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## ASPECTS OF CORPORATE REORGANIZATION UNDER SECTION 77B OF THE BANKRUPTCY ACT

ON JUNE 7th, 1934, the amendment to the Bankruptcy Act, commonly known as 77B, providing for the reorganization of industrial corporations that were in financial difficulties was adopted. The passage of the amendment was followed by the filing of petitions by many distressed corporations who sought to take advantage of its provisions as a shelter from the storm. As a result, many of the Federal Courts have been called upon to consider various provisions and phases of the enactment. While it is impossible at present to give any comprehensive picture of the results of these proceedings, or determine whether the act has furnished the relief anticipated, we can get some understanding of the problems presented and how the courts are dealing with them by an examination of the decisions so far rendered.

Before taking up the actual current decisions for consideration, it is desirable to review briefly the situation existing prior to the passage of the Act. Following the crash of 1929, and through the years of depression many large corporations found themselves unable to meet the pressing current obligations although having large and valuable "frozen" assets. When they looked about for relief two courses presented themselves, bankruptcy and a Federal Equity receivership.

The bankruptcy proceedings as set forth in the 1898 Act were designed for the purpose of liquidating the business of the corporation and distributing its assets as speedily as possible among the

creditors. A bankruptcy receiver or trustee might operate a business under court order for a limited period, but this was only for the purpose of securing a purchaser who might be induced to bid more for the business as a going enterprise than for its bare physical assets. It did not contemplate or provide for rehabilitation. It is true that in such proceedings a composition agreement might be effected.<sup>1</sup> Such action would restore the assets to the old corporation and enable it to continue its business, but there were inherent difficulties in these proceedings which made successful reorganization difficult. If a creditor held securities or liens on the bankrupt's property, the composition proceedings left them undisturbed.<sup>2</sup> He could not be compelled to surrender his security, even though it would be for the benefit of all, including himself. His rights to his liens were, at least in his opinion,<sup>3</sup> sacrosanct.

If the bankrupt were to attempt reorganization by way of transfer of assets to a new corporation, a small minority of creditors, even a single creditor, might defeat the whole plan. The court held stoutly to the doctrine that the only method by which a debtor could secure a restoration of his assets was by following the procedure laid down by statute for composition.<sup>4</sup> A sale of the bankrupt's assets to a new corporation formed of creditors or stockholders might be conducted and such sale would be perfectly legitimate.<sup>5</sup> In such instance, however, the assets would be acquired subject to all liens and rights of secured creditors, and a new

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1. Bankr. Act, Sec. 12, U. S. C. Title 11, Sec. 30.

2. Liens and securities which would be valid and unassailable in ordinary bankruptcy proceedings are equally protected in composition proceedings and are not discharged or affected. *In re Cyclopaean Co.*, 167 Fed. 971, 21 Am. Bankr. Rep. 679 (1909). *In re Stowell*, 24 Fed. 468 (1885).

3. This is not true as a matter of right however. "A secured debt or lien is, so far as the Constitution of the United States is concerned, a no more sacred kind of property than an unsecured debt." *In re Burgh*, 7 Fed. Supp. 184 (1933).

4. "An attempt to avoid the statutory requirements for the composition creates possibilities of wrong to creditors and when such wrong is called to the attention of the court it should be checked." *In re Malkan*, 261 Fed. 894; 44 A. B. R. 433 (1919).

5. *In re Fleig Mercantile Co.*, 237 Fed. 178; 38 A. B. R. 113 (1916).

corporation would be launched to carry on the business of the old burdened with all such encumbrances. This procedure can hardly be considered as a rehabilitation of the original corporation, and was designed primarily for the protection of certain groups of creditors and stockholders. Then again for a corporation to arrive at a position where it could take advantage of these proceedings, it had to be adjudicated a bankrupt. Many corporations needing rehabilitation were not in that condition and did not desire to become so either in fact or by decree.

In the Federal Equity procedure, a "friendly" creditor would be induced to file a bill against the corporation alleging an inability of the debtor to meet his debts as they matured, and praying for the appointment of a receiver. The debtor consented and a receiver was appointed to continue the business. This he did until a favored group of creditors or stockholders were ready to buy. This underlying conception was similar to the bankruptcy practice, but as it avoided the necessity of any adjudication and was less hampered by statutory provisions, it was the more favored procedure.

However, just as the need for reorganization became more acute, the Supreme Court of the United States questioned the right and power of a Federal Court to exercise jurisdiction in the so called friendly cases.<sup>6</sup> This left the effectiveness of the whole procedure in equity in doubt and corporations became unwilling to enter into such a proceeding lest the court should suddenly declare that it did not have jurisdiction in the particular case. In that event not only would the procedure go for naught, but bankruptcy and liquidation would almost inevitably follow as the very application to the court exposed the corporation's financial plight to all the world.

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6. In *Harkin v. Brundage*, 276 U. S. 36, (1928) the court stated, "We do not wish what we have said to be taken as a general approval of the appointment of a receiver under the prayer of a bill brought by a simple contract creditor simply because it is consented to at the time by a defendant corporation. The true rule in equity is that under usual circumstances a creditor's bill may not be brought except by a judgment creditor after a return of 'nulla bona' on execution." See also Shapiro

The second difficulty with the Federal Equity receivership, also inherent in this method, arose from a Supreme Court decision<sup>7</sup> which held that a dissenting creditor who did not participate in the new organization could follow the assets into the new corporation to the extent of the benefit conferred upon the stockholders. In effect, the creditor could say that the sale was fraudulent as to him insofar as stockholders secured assets which might have applied in satisfaction of his debt, and so compel the new organization to allow him the equivalent of which he claimed to have been deprived. This decision resulted in having plans for reorganization submitted to the court for approval, but left always open the danger of an attack by some disgruntled creditor who might set the entire proceedings aside.<sup>8</sup>

An excellent judicial picture of the difficulties inherent in the earlier practice and need for relief is found in the case of *Campbell v. Alleghany Corporation*.

"Prior to the passage of the act, neither proceedings under the old bankruptcy laws nor receiverships in equity furnished adequate relief for distressed corporate debtors, their creditors and stockholders, under modern conditions. Great corporate enterprises had grown up, with branches in many states, with a huge volume of bonded debts having different priorities with respect to different properties, and with many classes of stock having different voting privileges and property rights. Proceedings under the old bankruptcy laws were inadequate because no machinery existed to scale down secured debts without a sale of the security; and a sale almost necessarily resulted in a sacrifice of the property at an inadequate price because of the lack of persons in a position to bid for it. If forced to sale, it was frequently, if not generally, bought in by a committee of bondholders at the inadequate prices which forced sales notoriously yield, with the result that nonassenting bondholders received little

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v. Wilgus, 287 U. S. 348 (1932); and *First National Bank vs. Flershem*, 290 U. S. 504, (1934).

7. *Northern Pacific Railway Co. v. Boyd*, 228 U. S. 482, (1913).

8. *First National Bank v. Flershem*, 290 U. S. 504. In that case a plan of reorganization approved by the District Court and Circuit Court of Appeals was held invalid by the Supreme Court because it failed to protect a dissenting creditor adequately.

and stockholders nothing at all. Equity receiverships and foreclosures were inadequate for the same reason; and they were unsatisfactory for the additional reason that ancillary receiverships with their burden of fees and costs were necessary if the property to be administered lay in more than one jurisdiction. State laws were inadequate to meet the situation, which had become acute as a result of the widespread increase of corporate debts during the period of expansion and the shrinkage of property values which followed in the economic depression."<sup>9</sup>

In view of these procedural difficulties, it became necessary to evolve some new plan for reorganization of corporations. The business situation at the same time became acute and if failures by the wholesale were to be avoided some plan had to be designed to effectuate rehabilitation rather than liquidation.

The problem was submitted to Congress and hearings had before the House and Senate Judiciary Committees. The House Committee report<sup>10</sup> (adopted by the Senate Committee) submitted with the bill, which later became 77B, set forth the difficulties to be overcome briefly as follows, and the proposed method of accomplishment.

(a) Ancillary receiverships are obviated.

Under the former practice the assets of a corporation located in a district other than the one in which proceedings were instituted could only be administered with the help of ancillary receiverships. In one case there were as many as thirty-two ancillary receiverships and nothing could be done about it.<sup>11</sup> In the *Greyling Realty Corporation* case twenty ancillary receivers had been appointed before the passage of 77B. Thereafter proceedings were instituted under the amendment and jurisdiction over the entire estate given to the domiciliary receiver.<sup>12</sup>

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9. *Campbell v. Alleghany Corporation*, 75 Fed. (2nd) 947, (1935). A similar expression is found in the case of *Philadelphia Rapid Transit Co.*, 8 Fed. Supp. 51, (1934).

10. 73 Cong. House Report 194. 73 Cong. Senate Report 482.

11. *F & W Grand 5-10-25 Cent Stores, Inc.*

12. *In re Greyling Realty Corporation*, 74 Fed. Rep. (2nd) 734, Judge Manton, referring to the new jurisdiction, stated, "The court thus acquiring jurisdiction over

(b) Compensation of reorganization managers, counsel, etc., must be found by Judge to be reasonable and reimbursement is made only for actual and necessary expenditures.

Frequently reorganization managers, committees and their counsel had been able to collect exorbitant fees from the bondholders or other parties in interest, and these fees were not controllable by the court. The new plan proposed both publicity and court approval and control as a remedy.<sup>13</sup>

(c) The old debtor corporation is to be the reorganized corporation. This permits reorganization without sale and continues the old as far as possible.

(d) The plan of reorganization may provide for change of interest rates, modification of liens, extension of maturity dates and in other ways authorizes the modification of liens and other obligations.

(e) Liens can be satisfied. The purpose is to avoid cost of foreclosure.

(f) The debtor may be continued in possession of the assets with salaries of officers to be reasonable and subject to court approval. The Congressional Committees believed that the old officers would not require as great compensation as outside trustees as they would be willing to forego some part of their salaries to insure rehabilitation and their own future.<sup>14</sup>

the property of the debtor does so throughout the United States as against any state or federal receiver theretofore appointed in any other proceeding."

13. The operation of this feature can be seen in the case of *In re Wayne Pump Co.*, 9 Fed. Supp. 940; also in *Re Diversey Bldg. Corp.* rep. in C. C. H. "New Matters Division," page 3470, in which case the court reduced allowances as follows:—Bondholders' Committee—\$14,812.50 to \$3,625.00; Corporation's attorney—\$7,500.00 to \$3,000.00; Bondholders' attorney—\$10,000.00 to \$4,500.00; Mortgage Trustee's attorney—\$10,000.00 to \$2,500.00; Creditors' attorney—\$4,500.00 to \$1,400.00.

14. In addition to these main purposes, the Congressional Committees included the following incidental advantages:—

(g) The fact that outstanding securities may be amended makes unnecessary the cost of preparing new securities.

(h) The bill exempts the issuance of new securities from the Stamp Tax.

(i) The bill permits a plan of reorganization to be prepared and approved before court proceedings are instituted so shortening the time required for reorganization.

To remedy these conditions and to accomplish the purposes outlined, Section 77B was enacted by Congress to provide a suitable method for the reorganization of corporations generally, exclusive of railroads, banks, insurance companies<sup>15</sup> and building and loan associations. Railroad reorganizations are controlled by the provisions of Section 77, which are similar in large measure to 77B.

It is unnecessary to set forth in any great detail the various provisions of that act.

In general, it authorizes any corporation which could become a bankrupt to file a petition showing the need of relief. Such petition must set forth that it is insolvent or unable to meet its debts as they mature, and that it desires to effect a plan of reorganization. The court thereupon enters an order approving the filing.

"If the petition . . . is so approved an order of adjudication in bankruptcy shall not be entered and the Court in which such order . . . is entered shall . . . have exclusive jurisdiction of the debtor and its property, wherever located, for the purposes of this section, and shall have and may exercise all the powers . . . which a Federal Court would have had it appointed a receiver in equity of the property of the debtor by reason of its inability to pay its debts as they mature."<sup>16</sup>

The court may continue the debtor in possession or appoint a trustee, and shall notify creditors of the action taken. The action is subject to change at any time thereafter in the discretion of the Judge.<sup>17</sup>

The statute then provides for submission of the plan of reorganization which may include modification of the rights of creditors, secured or unsecured, and the rights of stockholders. Such plan shall provide for the protection of dissenting stockholders unless the court determines the corporation is insolvent, and also protection for creditors who may not accept the plan.<sup>18</sup>

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15. Proceedings were dismissed in *New York Title & Mortgage Co.*, 9 Fed. Supp. 319, and *In re National Surety Co.*, 7 Fed. Supp. 958, on ground such corporations were Insurance Companies.

16. Section 77B—Clause A.

17. Section 77B—Clause C.

18. Section 77B—Clause B.

The plan of reorganization may be presented by the debtor, by creditors or by stockholders, subject to a specified limitation as to numbers and amounts. Such plan must be accepted by two-thirds of each class of creditors affected thereby and by a majority of stockholders if they have any equity in the assets.<sup>19</sup>

If the court is satisfied that the plan is equitable and does not unduly discriminate in favor of any class of stockholders or creditors, and that all other proceedings set forth by the act have been complied with he shall confirm and order it made operative.<sup>20</sup>

Upon final confirmation the reorganized corporation shall be freed from all claims except those provided for in the plan, and the debtor, creditors and stockholders shall be bound by all its provisions.<sup>21</sup>

If no plan is presented or accepted within a reasonable time, the court may dismiss the proceedings or direct liquidation.<sup>22</sup>

The foregoing is only a brief summary of the section, but sufficient to show the conception of its framers and that it contemplated judicial rehabilitation.

"The great purpose of the statute is to prevent a sinking corporation from drowning. And it is with that idea that the courts of the United States are instructed to lend their aid to save a financially drowning corporation. If they are dead, then, of course, there is only bankruptcy for them. But while there is life there is always hope financially as well as physically."

The idea of legislating to rehabilitate is new and the procedure is likewise new. It was inevitable, therefore, that it should be assailed by those who felt it was an encroachment upon their property rights, and also that difficulty would be encountered in putting it into successful operation. As a result, we find the recent Federal reports filled with judicial decisions regarding the several provisions. It may be well, therefore, to examine some of the more

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19. Section 77B—Clauses D and E.

20. Section 77B—Clause F.

21. Section 77B—Clauses G and H.

22. Section 77B—Clause C 8.

important problems which have been the subject of litigation and see what the several courts have accomplished in clarifying the section and making it effective.

### CONSTITUTIONALITY

As was surmised by the drafters,<sup>23</sup> and in view of the fact that all legislation passed in the last three years seems to be commonly regarded as an encroachment upon constitutional rights, it was inevitable that one of the first problems to be determined was whether Section 77B was a valid exercise of legislative powers.

The Constitution of the United States provides that Congress shall have power to establish "uniform laws on the subject of bankruptcy."<sup>24</sup> The claim was, therefore, made that the proceedings contemplated by Section 77B affected not only corporations which were moribund but also solvent concerns, and hence the legislation was beyond the power of Congress as it did not relate to bankruptcy.

This question was very thoroughly considered by Judge Parker in the case of *Campbell v. Alleghany Corporation* and is worthy of somewhat extended quotation.<sup>25</sup>

"All phases of the relationship between a debtor financially embarrassed and his creditors are brought under the control of Congress by the constitutional grant of power; and the fact that a particular mode has heretofore been employed in dealing with the relationship is not to be taken as a measure of the power over it. . . .<sup>26</sup> Certainly, the act here in question is for the relief of corporate debtors who are unable to pay and their creditors, and falls well within the purpose of the constitutional grant of power."

The court adopts the doctrine of Chief Justice Marshall that,

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23. See Article by PROFESSOR GERDES in the NEW YORK UNIVERSITY LAW QUARTERLY REVIEW of December 1934, "*Constitutionality of Section 77B of the Bankruptcy Act.*"

24. Article 1, Section 8, Clause 4.

25. *Campbell v. Alleghany Corporation*, 75 Fed. (2nd) 947.

26. In support the Court cites the following Supreme Court decisions:—*Hanover Nat. Bank v. Moyses*, 186 U. S. 121; (1902) *Sturges v. Crowninshield*, 4 Wheat, 122.

"We are expounding a constitution intended to endure for ages to come and consequently to be adapted to the various crises of human affairs,"<sup>27</sup> and applies it to this section in the following clear and trenchant phrases:

"Doubts as to the validity of section 77B are based very largely upon the fact that the relief which it provides for embarrassed corporations, their creditors and stockholders, has not heretofore existed under the laws of this country, and for that reason seems novel and questionable. It must be remembered, however, that the power granted Congress over the subject of bankruptcies is plenary, and that in its exercise Congress is not limited by what has been attempted in the past but may shape its remedies in a way to meet adequately the problems of the present. Like other constitutional grants of power, that giving Congress power over bankruptcies is to be interpreted, not in the light of the conditions with which the framers of the Constitution were familiar, but of what is required under modern conditions to deal adequately with the relationship existing between embarrassed debtors and their creditors."

A similar opinion was rendered by the Circuit Court of Appeals in the Second Circuit at about the same date holding the enactment within the Congressional power over bankruptcies,<sup>28</sup> and the Circuit Court of Appeals in other circuits have followed these opinions.<sup>29</sup>

The legislation has also been assailed as being in violation of the Fifth Amendment because it provides for the taking of property without due process of law. If a secured creditor was compelled to readjust his position and scale down his debts, he was deprived of his property. This argument was no more effective than the preceding.

"There is no question, of course, but that the exercise of the bankruptcy power by Congress, as is the case with other delegated powers, is subject to the requirement of due process contained in that amendment. . . . But as any exercise of the bankruptcy power impairs the

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27. *McCulloch v. Maryland*, 4 Wheat. 316-407.

28. *In re Central Funding Corporation*, 75 Fed. (2nd) 257, (1935).

29. *Vitagraph v. St. Louis Properties*, 77 Fed. (2nd) 590; (1935) *Re New Rochelle Coal & Lumber Co.*, 77 Fed. (2nd) 881; *Pierce Arrow Sales Corp.*, 10 Fed. Supp. 776, (1935).

obligation of contracts, such impairment is not to be taken as in itself a denial of due process. For the provisions of the act to violate the amendment, they must be so grossly arbitrary and unreasonable as to be "incompatible with fundamental law."<sup>30</sup> We do not think that the requirement that secured creditors scale their debts in accordance with a plan which two-thirds of them are willing to accept and which has been approved by the court as reasonable and fair, and accept in lieu of payment in money such securities as are specified in the plan, can be said to be such an arbitrary and unreasonable exercise of the bankruptcy power as to amount to a denial of due process."<sup>31</sup>

Other attempts have been made to have the section declared unconstitutional for other reasons, but all have been unsuccessful.<sup>32</sup>

None of these questions has as yet come before the Supreme Court of the United States with reference to 77B. However, that court has passed upon analogous questions in the matter of railroad reorganizations. Railroad reorganizations are accomplished under Section 77 of the Bankruptcy Act passed by Congress in 1933. The purpose and plan of that legislation parallels general corporate reorganization as authorized by 77B. The power of Congress to provide for reorganization of railroads as part of its bankruptcy power was fully and completely sustained.

"While attempts have been made to formulate a distinction between bankruptcy and insolvency it long has been settled that, within the meaning of the constitutional provision, the terms are convertible. . . . From the beginning, the tendency of legislation and of judicial interpretation has been uniformly in the direction of progressive lib-

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30. Quoted from *Hanover Nat. Bank v. Moyses*, 186 U. S. 181, (1902).

31. *Campbell v. Alleghany Corp.*, 75 Fed. (2nd) at 953. See also for same view *Central Funding Corp.* 75 Fed. (2nd) 256; *In re Pierce Arrow Sales Corp.*, 10 Fed. Supp. 776.

32. (a) For example, on the ground that Congress had no power to issue process from the one District over the United States. Refuted in *Greyling Realty Corp.*, 74 Fed. (2nd) 734.

(b) On the ground that as it related only to corporate debtors it lacked the essential of uniformity. Refuted in *Campbell v. Alleghany Corp.*, 75 Fed. (2nd) 947; *In re Pierce Arrow Sales*, 10 Fed. Supp. 776; *In re East Contra Costa Irr. Dist.*, 10 Fed. Supp. 175.

eralization in respect of the operation of the bankruptcy power. . . . The fundamental and radically progressive nature of these extensions (referring to earlier statutes enlarging the power of the courts in bankruptcy) becomes apparent upon their mere statement; but all have been judicially approved or accepted as falling within the power conferred by the bankruptcy clause of the Constitution. Taken altogether, they demonstrate in a very striking way the capacity of the bankruptcy clause to meet new conditions as they have been disclosed as a result of the tremendous growth of business and development of human activities from 1800 to the present day. And these acts, far-reaching though they may be have not gone beyond the limit of congressional power; but rather have constituted extensions into a field whose boundaries may not yet be fully revealed. . . .

"It follows, from what has now been said, that Sec. 77, in its general scope and aim, is within the power conferred by the bankruptcy clause of the Constitution."<sup>33</sup>

As the provisions for railroad reorganization have been so entirely upheld, there can be little doubt that 77B, will also be regarded as valid legislation, and the decisions already rendered by the several Circuit and District Courts of the United States affirmed.

#### GOOD FAITH

The statute provides that the court shall only accept a petition if satisfied that it is filed in "Good Faith." Good faith implies good intentions and demands an investigation into the motives of the applicant for relief. This introduces an entirely new element into the bankruptcy law. Under the Act of 1898, if the conditions existed which met the provisions of the statute, jurisdiction existed and the court must take control of the estate of the bankrupt regardless of the motive of the petitioning creditors or the debtor.<sup>34</sup>

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33. *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway Co.*, 294 U. S. 648, (1935).

34. "If it be proved by competent evidence that the bankrupt is insolvent, and committed acts of bankruptcy, and the other necessary jurisdictional facts are present, an adjudication in bankruptcy will follow therefrom, and what reasons or motives inspired or instigated the proceedings are of no importance, and will not defeat an adjudication. It is the right of action which is evidenced by facts alleged and proven

Now the courts before taking jurisdiction are required to determine that the petitioner, whether creditor or debtor, is acting in accordance with good moral principles.

If a debtor corporation is merely seeking shelter to enable its officers to fend off suits and draw salaries while so doing, it is not acting in good faith, and the courts will not assume jurisdiction. The statute is not intended to be used as a nursing home for incurables.

On the other hand, the petitioning creditors are not acting in good faith if the suit is a so-called "strike suit," and brought merely to force payment of their particular claims or to enable legal racketeers to secure fees from the corporation be it a live or moribund one.

There is no difficulty in applying "good faith" to the extreme cases, but it is hard to define such a general phrase accurately or to apply it in given situations with any degree of uniformity.<sup>35</sup> Attempts have been made to clarify the matter by definition, and one Federal Court has declared:

"Good faith is a requirement that the petition should be filed with the actual intent and purpose to use Section 77B to effect a plan of reorganization. . . . Doing a thing in good faith is doing it honestly, when brought with respect to a corporation not in need of reorganization it is brought in bad faith."<sup>36</sup>

A petition filed either by or against a corporation which is conducting its normal business and capable of paying its obligations as they mature cannot take advantage of the statute for the sake of lowering an interest rate on its bonds or improving its financial structure. Such a corporation is not in need of reorganization and the court cannot lend its assistance for such a purpose. Neither can it be used as a weapon in a contest between stockholders.<sup>37</sup>

On the other hand, when a corporation is beyond hope of revival

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that must prevail; what ever may be the motive, it will not support or defeat the cause of action." *In re Automatic Typewriter Co.*, 271 Fed. 1, (1921).

35. *In re Prairie Ave. Bldg. Corporation*, 11 Fed. Supp., 125 (1935).

36. *In re South Coast Co.*, 8 Fed. Supp. 43 (1934).

37. *In re Picadilly Realty Co.*, 78 Fed. (2nd) 257 (1935).

and no rehabilitation is possible, an application to the Federal Court will not lie under this section. A proceeding in such a case is not in "good faith" because not capable of accomplishing anything.<sup>38</sup>

The same doctrine is applied in cases where proceedings have been taken in equity and plans for reorganization are well under way therein before the application is presented under Section 77B. The court takes the position that its jurisdiction is a discretionary one and should not be exercised to interfere with other proceedings which are equally capable of being brought to a successful conclusion.<sup>39</sup>

These situations involve an application of the doctrine of good faith under the more obvious circumstances. However, in one important case involving the transportation lines in the City of Philadelphia, the court was called upon to take into consideration the motives and status of the petitioning creditors. The company admittedly needed reorganization and its circumstances were such

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38. *Manati Sugar Co. v. Mock*, 75 Fed. (2nd) 284 (1935). *In re Murel Holding Corp.*, 75 Fed. (2nd) 941 (1935). *In re Grigsby-Grunow Co.*, 77 Fed. (2nd) 200 (1935).

A modification of this doctrine is found where the court finds that no rehabilitation is possible but where slow liquidation in accordance with a definite plan is proposed in preference to a sacrifice of the assets by quick sale. "The appellant argues that the proposed plan is a mere liquidation and not a reorganization, because the bondholders of the debtor succeed to no stock interest and receive only participation certificates in a new corporation which entitled them to nothing but liquidating dividends. But the liquidation may cover as long a period as ten years and the corporate structure of the plan prevents that prompt liquidation, which ordinarily follows an adjudication in bankruptcy, and is designed to continue the former business, except that of investing in new mortgages, so that there may be a chance to recover more from the collateral over a longer period than would be possible if a speedy liquidation were had." (*In re Central Funding Corporation*, 75 Fed. (2nd) 256). So saying the court held it had jurisdiction. It is submitted that reorganization strictly conceived implies a rehabilitation and continuance of business not liquidation and that 77B was not designed to provide for a slow payment of claims, but in all probability the doctrine of this case will be followed because of the obvious practical advantage to creditors generally.

39. *In re Electric Public Service Co.*, 9 Fed. Supp., 128 (1934). *In re Williamsport Wire Rope Co.*, 10 Fed. Supp., 481 (1935).

that rehabilitation was feasible. The petitioning creditors were bondholders, and apparently all necessary jurisdictional requirements had been meticulously observed. The application was opposed on the basis that the petitioning creditors had bought the bonds for the purpose of bringing the suit, and that the real object was a change of management desired by the authorities of the City of Philadelphia. The court dismissed the petition as not in good faith although recognizing the petitioners' purposes to be of the best and their motives of the purest.

"To find, however, that the purpose and motive was to safeguard their (petitioners) claims as creditors would be impossible. . . . The real purpose and motive behind the position existed before they became creditors and they became creditors solely as an aid in the accomplishment of their purpose. . . . They bought their way in as creditors and presumably can sell their way out. The petition is not in truth a real creditors' petition and in this sense is not in good faith."<sup>40</sup>

In this case, there was a strong dissenting opinion based partly on the ground that the conclusion as to lack of good faith was decided without the taking of any evidence, but also because there was no showing of any lack of good morals.<sup>41</sup>

With respect to the argument suggested in the majority opinion that the petitioners were not the real creditors because "they bought their way in and can sell their way out", it may be pointed out that such is the case with every holder of a security that has a market value. He may always sell in the market and so cease to be a creditor, and it cannot be held that a person is only to be classified as such when he is so caught as not to be able to relieve himself of that position by selling out if he chooses so to do.

No good reason is perceived for denying jurisdiction because a person may have only recently purchased an obligation of the debtor. Why should not stockholders believing that their corporation

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40. *In re Philadelphia Rapid Transit Co.*, 8 Fed. Supp., 51; Aff'd 73 Fed. (2nd) 1022.

41. The taking of testimony for the purpose of ascertaining good faith was authorized in *In re Syndicate Oil Corporation*, 9 Fed. Supp., 217.

needs rehabilitation and finding that the officers desire to hold on to their positions and so oppose any court action purchase securities in the open market and then take action? Their motives are good and the statute is remedial. To deny them this remedy on the mere argument that they are not genuine creditors seems an unnecessary restriction to place upon "good faith".

Again, it is argued that the petition is not in good faith because a change of management and not rehabilitation is the objective. If the corporation needs reorganization and the creditors seek the court for the purpose, the circumstance that a change of management may result or may even be hoped for, should not lead the court to deny jurisdiction.

The objective test which measured good faith upon the actual need of the corporation and the feasibility of rehabilitation is a far clearer and more certain basis upon which to place the court's jurisdiction than to rest the same upon a judicial determination of the validity and weight of conflicting and perhaps complicated motives of the applicant. Unless the debtor or creditors come into court with "unclean hands", the court shall assume jurisdiction when the financial status of the corporate debtor may be remedied to the advantage of all concerned.

#### CLAIMS AND APPROVAL OF PLAN

The statute provides that the plan of reorganization before becoming effective shall be confirmed by the Court. As a prerequisite to confirmation, the plan must be approved by two-thirds in amount of the claims of each class that would be affected thereby, and by a majority of the stockholders of each class if they are affected and the corporation is not insolvent.<sup>42</sup>

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42. 77B, sub. E, clause 1, provides:—"A plan of reorganization shall not be confirmed until it has been accepted in writing by or on behalf of creditors holding two-thirds in amount of the claims of each class whose claims have been allowed and would be affected by the plan, and by or on behalf of stockholders of the debtor holding a majority of the stock of each class. Provided, however, that such acceptance shall not be requisite to the confirmation of the plan by any creditor or class of creditors (a) whose claims are not affected by the plan, or (b) if the

The language is general and leaves many problems, difficult of solution, for the court to unravel. Claims, for example, include matured obligations and damage claims for breach of contract as well as primary and secondary obligations of the debtor. Are such obligations of one class or many? If many, how shall they be classified? Are tort liabilities included among claims and, if so, are they on a parity with debts? Before voting on a plan for reorganization must all unliquidated claims be reduced to judgment? What is meant by the term "affected"?

In the former bankruptcy practice, tort claims were not provable nor entitled to share in the distribution of the estate. The present section includes among creditors the holders of claims of every character against the debtor. The demands of a seaman for damages for personal injury and a death claim under the Federal Employer's Liability Act have been recognized as coming within the purview of the Act.<sup>43</sup> A conditional vendor is a claimant within the statutory provisions even though all he demands is the return of the goods subject to the conditional bill of sale, and if he fails to make his claim within the time set by the court his rights are barred just as that of any creditor who failed to file his proof of claim on time.<sup>44</sup> For the purpose of determining the amount of such liabilities of the debtor, the courts have permitted proceedings to be conducted in the re-

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plan makes provision for the payment of their claims in full, or (c) if provision is made in the plan for the protection of the interests, claims or liens of such creditor or class of creditors in the manner provided in subdivision (b), clause (5) of this section, and provided further, that such acceptance shall not be requisite to the confirmation of the plan by any stockholder or class of stockholders (1) if the judge shall have determined either that the debtor is insolvent, or that the interests of such stockholder or stockholders will not be affected by the plan, or (c) if provision is made in the plan for the protection of the interests of such stockholder or class of stockholders in the manner provided in subdivision (b), clause (4) of this section.

43. *In re Munson Steamship Line*, C. C. H., Sec. 3137, 3418. *Brown v. Missouri Pacific*, C. C. H., Sec. 3429

44. *In re Burgemeister Brewing Co.*, 11 Fed. Supp., 903. In that case the court approved a classification of claims which differentiated between claims as follows:—(a) conditional vendors, (b) mechanic lien claimants and (c) general creditors. *Contra: In re Lake's Laundry*, 11 Fed. Supp. 237.

organization suit itself and have in, at least, one instance authorized the prosecution in a state court to fix the liability.<sup>45</sup> While no very authoritative decision has as yet been rendered with respect to such tort claims, the tendency and trend of the decision indicates that they will all be considered as properly entitled to protection under the statute and treated in the same manner as general debts or contract claims as soon as the amounts have been fixed. No good reason appears why this should not be the correct procedure.

The recognition of the application of the statute to unliquidated claims involves the further problem of the right of such claimants on the plan of reorganization. If the plan be submitted before the claim has been definitely settled, should the claimant be permitted to vote and, if so, upon what basis? He is definitely entitled to vote on any plan that affects him, but to compute his claim on the amount of his demand may well give his claim an unfair and disproportionate weight as contrasted with the fixed and definite claims.

A somewhat analogous situation has arisen with respect to the right of a creditor to vote on a claim while the validity of the claim itself was under attack.<sup>46</sup> The claimant filed a claim for \$87,000,000, and other creditors asserted that it was fraudulent and invalid. The court permitted the creditor to vote saying that the determination of the validity of the claim could be later ascertained and determined, but that it would not delay taking a vote on the question of approval or disapproval of the plan while awaiting such a decision.

To this decision, there was a vigorous dissenting opinion pointing out that to allow a creditor to vote on a contested claim is unfair to the other creditors as it may result in securing the approval by the necessary two-thirds vote when, if reduced to its proper amount or eliminated, the vote would have been otherwise.

In the regular Bankruptcy practice, a creditor whose claim has

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45. *Missouri Gas & Electric Service Co.*, 11 Fed. Supp. 434.

46. *In re Philadelphia Rapid Transit Co.*, 11 Fed. Supp. 865.

not been allowed is not permitted to vote at meetings of creditors for the election of trustee or other purposes.<sup>47</sup> Until they have established their position, they cannot be regarded as entitled to take action that may control the status of the rest.

By analogy to this procedure, and considering the importance to the several creditors of the acceptance or rejection of a plan of reorganization, the dissenting opinion would seem the sounder view. The adoption of the majority opinion leaves open the door for unscrupulous claimants to file padded claims for the purpose of giving to their vote an unjustified weight and importance and might well result in having the approval or disapproval determined by the votes of creditors whose claims as presented were not genuine or sustainable when subjected to judicial scrutiny.

While the ascertainment of the validity of doubtful claims or the ascertainment of the amount due on unliquidated ones may delay the acceptance of a desirable plan of reorganization, it is submitted that such delay is better than having a judicial finding based upon an unsound premise.

In voting in such proceeding, it is essential that the real party in interest affirmatively approve. A trustee for bondholders cannot vote as the representative of the bondholders when the rights of the several holders are involved.<sup>48</sup> Neither should the trustee act for bondholders who fail to appear as consent cannot be inferred in such matters.<sup>49</sup> If the trust instrument itself contains a clause expressly permitting the trustee to vote as the agent and representative of either all bondholders or those not appearing, doubtless the court would recognize such a provision as valid and permit the trustee's vote to count as indicative of the approval or disapproval of the class it represented. Without such express authority, the bondholders are themselves the class and two-thirds of the class must approve before confirmation.

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47. *In re Walker*, 96 Fed. 550 (1899). *In re Evening Standard Publishing Co.*, 164 Fed. 517 (1908).

48. *Allied Owners Corporation*, 74 Fed. (2nd) 201.

49. This question was suggested in *Allied Owners Corporation*, 74 Fed. (2nd) 201, though not determined.

In determining whether a plan requires approval by any class of creditors or stockholders, it is necessary in the first instance to determine whether the proposal "affects" the particular class of creditors or stockholders. Insofar as creditors are concerned, the plan of reorganization must be approved by not less than two-thirds of each class affected, but stockholders are only considered when the corporation has not been found insolvent.<sup>50</sup> This leaves for the court's determination what is meant by the word "affected". Does it refer only to the dollar value of the stockholder's share or does it apply equally to the privileges of the debtor in relation to corporate management?

In a case arising in the District of Illinois, the plan proposed in reorganization provided that the equity of redemption permitting the corporation to redeem its property from a mortgage then a lien thereon be waived, and set up a program of business administration to operate for a number of years.

The allegation was then made that this plan did not adversely affect the several stockholders, first, because it was beneficial to them in the long run and, second, because the directors and not the stockholders administer its business and can waive the equity of redemption, fix salaries and declare or not declare dividends. The court, however, swept away these arguments saying, in substance, that any plan that modified the business operation of the corporation took away from the stockholders their right to vote for directors and that this was a substantial affecting of their interests.

The practical result of this decision is that in the case of every solvent corporation every plan must be voted upon by the stockholders, and that the court should not speak for them or take away their right of choice without their approval.<sup>51</sup>

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50. Section 77B, Clause E, Second proviso (1).

51. *In re National Lock Co.*, 9 Fed. Supp., 432:—"The plan proposed modifies and restricts this right of stockholders to vote in that it establishes the fiscal policies beyond their control. This provision of the plan is for the benefit of creditors and is adverse and in opposition to the rights and interests of the stockholders. Nor does it matter that some may think, and even the court may find, that the plan as a

## JURISDICTION

The statute gives to the District Court in which the proceedings are instituted jurisdiction over the assets of the debtor corporation wherever situated. This grant of power to the District Court is well within Constitutional authority as is also the grant of the right to issue process anywhere throughout the United States.<sup>52</sup> There is no method prescribed by the Act for the service of process and, therefore, the court may direct any mode of service which is reasonably calculated to notify all parties in interest of the pendency of the proceedings.<sup>53</sup> Normally it will direct service by mail and publication as has been the practice in Bankruptcy generally.

Section 77B, however, while granting this extensive power to District Courts and making the same exclusive, provides that only certain specified Districts shall have control of the proceedings involving the debtor corporation. The petition must be filed either in the district where the corporation for the preceding six months has had (a) its principal place of business, (b) its principal assets, or (c) in which it was incorporated.<sup>54</sup>

The petition may be filed by either creditors or the debtor. It is quite conceivable that three petitions might be filed practically simultaneously, one in each of the three possible districts. Under the bankruptcy and equity practice in similar conditions, the court first acquiring jurisdiction retained it, and all other courts, as a matter of comity, withdrew and permitted such court to administer the estate.<sup>55</sup> This rule does not apply to proceedings under Section 77B. The courts have determined that these proceedings were designed by Congress for the benefit of the debtor and, therefore,

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whole, may be "a good deal" even for the stockholders. They must have the right to vote on the matter. . . .

"In fairness it (the court) should permit, as far as lies in its power, the stockholders to vote upon any plan or reorganization in these proceedings."

52. *In re Greyling Realty Corporation*, 74 Fed. (2nd) 734.

53. *Flexner v. Farson*, 248 U. S., 289 (1919).

54. Section 77B—(a).

55. *Harkin vs. Brundage*, 276 U. S., 36, 43.

the debtor's petition, even though filed subsequent to a creditor's petition, is to be preferred, and its chosen jurisdiction is also to be preferred to the jurisdiction chosen by creditors. However, the courts have limited this preference somewhat by holding that the control of the proceedings should ultimately be placed in the jurisdiction best suited for the purpose. As one court stated, "The surprising activity of the petitioning creditors should not yield them any legal advantage. This is not a matter of priority in filing. The real interest of the debtor and of all its creditors and stockholders is the crucial matter."<sup>56</sup>

In addition to prescribing the jurisdiction in which the original petition may be filed, the statute authorizes the transfer of any proceedings already filed from one district to another if the interests of the parties will be best served in so doing. When the majority of the creditors and stockholders reside in one district and the corporation conducts its business therein, the court will transfer a proceeding instituted in the court of the domicile of the corporation to the district where the active business interests are.<sup>57</sup> However, this power to transfer will not permit a transfer to a jurisdiction that is not one of three in which the original petition might have been filed merely because the interests of the parties might more conveniently be served by using such district.<sup>58</sup>

One very interesting series of cases discussing the question of the selection of jurisdiction involved the Hamilton Gas Company. That company was a utility corporation owning and operating gas wells located in the States of West Virginia and Kentucky. It was incorporated under the Delaware statutes and had its executive offices in New York City. Prior to the passage of Section 77B, equity receivers had been appointed in Delaware, West Virginia, Kentucky, New York and Pennsylvania. In West Virginia and Kentucky, receivers appointed by the local State Court were

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56. *In re National Department Stores*, 8 Fed. Supp., 19.

57. *In re Sierra Salt Corporation*, 8 Fed. Supp., 922. *In re Consolidated Gas Utilities*, 8 Fed. Supp., 385. *In re Botany Worsted Mills*, 10 Fed., Supp., 267. *In re Kelly-Springfield*, 10 Fed. Supp., 414.

58. *In re Midland United Company*, 8 Fed. Supp., 92.

operating the wells in those localities when 77B was adopted. On the day the President signed the act, creditors filed a petition in the District of West Virginia, and on the next day the debtor filed one in the Southern District of New York. The petition filed in West Virginia alleged as its jurisdictional basis that both the principal assets and principal business were located in West Virginia because of the main gas wells located there. The debtor's petition claimed New York City as the situs of the principal business because the offices of the President were situated there and the executive business conducted therefrom. Objections to the jurisdiction of the West Virginia court were filed by the debtor, but the district Court sustained its right to retain the cause.

When the case came before the Circuit Court of Appeals in the Fourth Circuit<sup>59</sup> on appeal, that court held that the rule that between courts of concurrent jurisdiction the one first acquiring jurisdiction may retain it without interference did not apply, and that preference should be given to the jurisdiction selected by the debtor. In the opinion, the appellate court indicated a doubt whether New York had any jurisdiction and so it remanded the case to the District Court of West Virginia with instructions to determine whether the District Court in New York had jurisdiction and, if so, to transfer proceedings to that jurisdiction as the debtor had selected it.

The West Virginia District Court thereupon, in a well considered opinion, held that "principal business" meant the principal working operations of the company, and, therefore, such business was conducted at the place where its products were created or manufactured and not where the office of the President might happen to be. As a result, it decided that the New York District Court had no jurisdiction.<sup>60</sup>

In the meantime, the objections to the jurisdiction of the New York District Court were filed by creditors, but that court held that it had jurisdiction. Consequently, the Hamilton Gas Company

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59. *Hamilton Gas Company v. Watters*, 75 Fed. (2nd) 176.

60. *Watters v. Hamilton Gas Company*, 10 Fed. Supp., 323.

found itself subject to two exclusive jurisdictions and in danger of being administered by both.

Both cases went up on appeal to the respective Circuit Courts of Appeal. Fortunately the Circuit Court of Appeal of the Second Circuit determined that the principal place of business was in West Virginia and not New York and dismissed the New York proceedings,<sup>61</sup> while the Fourth Circuit of Appeals affirmed the decision of its District Court.<sup>62</sup> "The unseemly scramble for control of the reorganization of this company" was solved, but the case is an excellent illustration of the difficulties inherent in a statute which permits three possible exclusive jurisdictions.

The result of liberal jurisdictional provisions is to leave the question of which District Court shall control in doubt. Where a corporation has large manufacturing plants in several states and a main executive office in another, District Courts and even Circuit Courts of Appeal might well differ as to where the principal business was located and which court could best serve the interests of all concerned. This might mean prolonged litigation merely to determine the proper administrative control and affect injuriously the proceedings for rehabilitation which should be the primary concern. A definite and perhaps even arbitrary rule would be better than uncertainty.

As a guide in selecting the jurisdiction, the courts have stated that the debtor's interests were to be preferred to the creditors, though why this should be so is hard to see as it is the creditors' money, not the stockholders', that is primarily at stake. Presumably the view is the result of the depression period and the desire expressed by Congress to maintain in operation as many businesses as possible and prevent forced liquidation. While this may be desirable in times of crisis, a return to normalcy should reinstate the creditor in the position where he properly belongs. Proceedings should not be employed by the debtor or its officers to fend off creditors, and continue themselves in administrative control at

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61. *In re Hamilton Gas*, 79 Fed. (2nd) 97.

62. *Hamilton Gas v. Watters*, 79 Fed. (2nd) 438.

good salaries while the creditors wait. The petition first filed by bona fide creditors should have priority and a transfer to another jurisdiction should only be made upon application of a majority of creditors. Such a rule would set up a definite standard and at the same time let the persons most interested in the outcome control the place of administration.

Section 77B provides that the District Court having jurisdiction shall have exclusive control of the administration of the assets of the debtor. This has been construed to mean that all state receivers, federal equity receivers or any other authority having control of the assets must surrender the same to the trustees appointed by court in the reorganization proceedings if required so to do.<sup>63</sup>

Not only does the provision affect corporations being administered by a receiver or trustee appointed by judicial authority, but also those in the hands of a state official acting in pursuit of duties imposed upon him by a state legislature such as a Commissioner of Banking and Insurance.<sup>64</sup>

However, the federal courts are not required to take over the state proceedings but may permit them to continue if they believe that by doing so the rights of the persons interested would be the better protected.<sup>65</sup>

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63. "Congress has seen fit to extend the jurisdiction of the District Court and extend the provisions of the Bankruptcy Act to estates of debtors who are insolvent but whose insolvency is traceable to abnormal conditions. This enlargement of jurisdiction, carrying duties in many instances administrative in character, must be assumed in the spirit in which it is delegated. It is not a case of the District Court assuming a jurisdiction which may conflict with the jurisdiction of a state court that has appointed receivers. The United States District Court has no alternative. The right is conferred upon the debtor to petition the United States District Court for action and the court must act. . . . It is unfortunate that there may be clashes over jurisdiction or that animosities may develop between equity court receivers and counsel and trustees appointed under this section of the Bankruptcy Act. There is but one course open to the United States District Court. All state and Federal courts of equity must submit to and be bound by the lawful Congressional action such as bankruptcy legislation." In the matter of Sterba, 74 Fed. (2nd) 413. *In re Prairie Avenue Building Corp.*, 11 Fed. Supp., 125.

64. *In re Manbeach Realty Corp.*, 10 Fed. Supp., 523.

65. *In re Prairie Avenue Building Corp.*, 11 Fed. Supp., 125.

Corporations whose charters have been forfeited are subject to the same control as those in good standing.<sup>66</sup>

Under the original Bankruptcy Act where foreclosure or other proceeding had been instituted in a state court to enforce a lien prior to the adjudication, the Bankruptcy Court had been prevented from interfering with the continuance of such proceedings. Under Section 77B, the District Courts have acted to enjoin such proceedings and in other ways restrained the normal action of the state courts.<sup>67</sup>

Jurisdiction has even been exercised with respect to assets claimed by the debtor but in the hands of adverse parties. Prior to the present enactment, it was well settled that the jurisdiction of the bankruptcy court was limited to controversies relating to property in the actual or constructive possession of the bankrupt.<sup>68</sup> Since the passage of the present section, the courts have not hesitated to issue orders preventing the adverse party from foreclosing its lien or selling its collateral, although the property was definitely not in possession of the bankrupt.<sup>69</sup> This has been done by summary proceedings and plenary suits have not been deemed necessary. This is a distinct advance in the simplification of administration of the debtor corporation and in preventing the wasting of equities.

Another step in the same direction has been the holding that even when a plenary suit is necessary to reach and collect assets, the District Court having jurisdiction of the debtor may issue its original process to the third party wherever located and so draw that litigation into its own control.<sup>70</sup> While this procedure brings

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66. *In re East Delaware Place Bldg. Corp.*, 7 Fed. Supp., 892.

67. *In re Murel Holding Company*, 75 Fed. (2nd) 94. *In re Coney Island Hotel Corp.*, 76 Fed. (2nd) 126. *In re Prudence Bonds Corp.*, 75 Fed. (2nd) 262. *In re Island Park Association*, 77 Fed. (2nd) 334.

68. *Schumacher v. Beeler*, 293 U. S. 367; 55 Sup. Ct. 230 (1934). *Weidhorn v. Levy*, 253 U. S. 268; 40 Sup. Ct. 534 (1920). *Taubel-Scott-Kitzmiller Co., v. Fox*, 264 U. S. 426; 44 Sup. Ct. 396 (1924).

69. *Continental Illinois National Bank and Trust Company v. Chicago, Rock Island and Pacific Railway*, 294 U. S. 648; *Grand Boulevard v. Strauss*, 78 Fed. (2nd) 180.

70. *Thomas v. Winslow*, 11 Fed. Supp. 839.

a certain hardship upon the adverse party by compelling him to appear in a jurisdiction perhaps remote from his domicile or place of residence, it operates to centralize all questions relating to the debtor. There is nothing to prohibit Congress from granting such a power to any District Court, and the only real question is whether such power has been vested impliedly by Section 77B in the several District Courts. While, so far as we know, the case cited is the only one wherein the question has been raised, the advantage of so construing the act in the furtherance of quick re-organization is obvious and probably the opinion will be followed by other District Courts.

The trend of these cases has been toward a broad interpretation of the term "exclusive jurisdiction", and includes all litigation involving the debtor whether affecting adverse parties or not, and whether such litigation was commenced before or after the filing of the petition.

#### SUMMARY

Within the limits of this article it is impossible adequately to summarize all of the problems which have been and are being presented to the several courts day by day. The amount of litigation now taking place is tremendous both in volume and scope. No attempt is here made to consider the validity of any plans of re-organization which must of necessity in each case be approved by the court before the corporation can be rehabilitated. Many and varied have been the proposals submitted, the objections raised, and the modifications made to meet the statutory requirements as the courts have seen fit to interpret them. Consideration of such questions is beyond the purview of this article.

However, certain results and trends have become reasonably clear. The enactment is undoubtedly constitutional, at least in its general aspects. The court acquiring jurisdiction has been granted and will take control of all types of controversies when in so doing the best interests of the parties will be served. No petition will be accepted, however, which on its face or upon investigation shows

that the proceedings are brought for a sinister purpose or are impossible of accomplishing a reorganization.

Many problems involving the classification and voting of claims and the working out of fair plans of reorganization still remain, and it will take a longer time than has yet elapsed to ascertain whether the ultimate operation of the act will be of real benefit to either creditor or debtor or whether it will merely operate to preserve for the time being corporations that are incapable of surviving and for whose continued existence no real reason exists.

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