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NOTES AND COMMENTS

Bankruptcy—Factors to Consider in Choosing Between Chapter X and Chapter XI for the Adjustment of Unsecured Debts

In *SEC v. American Trailer Rentals Co.*,[1] the debtor's affiliate company sold 5,866 automobile trailers to hundreds of purchasers throughout the western states. The debtor then leased the trailers from the owners and placed them with service station operators who acted as agents for the debtor in renting the trailers to the public. When operating expenses far exceeded the return on the rentals, the debtor petitioned[2] for an arrangement under chapter XI of the Bankruptcy Act to adjust its obligations to trailer owners and other unsecured creditors. Chapter XI permits such adjustment by the settlement, satisfaction or extension of time of payment of the debtor's *unsecured* debts "upon any terms"[3] proposed by the debtor.[4] The debtor's proposed plan offered stock in a new trailer rental corporation formed by persons interested in the debtor in exchange for cancellation of the lease obligations and other unsecured claims.[5] Some of the shares were to be given debtor's stockholders. There

[1] 379 U.S. 594 (1965).

[2] "If no bankruptcy proceeding is pending, a debtor may file an original petition under this chapter with the court which would have jurisdiction of a petition for his adjudication." Bankruptcy Act § 322, 52 Stat. 907 (1938), 11 U.S.C. § 722 (1958).

[3] Bankruptcy Act § 356, 52 Stat. 910 (1938), 11 U.S.C. § 756 (1958).

[4] One of the key distinctions between chapter X and chapter XI is that the debtor proposes the plan in the latter proceeding, Bankruptcy Act § 306, 52 Stat. 906 (1938), 11 U.S.C. § 706 (1958), while either the debtor, trustee, creditor or stockholder may propose the plan in the former. Bankruptcy Act § 169, 52 Stat. 890 (1938), 11 U.S.C. § 569 (1958).

[5] At the time of filing the chapter XI petition, the debtor stated its total assets at $685,608 and total liabilities at $1,367,890. The plan proposed an exchange of stock in Capitol Leasing Corporation, a new company, in satisfaction of all but $55,557 of the outstanding claims. These latter were to be paid in cash in full. The stock exchange, giving trailer owners some 866,000 shares in Capitol Leasing, would eliminate all claims of trailer owners against the debtor, and in addition would vest title to the trailers in Capitol Leasing Corporation. The debtor was to transfer its old rental system to Capitol in exchange for 107,000 shares in the new corporation. These shares in turn were to be issued to debtor's stockholders. Officers and directors of debtor and certain trade and general creditors would receive about 104,000 shares in satisfaction of their claims. The debtor estimated that former trailer owners would hold 79.4% of the stock of the new corporation after the exchange. Other creditors excluding shareholders would hold 2.5%, creditor-shareholders, 6%, and shareholders of the debtor, 12.1%. Brief for Appellee, pp. 6-8.

was evidence that relevant data concerning the stock were not made known to the creditors in securing their acceptances of the plan[6] and that corporate funds of the debtor had been misappropriated.[7] It was undisputed that the company had never operated profitably, or that widespread debts were being adjusted. The SEC intervened,[8] seeking to dismiss the chapter XI proceeding, on the ground that it should have been brought under chapter X of the Bankruptcy Act and therefore chapter XI was not available. Chapter X, unlike chapter XI, permits the alteration or modification of rights of stockholders and of creditors generally, either *secured* or *unsecured*.[9] The SEC alleged that (1) more than a mere arrangement with unsecured creditors was in effect proposed and required, (2) public "investor creditors"[10] required a disinterested trustee to protect their interests, (3) rights of investor creditors could be adjusted only in a chapter X proceeding, and (4) the creditors should receive full compensation for their claims absent fresh contribution from debtor's stockholders who were to retain their equity under the plan.[11] The district court denied the SEC's motion to dismiss, and

[6] The S.E.C. alleges that at the time debtor was sending letters to the trailer owners urging them to exchange their trailers for shares of Capitol Leasing stock, the president of Capitol and the officers and directors of the debtor were withdrawing their trailers from debtor and were leasing them to another concern engaged in a similar business, and were also urging their relatives to do the same. This was not disclosed to the trailer owners, nor were trailer owners furnished information of Capitol's financial condition or its management. Trailer owners were not told of pending proceedings involving other stock fraud charges against Capitol.

In re American Trailer Rentals Co., 325 F.2d 47, 52 (10th Cir. 1963).

[7] The misappropriation, totaling at least $141,000, was attributed "almost completely" to a deceased member of debtor's original management group. 379 U.S. at 600.

[8] The authority to intervene in a chapter XI proceeding is given the SEC by Bankruptcy Act § 328, 66 Stat. 432 (1952), 11 U.S.C. § 728 (1958).

[9] Bankruptcy Act § 216, 52 Stat. 895 (1938), 11 U.S.C. § 616 (1958).

[10] The Court and the SEC refer to this class of creditors as "investment creditors" presumably because their interests are predicated on investment contracts. For purposes of this note it is presumed that the rental agreements between the debtor and the trailer owners were investment contracts. The question was not adjudicated in the principal case. For a discussion of investment contracts, see note 44 *infra*.

[11] This argument is an application of the "fair and equitable" test requiring that in any plan of corporate reorganization, unsecured creditors are entitled to priority over stockholders to the full extent of their claims, and that any plan is inadmissible which retains stockholders' interests without first fairly compensating unsecured creditors. The Court in the principal case outlines the history of the "fair and equitable" test before concluding that a 1952 amendment, Bankruptcy Act § 366, 66 Stat. 433

the court of appeals affirmed.[12] On certiorari to the Supreme Court, the decision was reversed. The Court reasoned that the widespread nature of the debts coupled with a "quite major" adjustment were facts alone sufficient to bar a chapter XI proceeding where, as here, there was a demonstrated need for a trustee's investigation, for which chapter XI does not provide.[13] Moreover, the plan amounted to a chapter X reorganization rather than a chapter XI arrangement. However, contrary to the SEC's argument, the Court refused to hold that a chapter X proceeding is mandatory in *all* cases involving rights of public investor creditors.

The statutes do not enumerate,[14] nor have the courts announced,[15] clear distinctions determinative in every case of a proper selection between chapter X and chapter XI for the adjustment of *unsecured* debts. The essential factor is not the size of the debtor, but the needs of the debtor to be served.[16] A chapter X proceeding is likely to be required where misdeeds of management have caused the debacle,[17] or where a need for new management is more pressing

(1952), 11 U.S.C. § 766 (1958), makes it inapplicable in a chapter XI proceeding. 379 U.S. at 611-612.

[12] *In re* American Trailer Rentals Co., 325 F.2d 47 (10th Cir. 1963).

[13] In so holding [to dismiss], we indicate no opinion as to whether or not a Chapter X reorganization would be appropriate in this case . . . . We merely hold that all issues relevant to the possible financial rehabilitation of respondent must here be determined within the confines of a Chapter X, rather than a Chapter XI proceeding.

379 U.S. at 620 n.20.

[14] While we do not doubt that in general . . . . the two chapters were specifically devised to afford different procedures . . . . we find in neither chapter any definition or classification which would enable us to say that a corporation is small or large, its security holders few or many, or that its securities are "held by the public," so as to place the corporation exclusively within the jurisdiction of the court under one chapter rather than the other.

SEC v. United States Realty & Improvement Co., 310 U.S. 434, 447 (1940).

[15] The surface alignment of the six leading decisions becomes plastic in the hands of those who, by a process of selective emphasis that disregards context, find statements in the opinions and facts in the records that seemingly can be moulded to fit either side of rival arguments in a particular case.

In re Herold Radio & Electronics Corp., 191 F. Supp. 780, 784 (S.D.N.Y. 1961), citing General Stores Corp. v. Shlensky, 350 U.S. 462 (1956), SEC v. United States Realty & Improvement Co., 310 U.S. 434 (1940), *In re* Lea Fabrics, Inc., 272 F.2d 769 (3rd Cir. 1959), *vacated,* SEC v. Lea Fabrics, Inc., 363 U.S. 417 (1960), SEC v. Liberty Baking Corp., 240 F.2d 511 (2d Cir.), *cert. denied,* 353 U.S. 930 (1957), SEC v. Wilcox-Gay Corp., 231 F.2d 859 (6th Cir. 1956), and *In re* Transvision, Inc., 217 F.2d 243 (2d Cir. 1954), *cert. denied,* 348 U.S. 952 (1955).

[16] General Stores Corp. v. Shlensky, 350 U.S. 462 (1956).

[17] *Ibid.*

than readjustment of the debt.[18] If the rights of interested parties will be prejudiced in the absence of a thorough investigation under chapter X, the chapter XI proceeding should be dismissed.[19] A chapter XI proceeding is improper where a plan of arrangement is contrary to the best interests of creditors.[20] There is no absolute rule that debtors with widespread, publicly-held securities must get relief under chapter X; but generally when such corporations propose to adjust widely scattered public debts, a chapter X proceeding is appropriate to assure judicial control over the formulation of a plan, SEC participation, and employment of a disinterested trustee to better serve the public and private interests concerned.[21] Even where public debt is not being adjusted, and the plan deals only with trade creditors, the need for a trustee's investigation of the management or a complicated debt structure may require a chapter X proceeding.[22] In determining to leave adjustments to chapter XI, courts have been influenced by the fact that the debtor has already undergone a thorough investigation,[23] that only the claims of trade and commercial creditors, rather than public investors, are involved,[24] or that trade creditors have stated their unwillingness to deal with a chapter X trustee while they will cooperate with current management.[25] Numerous other considerations may be pertinent under the facts of a particular case.[26] Underlying any choice between chapter X and chapter XI is "the basic assumption of Chapter X . . . that the investing public dissociated from control or active participation

[18] *In re* Transvision, Inc., 217 F.2d 243 (2d Cir. 1954), *cert. denied,* 348 U.S. 952 (1955).

[19] *Ibid.*

[20] In one case, the debtor's income exceeded expenses, exclusive of bond obligations, by $35,000 annually. The plan of arrangement would have paid one per cent a year for ten years on the bonded indebtedness of $1,200,000. Thus the payments would be only $12,000 annually and debtor would retain $23,000 above all expenses. The court said, with regard to this surplus: "Some explanation is surely due the creditors before they should be obliged to accept 10 cents on the dollar for their principal and nothing at all for their long overdue interest." Mecca Temple of Ancient Arabic Order of Nobles of Mystic Shrine v. Darrock, 142 F.2d 869, 871 (2d Cir. 1944).

[21] SEC v. United States Realty & Improvement Co., 310 U.S. 434 (1940).

[22] General Stores Corp. v. Shlensky, 350 U.S. 462 (1956).

[23] SEC v. Wilcox-Gay Corp., 231 F.2d 859 (6th Cir. 1956).

[24] *In re* Transvision, Inc., 217 F.2d 243 (2d Cir. 1954), *cert. denied,* 348 U.S. 952 (1955).

[25] Grayson-Robinson Stores, Inc. v. SEC, 320 F.2d 940 (2d Cir. 1963).

[26] For a discussion of some of the considerations that may be decisive, see *In re* Herold Radio & Electronics Corp., 191 F. Supp. 780, 786-87 (S.D.N.Y. 1961).

in the management, needs impartial and expert administrative assistance in the ascertainment of facts, in the detection of fraud, and in the understanding of complex financial problems."[27]

The decision to dismiss the chapter XI proceeding in the instant case accords with prior case law. Misappropriation of assets and the probable need for new management would require an independent trustee's examination under the principles stated. That the interests of public investors could best be protected in a chapter X proceeding was demonstrated by their acceptance of the chapter XI plan although pertinent data were withheld from them. Moreover, the debt was publicly held—not in the hands of trade creditors. There also was doubt that the plan was in the best interest[28] of trailer owners since they would be surrendering a tangible asset—title to their trailers—for an intangible interest in a corporation whose management had already failed in a similar endeavor.

The Court's alternative statement that the plan was in fact a "complete corporate reorganization" requiring a chapter X proceeding sheds little light on a vague area of bankruptcy law. May the debtor's stockholders and creditors be given securities in a *new* corporation as part of an arrangement? Under the statutes, a chapter XI proceeding may modify only the rights of *unsecured* creditors, upon any terms.[29] A leading authority notes: "No provision of the Act permits an arrangement proposed under Chapter XI to deal with the rights of secured creditors or with the rights of stockholders."[30] In the early district court case of *In re Credit Service, Inc.*,[31] the question was whether chapter XI permitted claims of unsecured creditors to be satisfied by exchange for stock in the debtor's subsidiary corporation, where the liabilities of the debtor-parent exceeded its assets. Since there was no stockholders' equity in the debtor to be protected, the court said, the proceeding

[27] SEC v. United States Realty & Improvement Co., 310 U.S. 434, 448-49 n.6 (1940).

[28] A plan proposed in chapter XI must be in the "best interests" of creditors before it can be confirmed by the court. Bankruptcy Act § 366, 66 Stat. 433 (1952), 11 U.S.C. § 766 (1958). It has been said that "best interests" refers to a comparison between what the creditors would receive under an arrangement, and what they would receive under liquidation of the assets. *In re* Village Men's Shops, Inc., 186 F. Supp. 125 (S.D. Ind. 1960).

[29] Bankruptcy Act §§ 306, 356, 52 Stat. 906, 910 (1938), 11 U.S.C. §§ 706, 756 (1958).

[30] 9 COLLIER, BANKRUPTCY, ¶ 8.01(3), at 155 (14th ed. 1964).

[31] 30 F. Supp. 878 (D.C. Md. 1940), *appeal dismissed per stipulation*, SEC v. Credit Service, Inc., 113 F.2d 940 (4th Cir. 1940).

could be under chapter XI. A year later the same court faced the situation where assets of the debtor exceeded liabilities, and the plan in chapter XI proposed the transfer of all debtor's assets to a new corporation in exchange for stock in the new corporation. The court said rights of debtor's stockholders were affected because they still had an equity in the debtor-parent; hence, the proceeding should be in chapter X.[32] In neither of these cases, as in the principal case, was it proposed that debtor's stockholders share in distribution of stock of a new or subsidiary corporation. The principal case does not note the distinction. It concludes only that the plan is a reorganization barred from Chapter XI because creditors' interests are being exchanged for stock in a *new* corporation—and this without regard to the nature of the insolvency.[33] Hence it appears that the Court has announced the rule that any plan including a provision for satisfaction of unsecured claims through exchange for stock in a new corporation is barred from chapter XI. Still to be answered by the Court is whether a chapter X proceeding is required where the debtor proposes to satisfy unsecured claims, not with stock in a new corporation, but in exchange for stock in a subsidiary corporation—the situation faced by the district court in *In re Credit Service, Inc.*[34] Apparently, such a plan would require a chapter X proceeding where the debtor's assets exceeded its liabilities,[35] while chapter XI would suffice where liabilities exceed assets.[36]

[32] *In re* May Oil Burner Corp., 38 F. Supp. 516 (D.C. Md. 1941).

[33] The Court gave only passing notice to participation by debtor's stockholders. It called the plan a reorganization because "the trailer owners are exchanging their entire interests, including a sale of their trailers, in exchange for stock in a new corporation, in which other creditors of respondent, including respondent's officers and directors, as well as respondent itself will have substantial interests." 379 U.S. at 615.

[34] 30 F. Supp. 878 (D.C. Md. 1940), *appeal dismissed per stipulation,* SEC v. Credit Service, Inc., 113 F.2d 940 (4th Cir. 1940).

[35] Where the debtor corporation has assets in excess of liabilities, its stockholders retain an equity in the corporation. To the extent that stock in a subsidiary corporation is exchanged for claims against the parent, the equitable interest of the parents' stockholders in the subsidiary corporation is diminished. Hence their interest is "affected" within the meaning of Bankruptcy Act § 107, 52 Stat. 884 (1938), 11 U.S.C. § 507 (1958), so that a proceeding in chapter XI would seem to be improper.

[36] Stockholders retain no equity where liabilities exceed assets. Hence they have no interest that could be affected in a chapter XI proceeding. An arrangement includes the modification of rights of unsecured creditors upon any terms for any consideration, Bankruptcy Act § 356, 52 Stat. 910 (1938), 11 U.S.C. § 756 (1958), and consideration includes "stock and certificates of beneficial interest therein." Bankruptcy Act § 306, 52 Stat. 906 (1938), 11 U.S.C. § 706 (1958). It would seem to follow, therefore,

A final question is whether, as the SEC argued,[37] every adjustment affecting the rights of public investor creditors should be in chapter X. Although the Court affirmed the use of chapter X as a general rule, the argument that it applies exclusively was rejected on the dual grounds that Congress had not so provided[38] and that the Court in *General Stores Corp. v. Shlensky*[39] had decided that such adjustment could be effected within narrow limits in a chapter XI proceeding. The reliance on *Shlensky* clearly seems wrong, as that case dealt not with investor creditors but with trade and commercial creditors.[40] And, as the Court in the principal case acknowledges, it was the character of the debtor, not the nature of the debt, which controlled in the *Shlensky* case.[41] In the light of the purposes of the Securities Act of 1933[42] it is submitted that Congress should give statutory sanction to the SEC argument requiring that chapter X be utilized whenever the rights of creditors, whose interests are predicated on the purchase of investment contracts required to be registered with the SEC,[43] are involved. A preliminary determination would be required to ascertain whether the security involved is in fact an investment contract within the

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that stock in a subsidiary corporation could be given in satisfaction of creditors' claims in a chapter XI proceeding where the debtor was insolvent in the bankruptcy sense.

[37] Brief for Appellant, p. 16.

[38] "The short answer is that . . . . Congress has drawn no such absolute line of demarcation between Chapters X and XI." 379 U.S. at 613.

[39] 350 U.S. 462 (1956).

[40] "It [the debtor] proposed an arrangement of its general unsecured trade and commercial debts, none of which is evidenced by any publicly held security. Petitioner has indeed no debts of any nature by way of bonds, mortgage certificates, notes, debentures, or obligations of like character, publicly held." *Id.* at 463.

[41] 379 U.S. at 614.

[42] The preamble to the act reads: "An act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." 48 Stat. 74. The Court in a leading case said: "The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions." SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953). See generally 1 Loss, SECURITIES REGULATION 118-128 (2d ed. 1961).

[43] Section 5 of the Securities Act of 1933, 48 Stat. 77, 15 U.S.C. § 77e (1958), requires that a registration statement of securities covered under the act be filed with the SEC. Section 7, 48 Stat. 78, 15 U.S.C. § 77f (1958), sets forth the information required, and under § 8(b), 54 Stat. 857, 15 U.S.C. § 77h(b) (1958), the statement can be determined ineffective if the necessary information is not provided. Section 9(a), 72 Stat. 945, 15 U.S.C. § 77i(a) (1958), permits judicial review of commission orders.

purview of the statute.[44] Such a rule would assure SEC intervention and independent trustee's investigation for the protection of the investing public just as these safeguards are provided today for the protection of stockholders and secured creditors whose rights are materially and adversely affected in an adjustment proceeding.

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Corporations—Disposition of Corporate Assets

Where does the control by shareholders over the disposition of corporate assets begin and the control by management end? Most statutes give the shareholder the right of control when the sale constitutes "substantially all" the corporate assets. But the confusion engendered over the definition of "substantially all" gives no precise answer to the question. The final determination of consent rights is one of policy—of balancing the shareholder's interest in protecting his investment against the director's interest in having efficient centralized management.[1]

[44] The determination of whether a particular agreement is an investment contract is often difficult to make. The term "investment contract" has been defined judicially in these terms:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946). A district court has said that "the elements that make up an 'investment contract' within the statutory definition, as distinguished from some other form of security, are not amenable to characterization in absolute terms. Consideration must be given to all surrounding and collateral arrangements." SEC v. Los Angeles Trust Deed & Mortgage Exchange, 186 F. Supp. 830, 888 (S.D. Calif. 1960), *modified and aff'd*, 285 F.2d 162 (9th Cir. 1961). For illustrative cases, see Farrell v. United States, 321 F.2d 409 (9th Cir. 1963); Roe v. United States, 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961); Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959); Penfield Co. v. SEC, 143 F.2d 746 (9th Cir. 1944).

[1] The primary purpose of this note is to discuss the concepts behind one of the fundamental corporate changes: the sale, lease, or exchange of all or substantially all the corporate assets. The focal point will be on the right of shareholders to approve such dispositions. For related works on this subject, see Note, 38 CALIF. L. REV. 913 (1950); Note, 9 SYRACUSE L. REV. 269 (1958); Note, 67 YALE L.J. 1288 (1958). This note will not discuss the procedure for obtaining shareholder consent, the value of consideration received, or fraudulent transfers of assets. For such discussion, see Note, 58 COLUM. L. REV. 251 (1958). The other fundamental changes of consolidation and merger are not discussed. For a comparison of these