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CORPORATE REHABILITATION UNDER THE BANKRUPTCY ACT OF 1973: ARE REPORTS OF THE DEMISE OF CHAPTER XI GREATLY EXAGGERATED?

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The revolutionary alteration in the nature of bankruptcy proceedings from basically judicial to basically administrative has received much critical attention to date in discussions of the proposed Bankruptcy Act of 1973.¹ Certainly, this fundamental change will have as profound effects upon corporate reorganization proceedings as it will have upon liquidation proceedings.² A specific evaluation of corporate rehabilitation procedure under Chapter VII of the Proposed Act must, however, inevitably focus not upon the Bankruptcy Administration but upon the collapse of the present bifurcated scheme into a single reorganization process.

The draftsmen of the Chandler Act of 1938,³ which added the present "Chapter proceedings"⁴ to the Bankruptcy Act of 1898,⁵ provided alternative systems for relieving embarrassed corporations: Chapter X, a thoroughgoing reorganization typically accompanied by

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1. The proposed Bankruptcy Act of 1973, H.R. 10792, 93d Cong., 1st Sess. (1973) [hereinafter cited as Proposed Act], was originally promulgated as Part II of the REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess. (1973) [hereinafter cited as COMMISSION REPORT]. The Commission on the Bankruptcy Laws of the United States [hereinafter cited as the Commission] was established by the Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468. The three-part Commission Report, including the Proposed Act, is available from the United States Government Printing Office, Washington, D.C.

2. For a discussion of the concept of administrative bankruptcy, see 1 COMMISSION REPORT, *supra* note 1, at 103-56.

3. Act of June 22, 1938, ch. 575, 52 Stat. 840.

4. The "Chapter proceedings" are: Bankruptcy Act §§ 101-276, 11 U.S.C. §§ 501-676 (1970) (Chapter X); *id.* §§ 301-99, 11 U.S.C. §§ 701-99 (Chapter XI); *id.* §§ 401-526, 11 U.S.C. §§ 801-926 (Chapter XII); and *id.* §§ 601-86, 11 U.S.C. §§ 1001-86 (Chapter XIII). Chapter XII is a recently rediscovered procedure for real property arrangements by noncorporate debtors which also would disappear as a separate proceeding under the Proposed Act, while Chapter XIII provides for wage-earner plans and would be transformed into Chapter VI of the Proposed Act. Inasmuch as the topic of the present discussion is corporate rehabilitation, Chapters XII and XIII are irrelevant, and the focus herein will be on Chapters X and XI.

5. Act of July 1, 1898, ch. 541, 30 Stat. 544.

complete recapitalization; and Chapter XI, intended to permit "simple" compositions with unsecured creditors. In the ensuing years, Chapter XI emerged as the much favored vehicle, for obvious reasons. In most Chapter X proceedings, the debtor's management is replaced by an independent trustee,⁶ and any proposed plan, to pass statutory muster, must provide for the elimination (or, where the debtor is solvent, at least a severe scaling down) of equity interests in the reorganized entity.⁷ When management also holds a substantial portion of the equity interests, a typical situation in medium-sized corporations, the preference for Chapter XI becomes overwhelmingly, sometimes desperately, strong. This is not to say that there often are not more benevolent reasons for resistance to Chapter X; Chapter XI has substantial advantages over the more extensive procedures in terms of speed, economy, and flexibility of consummation, which can ultimately mean a larger pie to be shared for the benefit of all concerned parties.⁸

It certainly was not intended that the form of relief be chosen in the sole discretion of the embarrassed debtor corporation. Nonetheless, the draftsmen failed to provide any standards in the statute for deciding when the more cumbersome and expensive procedures of Chapter X are required. Supreme Court statements on the subject border on the metaphysical and provide very little assistance in any particular case.⁹ The inevitable result in all too many cases has been protracted and expensive litigation at the commencement of debtor relief proceedings, which depletes the assets of the estate and delays commencement of the rehabilitation effort.

The consolidation of Chapters X and XI into a single corporate reorganization chapter, then, if it accomplishes nothing else, will eliminate the initial litigation over which type of relief is appropriate. At what price, however, is this early harmony achieved? Even a cursory glance at the proposed provisions of Chapter VII reveals that the procedures and substantive protections much more closely resemble cur-

6. See note 18 *infra*.

7. See text accompanying notes 160-68 *infra*.

8. See text accompanying notes 113-22 *infra*.

9. SEC v. American Trailer Rentals Co., 379 U.S. 594 (1965) (focusing upon the need to adjust widely-held public debt, and the whole history of the company and history of mismanagement); General Stores Corp. v. Shlensky, 350 U.S. 462 (1956) ("The essential difference [between Chapters X and XI] is not between the small company and the large company but between the needs to be served," focusing upon the need for an accounting by management for misdeeds, the need for new management, and whether a feasible plan could result under Chapter XI); SEC v. United States Realty & Improvement Co., 310 U.S. 434 (1940) (decided when Chapter XI plans had to be "fair and equitable" as well as "for the best interests of creditors," and hence of questionable precedential value).

rent Chapter X proceedings than they do those under present Chapter XI. This orientation toward the adaptation and modernization of Chapter X practice is intended to eliminate the abuses perceived in the relatively free-wheeling Chapter XI procedures. To be sure, Chapter XI, with its emphasis on speed and economy, has within it the seeds of abuse; to the extent that Chapter X is considered to be a voracious demon to be avoided at all costs, the tendency to "stretch" the reach, standards, and procedures of Chapter XI has resulted in some startling misapplications in the hands of "creative" attorneys. However, the flexibility of the procedures and appropriate exercises of imagination by reorganization lawyers have often resulted in the consummation of Chapter XI arrangements that are clearly in the best interests of all parties involved. This is especially true where it is reasonably certain that the bankrupt "patient," because of expense, delay, and interruption of operations, would have died on the elaborate operating table of Chapter X. Thus, the crucial inquiry becomes: in adopting most of the Chapter X safeguards in proposed Chapter VII to eliminate the major abuses inherent in Chapter XI, have the draftsmen of proposed Chapter VII eliminated, at the same time, the creativity permitted by Chapter XI that often results in successful rehabilitation? To state the question colloquially, have the draftsmen thrown out the baby with the bath water? Unfortunately, the most that can presently be said in response to this question is "probably not, but it depends"—depends upon the gloss placed by the Administrator and the courts upon several proposed provisions that are intended to mitigate the severity of current Chapter X in important, basic ways. On the other hand, the adoption of what is basically Chapter X procedure will also result in additional flexibility in certain areas for consummating plans that, under the present statute, would fall within Chapter XI, to the extent that they will still be permitted under Chapter VII.

Accordingly, this article will examine present Chapter XI, and attempt to isolate its weaknesses and strengths. The inquiry throughout will be: to what extent are the latter retained and the former eliminated in the proposed Chapter VII.

I. DOES PROPOSED CHAPTER VII ELIMINATE WASTEFUL INITIAL LITIGATION RESULTING FROM THE PREFERENCE FOR CHAPTER XI?

It was inevitable that the existence of alternative schemes of rehabilitation, one of which leaves management firmly in control, and the other of which not only replaces management with an independent

trustee but investigates it, and eliminates or scales down its equity holdings, would result in the filing of a Chapter XI rather than a Chapter X when any conceivable argument could be made for the propriety of that lesser form of relief. After all, management has little to lose in the subsequent battle, where the opposition is usually led by the Securities and Exchange Commission,¹⁰ in removing the proceeding into Chapter X; corporate, not personal, assets are being expended. Interestingly, in recent years the volume of this sort of litigation has lessened considerably. This phenomenon has been variously explained. Since the SEC is typically the only party in interest that actively seeks to transfer Chapter XI proceedings,¹¹ an expanded role for the Commission in Chapter XI, specifically approved by the Supreme Court,¹² may account for the recent decline in motions to transfer. Now that the SEC is free to investigate and otherwise participate in Chapter XI, it can act to protect public investors, presumably its primary source of concern, without seeking a transfer. Furthermore, the SEC has been occupied in recent years with an increasing caseload in the securities area, so that its ability to monitor reorganization cases has diminished. New Rule of Bankruptcy Procedure 11-15(b)¹³ sets a 120-day deadline from the first meeting of creditors for the making of a transfer motion unless the court, for cause shown, extends the time limit. It is too early to judge the effects of this rule on SEC policy; it could well result in an even further decline in the number of transfer motions, or could just as easily reverse current willingness to monitor and participate in Chapter XI proceedings, since the SEC (or any other party in interest) will usually be precluded from making the transfer motion later in the proceeding.

10. Bankruptcy Act § 328, 11 U.S.C. § 728 (1970). See text accompanying note 13 *infra* for a discussion of bankruptcy rule 11-15.

11. Of course, this is not invariably the case. See, e.g., *Schreibman v. Mason*, 377 F.2d 99 (1st Cir. 1967) (bondholder petitioned for transfer); *In re Meister Brau, Inc.*, 355 F. Supp. 515 (N.D. Ill. 1972) (shareholder sought the transfer); *In re Rice Barton Corp.*, 312 F. Supp. 1316 (D. Mass. 1970) (one creditor out of six hundred sought transfer). See also *In re Precision Transformer Corp.*, 333 F.2d 758 (7th Cir. 1964) (despite the pendency of an SEC section 328 motion, creditors holding claims totaling almost \$200,000 filed an involuntary Chapter X petition).

12. *SEC v. American Trailer Rentals Co.*, 379 U.S. 594, 613 (1965). The expanded rule was first approved by the Second Circuit in *SEC v. Canandaigua Enterprises Corp.*, 339 F.2d 14 (2d Cir. 1964).

13. Rules of Practice and Procedure for Bankruptcy have now been adopted, pursuant to authority conferred upon the Judicial Conference of the United States by 28 U.S.C. § 331 (1970) for ordinary bankruptcy and Chapter XIII proceedings, for Chapter XI proceedings (effective July 1, 1974), and for Chapter X proceedings (effective August 1, 1975). These rules may be found in *BANKRUPTCY ACT AND RULES* (Collier pamphlet ed. 1975).

Another cause, perhaps, of the reduced volume of litigation is the fact that the guidelines for determining which chapter is suitable have become quite flexible. At present, it is relatively rare that a corporation will be forced into Chapter X when its only hope for rehabilitation lies in Chapter XI. If a proceeding will "adjust" "publicly held debt," however, the court should remain predisposed to grant a transfer to Chapter X.¹⁴ Courts appear to be disposed to define those terms to reach the pragmatic result desired.¹⁵ To the extent that the combination of these developments prevents cases like *General Stores, Inc.*,

14. SEC v. American Trailer Rentals Co., 379 U.S. 594, 615 (1965).

15. For example, courts have characterized some types of securities as not "publicly held." Where a plan provided for \$9.2 million worth of convertible debentures held by one or more insurance companies to be replaced by preferred stock, the Sixth Circuit found the debentures too closely held to be considered "publicly held debt," and also ruled that shares held by at least seventy-seven persons were not publicly held. *In re KDI Corp.*, 477 F.2d 726 (6th Cir. 1973); cf. SEC Rule 146(g), 40 Fed. Reg. 21710 (1975), which presumptively limits a private offering of securities under section 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(2) (1970), to thirty-five persons. The Third Circuit has deemed important the fact that there were no preferred stockholders and no bondholders in a corporation and that management controlled over half the common stock, so that publicly held equity would not alone require a transfer. *In re Lea Fabrics, Inc.*, 272 F.2d 769 (3d Cir. 1959), *vacated as moot sub nom. SEC v. Lea Fabrics, Inc.*, 363 U.S. 417 (1960). On the other hand, debt was characterized as "publicly held" where bonds were originally issued almost solely to the members of an organization. *Mecca Temple of Ancient Arabic Order v. Darrock*, 142 F.2d 869 (2d Cir.), *cert. denied*, 323 U.S. 784 (1944). There was evidence there that the bonds had become scattered and that many were in the hands of nonmembers at the time a Chapter XI petition was filed.

While "publicly held debt" typically refers to the debt which existed at the time the Chapter XI petition was filed, the term appears to be expanding in one respect: the Supreme Court agreed with the Tenth Circuit's view that stock issued as the result of an arrangement should receive a clean bill of health in order to protect public investors. *SEC v. American Trailer Rentals Co.*, 379 U.S. 594, 615-16 (1965). Chapter X may thus be appropriate any time debt instruments which may be publicly traded are issued for claims, not on a theory that such issuance actually "adjusts" publicly held debt, but that "publicly held debt" includes debt resulting from an arrangement. In debating the merits of Chapter X, the Second Circuit considered whether the "General Debentures" to be issued to unsecured creditors would themselves become publicly traded and would therefore require prior SEC investigation. *Grayson-Robinson Stores v. SEC*, 320 F.2d 940 (2d Cir. 1963). It determined that the SEC had not shown evidence of very much potential trading in the instruments and thus affirmed the lower court's order denying the transfer to Chapter X.

Often the absolute priority rule applicable in Chapter X will benefit public creditors at the expense of public stockholders. One court balanced the interests of public holders of debt against those of public holders of equity and allowed the proceeding to remain in Chapter XI. *In re American Guar. Corp.*, 246 F. Supp. 322 (D.R.I. 1965). There, public debtholders were required to waive interest under the proposed plan, a sacrifice which was not regarded as a "major adjustment," and substantial equity was preserved for shareholders.

On the other hand, courts have found that a transfer to Chapter X would cause credit to evaporate so that the interests of debenture holders would be injured by a transfer. *In re Wilcox-Gay Corp.*, 133 F. Supp. 548 (W.D. Mich. 1955), *aff'd sub nom. SEC v. Wilcox-Gay Corp.*, 231 F.2d 859 (6th Cir. 1956).

where five years after the dismissal of a Chapter XI proceeding, with five years' worth of accompanying Chapter X administration expenses, the identical plan was proposed in a Chapter X proceeding and confirmed,¹⁶ reason will have won the day. In that event, consolidation of the two chapters into a single chapter, with the attendant disadvantages, may be premature.

It is hardly certain, however, that proposed Chapter VII will achieve elimination of initial litigation. The debate over which chapter is appropriate often focuses on the need for a trustee to perform an independent investigation. If the choice is only a decision as to whether a trustee is required, proposed Chapter VII, by collapsing Chapters X and XI but retaining the discretionary decision as to the need for a trustee, will have done little to alleviate the litigation-producing aspects of multiple chapters.

Recognizing the relationship between the transfer and the desirability of an investigation, courts generally take a pragmatic view of what has already been accomplished in Chapter XI.¹⁷ If the court concludes that a trustee would be redundant and if the debts of the business are large enough that a trustee would be mandatory in Chapter X,¹⁸ the court may decide to deny the transfer and avoid the expense of a trustee. In proposed Chapter VII, the issue of the appointment of a trustee cannot be circumvented in this way. If the debtor is a corporation having debts of one million dollars or more and 300 or more security holders,¹⁹ section 7-102(a) requires the Administrator

16. Weintraub & Levin, *A Sequel to Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation*, 26 *FORD. L. REV.* 292, 301 (1957).

17. In fact, one court stated that it would not confirm a Chapter XI plan unless it was the result of an "intelligent, efficient and disinterested investigation" of the debtor. *In re Credit Service, Inc.*, 31 F. Supp. 979, 982 (D. Md. 1940). In *In re American Guar. Corp.*, 246 F. Supp. 322 (D.R.I. 1965), since the plan called for an investigation directed by the referee of the allegations made by the SEC against past management, to be paid for by the debtor and the results to be reported to the SEC and all creditors and shareholders, the court denied the SEC's motion to dismiss the Chapter XI proceedings. See also *In re Barchris Constr. Corp.*, 233 F. Supp. 229 (S.D.N.Y. 1963), in which the court mistakenly asserted that no section 21a investigation had been conducted and cited that failure as the factor militating in favor of transfer to Chapter X. When the attorney for the receiver advised the court after its opinion was filed that such an inquiry had indeed been made, the court reaffirmed its original decision because the investigation, "while significant," was not "conclusive of the issues that were before the court." *Id.* at 236.

18. The judge must appoint a trustee if the indebtedness of the debtor, liquidated as to amount and not contingent as to liability, is \$250,000 or over. Bankruptcy Act § 156, 11 U.S.C. § 556 (1970); R. BANKR. P. 10-202.

19. "Securities" is defined to include both debt and equity securities. Proposed Act § 1-102(42).

to apply to the court to determine whether a trustee shall be appointed, and such appointment is presumptive. Thus, the collapse of the two chapters may do no more than push the litigation stage from the filing of the petition to the appointment of the trustee.²⁰ It may be argued that a debtor of the requisite size will be discouraged from contesting the appointment of the trustee by the presumption established by the statute. However, it must be remembered that management has everything to lose from the appointment of such a trustee, and, given the availability of the debtor's funds for the purpose, very little to lose in fighting to retain its position.

Ironically, the elimination of litigation over form of relief through the integration of the chapters and the inclusion of the presumptions as to the appointment of the trustee may prove to be too effective: it may serve to discourage management's filing of a reorganization petition at the time when everyone would benefit most therefrom. The automatic penalty that will attach to most petitions can only reinforce a Pollyanna-like attitude in management, for it has nothing to gain in realistically assessing a situation and recognizing that unaided recovery is not just around the corner. The only check on this aspect of human nature in proposed Chapter VII is the possibility of a creditors' petition.²¹ But creditors are seldom privy to the full range of information about the debtor that will result in a decision on the timing of the petition that will maximize its benefits for them. They will seldom realize that they should demand such information until the extent of the difficulties can no longer be kept private, at which time the most appropriate moment will probably already have passed. Furthermore, an involuntary petition will seldom be uncontested.²² It can hardly be argued that litigation is avoided in this way.

II. DOES PROPOSED CHAPTER VII ELIMINATE THE ABUSIVE ASPECTS OF CHAPTER XI?

Chapter XI procedure is, as noted, bottomed upon the continua-

20. Cf. Kennedy, *Foreword*, 21 U.C.L.A.L. Rev. 381, 397 (1973): "Chapter VII of the Proposed Act thus eliminates the pointless, time-consuming, expensive, and possibly fatal litigation of the question whether the case is being prosecuted under the right chapter."

21. "One or more creditors having claims not contingent as to liability and aggregating at least \$10,000, or an indenture trustee on behalf of security holders having claims aggregating at least \$10,000, may file a petition against the debtor for relief under Chapter VII." Proposed Act § 4-205(b).

22. Cf. Proposed Act §§ 4-208 to -210. Again, the debtor's funds will be used for this purpose, so there is no incentive to concede the issue.

tion of the debtor in possession of his own property. Unless the Chapter XI petition is filed in a pending bankruptcy in which a trustee has already been appointed,²³ no trustee is provided for in the Chapter XI scheme. Under the new Rules of Bankruptcy Procedure for Chapter XI, the appointment of a receiver is also discouraged;²⁴ in some jurisdictions this represents a substantial departure from prior practice.²⁵ Authorization for the continued operation of the business by the debtor in possession is routine in Chapter XI,²⁶ although the debtor then becomes an officer of the court and thus subject to the court's oversight.²⁷ The court's authority is broad: it "shall have all the title and exercise all the powers of a trustee appointed under this Act."²⁸ Accordingly, all of the rights, duties, and powers of a bankruptcy trustee are available to the debtor in possession, subject, however, to whatever "limitations, restrictions, terms, and conditions as the court may from time to time prescribe."²⁹ At the very least, the debtor in possession is required to file periodic reports on the operations of the business with the court.³⁰

In circumstances evidencing possible past management misdeeds, it is easy to criticize continuing the debtor in possession over the objection of even a single creditor or stockholder. In many such cases, however, a traditional Chapter XI composition with unsecured creditors would be perfectly adequate to revitalize the financial standing of the debtor, and either there is not a large number of public creditors needing the protection of the absolute priority rule,³¹ or there are offsetting considerations.³² The transfer of such a case to Chapter X solely to obtain an independent investigation of management is a perfect ex-

23. Bankruptcy Act §§ 321, 332, 11 U.S.C. §§ 721, 732; R. BANKR. P. 11-7, -18(a).

24. R. BANKR. P. 11-18(b) provides that if no trustee in a prior liquidating bankruptcy has previously qualified, "the debtor *shall* continue in possession" but "[o]n application of any party in interest, the court may, for cause shown, appoint a receiver to take charge of the property and operate the business of the debtor" (emphasis added).

25. The United States District Court for the Eastern District of Pennsylvania, for example, prior to the adoption of the Chapter XI rules, appointed a receiver as a matter of course in Chapter XI proceedings.

26. "Continuation of the business represents the norm in Chapter XI cases . . ." R. BANKR. P. 11-23, Advisory Comm. Note. See also Bankruptcy Act § 343, 11 U.S.C. § 743 (1970).

27. *Urban Properties Corp. v. Benson, Inc.*, 116 F.2d 321 (9th Cir. 1940).

28. Bankruptcy Act § 342, 11 U.S.C. § 742 (1970). To the extent that a Chapter X trustee's powers may be broader, the debtor in possession is endowed with them as well. *In re Schokbeton Indus. v. Schokbeton Prods. Corp.*, 466 F.2d 171, 174-75 (5th Cir. 1972).

29. Bankruptcy Act § 342, 11 U.S.C. § 742 (1970).

30. *Id.* § 343, 11 U.S.C. § 743; R. BANKR. P. 11-23.

31. See note 161 *infra*.

32. See note 15 *supra*.

ample of sacrificing the pragmatism and flexibility of Chapter XI to some higher good which may ultimately serve nobody's best interests, since the "price" of the transfer may be a sharply reduced return to creditors or even a depletion of assets of the debtor to the point where it cannot continue in business. This is not to imply, however, that an investigation is dispensible in such circumstances; indeed, it may take on added significance inasmuch as the debtor alone proposes a plan based on information which it controls, and, in virtually every case, will fashion a proposal that continues the old management's role.³³ In this regard, management may intentionally not look very hard for outside sources of funding that would provide for a higher payout in the plan, but that, because of the protections and compensation demanded by the third-party financier, may result in a dilution of management's role or interests. Where management also represents a substantial portion of the equity interest, a confirmed Chapter XI plan, given the absence of the absolute priority principle, will permit management qua shareholder to reap the benefits of the going-concern value of the business despite past and possibly future misdeeds.³⁴ Thus, if Chapter XI in this context is to operate reasonably fairly, a determination that management misdeeds have not caused the present difficulties is essential. Otherwise, the dual benefits accruing to management—retention of position and acquisition of the going-concern value of the enterprise at the expense of the creditors—are indefensible. Yet such a result is not infrequent in Chapter XI.

Of course, it is true that a trustee is not the only means by which this function of investigation can be performed. On occasion, the creditors' committee has thoroughly examined the debtor pursuant to its statutory authority,³⁵ but, more often than not, it will have no particular interest in doing so, for reasons to be explored. Some courts have de-

33. Of course, failure "to explain satisfactorily any losses of assets or deficiency of assets to meet . . . [the debtor's] liabilities" is a ground for denying the confirmation of a Chapter XI plan. Bankruptcy Act §§ 366(3), 14c(7), 11 U.S.C. §§ 766(3), 32c(7) (1970). However, objection on this ground must be specifically made, or the court has no independent duty with respect thereto. R. BANKR. P. 11-38(d).

34. "Going concern value" is used herein to mean the excess of value in the business enterprise over the liquidation value of the tangible assets. Such value is generally determined by a capitalization of the earnings of the enterprise. The difference between the two figures represents "good will," a highly valuable asset if the business is continued but typically worthless upon liquidation. See generally 1 A. DEWING, FINANCIAL POLICY OF CORPORATIONS 284-90 & nn.j-o (5th ed. 1953). Where, as in Chapter X, the absolute priority principle applies, this going concern value must be distributed first to the senior creditors. See note 161 *infra*.

35. Bankruptcy Act §§ 21a, 336(3), 339(1)(a), 11 U.S.C. §§ 44a, 736(3), 739(1)(a) (1970); R. BANKR. P. 205, 11-26, -29.

nied a petition for transfer to Chapter X on the grounds that, even if substantial evidence of management wrongdoing is uncovered, the stockholders' derivative action is an available alternative to the Chapter X trustee as a means of redress.³⁶ Occasionally, courts have even retained jurisdiction for the purpose of hearing such a derivative action.³⁷ The problem here is that a stockholder will seldom have incentive, even assuming the available means, to commit financial resources to a thorough investigation of management. An investigation by a stockholder rather than by a trustee will initially (and, unless he is successful in recovering a judgment, ultimately) be at his rather than at the estate's expense. This problem is magnified where management is not only in control of the information but represents a substantial portion of the equity holdings. In that case, there may be additional barriers to the bringing of a derivative action.³⁸ Thus, it would seem that, in the absence of a strong and independent creditors' committee to do the investigation (a rarity indeed), the stockholders' derivative action as a substitute for an investigation by management is more theoretical than real. In too many cases, therefore, the management of Chapter XI debtors is allowed to get away with, if not murder, at least fraud or gross injustice vis a vis creditors and outside stockholders. A transfer to Chapter X to correct such problems, however, may produce even greater pain to the innocent victims through a smaller recovery or elimination of their interests, with meager compensation coming from the knowledge that the wrongdoers have lost their positions.

The proposed Chapter VII adopts a slight modification of the Chapter X approach to the appointment of a trustee: as noted, the appointment is presumptive, but not mandatory, if there are more than one million dollars in debts and 300 or more security holders; below those guidelines the appointment is discretionary.³⁹ Two leading Chapter XI practitioners have conjured up visions of the appointment of a trustee in every case under Chapter VII because of "[f]irst, a discretionary power in the administrator to suggest a trustee in all cases

36. *Grayson-Robinson Stores v. SEC*, 320 F.2d 940 (2d Cir. 1963); *In re American Guar. Corp.*, 246 F. Supp. 322 (D.R.I. 1965); cf. *In re Lea Fabrics, Inc.*, 272 F.2d 769 (3d Cir. 1959), *vacated as moot sub nom. SEC v. Lea Fabrics, Inc.*, 363 U.S. 417 (1960); *In re Transvision, Inc.*, 217 F.2d 243 (2d Cir. 1954), *cert. denied*, 348 U.S. 952 (1955).

37. *In re Wilcox-Gay Corp.*, 133 F. Supp. 548 (W.D. Mich. 1955), *aff'd sub nom. SEC v. Wilcox-Gay Corp.*, 231 F.2d 859 (6th Cir. 1956).

38. Cf. *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R.*, 417 U.S. 703 (1974).

39. Proposed Act § 7-102(a).

and, secondly, what amounts to a subliminal indication that in public cases the appointment of the trustee by the administrator would become the rule rather than the exception."⁴⁰ That this result is not intended by the Commission is made clear by its note to proposed section 7-102. Indeed, its intent is quite the contrary: by establishing an administrative agency, the Commission believes that it will reduce the number of situations in which a disinterested trustee will be needed. The Proposed Act specifically provides that if a trustee is not appointed, the Administrator may perform certain of the duties of the trustee: he may, *inter alia*,

(5) investigate the acts, conduct, liabilities, and financial condition of the debtor, the operation of his business and the desirability of the continuance thereof, and any other matter relevant to the case or to the formulation of a plan; (6) . . . examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters; (7) as soon as practicable, file . . . a statement of his investigation, including any facts ascertained . . . pertaining to fraud, misconduct, mismanagement, irregularities, and causes of action available to the estate.⁴¹

Proposed section 7-103(b) further provides that, if no trustee is appointed, a "disinterested person" may be appointed by the Administrator, with the approval of the court, to perform the above duties and also, *inter alia*, to file a plan—another indication that it is not intended that trustees be appointed in all instances. Such disinterested person would certainly not have authority to operate the business in lieu of the debtor, as a trustee would. One of the draftsmen of proposed Chapter VII recently wrote:

A common complaint thus far heard from debtors' attorneys is that they will be put out of business because a trustee will be appointed routinely. That appears to be neither the concept nor the intent of the Act. The administrator does not act unilaterally but rather with the debtor and the creditors' committee. Should he override their wishes, a court hearing is afforded and with the separation of the court from the administration it is unlikely that the court will act as a mere rubber stamp.⁴²

Further flexibility is provided by proposed section 7-102(d),⁴³

40. Weintraub & Levin, *Chapter VII (Reorganizations) as Proposed by the Bankruptcy Commission*, 79 COM. L.J. 15 (1974).

41. Proposed Act § 7-103(b).

42. King, *The Business Reorganization Chapter of the Proposed Bankruptcy Code—Or Whatever Happened to Chapters X, XI and XII*, 78 COM. L.J. 429, 433 n.12 (1973).

43. Bankruptcy Act §§ 156, 160, 11 U.S.C. §§ 556, 560; R. BANKR. P. 10-202(d).

which continues an alternative presently available in Chapter X: "[i]f a disinterested trustee is appointed, a director, officer, or employee of the debtor may be appointed by the administrator as an additional trustee to operate the business of the debtor."⁴⁴ This provision could prove to be useful, inasmuch as it would permit the continuation of the debtor's business by present management, with all of the advantages of continuity inherent therein, while at the same time providing for an independent trustee to oversee that operation and to investigate past misdeeds. Because of restrictive judicial interpretation, the existing Chapter X provision has proved less useful than a surface reading may indicate.⁴⁵ Liberal use in proposed Chapter VII may provide a sub-

44. Proposed Act § 7-102(d).

45. In *Meredith v. Thralls*, 144 F.2d 473 (2d Cir.), *cert. denied*, 323 U.S. 758 (1944), the court read the standard of disinterestedness as set forth in Bankruptcy Act § 158, 11 U.S.C. § 558 (1970), as applicable so far as possible to the additional trustee. Thus, such trustee could own stock in violation of section 158(1) because directors would ordinarily own stock, but section 158(4) would apply to disqualify an additional trustee with an interest materially adverse to a class of creditors or shareholders. Later, in *In re Ocean City Auto. Bridge Co.*, 184 F.2d 726 (3d Cir. 1950), the Third Circuit held that an additional trustee could not even own stock. Congress intended an exception to section 158 only in that someone could be appointed who had "familiarity with the business of the debtor in the past, but no financial interest in its future, and that it did not intend to open the doors to the appointment of persons who by reason of ownership of securities or otherwise had an interest in the reorganization of the debtor which might make it difficult for them to act independently." *Id.* at 728-29.

Two later cases retreat from the disinterestedness standard outlined previously. The Second Circuit, in dictum, has stated that whereas the primary trustee must be disinterested, "no such requirement was or practically could be imposed on officers of the debtor . . ." *Nazareth Fairgrounds & Farmers' Mkt., Inc. v. Wolf*, 296 F.2d 678, 683 (2d Cir. 1961), *rev'd on other grounds sub nom. Wolf v. Weinstein*, 372 U.S. 633 (1963). Another court indicated that it would overturn the appointment of an additional trustee only if a factual showing could be made that the appointment was improper because it was harmful to the interests of creditors, shareholders, or the administration of the debtor. *In re Hudson View Towers, Inc.*, [1966-1967 Transfer Binder] *BANKR. L. REP.* ¶ 61,993, at 71,520 (S.D.N.Y. 1966). Its rationale for a loose standard rested on the ability of the court to remove such a trustee at any time with or without cause and its desire to use the trustee's knowledge and experience.

One court has read the legislative history of section 156 as limiting the appointment of an additional trustee to exceptional circumstances in which the individual's services are essential and it is not feasible to obtain them by employment under section 191. *In re Ocean City Auto. Bridge Co.*, 184 F.2d 726 (3d Cir. 1950). If this is a correct reading, a proceeding in Chapter X in which a trustee is appointed will rarely involve the operation of the business by someone familiar with the debtor. Collier disagrees with this interpretation, claiming that the language of section 156 and the legislative history indicate the appointment can be routine. 6 *W. COLLIER, BANKRUPTCY* ¶ 7.04, at 1166-67 (14th ed. 1972).

That the draftsmen of proposed section 7-102(d) intended to reject this restrictive interpretation is clear: "This subdivision also continues the possibility of the appointment of a director, officer, or employee of the debtor, *an appointee who obviously would not meet the disinterested test*, as an additional trustee for the sole purpose of conducting or helping conduct the business and the management of the property of the debtor." Proposed Act § 7-102, Advisory Comm. Note 6 (emphasis added).

stantial damper to the opposition that would otherwise arise to the appointment of an independent trustee, and the litigation attendant to that opposition. On the other hand, the officer in question must then act as a fiduciary of the creditors,⁴⁶ which may influence his business judgment. If the decisions he makes in the course of operating the business are more conservative or otherwise different from those that he would make if he were not a fiduciary, creditors may not benefit from his appointment, but may actually suffer therefrom, both in terms of the extra expense involved and the less oppressive business policies to be followed. Whether or not the provision ultimately proves to be useful as a means of defusing opposition to the appointment of a trustee, so that an independent investigation of management may be conducted, may thus turn on the severity of the fiduciary burdens placed upon the second trustee by the Administrator and the courts. Thus, proposed Chapter VII contains several permutations for permitting both an investigation of management and the uninterrupted continuance of the debtor's business. Imaginative use thereof may defuse one of the most serious built-in conflicts that creditors and outside stockholders face under the present scheme.

As noted, the problem may not have become serious in the first instance had Chapter XI creditors' committees performed their functions independently and imaginatively. Unlike Chapter X, wherein the court occupies a position of control over the committees, Chapter XI envisions a strong, independent creditors' committee. Unfortunately, such committees have not in practice been noted for their strength or independence. Chapter XI was founded on the rock of creditor control and has foundered on the shoals of debtor domination.

The statutory functions of the creditors' committee are clearly delineated. At the first meeting of creditors, the court presides over an examination of the debtor and witnesses,⁴⁷ typically conducted by the attorney for one of the creditors who would like to become attorney for the official creditors' committee. This initial examination was considered a vital part of the statutory scheme, but generally few creditors attend the first meeting. After that poorly attended meeting, the elected creditors' committee itself may "examine into the conduct of the debtor's affairs and the causes of his insolvency or inability to pay

46. *Cf. Wolf v. Weinstein*, 372 U.S. 633 (1963).

47. Bankruptcy Act § 336(3), 11 U.S.C. § 736(3) (1970); R. BANKR. P. 11-25 (a)(2).

his debts as they mature."⁴⁸ The examination by the creditors' committee may be quite informal and, consequently, may produce more useful information than a court hearing.

The committee may hire attorneys, accountants, and agents to lend their expertise to the proceedings.⁴⁹ Thus the debtor's books may be audited by an independent accountant, its assets may be appraised to determine the forced sale value, and a good overall view of the debtor's operation may be obtained by the committee. The vigilant committee may, therefore, perform much of the protective function of a Chapter X trustee by exerting the powers it is given in Chapter XI.

A creditors' committee should act as liaison between all creditors whom it represents and the debtor.⁵⁰ It can be quite helpful to the debtor in urging creditors to cooperate fully with it and in pressuring creditors to continue to ship essential merchandise so that the debtor can continue in business.⁵¹ The committee benefits both sides by consulting with the debtor on any proposed plans.⁵² In fact, the chances of acceptance of a plan proposed by a debtor without consultation with the creditors' committee are very slim.⁵³ The debtor will not want to risk antagonizing an active creditors' committee, so its plan will reflect a negotiated effort, although the statute requires that the plan be "proposed" by the debtor.⁵⁴

The committee also functions to disseminate continuously information to creditors.⁵⁵ Because it is considered knowledgeable about the debtor's affairs, its recommendation to accept a plan will sway creditors' votes. Thus, one court could say:

It is fairly obvious that no arrangement proposed by or in the interests of the management alone is likely to receive the approval of disinterested creditors unless and until they are thoroughly satisfied

48. Bankruptcy Act § 339(1)(a), 11 U.S.C. § 739(1)(a) (1970); R. BANKR. P. 11-29(a).

49. Bankruptcy Act § 339(2), 11 U.S.C. § 739(2) (1970); R. BANKR. P. 11-29(b).

50. Bankruptcy Act §§ 339(1)(c)-(f), 11 U.S.C. §§ 739(1)(c)-(f) (1970); R. BANKR. P. 11-29(a).

51. See Levy, *Creditors' Committees and Their Responsibilities*, 74 COM. L.J. 355 (1969); Walsh, *The Creation, Rights, Duties and Compensation of Creditors' Committees under Chapters X and XI of the Bankruptcy Act*, 40 BROOKLYN L. REV. 35 (1973).

52. Bankruptcy Act § 339(1)(c), 11 U.S.C. § 739(1)(c) (1970); R. BANKR. P. 11-29(a).

53. See Hertzberg, *Chapter XI and Chapter X* in BASIC BANKRUPTCY 111, 118 (L. Abramson ed. 1971).

54. Bankruptcy Act §§ 321-23, 11 U.S.C. §§ 721-23 (1970). See Note, *Allocation of Corporate Reorganizations between Chapters X and XI of the Bankruptcy Act*, 69 HARV. L. REV. 352, 354 (1955).

55. Bankruptcy Act § 339(1)(d), 11 U.S.C. § 739(1)(d) (1970); R. BANKR. P. 11-29(a).

that what is offered to them in exchange for their present claims is fair and equitable and in their interests. Under Chapter XI the creditors' committee seems to be the only effective agency which can act for the creditors in this respect.⁵⁶

An informed creditors' committee is in a position to insist on a wide variety of safeguards in any recommended extension plan.⁵⁷ To the extent that the committee exercises the leverage that it possesses, creditors will undoubtedly benefit.

Thus, if the creditors' committee performs its function conscientiously and independently, it can greatly help to move the process along. The existence of a creditors' committee should speed the proceedings because of the confidence it induces.⁵⁸ Delay may also be avoided through the possibility of continuing the creditors' committee into Chapter XI from a pre-filing attempt at an out-of-court settlement; so long as the majority continues, expenses incurred before the committee was formally elected in Chapter XI are reimburseable.⁵⁹

That, at least, is the theory. The fact is that creditors' committees have given rise to a wide variety of abuses in many different circumstances. Conceived of as a check upon the powers and control of the debtor in possession, and to some extent as a substitute for an independent trustee, in far too many cases the creditors' committee becomes a tool of management or of its own agents, or an instrument of repression for one creditor or class of creditors to dominate the others.

One major source of abuse is the representation by an attorney of both the committee and a creditor sitting on the committee. Representation of a committee can mean lucrative remuneration for a minimum of effort, since responsibility for progress in the proceeding rests not with the committee but with the debtor. It is not surprising, therefore, that the scenario typically involves attorneys for the major creditors, to the extent that they are bankruptcy "professionals," vying with each other for attention at the preliminary creditors' meeting and at the subsequent official meeting. The object, of course, is to be no-

56. *In re Credit Service, Inc.*, 31 F. Supp. 979, 982 (D. Md. 1940). See also *In re Nova Shoe Co.*, 210 F. Supp. 526 (S.D.N.Y. 1962), in which the court viewed the arrangement as all but accepted where the creditors' committee had approved the debtor's plan and was about to recommend acceptance to the creditors.

57. *Levy, supra* note 51, at 361. These safeguards include undated resignations of management, explicit treatment of future operational losses, and a pledge of issued capital stock.

58. *Ashe, Rehabilitation under Chapter XI: Fact or Fiction*, 72 *COM. L.J.* 259, 262-63 (1967).

59. See text accompanying note 148 *infra*.

ticed and selected as attorney for the committee. More often than not, where a "professional" is involved, an "unofficial" committee will have been put together by him and will be officialized at the first meeting on a *pro forma* basis; not surprisingly, its unofficial "advisor" will then be retained officially as counsel. This *fait accompli* is possible because the attorney already represents one of the creditors. The inevitable suspicion then arises: the committee is dominated by the attorney who is proceeding in the best interests not of the creditors as a whole, but rather of himself, or his individual client. All too often there is at least some validity to these suspicions, and sometimes the effects are outrageous. For example, a case has been documented in which a minor creditor, a competitor of the debtor, retained committee co-counsel to bid for the assets and urge creditors to reject any plan, so that a liquidation in bankruptcy would be the only viable route.⁶⁰ In such instances, creditor leadership of the proceeding is a fiction.

A second problem is that far too often the committee is not representative of all creditors.⁶¹ The source of this problem can be traced to the election of the committee by a majority both in number and amount of voting claims, *i.e.* those creditors who bother to participate in person or by proxy in the first meeting of creditors.⁶² Thus, more often than not, the committee is dominated by institutional creditors at the expense of individuals, or knowledgeable trade creditors at the expense of public creditors.⁶³ Obviously, the interests of these three groups will not necessarily correspond.

60. Salter, *An Abuse of Chapter XI (A Case History)*, 39 AM. BANKR. L.J. 105 (1965). Although the Chapter X trustee performs a plan-reviewing function somewhat similar to that of the Chapter XI creditors' committees, his position as a fiduciary and the statutory requirement of disinterestedness demand that no such conflict of interest exist. *E.g.*, the Judicial Council of the Third Circuit recommended the removal of a trustee's counsel because his law firm represented a company which had filed a plan of reorganization in the same proceeding. The attorney's refusal to advise on which plan should be accepted was considered inadequate to prevent the appearance of a conflict of interest. *Nolan v. Judicial Council of the Third Circuit*, 346 F. Supp. 500 (D.N.J. 1972), *aff'd*, 481 F.2d 41 (3d Cir.), *cert. denied*, 414 U.S. 880 (1973).

61. *In re FAS Int'l, Inc.*, 382 F. Supp. 77 (S.D.N.Y. 1974) (provision for a single creditors' committee when read with the classification of creditors section "assume[d] that conflicting interests would be subsumed under a single committee which [was] charged with representing 'the creditors' without exception," *id.* at 80); *In re Imperial "400" Nat'l, Inc.*, 274 F. Supp. 342 (D.N.J. 1966) (public investors had no voice on creditors' committee); *In re Herold Radio & Electronics Corp.*, 191 F. Supp. 780 (S.D.N.Y. 1961) (committee largely composed of trade creditors with only minority representation of debenture holders recommended plan which was found unfair to debenture holders).

62. Bankruptcy Act §§ 44a, 56, 11 U.S.C. §§ 72a, 92 (1970); R. BANKR. P. 207(b), 11-27.

63. *In re Herold Radio & Electronics Corp.*, 191 F. Supp. 780 (S.D.N.Y. 1961).

Attempts at abuse are not limited to these well-established patterns. In *In re Martin Warehouse Distributor, Inc.*⁶⁴ the creditors' committee was to retain supervisory powers over the debtor's performance after the confirmation of the plan of arrangement. The plan included a provision which would have exonerated the committee from all liability except fraud. The court would not allow the committee to take such extensive powers without concomitant responsibility for its actions.

One of the more blatant conflicts of interest built into the statutory scheme with respect to creditors' committees has been corrected by the new Rules of Bankruptcy Procedure for Chapter XI. Prior to the adoption of those rules, the compensation of the attorneys, agents, and accountants, as well as reimbursement to the committee for its other expenses, depended entirely upon confirmation of a plan.⁶⁵ Thus the creditors' committee, and more particularly its agents, usually more controlling than controlled, were hardly in a position to evaluate independently a plan and recommend its rejection where the alternative was liquidation of the debtor and no fees to the relevant participants. The new rules provide that a court may allow reimbursement of creditors' committee expenses whether or not a plan is confirmed.⁶⁶ Moreover, the rules make clear that the attorney for the debtor in possession may be paid as a claim of administration even if Chapter XI is superseded by straight bankruptcy,⁶⁷ so that pressure to accept the first plan proposed may be lessened.

Based on all of the above, it is not surprising that, while the creditors' committee was clearly intended to be part of the essential foundation of Chapter XI, to some extent a *quid pro quo* for retention of the debtor in possession of its property, many creditors do not so perceive it, and in some jurisdictions it is simply dispensed with as an unnecessary expenditure.⁶⁸ Referees surveyed in the Brookings Institution study of bankruptcy practices agreed that the committees are dominated by the attorneys, and a substantial minority believed committees to be useless, or at least not worth the attorneys' fees paid.⁶⁹ Many creditors polled by that study said that "a ring of bankruptcy lawyers"

64. BANKR. L. REP. ¶ 62,907 (S.D. Fla. 1968).

65. Bankruptcy Act § 339(2), 11 U.S.C. § 739(2) (1970).

66. R. BANKR. P. 11-29(c).

67. *Id.* 11-31.

68. Ashe, *supra* note 58, at 263; Hertzberg, *supra* note 53, at 121.

69. D. STANLEY & M. GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 136 (1971).

controlled Chapter proceedings despite the presence of creditors' committees,⁷⁰ and it is difficult to disagree.

The proposed Chapter VII substitutes a committee appointed by the Administrator for the Chapter XI elected committee.⁷¹ At a minimum this means that someone will be cognizant of the composition of the committee. The committee will include different types of creditors, "representative" of those holding claims. Additional committees may be appointed by the Administrator *sua sponte* or upon order of the court after a hearing on a complaint filed by a party in interest.⁷² Furthermore, any party in interest may apply to the court for a change in the composition of any committee, on the ground that it is not representative.⁷³ It has been noted that this section is mined with litigation-producing provisions, to the extent it proves worthwhile to litigate.⁷⁴ The standard to be applied is vague in the extreme: membership must be "representative."

The committee would still have extensive investigatory powers.⁷⁵ In fact, its functions under the proposed section generally track those specified in Chapter XI. They are broadened in only two respects. First, the committee is specifically required to consult with the Administrator on decisions in which it presently has no formal consultation function: issuance of certificates of indebtedness, sale or lease of the property of the debtor, and appointment of a trustee.⁷⁶ Secondly, it must consult with the trustee or debtor as to the operation of the business,⁷⁷ an area which at present is entirely within the formal control of the court.⁷⁸ The committee is further empowered to "perform such other services as may be in the interest of creditors."⁷⁹ Clearly, the creditors' committee contemplated by Chapter VII will preserve a substantial amount of its former power despite the additional administra-

70. *Id.*

71. Proposed Act § 7-101(a).

72. *Id.* § 7-101(b).

73. *Id.* § 7-101(c).

74. Weintraub & Levin, *supra* note 40.

75. Proposed Act § 7-101(d)(3)(C).

76. *Id.* § 7-101(d)(3)(A).

77. *Id.* § 7-101(d)(3)(B).

78. Bankruptcy Act § 343, 11 U.S.C. § 743 (1970); R. BANKR. P. 11-23.

79. Proposed Act § 7-101(d)(3)(H). This language may be contrasted with Bankruptcy Act § 339(1)(f), 11 U.S.C. § 739(1)(f) (1970), which restricted additional activities to "such other services as may contribute to the confirmation of the arrangement," although new rule 11-29(c), consistent with its allowance of compensation even though a plan is not confirmed, uses the same language as proposed Chapter VII in this regard.

tive layer of oversight provided. Are there checks to assure a more effective and constructive use of that power in the proposed scheme?

The extent to which the present abuses will be corrected is not clear. As noted, the attempt to make committees "representative" is loaded with litigation potential. The provision precluding the attorney for the committee from representing an individual creditor is also aimed at balancing the influence of different types of creditors in the proceeding, and to that extent corrects a present problem. However, there is nothing in the Proposed Act to prevent continuing domination of the committee by professionals, or to break up the real or perceived ring of bankruptcy attorneys, and there is no specific supervision of, or procedure for, calling to account and reviewing the work of the committee. It is, therefore, difficult to see why representation of the committee will become any more burdensome for the "professional" bankruptcy attorney and thus any less desirable as a source of an easy fee; in his battle to represent the committee, he should have a potent new weapon in his right to challenge, on "behalf" of his actual client, the composition of the committee as nonrepresentative. Having won the battle, however, he will have to relinquish representation of the creditor. Clearly, there will be sufficient incentive in many cases to take advantage of the potential for litigation built into this standard.

There may be, however, somewhat greater quality control over the creditors' committee's performance under proposed Chapter VII. First, the addition to the statutory scheme of a full-time Administrator to oversee the proceeding ought to result in closer attention to detail than previously provided by the bankruptcy judge, although the Administrator lacks any specific statutory powers of oversight with respect to the committee, except as to appointment. Secondly, proposed section 4-403(a)(8) permits an administrative claim against the debtor's estate for

compensation for services, representing a substantial contribution to a confirmed plan in a Chapter VII case, rendered by an attorney or accountant to an indenture trustee, a creditor, an equity security holder, or a committee representing creditors or equity security holders not appointed pursuant to section 7-101.⁸⁰

In addition, proposed section 4-403(a)(9) allows as an administration claim expenses "representing a substantial contribution to a confirmed plan in a Chapter VII case . . . incurred by a creditor, equity security

80. Proposed Act § 4-403(a)(8).

holder, or a committee representing creditors or equity security holders not appointed pursuant to section 7-101." Thus, unlike the current ineffectual backstop of the stockholders' derivative suit, the proposed Chapter VII provides an incentive for close monitoring of the official creditors' committee's performance by all sorts of potentially interested parties, who can then anticipate a priority allowance from the estate for their efforts. Obviously, this proposal has important downside risks: so long as a good possibility of compensation exists, informal creditors' committees can be expected to burst forth under Chapter VII. However, the draftsmen stopped short of allowances to any party in interest who might equitably be entitled thereto; the provisions for reimbursement depend, as under pre-Chapter XI Bankruptcy Rules procedure, on confirmation. Thus, while frivolous efforts will be discouraged, important contributions will go uncompensated, and, therefore, perhaps unmade if confirmation will not clearly follow.

The balance reached by the Commission is dubious. Instead of concentrating its proposals on assuring adequate performance by the official committee, it holds out a carrot to other interested parties to pick up whatever slack may be left, thereby opening up the coffers of the debtor to an almost unlimited number of potential seekers of hand-outs, so long as a plan is ultimately confirmed. It is difficult to see why additional powers of oversight or even control over the committee given to the independent administrator could not have accomplished the same result without turning the proceeding into a potential bonanza for every involved individual and his attorney, giving such parties incentive to disagree or to refuse to compromise so that they can later claim to have made a compensable contribution. In this respect the Commission has carried over into Chapter VII one of the least desirable aspects of Chapter X. The result appears simply to multiply the layers of bureaucracy without allaying the expense or assuring greater efficiency in the performance of the official creditors' committee's duties, while at the same time multiplying the number of potential hand-outs from the estate. Under the proposal, the Administrator has authority to add to the committee. If to this procedure were added a supervisory role and impeachment process, overseen by the bankruptcy court, greater efficiency could be achieved without expanding the number of potential recipients of the estate's largesse.

Another area related to the duties of the creditors' committee where the ideal of speed and economy often gives way to a reality of

abuse is the evaluation of the proposed plan and the solicitation of acceptances thereto.⁸¹ If the debtor is controlling the flow of information, it is inevitable that the creditors' committee will be ill-equipped to appraise the debtor's proposed plan unless it is prepared to ask the hard questions, demand the documentation, and possibly do a substantial amount of investigation.⁸² The court's perspective may also suffer from the slanted information it may be receiving.

In Chapter X the preliminary order of approval by the judge represents a disinterested evaluation of the plan before acceptances can be solicited from creditors and, where appropriate, stockholders.⁸³ In the interest of speed and economy, however, prior approval is not part of the Chapter XI scheme, and acceptances are solicited with no monitoring from the court. Indeed, acceptances may be solicited before the petition is even filed, and, if so, there is nothing in Chapter XI to prevent the plan from being confirmed as early as the first meeting of creditors.

This is not to say that there are no protections available. One of the prerequisite findings to confirmation of a plan, if objection is made, is that "the proposal and its acceptance are in good faith and have not been made or procured by any means, promises or acts forbidden by this Act."⁸⁴ Chapter XI courts also have the less drastic power to void acceptances for confusing and misleading solicitation.⁸⁵

Evidence of misleading solicitation has also resulted in transfers to Chapter X, where, for example, a "Debenture Holders' Protective Committee" sent out inaccurate and misleading letters recommending acceptance of a plan.⁸⁶ Where acceptances to a plan were solicited

81. The functions of a creditors' committee may include: "(c) to negotiate with the debtor concerning the terms of the proposed arrangement and to advise the creditors of its recommendations with respect thereto; (d) to report to the creditors from time to time concerning the progress of the proceeding; (e) to collect and file with the court acceptances of the arrangement proposed . . ." Bankruptcy Act §§ 339(1)(c)-(e), 11 U.S.C. §§ 739(1)(c)-(e) (1970). See also R. BANKR. P. 11-29(a).

82. Again, prior to the effective date (July 1, 1974) of the new rules for Chapter XI, the committee and its agents had a substantial stake in not examining the plan too closely if that would mean a recommendation of rejection. See text accompanying notes 60-62 *supra*.

83. Bankruptcy Act §§ 171-76, 11 U.S.C. §§ 571-76 (1970); R. BANKR. P. 10-303 to -304.

84. Bankruptcy Act § 366(4), 11 U.S.C. § 766 (1970). If no objection is made, however, this finding may be made by the court without taking proof. R. BANKR. P. 11-38(d).

85. SEC v. Crumpton Builders, Inc., 337 F.2d 907 (5th Cir. 1964).

86. SEC v. Liberty Baking Corp., 240 F.2d 511 (2d Cir.), *cert. denied*, 353 U.S. 930 (1957).

pursuant to a debtor's statement that the only alternative thereto was liquidation, the court transferred the proceedings to Chapter X because acceptances were virtually coerced.⁸⁷ These cases offer some indication that a court is not powerless to act and may itself subject the plan and acceptances to scrutiny, even when the creditors' committee has abdicated its role as chief watchdog. However, the bluntness of the threats available to the court, *i.e.* forcing the debtor into Chapter X or into ordinary bankruptcy, points up the dilemma faced when everybody benefits from a successful Chapter XI only if everyone acts responsibly therein. Attaining responsible behavior is the crux of the difficulty. The draconian alternatives available to the bankruptcy court for more than minor isolated misbehavior in the Chapter XI will typically benefit nobody.

Proposed Chapter VII continues the unsupervised solicitation of acceptances only for plans not affecting "publicly held securities," as that term is defined.⁸⁸ This is the relatively small group of debtors for whom Chapter XI-type composition plans will continue under very limited circumstances to be specifically available under Chapter VII.⁸⁹ However, because the provisions contemplate a representative creditors' committee, able to obtain compensation for expenses of employing experts other than attorneys and accountants to evaluate the plan,⁹⁰ there is some greater likelihood that the plan will be properly appraised before acceptances are solicited. The requirement that such a plan be unanimously accepted by all affected creditors further helps to guarantee appropriate appraisal; a single dissenter would seem to preclude confirmation of a plan of this type.⁹¹ For all other types of debtors and plans, the Chapter X approach of judicial and administrative supervision of solicitation of acceptances, after judicial approval of the plan, is followed in these proceedings.⁹² Of course, the Chapter VII court would still be empowered to examine the acceptances of the plan for good faith issues.⁹³ In summary, the net effect here is to continue the existing Chapter XI procedures for soliciting acceptances in the severely limited number of cases where composition plans will specifi-

87. *Norman Fin. & Thrift Corp. v. SEC*, 415 F.2d 1199 (10th Cir. 1969).

88. Proposed Act §§ 7-307 to -308. "Publicly held securities" is defined to mean "securities of a class the ownership of which is held of record by three hundred or more persons." *Id.* § 1-102(36).

89. See text accompanying notes 182-83 *infra*.

90. Proposed Act § 7-101(d)(1).

91. See text accompanying notes 182-89 *infra*.

92. Proposed Act §§ 7-306, -308.

93. *Id.* § 7-309(e).

cally be permitted. In all other cases, where the fairness of the plan will be measured pursuant to an ostensibly different standard, solicitation of acceptances will be closely regulated. Clearly, then, the abuses with respect to solicitation will have been cured for the most part in the Proposed Act. The question as to whether rigidity has unnecessarily replaced flexibility with respect to the ultimate purpose for the solicitation, the confirmation of a plan, will be discussed below.

Close attention to a plan's provisions before it is confirmed, and to the fair solicitation of acceptances, avails nothing when the creditors in question, upon the debtor's post-confirmation default in the performance of the plan's terms, are left without a summary remedy. This occurs when the plan does not provide that the bankruptcy court retain jurisdiction over the debtor,⁹⁴ and, unfortunately, it is the rare plan that does so provide. The Brookings Institution study found that, in general, bankruptcy judges oppose the retention of jurisdiction.⁹⁵ They believe that the debtor is better able to conduct its business without interference by the court, and they are under pressure from the Administrative Office of the United States Courts to close cases.

The considerations are not all one-sided, as provision for the retention of jurisdiction may benefit the debtor. For example, only where there has been such a retention of jurisdiction may an extension plan be altered or modified after confirmation.⁹⁶ On the other hand, retained jurisdiction enables creditors to invoke the authority of the bankruptcy court to enforce a deferred payment plan on which the debtor has defaulted. There are many salutary examples in the case law. In *Grayson-Robinson Stores*⁹⁷ the court was to retain jurisdiction for a predicted eleven years until all the payments had been made to creditors. The referee in *Wilcox-Gay*⁹⁸ retained jurisdiction so that evidence of debtor irregularities could be brought to his attention. Such retentions of jurisdiction can only increase the efficiency of the reorganization process. The reluctance on the part of debtors and courts to include such a provision is at least partially responsible for the Brookings Institution's finding that so few Chapter XI debtors remain

94. Bankruptcy Act § 368, 11 U.S.C. § 768 (1970) provides that the court "shall retain jurisdiction, if so provided in the arrangement" (emphasis added). Otherwise, the court retains jurisdiction for the very limited purpose of disposing of claims which have not been allowed or disallowed prior to confirmation. *Id.* § 369, 11 U.S.C. § 769.

95. D. STANLEY & M. GIRTH, *supra* note 69, at 144.

96. Bankruptcy Act § 363, 11 U.S.C. § 763 (1970).

97. *Grayson-Robinson Stores v. SEC*, 320 F.2d 940 (2d Cir. 1963).

98. *In re Wilcox-Gay Corp.*, 133 F. Supp. 548 (W.D. Mich. 1955), *aff'd sub nom. SEC v. Wilcox-Gay Corp.*, 231 F.2d 859 (6th Cir. 1956).

in operation very long after the confirmation of a plan.⁹⁹ This fact was recognized by the draftsmen of Chapter VII. The proposed provisions would allow modifications to be suggested by any party in interest if the Administrator permits.¹⁰⁰ If the plan has been substantially consummated, no modification can be obtained unless no creditor or equity securities holder is materially and adversely affected.¹⁰¹ Rather than requiring a Chapter VII plan to include a provision for retention of jurisdiction, the intention is that specific performance of a plan may be sought at any time by a party in interest.¹⁰² No longer will a debtor be able to ignore with impunity his obligations under the plan once confirmation has occurred. Jurisdiction of the bankruptcy court to enforce the terms thereof will remain available to any party seeking it for the course of the plan.

III. DOES PROPOSED CHAPTER VII RETAIN THE ADVANTAGEOUS ASPECTS OF CHAPTER XI?

Legitimate preferences for current Chapter XI revolve around its design for speed and economy in the confirmation and consummation of a plan. The Brookings Institution study found that a typical proceeding under Chapter XI lasts one and one-half years, which is the durational equivalent of a straight bankruptcy proceeding, while a Chapter X reorganization may take five years or longer to be fully consummated.¹⁰³ Accordingly, it would be helpful to pinpoint the delays inherent in current Chapter X which are absent from Chapter XI and to see which of those delays reappear in proposed Chapter VII.

The Brookings Institution study cites distribution as one of the chief sources of delay under Chapter X.¹⁰⁴ Although distribution may begin upon consummation of a plan,¹⁰⁵ obtaining proofs of claim and acceptances from widely scattered creditors and stockholders is quite time-consuming. Also, the statute provides for a period of at least five years during which assets must be kept available to pay creditors and security holders as they surrender their claims.¹⁰⁶ Only after that time

99. The study found that only one-third of the Chapter XI debtors are still in operation two years after the proceedings have closed. D. STANLEY & M. GIRTH, *supra* note 69, at 115.

100. Proposed Act § 7-305(a).

101. *Id.* § 7-305(b).

102. *Id.* § 7-303, Advisory Comm. Note 2.

103. D. STANLEY & M. GIRTH, *supra* note 69, at 143-45.

104. *Id.* at 145.

105. Bankruptcy Act § 224(4), 11 U.S.C. § 624(4) (1970).

106. *Id.* § 204, 11 U.S.C. § 604; R. BANKR. P. 10-405(b).

has expired do the unclaimed assets revert to the corporation.¹⁰⁷ Chapter XI, in contrast, lacks a section on surrender of claims in connection with distribution to all creditors whose proofs of claim have been allowed in the proceeding. Proposed Chapter VII continues the necessity for a period for surrender if it is required by the plan, but sets five years as the outside limit rather than the minimum period.¹⁰⁸

Another aspect of Chapter X which causes delay is the number of required formal hearings with notice to all parties. Hearings on the approval of the petition and the appointment of the trustee,¹⁰⁹ and for judicial approval of the plan before creditor approval,¹¹⁰ are both absent under Chapter XI. Proposed Chapter VII would carry over both of these hearings in most instances.¹¹¹ Furthermore, while many administrative decisions under both chapters require approval of the court, after hearing on notice to all parties in interest, the Chapter XI Rules provide that certain of those hearings may be held upon notice only to the creditors' committee, unless another party in interest specifically files a request with the court that he receive personal notice.¹¹² Accordingly, it is frequently possible to obtain the consent of the single creditors' committee, often through its attorney, to take the proposed action with the consent of the court forthcoming without a formal hearing. Since the proposed Chapter VII procedure in general more closely resembles present Chapter X, it can be expected that the typical case will have many more hearings than the current Chapter XI case.

There are many additional bottlenecks or possible bottlenecks in Chapter X which do not exist in Chapter XI: (1) the requirement of court approval of a petition as being proper and in good faith;¹¹³ (2) the trustee's investigatory report;¹¹⁴ (3) the SEC's advisory report;¹¹⁵ (4) the court order approving the plan as a prerequisite to soliciting acceptances;¹¹⁶ and (5) the requirement of creditor, and in some instances stockholder, acceptance by two-thirds in amount of claims of each class affected.¹¹⁷ Delay may also inhere in the require-

107. Bankruptcy Act § 205, 11 U.S.C. § 605 (1970); R. BANKR. P. 10-406(b).

108. Proposed Act § 7-312(c).

109. Bankruptcy Act § 161, 11 U.S.C. § 561 (1970); R. BANKR. P. 10-212.

110. Bankruptcy Act § 169, 11 U.S.C. § 569 (1970); R. BANKR. P. 10-303.

111. Proposed Act §§ 7-102(a), -306(a).

112. R. BANKR. P. 11-24(d).

113. Bankruptcy Act §§ 141-44, 11 U.S.C. §§ 541-44; R. BANKR. P. 10-113.

114. Bankruptcy Act § 167, 11 U.S.C. § 567 (1970); R. BANKR. P. 10-208.

115. Bankruptcy Act §§ 172-73, 11 U.S.C. §§ 572-73 (1970); R. BANKR. P. 10-303.

116. Bankruptcy Act § 176, 11 U.S.C. § 576 (1970); R. BANKR. P. 10-303 to -304.

117. Bankruptcy Act § 179, 11 U.S.C. § 579 (1970); R. BANKR. P. 10-305.

ments that the "judge" (defined to exclude the referee in bankruptcy¹¹⁸) perform certain functions in Chapter X which may be carried out by the "court" (the judge or referee¹¹⁹) in Chapter XI. These functions include authorizing the issuance of certificates of indebtedness,¹²⁰ permitting the rejection of executory contracts,¹²¹ and authorizing the lease or sale of property.¹²²

Under Chapter VII the aforementioned duties of judge or court would be vested in the Administrator, except that the court (defined as a "bankruptcy court or a judge of a bankruptcy court"¹²³) must authorize any proposed sale or lease which would transfer all or substantially all of the debtor's property.¹²⁴ Confirmation is, however, made easier because, as under current Chapter XI, only a majority in amount rather than two-thirds acceptance by each affected class of creditors and stockholders is required.¹²⁵ If the Bankruptcy Administration itself operates quickly, the procedure will be improved by the elimination of the need for a court's authorization of some routine steps of a proceeding. Unfortunately, it is contrary to historical precedent to suppose that an administrative bureaucracy will act with deliberate speed; if it does so, however, everyone stands to benefit from what will then constitute reasonably streamlined procedures. Greater supervision may then actually exist without accompanying unacceptable delays.

In addition to being far faster, Chapter XI is far less expensive than Chapter X. In fact, average costs in Chapter XI are below those of straight bankruptcy.¹²⁶ The monies available for a decent settlement in Chapter XI would often be entirely consumed in the course of a Chapter X proceeding in paying for a trustee, an investigation, and a trustee's report, etc.¹²⁷

As noted, Chapter XI allows compensation to agents, attorneys, and accountants of only one creditors' committee,¹²⁸ and compensates

118. Bankruptcy Act § 1(20), 11 U.S.C. § 1(20) (1970); R. BANKR. P. 902(4).

119. Bankruptcy Act § 1(9), 11 U.S.C. § 1(9) (1970).

120. *Id.* §§ 116(2), 344, 11 U.S.C. §§ 516(2), 744.

121. *Id.* §§ 116(1), 313(1), 11 U.S.C. §§ 516(1), 713(1); R. BANKR. P. 11-53.

122. Bankruptcy Act §§ 116(3), 313(2), 11 U.S.C. §§ 516(3), 713(2) (1970); R. BANKR. P. 11-54(b).

123. Proposed Act § 1-102(14).

124. *Id.* § 7-205.

125. *Id.* § 7-310(d)(1).

126. D. STANLEY & M. GIRTH, *supra* note 69, at 177-78.

127. *See, e.g., In re Lea Fabrics, Inc.*, 272 F.2d 769 (3d Cir. 1959), *vacated as moot sub nom. SEC v. Lea Fabrics, Inc.*, 363 U.S. 417 (1960).

128. Bankruptcy Act § 339(2), 11 U.S.C. § 739(2) (1970); R. BANKR. P. 11-29(b).

the disbursing agent if one is needed.¹²⁹ In addition, only one reasonable fee for the debtor's attorneys is permitted.¹³⁰ This is to be compared with Chapter X, under which reimbursement is forthcoming for expenses of petitioning creditors, for services of the referee acting as special master, for the trustee and other officers and their attorneys, for the debtor's attorney and the attorney for petitioning creditors, for committees or representatives of creditors and stockholders and their attorneys or agents, and for any other parties in interest and their attorneys or agents.¹³¹ In addition, expenses and services rendered in connection with suggestions for a plan which is ultimately confirmed, objections to a plan which is ultimately rejected, or contributions to administration which are beneficial to the estate may be allowed to creditors, stockholders and their attorneys.¹³²

Proposed Chapter VII provides for reimbursement of necessary and reasonable services rendered by an attorney or accountant to a number of entities, expenses and services of a trustee, expenses of the Administrator and any creditors' committee, and expenses for services of any parties in interest (their attorneys and accountants) which represent "a substantial contribution to a confirmed plan."¹³³ Clearly Chapter VII is nowhere near as penny-pinching as Chapter XI, but its potential price tag to the particular estate cannot be evaluated without knowing how many unofficial creditors' committees are likely to be formed, how many compensable contributions to a plan are likely to be made and how those contributions are to be valued, how frequently a trustee will be appointed, and how much expense the Administrator will incur in carrying out his duties.

Lack of disruption of the operation of the business in most Chapter XI proceedings has already been mentioned as a primary advantage of that type of proceeding.¹³⁴ Retention of management is often insisted upon by creditors, and this insistence has accounted for court decisions to keep debtors in Chapter XI despite objections.¹³⁵ One commentator has appraised the situation in this way:

Creditors are much more likely to ascribe the debtor's troubles to a combination of bad luck and ineptness, rather than dishonesty

129. Bankruptcy Act § 337(1), 11 U.S.C. § 737(1) (1970); R. BANKR. P. 11-38(a).

130. Bankruptcy Act §§ 64a(1), 302, 11 U.S.C. §§ 104a(1), 702 (1970); R. BANKR. P. 219, 11-31.

131. Bankruptcy Act §§ 241-42, 11 U.S.C. §§ 641-42 (1970); R. BANKR. P. 10-215.

132. Bankruptcy Act § 243, 11 U.S.C. § 643 (1970); R. BANKR. P. 10-215.

133. Proposed Act §§ 4-403(a)(3)-(10).

134. See text accompanying notes 23-30 *supra*.

135. *E.g., In re KDI Corp.*, 477 F.2d 726 (6th Cir. 1973).

of management. They are not always ready to believe that a disinterested trustee will necessarily prove less inept than the management he replaces, particularly while he is acquiring on-the-job training at their expense. They will often prefer to persuade the management that it should be supplemented, and less often replaced, by new blood.¹³⁶

Indeed, creditors have threatened to boycott any plans which call for the dismissal of current management.¹³⁷ The self-interest of trade creditors is better served by retaining current customers than by allowing new management, which may not make further purchases from these creditors, to be installed. This is clearly a prime area in which the interests of various classes of creditors may diverge.

In addition, consistency of management may be a prerequisite to retaining key employees "who would not remain through a lengthy Chapter X proceeding because of their lack of confidence in a trustee unknown to them and their fears that suppliers would cut off merchandise."¹³⁸ Indeed, creditors often refuse to ship on credit to a business run by a Chapter X trustee whereas they will continue such shipments to a debtor in possession under Chapter XI.¹³⁹

As noted, proposed Chapter VII would permit the appointment of a current manager of the business as a second, non-disinterested trustee to continue operations,¹⁴⁰ an action that may help maintain creditor confidence for the duration of the reorganization proceeding. Furthermore, to the extent that the new version of the absolute priority rule in Chapter VII will permit the future contributions of management to be recognized in the allocation of securities in the reorganized enterprise,¹⁴¹ this limited continuity may appear more meaningful to suppliers, since it will be seen as most likely continuing after consummation of the proceeding.

136. Coogan, *The Proposed Bankruptcy Act of 1973: Questions for the Non-Bankruptcy Business Lawyer*, 29 BUS. LAW. 729, 743 (1974).

137. *In re Wilcox-Gay Corp.*, 133 F. Supp. 548 (W.D. Mich. 1955), *aff'd sub nom. SEC v. Wilcox-Gay Corp.*, 231 F.2d 859 (6th Cir. 1956).

138. *See Grayson-Robinson Stores v. SEC*, 320 F.2d 940, 946 (2d Cir. 1963).

139. *See id.* Such a refusal sabotaged a plan after the proceedings were switched from Chapter XI to Chapter X in *In re Davega Stores Corp.*, BANKR. L. REP. ¶ 60,434 (S.D.N.Y. 1962). *See also In re Arlan's Dep't Stores*, 373 F. Supp. 520 (S.D.N.Y. 1974), where a transfer to Chapter X was granted even though Judge Carter acknowledged "the serious possibility that the debtor's line of credit will be substantially extinguished under Chapter X." *Id.* at 526. He went on to state, "I regret that people in the trade may wrongly construe a proceeding in Chapter X to be the harbinger of bankruptcy and liquidation." *Id.*

140. Proposed Act § 7-102(d). *See text accompanying notes 43-46 supra.*

141. *See text accompanying notes 196-201 infra.*

Another aspect of the continuity provided by the continuation of management in Chapter XI is the possibility of continuing an earlier attempt at out-of-court agreement with creditors to enter a Chapter XI proceeding with a minimum of disruption.

The continuity of dealing with a debtor from the time he becomes insolvent until his problems are consummated in a settlement did not stop when the composition settlement failed to obtain sufficient acceptances, but continued into the Chapter XI proceedings without loss of time or disruption of negotiations, which may have been months in the making.¹⁴²

Chapter XI limits the proposal of a plan to the debtor.¹⁴³ This monopoly, coupled with the possibility of soliciting acceptances even before the filing of the petition,¹⁴⁴ gives the debtor the ability to continue an unsuccessful out-of-court arrangement plan into Chapter XI and to have it accepted without delay. The ability to solicit acceptances prior to the approval of the plan is intimately related to this advantage. To the extent that the solicitation is no longer permitted, this valuable continuity is lost.

Furthermore, because involuntary petitions would be authorized in Chapter VII proceedings, the debtor is given less room to propose an out-of-court settlement, line up acceptances, terminate the composition effort, and file both plan and acceptances. A disgruntled major creditor could affect the timing of the initiation of the Chapter VII proceedings by filing an involuntary petition before the out-of-court effort had progressed very far.¹⁴⁵ Moreover, under Chapter VII, the debtor must relinquish his exclusive authority to propose a plan.¹⁴⁶ This loosening of debtor control will undoubtedly lessen his ability to put through a prior extrajudicial plan. Creditors will no longer be faced with the sole alternative of applying for an order of liquidation (or, perhaps in some cases, filing an involuntary Chapter X petition) when they do not wish to approve a debtor's proposal.¹⁴⁷ Under Chapter VII, the mechanism for continuing an out-of-court settlement attempt into an arrangement proceeding with little dislocation is substantially

142. Weintraub & Levin, *supra* note 40, at 20.

143. Bankruptcy Act § 323, 11 U.S.C. § 723 (1970).

144. *Id.* § 336(4), 11 U.S.C. § 736(4); R. BANKR. P. 11-37(a).

145. Proposed Act § 4-205(d).

146. *Id.* § 7-304(b).

147. This is the other side of the argument made earlier that the lack of flexibility of remedy serves to promote debtor misbehavior. Here, the same inflexibility improves good faith attempts at informal settlement. Far from being inconsistent, the two points underscore both the genius of Chapter XI and its basic flaw with respect to its assumptions about human nature and responsible behavior in a basically unsupervised setting.

weakened. To the extent that the overall scheme hinders rather than encourages informal settlement attempts, its approach may be seriously questioned.

In Chapter XI, the creditors' committee is another means of linking extrajudicial proceedings with those under the Bankruptcy Act. Under the present scheme, expenses incurred by a committee before its official election are allowed as long as a majority of the pre-filing committee is retained.¹⁴⁸ If substantially equivalent creditors' committees indeed exist out of court and in Chapter XI, the debtor and his creditors reap the benefits of a continuing relationship.¹⁴⁹ This continuity is jeopardized by the device of the appointment of the creditors' committee by the Administrator in proposed Chapter VII.¹⁵⁰ Unless the out-of-court committee was representative of different sorts of claims and was composed of creditors holding the largest amount of claims, it cannot be carried over unchanged. If the Administrator chooses not to appoint substantially the same committee, the only remedy is appeal to the court on the ground that the appointed committee is unrepresentative, an appeal that, under the given standards, is almost sure to fail.

An additional area of flexibility promoting confirmation of Chapter XI plans is the classification of creditors. Whereas all classifications in Chapter X are made by the judge,¹⁵¹ the debtor himself may classify creditors as part of his proposed Chapter XI arrangement,¹⁵² subject to summary classification by the court in the event of controversy.¹⁵³ After division into classes, creditors may be treated unequally by the plan,¹⁵⁴ but arbitrary classifications are prohibited.¹⁵⁵ Grouping creditors so that each class contains a majority likely to accept the plan is not precluded as long as some reasonable basis for such division can

148. Bankruptcy Act § 339(2), 11 U.S.C. § 739(2) (1970); R. BANKR. P. 11-29.

149. The assumption here is that the creditors' committee in question does not exhibit a large number of the common flaws discussed *supra*, and therefore does serve a useful function.

150. See text accompanying notes 66-69 *supra*.

151. Bankruptcy Act § 197, 11 U.S.C. § 597 (1970); R. BANKR. P. 10-302.

152. Bankruptcy Act § 351(1), 11 U.S.C. § 757(1) (1970).

153. *Id.* § 351, 11 U.S.C. § 751.

154. See S. KRAUSE, ARRANGEMENTS UNDER CHAPTER XI OF THE BANKRUPTCY ACT 116 (1968).

155. *In re Discon Corp.*, 346 F. Supp. 839, 841 (S.D. Fla. 1971); *In re Manufacturers' Credit Corp.*, 278 F. Supp. 384 (D.N.J.), *aff'd sub nom.* *Manufacturers' Credit Corp. v. SEC*, 395 F.2d 833 (3d Cir. 1968) (classification of creditors according to dates prior to which they had advanced money found arbitrary).

be shown.¹⁵⁶ Since creditor acceptance of the plan is the goal, the debtor must guard against the danger that creditors will so resent the classification imposed on them that they will impede acceptance of the arrangement.¹⁵⁷ Within these confines, the power to classify creditors strengthens the debtor's position in Chapter XI proceedings.

The Proposed Act would place this power in the hands of the Administrator, to be exercised on request of a party in interest. Explicit guidelines are provided for such classification: the class must be "of substantially similar character and the members [must] enjoy substantially similar rights."¹⁵⁸ While the meaning of this test (and particularly whether that meaning differs from the present test of rationality) will have to await administrative and judicial interpretation, there appears to be less opportunity for political gerrymandering based upon a perceived likelihood of acceptance of the plan. If the creditors themselves accept such gerrymandering as in their best interests, it is questionable whether inflexible prevention of such activity will promote any overriding public interest.¹⁵⁹

The ultimate scope of the plan in current Chapters X and XI is limited by the standards under each chapter for confirmation. While a plan under Chapter X must be "fair and equitable,"¹⁶⁰ that is, comply with the absolute priority principles laid down by the Supreme Court in the progeny of *Northern Pacific Railway Company v. Boyd*,¹⁶¹ a Chapter XI plan need only be "for the best interests of creditors."¹⁶² Since an arrangement under Chapter XI cannot affect secured creditors,¹⁶³ it is clear that the creditors referred to in this rubric are the unsecured creditors who can be affected. Definitions of this term of

156. See Rostow & Cutler, *Competing Systems of Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334 (1939).

157. See Hertzberg, *supra* note 53, at 118.

158. Proposed Act § 7-302.

159. See, e.g., *Bartle v. Markson Bros., Inc.*, 314 F.2d 303 (2d Cir. 1963).

160. Bankruptcy Act §§ 174, 221(2), 11 U.S.C. §§ 574, 621(2) (1970).

161. 228 U.S. 482 (1913). The progeny include *Marine Harbor Properties, Inc. v. Manufacturer's Trust Co.*, 317 U.S. 78 (1942) (Chapter X); *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510 (1941) (the last two under Bankruptcy Act of 1934, ch. 424, § 77B, 48 Stat. 912); *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939); *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445 (1926). Essentially, the absolute priority doctrine requires that each class of creditors, in order of seniority, must receive the "indubitable equivalence" of full compensation upon its claims pursuant to the plan before the next junior class of creditors is entitled to receive anything at all upon its claims, and all creditors must be so compensated before equity holders can receive anything. See *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935).

162. Bankruptcy Act § 366(2), 11 U.S.C. § 766(2) (1970).

163. *Id.* §§ 356, 357(1), 11 U.S.C. §§ 756, 757(1).

art vary slightly. All courts agree that the requirement is not satisfied if unsecured creditors would receive more from liquidation than from the plan.¹⁶⁴ Some courts deem a plan to be for the best interests of creditors if it will provide as much as liquidation; equivalency is the test.¹⁶⁵ Others heighten the standard by insisting that the plan yield more to creditors than they could expect from liquidation.¹⁶⁶ In any event, it is clear that the relevant comparison is to the expected returns from a bankruptcy liquidation. A plan does not have to be generous in its payment to creditors to be in their best interests. Plans have been confirmed that pay creditors a mere one percent of their claims.¹⁶⁷ Whatever the precise outer limits, it is clear that the test, unlike the standards for confirmation in Chapter X, permits a substantial range of bargaining between the debtor and the affected unsecured creditors about who—the unsecured creditors or the equity holders—will reap the benefit of the going-concern value of the enterprise that is preserved through rehabilitation in lieu of liquidation. Where public policy would not permit this good will factor to redound to the benefit of equity holders (because, for example, of the existence of a substantial number of public creditors plus a judgment that continuation of present management is not crucial to future success) Chapter X is the appropriate vehicle for corporate rehabilitation. Where this is not the case, however, Chapter XI standards of confirmation permit creditors, on a pragmatic and interested basis, to decide how much it is worth to them to see the debtor remain in business. They may decide for themselves how much of the maximum conceivable recovery, as measured by the application of the absolute priority standard, they will permit to redound to the equity holders and, thereby, generally to be shared by management. At the same time, management is free to decide at what point the effort to rehabilitate is not worth the candle because creditors are demanding too much of that going-concern value; if creditors are dissatisfied with management's decision in this regard, they have the option of filing an involuntary Chapter X petition. The range of negotiation permitted by the flexible standard thus permits an accord on mutually

164. *Technical Color & Chem. Works, Inc. v. Two Guys from Massapequa, Inc.*, 327 F.2d 737, 741 (2d Cir. 1964); 9 W. COLLIER, *supra* note 45, ¶ 9.17, at 282.

165. *In re Village Men's Shops, Inc.*, 186 F. Supp. 125 (S.D. Ind. 1960); Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 U.C.L.A.L. REV. 540 (1973).

166. *In re Peoples Loan & Inv. Co.*, 410 F.2d 851, 857 n.6 (8th Cir. 1969); *In re Discon Corp.*, 346 F. Supp. 839, 841 (S.D. Fla. 1971).

167. *In re Halperin*, [1962-1966 Transfer Binder] BANKR. L. REP. ¶ 60,737, at 69,155 (E.D.N.Y. 1963).

agreeable terms. When there is no substantial "public interest" to prevent a deal from being struck, in light of the self-interest of the negotiators on each side, a minimum of supervision and minimum standards for confirmation best serve all relevant interests. This process may be favorably contrasted with the Chapter X process, in which the absolute priority rule limits the range of negotiation to the type of capital structure and amount of senior securities which will be issued by the reorganized corporation. Of course, bargaining even in that area is limited by notions of "feasibility."¹⁶⁸ To the extent negotiation about distribution of going-concern value does take place, it must be disguised in terms of enterprise value.

The proposed Bankruptcy Act eliminates the "best interests of creditors" test from its standards for confirmation.¹⁶⁹ Even the provision on conversion of the proceeding to one for liquidation does not look to comparative yields between liquidation and a Chapter VII plan.¹⁷⁰ Instead, all Chapter VII plans, with the single exception mentioned, must be tested against a modified absolute priority rule.

A second Chapter XI standard for confirmation is "feasibility."¹⁷¹ "Feasibility" is also a prerequisite to confirmation of a Chapter X plan.¹⁷² However, substantial authority exists for the proposition that different standards attach to the determination of this element in the different chapters. While Chapter X feasibility is typically said to involve "the question of the emergence of the reorganized debtor in a solvent condition and with reasonable prospects of financial stability and success,"¹⁷³ the test for Chapter XI is "whether the things which are to be done after confirmation can be done as a practical matter under the facts."¹⁷⁴

This looser standard in Chapter XI has not been universally applauded. The Brookings Institution study points to the lack of attention to potential success of the business under the plan, as opposed to the success of the business in fulfilling the terms of the plan, as a main reason why only one-third of Chapter XI debtors are still in operation two years after the proceedings have closed.¹⁷⁵ Despite the negative

168. See text accompanying notes 171-77 *infra*.

169. Proposed Act § 7-310.

170. *Id.* § 7-112.

171. Bankruptcy Act § 366(2), 11 U.S.C. § 766(2).

172. *Id.* §§ 174, 221(2), 11 U.S.C. §§ 574, 621(2).

173. 6A W. COLLIER, *supra* note 45, ¶ 11.07, at 638.

174. 9 *id.* ¶ 9.18, at 287.

175. D. STANLEY & M. GIRTH, *supra* note 69, at 146.

slant placed thereon by that study, this definition of feasibility seems entirely appropriate, in light of the limited purposes of a Chapter XI arrangement. The typical rubric is "the probability of actual performance" of the arrangement.¹⁷⁶ Thus, within such a definition, a single payment plan for which the cash is already deposited is, without further inquiry, "feasible" even if the corporation collapses on the following day.¹⁷⁷ The alternative of liquidation would have provided less for creditors since, presumably, the "best interests" standard had been satisfied.

The Brookings Institution, however, has not been alone in criticizing this standard, and some courts have applied a definition of feasibility for Chapter XI which is virtually identical to that applied for Chapter X. Judge Medina, in *In re Transvision, Inc.*,¹⁷⁸ outlined the question involved in the feasibility test of Chapter XI as follows: Is there "a reasonable likelihood that the desired financial recovery will be effected without unduly prejudicing the rights of any interested parties"?¹⁷⁹ The Sixth Circuit affirmed a lower court's decision which used "feasibility" to mean a reasonable likelihood that confirmation of the plan will lead to financial recovery.¹⁸⁰ In another proceeding, an arrangement was not confirmed because there was insufficient evidence regarding the chance of financial success under the plan.¹⁸¹

There is no question but that the intention of the draftsmen of proposed Chapter VII was to adopt the Chapter X, and not the Chapter XI, notion of "feasibility" for all corporate reorganizations. Note 8 to proposed section 7-310 specifically states that it is "abandoning the judicial interpretation of 'feasibility'" for Chapter XI, which it characterizes as "the ability to meet plan requirements." Rather, proposed section 7-310(d)(2)(A) will require probability of financial success, and, accordingly, explicitly states that the plan must be "not likely to

176. *In re KDI Corp.*, 477 F.2d 726, 733 (6th Cir. 1973); *In re Village Men's Shops, Inc.*, 186 F. Supp. 125, 127 (S.D. Ind. 1960). Even under this definition the debtor is not required to reveal in the plan the source of funds needed for consummation thereof, nor even allege that it has access to such funds. *In re Gefke*, BANKR. L. REP. ¶ 65,397 (W.D. Wis. 1974).

177. *See In re Slumberland Bedding Co.*, 115 F. Supp. 39 (D. Md. 1953).

178. 217 F.2d 243 (2d Cir. 1954), *cert. denied*, 348 U.S. 952 (1955).

179. *Id.* at 246; *accord*, *United Properties, Inc. v. Emporium Dep't Stores*, 379 F.2d 55, 65 (8th Cir. 1967).

180. *In re Wilcox-Gay Corp.*, 133 F. Supp. 548 (W.D. Mich. 1955), *aff'd sub nom. SEC v. Wilcox-Gay Corp.*, 231 F.2d 859 (6th Cir. 1956).

181. *In re Deters*, BANKR. L. REP. ¶ 63,231 (W.D. Wis. 1969).

be followed by the liquidation of, or a need for further financial reorganization by, the debtor or any successor under the plan.”

It is suggested that, so long as the standard for confirmation of a Chapter XI plan is the “best interests of creditors,” the looser meaning of “feasibility” is consistent with the purposes of that Chapter. Assuming that the Chapter X standard of feasibility is not met in any particular case, and the rehabilitated corporation again meets with failure, the unsecured creditors will at worst receive more than they would have upon the immediate liquidation of the debtor. At best, of course, the corporation will be successfully rehabilitated, and, between these two extremes, many other parties will likely benefit from delayed liquidation.

But, as noted, the best interests of creditors will no longer be the test, and it is here that most vestiges of Chapter XI plans may disappear. For in applying a variation of current Chapter X standards—“fair and equitable” and “feasible”—to virtually all corporate rehabilitation efforts, the draftsmen seem to have made a policy decision that the potential abuses of Chapter XI in its current form outweigh its potential utility. To be sure, certain very limited possibilities for composition specifically remain. When a plan does not materially and adversely affect the claims or interests of holders of publicly held securities (defined as “securities of a class the ownership of which is held of record by three hundred or more persons”¹⁸²), the “fair and equitable” finding need not be made if the court finds that the plan has “been knowingly and voluntarily accepted by all creditors and equity security holders materially and adversely affected by it after full disclosure.”¹⁸³ One prominent commentator has argued that the unanimity in question is a majority acceptance by each class of accepted claims, rather than by every member of every class.¹⁸⁴ While the Commission Report itself is ambiguous as to what was intended,¹⁸⁵ the language and context

182. Proposed Act § 1-102(36).

183. *Id.* § 7-310(d)(2)(B).

184. Coogan, *supra* note 136, at 752.

185. At stake is who gets the difference between the liquidation value and the going concern value of a corporation. Should the statute permit the creditors themselves to decide by a majority vote? There is merit to the proposition that the creditors, if they are small in number and sophisticated, should be permitted to bargain out this issue of allocation of the going concern bonus with the debtor. This once was the law in equity receivership reorganizations, but it was subject to abuse, and judicial control was imposed by the Supreme Court in *Boyd*. Such judicial control is still needed, but the need for flexibility should also be recognized.

1 COMMISSION REPORT, *supra* note 1, at 259. See Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 HARV. L. REV.

seem to require complete unanimity; the draftsmen had no trouble requiring approval by a majority of each class when that is what they intended.¹⁸⁶ The "majority of each class" reading reduces to the proposition that, so long as there is no issue of unsecured debt in the hands of 300 or more members of the public, Chapter XI compositions could continue absolutely unabated, albeit unaided by the "cramdown" provisions of Chapter X which will be continued in Chapter VII.¹⁸⁷ This would follow at least to the extent that a composition plan "does not materially and adversely affect the claims or interests" of public stockholders.¹⁸⁸ Thus, rather than carving out a narrow exception for application of the modified absolute priority rule, the draftsmen, on this view, have forged a narrow exception where the fair and equitable standard must be applied. In other words, Chapter XI-type compositions are the order of the day, except where there is an unsecured debt issue held by more than 300 members of the public. If that is what the draftsmen intended, they certainly obfuscated the issue by treating the exception as the rule. Accordingly, this reading is rejected herein, and it is assumed that only absolute unanimity of all affected creditors, and no public debt issue, meets the specific statutory exemption for confirmation of a composition plan.¹⁸⁹

In all other cases under Chapter VII, the "fair and equitable" standard, as it is redefined in section 310(d)(2)(B), must be met. To be sure, the rule is restated and ostensibly loosened from the currently

1786, 1809 (1974), arguing for the unanimity requirement in order to narrow the instances in which there would be no court review of fairness. Otherwise, the author claims, the determination that acceptances were made in good faith, Proposed Act § 7-310(d)(2)(C), would become all important and would not provide sufficient protection.

186. See Proposed Act § 7-310(d)(1):

(d) *Confirmation.*—The court shall confirm a plan if—(1) it is accepted by a majority in amount of the creditors of each class materially and adversely affected who have accepted or rejected the plan and, if the debtor is not insolvent, by the holders of a majority in number of the equity securities of each class materially and adversely affected who have accepted or rejected the plan

187. See text accompanying note 235 *infra*.

188. Proposed Act § 7-310(d)(2)(B). When this is the case, the court "need not make the findings required" by the modified absolute priority rule.

189. Ironically, the proposal as interpreted here represents a return to the pre-1952 state of affairs. Prior to that time, a Chapter XI composition plan had to be "fair and equitable," unless it was unanimously accepted by all affected creditors, in which case no such finding had to be made. There was serious question as to how the insolvent corporation could comply with the absolute priority rule if at the same time equity interests could not be affected by the plan. Accordingly, in 1952, the "fair and equitable" requirement for Chapter XI plans was eliminated and the "best interests of creditors" test was retained. See *General Stores Corp. v. Shlensky*, 350 U.S. 462, 471 (1956) (Frankfurter, J., dissenting).

definitive pronouncements of the Supreme Court on the subject.¹⁹⁰ The valuation of the enterprise upon which the distribution of securities is based need only have a "reasonable basis," presumably a lessening of the burden of proof on the proponents of the plan on that issue.¹⁹¹ Secondly, the securities issued and other consideration distributed under the plan must be shown only to have a "reasonable probability" of fully compensating the respective recipients in exchange for their claims—presumably a softening of the burden of proof on this issue. Aside from these provisions directed to burden of proof, the other seemingly startling change from present case law comes in the provision ostensibly altering the cast of characters who may participate in the reorganized corporation. First, section 7-303(3) provides that a plan may include provisions for delayed participation rights for classes of creditors or individuals who would otherwise have been eliminated through strict application of the absolute priority rule, conditioned on the court's determination within a period specified in the plan (but not later than five years from the date of confirmation) that the reorganized debtor or its successor has attained a "financial status that warrants such participation."¹⁹² Secondly, the draftsmen would specifically overrule the Supreme Court's holding in *Case v. Los Angeles Lum-*

190. The changes proposed in the absolute priority rule are exhaustively examined in Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974); Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305 (1974); and Note, 87 HARV. L. REV. *supra* note 185.

191. Coogan argues that this phrase has additional significance in that valuation may be based on something other than capitalization of earnings, thus overruling *sub silentio* the entire line of post-*Boyd* Supreme Court cases, cited *supra* note 161. Coogan, *supra* note 136, at 752. There is nothing in the Commission Report or draftsman's notes to the statute to support his view, and some evidence to the contrary exists, e.g.:

The Commission recommends that:

1. The fairness test be modified (a) by substituting for the unqualified "fair and equitable" criterion, i.e., "absolute or strict priority," a test that precludes participation by junior interests where the *going concern value* does not cover senior interests, but easing the evidentiary basis for the valuation of the business

1 COMMISSION REPORT, *supra* note 1, at 258 (emphasis added).

192. The basic unfairness of contingent participation in Chapter X plans has been judicially recognized. See *Spitzer v. Stichman*, 278 F.2d 402 (2d Cir. 1960). Senior creditors, denied the right to exercise bargained-for contractual protective remedies against the debtor, must bear the full risk that the securities received in reorganization are overvalued, and thus full compensation will not have been received, but are denied the benefits of sharing in the residual value of the enterprise if it becomes profitable—a "heads I win, tails you lose" situation. The Commission makes no attempt to justify its approval of contingent participation in light of this criticism, and may, as subsequently suggested, simply be acknowledging reality and concluding that delayed participation is better than the alternative subterfuge for reaching the same result, through intentional overvaluation of the enterprise and the concomitant issuance of presently worthless securities.

ber Products Co.¹⁹³ that, to participate in the new capitalization of an insolvent corporation, equity security holders must make a contribution equal to the intrinsic value of the securities received "in money or money's worth." In *Case* Mr. Justice Douglas held that the promise of future services did not constitute "money or money's worth."¹⁹⁴ The draftsmen could not make their contempt for this holding more plain; under proposed section 7-303(4) a plan may provide for participation by such equity security holders if the court finds that they "will make a contribution which is important to the operation of the reorganized debtor or the successor under the plan," so long as such participation "reasonably approximates the value, if any, of their interests and the additional estimated value of such contribution."

The conclusion which this author reaches from examining these provisions that purport to modify the absolute priority principle is that the Commission has simply called a spade a spade and redefined the standard to accord with the practice. With respect to the current application of absolute priority in Chapter X, the Supreme Court has made clear that the appropriate valuation technique for determination of rights of participation in the reorganized corporation is capitalization of earnings.¹⁹⁵ In the uncomplicated situation, in which substantial portions of the assets are not being depleted, nor is a limited life predicted for a portion of the business, valuation pursuant to this formulation may be stated algebraically as $V=I/i$, where I equals the "typical annual earnings figure that the reorganized corporation can be expected to attain in the future, and i equals the appropriate capitalization rate for determining the present value of that stream of earnings in perpetuity. There is much learning as to generally acceptable practice for determining both I and i , but the inescapable fact remains that the process involves solving an algebraic formula in which all of the elements are unknowns. It is hardly surprising, then, that the valuation process, despite the rubric of accepted practice and requirement of proof by a preponderance of the evidence, is at best a ballpark guess and at worst a wild figment of some "expert's" imagination.¹⁹⁶ Predictably, suspicions arise

193. 308 U.S. 106 (1939).

194. *Id.* at 122.

195. Protective Comm. for Independent Stockholders v. Anderson, 390 U.S. 414 (1968); Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510 (1941); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939).

196. Even Mr. Justice Douglas had to admit that "an estimate, as distinguished from mathematical certitude, is all that can be made." Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941).

that the actual process in many cases is the determination of the desired V , and that I and i are filled in accordingly. And, of course, the primary consequence of a bigger or smaller V is the degree of participation of junior interests in the reorganized enterprise. If the Supreme Court is going to be so ornery as to suggest that contributions as a basis of participation must be in money or money's worth, and that does not include future services to be provided by the manager-equity holders, simply make the insolvent corporation solvent on a capitalized earnings basis, which is most easily and least noticeably accomplished by a relatively small decrease in i .¹⁹⁷ The same process can be used to give an interest to non-manager equity holders in an insolvent corporation. To be sure, the securities issued to such equity holders most likely will turn out to be worthless, but that is not the relevant consideration. For the manager-equity holders, the prime concern is retention of control over the corporation through equity ownership, and, therefore, retention of their management positions. For the non-manager equity owners, their claims were worthless anyway, so at worst they remain worthless. At best, if the corporation has reorganized and ends up successful, they will have received a substantial windfall at the expense of the creditors, who would, without the benign manipulation of the valuation figures, have ended up as the equity holders, and, therefore, as the beneficiaries of the reorganized corporation's success. Thus, despite the wide attention given to these alterations in current Chapter X standards, it may be cogently argued that all the Commission has done is to apply the bitter lesson of Prohibition: it is pointless to legislate when the protected class does not want to be protected.

It follows that, despite all the sound and fury, there may be no particular barrier to the continuation of Chapter XI-type compositions in a vast number of cases.¹⁹⁸ When management owns a large chunk of the equity, and there is not unanimous acceptance of the plan so that the explicit statutory exception will not apply, all that stands between a composition plan and confirmation is a finding by a cooperative judge that the managers will contribute services equal to the value of these equity interests.¹⁹⁹ When there are a substantial number of non-

197. For example, a predicted annual earnings stream of \$100,000 capitalized at ten percent results in a valuation of \$1,000,000, whereas the same earnings stream capitalized at twelve percent results in a valuation of only \$833,333.

198. Of course, if Coogan is correct, there will be very few cases where compositions are not permitted. See text accompanying notes 184-89 *supra*. The truth, it is submitted, lies in between Coogan's reading and a literal reading.

199. It is unrealistic to the point of absurdity to accept the proposed standard for participation based on future services in any literal sense. It is nothing more than a

managing stockholders, the lesser standard of proof both as to valuation of the enterprise and full compensation to senior interests should permit a finding of at least some residue of value available to them. If not, there is at least the possibility of delayed participation rights. Whether or not such a plan is a "composition" as that term is understood in Chapter XI usage is a question of platonic philosophy rather than law. Such a plan changes the form and schedule of payment of unsecured debt, and leaves management and its equity interests virtually intact.²⁰⁰ It does not, however, leave all equity interests intact, although they clearly may be affected less than is required under Chapter X. The irony here is that for all of the softening of the harsh effects of the absolute priority rule as presently applied, the fundamental defect of the rule is uncorrected: the only group whose interests *must* be adversely affected by the new, more benign version of the rule is public equity investors—the very group most in need of protection. On this reading, then, application of the modified absolute priority standard for virtually all cases will not, if a reasonably pragmatic approach is taken, eliminate composition settlements, but will merely place outside limits on the bargain that may be struck as to going-concern value. It may be questioned whether the Coogan approach²⁰¹ would not have been better, inasmuch as it would permit public equity holders to escape the effects of even the modified absolute priority rule so long as there are no outstanding public unsecured creditors who need the protection of the rule.

Even on a narrow reading, however, the standards leave room for considerable bargaining over going-concern value, albeit with very definite outside limits. When sophisticated trade creditors and lending

rubric to permit present management to remain at the helm with its interests intact, where that is appropriate. Were the standard to be taken seriously, it would necessarily follow that management has been compensated for future services in the form of common stock and is entitled to no additional compensation, monetary or otherwise, when the services are actually performed. Nobody, however, has suggested that this clearly unacceptable result would follow. Therefore, either management is being paid for its services twice under this standard, or the standard is more metaphorical than real. Furthermore, many state corporation statutes specifically or indirectly prohibit the issuance of stock in exchange for future services. *E.g.*, ABA-ALI MODEL BUS. CORP. ACT § 18 (1974); DEL. CODE ANN. tit. 8, § 152 (1974). Finally, if the stock were literally being issued for future services, its value would constitute taxable ordinary income to the recipient. Treas. Reg. § 1.61-2(d)(4) (1975).

200. It may be seriously questioned whether the policy behind this "hands off" approach is consistent with the policy behind Proposed Act § 4-406, which automatically and indiscriminately subordinates all insiders' creditor claims to all other unsubordinated but allowable claims.

201. See note 136 and accompanying text *supra*.

institutions bargain away part of the going-concern value that would be theirs if liquidation rights were the sole measure of participation, they do so out of knowledgeable self-interest, based on the expected generation of future business, development of their own good will, protection against loss from personal guarantees or other sources, etc. When, on the other hand, the going-concern value is allocated to junior interests at the expense of public investor creditors, no such pragmatic determination has been made, or indeed could be made, given the vast differences of position of members of that group. Thus, negotiated composition settlements should not be discouraged in the former case, but treated very warily in the latter. The ostensible application of the modified absolute priority standard in all cases will protect public creditors from having a composition settlement foisted upon them that would allocate "too much" of the going-concern value to the equity holders if it would be unfair to do so. Such an application should, however, permit almost any other agreed-upon bargain, limited in the final analysis only by a loose standard of rationality as to values assigned to the enterprise and to the future services to be provided. The higher standard of "feasibility" required in Chapter VII will help to assure that the sacrificing creditor will ultimately get at least as much as he is supposed to get, and, if he receives equity and the corporation is successful, possibly more—an exchange of some compensation for greater certainty of receiving that which he is promised. On this reading, the term "fair and equitable" would come to mean "fair" in a pragmatic and nontechnical sense. In the hands of fairminded and intelligent administrators and bankruptcy judges, the flexible standard suggested here will result in maximum justice in a maximum number of cases. The quality of the personnel is crucially important, since the statutory standards, coupled with the gloss provided on them, would make judicial review inordinately difficult.

If this reading of the confirmation standards turns out to be at all accurate, the other criticisms of the proposals made herein become ultimately less important. For, at the price of some greater expense and delay, composition settlements more closely supervised for fairness will be the order of the day—a not undesirable result. In that case, not only will the baby be saved from disposal, but the bath water itself will have been significantly sweetened. To the extent that composition-type arrangements will still be achievable, although within a somewhat narrower range of cases, the result will be to increase the flexibility in attaining that goal in several important respects.

First, there is annoyingly persistent case law under Chapter XI to the effect that a plan cannot "merely" provide for the liquidation of the debtor and distribution of the proceeds to creditors. In *In re Pure Penn Petroleum Co.*²⁰² the court refused to read into Chapter XI the authorization, explicit in Chapter X,²⁰³ for a plan providing for the sale of all assets. It recognized only two situations, neither of which were applicable on the facts, in which a Chapter XI debtor could sell all its assets: (1) an emergency in which immediate sale is required to prevent loss of value, and (2) a variant of the emergency context, in which the assets are perishable.

While the *Pure Penn* rationale can occasionally be circumvented,²⁰⁴ the principle remains a formidable barrier to plans of liquidation, even though the "best interests of creditors" test would be satisfied.²⁰⁵ In *Pure Penn*, the court evidenced concern for the stockholders, who would have no standing to participate in the Chapter XI proceeding, inasmuch as they cannot be "affected" thereby, but who, the court apparently felt, were entitled to the protections surrounding a bankruptcy liquidation²⁰⁶ even though the debtor was grossly insolvent and the stockholders would receive nothing in any kind of liquidation. It is difficult to reconcile the *Pure Penn* rationale with the many situations in Chapter XI in which plans that have had substantial indirect effect upon equity security holders have been readily approved.²⁰⁷

202. 188 F.2d 851 (2d Cir. 1951).

203. Bankruptcy Act § 216, 11 U.S.C. § 616 (1970) (Chapter X), provides in part: A plan of reorganization under this chapter—

...
(10) shall provide adequate means for the execution of the plan, which may include . . . the sale of all or any part of its property either subject to or free from any lien, at not less than a fair upset price and the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest

For application of that provision, see *Bankers Life & Cas. Co. v. Kirtley*, 338 F.2d 1006 (8th Cir. 1964). No comparable provision is contained in Chapter XI.

204. See *In re Blair & Co.*, 471 F.2d 178 (2d Cir. 1972), *vacated*, 414 U.S. 212 (1973); *In re Northern Ill. Dev. Corp.*, 324 F.2d 104 (7th Cir. 1963), *cert. denied*, 376 U.S. 938 (1964). There is, however, some danger in making the attempt, as the Second Circuit recently suggested in dictum that if the Chapter XI petition is merely an attempt to avoid inevitable liquidation, legal fees of the attorney for the debtor in possession may be denied. *In re Casco Fashions, Inc.*, 490 F.2d 1197, 1204 (2d Cir. 1973).

205. See *In re Ira Haupt & Co.*, 234 F. Supp. 167 (S.D.N.Y. 1964), *aff'd sub nom. Ira Haupt & Co. v. Klebanow*, 348 F.2d 907 (2d Cir. 1965).

206. "This would mean that a Chapter XI plan could bring about the same result as ordinary bankruptcy proceedings but minus the protective provisions which are part of the latter, especially as to a sale of all the assets." 188 F.2d at 855.

207. Any time common stock of the debtor is issued in exchange for unsecured claims, equity security holders are obviously adversely affected by the plan through the dilution of their interests. See *Posi-Seal Int'l, Inc. v. Chipperfield*, 457 F.2d 237 (2d Cir. 1972), in which the confirmation of a plan conditioned on a consummated recap-

Proposed Chapter VII adopts the Chapter X scheme on liquidating plans. Section 7-205 authorizes the sale of "all or substantially all of the property of the estate." However, it provides protection by requiring court authorization after notice and hearing, to be granted only "if in the best interests of the estate." The Official Note to this section states that no emergency need be found for such a sale to be allowed. In addition, liquidation plans are permitted under Chapter VII. Section 7-303(9) expressly provides that a Chapter VII plan may contain provisions for the sale of all assets of the debtor.

Another area where proposed Chapter VII will actually aid in the consummation of composition plans is with respect to the staying of the rights of secured creditors. Under the Bankruptcy Rules for Chapter XI, the filing of a petition operates as a stay of "any act or the commencement or continuation of any court proceeding to enforce any lien against [the debtor's] property."²⁰⁸ Unless the secured party seeks relief from the stay, the stay "shall continue until the case is closed, dismissed, or converted to bankruptcy or the property subject to the lien is, with the approval of the court, abandoned or transferred."²⁰⁹ While this rule represents a substantial departure from earlier practice, under which the stay of secured creditors had to be sought by the debtor,²¹⁰ the procedural change does not alter the substantive criteria for ending the stay vis a vis a specific secured creditor.²¹¹ There are substantial jurisdictional and judicially developed limitations on the bankruptcy court's power in this regard.

The automatic stay provision is limited by the summary jurisdiction of the bankruptcy court. In a Chapter XI proceeding, that court has "exclusive jurisdiction of the debtor and his property, wherever located."²¹² While this provision is sometimes read to limit the court's jurisdiction to property in the actual or constructive possession of the debtor,²¹³ the broader and better view permits jurisdiction pursuant

italization pursuant to state law was approved. *See also* *Flora Mir Candy Corp.*, No. 69-B-316 (S.D.N.Y., Feb. 2, 1971), *aff'd per curiam*, 454 F.2d 1176 (2d Cir. 1971), in which the court permitted the conversion feature of convertible debentures to be rejected as an executory contract, thus turning contingent equity interests into unsecured debt which was then scaled down in the plan. In this connection *see also In re Sequential Information Systems, Inc.*, BANKR. L. REP. ¶ 64,401 (S.D.N.Y. 1972).

208. R. BANKR. P. 11-44(a).

209. *Id.* 11-44(b).

210. Bankruptcy Act § 311, 11 U.S.C. § 711 (1970).

211. *Cf.* R. BANKR. P. 928: "These rules shall not be construed to extend or limit the jurisdiction of courts of bankruptcy over subject matter."

212. Bankruptcy Act § 311, 11 U.S.C. § 711 (1970).

213. 9 H. REMINGTON, A TREATISE ON THE BANKRUPTCY LAW OF THE UNITED STATES § 3573, at 214-18 (6th ed. 1955).

thereto to be based upon title in the debtor, even though possession is in a third party.²¹⁴ However, where a third party is in possession of property claimed by the debtor pursuant to a substantial adverse claim of right, the bankruptcy court, even under the broad view of its jurisdiction, loses any right it would have otherwise had to make orders respecting that property.²¹⁵ The other two bases of jurisdiction frequently cited as available to the bankruptcy court in Chapter XI cases, the All Writs Statute²¹⁶ and the inherent equity powers of a bankruptcy court,²¹⁷ will not in this situation aid the court in the exercise of power over that property.

Even if the court has summary jurisdiction to make orders with respect to the property in question, that jurisdiction is not without restrictions. Case law makes clear that the equities, as between the debtor and secured creditor, must be carefully weighed. Accordingly, a stay should be continued where relief is sought by the secured creditor only if it is essential to the Chapter XI proceeding and if the lienor will not suffer substantial injury thereby.²¹⁸ The latter requirement is usually met by a showing that the value of the property exceeds the security interest.²¹⁹ Thus the possibility that economic depreciation will cause a decline in the value of the collateral has been recognized as resulting in injury to creditors, and, unless a plan is imminent, further stay will be denied.²²⁰ If the lien is upon property that is unrelated to the business that is the subject of the Chapter XI proceeding, the secured creditor will ordinarily be allowed to foreclose.²²¹ Also, if there are sufficient other assets in the business to meet creditors' claims, a court will hesitate to restrain secured parties.²²²

The dual findings cited above are often not enough to assure the continued stay. Injunctions granted as essential to the confirmation of a plan have been conditioned upon compensation to the secured creditor. In *In re Atlantic Steel Products Corp.*²²³ foreclosure on a chattel

214. See 8 W. COLLIER, *supra* note 45, ¶ 3.01, at 146-47.

215. *In re Stockman Dev. Co.*, 447 F.2d 387 (9th Cir. 1971), *cert. denied*, 405 U.S. 923 (1972); *In re Barasch*, 439 F.2d 1393 (9th Cir. 1971).

216. 28 U.S.C. 1651 (1970).

217. See Bankruptcy Act § 2a(15), 11 U.S.C. § 11a(15) (1970).

218. *In re Tracy*, 194 F. Supp. 293 (N.D. Cal. 1961).

219. *In re Atlantic Steel Prods. Corp.*, 31 F. Supp. 408 (E.D.N.Y. 1939).

220. *In re Holiday Lodge, Inc.*, 300 F.2d 516 (7th Cir. 1962), *cert. denied*, 371 U.S. 824 (1962); *In re Empire Steel Co.*, 228 F. Supp. 316 (D. Utah 1964).

221. *Mundt v. Southland Sav. & Loan Ass'n*, 354 F.2d 81 (9th Cir. 1965); *In re Tracy*, 194 F. Supp. 293 (N.D. Cal. 1961).

222. *In re Tracy*, 194 F. Supp. 293 (N.D. Cal. 1961).

223. 31 F. Supp. 408 (E.D.N.Y. 1939).

mortgage on the debtor's plant and equipment was stayed so long as the debtor paid the accrued and monthly interest and so much of the principal as possible from its income remaining after payment of current operating expenses. A debtor-lessee in *In re Lane Foods, Inc.*²²⁴ obtained a stay of execution of an eviction warrant conditioned upon weekly rental payments to the lessor in advance.

Furthermore, a secured creditor will not be stayed beyond confirmation of the plan.²²⁵ Inasmuch as the plan cannot affect the secured creditor, to the extent that he is not satisfied with the result he still may be able to foreclose upon his security interest and effectively terminate the business as soon as the plan has been confirmed. Because of this inability to affect secured creditors' rights beyond a stay of foreclosure for the minimum necessary period, it is doubtful whether Chapter XI courts can force surrender of the debtor's property by a secured creditor who is in possession before the filing of the Chapter XI petition.²²⁶ Indeed, one commentator has even questioned whether rule 11-44, the automatic stay provision, applies in the case of a secured creditor in possession prior to filing.²²⁷ Whatever the ultimate outcome of these issues when they are litigated, it is clear that a Chapter XI court cannot authorize the sale of property on which there is a lien and allow the proceeds to be used for any purpose other than payment of the secured debt.²²⁸

All of the above is consistent with the first principle that, while a debtor should have reasonable opportunity to pull itself together without interference in order to propose a plan, the plan cannot affect secured creditors, and, therefore, these creditors cannot be economically injured by the attempt to reach a composition settlement. Given the different scope of a Chapter X plan, far more extensive powers to affect the rights of secured creditors during the course of the proceeding exist. First, it is quite clear that a Chapter X stay will reach property in the possession of secured creditors, and that secured creditors can be ordered to return pledged property for use in the continuing business.²²⁹ In addition, pursuant to certain judicially adopted safeguards,

224. 213 F. Supp. 133 (S.D.N.Y. 1963).

225. R. BANKR. P. 11-44(b) provides in part: "the stay shall continue until the case is closed, dismissed, or converted to bankruptcy"

226. See Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW. 15, 41 (1974).

227. *Id.* at 42.

228. *In re Camp Packing Co.*, 146 F. Supp. 935 (N.D.N.Y. 1956).

229. Bankruptcy Act §§ 111, 257, 11 U.S.C. §§ 511, 657 (1970). For an extreme application of this principle, see *R.F.C. v. Kaplan*, 185 F.2d 791 (1st Cir. 1950).

property collateralizing a debt can be sold by the debtor, and the proceeds used for purposes other than payment of the secured creditor's claim.²³⁰ Finally, and most far reaching, important Second Circuit opinions stand for the proposition that even creditors secured by depreciating collateral can be denied both reclamation and interim compensation during the court-supervised operation of the debtor's business.²³¹ The theory is that a plan, consistent with the absolute priority principle, will necessarily fully compensate the secured creditor for his claim to the extent that it was secured on the date of the filing of the petition. Obviously, if no plan is ultimately confirmed, the secured creditor will have been damaged by the stay. Accordingly, the standard for denial of all compensation in this situation is that the plan be more than "a mere will-of-the-wisp."²³²

Whatever the merits of the application of this standard in Chapter X, it is clear that its application would be entirely inappropriate in Chapter XI, inasmuch as a secured creditor will not be fully compensated by a plan; indeed, he cannot be affected against his will. However, the intention of proposed Chapter VII is to permit the debtor to tamper with the secured creditor's rights to the same extent as currently allowed under the most far-reaching case law.²³³ This means that a composition-type plan with unsecured creditors, to the extent that they are still permitted in Chapter VII, will not be aborted because of the intervening rights of a secured creditor. Thus, for example, in refusing to lift the stay of the secured creditor's rights to foreclose or repossess, the court may impose conditions that may include:

1. requiring other security of an equivalent value; 2. if there is no equity or the equity is marginal, requiring additional security to the extent of the anticipated decrease in the value of collateral as a result of use; and 3. giving a priority if it is clear that the proceeds of the liquidation of the property of the estate available to pay the claim will be sufficient.²³⁴

230. Compare *In re Third Ave. Transit Corp.*, 198 F.2d 703 (2d Cir. 1952) with *Central R.R. v. Manufacturers Hanover Trust Co.*, 421 F.2d 604 (3d Cir.), cert. denied, 398 U.S. 949 (1970). See also *In re Penn Cent. Transp. Co.*, 494 F.2d 270 (3d Cir. 1974), which elevates the standards to constitutional requirements.

231. *In re Yale Express System, Inc.*, 384 F.2d 990 (2d Cir. 1967); *In re Yale Express System, Inc.*, 370 F.2d 433 (2d Cir. 1966). For a complete examination of the *Yale Express* holding and the problem it relates to, see Rosenberg, *Beyond Yale Express: Corporate Reorganization and the Secured Creditor's Rights of Reclamation*, 123 U. PA. L. REV. 509 (1975).

232. See *In re Yale Express System, Inc.*, 384 F.2d 990, 991 (2d Cir. 1967).

233. See Proposed Act § 7-203, Advisory Comm. Note 1.

234. *Id.* § 7-203, Advisory Comm. Note 3.

This catalogue does not include the most far-reaching aspect of the case law that the section purports to codify—no immediate consideration at all to the secured creditor, and full compensation in the plan to be consummated at a later time. Thus, in the plan as finally confirmed—a plan that is otherwise a composition plan—the secured creditor whose rights were affected by the stay pending confirmation simply need be given consideration equal to the value of his security on the date of the petition. That consideration can take the form of any of the above-quoted provisions, or any other form deemed equitable. If the secured creditor in question refuses to accept the consideration provided in the plan, the “cramdown” provisions (another carryover from present Chapter X) provide that the plan can be confirmed over his objection as long as the judge finds the alternative consideration “equitable.”²³⁵ Clearly, a major obstacle to the confirmation of composition plans will have been removed in proposed Chapter VII in this way.

IV. CONCLUSION

It must be emphasized that the above discussion does not cover all of the changes in the current law of corporate rehabilitation proposed in the Bankruptcy Act of 1973. The virtually all-inclusive jurisdiction of the bankruptcy courts,²³⁶ the initial injunction against the exercise of the right of setoff,²³⁷ the injunction against termination of public utility service,²³⁸ and the nonenforcement of *ipso facto* termination clauses in leases²³⁹ will all aid the rehabilitation process. Furthermore, the stylistic as well as substantive alterations of current practice which the conversion to administrative bankruptcy will bring should not be underestimated, although a detailed analysis at this time would require the services of a clairvoyant. What is clear to this author is that the doomsday rhetoric of some Chapter XI advocates is at best premature and at worst irresponsible. A sympathetic reading of the proposed statute leads to the conclusion that Chapter XI-type compositions will remain a viable form of relief, but only where that form of relief is appropriate under the circumstances in light of the nature of the business and the parties interested in it, and with safeguards to minimize the opportunities for insiders to overreach those classes of interested parties that are not capable of fully protecting themselves.

235. *Id.* § 7-303(7).

236. *Id.* § 2-201.

237. *Id.* § 7-204.

238. *Id.* § 7-105.

239. *Id.* § 4-602(b).

It is not difficult to find fault with specific choices made by the Commission in pursuit of that dual goal, as this author has done. Hopefully, during the legislative process, which at this writing is still in the early stages, the criticisms made here and elsewhere will be considered, and in some of its specifics the final legislation will be improved. However, if the analysis of some of the provisions herein is correct, it must be concluded that the draftsmen, far from radically discarding Chapter XI, have conservatively reworked it, preserving that which is good and eliminating that which, in the light of almost forty years' experience, has proved to be unfair.