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problems which experienced and disinterested judges are better qualified to solve than anyone else. This does not mean that the courts should have the power to devise a plan of its own, but only the power to pass upon the fairness of the plan, and, if reasonable, to accept it. The courts might be given a slight power of amendment, but it can be argued that if a plan were amended under such power it should be submitted and passed upon by the majority.

CORPORATE REORGANIZATION UNDER THE BANKRUPTCY ACT

JOSEPH HEFFERNAN*

". . . the supreme power cannot take away from any man any part of his property without his consent."—John Locke (1690).¹

"Upon such confirmation . . . the plan and . . . the order . . . shall be binding upon . . . all stockholders . . . including those who have not, as well as those who have, accepted it, and . . . upon all creditors, secured or unsecured . . . including those who have not, as well as those who have accepted it." U. S. Bankruptcy Act, Sec. 77B(g) (1934).²

This paper will discuss the justifiability of this subsection of the corporate reorganization provisions of the bankruptcy act. Under the American scheme of government this means a consideration of the constitutionality of the legislation. It might be regarded as significant that a lawyer should begin a discussion of the subject by quoting "what a dead hand wrote" nearly two hundred and fifty years ago. The answer is that the hand is not yet dead. When the corporate reorganization provisions of the bankruptcy act (Sec. 77B) were proposed in Congress and the hearings held in committee upon the bill, names prominent in the legal profession came forward to protest its unconstitutionality.³ Their objections were two. It

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¹ "An Essay Concerning the True Original Extent and End of Civil Government," (1690), (Everyman Ed., p. 187). As a statement of Locke's precise position, it is conceded that this quotation is out of context and misleading. In fact it is fairly inferable from this same essay that Locke held that the consent in question could be given by a majority, either in person or through their duly chosen representatives. In any event, Locke was really undertaking nothing more ambitious in this essay than the refutation of the doctrine of absolute monarchy, and to justify the English Revolution of 1688. But his words have been taken over by the generations which followed him and used to justify absolute concepts of property rights. The course of this flow of ideas has been traced. Hamilton: Property According to Locke, 41 Yale L. J. 864 (1932).


is not bankruptcy legislation. And (even if it were so regarded), no security holder of a corporation may be required, without his consent, to accept satisfaction of his interest in the debtor's property in other than legal tender. He has a constitutional right to insist upon sale of the corporate assets and distribution to him in cash of his pro rata share. Unanimous consent of all security holders is required to effect reorganization without such a sale.

During the last fifty years the reorganization of corporations in this country has been effected chiefly by the instrumentality of equity receivership. The system was scandalously expensive, and the tragic dissipation of the efficiency of a going concern. No one questioned that. It was abolished as to railroad corporations in England as long ago as 1867, and for most other companies therein 1908. But the system remained here. In spite of the frightful economic scar which each reorganization left, it was generally thought that no citizen could be constitutionally forced, without his consent, to accept securities in the reorganized company to the exclusion of his ancient right to force a sale and partake of its proceeds.

I assume that no apology is needed today for an interpretation of such a phenomenon in terms of a philosophy which would seem to account for its being. It has come to be realized that a philosophy of values lies behind any view one may hold upon the justifiability of a given type of legislation or judicial action. A legal analysis of a theory of unconstitutionality would therefore be inadequate which did not discern the value judgment which conditions the existence of the doctrine of unconstitutionality in question. In the instance before us it seems apparent that the philosophy of John Locke as interpreted by his disciples has been read into the constitutional provisions which are assumed to strike down the corporate reorganization section of the bankruptcy act. The security holder's contract right to insist upon sale as provided in the bond is a property right. He cannot be deprived of that right without his consent. Even if he is in a minority of one. The Act of Congress which provides machinery for a plan that may proceed without his consent, deprives him of that property without due process of law.

Section 77B of the bankruptcy act defies this theory. In doing so the value judgment behind the doctrine which is rejected has necessarily been displaced by a different philosophy of values. No preamble to the amending section is present to make explicit the social or economic interest which was regarded as dominant. This paper will endeavor to discover one in its general intent, and to show that the choice of values which was made was abundantly reasonable from the standpoint of due process of law.

Is Section 77B Bankruptcy Legislation?

The amending section has been said not to be upon the subject of bankruptcies (1) because it does not provide for a sale and immediate distribution of the bankrupt's property among its creditors; (2) because it is legislation for the relief of "debtors" who need not be "insolvent," whereas

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5 A knowledge of the provisions of Section 77B on the part of the reader is assumed. The section has been fully analyzed, among others, by Weiner: Corporate Reorganization: Section 77B of the Bankruptcy Act, 34 Col. L. R. 1173 (1934); Friendly: Some Comments on the Corporate Reorganizations Act, 48 Harvard L. R. 39 (1934); Kaplan: Corporate Reorganization Under Section 77B of the Bankruptcy Act, 33 Mich. L. R. 77 (1934). For one not acquainted with the amendment, the following summary of those provisions of Section 77B considered within the scope of this article, will be helpful.
bankruptcy may deal only with "insolvents"; (3) because it provides machinery for the adjustment of the rights of shareholders among themselves, whereas bankruptcy may deal only with the creditor-insolvent debtor relation; (4) because it deals with secured creditors, which no bankruptcy law has ever done before. These are the views of Morford and Stebbins. The latter in a ten page article nowhere defines his concept of "insolvent". It is evident, however, that he as well as Mr. Morford, has in mind the present bankruptcy law definition—excess of liabilities over assets at fair valuation. This definition they read into the constitution. And they ask whether Sec. 77B complies with it. That section authorizes a corporation which is unable to meet its debts as they mature, and which may not therefore be insolvent in the present bankruptcy law sense, to be recognized in bankruptcy. Because this provision involves a definition of bankruptcy which does not fit into their antecedent concept of that term, they are ready to strike down the act of Congress.

Proceedings may be instituted by a petition filed either by the debtor corporation or by three of its creditors who are holders of provable claims in excess of $1,000, or by an answer filed by the corporation in a pending bankruptcy. The central jurisdictional fact which must be alleged is that the corporation is insolvent or unable to meet its debts as they mature, and that it desires to effect a plan of reorganization. The district judge with whom the petition is filed must be satisfied that the proceedings are instituted in good faith. If the petition is approved, no adjudication in bankruptcy is to be entered. The court acquires jurisdiction of the debtor and its property wherever located for the purpose of the proceedings. The court may appoint a trustee for the corporation, or continue the debtor in possession. It may give either the trustee or the debtor authority to continue the business.

A plan of reorganization is then proposed for the debtor. It may be proposed by the corporation itself, in which case no prior approval of the plan by any of its security holders is required. If the plan is proposed by creditors, ten per cent of all holding claims must have accepted it as a condition of its consideration by the court. If proposed by stockholders, five per cent of such security holders must first approve of it. The point to note is that the debtor is favored by exempting it from the necessity of getting any approval of its plan before it may be proposed to the court.

The plan must provide for the payment of the reorganization expenses. If the court finds the corporation to be insolvent in the bankruptcy sense (excess of liabilities over assets at a fair valuation), no provision need be made in the plan for stockholders. If there is no such finding, the plan must either be accepted by a majority of each class of stockholders whose interests are adversely affected thereby; or adequate protection for the realization of the value of the equity of such class of stock in the debtor's property must be made (a) by a sale of the property at not less than a fair upset price, or (b) by appraisal and payment in cash of the value either of their stock, or at the objecting stockholders' election, of the securities allotted to such stockholders under the plan, or (c) by such methods as will do substantial justice to such stockholders under the circumstances.

As to creditors, the plan must either be accepted by two-thirds in amount of each class affected by the plan, or the plan must provide for the payment of their liens or claims in cash in full; or it must provide adequate protection for the realization by the creditors of the value of their liens or claims, if the property affected by their liens or claims is dealt with by the plan. Such provision may be made (a) by a transfer of such property subject to their liens or claims or the retention of such property by the debtor subject to such claims, or (b) by a sale free of their liens or claims at not less than a fair upset price and the transfer of their claims to the proceeds of the sale, or (c) by appraisal and payment in cash of the value of their claims or liens, or, at the objecting creditors' election, of the securities allotted to them under the plan; or (d) by such method as will in the opinion of the judge equitably provide protection for them under the circumstances.

The trustee or debtor is authorized to issue certificates in exchange for cash for operating expenses, which may have priority over any existing indebtedness, secured or unsecured. After hearing such objections as may be made to the plan, the judge is authorized to confirm it if satisfied that (1) it is fair and equitable, (2) that it does not discriminate unfairly in favor of any class of creditors or stockholders, (3) that it is feasible, and (4) that it complies with the provisions...
The Constitution of the United States confers upon Congress the power "To establish . . . uniform laws on the subject of bankruptcies throughout the United States". It is well known that two rival theories of interpretation of constitutional provisions exist and are employed by the courts. One would apply the precise meaning of the words as of the time of the adoption of the clause in question. The other would leave it to each generation to work out for itself the scope of the constitutional immunity. No stronger example of the consistent application of the latter theory could be found than in the history of bankruptcy legislation. The concept of bankruptcy has not merely been an expanding one since 1789. It has radically altered.

I should not deny that the solution of a major economic or social problem is not to be sought by tracing a concept among its ancient origins. It is by the ethics of the consequences of acts, including legislative enactments, and not by the ethics of antecedent concepts, that their existence must be justified. However, I believe that it will be profitable to examine briefly the history of bankruptcy legislation for the light which that history throws upon the conception of the function of a bankruptcy statute in the economy of here and now. In Anglo-American law the first bankruptcy act appeared in 1542. Its title is: "An act against such persons as do make bankrupts." It was exactly that. It was aimed "against" fraudulent debtors only. It was limited to traders and merchants; no discharge of the debtor from his debts was provided; no voluntary petition could be filed. Obviously it was an act passed in aid of creditors only; there was no thought of making any provision "for the relief of debtors". In 1705 under the reign of Queen Anne a provision was added granting a very limited discharge. Thus the English law stood at the time of the adoption of the United States Constitution. The first American act was enacted in 1800. It seems identical in theory with the English law of Henry VIII. It too was aimed at fraudulent

of the act as to acceptance by security holders or provision for their interest is otherwise made as outlined above. All amounts to be paid as consideration by the debtor or any corporation acquiring the assets of the debtor as compensation to the reorganization managers or committee must be fully disclosed and found to be reasonable. Special relief from taxing statutes and dispensation from compliance with the Securities Act of 1933 are afforded to the debtor corporation. Then follows the provisions (Section 77B(g)) quoted at the beginning of this article, by which the plan is made binding upon all security holders of the corporation, whether or not they have accepted it. Upon such confirmation of the plan by final decree of the court, the debtor is discharged from all of its debts and liabilities except as specifically reserved in the decree defining the relative rights and privileges of creditors and stockholders in the new or reorganized corporation. In all the provisions of the amending section, the corporation is referred to as a "debtor", not as a "bankrupt". Section 77A provides that the federal courts shall exercise additional jurisdiction "for the relief of debtors" as provided in Section 77B.

8 Morford and Stebbins, loc. cit., supra note 3.
9 Article I, Section 8, Clause 4.
10 The Minnesota Mortgage Moratorium Case (Home Building & Loan Association v. Blaisdell, 290 U. S. 398 (1934)), is an example of the cleavage produced by these theories. The majority opinion in that case adopted the dynamic theory; the minority the static.
11 4 Anne c. 17.
debtor; limited to traders and merchants. Any extension beyond this scope to other debtors was assumed to be unconstitutional. No voluntary petition was provided for. A discharge could be had, but only by consent of two-thirds of the creditors in number and amount. In practice the discharge was an incident granted only in the rarest cases. It is again apparent that this was legislation solely in aid of creditors. The law was repealed in 1802.

When the panic of 1837 spread itself over the country there was no national bankruptcy law. A special session of Congress was called in 1841 to relieve economic distress. From that Congress there emerged a new conception of bankruptcy. The Act of 1841 provided for voluntary petitions; extended eligibility beyond the old limit of traders and merchants only to all debtors; and it eliminated, practically speaking, the necessity of creditor consent for a discharge. What is significant here is that a device, bankruptcy, which at the time of the adoption of the Constitution was solely one for the protection of creditors, has become dominantly a measure for the relief of debtors. It is one of the striking examples of the ability of the Anglo-American legal system to infuse old forms with a new content; to give expression to "the felt necessities of the times" even though the validity of the legislation which did so depended upon a reinterpretation of constitutional powers in terms of an existing need. The Act of 1841 was attacked as unconstitutional by Senator Benton on the ground that it was not a law on the subject of bankruptcies. On the static theory of interpretation the act clearly was unconstitutional. It was an act primarily for the relief of debtors. Bankruptcy in 1789 was a device for the benefit of creditors only; nothing more. The constitutionality of the act was upheld, however, when challenged in the courts. This fundamental shift in the concept of the term bankruptcy has remained in subsequent legislation. Until the 1933 amendments appeared, only two changes material here were made subsequent to 1841. An amendment to the 1877 act enacted in 1874 provided for compositions between debtors and their creditors. There was no reference to "bankrupts" in the section, but to "debtors". Such a composition could be confirmed if accepted by creditors holding a majority of the claims. In that case, it was binding upon the minority. The significance of the statute is its evidence of further indulgence toward the debtor. The constitutionality of this statute was sustained in In re Reiman.

The present law was enacted in 1898. Again the debtor was extended greater favors than ever before. The powers of creditors to file bankruptcy petitions against their debtors were drastically circumscribed. But the far-reaching alteration made in the law in aid of the debtor was the enactment of a new definition of insolvency, sui generis in the world. The common law definition of bankruptcy was suspension of payments. It is the English, the Canadian, and the Continental definition even today. The definition of bankruptcy in the act of 1867 was inability to meet maturing obligations. During the panic of 1873 this test resulted in many honest

13 Stat. 440 (1841).
14 Senate Document No. 65, 72nd Congress, 1st Session, at p. 51.
15 In re Klein, decided in the 8th circuit court, and, by direction of the United States Supreme Court, printed "as being of general interest" in 42 U. S. (1 Howard) 277 (1843).
16 Fed. Cas. No. 11, 673 (D. C.) and 11,675 (C. C.) (1875).
17 28 U. S. C. A.
18 Excess of liabilities over assets at a fair valuation. Bankruptcy Act, Section 1(15).
debtors being thrown into bankruptcy who might have paid their debts had their creditors shown a little patience. The purpose of the change of definition in 1898 then appears again to be in aid of the debtor; to prevent the recurrence of the treatment which debtors received at the hands of their creditors in 1873. The constitutionality of the 1898 act was sustained in Hanover National Bank v. Moyses.22

In the light of this review of bankruptcy legislation the objections to the constitutionality of Sec. 77B on the ground that it is not bankruptcy would seem to disappear. Evidently a bankruptcy law is no more than an act providing for the adjustment of the relation between a debtor who is unable to meet his obligations, and his creditor. Anything else is but a means to this end. A sale and immediate distribution of the property is one means of such adjustment. It involves liquidation, a synonym for sacrifice. A distribution of the corporate debtor's property by the issuance of securities to those holding an interest in that property, bondholders, creditors, and stockholders, is another means.23 It is probably a better means because it does not involve liquidation. If the creditor wants cash at once, he is free to sell his security. In declaring that a debtor "unable to meet its debts as they mature" should be eligible to relief under Section 77B Congress simply reenacted the definition of a bankrupt adopted in its three previous acts, the common law definition, and the definition universally followed in the legislation of the world. It seems frivolous to assert that Congress has not the power to do this now because it adopted another definition at one time.24

As for the contention that a bankruptcy law may not deal with the relation of stockholders among themselves, it would seem a complete answer to say that a bankruptcy law may constitutionally deal with the stockholders' rights when an adjustment of those rights is necessarily incidental to an exercise of its constitutional power to adjust the relation between debtor and creditor. An analogy is furnished in the power of Congress to control intra-state affairs whenever such control is necessary to the effective exercise of its power over interstate commerce.25 And as for the contention that no bankruptcy law has heretofore attempted to affect the secured creditors' lien, the short answer is that the statement is not accurate. The fact is that prior to the 1933 amendments Congress had dealt with the lien to the extent of allowing the property of a bankrupt to be sold free of the lien, remitting the lien to the proceeds of the sale. The creditor is vitally affected by such a procedure since he must be watchful to protect his lien at the sale, or otherwise possibly see it divested for a song.

Before 77B

The history of bankruptcy legislation is interesting history. But it has not been set out here because it is interesting. Its significance to the present discussion has already been indicated. It shows in an arresting manner the

22 186 U. S. 181 (1901).
23 We are not at this point concerned with what is a fair adjustment of the interests of bondholder, creditor, and stockholder in the reorganized company.
24 The courts have already answered this objection, made to a former act. In In re Klein, loc. cit, supra note 15, Mr. Justice Catron said that any law is "a bankruptcy law in substance and fact, that causes to be distributed by a tribunal the property of a debtor among his creditors . . . . Such a law may be denominated an insolvent law (and never mention the words 'bankruptcy' or 'bankrupt'); still it deals directly with the subject of bankruptcies, and is a bankruptcy law, in the sense of the Constitution. . . . ."
25 Shreveport Rate Cases (1914), 234 U. S. 342; Wisconsin Rate Case (1922), 257 U. S. 563.
progress of legislative value judgments in the bankruptcy field. For three hundred years of Anglo-American law bankruptcy was a device solely for the benefit of creditors. Beginning nearly a century ago the concept of bankruptcy altered to become dominantly remedial legislation for debtors. The subsequent acts of 1874 and 1898 not only preserved the altered concept but, as already shown, carried it further. The 1933 amendments carried the notion of indulgence toward the debtor further yet. They are in pari materia so that an understanding of the significance of all conditions the meaning of each. Section 74 grants relief to individual debtors by way of composition who are unable to meet their debts as they mature. Section 75 provides similar legislation adapted to the special problems of farmers. Section 77 is the railroad reorganization provision, almost identical, so far as the problems involved in this discussion are concerned, with Sec. 77B.

It is evident therefore that Congress in enacting these Acts for debtor relief did not accept as its standard an historic concept. It had in mind the genesis of the need, the condition out of which the demand for the legislation arose. Inevitably the amending sections embodied a philosophy of values. An understanding of this philosophy requires a review of the system which section 77B was designed to supplant.

In the first place the Act recognizes that American corporate activities are national in scope, and that judicial machinery must be accommodated to deal with its problems as a national unit. The possibilities of the utter dissolution of a corporate venture and the dissipation of its going-concern value by the appointment of State-court receivers for it in as many States as the company does business are well known. The danger was the more formidable because of the opportunity it offered to the merely unscrupulous creditor or his lawyer who instituted the action merely that he might personally profit in some administrative capacity by the legal ritual of dissolution. Prior to Section 77B the corporation's only protection against this possibility was vigilant action in its own behalf. Even though it were not insolvent in the present bankruptcy sense, if it felt itself open to the danger indicated, its only safe course was to arrange for an equity receivership before the sheriff could reach its door. A friendly suit in equity was instituted. The debtor corporation selected as plaintiff for the suit in which it was to be defendant, one of its simple contract creditors, an individual or corporation domiciled in a state other than its own. Suit could then be instituted in the federal court of the debtor's domicile. The theory of the action was that plaintiff was suing in behalf of himself and all creditors of the debtor for equitable execution; for the preservation of the corporation's assets for the benefit of all creditors; and for the sale of the debtor's property and ratable distribution according to the respective equities of its creditors. A receiver of the corporation was asked in the bill. The debtor answered, admitting the allegations of the petition, and joining in the prayer for the appointment of a receiver. Prima facie this procedure seems conclusive. But it was the best that could be done under the circumstances, and was specifically approved by the United States Supreme Court.

But since the jurisdiction of the receiver did not extend beyond the limits of the district of the federal court which made the appointment, in the

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26 From the act of Henry VIII in 1542, loc. cit., supra note 9, until the United States Act of 1841, loc. cit., supra note 13. Historical parallel is shown in England where voluntary petitions were allowed by statute of 1849, 12 and 13 Vict., c. 106. 27 Sections 73, 74, 75, 77, and Section 77B, although enacted in 1934, is properly a part of this group. It was introduced with the other sections but caught in the last minute legislative jam of the 72nd Congress, and not passed until the 73rd. 28 Re Metropolitan Ry. Receivership, 208 U. S. 90 (1908).
case of an ordinary business corporation, it was necessary to appoint ancil-
lar receivers in each federal court sitting in a district where the corpora-
tion conducted any of its activities. Almost invariably this meant a different
receiver for each judicial district. In the meantime creditors of the com-
pany would have formed committees, or at least one committee composed
of those creditors and representatives of the management who had fostered
the equity receivership. This committee proceeded to work out a plan of
reorganization (the plan might be full grown even before the equity pro-
ceeding were begun). Deposits of securities with the committee were
actively sought from all creditors, and such deposits were generally obtained
by the "reorganization committee", because most creditors favor continuance
of a business on the ground that they will stand a much better chance to
realize on their security from the reorganized company than by a liquidation
of the assets of the reorganizing company. It is not unusual for such a
committee to receive a deposit of eighty per cent of all outstanding bonds.
Under the equity practice, the plan of reorganization was then submitted to
the court for its approval, and the court gave it at least such cursory con-
sideration before proceeding with the sale. A sale was thought necessary
for the reason already indicated. It was quite generally supposed that the
security holder’s contract right to insist upon such a sale and the receipt of
his pro rata share of its proceeds could not be disregarded without his con-
sent. It goes without saying that unanimous consent of a great group of
security holders was never obtainable. So that a sale of the property was
held, on foreclosure of the corporate mortgage.

A mind trained in the common law tradition instinctively looks at such
a situation through the spectacles of analogies familiar to him. On its face
the foreclosure of an ordinary mortgage on a house and lot or small store
building seems to be similar. In fact there are essential differences. A
foreclosure “sale” of the assets of a large corporation when realistically
viewed is not a “sale” at all. It is but a step in the reorganization proceed-
ings, carefully worked out and rehearsed beforehand by the reorganization
committee. Since the creditor may apply his debt at par toward payment
of his bid at a sale on foreclosure or execution, no one was in a position to
bid against the reorganization committee holding a substantial percentage
of the bonds. The committee’s bid was satisfied by signing a receipt and
putting up a relatively small amount of cash. A competitive bidder on most
such sales would have to appear with $15,000,000 in cash or more (depend-
ing, of course, upon the size of the business). Did you ever know a banker
who would lend you $15,000,000 upon the security of a business which had
just demonstrated that it couldn’t make the grade, in order that you might
bid at such a sale? No competitive bidder ever appeared.29

This awkward procedure did finally result in the reorganization of the
debtor corporation. But it had many serious disadvantages. Everyone
knows that receivership is an expensive luxury. The receiver’s fee and his
attorney’s fee took sizeable percentages of the corporate income. It was
not unusual that this drain should continue as long as five years before
reorganization should be accomplished.30 But far worse was the extrav-
agance and inefficiency necessarily involved in ancillary receivership. In a
recent chain store equity proceeding, some fifty ancillary receivers were

29 These are facts of common knowledge among persons acquainted with the
mechanics of equity reorganization. Judicial notice of the fact that no competitive
bidder ever appears was taken by the United States Supreme Court in Louisville
30 The Pittsburgh, Shawmut and Northern Ry. Co. has been in receivership
continuously since 1905.
appointed in the various federal courts for the one company. Each receiver
supreme boss in his own district. Fifty receivers' fees; fifty attorneys' fees.
Not small fees either. The good will and going-concern value of the com-
pany inevitably suffered. "It's in receivership" is no complimentary tag for
a corporation, even if its financial condition is fundamentally sound and
resort is had to such proceedings merely as a protective device. The fore-
closure sale was another great expense; the organization of the new com-
pany, the printing and engraving of its securities and charter a further
drain. Designing creditors might muddle the whole situation by beginning a
bankruptcy proceeding, solely to force the debtor corporation to buy peace
from them. Corporations which really needed reorganization held off from
the equity method as long as possible because of these enormous hardships
which the procedure entailed. The Supreme Court of the United States
added to the unattractiveness of the device as a reorganization medium, just
before its usefulness was to expire by the enactment of Section 77B, by
questioning the availability of such proceedings for the reorganization of
any corporation other than a public utility.31

Due Process and the Dissenter

The disadvantages of reorganization in equity which have been outlined
were serious enough. But a still greater one existed. That problem was
how to deal with the dissenting security holder. It was a delicate one for
the courts. It is probably not unfair to say that no matter how equitable
the reorganization plan which was proposed, some recalcitrant security
holders took advantage of the situation to force the payment of more than
their fair share in the underlying properties of the debtor corporation. In
the eyes of the reorganization committee the dissenter was almost invariably
such a person. But to the court which had to pass upon the fairness of
the reorganization plan, he was the holder of a contract—a property right-
calling for the sale of the corporate debtor's property and a distribution to
him of his pro rata share of its proceeds.32 Due process of law, it was
assumed, compelled this result.33 And so a sale was ordered. To afford
some semblance of protection for the dissenting creditor's interest in the
proceeds of such a sale, the courts of equity developed the practice of setting
an upset (minimum) price which the property must bring at the public
outcry. If such a price were fixed at the fair value of the property, and the
corporate assets on the sale sold for such sum, the creditor would receive
the precise percentage of the proceeds of the sale to which he was entitled.
But we have already seen that there could be and was only one bidder at
every such sale. He could name his own price. Not only that, he could

31 First National Bank v. Flershem, 290 U. S. 504 (1934); Shapiro v. Wilgus,
32 The following statement by Justice Brewer is typical: "A party insisting
upon those rights is probably, or even certainly, bound to suffer loss, yet while he
insists it (the court) must protect him in his insistence. There is no wide discre-
 tion vested in the chancellor which permits him to disturb contract rights—rights
of property". Merchants' Loan & Trust Co. v. Chicago Rys. Co. (C. C. A), 118
Fed. 923, 927. In the case of In re Prudential Outfitting Company of Delaware,
Inc. (1818), 250 Fed. 504 (D. C., S. D. N. Y.), Judge Learned Hand said: "The
dissenting creditors must be paid in cash their own proportion of the bid which is
their inviolate right. A bankruptcy court under no circumstances will, or indeed,
can compel creditors to accept an aliquot interest in the assets of the bankrupt
under the guise of a sale." 33 Cutcheon: An Examination of Devices Employed to Obviate the Embar-
rassments to Reorganizations Created by the Boyd Case (1930) in Some Legal
Phases of Corporate Financing, Reorganization and Regulation, page 70 et seq.;
name his own upset price, since it would be futile for the court to fix any figure except one which the reorganization committee would be able and willing to pay. Realistically, therefore, the upset price is not calculated by the judge in equity chambers; it is arrived at in the lawyer's office.\textsuperscript{34} It must include cash enough to pay all the reorganization expense, no small item. Some cash in addition is thrown in for the dissenters. Counsel are careful to see that it is substantially less than what would probably be the value of the security which the dissenter declines and the majority have accepted. As a matter of fact the cash which the dissenter got by this process was but a dribble.\textsuperscript{35}

And this was due process for the dissenter. He had destroyed his rights by insisting upon his rights. One is inclined at first to reproach the chancellor for not affording him better protection. The answer is "the limits of effective legal action".\textsuperscript{36} For one who insisted upon a sale, equity could not be asked to produce a purchaser with millions in his pocket, ready and willing to bid in competition with the reorganization committee for the assets of the old company. But nothing short of that would serve to infuse a judicial sale of an enormous corporate property with any meaning.

We are now in a position to view Section 77B in its true perspective. If the security holder is a member of a class of creditors two-thirds of whom have accepted the reorganization plan, he must go along; his right to insist upon a sale and distribution of his interest in cash is gone. If he is a stockholder, a majority vote will bind him. He may protest that the plan is unfair, even though accepted by the requisite majorities. Can he say that it deprives him of due process of law? Again the final answer must be furnished by one's philosophy of values. But the analysis of conditions before the enactment of Section 77B has served this purpose. One who should contend that the plan as applied is unconstitutional because it deprives the creditor of his "inviolate property right" to insist upon a sale of the debtor's property, denies the power of Congress to legislate in the public interest\textsuperscript{37} if, incidentally to the promotion of that end, a "right" which has no substantial value whatever is extinguished. The dissenter has a "right" to cash in the sense of a metaphysical concept. Not in the sense that the right is of substantial value to him. It was competent for Congress to recognize this fact. Section 77B takes the realistic view that the dissenter may constitutionally be deprived of this nothingness. In its place it gives him

\textsuperscript{34} Lest this appear to be too baldly realistic, I may say that the ritual was for the judge to set the upset price upon the advice of the receiver. But the receiver in turn almost invariably cooperated with the reorganization committee and its counsel, learned from them their top bid price, which was then passed up through the receiver to the judge and appeared in the decree as the upset price.

\textsuperscript{35} To one not acquainted with corporate reorganization practice, this statement may appear startling. But all commentators on the subject agree that it is no exaggeration. Louis B. Whele (Railroad Reorganization Under Section 77 of the Bankruptcy Act, 44 Yale L. J. 197, December, 1934) depreciates the coercive power of legislation of the type of Section 77B over the dissenter. He admits, however, that equity's attempts for the last 50 years to obtain substantial cash for the dissenter have been fruitless. This at page 114.

\textsuperscript{36} The case of Phipps v. Chi., R. I. & P. Ry. Co. (C. C. A. 8th, 1922), 284 Fed. 945, in which the court refused a sale and insisted upon protecting the dissenter against himself by offering him only preferred stock in the reorganized company, is famous mostly because of this unique treatment of the dissenter. Ninety-five per cent of creditors and 99 per cent of stockholders had accepted this arrangement. But certiorari was granted by the Supreme Court of the United States, and counsel for the railroad company, possibly fearing a reversal there, settled with the dissenter. The case was generally criticized, and no subsequent decision followed the practice.

\textsuperscript{37} The interest of the general public in Section 77B is discussed below.
such securities in the reorganized company as his brother shareholders have agreed to accept. It will be a rare case in which these are not marketable for cash, if cash is his great concern.

Assume that a plan of reorganization under Section 77B provides for an exchange of securities only. It is submitted to the court and approved. Two-thirds of the creditors and a majority of stockholders have accepted it. Others refuse. They insist upon cash for their interests. If they constitute a sizeable percentage, say the other one-third of creditors and forty-five per cent of the stockholders, it is very likely that they could frustrate the proceeding, if it were in equity reorganization. The result there would be liquidation. Liquidation prices for enormous business properties, as everyone knows, are scrap prices. But if liquidation proceeds, ultimately the recalcitrants will receive their pro rata portion of the proceeds of such a sale. Had they accepted the reorganization plan, it is almost a certainty that the security which they would have received from the reorganized, going-concern, in exchange for that which they held in the former company, would have been saleable at a greater sum than each realized through the liquidation sale. In this situation, Section 77B protects the security holder against himself by forcing the reorganization plan’s offering upon him. If it be said that the dissenter does not favor liquidation to reorganization, but only wants fair treatment under a fair plan, I think it is an answer to say that he is to receive exactly the same treatment as those security holders of his class who think the plan is reasonable and who have accepted it; that a majority favor the plan; that orthodox corporation law has for decades made possible corporate action of vast importance to all security holders by vote of a majority of the shareholders; and that the federal court has examined the plan and found it fair. By the traditional common law machinery for determining fairness—the vote of a majority of his peers, and the finding of a judicial tribunal—the plan may be said to grant the dissenter equitable treatment. Logically he is forced, then, to the contention that no plan of reorganization, even though it may have been objectively found to be fair, may constitutionally deprive him of his “inviolate contract right” to insist upon a sale. The argument comes round to one depending for its answer upon our philosophy of values. There is, of course, something to be said for the theory that contract rights should be maintained unimpaired. What value judgment did Congress regard of paramount importance to this one?

Bankruptcy and the Public Interest

Jerome Frank fears that Section 77 (which is substantially identical with Sec. 77B so far as the points here discussed are concerned) may operate to give the bondholders an undue advantage over the stockholders. Louis B. Wehle believes that Section 77 gives the stockholders such an unjustifiable advantage over the bondholders as to create a serious question of the constitutionality of the law. Each treats of the amending section as if its sole aim were to furnish a vehicle for the adjustment of the relative claims of the security holders among themselves; the one from the view of the anxious stockholder, the other from that of the more anxious bondholder. I profess to see in Section 77B something more, to which the provisions looking to the adjustment of security holders relative claims are secondary. The inclusion of a review of the history of Anglo-American bankruptcy legislation in this paper has been pointless unless it has induced a conviction that for

the last century bankruptcy has been dominantly a device intended for the relief of debtors. And not only has that concept of bankruptcy obtained, but every single bankruptcy amendment, at present day, has been more liberal to the debtor than the last. Whatever one may think of the Frazier-Lemke bill,\textsuperscript{40} the last of all, it is unquestionably more indulgent than any other ever enacted. The significance of this trend to the present discussion is apparent. To me it seems that the dominant intent of Congress in the enactment of Sec. 77B was not to provide a vehicle for the adjustment of interests between security holders; it was to afford relief to the corporate debtor itself as a unit distinct from those who are interested in it as investors; to lessen the impact of the fixed charges upon the corporate income; to enable the corporation thereby to continue to live and perform its function as a vital unit in the economic organization of society today, rather than to be liquidated at a frightful social and economic loss to the community which it serves.

Text books and cases on corporation law are abundantly filled with discussions of the reality or non-reality of corporate existence distinct from the shareholders. This paper will not enter the realm of that dispute. But a sense of realism, I believe, compels the conclusion that in so far as Sec. 77B deals with the debtor corporation, it deals with it upon the basis of an economic and social unit distinct from its security holders. A corporation is an employer of labor. In thousands of communities in the United States it is the most important economic unit present there. Upon its continuity of operation the economic and social destiny of the major portion of that community depends. Short of an act of God, no greater calamity could befall such a community than the liquidation of the business and the dismantlement of the primary source of employment for that district.

I should like to make the point by an example of a corporation now in reorganization under Sec. 77B. It is The Studebaker Corporation, an automobile manufacturing company, the makers of "Studebaker" cars. Most of its manufacturing activities are carried on at South Bend, Indiana, a city of a hundred thousand people. It is virtually the only industry in that city. It has 9,882 employees; 881 preferred stockholders; 37,452 common stockholders.\textsuperscript{41} The corporation, and predecessor companies, had a long and profitable business record until the coming of the present economic decline. A few years ago, during the "new era" financing, it issued nearly $15,000,000 of ten year 6% notes. The default on these is the occasion for the present reorganization. The last available statement of financial condition\textsuperscript{42} showed total assets of the company of $85,000,000, more than three-fourths of which was represented by investment in land and factory buildings. Working capital is utterly inadequate. A plan of reorganization has been proposed and already accepted by two-thirds of the creditors. Inevitably some will not come in. But under Sec. 77B these dissenting creditors can now be bound by the plan and permit the reorganization of this company.

Had it not been for the new legislation it is not unreasonable to suppose that reorganization of this corporation would have been impossible. Apart from the strain of expense on the corporation which would have been entailed by an equity receivership proceeding, it does not seem likely that cash could be raised at this time to buy out dissenting creditors. As we have seen, some cash always had to be supplied for this purpose, in an equity

\textsuperscript{40} Bankruptcy Act, Section 75(s), 11 U. S. C. A: No. 203(s), approved June 28th, 1934.
\textsuperscript{41} As of 5-1-34. Moody's Industrials, 1934, Addenda, p. 3338.
reorganization. The alternative was liquidation. What this would mean for the employees of Studebaker and for the city of South Bend can be imagined. If the plant were dismantled, nearly ten thousand employees' families would lose their means of support; property values in the city would not recover for fifty years. If the federal court makes the plan of reorganization of The Studebaker Corporation under Sec. 77B binding on those creditors of the company, less than one-third, who have not accepted the plan, will it deprive them without due process of law of their "inviolate property right" to insist upon a sale of the assets of the company? I agree that the enormity of the public need is not the measure of the power of Congress. But the presence of that need is a consideration not to be overlooked in determining whether a power, conceded to exist, is reasonably exercised by a statute which seeks to preserve vital economic and social interests from dissolution. If this is an adequate analysis, there would seem to be only one answer to the contention that Sec. 77B is not due process of law.

If further support for the contention that the dominant purpose of Sec. 77B is to aid the debtor corporation itself to avoid liquidation by reorganization were needed, it may be found on the face of the act itself. Proceedings may be instituted by the debtor corporation itself. The debtor may be continued in possession without the appointment of a trustee, and authorized to continue the business. The debtor may propose a plan of reorganization in its own behalf without first securing the consent of some security holders, whereas if the latter propose a plan, it must first be accepted by a substantial percentage of the corporation's investors. The trustee or debtor is authorized to issue certificates in exchange for cash with priority over any existing liens in order to obtain money to continue the business. Reorganization expenses, including compensation of committees, which are borne by the debtor, are limited to such amounts as are found to be reasonable by the court. Special relief from taxing statutes and dispensation from compliance with the Securities Act of 1933 are afforded to the debtor corporation. And, strongest of all, is the provision that the debtor may effect reorganization by a plan accepted by only two-thirds of creditors and a majority of stockholders, relieving it of the former burden of buying off dissenters. When so accepted the plan is binding and the debtor discharged from all its obligations except as provided in the reorganization decree.

If my view as to the value judgment which Congress considered the dominant one in the enactment of Sec. 77B is the correct one, I believe it will go far to furnish the solution of the question whether a plan of reorganization under the statute provides a reasonable adjustment of the relative claims of security holders among themselves. I do not deny that the adjustment of such interests is an important function of the statute. But I believe that we must approach the conference table for such an adjustment bearing in mind that Congress intended that the dominant purpose of its enactment—to insure the continuance of the corporate enterprise—should have an impact upon our deliberation. I submit as a direct contact between the two interests the financial pages of the daily newspapers which inform us from time to time that a certain company has laid off several thousand employees in order that current income may be used to keep the "bond-budget" intact.

43 It is submitted that this statement is a reasonable interpretation of the effect of Nebbia v. New York (1934), 54 S. Ct. 510.
44 If both the debtor corporation and some of its creditors institute proceedings under Section 77B, the debtor's petition will be preferred, if diligently filed, even though its petition were not the first one filed. In re National Dept. Stores, 8 Fed. Supp. 19 (September, 1934).
It is a commonplace now to observe that property is not an absolute; that it is but a bundle of equities or legal expectations. The state confers them and may, within reasonable limits, alter them from time to time. What those reasonable limits are is determined, by and large, upon the basis of the economic and social need. The economic philosophy of Section 77B is continuity of corporate enterprise. An almost indispensable factor in such continuity is the corporate management. And the corporation management, as everyone knows, is invariably associated with the stockholders group rather than the bondholders. If the corporation is to continue, the management must continue with it. Furthermore, some cash must be advanced even under Section 77B, in order to meet the reorganization expense, and generally to provide immediate working capital. Past experience with reorganization has demonstrated that it is only the stockholders who are willing to come forward with this fresh money. Surely it was competent for Congress to recognize these facts; and to provide that in the adjustment of the conflict of interest between bondholders and stockholders the absolute priority rights of bondholders under their contracts should be to some extent disregarded to the advantage of the stockholders, in order that the latter would have an incentive to stand by the business and furnish the new cash, rather than to let the enterprise die. If we remember that the pervading purpose of the act is to preserve the life of the company, such an adjustment of conflicting interests seems a reasonable exercise of the power of Congress. If we do not see such a dominant scheme in the statute, but discuss it simply from the standpoint of the relative rights of stockholders and bondholders in the corporate debtor's property, as did Wehle, then I should concede that a plan of reorganization which gives stockholders an interest in the new company based solely upon their supposed equity in the old, when the interest of bondholders has not been recognized in full, presents a more serious question of the constitutionality of the statute.

Wehle's approach to the adjustment of the relation of stockholders' and bondholders' interests in the debtor's property is evidently from the angle of how the act will affect the interests of the bondholders. His point of departure is the "trust fund principle". His theory is that equity regards the corporate debtor's property as a trust fund for the benefit of creditors, out of which they are entitled to recognition of their claims in full before stockholders may claim any interest in such property. The practice in equity receivership was then to proceed with a sale of the debtor's property and to divide the proceeds, either in the form of cash or securities in the new company. Stockholders were disregarded entirely except to the extent that they contributed cash for the new enterprise. The amending section, by requiring that stockholders be dealt with in any plan of reorganization unless the court find that the debtor is "insolvent" (virtually an impossibility in dealing with a vast business enterprise), practically means that the equity security holders must be dealt with in every case. The result is to give stockholders a new weapon against the trust fund principle. To that extent, he concludes, valuable property rights which under the old practice of equity reorganization were shared wholly by the bondholders, must now be divided with the stockholders. Hence there is a taking of the bondholders' property (and a giving of that property to the stockholder), Wehle concludes, as a result of the amending section.

In the first place, it may be questioned whether his trust fund premise is based upon an adequate analysis. The trust fund theory in general as applied to corporate assets has been very much criticized. By the present weight of authority the trust fund doctrine has no application except on
the dissolution of a corporation.\textsuperscript{46} Section 77B is designed to avoid dissolution. It is submitted that the trust fund doctrine has no proper application to the reorganization of a corporation unless it means simply that equity will require the reorganization to be effected with due regard to the relative claims of all classes of security holders. But the statute in ipsis verbis requires that. Whether or not a particular plan provides such treatment, it is submitted, will depend in the last analysis upon a consideration of the theory of the statute which this paper attempts to advance.

But the fundamental weakness of the trust fund analysis, I believe, lies in the fact that one who argues that it is applicable to the reorganization of an enormous business unit is betrayed in this instance by the common law tradition of argument by analogy. The legal theory which underlies the distribution of the proceeds of a mortgage foreclosure sale of a house and lot, or small store building, is familiar enough to the common law lawyer. The "trust fund theory" would at least explain the result. Out of the sale price, the first money goes to pay the first mortgage to the satisfaction of that lien in full; the next money to the second mortgage, and so on. If there is anything over, it goes to the mortgagor as the owner of the equity. The scheme of such legislation providing for such a sale is to give the owner only such sum as remains after creditors are paid in full out of the sale proceeds. Why is this theory adopted? Is it not because of the belief on the part of the legislature that it will operate to adjust the relative rights of the parties in the property fairly and equitably? It is assumed, and properly so, I believe, that the property will sell upon competitive bidding, or at least where such bidding is reasonably possible; as a result, it will sell for a figure having a reasonable relation to its fair value. Since that safeguard is present, the interest of the owner of the property is protected as well as the interest of the lienholder. When equity came to deal with a foreclosure of the property of a vast corporate enterprise it was not unusual that it should have carried over into this field the theories of liquidation of small property interests. A sale of the corporate assets was held. The proceeds were distributed in accordance with absolute priorities of the lien creditors. But it is apparent from what has already been said, that this process differs fundamentally from the foreclosure of a lien on a small property. In the corporate foreclosure the interest of the owners of the equity in the property is divested by a device which furnishes no assurance, practically speaking, that the property will sell for a sum which bears a reasonable relation to its worth. We have seen that in fact it sells for such sum as a committee of creditors wish to bid for it. Had it sold for its fair value, in most cases there would be something to distribute to this class of junior security holders.\textsuperscript{47}

Congress could not provide a purchaser at these sales who would bid the fair value of the property. But it is submitted that it could take a realistic

\textsuperscript{45} Loc. cit., supra note 35. Wehle has made at least one worth-while contribution to the discussion of constitutionality. That is his treatment of the Gebhard case (Canada Southern Ry. v. Gebhard, 109 U. S. 527 (1883)), which has often been cited as supporting the constitutionality of No. 77B, at least by dictum. This case was one in Conflict of Laws. It was concerned with an application of the law of Canada. Due process could not therefore have been involved. And the dictum, itself, as Wehle explains by its context, is equivocal.

\textsuperscript{46} 15 Fletcher: Cyclopedia of Corporations, Sections 7375, 7386; Fogg v. Blair, 133 U. S. 534, 10 S. Ct. 338.

\textsuperscript{47} In the famous Boyd case (Northern Pac. Ry. Co. v. Boyd, 228 U. S. 482, 33 S. Ct. 554 (1913)), the railroad cost $241,000,000. The lien debts were $157,000,000. The road sold on foreclosure for $61,000,000, and the purchaser at once issued $190,000,000 of bonds and $155,000,000 of stock on property which a month before had been bought for $61,000,000.
view of foreclosure proceedings of enormous corporate properties; that it could realize that sales of such properties when no competitive bidders can possibly appear are but a farce; that to vest title in the lien holders by the use of such a device really amounts to a deprivation, by the process of law, of the property interest of the equity security holders in the corporate assets to the extent that the fair value of those assets exceeds the amount of the claims against them held by the lienholders who purchase at the fictive sale. Because foreclosure sale of small mortgaged property will adequately protect the interests of both debtor and creditor, does this mean that the foreclosure device is immune from constitutional abolition in a situation where it does not protect the interest of the equity owners of the property? Ancient analogies belie the assertion that such a step is not possible. Courts of equity began three centuries ago to take charge of the incidents of the contract between borrower and lender in many essentials. The doctrine of the redemption of mortgaged property after the law day; the rule against clogging the equity of redemption; usury legislation, are familiar examples. The theory of such interference was that the necessitous debtor was not free to bargain.48 It is submitted that the same theory underlies Section 77B in according the shareholders a place in reorganization (in any case in which it is not found that the corporation is insolvent). The law saves for him what he was powerless to save for himself, his equity in the property. It does this by providing that a plan of reorganization must provide securities for the shareholders to the extent of their interest in the assets of the corporation at a fair valuation.

If this is a correct analysis of the theory underlying the treatment which Section 77B accords to the stockholders, it would seem that he is not receiving an undue advantage over the bondholder, but for the first time in American history a measure of protection has been afforded to safeguard his interest upon reorganization of his company. In this perspective the statute is seen as a measure to protect and conserve property; not one which deprives the creditor of some part of his property without due process of law. A choice of interests was inevitably presented to Congress. It chose to enact legislation which would prevent the destruction of the stockholder's equity upon reorganization. By doing so a measure of property values which had formerly gone to the bondholder upon purchase at the foreclosure sale was lost to him. It would have been no less a choice had Congress not acted. By its Act, the bondholder lost his windfall; it was "taken" from him, in a realistic sense; but it was restored to the stockholder who in equity was entitled to the interest. It would appear to me to be within the power of Congress, under the bankruptcy clause, to provide by legislation for equality of bargaining power between stockholder and bondholder in the adjustment of their relative rights in the corporate assets upon reorganization; and that such is the effect of Section 77B.

If my analysis of the theory which underlies the existence of Section 77B has been adequate, it would seem to me that only one view of its constitutionality may be held. I agree that the existence of a national need does not create national power. But the power of Congress to enact bankruptcy legislation is expressly given. Only two questions can therefore arise. Is the legislation upon the subject of bankruptcies? And does it conform to the general limits set by due process of law upon Congressional action? The answer to the first question I have attempted to show by a review of the expanding concept of bankruptcy, and the alteration of the bankruptcy

48"... necessitous men are not, truly speaking, freemen, but, to answer a present exigency, will submit to any terms that the crafty may impose upon them." Vernon v. Bethell, 2 Eden 110, 113 (1762).
device at the hands of Congress from a creditor's remedy to what is dominantly a debtor's relief statute. But this history is more significant to the second question. It demonstrates that the pervading purpose of the corporate reorganization statute was, in common with the uninterrupted trend of all bankruptcy amendments, to aid the corporate debtor itself as a legal entity performing an economic and social function, the continuity of which is vital to the economy of today. A secondary, though important, aim of the section was to provide for the adjustment of the relative interests of stockholders and bondholders in the property of the corporate debtor, particularly by affording the shareholder a means of preserving his equity in the corporate assets which the chancellor in an equity reorganization was powerless to give. The accomplishment of this dominant aim—the continuance of the debtor in business—is insured by the provisions binding dissenting security holders to a plan found to be fair by the court and accepted by the requisite majorities of those who have invested in the company. It is at this point that Congress was called upon to write into the act its philosophy of values. It chose, as we have seen, the value judgment that the continuity of the corporate enterprise rather than its liquidation was socially and economically more desirable than the inviolate maintenance of the dissenting security holder's right to force a realization upon his claim in cash—a right which realistically viewed was of no substantial value to the dissenter but which too often meant the liquidation of the corporate enterprise. The philosophy of values which the act embodies, the choice of interests which was made by Congress, would seem to me to be well within the bounds of due process of law.
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