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William O. Douglas — His Work in Policing Bankruptcy Proceedings

*John W. Hopkirk**

Professor Hopkirk here undertakes a study of the contributions and theories of Justice William O. Douglas in the field of bankruptcy and corporate reorganization. The author derives the basic theories of Douglas in the bankruptcy field through an analysis of his work on the SEC Protective Committee Study of bankruptcy law, as Chairman of the SEC, and as Justice on the United States Supreme Court. He concludes that Douglas throughout his career manifested a continuity of approach to bankruptcy problems emphasizing functional analysis.

William O. Douglas, while associated with the Securities and Exchange Commission during the mid-nineteen thirties, was responsible for a study of methods and procedures of corporate reorganization. By examining this area of Douglas' work, we can compare the position on corporate reorganization which the Justice developed as an administrative official for the New Deal with his later consideration of the same problems as a member of the Supreme Court of the United States. Through this comparison we can observe a number of basic attitudes which were manifested by Douglas both before and since he has joined the Court. Important among these are his philosophy of individual self-reliance and his thorough commitment to the functional approach in analyzing legal problems.

Douglas' self-reliant individualism is a philosophy which he has long extended beyond the personal arena, emphasizing the moral responsibility of individuals in dealing with social, economic, and political problems. This theme, suggested in much of Douglas' autobiographical writing,¹ was applied to the economic sphere in a speech made by Douglas during his period as Chairman of the Securities and Exchange Commission.

The disappearance of free enterprise has submerged the individual in the impersonal corporation. And when a nation of shopkeepers is transformed into a nation of clerks enormous spiritual sacrifices are made. Communities everywhere lose men of stature and independence. Man loses opportunities to develop his personality and his capacities. He is denied a chance to stand

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1. DOUGLAS, OF MEN AND MOUNTAINS 210-11 (1950). This aspect of Douglas' attitudes is also discussed by the writer in *W. O. Douglas, Individualist* (unpublished doctoral dissertation, Princeton University, 1958).

on his own before man and God. He is subservient to others and his thinking is done for him from afar. His opportunities to become a leader, to grow in stature, to be independent in mind and spirit, are greatly reduced. Widespread submergence of the individual in a corporation has as insidious an effect on democracy as has his submergence in the state in other lands.²

Examination of Douglas' work in the field of corporate reorganization not only shows us something of this viewpoint in operation, but also portrays social problems which undoubtedly served to intensify Douglas' feeling of the importance of personal ethical responsibility in dealing with corporate finance.

A second basic element, Douglas' thorough commitment to the functional approach in analyzing legal problems, often has been referred to as "legal realism." Douglas, early in his career, argued for a functional approach which he believed would focus attention on the economic and social forces involved in litigation over business affairs.

[Concentration on functions] would lead rather to a consideration of the phenomena observed in the organization and operation of a business than of the mere form itself of business. That would result in observations of the things men attempt to do and are found doing when engaging in business. That would lead to the emphasis being placed on the end sought. . . . That would shift the emphasis from forms of business units to the uses to which the units are put. That would discard at one sweep the theological refinements of the concepts. Instead of having his mind cluttered up with many analytical distinctions (oftimes metaphysical) the student would start with considerations more fundamental. The process would be concerned almost solely with the incidents of economic, social, and business problems; with a consideration of the social controls over such economic, social, and business forces; with the results of such controls. Around such incidents would the legal and non-legal material be grouped.³

A corollary to his use of the functional approach is Douglas' ability to plunge into a morass of complicated materials, sort them into a pattern, and prescribe a course of action. Judge Charles E. Clark, Dean of the Yale Law School during much of Douglas' tenure as a professor there, characterized the Justice as being "a horse for work," a man who could be depended on to expeditiously complete work of almost any magnitude.⁴

2. DOUGLAS, *DEMOCRACY AND FINANCE*, 15-16 (1940).

3. Douglas, *A Functional Approach to the Law of Business Associations*, 23 *ILL. L. REV.* 673, 675-76 (1929). The writer examines Douglas' development as a legal functionalist more fully in *The Influence of Legal Realism on William O. Douglas*, in *ESSAYS ON THE AMERICAN CONSTITUTION* 59-76 (1964).

4. Interview With Judge Clark, New Haven, Conn., June 10, 1953.

I. HOW DOUGLAS CAME TO BE RECRUITED TO HEAD THE SEC PROTECTIVE COMMITTEE STUDY

Interest in the functional study of business law had led Douglas in the late twenties to embark on an extensive study of the administration of the Bankruptcy Act of 1898. Douglas expressed his concern functionally as follows:

The present Act was passed in 1898 and, though amended several times, has never been changed fundamentally. During the thirty-three years it has been in force no inventory . . . has been made . . . to determine its incidences. . . . The only data available are those contained in the annual reports of the attorney-general. They are practically valueless for even an administrative, let alone a functional, study of bankruptcy. They reveal little of the kinds of persons using bankruptcy. No clues are given as to why they are there. No information is set forth showing what treatment they obtain—whether they applied for a discharge, whether the application was contested, whether the discharge was granted or refused and if refused on what ground. Nothing is given showing how the various subdivisions of the discharge section [14(b)] are working.⁵

From both a personal and a scholarly standpoint, Douglas' timing in embarking on bankruptcy studies could not have been better; the events of 1929 furnished increasing quantities of material for study and spawned numerous governmental investigations. Douglas' views of bankruptcy problems were sought by individuals as highly placed as Solicitor-General Thomas D. Thacher, who was conducting an investigation at the behest of President Hoover into "the whole question of bankruptcy law and practice."⁶ Interest in the topic of the bankruptcy study became so great that a popular magazine published the gist of Douglas' discoveries as to causes of bankruptcy, titling its report "Have You the Right to Be in Business?"⁷

Meanwhile Congress had been exploring questionable practices in the realm of corporate finance, the hearings having since been widely known by the name of the committee's chief counsel, Ferdinand Pecora. One outcome of those hearings was a decision to have the SEC conduct further investigation of the role of security holders' protective committees in reorganization proceedings. The mandate for this investigation was written into section 211 of the Securities Exchange Act of 1934.

5. Douglas, *Some Functional Aspects of Bankruptcy*, 41 YALE L.J. 329, 330-31 (1932). See also Clark, Douglas & Thomas, *The Business Failures Project—A Problem in Methodology*, 39 YALE L.J. 1013 (1930); Douglas & Thomas, *The Business Failures Project—an Analysis of Methods of Investigation*, 40 YALE L.J. 1034 (1931).

6. *Message Recommending the Strengthening of Procedures in the Judicial System, together with the Report of the Attorney-General on Bankruptcy Law and Practice*, S. Doc. No. 65, 72d Cong., 1st Sess. 45 (1932).

7. Wieshart, *American Magazine* August, 1930, p. 26.

The [Securities and Exchange] Commission is authorized and directed to make a study and investigation of the work, activities, personnel, and functions of protective and reorganization committees in connection with the reorganization, readjustment, rehabilitation, liquidation, or consolidation of persons and properties and to report the result of its studies and investigations and its recommendations to the Congress on or before January 3, 1936.⁸

As Joseph Kennedy and James Landis, Chairman and member of the new commission, were looking for someone to carry out the protective committee study, Douglas happened to be publishing a recent phase of his studies, a discussion of the role of protective committees in railroad reorganizations.⁹ Although Kennedy and Landis reportedly had little or no personal acquaintance with Douglas,¹⁰ his accomplishments were enough to make them feel he was the man they needed for the job.

Douglas' approach must have seemed a reasonable one to a New Dealer. Protective committees had a useful role to play but required reform and regulation. As Douglas had written from his vantage point at Yale:

The need for increased regulation has not been due primarily to the incompetency or to the fraudulent proclivities of committee members. Rather, the need has arisen because so often the committees have been constituted by the inside groups, those affiliated with or drawn from the old management or the financial interests associated with it. Often the interests of these members have been clearly those of speculative equity groups, not motivated solely or dominantly by the urge to protect the interests of the securities which they represent.¹¹

II. ORGANIZATION AND APPROACH OF THE PROTECTIVE COMMITTEE STUDY

Around him on the Protective Committee staff Bill Douglas gathered a small group of bright young men, many of them recent Yale Law

8. 48 Stat. 909 (1934), 15 U.S.C. 78(b) (1958). A definition may be in order here for those unfamiliar with the apparatus of corporate reorganization. Protective or reorganization committees are committees set up ostensibly to represent the interests of a particular class of security holders during negotiations directed towards a reorganization of the financial structure of a concern. Although such negotiations most commonly occur during the bankruptcy or receivership of a corporate debtor, they may be commenced in order to forestall arrival at such dire financial straits.

9. Douglas, *Protective Committees in Railroad Reorganizations*, 47 HARV. L. REV. 565 (1934).

10. *Bill and Billy*, Time Oct. 11, 1937, pp. 61, 64. Douglas was appointed by Kennedy July 16, 1934, to be head of the Department of Reorganization, which position carried with it responsibility for all matters affecting corporate reorganizations and related problems. N.Y. Times July 17, 1934, p. 29.

11. Douglas, *supra* note 9, at 567. As we consider his work further it will be interesting to note the extent to which his SEC investigation consists in spelling out at length these same views.

School graduates. Since this group was small, organization of the study could remain quite informal. The cohesion and spirit of the staff greatly simplified its task. According to one of the major participants, the principal organizational problem may well have been adaptation to government red tape, since virtually all lacked significant experience in Washington.¹²

Douglas was closely involved in direction of this investigation for several years. In the early stages he continued to teach at Yale, commuting back and forth to his classes, while in the later years of report-writing he increasingly had to divert his attention to the broader problems facing a member and chairman of the SEC. His imprint is extensive throughout the eight volumes of the SEC final report. In fact, he wrote a considerable portion of the report's 4,048 pages himself. Samuel O. Clark, Abe Fortas, and a few others prepared other parts of the first drafts, but the boss went over all of them subsequently. He gave particular attention to important sections such as those embodying the summaries and conclusions of the different volumes.¹³ For these reasons the report is useful as an indication of Douglas' attitudes on the problem of corporate reorganization procedures.

Shortly after the SEC study group was organized, it settled down to the basic fact-finding task. The scope set for the project indicates the thoroughness of Douglas' grounding in fact-oriented research. Questionnaires were sent out to obtain basic data from recently reorganized companies, from protective committees, and from those serving

12. Interview With Samuel Ohrman Clark, Jr., Washington, D.C., June 18, 1953. Altogether there were no more than a handful of assistants on the project. Clark, chief counsel for the study, stated that all who participated in the work (except for secretarial assistants) are listed in the letters transmitting various parts of the study to Congress. Others besides Clark so mentioned include: Abe Fortas, Samuel H. Levy, Martin Riger, George H. Dession, R. B. Ainsworth, Philip Blacklow, F. A. Doolittle, J. Q. Newton, Jr., Frandis F. Lincoln, Roger Foster, E. J. Fruchtman, J. P. Goode. Several of these individuals participated only in work on one or two sections of the report.

13. Interview With S. O. Clark, Jr. The various parts of the report and the sequence in which they were prepared give an indication of the magnitude of the investigation and the manner in which the group approached its task. SEC REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES: pt. IV, *Committees for the Holders of Municipal and Quasi-Municipal Obligations* (April 30, 1936); pt. III, *Committees for the Holders of Real Estate Bonds* (June 3, 1936); pt. VI, *Trustees Under Indentures* (June 18, 1936); pt. I, *Strategy and Techniques of Protective and Reorganization Committees* (May 10, 1937); pt. V, *Committees and Agencies for Holders of Defaulted Foreign Government Bonds* (May 14, 1937); pt. II, *Committees and Conflicts of Interest* (June 21, 1937); pt. VII, *Management Plans Without Aid of Committees* (May 10, 1938); pt. VIII, *A Summary of the Law Pertaining to Equity and Bankruptcy Reorganizations and of the Commission's Conclusions and Recommendations* (September 30, 1940) [hereinafter cited as REPORT ON PROTECTIVE COMM.].

as trustees for debentures. Hearings were then started which went on month after month.¹⁴ As they moved on to oral examination, Douglas frequently conducted the interrogation of witnesses personally. One after another a long procession of corporation officials, bankers, investment underwriters and their attorneys passed through the hearing room. Frequently Douglas uncovered evidence of a single-minded pursuit of gain in the course of which those investigated appeared to have abandoned the fiduciary obligations of trustees, the duty of corporation officials to stockholders' interests, and the ethical standards of conduct supposedly adhered to by members of the bar. While Douglas had had some prior intimation of these lapses gained from his brief, early work in the Wall Street law firm of Cravath, de Gersdoff, Swaine & Wood, from his previous study of reorganization, and from prior investigation of these same matters by others, apparently he was surprised to find such extensive evidence as was uncovered in this investigation.¹⁵

The SEC group attacked the problem from the broad, functional approach that had become so typical of Douglas. In Douglas' view it was impossible to comprehend the reorganization process without a knowledge of the law involved, but complete understanding often demanded that legal cloaks be stripped away.

A study of reorganizations. . . entails an examination of the objectives of reorganization both in theory and in practice. It also involves consideration of the strategy and techniques which have been employed to reach those objectives. These can best be understood and appreciated if they are divested of their legal garb. It is in such manner that these matters are dealt with in this part of our report.¹⁶

Douglas began the process of considering reorganization techniques

14. The bulk of the oral evidence appears to have been gleaned from the following individual investigations by the Protective Committee Staff. In a number of these cases prior work, such as that of the Pecora Committee, had pointed the way to Douglas' sleuths. The hearings included: *Proceedings Before the Securities and Exchange Commission in the Matter Of: Associated Gas and Elec. Co.* (1935); *The Baldwin Locomotive Works* (1935); *Bondholders Protective Comm. for the Republic of El Salvador* (1935); *Celotex Co.* (1935); *Cuba Cane Sugar Corp.* (1935); *Federal Public Service Corp.* (1935); *Foreign Bondholders Protective Council, Inc.*, (1935); *R. Hoe and Co., Inc.* (1935); *Institute of International Finance* (1935); *Kreuger & Toll Co.* (1935); *McLellan Stores Co.* (1935); *Paramount Publix Corp.* (1935); *Protective Comm. for Bondholders of the City of Asbury Park, New Jersey, and other Municipalities and Public Instrumentalities* (1935); *Protective Committees for Bondholders of the City of Coral Gables, Florida* (1935); *Readjustment of External Obligations and Protective Committees and of Protective Organizations for Security Holders of the Republic of Peru* (1935). Transcripts of the hearings in these cases are on file with the Securities and Exchange Commission, Washington, D. C.

15. Interview with Samuel O. Clark, Jr.

16. 1 REPORT ON PROTECTIVE COMM. 2.

“divested from their legal garb” by setting forth the differing positions from which the general investor and the “insider” frequently approached reorganizations. There is little difficulty in telling on which side Douglas’ Calvinistic background placed him. The problems are clearly stated on the second page of the general report in language bearing the Douglas imprint.

Reorganizers and investors will at times have different objects in reorganizations. Investors will be interested in an expeditious, economical, fair, and honest readjustment of their company’s affairs. They will be concerned with having the business restored to an efficient and trustworthy management as quickly as possible, so that they may the sooner have dividend or interest payments on their investments resumed. They will be interested in suffering the least possible impairment of their investment whether by reduction in interest or principal or by loss of security. They will want fair treatment accorded them by those whose claims are senior and junior to their own. They will be desirous of keeping reorganization costs at a minimum. They will be concerned with the cancellation of burdensome contracts and with the collection of all assets of the company, whether these assets be in the form of claims against their officers, directors, and bankers for mismanagement and the like, or otherwise. They will be desirous of having the company which emerges from the reorganization adequately financed. They will want that company to have a sound financial structure, so that there will be no immediate necessity for another receivership or bankruptcy, sometimes referred to as an “expensive luxury at best.” If their company has been a preserve for exploitation, they will want to be rid of the despoilers. They will want an extravagant, wasteful, inefficient, or faithless management ousted from control and a new one installed. In other words, before the new venture is started they will want a complete accounting of the old; they will consider that no reorganization is complete unless there is such an accounting. From the investors’ point of view no reorganization could be thoroughgoing unless the reorganizers adhered to these objectives of expedition, economy, fairness, and honesty.¹⁷

In actual practice the best that is attainable ordinarily falls considerably short of perfection. So it is with even the best of reorganizations. To prevent loss of large sums in legal fees and court expenses, maximum recovery for the interests of a given class of security holders may have to be sacrificed to a speedier settlement of the reorganization. Often if any losses are to be recouped from future earnings the business must be kept going. In such cases the debenture holders may have to make concessions to the stockholders of a corporation and forego their rights to an immediate foreclosure of the business lest they then find themselves faced with no alternative but piecemeal sale of its assets at a fraction of their value. Thus it is that discretionary acts and decisions play a large role in the accomplishment of any reorganization.

17. 1 REPORT ON PROTECTIVE COMM. 2-3.

With the entry of discretionary judgment an evaluation by objective criteria of the extent to which representatives have adequately fulfilled their trust becomes impossible. The opportunity for what George Washington Plunkitt called "honest graft" insinuates itself into the situation. In such circumstances only the sense of loyalty which a representative feels for those for whom he acts can assure adherence to high standards of fiduciary responsibility. Such loyalty in turn requires a disinterested passion for the interests he guards.

The Protective Committee Study found that too frequently the greatest flaw in the reorganization techniques of the day was lack of this disinterested spirit:

Reorganizers have at times had objectives not only different from but incompatible with those of investors. Reorganizers have frequently been interested in expeditious reorganizations not primarily to avoid expense, not necessarily because of the desire to have dividend and interest payments quickly resumed, but largely because of their desire to consummate a reorganization of their own liking. Reorganizers frequently have not been concerned, in the manner of investors, with economy in reorganization, as economy would interfere with their profits. Reorganizers at times have not been interested in fair reorganizations, since fairness might seriously intrude into their own plans and affairs. Reorganizers at times have not desired honest reorganizations, in the investors' sense of the word, because such reorganizations would be costly to them. They have been motivated by other factors. And they have endeavored—in large measure with success—to mould the reorganization processes so as to serve their own objectives.¹⁸

A. *Reorganization Strategy—the Stakes Involved*

As the study progressed Douglas and his associates spelled out more and more the extent to which the negotiations and techniques of those who participated in reorganizations might be directed towards controlling the reorganization itself and the business units which would emerge from the reorganization. The reorganization of the Celotex interests provided one example of this struggle.

Celotex, founded and built up for the most part by Bror G. Dahlberg, had fallen upon less prosperous days and was in receivership. Dahlberg's leadership was being seriously threatened by a powerful group of security holders who attributed the company's difficulties to Dahlberg's mismanagement of its affairs. At this juncture Dahlberg joined forces with Walter S. Mack, Wallace Groves, and William B. Nichols. Mack was an officer in a concern devoted to industrial management and reorganization work, and in two investment trusts related to it.

Together the group set up the Central Securities Company through

18. 1 REPORT ON PROTECTIVE COMM. 4.

which Dahlberg was to have a part interest in the reorganization and a place in the new company. Control was to pass to the Phoenix Security Corporation, the other owner of Central Securities. Groves was president of Phoenix and held 300,000 shares of its stock; Mack was vice-president and held 6,400 shares; William B. Nichols & Co. owned 4,400 shares.¹⁹ Mack was also a vice-president of Nichols & Co.

Groves and Dahlberg then established a reorganization committee for Celotex. Its chairman: William B. Nichols. Nichols & Co. was to provide reorganization services to the committee at a fee of 2,500 dollars per month plus special compensation for Nichols himself.²⁰ Eventually the reorganization committee presented to the security holders a plan of reorganization which it received ready-made from the hands of Dahlberg, Mack, and Groves. By compromising with the demands of one of the more vociferous security holders the promoters gained control of this company.

The Douglas study was understandably critical of this reorganization.

Very definitely, this was not an activity which was designed to aid investors whose moneys were tied up in the prostrate Celotex Company. On the contrary, this outside group did not hesitate to use and abuse the protective committee machinery and to buy up securities at depressed prices to promote their own fortunes. Against the financial resources, composed largely of other people's money, the strategic advantages and the ruthlessness of this group, investors in this company were helpless. Such a group obviously has objectives different from those of investors. It is engaged in a purely entrepreneurial venture, for profit. Especially is its activity dangerous in light of the power which it has against unorganized, weak security holders. And especially dangerous and vicious are its incursions likely to be when it screens them behind a protective committee which invites unsuspecting and unwarned investors to entrust their securities to it. Such a group through the devices of a protective committee invites investors to further its selfish and undisclosed schemes with startling ruthlessness.²¹

Obviously men do not engage in struggles for the financial control of reorganizations and reorganized companies without a reason. The Douglas group documented some of the numerous and substantial sources of financial reward for such efforts. One example was the underwriting of new securities issues in the Celotex reorganization. Central Securities took the underwriting commitment for 75,000 shares of new common stock. It undertook to purchase at a price of \$6.66 a share any part of its stock commitment not subscribed for by the

19. 1 REPORT ON PROTECTIVE COMM. 102.

20. 1 REPORT ON PROTECTIVE COMM. 106.

21. 1 REPORT ON PROTECTIVE COMM. 136.

stockholders. The total sum it could have been obligated for under this arrangement was approximately half a million dollars.²² Actually it was "required" to supply only 72,218 dollars. With the stock selling at the time at about twelve dollars a share, it realized a profit of 57,905 dollars on its commitment. In return for this "risk" of underwriting, and for the advance of some other sums which the group had to spend anyway in order to gain control of the company, Central Securities was given a compensation of 25,000 shares, securities worth 300,000 dollars. As a further compensation it received an option to purchase 50,000 additional shares at \$6.66 a share, a chance for an additional 267,000 dollars profit. Thus, neglecting the advances made by Central Securities, which were to finance gaining control of the company, the group made an immediate unrealized profit of 624,905 dollars on its underwriting obligation of 499,500 dollars, of which obligation it actually supplied 72,218 dollars. The stock rapidly rose in price. When listed on the New York Stock Exchange a month and a half later it was selling at about twenty dollars a share. In November 1936, a year later, the price ranged from 27% to 33%. At thirty dollars a share the underwriting was worth 2,170,091 dollars.²³

The Douglas investigation highlighted many other advantages obtainable by insiders controlling reorganizations. There were all manner of supplies and professional services which such groups could contract to furnish the debtor. They could take steps to enrich themselves by acts which altered the prices of the debtor's securities. The management could cover up wrongdoing which might make privileged groups liable to suit for recovery of wasted or wrongfully dispersed assets or for damages. Friendly trust companies could earn lucrative fees for their services as depositaries for the securities of protective committee members. The opportunity to provide such services, requiring little more than honest but routine clerical work, was often insisted upon by a bank before its officers would consent to participate in a reorganization.²⁴

Douglas and his fellow investigators directed one of their most

22. 1 REPORT ON PROTECTIVE COMM. 129.

23. Profit figures are tabulated in 1 REPORT ON PROTECTIVE COMM. 134-35. Stock prices are given in 1 REPORT ON PROTECTIVE COMM. 130.

24. 1 REPORT ON PROTECTIVE COMM. 168ff.

Eagerness to obtain the business is easily understood if one notes the sums dispersed to depositaries in a few reorganizations. American Bond and Mortgage had paid, up to March, 1933, \$332,355.61. 1 REPORT ON PROTECTIVE COMM. 169. Ninety seven committees in Strauss-controlled real estate reorganizations paid the Strauss National Bank and Trust Co. more than \$495,500. 1 REPORT ON PROTECTIVE COMM. 170. Detroit, Michigan, municipal securities committees paid three banks \$474,704.30. In the Chicago, Milwaukee, St. P. & P.R.R. reorganization depositaries were paid \$817,755.41. 1 REPORT ON PROTECTIVE COMM. 179. Part I of the Report details these and other questionable practices at length.

scathing attacks at members of their own profession who by pyramiding the costs of reorganization ate still further into the assets of the bankrupt. In the investigators' minds the crime was further compounded by the fact that these same lawyers at times were responsible for the original dissipation of the assets. The general report indicted the reorganization bar as follows:

The depression with its consequent wave of security defaults presented the legal profession with an unsurpassed opportunity to render genuine public service in the rehabilitation of corporate enterprises in the interests of investors. Yet, though there are, of course, exceptions, the profession by and large has not evidenced a desire to promote reorganization expeditiously economically, and solely in the interests of investors. On the contrary, it has evidenced ability and ingenuity in furthering the interests of those who utilize the reorganization processes to serve selfish ends. . . .

We are particularly concerned with the shift of the reorganization bar from standards of professional service to those of pecuniary gain. In its avarice for reorganization fees the legal profession by and large has forsaken the traditions of officers of the court and has become highly entrepreneurial in nature. Furthermore . . . members of the reorganization bar have not been reluctant to occupy inconsistent positions, and under the guise of disinterested service to the estate, to act as the faithful servant of interests hostile to the investors.²⁵

Douglas was not unaware of the fact that legal services in reorganizations were often of great importance and that they could take many hours of a firm's time. He had his own experience as a young associate in Cravath, de Gersdoff, Swaine, & Wood to draw upon.²⁶ That experience may also have suggested to him what his group declared might be the root of the difficulty.

The vice of the situation remains despite persuasive arguments that particular jobs are well done. The vice is that the bar has been charging all that the traffic will bear. It has forsaken the tradition that its members are officers of the court and should request and expect only modest fees. This condition has prevailed to an extent throughout the profession. And it is not a new development; it is a practice of long standing. But it has been accentuated in the case of the financial bar, which has been dominant in reorganizations. Part of this unseemly tendency of the financial bar to demand huge fees may be due to the business cast of law practice of that kind. Part may be due to overspecialization in financial centers with large law offices composed of dozens of lawyers, a huge overhead, and consequent

25. 1 REPORT ON PROTECTIVE COMM. 212-13.

26. "My bankruptcy practice was short-lived. But what it lacked in duration it compensated for in size however, for I helped to prepare a two and a half million dollar proof of claim and a half a million dollar reclamation petition in the G. L. Miller bankruptcy and filed both a few minutes before the time for filing expired." Douglas, Address, 3 REF. J. 48 (1929). Douglas was an associate of the Cravath firm from September 15, 1925, to January 28, 1926, and again from October 1, 1926, to June 30, 1927. 2 SWAINE, THE CRAVATH FIRM at xv (1948).

artificial standards of the worth of legal services. In other words, organization for the practice of law on the large scale of mass production has contributed to the alleged necessity of computing legal fees on an overhead rather than a service basis. Part may be due to the fact that the practice of financial law has been to a great extent monopolized by relatively few firms. This has meant setting monopolistic prices on the legal services of the select financial bar. But whatever may have been the cause, the end result has been that more conservative and modest professional standards have been discarded.²⁷

B. Reorganization Strategy—The Techniques Employed

The usefulness to insiders of control of a debtor company and of the procedures of reorganization has already been illustrated in part. It is through this control—control over the manner in which proceedings are conducted, control over the actions of indenture trustees, and control over the selection and approval of reorganization committees—that insiders further their own purposes.

Control over proceedings was important if inside groups were to carry out their plans. If a corporation was thrown into bankruptcy by unfriendly creditors there was always the possibility that the management would lose out to independent trustees. Therefore it was important for the controlling group to beat others to the courts.

In their study of the R. Hoe & Co. receivership, the Douglas investigators documented the length to which groups would go in striving to attain friendly receiverships. The company was faced by a suit in the state courts for appointment of a receiver after it had voted to default on interest payments. Hoe's lawyers advised that steps be taken to have a federal receiver appointed since this would facilitate continuance of inside control. Under federal law such action was possible, however, only if suit was commenced by an out-of-state creditor with claims exceeding 3,000 dollars. Only two creditors approximated these requirements. One, a competitor, was thought to be *ipso facto* undesirable as an agent in such proceedings. The other, Jones & Laughlin Steel Corporation, held claims of less than 3,000 dollars and, in addition, refused to be a party to such an undertaking. It did agree to assign its claim, however. Hoe then moved to increase its debts to Jones & Laughlin and arranged to have the enlarged claim assigned to a New Jersey resident, one Christian, prospective son-in-law of Hoe's president. Hoe then had its English subsidiary cable Christian the funds necessary to purchase the Jones & Laughlin claim. Thus the transaction would not appear on its own books. Next the company's lawyers obtained independent counsel for Christian, handing them the documents necessary for the contemplated action.

27. 1 REPORT ON PROTECTIVE COMM. 215-16.

Christian, by now somewhat bewildered but anxious to please his father-in-law-to-be, signed the necessary papers, apparently without great understanding of what was going on.²⁸

Control of indenture trustees was also of importance to those who sought painless reorganization. Frequently, when a corporation borrows funds through flotation of securities an elaborate agreement is drawn up appointing a trustee, ordinarily a banking corporation, to police the rights of holders of the securities concerned. As with the long-established attitude of the reorganization bar, testimony brought out in the Protective Committee hearings revealed that trustees set up under these indentures had gradually come to observe only minimum standards for their fiduciary role.

In the investigation of the reorganization of the Baldwin Locomotive Works the Douglas group unearthed an example of what this could mean. The indenture securing the first mortgage bond issue of the company provided that "the unencumbered quick assets of the Corporation . . . shall at all times equal or exceed the aggregate indebtedness of the Corporation. . . ." It provided, as a duty on Baldwin's part, for periodic delivery to the trustee of a schedule "showing in general and summarized form, the nature, description and value of the quick assets of the Corporation on hand at the date of the close of said fiscal year; and the description and amount of the aggregate indebtedness of the Corporation at said date."

These explicit provisions were, according to the investigators, "continually violated by the company." They discovered that although Baldwin's statements to the trustees clearly failed to conform to the requirements of the indentures, conduct tantamount to default, the trustee took no action until the corporation itself had publicly announced its default in payment of the principal or interest.²⁹ The trust officer for the trustee told the Douglas group that this practice of ignoring the existence of indenture violations, based on fairly typical clauses exempting the trustee from obligation to act unless demanded by holders of twenty-five per cent (in value) of the trust issue, was a general one.

The seriousness of such behavior as a possible detriment to the interests of the lone security holder seemed clear. Typically such an investor has never seen the indenture, a complex and lengthy legal document. Frequently he has not the time or the money to police the behavior of his debtor and must rely on the trustee. In such cases as the one cited, however, while the trustee ignores failure of the

28. For an account of this see 1 REPORT ON PROTECTIVE COMM. 250ff and material there cited. This particular type of behavior became unnecessary after the passage of section 77B of the Bankruptcy Act of 1934, 43 Stat. 912 (1934).

29. 6 REPORT ON PROTECTIVE COMM. 35.

debtor to fulfill conditions of the loan, the funds from which the security holders might be paid may be largely dissipated.

Control over committee machinery has also been discussed in part. If a committee has members possessing the special interests held by Nichols in the Celotex reorganization, it is not hard to see what the advantages could be to insiders. Such groups always faced the threat that independent interests might attempt to organize for their own protection, however.

The Douglas group found certain tried and true techniques available for discouraging organization by independent outsiders. Insiders will know in advance of financial difficulties which may lead to default, enabling them to organize committees and get them into the field ahead of any competing groups.³⁰ Either the company or its investment bankers have access to the lists of the security holders of the corporation. The study indicated that it was a frequent practice to refuse access to these lists to all except members of the inside group. Without such a list, a competing committee found much greater obstacles involved in attempting to contact security holders, present them with information concerning the company's affairs, and mobilize them for independent action.³¹

The committee investigation staff believed that the independent security holder frequently is poorly equipped to judge for himself the wisdom of a proposed course of action. Under such circumstances, the management of the reorganizing corporation possesses a distinct persuasive advantage in regard to reorganization plans to which it chooses to give its stamp of approval. A prominent banking house enlisted on the side of management can wield similar influence.³²

All manner of devices were frequently employed to persuade security holders to deposit their securities with a protective committee. First in the field, the management committee typically was able to obtain a high percentage of deposits. Deposit agreements, the study revealed, typically contained provisions giving almost complete authority to the committee and granting the privilege of withdrawal of deposited securities only on payment of a substantial penalty. Thus, once the management group had fastened its grip on the independent investor it was difficult for him to escape.

III. SEC CHAIRMAN DOUGLAS IMPLEMENTS BANKRUPTCY REFORMS

Through elaboration of such material Douglas' Protective Committee Study drew a picture which pointed up sharply the inadequacies

30. 1 REPORT ON PROTECTIVE COMM. 388-408.

31. 1 REPORT ON PROTECTIVE COMM. 408-57.

32. 1 REPORT ON PROTECTIVE COMM. 458-78.

which he felt to be present in existing corporate reorganization procedures. The Securities and Exchange Commission then immediately drew up proposals to eliminate such practices through remedial legislation. This was natural because Congress had intended the study to serve as a guide to needed legislation. The vigor with which the SEC pushed its recommendations is not surprising either, for Douglas himself became a Commissioner in January 1936, and Chairman in September 1937.

The easiest way to measure the success which Douglas experienced in getting his recommendations adopted is to look at some of the SEC-sponsored provisions in two laws, chapter X of the (Chandler) Bankruptcy Act of 1938³³ and the Trust Indenture Act of 1939.³⁴

A. Chapter X of the Chandler Bankruptcy Act of 1938

No statutory authorization had existed for federal courts to participate in reorganizations of corporations (as distinguished from authority over bankruptcy proceedings in which the estate of a corporate debtor would be liquidated) prior to addition of sections 77A and 77B to the Bankruptcy Act in 1934.³⁵ Section 77B began a process of federal control of reorganizations at approximately the same time that the Douglas group began its study. As a result, some amelioration of conditions in reorganizations had already taken place. Douglas and his associates felt, however, that numerous improvements still were required.

When originally passed, section 77B was regarded as a piece of emergency legislation.³⁶ As the depression continued extensive use revealed its faults but simultaneously demonstrated its usefulness. Meanwhile, studies such as the Thacher investigation, Douglas' bankruptcy studies at Yale, and the activities of other academicians and practitioners in the field had produced a growing feeling of need for general revision of the bankruptcy laws. In 1932 such dissidents formed the National Bankruptcy Conference, an informal organization devoted to the writing of thorough-going amendments to the bankruptcy laws.³⁷ Extensive hearings were held by the House Judiciary Subcommittee headed by Representative Chandler.

As the work of all these groups was nearing completion, the

33. 52 Stat. 883 (1938), 11 U.S.C. § 112 (1958).

34. 53 Stat. 1140 (1939).

35. 48 Stat. 912 (1934).

36. *Hearings Before the Committee on the Revision of the Bankruptcy Act of the House Committee on the Judiciary*, H.R. Doc. No. 8046, 75th Cong., 1st Sess. 5 (1937).

37. *Hearings Before the Committee on the Revision of the Bankruptcy Act of the House Committee on the Judiciary*, H.R. Doc. No. 8046, 75th Cong., 1st Sess. 3 (1937).

Douglas reports began to flow to Congress. Representative Chandler requested the Douglas group to meet with representatives of the National Bankruptcy Congress and iron out such differences as they might have concerning the proposed legislation. In the course of this work the revision of 77B, chapter X of the Chandler Act, became a vehicle for enactment of many of Douglas' views on corporate reorganization.³⁸ The congressional hearings reveal through Douglas' own testimony the features of the new chapter X which he regarded as of central importance. In only a few instances does it appear that Douglas failed to place in the law provisions in conformity with the position of his Commission.³⁹

A number of provisions served to decrease greatly the potentially undesirable control of management over corporate reorganizations. A key factor in achieving this was the independent trustee, one of the major requirements Douglas felt necessary for the elimination of dishonesty.⁴⁰ The Chandler Act required that in all cases where the debtor's liquidated liabilities exceeded 250,000 dollars the judge must appoint an independent trustee to administer the affairs of the debtor.⁴¹ In addition, in the reorganization proceedings this trustee was to be represented only by a disinterested attorney.⁴² The trustee could investigate the conduct of the business. He had the legal duty of reporting any evidence of "fraud, misconduct, mismanagement, and irregularities,"⁴³ and was to prepare a report on the financial condition of the business for creditors, stockholders, and other interested persons.⁴⁴ In addition to this the trustee was given the responsibility for drawing up a plan of reorganization which would protect the legitimate interests of all those holding claims on the debtor's assets.⁴⁵

38. Douglas told the Senate Committee holding hearings on the bill, "Our recommendations as respects 77 (b) are contained in Chapter X of H.R. 8046." Senate Comm. on the Judiciary, *Hearings Before the Subcommittee on the Revision of the National Bankruptcy Act of the Senate Committee on the Judiciary*, H.R. Doc. No. 8046, 75th Cong., 2d Sess. 10 (1938).

39. See Douglas' testimony, *Hearings Before the Committee on the Revision of the Bankruptcy Act of the House Committee on the Judiciary*, H.R. Doc. No. 8046, 75th Cong., 1st Sess. 162ff (1937). Also see the exchange between Jacob Weinstein and members of the committee, *Hearings Before the Subcommittee on the Revision of the National Bankruptcy Act of the Senate Committee on the Judiciary*, H.R. Doc. No. 8046, 75th Cong., 2d Sess. 132 (1938).

40. *Hearings Before the Subcommittee on the Revision of the National Bankruptcy Act of the Senate Committee on the Judiciary*, H.R. Doc. No. 8046, 75th Cong., 2d Sess. 164 (1938). Many of the reforms outlined in the following pages follow almost verbatim recommendations in 1 REPORT ON PROTECTIVE COMMITTEES 898-902.

41. 52 Stat. 888 (1938), 11 U.S.C. § 556 (1958).

42. 52 Stat. 888 (1938), 11 U.S.C. § 157, 8 (1958).

43. 52 Stat. 890 (1938), 11 U.S.C. § 567 (1958).

44. 52 Stat. 890 (1938), 11 U.S.C. § 567 (1958).

45. 52 Stat. 890 (1938), 11 U.S.C. § 569 (1958).

A second major feature of the law's scheme for assuring the establishment of a practical and fair scheme of reorganization was the provision for intervention of the SEC whenever the estate's liabilities exceeded 3,000,000 dollars (discretionary power existed in the case of lesser indebtedness). If the Securities and Exchange Commission so desired, it could then report its views on their merits. The Commission, under certain circumstances, also could appear in a role analogous to that of *amicus curiae*.⁴⁶

So that the interests of those participating in the proceedings might be known, the law required disclosure of the terms of agreements under which those appearing acted, of their own claims and security holdings, as well as those of persons they represented, and of the time when these interests were acquired.⁴⁷ The judge was granted broad authority to disallow undesirable provisions in proxy and deposit agreements, to restrain exercise of those "unfair or not consistent with public policy," and to limit claims or stock acquired in contemplation of the reorganization proceedings "to the actual consideration" paid for them.⁴⁸

Still further measures were taken to lessen the opportunity for speculative gain or excessive profits from services in reorganization, so that participation would be less eagerly sought by others than bona fide holders of claims and securities. Awards for services were to be limited to "reasonable compensation and reimbursement for proper costs and expenses."⁴⁹ Persons seeking compensation, moreover, were to file with the court, under oath, a statement showing any trading done in the securities or claims of the debtor after the commencement of proceedings under chapter X. The new law provided that:

No compensation or reimbursement shall be allowed to any committee or attorney, or other person acting in the proceedings in a representative or fiduciary capacity, who at any time after assuming to act in such capacity has purchased or sold such claims or stock, or by whom or for whose account such claims or stock have, without the prior consent or subsequent approval of the judge, been otherwise acquired or transferred.⁵⁰

Chapter X further provided that while the debtor, indenture trustees, and any creditor or stockholder might be heard as of right on any matter coming before the court, in addition "the judge may, for cause shown, permit a labor union or employees' association, representative

46. 52 Stat. 890, 91, 94 (1938), 11 U.S.C. §§ 571, 72, 608 (1958).

47. 52 Stat. 895 (1938), 11 U.S.C. § 610, 11, (1958).

48. These provisions are also contained in 77B, 48 Stat. 912, 915 (1934).

49. 52 Stat. 900 (1938), 11 U.S.C. § 641 (1958). Again, 77B had contained similar provisions, compensation for services rendered was to be "reasonable," reimbursement was to be for "actual and necessary expenses." 48 Stat. 912, 917 (1934).

50. 52 Stat. 901 (1938), 11 U.S.C. § 649 (1958).

of employees of the debtor, to be heard on the economic soundness of the plan affecting the interests of the employees."⁵¹ This provision had been foreshadowed by some of Douglas' suggestions in the early stages of the Yale Business Failures Project almost ten years before. In 1930 he had argued that although workers "do not have an investment in the business in the legal or popular sense," they possessed a "prospective income" from it which gave them a status in the enterprise with "a measurable degree of permanency." Douglas had then argued that a court not only should take into consideration the welfare of the employees as well as the creditors and stockholders, but that in the year 1930 it might also find relevant the state of the labor market generally at the time. Basing his premise upon the functional approach to corporate reorganization, Douglas had argued that:

A liquidation which would cause an immediate displacement of labor with little chance of an early absorption of the displaced labor might argue for such attempt [to rehabilitate the business or to sell it as a going concern] even though it would not be deemed good judgment if the interests of creditors and stockholders alone were considered.⁵²

B. *The Trust Indenture Act of 1939*

A further portion of the Douglas reform program became law with the passage of the Trust Indenture Act of 1939.⁵³ Sponsored by Senator Barkley, it had been drawn up by the SEC⁵⁴ in consultation with bankers, insurance companies, and others interested in the problem. An amendment to the Securities Act, this law provided for registration with the SEC of all indentures whose issuance and sale depended in any way on use of the mails or facilities of interstate commerce. Any indenture under which securities were issued would be valid only if the Commission found it conformed to certain requirements. SEC supervision was intended to ensure compliance with various provisions of the law designed (1) to keep the trustee disinterested, (2) to prevent him from acting for more than one securities issue of a given corporation, and (3) to make him liable for failure to watch carefully over the interests he had undertaken to guard.

51. 52 Stat. 894 (1938), 11 U.S.C. § 606 (1958).

52. Douglas & Weir, *Equity Receiverships in the U.S. District Court for Connecticut: 1920-1929*, 4 CONN. B.J. 1, 9 (1930). During the House hearings on the relevant provision in chapter X, Representative Michener, a Michigan Republican, was strongly critical of this provision and questioned Douglas sharply. Douglas replied at one point that this "is not a great revolutionary step but only a recognition of what enlightened judges have occasionally done." *Hearings Before the Committee on the Revision of the Bankruptcy Act of the House Committee on the Judiciary*, H.R. Doc. No. 8046, 75th Cong., 1st Sess. 195 (1937).

53. 53 Stat. 1140 (1939).

54. *Hearings Before the Committee on Trust Indentures of the Senate Committee on Interstate Commerce* H.R. Doc. 10292, 75th Cong., 3d Sess. 16 (1938).

IV. REACTION TO THE PROTECTIVE COMMITTEE STUDY

Reactions to the Protective Committee Study and to its proposed reforms were mixed. Examination of the special series of eulogies printed in the *Journal of the National Association of Referees in Bankruptcy*⁵⁵ on the occasion of the passage of the Chandler Act makes it clear that the SEC-sponsored provisions of chapter X were recognized as novel and experimental. The American Bar Association Committee on Commercial Law and Bankruptcy had opposed the proposal for a disinterested trustee.⁵⁶ Henry H. Heimann, Executive Manager of the National Association of Retail Credit Men, recognized the divergence of views on chapter X but felt there was:

no doubt . . . that the basic philosophy of the chapter, which is by no means inconsistent with the traditional philosophy of bankruptcy law in this country, and which is designed to give creditors and investors a more active part in reorganization proceedings, should be beneficial.⁵⁷

John Gerdes, a bankruptcy practitioner and professor of law at New York University, singled out the SEC reforms for particular attention. He was somewhat less optimistic than Heimann.

That these and other innovations are sincerely designed to meet recognized abuses and deficiencies in reorganization practice as it existed under § 77 B and under the equity receivership, may not be doubted. With their purpose of affording independent investors a larger measure of protection, and with their effort to furnish the smaller creditors and stockholders with fuller information concerning the proceedings and the manner in which their interests are to be affected, no one can quarrel. But opinions can and do differ as to whether the devices which have been adopted will prove workable and completely satisfactory from a practical standpoint and as to the extent to which the delay and expense resulting from the added steps in the procedure may offset the benefits which might otherwise result. Not without foundation is the fear that at least some of these changes will produce serious disadvantages of their own.⁵⁸

Jacob M. Lashley, a member of the Board of Governors, felt that such provisions as that for making lists of security holders available to interested parties through the courts would "meet with satisfaction among the members of the bar and other interested persons who have found difficulty in submitting plans and other information to creditors . . ."⁵⁹ He thought that the provisions for intervention of the SEC could only be evaluated with the passage of time. However,

55. 12 REF. J. 133-37 (1938).

56. *Id.* at 137.

57. *Id.* at 134.

58. *Id.* at 135.

59. *Id.* at 133.

when he turned to the assumptions behind some of the other SEC reforms, Lashley adopted a different tone.

But the procedure adopted, in some respects presupposes a greater degree of sinister motives upon the part of stockholder managements, underwriters, attorneys or others who have been connected with debtors, than may be warranted by the experience of many. Moreover, there is reason to suspect that a disinterested trustee might not be in as favorable position, and also might lack the incentives which the former owners or managers would have, to prepare and press through a plan to completion.⁶⁰

The tone of these last views of Lashley approaches in tenor Robert T. Swaine's irate discussion of most of the Protective Committee study and its reform program. The following is about as kind a passage as can be found in his analysis.

The two Reports (the main Protective Committee study and one of its parts, *Trustees Under Indentures*) contain many fair analyses of abuses and defects in past reorganization technique and the two Bills contain many wise provisions directed toward the correction of those abuses and defects. But the dominant philosophy of the Reports and the dominant philosophy of the Bills will not produce reorganization procedure which is "expeditious, economical, fair and honest."⁶¹

Most of Swaine's article is devoted to discussion of "the mistaken philosophy and scheme of these Bills."⁶² He doubted the desirability or necessity for independent trustees in all large reorganizations and for restrictions on the membership and composition of protective committees. He believed that SEC-sponsored provisions of the latter sort constituted "governmental obstruction of the control by security-holders of their own organization for their mutual interests. . . ."⁶³

Many of the provisions for SEC intervention were also distasteful to him, particularly provisions under which the Commission could advise the court on the desirability of arrangements for management of the debtor after reorganization. As he saw it this meant that:

A politically constituted administrative bureau, . . . , is to have a voice in, and as a practical matter a veto power over, the determination by the

60. *Ibid.*

61. Swaine, *Democratization of Corporate Reorganizations*, 38 COLUM. L. REV. 256, 278 (1938). The quotation, the reader will recall, comes from the Protective Committee Report. Swaine, was, of course, a leading figure in the New York financial bar, and at one time was prepared to offer Douglas a partnership in his firm. Interview With Dorothy Swaine Thomas, Philadelphia, Pennsylvania, May 29, 1953. Mrs. Thomas, who is related to Swaine, was later associated with Douglas in research projects at Yale University.

62. Swaine, *supra* note 61.

63. *Id.* at 277.

security holders of the persons who are to manage the security holders' private business after reorganization.⁶⁴

The essence of Swaine's criticisms was that the Protective Committee study painted a picture too atypical to be valuable as a guide for general revision of corporate reorganization procedures and that better results could be attained if one permitted greater flexibility in the reorganization process. The appointment of an independent trustee should be left to the discretion of the court. Security holders should be protected by full disclosure of the interests of their agents and then left to manage their own affairs. The SEC should offer its expert services only when requested in respect to a particular issue.⁶⁵

Swaine's views do not give us the perspective we seek in regard to the merits of the reorganization studies. In concluding our examination of this important part of Douglas' pre-court work, a better picture can be obtained from the other two participants in the *Columbia Law Review's* symposium on the program. Joseph L. Weiner observed that the material presented in the SEC report was far from novel. "The factual portions of the Report disclosed little that students of reorganization have not generally known, and reorganizers taken for granted."⁶⁶

Weiner also noted that there would be disagreement among those acquainted with reorganization as to the extent to which the abuses documented in the study were typical. His evaluation was not far from that contained in the balanced criticisms made by E. Merrick Dodd, Jr. On the accuracy of the picture painted by the report, Dodd observed that:

The impression which it creates in the mind of one reader, at least, is that the individual case histories which it contains are accurately stated, but that both the manner in which these cases have been fitted into the general scheme and the comments which the Commission has made on the facts which they disclose have the effect of emphasizing the dangers which inhere in existing reorganization methods and of minimizing both the advantages which these methods may have and the extent to which those advantages would be jeopardized by the adoption of the Commission's reform.

Both Part I and Part II of the report are essentially briefs—fair-minded and well documented briefs to be sure—in support of the Commission's recommendations for reform.⁶⁷

64. *Id.* at 277-78.

65. Swaine summarizes his own views as to a desirable program in his article. *Id.* at 278-79.

66. Weiner, *The Securities and Exchange Commission and Corporate Reorganization*, 38 COLUM. L. REV. 280 (1938).

67. Dodd, *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganization*, 38 COLUM. L. REV. 223, 225 (1938).

Dodd was a professor at Harvard and thus somewhat more detached from the various interests concerned with the reform than were many members of the bar. He felt that many of the recommendations that had been made by the Douglas group were needed. He could understand hesitation about forcing the reorganization court to appoint an independent trustee in all major cases. Dodd, however, felt that the real question was not whether it might be possible to handle some individual reorganizations more easily in other ways.

It is whether the interests of the whole body of American investors are not best safeguarded by a rule which would compel those corporation officers and directors who are inclined to ignore their fiduciary obligations to face the certainty that if reorganization becomes imperative an investigation of their managerial delinquencies will inevitably result.⁶⁸

In Dodd's opinion the case which the SEC made for "drastic" changes in the protective committee system was "unanswerable." He, like some others, felt, however, that the SEC remedies perhaps were too inflexible. He feared that they might discourage most of those with any motive for participating energetically in the work of the committees.⁶⁹

Weiner also felt that difficulties might arise in implementing some of the remedies. Although he thought many of the measures "reasonably appropriate" steps to improvement of the reorganization process, he feared that competent independent trustees might be hard to find.⁷⁰ He also believed that the role of the SEC might be more limited than was implied in the reform proposals,⁷¹ a view partially borne out in later study of the operation of chapter X. In the opinion of one observer, a decade of experience reveals that while the SEC had probably contributed to uniformity of administration of the law and reduced blatant violations of the act, its views on the desirability of reorganization plans studied by it had had little effect on acceptance of those plans.⁷²

V. JUSTICE DOUGLAS' VIEWS ON CORPORATE REORGANIZATION

A review of the Protective Committee Study headed by Douglas

68. *Id.* at 229-30.

69. *Id.* at 249.

70. Weiner, *supra* note 66, at 290.

71. *Id.* at 289. For comments supporting the program see also Rodwin, *Trustees Under Indentures—The Old Order Changes* in 3 CORPORATE REORGANIZATION 223 (1937); Jackson, *A Realistic Approach to Amendment of Section 77 B of the National Bankruptcy Act*, in 3 CORPORATE REORGANIZATION 311 (1937); Jackson, *The New Deal in Corporate Reorganization*, in 4 CORPORATE REORGANIZATION 3 (1937).

72. See Billyou, *A Decade of Corporate Reorganization Under Chapter X*, 49 COLUM. L. REV. 456 (1949).

shows us a picture of a man who successfully organized study of complicated relationships in the field of corporate finance, stripping away the various legal arrangements involved to reveal practices which, in their functional significance, deeply shocked his sense of propriety. Having done so, he pushed ahead vigorously and effectively to have his suggested reforms embodied in law. By the time that these legal reforms had been enacted, however, the New Deal was running out of steam on the political front. Douglas, having risen to the Chairmanship of the SEC through vigorous prosecution of such programs as the Protective Committee Study, was about to move into the judicial arena. His nomination as an Associate Justice on March 20 and confirmation by the Senate on April 4, 1939, brought him to the Court at a time when cases involving interpretation of the revised bankruptcy act were just beginning to come before our high tribunal. Apparently combining his special knowledge of corporate reorganization with persuasive argument, Douglas was able to gain unanimous acceptance for his views in many of his early decisions.

Examination of these cases demonstrates the manner in which Douglas as judge executed the policies developed by Douglas as administrator. It also provides some additional glimpses of the functional approach to legal problems.

In Justice Douglas' earlier work for the Securities and Exchange Commission we saw the emphasis he placed on protection of creditors' rights in reorganizations. His opinion in *Case v. Los Angeles Lumber Products Co.*⁷³ supports that position for a unanimous Court. Handed down in his first year on the bench, the decision turned around the conflicting doctrines of "full or absolute priority" or of "relative priority" as guides in payment of creditors. To grasp the full significance of the *Los Angeles Lumber Products* decision, we will have to delve briefly into the background of these theories.

In their arrangements for participation of unsecured creditors and stockholders, reorganization proposals frequently make the issue of what constitutes a satisfactory repayment of creditors a matter of central importance. If the stockholders retain an equity in the corporation when its assets are insufficient to recompense creditors in full, debts have not been really paid. Schemes for distributing the assets among various classes of creditors holding differing rights to priority of payment can raise quite analagous questions. Have those been adequately recompensed whose money originally purchased claims to first priority in payment?

By 1930 two main schools of thought had developed regarding interpretations of what was legally required in such circumstances.

73. 308 U.S. 106 (1939).

One of the major ones was the school of "relative priority" which held "that the relative priorities of the old securities, senior to the most junior securities which continue to have any interest in the property must not be inequitably disturbed."⁷⁴

Another theory, the rule of "absolute priority," was said to hold "that each class of senior securities, starting at the top, must be given in reorganization new securities having a 'value' . . . equal to its full principal and interest before anything could be given to the next junior class."⁷⁵

Presumably some rule such as those mentioned above might determine the meaning of provisions in corporate reorganization sections of the bankruptcy laws which required that plans could not be approved unless they were "fair and equitable."⁷⁶ Douglas played a large role in attempts to spell out the nature of a "fair and equitable" reorganization. In the major cases dealing with the problem, Douglas wrote the Court's opinion three out of four times. With the exception of the third case, in which Roberts dissented, the new Justice set forth his views for a unanimous Court. Together these three cases, embodying a position supported by the SEC,⁷⁷ probably represent Douglas' most significant addition to interpretation of the Bankruptcy Act.

On first impression these opinions seemed to place the Court's stamp of approval upon the "absolute" or "full priority" rule. In *Case v. Los Angeles Lumber Products Co.*, Douglas' opinion first declared that the words "fair and equitable" of section 77B were "words of art" which had acquired a fixed meaning in equity reorganizations and were intended to embrace the "rule of full or absolute priority"⁷⁸ set

74. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901, 907 (1927). Swaine maintains that with the passage of time this was corrupted into a third theory, the "composition theory," under which stockholders could continue to participate as long as they sacrificed as much or more percentage wise as did the creditors. See his article, Swaine, *A Decade of Railroad Reorganization Under Section 77 of the Federal Bankruptcy Act*, 56 HARV. L. REV. 1193, 1204-05 (1943), and the works therein cited at 1204 n.92.

75. Swaine, *A Decade of Railroad Reorganization*, *supra* note 74, at 1204. This is Swaine's interpretation of the rule set forth in a classic article by James C. Bonbright and Milton M. Bergermann, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928).

76. Section 77(g) (railroad reorganizations) required the district judge, before approval, to satisfy himself that the reorganization plan "is equitable and does not discriminate unfairly in favor of any class of creditors or stockholders." Bankruptcy Act of 1898, as amended ch. 204, 47 Stat. 1467, 1479 (1933). Section 77B(f) required satisfaction that "it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders. . . ." Bankruptcy Act of 1898, as amended ch. 424, 48 Stat. 911, 920 (1934).

Its replacement, chapter X, used the term "fair and equitable. . . ." 52 Stat. 840 (1938), 11 U.S.C. 616(8) (1958).

77. See 8 REPORT ON PROTECTIVE COMM. 142 ff.

78. 308 U.S. 106, 118 (1939).

forth in *Northern Pacific Ry. v. Boyd*.⁷⁹ In this reorganization the bankruptcy court, although finding that assets of the company were admittedly less than 900,000 dollars while liabilities exceeded 3,800,000 dollars, had nonetheless approved a plan which allowed stockholder participation in the reorganized company.⁸⁰ Although the stockholders contributed no cash as a means of obtaining a new equity, the lower court reasoned that their participation was permissible because of certain intangible contributions: provision of "continuity of management," refraining from opposition to the plan, abstention from extensive litigation, and the like.⁸¹

Quoting from *Kansas City Terminal R.R. v. Central Union Trust Co.*, Justice Douglas reaffirmed that "to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation."⁸² The considerations purportedly offered by the old stockholders were to be ignored.

Such items are illustrative of a host of intangibles which, if recognized as adequate consideration for issuance of stock to valueless junior interests, would serve as easy evasions of the principle of full or absolute priority of *Northern Pac. Ry. v. Boyd* and related cases.⁸³

Though the *Los Angeles* decision gave certain factors new importance in reorganization, their exact significance was not settled until further decisions had been handed down by the Court. One of these major issues raised by the opinion was that of value. Valuation of the property would be of much greater importance if the law clearly demanded that when they had no remaining equity shareholders must always be completely barred from sharing in a corporation's assets. Despite the issue's importance, however, valuation is a rather complicated problem on which the *Los Angeles* opinion offered little guidance.

Even though clarification of such problems awaited the future, the

79. 228 U.S. 482 (1913). Discussion of the rule of the *Los Angeles Lumber Products* case is very extensive. For a balanced discussion see Dodd, *The Los Angeles Lumber Products Company Case and Its Implications*, 53 HARV. L. REV. 713, 753 (1940); Note, 34 ILL. L. REV. 589-96 (1940); Note, 25 IOWA L. REV. 793-801 (1940); Note, 49 YALE L.J. 1099-1105 (1940). For a treatment of more recent developments following from the case consult Billyou, *supra* note 72; Guthmann, *Absolute Priority in Reorganization: Some Defects in a Supreme Court Doctrine*, 45 COLUM. L. REV. 739-54 (1945); Swaine, *A Decade of Railroad Reorganization*, *supra* note 74, at 1037-58, 1193-1224 (1943).

80. 308 U.S. 106, 119 (1939).

81. Case v. Los Angeles Lumber Products Co., *supra* at 112-13.

82. 271 U.S. 445 (1926), quoted at 308 U.S. 106, 120 (1939).

83. 308 U.S. 106, 122. Another early unanimous Douglas opinion concerned with application of this rule in straightforward fashion among varying classes of creditors was *Marine Harbor Properties v. Manufacturer's Trust Co.*, 317 U.S. 78 (1942).

Los Angeles case still was of notable significance. One commentator has observed that it helped "to dissipate much of the fog which theretofore enshrouded reorganization under the federal statutes."⁸⁴

In *Consolidated Rock Products Co. v. DuBois*,⁸⁵ decided two years later, Douglas, again speaking for a unanimous Court, reaffirmed the position of the *Los Angeles* case. At the same time he clarified some of the collateral questions raised by that decision. Here the Justice indicated that any plan must necessarily be rejected when, like the one under consideration, it failed to properly evaluate the assets of two subsidiaries of a holding company. Reorganization contemplated formation of a new company in which assets of the parent and subsidiaries would be merged. As Douglas indicated, without proper valuation two vital problems remained unsolved.

The first problem involved the primary issue growing out of the *Los Angeles* doctrine, namely the extent to which the stockholders of the parent might retain any equity in the new corporation. The plan had ignored a claim of the subsidiaries against the parent for over 5,000,000 dollars face value. Technical arguments as to inability of the subsidiaries to press the claim met Douglas' intransigent insistence on honesty, which he expressed in familiar language.

Equity will not permit a holding company which has dominated and controlled its subsidiaries to escape or reduce its liability to those subsidiaries by reliance upon self-serving contracts which it has imposed on them. A holding company, as well as others in dominating or controlling positions, has fiduciary duties to security holders of its system which will be strictly enforced.⁸⁶

The second problem was the impossibility of determining the fair proportion of participation in the new company for bondholders

84. Billyou, *supra* note 72, at 497.

85. 312 U.S. 510 (1941). See Douglas' discussion of the significance of this case in *Institutional Investors v. Chicago, Mil., St. Paul & Pac. Ry.*, 318 U.S. 523 (1943).

86. 312 U.S. at 522. Another problem related to the participation of shareholders in the new company was the adequacy of the bondholders' remuneration. Douglas voiced the Court's objections to the plan on the ground that "the bondholders have not been made whole. They have received an inferior grade of securities, inferior in the sense that the interest rate has been reduced, a contingent return has been substituted for a fixed one, the maturities have been in part extended and in part eliminated by the substitution of preferred stock, and their former strategic position has been weakened. Those lost rights are of value. Full compensatory provision must be made for the entire bundle of rights which the creditors surrender." *Id.* at 528.

See the same point in *Institutional Investors v. Chicago, Mil., St. P. & Pac. Ry.*, *supra* note 85, at 569-70. Note in this connection, however, Roberts' criticism of Justice Douglas' summary treatment of the bondholders of a lessor in the *Milwaukee* case, *id.* at 576. In partial justification of Douglas on that point one should observe that Douglas bases his position in large part on the view that the Court ought not to reverse the ICC and bankruptcy court where reasonable grounds for their action may be inferred. *Id.* at 550-51.

secured by different portions of the corporate property. Bondholders of each subsidiary could share in earnings of the new company on a "fair and equitable" basis only if the value of their present interest was determined.⁸⁷

After dealing with these points Justice Douglas turned to the related valuation question. For reorganization purposes he held that the only fair valuation would be a capitalization of prospective earnings. A sound financial structure would be impossible unless there was reasonable expectation that interest and dividend requirements of the new securities would be covered. Moreover, the rule of absolute priority could not be otherwise satisfied for "unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result."⁸⁸

Evaluation of Douglas' Contribution to the "Full Priority" Doctrine

Just what was the contribution of these two opinions to the field of reorganization law? How practical and efficient were the tests they set up? Such considerations come to mind when one examines the significance of Douglas' legal approach in the field of corporate reorganization.

Early commentators on the *Los Angeles* and the *Consolidated Rock Products* cases took the view that the decisions had firmly established "the absolute priority" doctrine attributed by Douglas to *Northern Pacific Ry. Co. v. Boyd*.⁸⁹ In evaluating the two cases it is significant to note that Justice Douglas' certainty that such a rule was clearly stated in the *Boyd* case was not shared by all other readers of that and related decisions. A good many were of the opinion that prior cases stood for considerably less.⁹⁰ Later observers have concluded that actually the *Los Angeles* case, rather than the *Boyd* case, was the first instance in which the Court really employed the "absolute priority concept."⁹¹

Justice Douglas' language was so strong in the *Los Angeles* and *Consolidated Rock Products* cases that we can easily understand why observers felt that, whatever its antecedents, the rule was now firmly enthroned. With such a conviction spreading, discussion soon began to dwell on the difficulties for reorganization which might ensue.

One writer, Harry G. Guthmann, saw numerous disadvantages stemming from the manner in which stockholders were excluded in

87. *Id.* at 564-65.

88. *Id.* at 565-66. See treatment of the same point in *Institutional Investors v. Chicago, Mil., St. Paul & Pac. Ry.*, *supra* note 85, at 540.

89. Guthmann, *supra* note 79, at 739.

90. Dodd, *supra* note 67, at 719.

91. Billyou, *supra* note 72, at 482.

the *Los Angeles* case. To him it seemed obvious that the purpose of a reorganization was to retrieve from the debtor's estate additional assets beyond what could be obtained through mere liquidation together with satisfaction of creditors dollar for dollar until funds were exhausted. Starting from this premise reorganization assumed that earning power in a business as a going concern gave it value beyond what could be obtained through a forced sale.

In the opinion of Guthmann, Justice Douglas recognized the importance of earning power, but neglected the self-evident fact that much of this earning power was dependent on the continued efforts of the stockholders' agent, the existing management. "The mere fact that the contribution of management is intangible is no argument that it is in any way unreal."⁹² This point undoubtedly has merit in some cases. Douglas, however, apparently chose to lay more stress on the possible advantages coming from removal of the management that had led the business to misfortune.

Guthmann also pointed to the problem of how one determines when the value of a business has sunk so low that the existing stockholders have lost their equity in the property.⁹³ This issue has been almost universally recognized as of central importance to a rigid application of the "absolute priority doctrine." Guthmann felt that valuations in instances such as this were much less certain than an isolated reading of the two cases under discussion might lead one to think. Another writer, Blum, points out that once market value is abandoned as a standard the valuation process inevitably becomes an exercise in judgment. Even when conducted on the most informed basis, expert opinions as to reorganization value still are likely to vary considerably. Three separate guesses are required in any valuation capitalizing prospective earnings, the procedure Justice Douglas and most others have approved of. First one must estimate what the average annual future earnings of the business are likely to be. Then one must determine how long a life the reorganized company can be expected to have. Finally one must decide upon an appropriate rate of return at which to capitalize the estimated earnings.⁹⁴ The possibility of error is illustrated by the fact that the SEC, up to 1949, significantly underestimated the actual earnings realized by the businesses in whose reorganizations it had participated under chapter X.⁹⁵

92. Guthmann, *supra* note 79, at 742.

93. Guthmann, *supra* note 79, at 744-45. See Billyou, *supra* note 72, at 498; Swaine, *A Decade of Railroad Reorganization*, *supra* note 74, at 1205; see generally, Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565 (1950).

94. Blum, *supra* note 93, at 573-75. See also Guthmann, *supra* note 79, at 744-45.

95. Billyou, *supra* note 72, at 499.

Because of such uncertainties, Douglas had already begun to add qualifications to his doctrine by the time he restated it in the *Consolidated Rock Products* case. Discussing the manner of awarding full compensation to senior claimants he urged that:

Practical adjustments, rather than a rigid formula, are necessary. The method of effecting full compensation for senior claimants will vary from case to case. . . . The creditors are entitled to have the full value of the property, whether present or prospective, for dividends or only for purposes of control, first appropriated to payment of their claims. But whether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on the facts and requirements of each case.⁹⁶

Such qualifications in this and later opinions, together with the passage of time, led the reorganization bar to the conclusion that "the full priority" rule had considerable flexibility to it. Looking back, Robert T. Swaine noted that the *Los Angeles* and *Consolidated Rock Products* cases had been extreme situations. In those cases the disparity between the claims of senior creditors and their compensation was so great that any participation of the old stockholders could be considered quite unreasonable. The decisions merely established "the invalidity of the composition theory in the ordinary industrial reorganization."⁹⁷ But this still left a wide field in which the freedom of action available to the reorganizer had not yet been determined by the Court. As Swaine saw it: "A denial that reorganization could validly disregard all factors of valuation, aggregate and relative, was not a requirement of precise dollar valuations."⁹⁸

Justice Douglas' opinion in the *Milwaukee* case, decided in 1943, added still more to the flexibility sanctioned by the Court in redistributing corporate assets. He elaborated on the impossibility of attaining certainty in valuation proceedings, making it clear that the Court would demand only a judgment based on the best available data. He held that a plan approved by the Interstate Commerce Commission (approval required in railroad reorganizations carried out under section 77) need not embody a "precise finding as to the value of the road" in order for the Commission to determine that the old stockholders had no equity remaining.⁹⁹ In distributing the new securities it was not necessary to interpret requirements that groups of senior security holders be given "the equitable equivalent" of what they surrender so as to require a valuation of those

96. *Consolidated Rock Products v. DuBois*, 312 U.S. 510, 529 (1941).

97. Swaine, *A Decade of Railroad Reorganization*, *supra* note 74, at 1205.

98. *Id.* at 1207.

99. 318 U.S. 523, 529. With the companion decision in *Ecker v. Western Pacific*

securities and of the holders' sacrifices in terms of dollars and cents.

A requirement that dollar values be placed on what each security holder surrenders and on what he receives would create an illusion of certainty where none exists and would place an impracticable burden on the whole reorganization process.¹⁰⁰

These opinions, taken as a whole, eliminated flagrant disregard of the dominant claims of senior creditors. Interestingly, however, those creditors proved unwilling, in many cases, to demand the full measure of what Douglas was willing to grant them. De Forest Billyou notes that in cases where the SEC has expressed doubts that the plans were "fair and equitable" there has been no appeal by senior creditors from approval of the schemes involved.

This silent acceptance of dubious plans is significant and may, perhaps be used as stark evidence that creditors, at least when organized and represented in the manner permitted by Chapter X, are content with something far less than even "the full priority rule of *Northern Pacific Ry. Co. v. Boyd*."¹⁰¹

The "absolute priority rule" had become, perhaps, as Swaine suggested, something "positional or comparative—*i.e.*, relative."¹⁰²

A brief examination of a number of other bankruptcy cases is of interest in order to amplify Justice Douglas' view that the great powers of the bankruptcy and reorganization courts are intended to

R.R., 318 U.S. 448 (1943), and the denial of certiorari by the Court in Chicago and Northwestern Ry. v. Mutual Savings Bank Group Committee, 318 U.S. 793 (1943), the Milwaukee reorganization case provided "the first comprehensive review of Section 77." Swaine, *A Decade of Railroad Reorganization*, *supra* note 74, at 1037.

100. 318 U.S. at 565. The reader may wish to consider the possibility that Douglas' shift in position here was influenced in part not merely by considerations of problems in administering the bankruptcy laws, but also by the desirability of respect for the decisions of regulatory commissions. Such a viewpoint would be natural in a former Chairman of the SEC, and is stated strongly in one of Douglas' most significant opinions, *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

101. Billyou, *supra* note 72, at 487. In railroad reorganizations they have become content with even less, a composition statute having been adopted more recently which has eliminated most railroad reorganization proceedings under section 77. See Polatsek, *The Wreck of the Old 77*, 34 CORNELL L.Q. 532 (1949).

102. Swaine, *A Decade of Railroad Reorganization*, *supra* note 74, at 1209. Following somewhat the same vein as that in the cases discussed above, Douglas, in another group of opinions, insists upon adequate compensation of senior rights. These decisions bring out his rather general dislike of special preferences in any form when the issue is that of distribution of assets in bankruptcy, whether the claimant of special consideration represents labor, an insurance company, or even a state government. See *Nathanson v. NLRB*, 344 U.S. 25 (1952) (Black and Jackson, J., dissenting); *Gardner v. New Jersey*, 329 U.S. 565 (1947); *American Surety Co. v. Bethlehem National Bank*, 314 U.S. 314 (1941) (Douglas and Black, J., dissenting). The conditions under which he felt a special preference might be justified are indicated by Douglas in *Mason v. Paradise Irrigation District*, 326 U.S. 536 (1946).

fulfill certain important functions: preventing debtors from being paralyzed by the burden of their obligations; protecting creditors and investors generally in as full a measure as possible; exacting retribution for dishonesty, unconscionable conduct, and secret manipulations on the part of insiders.¹⁰³

In *Reconstruction Finance Corp. v. Bankers Trust Co.*,¹⁰⁴ decided in 1943, Justice Roberts' majority opinion suggested that provisions authorizing the Interstate Commerce Commission to determine reimbursable expenses were constitutional only because review by the courts was not precluded. Douglas felt that exercise of careful control over such allowance, the sort of control an administrative agency like the ICC could provide, was in keeping with his feeling that reorganization profiteering should be prevented. He did not believe that the courts had legal authority to review the ICC's approval of these allowances, nor did he feel that the lack of review made the provision unconstitutional. In discussing the question he took advantage of the occasion to indicate the broad authority he believed Congress possessed under the bankruptcy power of the Constitution.

It is Congress which has the power under the Constitution to establish "uniform Laws on the subject of Bankruptcies throughout the United States." The scope of the bankruptcy power is not restricted to that which has been exercised. The fact that Congress has customarily entrusted administration of the various bankruptcy acts to the courts does not mean that it must do so. . . . When it comes to fees for services rendered or expenses incurred in connection with bankruptcy proceedings, Congress has plenary power. . . . It could provide that no fees for services rendered during the bankruptcy proceedings might be paid from the estate.¹⁰⁵

On other occasions Justice Douglas indicated that he believed this plenary power over bankruptcy exercisable by Congress is necessarily so great that it might prove a significant barrier to state independence of action in other fields. It could prevent a state from adversely interpreting a corporation's charter so as to thwart acceptance of a reorganization plan on the one hand,¹⁰⁶ or force serious modification of a state's power to collect taxes owed it by a debtor whose estate was under the supervision of the bankruptcy court. He spoke of "the arsenal of authority granted the reorganization court"¹⁰⁷ (a characteristically functional approach), empha-

103. These were all concerns on which Douglas had expressed himself as far back as the Bankruptcy Studies at Yale. See my discussion in *The Influence of Legal Realism on William O. Douglas*, *supra* note 3, at 73-75, and Douglas' works there cited.

104. 318 U.S. 163 (1943).

105. 318 U.S. at 175. See support for this position in Note, 56 HARV. L. REV. 1156, 1160 (1943).

106. *Callaway v. Benton*, 336 U.S. 132 (1949) (Douglas, J., dissenting).

107. *Gardner v. New Jersey*, 329 U.S. 565, 579 (1947). In another case a somewhat

sizing that its purpose included "the compromise or settlement of claims, so that interminable litigation might be ended and the interests of expedition in promulgating a plan of reorganization served."¹⁰⁸ Those purposes had led to broad definitions of jurisdiction. Creditors, for example, include "all holders of claims of whatever character against the debtor or its property. . . ."¹⁰⁹ and could comprehend a state seeking payment of back taxes owed it by the railroad.

From an examination of *Anderson v. Abbott*¹¹⁰ we are able to clarify Justice Douglas' views as to how the Court should act in implementing congressional regulation of bankruptcy. In this case the late Justice Jackson, sharply dissenting, accused Justice Douglas and his majority colleagues of injecting the Court into the realm of legislation.

The litigation concerned Banco Kentucky, which had been established as a holding company to effect a merger of various banks. Upon failure of the merged banks, their stockholders were subject to an assessment in accordance with double liability provisions of the bank stocks. While the entire Court agreed that those shareholders of Banco who had transferred bank shares to it could be held liable,¹¹¹ the minority felt that Justice Douglas and his colleagues went too far in holding that purchasers of Banco stock for cash were also liable for an assessment.¹¹²

Justice Douglas' approach is interesting because of its reliance on an examination of the functional realities which he saw in the financial arrangements with which the case was concerned. Applying such analysis, the Justice thought it clear that old stockholders retained their former investment position and control of the bank, while the new company did not provide an adequate financial substitute for their previous liability. Therefore, the Court should impose liability upon them.

The Justice also insisted on holding cash purchasers of Banco stock liable, again by reasoning as to the functions performed and performable by Banco. All but a small portion of Banco's holdings were double liability bank stocks and that small remainder was of

similar holding was used to answer non-participating stockholders who brandished a bondholder agreement not to foreclose. Justice Douglas there held that the bankruptcy court cannot allow itself to be bound by such previous contracts of the parties involved. *Case v. Los Angeles Lumber Co.*, 308 U.S. 106, 126-29 (1939).

108. *Id.* at 581.

109. Bankruptcy Act of 1898, as amended, ch. 774, 49 Stat. 911 (1935).

110. 321 U.S. 349 (1944).

111. Justice Jackson, however, felt that liability for bank shareholders could only be established on a different principle than Justice Douglas employed, and after examining evidence on the point. *Id.* at 369-72.

112. *Id.* at 372.

dubious value. For all practical purposes, then, Banco held nothing but double liability bank shares.

The device used here can be so readily utilized in circumvention of the statutory policy of double liability that the stockholders of the holding company rather than the depositors of the subsidiary banks must take the risk of the financial success of the undertaking.¹¹³

To Justice Douglas, public policy was clearly one of the reasons why liability had to be extended to cash purchasers of Banco shares. "To allow this holding company device to succeed would be to put the policy of double liability at the mercy of corporation finance."¹¹⁴

Finally, answering those who might accuse him of judicial activism, Justice Douglas argued that there was a clear congressional purpose to maintain double liability on bank stocks and declared:

Judicial power hardly oversteps the bounds when it refuses to lend its aid to a promotional project which would circumvent or undermine a legislative policy. . . . If the judicial power is helpless to protect a legislative program from schemes for easy avoidance, then indeed it has become a handy implement of high finance.¹¹⁵

This last quotation reveals how concentration on the functions actually being carried out by particular practices is used by Justice Douglas to support judicial action which he believes necessary to further desirable public policy. Legislative programs, he here suggests, may require the Court to shape and supplement policy in a vigorous fashion if the programs are not to become mere lifeless shells.

When Douglas turns to the issue of the scope of relief afforded debtors by the Bankruptcy Act, we find him using the same approach. He argues strongly for policies which he believes are needed to preserve the spirit of congressional legislation. Justice Douglas has long emphasized that provision of relief to debtors was one of the main functions which the broad powers of the bankruptcy court should serve.¹¹⁶ Part of his individualism would seem to be a view that Americans ought not to have their initiative excessively stifled by a heavy burden of debt.

This principle Douglas expressed for a unanimous Court in *Wright v. Central Life Insurance Co.*,¹¹⁷ decided early in his judicial career. There a conflict had arisen between two provisions of the second Frazier-Lemke Act, a depression-born law intended to provide special

113. *Id.* at 359.

114. *Id.* at 363.

115. *Id.* at 366.

116. See Douglas, *Bankruptcy*, 1 ENCYC. SOC. SCI. 449 (1930).

117. 311 U.S. 273 (1940).

relief for farmer debtors. Justice Douglas, resorting to a pattern of analysis typical for him, pointed to the purpose and function which he felt the act was intended to fulfill. He believed that where these were kept in mind the conflict could be easily resolved.

This act provided a procedure to effectuate a broad program of rehabilitation of distressed farmers faced with the disaster of forced sales and an oppressive burden of debt.¹¹⁸

So long as the creditor's rights were protected to the extent of the value of the property it

certainly is in no position to insist that doubts or ambiguities in the Act be resolved in its favor and against the debtor. Rather, the Act must be liberally construed to give the debtor the full measure of the relief afforded by Congress, lest its benefits be frittered away by narrow formalistic interpretations which disregard the spirit and the letter of the Act.¹¹⁹

In several instances involving this particular issue of liberal relief to debtors Justice Douglas was unable to convince the majority of the Court and found himself in dissent. An interesting illustration is provided by the case of *Reitz v. Mealey*,¹²⁰ decided a year after the *Wright* case just discussed. Here bankruptcy collided with state efforts to control negligent motorists, a conflict which Douglas had noted as early as 1930.¹²¹ A New York financial responsibility law provided for suspension of the operator's license of any person who had not, within fifteen days, satisfied any judgment against him "for injury to person or property resulting from operation of a motor car." Discharge from bankruptcy was declared not to satisfy such judgments. Amendments suspended operation of the statute unless requested by the creditor holding the unsatisfied judgment. Reitz had his chauffeur's license suspended, although he was discharged from the debt in bankruptcy proceedings. Justice Owen Roberts and four associates upheld the law, pointing out that this could be viewed

118. *Id.* at 278. For discussion of this and earlier cases see Note, 35 ILL. L. REV. 878-82 (1941).

119. 311 U.S. at 278-79.

120. 314 U.S. 33 (1941). Justice Black joined Justice Douglas in this dissent (together with Byrnes and Jackson), as he did in two other cases: *Union Joint Stock Land Bank v. Byerly*, 310 U.S. 1 (1940), a joint dissent with Murphy where the trio wished to allow a farmer more liberal relief under the Frazier-Lemke Act than the majority granted, and *Harris v. Zion's Savings Bank & Trust Co.*, 317 U.S. 447 (1943), where the majority denied access to the bankruptcy court, on the basis of a state law prohibiting it, for the executor of the estate of a deceased farmer. Significant support for the dissenters in the *Byerly* case is to be found in Note, 53 HARV. L. REV. 1388-89 (1940); and for the Douglas position in the *Harris* case in Note, 43 COLUM. L. REV. 516-20 (1943).

121. See Douglas, *Automobile Insurance*, 1 ENCYC. SOC. SCI. 330-32 (1930); Douglas, *supra* note 5, at 342-43.

as an exercise of the police power by the state. As such they felt it to be a justifiable scheme for enforcing greater care upon motorists and protecting the residents of the state from possible injury by irresponsible motorists. Justice Roberts replied to the contention that the amendments transformed this into a scheme for collecting debts with the observation that, if the amendments fell, Reitz would be just as badly off, since the statute would remain without the discretionary suspension.¹²² Douglas felt that "unless we are to overlook the realities of collection methods" it was impossible to avoid a finding that the law contravenes the constitutional bankruptcy powers.¹²³ His views are interesting both for the expression of his values on the point, and as an illustration of the functional approach.

Under the New York scheme a creditor whose claim has been discharged still holds a club over his debtor's head. The state has given him a remedy which survives bankruptcy. If the bankrupt refuses to pay his discharged debt, the creditor will see to it that his driver's license is suspended. If, however, the bankrupt will pay up, the creditor will refrain.

The practical pressures of this collection device are apparent. Where retention of the operator's license is essential to livelihood, as here alleged, the bankrupt is at the creditor's mercy. Bankruptcy is not then the sanctuary for hapless debtors which Congress intended.¹²⁴

One final Douglas opinion, though not of great length or vital significance, deserves attention as an effort to establish a new precedent, seeking a more realistic position and elimination of ethereal judicial speculation through use of the functional approach. In reorganization proceedings for the New Haven Railroad a question arose as to the value of a claim for damages resulting from the disallowance of a 999 year lease on certain traction properties. Justice Stanley Reed, for the majority, held that the only way to establish damages was to determine them for a given, relatively short term of years, and to assume no further damages provable.¹²⁵ Justice Frankfurter, in one dissent, argued that the Court could not assume that the bankruptcy law intended courts to refrain from receiving proof of damages for the 969 year remainder of the term of the lease.¹²⁶

122. 314 U.S. at 39-40. Concerning this last argument of the majority Note, 55 HARV. L. REV. 677-78 (1941), is instructive. It is there pointed out that by such reasoning it becomes impossible to ever challenge the validity of the amendments. Discussion is also strongly critical of the majority in Note, 39 MICH. L. REV. 645-48 (1941).

123. 314 U.S. at 43. In his earlier scholarly examination of the functions of the Bankruptcy Act Justice Douglas had concluded that some remedy was needed for the problem of financial irresponsibility among motorists but that none was then available and a remedy would have to wait upon action by Congress. See Douglas, *supra* note 5.

124. 314 U.S. at 41.

125. *Palmer v. Connecticut Ry. & Lighting Co.*, 311 U.S. 544, 557 (1941).

126. *Id.* at 562-63.

Justice Douglas, joined by Justice Black, attempted to reduce ethereal speculation by a third solution seeming to bear within it the essence of practicality.

It is plain that any attempted computation of future rental values of this property for the next 969 years would at best be a mere flight "into the realm of pure speculation". . . . From our point in history 969 years hence is perpetuity. It covers a longer span than from 1941 A.D. to 500 years before Columbus discovered America. To project past earnings of a present enterprise through such vicissitudes of time would be to assume a static quality in society which even a decade of history would disprove.¹²⁷

Justice Douglas then suggested that the following simple, realistic approach be adopted.

[To] call something a 999 year lease doesn't make it a lease. For all practical purposes it is ownership. Therefore the present value of the lease is no more or less than the value of the property. Have it appraised and be done with speculation.¹²⁸

VI. CONCLUSION

William O. Douglas' major contributions to the field of bankruptcy law are marked by a high degree of continuity in approach and in solutions. An attitude of uncompromising insistence on the payment of obligations was reflected in the Protective Committee studies and carried over to the Justice's statements in *Los Angeles Lumber Products* and subsequent cases. This approach is tempered only by the Justice's additional conviction, seen here in *Reitz v. Mealey*, that one of the great purposes of the Bankruptcy Act is to relieve individuals of a crushing burden of debt.

On the Court we see the Justice's firm position on the rights of creditors carried far enough to earn him substantial credit for the establishment of a new doctrine, that of "absolute priority" of senior creditors' claims in reorganization settlements. We have noted that this doctrine proved to be difficult of rigid application and, in final interpretation, was somewhat more flexible than might be thought at first glance.

In both his administrative studies and his Court discussions of bankruptcy problems we find Douglas focusing his attention regularly on what he sees to be the actual economic practices being carried out through the legal machinery involved. In the *Banco Kentucky* case he goes far in judicial interpretation of legislative intent, so as to thwart a scheme which could have all too easily

127. *Id.* at 564-65.

128. *Id.* at 567-68.

defeated the congressional purpose as he saw it. The same desire to strip practices down to their functional bones created doubts within himself as he looked at New York's automotive financial responsibility law and subsequently led to an unorthodox but attractively uncomplicated approach to valuation in regard to the New Haven Railroad's traction properties.

Douglas' energetic attack on the economic problems of bankruptcy and his pronounced skill in portraying their significance in functional terms resulted in many of his proposed solutions becoming the law of the land through the Trust Indentures Act and chapter X of the Chandler Bankruptcy Act. When Douglas moved to the Court he attained notable success, no doubt in large part because of his background, in shaping the law of bankruptcy from the judicial side as well. Certainly, if the functional movement in the law were seeking advertisement for success, it could ask for no more persuasive record than that of its exponent, Justice Douglas, in the field of bankruptcy and corporate reorganization.

