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CHAPTER X OR SCHACKNO ACT PROCEEDINGS?

NATHAN SIEGEL

Recently three decisions have been handed down by the Circuit Court of Appeals for the Second Circuit which involve the question of whether a petition under Chapter X of the Bankruptcy Act is filed in good faith when there is a prior Schackno Act proceeding pending in the state court.¹ The problem presented as a result of these decisions transcends in importance the immediate issues involved. That problem is whether the federal courts shall yield their paramount jurisdiction in bankruptcy to the state courts. Preliminary to a discussion of this problem and these decisions of the court, it may be well to sketch first the nature and history of proceedings under the Schackno Act.

The Schackno Act Proceedings

In New York in 1933 there were outstanding certificates of participation in guaranteed mortgages in an amount of about one billion dollars. Over seventy-five per cent in amount of these mortgages was in default.² A number of large bond and mortgage companies had been placed in either rehabilitation or liquidation proceedings by the Superintendent of Insurance. It was feared that the foreclosure of these defaulted mortgages at that time would ruin the owners of real estate and seriously depress the value of the mortgage securities. The New York state legislature, therefore, declared a public emergency and enacted the so-called Schackno Act.³ By virtue of this act, and the Mortgage Commission Act of 1935⁴ which supplemented it, machinery was set up whereby certificate holders, who formerly could exercise their right of ownership in their mortgages only by unanimous action, were allowed by the vote of two-thirds in amount to bind the rights of all.⁵ Additional special terms were created to handle the cases which flowed into the courts. The procedure which was followed there is briefly as follows: Upon the request of the holders of at least fifteen per cent of the principal amount of a mortgage investment, a plan of reorganization would be proposed;⁶ or the Mortgage

¹Brooklyn Trust Co. v. Rembaugh, 110 F. (2d) 838 (C. C. A. 2d 1940); *In re* Castle Beach Apartments, 113 F. (2d) 762 (C. C. A. 2d 1940); *In re* Blinrig Realty Corp., 114 F. (2d) 100 (C. C. A. 2d 1940). The author, who is associated with David W. Kahn, Esq., was of counsel in the *Rembaugh* Case.

²Report to the Governor by George W. Alger, Commissioner appointed under the Executive Law (Aug. 5, 1934) Appendices IV and V.

³L. 1933, c. 745 as amended, N. Y. UNCONSOL. LAWS §§ 1796 *et seq.*

⁴L. 1935, c. 290 as amended, N. Y. UNCONSOL. LAWS §§ 1752 *et seq.*

⁵§ 7 of the Mortgage Commission Act, *supra* note 4; § 6 (3) and § 8 of the Schackno Act, *supra* note 3.

⁶§ 6 (1) of the Schackno Act, *supra* note 3.

Commission would, pursuant to the power delegated to it,⁷ investigate the earning capacity of the property involved, make its recommendations to the court, and propose a plan of reorganization which incorporated these recommendations. The plan might provide that the trustee be elected by the certificate holders or that he be the nominee of the court.⁸ Notice of the proceeding and plan would then be given to the certificate holders; and if sixty-six and two-thirds per cent consented to the plan, and the court approved it as fair and equitable, it would become effective.⁹

A declaration of trust was made the source of the trustee's powers. The customary provision to be found in this declaration vested the trustee "with all the rights and powers of an absolute owner of the property." The trustee's power was limited only to the extent that it could not extend a bond and mortgage or reduce the rate of interest or sell except upon permission of the court. The trust was terminable upon the written application of two-thirds of the certificate holders and the approval of the court. After the consummation of the reorganization, an order would be entered declaring that the court retained jurisdiction until the complete liquidation of the trust estate and termination of the trust.¹⁰

If after a period of operation under the plan an owner of the property found the terms of amortization and interest payments so onerous that he was unable to meet them, the trustee had several alternate remedies. He could foreclose, take title, and then administer the property for the benefit of certificate holders. Thereafter, he could sell the property subject to the outstanding mortgage and arrange new terms with a new owner. Or he could recommend to the court a modification of terms for the original owner. As a consideration for this modification the owner would often be compelled to make a further investment of capital into the property and also to agree to make improvements and repairs so that the security of the certificate holders would not be impaired.

In the past, the procedure followed by an owner who could not meet the terms of a plan of reorganization was to seek a modification of the plan in the state court. Recently, particularly in cases where the Schackno trustee has been unwilling to recommend a reduction in the scale of payments and has instituted foreclosure proceedings, owners, in a desperate attempt to save their property, have sought relief under Chapter X of the Bankruptcy Act. These attempts to invoke the jurisdiction of the federal court have been vigorously opposed by the Schackno trustees.

⁷§ 10 of the Schackno Act, *supra* note 3; see *Matter of Lawyers' Mortgage Co.*, 277 N. Y. 244, 250, 251, 14 N. E. (2d) 55 (1938).

⁸§ 6 of the Mortgage Commission Act, *supra* note 4.

⁹§ 7 (4) of the Mortgage Commission Act, *supra* note 4.

¹⁰See § 8 of the Schackno Act, *supra* note 3.

It is feared that if petitions for reorganizations under Chapter X are sustained in such cases the federal courts would be flooded with a mass of litigation, that many of the reorganization "applecarts" in the state court would be upset, that the beneficial results obtained for certificate holders during the last six years would be nullified, and that the chaos from which they were relieved in 1933 would be revived. The Schackno trustees further claim that the state court is fully equipped and ready to render relief to those entitled to it. Undoubtedly these are formidable reasons.

The Provisions of Chapter X

Let us now examine the legal arguments of the Schackno trustee and the debtor. These depend upon the structure of Chapter X considered in its entirety.

Section 141¹¹ of Chapter X provides that upon the filing of a petition by a debtor, the judge shall enter an order approving the petition if satisfied that it complies with the requirements of the Chapter and has been filed in good faith. This provision, which is substantially what the law was under former Section 77B (a),¹² was included as part of the general legislative policy which is present in other provisions of Chapter X to grant the district judge the widest discretionary powers.¹³ Under Section 77-B (a), however, Congress did not attempt to declare what was meant by "good faith." Congress laid the problem of interpretation of that term in the lap of the courts. "Good faith," the courts declared, was present within the meaning of Section 77-B (a) where the petition showed a need for reorganization and where the reorganization had a reasonable probability of being effected.¹⁴ Honesty and good intentions were not enough to constitute good faith. If it appeared that there was no hope at all of a successful reorganization at the threshold of the proceeding then the petition was not filed in good faith.¹⁵

When Congress enacted Chapter X, it attempted to embody therein a number of standards of good faith which had been previously reflected by the judicial interpretations under Section 77-B.¹⁶ But Congress was more articulate in Chapter X, in order to provide a definite guide for the courts so

¹¹52 STAT. 887 (1938), 11 U. S. C. § 541 (1939).

¹²48 STAT. 912 (1934) as amended.

¹³*In re* Prairie Ave. Bldg. Corp., 11 F. Supp. 125, 127 (E. D. Ill. 1935).

¹⁴*R. L. Witters Associates, Inc. v. Ebsary Gypsum Co.*, 93 F. (2d) 746 (C. C. A. 5th 1938); *Manati Sugar Co. v. Mock*, 75 F. (2d) 284, 285 (C. C. A. 2d 1935); *In re* Coney Island Hotel, 76 F. (2d) 126 (C. C. A. 2d 1935).

¹⁵*Tennessee Pub. Co. v. American National Bank*, 299 U. S. 18, 57 Sup. Ct. 85 (1936); *Manati Sugar Co. v. Mock*, *supra* note 14; *Provident Mutual Life Ins. Co. v. University Ev. L. Church*, 90 F. (2d) 992 (C. C. A. 9th 1937).

¹⁶SEN. REP. 1916, 75th Cong., 3d Sess. (1938) 27; H. R. REP. 1409, 75th Cong., 1st Sess. (1937) 42.

that its dockets would not be clogged with imaginary and impracticable schemes of salvation.¹⁷ Thus Section 146¹⁸ of Chapter X sets forth certain standards of a negative character by which the term "good faith" can be more easily determined:

"Without limiting the generality of the meaning of the term 'good faith,' a petition shall be deemed not to be filed in good faith if—

(1) the petitioning creditors have acquired their claims for the purpose of filing the petition; or

(2) adequate relief would be obtainable by a debtor's petition under the provisions of chapter 11 of this Act; or

(3) it is unreasonable to expect that a plan of reorganization can be effected; or

(4) a prior proceeding is pending in any court and it appears that the interests of creditors would be best subserved in such prior proceeding."

The Schackno trustee usually relies on subsections (3) and (4) of Section 146. He takes the position that it is unreasonable to expect that a plan of reorganization can be effected in the bankruptcy court and that the interests of creditors and stockholders would not be best served in that proceeding.

The argument that it is unreasonable to expect that a plan of reorganization can be effected is based on two grounds—first, that the debtor may be insolvent and hence have no right to be heard on the plan, and second, that the Schackno trustee is vested with the sole right to vote on the plan and will refuse to consent to any plan which the debtor may propose.

The Insolvency of the Debtor

The theory of the Schackno trustee is that if a debtor is insolvent, its stockholders have no equity in the property and consequently nothing to protect. If the stockholders' interests are not to be affected by the reorganization, they have no standing in the proceeding and therefore no right to be heard on any plan.¹⁹ The Schackno trustee further makes the point that if a debtor has no equity and a plan scales down the rights of certificate holders it would have the effect of benefiting stockholders at the expense

¹⁷See *Tennessee Pub. Co. v. American National Bank*, *supra* note 15.

¹⁸52 STAT. 887 (1938), 11 U. S. C. § 546 (1939); see *In re Reliable Estates*, 33 F. Supp. 588 (E. D. N. Y. 1940). The introductory words of Section 146, "Without limiting the generality," are explained by Gerdes as follows: "As a result of experience with proceedings under Section 77-B . . . , the statute specifically enumerates some of the circumstances which are deemed to indicate a lack of good faith, although these are not intended to be all inclusive." Gerdes, *Changes Effected by Chapter X of the Bankruptcy Act* (1938) 52 HARV. L. REV. 1, 8.

¹⁹Under Section 206 of Chapter X, [52 STAT. 894 (1938), 11 U. S. C. § 606 (1939)] stockholders of an insolvent debtor would probably have the right to be heard on the fairness of a plan, [see *In re Reading Hotel Corporation*, 10 F. Supp. 470 (D. C. Pa. 1935)] but under Section 179 [52 STAT. 891 (1938), 11 U. S. C. § 579 (1939)], they would not have the right to accept or reject a plan except perhaps upon a fair contribution.

of the secured creditors, thus violating the doctrine of absolute priorities laid down in the cases of *Northern Pacific Co. v. Boyd*²⁰ and *Case v. Los Angeles Lumber Co.*²¹ Although this argument doubtless should carry weight after the plan is proposed upon a consideration of its fairness, it is of no materiality at the inception of the proceeding where only "good faith" in the filing of the petition is at stake. Even if stockholders have no equity, a plan may nevertheless provide for some degree of participation for them upon a fair contribution.²² If no contribution is later made by the debtor or stockholders, then no provision for participation need be made for them. For these reasons, the debtor's insolvency as a ground for dismissing a petition was held to be untenable by the courts under former Section 77-B. In the case of *In re Central Funding Corporation*,²³ it was said that to restrict reorganizations to a case where the debtor is solvent would deprive the section of much, if not most, of its usefulness. This ruling is reflected in Section 179 of Chapter X.²⁴ That section provides that as prerequisites to a hearing for confirmation of a plan, the plan shall have been accepted in writing by the necessary majority of creditors and that if the debtor shall not have been found to be insolvent, by or on behalf of stockholders holding the majority of stock. In other words, if the debtor is insolvent, a petition may nevertheless be filed in good faith; but in that event the stockholders will have no right to vote upon the confirmation of the plan. In its interpretation of Chapter X, the circuit court in the cases under discussion has followed the construction of the Act laid down in *Central Funding Corporation, supra*, and has held that a petition may be filed in good faith even when the debtor is insolvent.²⁵

Is it unreasonable to expect that a plan of reorganization can be effected?

The second ground assigned by the Schackno trustee to show that it is unreasonable to expect that a plan of reorganization can be effected is most ingenious. The trustee says that by virtue of the reorganization proceeding in the state court the certificate holders had elected to change their property

²⁰228 U. S. 482, 33 Sup. Ct. 554 (1913).

²¹308 U. S. 106, 60 Sup. Ct. 1 (1939). The doctrine of these cases is that stockholders may not participate in a reorganization where the debtor is insolvent unless they make a fresh and adequate contribution. See also *Consolidated Rock Products Co. v. du Bois*, 61 Sup. Ct. 675 (1941), holding that the absolute priority rule applies to reorganization of solvent as well as insolvent companies.

²²308 U. S. 106, 121. The new money obtainable from stockholders may be essential to the success of a reorganization. See *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U. S. 445, 455, 456, 46 Sup. Ct. 549 (1926).

²³75 F. (2d) 256 (C. C. A. 2d 1935). See also *Case v. Los Angeles Lumber Co.*, 308 U. S. 106, 117, 121, 60 Sup. Ct. 1 (1939).

²⁴52 STAT. 892 (1938), 11 U. S. C. § 579 (1939).

²⁵*In re Castle Beach Apartments*, 113 F. (2d) 672 (C. C. A. 2d 1940); *In re Blinrig Realty Corporation*, 114 F. (2d) 100 (C. C. A. 2d 1940).

rights from those of co-owners of the bond and mortgage to those of beneficiaries of an express trust, and that they had thereby surrendered all their incidents of ownership including the right to vote in the reorganization. Now, argues the Schackno trustee, since I have the sole right to vote and since I register my unalterable opposition to any reorganization under Chapter X no matter how beneficial it may be to the certificate holders, the court can have no alternative but to dismiss the petition.²⁶

If the Schackno trustee possesses the arbitrary power to vote for all certificate holders, what is the source of this power? Admittedly, the Schackno Act does not expressly bestow it upon the trustee. Nor is there any explicit delegation of such a power in the deed of trust. So extensive a power should scarcely be implied in view of the fact that Schackno trustees "are purely statutory trustees possessing only such power and authority as is conferred upon them by statute."²⁷ Furthermore, it does not seem that even in the state court would the Schackno trustee have the right to vote on a plan of reorganization to the exclusion of the certificate holders. The special term of the supreme court can approve the plan only if two-thirds in principal amount of the certificate holders accept it.²⁸

Does the Schackno trustee derive any greater power from the provisions of the Bankruptcy Act? Former Section 77-B (b) 10²⁹ defined a creditor as a holder of claims of all kinds against the debtor or its property. "Claims" included securities other than stock, of whatever character. "Securities" included evidences of indebtedness, either secured or unsecured, and certificates of beneficial interests in property. Construing these provisions, the circuit court, in *In re Park-83rd Street Corporation*,³⁰ overruled the claim advanced by a mortgage trustee that it could vote for all certificate holders and held that a holder of a participation certificate in a mortgage was a holder of a "claim" as thus defined in Section 77-B, and, therefore, that the creditor was entitled to vote.³¹

²⁶The trustee also argues that under the terms of his trust, he cannot consent to a reorganization in the federal court without the approval of the state court. Of course, if the consent of the trustee is not essential to a Chapter X reorganization, then the approval of the state court is also unnecessary.

²⁷Weil v. President etc. of Manhattan Co., 275 N. Y. 238, 242, 9 N. E. (2d) 850 (1937).

²⁸§ 7 (1) of the Mortgage Commission Act, *supra* note 4.

²⁹48 STAT. 912 (1934) as amended.

³⁰93 F. (2d) 295 (C. C. A. 2d 1937). See also *In re Sherman Square Apartments*, 93 F. (2d) 1015 (C. C. A. 2d 1937), *cert. denied*, 303 U. S. 658, 58 Sup. Ct. 763 (1938).

³¹In *In re Allied Owners Corporation*, 74 F. (2d) 201 (C. C. A. 2d 1934), the court pointed out that if a trustee of a mortgage were allowed to vote for all bondholders, the requirement in Section 77-B that a plan be accepted by two-thirds of each class of creditors would be meaningless. See also *Guaranty Trust Co. v. Missouri Pac. Ry. Co.*, 238 Fed. 812 (E. D. Mo. 1916); *Bitker v. Hotel Duluth Co.*, 83 F. (2d) 721 (C. C. A. 8th 1936), *cert. denied*, 299 U. S. 577, 57 Sup. Ct. 42 (1936); *Herbert v. Apartments Corp. v. Mortgage Guarantee Co.*, 98 F. (2d) 662 (C. C. A. 3rd 1938).

The trustee can gain no more solace from the provisions of Chapter X than from Section 77-B. Section 106, subdivisions (1) and (4),³² which together define the term "creditor," follow the language of former 77-B (10); and if the reasoning of the *Park-83rd Street* case, *supra*,³³ is still sound, the holder of the certificate is the creditor entitled to vote. This conclusion is further fortified by other provisions in Chapter X. This Section 198,³⁴ a new provision in the Act, states that an indenture trustee "may file claims for all holders, known or unknown, of securities issued pursuant to the instrument under which he is trustee, who have not filed claims. . . ." In computing the majority necessary for the acceptance of the plan, however, "only the claims filed by the holders thereof, and allowed, shall be counted." It would seem clear from this section that the term "holders" means the certificate holders and not the indenture trustee. Moreover, Section 216 (10)³⁵ of Chapter X declares that a plan or reorganization may provide for the cancellation or modification of indentures or other similar instruments; and Section 227³⁶ of Chapter X provides that the court may direct the debtor, any mortgagee, or indenture trustee to execute or join in whatever instruments may be necessary to effect a transfer of property under a plan, and even to satisfy liens. Sections 216 and 227 could easily be nullified if a Schackno trustee were able to defeat a plan simply by refusing to consent to it, for the result would then be that the federal court could cancel or modify an indenture only when the latter was willing to consent thereto.

The answer which the Schackno trustee makes to all these arguments is that it is not an "indenture trustee" but a trustee of an express trust. The Schackno trustee claims that he is in the position of a trustee of a bankrupt corporation which owns a mortgage and that the certificate holders occupy a position which corresponds to that of stockholders; or that he is in the position of a trustee of a voluntary trust under a will with power to manage and liquidate for certain legatees, and that the certificate holders hold a position similar to the legatees.³⁷ In neither case would the stockholders or legatees be entitled to vote on a plan.

This reasoning seems to ignore the definition of an "indenture trustee" set forth in Section 106 (8)³⁸ of Chapter X. That section provides that "'indenture trustee' shall mean a trustee under a mortgage, deed of trust, or indenture,

³²52 STAT. 883 (1938), 11 U. S. C. § 506 (1), (4) (1939).

³³*Supra* note 30.

³⁴52 STAT. 893 (1938), 11 U. S. C. § 598 (1939).

³⁵52 STAT. 895 (1938), 11 U. S. C. § 616 (10) (1939).

³⁶52 STAT. 899 (1938), 11 U. S. C. § 627 (1939).

³⁷See *Montgomery v. M'Dermott*, 103 Fed. 801, 805, 806 (C. C. A. 2d 1900); *cf. In re Murel Holding Corp.*, 75 F. (2d) 941 (C. C. A. 2d 1935), where the mortgage was held by a single creditor, the Metropolitan Insurance Co.

³⁸52 STAT. 883 (1938), 11 U. S. C. § 506 (8) (1939).

pursuant to which there are securities outstanding, other than voting-trust certificates, constituting claims against a debtor or claims secured by a lien upon any of its property." It would seem that the Schackno trustee falls within this comprehensive definition since it is a trustee either under a deed of trust or indenture. Calling itself a trustee under an express trust instead of an indenture trustee can not help it, for it merely has the powers customarily committed to an indenture trustee, such as the collection of the income from the trust estate and its conversion into other forms of security.

But even if the certificate holders had agreed expressly to disenfranchise themselves, it is hardly open to question but that the court could under Section 212³⁹ of Chapter X disregard the agreement and allow them to vote. As Judge Chase, speaking for the circuit court, indicated in the *Casile Beach*⁴⁰ case, "They are trustees . . . acting as such for the benefit of the certificate holders and may not vote in their stead unless, at least, the judge permits that. Sec. 212 of the Bankruptcy Act. . . ." In the later case of *In re Blinrig Realty Corporation*,⁴¹ the same proposition was urged again, but Judge Chase adhered to his previous ruling. The trustee, he said, has "no such certain power to block the acceptance of a plan in its capacity as trustee."⁴² It is submitted that this is a salutary principle. Once technicalities are disregarded, it becomes obvious that the bondholders are the real creditors and that it is their interests which are being affected. Therefore, they should have the right to elect between the federal court proceeding and the state court proceeding.

Is a prior proceeding pending in which the interests of creditors and stockholders will be best served?

The other ground usually relied upon by the Schackno trustee in seeking a dismissal of the petition as not being filed in good faith is that a prior proceeding is pending and that the interests of creditors and stockholders will be best served in that proceeding. The prior proceeding which is pending may be the Schackno proceeding which has not as yet been consummated or a foreclosure proceeding instituted by the Schackno trustee after consummation.

That a prior proceeding is pending is not of itself enough to bar a petition

³⁹52 STAT. 895 (1938), 11 U. S. C. § 612 (1939). "The Judge may examine and disregard any provision of a . . . trust mortgage, trust indenture or deed of trust . . . , may restrain the exercise of any power which he finds to be unfair or not consistent with public policy. . . ." A capricious refusal to vote for a plan which is definitely beneficial might under this section disqualify the trustee from voting even if it had the power, on the ground that the power was being exercised unfairly. *In re 236 West 38th Street Corp.*, 37 F. Supp. 667 (S. D. N. Y. 1941).

⁴⁰113 F. (2d) 762, at 764.

⁴¹*Supra* note 1.

⁴²114 F. (2d) 100, at 101.

for reorganization from being filed in the federal court. Section 256⁴³ of Chapter X makes it clear that a petition may be filed under the Chapter notwithstanding the pendency of a prior mortgage foreclosure. Moreover, an examination of Section 146 (3)⁴⁴ discloses that it requires more than a prior proceeding pending in the state court to stamp a petition as being filed in bad faith. The subdivision is conjunctive in character and requires also that the interests of creditors and stockholders will be best served in that pending proceeding.

It is interesting to note, however, that in the three recent decisions of the Second Circuit Court, *Brooklyn Trust Co. v. Rembaugh*, *In re Castle Beach Apartments*, and *In re Blinrig Realty Corporation*, the court did not seem to give consideration at all to the question of whether the interests of creditors and stockholders would be better subserved in the prior pending proceeding.

The Rembaugh, Castle Beach, and Blinrig Cases

In *Brooklyn Trust Co. v. Rembaugh*,⁴⁵ the first of these cases, the debtor had consented to a Schackno reorganization proposed by the Mortgage Commission. The debtor met the payments provided for in the plan for several years, when it defaulted. Foreclosure proceedings were instituted by the Schackno trustee, and a receiver was appointed. The debtor tried to obtain a modification of the state plan from the Schackno trustee and, failing in that, filed its petition under Chapter X for reorganization. The district court approved the petition as one filed in good faith, but the circuit court reversed. Judge Chase, writing the opinion for the court, held that the bankruptcy court had jurisdiction by virtue of Section 256 which expressly conferred it, notwithstanding the prior proceedings in the state court. He further declared there was no fault to be found with the exercise by the district court of its discretion in approving the petition "as one filed in good faith within the 'broad meaning' of that term." But he held that there was another phase of the requirement of good faith lacking. There was the fact that the debtor, having previously assented to the plan in the state court, could not, when it found the state order difficult to comply with, seek relief in the federal court instead of the state court. In the words of Judge Chase, the debtor "could not escape from the consequences of the plan to which it had assented by simply filing a petition for reorganization in the federal court while the proceedings in the state court were still pending."⁴⁶

⁴³52 STAT. 902 (1938), 11 U. S. C. § 656. See *Brooklyn Trust Co. v. Rembaugh*, *supra* note 1, at p. 840.

⁴⁴*Supra* note 18.

⁴⁵*Supra* note 1.

⁴⁶110 F. (2d) 838, at 840.

Shortly thereafter, the same court decided the *Castle Beach Apartment*⁴⁷ case. There, the debtor who filed under Chapter X was a purchaser of the property upon a foreclosure sale which followed an unsuccessful attempt by the original owner to reorganize under state law. The decision of the district court finding the petition to be filed in good faith was affirmed. Judge Chase found little merit in the argument that it was unreasonable to expect that a reorganization could be effected because the debtor was insolvent. He ruled also that the Schackno trustee had no right to vote for all the certificate holders. Judge Chase then distinguished his own opinion in *Brooklyn Trust Co. v. Rembaugh*, and said that the bad faith, which was imputed to the original owner in that case because it sought relief from state court proceedings to which it had previously assented, could not be imputed to the purchaser, the debtor of the *Castle Beach* case, who had nothing to do with the prior state court proceedings.

The last case to be decided in this series was *In re Blinrig Realty Corporation*.⁴⁸ There the debtor never assented to a modification or reorganization in the state court. Attempts were made at various times by the Schackno trustee to obtain the acceptance of a plan by the debtor but without success. A plan submitted in 1936 was refused by the debtor. A later attempt in 1937 to modify and extend the mortgage was abandoned by him. After an action to foreclose was begun by the Schackno trustee because of defaults in payment of interest and principal, the owner filed its petition under Chapter X. The district judge's decision finding the petition to be filed in good faith was reversed.

Judge Chase, again writing for the Second Circuit Court, reaffirmed his previous rulings that the state court proceeding was no bar in itself to relief and that the Schackno trustee was not vested with the right to vote for all certificate holders. But Judge Chase declared that good faith was lacking because the history of the the debtor's efforts to reorganize in the state court did not warrant the belief that the efforts in the federal court would be crowned with any greater success. He said that a change of tribunals was not enough to sustain the plea that the debtor's creditors would agree to a plan containing less favorable terms than those proposed in the state court, or that the debtor could do any better than he was able to do in the state court.

Of these three cases, both the debtor who assented to the state court plan and tried in vain to comply with it and the debtor who refused to assent thereto because he felt compliance would be difficult were denied relief in the federal court. The only one for whom the bars were let down was a purchaser from the original owner upon the foreclosure in the state court. An interesting

⁴⁷*Supra* note 1.

⁴⁸*Ibid.*

question may arise if a nominee of an original owner purchased the property upon the foreclosure. Would he hold the position of a stranger? If the owner sold the property before foreclosure proceedings were instituted, would the purchaser have the rights of a purchaser upon foreclosure? If he has the same rights, a device is available to avoid the ruling of the *Rembaugh* and *Blinrig* cases and to come within the ruling of the *Castle Beach* case. The original owner need only form a new corporation to which he can sell or convey his property or make the transfer to any "dummy."⁴⁹ The subterfuge could not without difficulty be discovered and the original owner would, under the guise of purchaser, be allowed to file a petition for reorganization.

It is questionable whether Congress contemplated any such distinction between original owners and purchasers in enacting Section 146. Congress was most concerned with the forum in which the interests of stockholders and creditors would be best protected. Yet, as we have pointed out, the circuit court is strangely silent on this crucial requirement. It seems that had the court proceeded to inquire into that phase of the Act, as it was bound to do, it would have found that the interests of creditors and stockholders would be best subserved in the federal court.

*The Rights of Creditors and Stockholders in the State Court
and in the Federal Court*

So far as the certificate holders are concerned, a most persuasive argument can be made that their rights would be better protected in the state court. If the Schackno trustee foreclosed and bid in the property upon foreclosure, the certificate holders would become the owners free and clear of the claims of stockholders. Thereafter, if the property earned more than its fixed interest rates, the surplus could be divided among the certificate holders as an additional dividend instead of being paid to the stockholders. If the property were resold, the proceeds of the sale after deduction of administration expenses could be divided pro rata among certificate holders.

Chapter X, however, contemplates the protection of the rights not only of the secured creditors but likewise of stockholders and unsecured creditors. It is perfectly plain that the continuance of a foreclosure would wipe out the interests of these groups and prevent them from getting any relief whatever.

In a reorganization proceeding under Chapter X, fair and adequate treatment would be made for them. If the debtor were insolvent some participation could be given junior interests upon a reasonable contribution.⁵⁰

⁴⁹Formation of a corporation for express purpose of taking title to property and for filing of petition in reorganization was held not sufficient to impute bad faith in *In re Knickerbocker Hotel Co.*, 81 F. (2d) 981 (C. C. A. 7th 1936); but see *In re North Kenmore Bldg. Corporation*, 81 F. (2d) 656 (C. C. A. 7th 1936).

⁵⁰*Case v. Los Angeles Lumber Co.*, 308 U. S. 106, 60 Sup Ct. 1 (1939).

There are, however, many reasons to believe that the rights of secured creditors may also be better protected in the federal court than in the state court. In the first place, the doctrine of absolute priorities enunciated in *Northern Pacific Railroad v. Boyd*⁵¹ and *Case v. Los Angeles Lumber Products Company*⁵² is applicable in Chapter X but finds no currency in state court reorganizations. Assurance is thereby given that the rights of senior classes of creditors will not be disturbed by concessions to junior classes unless the latter provide a fair and adequate consideration for what they receive. Secondly, the structure of Chapter X offers many other protective considerations.

In large cases where the liabilities exceed \$250,000, an independent disinterested trustee must be appointed.⁵³ The attorney for this trustee must also be disinterested.⁵⁴ The trustee, upon appointment and qualification, must investigate the property, and its management and operation and the desirability of its continuance.⁵⁵ The trustee must report to the judge in charge concerning any fraud, misconduct, or mismanagement.⁵⁶ The results of the investigation are sent to creditors and stockholders and the latter are asked to suggest proposals to be included in the plan.⁵⁷ Before approving a plan, a judge may seek the aid of the Securities and Exchange Commission for an advisory report.⁵⁸ Notice of the hearing on the plan is then given to creditors and stockholders.⁵⁹ Consent of the court is required for solicitation of acceptances of the plan, else the acceptance is invalid.⁶⁰ The district judge must make an independent inquiry of the fairness of the plan; he must examine the new capital structure; he must make a finding that the earning capacity of the new enterprise will be sufficient to meet fixed charges; he must determine whether the distribution of new securities fairly reflects existing rights and whether all rights are equitably treated.⁶¹ After the plan is scrutinized by the judge and the Securities and Exchange Commission, it is submitted with all

⁵¹228 U. S. 482, 33 Sup. Ct. 554 (1913).

⁵²308 U. S. 106, 60 Sup. Ct. 1 (1939).

⁵³Section 156, 52 STAT. 888 (1938), 11 U. S. C. § 556 (1939); SEN. REP. *supra* note 16, at p. 19.

⁵⁴Section 157, 52 STAT. 888 (1938), 11 U. S. C. § 557 (1939).

⁵⁵Section 167 (1), 52 STAT. 890 (1938), 11 U. S. C. § 567 (1) (1939).

⁵⁶Section 167 (3), 52 STAT. 890 (1938), 11 U. S. C. § 567 (3) (1939).

⁵⁷Section 167 (5), (6), 52 STAT. 890 (1938), 11 U. S. C. § 567 (5), (6) (1939).

⁵⁸Section 172, 52 STAT. 890 (1938), 11 U. S. C. § 572 (1939). *In re* 263 West 38th Street Corp., 37 F. Supp. 667 (S. D. N. Y. 1941); see *Securities and Exchange Commission v. United States Realty and Improvement Co.*, 310 U. S. 434, 60 Sup. Ct. 1044 (1940).

⁵⁹Section 171, 52 STAT. 890 (1938), 11 U. S. C. § 571 (1939).

⁶⁰Section 176, 52 STAT. 891 (1938), 11 U. S. C. § 576 (1939).

⁶¹*Case v. Los Angeles Lumber Co.*, *supra* note 52, at p. 115; *Consolidated Rock Products Co. v. du Bois*, *supra* note 21; see *In re United Railways and Electric Co.*, 11 F. Supp. 717 (D. C. Md. 1935).

other available data and reports to parties interested for consideration, so that they can benefit from the analysis to which it has been subjected.⁶² If the plan has been accepted by the necessary majorities, a hearing is held for its confirmation upon due notice to all creditors and stockholders.⁶³ If the plan is fair, equitable, and feasible,* and if its proposal and acceptance are in good faith and not in violation of any of the prohibitions contained in the Act, it will be confirmed.⁶⁴ The court's investigation does not stop here but is directed even to the methods by which the management of the reorganized corporation is to be chosen in order to insure adequate representation for the interests of all creditors and stockholders.⁶⁵ Also, to that end, the judge may pass upon the qualifications of the management and voting trustees, if any, upon the consummation of the plan.⁶⁶ Finally, the court has full power to review all fees and expenses in connection with the reorganization from whatever source they may be payable.⁶⁷ In that way, every possible safeguard is maintained for the protection of every class. The Schackno Act, on the other hand, does not provide for corresponding safeguards. Particularly is it lacking in a device whereby the certificate holders, unsecured creditors, and stockholders receive a full and impartial report from a disinterested trustee, and whereby the court obtains the benefit of an expert advisory report from a public agency such as the Securities and Exchange Commission. This in itself is a sufficient guaranty that the proceedings under Chapter X will be exercised for the benefit of all parties.

In analyzing the decisions of the circuit court in the *Rembaugh* and *Blinrig* cases it is important to understand, first, what is the real basis which underlies these decisions and, second, whether this basis has any validity in law or reason.

What was the basis of the *Rembaugh* case? Surely it was not the consent to the prior proceeding in the state court which caused the court to impute bad faith to the debtor. For if it were consent, then by the same token in

⁶²Section 175, 52 STAT. 891 (1938), 11 U. S. C. § 575 (1939).

⁶³Section 179, 52 STAT. 891 (1938), 11 U. S. C. § 579 (1939).

*See Gilchrist, "Fair and Equitable" Plan of Reorganization: A Clearer Concept (1941) 26 CORNELL L. Q. 592; see also Dean, *A Review of the Law of Corporate Reorganizations* (1941) 26 CORNELL L. Q. 537. [Ed.]

⁶⁴Section 221 (2), (3), 52 STAT. 897 (1938), 11 U. S. C. § 621 (2), (3) (1939).

⁶⁵Section 221 (5), 52 STAT. 897 (1938), 11 U. S. C. § 621 (5) (1939).

⁶⁶Section 216 (11), 52 STAT. 895 (1938), 11 U. S. C. § 616 (11) (1939); see SEN. REP. *supra* note 16, at p. 35.

⁶⁷Section 221 (4), 52 STAT. 897 (1938), 11 U. S. C. § 621 (4) (1939). Under the ruling of *Woods v. City National Bank & T. Co.*, 61 Sup. Ct. 493 (1941), a petitioner for allowances who has served conflicting interests will be denied compensation even though no fraud or unfairness have been shown. While the state court passes on fees of the trustee and his attorneys, its power is not as comprehensive as the federal court.

the *Blinrig* case, where consent to the prior proceeding was lacking, the court should have found that the petition was filed in good faith. Certainly, too, it was not that a prior petition was pending in the state court because, as the court admitted, Section 256 of Chapter X expressly provides for that contingency. The sole ground remaining common to both cases was that the debtors were seeking to escape from terms demanded in the state court with which they found it difficult to comply. In the last analysis, the circuit court was examining the motives of these debtors although good faith, which is a question of fact, had already been determined in favor of the debtors by the district court to whose care and discretion the question had been committed by statute. This is opposed to the rule in bankruptcy cases where the motives of a party instituting a bankruptcy petition are considered to be immaterial.⁶⁸ If a debtor files its petition in bankruptcy for the sole purpose of wiping out his debts, his discharge is not denied on that account nor is the right to file the petition barred. That was the purpose of the Act.⁶⁹ Now admittedly, one of the main purposes of Section 77-B and the Chandler Act was to avoid the drastic consequences of foreclosure and liquidation.⁷⁰ A logical corollary to this proposition is that a debtor may be relieved from the severity of its obligations. There is nothing unusual about this. Thus it is well settled that bankruptcy proceedings may modify and affect property rights established by state law, including a mortgage contract.⁷¹ Indeed, the Chandler Act was included in the Bankruptcy Act so that the constitutional right which exists in bankruptcy to modify contracts over the protest of minority groups would be available in reorganization proceedings also.⁷² One of the means of effectuating that purpose is found in Section 216.⁷³ That section provides that a plan of reorganization may include adequate means for the execution of the plan, which among other things may involve the rejection of executory contracts, the satisfaction or modification of liens, the cancellation or modifica-

⁶⁸*In re Dressler Producing Corporation*, 262 Fed. 257 (C. C. A. 2d 1919); *Struthers Furnace Co. v. Grant*, 30 F. (2d) 576 (C. C. A. 6th 1929).

⁶⁹*Ibid.*

⁷⁰H. R. REP. *supra* note 16, at p. 38; H. R. REP. 194, 73rd Cong., 1st Sess. p. 2; *Kuehner v. Irving Trust*, 299 U. S. 445, 452, 57 Sup. Ct. 298 (1937); *Case v. Los Angeles Lumber Co.*, *supra* note 52, at p. 124.

⁷¹*Wright v. Union Central Insurance Co.*, 304 U. S. 502, 516, 58 Sup. Ct. 1025 (1938); *Wright v. Venton Branch*, 300 U. S. 440, 470, 57 Sup. Ct. 556 (1937).

⁷²FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION (1939) 25; see *In re Allied Owner's Corporation*, *supra* note 31.

⁷³52 STAT. 895 (1938), 11 U. S. C. § 616 (1939). This section was derived from former Section 77-B, [48 STAT. 912 (1934) as amended] which was held to be constitutional in *In re Central Funding Corporation*, *supra* note 23. Also, under Section 116 (3), 52 STAT. 885 (1938), 11 U. S. C. § 516 (3), the trustee may upon good cause shown and order of the court borrow money upon certificates of indebtedness which will be given priority over existing mortgage liens. *In re Prima*, 88 F. 2d 785 (C. C. A. 7th 1938).

tion of indentures, the curing or waiving of debts. And, of extreme pertinency to proceedings pending in state courts similar to those under Schackno reorganizations, Section 216 (10) provides for extensions of maturity dates and changes in interest rates and other terms of outstanding securities.

In view of this section and the others already adverted to, any claim that a debtor may not seek relief in the federal court when it finds the state order difficult to comply with disregards the plain words of the Act. Obviously, a debtor will seek a modification in the federal court only in order to be relieved of "irksome" conditions—not when they are easy to comply with. And the simple fact is that the typical debtor who turns to the federal court has already been turned away by the state court. If the Schackno trustee refuses to recommend a modification of terms, it is rare that a special term court will override the trustee's decision. What recourse is left for the debtor then? The law does not require him to take successive, expensive, and perhaps fruitless appeals.⁷⁴ Congress has provided a remedy in the federal court that is economical, swift, and fair. As Mr. Justice Hughes declared in a case⁷⁵ involving a proceeding under Section 75 of the Bankruptcy Act, a debtor should not be charged with bad faith because it takes the course provided for it by Congress. Only recently, a similar observation was made by the circuit court of appeals with respect to a proceeding filed under Chapter XI of the Chandler Act. In reply to the appellant's contention that the debtor's petition was not filed in good faith but merely to get rid of the state receivership, Judge Swan said, "The answer is that the debtor has a legal right to have her property administered in bankruptcy."⁷⁶

Let us suppose that instead of a voluntary petition in reorganization the proceeding had been an involuntary one instituted by unsecured creditors whose claims had been incurred after the approval of the Schackno reorganization. No valid argument could be made that the bar to a debtor's petition operated likewise to bar these creditors. Yet it would seem to follow that if the court would have entertained an involuntary petition against the debtor it likewise should where a voluntary petition filed by the debtor is involved.

Nor is there any sound reason why the debtor's consent to the state court proceedings forecloses it in the federal court.⁷⁷ Admittedly, by so consenting

⁷⁴See *Local Loan Co. v. Hunt*, 292 U. S. 234, 241, 242, 58 Sup. Ct. 695 (1934); *Gross v. Irving Trust Co.*, 289 U. S. 342, 345, 53 Sup. Ct. 605 (1932).

⁷⁵*John Hancock Mutual Life Ins. Co. v. Bartels*, 308 U. S. 180, 185, 58 Sup. Ct. 605 (1939); see also *In re Surf Bldg. Corp.*, 11 F. Supp. 295, 296 (E. D. Ill. 1934) (petition in 77-B).

⁷⁶*In re Koch*, 116 F. (2d) 243, 247 (C. C. A. 2d 1940).

⁷⁷Consent to pending state court proceedings was given but the question was not squarely raised that such consent barred relief in the federal court in *In re Union National Bank v. Lehmann-Higginson Grocer Co.*, 82 F. (2d) 969 (C. C. A. 10th 1936); *In re Cloisters Bldg. Corp.*, 79 F. (2d) 694 (C. C. A. 7th 1935), *cert. denied*, 296 U. S. 657, 56

it did not also agree not to resort to a federal reorganization. A debtor's consent to a judgment in the state court or a composition, or an assignment for the benefit of creditors, nevertheless, leaves him free to apply to a bankruptcy court in order to wipe out the judgment or to nullify the composition or assignment.⁷⁸ So also, creditors who are parties to, or consent to, state court proceedings are not thereafter barred from joining as petitioning creditors in involuntary proceedings.⁷⁹ Indeed, it would seem that an express agreement by a debtor not to avail itself of its constitutional rights in bankruptcy would be declared void as being against public policy.⁸⁰ And had the Schackno Act declared that as a condition to reorganizing in the state court the debtor thereby waived his rights *in futuro* to file under Chapter X, there can be little doubt that it would be invalid.⁸¹ Yet the result of the decisions of the circuit court is to endow the state statute with that very force which the state legislators themselves were powerless to give to it.

The issue involved here, however, is not one of the power of the bankruptcy court to supersede the state court proceedings. That right is unquestioned and beyond dispute. The problem rather is one of policy. Shall the state court be permitted to retain its jurisdiction? To accept that view is, in effect, to surrender to the state court the paramount and exclusive jurisdiction which the federal courts have always exercised in the field of bankruptcy and reorganization. This superior jurisdiction is manifested in many ways where proceedings are first instituted in state courts. Thus, state banking laws relative to bank insolvencies⁸² or state laws which purport to grant a discharge to a debtor of his debts⁸³ are superseded by the Bankruptcy Law. An assignment for the benefit of creditors or composition under state law must give way to the bankruptcy laws, and the assignee may be required by summary order to turn over the assets in his hands to the trustee in bankruptcy.⁸⁴ The

Sup. Ct. 382 (1936), the courts merely holding that the petitions were filed in good faith despite the pending state court proceedings. See also cases cited *supra* note 68.

⁷⁸See *Matter of Denton & Haskins Music Pub. Co.*, 10 F. Supp. 802, 804 (S. D. N. Y. 1935); *Struthers Furnace Co. v. Grant*, *supra* note 68.

⁷⁹*In re Curtis*, 91 Fed. 737 (S. D. Ill. 1889), *aff'd*, 94 Fed. 630 (C. C. A. 7th 1889); *In re Greenberg*, 23 F. Supp. 836 (S. D. N. Y. 1938).

⁸⁰See *In re Weitzen*, 3 F. Supp. 698 (S. D. N. Y. 1933); *In re Los Angeles Lumber Products Co.*, 24 F. Supp. 501, 515, 516 (D. C. Cal. 1938), *aff'd*, 100 F. (2d) 963 (C. C. A. 9th 1939), *rev'd on other grounds*, 308 U. S. 106, 60 Sup. Ct. 1 (1939); *cf.* *Local Loan Co. v. Hunt*, *supra* note 74.

⁸¹*In re Mt. Forest Fur Farms of America*, 103 F. (2d) 69 (C. C. A. 6th 1939), *cert. denied*, 308 U. S. 583, 46 Sup. Ct. 351 (1939). See *In re Drake Motor and Tire Mfg. Corporation*, 16 F. (2d) 142 (D. Tenn. 1923).

⁸²*In re Bajardi*, 8 F. (2d) 551 (C. C. A. 2d 1926), *cert. denied*, 270 U. S. 651 (1926); *In re Prudence Co.*, 79 F. (2d) 77 (C. C. A. 2d 1935), *cert. denied*, 296 U. S. 646, 56 Sup. Ct. 247 (1935).

⁸³*International Shoe Co. v. Pinkus*, 278 U. S. 261, 49 Sup. Ct. 108 (1929).

⁸⁴Section 3 (a) 5, 30 STAT. 546 (1898) as amended, 32 STAT. 797 (1903), 11 U. S. C. § 21 a (5); *In re Louis Newberger*, 233 Fed. 701 (S. D. N. Y. 1916), *aff'd*, 240 Fed. 947 (C. C. A. 2d 1917).

power of the state court to fix the compensation of receivers and to name counsel for receivers comes to an end with the supervening bankruptcy and then vests in the bankruptcy courts.⁸⁵ In these cases the state proceedings or laws were suspended because they conflicted with or encroached upon the paramount jurisdiction of the bankruptcy courts. The wisdom of this course in the extension of federal jurisdiction should be recognized also in cases where a debtor who previously reorganized under the Schackno Act seeks to have his real property administered in a federal reorganization court. It must be kept firmly in mind that the Schackno Act was designed primarily to be of assistance to certificate holders. It therefore can scarcely be seized as a vehicle of aid for a failing debtor. Nor can it be considered as the equivalent of the federal reorganization statute in which the claims of all creditors and stockholders are impartially adjusted and determined.

Conclusion

From a reading of the provisions of Chapter X, its history and background, it is clear that Congress intended to abandon state courts as a forum for corporate reorganizations and to concentrate proceedings of that character in the federal court. Jurisdiction should not be disclaimed because of "convenience,"⁸⁶ or comity,⁸⁷ or because of the groundless fear that the federal court would be flooded with cases. There is every reason to believe that the federal court will be just as zealous in its protection of the rights of all parties as will the state court. It is surely as well equipped as is the state court to handle these cases. Moreover, Chapter X affords an expeditious and economic method of reorganization, and, as demonstrated above, offers many protective safeguards not to be found under the Schackno proceedings.

By holding that a debtor may not seek relief in the federal court because it finds conditions "irksome" in the state court and difficult to comply with, the circuit court has substituted its own standard of good faith for that of the Act. The provisions of Section 146 (4) in Chapter X preclude an assertion of good faith when two factors are present: (1) that a prior proceeding is pending in another court, and (2) that the interests of creditors and stockholders would be best subserved in such prior proceeding. The circuit court by its rulings in the *Rembaugh* and *Blinrig* cases has, in effect, found bad faith in the filing of the petition merely from the pendency of the state court

⁸⁵Gross v. Irving Trust, *supra* note 74; Taylor v. Sternberg, 293 U. S. 470, 55 Sup. Ct. 260 (1934).

⁸⁶*In re* Manbeach Realty Corporation, 10 F. Supp. 523 (E. D. N. Y. 1935); *In re* Sterba, 74 F. (2d) 413, 416 (C. C. A. 7th 1935).

⁸⁷*Cf.* Matter of Amawalk Nursery, Inc. (not reported), Southern District of New York No. 60774, Judge Knox; *In re* Greyling Realty Corp., 74 F. (2d) 734 (C. C. A. 2d 1935).

proceedings. It has failed, however, to inquire whether the rights of creditors and stockholders would be best subserved therein. This narrow construction of a remedial statute⁸⁸ only tends to whittle away the broad power of the bankruptcy court of reorganizations and to defeat the plain intent of Congress. For these reasons, it is submitted, the *Rembaugh* and *Blinrig* rulings need reconsideration and revision.⁸⁹

⁸⁸Chapter X is a remedial statute and should be liberally construed. See *In re Lake's Laundry*, 79 F. (2d) 326 (C. C. A. 2d 1935), *cert. denied*, 296 U. S. 622, 56 Sup. Ct. 144 (1935), construing Section 77-B.

⁸⁹See *In re Julius Roehrs Co.*, 115 F. (2d) 723 (C. C. A. 3d 1940). The *Rembaugh*, *Blinrig*, and *Castle Beach* cases are referred to and discussed in recent cases in the Southern District Court of New York. *In re 263 West 38th St. Corporation*, *supra* note 39, per Judge Hulbert; *In the Matter of Marine Harbor Properties, Inc.* (not reported), No. 79473 (Sept. 30, 1941), per Judge Bright (petitions under Chapter X sustained); *In re Paloma Estates* (not reported) No. 78958 (July 25, 1941), per Judge Knox (petition dismissed).