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Francis F. Quittner

Jeffrey Chanin

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A NEW DEBTOR RELIEF PROCEEDING FOR THE MIDDLE SIZE CORPORATION: SOME CONCRETE PROPOSALS (CHAPTER X-1/2)

Francis F. Quittner* and
Jeffrey Chanin**

I. INTRODUCTION

The need for new debtor relief options to supplement the corporate rehabilitative opportunities now available under Chapters X and XI of the Bankruptcy Act¹ has now become unmistakable and is well recognized by the bar,² the courts,³ and the National Bankruptcy Conference.⁴ The debate presently in progress relates generally to the method by which such additional relief should be afforded. There are three general proposals presently under consideration. One proposal suggests that Chapter X be amended to allow for a pervasive reorganization of middle size corporations with some relaxation of the time-consuming procedural requirements of that proceeding. Another alternative offered is the creation of a new

* LL.B. 1925, Fordham University; Member, National Bankruptcy Conference; Chairman, Bankruptcy Committee of Ninth Circuit Judicial Conference 1954-1964; Member, California Bar.

** B.A. 1962, Brooklyn College; LL.B. 1965, Harvard University; Member, California State Bar Committee on Debtor-Creditor Relations; Member, California Bar.

¹ Chapter X, "Corporate Reorganizations," Bankruptcy Act §§ 101-276, 11 U.S.C. §§ 501-676 (1964). Chapter XI, "Arrangements," Bankruptcy Act §§ 301-399, 11 U.S.C. §§ 701-99 (1964). Chapter XII, "Real Property Arrangements by Persons Other Than Corporations," Bankruptcy Act §§ 401-526, 11 U.S.C. §§ 801-926 (1964) (Available only to non-corporate debtors). Real property arrangements are not treated in this article due to the limited scope and utility of this proceeding.

² See Quittner, *Recent Developments Under Chapters X and XI of the Bankruptcy Act*, 21 BUS. LAW. 107 (1965); Weintraub and Levin, *From United States Realty to American Trailer Rentals: The Availability of Debtor Relief for the Middle-Sized Corporation*, 34 *FORDHAM L. REV.* 419 (1966).

³ *SEC v. Canandaigua Enterprises Corp.*, 339 F.2d 14 (2d Cir. 1964). "[W]e know of no skill 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 Chapter X proceedings 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." *Id.* at 19.

⁴ National Bankruptcy Conference Resolution No. 3 (1965), "Resolved that the conference approves the proposal that the committee on arrangements and reorganization study the desirability of including another chapter in the Bankruptcy Act to satisfy the needs of the so-called 'middle-sized corporation.'"

chapter proceeding (hereinafter referred to as Chapter X-1/2) to afford speedy, relatively inexpensive and pervasive debtor relief for the middle-size corporation. Finally, there is the suggestion that the scope of arrangement proceedings be broadened to permit a more extensive reorganization of a corporate debtor's capital and debt structure. This article supports the view favoring creation of a new Chapter; after briefly exploring the rationale of this position, specific proposals will be suggested for certain basic features of this proceeding.

II. REORGANIZATION VS. ARRANGEMENT

When a corporation of intermediate size, with publicly held securities, finds itself in serious financial difficulty, requiring action, a choice must be made between the available alternatives for debtor relief. Depending upon the nature and extent of the general financial problem and remedy required, any one of the following might be attempted: (a) an informal out-of-court moratorium, composition or settlement with creditors; (b) the filing of a petition for an arrangement under Chapter XI of the Bankruptcy Act; (c) the filing of a petition for reorganization under Chapter X of the Bankruptcy Act; (d) a corporate liquidation or dissolution under applicable state law; (e) an assignment for the benefit of creditors; (f) the filing of a voluntary petition in bankruptcy. Clearly alternatives *d*, *e* and *f* are oriented toward liquidation, and would be chosen only where no reasonable expectation of rehabilitating the company exists. Therefore, a firm with rehabilitation potential is left with a choice of one of the three remaining alternatives.

When the financial problems require only a breathing spell from creditor pressure or where all or substantially all of the creditors will agree to a composition or moratorium, the first choice should ordinarily be an informal out-of-court arrangement. This option affords the advantage of low cost, speed, flexibility and little or no disruption of business activity. Unfortunately, in many cases, such a course of action is not feasible due to creditor recalcitrance, levies, attachments (or the threat thereof), creditor-management distrust, or due to the need for a more thoroughgoing and drastic remedy for corporate financial ills. In these cases, the only available alternatives are a Chapter XI arrangement or a Chapter X reorganization. The basic characteristics of these proceedings must be understood in order to intelligently choose the most appropriate vehicle for corporate rehabilitation.

A. *The Common Ground*

As contrasted with bankruptcy or non-bankruptcy liquidations, Chapters X and XI look toward the rehabilitation of the debtor

corporation and its continued operation. Under both proceedings, the corporate debtor can continue to operate under the supervision of the bankruptcy court without harassment by individual creditors.⁵ Financing can be obtained upon certificates issued under the aegis of the court on such terms as the court may approve.⁶ Under each chapter, preferences and other types of voidable transfers can be set aside,⁷ and the validity and amount of questionable claims can be expeditiously determined.⁸ Under both, either upon approval of an application to the court or by the terms of an arrangement, executory contracts of the debtor may be rejected, with damages resulting therefrom being treated as unsecured claims.⁹ Further, certain limited tax advantages arise from the fact that forgiveness or reduction of indebtedness does not result in taxable income to the debtor when properly accomplished by one of these reorganization proceedings.¹⁰

Finally, each chapter provides for approval of plans by a less

⁵ *Chapter X:*

Bankruptcy Act § 113, 11 U.S.C. § 513 (1964) (Discretionary temporary stay of foreclosures and other lien enforcement proceedings prior to approval of petition).

Bankruptcy Act § 116(4), 11 U.S.C. § 516(4) (1964) (Stay of actions or proceedings to enforce liens (post approval)).

Bankruptcy Act § 148, 11 U.S.C. § 548 (1964) (Automatic stay of foreclosures, enforcement of liens, prior bankruptcy proceedings or receiverships (post approval)).

Bankruptcy Act § 189, 11 U.S.C. § 589 (1964) (Operation of business by trustee or debtor in possession).

Chapter XI:

Bankruptcy Act § 314, 11 U.S.C. § 714 (1964) (Discretionary stay of actions to enforce liens and other suits against the debtor).

Bankruptcy Act § 343, 11 U.S.C. § 743 (1964) (Operation of debtor's business by receiver, trustee or debtor in possession).

Both:

Bankruptcy Act § 2(a)(15), 11 U.S.C. § 11(a)(15) (1964) (General omnibus jurisdiction of bankruptcy courts to enforce provisions of the Act).

Bankruptcy Act § 11(a), 11 U.S.C. § 29(a) (1964) (Stay of pending actions upon dischargeable debts until a discharge is granted or the case dismissed).

⁶ "[U]pon such terms and conditions and with such security and priority in payment over existing obligations as in the particular case may be equitable." Bankruptcy Act §§ 116(2), 344, 11 U.S.C. §§ 516(2), 744 (1964).

⁷ See Bankruptcy Act §§ 102, 112, 187, 188, 302, 60, 67, 70(c), 70(e), 11 U.S.C. §§ 502, 512, 587, 588, 702, 96, 107, 110(c), 110(e) (1964). *In re J. R. Cianchette & Sons*, 198 F. Supp. 740 (N.D. Me. 1961); *In re Savage Mills, Inc.*, 170 F. Supp. 559 (E.D.N.Y. 1959); *Whiteford Plastics Co. v. Chase National Bank*, 179 F.2d 582 (2d Cir. 1949); *In re Custom Made Tires Corp.*, 108 F.2d 172 (2d Cir. 1939).

⁸ See Bankruptcy Act §§ 196, 336(2), 369, 11 U.S.C. §§ 596, 736(2), 769 (1964).

⁹ Bankruptcy Act §§ 116(1), 202, 313(1), 353, 11 U.S.C. §§ 516(1), 602, 713(1), 753 (1964).

¹⁰ Bankruptcy Act §§ 268, 395, 11 U.S.C. §§ 668, 795 (1964). Where a reorganization has as one of its principal purposes the avoidance of taxes the court can refuse to confirm the plan of reorganization. Bankruptcy Act § 269, 11 U.S.C. § 669 (1964). In an arrangement proceeding where it is found that tax avoidance is one of the principal purposes of the proceeding, the exemption from income taxation may be disallowed. Bankruptcy Act § 395, 11 U.S.C. § 795 (1964).

than unanimous vote of creditors that binds the dissenting minority. In Chapter XI a majority in number and amount of creditors of each class having proved and allowed claims is sufficient,¹¹ while in Chapter X the acceptance of the plan by the holders of claims equal to two-thirds of the total dollar amount of each class of proved and allowed debts and a simple majority of the outstanding stock of each class in which proofs of interests have been filed and allowed is sufficient to bind all members of each class.¹²

Having outlined the basic common ground of Chapters X and XI, it remains to sketch the essential distinguishing characteristics of the two proceedings.

B. Chapter X

A Chapter X proceeding may be commenced by a petition of the debtor corporation, three of its creditors or an indenture trustee.¹³ It requires the appointment of an independent and "disinterested" trustee¹⁴ whenever the debts of the corporation exceed \$250,000.¹⁵ The petition must be approved by the judge before a plan can be proposed.¹⁶ The debtor, creditors, an examiner or a stockholder may, under certain circumstances, propose a plan of reorganization where no trustee is appointed,¹⁷ but in all other cases the trustee is the sole party empowered to submit a plan.¹⁸ Throughout a Chapter X proceeding, the Securities and Exchange Commission is a party in interest and acts as advisor to the court on the merits of the plan.¹⁹ A Chapter X proceeding is, for the most part,

¹¹ Bankruptcy Act § 362(1), 11 U.S.C. § 762(1) (1964).

¹² Bankruptcy Act § 179, 11 U.S.C. § 579 (1964) (Note that stockholder approval is required only where the debtor is found "not to be insolvent.").

¹³ Bankruptcy Act § 126, 11 U.S.C. § 526 (1964). *See also* Bankruptcy Act § 107, 11 U.S.C. § 507 (1964).

¹⁴ The term "disinterested" as used in Chapter X has a special meaning which is defined in Bankruptcy Act § 158, 11 U.S.C. § 558 (1964). In general the requirement of "disinterestedness" is one which bars any person having any direct or indirect interest in the debtor, its creditors or securities holders from acting as trustee. Note also that the attorney for the trustee must also be "disinterested." Bankruptcy Act § 157, 11 U.S.C. § 557 (1964).

¹⁵ Bankruptcy Act § 156, 11 U.S.C. § 556 (1964).

¹⁶ *See* Bankruptcy Act §§ 141-49, 161-69, 11 U.S.C. §§ 541-49, 561-69 (1964).

¹⁷ Bankruptcy Act § 170, 11 U.S.C. § 570 (1964). Stockholders have the right to propose a plan of reorganization only "if the debtor is not found to be insolvent." § 170(3). The "examiner" referred to in section 170(4) is a "disinterested" person appointed by the judge where the debtor is continued in possession and no trustee is appointed and acts in the capacity of trustee for certain specified purposes. Bankruptcy Act § 168, 11 U.S.C. § 568 (1964).

¹⁸ Bankruptcy Act § 169, 11 U.S.C. § 569 (1964). Note, however, that suggestions or proposals of a plan may be given to the trustee by stockholders and creditors and the trustee is required to give such parties notice of their right to do so. Bankruptcy Act § 167(6), 11 U.S.C. § 567(6) (1964).

¹⁹ Bankruptcy Act § 161, 11 U.S.C. § 561 (1964) (SEC given notice of hearing).

administered by the United States District Judge, but certain specific aspects of the case may be referred to a referee in bankruptcy, who may act as referee or special master.²⁰

The most important characteristic of Chapter X which distinguishes it from Chapter XI is the clear authority of the reorganization court, through a plan, to affect not only unsecured indebtedness, but secured indebtedness and shareholders' equity as well.²¹ Further, the pervasive quality of a Chapter X reorganization even extends to subsidiaries of a debtor corporation where required.²²

C. Chapter XI

A Chapter XI proceeding can be initiated by means of a voluntary petition for an arrangement filed by the debtor.²³ The debtor alone has the power to propose or modify an arrangement²⁴ and, in many cases, where a receiver is not appointed,²⁵ remains in possession of its property and operates its business under court supervision.²⁶ An arrangement can generally be proposed and presented to creditors at any time, and the court will receive acceptances of the arrangement at the first meeting of creditors or at any continuation

Bankruptcy Act § 171, 11 U.S.C. § 571 (1964) (SEC given notice of hearing on approval of plan).

Bankruptcy Act § 172, 11 U.S.C. § 572 (1964) (SEC empowered to examine plan and submit report to court).

Bankruptcy Act § 173, 11 U.S.C. § 573 (1964) (SEC report on plan required before judge can approve plan where SEC does not notify court that it does not intend to file such a report).

Bankruptcy Act § 179, 11 U.S.C. § 579 (1964) (SEC notified and is a party to hearing on confirmation of plan).

Bankruptcy Act § 208, 11 U.S.C. § 608 (1964) (SEC may intervene generally as a party at any stage in the proceeding).

²⁰ Bankruptcy Act § 117, 11 U.S.C. § 517 (1964).

²¹ Bankruptcy Act § 216, 11 U.S.C. § 616 (1964).

²² Bankruptcy Act § 129, 11 U.S.C. § 529 (1964) (Permits reorganization of parent and subsidiary by a single reorganization court even where they are located in different districts or states).

²³ Bankruptcy Act §§ 321-22, 11 U.S.C. §§ 721-22 (1964). However, in practice creditors can often force the debtor into an arrangement by threatening to file an involuntary petition in bankruptcy, thus leaving the debtor with no choice but to resist the involuntary petition or file a petition for an arrangement under § 321 of the Act. Cf. the alternatives under Chapter X, Bankruptcy Act § 126, 11 U.S.C. § 526 (1964).

²⁴ Bankruptcy Act §§ 306(1), 323, 363, 11 U.S.C. §§ 706(1), 723, 763 (1964).

²⁵ Bankruptcy Act § 332, 11 U.S.C. § 732 (1964). The practice with regard to the appointment of a receiver vel non differs from district to district. *E.g.*, in the Central District of California, "in proceedings for arrangement under the Bankruptcy Act, the debtor shall be continued in possession only in exceptional cases where compelling considerations so require." CENT. DIST. OF CAL. BANKRUPTCY R. 218(a) (West Supp. 1967).

²⁶ Bankruptcy Act §§ 342-43, 11 U.S.C. §§ 742-43 (1964).

thereof.²⁷ Generally, several meetings will be required before a plan is formulated which will command the necessary acceptance of the majority in number and amount of each class of unsecured creditors.²⁸ The entire arrangement proceeding is usually handled by a referee in bankruptcy since all references to judicial authority in Chapter XI are either to the "court"²⁹ or jointly to the judge and referee. When the arrangement has been confirmed, the debtor is usually revested with its assets and is discharged from its outstanding, dischargeable obligations.³⁰ Note once again that classically in Chapter XI proceedings only unsecured indebtedness can be affected or treated by the arrangement and any secured debt remains as it was before the proceeding was commenced or the arrangement confirmed.

III. CHAPTER "X-1/2"

A. Goals

Before turning our attention to the substantive and procedural shape which the proposed chapter proceeding might take, it is wise to consider the purpose of such legislation. The primary goal of this suggested new proceeding, is to fill a present need for more pervasive and adequate rehabilitative relief in a form which will not, by its own terms, cause the corporate debtor's demise. However, to state this as a goal is to say very little about the actual nature of the problem at hand. Should speed, efficiency and low costs be emphasized? Should Chapter X-1/2 emphasize protection of both creditors and stockholders or one as opposed to the other? What role should the government have in the proceeding and through what agency? To whom is the leadership of the proceeding to be given: the debtor, a trustee, or other? How pervasive is the new proceeding to be? The responses to some of these considerations seem reasonably well-established and others not.

Some proposals must be incorporated in any future enactment of Chapter X-1/2 if adequate relief to the middle-size corporation is to be afforded. Decisions between alternatives necessarily involve

²⁷ Bankruptcy Act § 336(4), 11 U.S.C. § 736(4) (1964).

²⁸ Bankruptcy Act § 362(1), 11 U.S.C. § 762(1) (1964).

²⁹ Bankruptcy Act § 1(9), 11 U.S.C. § 1(9) (1964), defines "court" as either the judge or referee. In the Central District of California all arrangement proceedings are referred generally to the referees in bankruptcy. CENT. DIST. OF CAL. BANKRUPTCY R. 202(a) (West Supp. 1967).

³⁰ Bankruptcy Act § 371, 11 U.S.C. § 771 (1964). (Note that the discharge is conditioned by the terms of the arrangement.). Compare the effect of a final decree in a Chapter X proceeding which discharges the debtor from all of its debts whether dischargeable or not (Bankruptcy Act § 228(1), 11 U.S.C. § 628(1) (1964)), with confirmation under Chapter XI which does not discharge debts enumerated in section 17 of the Act. Bankruptcy Act § 371, 11 U.S.C. § 771 (1964).

a balancing of various interests and in some cases a clear preference must be shown in order to obtain effective relief. It is submitted that the following principles should guide those charged with the preparation and drafting of such legislation.

1. The new proceeding should be available only to corporations. Since Chapter X is available to corporate debtors, the issue of a shift from chapter to chapter by a proceeding under section 328 of the Bankruptcy Act or otherwise does not arise in the case of non-corporate debtor proceedings.³¹ In addition, the problem of debtor needs versus feasibility tends to arise most often in cases involving corporate debtors; also, the special problems of securities holders occur only in corporate debtor proceedings. To meet these problems squarely and to eliminate the necessity of dealing with special problems of non-corporate debtors,³² the scope of any new proceeding of the type under discussion should be limited to corporations.

2. Availability of the new proceeding should be limited to corporate entities having a fixed maximum indebtedness and a fixed maximum number of shareholders. The National Bankruptcy Conference Subcommittee studying this problem has reached a tentative consensus which would limit the scope of this proposed chapter to corporations having a scheduled indebtedness (secured and unsecured) of not more than six million dollars and securities holders of all classes not exceeding 5,000 in number. There is some justification for the above figures which can be drawn from section 172 of Chapter X which provides a judge with the option of submitting a plan of reorganization to the Securities and Exchange Commission, when the debtor's scheduled indebtedness does not exceed three million dollars and requiring him to do so in all other cases. Allowing for inflationary trends over the past 30 years, since the enactment of Chapter X, the above figures might have some appeal as being in keeping with the spirit of the Chandler Act Amendments of 1938.

3. Chapter X-1/2 should not contain unessential time-consuming procedural steps. In reorganization proceedings a great deal of delay is occasioned by required hearings at virtually every step in the proceeding with time being consumed by notice periods, required mailings, etc. It is this delay and the increased costs occasioned thereby, which has in many cases caused an entire reorganization to collapse with disastrous consequences to all concerned. In debtor

³¹ The real property arrangement (Chapter XII) is available only to non-corporate debtors including individuals, partnerships; the Chapter XIII wage earner plan is available only to employed individuals. Bankruptcy Act §§ 406(6), 606(3), (6), 11 U.S.C. §§ 806(6), 1006(3), (6) (1964).

³² *E.g.*, community property, death.

relief proceedings "time and money" and the funds often wasted by unnecessary procedural delays can be put to better use.

4. The new chapter proceeding should emphasize debtor relief. In this area, as in others, a choice has to be made; therefore, the rehabilitation features of the proceeding should be emphasized. In any event, such a new proceeding should provide an adequate opportunity for interested parties to investigate past corporate affairs to at least the degree presently afforded by Chapters X and XI.³³

5. The new chapter should provide a central role for the Securities and Exchange Commission within its framework so that the interests of public securities holders are adequately protected.

6. The debtor should have a greater role in the proceeding than is presently allowed by Chapter X. In many ways the debtor, through its officers and agents, is in the best position to accept and carry out the leadership role in debtor relief proceedings. Giving the debtor greater latitude in its role would facilitate operations, cut costs and eliminate duplication of effort.

7. An active role for creditors and stockholders' committees should be provided for and encouraged. Past experience has shown that creditors and stockholders who act independently in chapter proceedings are often tilting at windmills with their actions often overlooked. Creditors and stockholders acting in concert through representative committees with retained counsel and a recognized role to play would strengthen the positions of all creditors and stockholders, and would facilitate a more constructive relationship between the debtor and the other interests involved.

8. The new proceeding should be referable in its entirety to a referee in bankruptcy at an early stage. Recognition of the training and experience of referees in bankruptcy requires that they should be preferred as the judicial officer to oversee the proceedings; however, the ultimate power to refer or not to refer should be left to the discretion of the district judge.

9. The absolute priorities rule (sometimes called the "fair and equitable requirement") should not be carried over to the proposed new chapter. The requirement imposed by section 174 of Chapter X that a plan be "fair and equitable and feasible" has proved in many cases to be so harsh as to work an injustice on all parties concerned. A more flexible approach calling upon the good sense of all parties and the equities of the particular case should be adopted.

³³ Bankruptcy Act §§ 167, 336, 337, 11 U.S.C. §§ 567, 736, 737 (1964).

B. Some Concrete Suggestions

As the court indicated in *SEC v. Canadaiqua Enterprises Corp.*,³⁴ "the decision by the district judge [Chapter X v. Chapter XI] is almost bound to reflect his particular experience and predilections . . ." ³⁵ The following proposals are, to an undetermined extent, similarly derived.

1. *Initiating the proceedings.* The debtor, three or more creditors having secured or unsecured claims liquidated as to liability and amount of \$25,000 or more, or an indenture trustee should be able to initiate the proceeding. This provision is in accord with section 126 of Chapter X with the minimum claim increased from \$5,000 to \$25,000. Although in Chapter XI only the debtor may initiate a proceeding, it is believed best to give creditors an alternative to an involuntary petition in bankruptcy. It also provides an alternative to an involuntary reorganization under Chapter X which creditors might well be reluctant to invoke due to absolute priority problems or the high cost of such proceedings. Further, it should be possible to file in a pending bankruptcy proceeding either before or after adjudication.³⁶

The petition should require the allegation of all the items required by section 130 of the Bankruptcy Act,³⁷ except for the allegation required by subsection (7) that adequate relief cannot be obtained under Chapter XI of the Bankruptcy Act.³⁸ In place of

³⁴ 339 F.2d 14 (2d Cir. 1964).

³⁵ *Id.* at 19.

³⁶ In accord with § 127 (of Chapter X) and § 321 (of Chapter XI), 11 U.S.C. §§ 527, 721 (1964).

³⁷ Bankruptcy Act § 130, 11 U.S.C. § 530 (1964):

Every petition shall state—

- (1) that the corporation is insolvent or unable to pay its debts as they mature;
- (2) the applicable jurisdictional facts requisite under this chapter;
- (3) the nature of the business of the corporation;
- (4) the assets, liabilities, capital stock, and financial condition of the corporation;
- (5) the nature of all pending proceedings affecting the property of the corporation known to the petitioner or petitioners and the courts in which they are pending;
- (6) the status of any plan of reorganization, readjustment, or liquidation affecting the property of the corporation, pending either in connection with or without any judicial proceeding;
- (7) the specific facts showing the need for relief under this chapter and why adequate relief cannot be obtained under Chapter XI of this Act; and
- (8) the desire of the petitioner or petitioners that a plan be effected.

³⁸ Since one of the goals of the proposed new proceeding is to avoid uncertainty as to where the debtor belongs (Chapter X or XI) the requirement of section 130(7) of Chapter X that the petition state that adequate relief cannot be obtained under Chapter XI must be deleted. A corporation meeting the numerical tests of indebtedness and stock interests should be permitted to invoke the relief of this new proceeding without having to demonstrate that Chapter XI is not available to serve its needs.

section 130(7) the petition should require a recitation of facts indicating that the debtor's liabilities and outstanding stockholdings comply with the numerical qualification tests for the chapter outlined above.

2. *Approval of the petition.* In voluntary cases, the court should be able to automatically approve a petition containing the requisite allegations retaining the right to dismiss, adjudicate or transfer the proceeding to Chapter X at any time thereafter: prior to confirmation, if it appears that the facts alleged in the petition are untrue; or in the case of fraud upon the court; or where it later is established that the company did not meet the fixed requirements of the chapter. The elimination of the requirement of a formal hearing on approval in voluntary cases would be the first instance of time saving in the new reorganization proceedings. A meeting of creditors and stockholders similar to the first meeting of creditors in Chapter XI cases³⁹ would seem an adequate substitute for a formal hearing as well as that required under section 161 of Chapter X. If the court retains the right to dismiss, adjudicate or transfer to Chapter X, then there would seem to be no real need for this intervening step. Limiting this power to the pre-confirmation period seems appropriate, since, if the proceeding has been sufficiently successful to be confirmed, then there is no real need for a transfer, dismissal or adjudication. All parties by that time would have had an adequate opportunity to investigate and ascertain the facts required to initiate a proceeding to dismiss, transfer or adjudicate.

3. *Reference of the proceeding.* At this point in the progress of the proceeding, the district judge should be given the discretionary authority to refer the entire proceeding to a referee in bankruptcy.⁴⁰

The present practice in Chapter X proceedings varies from district to district.⁴¹ However, in too many instances all that results from the division of judicial authority inherent in the use of referees as special masters is a waste of time and duplication of effort, since the process of special reference requires a hearing before the referee acting as special master and often another before the judge to consider the master's report.⁴² By permitting a discre-

³⁹ Bankruptcy Act §§ 334, 335, 11 U.S.C. §§ 734-35 (1964).

⁴⁰ The concept of automatic reference, adopted in many districts, might ultimately relieve the district judges of any non-appellate role in these proceedings.

⁴¹ The authors are informed by the court that in the Second Circuit the judges customarily retain reorganization cases and refer only specific problems to referees acting as special masters. In California the majority of the Chapter X cases are referred to referees, as referees and as special masters, and with few exceptions the referees conduct the entire proceeding.

⁴² In the authors' experiences, the district judges rarely act contrary to the

tionary general reference all parties will be protected by the right to petition for a direct review of the referee's orders by the district judge,⁴³ while the expertise and experience of referees in bankruptcy can be brought directly to bear on the difficult problems involved in these proceedings.

4. *Appointment and qualification of a trustee.* The judge or the referee should have the authority and discretion to appoint a trustee or not, as the facts of the case dictate. There should be no statutory requirement that a trustee be appointed where the assets or liabilities of the debtor exceed a certain sum.⁴⁴ Whether a trustee should or should not be appointed should depend upon the needs of the case, *i.e.*, does the debtor have adequate management, are there any facts indicating wrongdoing on management's part, would creditors and others be better protected with a trustee in control? The determination of all of these questions should be left to the discretion and judgment of the court. Any party in interest should have the right to petition the court to appoint a trustee at the time of the filing of the petition and at any time thereafter where the court retains the debtor in possession.

It should be clearly set forth that a trustee or debtor in possession possesses all of the title, powers, rights, duties and obligations of a trustee in ordinary bankruptcy proceedings as well as the powers of a receiver in equity and is vested with all of the avoidance powers granted by sections 60, 67 and 70 of the Bankruptcy Act.⁴⁵

Proceedings similar to those required by section 161 of Chapter X⁴⁶ should be replaced by a noticed first meeting of creditors and stockholders similar to the first meeting of creditors in arrangement proceedings. This section of Chapter X presently provides for a hearing to be held not less than 30 days, nor more than 60 days after the approval of the petition, upon 30 days notice to determine whether or not the trustee is qualified and disinterested. Provision should be made for the filing of an affidavit by the trustee which states that he is a disinterested person and not disqualified by any

recommendations of the referee and special master where no exceptions are taken to the master's findings and report.

⁴³ *Cf.* Bankruptcy Act § 39(c), 11 U.S.C. § 67(c) (1964).

⁴⁴ *Cf.* Bankruptcy Act § 156, 11 U.S.C. § 556 (1964) (requires the appointment of a trustee where the debtor's liquidated and non-contingent liabilities are \$250,000 or more).

⁴⁵ 11 U.S.C. §§ 96, 107, 110 (1964).

⁴⁶ Bankruptcy Act § 161, 11 U.S.C. § 561 (1964): "The Judge shall fix a time of hearing, to be held not less than thirty days and not more than sixty days after the approval of the petition, of which hearing at least thirty days' notice shall be given by mail to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission and such other persons as the judge may designate, and, if directed by the judge, by publication in such newspaper as the judge may designate."

of the provisions now contained in section 158.⁴⁷ If it appears to the Securities and Exchange Commission or any other party in interest that the affidavit of the trustee is false or improper, then a motion could be made for his removal.

It is recommended that serious thought be given to a relaxation of the requirement of "disinterestedness" as it is presently applied to trustees and their counsel in Chapter X proceedings. The new proceeding should permit the inclusion of persons who are otherwise qualified and in some cases familiar with the debtor's affairs but who may be presently disqualified from acting in Chapter X cases. One suggestion might be to permit the judge or referee to appoint any person as trustee or as trustee's counsel who could not have been barred from acting as receiver or receiver's counsel in a Chapter XI proceeding.

If the debtor is initially permitted to remain in possession, then the court should be able on its own motion or upon the filing of any objections to determine, after a hearing, whether the debtor should be allowed to remain in possession. Many districts, including California, have local rules governing arrangements which require the court, upon short notice to the creditors, to direct the debtor and all other parties to appear and show cause why a receiver should not be appointed.⁴⁸

The adverse effects of the present Chapter X rules are self-evident. During the 60-day lapse between the appointment of a trustee and the hearing under section 161 of the Bankruptcy Act (the 60-day limit is usually taken advantage of rather than the 30-day period), the trustee is in limbo and usually does nothing more than preserve the property pending the hearing. Sixty days which could be devoted to productive activity, therefore, are wasted.

5. *Preparation of schedules.* In cases of a voluntary petition the debtor should be required to file schedules of assets and lia-

⁴⁷ Bankruptcy Act § 158, 11 U.S.C. § 558 (1964). "A person shall not be deemed disinterested . . . if:

- (1) he is a creditor or stockholder of the debtor; or
- (2) he is or was an underwriter of any of the outstanding securities of the debtor or within five years prior to the date of the filing of the petition was the underwriter of any securities of the debtor; or
- (3) he is, or was within two years prior to the date of the filing of the petition, a director, officer, or employee of the debtor or any such underwriter, or an attorney for the debtor or such underwriter; or
- (4) it appears that he has by reason of any other direct or indirect relationship to, connection with, or interest in the debtor or such underwriter, or for any reason an interest materially adverse to the interests of any class of creditors or stockholders."

⁴⁸ E.g., CENT. DIST. OF CAL. BANKRUPTCY R. 218(a) (West Supp. 1967) (This is usually accomplished by a *sua-sponte* order to show cause.).

bilities and a statement of affairs with its petition or within such further time as the court allows. Further approval of the petition could be conditioned upon the filing of such schedules so the judge would be able to base his decisions upon a verified document which would provide him with information of the debtor's financial affairs. The schedules, statement of affairs and statement of executory contracts should be in the form customarily used in bankruptcy and arrangement proceedings. In addition to the above the debtor should be required to file a document disclosing the names and addresses of its stockholders and the number and type of shares held.

Where an involuntary petition is filed and approved, the court should be empowered to order the filing of the above documents within a reasonable time after approval. In Chapter X proceedings the trustee, after appointment and qualification, or the debtor in possession (where no trustee is appointed) prepares lists of creditors and stockholders.⁴⁹ It might be well to make provision in the new proceedings for the trustee to examine the debtor's schedules and submit a report within a short period after the debtor's schedules are filed. Such a report would serve to verify or contradict the facts and figures contained in the debtor's schedules and would enable the court to ascertain with reasonable certainty whether the debtor is entitled to relief under the new proceeding.

6. *Proposing the plan.* The new chapter proceeding should allow for the filing of a plan in all cases by the debtor, the trustee (where appointed), any substantial creditor or group of creditors, any indenture trustee and, where the debtor is not insolvent, by any substantial stockholder or group of stockholders. It would seem most advantageous to permit as many substantial parties in interest as possible to propose plans subject to court approval since all of the interests enumerated above have a stake in the conduct and outcome of the proceedings; they should be permitted to participate to the fullest possible extent. Participation of the debtor in this aspect of the proceeding would encourage it to take an active and leading role in the proceeding. In Chapter X proceedings many debtors fail to take an active part due to their limited statutory capacity to initiate a reorganization program. Certainly stockholders and creditors or their representatives should be encouraged to offer constructive assistance in the rehabilitation program; however, some reasonable minimum dollar or share limitation should be imposed to insure that a plan put forth by such a party or group has more than *de minimis* support. By this requirement the concept of collective effort by these parties would be encouraged.

⁴⁹ Bankruptcy Act §§ 163-64, 11 U.S.C. §§ 563-64 (1964).

7. *Substantive requirements to be imposed on plans in Chapter X-1/2.* The difficulties involved in obtaining the consents of creditors and others to plans of arrangement and reorganization can only be fully appreciated by those who have experienced the problem. The two-thirds creditor consent requirement of Chapter X proceedings and, where the debtor is solvent, the additional requirement of approval by a majority of the outstanding stock⁵⁰ imposes an extremely difficult burden upon the proponents of a reorganization program. It seems appropriate that a simple majority in amount rule should govern in this proposed proceeding. The probability of confirmation will be enhanced and the opportunity for a single large creditor to extract personal advantage from recalcitrance will be diminished. Thus, the acceptance of a majority in amount of the allowed claims should be considered sufficient with the addition of a stockholders' majority requirement where the debtor is not insolvent.

The general scope and requirements of plans of rehabilitation under this new proceeding should generally follow the present scheme contained in Chapter X with one specific and important exception—the requirement of absolute priority. A plan should be capable of treating creditors and stockholders in any way subject to their approval and confirmation of the court. The issuance of notes, securities or any other program which is acceptable to the requisite number of creditors and stockholders should be capable of confirmation subject to the general requirements of feasibility, good faith and best interests of stockholders and creditors. The varieties of plans which might be put forth are as numerous as the creative imaginations of attorneys and businessmen will allow; the greatest breadth and scope feasible should be encouraged if rehabilitation programs are to be capable of dealing with the astounding variety of problems which arise in these types of cases.

The commonly used expression, "absolute priority rule," is derived from the requirement that the reorganization judge must, among other things, find that a plan of reorganization is "fair and equitable and feasible" before he can approve or confirm such a plan.⁵¹ The terms fair and equitable are terms of art having a special meaning and should be differentiated from the term "feasible" which relates to the economic soundness of the rehabilitative program.⁵² The statutory requirement of Chapter X that a plan be "fair and equitable" is considered to have been first enunciated in the

⁵⁰ Bankruptcy Act § 179, 11 U.S.C. § 579 (1964).

⁵¹ Bankruptcy Act §§ 174, 221(2), 11 U.S.C. §§ 574, 621(2) (1964).

⁵² See 6A COLLIER, BANKRUPTCY ¶ 16.04, at 585-88, ¶ 11.07, at 637-44 (14th ed. 1965).

case of *Northern Pacific Railway Co. v. Boyd*.⁵³ This case arose from an equity receivership proceeding in which general creditors were denied participation in the reorganized company while stockholders were permitted to participate upon conditions. In this action brought by a creditor against the reorganized company, the Supreme Court held that "any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation."⁵⁴ Although oft-times honored only in the breach, the absolute priority rule continued to receive the judicial approval of the Supreme Court.⁵⁵ When former section 77B (the predecessor of Chapter X) was enacted by Congress, it included the statutory requirement that a plan be "fair and equitable."⁵⁶ This provision was held to embody the fixed meaning of the "absolute priority rule" enunciated in the *Boyd* case.⁵⁷ The Chandler Act Amendments of 1938 which included the present Chapter X carried forward the language of section 77B. In the case of *Consolidated Rock Products Co. v. DuBois*⁵⁸ the Supreme Court held that the absolute priority rule, enunciated in *Northern Pacific Railway Co. v. Boyd* and made applicable to section 77B reorganizations by *Case v. Los Angeles Lumber Products Co.*,⁵⁹ applied in all proceedings under Chapter X of the Bankruptcy Act.

Under the absolute priority rule, a plan is not fair and equitable and cannot be judicially approved unless it affords participation for claims and interest holders in accordance with their legal priorities. Thus, it requires that the value of the debtor's assets support the extent of the participation permitted each class of claim or interest holder in the plan.⁶⁰ This rule was made inapplicable to Chapter XI proceedings by section 366 of the Bankruptcy Act.⁶¹

The decision to adopt, reject or modify the absolute priorities rule will be perhaps the most important and critical choice facing

⁵³ 228 U.S. 482 (1913).

⁵⁴ *Id.* at 505.

⁵⁵ *E.g.*, *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445 (1926); *Kansas City S. Ry. v. Guardian Trust Co.*, 240 U.S. 166 (1916).

⁵⁶ Bankruptcy Act § 77B(f)(1), 48 Stat. 912, 919 (1934) (Now Chapter X, Corporate Reorganizations, 11 U.S.C. §§ 506-676 (1964)).

⁵⁷ *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

⁵⁸ 312 U.S. 510 (1941). *See also* *Marine Harbor Properties, Inc. v. Manufacturers Trust Co.*, 317 U.S. 78 (1942).

⁵⁹ 308 U.S. 106 (1939).

⁶⁰ 6A COLLIER, BANKRUPTCY *supra* note 46, ¶ 11.06, at 607-37.

⁶¹ "The court shall confirm an arrangement if satisfied that— . . . (2) it is in the best interest of the creditors and is feasible . . . Confirmation of an arrangement shall not be refused solely because the interests of a debtor, or if the debtor is a corporation the interests of its stockholders or members will be preserved under the arrangement." Bankruptcy Act § 366, 11 U.S.C. § 766 (1964).

those who are charged with drafting and enacting the proposed new chapter proceeding. The inclusion of the rule as it is presently applied in reorganization proceedings would severely limit the usefulness and effectiveness of the new chapter. Debtors and their shareholders will be reluctant to initiate Chapter X-1/2 proceedings and will have no incentive to take an active interest therein if they will be excluded from participation should the company prove to be insolvent upon valuation. Chapter XI proceedings will be resorted to as they now are to avoid the harsh results engendered by the application of absolute priority principles.⁶²

In a substantial number of Chapter X reorganizations, stockholders are completely eliminated from participation in the reorganization program with the result that creditors receive all or substantially all of the equity securities or other consideration issued by the reorganized debtor and in some cases receive more than a 100% return on their claims.⁶³ Based upon the harsh and unfair results often created by application of the absolute priorities rule—the diminished attractiveness of the new proceeding to debtors by inclusion of the rule, the potential elimination of stockholder interest and participation in the proceeding, the diminished flexibility of the vehicle to meet the needs of the debtor and others—it is suggested that the new proceeding not adopt the absolute priority principle. Instead a modified concept of relative priorities might be adopted in which the fixed priorities of creditors and stockholders would be generally recognized, except where in the court's judgment, upon full and open hearing, good and sufficient cause exists for deviating from this principle. Such a rule would place the burden upon those seeking to deviate from the absolute priorities principle to establish to the court's satisfaction that such is necessary, feasible and not inequitable.

8. *Approval of the plan.* The present Chapter X requirement of court approval of a plan prior to confirmation should be retained⁶⁴ and the debtor and the various committees should be

⁶² Practitioners and text writers in the field tend to generally favor a more relaxed rule sometimes referred to as the "Relative Priority Rule." See Bonbright & Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928); Dodd, *Reorganization Through Bankruptcy: A Remedy for What?*, 48 HARV. L. REV. 1100 (1935).

⁶³ E.g., in the case of Yuba Consolidated Industries, Bankruptcy Case No. 64013, a Chapter X proceeding recently concluded in the Northern District of California, the old stockholders of this publicly-held corporation were not permitted to participate in the plan which resulted in their interests being completely eliminated. The general creditors received new equity securities of the debtor company and, within a few months after confirmation, the value of the securities distributed to creditors exceeded the full amount of the creditors' claims.

⁶⁴ Bankruptcy Act § 174, 11 U.S.C. § 574 (1964).

permitted to solicit the consents of creditors and stockholders in the manner presently permitted in Chapter XI.⁶⁵

9. *Confirmation and consummation of the plan.* The confirmation of a plan in the new proceeding should bind all parties by its terms and upon consummation should discharge the debtor from all of its obligations and terminate all rights of stockholders, except as provided in the plan.

10. *Participation of the Securities and Exchange Commission.* Since the interest of stockholders and bondholders can be affected and altered by the proposed new reorganization proceeding, the Securities and Exchange Commission should have an active role to play in all stages of the proceeding. Limiting the statutory participation of the Securities and Exchange Commission solely to motions to remove the proceeding to Chapter X is not wise,⁶⁶ since the expertise and cooperation of the commission's staff⁶⁷ can be of great assistance in bringing the rehabilitation proceeding to a satisfactory conclusion.

The Securities and Exchange Commission should be considered a party in interest to all hearings which in any way affect the interests of stockholders or bondholders; it should be given an opportunity to examine any plan filed with the court and have the authority to file a report with the court prior to confirmation.⁶⁸ The submission of the plan to the Securities and Exchange Commission

⁶⁵ See Bankruptcy Act § 339, 11 U.S.C. § 739 (Supp. 1968) (powers and duties of creditors' committees in Chapter XI proceedings). This section permits such committees, among other things, ". . . (c) to negotiate with the debtor concerning the terms of the proposed arrangement and to advise the creditors of its recommendations with respect thereto; . . . (e) to collect and file with the court acceptances of the arrangement proposed; and (f) to perform such other services as may contribute to the confirmation of the arrangement."

⁶⁶ See Bankruptcy Act § 328, 11 U.S.C. § 728 (1964) (Chapter XI). *But cf.* the Supreme Court in *SEC v. American Trailer Rentals Co.*, 379 U.S. 594 (1965), which indicated that the role of the SEC in Chapter XI proceedings was not so limited and that its function in such proceedings is a more general one. (Goldberg, J.).

⁶⁷ The advisory function of the SEC in Chapter X proceedings is generally administered through its Division of Corporate Regulation, which is also charged with administering the Commission's functions under the Public Utility Holding Company Act of 1935 ch. 687, Title I, 49 Stat. 803 (1935), *as amended*, 15 U.S.C. §§ 79 to 792-6 (1964) and the Investment Company Act of 1940 ch. 686, Title I, 54 Stat. 789 (1940), *as amended*, 11 U.S.C. §§ 72, 107 (1964), 15 U.S.C. § 80(a)(1)-80(a)(52) (1964). This division working in conjunction with the Commission's regional offices assists the Commission in determining whether or not to participate in a reorganization proceeding and its position vis-a-vis the proceeding.

⁶⁸ In Chapter XI, as it presently exists, there is no statutory provision for a SEC report on any plan. In Chapter X the court is required to submit a plan to the SEC where the scheduled indebtedness exceeds \$3,000,000 and has the option to submit a plan where the scheduled indebtedness is less than \$3,000,000. Bankruptcy Act § 172, 11 U.S.C. § 572 (1964). The court cannot approve any Chapter X reorganization plan which has been submitted to the Securities and Exchange Commission until a report is filed or until it is notified that no report will be filed. Bankruptcy Act § 173, 11 U.S.C. § 573 (1964).

should be left to the court's discretion since the Securities and Exchange Commission will be able on its own initiative to file a report and to make its position on the plan known prior to confirmation.

11. *The issuance of securities pursuant to a plan.* Both Chapter X and XI contain provisions exempting transactions in securities issued pursuant to a plan of reorganization or arrangement from the registration requirement of section 5 of the Securities Act of 1933. In reorganization proceedings, securities issued in exchange for securities and claims, or partly in exchange and partly for cash are exempt.⁶⁹ In arrangements, securities issued in exchange for claims, or partly in exchange and partly for cash are granted a like exemption.⁷⁰ California, among other states, has also exempted from the coverage of its Corporate Securities Law any security issued pursuant to a plan of reorganization or arrangement.⁷¹

Since the new chapter proceeding is designed, in part, to include a reorganization of a debtor's capital, as well as debt structure, the broader exemptive approach of Chapter X should be adopted so as to include securities issued to stockholders. In addition, the new proceeding should include a further provision exempting any debt securities issued pursuant to a plan from the registration requirements of the Trust Indenture Act of 1939.⁷² Special care should be taken to also exempt securities issued to parties such as a trustee, his counsel, other personnel and groups entitled to compensation as a cost of administration.⁷³

Additional consideration should be given to the broadening of the exemption to include individuals or small groups who invest cash or property in order to provide the funds necessary to consummate the proceedings, and who receive in exchange a portion of the debtor's capital stock. Such persons or groups are generally quite

⁶⁹ Bankruptcy Act § 264, 11 U.S.C. § 664 (1964).

⁷⁰ Bankruptcy Act § 393, 11 U.S.C. § 793 (1964).

⁷¹ CAL. CORP. CODE § 25100(K) (West 1955).

⁷² It should be noted that by reason of § 3(a)(10), the Securities Act of 1933 provides its own exemption for securities issued in exchange for outstanding securities, claims or property interests or partly in such exchange and partly for cash where the terms and conditions of the exchange are approved after hearing by a court or other governmental agency authorized so to do. The SEC has stated that securities issued in accordance with the terms of § 3(a)(10) pursuant to a confirmed plan of reorganization (under Chapter XV, 56 Stat. 787 (1942), terminated under terms of the Act itself, 56 Stat. 787, 795, on November 1, 1945) are exempt from Securities Act registration by reason of § 3(a)(10). 17 C.F.R. § 240.14a-8 (Supp. 1944). There has, as yet, been no authoritative ruling as to whether § 3(a)(10) of the Securities Act can be taken advantage of in Chapter XI proceedings; however, there seems to be no reason why it should not be applicable at least as regards securities issued in exchange for claims and other property interest pursuant to a confirmed arrangement.

⁷³ Bankruptcy Act §§ 64, 241-44, 11 U.S.C. §§ 104, 641-44 (1964).

sophisticated; further, the issuance is essentially a private placement, with the court and the Securities and Exchange Commission overseeing the transactions.

The importance of the exemption from Securities Act registration to many debtor proceedings cannot be underemphasized since the high cost involved in registering a security with the SEC in terms of attorneys' fees, accountants' fees, printing costs, etc., is in most cases far beyond the reach of financially ailing corporate debtors, and without the exemption no plan of rehabilitation may be possible.

IV. CONCLUSION

The suggestions which have been proposed deal only with some of the problems encountered in corporate debtor relief proceedings, and do not touch upon other basic problems which must be dealt with by the proposed new chapter. The present goal of this article will have been attained if the reader can appreciate some of the basic problems and difficulties involved in corporate rehabilitation efforts and the urgent need for additional relief to complement and supplement the present alternatives. The substance and form of the proposed vehicle for debtor relief has yet to be determined; it is hoped that this proposal of certain fundamental features of this new proceeding will promote research, discussion and debate which will ultimately lead to the proposal and enactment of this much needed legislation.