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EXTRA-JUDICIAL ADMINISTRATION OF INSOL- VENT ESTATES: A STUDY OF RECENT CASES

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One of the most interesting legal developments of the last year has been the scientific study of insolvency instigated by the New York bankruptcy investigation.¹ This investigation began last January as a federal grand jury probe, ordered by the six federal judges sitting in the Southern District of New York, and, because of many sensational developments, it soon grew into a general public inquiry. For many weeks the hearings were conducted before Federal Judge Thomas D. Thacher by United States Attorney Charles H. Tuttle, and a great deal of information was uncovered concerning all sorts of fraudulent practices in the liquidation of bankrupt estates.² As their work advanced, however,

¹This article was prepared as a result of an investigation made by the author during August and September, 1929, while he was a member of Colonel William J. Donovan's Bankruptcy Investigation Staff. Mr. Billig was in charge of the "friendly adjustment" phase of the investigation, as a result of his work in that field during the previous two years.

²The early developments in the investigation are described in Billig, *What Price Bankruptcy: A Plea for "Friendly Adjustment"* (1929) 14 CORN. L. Q. 413.

the investigators were impressed with the necessity for a more general analysis of our bankruptcy system, looking toward a cure for existing evils.

It was at this stage of the proceedings that the three bar associations in the Southern District of New York³ took active steps to carry forward, on a more extensive scale, the excellent work begun by Mr. Tuttle. A substantial fund was raised and Colonel William J. Donovan—recently of the Department of Justice—was employed as special counsel. The National Association of Credit Men and the New York Credit Men's Association joined forces with the lawyers, and thereupon the investigation passed into the second, and what may be termed the legal-economic, phase.

This latter stage of the investigation has proved to be a fine example of what may be accomplished through a scientific approach to the study of legal problems. For Colonel Donovan, equipped with a long experience in the practice of law, was not content merely with investigating bankruptcy administration as an isolated system. He sought information, not only on the functioning of the United States Bankruptcy Act⁴ in the business community, but also on the operation of other systems which prevail in English-speaking commercial communities,⁵ for the liquidation of insolvent estates.

The outstanding extra-judicial system investigated under the Donovan plan was the so-called "friendly adjustment" method of winding up the affairs of insolvent debtors without recourse to a court of bankruptcy.⁶ This scheme—which was first used on an extensive scale by the San Francisco Board of Trade,⁷ and later fostered by the National Association of Credit Men—rests on the

³ The Association of the Bar of the City of New York, the New York County Lawyers Association, and the Bronx County Bar Association.

⁴ 30 STAT. 544 (1898), 11 U. S. C. (1928).

⁵ One of those investigated was the Canadian bankruptcy system, which has incorporated into statutory form many of the features of the friendly adjustment plan.

⁶ For a full discussion of the friendly adjustment plan, see Billig, *op. cit. supra* note 2.

⁷ (1927) FIFTIETH ANNUAL REPORT, BOARD OF TRADE OF SAN FRANCISCO.

fundamental assumption that insolvency is primarily an economic rather than a legal problem, and that only very simple machinery is necessary for reducing the debtor's assets to cash and disbursing the proceeds among his creditors.

In order to test this hypothesis, the National Association of Credit Men, during the last twenty-five years, has organized and operated a chain of "approved" adjustment bureaus in some sixty-eight commercial centers of the United States, for the primary purpose of liquidating the estates of insolvent debtors outside of court whenever possible.⁸ With the passage of time, these bureaus have increased their efficiency to such a point that they succeed in saving a higher percentage of the debtor's assets for the creditors than is obtained in bankruptcy, and at a considerable saving of both time and money. It is because of these exceptional results that it was decided the Donovan Investigation should include a thorough study of the friendly adjustment system.

Before attempting a discussion of the methods used and the information obtained in the subsequent survey of adjustment bureaus, a word must be said concerning certain limitations which attach to this extra-judicial type of settlement. The phrase "friendly adjustment" is of fairly recent origin in the business community, and means that type of settlement or liquidation effected through the coöperation of the insolvent debtor with his creditors. As has already been pointed out, the plan theoretically assumes the primarily economic nature of the liquidating process and the use of relatively simple machinery. This, of course, car-

⁸ At present there are approved adjustment bureaus located in the following cities: Los Angeles, Oakland (Cal.), San Diego (Cal.), San Francisco, Denver, Washington, Tampa, Jacksonville, Miami, Atlanta, Augusta, Boise (Idaho), Chicago, Evansville (Ind.), Indianapolis, South Bend (Ind.), Davenport (Iowa), Des Moines, Sioux City (Iowa), Wichita (Kan.), Lexington (Ky.), Louisville, New Orleans, Baltimore, Boston, Springfield (Mass.), Detroit, Grand Rapids (Mich.), Duluth, St. Paul, Kansas City, Billings (Mont.), Great Falls (Mont.), Omaha, Newark (N. J.), Buffalo, New York City, Charlotte (N. C.), Cincinnati, Cleveland, Columbus, Toledo, Youngstown (Ohio), Oklahoma City, Portland (Ore.), Allentown (Pa.), Philadelphia, Pittsburgh, Providence, Chattanooga, Knoxville, Memphis, Dallas, El Paso (Tex.), Houston (Tex.), San Antonio (Tex.), Salt Lake City, Lynchburg (Va.), Norfolk, Richmond, Seattle, Spokane, Tacoma (Wash.), Clarksburg (W. Va.), Huntington (W. Va.), Milwaukee, Green Bay (Wis.), Oshkosh (Wis.).

ries with it certain inevitable concomitants, which may be listed as follows :

1. The friendly adjustment plan can operate successfully only where the debtor is honest and willing to work with his creditors. In cases where he has concealed assets, recourse must be had to legal means, in order that he may be compelled to perform as a legal duty what he refuses to recognize as a moral obligation.

2. The friendly adjustment plan presupposes the coöperation of the creditors (general, secured, and preferred) in a common cause. If the creditors refuse to unite in a contract with the debtor and the liquidating agent, with regard to their respective shares in the assets of the estate, then it becomes necessary to have the extent of their respective participation fixed by a court of bankruptcy.

3. The friendly adjustment plan, if it is to function efficiently, requires the existence of a permanent liquidating agent equipped with a staff skilled in the administration of insolvent estates.

4. The friendly adjustment plan also requires that the liquidating agent be under the supervision of some central authority which keeps a constant check on the liquidator's activities. Otherwise, the way lies open for the perpetration of fraud upon debtor and creditors alike.

Limitations 1 and 2 are self-explanatory. The managers of the adjustment bureaus operated by the National Association of Credit Men are unanimous in their belief that it is unwise to attempt a friendly settlement of the estate of a dishonest debtor.⁹ Merchants and other business men who conceal assets or indulge

⁹ The universality of this attitude has been voiced by such veteran adjustment bureau managers as Thomas O. Sheckell, of the New York Credit Men's Adjustment Bureau; H. M. Oliver, of the Credit Association of Western Pennsylvania; Hugh Wells, of the Cleveland Association of Credit Men; L. E. Deeley, of the Detroit Association of Credit Men; and W. C. Rodgers, of the Northwestern Jobbers' Credit Bureau.

in other fraudulent practices can only be dealt with through a court of law which has the power to subpoena the dishonest bankrupt and his confederates and to order the production of necessary records. However, despite this limitation, it is the contention of credit men everywhere that the vast majority of debtors are much more deficient in the management of their affairs than in their morals, and that inefficiency (plus a certain amount of ill fortune) is the real cause of the bulk of business failures.¹⁰ Therefore, even eliminating the dishonest debtor, a large number of inefficient but honest insolvents remain, to whose estates the friendly adjustment plan is applicable.

In contrast to the general experience in bankruptcy, the necessary coöperation of creditors (limitation 2) is obtained to a marked degree by the adjustment bureaus. The reason for this difference is not difficult to find. The average business man considers bankruptcy administration a strangely unfamiliar legal proceeding, which advances at a pace entirely too slow to satisfy his ideas of commercial efficiency. Furthermore, the Bankruptcy Act at no point provides for the recognition by the court of recommendations made by the creditors as to the person who shall serve as receiver. Accordingly, the creditor is all too willing to turn over his claim to a lawyer or collection agency, and thereafter trouble himself no more concerning it. On the other hand, the principal creditors in the more important commercial centers have been educated by the bureaus to an entirely different viewpoint concerning the friendly adjustment plan of settlement. The secret of this lies in the fact that the adjustment bureau is itself an organization maintained by and for the creditors. As an integral part of the local credit association which keeps these same creditors supplied with credit information, they are familiar with

¹⁰ The Bradstreet report on causes of business failures in the United States during 1928 states that, out of 20,373 such failures, 6,396 were caused by the incompetence of the insolvent; 7,290 resulted from his lack of capital; and such "specific conditions" as disaster, war and floods were responsible for 3,613 others. Only 544 of the failures reported were caused by fraudulent conduct on the part of the insolvent. The remainder were brought about by inexperience, unwise credits, neglect of business affairs, and competition.

its workings and its personnel, and the natural result is confidence and coöperation. The creditors know that the liquidation will be conducted by a bureau with which they are familiar, working through a creditors' committee, and that no major move in the settling of the estate will be made without their approval.

The third limitation stipulates the necessity for a permanent liquidating organization. It is at this point that something should be said concerning the present lack of such an organization as a factor in the high cost of bankruptcy administration; for even the most staunch opponent of any change in the present bankruptcy system will admit that one of the factors responsible for the enormous expense is the high overhead cost of setting up a brand new liquidating organization for virtually every case settled in bankruptcy.¹¹ The individual receiver or trustee may be a thoroughly conscientious and highly efficient person, but it is natural that, unless he makes a business of settling insolvent estates, he will not possess the organization necessary for marketing the assets, collecting the accounts receivable, and distributing the proceeds. The special creation of this necessary organization loads the estate with excessive administration costs which are highly burdensome, especially in cases involving assets of \$10,000 or less.¹²

The adjustment plan of the National Association of Credit Men shows a marked contrast to bankruptcy, in providing for a permanently organized liquidating unit which is not re-created for each case settled. To this organization structure are attributable many of the "economies of large scale production", so familiar to students of economics, which are reflected in lower administration costs and higher returns to creditors. As has been already mentioned,¹³ there are sixty-eight of these bureaus in important trade centers. They are all operated under the auspices

¹¹ See Tuttle, *Bankruptcy Act Criticized* (1929) 31 CREDIT MONTHLY 18.

¹² The statements in this paragraph are, of course, not applicable to the present bankruptcy machinery in the Southern District of New York; for, since Jan. 6, 1929, the Irving Trust Company, specially equipped to handle bankruptcies, has been appointed receiver in all cases.

¹³ *Supra* note 8.

of the National Association of Credit Men, an organization which binds together credit department representatives of business houses in all parts of the country. The bureaus are incorporated, non-profit-making units, in charge of a manager and staffed with heavily bonded, full-time employees, who are skilled in the settling of insolvent estates. Bureaus such as the New York Credit Men's Adjustment Bureau, in New York City, or the Northwestern Jobbers' Credit Bureau, in St. Paul, which sell most insolvent stock privately, maintain long lists of buyers with whom close touch is kept. Others, such as the Adjustment Bureau of the Cleveland Association of Credit Men, or that of the Detroit Association of Credit Men, which sell the assets publicly, employ their own auctioneers and have worked out elaborate plans for assuring honest public sales. Scientific study also has been applied with great success, especially in New York City,¹⁴ to the difficult problem of collecting the accounts receivable of the insolvent estate.

This, then, is the type of permanent liquidating organization which functions in winding up the estates of insolvent debtors outside of court. Passing from the structure of the liquidating unit, something may be said concerning the mechanics of liquidation that it employs.¹⁵

A typical bureau case is opened by advice to the bureau from one of its creditor members that retailer *X* is not meeting his accounts. A few telephone calls by the bureau manager to other wholesalers in the same or kindred lines of business as that of the complaining creditors will satisfy him that the delinquency of *X* is general, and *X* will then be invited by the manager to call at the bureau and "talk things over". And it should be pointed out here

¹⁴ The following cases, from the files of the New York Credit Men's Adjustment Bureau, show the results obtained by that organization in collecting accounts receivable: (1) of \$16,432.18 in accounts receivable, standing on the books of an insolvent New York City cloak manufacturer, \$15,902.48 was collected; (2) of \$22,842.85 in such accounts, on the books of an insolvent cotton goods concern in the same city, \$16,661.44 was collected. (3) of \$36,041.02 in book accounts owned by an insolvent woolen jobber, \$26,298.06 was collected.

¹⁵ The liquidating process is described in great detail in Billig, *op. cit. supra* note 2, at 428 *et seq.*

that bureau managers in many cities are performing an excellent service by aiding the creditors to *save* failing debtors rather than to *liquidate* them. For this first meeting between the debtor and the manager often brings out facts which otherwise would not appear until after the involuntary petition had been filed and the stigma of being a bankrupt already had attached to the debtor. Bureau technique varies from city to city, but invariably the debtor has the opportunity of talking over his affairs, usually first with the manager and later with his creditors at their initial meeting. A thorough investigation of the debtor's financial affairs is made, and the creditors then are in a position to determine whether they will (1) operate the business temporarily, through the bureau, under an operating assignment, or (2) close it out under a liquidating assignment. If the latter plan is chosen, the bureau manager takes a deed of trust for the benefit of creditors and the bureau staff sets to work to liquidate the estate in a speedy, economical, and efficient manner.

The fourth limitation states that the friendly adjustment plan requires the permanent liquidating agent to be under some sort of supervision. The reason for this is obvious, for otherwise the abuses of dishonesty, self-interest, and inefficiency which are charged against officials administering an estate in bankruptcy might become even more prevalent in the case of bureau employees operating under the friendly adjustment plan. Therefore, in order to guard against this possibility, the National Association of Credit Men has devised a plan for affiliating only those bureaus which conform to certain high standards. These bureaus are placed on the approved list, which at the present time numbers sixty-eight. The requirements for qualifying are thus described by the national association:

"In order to secure the approval of the National Association of Credit Men, adjustment bureaus are required to comply with strict regulations covering organization, man-

agement, personnel, machinery, policies, protection of clients' interests, care in correspondence, finances, records, and supervision by local boards of directors and by the National Association of Credit Men." ¹⁶

It is therefore only with the activities of bureaus on this approved list that this discussion proposes to deal, for they operate the friendly adjustment plan within the four limitations previously discussed; namely, (1) only the estates of honest, cooperating debtors are settled outside of court; (2) only those estates are settled outside of court which have the unqualified cooperation of the creditors; (3) a permanent liquidating agent equipped with a skilled staff is maintained; (4) the National Association of Credit Men maintains strict supervision over the "approved" adjustment bureaus.

METHOD OF INVESTIGATION

It was with these four limitations of extra-judicial types of settlement in mind, then, that the Donovan investigating committee determined to limit this phase of its study to friendly adjustments supervised by the approved adjustment bureaus of the National Association of Credit Men. The next step was to decide upon the method of approach best suited to arriving at the basis of a fair comparison with bankruptcy. Several possible plans were considered, the committee eventually choosing to use the "comparative case method" in several "key cities". This method required for its basic data statistics taken from two, or possibly more, cases of similar size in the same general line of business, closed in the same community at about the same time by the *same liquidating agent*—on the one side, a case or cases closed in bankruptcy, and, on the other side, a case or cases closed under the friendly adjustment plan.

¹⁶ *In Defense of the Nation's Receivables* (1927) 9, published by the National Association of Credit Men.

The limitation to cases closed by the *same liquidating agent* was made because of a desire to reduce all factors to the lowest possible common denominator. For a comparison of two cases closed out by two *different* liquidating agents might represent a measure of the relative efficiency of the respective liquidators, rather than a fair estimate of the results possible under each system.

Therefore, it was an especially fortuitous circumstance that the approved adjustment bureau uses both the friendly adjustment plan and the bankruptcy court in liquidating insolvencies, and thus furnishes within itself the desirable reduction to a common denominator. As to this double function of the adjustment bureau, let it be repeated that the bureau, wherever possible, uses the friendly adjustment plan. However, it sometimes happens that the debtor's estate is already in bankruptcy when the bureau is called in, or that the debtor will refuse to work with his creditors, or, in some instances, that one or more of the creditors will insist that the estate be liquidated in bankruptcy. In some of these cases the bureau manager may be named receiver and perhaps later elected trustee, and the bureau organization will then effect the liquidation by using the machinery of bankruptcy, rather than the mechanics of adjustment.

Thus it will be seen at once that, if those bureau bankruptcies are eliminated wherein large sums were spent pursuing concealed assets, the other bankruptcy cases (involving the normal liquidating process of selling the assets, paying the expenses of administration, and distributing the dividends to creditors) can be compared fairly with similar cases administered under the friendly adjustment plan, and a scientific conclusion reached as to the relative merits of the two systems in certain types of cases.

Accordingly, the committee chose five key cities—Pittsburgh, Cleveland, Detroit, St. Paul, and New York—and studied comparative cases taken from the files of the approved adjustment bureaus

operating in those cities.¹⁷ As it is impossible to present in detail the statistics from all these cities, the results of the survey in Pittsburgh and Cleveland are herein set forth as indicative of the general nature of this friendly adjustment phase of the bankruptcy investigation.

THE PITTSBURGH CASES

Twenty cases were chosen from the files of the adjustment bureau of the Credit Association of Western Pennsylvania. This bureau handles insolvencies covering a wide territory,¹⁸ in a thickly populated industrial district, its most common type of case being the small retail store with assets of \$10,000 or less. Its work is almost evenly divided between settlements effected under the friendly adjustment plan and those administered in bankruptcy. In the two-year period ending June 30, 1929, the bureau closed 97 friendly adjustments and 103 bankruptcies. Insolvent stocks disposed of under the former plan were sold privately, while those closed out under the latter method were sold at public auction by the receiver. In all the bankruptcies here considered, the bureau manager, Mr. H. M. Oliver, was named receiver by the local court, and in every instance was later elected trustee. For these services he received the usual commissions prescribed by the Bankruptcy Act. In the friendly adjustment cases, the bureau charged a flat fee of ten per cent of all moneys passing through its hands. This figure included practically all the expenses of administration, in seven of the nine friendly adjustments studied. In the remaining two cases, unusual factors raised the administration expenses slightly above twenty-one per cent.

¹⁷ Ninety-one comparative cases taken from the files of these bureaus were studied during August and September, 1929. Mr. Paul O. Ritter, a member of the Pennsylvania bar and a graduate of the Yale University School of Law, assisted the author in the preparation of these cases.

¹⁸ This territory is bounded by Altoona, Pa., on the east, where a branch office is maintained, Wheeling, W. Va., on the southwest, and Erie, Pa., on the north. The principal bureau office is located in the Chamber of Commerce Building in downtown Pittsburgh.

The following seven groups of comparative cases were analyzed:

1. Three hardware and electrical supply stores with liquidated assets ranging from \$1803.00 to \$2186.00, two being administered in bankruptcy and one in friendly adjustment.

2. Two groceries with liquidated assets of \$1530.00 and \$1650.00 respectively, one being administered under each plan.

3. Two groceries with liquidated assets of \$2503.00 and \$2711.00 respectively, one being administered under each plan.

4. Two men's clothing stores with liquidated assets of \$860.41 and \$906.86 respectively, one being administered under each plan.

5. Four confectionery stores and restaurants with liquidated assets ranging from \$1181.00 to \$1900.00, two being administered under each plan.

6. Five drug stores with liquidated assets ranging from \$1296.00 to \$3301.00, three being administered in bankruptcy and two in friendly adjustment.

7. Two notion and variety shops with liquidated assets of \$1137.00 and \$1657.00 respectively, one being administered under each plan.

Since the length of this article will not permit a detailed analysis of each of these groups of cases, the appended statistical chart was prepared for the purpose of bringing out in a concise manner the contrast between bankruptcy liquidation and a friendly adjustment in at least three particulars:

Method of Settlement	Name and Address	Business	Liquidated Assets	Paid General Creditors	Paid Secured and Preferred Creditors	Total Paid Creditors	% of Assets Paid to General Creditors	% of Assets Paid to Creditors	Attorneys' Fees	Other Expenses of Admin.	Total Expenses of Admin.	% of Assets Paid to Attorneys	% of Assets Paid to Other Expenses	% of Assets Paid to Legal Expenses	Time Consumed in Settlement
<i>Hardware Stores</i>															
Bankruptcy	Store No. 1, Finlayville, Pa.	Hardware	\$2186.99	\$ 824.35	\$ 328.01	\$1152.36	37.69	55.00	\$775.00	\$759.65	\$1034.65	12.57	04.74	47.31	12 mo., 7 days
Bankruptcy	Store No. 2, Pittsburgh, Pa.	Hardware and Electrical Supplies	1874.31	—	809.83	809.83	—	43.20	179.00	885.48	1064.48	9.55	47.55	56.80	7 mo., 10 days
Friendly Adjustment	Store No. 3, Narrows, Pa.	Hardware and Electrical Supplies	1803.00	1281.72	335.60	1618.32	71.09	18.67	—	184.68	184.68	—	10.24	10.24	2 mo., 9 days
<i>Groceries</i>															
Bankruptcy	Store No. 4, Pittsburgh, Pa.	Grocery	1650.00	591.30	300.00	891.30	35.84	18.18	190.00	568.67	758.67	11.52	34.46	45.98	8 mo., 12 days
Friendly Adjustment	Store No. 5, Braddock, Pa.	Grocery	1539.47	787.18	566.21	1353.39	51.43	37.00	—	177.08	177.08	—	11.57	11.57	14 mo., 16 days
Bankruptcy	Store No. 6, New Kensington, Pa.	Grocery	2711.95	900.51	757.31	1657.82	33.21	27.92	365.25	687.88	1054.13	13.51	25.36	38.87	14 mo., 8 days
Friendly Adjustment	Store No. 7, Wilkensburg, Pa.	Grocery	2503.21	1369.64	600.00	1968.64	54.68	24.47	—	534.57	534.54	—	21.35	21.35	3 mo., 5 days
<i>Men's Clothing Stores</i>															
Bankruptcy	Store No. 8, Duquesne, Pa.	Men's Clothing	860.41	89.21	187.50	276.71	10.36	21.79	145.00	438.70	583.70	16.85	50.99	67.84	9 mo., 13 days
Friendly Adjustment	Store No. 9, Pittsburgh, Pa.	Men's Clothing	968.86	648.03	156.25	804.28	71.46	17.23	—	109.58	102.58	—	11.31	11.31	1 mo., 26 days
<i>Confectionery Stores and Restaurants</i>															
Bankruptcy	Store No. 10, Pittsburgh, Pa.	Confectionery	1377.92	224.60	306.00	330.60	16.91	23.04	130.00	667.32	797.32	9.79	50.25	60.04	12 mo., 28 days
Bankruptcy	Store No. 11, Pittsburgh, Pa.	Confectionery	1181.85	—	—	—	—	—	300.00	881.85	1181.85	25.58	74.62	100.00	8 mo., 10 days
Friendly Adjustment	Store No. 12, Pittsburgh, Pa.	Restaurant	1622.13	414.10	999.50	1413.60	25.85	62.38	—	188.53	188.53	—	11.77	11.77	2 mo., 23 days
Friendly Adjustment	Store No. 13, Pittsburgh, Pa.	Restaurant	1900.00	646.54	1063.16	1709.50	34.02	55.96	—	190.50	190.50	—	10.02	10.02	1 mo., 16 days
<i>Drug Stores</i>															
Bankruptcy	Store No. 14, Wilkensburg, Pa.	Drug Store	1296.91	195.08	399.50	594.58	15.04	30.86	200.00	592.33	702.33	15.42	38.73	54.15	6 mo., 9 days
Bankruptcy	Store No. 15, Pittsburgh, Pa.	Drug Store	2914.68	—	2139.14	2139.14	—	73.39	397.01	468.53	775.54	10.54	16.07	26.61	8 mo., 7 days
Bankruptcy	Store No. 16, Narrows, Pa.	Drug Store	4777.95	3381.54	548.54	3929.54	70.77	11.47	281.78	566.65	848.41	5.90	11.86	17.76	11 mo., 7 days
Friendly Adjustment	Store No. 17, Wilkensburg, Pa.	Drug Store	2759.58	2371.11	109.61	2480.72	89.92	3.97	—	278.86	278.86	—	10.11	10.11	2 mo., 24 days
Friendly Adjustment	Store No. 18, Arnold, Pa.	Drug Store	3301.35	2177.35	790.15	2917.50	64.44	23.93	—	381.85	381.85	—	11.63	11.63	5 mo., 11 days
<i>Notion and Variety Shops</i>															
Bankruptcy	Store No. 19, Pittsburgh, Pa.	Variety Store	1137.51	149.69	400.00	549.69	13.16	35.16	125.00	462.83	587.82	10.99	40.69	51.68	9 mo., 10 days
Friendly Adjustment	Store No. 20, Pittsburgh, Pa.	Notion Shop	1657.31	1285.08	14.00	1299.08	77.54	.84	60.00	298.33	358.33	3.62	18.00	21.62	14 mo., 27 days

(1) the percentage return from the sale of the assets which was distributed to creditors; (2) the percentage return from the sale of the assets which was consumed by expenses of administration; and (3) the time consumed in settling the estate.¹⁹ In order to drive home the conclusions reached, as well as to explain more fully the methods used in case analysis, two Pittsburgh hardware store liquidations (Store No. 2 and Store No. 3 on the chart) will be discussed in detail.

The proprietor of Store No. 2, located in Stanwix Street, Pittsburgh, filed a voluntary petition in bankruptcy on May 5, 1928, and Mr. Oliver, the bureau manager, was named receiver. He sold the assets at public sale on May 29, 1928, for \$1077.00. The record of receipts and disbursements tells the usual story of the fate of general creditors when a small estate is administered in bankruptcy:

Receipts

From sale of stock and fixtures.....	\$1077.00
From rent of rooms sublet by bankrupts.....	446.70
From book accounts.....	350.61
	\$1874.31

Disbursements

Paid to general creditors.....	\$00.00
Paid to preferred creditors:	
Wage claim	\$763.29
Public Utility claim	46.54
	\$809.83
Attorneys' fees	179.00
Receiver's fee	71.49
Trustee's fee	33.32

¹⁹ In the friendly adjustments, the time stated on the chart begins when the liquidating assignment or deed of trust was taken by the bureau manager, and it ends with the payment of the final dividend. In the bankruptcies, the time stated begins with the filing of the petition and ends with the discharge of the trustee.

General expenses :

Referee's expenses	\$88.40	
Referee's filing fees	9.25	
Referee's commissions	7.64	
Appraisers (3 @ \$10.00 each)....	30.00	
Insurance on stock.....	12.42	
Receiver's bond	10.00	
Trustee's bond	5.00	
Notary fees (12 @ \$.50 each).....	6.00	
Administration rent	502.41	
Clerical, postage, stationery.....	43.60	
Protest fees on check.....	2.65	
Storage of automobile belonging to estate	30.00	
Padlocks	2.55	
Telephone75	
Paid to clerk of court.....	30.00	
		780.67
		<u>\$1874.31</u>

As this estate was skillfully managed, the plight of the general creditors (whose allowed claims totalled \$7031.61) was due not to any inefficiency on the part of the receiver-trustee, but rather, in a large part, to the expenses (56.80 per cent of the liquidated assets in this case) necessary in any normal bankruptcy administered under the present system.

These are in some degree due to the necessity of setting up separate machinery to settle each estate. Even where an adjustment bureau manager serves as receiver and trustee, as in Store No. 2, numerous other individuals not on the manager's staff participate in the adjudication and therefore must receive compensation.

For example, the attorneys for the bankrupt, the receiver, and the trustee were paid \$179.00, or 9.55 per cent of the liquidated

assets; and, if this had been an involuntary petition, a fourth attorney, representing the petitioning creditors, would have been paid from \$50.00 to \$100.00, under the scale of fees allowed in Pittsburgh in the administration of estates of this size.

Another item of expense that should be noted is the payment of \$502.41 for administration rent. In the case of Store No. 2, it was only because of Mr. Oliver's promptness in holding the receiver's auction twenty-seven days after the petition was filed that this item did not eat up everything received from the sale. As a matter of fact, the item of rent in this case is far lower than usual, for the typical bankruptcy case is much longer drawn out than this one (the preferred creditors were paid their dividend on July 31, 1928, and Mr. Oliver was discharged as trustee on December 12, 1928). The very fact that creditors have six months from the date of the adjudication in which to file their claims makes the period of liquidation normally a long one, and the item of administration rent is bound to be correspondingly high.

In striking contrast to the results appearing in the bankruptcy of Store No. 2 are those in the case of Store No. 3, liquidated under the friendly adjustment plan by the Credit Association of Western Pennsylvania. This store, located at Natrona, Pa., also dealt in hardware and electrical supplies. It was placed in the bureau's hands, under an assignment in trust, on December 6, 1927. Twenty-three days later the assets were sold at private sale for \$1800.00, thus making this estate virtually the same size as that of Store No. 2. On February 15, 1928, the preferred creditors were paid in full, and the general creditors were mailed checks covering 45.44 per cent of their allowed claims of \$2820.27. The record of receipts and disbursements was as follows:

Receipts

From sale of stock and fixtures.....	\$1800.00
From book accounts.....	3.00
	\$1803.00

Disbursements

Paid to general creditors.....	\$1281.72
Paid to preferred creditors.....	336.60
Adjustment bureau commission.....	180.00
Adjustment bureau expenses.....	4.68
	<hr/>
	\$1803.00

A comparison of the results obtained in these two cases brings out forcibly the high cost of bankruptcy, as compared with the low cost of friendly adjustment. Of the \$1874.31 received for the assets of Store No. 2, 43.20 per cent went to creditors and 56.80 per cent to expenses of administration. Of the \$1803.00 received for the assets of Store No. 3, 89.76 per cent went to creditors and 10.24 per cent to expenses of administration.

This comparison is manifestly fair, with one exception; namely, that Store No. 2 was loaded with an item of administration rent of \$502.41, not present in the case of Store No. 3. Let us assume for our purposes that Store No. 3 is under a similar burden. This assumption would bring the expenses of administration from \$184.68 to \$687.09, and would leave only \$1115.91, or 61.89 per cent of the liquidated assets, for the creditors. However, even so, the creditors in this case would be participating in the assets to the extent of 18.69 per cent *more* than in the case of Store No. 2. Therefore, we may conclude from these cases that the same liquidating agent, operating in the same district at about the same time, is required, when it winds up an \$1800.00 hardware store in bankruptcy, to spend some 18 per cent more of the money received from the assets, for expenses of administration, than when it liquidates a hardware store of like size under the friendly adjustment plan.

THE CLEVELAND CASES

Nineteen cases (ten bankruptcies and nine friendly adjustments) were studied in Cleveland, which were taken from the files

of the Credit Men's Adjustment Bureau, affiliated with the Cleveland Association of Credit Men. This bureau is in charge of Mr. Hugh Wells, a lawyer and credit man who has the respect of the business community. It covers the Northern Ohio territory bounded roughly by Painesville, Akron, Mansfield, and Sandusky. It liquidates insolvent estates wherever possible under the friendly adjustment plan, but also participates extensively in Cleveland bankruptcies. During the three-year period ending April 30, 1929, the bureau closed 103 friendly adjustments with unsecured liabilities of \$782,086.96 and cash recoveries of \$310,482.67. In the same period, it controlled 306 bankruptcies with unsecured liabilities of \$6,628,399.31 and cash recoveries of \$1,229,206.43. All of the insolvent stocks figuring in these cases were sold at public auction, irrespective of whether the case was closed in bankruptcy or outside of court. However, the Cleveland bureau does everything possible to conduct an honest auction, in which the small shop keeper who is not a professional bidder may participate. Accordingly, the bureau auctioneer is instructed first to take bulk bids on certain lots of the stock, and later to take piecemeal bids on the same lots from various buyers. If the bulk bid for a certain group of items totals more than the piecemeal bids for the same group, the bulk bid will prevail, and *vice versa*. This bureau, for handling claims, charges creditors 7½ per cent of the actual money paid over to them, the fee covering a part, but not all, of the liquidating expenses.

The following nine groups of comparative cases were analyzed:

1. Two meat and grocery supply stores with liquidated assets of \$1000.00 and \$1100.00 respectively, one being administered under each plan.

2. Two cigar stores with liquidated assets of \$1705.00 and \$1824.00 respectively, one being administered under each plan.

3. Two shoe stores with liquidated assets of \$1016.00 and \$1167.00, one being administered under each plan.

4. Three other shoe stores with liquidated assets ranging from \$3640.00 to \$4460.00, two being administered in bankruptcy and one in friendly adjustment.

5. Two dry goods stores with liquidated assets of \$1716.00 and \$1943.00 respectively, one being administered under each plan.

6. Two other dry goods stores with liquidated assets of \$5798.00 and \$6304.00 respectively, one being administered under each plan.

7. Two clothing stores with liquidated assets of \$9354.00 and \$11,632.00 respectively, one being administered under each plan.

8. Two hardware stores with liquidated assets of \$2090.00 and \$2245.00 respectively, one being administered under each plan.

9. Two electrical stores with liquidated assets of \$2617.00 and \$2765.00 respectively, one being administered under each plan.

As in the Pittsburgh cases, no attempt will be made here to analyze in detail the distribution sheet of each of these cases. However, the appended chart was prepared in order to set out in statistical form the principal totals and percentages. The friendly adjustment and bankruptcy cases in a given group should be compared, with a view to determining both the money cost and the amount of time consumed in administering an estate under either system.

CLEVELAND

Method of Settlement	Name and Address	Business	Liquidated Assets	Paid General Creditors	Paid Secured and Preferred Creditors	Total Paid Creditors	% of Assets Paid Gen'l and Pfd. Creditors	% of Assets Paid All Gen'l Creditors	Attorneys' Fees	Other Expenses of Admin.	Total Expenses of Admin.	% of Assets Paid to Other Expenses	% of Assets Paid to Total Admin. Expenses	Time Consumed in Settlement
<i>Meats and Groceries</i>														
Bankruptcy Friendly Adjustment	Store No. 1, Cleveland	Meats and Groceries	\$1,000.83	\$ 125.43	\$ 210.07	\$ 364.30	12.53	23.89	\$338.50	\$ 207.83	\$ 636.33	33.82	29.76	10 mo., 18 days
	Store No. 2, Lakewood, O.	Meats and Groceries	1,100.00	833.93	78.07	912.00	75.81	7.10	100.00	88.00	188.00	9.09	8.00	1 mo., 25 days
<i>Cigar Stores</i>														
Bankruptcy Friendly Adjustment	Store No. 3, Cleveland	Cigar Store	1,824.83	674.37	105.46	778.83	36.99	5.78	450.00	596.00	1,046.00	24.66	32.66	15 mo., 6 days
	Store No. 4, Cleveland	Cigar Store	1,705.00	1,613.41	—	1,633.41	93.80	—	—	71.56	71.56	—	4.20	29 days
<i>Shoe Stores</i>														
Bankruptcy Friendly Adjustment	Store No. 5, Cleveland	Shoe Store	1,016.01	241.41	—	241.21	23.74	—	435.00	339.00	774.80	42.81	33.45	15 mo., 1 day
	Store No. 6, Cleveland	Shoe Store	1,167.41	978.00	—	978.00	83.85	—	—	783.51	1,881.51	—	16.15	22 mo., 2 days
Bankruptcy	Store No. 7, Cleveland	Shoe Store	4,348.05	395.23	2,371.00	2,766.23	9.09	54.53	790.00	791.82	1,581.82	18.21	36.38	18 mo., 10 days
Bankruptcy	Store No. 8, Cleveland	Shoe Store	3,640.91	1,024.63	1,053.68	2,077.71	28.14	28.92	825.00	738.20	1,563.20	22.65	20.28	23 mo., 14 days
Bankruptcy Friendly Adjustment	Store No. 9, Elyria, O.	Shoe Store	4,460.00	3,151.95	800.00	3,951.95	70.67	17.94	—	568.05	568.05	—	11.39	2 mo., 11 days
<i>Dry Goods Stores</i>														
Bankruptcy Friendly Adjustment	Store No. 10, Cleveland	Dry Goods	1,943.68	339.41	771.00	1,110.41	17.45	39.67	350.00	483.27	833.27	18.01	24.87	8 mo., 27 days
	Store No. 11, Cleveland	Dry Goods	1,776.62	958.37	400.00	1,358.37	54.84	23.30	—	358.05	358.05	—	20.85	5 mo., 2 days
Bankruptcy	Store No. 12, Cleveland	Dry Goods	5,798.07	3,013.85	680.25	3,694.10	51.98	11.73	735.00	1,368.97	2,103.97	12.68	23.61	17 mo., 17 days
Bankruptcy Friendly Adjustment	Store No. 13, Lodi, O.	Dry Goods	6,304.86	5,373.38	1,450.00	5,659.88	87.61	2.32	—	634.98	634.98	—	10.07	4 mo., 28 days
<i>Clothing Stores</i>														
Bankruptcy Friendly Adjustment	Store No. 14, Cleveland	Clothing	9,354.67	6,596.57	817.66	7,414.23	70.32	8.74	750.00	1,190.44	1,940.44	8.02	12.72	8 mo., 26 days
	Store No. 15, Canton, O.	Clothing	11,632.75	9,682.11	407.13	10,089.24	84.23	3.50	—	1,533.51	1,533.51	—	13.27	15 mo., 13 days
<i>Hardware Stores</i>														
Bankruptcy Friendly Adjustment	Store No. 16, Cleveland	Hardware	2,245.00	1,035.59	511.55	1,547.14	46.13	22.79	263.77	434.09	697.86	11.75	10.33	8 mo., 22 days
	Store No. 17, Cleveland	Hardware	2,090.03	1,850.03	200.00	2,050.03	88.32	9.57	—	40.00	40.00	—	1.91	1 mo., 1 day
<i>Electrical Stores</i>														
Bankruptcy Friendly Adjustment	Store No. 18, Cleveland	Electrical Store	2,617.16	457.92	1,057.68	1,515.60	17.50	40.41	555.00	576.56	1,101.56	22.03	42.09	16 mo., 23 days
	Store No. 19, Cleveland	Electrical Store	2,765.16	1,779.04	802.97	2,582.01	64.34	29.04	—	183.15	183.15	—	6.62	6 mo., 23 mo.

As an example of typical small cases, the record of receipts and disbursements in the liquidations of Store No. 3 and Store No. 4 will be given in detail. Both of these cases involved small Cleveland cigar stores; the first, a bankruptcy, being finally closed on October 21, 1925, and the second, a friendly adjustment, being completed on September 10, 1927.

The case of Store No. 3 was an involuntary bankruptcy, in which a receiver was appointed from outside the bureau, but in which Mr. Hugh Wells, the bureau manager, was elected trustee. The petition was filed July 5, 1924, and the assets were sold by the trustee at public sale in piecemeal lots on August 28, 1924. The first dividend was paid June 4, 1925, and the trustee was finally discharged on October 21, 1925. In other words, more than fifteen months was consumed in settlement.

Receipts

From sale of stock and fixtures.....	\$1474.54
From book accounts.....	350.29
	\$1824.83

Disbursements

Paid to general creditors (dividend of 11.8%)...	\$673.37
Paid to preferred creditors.....	80.46
Debtor's rent	25.00
Attorneys' fees	450.00
Receiver's and Trustee's fees.....	75.00
General expenses:	
Court costs	\$75.28
Administration rent	250.00
Sales expenses	124.72
Receiver's and Trustee's bonds....	10.00
Appraisers' fees	60.00
Trustee's expenses	1.00
	521.00
	\$1824.83

The Cleveland bureau was called into the case of Store No. 4 at a time when the proprietor owed more than \$6500.00 in general

liabilities, with assets that were appraised at \$2218.84. Mr. Wells, the bureau manager, took title to the debtor's assets for the benefit of creditors on August 12, 1927, and, after notifying all the creditors, in compliance with the Ohio Bulk Sales Law, sold the stock and fixtures in bulk, on August 28, 1927. The creditors were paid a first and final dividend on their claims on September 10, 1927, and the case was closed.

Receipts

From sale of stock and fixtures	\$1705.00
	\$1705.00

Disbursements

Paid to general creditors (dividend of 25%)	\$1633.44
Bureau fee	61.56
Appraisers' fee	10.00
	\$1705.00

A summary comparison of these two cases brings out the following facts of extreme importance in our study: (1) the estates varied little in size; (2) both cigar stores were in Cleveland, and were closed within two years of each other; (3) in the bankruptcy, 42.68 per cent of the money received from the sale of the assets was paid to creditors, and 57.32 per cent went to expenses of administration; (4) in the friendly adjustment, 95.80 per cent of the money received from the sale of the assets was paid to creditors and only 4.20 per cent went to expenses of administration; (5) the bankruptcy required more than fifteen months for liquidation, while the friendly adjustment was completed in 29 days. The significance of this comparison is that, at least where small cases of the character herein discussed are concerned, bankruptcy is an unwieldy, expensive procedure which leaves little for the creditors.

The distribution analysis of the money collected from sale of assets in 22 friendly adjustments and 98 bankruptcies closed by

the Cleveland bureau during the year ending April 30, 1929, was as follows:²⁰

	Bankruptcy	Percentage of the proceeds	Friendly Adjustment	Percentage of the proceeds
Rent	\$ 9,346.13	2.023	\$ 525.92	.690
Secured claims	109,529.65	23.713	112.59	.148
Exemptions	3,824.50	.827	590.59	.775
Atty. fees	54,248.11	11.743	1,093.11	1.434
Rec. and Trustee fees.	15,815.92	3.423	4,889.23	6.415
Court costs	10,912.18	2.362	213.78	.280
Selling expense	22,383.57	4.845	2,907.41	3.815
Operation expense ...	1,815.73	.393	2,506.33	3.286
Prof. labor claims ...	6,076.97	1.315	2,660.49	3.288
Taxes	24,301.73	5.260	4,168.45	5.469
Bonds	1,509.25	.326	90.00	.118
Appraisers fees	6,419.00	1.389	350.34	.459
Incidental expense ...	1,272.21	.275	2,653.05	3.481
Stenographer expense.	1,931.67	.418	0.00	.000
To general creditors..	177,692.03	38.462	53,394.72	70.256
Administration expenses	7,090.43	1.534	0.00	.000
Auditing, Ins., etc. ...	7,816.13	1.692	65.96	.086
Total	\$461,085.21	100.000	\$76,221.97	100.000

CONCLUSIONS ²¹

This study of adjustment bureau operations brings home to any unprejudiced observer at least one fundamental fact. It is that the National Association of Credit Men, originally one of the major sponsors of the Bankruptcy Act, has in many instances abandoned the use of the machinery provided for in that Act, and now adjusts a vast number of merchant insolvencies in its own commercial forum. The reason for this result is simply that business men find the adjustment plan free from the large expenditure of time and money which attends the prescribed technique of bankruptcy in the average case.

Because of the wide divergence in mechanics between the two systems, there are some who believe that no union is possible and

²⁰ This analysis was taken from the (1929) ANNUAL REPORT, CLEVELAND ASSOCIATION OF CREDIT MEN. Similar tables for 1928 and 1927 appear in the annual reports, and show figures closely paralleling those for 1929.

²¹ These suggestions do not purport to be in any sense the conclusions of the Bankruptcy Investigation, but are merely the independent reactions of the writer to his work in friendly adjustment.

that the present dual plan will persist. Certainly, we must continue to have a National Bankruptcy Act, and it is impossible to have a single system that is extra-judicial in nature. This is so, not only because legal machinery is necessary for certain phases of insolvency, but also because friendly adjustment (even within the limits set forth earlier in this article) would have extreme difficulty in functioning if the National Bankruptcy Act were not in force. Paradoxical though it may seem, the success of friendly adjustment is partially dependent upon the existence of a National Bankruptcy Act which has deficiencies; for, as things are constituted at present, the creditors know that unless they cooperate, the bureau manager will turn over the estate to a court of bankruptcy for administration, with the resulting increase in cost and decrease in dividends. In other words, the danger of an economic disadvantage to the creditor in bankruptcy operates with the force of law as at least one factor in securing cooperation of the creditors outside of court.

Since the problem of insolvency, then, cannot be solved without the existence of a National Bankruptcy Act—even in that field of insolvency wherein the friendly adjustment plan functions successfully—it would seem obviously desirable to overcome the deficiencies of our National Bankruptcy Act by incorporating in it, so far as possible, certain features which have contributed to the success of friendly adjustments.²² In this direction, the following suggestions are submitted:

1. Provide in the act for the appointment only of corporate receivers properly staffed with experts skilled in the liquidation of insolvent estates, and with permanent counsel employed.

This provision would eliminate the individual receiver and would be a factor in preventing the initial control of the estate by a "bankruptcy ring." The corporate receiver, whether a credit association or a trust company, should be in the business of settling

²² Many of these same features have been incorporated into the Canadian Bankruptcy Act and apparently have worked successfully. See the testimony of Mr. Robert B. Thayer before Federal Judge Thacher, reported in *New York Times*, Sept. 10, 1929, at 15.

insolvent estates, thus eliminating the expense involved in setting up new liquidating machinery for every bankruptcy. Several of these approved liquidators might exist in metropolitan areas and compete for receiverships on the basis of efficiency. Creditors soon would learn to recognize the organization obtaining for them the largest dividends, and the election of these liquidators to trusteeships would usually follow.

2. Provide in the act for official recognition by the bankruptcy court of the recommendations made by a bona fide creditors' committee, especially with respect to the appointment of the receiver.

In any friendly liquidation the creditors' committee is one of the most important factors involved, the bureau manager seeking its advice on every important move in the case. In bankruptcy, however, the act makes no provision for participation by the creditors prior to the election of the trustee. Meanwhile, a receiver friendly to the "bankruptcy ring" may have been appointed and the assets already sold at public auction for whatever they would bring. Permitting the participation of creditors from the start of the case and providing for the appointment of approved official liquidators would contribute to an honest and efficient administration.

3. Incorporate in the Bankruptcy Act provisions giving the receiver and trustee broad powers with respect to the disposition of assets and other matters vital to a successful administration of the estate. The exercise of such powers, however, should be conditioned on the approval in writing of the creditors' committee.

The reason for this provision is obvious to any student of bankruptcy economics. Under the present administration of bankruptcy in this country (but apparently not in Canada) the receiver and the trustee must each petition the court for permission to do such acts as selling real estate at auction, redeeming property from a lien, selling property subject to a lien, selling property at private sale, or selling perishable property.²³ The requirement for these

²³ See Official Forms in Bankruptcy, No. 42, 43, 44, 45, and 46, prescribed by the Supreme Court, 11 U. S. C. A. 91 *et seq.* (1928).

petitions is based on the theory that the liquidation of an insolvent estate is a legalistic function, whereas the modern approach regards it as an economic function. Therefore, if the receiver or trustee is the skilled liquidator stipulated for above, and if the creditors' committee is given proper recognition, it seems much more in keeping with the present theory of saving the time of jurists for legal matters that the receiver or trustee should be given broad powers in the way of making whatever moves are necessary for disposing of the assets, provided the creditors' committee assents in writing.

4. Incorporate in the Bankruptcy Act some of the efficiency measures that the credit men have found successful under the friendly adjustment plan.

For example, the time given to creditors for filing claims could be easily reduced from six months to thirty days, or at the outside sixty days, from the date of adjudication. The amendment of 1926 recognized the economic waste occasioned by permitting creditors to file and prove their claims at any time within one year from the date of adjudication, and so reduced the period to six months.²⁴ That a further reduction in time would be practicable is demonstrated by the many friendly adjustment cases which are closed in a few months' time—even where scores of widely scattered creditors are involved.

Then, too, under the proposed system of organization liquidators, the services of certain persons connected with every bankruptcy could be eliminated; for example, the three appraisers provided for in the act. The adjustment bureaus use only one salaried appraiser in a given case, but he is an expert in evaluating insolvent stocks, and is, of course, heavily bonded.

Other changes than these may be desirable in the Bankruptcy Act, but I have limited myself to those suggested by a study of friendly adjustments.

²⁴ BANKRUPTCY ACT, 44 STAT. 666 (1926), 11 U. S. C. § 93 (N) (1928).