final decree in a corporate reorganization discharges all debts and liabilities of the debtor except as provided in the plan or in the confirmation or turnover order.⁷⁷ But the periodic nature of most federal and local taxes, and the necessary delays involved in the audit of the returns filed, often render impracticable the complete determination and establishment of tax claims in the same period as other claims against the debtor or its estate. This is particularly true of income and other taxes which arise during the course of the proceeding. In the case of federal taxes the Secretary of the Treasury, under his power to accept or reject plans, has customarily insisted upon a general assumption, by any new corporation formed under the plan, of taxes not paid or compromised. This procedure, however, was cumbersome, and in any event did not solve the similar problem as to state taxes. In order to facilitate the closing of estates, and at the same time protect the collection of government revenue, the new amendments expressly provide that all taxes found to be owing to the United States or any state from a debtor within one year from the filing of the reorganization petition and not assessed prior to the confirmation of the plan, as well as all taxes which may become owing from a trustee or debtor in possession, may be assessed against and collected from the debtor or the new corporation organized or made use of under the plan. The United States or any state may, of course, accept any provisions of the plan dealing with the assumption, settlement or payment of such taxes.⁷⁸

⁷⁶ §267. As to the inclusion of state stamp taxes, see *supra* note 75.

⁷⁷ §228 (1); see also §226.

⁷⁸ §271.

CONCLUSION

Although section 77B was hastily adopted in 1934 as an emergency measure, its underlying principles have now become an integral part of our bankruptcy structure. In recasting and rendering more workable the former provisions, and in many of the important new provisions which it adds, the Chandler Act represents a definite advance. Of the new philosophy of reorganizations involved in certain of its provisions, it has been well said, "These proposals for active participation in the formulation of the plan by the trustee and, in the case of the larger reorganizations, by the Securities and Exchange Commission, and the further recommendation that the law require that the plan be scrutinized by the court before stockholders and creditors are asked to accept it, indicate a lack of sympathy on the part of the Commission (Congress) with the proposition that a reorganization plan is in essence a bargain between the various classes of security holders and creditors and that the parties should be free to agree upon the terms of that bargain, subject only to a judicial review of limited scope Even one who, like the writer of this article, believes that it would be extremely unwise to attempt to eliminate altogether the practice of treating a reorganization plan as an agreement between committees, may nevertheless feel that it is desirable that trustees and courts play a much more active part in the final formulation of reorganization plans than they have done in the past, and that it is important that the judge be given not only the power but the duty of concerning himself with a plan unbiased by acceptances by creditors and stockholders which are artificially induced by a procedure which makes assent largely automatic and unreal."⁷⁹ Whether through these provisions the pendulum will prove now to have swung too far in the direction of governmental restraint and supervision, experience and procedure under the new amendments will alone determine.

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⁷⁹ Dodd, *op. cit. supra* note 20, at 231-232, 237.