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COMMENTS

SUMMARY JURISDICTION OF THE CHAPTER X COURT IN CORPORATE REORGANIZATION

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An interesting fusion of two long-developing lines of legal thought is expressed in the recent decision of the U. S. Court of Appeals for the Third Circuit in *Matter of International Power Securities Corporation*,¹ a debtor in reorganization under Chapter X of the Bankruptcy Act. It is first an extension of the doctrine of unification of control by a single court over the property and affairs of a debtor under its protection, and, second, an assertion of the great breadth of the court's jurisdiction over all matters prerequisite to the debtor's reorganization.

The debtor, International Power Securities Corporation, has as its principal assets certain mortgages on power plants in Italy owned by Societa Edison of Milan, an Italian corporation. These mortgages formed the collateral behind the debtor's own publicly-held bond issues. By the terms of the mortgages Societa Edison was permitted to pay off its obligations to the debtor corporation by turning in the debtor's bonds, in lieu of cash, for amortization payments, and bond interest coupons, in lieu of cash, for its own interest payments. In 1940 Societa Edison failed to pay the interest on its mortgages, and as a result the debtor was forced to default on the interest payments on its bonds. Amortization of Societa Edison's mortgages and of the debtor's bonds has likewise ceased.

The two blocks of bonds which were the subject of the order appealed from totalled almost one-third of the debtor's outstanding obligations. One block, \$3,929,000 in face amount, was concededly owned by Societa Edison and was held in Italy. The other, \$1,250,000 in face amount, was held at the National City Bank of New York, ostensibly for account of the Banco di Roma of Lugano, Switzerland. Upon the petition of the disinterested trustee, who claimed that the latter block of bonds was in fact owned by Societa Edison and that, therefore, rights of set-off or counterclaim existed as long as the bonds were so owned, the District Court for New Jersey issued a temporary injunction restraining the two banks and Societa Edison from selling or otherwise disposing of them. All three appeared specially to contest the court's jurisdiction. None of them had appeared in the proceeding or done business within the District of New Jersey. Notice of the trustee's application was served on Societa Edison and the National City Bank outside the district and on the Swiss bank by mail. The court continued the temporary injunction until a later hearing at which proofs were submitted as to the ownership of the \$1,250,000 of bonds. At that hearing the banks renewed their jurisdictional objections, pointing out (1) that both the bonds and the banks were outside the normal territorial jurisdiction of the court, and (2) the summary extraterritorial jurisdiction of the bankruptcy

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1. 170 F. 2d 399 (C. A. 3d 1948).

court under Chapter X did not apply here because this type of jurisdiction could be used only to protect the debtor's assets, whereas the bonds in question were the debtor's liability. The court did not specifically rule on the jurisdictional question. The proofs showed that one Valerio, general manager of Societa Edison, retained an agent in this country to purchase the bonds, that Valerio specifically approved in advance the purchase of at least \$1,048,000 of the \$1,250,000 and that he supplied the funds to finance the acquisitions. When Valerio found difficulty in transmitting funds from Italy, his agent borrowed money from the National City Bank for that purpose, informing the bank that the loan was to finance the purchase of the bonds for Societa Edison. Despite these facts, the District Court was unconvinced that Societa Edison owned the bonds, but it lifted the restraint against the banks while continuing it against Societa Edison, on the theory that if Edison were in fact the owner, the restraint against it would adequately protect the debtor's estate.

The Court of Appeals held that not only did the District Court have the right to enjoin the banks and Societa Edison from selling the bonds but that the lifting of the injunction as to the banks was reversible error since in view of what it called Societa Edison's "hidden ball play" the continuance of the injunction against Societa Edison alone was inadequate to meet the needs of the situation.

The decision rests mainly on the extraterritorial power of the reorganization court, as a court of bankruptcy,² to protect the debtor's property. It specifically holds that the right of equitable set-off here asserted by the trustee is property which the court could protect, though it points out the necessity of drawing a sharp distinction between the *protection* of choses in action and their *enforcement*. Yet the decision can be considered from another point of view as well. It is a development of the law of reorganization as distinct from the law pertaining to the bankruptcy powers. Since Chapter X traces its history from equity receiverships, via the former Section 77B, there is a merger of the equity receivership and bankruptcy concepts resulting in the fullest powers of both being concentrated in the reorganization court. Let us look at such a court from both viewpoints.

Tracing first the scope of that court's bankruptcy powers, we may note first that it has broad statutory authority to make orders, issue process and enter judgments so as to carry out the purposes of the Act.³ Its control comprehends all property of the debtor in the court's actual or constructive possession, wherever located.⁴ And its administration of the estate can be carried on within its own four walls without the cumbersome ancillary procedures necessary in equity receiverships.⁵ The extreme limit of a bankruptcy court's summary

2. Under Chapter X, reorganization courts have substantially the same jurisdiction and powers, both before and after the approval of a petition, as an ordinary bankruptcy court has before and after adjudication, 52 STAT. 884 (1938) 11 U. S. C. §§ 512, 514 (1940).

3. 30 STAT. 545 (1898), as amended, 52 STAT. 842 (1938), 11 U. S. C. § 11 (a-15) (1940).

4. The language of former § 77B giving the court exclusive jurisdiction of the debtor and its property wherever located was incorporated into Chapter X. 52 STAT. 884 (1938), 11 U. S. C. § 511 (1940).

5. One of the main objectives of § 77B was to obviate the need for ancillary receiver-

jurisdiction, before the passage of Section 77B and Chapter X, was generally stated to be about as follows: that it could not adjudicate a controversy about property held adversely to the bankrupt estate under a substantial claim of right, unless the adverse claimant consented.⁶ That rule was not literally true even in straight bankruptcy proceedings. The trustee was, and is, vested with property which the bankrupt had fraudulently conveyed⁷ or preferentially transferred,⁸ whatever the actual good faith of the transferee and despite the fact that in either case the bankrupt has always parted with his interest in the property.

Today, the power of the bankruptcy court over property of the estate is liberally used by reorganization courts for the collection and distribution of the assets of the debtor. This power is indulged in even to the extent of enjoining activities which might adversely affect the debtor's property. Thus, in *Continental Illinois Nat. Bank & Trust Co. v. Chicago, R. I. & Pac. Ry.*,⁹ it was held proper for the court in a summary proceeding to enjoin the sale of collateral held by certain note holders. There, too, technical objections were raised as to jurisdiction. It was claimed that there was no in personam jurisdiction, that there was no jurisdiction over the property whose sale was restrained, and that such an injunction could not be granted in a summary proceeding. The Supreme Court waved aside these objections, holding that the debtor's equity of redemption in the collateral was a property interest over which the court was given exclusive jurisdiction, that the court must have the power to preserve and safeguard such property, and that to that end it can have process served upon the persons to be enjoined wherever they can be found within the United States.¹⁰ Not only can it summarily enjoin the sale

ships. H. R. REP. NO. 194, 73d Cong., 1st Sess. (1934). Chapter X also was intended to centralize power in one court. *In re Greyling Realty Corp.*, 74 F. 2d 734 (C. C. A. 2d 1935), *cert. denied sub nom.* Troutman v. Compton, 294 U. S. 725 (1935).

6. *Harrison v. Chamberlin*, 271 U. S. 191, 193 (1926); *Jaquith v. Rowley*, 188 U. S. 620, 625, 626 (1903). In some cases fears are expressed as to the possible results of the extension of the summary jurisdiction beyond traditional bounds. "Neither exclusive jurisdiction of the debtor nor power to issue process outside the district confers upon the bankruptcy court the power, in a summary proceeding, to decide, without the consent of an adverse claimant, a controversy concerning property in his possession, unless his claim be merely colorable. Were it otherwise, every bona fide possessor of property held adversely to a bankrupt could be haled into a distant Federal Court to defend his right to the property whenever the trustee in a reorganization proceeding should choose to corral him summarily." *In re Mt. Forest Fur Farms of America, Inc.*, 122 F. 2d 232, 239 (C. C. A. 6th 1941), *cert. denied*, 314 U. S. 701 (1942).

7. 30 STAT. 565 (1898), as amended, 52 STAT. 879 (1938), 11 U. S. C. § 110 (a-4) (1940).

8. 30 STAT. 562 (1898), as amended, 52 STAT. 869 (1938), 11 U. S. C. § 96 (b) (1940).

9. 294 U. S. 648 (1935). This was a railroad reorganization case under § 77 (53 STAT. 1406 (1939), 11 U. S. C. § 205 (1940)). The exclusive jurisdiction of the court over the debtor's property under this section is given in the same language as that of § 77B and Chapter X.

10. *Id.* at 683.

of such property but it can summarily retake possession of it.¹¹ And a pledgee creditor who refuses to file a claim does not thereby evade the jurisdiction of the Court. This was decided in *In re Cuyahoga Finance Co.*,¹² where the court summarily determined the amount of the debtor's set-off against a pledgee who neither filed a claim or otherwise appeared in the case. The court held that it had jurisdiction of all of the debtor's tangible and intangible assets whether or not in its possession, and that as a Chapter X court it was "clothed with authority and charged with the duty to proceed to consummation of a plan or reorganization in a summary way."¹³ The asset here involved—that is, the equity of redemption in the pledged property—was of a kind over which an ordinary bankruptcy court would not have had summary jurisdiction.¹⁴ But the jurisdiction of the Chapter X court was viewed as an extension of bankruptcy powers and as a unification of these powers with the traditional authority of equity courts to administer the necessary relief in a single action.

The idea of the protection of the debtor's property is seen in another form in *In re Standard Gas & Electric Co.*¹⁵ There the trustee had brought suit in a state court against former directors, and the stockholders sought to intervene in that action. The federal court enjoined them from so doing, holding that the chose in action—the suit against the directors—was an asset of the debtor and that the court could restrain the stockholders from interfering with it. One might suppose that the idea of "protection of the debtor's property" is stretched to the uttermost by the inclusion in it of so intangible an asset. But surely the bursting point is reached when such a suit is considered property of the debtor whether or not the debtor has an equity in the result! Yet in another case the court reached that conclusion by means of the same old theory.¹⁶

None of this rationale can be applied to *In re Burton Coal Co.*¹⁷ There the court took summary jurisdiction of a dispute between parties concerning which neither the debtor nor its trustee had any interest. The claim of a creditor was secured by stock of the company being reorganized. When others claimed to own the stock, the creditor applied to the reorganization court for an order establishing his right to it. The appellate court recognized that as the amount of the creditor's claim depended on his ownership of the stock there could be no reorganization until the question was decided, and a summary proceeding before the Chapter X court, rather than a plenary suit outside it, was held to be the proper way of settling it. This decision is no mere extension of bankruptcy powers to protect the debtor's property. No property of the debtor

11. *Grand Boulevard Inv. Co. v. Strauss*, 78 F. 2d 180 (C. C. A. 8th 1935).

12. 136 F. 2d 18 (C. C. A. 6th 1943).

13. *Id.* at 21.

14. *May v. Henderson*, 268 U. S. 111 (1925).

15. 139 F. 2d 149 (C. C. A. 3d 1943).

16. *Central Hanover Bank & Trust Co. v. President & Directors of the Manhattan Co.*, 105 F. 2d 130 (C. C. A. 2d 1939). The right of bondholders to compel restitution by mortgage trustees, who had allegedly wrongfully allowed substitution of collateral, was held to be property of the debtor, whether or not an equity in the collateral still remained after satisfaction of the bondholders' claims.

17. 126 F. 2d 447 (C. C. A. 7th 1942).

is being protected. What is being protected is the authority of the reorganization court over all activities leading to a fair and feasible plan.

It is as a development of the law of corporate reorganization that the case can best be understood. It is, in a new form, the familiar equity doctrine that when equity acquires jurisdiction it will decide all matters incidental to the main objective of the case.¹⁸ In Chapter X, a fair and feasible plan is always the main objective.¹⁹ If it is impracticable to reorganize the debtor on fair and feasible lines, the Chapter X proceeding may be dismissed or the debtor thrown into bankruptcy.²⁰ Looked at with the objectives of reorganization courts in mind, the results of many of the cases become acceptable without resort to the bankruptcy power. The foregoing discussions of the *Continental Illinois* and the *Cuyahoga Finance* cases show that the courts recognized this, though they preferred to ground their reasoning mainly on the bankruptcy power.²¹ Aside from that power a reorganization court may proceed towards its objective, a plan, settling incidental matters on the way. Such matters as whether or not a debtor has an equity in specific pledged property become unimportant in deciding whether or not that property comes under the jurisdiction of the court.²²

The *International Power Securities* case is, as previously indicated, a merger of two ideas. The opinion is based mainly on the extension-of-bankruptcy-powers idea. The right of set-off is held to be property and the court so justifies the injunction. Yet a more tenuous type of property can hardly be imagined. There is no equity of redemption to be protected. The trustee has asserted

18. Allowances are included among such incidental matters. It is not necessary that the allowances be payable out of the estate for the court to have jurisdiction over them. Section 221 (4) of the Bankruptcy Act (52 STAT. 897 (1938), 11 U. S. C. § 621 (4) (1940)) gives the court jurisdiction over allowances "for services and for costs and expenses in, or in connection with, the proceeding or in connection with the plan and incident to the reorganization. . . ." *Leiman v. Guttman*, 69 Sup. Ct. 371 (1949).

19. The same is true in railroad reorganizations under § 77. An injunction was issued during the course of the reorganization of the New York, New Haven & Hartford Railroad to restrain a bank from selling securities pledged with it by the debtor as collateral, a situation similar to that in the *Continental Illinois* case. The injunction was later dissolved on the ground that such dissolution would no longer hinder or obstruct reorganization. *In re New York, N. H. & H. R.R.*, 102 F. 2d 923, 925 (C. C. A. 2d 1939).

20. 52 STAT. 899 (1938), 11 U. S. C. § 636 (1940). Whether or not the debtor is solvent is not decisive on the question of the appropriateness of straight bankruptcy under such circumstances. *In re Dollar Dry Cleaning Co.*, 33 F. Supp. 861 (D. C. Conn. 1940).

21. In *In re United States Realty & Improvement Co.*, 153 F. 2d 853 (C. C. A. 2d 1946) the court restrained a pledgee in possession of securities issued by the debtor from enforcing his pledge pending an exploration of efforts to work out a plan. But where the sale of bonds of a debtor held by a pledgee would not affect the debtor's reorganization the court has no power to restrain the sale. *In re Hotel Martin Co. of Utica*, 94 F. 2d 643 (C. C. A. 2d 1938).

22. It is of course not unusual to reorganize a corporation even though there is no equity for stockholders. *Case v. Los Angeles Lumber Co.*, 308 U. S. 106 (1939); *In re 620 Church Street*, 299 U. S. 24 (1936); *In re Central Funding Corp.*, 75 F. 2d 256 (C. C. A. 2d 1935).

no cause of action which he could translate into a lawsuit. There is no property to which his rights attach, except while the bonds are in the hands of Societa Edison, or which could conceivably become an asset of the estate. Is such an inchoate chose in action property? On this ground the decision may be questioned. Yet on another theory it is a sound result. The sale of the bonds by Societa Edison to an innocent purchaser for value might have wiped out the possibility of a set-off, thus increasing the liabilities to which the estate would be subject. To avoid such a result the court can restrain such an act.

Perhaps a more serious objection than the fact that no property is being protected is the question of how the injunction can be made effective, and what sanctions, if any, are available if it is disregarded. "The foundation of jurisdiction is physical power."²³ The court here has no physical power over the Italian company or the Swiss bank. It can, by virtue of its extraterritorial bankruptcy powers, reach the National City Bank, but that bank is a mere custodian. It can be prevented from making a book transfer or a physical delivery of the bonds, but is that effective in preventing a new owner from being an innocent purchaser for value? Possibly it is. A buyer from Societa Edison could rescind when he found himself unable to get delivery, and his failure to rescind after being thus put on inquiry might leave him standing in the shoes of the seller. The court's opinion does not consider any of these possibilities, nor does it indicate whether a different result would have been reached had the bonds, too, been outside the country. The limitations of the powers of Congress and the courts under the bankruptcy clause²⁴ have never been exactly defined, but clearly those powers are growing and developing in response to economic needs. To bend jurisdictional questions to the requirements of public policy as to fair and feasible corporate reorganizations is merely to give the court power to do work that needs to be done. This appears to be the true rationale behind the line of cases we have been considering. A bankruptcy court deals with a dead thing: a reorganization court is a doctor, called in while the patient is still breathing and capable, in many cases, of being put back on his feet. To say that a reorganization court can, as a court of equity, give all the relief necessary in a single proceeding is not enough. Of course it can give relief if it has jurisdiction to do so; the problem was to give it the jurisdiction. This Section 77 and Chapter X have done,²⁵ and attempts to show that jurisdiction of today's extent existed before Section 77 will prove fruitless. That

23. Holmes, J., in *McDonald v. Mabee*, 243 U. S. 90, 91 (1917).

24. U. S. CONST. Art. 1, § 8. The clause has been held to authorize Congress "to establish uniform laws on the subject of any person's general inability to pay his debts. . . ." *Continental Illinois National Bank & Trust Co. v. Chicago, R. I. & Pac. Ry.*, 294 U. S. 648, 670 (1935), and cases cited. Hence it covers the concept of "equity" insolvency (inability to pay debts as they mature) as well as that of "bankruptcy" insolvency (excess of liabilities over assets).

25. In *Manhattan Co. v. New York, N. H. & H. R.R.*, 171 F. 2d 482 (C. A. 2d 1948), Learned Hand, J., reads the *Continental Illinois* case in terms of the exercise of the reorganization power, specifically distinguishing that power from the power of the ordinary bankruptcy court.