LANDLORDS' CLAIMS UNDER SECTION 77B OF THE BANKRUPTCY ACT

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THE reorganization of the McCrory Stores Corporation has focused attention upon the future rent clause in the Corporate Reorganization Act. The difficulties of this case indicate that the Act was not drafted with adequate clarity and foresight. On January 14, 1933, the McCrory Stores Corporation, faced with pressure from its banks, and desiring to reduce the rentals of its many stores under long-term leases, filed a petition in bankruptcy. On July 5, 1934, the company took advantage of the newly enacted Section 77B and filed a petition for reorganization. Negotiations soon indicated that the most difficult block of claims to adjust were those of the company's many landlords. An examination of many of the company's leases brought to light a variety of rent acceleration clauses operative in case of bankruptcy or receivership proceedings, agreements to pay taxes and assessments, covenants to build upon the property, and covenants to restore the premises to their previous architectural pattern upon the termination of the lease.

In an endeavor to negotiate company settlements with its landlord claimants, the McCrory Company had authorized the *A* Company to act as its agent.¹ While the *A* Company was so engaged,² the *B* Company, which had already purchased substantial amounts of McCrory debentures and preferred stock,³ decided that it must control the landlord situation in order to effect a plan of reorganization favorable to its own interests.⁴ To that end, it appointed one *C* as its agent,⁵ and secured the election of *C* to the McCrory board of directors as a representative of the preferred stockholders.⁶ *C* remained a board member just long enough to secure confidential company information concerning the status of the landlord negotiations,⁷ and to make a deal with the *A* Company whereby the latter would assist the the *B* Company, rather than devote its efforts on behalf of company settlements.⁸ He then resigned,⁹ and within a few days purchased a substantial block of landlord claims, concerning which, company settlements had been well nigh completed.¹⁰ By the early summer of 1935, the *B* Company had acquired almost all of the landlord claims, and under⁷ its leadership a preferred stockholders' protective committee sponsored a plan of reorganization.

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1. Stenographic Minutes of Hearing before Special Master, at 355-6.

2. Id. at 356-8, 863-5, 871, 880.

3. Id. at 615, 618, 621.

4. Id. at 709.

5. Id. at 716-7.

6. Id. at 655, 737.

7. Id. at 386.

8. Id. at 755-6.

9. Id. at 753-4.

10. Id. at 759, 629.

The details of this plan¹¹ are unimportant for the purpose of this paper. Suffice it to say that the plan provided, *inter alia*, that the *B* Company turn in its assigned landlord claims at the value of their cost of acquisition, plus interest, engineering and legal expenses, and a substantial commission to its agent *C*. Payment to the *B* Company was to be made partly in cash, a small portion of the remaining amount in new common stock at the rate of \$6.50 a share, and the major part in new common at the rate of \$5.40 a share. In addition, the *B* Company offered to underwrite without any charge the new common stock offering at \$6.50 a share.

This plan was referred to a special master and extensive hearings thereon were held. The principal opposition arose from the majority stockholders' protective committee, which alleged that the proposed plan unfairly discriminated in favor of the *B* Company, that it would give the *B* Company voting control of the McCrory Corporation, that *C*, and consequently also his principal, had been guilty of breach of fiduciary duties towards the debtor corporation, and that for that reason and on the basis of the "scrutiny" clause in Section 77B neither *C* nor *B* Company should be permitted to profit from the reorganization.¹² Without referring to the fiduciary or scrutiny arguments, the special master rejected the proposed plan on the ground that the *B* Company and *C* had, by entering the affairs of the debtor with the express intention of accomplishing a reorganization, become "reorganization managers" within the meaning of Section 77B (f. 5)¹³ and that consequently their compensation should be reasonable or subject to judicial approval; moreover, they were not entitled to payment in stock since they were in a position to know the true value of the stock better than the other parties and could secure for themselves an unconscionable profit. Upon reference back to the United States District Court, Judge Patterson affirmed the master's decision,¹⁴ but primarily on the ground that *B* Company and *C* had been guilty of breach of fiduciary obligations.¹⁵ Their compensation, he declared,

11. For an analysis of this plan, see in the Matter of McCrory Stores Corp., U. S. Dist. Ct. (S. D. N. Y.), September 30, 1935.

12. Oral argument before the Special Master and the District Court.

13. "After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that . . . (5) . . . all amounts to be paid to committees or reorganization managers, whether or not by the debtor or any such corporation for services or expenses incident to the reorganization, have been fully disclosed and are reasonable, or are to be subject to the approval of the judge." BANKRUPTCY Act, § 77B (f. 5); 48 STAT. 912, 11 U. S. C. A. § 207 (1934).

14. In the Matter of McCrory Stores Corp., U. S. Dist. Ct. (S. D. N. Y.), September 30, 1935.

15. "Under ordinary conditions a director may purchase claims against his corporation at a discount and enforce them for their full amount. *Seymour v. Spring Forest Cemetery Assoc.*, 144 N. Y. 333 (1895); *Glenwood Mfg. Co. v. Syme*, 109 Wis. 355 (1901); *FLETCHER, CORPORATIONS* (Rev'd ed. 1931) § 2289. But the case is different where the corporation is

should be limited to the actual amount which they paid for the landlord claims, plus a small amount to cover their reasonable expenses in acquiring these claims.

Immediately upon the handing down of this decision, the majority common stockholders' committee filed a substitute plan of reorganization which proposed to pay off *B* Company in cash in an amount equal to that which it had paid its assignors, plus reasonable expenses. The money necessary to make these cash payments was to be raised by an underwriting of new debentures and common stock by a group of bankers at normal commission rates.¹⁶ A minority stockholders' committee, co-operating with the *B* Company, sponsored an alternative plan which provided that *B* Company be paid its acquisition costs and expenses in common stock at the rate of \$10.75 a share. The necessary money under this plan was to be raised by the underwriting of new debentures and common stock by the *B* Company at a lower rate of commission than that arranged for under the majority proposal.¹⁷

Judge Patterson, after argument on the merits of these plans, approved that submitted by the minority stockholders' committee.¹⁸ His principal reasons were that the underwriting costs were less therein, that the majority underwriting agreement was conditional, whereas that of the *B* Company was unconditional. Probably he was most influenced by the fact that the approval of the majority proposal to pay off the *B* Company in cash would result in extensive and ruinous litigation brought by the *B* Company to enforce its claims to their fullest extent.

The master's report and the two district court decisions deftly avoided the difficult problems of construing the meaning of the future rent clause in Section 77B. Nevertheless, the facts in the *McCrorry* case clearly raise a problem as to what landlord claims are now provable in a corporate reorganization, and as to the effect of the three year rent limitation. They raise a question, as well, as to the application of the *Boyd* case¹⁹ doctrine to reorganizations under Section 77B and the precise intentment of Congress in the "scrutiny" clause.

insolvent and is itself in the field to settle the claims. A director who acquires claims under such circumstances may enforce them for no more than the cost of acquisition. . . . It is true that if someone with money had not appeared on the scene and reduced the scattered claims of landlords to a single control, reorganization of the debtor would have been a most difficult task. It is also true that the present plan of reorganization is vastly more favorable to creditors and stockholders than the plan to which the debtor was then committed under its contract with the Chicago group. It may well be that the creditors and stockholders are better off because of the United's [*B* Company's] activities in the situation. These matters, however, have no legal significance." *Ibid*.

16. See in the Matter of *McCrorry Stores Corporation*, U. S. Dist. Ct. (S. D. N. Y.), November 12, 1935.

17. *Ibid*.

18. *Ibid*.

19. *Northern Pacific Ry. v. Boyd*, 228 U. S. 482 (1913).

In order to determine what landlord claims are provable under Section 77B and what claims are limited thereunder to three years future rent, it is first essential that we determine the status of various types of landlord claims prior to the enactment of that amendment. Under the former Section 63 (a), rent already due at the time of the filing of a petition in bankruptcy was a provable claim;²⁰ but rent accruing after the filing of the petition was not provable, nor was the landlord permitted to prove a claim for damages that resulted from the breach of his lease agreement.²¹ In the *Manhattan Properties* case²² the Supreme Court went far towards settling the problem of what constituted accrued rent. The Court was there confronted with a lease containing a clause which gave the landlord a right of re-entry upon the bankruptcy of his lessee, and a covenant indemnifying him against all loss of rent which might result during the residue of the lease term. Construing such an acceleration clause as not immediately effective upon the filing of the bankruptcy petition, but contingent upon the option of the landlord, the Court held that rent accruing after the filing of the petition as a result of the landlord's re-entry is a contingent claim, and, moreover, that the liability of the debtor arose only from an act performable subsequent to bankruptcy. Accordingly, the claim was not provable in bankruptcy. The test of provability thus laid down stressed the time when liability arose. If such liability was non-existent at the moment of bankruptcy, but came into being thereafter upon the election of the claimant, the claim was not provable.²³ This test was premised on the common law notion that rent proceeds from the soil, and is not earned until occupancy

20. In re Sherwoods, 210 Fed. 754 (C. C. A. 2d, 1913).

21. *Manhattan Properties, Inc. v. Irving Trust Co.*, 291 U. S. 320 (1934); In re Roth & Appel, 181 Fed. 667 (C. C. A. 2d, 1910). The claim in the latter case was for rent accruing after the petition was filed. See also, *Trust Co. of Georgia v. Whitehall Holding Co.*, 53 F. (2d) 635 (C. C. A. 5th, 1931); In re Outfitters' Operating Realty Co., 69 F. (2d) 484 (C. C. A. 2d, 1934); In re Blum Bros. Co., 55 F. (2d) 723 (S. D. Ohio, 1932). As to claims other than for rent, the courts have taken a contrary view. Thus in *Maynard v. Elliott*, 283 U. S. 273 (1931), the claimant held notes endorsed by the bankrupt and, although some of the notes were payable a year or more after the adjudication, nevertheless, the claim was held to be provable. The Court declared that claims founded upon contracts which are fixed in amount or susceptible of liquidation may be proved although they are not absolutely owing at the time the bankruptcy petition is filed. For a review of the authorities prior to the *Manhattan Properties* case, see Clark, Foley and Shaw, *Adoption and Rejection of Contracts and Leases by Receivers* (1933) 46 HARV. L. REV. 1111; Douglas and Frank, *Landlords' Claims in Reorganizations* (1933) 42 YALE L. J. 1003; Schwabacker and Weinstein, *Rent Claims in Bankruptcy* (1933) 33 COL. L. REV. 213; Schmitt, *Rights of the Landlord* (1933) 5 MISS. L. J. 147.

22. 291 U. S. 320 (1934).

23. The conclusion of the *Manhattan Properties* case was independently reached and applied to an accelerated rent claim in the case of *In re Van Fleet*, 4 Fed. Supp. 332 (W. D. Pa. 1933).

is enjoyed. If, therefore, a claim is strictly one of unaccrued rent, it is contingent and unprovable. But if the breach of a lease covenant may be classed in some other category, it might be provable.

Acting upon this legal proposition, attornies for landlords endeavored so to draft leases that at least some of the lessor's payments would not be construed as rent, and consequently, that covenants indemnifying the landlord in case of premature termination of the lease would not be construed as rent acceleration clauses. Thus, in *Perry v. Irving Trust Company*²⁴ the lease agreement provided that the filing of a petition in bankruptcy by the lessee would *ipso facto* terminate the lease and entitle the lessee to an amount equal to the rent reserved for the remainder of the lease term less the fair rental value of the premises for the remainder of the term. Such a covenant was held to provide a legitimate liquidation of contingent damages²⁵ by the parties themselves, and hence not to be void as placing a penalty upon the lessee. And since the lessee-debtor's liability to his lessor-creditor was not made contingent upon the exercise of any option by the latter, but vested immediately upon the former's filing of a petition in bankruptcy, the claim was declared by the Court to be provable in bankruptcy.

The following situations similarly illustrate the attempts of the federal courts under the former Section 63 (a) to determine whether or not a landlord's claim was for rent, and therefore contingent and unprovable. Thus claims based upon a lease agreement containing a covenant on the part of the lessee to purchase the premises during the lease term and to make instalment payments of fixed amounts were held not to be rent claims and hence were declared to be provable in bankruptcy.²⁶ Claims based on the bankrupt's guaranty of rent payments by a solvent lessee who had not defaulted on the rent were not provable, even though the bankrupt guarantor and the lessee were members of the same intercorporate set-up.²⁷ Similarly unprovable were claims for the recovery of sums paid to a bankrupt in consideration of the assignment of a lease by the bankrupt,²⁸ or for the recovery of sums which the bankrupt had agree to pay in the future instalments for the assignment of a lease to it.²⁹ Where the lessee, desiring to remodel the premises in order that all its stores conform to certain architectural and decorative specific-

24. 293 U. S. 307 (1934); Note (1935) 44 YALE L. J. 670.

25. See *Kothe v. R. C. Taylor Trust*, 280 U. S. 224 (1930).

26. *In re Marshall's Garage, Inc.*, 63 F. (2d) 759 (C. C. A. 2d, 1933).

27. *Marshall & Ilsley Bank v. Irving Trust Co.*, 70 F. (2d) 691 (C. C. A. 2d, 1934); cf. *Central Trust Co. v. Chicago Auditorium*, 240 U. S. 581 (1916); *Trust Co. of Georgia v. Whitehall Holding Co.*, 53 F. (2d) 635 (C. C. A. 5th, 1931).

28. *Cloudy Realty Corp. v. Irving Trust Co.*, 70 F. (2d) 263 (C. C. A. 2d, 1934), cert. denied, 292 U. S. 653 (1934).

29. *Wright v. Irving Trust Co.*, 70 F. (2d) 245 (C. C. A. 2d, 1934).

ations, covenanted to restore the premises to their former condition at the end of the lease term or at its expiration by operation of law, and where the lease was terminated by the lessee's bankruptcy, conflicting results were reached as to whether the landlord's claim based upon the covenant to restore the premises was for rent and therefore unprovable.³⁰ Similar conflict existed as to claims upon lease covenants by which the lessor advanced money to the lessee to improve the property and the money was repayable in instalments over the lease term.³¹ Where the covenant breached by the lessee was one to erect a building upon the premises during the lease period, the choice of words used by the parties as to when the claim vested and the method of calculating the damages was determinative of the issue of provability.³² Such was the status of legal decisions prior to the 1934 amendments to the Bankruptcy Act, which attempted to modify some of the above rules concerning landlord claims.

Section 63 (a) was changed to provide that "claims for damages respecting executory contracts including future rents" shall henceforth be provable in ordinary bankruptcy proceedings, with the stipulation, however, that the claim of a landlord for injury resulting from the rejection by the trustee in bankruptcy of an unexpired lease or for damages or indemnity under a covenant contained in such lease shall be limited to one year's future rent.³³ Section 77B similarly renders future

30. In the case of *In re Metropolitan Chain Stores, Inc.*, 66 F. (2d) 485 (C. C. A. 2d, 1933), such a claim was held provable. However, the same court in the case of *In re F. & W. Grand 5-10-25 Cent Stores, Inc.*, 69 F. (2d) 807 (C. C. A. 2d, 1934), held that in view of the *Manhattan Properties* decision such a claim was unprovable. Cf. *McDonnell v. Woods*, 298 Fed. 434 (C. C. A. 1st, 1924); *In re Barton Co.*, 34 F. (2d) 517 (D. N. H. 1929).

31. Held to be provable in *Trust Co. of Georgia v. Whitehall Holding Co.* 53 F. (2d) 635 (C. C. A. 5th, 1931); *Winston-Salem Masonic Temple Co. v. Irving Trust Co.*, 69 F. (2d) 484 (C. C. A. 2d, 1934). Held to be unprovable in *In re H. M. Lasker Co., Inc.*, 251 Fed. 53 (C. C. A. 3d, 1918); *In re Boggs-Rice Co. Inc.*, 4 F. Supp. 431 (W. D. Va. 1933).

32. In *In re Metropolitan Chain Stores, Inc.*, 2 F. Supp. 287 (S. D. N. Y. 1932), such a claim was allowed; but the same court in *In re Schulte-United, Inc.*, 2 F. Supp. 285 (S. D. N. Y. 1932), disallowed the claim by distinguishing the facts and the wording of the lease from that in the former case.

33. "(a) Debts of the bankrupt may be proved and allowed against his estate which are . . . (7) claims for damages respecting executory contracts including future rents whether the bankrupt be an individual or a corporation, but the claim of a landlord for injury resulting from the rejection by the trustee of an unexpired lease of real estate, or for damages or indemnity under a covenant contained in such lease shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises plus an amount equal to the unpaid rent accrued up to said date: *Provided*, that the court shall scrutinize the circumstances of an assignment of future rent claims and the amount of the consideration paid for such assignment in determining the amount of damages allowed assignee hereunder." 48 STAT. 991, 11 U. S. C. A. § 103 (1934).

rent claims provable for reorganization purposes on a parity with other claims, and limits them to three years future rent.³⁴ Both declare that "the court shall scrutinize the circumstances of an assignment of future rent claims and the amount of the consideration paid for such assignment in determining the amount of damages allowed the assignee hereunder."³⁵ Do these statutory changes abolish the previous judicial distinctions between the various types of landlord claims? Are all landlord claims under all varieties of acceleration and indemnity clauses to be treated alike? Are all types of landlord claims henceforth limited to three years future rent in corporate reorganizations? If not, then to what kind of claims do these limitations apply?

Section 77B does not, as some attorneys seem to think, allow the proof of claims for future rent as such. Rather, it provides that the landlord shall henceforth have a claim for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease.³⁶ Thus if the landlord claimant should file his claim for rent for the balance of the lease term rather than for damages—i.e., the difference between the rent reserved in the lease for the balance of the lease term and the fair rental value of the premises for that period—his claim must be rejected. Moreover, not all types of landlord claims that formerly were unprovable are rendered provable by the terms of this Section. The Act provides that the landlord shall be deemed a creditor only if the executory contract or unexpired lease shall be rejected in a reorganization proceeding, or shall have been rejected by a trustee in bankruptcy in a proceeding pending prior to the institution of reorganization proceedings.³⁷ It is important to reiterate

34. "In case an executory contract or unexpired lease of real estate shall be rejected pursuant to direction of the judge given in a proceeding instituted under this section, or shall have been rejected by a trustee or receiver in bankruptcy or receiver in equity, in a proceeding pending prior to the institution of a proceeding under this section any person injured by such rejection shall, for all purposes of this section and of the reorganization plan, its acceptance and confirmation, be deemed to be a creditor. The claim of a landlord for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall be treated as a claim ranking on a parity with debts which would be provable under Section 63 (a) of this Act, but shall be limited to an amount not to exceed the rent, without acceleration, reserved by said lease for the three years next succeeding the date of surrender of the premises to the landlord or the date of re-entry of the landlord, whichever first occurs, whether before or after the filing of the petition, plus unpaid rent accrued up to such date of surrender or re-entry: *Provided*, that the court shall scrutinize the circumstances of an assignment of future rent claims and the amount of the consideration paid for such assignment in determining the amount of damages allowed assignee hereunder." 48 STAT. 912, 11 U. S. C. A. § 207 (1934).

35. *Supra* notes 33 and 34.

36. § 77B (b), see *supra* note 34.

37. *Ibid.* The Act specifically provides that after or upon the approval of the re-

that a claimant cannot be deemed a creditor, for the purpose of this new right, unless he brings himself within the class of "any person injured by such rejection."³⁸

In rendering provable the above claim of the landlord for injury resulting from the rejection of an unexpired lease or for damages or indemnity under a lease covenant, Section 77B restricts the maximum recovery of the landlord to "an amount not to exceed the rent, without acceleration, reserved by said lease for the three years next succeeding the date of surrender of the premises to the landlord or the date of re-entry of the landlord, whichever first occurs . . . plus unpaid rent accrued up to such date of surrender or reentry."³⁹ This three year limitation, however, is not applicable to landlord claims that were already provable under the former Section 63 (a). The Act specifically refers to claims resulting from the rejection by the trustee of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such a lease,⁴⁰ and thereby includes under the three year provision only unexpired leases that have been rejected. This provision would not seem to include the *Perry* case⁴¹ situation, since the court there held the claim to be based on an independent express covenant which terminated the lease upon bankruptcy so that it was not unexpired and could not be rejected by the trustee. To reach the contrary result would require holding that a lease which had terminated by its own terms had not expired, and would seem to conflict with the usual rule of statutory construction, that already existing rights are only to be overruled by express repeal. The only case that has arisen under Section 77B where it has been necessary to determine the application of the three year rent limitation is the Radio-Keith-Orpheum reorganization. There the lessee had covenanted to pay over a period of years the unamortized costs of constructing the leased theatres. The special master reached the conclusion that the claim based upon the breach of this covenant was not for future rent *per se*, but rather was a species of landlord claims that previously had been provable under the old Section 63 (a). Accordingly, the landlord was held entitled to prove his claim for his entire damages, and was not restricted in any manner by the three year future rent clause.⁴²

Where the landlord claim is one rendered provable by Section 77B, although not provable under the former Section 63 (a), it is important to determine whether the claim is limited to three years future rent or

organization petition, the judge "may direct the rejection of contracts of the debtor executory in whole or in part." § 77B (c, 5); 48 STAT. 912, 11 U. S. C. A. § 207 (1934).

38. *Ibid.*

39. § 77B (b); see *supra* note 34.

40. *Ibid.*

41. See *supra* note 24.

42. Report of Special Master, In the Matter of Radio-Keith-Orpheum Corporation, U. S. Dist. Ct. (S. D. N. Y.) June 12, 1935.

whether the landlord, in addition, has a right, under the doctrine of the *Boyd* case,⁴³ to share in the reorganization for his damages resulting from the rejection of the lease beyond the three year period. Prior to the enactment of Section 77B, a claim for future rent *per se*, not being provable, was not discharged upon the debtor's release from bankruptcy;⁴⁴ and theoretically at least, the landlord could pursue his claim against the discharged debtor. And under the doctrine of the *Boyd* case⁴⁵ such a claimant was entitled in the case of a subsequent corporate reorganization to priority to stockholders in the assets of the bankrupt corporation, and, if not granted an "equitable settlement," he was entitled to pursue the assets against the successor corporation. Thus if a reorganization plan, which provided for participation by the stockholders of the old company upon the payment of some cash, made no provision for unsecured creditors, and if in resulting litigation by unsecured creditors, it had been determined that the assets of the old company were insufficient to pay the mortgage debts, and that consequently there was no equity in the property out of which to pay off the unsecured creditors, the claimant could collect from the new corporation. The Supreme Court reached this result in the *Boyd* case by holding that the conveyance to the new company was fraudulent as to creditors who had been omitted from the reorganization plan. If Section 77B has abrogated this doctrine of the *Boyd* case, then the landlord, filing a claim for future rent, is limited to a recovery of three years future rent; but if the *Boyd* case is still good law under Section 77B, then some provision must be made in reorganizations for future rent claims beyond the three year period.

While Section 77B is not explicit on this point, several provisions suggest that the *Boyd* case has, in fact, been overruled. In the first

43. 228 U. S. 482 (1913).

44. *Dunbar v. Dunbar*, 190 U. S. 340 (1903); *In re Frischknecht*, 223 Fed. 417 (C. C. A. 2d, 1915); *In re United Button Co.*, 140 Fed. 495 (D. Del. 1906), *aff'd*, 149 Fed. 48 (C. C. A. 3d, 1906); *In re Gerson*, 105 Fed. 891 (E. D. Pa. 1901).

45. Briefly stated, the facts of the *Boyd* case are as follows: A reorganization plan, which provided for participation by the stockholders of the old company upon the payment of some cash, made no provision for unsecured creditors, and it had been judicially determined that there was no equity in the property out of which to pay off the unsecured creditors. Later *Boyd*, an unsecured creditor, brought suit against the new, reorganized company. The Supreme Court held, in effect, that the conveyance to the new company was fraudulent as to such creditors and decided that *Boyd* could pursue his remedy against the property of the new company which it had acquired from the old corporation. This decision reiterated the principle enunciated in *Railroad Company v. Howard*, 74 U. S. 392 (1868), and *Louisville Trust Co. v. Louisville Ry. Co.*, 174 U. S. 674 (1899). For analyses of the *Boyd* case doctrine, see Douglas and Frank, *Landlords' Claims in Reorganizations* (1933) 42 YALE L. J. 1003; Gerdes, *A Fair and Equitable Plan of Corporate Reorganization under Section 77B of the Bankruptcy Act* (1934) 12 N. Y. U. L. Q. REV. 1; Foster, *Conflicting Ideals for Reorganization* (1935) 44 YALE L. J. 923.

place, Section 77B provides that upon the confirmation of a reorganization plan, the property of the debtor shall be conveyed pursuant to the plan free and clear of all claims and that the final decree shall discharge the debtor from all its debts and liabilities.⁴⁶ In this important respect Section 77B makes a radical departure from the old bankruptcy rules that unprovable claims are not discharged and that the claimant of an unprovable claim may attempt to secure satisfaction from the debtor after his bankruptcy discharge. In the second place, it provides only one measure of damages for landlords whose leases are rejected, namely, that their proof of claim shall be limited to three years future rent.⁴⁷ Nowhere does the act, in outlining the rights of landlord, declare that he shall be entitled to three years future rent plus additional claims, prior to those of the stockholders, for loss of rent on the remainder of the lease term. The new future rent clause was undoubtedly inserted into the Bankruptcy Act to save the landlord from the inequities that frequently resulted from compelling him to pursue his claim against the discharged bankrupt; and, as a *quid pro quo* for this new right, Congress limited his claim to three years future rent. For, if landlords, especially in chain store reorganizations, were permitted to come into the reorganization ahead of the stockholders for indefinite future rent claims under the *Boyd* case doctrine, the equities of the stockholders in most instances would be wiped out. And finally, an earlier draft of Section 77B, giving landlords a right to claim damages to the extent of one year future rent on par with other creditors and retain the remainder of their claims

46. "(g) Upon such confirmation the provision of the plan and of the order of confirmation shall be binding upon (1) the debtor, (2) all stockholders thereof, including those who have not, as well as those who have, accepted it, and (3) all creditors, secured or unsecured, whether or not affected by the plan, and whether or not their claims shall have been filed, and, if filed, whether or not approved, including creditors who have not, as well as those who have, accepted it.

"(h) Upon final confirmation of the plan, the debtor and other corporation or corporations organized or to be organized for the purpose of carrying out the plan, shall have full power and authority to, and shall put into effect and carry out the plan and the orders of the judge relative thereto, under and subject to the supervision and control of the judge, and the property dealt with by the plan, when transferred and conveyed by the trustee or trustees to the debtor or the other corporation or corporations provided for by the plan, or, if no trustee has been appointed, when retained by the debtor pursuant to the plan or transferred by it to the other corporation or corporations provided for by the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention. . . ." 48 STAT. 912, 11 U. S. C. A. § 207 (1934). It may be, however, that in passing upon the fairness of a proposed plan, a judge may require that provision be made for the payment of contingent claims.

47. *Supra* note 34.

in a subordinate rank,⁴⁸ was amended so as to eliminate all claims for unexpired lease rent beyond three years rent.⁴⁹ This deliberate elimination by Congress of the balance of the landlord's claim over and above the three year claim for damages, considered in the light of the express intention to discharge the debtor and its assets from all claims upon the confirmation of a reorganization plan by the court, seems to refute completely the contention that lessors are entitled to recovery under the *Boyd* case doctrine.

Of all the landlord claims provisions in Section 77B, probably the most difficult to construe and apply is the "scrutiny" clause.⁵⁰ In the *McCrory* case the court did not find it necessary to rule definitely upon the construction of that proviso, inasmuch as it held that, upon the principles of constructive trusts, the assignee of the landlord claims in that case was not entitled to profits from its misconduct.⁵¹ But suppose the conduct of *B* Company and *C* had been such that they were not guilty of

48. "Provided, that the claim of a landlord for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall not be treated as a claim ranking on a parity with debts which would be provable under Section 63 (a) of this Act, except up to an amount equal to the rent reserved by said lease for the year next succeeding the date of the order approving the petition or answer under this section plus an amount equal to the unpaid rent accrued up to said date, but the balance, if any, of such claim shall be subordinate in rank to debts so provable." Hearing on H. R. 5884, 73d Cong., 2d Sess., March 15, 1934.

49. H. R. REP. No. 1821 (Conference Committee) 73d Cong., 2d Sess. (1934). Nor is there any constitutional reason why Congress could not limit a landlord to a recovery of a maximum amount of damages measured by the three year period. Congress had created a new right in allowing the landlord to prove any damages in a bankruptcy proceeding whatsoever, and Congress could place conditions and limitations upon the exercise of that new right. Certainly any landlord who files a claim in a Section 77B proceeding must have waived any constitutional objection that he may have had against the three year rent limitation, by indicating his willingness to accept the new right enacted by the statute. See *Clay v. Smith*, 28 U. S. 411 (1830); *Daniels v. Tearney*, 102 U. S. 415 (1880); *Béaupre v. Noyes*, 138 U. S. 397 (1891); *Eustis v. Bolles*, 150 U. S. 361 (1893).

50. See *supra*, note 34.

51. "The opponents of the plan appeal to the 'scrutiny clause' in section (b) of the Act as an independent ground of holding the United down to bare cost. . . . The argument is that the 'scrutiny clause' establishes a new rule of substantive law, that under the act assignees of rent claims are not to have the rights of their assignors. I am of the view that the clause does not go that far. If Congress had intended that the claim of the assignee should be restricted to what he had paid for the claim it would have been simple to say so. Moreover, on such a construction a scrutiny of the 'circumstances' of an assignment would be superfluous; the only inquiry would be as to the 'amount' paid. Proper effect is given to the 'scrutiny clause' by holding that the circumstances of the assignment and the amount paid by the assignee shall be of evidentiary force in deciding how much the claim is really worth. The clause may have also been intended as a caution or reminder to the courts to take pains to determine whether settled principles of equity may not disable an assignee of such a claim from enforcing the claim for more than the amount he paid for it, an instance being this very case." In the Matter of *McCrory Stores Corporation*, U. S. Dist. Ct. (S. D. N. Y.) September 30, 1935.

any breach of fiduciary duty; suppose their sole participation in the reorganization had been that of speculators purchasing landlord claims at a discount.

A reading of the entire Section 77B conveys a definite impression that the object of Congress in inserting the scrutiny proviso was to secure a judicial examination of assignments in order to prevent piratical speculation in landlord claims, such as has occurred in well nigh every recent chain store reorganization both prior and subsequent to the enactment of this legislation. Under Section 77B (f), the court, before it accepts a reorganization plan, must not only be satisfied that it is fair and equitable and not unfairly discriminatory in favor of any class of creditors or stockholders, but it must, in addition, see to it that the proposed plan complies with the provisions of subdivision (b). The instruction to scrutinize assigned landlord claims is a significant part of the latter subdivision. A similar instruction for scrutinization is found in Section 77B (b) regarding depositary agreements, trust indentures, and committee authorizations; and in interpreting this requirement, the Circuit Court of Appeals, in the case of *In re Fox Metropolitan Playhouses, Inc.*,⁵² said:

"Subdivision (b) of Section 77B (11 U. S. C. A. § 207b) provides that the judge shall 'scrutinize and may disregard any limitations or provisions of any depositary agreements, trust indentures, committee or other authorizations affecting any creditor acting under this section and may enforce an accounting thereunder or restrain the exercise of any power which he finds to be unfair or not consistent with public policy and may limit any claim filed by such committee member or agent, to the actual consideration paid therefor.'

"Thus this petitioner is afforded an opportunity to show, when the plan is considered, whether any of the noteholders' committee members have purchased bonds and are now attempting to obtain higher prices for them or are otherwise profiting from the plan of reorganization. If called to the court's attention, subdivision (b) becomes operative and will be a curb against such profiteering."

The natural desire of speculators to seek to capture the management of a reorganized corporation by purchasing the claims of landlords, in the manner attempted in the *McCrary* case, is well known. The activities of such financial pirates very often leads to litigation and delay, if not to prevention of fair settlement. These results were disapproved of before the enactment of '77B, and it is reasonable to believe that the scrutiny clause was aimed at preventing them.

Thus, it is made mandatory that the court scrutinize the circumstances of an assignment of future rent claims and the amount of consideration paid for such assignment. Moreover, the critical investiga-

52. 74 F. (2d) 722, 724 (C. C. A. 2d, 1935).

tion, implied in the word "scrutinize,"⁵³ demands that, where an assignee controls a group of landlord claims, as the *B Company* did in the *McCrorry* case, each assignment must be separately examined. Thus the court is instructed to scrutinize "the circumstances of *an* assignment . . . and the amount of consideration paid for *such* assignment."⁵⁴ Consequently, if the court approves a reorganization plan without being thoroughly informed as to the circumstances of each assignment of future rent claims, its confirmation constitutes reversible error.⁵⁵

In addition to the admonition to the court that it determine all the facts relative to assignments of landlord claims, the "scrutiny" clause seems to be intended to have some effect upon the rights of the parties to share in the reorganized corporation. The very terms of this clause, taken literally, indicate that, regardless of the amount of damages which might be allowed to a landlord, circumstances may require that the landlord's assignee be limited to the amount of consideration which he paid for the claim. To what end does Congress direct the court to scrutinize the circumstances of, and the consideration for the assignment? The answer is found in the words "in determining the amount of damages allowed assignee hereunder." This analysis leads to the conclusion that, where an assignee of the landlord claim is a speculator seeking to profit through the reorganization, his maximum provable allowance may be limited to the consideration he paid, plus possibly a reasonable allowance for his efforts insofar as they actually facilitated the reorganization.

This conclusion is substantiated by an analysis of Section 77B. The primary purpose of the Section was to facilitate corporate reorganizations, to provide for readjustments in the capital structure of embarrassed debtors so as to permit them to continue in business without wiping out the interests of their stockholders.⁵⁶ At the same time, Congress was familiar with the situation of landlords who had no prov-

53. See *Commonwealth v. White*, 271 Pa. 584, 115 Atl. 870 (1922).

54. *Supra* note 34.

55. Even without this statutory requirement, it would be mandatory upon the court to examine carefully into the assignment of future rent claims. In corporate equity reorganization cases, the United States Supreme Court has held that it is error for a lower court to approve a reorganization plan as fair and equitable without full information. *National Surety Co. v. Coriell*, 289 U. S. 427, 435, 436 (1933); *First National Bank v. Flershem*, 290 U. S. 504, 525 (1934); see also, *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U. S. 445, 455 (1926); *Palmer v. Bankers' Trust Co.*, 12 F. (2d) 747, 754 (C. C. A. 8th, 1926); PAYNE, PLANS OF CORPORATE REORGANIZATION 76. These decisions are applicable in Section 77B reorganizations. In re *National Public Service Corp.*, 68 F. (2d) 859, 862 (C. C. A. 2d, 1934).

56. In re *Allied Owners' Corp.* 74 F. (2d) 201 (C. C. A. 2d, 1934); *Campbell v. Alleghany Corp.*, 75 F. (2d) 947 (C. C. A. 4th, 1934); In re *National Lock Co.*, 9 F. Supp. 432, 434 (N. D. Ill. 1934).

able claim in bankruptcy for future rent. Its members were aware that many reorganizations had been consummated in which landlords' claims had been disregarded. Thus, while endeavoring to save embarrassed corporations for the owners of the equity, Congress at the same time wished to do a measure of justice to landlords, and provided a new right for them in Section 77B. This was the right, if the facts so warranted, to prove damages to an amount not exceeding three years future rent. Assignees of landlords, however, stood on a different footing. There was no need to protect them. Lack of protection to assignees of lessors most assuredly was not an evil to be remedied. If the landlords alone were protected by the new right, the purpose of Congress was subserved.

Congress had ample reason to make a distinction between the claim of the landlord and that of his assignee. The landlord's claim was itself notoriously uncertain and speculative, so that the landlord could easily be subject to overreaching by acquisitive assignees. The wholesale acquisition of landlord claims by an assignee interested in obtaining a position for himself in a reorganization could well be deemed repugnant to the spirit of the Act. Moreover, since the landlord claims would, despite the limitation of three years maximum rent, still be uncertain and speculative, assignment would tend to breed litigation. The landlord normally is interested in maintaining a continuous relationship with his tenant; and without interference by outsiders, whether assignees or not, the differences between the landlord and the embarrassed tenant debtor are normally composed satisfactorily. This relationship is wholly lost when the claim is separated from the ownership of the land and the assignee is interested solely in extracting the maximum amount of damages without reference to its effects upon the continuance of the business.

An examination of the type situations that arise in chain store reorganization likewise leads to this same conclusion. Thus if *X* bought a future rent claim with a provable value of \$100,000 for a consideration of \$30,000, and if the circumstances demonstrate that the lease, and the lease covenant for indemnity by the tenant, in the case of his breach of the lease or of the legal re-entry by the landlord, had been assigned to *X* as security for a loan, perhaps, prior to the filing of a reorganization petition under Section 77B or the commencement of bankruptcy proceedings, and that the assignment had no connection with such proceedings, then *X* would be entitled to \$100,000. Again, the future rent claims may be shown to have been purchased in good faith by a bona fide stockholders' or creditors' committee in order to facilitate the reorganization, or the landlord may have assigned his claim to a bona fide landlords' committee for the same purpose. If the scrutiny of the circumstances of the assignment clearly demonstrates that the committee

was not endeavoring to profiteer against the corporation but was merely employing the claims to facilitate the reorganization, then possibly the assignee should not be penalized in determining the measure of its recovery. But, on the other hand, if the circumstances of an assignment demonstrate that *X* had contacted the landlords, had purchased their claims at a discount, possibly by misrepresenting to them the true prospects of the reorganization, had thereby prevented the corporation to its detriment from dealing directly with its individual lessors and from compromising with them their individual claims, and now is seeking to profit by his transactions, the court would be justified, possibly even required, to limit the assignee's recovery to the actual consideration which he paid. This would be the most effective method of curbing profiteering in such claims. Furthermore, if *X* paid \$30,000 for a claim and if the debtor would clearly have been able to compromise that claim with the landlord for \$20,000, then the damages recoverable by *X* may be limited to \$20,000. *X*'s intermeddling should not be permitted to operate adversely to the financial interests of the debtor corporation. Such a circumstance would warrant punitive damages against the assignee to the extent of the loss to the debtor corporation.

In opposition to this analysis it may be urged that the restrictions upon assignees is contrary to public policy. But at the early common law, choses in action were, with few exceptions, not assignable at all unless the debtor assented to the assignment and promised to pay the assignee.⁵⁷ The courts were then of the opinion that to permit an assignment of the right to repair to the courts would unduly encourage litigation. In modern times also, numerous prohibitions and restrictions upon assignments exist. For example, the right to receive alimony or separate maintenance allowances has been declared to be non-assignable.⁵⁸ In many jurisdictions, statutes have been enacted prohibiting and declaring void assignments of future wages except such as fall within the exceptions and conditions named in such statutes.⁵⁹ And the assignment by certain classes of public servants of their unearned salaries or fees of office have been forbidden by statute in many states, and even in the absence of statute the great weight of authority is to the effect that an assignment by a public officer of his unearned salaries or fees is void

57. *Tiernan v. Jackson*, 30 U. S. 580 (1831); *Burke's Case*, 13 Ct. of Cl. 231 (1877); *Cavender's Case*, 8 Ct. of Cl. 281 (1872); *Brush v. Curtis*, 4 Conn. 312 (1822).

58. *Jordan v. Westerman*, 62 Mich. 170, 28 N. W. 826 (1886); *Bigelow v. Old Dominion Copper Mining Co.*, 74 N. J. Eq. 457, 71 Atl. 153 (Ch. 1908); *Lynde v. Lynde*, 64 N. J. Eq. 763, 52 Atl. 694 (1902); *Mann v. Herkimer County Mutual Insurance Co.*, 4 Hill 187 (N. Y. 1843); *Kempster v. Evans*, 81 Wis. 274, 51 N. W. 327 (1892).

59. CONN. GEN. STAT., 1902, § 836; MASS. ACES, 1905, at 308; N. Y. CONSOL. LAWS, 1909, c. 41, § 42.

as against public policy.⁶⁰ And Congress has placed rigid restrictions upon the assignment of claims against the federal government.⁶¹

It seems desirable to extend the operation of the "scrutiny" clause beyond those circumstances where the assignee comes into court with unclean hands, or has, as in the *McCrory* case, acquired the assigned claims under such circumstances that he should be held to be a fiduciary for the debtor or the reorganized company. This again is merely an effort to render meaningful the words which Congress intended to have effect. If the sole purpose of the "scrutiny" clause were to instruct the court to apply long established doctrines of equity jurisprudence, that provision is mere verbiage. To give meaning, as is required by the rules of statutory construction, to all the provisions of the statute, it is necessary to apply the "scrutiny" clause to the typical case where the evidence does not rise to that degree of proof which would enable the court to treat the assignee as a constructive trustee, but where the circumstances are such that it would be unfair and inequitable to allow him damages to the full extent to which the landlord might have been able to prove.

The above analysis indicates that ambiguity, nevertheless, exists as to the true intent of Congress. The very attempts of the court and special master in the *McCrory* case to avoid the necessity of construing the landlord claim provisions of the act demonstrates this uncertainty. If Section 77B is to function adequately in facilitating fair plans of reorganizations, it seems desirable that Congress amend the statute to indicate clearly the types of landlord claims that are provable for reorganization purposes, the types of claims that are to be limited by the three years rent clause, the rights of landlords beyond the three years rent, and the rights of assignees of landlord claims. Judicial determination of these questions cannot safely be awaited. For, wherever possible, courts anxious to facilitate reorganizations will, as was done in the *McCrory* case, side-step the issues, and if necessary, even make legally unnecessary concessions to landlords and assignees who threaten to prosecute their alleged rights to the highest court and thus postpone the debtor's reorganization indefinitely.

60. *Emerson v. Hall*, 39 U. S. 409 (1839); *Dunkley v. Marquette*, 157 Mich. 339, 122 N. W. 126 (1909); *Swenk v. Wyckoff*, 46 N. J. Eq. 560, 20 Atl. 259 (1890); *Blicz v. Lawrence*, 58 N. Y. 442 (1874).

61. 35 STAT. 411, 31 U. S. C. A. § 203.