Corporate Rehabilitation under Current and Proposed Bankruptcy Law

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NOTE

CORPORATE REHABILITATION UNDER CURRENT AND PROPOSED BANKRUPTCY LAW

I. INTRODUCTION

"Business failures, including the corporate bankruptcy phenomenon, are sobering economic realities reflecting the uniqueness of the American way of corporate death." Implicit in a capitalistic society is the harsh fact that some enterprises will fail to survive the competitive scramble for the market. Rarely, however, will business failures be attributable to a single cause; to the contrary, most result from the interplay of numerous complex factors. Many analysts denominate these factors as the immediate causes (those most proximately precipitating the financial crisis) or the underlying causes (those creating the firm's vulnerability to the immediate cause). One author has classified the causes as endogenous (internal to the firm), and exogenous (external to the firm). The present adverse business climate, with its accompanying tight credit conditions, constitutes an exogenous or underlying cause. Thus, the increased number of filings in the Bankruptcy Division of the Federal District Courts can be seen as a consequence of the current recession. This conclusion is supported by studies which indicate a clear correlation between recessionary periods and business failures. In light of this fact, and

3. Id. at 11. See also D. Stanley and M. Girth, Bankruptcy: Problem, Process, Reform 111 (1971) [hereinafter cited as Brooking Report]. The Brooking Report is a result of a study undertaken by the Brookings Institution, an independent organization devoted to nonpartisan research, education, and publication in economics, government, foreign policy, and the social sciences generally. It was stated in the forward that the study was initiated at the request of representatives of the federal judiciary because of the lack of major studies in the areas of bankruptcy administration and policy during the last two or three decades.
4. Fredland, supra note 2, at 12.
5. Id. at 13. See also E. Altman, Corporate Bankruptcy in America 46-49 (1971) for discussion and tables of the relationship of business failures to various economic indicators.
because of today's increasingly unstable economic conditions, the subject of business bankruptcies assumes particular importance. Numerically, business collapses currently constitute only about 8 percent of total bankruptcy (down from approximately 25 percent in 1950), but the average liability of business failures has increased dramatically in recent years.  

"Although relatively few firms fail, these most extreme cases of business difficulty do impose social costs which make them a legitimate object of public concern."

A financially distressed business debtor may seek, or be compelled to seek, relief under Chapters I-VII of the Bankruptcy Act (straight bankruptcy), which provide essentially for a liquidation of assets, distribution to creditors, and complete discharge of debt. In the event that financial rehabilitation appears to be more desirable, a business beset by financial crisis may invoke the Chapter X reorganization provisions or Chapter XI arrangement provisions of the Bankruptcy Act. Both chapters are designed to allow a financially troubled business to continue operations on the theory that creditors and other interested parties will benefit if the business can be salvaged and preserved as a going

7. Id.
9. The overwhelming number of business bankruptcies are straight liquidation proceedings under Chapters I-VII. Indicative of this is the fact that of the total number of 189,513 bankruptcy proceedings (business and nonbusiness) commenced in the United States during the fiscal year ending on June 30, 1974, 157,967 were straight bankruptcies. There were only 163 Chapter X proceedings initiated and 2,171 Chapter XI filings. "Tables of Bankruptcy Statistics," Table F 2, for the fiscal year ending June 30, 1974, published by the Administrative Office of the United States Courts.
10. A Chapter XI proceeding is strictly voluntary on the part of the debtor while Chapter X may be invoked by creditors. See notes 34-35 and accompanying text infra. Although the Bankruptcy Act of 1898 did not provide for rehabilitation, the Chandler Act of 1938 added Chapters X and XI which did permit rehabilitation. Chapter X is codified in 11 U.S.C. §§ 501-676 (1970). Chapter XI is codified in 11 U.S.C. §§ 701-99 (1970). Although Chapter VII of the proposed Act is a consolidation of present Chapters X, XI, and XII, only Chapters X and XI, which deal with corporate bankruptcies, will be discussed in this note. Chapter XII, which deals only with individuals owning real property, will not be discussed because of its minimal use and importance. See Report of the Commission on the Bankruptcy Laws of the United States, Part I, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. 240-41 (1973) [hereinafter cited as I Commission Report and Part II will be cited as II Commission Report], and J. MacLachlan, Bankruptcy 372-73 (1956) for comment on the suggestive use of Chapter XII.
concern. However, the procedures employed under these two chapters are, at least theoretically, vastly different.\textsuperscript{11}

The focus here is primarily on the problem of the corporate debtor\textsuperscript{12} and the viability and desirability of the Chapters X and XI rehabilitative procedures which may or may not provide a solution to the debtor's financial problem. In Part II, the theoretical distinctions between the two chapters will be examined, as well as the difficulties encountered when attempting to devise a proper remedy for the financial ills of a particular debtor. This choice of remedy issue will be further developed in light of the problem of determining whether Chapter X or XI is applicable to a given factual situation. As will be seen, the Securities and Exchange Commission sometimes plays a significant role in this choice. In Part III, some practical problems of the present corporate rehabilitation system will be considered, followed by a critical analysis of the solutions to these problems suggested by Chapter VII of the proposed Bankruptcy Act.\textsuperscript{13}

\begin{itemize}
\item \textsuperscript{11} The initial conceptual disparity between the two chapters is illustrated by the fact that the Securities and Exchange Commission was instrumental in obtaining congressional approval of Chapter X, while the National Association of Credit Men was the primary impetus behind the passage of Chapter XI. Chapter X was enacted to provide protection for the investing public while affording relief to large publicly held corporations. On the other hand, Chapter XI was intended merely to establish a quick, simple, and practical method for small and middle-sized businesses to obtain economic relief. See Rostow & Cutler, \textit{Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act}, 48 \textit{Yale L.J.} 1334 (1939). In this article, which was published soon after the enactment of Chapters X and XI, the following observation was made which emphasizes the breadth of the originally perceived difference between the two chapters:

Chapter X is reorganization in the grand manner. It represents the response of its draftsmen to the great reorganization cases and to the atmosphere of melodrama and importance which colors all discussion of them . . . . Chapter XI, on the other hand, has about it the grubbiness of bankruptcy. It provides a cheap and practical method of settlement . . . for poor debtors whose estates cannot afford the expense of an elaborate public ceremonial.

\textit{Id.} at 1334.

\item \textsuperscript{12} The provisions of Chapter XI are equally applicable to an individual or to a partnership. Although Chapter X is available only to "corporations," section 1(8) of the Bankruptcy Act (11 U.S.C. § 1(8)) defines this to include, for purposes of the Act, certain unincorporated concerns and associations and businesses conducted by trustees.

\item \textsuperscript{13} The Bankruptcy Commission was established in 1970 by Public Law 91-354 (84 Stat. 468). In 1973 the Commission submitted a report consisting of two parts. Part I contains an analysis of present Bankruptcy law with recommendations for certain changes therein, and Part II contains the text of the proposed Bankruptcy Act of 1973. Also submitted was an appendix (Part III) which contains certain studies which were conducted by or on behalf of the Commission. See I \textit{COMMISSION REPORT, supra} note 10, Letter of Transmittal. The proposed Act was introduced in the House on October 9, 1973, H.R. 10972, 93d Cong., 1st Sess. (1973).

The authors of this note are aware that they have undertaken the consideration of a
II. A REVIEW OF CHAPTERS X AND XI

A. Introduction

"The underlying thesis of reorganization law is that the going concern value of the debtor's assets is greater than their forced liquidation value."14 Straight bankruptcy (liquidation)15 should be employed only when there appears to be so little hope of successfully injecting new life into a corporation that further expenditures of time and money are unjustified.16 A business that is allowed to continue in existence and to maintain its goodwill may reestablish itself as a healthy operation worth substantially more than just the mere value of its assets. In fact, one of the statutory prerequisites of confirmation of a Chapter X reorganization plan is a showing of "feasibility"17 or a "reasonable prospect for survival"18 for the immediate future. This feasibility requirement illustrates one of the limitations on the policies underlying Chapter X; while the statute favors the preservation of a going concern, it has been noted judicially that the Act is not designed to "place crutches under corporate cripples, fit subjects for liquidation, and send them out to be a menace to all who might purchase their securities or deal with them on credit."19

The group which conducted the Brookings study found that relatively little actual rehabilitation is effectuated through Chapters X and XI, and this finding precipitated a proposal for an extensive revision of those chapters.20 It was found that the complexities and delays inherent in a Chapter X proceeding created staggering amount of material in relatively few pages. It is our hope, however, to at least bare the most significant areas of concern to the practitioner who may become directly or indirectly involved in a corporate rehabilitation and who is not intimately acquainted with Chapters X and XI of the Bankruptcy Act. This goal of covering a rather broad spectrum at times necessarily resulted in the sacrifice of analytical depth.

15. The straight bankruptcy provisions of the present Bankruptcy Act are contained in Chapters I-VII. These provisions of the proposed Act are contained in Chapter V.
16. "Economically, liquidation is justified when the value of the assets sold individually exceeds the capitalized value of the assets in the marketplace." E. Altman, CORPORATE BANKRUPTCY IN AMERICA 12 (1971).
20. BROOKINGS REPORT, supra note 3, at 3.
significant obstacles to the survival of a corporation. Less than one-fourth of the Chapter X proceedings concluded during the fiscal years of 1964 through 1969 resulted in successful reorganizations. Of the arrangements attempted under confirmed Chapter XI plans, only one-third of the businesses were self-operating two years after the proceedings were terminated.

Despite these somewhat discouraging statistics, Chapter X reorganizations and Chapter XI arrangements are nonetheless still frequently attempted. Peter Coogan has explained this taunting of the failure rate as follows:

Creditors will often prefer what may become a slow liquidation under a chapter proceeding to a straight liquidation bankruptcy. Even where the chance of a successful reorganization seems remote, customers are more likely to pay up accounts, inventory can be sold in something approaching the ordinary course of business, the debtor finds a buyer for individual items of equipment; and perhaps, units of business that the debtor has been unable to operate successfully can be sold at better than

21. Id. at 145.
22. Id. Statistics are from "Tables of Bankruptcy Statistics," Table F4b, for the respective years, published by the Administrative Office of the United States Courts. The Brookings Report figures went through 1968. The 1969 statistics, the most recent ones available on this point, indicate even fewer successful reorganizations, about one-fifth of the total Chapter X filings.
23. Id. at 115-17. The following graph, found on page 116, illustrates the results of Chapter XI arrangements in a sampling of districts:

Table 6-3. Results of Confirmed Chapter XI Plans Two Years after Proceeding Closed, by District in Percent

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Still in business</td>
<td>33</td>
<td>—</td>
<td>33</td>
<td>—</td>
<td>32</td>
<td>39</td>
<td>18</td>
</tr>
<tr>
<td>Business discontinued</td>
<td>30</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>50</td>
<td>—</td>
</tr>
<tr>
<td>Assets sold to finance plan</td>
<td>14</td>
<td>—</td>
<td>17</td>
<td>—</td>
<td>28</td>
<td>6</td>
<td>29</td>
</tr>
<tr>
<td>Liquidated after plan confirmed</td>
<td>8</td>
<td>—</td>
<td>17</td>
<td>50</td>
<td>20</td>
<td>6</td>
<td>—</td>
</tr>
<tr>
<td>Default under plan</td>
<td>5</td>
<td>100</td>
<td>—</td>
<td>—</td>
<td>8</td>
<td>—</td>
<td>11</td>
</tr>
<tr>
<td>Business under new control</td>
<td>5</td>
<td>—</td>
<td>—</td>
<td>50</td>
<td>—</td>
<td>—</td>
<td>25</td>
</tr>
<tr>
<td>Merged into parent company</td>
<td>1</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>4</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>No data</td>
<td>6</td>
<td>—</td>
<td>33</td>
<td>—</td>
<td>8</td>
<td>—</td>
<td>18</td>
</tr>
</tbody>
</table>

Source: Dun and Bradstreet records, 1967. Percentages may not add to 100 because of rounding.

a. There were no Chapter XI cases in Oregon or Western Texas.
liquidation values to someone who is persuaded that he can do what the debtor could not do.24

There remains, of course, the statutory mandate that a plan be feasible, and, under Chapter X, that a plan be filed in good faith.25 Remington, in his treatise on bankruptcy law, has stated with regard to Chapter X, that "petitions to reorganize corporations ripe for liquidation cannot be approved as filed in good faith, since good faith implies honesty of purpose to preserve going concern values and to avoid the evils of liquidation."26 This statement is further qualified by the proviso that if a plan is initially approved as filed in good faith, the fact that liquidation ultimately becomes "the more desirable way of winding up the debtor's estate" is of no importance.27 Case law has also established that a straight bankruptcy should not be contemplated under Chapter X unless the plan fails.28 Of course, the future survival of a Chapter X corporation is generally of particular concern to interested parties because the plan frequently involves a readjustment of the capital structure and the issuance of stock or long term securities in partial or complete satisfaction of claims.29 The situation is easily envisioned in which a Chapter X plan, followed by eventual liquidation, could drastically alter the status of certain creditors.30 Under a Chapter XI plan, which ordinarily involves merely the extension or composition of claims, the feasibility problem would not appear quite as significant. In fact, the authors of the Brookings Report, after discussing the failure statistics of Chapter XI, concluded that the high failure

26. 11 H. Remington, Bankruptcy § 4465, at 158 (1961) (footnotes omitted) [hereinafter cited to the appropriate volume as Remington]. An exception to this is said to exist if the corporate purpose is holding and liquidation.
27. Id.
28. See In re USA Motel Corp., 450 F.2d 499 (9th Cir. 1971); Dubladenhill, Inc. v. Sharrets, 375 F.2d 558 (4th Cir. 1967). But see In re R.L. Witters Associates, 93 F.2d 746 (5th Cir. 1938) (reversing a dismissal of a petition calling for ultimate liquidation and holding that a gradual liquidation was permitted under § 77B, the precursor of Chapter X). According to Remington, this latter decision is unique in its view. 11 Remington § 4465, at n.2.
30. This could occur, for example, if a secured creditor of a developer, in exchange for shares of stock, relinquishes a security interest in certain capital assets which are to be sold so that the proceeds can be funneled into a more promising project to keep the corporation from collapsing. If the business then fails, that creditor would probably take a total loss.
rates did not signify that the plans should not have been attempted.\textsuperscript{31} In their opinion, however,

\begin{quote}
[i]t does mean that the referees concern themselves very little with the future prospects of the business when they approve payment plans. The statutory requirement that a plan be "feasible" has been interpreted in practice to mean that the creditors seem likely to receive what is being promised them, rather than that the debtor seems likely to survive. Such an interpretation may produce more money for creditors than they would receive in straight bankruptcy, but it does not assure rehabilitation of the debtor.\textsuperscript{32}
\end{quote}

In the event that a financially troubled corporation concludes that rehabilitation appears to be more advantageous than straight bankruptcy, it must determine whether to seek assistance under Chapter X or under Chapter XI. Its decision will be contingent first upon the needs and preferences of the corporation, and then upon the court's determination that the plan meets the statutory requirements of the particular chapter elected. Generally, however, Chapter X is deemed appropriate for large publicly held corporations or corporations with complicated debt structures in situations where the rights of secured creditors must be affected. Chapter X is also appropriate where a realignment of the capital structure may be necessary, or when a pervasive reorganization is required. Chapter XI, on the other hand, is normally considered the proper route in the case of a small corporation which requires only the composition and extension of claims of unsecured creditors.\textsuperscript{33} An analysis of various provisions of the two chapters will show that Chapter X is by far the more structured and court-controlled approach to corporate resuscitation.

\section*{B. Initiation of Proceedings and Immediate Concerns}

\subsection*{1. The Petition}

A corporate debtor may voluntarily seek relief under either chapter\textsuperscript{34} or may involuntarily be forced into a Chapter X proceeding if a petition is filed by three or more creditors with claims aggregating \$5,000 or more against the corporation or its prop-

\textsuperscript{31} Brookings Report, supra note 3, at 115.
\textsuperscript{32} Id.
\textsuperscript{33} See Seidman, Chapter X or Chapter XI?, 76 Com. L.J. 33 (1971).
erty. Under either chapter, the debtor voluntarily seeking relief must allege in its petition that it is either "insolvent or unable to pay its debts as they mature." A Chapter XI petition is only required to contain that allegation and a proposed plan of arrangement (or statement of intention to submit one). In sharp contrast, the requirements of Chapter X are much more stringent and numerous. Every petition must state "the specific facts showing the need for relief under this chapter and why adequate relief cannot be obtained under chapter XI . . . ." When a Chapter XI plan is involved, court approval is not required before submission for consideration by creditors. However, when a Chapter X petition is filed, the court must examine it first. Approval requires "(1) a conclusion of law to the effect that the petition complies with the Act, and (2) a finding of fact that the petition is filed in good faith." According to authorities on the subject, good faith presupposes more than merely good intentions. A realistic intent to effect a reorganization is required, as

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38. The specific requirements which must be met by a Chapter X petition are set forth in section 130 of the Bankruptcy Act (11 U.S.C. § 530). Additional requirements of an involuntary petition are contained in section 131 (11 U.S.C. § 531).
41. 11 REMINGTON § 4460, at 149. See Bankruptcy Act §§ 141-44, 11 U.S.C. §§ 541-44 (1970). Although the requirement of good faith is not defined, section 146 of the Act (11 U.S.C. § 546) establishes the following circumstances which, although not an exclusive list, compel a dismissal of the plan as not having been filed in good faith:
(1) the petitioning creditors have acquired their claims for the purpose of filing the petition; or
(2) adequate relief would be obtainable by a debtor's petition under the provisions of chapter XI of this Act; or
(3) it is unreasonable to expect that a plan of reorganization can be effected; or
(4) a prior proceeding is pending in any court and it appears that the interests of the creditors and stockholders would be best subserved in such prior proceeding.
42. 11 REMINGTON § 4461, at 153; 2 MODERN BANKRUPTCY MANUAL § 1527 (1966).
well as circumstances indicating the existence of a legitimate possibility of successful rehabilitation.\textsuperscript{43}

2. Immediate Relief

Generally, if a debtor is in a position of such financial instability that it must seek relief under the Bankruptcy Act, the situation is sufficiently critical that a stay enjoining foreclosures and other actions is essential to continuing operations.\textsuperscript{44} Such a respite is provided under either chapter; in a Chapter X proceeding, the court may stay or enjoin suits immediately upon the approval of a petition.\textsuperscript{45} Court approval of the petition also operates as an automatic stay of "a prior pending bankruptcy, mortgage foreclosure, or equity receivership proceeding, and of any act or other proceeding to enforce a lien against the debtor's property."\textsuperscript{46}

Under Chapter XI the court is also effectively empowered to stay or enjoin actions against the debtor until issuance of the final decree.\textsuperscript{47} This authority appears to be restricted primarily by the fact that an arrangement is permitted to affect only the rights of unsecured creditors.\textsuperscript{48} The determination, however, of whether a secured creditor is affected is within the exclusive province of the court\textsuperscript{49} which construes its powers very liberally in an effort to effectuate corporate rehabilitation.\textsuperscript{50} In this respect, it has been

\textsuperscript{43} See note 42 supra.
\textsuperscript{44} See generally Coogan, Proposed Act at 745.
\textsuperscript{46} Bankruptcy Act § 148, 11 U.S.C. § 548 (1970). This authority to stay or enjoin actions is in addition to that conferred generally by section 11 of the Act (11 U.S.C. § 29), which is applicable to all bankruptcy proceedings.
\textsuperscript{47} Bankruptcy Act § 314, 11 U.S.C. § 714 (1970). A stay or injunction may be granted under this section only until the final decree is issued. Under section 357(7) of the Act (11 U.S.C. § 757(7)), however, the court may expressly retain jurisdiction over the arrangement. \textit{In re Gordon}, 44 F. Supp. 581 (S.D.N.Y.), \textit{aff'd} \textit{per curiam}, 131 F.2d 863 (2d Cir. 1942). \textit{See also} 9 REMINGTON § 3653. Section 357(7) of the Act allows for possible retention of jurisdiction until the provisions of the arrangement have been performed. It does not delineate the permissible scope of such jurisdiction. Although the case law would indicate that the scope is limited, continued authority to grant stays of action does not appear to be excluded. \textit{See generally} Seedman v. Friedman, 132 F.2d 290 (2d Cir. 1942); \textit{In re Pathe News, Inc.}, 276 F. Supp. 670 (S.D.N.Y. 1967); 9 REMINGTON § 3653.
\textsuperscript{49} Bankruptcy Act §§ 308, 11 U.S.C. § 708 (1970) provides: A creditor shall be deemed to be "affected" by an arrangement only if his interest shall be materially and adversely affected thereby. In the event of controversy, the court shall after hearing upon notice summarily determine whether any creditor is so affected.
said that the difference between Chapters X and XI "may be more apparent than real." If salvaging a corporation is a hopeful prospect, a court may be inclined to find that the secured creditors are not "affected" by the arrangement and thus aid the debtor in retaining property crucial to its business operations.

Current financing is another immediate problem generally encountered by debtors seeking relief under the Bankruptcy Act. Obviously, if a debtor's financial condition has become sufficiently serious to require relief, there is likely to be a critical shortage of working capital. Furthermore, few lenders will be willing to provide loans without some assurance of priority. Under Chapter XI, this problem is mitigated by the provision permitting immediate action by the trustee. During the pendency of the proceedings, the court can authorize the trustee or debtor in possession to issue certificates of indebtedness with whatever agreed-upon priority seems equitable. Chapter X, on the other hand, compounds the problem of current financing by allowing the issuance of certificates of indebtedness only after approval of the petition. However, this approval may be substantially delayed pending a good faith determination which must generally be made at a judicial hearing. "To a debtor who seeks reorganization only when he is unable to meet this week's payroll, a prospect of a Chapter X court-approved borrowing next month is not appealing."

51. Coogan, Proposed Act at 745.
52. Id. According to Mr. Coogan, the court, bound by section 308, must be convinced that the secured party will not be permanently injured, a matter on which the court and a secured party may disagree. A secured party may, in some instances, be more or less "forced" into a position of allowing himself to be "affected" under a Chapter XI arrangement:

[A] secured creditor . . . who is "temporarily" enjoined from repossessing his collateral may be "persuaded" to accept something less than his full claim by the debtor's power to take the final step of liquidation bankruptcy. His collateral may be readily saleable for the amount of the debt secured, but more than likely it is worth less to a stranger than it is to this debtor if he can be rehabilitated. For example, a fixture installed on the debtor's premises, or work-in-process may be worth little apart from the debtor's operations. Pressure of affairs may lead the secured party to accept something a little more than liquidation value.

Id.

54. Id. See generally White Chem. Co. v. Moradian, 417 F.2d 1015 (9th Cir. 1969). But see White v. Murtha, 343 F.2d 831 (5th Cir. 1965); In re Delaware Hosiery Mills, 202 F.2d 951 (3d Cir. 1953).
56. See notes 41-43 and accompanying text supra.
57. Coogan, Proposed Act at 744.
3. Jurisdiction and Control of Property

Under both Chapters X and XI, the court in which the petition is filed has exclusive jurisdiction over all property constructively or actually possessed by the debtor as of the date of filing.\(^{58}\) The debtor relinquishes all right of control over its property, and the court is empowered to resolve all controversies involving such property.\(^{59}\) Additionally, the court may appoint a receiver to protect and conserve the debtor’s estate prior to petition approval in a Chapter X proceeding,\(^ {60}\) or, in a Chapter XI proceeding, “upon application of any party in interest . . . , if necessary.”\(^ {61}\)

The management, officers, and board of directors of a financially distressed corporation will ordinarily have a very definite interest in remaining in control of corporate affairs. Unless the failure was caused directly by management incompetence or dishonesty, a change of control at a financially critical time may be more detrimental than advantageous.\(^ {62}\) Management, with an intimate knowledge of the debtor’s affairs, may have valuable contacts with customers which might be severed if control were placed in a disinterested trustee.\(^ {63}\) Furthermore, delicate negotiations for the sale of certain assets or the borrowing of money may be endangered by a change in management.\(^ {64}\) For these reasons, a Chapter XI proceeding in which the debtor customarily remains in possession\(^ {65}\) will generally be preferred by the debtor and may often be more advantageous to all interested parties. It should not be forgotten, however, that a debtor in possession holds the property and conducts business as trustee and is at all times technically subject to court control.\(^ {66}\)

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58. Bankruptcy Act §§ 111, 112, 311, 312, 11 U.S.C. §§ 511, 512, 711, 712 (1970). Although nowhere is the jurisdiction over encumbered property expressly conferred by statute on a Chapter XI court, the powers granted clearly seem to include such jurisdiction. For an analysis of the problem, see Lockhart v. Garden City Bank & Trust Co., 116 F.2d 658 (2d Cir. 1940), 2 Modern Bankruptcy Manual § 1291 (1966) and 9 Remington § 3573.

59. 9 Remington § 3573; 11 Remington § 4358, at 36.


62. See generally Coogan, Proposed Act at 743-44.

63. See In re KDI Corp., 477 F.2d 726, 734 (6th Cir. 1973).

64. Coogan, Proposed Act at 743.

65. Bankruptcy Act § 342, 11 U.S.C. § 742 (1970). It is within the court’s discretion whether to appoint a trustee or allow the debtor to remain in possession. “In some districts, management is regularly replaced, and in other districts, a receiver is appointed to meet a special problem.” Coogan, Proposed Act at 743.

of Chapter X is the change of control, and in any situation where the liquidated indebtedness of a debtor is $250,000 or more, it is mandatory that a disinterested\textsuperscript{67} trustee be appointed to hold the property and conduct corporate affairs.\textsuperscript{68}

C. The Plans

1. Chapter XI

The debtor in a Chapter XI proceeding controls the preparation and execution of the plan of arrangement. In its petition for relief the debtor must set forth the provisions of the arrangement it proposes or state that it intends to propose an arrangement at a later date.\textsuperscript{69} An arrangement can modify only the rights of unsecured creditors;\textsuperscript{70} it cannot alter the rights of a secured creditor unless they are waived.\textsuperscript{71} Normally, an arrangement does not affect equity holders except through indirect means.\textsuperscript{72} Most arrangements, however, are fairly simple. In one study it was found that Chapter XI plans are ordinarily of three types:

(1) a composition plan, under which unsecured creditors agree to accept less than 100 percent payment; (2) an extension plan, under which unsecured claims are paid in full but over a longer period of time; and (3) a combination of both.\textsuperscript{73}

Regardless of the nature of the plan of arrangement, the debtor normally remains in possession of its business and is responsible for executing the plan\textsuperscript{74} with negligible court intervention.

2. Chapter X

The court closely controls the preparation and execution of

\textsuperscript{67} Section 158 of the Bankruptcy Act (11 U.S.C. § 558) sets forth several classes of individuals who are automatically classified as interested parties.


\textsuperscript{72} In Posi-Seal Int'l v. Chipperfield, 457 F.2d 237 (2d Cir. 1972), a condition precedent to the arrangement was agreement by present stockholders to a distribution of stock to third parties. After such agreement, the plan was accepted and the courts approved the arrangement which indirectly affected the stockholders' interests. For further discussion of Posi-Seal see notes 184-89 and accompanying text infra.

\textsuperscript{73} Brookings Report, supra note 3, at 138.

\textsuperscript{74} If necessary the court may appoint a receiver to assist in the rehabilitation of the debtor. Bankruptcy Act § 332, 11 U.S.C. § 732 (1970).
plans under Chapter X. If a trustee has been appointed he has the responsibility of either formulating the plan for rehabilitation or reporting to the court why a plan cannot be effected. The judge sets the time limit within which the trustee must prepare and file the plan and fixes a hearing date for consideration of the plan and any objections to it. In addition, the judge may direct the trustee to perform various investigatory functions to determine the desirability of the continuance of the business and any other matters relevant to the formulation of the plan. The judge may also require the trustee to inform the creditors, stockholders, the Securities and Exchange Commission, and other interested parties concerning the investigation of the debtor. Interested parties may submit suggestions and proposals for the plan of rehabilitation to the trustee, but he is ultimately responsible for preparing the plan and submitting it to the court for approval.

The trustee’s proposed plan ordinarily contains some of the optional provisions specified in section 216 of the Act (11 U.S.C. § 616). It must, however, include the mandatory provisions set forth in that section. A modification or alteration of the rights

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75. When the debtor continues in possession plans may be filed by the debtor, any creditor, by a stockholder, or an examiner, if directed to do so by the court. Bankruptcy Act § 170, 11 U.S.C. § 570 (1970).
77. Id.
78. Bankruptcy Act §§ 167(1) & (2), 11 U.S.C. §§ 567(1) & (2) (1970) provide: The trustee upon his appointment and qualification—(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge; (2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them . . . .
80. Bankruptcy Act § 167(6) (11 U.S.C. § 567(6)) provides that the trustee “shall give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan, or proposals in the form of plans, within a time therein named.”
82. In 11 Remington § 4568, at 323, the mandatory and optional provisions of section 216 are explained as follows:
The mandatory requirements are:
(1) provisions modifying the rights of secured or unsecured creditors or some class of them, § 216(1);
(2) provision for the payment of costs, expenses, and allowances, § 216(3);
(3) specification of the claims to be paid in cash in full, if any, § 216(5);
(4) specification of creditors and stockholders, if any, not affected by the plan, § 216(6);
(5) provision for the adequate protection for any class of creditors affected by the plan which does not accept by two-thirds majority, § 216(7);
of creditors and stockholders, or some class of them, is required. Provisions must be included for payment of all administrative costs, and the plan must specify which claims are to be paid in cash in full. The plan must identify the creditors or stockholders which will be unaffected by its provisions and must also provide for any class of creditors or stockholders which, although affected by the plan, refuses to approve it. The plan may also include any other appropriate provisions consistent with the goals of reorganization and rehabilitation. Almost "invariably [the plan] entails a restructuring of the old capital accounts as well as plans for improving the productivity of the debtor." The plans are as varied as the factual circumstances which necessitate rehabilitation. In short, the trustee is limited only by his imagination and the mandatory provisions of section 216 in his preparation of the plan of reorganization.

After the plan has been prepared, it must be approved by the judge before being presented to the creditors and shareholders for acceptance. This approval is contingent upon compliance with section 216, and with the "feasibility," and "fair and equitable,"

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(6) provision for the adequate protection of any class of stockholders which is affected and does not accept the plan by the required majority, § 216(8);
(7) provision of adequate means of execution of the plan, § 216(10);
(8) equitable provisions as to the selection of new officers upon the consummation of the plan, § 216(11);
(9) charter amendments or new charters to prohibit the issuing of nonvoting stock and providing for certain restrictions on stock issues, and for equitable provisions in securities to be issued, § 216(12); and
(10) if settlement of claims belonging to the estate is not provided for by plan, the plan must provide for their enforcement by the trustee or by an examiner, § 216(13).

The optional features may include only:
(1) provisions modifying the rights of stockholders, § 216(1);
(2) plans may deal with all or any part of the property of the debtor, § 216(2);
(3) executory contracts may be rejected, except contracts in the public authority, § 216(4);
(4) provisions for the retirement of indebtedness, § 216(9);
(5) provisions for the settlement of claims belonging to the debtor, § 216(13); and
(6) other provisions not inconsistent with Chapter X, § 216(14).

90. E. Altman, Corporate Bankruptcy in America 8 (1971).
91. See note 83 supra.
requirements. The judge has a great amount of control over a Chapter X plan by virtue of this power to determine the presence or absence of these factors. If the plan has been submitted to the Securities and Exchange Commission, then the judge must await that agency's report before approving the plan.

For the judge to assess the fairness and feasibility of the plan, the valuation of the business must be established to determine interests of secured and unsecured creditors as well as the interests of the various stockholders. This requirement was firmly established in Consolidated Rock Products Co. v. Du Bois. There the district court had favorably ruled on the fairness of the reorganization plan, but no valuation had been made. In affirming the Ninth Circuit's reversal, Justice Douglas stated that a valuation was essential to a fairness determination, saying: "Absent the requisite valuation data, the [district] court was in no position to exercise the 'informed independent judgment' which appraisal of a plan of reorganization entails." Furthermore, in order to accomplish this valuation, some effort was required "to value the whole enterprise by a capitalization of prospective earnings."

A valuation is also necessary so that the fairness determination will meet the requirements of the strict or absolute priority rule. In the context of this rule, the words "fair and equitable" are "words of art which . . . [have] acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations," and this fixed meaning is that "the stockholder's interest in the property is subordinate to the rights of creditors." Thus, in Chapter X reorganizations, the term "fair

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93. Under section 172 of the Bankruptcy Act (11 U.S.C. § 572) the judge may request the Securities and Exchange Commission to examine and report on the plan if the scheduled indebtedness of the debtor is less than $3,000,000, and must request an examination and report if the scheduled indebtedness exceeds $3,000,000.
94. The judge may also approve the plan if he has notice that the Securities and Exchange Commission will not file a report or if the time within which to file the report has expired. Bankruptcy Act § 174, 11 U.S.C. § 574 (1970).
95. Id.
96. 312 U.S. 510 (1941).
97. Id. at 520 (citations omitted).
98. Id. at 525. This was necessary to determine if the plan conformed to the absolute priority rule established in Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939). Also, a determination must be made concerning which assets are subject to claims of creditors and stockholders. 312 U.S. at 520.
100. Id. at 115.
101. Id. at 116, quoting from Louisville Trust Co. v. Louisville, New Albany & Chi-
and equitable” connotes strict priority, and the proper priority cannot be determined without a valuation. A valuation is also needed to establish the solvency of the debtor. This is important because, in a case of actual insolvency, as distinguished from inability to pay debts, the stockholders are deprived of the right to participate in the reorganized company and their acceptance of the plan is not required.102

To satisfy the strict priority rule the judge divides the creditors and stockholders into classes.103 The claims of a senior class must be fully satisfied before the claims of a junior class can be given any consideration.104 Obviously this means that the claims and rights of some creditors and stockholders will probably be eliminated in the plan of reorganization. In essence, “fair and equitable” means that stockholders and junior creditors can participate in the reorganization plan only if the claims of senior claimants are fully satisfied.

After making the determination that the plan proposed by the trustee is “fair and equitable,” the judge must determine whether it is “feasible.”105 In making this decision the court basically considers whether there is a reasonable prospect that the debtor will be rehabilitated and will be able to meet its future financial obligations.106 The focus is not on absolute certainty of success; rather, the inquiry concerns whether there is reasonable assurance of success. The purpose of reorganization is to rehabilitate and not “to place crutches under corporate cripples.”107 Thus, in determining feasibility the court is concerned with practicality and focuses on whether there is reasonable assurance that the plan will be consummated.108 Once the judge determines that a plan proposed by the trustee meets the appropriate requirements,109 then he must enter an order approving the plan

102. 11 REMINGTON §§ 4575-76.
103. Under section 197 of the Bankruptcy Act (11 U.S.C. § 597) the judge may summarily divide creditors and stockholders into classes.
108. Id. See also 11 REMINGTON § 4583; 2 MODERN BANKRUPTCY MANUAL § 1581 (1966).
109. See note 93 and accompanying text supra.
and fixing a time within which the creditors and stockholders may accept or reject the plan.\textsuperscript{110}

\section*{D. Acceptance, Confirmation, and Consummation of a Plan}

\subsection*{1. Acceptance}

Before an arrangement proposed under Chapter XI can be confirmed by the court, the plan must be accepted in writing by a majority, both in number and in amount, of the creditors affected by the arrangement.\textsuperscript{111} Acceptances may be solicited before or after the filing of the petition for an arrangement.\textsuperscript{112} Under Chapter X, in order to secure a hearing for consideration of confirmation, the proposed plan must be accepted in writing by creditors holding two-thirds in amount of the claims filed and allowed of each class.\textsuperscript{113} If the debtor is solvent, the plan must also be accepted by a majority of each class of stockholders.\textsuperscript{114} Acceptances solicited before the judge has approved a plan under Chapter X are invalid, unless the court had given its consent prior to the solicitation.\textsuperscript{115} After the requisite votes are secured, the judge designates a hearing date for consideration of confirmation of the plan and gives notice of the hearing to all interested parties.\textsuperscript{116}

\subsection*{2. Confirmation}

Before a court will confirm\textsuperscript{117} a Chapter XI arrangement, two

\begin{itemize}
\item \textsuperscript{110} \textit{Id.}
\item \textsuperscript{111} Bankruptcy Act § 362, 11 U.S.C. § 762 (1970). This section also provides that if the creditors are divided into classes the plan of arrangement must be accepted in writing by a majority of each class before the plan can be confirmed. Under section 361 of the Act (11 U.S.C. § 761) an arrangement may be confirmed at the initial meeting of creditors if it has been accepted in writing by all creditors affected by it.
\item \textsuperscript{114} \textit{Id.}
\item \textsuperscript{116} Section 179 of the Act requires that notice of the hearing be given “to the debtor, creditors, stockholders, indenture trustees, the Secretary of the Treasury, the Securities and Exchange Commission, and such other persons as the judge may designate . . . .” Bankruptcy Act § 179, 11 U.S.C. § 579 (1970).
\item \textsuperscript{117} Bankruptcy Act § 366, 11 U.S.C. § 766 (1970) provides:
\begin{itemize}
\item The court shall confirm an arrangement if satisfied that—
\begin{itemize}
\item (1) the provisions of this chapter have been complied with;
\item (2) it is for the best interests of the creditors and is feasible;
\item (3) the debtor has not been guilty of any of the acts or failed to perform any of the duties which would be a bar to the discharge of a bankrupt; and
\item (4) the proposal and its acceptance are in good faith and have not been made
\end{itemize}
\end{itemize}

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conditions must be satisfied; the arrangement must be "in the best interests of the creditors," and it must be "feasible." One judicial decision suggested this definition: "To be in the best interests of creditors the plan must give the creditors more than they would receive in liquidation." A recent commentator, however, noted that the creditor himself is not necessarily the judge as to what is in his best interest. As for feasibility, no fixed standard exists; an arrangement is generally considered feasible if "the creditors . . . [are] assured of receiving what is promised them under the arrangement but it does not require an assurance of future business success." In other words, the court's focus in determining feasibility under Chapter XI is on the likelihood of payment of creditors, as provided by the plan, rather than on the probability of the rehabilitation of the corporation.

The standards for confirmation of a Chapter X plan are much more stringent than those for arrangements. Again, feasi-
bility\textsuperscript{124} of the plan is a prerequisite to confirmation, but the
courts appear to use this term differently in Chapter X proceed-
ings. The court in \textit{In re Barlum Realty Co.}\textsuperscript{125} gave this definition:

Feasibility means that the reorganized company will emerge in
a solvent condition with reasonable prospects of financial stabili-
ty and success. Some of the factors to be considered in this
determination involve the soundness of the proposed capital
structure and the ability of the reorganized company to meet its
financial obligations at their maturity dates.\textsuperscript{126}

Thus, the courts take different approaches in considering the
feasibility of a reorganization plan vis-à-vis a plan of arrange-
ment. An arrangement will be approved as feasible if creditors
will receive what they are promised, but when a plan of reorgani-
ization is at issue, the courts consider whether there is a reason-
able prospect of the business surviving.\textsuperscript{127}

The requirement that a plan be “fair and equitable” for con-
firmation is unique to Chapter X.\textsuperscript{128} As previously noted,\textsuperscript{129} the
courts have interpreted “fair and equitable” to require a division
of creditors and stockholders into classes\textsuperscript{130} where the claims of
each class, from the senior to the junior classification, must be
fully satisfied before another class may receive payment on their
obligations.\textsuperscript{131} In essence, the strict or absolute priority rule re-
quires that parties affected by the reorganization be allowed to
retain the advantage of their respective priorities. Naturally, this
often eliminates some creditors and stockholders from participat-
ing in the reorganized business.

\textsuperscript{124} See notes 106-09 and accompanying text supra for a discussion of “feasibility”
at time of approval of plans.
\textsuperscript{126} Id. at 87. See Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 525 (1941).
\textsuperscript{127} It appears that the courts do focus on the prospect of business survival when
considering the “feasibility” of proposed plans of reorganization. The statistical data in
note 22 and the accompanying text supra indicate that approximately one-fourth of the
businesses succeeded that went through a reorganization during the study period.
\textsuperscript{128} The “fair and equitable” standard is included in section 221(2) of Chapter X
(11 U.S.C. § 621(2)) and was included in section 366(4) of Chapter XI until 1952, when it
was deleted by statute. 66 Stat. 433 (1952).
\textsuperscript{129} See notes 102-05 and accompanying text supra.
\textsuperscript{130} The division of creditors and stockholders into classes is summarily performed
\textsuperscript{131} Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939). See also 11
In some cases a majority of senior creditors or stockholders may favor the participation of junior creditors or stockholders without following strict priority, but this is not permissible. Adherence to the strict priority rule is absolutely necessary for a plan to be "fair and equitable." Thus, even where a plan is overwhelmingly supported by creditors it cannot be confirmed if it violates their priority rights.\textsuperscript{132}

3. Consummation

Upon confirmation, the provisions of an arrangement under Chapter XI are binding on the debtor and all of its creditors, whether or not they have accepted it.\textsuperscript{133} After confirmation, parties entitled to payment for priority debts and for costs and expenses incident to the arrangement are paid from the money that was previously deposited into the court by the debtor.\textsuperscript{134} The consideration for the arrangement is then distributed to the creditors whose claims were filed timely and allowed under the Act.\textsuperscript{135} Finally, the court dismisses the case\textsuperscript{136} and the debtor is discharged from all its unsecured debt provided for by the arrangement.\textsuperscript{137}

Upon confirmation of a plan of reorganization under Chapter X, its provisions become binding upon the debtor and any corporation created by the plan.\textsuperscript{138} It is also binding upon all creditors and stockholders of the debtor, whether or not they have accepted it.\textsuperscript{139} The debtor or any corporation created to execute the plan must comply with the provisions of the plan and take all action necessary to carry it out.\textsuperscript{140} If the plan requires payments to creditors and stockholders, then such payments shall be made as the judge directs.\textsuperscript{141}

After the plan of reorganization has been consummated, the judge enters a final decree discharging the debtor from its debts.

\textsuperscript{132} See Sophian v. Congress Realty Co., 98 F.2d 499 (8th Cir. 1938); Price v. Spokane Silver & Lead Co., 97 F.2d 237 (8th Cir. 1938); In re Barclay Park Corp., 90 F.2d 595 (2d Cir. 1937).


\textsuperscript{134} Bankruptcy Act § 367(2), 11 U.S.C. § 767(2) (1970). The debtor is required to deposit money necessary to pay the costs and expenses of the arrangement proceedings prior to confirmation under section 337(2) of the Act (11 U.S.C. § 737(2)).


\textsuperscript{139} Id.


and terminating all rights of stockholders, except as provided in the plan.\textsuperscript{142} The court then discharges the trustee, makes provisions for injunctions and other necessary equitable relief, and closes the estate.\textsuperscript{143} At this time the debtor hopefully is well on its way to becoming a viable corporation.

\section*{E. The Role of the Securities and Exchange Commission}

The Securities and Exchange Commission (SEC), if it feels that the debtor seeking relief under Chapter XI should be under Chapter X, may apply to the court to transfer the proceeding.\textsuperscript{144} If the court agrees, it will either dismiss the Chapter XI proceedings, or allow the petition to be amended to comply with the requirements of Chapter X.\textsuperscript{145} In most cases the management of the debtor corporation prefers a Chapter XI proceeding as an arrangement is ordinarily faster and less expensive than a reorganization. The debtor retains possession of its business\textsuperscript{146} and normally formulates the rehabilitation plan to be employed.\textsuperscript{147} Further, in an arrangement only the interests of unsecured creditors can be affected by the plan.\textsuperscript{148} On the other hand, a reorganization under Chapter X is closely controlled by the court. A disinterested trustee is usually appointed\textsuperscript{149} who assumes control of the debtor\textsuperscript{150} and prepares the plan of reorganization.\textsuperscript{151} Even debt and equity holders may be affected by the proposed plan.\textsuperscript{152} The court closely supervises the preparation and execution of the plan.\textsuperscript{153} Furthermore, the SEC is an interested party in Chapter X reorganizations,\textsuperscript{154} although only as an advisor.\textsuperscript{155} While the SEC is not responsible for formulating a plan, it is expected to

\textsuperscript{142} Bankruptcy Act § 228(1), 11 U.S.C. § 628(1) (1970). The court may make binding provisions for creditors and stockholders in its order confirming the plan or directing the transfer or retention of property.


\textsuperscript{145} \textit{Id.}


\textsuperscript{152} See note 84 and accompanying text supra.

\textsuperscript{153} See notes 76-82 and accompanying text supra.


file a report with the judge to assist him in deciding whether a proposed plan complies with the Act, and is fair and equitable, and feasible.158

Obviously, a debtor would normally prefer to proceed under Chapter XI. The Supreme Court has said, however, that the types of relief afforded by the chapters are not alternate routes to rehabilitation, but "[r]ather . . . they are legally, mutually exclusive paths to . . . financial rehabilitation."157 Thus, if a debtor has attempted to proceed under Chapter XI and the SEC has intervened to remove it to a Chapter X proceeding then the court must determine the proper avenue of relief.158 This determination may be a significant problem where the proceeding involves a medium-sized corporation.159 Normally, no problem arises with small corporations with few shareholders because there is little public interest involved and Chapter XI arrangements can usually provide the needed relief. Similarly, large corporations with complicated debt structures that have severe financial problems must generally proceed under the stricter requirements of Chapter X.

It is often difficult to determine which method of rehabilitation the court will deem proper. The first case in which the SEC advocated the transfer of a Chapter XI proceeding to Chapter X was SEC v. United States Realty & Improvement Co.160 The Supreme Court faced two issues: whether Chapter XI would provide the debtor adequate relief, and whether the SEC was entitled to intervene in the proceeding. The Court concluded that the debtor could not obtain adequate relief under Chapter XI because its complicated debt structure had to be readjusted and the proposed plan would alter the rights of stockholders. Additionally, the proposed plan did not meet the "fair and equitable" standard which was required by Chapter XI. The Court indicated that a Chapter XI arrangement would be appropriate "where there are no public or private interests involved requiring protection by the procedure and remedies afforded by Chapter X."161 The Court also ruled that the SEC could intervene in Chapter XI proceedings to protect the public's interest.162

159. See Seidman, Chapter X or Chapter XI?, 76 Com. L.J. 33 (1971).
160. 310 U.S. 434 (1940).
161. Id. at 454.
162. The right of the SEC to intervene in Chapter XI was never seriously challenged
Since the Court failed to formulate a workable test for the selection of the proper chapter, more litigation followed. In *General Stores v. Shelensky*, Justice Douglas, writing for the Court, established what has become known as the “needs” test to determine the appropriate chapter for relief. He indicated that in *United States Realty* it had been argued “that it is the character of the debtor that determines whether Chapter X or Chapter XI affords the appropriate remedy.” The same argument was advanced in *General Stores*. Justice Douglas explained that the Court had not adopted that view in *United States Realty*, but had emphasized the need to determine on the facts of the case whether the formulation of a plan under the control of the debtor, as provided by Chapter XI, or the formulation of a plan under the auspices of disinterested trustees, as assured by Chapter X and the other protective provisions of that chapter, would better serve “the public and private interests concerned including those of the debtor.”

He added, “The essential difference is not between the small company and the large company but between the needs to be served.” Justice Douglas noted that Chapter X was a more adequate remedy (1) when it was necessary to readjust the debts of the insolvent company and apply the fair and equitable doctrine; (2) when the debt structure had to be readjusted; (3) when an accounting for management misdeeds was needed; and (4) when new management was necessary.

Probably the most notable interpretation of the “needs” test is that of Judge Friendly in *SEC v. Canandaigua Enterprises Corp.* In analyzing its merits he said:

Although the “needs” test yields fairly certain and predictable results in cases at the ends of the spectrum, it is a highly erratic guide in the broad middle range. No one would doubt that a seriously embarrassed giant corporation, with secured and unsecured publicly held debt, trade and general creditors, and preferred and common stock, “needs” reorganization under Chap-

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after *United States Realty* and in 1952 section 328 of the Bankruptcy Act (11 U.S.C. § 728) was enacted authorizing intervention by the SEC.

164. Id. at 465.
165. Id.
166. Id. at 466.
167. Id. at 466-67.
168. 339 F.2d 14 (2d Cir. 1964).
ter X; no one would doubt either that a small company requiring nothing more than a moratorium from trade creditors "needs" only the swift and simple procedures of Chapter XI. 169

He first explained that in some cases the debtor "needs" features of both chapters such as the protective procedures and remedies of Chapter X and the speed and simplicity of Chapter XI. He observed:

The "needs" for the two chapters are not only conflicting but largely imponderable; we know of no scale sufficiently sensitive to weigh the near certainty of achieving a Chapter XI arrangement that may not be altogether fair and equitable against the possible emergence of a better plan from a Chapter X proceeding during which the patient may die before an operating room is ready or for which the fees of the surgeon and others in attendance may exceed the patient's means. 170

Even though few creditors or stockholders opposed the proposed arrangement in Canandaigua, Judge Friendly felt compelled to transfer the proceeding to Chapter X because, under the arrangement, publicly held debt was being subjected to adjustments in violation of the fair and equitable standard of Chapter X. 171

Shortly after Canandaigua, the Supreme Court again addressed the chapter selection issue in SEC v. American Trailer Rentals Co. 172 Basically, the Court reaffirmed the principles enunciated in United States Realty and General Stores and emphasized that the two chapters provided distinct methods of rehabilitation and were not alternate routes to the same goal. 173 The Court expressly reiterated the principle that "as a general rule Chapter X is the appropriate proceeding for adjustment of publicly held debt." 174 Explaining General Stores, the Court stated, "'Simple' compositions are still to be effected under Chapter XI." 175 Public debt could be directly affected by a Chapter XI proceeding where the public investors are few in number and familiar with the operations of the debtor, or where, although the public investors are greater in number, the adjustment of their debt is

169. Id. at 18.
170. Id. at 19.
171. Id. at 21.
173. Id. at 607.
174. Id. at 613.
175. Id. at 614.
The bankruptcy claim was relatively minor, consisting, for example, of a short extension of time for payment.\textsuperscript{176}

Interpreting \textit{General Stores} the Court remarked:

Chapter X is . . . the appropriate proceeding where the debtor has widespread public stockholders and the protections of the public and private interests involved afforded by Chapter X are required because, for example, there is evidence of management misdeeds for which an accounting must be made, there is a need for new management, or the financial condition of the debtor requires more than a simple composition of its unsecured debts.\textsuperscript{177}

The SEC argued in \textit{American Trailer Rentals} that all proceedings involving public debt had to be brought under Chapter X because its right to intervene in Chapter XI proceedings was limited to a request for removal of the proceeding to Chapter X.\textsuperscript{178} The Court rejected this argument saying that, while the SEC did not have statutory responsibilities under Chapter XI, the SEC could intervene and be heard in Chapter XI proceedings.\textsuperscript{179}

A review of several cases since \textit{American Trailer Rentals} shows that the chapter selection issue is not yet settled. In \textit{Normal Finance \& Thrift Corp. v. SEC},\textsuperscript{180} the Tenth Circuit granted the SEC's motion to dismiss the Chapter XI proceeding initiated by the debtor. The arrangement proposed by the debtor had been accepted "by the requisite number and dollar volume of the unsecured creditors."\textsuperscript{181} Purporting to follow \textit{American Trailer Rentals}, the court ruled that the debtor would have to proceed under Chapter X to get rehabilitative relief. The court's decision seemed to be based on the creditors' lack of sophistication and the type of investments involved.\textsuperscript{182} Considering the facts of the case, this was probably the best result; however, it appears that the court could easily have declared that the proposal was a simple composition and allowed it to remain in Chapter XI.\textsuperscript{183}

\begin{flushleft}
\textsuperscript{176} \textit{Id.} \\
\textsuperscript{177} \textit{Id.} at 615. \\
\textsuperscript{178} \textit{Id.} at 612. \\
\textsuperscript{179} \textit{Id.} at 613. \\
\textsuperscript{180} 415 F.2d 1199 (10th Cir. 1969). \\
\textsuperscript{181} \textit{Id.} at 1202. \\
\textsuperscript{182} \textit{Id.} at 1203. The court also cited prior misdeeds of management as a reason for transfferal to Chapter X, but that did not appear to be the primary reason. \\
\textsuperscript{183} \textit{Id.} at 1204. This is true because there were relatively few creditors involved from a small geographic area and the plan had been accepted.
\end{flushleft}
The extent of SEC involvement is not limited to requests for transfers of proceedings. In *Posi-Seal International, Inc. v. Chipperfield*, the circuit court asked for the SEC’s opinion on the propriety of a Chapter XI proceeding, and its resulting amicus curiae brief supported confirmation of the plan. After an arrangement plan had been approved, an action for removal was initiated by a shareholder of the debtor alleging that the plan affected the rights of shareholders. In order for the plan to be approved, there was to be a “reverse split of the debtor’s stock . . . [with a] distribution of a large part of it to third parties.” Obviously, this affected the rights of stockholders but the court found the reverse split to be “a condition precedent to the consummation of the plan and not created by the terms of the arrangement.” Since there were approximately 1,700 shareholders and 4,874,174 shares of common stock outstanding, it is arguable that the public interest was so great that the case should have been transferred to Chapter X. The court, however, took a pragmatic view of the proceedings and allowed the arrangement to stand since there was no indication of management wrongdoings.

The Sixth Circuit appeared to take a pragmatic view of a rehabilitation proceeding in the case of *In re KDI Corp.* In 1969 KDI had sales of approximately $140,000,000 and earnings of over $5,000,000 but by August of 1970 the company did not have funds to pay its current obligations. New management was installed and on December 30, 1971, a petition was filed under Chapter XI along with a proposed plan of arrangement. By October 29, 1971, a majority in number and amount of each class of creditors had approved the plan. It was admitted that the plan would cause significant changes in the capital structure of the debtor. The appellants contended that the “arrangement . . . [was] actually a reorganization and that the capital structure of KDI . . . [was] too complex for proceedings under Chapter XI.” The court rejected the argument. Concluding that all of the debt sub-
ject to the arrangement was unsecured and that the new management was correcting past mistakes, the court ruled that the Chapter XI arrangement was appropriate. Apparently the crucial consideration was the fact that the arrangement was working. Accordingly, the court declined to disturb the arrangement, distinguishing Normal Finance & Thrift Corp. 193

The cases since American Trailer Rentals indicate that the lower courts still have problems deciding which of the two methods of corporate rehabilitation is the appropriate one in a given case. It appears that the courts are pragmatic and if the arrangement is likely to succeed they allow it to be consummated. 194

Obviously, better guidelines are needed to prevent the unnecessary cost of litigation incurred in determining the appropriate chapter for relief.

III. PROBLEMS OF THE PRESENT SYSTEM AND PROPOSED CHAPTER VII

On its face, Chapter VII of the proposed Bankruptcy Act, as a consolidation of present Chapters X, XI, and XII, would avoid the litigation costs sustained in resolving the chapter selection issue. Considerable debate exists, however, as to whether the proposed act would solve other problems present in the existing law, some a product of the present bankruptcy system generally and others peculiar to Chapters X and XI. 195 Acknowledging the inadequacies of the structure in its present form, Congress commissioned a group to examine the existing system and to formulate

193. The court was well aware of the fact that the new president and chief executive officer of KDI had indicated that he would leave the company if the proceeding was transferred to Chapter X. Also, the banks, who were the largest creditors of KDI, notified the referee that adjustments of the terms of their loans were contingent on remaining in Chapter XI. Id. at 734.


a feasible alternative which would eliminate its negative aspects. A House Judiciary Committee Report asserted "that the present body of laws comprising our bankruptcy system is obsolete, highly uneconomical, and incapable of adequately conforming to the requirements of our modern economy." Among the reasons for revision of the Bankruptcy Act enumerated in the congressional resolution to create the bankruptcy commission were the following: (1) the significant change in social and economic conditions in this country in the more than 30 years since the last major revision of the Act; (2) the fact that more than one-fourth of the referees encounter difficulties in performing their duties. Thus, substantial improvements in the Act were needed. An exhaustive study undertaken by the Brookings Institution delineated many of the undesirable features inherent in current bankruptcy law. Prominent among the shortcomings is the discrepancy from state to state and district to district in the application of state and federal law, e.g., priority rules which vary among the states and the diversity in district court judges' policies as to allowing a debtor to remain in possession in a Chapter XI proceeding. Many judges permit a debtor to retain control of a business almost as a matter of course, while others generally appoint a trustee. Other problems pointed out in the Brookings study include the following: (1) inadequate representation of debtors by attorneys who use little imagination and fail to question valuations, lien validity, etc.; (2) use of the adversary system in situations where minimal adversary interest, if any, exists; (3) management by referees, trustees, and the bankruptcy

196. "The Commission on the Bankruptcy Laws of the United States was established by Public Law 91-354 (84 Stat. 468) effective July 24, 1970. The Commission, however, did not become fully operational until June 1, 1971. On July 30, 1973, two years and two months after it began its studies, the Commission filed its Report with the President, the Congress, and the Chief Justice of the United States.


199. Id.


201. For a strong disagreement with the Brookings findings and conclusions, particularly with the view on the administrative nature of bankruptcy proceedings, see Revit, Bankruptcy Administration and the Brookings Report—A Critical Analysis, 77 Com. L.J. 179 (1972).


203. See generally Seidman, Chapter X or Chapter XII?, 76 Com. L.J. 33 (1971).
bar which fails to properly serve debtors, creditors, or the public, and which is "categorized by loose supervision, infrequent field examinations, little concern for qualifications of personnel, archaic procedure, high costs, and unwarranted delays." With regard to excessive administrative costs, the authors of the Brookings report found that

> [o]ver 70 percent of all bankruptcy cases have no assets left after exempt property is set aside and pay neither administrative costs nor creditors. In just over half of the rest, administrative costs consume the excess assets. Thus creditors receive payment in approximately 15 percent of the cases. In this last group, administrative costs consume an average of one-quarter of the assets.

It was further concluded that the above mentioned deficiencies "are the natural result of using a judicial system to try to solve problems that are by nature administrative." With regard to Chapters X and XI, an important concern was the fact that there were relatively few successful rehabilitations. The Brookings group criticized administrative inefficiencies as being the primary factor in the vast majority of the ills of the system.

After more than two years of hearings, study, and careful deliberation, the Commission on Bankruptcy Laws submitted its report and recommendations. Harold Marsh, Chairman of the Commission, explained the report as follows in his letter of transmittal to the President, the Chief Justice of the United States, and the Congress:

Part I consists of an analysis and evaluation of the present system of bankruptcy administration in the United States and our recommendations for changes therein to reflect and adequately meet the demands of present technical, financial, and commercial activities. Part II consists of the text of proposed statutory changes to effectuate our recommendations, including a new "Bankruptcy Act of 1973" (together with explanatory notes).

The proposed Act (Part II of the Commission's report) would drastically alter both current procedures and certain substantive aspects of corporate debtor rehabilitation. As far as struggling

205. Id. at 4.
206. Id. at 197-98.
207. Id. at 198.
businesses are concerned, the major changes include the proposed creation of a Bankruptcy Administration under Chapter IV and the consolidation of present Chapters X, XI, and XII into the proposed Chapter VII. The proposed Bankruptcy Administration would be "empowered to handle almost all matters in proceedings under the Act which do not involve litigation."209 This proposal was adopted in response to criticism that the current system requires the district judge and referee to perform both judicial and administrative functions. Some writers suggest that the two functions should be separated—that a judge or referee should not be placed in the position of supervising the operation of an estate as well as adjudicating the disputes arising in connection therewith.210 The referee is faced with an almost intolerable burden of performing the judicial functions increasingly entrusted to him211 while at the same time performing his normal tedious administrative responsibilities.212

Under the proposed Act, the Bankruptcy Administrators would assume many of the duties presently performed by referees, trustees, receivers, appraisers, accountants, and attorneys.213

In short, a corps of in-house professional and clerical employees, replacing the present combination of professionals selected on a non-merit basis and individuals from private practice, would execute most of the duties of the Administration outlined in the proposed Act. However, the Administration would also be authorized to employ outside professionals (such as attorneys, accountants, auctioneers, and appraisers) where this would be more economical or efficient.214

The concept of an agency under the auspices of the executive branch to administer all bankruptcy cases has aroused great an-

209. Id. at 7.
214. Id.
agonism. The administrator not only will assume all of the present administrative responsibilities of bankruptcy judges, but many of his powers are judicial, as well. There is some question whether this government bureaucracy would be far more costly and inefficient than the system it is designed to replace.

Another major controversial proposal is the consolidation of Chapters X, XI, and XII into a single chapter (Chapter VII) designed to allow more flexibility. Chapters X and XI, as they presently exist, have been the focus of considerable criticism on various counts. Among the targets of attack have been: (1) the "fair and equitable" doctrine (absolute priority rule); (2) the varying feasibility standard; (3) the requirement that a debtor be removed from control in almost all Chapter X proceedings; and (4) SEC intervention to transfer a proceeding from Chapter X to Chapter XI. It has been argued that the SEC role in this respect

215. Seidman, The Bankruptcy Act of 1973—A Critique, 79 Com. L.J. 297, 299 (1974). This article also said that "because of the violent reaction to the proposal for a national director, the chairman and the staff of the House Subcommittee which is considering the proposed bill have spread the word that they are not committed to the concept and have invited alternative proposals." Id. See also Hertzberg & Weingarten, The Powers of the Administrator under the Proposed Bankruptcy Act, 79 Com. L.J. 82 (1974).


The administrator would be authorized, at various times required, to serve as judge, litigant, counsellor to debtors, advisor and consultant to creditors, appointee of fiduciaries, clerk of the court, trustee, receiver, distributing agent, court advisor, liquidator, appraiser, rulemaker, and regulator of fees . . . .

Id. Situations in which the administrator performs these functions are replete in the proposed Act. For example, the administrator would act as a judge under the following sections of the proposed Act: 7-102 (determines the necessity for a trustee); 7-302 (creates classifications of creditors and equity holders); 7-103(a)(6) (may allow trustee to examine witnesses). He may act as a litigant under: 2-205 (can be heard on approval and acceptance of a plan); 7-310(b) (may object to confirmation of the plan). He may act as an advisor and consultant to creditors under: 7-101(d)(3) (consults with creditors committee as to administration of the estate); 7-101(d)(4) (meets with committee to review financial condition of debtor and to consider appointment of trustee). He may act as trustee under: 7-103(b) (if no trustee appointed, administrator may perform all of duties of trustee outlined in 7-103(a)). There is no question that the administration is given broad, permissive powers in the proposed Act.


218. Although Chapter XII provides a form of rehabilitation for business debtors, it is not available to corporations; thus, it has not been treated in this paper. See note 10 supra.

219. According to one author:

One may argue that a petition by the SEC under § 328 of the Bankruptcy Act to dismiss a Chapter XI case and basically to convert it to Chapter X is no real problem today, on the ground that such petitions are rare due to an enlightened
has resulted in unnecessary and costly litigation causing enormous administrative expenses and prejudicial delay in implementing a plan. In Senate hearings prior to the establishment of the Bankruptcy Commission, the need for revision of Chapters X and XI was advanced.\(^{220}\) Asa S. Herzog, Referee in Bankruptcy for the Southern District of New York, stated:

Chapter XI cases have been frequently converted to Chapter X proceedings at the instance of the Securities and Exchange Commission on the theory that only such a move will protect public investors. In truth and in fact, in almost all these cases the investors are ultimately left out in the cold whereas in Chapter XI proceedings they could have participated in the rehabilitated company.\(^{221}\)

Proposed Chapter VII would eliminate the problem of SEC intervention to transfer a proceeding from Chapter XI to Chapter X. All cases of corporate rehabilitation would be handled under Chapter VII. The administrator would assume the current role of the SEC of protecting the public's interest in corporate rehabilitation.\(^ {222}\) Some question remains, however, whether the proposed Bankruptcy Administration can fulfill the role of the SEC.\(^ {223}\)

Proposed Chapter VII provides a compromise between Chapter X's compulsory change of control and Chapter XI's usual practice of management control.\(^ {224}\) The administrator is vested with considerable discretion as to whether to appoint a trustee regardless of the amount of the debt.\(^ {225}\) Normally the estate will

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\(^{220}\) See notes 156-58 and accompanying text \textit{supra} on the SEC's advisory role in current Chapter X proceedings.

\(^{221}\) Basic arguments against excluding the SEC are: (1) if the debt is publicly held, then the SEC is probably familiar with the corporation, and (2) the SEC has had 30 years of experience regulating securities and assisting corporate rehabilitation. It therefore seems spurious to create and use a new government bureaucracy as a substitute for a highly respected and efficient organization. \textit{See generally} Weintraub & Levin, \textit{Chapter VII (Reorganizations) as Proposed by the Bankruptcy Commission}, 47 \textit{Am. Bank. \& Com.} \textit{L.J.} 323, 331 (1973).

\(^{222}\) Coogan, \textit{Proposed Act} at 742-44.

be managed by the administrator unless a particular need for a trustee is established. If the business has debts of $1,000,000 or more and 300 or more security holders, a trustee must be appointed unless the court finds that protection offered by an independent trustee is unnecessary or inordinately expensive. This provision has been criticized as one which would in practice lead to the appointment of a trustee in all cases involving a publicly held corporation and would result in the administrator's recommendation being practically controlling. In theory, however, the section appears logically sound and would not necessarily be subject to the abuses hypothesized by some authors. To the contrary, it may prove move flexible and desirable than the present system.

As in present Chapters X and XI, Chapter VII would embody a requirement of feasibility for confirmation of a plan. The notes to the proposed Act, however, expressly reject the Chapter XI feasibility standard (the likelihood that the creditors will receive what is promised them under the plan). Instead, the Chapter X interpretation of feasibility is adopted which requires a likelihood of a successful rehabilitation. Critics of this proposal have asserted that such a standard eliminates desirable flexibility currently available under Chapter XI. This argument addresses itself to the desirability of standards and procedures allowing for slow liquidation which is supposedly not contemplated under the present Act and which would be precluded under Chapter VII.

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226. Id.
230. Id. Note 8 states in part: "If a debtor has no hope of continuing, liquidation should occur in order to prevent loss to future creditors and investors." For a discussion of the Chapter X feasibility requirement see notes 106-09 and 125-28 and accompanying text supra.
232. For other discussion of slow liquidations under the present Act see notes 20-28 and accompanying text supra. But see Coogan, Proposed Act at 753, where Mr. Coogan states:

Section 7-112 would seem to allow a procedure of slow liquidation until it ap-
The proposed Chapter VII envisions the use of a modified version of the strict priority rule presently used in Chapter X proceedings to determine the fairness of plans of reorganization.\textsuperscript{233} The "best interests of creditors" standard of the present Chapter XI is abandoned in favor of applying the fair and equitable doctrine to all plans of reorganizations.\textsuperscript{234} Perhaps the greatest modification to the existing strict priority rule would be that a plan could be approved if "there is a reasonable basis for the valuation on which the plan is based."\textsuperscript{235} While the proposed Act is not intended to alter the principle that senior interests participate prior to juniors, it would allow the court "more leeway in arriving at an informed estimate of valuation."\textsuperscript{236} This would appear to encourage competing interests to negotiate the valuation of the debtor. Such a process probably would lead to higher valuations and allow more creditors to participate in the reorganized business. However, senior claimants are likely to object to this approach because they may feel undercompensated because of the higher valuations. Other probable points of controversy are that the proposal specifically allows possible participation at a future date by interests initially precluded\textsuperscript{237} and allows ownership to participate in violation of strict priority if the participation is supported by a contribution to the plan.\textsuperscript{238} Obviously, the proposed "fair and equitable" standard could be a major source of litigation if the proposed Act is adopted. However, if it is judicially construed to allow Chapter XI type arrangements, and if standards are developed for valuations, then the adoption of this doctrine to determine the fairness of plans should be an improve-

\begin{itemize}
\item \textsuperscript{233} II COMMISSION REPORT, supra note 10, at 241-42, 252, 254 (§§ 7-310(d)(2)(B), 7-303(3) & (4), and § 7-310, Notes 6 & 9, Bankruptcy Act of 1973). For a detailed discussion of the strict priority rule and the proposed rule under Chapter VII, see Note, The Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations, 87 Harv. L. Rev. 1786 (1974).
\item \textsuperscript{235} II COMMISSION REPORT, supra note 10, at 252 (§ 7-310(d)(2)(B) Bankruptcy Act of 1973).
\item \textsuperscript{236} Id. at 254 (§ 7-310, Note 9(c), Bankruptcy Act of 1973).
\item \textsuperscript{237} Id. at 241 (§ 7-303(3) Bankruptcy Act of 1973).
\item \textsuperscript{238} Id. at 242 (§ 7-303(4) Bankruptcy Act of 1973).
\end{itemize}
ment over the present system. \(^{239}\)

In summary, one cannot argue with the goals of the proposed Act; but they are not likely to be attained unless certain sections are substantially revamped. As one commentator has said:

Very few people disagree with the objectives expressed, but most informed and interested parties become emotional about some part of the proposed Act. The commission tried to assemble regulations that would cover all situations in all communities whether large or small, urban or rural — and all business from the multinational conglomerates to the "mom & pop" grocery store. It just wasn't in the cards. \(^{240}\)

There is no doubt that the present system of relief offered to corporate debtors under the Bankruptcy Act is in need of comprehensive changes. The Act proposed by the Bankruptcy Commission, however salutary its provisions may be, should not be substituted for the present Act without detailed examination and modification.

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\(^{239}\) The proposal to allow future participation if warranted (§ 7-303(3)) is not expected to create a great amount of litigation. However it may create problems in formulating plans and determining valuation. Allowing the owners of the debtor (§ 7-303(4)) to participate in the reorganized company is not likely to provoke much litigation, because the participation is conditioned on the owner making a meaningful contribution to the plan.
