NOTES

Priority Claims Under Section 77B of the Bankruptcy Act

Although it has been stated with regard to priorities in corporate reorganizations [1] under Section 77B of the Bankruptcy Act [2] that ". . . the rules of priority which obtain in *equity* are *controlling* and if the plan of reorganization does not retain to each class of claims the priority or preference which it would have been given in a court of equity, the plan fails to meet with the test of fairness",[3] this generalization appears to be invalid. However, it should be added that the courts are not unlikely to adopt the same misconstruction of the Section. Nevertheless it seems that an adequate discussion of this phase, at least, of 77B necessitates something more than a restatement of the rules of equity receiverships, prefaced by a brief notation that 77B was intended to effect no change. It will be the purpose of this treatment to examine the changes which do appear to have been intended, and to attempt to develop a hierarchy of priorities, rather than to catalogue minutely the valid administration expenses or the plethora of state insolvency preference statutes.

The Provisions of Section 77B

The provisions of the Section itself which are pertinent to a study of priorities are subdivisions (b)(10),[4] (b)(3),[5] (c)(3) [6] and (e)(1),[7] and subsection (k).[8] Although somewhat inartistically arranged and variously expressed, these provisions do appear to establish a complete, and not irrational system of priorities.

Basic, and most comprehensive in scope, but unhappily the provision most likely to be distorted, is the first, (b)(10). The most tenable construction of

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1. This note will discuss only those priority problems which arise in connection with a reorganization. If a reorganization is found inadvisable and an order of liquidation is entered under § 77B (c) (8), the priorities provided for in § 64 of the Bankruptcy Act [30 STAT. 544, 563 (1898), *amended*, 44 STAT. 666 (1926), 11 U. S. C. A. § 104 (Supp. 1936)] will govern. § 77B (k) (5).

2. 48 STAT. 912 (1934), *amended*, 49 STAT. 664, 965 (1935), 11 U. S. C. A. § 207 (Supp. 1936).

3. 2 GERDES, CORPORATE REORGANIZATIONS (1936) § 639 (italics added).

4. "For all purposes of this section unsecured claims which would have been entitled to priority over *existing mortgages* if a receiver in equity of the property of the debtor had been appointed by a Federal court . . . shall be entitled to such priority. . . ." (italics added.)

5. Subdivision (b) (3) requires the plan to ". . . provide for the payment in cash of all costs of administration and other allowances made by the court except that compensation or reimbursement provided for in subdivision (c), clause (9) . . . may be paid in securities . . . if those entitled thereto will accept . . . and the court finds such compensation reasonable".

Subdivision (c) (9) provides that ". . . the judge . . . (9) may allow a reasonable compensation for the services rendered and reimbursement for the actual and necessary expenses incurred in connection with the proceeding and the plan by officers, parties in interest, depositaries, reorganization managers and committees or other representatives of creditors or stockholders, and the attorneys or agents of any of the foregoing and of the debtor. . . ."

6. Subdivision (c) (3) authorizes the issue of trustee's certificates ". . . for such lawful purposes . . . and with such security and such priority in payments over existing obligations, secured or unsecured, as may be lawful in the particular case".

7. As amended, 49 STAT. 965 (1935). "If . . . the United States is a creditor on claims for taxes or customs duties . . . no plan which does not provide for the payment thereof shall be confirmed by the judge except upon the acceptance of a lesser amount by the Secretary of the Treasury. . . ."

8. See *supra* note 1.

which this subdivision is susceptible would allow priority in 77B reorganizations to all unsecured claims which would have been prior to mortgages in an equity receivership,[9] and to no other unsecured claims. But this reading eliminates an important and well recognized body of equity priorities, namely, those unsecured[10] claims which were preferred over other unsecured creditors, but not over mortgagees and lienors.[11] And therefore the constant resort to equity analogies in the application of 77B[12] may result in a gradual extension of the plain import of (b)(10), to prevent so drastic a modification of receivership principles. However, this approach, while appropriate with regard to many other provisions of the Section, is undesirable here. In the first place, (b)(10) is unambiguous, and needs no "clarification". Nor will it do to say that Congress intended the clause to be merely illustrative rather than all inclusive, or that these priorities were required, while the fate of the other equity priorities was consigned to the discretion of the 77B court.[13] The amended Section 77, governing railroad reorganizations, expressly grants priority in subdivision (b) to all unsecured claims which would have been entitled to equity priority,[14] and

9. See, *e. g.*, Reynolds v. Black, 91 Iowa 1, 58 N. W. 922 (1894); St. Paul Title Ins. & Trust Co. v. Diagonal Coal Co., 95 Iowa 551, 64 N. W. 606 (1895); Sitton v. DuBois, 14 Wash. 624, 45 Pac. 303 (1896). Included also, in addition to these cases, which concerned state priority statutes, are six months claims to the limited extent that they will be applicable in the reorganization of industrial corporations and public utilities, *q. v. infra* p. 821. Friendly, *Some Comments on the Corporate Reorganization Act* (1934) 48 HARV. L. REV. 39, 59-60, adopts a similar view. Friendly, however, would apparently have (b) (10) govern liens as well as unsecured claims, which would curtail the recognition of many statutory liens, all of which appear to be dealt with and upheld by (k), *infra* p. 817. Also he does not distinguish between unsecured priority claims which are preferred only to subsequent mortgages and those which are preferred to antecedent mortgages as well.

Properly construed, (b) (10) should grant priority only to those unsecured claims which equity would prefer to antecedent mortgages, for otherwise the word "existing" is tautological, requiring merely that the mortgages in the equity receivership exist in the equity receivership. But this distinction, while material with regard to liens, seems never to have been drawn with regard to non-lien priority claims, and the broader construction is followed in this note. Unsecured claims, if preferred at all over a mortgage, are usually prior to every mortgage, regardless of when it was created.

A restricted interpretation might confine such priorities only to those 77B proceedings in which a mortgage actually does exist. However, this limitation is unwarranted, since there no apparent reason why the claimant, in order to be preferred, should have to be followed by a mortgage in addition to unsecured claims, if he would prevail over both, were both present. The purely fortuitous existence of a mortgage in the particular case should not affect the relationship among the other groups of creditors. Furthermore, the restriction would seldom be material, for it is hardly likely that many unmortgaged corporations will find themselves in a reorganization court.

Finally, there seems to be no reason to treat other liens differently from mortgage liens, although the Section refers only to the latter. A priority claimant who prevails over or is subordinate to one fares similarly with regard to the other. See the use of the comprehensive terms "lien" and "lienholder" in 1 CLARK, RECEIVERS (2d ed. 1929) § 668; 16 FLETCHER, CORPORATIONS (Perm. ed. 1933) § 7952.

10. Secured claims are expressly entitled to their priority status, whatever it may have been under state law, in a 77B proceeding. See *infra* pp. 817, 825.

11. See, *e. g.*, Conard v. Atlantic Ins. Co. of N. Y., 1 Pet. 386 (U. S. 1828) (federal tax claim); Marshall v. New York, 254 U. S. 380 (1920) (state tax claim); Schmidtman v. Atlantic Phosphate & Oil Corp., 230 Fed. 769 (C. C. A. 2d, 1916) (wage claim).

12. Duparquet Huot Moneuse Co. v. Evans, 297 U. S. 216 (1936), 84 U. OF PA. L. REV. 782. See Sabel, *The Corporate Reorganizations Act* (1934) 19 MINN. L. REV. 34, 36.

13. A similar argument was employed in *In re* Central Public Serv. Corp., C. H. Bankr. Serv. ¶ 3723 (D. Md. 1935), to grant a priority over other unsecured claimants. The court held that subdivision (k) removed the obligation from the bankruptcy court to grant the priorities of § 64, leaving to the discretion of the court under 77B (a) the allowance of priorities. For a criticism of this view, see *Developments in the Law—Reorganization under Section 77B of the Bankruptcy Act* (1936) 49 HARV. L. REV. 1111, 1177-1178.

14. 49 STAT. 911, 913, 11 U. S. C. A. § 205 (b) (Supp. 1936).

not merely to those that equity preferred to mortgagees.[15] Not only should some effect be given to this difference in phraseology, but a comparison of Section 77 with 77B affords some evidence that the draftsmen were capable of differentiating and of expressing their intent.[16] Furthermore, when in 1935, Congress was apprehensive lest government claims be denied priority,[17] as many of them would have been under the reading set out above,[18] taxes and customs duties were clearly preferred by an amendment.[19] But priority was not extended to any other claims, similarly barred, and Senator Burke stated that this was the intent of Congress.[20]

Thus, (b)(10) does not *compel* the recognition of the priority status of claims preferred merely over unsecured obligations. And neither (b)(10) nor any other provision of 77B *permits* such action. It is fundamental that priorities not expressly incorporated into the Bankruptcy Act are inapplicable in bankruptcy proceedings,[21] and 77B is part of the Bankruptcy Act, so that reorganization proceedings are now bankruptcy proceedings.[22] Also, it should be remem-

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15. The original § 77 did restrict priorities, in the same language employed by 77B. 47 STAT. 1474, 1477 (1933), 11 U. S. C. A. § 205n. (c) (Supp. 1936). The force of the phrase "over existing mortgages" in the original § 77 (c) has been recognized. See Rodgers and Groom, *Reorganization of Railroad Corporations under Section 77 of the Bankruptcy Act* (1933) 33 COL. L. REV. 571, 599.

16. Of course, there is the equally valid argument that the amendment of § 77 after so brief a time demonstrates that Congress desired to incorporate the entire equity priority system into the reorganization section, and thought that it had done so by the original § 77.

17. 79 CONG. REC. 14101, 14658 (1935). There appear to be no reported decisions denying federal priority under 77B, although the Congressional discussion indicated that there had been such action by the courts.

18. Debts, other than taxes or customs dues, owing to the United States and preferred by REV. STAT. § 3466, 31 U. S. C. A. § 191 (1927), have priority over unsecured creditors only. Conard v. Atlantic Ins. Co. of N. Y., 1 Pet. 386 (U. S. 1828); United States v. Guaranty Trust Co. of N. Y., 33 F. (2d) 533 (C. C. A. 8th, 1929), *aff'd*, 280 U. S. 478 (1930). Compare Thelusson v. Smith, 2 Wheat. 396 (U. S. 1817) with Brent v. Bank of Washington, 10 Pet. 596 (U. S. 1836). Tax claims now have a lien status, first conferred by 14 STAT. 107 (1866), REV. STAT. § 3186, 26 U. S. C. A. §§ 1560-1562 (1935). See *infra* p. 817, Blair, *The Priority of the United States in Equity Receiverships* (1925) 39 HARV. L. REV. 1.

19. 49 STAT. 965 (1935), 11 U. S. C. A. § 207 (e) (1) (Supp. 1936).

20. 79 CONG. REC. 14101 (1935).

21. Missouri v. Ross, 80 F. (2d) 329 (C. C. A. 8th, 1935), *aff'd*, 299 U. S. 72 (1936); Guarantee Title & Tr. Co. v. Title Guaranty & Sur. Co., 224 U. S. 152 (1912); Davis v. Pringle, 268 U. S. 315, 317 (1925) ("It may be assumed that the priority must be found if at all in the Bankruptcy Act . . ."). See *In re* Island Dredging Corp., 61 F. (2d) 765, 767 (C. C. A. 2d, 1932); Sixpenny Sav. Bk. v. Estate of Stuyvesant Bk., 22 Fed. Cas. No. 12919 (S. D. N. Y. 1874), at 269; 2 COLLIER, BANKRUPTCY (13th ed. 1923) 1474 (". . . the bankrupt (sic) act not only controls the State law . . . but by its express regulation of these priorities excludes the State law altogether."); Friendly, *supra* note 9, at 61.

The provision of the Judicial Code requiring federal receivers and managers appointed by federal courts to operate the receivership property according to the valid laws of the state wherein it is situated [36 STAT. 1104 (1911), 28 U. S. C. A. § 124 (1927)] would not seem to vary this principle. In the first place, granting priorities is not the operation of property. Secondly, priority laws of the states may be considered as not "valid laws" in bankruptcy proceedings. This provision is obviously designed to cover such things as safety regulations, workmen's compensation, etc.

REV. STAT. §§ 917 and 918, authorizing the federal courts to prescribe their own procedure and practice [28 U. S. C. A. §§ 730, 731 (1927)] are likewise inapplicable here. Although matters of priority are for the forum, they are so substantial as not to come within a grant of power over procedure. The minuteness with which Congress has hitherto regulated priorities would seem to substantiate this. See *infra* p. 820, discussing this question in the *equity* courts.

22. See Continental Ill. Nat. Bk. & Tr. Co. v. Chicago, R. I. & P. Ry., 294 U. S. 648, 672 (1935); Kaplan, *Is Section 77B a Proper Part of a Bankruptcy Act?* (1935) 21 A. B. A. J. 47; Silbiger, *Is Section 77B of the Bankruptcy Act a Law on the Subject of Bank-*

bered that even as restricted here, 77B contains a rather extensive system of priorities, so that there is no necessity to include others "forgotten" by the legislators.

It has been argued, too, that subsection (k) completely disenabled the court to grant such additional priorities on the ground that Section 64, while not a serious obstacle in a liquidation, might encourage creditors whose chances of obtaining a priority were speculative to obstruct an expeditious reorganization.[23] This viewpoint is strengthened by the similarity between the claims preferred by Section 64 and those enjoying priority in equity, although the order of priority was different.[24] Therefore, it may well be that by excluding Section 64, which preferred wage claims,[25] non-lien tax claims,[26] and "debts owing to any person who by the laws of the States or of the United States is entitled to priority",[27] only to unsecured creditors,[28] Congress desired to eliminate the priority accorded to substantially the same group of creditors in equity.[29]

It would seem unsound to attach any material importance in the case of substantive rights to that vague half sentence obscurely placed in the depths of a subsection devoted wholly to procedure, subsection (a), and which vests in the reorganization court ". . . all the powers, not inconsistent with this section, which a Federal court would have, had it appointed a receiver in equity . . .".[30]

Finally, Section 77B, while largely devoted to remedying the defects and abuses adhering to the procedure of the equity receivership,[31] was also intended "for the relief of debtors".[32] Therefore, it is not unreasonable to expect that the equity rules, which emphasized the rights of the creditors,[33] should be modified somewhat by regarding less highly the various interests of the creditors in order to facilitate a rehabilitation in which all may join and benefit the majority. The curtailment of the rights of lien-holders by 77B,[34] for the first time in bank-

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ruptcies Within the Meaning of Article I, Section 8 of the Constitution? (1935) 1 CORP. REORG. 300; Gerdes, *Constitutionality of Section 77B of the Bankruptcy Act* (1934) 12 N. Y. U. L. Q. REV. 196.

23. *Developments in the Law, supra* note 13, at 1178.

24. See, *e. g.*, Rogge, *The Differences in the Priority of the United States in Bankruptcy and in Equity Receiverships* (1929) 43 HARV. L. REV. 251.

25. § 64 (b) (5), 11 U. S. C. A. § 104 (b) (5) (Supp. 1936).

26. § 64 (b) (6), *id.* at (b) (6).

27. § 64 (b) (7), *id.* at (b) (7).

28. *In re* Brannon, 62 F. (2d) 959 (C. C. A. 5th, 1933), *cert. denied sub nom.*, Ryan v. Dallas, 289 U. S. 742 (1933); Dunn v. Interstate Bond Co., 68 F. (2d) 364 (C. C. A. 5th, 1934), *cert. denied*, 292 U. S. 645 (1934); Odendahl v. Pokorny Realty Co., 76 F. (2d) 271 (C. C. A. 5th, 1935).

29. For a convenient illustration of the similarity, compare the text to which notes 25, 26, 27 are appended with Fordham, *Preferences of Prereceivership Claims in Equity Receiverships* (1931) 15 MINN. L. REV. 261, 285 and 2 GERDES, *op. cit. supra* note 3, § 660.

30. § 77B, 11 U. S. C. A. § 207(a). To confer equity powers on the 77B court does not mean that the court is to adopt in toto all the equity rules. "Power" is more nearly akin to "jurisdiction" than to the body of decisional precepts. In other words, the reorganization court has the power to grant priorities, as did the equity and bankruptcy courts, but the Section restricts the exercise of the power to certain instances, and these rules may differ from the equity rules as they differ from the bankruptcy law. *Cf.* note 21 *supra*, on the Judicial Code provisions.

31. See Duparquet Huot & Moneuse v. Evans, 297 U. S. 216, 219 (1936), 84 U. OF PA. L. REV. 782; *In re* Greyling Realty Corp., 74 F. (2d) 734, 736 (C. C. A. 2d, 1935).

32. Bankruptcy Act, § 77A, 48 STAT. 912, 11 U. S. C. A. § 206 (Supp. 1936); Campbell v. Alleghany Corp., 75 F. (2d) 947, 950 (C. C. A. 4th, 1935), *cert. denied*, 296 U. S. 581 (1935); *In re* Philadelphia Rap. Tr. Co., 8 F. Supp. 51, 54 (E. D. Pa. 1934), *aff'd sub nom.*, Wilson v. Philadelphia Rap. Tr. Co., 73 F. (2d) 1022 (C. C. A. 3d, 1934).

33. But see Davis v. Gray, 16 Wall. 203, 217-218 (1872).

34. § 77B (b). See *In re* Tennessee Pub. Co., 81 F. (2d) 463 (C. C. A. 6th, 1936), 84 U. OF PA. L. REV. 782, *aff'd sub nom.*, Tennessee Pub. Co. v. American Nat. Bk., 299 U. S. 18 (1936).

ruptcy legislation, affords additional illustration of a lessening of the protection thrown about hitherto preferred groups.

The primary significance of subsection (k), which eliminates the priorities of Section 64 of the Bankruptcy Act from 77B reorganization proceedings, lies in its adoption of all other provisions of the Act except those inconsistent with the provisions of 77B,[35] "whether or not an order to liquidate the estate has been entered". This would seem to incorporate into 77B, Sections 67 (d) [36] and 70 (a),[37] preserving valid liens.

Claims Accorded Priority [38]

Federal Governmental Claims. Obligations owing to the Federal Government receive priority by the amended subdivision (e)(1) and subsection (k), the latter of which preserves tax liens attaching by virtue of Revised Statutes, Section 3186.[39] The result is that federal claims for taxes and customs duties will be preferred, but the United States should share pro rata with other unsecured creditors in so far as its other claims are concerned, the purpose of (e)(1), in dealing with federal claims in general, being merely to authorize the Secretary of the Treasury to act on behalf of the United States, which shall be deemed to be affected by any plan submitted whenever it is a creditor.[40] However a distinction is drawn with regard to taxes and customs dues, for no plan may be approved which does not provide for their payment [41] in full,[42] with the proviso that the Secretary may accept less, with his consent being conclusively presumed if he fails to accept or reject the plan within ninety days.

In equity receiverships, Sections 3466 [43] and 3186 [44] of the Revised Statutes were the bases of federal priority. Much of the effect of Section 3186 has been incorporated into (e)(1), but Section 3466, which granted priority to all debts owing to the Federal Government, but only over unsecured creditors,[45] and

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35. There are certain other exceptions not material here, such as provisions in the Bankruptcy Act for the appointment of a referee, payment of dividends, etc., which also apply only when an order for liquidation has been entered. See *supra* note 1.

36. 36 STAT. 842 (1910), 11 U. S. C. A. § 107 (d) (1927). "Liens given or accepted in good faith and not in contemplation of or in fraud upon the provisions of this title, and for a present consideration, which have been recorded according to law, if record thereof was necessary in order to impart notice, shall, to the extent of such present consideration only, not be affected by anything herein (*i. e.*, the Bankruptcy Act)".

37. 30 STAT. 544, 565 (1898), 11 U. S. C. A. § 110 (a) (1927). "The trustee . . . shall . . . be vested . . . with the title of the bankrupt. . . ."

38. This portion of the discussion will be devoted to a determination of what claims have any priority, regardless of the rank. The next section, *infra* pp. 823 *et seq.*, will deal with the order of the priority claims.

39. 26 U. S. C. A. §§ 1560-1562 (1935).

40. But see *Developments in the Law, supra* note 13, at 1179, which apparently interprets (e) (1) to grant priority to all federal claims.

41. It is not stated clearly in 77B whether by "payment" is meant payment in cash or in securities. Subdivision (b) (1), requiring the payment of administration expenses, does stipulate for cash in some circumstances while permitting securities as payment for other expenses. The failure to mention cash in (e) (1) may be construed as allowing the option of cash or securities. On the other hand, it seems doubtful whether the United States is expected to become a security holder in a multitude of reorganized corporations of every description. But compare the R. F. C. Act and its amendments which expressly contemplate such a course, at least with regard to insurance companies and banks. 47 STAT. 5 (1932), *amended*, 48 STAT. 119 (1933), 48 STAT. 1111 (1934), 49 STAT. 3, 4 (1935); 15 U. S. C. A. §§ 605e-g, 606a-i (Supp. 1936).

42. The Section is not explicit on this point, but such would seem to be its plain intent.

43. 31 U. S. C. A. § 191 (1927).

44. 26 U. S. C. A. §§ 1560-1562 (1935).

45. United States v. Hooe, 3 Cranch 73 (U. S. 1805); Brent v. Bank of Washington, 10 Pet. 569 (U. S. 1836).

perhaps "general lienors",[46] has fared less favorably. Such priorities should be non-existent in 77B proceedings. As we have seen, if the merest inference be valid, subdivision (b)(1) would exclude them, and the expression of Congressional intent to prefer only taxes and customs duties by (e)(1) is indisputable.[47] Therefore, with Section 64 of the Bankruptcy Act inapplicable under 77B (k), and with Section 3466 not made part of the reorganization law by any other provision, there can be no federal priority in the absence of a lien, since it has become well nigh axiomatic by now that the United States Government is to be preferred only to the extent that Congress, by statute, specifically requires such treatment.[48] There is no general common law prerogative giving the Federal Government a preference, as there is in many state governments.[49]

Federal taxes imposed during the period of administration will likewise receive priority, since the wording of (e)(1) is broad enough to include them as well as pre-receivership taxes. In addition, they are necessary administration expenses,[50] and should be preferred on that ground under subdivisions (b)(3) and (c)(3).

Claims Preferred by State Insolvency and Lien Laws. Debts owed to the states themselves or to their local government units, and private claims entitled to preferential treatment because of state law are governed by the same provisions of 77B, subdivision (b)(10) and subsection (k).

Those state tax claims which are given the status of liens by state law will receive priority under (k), which adopts Section 67 (d) of the Act, and thus preserves liens. Although there was some effort recently in a district court case,[51] later reversed,[52] to confine the effect of 67 (d) to voluntarily contracted liens, that Section has been repeatedly held applicable to all liens, whether "statutory",[53] such as mechanics' liens, tax liens, etc., or contractual. The validity of liens is generally determined by the law of the state in which the property is situated at the time the lien is sought to be created.[54] Thus to the extent that the property of the debtor corporation is present within the claimant state, that state may subject it to a lien for the payment of taxes or other obligations, and the 77B court must recognize the priority thereby acquired.

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46. Thelusson v. Smith, 2 Wheat. 396 (U. S. 1817). But *cf.* Conard v. Atlantic Fire Ins. Co. of N. Y., 1 Pet. 386 (U. S. 1828).

47. 79 CONG. REC. 14101, 14658 (1935).

48. Brent v. Bank of Washington, 10 Pet. 596 (U. S. 1836); Davis v. Pringle, 268 U. S. 315 (1925); see United States v. State Bank of N. C., 6 Pet. 29, 35 (U. S. 1832). See *supra* note 21.

49. Marshall v. New York, 254 U. S. 380 (1920), and cases cited therein, at 383.

50. Wire Wheel Corp. of America v. Fayette Bk. & Tr. Co., 30 F. (2d) 318 (C. C. A. 7th, 1928), *cert. denied,* 279 U. S. 873, 877 (1929).

51. *In re* Brannon, 53 F. (2d) 401 (N. D. Tex. 1931).

52. *In re* Brannon, 62 F. (2d) 959 (C. C. A. 5th, 1933), *cert. denied sub nom.,* Ryan v. Dallas, 289 U. S. 742 (1933).

53. *Ibid;* Henderson v. Mayer, 225 U. S. 631 (1912); Richmond v. Bird, 249 U. S. 174 (1919); Straton v. New, 283 U. S. 318 (1931).

54. Swank v. Hufnagle, 111 Ind. 453, 12 N. E. 303 (1887); Campbell v. Coon, 149 N. Y. 556, 44 N. E. 300 (1896); RESTATEMENT, CONFLICT OF LAWS (1934) §§ 223, 225, 230 (land); Youssoupoff v. Widener, 246 N. Y. 174, 158 N. E. 65 (1927); 2 BEALE, CONFLICT OF LAWS (1935) § 279.1; RESTATEMENT, CONFLICT OF LAWS § 279 (chattels). When a right or a chattel is "embodied in a document", the law of the place where the document is situated governs the creation of interests in it. Hutchison v. Ross, 262 N. Y. 381, 187 N. E. 65 (1933); 2 BEALE, CONFLICT OF LAWS § 262.1; RESTATEMENT, CONFLICT OF LAWS §§ 262, 349. When the property is a chose in action, the law of the place where the debtor is would seem to control the creation of interests in the property *without* the consent of the owner-creditor, whereas in the case of a voluntary transfer, the place of transfer governs. See RESTATEMENT, CONFLICT OF LAWS §§ 108, 350-352.

In addition to state lien claims, the 77B court should award priority to such unsecured claims of the state as were, again by local law,[55] preferred in insolvency to existing mortgages, and to such unsecured tax claims only. This eliminates the priority formerly enjoyed in equity by non-lien local tax claims having precedence over other unsecured creditors, but not over mortgagees.[56] That Congress has the constitutional power to affect the rights of the states in the estate of a bankrupt has been confirmed by the United States Supreme Court, both where the United States was the adverse claimant[57] and where individuals were alone benefited,[58] although the receivership courts, unhampered by a definitive statute, have displayed considerable liberality toward the states.

However, the few decisions on this point have followed the equity rules.[59] The courts ignored completely (b)(10), concerning themselves chiefly with the application of subsections (a) and (k). They were moved secondarily by an unnecessary respect for the sovereign prerogative of the state as a tax gatherer. The decisions were based on the contention that (k) did not absolutely forbid all priorities, but merely rendered those particular ones no longer obligatory. Then, with the support of (a), which permits the exercise of all the powers of a federal receivership court, priority was granted to state claims which were entitled to preference over unsecured creditors only. But, while 77B (k) does not expressly forbid the equity priorities, it certainly furnishes no basis for their application. Furthermore, such extreme emphasis upon subsection (a) as a source of substantive power seems unwarranted.

Valid state taxes accruing subsequent to the approval of the petition are in a better position, rightfully, than pre-receivership state claims. They should be treated, as in equity,[60] like any other administrative expense and should be accorded the priority attached thereto under (b)(3) and (c)(3).[61]

The same principles should govern private claims preferred by state law. Thus wages,[62] workmen's compensation claims,[63] rent,[64] priorities of residents

55. The equity courts followed the law of the taxing state in determining the priority of tax claims. Marshall v. New York, 254 U. S. 380 (1920).

56. *E. g.*, that in Marshall v. New York, 254 U. S. 380 (1920), cited *supra* note 55. See also County of Spokane v. United States, 279 U. S. 80 (1929).

57. This would seem to be obvious under the doctrine of McCulloch v. Maryland, 4 Wheat. 316 (U. S. 1819) and Veazie Bank v. Fenno, 8 Wall. 533 (U. S. 1869). County of Spokane v. United States, 279 U. S. 80 (1929); Stover v. Scotch Hills Coal Co., 4 F. (2d) 748 (W. D. Pa. 1924).

58. New York v. Irving Trust Co., 288 U. S. 329 (1933).

59. *In re* Central Public Service Corp., C. C. H. Bankr. Serv. ¶3723 (D. Md. 1935). See also, *In re* Pierce-Arrow Motor Car Co., W. D. N. Y., Dec. 19, 1935, discussed in *Developments in the Law*, *supra* note 13, at 1177.

60. McGregor v. Johnson, 39 F. (2d) 574 (C. C. A. 2d, 1930); Hardee v. American Sec. & Tr. Co., 77 F. (2d) 382 (App. D. C. 1935); Piedmont Corp. v. Gainesville & N. W. R. R., 30 F. (2d) 525 (N. D. Ga. 1929); Central Trust Co. v. New York C. & N. R. R., 110 N. Y. 250, 18 N. E. 92 (1888); Gehr v. Iron Co., 174 Pa. 430, 34 Atl. 638 (1896). 48 STAT. 993 (1934), 28 U. S. C. A. § 124 (a) (Supp. 1936) expressly subjects federal receivers and trustees to the payment of state taxes ordinarily applicable to the business they are managing. See also, 36 STAT. 1104 (1911); 28 U. S. C. A. § 124 (1927).

61. *In re* Preble Corporation, 15 F. Supp. 775 (S. D. Me. 1936).

62. Schmidtman v. Atlantic Phosphate & Oil Corp., 230 Fed. 769 (C. C. A. 2d, 1916); Fitzgerald v. Maxim Powder Mfg. Co., 33 Atl. 1064 (N. J. Eq. 1896); Kauper, *Insolvency Statutes Preferring Wages Due Employees* (1932) 30 MICH. L. REV. 504; Note (1932) 30 MICH. L. REV. 942; PA. STAT. ANN. (Purdon, 1931) tit. 43, § 221; N. Y. CONSOL. LAWS (Cahill, 1930) c. 24, § 180.

63. Bowen v. Hockley, 71 F. (2d) 781 (C. C. A. 4th, 1934), 34 COL. L. REV. 1558, 19 MINN. L. REV. 253; PA. STAT. ANN. (Purdon, 1931) tit. 77, § 621; N. Y. CONSOL. LAWS (Cahill, 1930) c. 66, § 34. Statutes also grant priority to the claims of compensation insurers against the insured insolvent employer for premiums. PA. STAT. ANN. (Purdon, Supp. 1936) tit. 40, § 812; N. Y. CONSOL. LAWS (Cahill, Supp. 1935) c. 66, § 130.

64. PA. STAT. ANN. (Purdon, 1931) tit. 39, § 96.

over foreign corporations [65] and any other claims which were prior by state law, and therefore in the equity court received a preference, will retain their favored position only if they satisfy the exacting requirements of 77B that they be a lien, or an unsecured claim which is prior to mortgages.[66]

Priorities,[67] like exemptions,[68] are usually considered to be governed by the forum, and one would especially expect this to be so where the procedure in the forum has developed out of the execution process.[69] Furthermore, the principles of the equity receivership should certainly be, if anything is, a matter of general commercial concern within the spirit of the rule of *Swift v. Tyson.*[70] Thus the conclusion is inescapable that the federal equity courts should never have applied the state priority statutes, but should have contented themselves with a recognition of appropriate federal statutes like Revised Statutes, Section 3466 [71] and a development of their own rules where necessary, as in the case of "six months" claims.[72] However, the obviously substantial nature of the priority claimant's right has led the federal courts to consider it as something in the nature of a lien or "quasi-lien", which, following the usual conflict of laws rules, should be governed by the state of creation. But even while erroneously adopting the

65. *In re* Boggs-Rice Co., 66 F. (2d) 855 (C. C. A. 4th, 1933), 34 COL. L. REV. 553, 12 TENN. L. REV. 131; TENN. CODE ANN. (Michie, 1932) § 4134. This priority is unconstitutional as against a natural person who is a non-resident. Blake v. McClung, 172 U. S. 239 (1898); *cf.* Blake v. McClung, 176 U. S. 59 (1899).

66. Of course, the reorganization court, like the receivership court must decide whether the state statute is really an insolvency statute, whether it was intended to apply only to state proceedings, and must ascertain from it the extent of the claims and the particular kinds of beneficiaries and corporations to which its attention is directed. See *In re* Northumberland Mining Co., C. C. H. Bankr. Serv. 3444 (N. D. Pa. 1935); McDaniel v. Osborne, 72 N. H. 601 (Ind. App. 1904); Fordham, *op. cit. supra* note 29, at 287; Kauper, *loc. cit. supra* note 62.

The distinction between a lien and a priority of an unsecured debt has thus become extremely important, although under the equity receivership rules it was not to be ignored, since upon it depended the rank of the various priority claimants in many instances. See, *e. g.,* County of Spokane v. United States, 279 U. S. 80 (1929); Schmidtman v. Atlantic Phosphate & Oil Corp., 230 Fed. 769 (C. C. A. 2d, 1916), and cases cited therein.

The description of it in the state statute as a lien should be of some weight. Likewise, and perhaps more conclusive, is the priority given to it in the state against subsequent encumbrances and attempted conveyances of the property. *Cf.* Schmidtman v. Atlantic Phosphate & Oil Co., 230 Fed. 769 (C. C. A. 2d, 1916); Seymour v. Berg, 227 Ill. 411, 81 N. E. 339 (1907); McDaniel v. Osborn, 166 Ind. 1, 75 N. E. 647 (1905); Sitton v. DuBois, 14 Wash. 624, 45 Pac. 303 (1896). Many states term the preference a "lien", but say that it attaches only when the property passes into the hands of the receiver, so that it attaches only to the unliened assets, as that is all that the receiver takes. Clough v. Superior Equipment Co., 18 Del. Ch. 65, 202, 156 Atl. 249 (1931); see the discussion in Fitzgerald v. Maxim Powder Mfg. Co., 33 Atl. 1064 (N. J. Eq. 1896). Such a "lien" would seem to have none of the attributes normally adhering to liens, and should be treated for the purposes of 77B as a priority claim only, with the result that it should not be recognized, for it is not prior to existing mortgages. In general, there must be something resembling an interest in property, something "carved out" of it and transferred to the creditor as security, whether done voluntarily, as by a mortgage, or involuntarily as in the case of tax or mechanics' liens.

67. The Colorado [1923] P. 102 (C. A.); The Zigurds [1932] P. 113; 3 BEALE, CONFLICT OF LAWS (1935) § 600.1.

68. Chicago, R. I. & P. Ry. v. Sturm, 174 U. S. 710 (1899); Morgan v. Neville, 74 Pa. 52 (1873); RESTATEMENT, CONFLICT OF LAWS (1934) § 600. *Contra:* Drake v. Lake Shore & M. S. Ry., 69 Mich. 168 (1888).

69. See 1 CLARK, RECEIVERS (2d ed. 1929) cc. II, V, VI.

70. 16 Pet. 1 (U. S. 1842). That is, while the holding of the case does not govern this situation, the desire manifested in it for a uniform commercial law should have encouraged the federal equity courts to formulate a federal law of priorities in receiverships, rather than permit so important a subject to be governed by the diverse and often provincially capricious views of the state legislatures, such as that discussed in *supra* note 65.

71. 31 U. S. C. A. § 191 (1927).

72. See *infra* p. 821.

state priority rules as a matter of convenience, several of the federal courts have realized that the local law placed no constraint upon them,[73] although Mr. Justice Brandeis appears to think otherwise.[74] However, right or wrong, the practice has grown up, and while it probably should be discarded to decrease the number of priorities, it is likely to remain. And especially is it likely to remain in 77B proceedings, with (b)(10) "codifying" at least a portion of the previous error. The 77B court will probably, and should confine itself, as did the equity court, to a recognition of state priorities only to the extent that property exists in that state, for the state law should be given no greater effect here than it is given in the case of a lien,[75] where it is properly held to be controlling.

Six Months Claims. Pre-receivership claims, principally for wages and supplies, accruing immediately before the petition, and conveniently denominated as "six months" claims, while of consequence as priority claims in railroad reorganizations under Section 77,[76] should have little pertinency in 77B proceedings. The currently strong position of the major portion of the public utility industry other than railroads will confine the operation of 77B largely to private corporations, and regardless of the real reasons underlying the "six months" rule,[77] these corporations have been held by equity courts to be unaffected by it.[78] Therefore, as such claims were only on a parity with unsecured obligations of commercial corporations in equity, they are not within the priority system of 77B.[79]

In the reorganization of those less affluent public service corporations rendering traction, gas and water service which will wend their way into 77B, the "six months rule" would appear to apply, with the customary priority in income [80] or corpus.[81] While the cases before the Supreme Court have been concerned exclusively with railroad receiverships [82] and there has been some hesitancy among lower federal courts in extending the rule to other utilities,[83] the general

73. Dickinson v. Saunders, 129 Fed. 16 (C. C. A. 1st, 1904); Crampton v. Lautz Bros. & Co., 274 Fed. 743 (W. D. N. Y. 1921); Mastin & Co. v. Pickering Lumber Co., 2 F. Supp. 605 (N. D. Cal. 1933). *Cf.* Stanley Works v. Garland Typewriter Mfg. Co., 278 Fed. 995 (E. D. N. Y. 1922).

74. Marshall v. New York, 254 U. S. 380 (1920).

75. See *supra* note 54.

76. § 77 (b), 11 U. S. C. A. § 205 (b) (Supp. 1936), 49 STAT. 911, 913 (1935).

77. See Fosdick v. Schall, 99 U. S. 235 (1878); Southern Ry. v. Carnegie Steel Co., 176 U. S. 257 (1900); Turner v. Indianapolis, B. & W. Ry., 24 Fed. Cas. No. 14,258 (C. C. D. Ill. 1878); Pennsylvania Steel Co. v. New York City Ry., 216 Fed. 458 (C. C. A. 2d, 1914); La Hote v. Boyet, 85 Miss. 636, 38 So. 1 (1904); FitzGibbon, *Present Status of the Six Months' Rule* (1934) 34 COL. L. REV. 230; Wham, *Preference in Railroad Receiverships* (1928) 23 ILL. L. REV. 141; Hirth, *Priority of Claims in Public Utility Receiverships* (1929) 27 MICH. L. REV. 241.

78. Spencer v. Taylor Creek Ditch Co., 194 Fed. 635 (C. C. A. 9th, 1912); De Vries v. Alsen Cement Co., 290 Fed. 746 (C. C. A. 2d, 1923); Cowan v. Pennsylvania Plate Glass Co., 184 Pa. 1, 38 Atl. 1075 (1898). Occasionally, lower federal courts or state courts have allowed such priorities in private corporation receiverships. Olyphant v. St. Louis Ore & Steel Co., 22 Fed. 179 (C. C. E. D. Mo. 1884); LeHote v. Boyet, 85 Miss. 636, 30 So. 1 (1904).

79. *In re* James Butler Grocery Co., 10 F. Supp. 809 (E. D. N. Y. 1935); see *supra* pp. 814-817.

80. Fosdick v. Schall, 99 U. S. 235 (1878) (pre-receivership income); Virginia & Ala. Coal Co. v. Central R. R. of Ga., 170 U. S. 355 (1898) (receivership income).

81. Pennsylvania Steel Co. v. New York City Ry., 208 Fed. 168 (S. D. N. Y. 1913), *aff'd*, 216 Fed. 458 (C. C. A. 2d, 1914), *cert. denied*, 238 U. S. 632 (1914) (unmortgaged corpus); Wood v. Guarantee Trust Co., 128 U. S. 416 (1888) (mortgaged corpus). For a summary of the order in which the various funds must be exhausted, see Guaranty Trust Co. of N. Y. v. Albia Coal Co., 36 F. (2d) 34, 36 (C. C. A. 8th, 1929); FitzGibbon, *supra* note 76, at 841, 842 n. 59.

82. See Wood v. Guarantee Trust Co., 128 U. S. 416 (1888).

83. Bound v. South Carolina Ry., 50 Fed. 312 (C. C. D. S. C. 1892).

practice in the federal courts has been to do so,[84] and that custom was so firmly entrenched that it is entitled to and will be treated as a recognized priority in equity of unsecured claims over mortgages, thus giving the claimant a priority by virtue of (b)(10).

Administration and Operating Expenses. The priority of administration and operating expenses appears to be assured, and the rank in the order of priorities of many such claims, especially those for operating expenses, has been advanced to the disadvantage of lienholders.[85] Subdivision (b)(3) compels the inclusion in the reorganization plan of provisions for the payment in cash of administrative costs and other allowances by the court, with the exception of certain fees to parties,[86] which may be paid in securities if such claimants acquiesce. Subdivision (c) (3) also manifests an intent to authorize priority for trustees' certificates, although the exact nature of that priority is rather obscurely stated.[87] Of course, the problem still exists, as it did in equity, to determine what are proper administrative expenditures.[88] However, such an inquiry would be a labor of supererogation here, as the equity rules are applicable under 77B.[89] The only problems of considerable novelty are those centering about rank,[90] about (c)(9) providing for allowances to parties,[91] and about (i) which authorizes the judge to make such orders as he may deem equitable to protect the obligations incurred in a prior receivership which is supplanted by a reorganization proceeding.[92] The payments mentioned in (i) probably will be treated as administrative expenses under (b)(3) and (c)(3).

Interest. While the general rule seems to be that unsecured claims cease to accumulate interest from the time the petition is filed, priority claims draw interest, which receives the same preferred status as the principal of the claim.[93]

Summarizing briefly, it appears that under 77B priorities should be substantially fewer than they were in equity receiverships. Eliminated are three well recognized groups of equity priorities:

(1) Federal claims which were prior by virtue of Rev. Stat. Section 3466, but which were not liens under Section 3186; (2) State governmental claims which, by state law, were preferred over unsecured creditors but not over lienors, and which were themselves not liens; (3) Individual claims with the same status, by local law, as the state claims above.

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84. American Trust Co. v. Metropolitan S. S. Co., 190 Fed. 113 (C. C. A. 1st, 1911), *cert. denied*, 223 U. S. 727 (1911); Continental & Com. Tr. & Sav. Bk. v. North Platte Valley Irr. Co., 219 Fed. 438 (C. C. A. 8th, 1915); Keelyn v. Carolina Mut. T. & T. Co., 90 Fed. 29 (C. C. D. S. C. 1898).

85. See *infra* p. 823.

86. 77B (c) (9).

87. See (1937) 85 U. OF PA. L. REV. 736, 738.

88. 1 CLARK, RECEIVERS (2d ed. 1929) §§ 637-645, pp. 868-907; 16 FLETCHER, CORPORATIONS (Perm. ed. 1933) §§ 7947-7949, 7954-7956; 3 GERDES, CORPORATE REORGANIZATIONS (1936) c. 25.

89. *In re* Avorn Dress Co., 78 F. (2d) 681, 79 F. (2d) 337 (C. C. A. 2d, 1935) (debtor in possession as trustee may purchase goods in ordinary course of business and seller will be entitled to priority, but one lending cash without a specific court order is not preferred); *In re* James Shaw & Co., C. C. H. Bankr. Serv. ¶ 3516 (S. D. N. Y. 1935); Public Serv. Comm. of Pa. v. Philadelphia R. T. Co., 82 F. (2d) 481 (C. C. A. 3d, 1935), *cert. denied sub nom.*, Citizens Pass. Ry. Co. of Phila. v. Public Serv. Comm. of Pa., 298 U. S. 673 (1936); *In re* Neustadtl Brewing Corp., 13 F. Supp. 832 (M. D. Pa. 1936) (reasonable allowances for use and occupation).

90. See *infra* pp. 823 *et seq.*

91. See *In re* Flamingo Hotel Co., 81 F. (2d) 749 (C. C. A. 7th, 1936), and cases collected in C. C. H. Bankr. Serv. ¶¶ 2331-2342; Medill, *Fees and Expenses in a Corporate Reorganization Under Section 77B* (1936) 34 MICH. L. REV. 331.

92. *In re* United Cigar Stores Co. of America, 78 F. (2d) 691 (C. C. A. 2d, 1935); *In re* Parker-Young Co., C. C. H. Bankr. Serv. ¶ 3399 (D. N. H. 1935).

93. Board of Comm'rs of Sweetwater Cty. v. Bernardin, 74 F. (2d) 809 (C. C. A. 10th, 1934), and cases collected therein, at 814-815.

Retaining their priority are:
(1) Liens; (2) Federal tax and customs claims; (3) Unsecured claims of the states which, by local law, have priority over liens in insolvency; (4) Individual claims in a similar position; (5) "Six months" claims in public utility reorganizations; (6) Administration and operating expenses during the reorganization proceedings, including reasonable expenses incurred in prior receiverships supplanted by the 77B reorganization. The bankruptcy priorities of Section 64, as such, are inapplicable, but as the list of priorities illustrates, many of the claims benefited by Section 64 are still preferred, as are liens which were protected by Sections 67(d) and 70(a).

The Order of Priority Claims

Somewhat more uncertain than the determination of what claims are entitled to priority over unsecured creditors is the fashioning of a hierarchy among these preferred claims when the assets of the insolvent corporation are insufficient to satisfy all of them. Although the equity courts were frequently met with the problem, there has been little discussion of it in its entirety. Little light will be shed by Section 77B with its unfortunate lack of explicitness on the point and the total absence of anything like the helpful, even if not automatically determinative provisions of Sections 64 [94] and 67 (d) [95] of the Bankruptcy Act. Properly, therefore, in view of the ambiguity of 77B, the reorganization courts should and probably will be guided by the equity precedents,[96] subject, of course, to the modifications compelled by the altered purpose and scope of the Section.

Administration costs, in the more narrow sense, as distinguished from operating expenses, will undoubtedly receive the highest rank in the priority order. The court will be certain to insure the payment of its costs, masters' and trustees' fees, etc., and perhaps also the allowances permitted under (c)(9) to parties, attorneys and others for "services rendered" and "necessary expenses incurred in connection with the proceeding and the plan".[97] These costs should precede even mortgages, although the particular mortgagee neither institutes the proceedings nor benefits by them. This is a departure from equity principles which, in the absence of institution of the proceedings by lienors or benefit to the lienors as a result of the receivership, did not permit a divestiture of liens in favor of administration expenses, except in the income realized during the administration.[98] But the departure would seem justified by the fact that the 77B court may reorganize all interests, whether secured or unsecured, so that the proceedings are on behalf of all and affect all.

In equity receiverships, operating expenses, when duly authorized by the court, were prior to unsecured creditors, since ostensibly the receivership was conducted for their benefit.[99] But the displacement of liens by such expenses was rare.[100] Under 77B, the unsecured creditors should be in the same position

94. 30 STAT. 544, 563 (1898), *amended,* 44 STAT. 666 (1926), 11 U. S. C. A. § 104 (Supp. 1936).

95. 30 STAT. 544, 564 (1898), *amended,* 36 STAT. 842 (1910), 11 U. S. C. A. § 107 (d) (1927).

96. See *supra* notes 12, 31.

97. *Cf. In re* Flamingo Hotel Co., 81 F. (2d) 749 (C. C. A. 7th, 1936).

98. See 16 FLETCHER, CORPORATIONS (Perm. ed. 1933) §§ 7947-7948.

99. Smith v. Shenandoah Valley Nat. Bk., 246 Fed. 379 (C. C. A. 4th, 1917); Byrnes v. Missouri Nat. Bk. 7 F. (2d) 978 (C. C. A. 8th, 1925); Cox v. Snow, 47 Idaho 229, 273 Pac. 933 (1929); Lewis and Jones & Laughlins Ltd. v. Linden Steel Co., 183 Pa. 248, 38 Atl. 606 (1897).

100. Liens could be subordinated, in the case of private corporations, in only two situations: (1) when the lienholders "expressly or impliedly consented", which meant institution of or intervention by them in the receivership [Kneeland v. American L. & T. Co., 136

as previously, whereas the lienor should find himself divested of much of the protection formerly thrown about him.

Section 77B expressly contemplates continued operation of the debtor corporation for the purpose of rehabilitation,[101] and reorganization of secured claims, which no longer are inviolable. These provisions, coupled with that permitting the issuance of trustees' certificates "for such lawful purposes . . . and with . . . such priority . . . as may be lawful in the particular case" [102] appear to extend the power of the court to prefer ordinary operating charges to outstanding liens. And the Section was so construed in the recent case of *In re Prima Co.*[103] The operating expenses in that case were granted priority over the claims of non-assenting bondholders when the operation of the plant was felt necessary to preserve its "going value" and to adequately realize the value of perishable stock, although there was other property more than sufficient to satisfy the mortgages. In fact, the court relied heavily upon this surplus in permitting the priority, pointing out that the mortgagees were thus not adversely affected in a material way. One would think that the lien would also be subordinated when the value of the property was less than the lien claim and the additional value accruing by the operation of the plant enhanced the likelihood of complete satisfaction of the mortgage claim. If this be conceded, the only situation which presents any difficulty is that in which the estate is approximately equal to the mortgage indebtedness, so that unwise expenditures may render impossible complete payment. The *Prima* case does not govern this last case, although from the language of the opinion it may be inferred that the same result would be reached if the court thought the particular expenditure judicious. The only solution is circumspection on the part of the court and hesitancy to allow the priority unless a relatively clear showing is made that the operation will be advantageous to the 77B estate.[104]

Therefore, whether personally benefited or not, the secured creditor must submit to subordination to claimants who contribute to the operation during the reorganization proceedings, and preserve the interests of all those who had shared in the enterprise, whether as secured or unsecured creditors, or as shareholders. The only limitation is that the court should not risk a vain sacrifice of the lienor's security.

U. S. 89 (1890); Jerome v. McCarter, 94 U. S. 734 (1876)], or actual consent [see Baltimore B. & L. Ass'n v. Alderson, 90 Fed. 142, 147 (C. C. A. 4th, 1898)], the latter of course not being displacement; (2) when the expense incurred was essential to the preservation of the secured creditor's interest in the property, either by protecting physically the property to which the lien attached [Montgomery Coal Corp. v. Allais, 223 Ky. 107, 3 S. W. (2d) 180 (1928); Porch v. Agnew, 67 N. J. Eq. 727, 57 Atl. 546 (1904), 70 N. J. Eq. 328 (1905); Lockport Felt Co. v. United Box Board & Paper Co., 74 N. J. Eq. 686, 70 Atl. 980 (1908). But *cf.* Raht v. Attrill, 106 N. Y. 423, 13 N. E. 282 (1887)], or by preventing the legal destruction of the lienholder's interest, such as that which would attend a foreclosure by a superior lienor [Lockport Felt Co. v. United Box Board & Paper Co., 74 N. J. Eq. 686, 70 Atl. 980 (1908); *cf.* Title Ins. & T. Co. v. California Development Co., 171 Cal. 227, 152 Pac. 542 (1915); McDermott v. Pentress Gas Co., 82 W. Va. 230, 95 S. E. 841 (1918). See Note (1931) 79 U. OF PA. L. REV. 788, and cases cited therein], or by a governmental body for non-payment of taxes [Hanna v. State Trust Co., 70 Fed. 2 (C. C. A. 8th, 1895)]. Expenses incurred for continued operation rather than preservation of the property could not displace liens.

In the receivership of a public utility, operating expenses were permitted to displace liens, the rule being based on much the same principles as those underlying the similar priority accorded to six months pre-receivership claims. Fosdick v. Schall, 99 U. S. 235 (1878); Union Trust Co. v. Illinois M. R. R., 117 U. S. 434 (1886); Meyer v. Johnston, 53 Ala. 237 (1875). But *cf.* Bound v. South Carolina Ry., 50 Fed. 312 (C. C. D. S. C. 1892).

101. 77B (c) (2).

102. 77B (c) (3).

103. C. C. H. Bankr. Serv. ¶ 4451 (C. C. A. 7th, 1937), 85 U. OF PA. L. REV. 736.

104. See *id.* at p. 2397.

Also prior to the mortgagee should come the unsecured claimant upon whom state insolvency statutes confer priority to mortgages, for (b)(10) compels the retention of that rank. But like the mortgage, these claims are inferior to the reorganization costs. "Six months" claimants, likewise, will precede the mortgagee under (b)(10). And in view of the basis of the "six months" rule,[105] such claims should be prior to those preferred by state statutes, whenever they do not merely duplicate each other. But again, the administration and operating expenses are prior, in so far as corpus and receivership income are concerned.[106] In pre-receivership income, however, the "six months" claimant may be preferred even over these expenses, and such income may be traced into the corpus.[107]

The priorities of the reorganization expenses *inter sese* are of no practical importance, since all must be paid in order to secure approval of the plan. Similarly the relative ranks of administrative charges and federal taxes which accrued before the reorganization is of little moment since again both must be paid. Taxes, whether state or federal, which accrue during the proceedings are, as has been seen,[108] properly treated as administration expenses and are entitled to the same position in the priority order.

The position of federal taxes and customs claims in the scale of priorities is one of uncertainty. Subdivision (e)(1) compels the disapproval of any plan not providing for their payment, but it does not purport to rank these claims. Therefore, if a mortgage is entitled to priority over the taxes, the plan should not be approved unless both claims are provided for. In the event of the inability to satisfy both fairly, the reorganization is not feasible, and liquidation should be ordered. In determining what mortgages are prior, perhaps the soundest solution would be to continue the lien order prevailing under Section 3186, for (e)(1) does not render it inapplicable. United States claims, therefore, would precede subsequently perfected liens, but would follow liens antecedent in time. Each lien would have to be duly recorded or filed to retain its position, so that tax liens which were not properly filed would be subordinate to other liens,[109] and would be prior only to unsecured creditors. As against the latter, the taxes are still a lien, even though they are not filed.

When the unsecured creditor is one entitled to priority over mortgagees by a state insolvency statute, the court is confronted by the same kind of dilemma as that which first appeared in *Ferris v. Chic-Mint Gum Co.*,[110] and which has since become familiar by repeated discussion.[111] In the *Ferris* case, a mortgage was first created; then a tax lien in favor of the Federal Government arose under Section 3186; finally a local tax lien attached. By state law, the local lien was preferred over the antecedent mortgage; by Section 3186, the federal lien was prior to the later created local lien, but inferior to the mortgage. The problem was to prefer the local lien to the mortgage, the mortgage to the federal lien, and at the same time to have the federal lien precede the local lien. The court apparently failed to realize the full implication of the situation, and without any hesitation placed the local lien first, the mortgage second, and the federal

105. See *supra* note 77.

106. The six months claimant is preferred only in the net receivership income. Union Trust Co. v. Souther, 107 U. S. 591 (1882); Virginia & Ala. Coal Co. v. Central R. R., 170 U. S. 355 (1898).

107. Burnham v. Bowen, 111 U. S. 776 (1884); Union Trust Co. v. Morrison, 125 U. S. 591 (1888).

108. See *supra* pp. 818, 819.

109. REV. STAT. § 3186 expressly so provides. 26 U. S. C. A. §§ 1560-1562 (1935). *In re* MacKinnon Mfg. Co., 24 F. (2d) 156 (C. C. A. 7th, 1928).

110. 14 Del. Ch. 232, 124 Atl. 577 (1924).

111. County of Spokane v. United States, 279 U. S. 80, 91 (1929); Blair, cited *supra* note 18, at 28-30; Rogge, cited *supra* note 24, at 275.

claim last, saying that the United States wished to follow the mortgage, so that the government must have wished to follow every claim prior to the mortgage.

This decision has been deservedly criticized, and the "accepted" solution is that formulated in some detail by Paxton Blair.[112] Stated briefly in the words of the Supreme Court, ". . . the relative priorities could have been maintained . . . by setting apart sufficient funds to pay the mortgage before paying the federal taxes and then providing for payment of the state tax out of the sum so set apart." [113] In the balance of the estate, the United States would come first, but the mortgagee would follow the state in the fund set aside.

Rather ingenious, this plan purports to give effect to the conflicting state and federal priority rules. Yet it appears faulty, especially when all the property is mortgaged. Why not set aside a sum equal to the wage claim and from that pay the United States, which is entitled to priority over wages by Section 3186? The mortgagee, again, could not complain, as the state law subordinated him to a claim of that amount anyway. It seems obvious that no answer exists to this problem of how to reconcile the conflicting rules, for it must be admitted that if there is property worth $1,000, and a mortgage, a wage claim, and a tax claim each for $1,000, the wages alone will be paid. But that is directly in the teeth of Section 3186, which requires the United States to be paid ahead of every claimant except an antecedent mortgagee or other lienor.

Perhaps the soundest solution, although one whose simplicity is not likely to appeal to the more legalistically minded, would be to pro rate the fund among the three groups, following the payment of the administration expenses. This at least has the merit of frank admission of defeat. Another might be based on the supremacy clause of the Constitution,[114] recognizing the federal statute, whether enacted under the bankruptcy power or the taxing power, as decisive. The state rule would then be discarded because of the conflict, and the mortgagee would be first, the United States second, and the wage claimant third. The chief criticism would be the subjection of the relation between the mortgagee and the wage claimant to the purely fortuitous existence of unpaid federal taxes. Subdivision (b) (10) is of no assistance. If it had read that unsecured claims which were entitled to priority *under state law* should keep that rank, instead of "if a receiver in equity . . . had been appointed", the question would seem to be settled. One federal statute, Section 3186, would then subordinate taxes to mortgages, and another federal statute, 77B (b) (10), would place the wage claim before the mortgage. Logic might then permit the solution arrived at by the *Ferris* case without the benefit of a federal rule comparable to this. But as the law now stands, no one can say what the relation was in equity among the three claims, which relation is adopted by 77B, although the Supreme Court has viewed without disapproval,[115] if not with approval, the solution offered by Blair.

To recapitulate, the order of the priority claims in a reorganization under 77B should be:

1. Administrative and operating expenses, including allowances for prior receiverships and for the services and expenses incurred under (c) (9).

2. "Six months" claims in public utility reorganizations, which are prior even over the administration costs in the pre-receivership income.

3. Unsecured claims entitled to priority over mortgages by state insolvency laws, whether the debt is owed to the state itself or to an individual.

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112. Blair, cited *supra* note 18, at 29-30.
113. County of Spokane v. United States, 279 U. S. 80, 91 (1929).
114. U. S. CONST. Art. VI, cl. 2.
115. County of Spokane v. United States, 279 U. S. 80, 91 (1929).

4. Mortgages and other liens in the order of their priority under the law of the state in which the property has its physical situs.

5. Federal taxes and customs claims, accruing before the petition, which may alter the ranking in three ways:

a. (4), then (5), then (3).

b. (3), (4), and (5) share ratably.

c. Set aside enough to pay (4); from that fund pay first (3), then (4), then (5); from the balance of the estate after the fund is created, first pay (5), then (3). This conflict will arise only in connection with liens which are prior to the federal lien. The federal lien is prior to subsequently created liens under Revised Statutes, Section 3186.

6. Unsecured creditors' claims other than those in (5).

7. Shareholders.

H. E. K.

Collateral Attack[1] Upon Decrees, Orders and Findings of a 77B Court

The scope and the magnitude of a corporate reorganization under Section 77B[2] of the Bankruptcy Act demand that the judgments, decrees and orders of the 77B court be impervious to collateral attack by anyone. The typical 77B reorganization involves hundreds of thousands of dollars, and yet some small claimant, who undoubtedly had actual notice of the reorganization proceedings, but who intentionally failed to participate therein in order to see whether it would result advantageously to him, may attempt to upset the entire reorganization because of some technical defect. Assuredly, some theory should, and will, be evolved whereby 77B judgments, decrees and orders will be rendered conclusive.[3]

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1. Collateral attack, as distinguished from a direct mode of assailing a judgment, is an attempt in an independent proceeding to deprive the judgment of any adjudicative effect upon the assailant. 1 FREEMAN, JUDGMENTS (5th ed. 1925) § 304. Thus a motion to set aside an adjudication is not a collateral attack. *In re* Campbell County Hardware Co., 15 F. (2d) 78 (D. Tenn. 1924).

2. 48 STAT. 911 (1934), 11 U. S. C. A. § 207 (a) (Supp. 1936).

3. The theory of the authors of this note is as follows:—Although the dogma is that equity acts only in personam, it has been pointed out that the most outstanding illustration of the inadequacy of this dogma is the federal equity receivership whose real purpose is the ratable distribution of the corporate debtor's assets among creditors entitled to share. Dodd, *Equity Receiverships as Proceedings in Rem* (1928) 23 ILL. L. REV. 105.

Furthermore, while prior to the case of Gratiot County State Bank v. Johnson, 249 U. S. 246 (1919), it was commonly said that the bankruptcy court acts in rem [see *infra* notes 60 and 71], the *Gratiot* case clarified this general statement to mean that the bankruptcy court acts in rem only as to the status of the debor as bankrupt and in other respects does not act in rem so as to bind everyone in a collateral proceeding. [*E. g.*, in plenary suits by the trustee wherein issues decided in the bankruptcy adjudication again must be proved.] However, as will be indicated, this case can be restricted to the type of problem therein involved. Therefore, it is submitted that, if Section 77B is based upon equity and bankruptcy precedents, the jurisdiction of the 77B court is in rem, generally speaking, and its decrees, orders and findings will be in most instances unimpeachable.

However, even though the jurisdiction of the 77B court be held real [according to another accepted maxim of the courts and text-book writers], there must still be jurisdiction over the subject-matter of the action, since if a court has no such jurisdiction, its pretended judgment is null and void, not only upon direct attack but likewise in a collateral action. 1 FREEMAN, JUDGMENTS (5th ed. 1925) §§ 325, 333, 337. The case of Thompson v. Whitman, 85 U. S. 457 (1873), held that a mere recital in the record of a court of the jurisdictional facts upon which its jurisdiction over the subject-matter of the action depended, is not deter-

As is generally assumed by 77B lawyers, Section 77B is the embodiment of most of the characteristics of federal equity receivership,[4] eliminating certain imperfections.[5] But since Section 77B is also a part of the Bankruptcy Act, it is quite certain that the 77B court will rely upon either equity or bankruptcy precedents in making a decree or finding. Therefore, if 77B proceedings are to have a conclusive effect, the problem resolves itself into one of selecting those aspects of equity and bankruptcy law which will have this desirable consequence.

I. *Associations Subject to Section 77B*

Any moneyed, business or commercial corporation, except a municipal, insurance, railroad or banking corporation or a building and loan association, may be reorganized under Section 77B.[6] Doubtless, on the basis of the bankruptcy precedents, the 77B court has jurisdiction to determine whether or not the association sub judice is amenable to 77B proceedings.[7]

Where there is nothing on the face of the record showing that the association is incapable of reorganization under Section 77B, the order of approval of the petition can not be impeached in a collateral action.[8] Thus, in *Marin v. Auge-*

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mined proof of jurisdiction over the subject-matter. But if a party has actually contested and litigated the existence of the jurisdictional facts upon which such jurisdiction is based, it would seem that the decision on this issue should prevent him and his privies from relitigating the question collaterally on the ground that public policy requires that there be an end to litigation. Gavit, *Jurisdiction of the Subject Matter and Res Judicata* (1932) 80 U. OF PA. L. REV. 386; (1936) 46 YALE L. J. 159. And, since the nature of the 77B proceedings apparently is in rem, there is sound argument that if some interested party has really disputed and litigated the point, the finding of the court should be decisive upon everyone. Moreover, it may be asserted even that if there has been an opportunity to litigate the jurisdictional facts in the 77B court, there is no denial of due process in making the decision unquestionable, because reorganization proceedings generally extend over a long period of time and no interested person should be permitted to procrastinate in objecting to the jurisdiction of the 77B court, with the intent of seeing whether the reorganization results to his benefit. However, the approach of the courts to the problem under discussion is entirely different, as the analysis of the cases discloses.

4. Duparquet Huot & Moneuse Co. v. Evans, 56 Sup. Ct. 412 (1936). See *In re* Greyling Realty Corp., 74 F. (2d) 734, 736 (C. C. A. 2d, 1935); Dodd, *Reorganization Through Bankruptcy: A Remedy for What?* (1935) 48 HARV. L. REV. 1100, 1135; Friendly, *Some Comments on the Corporate Reorganizations Act* (1934) 48 HARV. L. REV. 39; Sabel, *The Corporate Reorganizations Act* (1934) 19 MINN. L. REV. 34.

5. For a discussion of the defects in the federal equity receivership, and the manner in which they were attempted to be remedied by Section 77B, see 1 GERDES, CORPORATE REORGANIZATIONS (1936) 40-66.

6. 48 STAT. 911 (1934), 11 U. S. C. A. § 207 (a) (Supp. 1936). This provision is based on Section 4 of the Bankruptcy Act, 30 STAT. 547 (1898), *as amended*, 49 STAT. 246 (1935), 11 U. S. C. A. § 22 (Supp. 1936). Although it may be contended that some corporations are subject to involuntary proceedings which are not subject to voluntary proceedings, because Section 77B (a) authorizes the initiation of involuntary proceedings against "any corporation" without adding the clause, "which could have become a bankrupt under Section 4 of this Act", indubitably no such difference was intended. 1 GERDES, CORPORATE REORGANIZATIONS (1936) 162n. 2.

7. Denver First Nat. Bank v. Klug, 186 U. S. 202 (1902); Altonwood Park Co. v. Gwynne, 160 Fed. 448 (C. C. A. 2d, 1908); *In re* New England Breeders' Club, 169 Fed. 586 (C. C. A. 1st, 1909), *cert. denied sub nom.*, Hub Construction Co. v. Hobbs, 215 U. S. 598 (1909). In the exercise of such jurisdiction, the court decides a mixed question of law and fact. Thus, if the court holds that a corporation may undergo bankruptcy proceedings, a writ of mandamus does not lie on behalf of a creditor of the association to review the decision. *In re* Riggs, 214 U. S. 9 (1909).

8. *In re* Columbia Real Estate Co., 101 Fed. 965 (D. Ind. 1900), *aff'd*, 112 Fed. 643 (C. C. A. 7th, 1902); *In re* Urban & Suburban Realty Title Co., 132 Fed. 140 (D. N. J. 1904); Edelstein v. United States, 149 Fed. 636 (C. C. A. 8th, 1906), *cert. denied*, 205 U. S. 543 (1907); *In re* Broadway Savings Tr. Co., 152 Fed. 152 (C. C. A. 8th, 1907); *In re* First Nat. Bk. of Belle Fourche, 152 Fed. 64 (C. C. A. 8th, 1907); *In re* New York Tunnel Co., 166 Fed. 284 (C. C. A. 2d, 1908). Similarly, where the face of the record does not show

dahl,[9] there was a suit in a Minnesota District Court to sequester the assets of a Minnesota corporation, begun by a judgment creditor of the corporation after an execution on his judgment had been returned unsatisfied. A receiver was duly appointed, and, because the available assets were insufficient to pay the receivership expenses and the corporate debts, by a petition in the suit he sought an assessment on the shareholders of the corporation, under a clause in the Minnesota constitution providing for a shareholders' superadded liability in the case of all corporations except manufacturing corporations. After public notice and a hearing upon the petition, the Minnesota court rendered an order of assessment, directing that the assessment be paid to the receiver. Augedahl, a shareholder residing in North Dakota, refused to pay the assessment, and so the receiver instituted suit in a North Dakota court to recover upon the order. The defendant objected on the ground that the Minnesota court had been without jurisdiction to make the order, the corporation being a manufacturing corporation, and therefore the order was not entitled to full faith and credit but could be collaterally attacked. The North Dakota court sustained this contention, but upon review by the United States Supreme Court, the judgment was reversed by a six to three decision. The majority of the Court stated that the exception of manufacturing corporations from the double liability provision of the state constitution went "to the merits rather than to the jurisdiction".[10] The Court expressly distinguished the case of *Thompson v. Whitman,*[11] conceding that the latter case holds that a judgment may be collaterally attacked by showing an absence of jurisdiction over the subject-matter, but deciding that the Minnesota court had jurisdiction over the subject-matter.

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anything negativing the fact that the corporation is within the excluded classes of associations, the court will not suffer anyone to object to the order of adjudication, either by motion to vacate or upon collateral attack, because in actual fact the association is a municipal, railroad, insurance or banking corporation or a building and loan association. United States v. Freed, 179 Fed. 236 (S. D. N. Y. 1910) (collateral attack); Dodge v. Kenwood Ice Co., 204 Fed. 577 (C. C. A. 8th, 1913) (motion to vacate). Likewise, if the petition avers that the association is not in one of the excluded classes, but the averment is defective, the record here too is unimpeachable. *In re* Marion Contract & Construction Co., 166 Fed. 618 (D. Ky. 1909).

9. 247 U. S. 142 (1918).

10. *Id.* at 147. "Charged with the duty, as the court was, of ascertaining whether there was any liability to be enforced, it was its province to consider and decide every question which was an element in that problem, including the one of whether the corporation was in the excepted class. That question required solution and in the power to solve it was lodged in the court. The court did solve it, for . . . the order making the assessment is 'necessarily based upon a determination that the corporation is of the class whose stock is assessable, and not of the excepted class.' Whether the decision was right or wrong is not open to discussion here. If wrong it was subject to correction on proper application to the court which made it, or on appeal, but it was not void or open to collateral attack. . . . *In re First National Bank,* 152 Fed. Rep. 64, 68-70." *Id.* at 149.

This view was not novel with the Supreme Court, but originated in the *Belle Fourche* and *Broadway Savings* cases, which held that the petition in bankruptcy conferred upon the court jurisdiction over the subject-matter, and whether the particular association was subject to the Bankruptcy Act pertained only to the sufficiency of the cause of action; that is, if the court decided that the corporation was capable of being adjudicated a bankrupt, it would approve the petition, but otherwise it would dismiss it. In 1 GERDES, CORPORATE REORGANIZATIONS (1936) 219, the view is expressed that this was overruled by the Vallelly case, 254 U. S. 348 (1920). A different position is taken also in 1 REMINGTON, BANKRUPTCY (4th ed. 1934) 82, 83, on the ground that if the amenability of an association to bankruptcy pertained not to jurisdiction over the subject-matter, but simply to the sufficiency of the cause of action, the defect could not be raised if there was waiver, consent, estoppel or laches; but, it is pointed out, that certainly neither waiver nor consent would make the adjudication of the association good by conferring jurisdiction, so that all the court meant was that if the record omitted all allegations as to the nature of the association, the adjudication imported a finding of the requisite jurisdictional facts and hence was unimpeachable.

11. 18 Wall. 457 (U. S. 1873).

However, where it appears upon the face of the record, affirmatively and not by mere omission, that the corporation belongs to one of the classes excluded from the Bankruptcy Act, the United States Supreme Court has held in *Vallely v. Northern Fire & Marine Ins. Co.*,[12] that the adjudication of bankruptcy may be vacated by the debtor, even though it acquiesced in the adjudication (waiver), aided the trustee in the administration of the bankrupt estate (estoppel), and made the motion to vacate about eight months after the adjudication (laches). But this decision should not furnish a precedent in a collateral proceeding challenging the order of approval rendered by the 77B court. In this and subsequent cases, the corporation involved was one affected with a public interest, such as an insurance,[13] banking,[14] railroad,[15] public utility,[16] and municipal [17] corporation,[18] for all of which corporations there is special legislation governing the administration of their property upon insolvency.[19] Because of this fact, the Court in the *Vallely* case was apprehensive of the great disorder that might result should the corporation be adjudicated bankrupt under the Bankruptcy Act.[20] The Court recognized the plausibility of the argument of counsel [21] based, *inter alia,* upon the *Belle Fourche* and *Broadway Savings* cases, but nevertheless sustained the motion to vacate, without even considering, let alone overruling, the *Marin* case. It is quite probable that if the objection had been raised upon a true collateral attack, notwithstanding the appearance of the defect upon the face of the record, the Court might have repelled the attack on the ground that undermining the adjudication would effectuate much greater disorder.[22]

A quite different problem is presented where the court's jurisdiction over the subject-matter is conceded. Thus, in *Krey Packing Co. v. Wildwood Springs Resort Ass'n,*[23] one group of creditors filed an involuntary petition against an association, alleging that it was a common law trust. Thereafter, another group of creditors filed an involuntary petition against the same association in the same court, averring that it was a co-partnership. The former petition was first approved, and then members of the bankrupt association moved to dismiss the second petition. In granting the motion, the court declared that since the ques-

12. 254 U. S. 348 (1920).
13. *Ibid.*
14. Woolsey v. Security Trust Co., 74 F. (2d) 334 (C. C. A. 5th, 1934).
15. See *In re* New York Tunnel Co., 166 Fed. 284, 285 (C. C. A. 2d, 1908).
16. *In re* Hudson River Electric Co., 167 Fed. 986 (N. D. N. Y. 1909).
17. See Vallely v. Northern Fire & Marine Ins. Co., 254 U. S. 348, 356 (1920).
18. But see *In re* Elmsford Country Club, 50 F. (2d) 238 (S. D. N. Y. 1931), where a New York membership club (golf) was involved, and a motion to vacate was allowed.
19. See Columbia Ry. Gas & Elec. Co. v. South Carolina, 27 F. (2d) 52 (C. C. A. 4th, 1928).
20. "It is not necessary to point out the disorder that would hence result and the difficulties that the officers of a bankruptcy court would encounter in such situation. . . . For a court to extend the act (Bankruptcy) to corporations of either kind is to enact a law, not to execute one." Vallely v. Northern Fire & Marine Ins. Co., 254 U. S. 348 (1920), at 356.
21. *Id.* at 353.
22. Such was the decision in Earnhardt v. Brown, 197 N. C. 204, 148 S. E. 25 (1929). In that case, subscribers to stock in a bankrupt building and loan association and borrowers therefrom brought suit to restrain foreclosure of their deed of trust and to cancel the indebtedness secured thereby, after deducting the payments made on their shares from the amount borrowed. The trustee in bankruptcy resisted the plaintiffs' claim. It appeared that the record in the bankruptcy proceeding revealed that the bankrupt was a building and loan association. Relying upon the *Vallely* case, the plaintiffs contested the capacity of the trustee in bankruptcy to be a party to the suit. But without discussion the North Carolina Supreme Court said that the *Vallely* case was distinguishable, and affirmed a judgment authorizing a foreclosure of the deed of trust, relying solely on Denver First Nat. Bank v. Klug, 186 U. S. 202 (1902).
23. 4 F. (2d) 793 (C. C. A. 8th, 1925).

tion whether the association was a common law trust was an issue in the first proceeding and was necessarily so determined by the adjudication, that finding was res judicata in the second proceeding.

II. *Initiation of Involuntary Proceedings Under Section 77B*

Section 77B provides that three or more creditors who have provable claims aggregating $1,000 or over may file a petition against the debtor corporation.[24]

A. *Number of Creditors:* Whether or not the number of creditors required to file a petition in involuntary bankruptcy is a jurisdictional fact that can be disproved upon collateral attack has never been decided by the United States Supreme Court.[25] However, several federal lower court cases have arisen involving direct attacks, such as motion to dismiss, demurrer, motion to grant a discharge, or motion to vacate, and the decisions are about equally divided. Some hold that the number of creditors is a requirement pertinent to the court's jurisdiction over the subject-matter.[26] On the other hand, it has been said [27] that "neither the fact of the existence of (three) creditors . . . nor the averment of that fact is indispensable to the jurisdiction of the court" over the subject-matter,[28] but is requisite only to constitute a good cause of action and to invoke a favorable adjudication. Since no cases have been decided relative to collateral attack, and since those concerning direct attack are almost evenly divided, it is submitted that in the event of a collateral attack upon a decree, order or finding of a 77B court because of a defect in the number of petitioning creditors, the court entertaining the collateral action may well follow the line of cases which hold that the number of creditors requirement is not jurisdictional.

B. *Validity of Petitioning Creditors' Claims:* In connection with the requirement of 77B that creditors must have provable claims in order to file an involuntary petition,[29] two problems arise: First, whether the adjudication can be collaterally attacked on the ground that the petitioning creditors did not have provable claims; and second, whether the finding that the creditors did have such claims is res judicata in subsequent proceedings.

As to the first question, it has been held by the United States Supreme Court that the adjudication is not subject to collateral attack, on the theory that the defect in the nature of the claim does not pertain to jurisdiction over the subject-matter.[30]

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24. 48 STAT. 912 (1934), 11 U. S. C. A. § 207 (a) (Supp. 1936).

25. Text-book writers have taken opposing views. In 1 GERDES, CORPORATE REORGANIZATIONS (1936) 274, the view is expressed that the requirement is jurisdictional and cannot be waived. On the other hand, it is said in BLACK, BANKRUPTCY (4th ed. 1926) § 276, that the weight of authority is that the requirement is not jurisdictional.

26. *In re* Scammon, Fed. Cas. No. 12,427 (N. D. Ill. 1874); *In re* Gillette, 104 Fed. 769 (W. D. N. Y. 1900); Cutler v. Nu-Gold Ring Co., 264 Fed. 836 (C. C. A. 8th, 1920); Navison Shoe Co. v. Lane Shoe Co., 36 F. (2d) 454 (C. C. A. 1st, 1929). "If the petition for adjudication were made by only two creditors, the law requiring three, would be a jurisdictional defect on the face of the record, making any adjudication void." See the New York Tunnel case, 166 Fed. 284, 285 (C. C. A. 2d, 1908).

27. *Ex parte* Jewett, Fed. Cas. No. 7303 (D. Mass. 1875); *In re* Duncan, Fed. Cas. No. 4131 (S. D. N. Y. 1876); *In re* Henderson, 9 Fed. 196 (S. D. Ohio, 1881); *In re* Haff, 136 Fed. 78 (C. C. A. 2d, 1905).

28. *In re* Plymouth Cordage Co., 135 Fed. 1000, 1003 (C. C. A. 8th, 1905).

29. 48 STAT. 912 (1934), 11 U. S. C. A. § 207 (a) (Supp. 1936).

30. Chapman v. Brewer, 114 U. S. 158 (1885). This was a suit by an assignee in bankruptcy against a person claiming an adverse interest in the bankrupt's property. In holding the adjudication unimpeachable, the Court said: "It is also objected by the defendant that . . . the record does not show that the petitioner filed any proof of his claim. . . . The adjudication states that, on consideration of the proofs, it was found that the facts set forth in the petition were true. It was not necessary to show in this case what the proofs were. If the District Court had jurisdiction of the subject matter, and the bankrupt voluntarily

But there is a division of authority on the question whether the adjudication is res judicata of the validity of the claim in plenary suits, or on appeal from subsequent disallowance by the referee of the petitioning creditor's claim. In the case of *In re Uhlfelder Clothing Co.*,[31] it was held that the adjudication was conclusive;[32] but in *In re Continental Engine Co.*,[33] the court permitted the referee to disallow a claim of one of the petitioning creditors. The difference in opinion rests on a determination of who are recognized as "parties" to the bankruptcy proceedings. The court in *Ayres v. Cove*,[34] declared that all creditors are represented by the bankrupt, but the *Continental* case recognized as parties only creditors who appeared. For this reason, the latter case argued that the trustee in bankruptcy is not precluded from contesting the claim on behalf of non-intervening creditors.[35] It seems that this view is compelled by the decision in the *Gratiot* case, for, since creditors are under no obligation to intervene, they are not bound by the findings.

In an equity receivership proceeding, it is necessary that a creditor have a judgment with a return of *nulla bona* before he may have a receiver appointed for his debtor.[36] Since this requisite is similar to the requirement of the provability of the petitioning creditors' claims in bankruptcy proceedings, it would seem that 77B courts may be influenced by the equity decisions. As to individual debtors, although no case could be found allowing collateral attack on the appointment of a receiver on the ground that the creditor was a simple contract creditor, the proceedings have been dismissed on this ground;[37] and *In re Richardson's Estate*[38] indicates that collateral attack might be permitted in a suit by the trustee in bankruptcy to recover property from a state receiver who was appointed at the instance of a simple contract creditor, for in that case the court justified the receiver's appointment on the ground that one of the petitioning creditors was a lien creditor, which conferred jurisdiction upon the court, and although it made an unwarranted extension of the receivership to all of the debtor's property, this was only an erroneous exercise of jurisdiction not open to collateral attack. As to corporate debtors, consent by the corporation will render the appointment of the receiver impregnable upon collateral attack, even though it be made upon petition of a simple contract creditor,[39] the theory being that corporations constitute a well recognized head of equity jurisdiction and that it is not necessary to the court's jurisdiction over the subject-matter that the creditor be a lien creditor.[40]

Thus by equity receivership precedents, the 77B court's approval of the petition for reorganization is unimpeachable by reason of a defect in the provability of the petitioning creditors' claims. But in view of the decision in the

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appeared, and the adjudication was correct in form, it is conclusive of the fact decreed, and can be impeached only by a direct proceeding. . . ." *Id.* at 168-169.

31. 98 Fed. 409 (D. Cal. 1899).

32. But it was also held that the adjudication was *not* conclusive of the validity of notes brought in collaterally to prove insolvency.

33. 234 Fed. 58 (C. C. A. 7th, 1916).

34. 138 Fed. 778 (C. C. A. 8th, 1905).

35. The court relied on the dissent by J. Sanborn in *Ayres v. Cove.*

36. Maxwell v. McDaniels, 184 Fed. 311 (C. C. A. 4th, 1910) (appeal).

37. Lion Bonding & Surety Co. v. Karatz, 262 U. S. 77 (1923).

38. 294 Fed. 349 (D. Tex. 1923).

39. American Can Co. v. Erie Preserving Co., 171 Fed. 540 (W. D. N. Y. 1909).

40. Brown v. Lake Super. Iron Co., 134 U. S. 530 (1889). The language of the Court indicates a strong tendency to allow no collateral attack if possible: "After months had passed, much business had been transacted and large responsibilities assumed, the corporation, for the benefit of a few creditors and to destroy the equality between all, comes in with the technical objection that the creditors initiating the proceedings should have taken one step more at law before coming into equity." *Id.* at 535.

Gratiot case, it is not unlikely that the approval of the petition by the 77B court will not be res judicata in plenary suits. This, however, will not have a disturbing effect, because the entire reorganization will not be undermined.

C. *Amount of Claim:* Under bankruptcy law, if the petition is regular on its face, then the amount of the claim is not a fact which can be shown on collateral attack.[41] Thus, as was said *obiter* in the *New York Tunnel*[42] case, "if the aggregate amount of claims were stated to be $500, as required by law, and because of set-offs or other reasons was in point of fact less, an adjudication would be an error to be corrected by appeal," and would not be void. But where the defect in the amount of the claim is apparent upon the surface of the record, no case could be found involving a collateral attack, but there is a division of authority in the direct attack cases. Some hold that the amount-of-claim requirement is not a jurisdictional fact;[43] others adhere to the view that this requisite is pertinent to the jurisdiction of the court over the subject-matter of the action.[44]

According to the decisions in ordinary federal cases, the amount claimed in the petition in good faith and not colorably is the test. Where the facts, as they appear on the record, do not create a legal certainty of the insufficiency of the amount in controversy, the court has no right to dismiss the suit.[45] But if it affirmatively appears on the face of the record that the requisite amount does not exist, then there is a defect in the jurisdiction of the court over the subject-matter, which is always open for consideration, and which can not be cured by the consent of the parties.[46]

Therefore, when a problem arises as to the amount of the claim in a 77B proceeding, if the bankruptcy and ordinary federal precedents are followed, there is no difficulty where the record is fair on its face. But if it is apparent on the record, then there is a choice between the ordinary federal cases and some of the bankruptcy decisions. Since there was no case concerning a collateral attack for an apparent defect, it would seem that sound principle dictates that the amount of the claim is not a jurisdictional fact for purposes of collateral attack upon 77B proceedings.

III. *Proper District for Initiating 77B Proceedings*

Section 77B provides that the petition, whether voluntary or involuntary, shall be filed with the court in whose territorial jurisdiction the corporation, during the preceding six months or the greater portion thereof, has had its principal place of business or its principal assets, or in any territorial jurisdiction

41. Michaels v. Post, 21 Wall. 398 (U. S. 1874); 46 YALE L. J. 159, 160 (1936).

42. 166 Fed. 284, at 285 (C. C. A. 2d, 1908).

43. *In re* Duncan, Fed. Cas. No. 4131 (S. D. N. Y. 1876); *In re* Funkenstein, Fed. Cas. No. 5158 (D. Cal. 1876); *In re* Henderson, 9 Fed. 196 (S. D. Ohio 1881) (In a note to this case, decisions are cited both ways).

44. Taft Co. v. Century Savings Bank, 141 Fed. 369 (C. C. A. 8th, 1905); Doty v. Mason, 244 Fed. 587 (S. D. Fla. 1917); see Finn v. Carolina Portland Cement Co., 232 Fed. 815, 818 (C. C. A. 5th, 1916). A discharge can not be collaterally attacked for failure to itemize claims in the petition. Barrett v. Carney, 33 Cal. 530 (1867). Where the Bankruptcy Act required petitioning creditors to have claims aggregating $500 and the form required by the United States Supreme Court for a creditors' petition required the nature and amount of each claim to be stated with particularity, the failure to do so was held not an error which can furnish the basis for a collateral attack. Bail v. Hartman, 9 Ariz. 321, 83 Pac. 358 (1905).

45. Barry v. Edmunds, 116 U. S. 550 (1886); Witmore v. Rymer, 169 U. S. 115 (1898); Reed, etc. Inc. v. Miller, 2 F. (2d) 280 (E. D. Pa. 1924).

46. Hegler v. Faulkner, 127 U. S. 482 (1888); Holt v. Indiana Mfg. Co., 176 U. S. 68 (1900); Edwards v. Bates County, 55 Fed. 436 (W. D. Mo. 1893); Robinson v. W. Va. Loan Co., 90 Fed. 770 (D. W. Va. 1898); Royal Ins. Co. v. Stoddard, 201 Fed. 915 (C. C. A. 8th, 1912); New York Life Ins. Co. v. Marshall, 23 F. (2d) 225 (C. C. A. 5th, 1928).

in the state in which it was incorporated.[47] This section should be construed in the light of *Fairbanks Steam Shovel Co. v. Wills*,[48] in which the United States Supreme Court, under a similar provision of the Bankruptcy Act proper, held that the question of the trustee's capacity to sue, which was challenged on the ground that the corporation did not have its principal place of business in the district, was capable of being "waived". Since jurisdiction over the subject-matter can not be waived or conferred by consent of the parties, according to the dogma, this decision clearly indicates that the propriety of the district for filing a petition does not relate to jurisdiction over the subject-matter, but must pertain to venue[49] only, concerning which collateral attack is not permissible.

However, the lower federal courts have apparently overlooked the *Fairbanks* case not only in ordinary bankruptcy proceedings,[50] but also in proceedings under 77B. Thus, in *Hamilton Gas Co. v. Watters*,[51] an involuntary petition for reorganization under 77B was filed in the District Court for the Southern District of West Virginia, alleging that the corporation had its principal place of business therein. Then the debtor filed a voluntary petition in the District Court for the Southern District of New York, averring that its principal place of business was located in that district. The latter petition was first approved. The debtor then answered the former petition, declaring that the West Virginia court was without jurisdiction. But the West Virginia court approved the petition and denied the debtor's motion to dismiss. Upon appeal, the West Virginia Circuit Court of Appeals reversed the decree, saying:

> "If it should be found that the principal place of business of the debtor during the six months preceding the filing of the petition was not in the Southern District of New York, then the New York Court had no jurisdiction to pass upon the petition, and the court below should retain jurisdiction . . . If, however, the principal place of business of the debtor was in the Southern District of New York, the court below should vacate its order approving the creditors' petition filed therein . . ." [52]

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47. 48 STAT. 912 (1934), 11 U. S. C. A. § 207 (a) (Supp. 1936). It is said in 1 GERDES, CORPORATE REORGANIZATIONS (1936) 224, that the requirement pertains to the court's jurisdiction over the subject-matter, and if not satisfied, the court has no power to proceed, and jurisdiction can not be conferred by waiver or consent.

48. 240 U. S. 642 (1916). In this case, a creditors' petition in bankruptcy was filed in the District Court for the Southern District of Illinois, and the corporate debtor was adjudicated bankrupt. Then, the bankrupt filed a petition with the bankruptcy court to restrain a chattel mortgagee of the bankrupt from selling the mortgaged property. The mortgagee appeared and answered without questioning the jurisdiction of the court. Thereafter, a trustee was appointed and substituted as a party to the controversy in place of the bankrupt. Then the mortgagee for the first time objected to the appointment of the trustee and his capacity to sue, on the ground that the corporation's principal place of business was in the Northern District of Illinois, but the Court rejected this contention because by answering and making the defense on the merits the defendants had effected a "waiver".

49. Similarly, if the proceedings are brought in the wrong division of the proper district which contains more than one division, the courts say that this raises a problem of venue only, and not of jurisdiction, and collateral attack is not permitted. Clark-Herrin-Campbell Co. v. Claflin Co., 218 Fed. 429 (C. C. A. 5th, 1914); *In re* Carter-Williams Grain & Coal Co., 297 Fed. 441 (C. C. A. 8th, 1924); *In re* Lewis, 32 F. (2d) 287 (D. Miss. 1929). *Cf. In re* Miller's Dresses, Inc., 1 F. Supp. 378 (D. Tex. 1932).

50. Thus, see Central Republic Bank & Trust Co. v. Caldwell, 58 F. (2d) 721, 730 (C. C. A. 8th, 1932); Finn v. Carolina Portland Cement Co., 232 Fed. 815 (C. C. A. 5th, 1916). But it was not overlooked in Roszell Bros. v. Continental Coal Corp., 235 Fed. 343 (E. D. Ky. 1916), *aff'd sub. nom., In re* Continental Coal Corp., 238 Fed. 113 (C. C. A. 6th, 1916) (a collateral attack case relying on the *Fairbanks* case).

51. 75 F. (2d) 176 (C. C. A. 4th, 1935).

52. *Id.* at 182. The same result was reached upon identical facts in another 77B case, *In re* Kelly-Springfield Tire Co., 10 F. Supp. 419 (S. D. N. Y. 1935), decided in reliance solely upon the *Hamilton Gas* decision.

Inasmuch as the *Fairbanks* case undoubtedly decided that the propriety of the district in which to file a petition does not savor of jurisdiction over subject-matter, and a defect therein can not be collaterally attacked, it seems that the above two 77B decisions are clearly erroneous, and are also unsound in policy, since the result fosters competition among the reorganization courts with consequent friction and disorder in the administration of debtors' estates.[53]

IV. *Insolvency of the Debtor*

When a voluntary petition in bankruptcy has been filed, the question of insolvency is not in issue,[54] and therefore an adjudication on such a petition will not be res judicata on the bankrupt as to the question of insolvency either at the time of the filing of the petition or any time prior thereto.[55] Quite obviously, too, the adjudication can not be attacked collaterally on this ground.

However, in the case of an involuntary petition, the Bankruptcy Act makes proof of insolvency at the date of the petition a condition precedent to an adjudication.[56] This being so, the adjudication cannot be collaterally impeached by any who were "parties or privies" to the bankruptcy proceeding, since the adjudication of insolvency is conclusive upon them.[57] Whether non-intervening creditors could upset a bankruptcy proceeding after adjudication on the ground that the debtor was solvent has apparently not yet been decided; dicta, however, indicate that they could not. Thus it has frequently been reiterated, and apparently never expressly denied, that the adjudication of the status of the bankrupt is in rem, and is therefore binding on the world,[58] so that notice alone of the proceeding should be sufficient to avoid the possibility of collateral attack on the adjudication.

As to whether the adjudication is res judicata of insolvency in a later plenary suit against a non-intervening creditor, the United States Supreme Court held, in *Gratiot County State Bank v. Johnson*,[59] that such creditors are not

53. As for the "six months or the greater portion thereof" requirement, this can not be raised in a collateral attack by a creditor upon the adjudication, if the bankrupt filed the petition without fraudulent intent. *In re* Tully, 156 Fed. 634 (E. D. N. Y. 1907); Barrett v. Carney, 33 Cal. 430 (1867).

54. See discussion in *In re* Pryatt, 257 Fed. 362, 363 (D. Nev. 1918).

55. *In re* Ann Arbor Machine Co., 278 Fed. 749 (D. Mich. 1922); People's Nat. Bank v. Foltz, 25 F. (2d) 295 (C. C. A. 6th, 1928). *Cf.* Abbott v. Wauchula Mfg. Co., 240 Fed. 938 (C. C. A. 5th, 1917), where the court held that the admission by the bankrupt of insolvency made the adjudication on an involuntary petition collaterally unimpeachable; the theory apparently being that the court has determined the question of insolvency, and not that the admission amounts to a voluntary petition, for in such case the decision of the question of insolvency would not be res judicata. But see *In re* Gibney Tire & Rubber Co., 241 Fed. 879 (D. Pa. 1917), where the court said that the petition could not be vacated on the ground of insolvency, the admission of the bankrupt having the effect of eliminating the question of insolvency as an issue.

56. 30 STAT. 546 § 3 (b) (1898), 11 U. S. C. A. § 21 (b) (1927).

57. *In re* Malkan, 261 Fed. 894 (C. C. A. 2d, 1919). See Simpson v. Western Hardware Co., 97 Wash. 626, 167 Pac. 113 (1917).

58. See Abbott v. Wauchula Mfg. Co., 240 Fed. 938 (C. C. A. 5th, 1917); also cases cited *infra* note 71.

59. 249 U. S. 246 (1919). This case overruled a line of lower court decisions to the effect that persons whose acts predicated the bankruptcy were "parties" and bound by the adjudication of insolvency at the date of the transfer. Bear v. Chase, 99 Fed. 920) (C. C. A. 4th, 1900); *In re* American Brewing Co., 112 Fed. 752 (C. C. A. 7th, 1902); Cook v. Robinson, 194 Fed. 785 (C. C. A. 9th, 1912); Lazarus v. Eagen, 206 Fed. 518 (D. Pa. 1912); Breckons v. Snyder, 211 Pa. 176 (1905). Following the *Gratiot* case: Sanitary Mfg. Co. v. Momsen Co., 51 F. (2d) 684 (C. C. A. 9th, 1931); Charlesworth v. Hipsh, Inc., 84 F. (2d) 834 (C. C. A. 8th, 1936). The theory of the *Gratiot* decision is that while creditors have a right to intervene, they are under no duty to do so. A case decided in the same year as the *Gratiot* case seemingly misconstrues that decision, holding that the question of insolvency is res judicata and cannot be relitigated in the plenary suit, but that whether there has been an unlawful preference is not conclusively decided because of the additional element that the

"parties" and are not precluded from disputing the question, on the theory that while the creditors have a right to intervene in the bankruptcy proceedings, they are under no duty to do so. However, the Court expressly distinguished between the problem as to the adjudication of the *status* of the debtor, and the problem as to the effect of the finding of insolvency in subsequent suits against alleged fraudulent transferees, recognizing that the former was in rem.[60] Thus, in that case, the trustee's capacity to sue was not denied by the Court, but it was held that the finding that the debtor was insolvent at the time of the transfer was not conclusive on the transferee, although that was the act of bankruptcy on which the adjudication was predicated.

In equity receivership cases, the court's determination of the insolvency [61] of a business for which a receiver has been appointed has been held conclusive on collateral attack.[62] Furthermore, the finding of insolvency is also res judicata in later proceedings, as under Section 77B, since the parties and the issues are substantially identical.[63]

Since Section 77B makes the existence of insolvency (whether in the equity or the bankruptcy sense) a jurisdictional fact with respect to both creditors' [64] and debtors' petitions,[65] courts entertaining suits attacking 77B proceedings will be confronted with the same problems that have arisen in bankruptcy and equity receivership situations. This much is quite certain: Neither the equity nor the bankruptcy precedents will permit the reorganization proceedings to be entirely undermined because of the debtor's solvency. However, it is doubtful whether the *Gratiot* case can be nullified by permitting the finding of insolvency to be res judicata as against non-intervening creditors; for, just as in ordinary bankruptcy proceedings, it is a "hardship" to require creditors to appear in the reorganization proceeding or be forever concluded by the findings, and "hardship" was the basic reason given in the *Gratiot* case.[66] Nor will the cases which held the equity receivership determination of insolvency to be res judicata in later 77B proceedings permit an opposite result in the *Gratiot* type of situation, for those cases hold merely that in later proceedings respecting the *status* of the debtor the finding shall be res judicata, and not that the finding shall be final in determining the property rights of a transferee.

V. *Acts of Bankruptcy*

Section 77B, as well as the strict Bankruptcy Act, requires that an act of bankruptcy shall have been committed within four months of the filing of an

guilty knowledge and fraudulent conduct of the grantee must be shown. Ward v. Central Trust Co., 261 Fed. 344 (C. C. A. 7th, 1919).

60. "The adjudication is, for the purpose of administering the debtor's property, that is, in its legislative effect, conclusive upon all the world . . . So far as it declares the status of the debtor, even strangers to the decree may not attack it collaterally." Gratiot County State Bank v. Johnson, 249 U. S. 246, at 248 (1919).

61. *I. e.*, inability to meet current debts as they mature.

62. Welch v. Capital Co., 76 Ind. App. 416, 132 N. E. 313 (1921).

63. *In re* Wickwire Spencer Steel Co., 12 F. Supp. 528 (W. D. N. Y. 1935).

64. "Three or more creditors . . . may file a petition stating that such corporation is insolvent or unable to meet its debts as they mature . . ." 48 STAT. 912 (1934), 11 U. S. C. A. 207 (a) (Supp. 1936).

65. "Any corporation . . . may file . . . a petition stating the requisite jurisdictional facts . . . and that the corporation is insolvent or unable to meet its debts as they mature." 48 STAT. 911 (1934), 11 U. S. C. A. 207 (a) (Supp. 1936).

66. The Court said: ". . . to require every creditor to acquaint himself with the issues raised in every proceeding in bankruptcy against his debtors, in order to determine whether a decision on any such issue might conceivably affect his interests; and, if so, either to participate in the litigation, or, at his peril, suffer the decision of every question therein litigated to become *res judicata* as against him, would be an intolerable hardship upon creditors." 249 U. S. 246, at 250.

involuntary petition.[67] In connection with this provision, two problems arise, just as in the case of insolvency and the validity of petitioning creditors' claims: First, whether the approval of the petition is open to collateral attack; and second, whether the adjudication or approval is res judicata against transferees upon the question whether there was the commission of an act of bankruptcy.

As to the first problem, the adjudication can not be impeached collaterally on the ground that there was no act of bankruptcy;[68] nor even on the ground that the act of bankruptcy alleged and proved had been previously determined not to be an act of bankruptcy.[69] Similarly, this is no basis for questioning the trustee's capacity to sue.[70] The theory apparently is that the defect does not relate to jurisdiction over the subject-matter. Thus, it would seem that these decisions are persuasive of the distinction suggested concerning insolvency, and it is likely that a similar result will be reached in the latter situation, for there is no substantial difference between the nature of the act of bankruptcy prerequisite and that of the prerequisite of insolvency; if one does not pertain to the subject-matter, neither should the other.

However, with reference to the second problem, the adjudication is not, in a plenary suit against the transferee, res judicata of the particular act of bankruptcy on which the adjudication is based.[71] The reasoning is that he is not a "party" to the bankruptcy proceeding, and further that the right of the transferee to retain the security was not litigated in the bankruptcy proceeding. But if the transferee appears in the proceeding, he is bound by the adjudication;[72] probably, however, this finality would be limited to questions litigated in the bankruptcy proceeding, and would therefore not include the creditor's intent to defraud, since that is not essential to an act of bankruptcy.[73] However, if the petition alleges several acts of bankruptcy, and there is a general adjudication, the adjudication is not res judicata as to the commission of any of the acts of bankruptcy,[74] or any element, even as to participating creditors. Possibly, if there was a common element in the acts of bankruptcy averred, *e. g.*, a transfer of property within four months, the court would hold that element to have been conclusively decided.

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67. 48 STAT. 912 (1934), 11 U. S. C. A. 207 (a) (Supp. 1936).

68. *In re* Hecox, 164 Fed. 823 (C. C. A. 8th, 1908).

69. Larkin-Green v. Sabin, 222 Fed. 814 (C. C. A. 9th, 1915). The lower court stated an additional reason, namely, that defendant was estopped by reason of participation by proving his claim; perhaps this affected the Circuit Court of Appeals decision. 218 Fed. 984 (D. Ore. 1914). *Cf.* cases cited *supra* note 63, holding that proof of claim will not work an estoppel respecting collateral attack because of improper district.

70. Michaels v. Post, 21 Wall. 398 (U. S. 1874); Ward v. Central Trust Co., 261 Fed. 344 (C. C. A. 7th, 1919); Silvey & Co. v. Tift, 123 Ga. 804, 51 S. E. 748 (1905).

71. "Its adjudication of bankruptcy is a judgment *in rem* fixing the *status* of the bankrupt, which, upon that point, is binding on the world, and can only be impeached for fraud in obtaining it . . . Although the adjudication of bankruptcy is a judgment *in rem* and as such conclusive on all the world, and although in arriving at that judgment, the bankrupt court declares the conveyance alleged as the act of bankruptcy to be a preference among creditors, . . . such declaration is no part of the judgment, but is merely incidental to it. . . . No one not a party to the record is affected by it, except so far as it is *in rem*." Lewis v. Sloan, 68 N. C. 557, 561, 562 (1873). "The adjudication in bankruptcy, therefore, conclusively determined the status of Griffin as a bankrupt, but did not conclude the defendants from making their defense on a suit by the trustee in bankruptcy against them to recover the property." Silvey & Co. v. Tift, 123 Ga. 804, 814, 51 S. E. 748, 753 (1905). "As a judgment *in rem* it conclusively fixed the status of Screws as a bankrupt, but Everett . . . had still a right to be heard on the validity of the transfer." Traders' Ins. Co. v. Mann, 118 Ga. 381, 382, 45 S. E. 426 (1903).

72. Magnus v. Ketcham, 112 Fed. 752 (C. C. A. 7th, 1902). See Silvey & Co. v. Tift, 123 Ga. 804, 813, 51 S. E. 748, 752 (1905).

73. See Ward v. Central Trust Co., 261 Fed. 344 (C. C. A. 7th, 1919).

74. *In re* Letson, 157 Fed. 78 (C. C. A. 8th, 1907); *In re* Julius Bros., 217 Fed. 3 (C. C. A. 2d, 1914); Carter v. Whisler, 275 Fed. 743 (C. C. A. 8th, 1921); Silvey & Co. v. Tift, 123 Ga. 804, 51 S. E. 748 (1905).

Since no act of bankruptcy is necessary in a voluntary petition, the question has been presented whether a debtor's answer admitting insolvency and acquiescing in the adjudication will make the proceeding a voluntary one, eliminating the necessity of an act of bankruptcy. The courts have apparently adopted the view that it does not have this effect.[75] The result is of little import, since there could be no collateral attack on the adjudication even upon an involuntary petition.

The equity receivership has no requirement analogous to that of an act of bankruptcy, so the sole reliance will have to be upon bankruptcy precedents in deciding collateral attacks upon 77B decrees, orders and findings. The result then should be the same as that suggested in regard to insolvency: The adjudication will not be impeachable, but non-intervening creditors will not be bound in plenary suits as to the commission of the act. The recent 77B decisions bear out this suggestion. Thus, although a prior foreclosure receivership is not an "equity receivership" under Section 77B,[76] the court has held, in both *In re 211 East Del. Place Bldg. Corp.*[77] and *In re Blackwood Ass'n Hotels, Inc.*,[78] that the approval of the petition in 77B is not open to collateral attack, since a sufficient act of bankruptcy is not essential to jurisdiction over the subject-matter; the court had power to decide and although it decided erroneously, the sole remedy is by appeal.

VI. *Good Faith*

Section 77B provides that the 77B court shall approve the petition for reorganization, whether voluntary or involuntary, only if satisfied that it has been filed in good faith.[79] The nature of this good faith requirement is not within the scope of this article,[80] but, aside from signifying honesty of purpose on the part of the petitioner,[81] it means that if a bankruptcy or equity or foreclosure proceeding has been going on for some time in another court, the 77B court may refuse to entertain the petition for reorganization and thereby interfere with the pending proceeding.[82] In other words, there may be a lack of good faith if the wisdom or feasibility of reorganization is dubious.[83]

75. *In re* Condon, 209 Fed. 800 (C. C. A. 2d, 1913); *In re* Elmsford Country Club, 50 F. (2d) 238 (S. D. N. Y. 1931).

76. Duparquet Huot & Moneuse Co. v. Evans, 56 Sup. Ct. 412 (1936).

77. 14 F. Supp. 96 (D. Ill. 1936).

78. C. C. H. Bankr. Serv. ¶4023 (D. Ill. 1936).

79. 48 STAT. 912 (1934), 11 U. S. C. A. § 207 (a) (Supp. 1936).

80. On what is "good faith", see Gerdes, *"Good Faith" in the Initiation of Proceedings Under Section 77B of the Bankruptcy Act* (1935) 23 GEO. L. J. 418; Note (1934) 48 HARV. L. REV. 287.

81. The general rule in the bankruptcy cases is that the reasons or motives which inspired the filing of the petition, whether voluntary or involuntary, are immaterial; thus it makes no difference whether it is filed vexatiously or maliciously, for a sinister, selfish and ulterior purpose. *In re* Fowler, Fed. Cas. No. 4,998 (D. Mass. 1867); Bank of Elberton v. Swift, 268 Fed. 305 (C. C. A. 5th, 1920); *In re* Automatic Typewriter & Service Co., 271 Fed. 1 (C. C. A. 2d, 1921); Security Bank & Trust Co. v. Tarlton, 294 Fed. 698 (D. Tenn. 1923); *In re* Pickering Lumber Co., 1 F. Supp. 82 (D. Mo. 1932); *In re* Van Bokkelen, Inc., 7 F. Supp. 639 (D. Md. 1934); *In re* National Motorship Corp., 7 F. Supp. 1001 (S. D. N. Y. 1934). *Contra: In re* United Grocery Co., 239 Fed. 1016 (D. Fla. 1917); *In re* Weidenfeld, 257 Fed. 872 (E. D. N. Y. 1919). For a special exception, see Zeitinger v. Hargadine-McKittrick Dry Goods Co., 244 Fed. 719 (C. C. A. 8th, 1917); *In re* Denton Stores Co., 5 F. Supp. 307 (S. D. Ohio 1933) (vacation of adjudication permitted if procured by corporate directors to hinder action already, or about to be, begun against them, for mismanagement). But the motive of the petitioner for a consent receivership may be investigated. First Nat. Bank of Cincinnati v. Flershem, 290 U. S. 504 (1934).

82. Note (1934) 48 HARV. L. REV. 283, 289. See *In re* Prairie Ave. Bldg. Corp., 11 F. Supp. 125 (E. D. Ill. 1935).

83. Manati Sugar Co. v. Mock, 75 F. (2d) 284 (C. C. A. 2d, 1935); *In re* Tennessee Pub. Co., 81 F. (2d) 463 (C. C. A. 6th, 1936), *cert. granted,* Tennessee Pub. Co. v. American Nat. Bank, 56 Sup. Ct. 943 (1936).

If the 77B court should be satisfied that the good faith requirement has been fulfilled, will a collateral attack for lack of good faith be permitted? This question was squarely raised and decided in *Albert Pick & Co. v. Webster Hall Corp.*[84] In that case a 77B petition was filed by the debtor in the District Court for the Eastern District of Michigan, without notice to any interested party, and was approved by the court. A date for the hearing upon the matter of the appointment of a trustee was fixed, and at that time, the receiver of the District Court for the Western District of Pennsylvania, at the request of certain creditors but not by order or with the knowledge of the court, appeared and asked for the transfer of the proceedings to his court, on the ground that all the property of the debtor was in the Western District of Pennsylvania and had been under his receivership for about four years. Nevertheless, the District Court for the Eastern District of Michigan appointed a trustee who demanded that the receiver turn over to him all the property in his hands. The receiver immediately asked the District Court for the Western District of Pennsylvania for instructions, and he was ordered to comply with the demand of the trustee. The court said:

> "The court for the Eastern District of Michigan had jurisdiction to entertain the reorganization petition and pass upon its form and good faith, and to appoint a permanent trustee, and thus assume control over the estate of the defendant in the instant action. Some of the circumstances attending its assumption of control may be regrettable, but the jurisdiction is plain . . ."

This decision is the only one extant upon the point under discussion and appears eminently correct. Good faith is an intangible, discretionary thing which the 77B court is under a duty to find affirmatively before proceeding further, and if the court does proceed further, no one should be able in a collateral proceeding to impugn the lack of good faith.

VII. *Fairness and Equity of the Plan of Reorganization*

Section 77B (f) provides that "After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders . . ."[85]

Before the passage of this clause of Section 77B, the case of *Northern Pac. Ry. v. Boyd*,[86] decided by the United States Supreme Court, was considered the guiding light by which to test the fairness of a plan of corporate reorganization. In that case, probably the most prominent in the law of corporate reorganizations, the plan of reorganization of the Old Company in the equity receivership did not provide for the unsecured creditors, although the plan did permit participation by stockholders and secured creditors. In a previous action by some unsecured creditors of the Old Company, in which it had been alleged that the plan was the outcome of a conspiracy between the secured creditors and the stockholders to exclude the unsecured creditors, the court had decided that the

84. C. C. H. Bankr. Serv. ¶ 3269 (W. D. Pa. 1935). Accord: *In re* Cheney Bros., 12 F. Supp. 609 (D. Conn. 1935) (motion to vacate).

85. 48 STAT. 911 (1934), 11 U. S. C. A. § 207 (f) (Supp. 1936).

86. 228 U. S. 482 (1913). For discussions of this case, see Dodd, cited *supra* note 4, at 1100; Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization* (1933) 19 VA. L. REV. 540; Friendly, cited *supra* note 4, at 74; *Developments in the Law—Reorganization Under Section 77B of the Bankruptcy Act* (1936) 49 HARV. L. REV. 1111, 1190; 2 GERDES, CORPORATE REORGANIZATIONS (1936) 1725 *et seq.* It would seem that the *Boyd* case was incorrectly decided from the collateral attack aspect because the Court had jurisdiction and only its exercise of jurisdiction was erroneous.

Old Company had no equity in the property. Boyd, an unsecured creditor, then brought suit against the New Company, averring that the sale in the receivership proceedings to the defendant was invalid as to his unsecured claim because made pursuant to an illegal plan of reorganization, and praying that the property transferred to the New Company be subjected to the payment of his claim. It appeared that the suit by Boyd was brought about ten years after the plan of reorganization had been effected; and that the plaintiff had not only notice by publication, but also actual knowledge of the pendency of the proceedings and yet took no steps to assert his rights. The Supreme Court decided that the sale to the New Company was "fraudulent" with respect to the unsecured creditors and affirmed a decree subjecting the property transferred to the defendant to the satisfaction of Boyd's claim.

In other words, according to the *Boyd* case, if a plan of reorganization provides for participation by stockholders, without according to creditors their priority rights over stockholders, the plan is first of all fraudulent in law, and secondly, creditors who have been imposed upon may in a collateral proceeding against the reorganized corporation secure satisfaction of their claims out of the reorganized property. This principle was not original with the *Boyd* case, but had been propounded in earlier Supreme Court cases.[87] Yet, when reiterated by the Court, the decision aroused the antagonism of the reorganization bar against it, and till this day the principle has been exceedingly unpopular because of its undue favoritism to minorities.[88] Nevertheless, when clause (f) of 77B was enacted, it was generally assumed that it was intended to embody the principle of the *Boyd* case,[89] so much so that one writer said that the nullification or modification of the principle would involve the taking of the property of creditors without due process of law.[90]

However, a sounder interpretation of 77B (f) was rendered in the recent case of *Downtown Inv. Ass'n v. Boston Metropolitan Bldgs., Inc.*,[91] where the court declared that Section 77B (f) did not incorporate into itself the "fixed principle" of the *Boyd* case as to what constitutes a fair and equitable plan of reorganization. But because of the belief that one of the chief reasons for the enactment of 77B was to preclude unreasonable minorities from obstructing fair and equitable plans of reorganization and thereby to facilitate corporate reorganizations,[92] the court said:

> "We agree with counsel . . . that a plan under 77B is in substance nothing more than a composition between the creditors and the debtor and that it is merely an extension of section 12 of the original Bankruptcy Act with such additions and provisions as are necessary to adapt it to the complicated conditions that may arise in corporate reorganizations.[93]
>
> "Reorganization plans under 77B may differ from offers in composition in form and complexity, but the difference is little more than one of degree. A plan of reorganization when accepted is nothing more than an

87. Railroad Co. v. Howard, 7 Wall. 392 (U. S. 1869); Louisville Trust Co. v. Louisville, N. A. & C. Ry., 174 U. S. 674 (1899).

88. See Dodd, cited *supra* note 4, at 1101, n. 2.

89. *Id.* at 1132; *Developments in the Law,* cited *supra* note 86, at 1190; 2 GERDES, CORPORATE REORGANIZATIONS (1936) 1737.

90. Dodd, cited *supra* note 4, at 1132.

91. 81 F. (2d) 314 (C. C. A. 1st, 1936). The court said: "This raises a question of whether a plan under 77B to be fair and equitable must measure up to the rulings of the Supreme Court in equity receiverships as announced in the case of Northern Pacific Railway Co. v. Boyd . . . This is an important question upon which we find no direct authority or precedent." *Id.* at 322.

92. *Id.* at 323.

93. *Id.* at 318.

agreement between the debtor and its creditors and stockholders, or if the debtor has been declared insolvent, then between the several classes of creditors." [94]

Although this opinion has been severely criticized on the ground that it does not bear out a proper statutory construction of 77B (f),[95] nevertheless there is no doubt that it is welcome to the reorganization bar as a whole. The fact that the *Boyd* case was decided by a five to four vote indicates the weakness of the *Boyd* principle, and the *Downtown* case supplies the means whereby to circumvent the non-democratic consequences of the *Boyd* principle.

The *Downtown* case involved an appeal from an order confirming a plan of reorganization and not a collateral attack, but it would seem that if, as stated in the *Downtown* case, the principles of composition under Section 12 of the Bankruptcy Act [96] are applicable to 77B (f), creditors whose rights have not been adequately provided for in the plan of reorganization would be powerless to make a successful collateral attack upon it.[97] In ordinary bankruptcy proceedings, it has been held by the United States Supreme Court in *Hanover Nat. Bank v. Moyses* [98] that a discharge in bankruptcy discharges all debts if there has been notice by publication to creditors, personal service being unnecessary because the discharge is in rem and not in personam. Composition agreements, though in a sense superseding the bankruptcy proceedings, are regarded as part of the bankruptcy proceedings,[99] and when confirmed, have the effect of a discharge.[100] Apparently, therefore, mere notice by publication is constitutionally adequate to bar any objections by a creditor who fails to enter the composition, even though his claim be omitted from the agreement.[101]

It is true that compositions concern only unsecured creditors and that 77B reorganizations are inherently more complicated because of the numerous different classes of creditors involved, but essentially the problem is identical in both cases. Although 77B courts have permitted direct attacks upon orders confirming plans of reorganization because creditors have not been provided for sufficiently,[102] apparently no case has yet arisen wherein a collateral attack upon the confirmation has been attempted. Should such a case arise, however, the court

94. *Id.* at 323.

95. *Developments in the Law,* cited *supra* note 86, at 1191.

96. 30 STAT. 549 (1898), 11 U. S. C. A. § 30 (1927).

97. Assuredly 77B proceedings are very similar to composition agreements. Composition agreements are effected by the consent of a majority of the unsecured creditors, resulting in a settlement of the claims at a stipulated percentage. A cash deposit sufficient to pay off priority claims and costs must be made. *In re* Fisher & Co., 135 Fed. 223 (D. N. J. 1905); *In re* Harvey, 144 Fed. 901 (E. D. Pa. 1906). But creditors may waive the deposit of cash in payment of their percentages. Kinkead v. Bacon & Sons, 230 Fed. 362 (C. C. A. 6th, 1916). This deposit, whether cash or notes, is distributed among the creditors and the debtor is given a discharge. Matter of Englander's, Inc., 267 Fed. 1012 (E. D. Pa. 1920).

98. 186 U. S. 181 (1901). "Congress may prescribe any regulations concerning discharge in bankruptcy that are not so grossly unreasonable as to be incompatible with fundamental law, and we can not find anything in this act on that subject which would justify us in overthrowing its action . . . If such notice to those who may be interested in opposing discharge, as the nature of the proceedings admits, is provided to be given, that is sufficient." *Id.* at 192. Of course, if no notice is given, the debt is not discharged. 42 STAT. 354 (1922), 11 U. S. C. A. § 35 (1927).

99. See *In re* Bickmore Shoe Co., 263 Fed. 926, 928 (N. D. Ga. 1920).

100. 36 STAT. 839 § 6 (c) (1910), 11 U. S. C. A. § 32 (c) (1927); *In re* Ullman, 180 Fed. 944 (S. D. N. Y. 1910).

101. A state court will not permit collateral attack upon the composition. Loeffler v. Wright, 13 Cal. App. 224, 109 Pac. 269 (1910). Thus, even if notice is mailed to a wrong address, the creditor may not have the composition set aside. *In re* Rudnick, 93 Fed. 787 (D. Mass. 1899); *In re* Siff, 295 Fed. 761 (S. D. N. Y. 1923); see Lindh v. Booth Fisheries Corp., 80 F. (2d) 733 (C. C. A. 9th, 1935).

102. *In re* Parker-Young Co., 15 F. Supp. 965 (D. N. H. 1936).

will very probably follow the bankruptcy principles of composition. If the doctrine of the *Boyd* case is adopted, corporate reorganizations under Section 77B will be greatly impeded because that doctrine permits creditors to withhold participation in order to determine whether the plan will result beneficially to them.

In this connection, there should be noted the case of *In re 620 Church Street Bldg. Corp.*,[103] recently decided by the United States Supreme Court, which seems to impose a very important limitation upon the *Boyd* case. In that case, there was a proceeding under 77B, resulting in the confirmation of a plan of reorganization. The unsecured creditors prayed an appeal from the confirmation to the Circuit Court of Appeals upon the ground that the plan was unfair and inequitable and deprived them of their property without due process of law, and insisting that their consent to the plan was necessary. It appeared that there was no equity in the property above the secured indebtedness, and that in addition to the unsecured creditors the stockholders had not been allowed to participate in the plan. The Circuit Court of Appeals refused to review the confirmation, and, upon certiorari from the Supreme Court, it was held that the Circuit Court had not abused its discretion in declining to review because the unsecured creditors had not shown any injury, there being no equity in the property above the secured indebtedness and the reorganization court having appraised the unsecured creditors' claims as having "no value". In other words, if upon direct attack a creditor may not be allowed to attack the plan as being unfair and inequitable because he shows no injury, *a fortiori* a collateral attack will not be permitted when he can prove no injury. In the *Boyd* case, as the dissenting opinion pointed out,[104] the plaintiff had not been injured, and yet the Court permitted him to object to the fairness and equity of the plan upon collateral attack. Consequently, the *Church Street* case appears to restrict the decision in the *Boyd* case.

Conclusion

An analysis of the cases reveals, first of all, that there is a prime necessity for a redefinition of terms. What constitutes a "collateral attack"? Thus, is a motion to vacate a collateral attack? What is meant by "jurisdiction"? Do certain facts pertain to jurisdiction more so than other facts?[105] Should the regularity of the record be important? If so, why is a judgment of a federal district court immune from collateral attack, notwithstanding that the face of the record reveals a lack of diversity of citizenship?[106] In the second place, courts should keep in mind a distinction between jurisdiction and the exercise of jurisdiction. There may be jurisdiction, but the exercise thereof may be erroneous. Thirdly, in connection with the last-mentioned point, courts should attempt to reconcile the conflicting principles of due process and finality of judgments.[107] Finally, courts should confer greater finality upon orders of the 77B court where an attempt is being made to upset an entire scheme than where a mere incident of the reorganization is being contradicted without any threat of undermining the reorganization and undoing work which may have necessitated many years and exhausted considerable funds to accomplish.

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103. 299 U. S. 24 (1936).
104. Northern Pac. Ry. v. Boyd, 228 U. S. 482, at 511 (1913).
105. See Farrier, *Full Faith and Credit of Adjudication of Jurisdictional Facts* (1935) 2 U. OF CHI. L. REV. 552.
106. Des Moines Navigation & R. R. v. Iowa Homestead Co., 123 U. S. 552, 557 (1887). *A fortiori*, where the lack of diversity of citizenship is not apparent on the face of the record. McCormick v. Sullivant, 10 Wheat. 192 (U. S. 1825); Dowell v. Applegate, 152 U. S. 327 (1894).
107. See Gavit, *Jurisdiction of the Subject Matter and Res Judicata* (1932) 80 U. OF PA. L. REV. 386.