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BANKRUPTCY

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During 1975-76, several significant developments occurred in the area of bankruptcy law. Probably the most significant of these was the 1976 legislative overhaul of chapter IX of the Bankruptcy Act,[1] the chapter governing the rehabilitation of financially embarrassed local governmental units. This marked the first comprehensive revision of a "chapter" proceeding since the Chandler Act Amendments in 1938.[2] In addition, the United States Supreme Court completed the bankruptcy rulemaking process by adopting rules governing proceedings under section 77,[3] chapter IX,[4] chapter X[5] and chapter XII[6] of the Act. Finally, there were also developments in the case law area[7] ranging from consideration of a Seventh Circuit bankruptcy decision by the United States Supreme Court to several important decisions in the Seventh Circuit itself. This article will consider each of these developments.

LEGISLATIVE DEVELOPMENTS REGARDING MUNICIPAL BANKRUPTCY

Chapter IX of the Act has a checkered history. During the depression of the 1930's, many beleagured cities were unable to meet their financial obligations and the law provided such municipalities with *no* available procedures to facilitate refinancing or to force any alteration of the rights of recalcitrant bondholders. Thus, the spectre of payless paydays and the forfeiture of corporate charters to the state was very real. Subsequent attempts by state legislatures to provide procedures for binding rearrangement of the obligations of insolvent municipalities ran afoul of the constitutional prohibition on state interference with obligations under contracts.[8] As a result, it

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1. Bankruptcy Act §§ 81-98, 11 U.S.C.A. §§ 401-418 (1976) [hereinafter referred to in the text as the Act].
2. Pub. L. No. 75-696, 52 Stat. 840-940 (1938).
3. 11 U.S.C. § 205 (1970).
4. Bankruptcy Act §§ 81-98, 11 U.S.C.A. §§ 401-418 (1976).
5. Bankruptcy Act §§ 101-126, 11 U.S.C.A. §§ 501-676 (1976).
6. Bankruptcy Act §§ 401-526, 11 U.S.C. §§ 801-926 (1970).
7. *See* text accompanying notes 182-237 *infra*.
8. U.S. CONST. art I, § 10.

became Congress' responsibility to deal with the problem under its bankruptcy power.[9]

Congress' first attempt to remedy the situation in 1934 confronted another constitutional obstacle—the tenth amendment.[10] In *Ashton v. Cameron County Water Improvement District No. 7*,[11] the United States Supreme Court held that if the bankruptcy power of Congress permitted the federal courts to interfere with the obligations of state governments or subdivisions thereof, "they are no longer free to manage their own affairs; the will of Congress prevails over them. . . . And really, the sovereignty of the state, so often declared necessary to the federal system, does not exist."[12]

In response to the Supreme Court's holding, Congress drafted a revised chapter IX which did not conflict with the tenth amendment.[13] However, it was this Act with relatively minor amendments in 1940, 1942, and 1946,[14] which proved patently inadequate to solve the more recent financial problems of New York City and other large, local governmental units.[15]

In 1973, a Presidential Commission completed a comprehensive study of the strengths and weaknesses of both the liquidation and reorganization provisions of the present Act.[16] The Commission proposed a new approach to bankruptcy in which proceedings would be jointly administered by a federal agency, the United States Bankruptcy Administration, and federal bankruptcy courts.[17] The basic thesis of the Commission was that the present liquidation and reorganization process could be made substantially more efficient by turning over many of the clerical functions now handled by bankruptcy judges and bankruptcy courts to the newly conceived federal Bankruptcy Administration. The Commission's proposal also contained numerous recommendations for substantive changes and improvements in the present law including major changes in connection with involuntary petitions,[18] the trustee's avoiding powers,[19] and a merger of chapters X, XI, and XII of the present statute.[20] The Commission's proposal was introduced in the

9. Specifically, the bankruptcy clause states that: "[t]he Congress shall have the power . . . [t]o establish . . . uniform laws on the subject of Bankruptcies throughout the United States . . . ." U.S. CONST. art. I, § 8.

10. U.S. CONST. amend. X.

11. 298 U.S. 513 (1936).

12. *Id.* at 531.

13. United States v. Bekins, 304 U.S. 27 (1938).

14. *See generally* 5 W. COLLIER, COLLIER ON BANKRUPTCY 546-57 (14th ed. 1976) [hereinafter cited as COLLIER].

15. 11 U.S.C. §§ 401-404 (1970).

16. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, Pts. I, II, III, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 1 (1973) [hereinafter cited as REPORT].

17. REPORT, *supra* note 15, Pt. I at 103-156.

18. *Id.* at 185-191.

19. *Id.* at 200-212.

20. *Id.* at 237-262.

United States House of Representatives during the 94th Congress.[21]

Soon after the Commission's report was published, the bankruptcy judges drafted their own proposal for widespread legislative revision of the Act. The judges' proposal encompassed administration of all aspects of liquidation and reorganization proceedings by the bankruptcy courts and judges without participation of an independent federal bureaucracy in the process. The judges agreed with the Commission's conclusions that many of the substantive provisions of the present statute needed major overhaul and made proposals for such changes which were, in many instances, identical to those proposed by the Commission. The judges' bill was also introduced in the 94th Congress.[22]

In 1975-76, extensive hearings were held on both bills before the House Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary. Initially, it was expected that the Senate would conduct hearings on the proposed bankruptcy legislation during the next session and that Congress would enact an all encompassing revision of the existing Act within the next year.

However, the need to remedy specific flaws under the existing chapter on municipal bankruptcy was so immediate that our nation's cities could not wait for an omnibus bill to be passed by Congress.[23] By 1975, the financial condition of New York City had become critical. Default appeared imminent. Envisioning chaos and disaster, Mayor Beame, Wall Street attorneys and Congress all turned to the Act to see what provisions it offered to aid this economically troubled municipality in putting its financial house back in order. When Congress, the bar of New York and the financial community looked to the long forgotten chapter IX of the Act, they discovered to their great surprise that the draftsmen of chapter IX never contemplated the insolvency of the nation's largest city and that chapter IX provided no alternatives for relief to New York City. For this reason, in 1975-76, Congress focused its specific attention on the problem of municipal insolvency. On April 8, 1976, a new version of chapter IX of the Act was enacted[24] and on April 26, 1976, the chapter IX Rules and Official Forms were ordered to become effective by the United States Supreme Court on August 1, 1976.[25]

21. H.R. 31, 94th Cong., 1st Sess. (1975).

22. H.R. 32, 94th Cong., 1st Sess. (1975).

23. As early as 1973, the Commission anticipated the possibility of a major municipal collapse as well as the inadequacy of chapter IX to deal with such an event. In one of its most sanguine observations the Commission said: "There have been some 350 odd cases filed under Chapter IX . . . . However, since the early 1950's only a handful of cases has been filed. For fiscal year 1972, only one case was filed in the United States. The present calm may well be ending." REPORT, *supra* note 15, Pt. I at 273.

24. Act of Apr. 8, 1976, Pub. L. No. 94-260, 90 Stat. 315.

25. 11 U.S.C.A. app. Sup. Ct. Order of Aug. 26, 1976.

Initiation of Proceedings

Chapter IX of the Act as it existed in the beginning of 1976 was designed to solve the problems of a relatively small governmental unit. The main purpose of chapter IX was to provide a framework within which a financially troubled irrigation district, small municipality or county could continue to operate while working out a deal with a recalcitrant minority of investor creditors. The theory was that the local governmental unit in financial trouble would begin to make a deal with its creditors, get the approval of a majority of them and then use chapter IX to bind the dissenters. Specifically, chapter IX required the petitioner to have the approval of fifty-one percent of its creditors to a plan of adjustment *before* being eligible to file a petition.[26]

Such a provision may have made sense in the case of a drainage district where the creditors could be readily identified and negotiated with. However, it presented an impossible precondition in the case of New York City or any other unit with large numbers of outstanding securities holders.

The most significant change contained in the 1976 Act is in the area of eligibility for relief. Under the new section 84,[27] any political subdivision, agency, or instrumentality of a state is eligible for chapter IX relief if it: (1) is generally authorized by the state to file for relief;[28] (2) is insolvent in either the bankruptcy (balance sheet) sense or unable to meet its debts; and (3) has *either* obtained the approval of fifty-one percent of its creditors to its plan, *or* at least negotiated with its creditors, shown why such negotiation is impractical or presented sufficient evidence that an unsecured creditor will try to grab a portion of its assets.[29] In effect, this opens the courthouse door to any insolvent State governmental unit.[30]

26. Former Bankruptcy Act § 83(a), 11 U.S.C. § 403(a) (1970) (amended 1976).

27. Bankruptcy Act § 84, 11 U.S.C.A. § 404 (1976).

28. The House of Representatives' version would have permitted the entity to file if it was not "prohibited by state law from filing a petition under this chapter." H.R. REP. No. 686, 94th Cong., 1st Sess. 6 (1975). That was changed in Conference to require "general authorization by the legislature, or by a governmental officer (which includes the chief executive) or government organization (such as a Municipal Finance Commission) empowered by State law to authorize filing." CONF. REP. No. 938, 94th Cong., 2d Sess. 17 (1976). Thus, there apparently must be some affirmative indication of authority by the state that the entity may file a chapter IX petition. That is a change in prior law which has the effect of making the relief available under chapter IX more difficult to obtain. *See generally* 5 COLLIER, *supra* note 14, at 1564-65. Since the *affirmative* consent of the state is not constitutionally required (United States v. Bekins, 304 U.S. 27, 46 (1938)), the logic behind raising a technical barrier to relief is unclear. If the state's consent is to be required, the debtor should be allowed to obtain it at any time up to the confirmation of the plan, with the proceeding being dismissed if the debtor is unable to obtain the state's authority. *See* Bankruptcy Act §§ 94(b)(6), 98(b), 11 U.S.C.A. §§ 414(b)(6), 418 (b) (1976). The chaotic emergency conditions which will inevitably precede a chapter IX petition should not be made even more uncertain by the need to obtain the state's permission *before* filing.

29. Bankruptcy Act § 84, 11 U.S.C.A. § 404 (1976).

30. There is no limit as to the size of the entity which can use chapter IX. Although there was some discussion of making the relief provided by the 1976 Act available only to large cities, that restriction was dropped and the new Act applies equally to large and small municipalities. Bankruptcy Act § 84, 11 U.S.C.A. § 404 (1976).

Administration of Proceedings

Once the petition is filed, the chief judge of the district notifies the chief judge of the corresponding circuit, and the court of appeals judge designates the district judge who is to hear the case.[31] The case cannot be referred to a bankruptcy judge generally, although a bankruptcy judge may hear specific aspects of the case as a special master.[32] The court's jurisdiction is limited to matters concerning the debtor's financial difficulties and the plan for solving those difficulties. The local governmental officials and the state remain in control of the affairs of local government in accordance with state law.[33] Under the Constitution, an elected or appointed state official cannot be replaced by a federal official, and thus, an independent bankruptcy trustee is not appointed.[34] For much the same reason the proceedings are strictly voluntary. There is no involuntary chapter IX petition and either the state or debtor can terminate the case at any time by withdrawing its consent to the proceeding.[35]

Once the proceeding is underway, the Act provides for participation of a variety of parties in the process leading to the adoption and implementation of a plan. Whereas the former chapter IX contemplated negotiation with secured or unsecured creditors who were the holders of securities, *i.e.*, investor creditors,[36] the new Act unequivocally includes all of the debtor's investor

31. Bankruptcy Act § 82(d), 11 U.S.C.A. § 402(d) (1976).

32. Bankruptcy Act § 87(a), 11 U.S.C.A. § 407(a) (1976); Bankruptcy Rule 9-13, 11 U.S.C.A. app. R. 9-13 (1976). Only a bankruptcy judge can serve as special master. However, any references of any part of the case is to be done only in extraordinary cases. *Id. See also* the definitions of "court" in section 81 (11 U.S.C.A. § 401 (1976)) and "court" and "judge" in rule 9-38(6) (11 U.S.C.A. app. R. 9-38(6) (1976)).

33. Bankruptcy Act § 83(a), 11 U.S.C.A. § 403(a) (1976). *See* text accompanying notes 11-12 *supra* which points out that interference with local and state sovereignty would invalidate chapter IX under the tenth amendment. For this reason, the court's role "is strictly limited to disapproving or to approving and carrying out a proposed composition." Leco Properties v. R.E. Crummer & Co., 128 F.2d 110, 113 (5th Cir. 1942). *See generally* H.R. REP. NO. 686, 94th Cong., 1st Sess. 9-11 (1975). On the other hand, the states cannot enact competing municipal insolvency legislation which would be binding on dissenters without running into the supremacy clause of the Constitution. Bankruptcy Act § 83, 11 U.S.C.A. § 403 (1976). *See* International Shoe Co. v. Pinkus, 278 U.S. 261 (1929).

34. A trustee can be appointed for the limited purpose of pursuing causes of action under the bankruptcy trustee's powers to avoid preferences, fraudulent conveyances, and certain statutory and judicial liens under sections 60, 67, and 70 of the Bankruptcy Act (11 U.S.C. §§ 96, 107, 110 (1970)). The trustee is appointed only if the debtor refuses to pursue the matter and then only for the limited purpose of pursuing the action. Bankruptcy Act § 85(h), 11 U.S.C.A. § 405(h) (1976). This represents a change in the law from the previous chapter IX where it was believed the bankruptcy trustee's avoiding powers were unavailable. 5 COLLIER, *supra* note 14, at 1597-99. *See* text accompanying notes 91-95 *infra*.

35. H.R. REP. NO. 686, 94th Cong., 1st Sess. 7, 10-11 (1975).

36. Former Bankruptcy Act § 82, 11 U.S.C. § 402 (1970) (amended 1976). A "creditor" was a holder of a "security." *Id.* The definition of "security" included "bonds, notes, judgments, claims and demands, liquidated or unliquidated, and other evidences of indebtedness either secured or unsecured, and certificates of beneficial interest in property." *Id.* The courts gave this definition a broad scope and included creditors in chapter IX whose claims could hardly be

and non-investor, secured and unsecured creditors in the proceeding.[37]

In addition to the debtor and its creditors, there are a number of other, potential parties to the proceeding. The state and the United States Treasury Department are entitled to participate. Further, the statute provides that the Securities and Exchange Commission[38] is to serve the same investor protection role in chapter IX as it presently serves in chapter X corporate reorganization proceedings.[39] Also, labor unions may be heard on the economic soundness of the plan with the permission of the court.[40]

Secured and unsecured creditors can participate pro se, by attorney, or by committee or representative.[41] Committees of creditors, their attorneys and attorneys for petitioners must disclose all compensation arrangements and can petition the court for awards of compensation from the debtor.[42] Although there seemed to be an intent to democratize the rehabilitation process, the statute encourages efficient administration of the proceeding through the participation of powerful, centralized creditor representatives such as indenture trustees and unions.[43]

considered investment related. Poinsett Lumber & Mfg. Co. v. Drainage Dist. No. 7, 119 F.2d 270 (8th Cir. 1941). Nevertheless, while the thrust of former chapter IX was investor-related, the new chapter IX is not so limited.

37. Bankruptcy Act § 81(3), 11 U.S.C.A. § 401(3) (1976). Creditors must, however, be creditors *of the petitioner*. Thus, holders of industrial development bonds issued by local governments on behalf of private businesses under the Internal Revenue Code (I.R.C. § 103 (c)) are not within the chapter IX definition of creditor. Since only the private business is liable for payment on these bonds, they are not affected by chapter IX. *See* CONF. REP. NO. 938 on H.R. 10624, 94th Cong., 2d Sess. 15 (1976).

38. Hereinafter referred to in the text as the SEC.

39. Although section 93 seems to contemplate a role for the SEC limited to objecting to unfair plans (11 U.S.C.A. § 413 (1976)), Bankruptcy Rule 9-15(b) is not so limited but instead contemplates full participation by the SEC as a party with the same limitation on the SEC's right of appeal which appears in chapter X. 11 U.S.C.A. app. R. 9-15(b) (1976). Compare Bankruptcy Act § 208, 11 U.S.C. § 608 (1970) and Bankruptcy Rule 10-210(c), 11 U.S.C.A. app. R. 10-210(c) (1976).

40. Bankruptcy Act § 94(a), 11 U.S.C.A. § 414(a) (1976). Unions can also participate more actively as a representative of employee creditors in connection with unpaid wages or damages from the rejection of a collective bargaining agreement. *See* Bankruptcy Act § 86(a), 11 U.S.C.A. § 406(a) (1976).

41. Bankruptcy Act § 86(a), 11 U.S.C.A. § 406(a) (1976); Bankruptcy Rules 9-15(a), 9-16, 9-43, 11 U.S.C.A. app. R. 9-15(a), 9-16, 9-43 (1976).

42. Bankruptcy Act §§ 86(b), 87(b), 11 U.S.C.A. §§ 406(b), 407(b) (1976); Bankruptcy Rules 9-16, 9-19, 11 U.S.C.A. app. R. 9-16, 9-19 (1976). Rule 9-19 adds a weakened version of the anti-trading provision of section 249 of chapter X to chapter IX. 11 U.S.C. § 649 (1970). The rule forbids compensation to those acting in a representative capacity who have traded in the petitioner's securities without court permission after the inception of the chapter IX proceeding or after the beginning of the representation. (Bankruptcy Rule 9-19(c)(2)). Neither it nor section 249 requires the representative or insider to disgorge profits. The rule is that they can trade or receive compensation from the debtor but not both. The rule is meant to discourage insider trading, not to prohibit it. However, rule 9-19(c)(2) weakens section 249 by permitting the court to prospectively or retroactively sanction voluntary trading by fiduciaries in chapter IX proceedings, something section 249 does not give the court discretion to do. Thus, a chapter IX court could permit both trading and compensation. The rule has been similarly weakened by the chapter X rules. *See* Bankruptcy Rule 10-215(c)(4), 11 U.S.C.A. app. R. 10-215(c)(4) (1976).

43. One other party, the "special taxpayer," is entitled to be heard in objection to a plan.

The principal purpose of chapter IX is the negotiation and implementation of a plan to solve the debtor's financial ills. In this area, the new Act adds a number of provisions designed to facilitate the negotiation process. The filing of the petition acts as an automatic stay of all creditors' actions against the debtor, its property, officers, or inhabitants. This includes staying any rights of set-off, particularly against compensating balances.[44] In addition, the chapter IX debtor is now expressly given the power to reject executory contracts and unexpired leases.[45] This provision, which is similar to section 70b,[46] may become important in connection with collective bargaining agreements.[47] The debtor can now compel unions, landlords and others who may be parties to long term contracts which are regarded by the debtor as onerous to renegotiate on terms more acceptable to the debtor.

On the other hand, the debtor-petitioner is protected against ipso facto clauses in leases, *i.e.*, clauses which purport to work an automatic termination of the lease upon the bankruptcy of the lessee.[48] Such clauses, which are specifically enforceable in straight bankruptcy under section 70b, have not been enforced by the courts in corporate reorganizations under chapters X and XI.[49] The new Act makes them specifically unenforceable in chapter IX proceedings. Thus, while an insolvent governmental tenant cannot be summarily evicted, the landlord is entitled to all unpaid rent plus adequate assurances of future performance under the lease. The ball is clearly in the debtor's court. If the lease is regarded by the debtor as attractive, the debtor can affirm it and the other party cannot use the fact of bankruptcy as an escape clause. However, if the lease is unattractive to the debtor, the debtor can, at his option, reject it and the other party is left with a claim for damages.

In an attempt to lessen the urgency of the negotiations and provide the petitioner with operating funds during the pendency of chapter IX proceedings, the new Act gives the district court judge the power to authorize the

Bankruptcy Act § 93, 11 U.S.C.A. § 413 (1976). A special taxpayer is one who because of ownership of real estate can be singled out for special assessment to help the debtor make payments under the plan. Although the rules give special taxpayers broad rights of participation, (Bankruptcy Rule 9-15(a)(1), 11 U.S.C.A. app. R. 9-15(a)(1) (1976)), special taxpayers, their committees, and attorneys are apparently not entitled to be compensated by the petitioner for their services. even for successful objection to or negotiation of a plan. *Compare* Bankruptcy Act § 87, 11 U.S.C.A. § 407 (1976) *with* Bankruptcy Act § 243, 11 U.S.C. § 643 (1970).

44. Bankruptcy Act § 85(e), 11 U.S.C.A. § 405(e) (1976).

45. Bankruptcy Act §§ 82(b)(1), 88(c), 11 U.S.C.A. §§ 402(b)(1), 408(c) (1976).

46. Bankruptcy Act § 70(b), 11 U.S.C.A. § 110(b) (1970).

47. If a collective bargaining agreement is rejected, it will presumably be renegotiated in accordance with state and local law. King, *Municipal Insolvency, Chapter IX Old and New, Chapter IX Rules,* 50 AM. BANK. L.J. 55, 62 (1976).

48. Bankruptcy Act § 85(f), 11 U.S.C.A. § 405(f) (1976).

49. Queens Boulevard Wine & Liquor Corp. v. Blum, 503 F.2d 202 (2d Cir. 1974) (chapter XI); Weaver v. Hutson, 459 F.2d 741, 744 (4th Cir. 1972), *cert. denied*, 409 U.S. 957 (1972) (chapter X).

debtor to issue certificates of indebtedness.[50] This method of funding, which is common to other reorganization proceedings,[51] permits an insolvent entity to obtain operating funds by selling certificates for cash. These certificates may have priority over all existing indebtedness of the debtor, secured or unsecured. Therefore, they are theoretically safe and attractive to investors despite the insolvency of the issuer.

This device works well in the context of a relatively small debtor in a fairly quick proceeding such as a chapter XI arrangement. There, the amounts the lender is being asked to risk are small and the grant of the highest repayment priority makes repayment within a reasonable period of time dependable. This logic collapses in the context of the insolvency of a large governmental unit. As pointed out by Representative Holtzman in an addendum to House Committee Report No. 686,[52] the mere grant of authority to issue certificates of indebtedness does not mean that such will in fact be saleable and that the petitioner will be assured adequate operating funds. Certificates of indebtedness can hardly be considered a risk free investment in light of the fact that the statute specifically subordinates certificates to operating expenses of the debtor-government and, in the context of such cities as New York or Chicago, a chapter IX proceeding is likely to be a drawn out affair stretching out over one or more decades. The Penn Central experience tends to confirm Representative Holtzman's suggestion that absent federal guarantees, the financial community will not touch these certificates.[53]

This is a serious deficiency in the new municipal insolvency procedure, one which Congress will have to remedy on an ad hoc basis by federal guarantees at least in the context of a debtor of anything more than modest size. Chapter IX will not work for New York City unless it can be assured of the funds to maintain vital services, such as police and fire protection, during the lengthy process of negotiating a settlement with its innumerable creditors.

The Plan of Reorganization

The new Act assists the petitioner greatly in negotiating with creditors by giving the court broad authority to classify creditors.[54] Previously, the courts were required to place all secured claims in a separate class and claims payable out of the same source had to be placed in the same class.[55] This

50. Bankruptcy Act § 82(b)(2), 11 U.S.C.A. § 402(b)(2) (1976).

51. *See, e.g.*, Bankruptcy Act §§ 77(c)(3), 116(2), 344, 446, 11 U.S.C. §§ 205(c)(3), 516(2), 744, 846 (1970). These sections are included under railroad reorganization, chapters X, XI and XII respectively.

52. H.R. REP. NO. 686, 94th Cong., 1st Sess. 55 (1975).

53. *Id.*

54. Bankruptcy Act § 88(b), 11 U.S.C.A. § 408(b) (1976); Bankruptcy Rule 9-22(g), 11 U.S.C.A. app. R. 9-22(g) (1976).

55. Former Bankruptcy Act § 83(b), 11 U.S.C. § 403(b) (1970) (amended 1976). *See* 5 COLLIER, *supra* note 14, at 1579-81.

resulted in some glaring inequities because claims with differing rights against the same fund or property were in one class and, therefore, had to receive identical treatment. This requirement that the debtor settle on identical terms with creditors with differing, often conflicting interests, made the negotiating process delicate and difficult. The new statute corrects this difficulty and facilitates negotiations when it permits the court wide latitude in identifying classes of creditors with homogenous interests and rights for purposes of the plan. This enables the petitioner and each group of creditors to settle on such different terms as fairly meet the rights and needs of each particular group.

To help the debtor, the statute permits the court to carve out a special class of creditors, those having claims of $250 or less, "for administrative convenience."[56] Presumably, these creditors will be paid in full immediately and, thus, the expense of administering the case will be greatly reduced by substantially reducing the number of creditors who would otherwise be entitled to various notices and opportunities to be heard as well as to vote on the plan.[57]

Under the new Act only the petitioner can propose such a plan. Neither the court nor the creditors can propose competing plans which could be binding on the debtor.[58] As to the terms of the plan itself, the new statute provides a scheme which is basically similar to the former chapter IX but has several significant departures as well.

Similar to the former chapter IX, the new Act provides that, for a plan to be adopted, all three of the following conditions must be met: (1) the plan must be proposed by the debtor;[59] (2) a sufficient number of the creditors must agree to it;[60] and (3) a court of competent jurisdiction must determine that the plan agreed to meets the requirements of the statute.[61] If any one of these three steps is lacking, the proceeding fails. Each of these steps is independent of the others. Thus, even if ninety-five percent of the debtor's creditors of each class consent to an unfair and inequitable plan, the court cannot approve it. On the other hand, the court may not approve a patently fair and equitable plan if it is not approved by the requisite majorities of each class of creditors affected by the plan.[62]

56. Bankruptcy Act § 88(b), 11 U.S.C.A. § 408(b) (1976).

57. *See generally* 9 COLLIER, *supra* note 14, at 230. A question arises as to whether this would permit payment of unsecured debenture holders with claims of less then $250 before mortgage bondholders or revenue bondholders receive anything. *See also In re* Hudson-Ross, Inc., 175 F. Supp. 111, 112 (N.D. Ill. 1959).

58. Bankruptcy Act § 90(a), 11 U.S.C.A. § 410(a) (1976); Bankruptcy Rule 9-24(a). 11 U.S.C. app. R. 9-24(a) (1976). However, a creditor can, with the written permission of the debtor, file a modification of a plan filed by the petitioner. Bankruptcy Act § 90(b); Bankruptcy Rule 9-26.

59. Bankruptcy Act § 90(a), 11 U.S.C.A. § 410(a) (1976).

60. Bankruptcy Act § 92(b), 11 U.S.C.A. § 412(b) (1976).

61. Bankruptcy Act § 94(b), 11 U.S.C.A. § 414(b) (1976).

62. *See generally* American United Mut. Life Ins. Co. v. Avon Park, 311 U.S. 138 (1940).

The plan must be approved by two-thirds in amount of each class of claims against the debtor and a simple majority in number of the members of each class of the debtors' creditors.[63] This is a hybrid between the approach of former section 83(d)[64] of chapter IX (two-thirds in amount only) and present section 362[65] of chapter XI (a simple majority of number and amount). The precise reason for the dual requirement is not clear.

What is clear, however, is that this vote is a separate, additional, and distinct requirement from confirmation by the court. The court cannot force a plan on unwilling investors.[66] In deciding how to vote, the creditors receive either the plan itself (which is likely to be too long and incomprehensible for the average creditor) and/or a "summary thereof *approved by the court*."[67] Unfortunately, neither the Act nor the Bankruptcy Rules[68] set forth any procedure for the court to approve a summary of a plan or suggest whose summary this is to be. Perhaps it is to be done at the first meeting of creditors.[69]

The creditors are also to receive "any analysis" of the plans before voting.[70] Presumably, the reference made in this provision is to an advisory report on the plan prepared and filed by the SEC as under chapter X.[71]

Under section 97, however, the plan can be one like the New York municipal assistance exchange plan which has been offered to investors and partially completed before the filing under the Bankruptcy Act. Fleshing Nat'l Bank v. Municipal Assistance Corp. for the City of New York, 40 N.Y.2d 731, 390 N.Y.S.2d 22 (1976). *See also* Ropico, Inc. v. City of New York, 415 F. Supp. 577 (S.D.N.Y. 1976). In such case, the prior exchanges count as assenting votes. 11 U.S.C.A. § 417 (1976).

63. Bankruptcy Act § 92(b), 11 U.S.C.A. § 412(b) (1976). Section 92(c) and Bankruptcy Rule 9-25 (11 U.S.C.A. app. R. 9-25 (1976)) outline the criteria for computing the vote of creditors. Generally, only a creditor whose claim has been finally allowed can vote and the computation of the necessary majorities is based only on the actual votes cast. Abstentions do not count. This makes the debtor's task easier than under the former chapter IX which requires the debtor to obtain the written consent of the holders of two-thirds of the *total* claims against it. Thus, under the former chapter IX an abstention was a "No" vote.

64. Former Bankruptcy Act § 83(d), 11 U.S.C. § 403(d) (1970).

65. Bankruptcy Act § 362, 11 U.S.C. § 762 (1970).

66. The statute does have a cram-down provision for dealing with a class of recalcitrant creditors. *See* Bankruptcy Act § 92(d), 11 U.S.C.A. § 412(d) (1976). This provision cannot be used to deal with a reluctant minority within a class. H.R. REP. NO. 686, 94th Cong., 1st Sess. 31 (1975).

67. Bankruptcy Rule 9-24(b), 11 U.S.C.A. app. R. 9-24(b) (1976) (emphasis supplied).

68. Hereinafter referred to in the text as the Rules.

69. *But see* Bankruptcy Rule 9-17(b) which contains an agenda of the first meeting without mentioning the plan or a summary thereof. 11 U.S.C.A. app. R. 9-17(b) (1976). The draftsmen's comments suggest the approval will precede the first meeting of creditors. By way of contrast, sections 169-175 (11 U.S.C. §§ 569-575 (1970)) and Rules 10-301 to 10-305 (11 U.S.C.A. app. R. 10-301 to 10-305 (1976)) set out a clear court-supervised procedure in chapter X for ensuring that the investors have adequate information about a plan *before* voting on it. In chapter X, *before* any document soliciting voter approval of a plan can be presented to those affected by the plan, there are hearings after appropriate notice at which a record with respect to the plan is developed. Subsequently, the court is to approve a plan for submission to affected interests. Bankruptcy Act § 176; Bankruptcy Rule 10-304.

70. Bankruptcy Act § 90(b), 11 U.S.C.A. § 410(b) (1976); Bankruptcy Rule 9-24(b), 11 U.S.C.A. app. R. 9-24(b) (1976).

71. *See* section 172 of chapter X (11 U.S.C. § 572 (1970)); Bankruptcy Rule 10-303, 11 U.S.C. app. R. 10-303 (1976).

However, the SEC will also need a hearing of some sort in which to develop the record on which such an advisory report is to be based.[72] Unfortunately, neither the Act nor the Rules provides for such a hearing. The Rules should be amended to provide the same three step process of preliminary court approval after the full hearing, investor vote, and final court confirmation which now exists in chapter X.[73] Such procedures would assure a fair and informed vote by investors on the merits of the plan.

As under former chapter IX, the plan proposed by the debtor and approved by the creditors must be fair and equitable or it cannot be confirmed by the court.[74] However, the draftsmen turning to chapter X[75] and XI[76] added the additional requirement that it be "feasible."[77]

Fairness of the Plan

The fair and equitable phrase in bankruptcy reorganization embodies the "absolute priority" rule which, in the corporate context, requires that senior classes be compensated in full before any lower, junior class can receive anything for settling their claims against the debtor.[78] In the context of a

72. Bankruptcy Rule 10-303(a), 11 U.S.C. app. R. 10-303(a) (1976).

73. In chapter X, a hearing is held after which the court may or must, depending upon the amounts involved, submit any plan or plans it finds "worthy of consideration" to the SEC for an advisory report. Thereafter, another hearing may be held to explore questions raised in the SEC report. Next, the court approves the plan and it is submitted to those affected by it for a vote. Finally, if the requisite majorities approve the plan, and if the court is satisfied that the plan accords with the requirements of chapter X, then the court confirms the plan and it is implemented. *See generally* Bankruptcy Rules 10-302, 10-305, 10-307, 11 U.S.C.A. app. R. 10-302, 10-305, 10-307 (1976). *See also* SEC TENTH ANNUAL REPORT 141 (1944). The same procedure should be provided in the chapter IX rules.

74. Bankruptcy Act § 94(b)(1), 11 U.S.C.A. § 414(b)(1) (1976). The new statute omits the additional test formed in former section 83(e) that the plan be "for the best interests of creditors." 11 U.S.C. § 403(e) (1970). The draftsmen believed it to be redundant. H.R. REP. NO. 686, 94th Cong., 1st Sess. 14 (1975).

75. Bankruptcy Act § 221(2), 11 U.S.C. § 621(2) (1970).

76. Bankruptcy Act § 366(2), 11 U.S.C. § 766(2) (1970). *See also* Bankruptcy Act §§ 472(2), 656(2), 11 U.S.C. §§ 872(2), 1056(2) (1970) (these sections are included under chapters XII and XIII respectively).

77. Bankruptcy Act § 94(b)(1), 11 U.S.C.A. § 414(b)(1) (1976). The statute also sets up several other requirements for a plan to be confirmed by the court which are mostly carried over from former chapter IX. These provisions are designed to ensure that: (1) the plan does not unfairly discriminate in favor of any creditor or class of creditors; (2) it complies with chapter IX; (3) all payments to attorneys and others under the plan have been fully disclosed; (4) the debtor is acting in good faith; and (5) the debtor is not prohibited by state law from fulfilling the terms of the plan. *See* Advisory Committee Note accompanying Bankruptcy Rule 9-27, 11 U.S.C.A. app. R. 9-27 (1976).

78. *See generally* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939); Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 529 (1940). The effect of this rule in the corporate context is, for example, to require the interests of the shareholders of the debtor corporation to be cancelled unless all of the creditors of the corporation receive full payment for their claims either in cash or securities of the reorganized corporation. Generally, it requires valuation of the corporation to determine the value of claims against the debtor and the value of new securities being issued in exchange for those claims. *See* Protective Comm. v. Anderson, 390 U.S. 414 (1968). The rule applies to railroad reorganizations under section 77 and to corporate reorganiza-

chapter IX proceeding, the absolute priority rule has a different meaning. The test which has been generally articulated and applied in chapter IX proceedings in applying the fair and equitable standard in chapter IX is whether the cash or new securities which a creditor has received are "all that could reasonably be expected in all the existing circumstances."[79] The approach seemed to be that the court would try to determine the amounts and sources of reasonably anticipated future revenues and then try to decide how much of those revenues each claimant could have expected to receive. If what was being received in the reorganization approximated what the claimant could reasonably have expected to receive, the plan was "fair and equitable."[80]

This approach is easily workable in the context of small governmental units with few sources of income and few classes of creditors. In smaller cases, it is easier to identify and sort out the relative rights of each class of creditors in each source of income. Also, it is fairly easy to produce evidence on which to found a reasonable estimate of future income and then give each class of claimants a settlement in cash or securities which represents a fair exchange for that bundle of rights which that class has against the various sources of future income.[81] The question remains, however, as to how a court is to sort out the relative rights of each of the many classes of creditors of say New York City, or Cook County, Illinois, with total claims in the hundreds of millions of dollars, or even in the billions of dollars, against the innumerable sources of income available to those entities. The problem of doing the same thing with the rights of creditors and stockholders of an ordinary business corporation (even one worth "only" millions of dollars) which has given the courts enough trouble over the years,[82] pales by comparison. Such a process is likely to require years and millions of dollars in attorneys' fees to complete, if it can in fact be completed at all.

tions under chapter X but does not apply to chapter XI arrangement proceedings where the claims of creditors can be scaled down without any reduction of the interests of shareholders. *See* Bankruptcy Act § 366, 11 U.S.C. § 766 (1970).

79. *See, e.g.*, West Coast Life Ins. Co. v. Meced Irrigation Dist., 114 F.2d 654, 685 (9th Cir. 1940), *cert. denied* 311 U.S. 718 (1941).

80. Specifically, the United States Supreme Court explained that:

> [W]here future tax revenues are the only source to which creditors can look for payment of their claims, considered estimates of those revenues constitute the only available basis for appraising the respective interests of different classes of creditors. In order that a court may determine the fairness of the total amount of cash or securities offered to creditors by the plan, the court must have before it data which will permit a reasonable and, hence, an informed estimate of the probable future revenues available for the satisfaction of creditors. And where, as here, different classes of creditors assert prior claims to different sources of revenue, there must be a determination of the extent to which each class is entitled to share in a particular source, and of the fairness of the allotment to each class in the light of the probable revenues to be anticipated from each source.

Kelley v. Everglades Drainage Dist., 319 U.S. 415, 419-20 (1943).

81. *See, e.g.*, Taylor v. Provident Irrigation Dist., 123 F.2d 965 (9th Cir. 1941), *cert. denied*, 315 U.S. 821 (1942).

82. *See, e.g.*, Protective Comm. v. Anderson, 390 U.S. 414 (1968).

The negotiated composition approach of chapter XI, rather than the strict priority approach of chapter X, seems to be more appropriate to chapter IX. The absolute priority rule is a device to prevent junior classes of interest from overreaching by fraud or weight of numbers the interests of senior creditor classes. The rule is not constitutionally required. Municipal insolvency is hardly the context in which those in control of the debtor are going to be guilty of fraud and overreaching vis-a-vis the interests of small, widely scattered, unsophisticated investors with senior claims. This is so, particularly in light of the participation by the SEC in the proceeding. It would seem to be in the best interests of the debtor-municipality *and* its public investor creditors to wind-up the proceeding as quickly as possible in order to remove the cloud hanging over the city and to get the flow of payments to the public investors started again. This can best be done by eliminating the absolute priority rule from chapter IX.[83]

The new Act adds a new twist to chapter IX proceedings—the creation of priority, *unsecured* creditor classes. The plan must provide for full payment, ahead of all other secured and unsecured creditors, of: (1) the costs of administration; (2) obligations due on account of services or supplies provided the debtor within three months before the petition; and (3) all secured and unsecured claims of the United States.[84]

The concept of statutory priorities is new in chapter IX. However, priorities have long been employed for some time now in straight bankruptcy and in certain arrangement proceedings under the Act.[85] However, the section 64[86] priority provision differs from section 89[87] in one significant respect. Whereas section 64 orders priorities among unsecured creditors *after* the lien claims of secured creditors have been paid in full, section 89 mandates payments to certain types of creditors *before* the payments to secured creditors and without regard to whether the claim of the priority creditor is secured or unsecured. While it is not clear that Congress intended this result, the definitions of "creditor" and "claim" in chapter IX strongly indicate that chapter IX mandates a substantial reordering of priorities.[88] The effect of the new priority rules of chapter IX seem to greatly increase the risk taken by

83. *See* REPORT, *supra* note 15, Pt. II at 270, which recognizes the inappropriateness of the fair and equitable standard in municipal bankruptcies.

84. Bankruptcy Act § 89, 11 U.S.C.A. § 409 (1976).

85. *See* section 64(a) (11 U.S.C. § 104(a) (1970)) which applies in a straight bankruptcy, chapter XI, and section 659 of chapter XIII (11 U.S.C. § 1059 (1970)). There is no priority provision as such in chapter X. *See* Bankruptcy Act §§ 199, 216(3), 11 U.S.C. §§ 599, 616(3) (1970).

86. Bankruptcy Act § 64, 11 U.S.C. § 104 (1970).

87. Bankruptcy Act § 89, 11 U.S.C.A. § 409 (1976).

88. Bankruptcy Act §§ 81(1), 81(3), 11 U.S.C.A. §§ 401(1) 401(3) (1976). Section 89 requires the priority "creditors" to "be paid in full in advance of any distribution to creditors under the plan." 11 U.S.C.A. § 409 (1976). A "creditor" is defined in section 81(3) as a holder of a "claim." A "claim" is defined in section 81(1) to include both secured and unsecured claims.

investors in municipal bonds by forcing a reordering of contractual priorities in a bankruptcy proceeding.

The notion of affording priority to the costs of administering a proceeding and claims arising from the operation of a debtor in some given period immediately before the filing of a petition is not unknown in bankruptcy and reorganization. Costs of administration must be afforded a high priority in order to insure that the debtor will be able to both continue its operations after bankruptcy and secure the assistance of capable experts such as attorneys and accountants in working out its financial difficulties. Administration claims have therefore enjoyed a priority, for example, in chapter X, ahead of even secured claims.[89] There is no reason why administration claims should not enjoy a similar priority in chapter IX proceedings as well. Public policy requires the continued functioning of the debtor government during the pendency of the chapter IX proceeding. The only way this can be assured is if those who supply the debtor with goods and services and otherwise fund the debtor during the chapter IX case have prior assurance that they are not throwing good money after bad.

The first priority of section 89(1) should give workers, suppliers and bankruptcy counsel such assurance, thus keeping city hall, the police department, and the fire station open despite the bankruptcy. It can be presumed that municipal bondholders knew that their claims would be subordinated to administration claims in the event of insolvency at the time they purchased their securities.

Similarly, the priority afforded those claims arising from the operation of the debtor in the three months immediately preceding the petition is in effect, a "six months rule" only cut in half. Specifically, the "six months rule" is the railroad reorganization doctrine which affords priority, even over secured claims, to claims of creditors whose claims arose from operations of the railroad in the six months immediately preceding approval of a section 77 petition.[90] Its purpose is to encourage people to continue to deal with the debtor even though bankruptcy appears imminent. The provision makes good sense in chapter IX where the public interest requires continuity of services by the government even in the face of impending bankruptcy.

89. *See* 6A COLLIER, *supra* note 14, at 430-37. The priority of the administration claims over the secured claim may be limited to those situations where the chapter X proceeding benefited the secured creditor by, for example, preserving going-concern values. However, since such benefits can be routinely shown, administration claims in chapter X as a general rule can be said to enjoy a priority even over secured claims.

90. Wise v. Chicago, Rock Is. & Pac. Ry. Co. (*In re* Chicago, Rock Is. & Pac. Ry. Co.), 90 F.2d 312 (7th Cir.), *cert. denied*, 302 U.S. 717 (1937); Fosdick v. Schall, 99 U.S. 235 (1879). Some case law has applied the doctrine in chapter X, at least where the continued operation of the debtor is in the public interest. Mizrahi v. Martin (*In re* Hallmark Medical Serv., Inc.), 475 F.2d 801 (5th Cir.), *cert. denied*, 414 U.S. 1003 (1973).

In total dollar terms, the amount of these two categories of claims could run well into seven or even eight figures. In relative terms, however, the total amount of such claims will not represent a significant portion of the claims against the debtor. An insolvent city will only be able to go through one or two payless paydays before being forced to file a chapter IX petition. Thus, the amount of "three month" priority claims will not be comparatively significant.

The third category of priorities, on the other hand, does involve significantly greater fiscal impact. Section 89 provides priority to "debts owing to any person, which by the laws of the United States (other than this Act) are entitled to priority."[91] The *only* non-bankruptcy, priority statute is RS 3466.[92] Since 1797, this federal statute has given priority to *all* claims which the United States has against an insolvent debtor. This priority applies in theory to secured and unsecured federal claims alike.

The real significance of RS 3466 is, of course, with federal unsecured claims. The federal tax lien and other United States' secured claims do not need any additional priority. A lien enables the government to be assured of satisfaction of its claims.[93] It is the unsecured claims of the United States which need the assistance of RS 3466.

It has long been recognized that the priority afforded federal unsecured claims under RS 3466 does *not* move such claims ahead of prior, perfected, consensual liens which others have in the debtor's property.[94] Thus, absent section 89 (3) in the context of municipal insolvency under RS 3466, the unsecured claims of the United States ordinarily would be subordinated to claims of investors based on bonds secured by future tax revenues or other property.[95]

The new priority provision of section 89 (3) reverses this ancient rule and provides that *all* federal claims now come ahead of *all* other claims (save for administrative and "three month" claims), both secured and unsecured against a municipal debtor. Since RS 3466 covers all United States claims including tax or any other, the amounts of these claims in the event of federally guaranteed loans to a municipality on the road to bankruptcy, for

91. Bankruptcy Act § 89, 11 U.S.C.A. § 409 (1976).

92. 31 U.S.C. § 191 (1970) [hereinafter referred to in the text as RS 3466].

93. Phelps v. United States, 421 U.S. 330 (1975).

94. Exchange Bank & Trust Co. v. Tubbs Mfg. Co., 246 F.2d 141 (5th Cir.), *cert. denied*, 355 U.S. 868 (1957); United States v. Guaranty Trust Co., 33 F.2d 533 (8th Cir. 1929); Bank of Wrangell v. Alaska Asiatic Lumber Mills, Inc., 84 F. Supp. 1 (D. Alas. 1949). *See also* United States v. Texas, 314 U.S. 480, 484-85 (1941); Thelusson v. Smith, 15 U.S. (2 Wheat.) 396 (1817). *See* Bankruptcy Act § 64a(5), 11 U.S.C. § 104(a)(5) (1970), which gives unsecured claims of the United States limited priority over other *unsecured* claims in straight bankruptcy.

95. Of course, once a creditor has a proper perfected lien in the debtor's assets, the United States cannot thereafter obtain a prior lien in those same assets. United States v. New Britain, 347 U.S. 81, 85 (1954).

example, could be substantial. Thus, a creditor who believed it had negotiated a stable pledge of future revenues with the governmental debtor in order to minimize the risk of the loan[96] could find its security short lived in chapter IX as it waits for years while the city tries to pay off in full an unsecured claim owed to the federal government first.

It is unclear whether Congress intended this result or whether it is a legislative gaffe. In any case, section 89(3) would appear to materially increase the risk assumed by those who choose to lend to municipalities and other local governmental units. It would seem to be a provision that such financiers should keep in mind at the time of the investment, not at the time of insolvency.

Feasibility of the Plan

In addition to being fair and equitable and providing for payment of priority claims, the plan must be feasible. While both houses wrestled with the notion of requiring the debtor to present the court with a balanced budget, both eventually decided against that approach.[97] Instead the final bill opted for the less rigorous feasibility test.

> The feasibility requirement means that there is a reasonable prospect that the petitioner will be able to perform under the plan. That is, it must appear to the court, based on the petitioner's past and projected future tax revenues and expenses that it will have enough to make the payments required by the plan.[98]

This seems to be a sounder legislative approach. It gives the court greater flexibility and facilitates the proof of compliance with the statutory requirement which is prerequisite to the approval of the plan. At the same time, however, this approach still requires the court to protect investors by rejecting visionary schemes for resuscitation. Also, it obviates a potential tenth amendment (impermissible interference with local governmental powers) objection which could arise from a strict balanced budget requirement.

Once the plan is confirmed by the court, if a disbursing agent is appointed by the court, the debtor makes a deposit with the disbursing agency for the consideration to be distributed under the plan. At that point, the debtor

96. Security interests in local government financing are, of course, different from security interests in the private sector. Generally, a creditor cannot take a first mortgage on city hall since public policy would preclude the creditor from realizing on its security by foreclosure in the event of default. Generally, the municipality pledges a portion of certain specific or general future tax revenues and its good faith in levying and collecting those taxes. *See* L. MOAK & A. HILLHOUSE, CONCEPTS AND PRACTICES IN LOCAL GOVERNMENT FINANCE 316-27 (1975). Under old chapter IX, the creditor could generally anticipate that he would get first crack at the pledged revenues under the plan of composition. Section 89 puts the secured creditor *behind* the priority claims in distribution of the pledged revenues when they materialize. 11 U.S.C.A. § 409 (1976).

97. H.R. REP. NO. 686, 94th Cong., 1st Sess. 59-60 (1975); CONF. REP. NO. 938, 94th Cong., 2d Sess. 21 (1976).

98. H.R. REP. NO. 686, 94th Cong., 1st Sess. 59-60 (1975).

is discharged on all of its obligations except those existing under the plan.[99] Thus, the discharge does not wait until the debtor completes payments of the obligations issued under the plan, although the court does retain jurisdiction over the case for as long as it determines it is necessary for successful execution of the plan.[100] This might be as long as the term of the longest debt security instrument issued pursuant to the plan.[101]

The significance of the immediate discharge provision is the real possibility of a default by the debtor in meeting the obligations issued by it under the plan. In such event, the creditors would not be allowed to assert claims they had *before* the first chapter IX proceeding less any dividends received, but could only assert in a second chapter IX proceeding the unpaid portion of any reduced obligations issued to them under the abortive plan of reorganization confirmed by the first chapter IX court.[102] This is certainly a matter which the court must keep in mind in passing on the feasibility of the plan and contemplating the possibility of requiring the debtor to submit a balanced budget.

Other Provisions

Creditors should note one final point about the new chapter IX provision dealing with a municipality in shaky financial condition but which is not yet in bankruptcy. The former chapter IX was silent on the question of whether a chapter IX debtor acquired the avoiding powers of a straight bankruptcy trustee.[103] Accordingly, it was thought that a chapter IX debtor lacked the power to set aside preferences, or liens acquired within four months of bankruptcy.[104] The new chapter IX changes this view and expressly provides that the chapter IX debtor has the power to set aside preferences under section 60,[105] liens acquired against it by legal proceedings within four months under section 67a,[106] fraudulent conveyances under section 67d, unperfected secur-

99. Bankruptcy Act § 95(b)(1), 11 U.S.C.A. § 415(b)(1) (1976). Actually not all claims against the debtor are discharged. Creditors who had neither notice nor actual knowledge of the proceeding are not affected by the discharge. Bankruptcy Act § 95(b)(2)(B). *See* Bankruptcy Act § 17a(3), 11 U.S.C. § 35(a)(3) (1970). In addition, the plan does not affect a claim "excepted from discharge by . . . order confirming the plan." Bankruptcy Act § 95(b)(2)(A). While section 17 is clearly not applicable in chapter IX, it may be that the court has equitable powers to refuse the discharge of claims which would not be dischargeable under section 17. Thus, it would seem an investor, who bought securities of the debtor issued on the strength of a fraudulent prospectus, could argue that his claim should not be discharged for the policy reasons found in section 17a(2), even if the plan has been accepted by two-thirds in amount and a simple majority in number of his fellow investors.

100. Bankruptcy Act § 96(e), 11 U.S.C.A. § 416(e) (1976).

101. H.R. REP. No. 686, 94th Cong., 1st Sess. 35 (1975).

102. Compare Bankruptcy Act § 660 of chapter XIII. 11 U.S.C. § 1060 (1970).

103. Compare Bankruptcy Act § 342 of chapter XI which expressly gives a chapter XI debtor possession of such powers. 11 U.S.C. § 742 (1970).

104. 5 COLLIER, *supra* note 14, at 1597-99.

105. Bankruptcy Act § 60, 11 U.S.C. § 96 (1970).

106. Bankruptcy Act § 67a, 11 U.S.C. § 107(a) (1970).

ity interests under section 70c,[107] and pursuant to section 70e, other remedies available to its creditors under state law.[108]

The effect of these provisions is particularly ominous to unsecured creditors who settle with the debtor within four months of the petition. Such settlements with unsecured creditors could be preferential.[109] If the debtor refused to welch on its pre-bankruptcy bargain with its creditors, other creditors can compel the debtor to act by obtaining the appointment of a trustee to derivatively pursue the cause of action.[110]

It would seem, however, that these powers sound more ominous in theory than they are in practice. This is because it would seem to be virtually impossible to prove a case on behalf of a debtor municipality under sections 60, 67a, or 67d. An essential requirement of each of those sections is that the party seeking to set aside a transaction or lien must prove that at the time the transaction took place (or was perfected) the debtor was "insolvent". "Insolvent" for these purposes is not the inability of the debtor to meet current maturities but imports a version of the balance sheet approach to insolvency, *i.e.*, did the debtor's liabilities exceed its assets.[111] It would seem to be an insurmountable task in all but very simple cases to prove that on any given date the fair value of the assets of a large municipality was less than the amount of its liabilities. Thus, the possible impact of section 89(h) in the case of New York City is somewhat reduced. In any case, if Congress seriously intended for the debtor or its creditors to have these avoiding powers available as a tool in chapter IX, it would seem that the provision should be amended to make it clear that when the insolvency of the debtor must be proved, proof of either inability to pay debts or liabilities in excess of assets will suffice.

Summary

While it is clear that new chapter IX is a significant improvement over the old chapter IX, particularly in providing realistic access to bankruptcy relief for financially troubled local governments, it is also clear that the

107. Bankruptcy Act § 70c, 11 U.S.C. § 110(c) (1970).

108. Bankruptcy Act § 85(h), 11 U.S.C.A. § 405(h) (1976). *See also* section 85(g) which permits amounts set off by creditors within four months of bankruptcy to be recovered by the debtor without having to show insolvency or creditor knowledge. Thus, section 68 is not available to help creditors in chapter IX and the usefulness of protective devices such as compensating balances is severely limited.

109. But settlements with employees and suppliers on claims accruing within *three* months of bankruptcy would not be preferential in light of the high priority afforded such claims under section 89. *See also* Palmer Clay Prods. v. Brown, 297 U.S. 227 (1936).

110. Bankruptcy Act § 89(h), 11 U.S.C.A. § 409(h) (1976). For the procedure followed in pursuing these rights refer to Bankruptcy Rules 9-34, 9-35, 11 U.S.C.A. app. R. 9-34, 9-35 (1976).

111. For the purposes of sections 60 and 67a (11 U.S.C. §§ 96, 107a (1970)), the definition of insolvency is that found in section 1(19) (11 U.S.C. § 1(19) (1970)). Section 67d has its own insolvency definition, section 67(1)(d), which also focuses on the debtor's balance sheet.

statute was written in haste. It would seem that more careful thought and redrafting is necessary in the area of: (1) standards for the plan; (2) procedure for consideration of the plan; (3) review by the SEC and preliminary approval by the court of the plan *before* submission to a creditor vote; (4) the question of the use by a Chapter IX debtor of the straight bankruptcy trustee's avoiding powers; and, most importantly, (5) the priority of federal government claims.

NEW BANKRUPTCY RULES

In addition to the statutory changes in chapter IX and the adoption of chapter IX rules, completion of the rules process was achieved in 1975-76. On August 1, 1975, the rules for proceeding under chapters X and XII became effective. On August 1, 1976, the final part of the Rules, Part VIII dealing with railroad reorganizations under section 77 of the Act,[112] became effective. The statutory mandate given to the rulemakers was broad in that it authorized them to go so far as to overrule the procedural provisions of the Act by rule.[113] However, particularly in the chapter X area, the rulemakers have stretched this mandate to the limit by taking an even broader view of what provisions of the statute were procedural.

Chapter X Rules

Chapter X proceedings involve comprehensive, corporate reorganization proceedings for large, public businesses. Only corporate bodies are eligible for chapter X relief.[114] Chapter X provides that the proceeding can be begun by voluntary or involuntary petition.[115] In all but the smallest cases, the management of the debtor *must* be displaced by an independent, disinterested trustee.[116] The trustee, with the possible assistance of the SEC, investigates and reports to the court and the interested creditors and stockholders concerning the stewardship of prior management and the debtor's future business prospects.[117] The trustee, as well as any creditor and stockholder, proposes a

112. Bankruptcy Rules 8-1 to 8-706, 11 U.S.C.A. app. R. 8-1 to 8-706 (1976).

113. The enabling statute provides that:

> The Supreme Court shall have the power to prescribe by general rules the forms of process, writs, pleadings, and motions, and the practice and procedure under the Bankruptcy Act.
>
> Such rules shall not abridge, enlarge or modify any substantive right.
>
> . . . .
>
> All laws in conflict with such rules shall be of no further force or effect after such rules have taken effect.

28 U.S.C § 2075 (1970).

114. Bankruptcy Act §§ 126, 106(3), 11 U.S.C. §§ 526, 506(3) (1970). *See also* Bankruptcy Act § 1(8).

115. Bankruptcy Act § 126, 11 U.S.C. § 526 (1970); Bankruptcy Rules 10-101, 10-104, 10-105, 11 U.S.C.A. app. R. 10-101, 10-104, 10-105 (1976).

116. Bankruptcy Act § 156, 11 U.S.C. § 556 (1970); Bankruptcy Rule 10-202, 11 U.S.C.A. app. R. 10-202 (1976).

117. Bankruptcy Act § 167, 11 U.S.C. § 567 (1970); Bankruptcy Rule 10-208, 11 U.S.C.A. app. R. 10-208 (1976).

plan or competing plans of reorganization.[118] The court then holds a hearing on the proposed plans, submits them to the SEC for an advisory report and approves a plan.[119]

The plan can affect the rights of secured creditors, unsecured creditors and stockholders. However, the plan must be fair, equitable and feasible. In other words, it must satisfy the absolute priority rule. Thus, before any junior class can participate, senior classes must receive cash or securities in the reorganized corporation which amount to full satisfaction of their claims.[120] Accordingly, the rights of stockholders are commonly wiped out in chapter X, and unsecured creditors usually receive less than full payment.

Once the plan is approved initially by the court, it is submitted to those creditors and stockholders affected by it.[121] Then, it returns to the court for a second examination. If the court is satisfied that the plan is fair, equitable and feasible and the other requirements of the Act have been met, the court confirms the plan.[122] The plan is then put into effect and the reorganized corporation is sent back into the world to fend for itself.[123]

While this is the manner in which chapter X was intended to work, in practice, chapter X reorganizations are often long, expensive, and cumbersome proceedings. The success rate is relatively low and liquidation rather than reorganization is the most common result. The mandatory dislocation of management by a disinterested trustee makes it extremely unpopular with those in control of the debtor and the considerable expense and delay in payment makes it very unattractive to creditors. Nevertheless, chapter X is the appropriate legal avenue to pursue where a large, public, corporate debtor is involved which has a complex capital structure, problems with secured and unsecured creditors and where there is a need for a disinterested inquiry into the quality of management's performance.[124]

118. Bankruptcy Act § 169, 11 U.S.C. § 569 (1970); Bankruptcy Rule 10-301, 11 U.S.C.A. app. R. 10-301 (1976).

119. Bankruptcy Act §§ 171-174, 11 U.S.C. §§ 571-574 (1970); Bankruptcy Rule 10-303, 11 U.S.C.A. app. R. 10-303 (1976). Actually, the court could approve more than one plan which it finds to be fair and equitable and feasible and leave it to affected creditors and stockholders to choose between them.

120. *See generally* Bankruptcy Act § 174, 11 U.S.C. § 574 (1970); 6A COLLIER, *supra* note 14, at 607-37.

121. Bankruptcy Act § 179, 11 U.S.C. § 579 (1970); Bankruptcy Rule 10-305, 11 U.S.C.A. app. R. 10-305 (1976). The plan must be approved by two-thirds in amount of each creditor class affected, and if the debtor is not insolvent, by a majority of the shares of stock.

122. Bankruptcy Act § 221, 11 U.S.C. § 621 (1970); Bankruptcy Rule 10-307, 11 U.S.C.A. app. R. 10-307 (1976). *See also* Bankruptcy Act § 216, 11 U.S.C. § 616 (1970).

123. Bankruptcy Act §§ 228-229, 11 U.S.C. §§ 628-629 (1970); Bankruptcy Rules 10-306, 10-309, 11 U.S.C.A. app. R. 10-306, 10-309 (1976).

124. *See, e.g.*, SEC v. American Trailer Rentals, 379 U.S. 594 (1965). *See also* Bankruptcy Act § 328, 11 U.S.C. § 728 (1970); Bankruptcy Rule 11-15, 11 U.S.C.A. app. R. 11-15 (Supp. IV 1974).

The new Rules attempt to establish a procedural format for dealing with a large, complex proceeding involving thousands of creditors and stockholders. In general, the Rules do quite well. Unfortunately, however, the rulemakers endeavored to delete significantly some of the investor protection provisions of chapter X.

The chapter X rules, like the straight bankruptcy rules, are divided into nine parts. Part I deals with the initiation and assignment of the proceeding.[125] Probably the most significant rule in this regard is rule 10-103 which permits the entire case to be referred to a bankruptcy judge.[126] Formerly, under section 117[127] of chapter X, the case would be assigned to a district judge who could refer to the referee (bankruptcy judge) only those parts of the proceeding not reserved to the judge by chapter X.[128] The rule overrides this provision and provides an affirmative presumption of sorts that the entire case is to be heard by a bankruptcy judge. If either the local rule or the district judge to whom it is assigned permits, the entire case (or part of a case) can be referred to the bankruptcy judge. Since one can hardly imagine a district judge voluntarily crowding his docket with such a time consuming proceeding, rule 10-103 should have the effect of transferring virtually all chapter X cases to the bankruptcy court in order to avoid a bifurcated proceeding. It is submitted that this is in the interests of all parties.

Part II of the rules governs appointment of the trustee, duties of the trustee, intervention by parties, and compensation.[129] In all but the smallest chapter X case, *i.e.*, in any case where fixed liabilities are $250,000 or more, a trustee must be appointed.[130] In chapter X, the trustee is not elected by the creditors, as in straight bankruptcy,[131] but instead is appointed by the court.[132] The Rules continue the requirement of sections 156 to 158 that the trustee be "disinterested."[133] However, the concept of "disinterested" trustee as

125. Bankruptcy Rules 10-101 to 10-118, 11 U.S.C.A. app. R. 10-101 to 10-118 (1976).

126. Bankruptcy Rule 10-103, 11 U.S.C.A. app. R. 10-103 (1976).

127. Bankruptcy Act § 117, 11 U.S.C. § 517 (1970).

128. When the Act says a matter shall be heard by a "judge" and not by "the court," *only* a district judge can hear it. *Compare* Bankruptcy Act section 1(20) *with* section 1(9). For examples of such provisions in chapter X refer to Bankruptcy Act section 156 (appointment of a trustee), section 174 (approval of a plan), section 221 (confirmation of a plan) and sections 241-249 (awarding of fees). Of course the referee could hear these matters as special master and make recommendations to the judge. However, an inevitable result of section 117 was a bifurcated proceeding unless the district judge kept the *whole* case. The resulting overlap was often time consuming since this procedure proved to be little more than an idle ceremony wherein the district judges would confirm the bankruptcy judges' reports in the capacity of a special master in such matters normally reserved to the "judge."

129. Bankruptcy Rules 10-201 to 10-217, 11 U.S.C.A. app. R. 10-201 to 10-217 (1976).

130. Bankruptcy Rule 10-202, 11 U.S.C.A. app. R. 10-202 (1976).

131. *See* Bankruptcy Rule 209(a), 11 U.S.C.A. app. R. 209(a) (Supp. IV 1974).

132. Bankruptcy Rule 10-202, 11 U.S.C.A. app. R. 10-202 (1976). Whereas the power to select a chapter X trustee was reserved to the district judge under section 156 (11 U.S.C. § 556 (1970)), this rule permits the "court," *i.e.*, the bankruptcy judge, to make the appointment.

133. Bankruptcy Act §§ 156-158, 11 U.S.C. §§ 556-558 (1970). The provision for a second

defined in section 158 of chapter X is weakened in one significant respect by rule 10-202(c)(2)'s provision that: "[r]epresentation of a creditor or a stockholder of the debtor in a matter other than one which may become involved in the chapter X case need not be deemed of itself to affect the disinterestedness of an attorney."[134] The failure of the rulemakers to explain why this exception was limited to attorneys raises the inference that since lawyers wrote the rules, the bar attempted to merely take care of its own. Since either an employee or the agent of a stockholder or creditor could also serve equally well as trustee, it is submitted that if the standard of disinterestedness is to be eroded, then the exception should not be limited to lawyers.[135]

In any case, this provision overrules the Seventh Circuit's decision in *In re Chicago Rapid Transit Co.*,[136] thus, diluting the standards concerning disinterested parties. It is hard to see how one who has a client who has a significant interest in a case could be "disinterested" even if the representation of that client was confined to matters other than the chapter X case. If an actual conflict of interest is not created by such a dual representation, then certainly the appearance of a conflict is created. It is also hard to believe that a competent attorney with no prior connection with *any* party in interest cannot be found by the court after diligent inquiry to avoid the appearance of bias in what is necessarily a difficult situation for creditors and stockholders.

One of the clearly identified defects of prior reorganization processes

additional trustee who is not disinterested, found in section 156, is not found in rule 10-202. Thus, all trustees appointed in chapter X must be disinterested. Old management can no longer be retained with the title of additional trustees although the trustee could retain old management to assist him as employees of the debtor corporation in running the business without the title of trustee. General counsel to the trustee must also be disinterested, although special counsel need not be. Bankruptcy Rule 10-206(a), 11 U.S.C.A. app. R. 10-206(a) (1976). A rather Draconian provision is contained in rule 10-206(b) which threatens a trustee with total forfeiture of compensation if his general counsel is not in fact disinterested. The loss of compensation is limited to the situation where counsel conceals the facts regarding his conflict and the trustee fails to make diligent investigation into the lawyer's impermissible "connection." Since a chapter X trustee usually becomes the full-time chief executive officer of a large corporate debtor and is compensated accordingly, the amounts at risk could be substantial. How a layman could be expected to discover an attorney's connection before employment is unclear. However, a cautious trustee would make an inquiry in every case. Such inquiry would most likely be wasteful and unproductive in almost every case. The same end, disclosure of conflicts, can be accomplished without unnecessary waste of the trustee's time and energy by requiring counsel to live up to the ethical standards of the profession, under the gentle compulsion of the threatened loss of counsel's compensation for failure to disclose as provided in rule 10-206. 11 U.S.C.A. app. R. 10-206 (1976). Threatening the trustee's compensation is a case of unnecessary overkill and may discourage cautious but competent people from serving.

134. Bankruptcy Rule 10-202(c)(2), 11 U.S.C.A. app. R. 10-202(c)(2) (1976).

135. *But see* Meredith v. Thralls, 144 F.2d 473 (2d Cir.), *cert. denied*, 323 U.S. 758 (1944). Under rule 10-202(c)(2), an attorney who was or is an employee of a stockholder or creditor would not be barred from serving as *trustee*, although all other employees of the creditor or stockholder would be so barred. 11 U.S.C.A. app. R. 10-202(c)(2) (1976).

136. 93 F.2d 832 (7th Cir. 1937). This case was decided pursuant to former Bankruptcy Act § 77B, the predecessor to chapter X. Chandler Act, ch. 575, § 1, 52 Stat. 840 (1938) (current version incorporated at 11 U.S.C.A. §§ 501-676 (1976)).

was that court possessed the power to appoint trustees that were "sympathetic" to management.[137] This enabled old management to control the proceedings. Chapter X corrected this abuse and protected investors by insisting that those in control of the proceeding, the trustee and his counsel, should be totally disinterested. It seems strange and unjustified to now retreat from this high standard. There is no evidence that it has been impossible to find competent attorneys to serve as chapter X trustees who are free from all bias.

Part II of the chapter X rules retreats from the investor protection provisions of the Act in another area. Section 249 of chapter X is meant to protect investors from the evils of insider trading in the debtor's securities by providing that any fidiciary or other representative (including committees or attorneys) who buys or sells securities of the debtor after the fidiciary relationship begins forfeits all compensation from the debtor estate.[138] The provision is absolute in its terms. The court has no power to rescue the voluntary trader by prior or subsequent approval. The court's discretion is limited solely to situations of involuntary transfer by, for example, devise. Only in such cases can the court prevent application of the section 249 penalty by sanctioning the transfer.

Section 249 was meant to be a broad prophylactic rule. Insiders who traded knew they did so on automatic penalty of forfeiture of compensation.[139] There was no hope of trading and then obtaining a reprieve from a lenient court. The rulemakers changed this in rule 10-215(c)(4)[140] to permit the court to approve either before or after voluntary trading by insiders in the debtor's securities. By doing so, the penalty of loss of compensation was removed. This rule is likely to encourage insider trading in the debtor's securities while further eroding the investor protections of chapter X.[141]

As to the parties to the proceeding, rule 10-210 continues the democratization approach of chapter X by opening the proceedings to all interests. It provides for intervention of right for management, all creditors, stockholders, and indenture trustees. In addition, the investor protection role of the SEC as a

137. 6 COLLIER, *supra* note 14, at 1143-47.
138. Bankruptcy Act § 249, 11 U.S.C. § 649 (1970).
139. Wolf v. Weinstein, 372 U.S. 633 (1963).
140. Bankruptcy Rule 10-215(c)(4), 11 U.S.C.A. app. R. 10-215(c)(4) (1976).
141. Other than this, rules 10-215 and 10-216 generally make no changes in practice under sections 241-249 with respect to applications for and allowance of compensation to those who are entitled to compensation from the estate on account of services rendered during a chapter X case. Rule 10-217 makes it clear that the power of the court to examine transactions between the debtor and its attorney under section 60d (11 U.S.C. § 96(d) (1970)) and rule 10-220 applies in chapter X as well. *See also* Bankruptcy Rule 10-215(b), 11 U.S.C.A. app. R. 10-215(b) (1976). The court can set aside any attorneys' fees paid by the debtor in contemplation of bankruptcy and/or chapter X which it deems unreasonable. Contemplation of bankruptcy includes payments made by the debtor to a lawyer to avoid bankruptcy as, for example, in attempting to effect a common law composition or exchange of securities. *In re* Carter Semiconductor, Inc., BANKR. L. REP. (CCH) ¶ 66, 119 (E.D.N.Y. 1975).

party to the proceedings and permissive intervention by unions on the economic soundness of a plan is specifically provided for. The court is also given virtually unlimited authority to allow any other interest to be heard on a permissive basis.[142] In this regard, the rules make no change in the procedure under the statute.[143]

Part III of the chapter X rules contains the rules which relate to the procedure involved in the proposal, approval, and confirmation of the reorganization plan. Actually, the first step in the plan process is found in rule 10-208(a)(8) which requires the trustee to notify creditors and stockholders that they may submit proposals for a plan to the *trustee*.[144] The trustee is then given a period of time under rule 10-301 to file a plan or submit a report as to why a plan cannot be formulated.[145] Only *after* the expiration of the time afforded the trustee to act may the debtor, creditors and stockholders file their own plan proposals with the court.[146] The court then holds a hearing on the plan and submits such plans as it deems "worthy of consideration" to the SEC for an SEC Advisory Report.[147] Thereafter, a second (or continued) hearing is held on the SEC's report. If additional evidence is generated at that hearing, the plan or plans can be resubmitted to the SEC for a supplemental report.[148] Thereafter, the court approves a plan and sends it out for a vote.

The Rules make no change in the substantive requirement that in order to be approved a plan must be "fair and equitable and feasible."[149] In order to ensure that all affected parties will make an intelligent decision on the plan,

142. Bankruptcy Rule 10-210, 11 U.S.C.A. app. R. 10-210 (1976).

143. Bankruptcy Act §§ 206-208, 11 U.S.C. §§ 606-608 (1970).

144. Bankruptcy Rule 10-208(a)(8), 11 U.S.C.A. app. R. 10-208(a)(8) (1976). Rule 10-208 tracks closely with section 167 (11 U.S.C. § 567 (1970)) and requires the trustee to make an in-depth inquiry into and report with respect to the history, business, and affairs of the debtor. This inquiry and report serves two functions: (1) to uncover any causes of action against those who were responsible for the collapse; and (2) to provide information about the debtor's prospects on which the formulation of a plan can be based. The inquiry and report appear to be, and should be, mandatory.

145. Bankruptcy Rule 10-301, 11 U.S.C.A. app. R. 10-301 (1976).

146. Bankruptcy Rule 10-301(c), 11 U.S.C.A. app. R. 10-301(c) (1976). The draftsmen perceived that this requirement that the trustee get the first bite at the plan represents no change in present law and is an investor-protection device since it prevents "insiders" from acquiring control of the proceeding and steamrolling a plan.

147. Bankruptcy Rule 10-303(b), 11 U.S.C.A. app. R. 10-303(b) (1976). If indebtedness is at least $3,000,000, the reference to the SEC is mandatory; otherwise it is discretionary with the court. This is in accord with present section 172. 11 U.S.C. § 572 (1970). Here, the draftsmen should have changed the prior procedure. The need for an SEC report turns not on the number of dollars involved but on the number of investors involved. Since the SEC generally participates only in those chapter X proceedings in which public investors are involved, the draftsmen should have made plain reference mandatory in all cases where the SEC was a party and discretionary in all other cases.

148. Bankruptcy Rule 10-303(c), 11 U.S.C.A. app. R. 10-303(c) (1976). Again this codifies present, albeit non-statutory, practice.

149. Bankruptcy Act § 174, 11 U.S.C. § 574 (1970). In order to be approved, the plan must also satisfy the rather detailed requirements of section 216. 11 U.S.C. § 616 (1970).

the Rules provide the voter with summaries of the plan, the SEC report and the court's opinion approving the plan. The voter may, if the court so orders, receive a full text of any or all of the foregoing documents in addition to or in lieu of a summary.

This represents a change from a prior law which *required* transmission of the full plan.[150] Since the plan would rarely be comprehensible to a public investor, the transmission of a clear summary appears to make sense both from the point of view of facilitating an intelligent decision making process and as a matter of economy. The Rules continue the prohibition on solicitation of votes by any person, including the trustee, prior to the approval of the plan.[151] By appropriate reference to "other law," however, the Rules should make it clear that such solicitations are in appropriate cases subject to other proxy solicitation rules such as bankruptcy rule 208 and section 14 of the Securities Exchange Act of 1934.[152]

Probably the most significant change in the plan process is found in the area of voting by creditors and stockholders. Under section 179,[153] a plan must be approved by two thirds in *amount* of each class of creditors. If the debtor is not insolvent, the plan must also be approved by a majority of shares of each class of stock.[154] The requisite majorities were computed with respect to the stockholder's claims proved and allowed. Thus, if a creditor or stockholder, whose claim had been proved and allowed, failed to vote, the abstention was counted as a "no" vote.

Under rule 10-401, it is no longer necessary for most creditors and stockholders to file proofs of claim.[155] Accordingly, rule 10-305[156] computes only the votes of those who actually vote on the plan instead of basing the computation of acceptances and rejections on the proofs of claim. An abstention is of no force or effect.[157] Thus, it should be easier to obtain the

150. Bankruptcy Act § 175(a), 11 U.S.C. § 575(a) (1970). Compare Rule 10-303(e), 11 U.S.C.A. app. R. 10-303(e) (1976).

151. Bankruptcy Act § 176, 11 U.S.C. § 576 (1970); Bankruptcy Rules 10-303(c), 10-304, 11 U.S.C.A. app. R. 10-303(c), 10-304 (1976). The statute only prohibited the solicitation of acceptances. The rule prohibits the solicitation of either affirmative or negative votes.

152. 15 U.S.C. § 78n (1970). *See also* Rule 10-211(b), 11 U.S.C.A. app. R. 10-211(b) (1976).

153. Bankruptcy Act § 179, 11 U.S.C. § 579 (1970).

154. If the corporation is insolvent, the stockholders can receive nothing under the plan pursuant to the absolute priority rule and thus, since they have no interest in the business, they are not affected and do not vote. Bankruptcy Act § 179, 11 U.S.C. § 579 (1970).

155. Only creditors with disputed, contingent, or unliquidated claims and creditors and stockholders whose claims are not listed on the debtor's records need file a proof of claim. Bankruptcy Rule 10-401, 11 U.S.C.A. app. R. 10-401 (1976).

156. Bankruptcy Rule 10-305, 11 U.S.C.A. app. R. 10-305 (1976).

157. *See also* Bankruptcy Form No. 10-7, 11 U.S.C.A. app. Form No. 10-7 (1976). Actually it is not precisely accurate that an absention would always be of no force and effect. Rule 10-305(e) provides that the amount of creditors' claims and shares approving the plan shall "in no event be less than the requisite majorities of the filed and allowed claims and stock interests." 11 U.S.C.A. app. R. 10-305(e) (1976). Under rule 10-401, an indenture trustee may file a proof of

acceptances required for the adoption of a plan of reorganization.[158]

After the plan has been approved by the court and by those creditors and stockholders affected by it, it returns to the court for a second review (in fact, a *third* hearing) leading to the final step in the adoption of a plan of reorganization—which is confirmation. The approval of a plan does not affect the right of parties in interest to object to confirmation.[159] And the issues involved in confirmation are a good deal broader than those involved in approval by the court. In considering whether to confirm the plan, the court not only considers again whether the plan is fair and equitable and feasible, but, if the plan is one of reorganization as opposed to liquidation, the court must satisfy itself as to the suitability of those who are to manage the business. In any case, the court must be satisfied as to the bona fides of those proposing the plan and the manner in which acceptances were obtained.[160]

The Rules make no significant change in the statutory requirements in connection with confirmation. The only really significant provision in the Rules with respect to confirmation is the requirement that objections to the confirmation of a plan be filed at least ten days before the hearing on confirmation.[161] The Rules also provide "if more than one plan has received the requisite number of acceptances, the court shall consider the preferences indicated by the creditors and stockholders. . . in determining which plan to confirm."[162] This statement is close to a legal nullity. It does not limit the court's discretion to approve the plan which is less preferred by those affected. Notably, the text of this rule states what "ought" to be, not what "must" be. Thus, the rule should be changed to require the court to comply

claim for the entire class for which it is trustee. 11 U.S.C.A. app. R. 10-401 (1976). However, an indenture trustee is not a creditor for voting purposes. Individual investors whom it represents retain the right to vote themselves. Thus, the rules failed to carry over or change section 198 to the effect that when an indenture trustee files a claim for a group of public investor creditors, only actual votes count in the computation of the requisite majorities. 11 U.S.C. § 498 (1970). As a result, it may be argued that the plan must be accepted by two-thirds of the amount of bondholders or debenture holders, not just two-thirds of those voting. This argument assumes that the debenture or bondholders are a separate class of creditors. Abstention by such a creditor would be a "no" vote.

In the case of bearer-debt securities, this could be a serious problem. It might be avoided by either the indenture trustee declining to file a proof of claim or by a change in the rules. Since the rules do not *require* an indenture trustee to file a proof of claim, but merely permit it, and since the claims of debenture or bondholders are presumably not the type for which a claim must be filed under rule 10-401, it would be best for an indenture trustee not to undertake the useless task of filing the proof of claim. Failure to file affects no rights, including the indenture trustee's absolute right to be heard. *See* Bankruptcy Rule 10-210(a)(1), 11 U.S.C.A. app. R. 10-210(a)(1) (1976).

158. It should be remembered, however, that chapter X has "cramdown" provisions for forcing a plan on an unwilling class of creditors and stockholders. Bankruptcy Act §§ 216(7)-(8), 11 U.S.C. §§ 616(7)-(8) (1970). These provisions are not affected by the rules.

159. Bankruptcy Rule 10-303(h), 11 U.S.C.A. app. R. 10-303(h) (1976).

160. Bankruptcy Act § 221, 11 U.S.C. § 621 (1970). If the United States is a creditor, the court must satisfy itself that the requirements of section 199 are met. 11 U.S.C. § 599 (1970).

161. Bankruptcy Rule 10-307(a)(1), 11 U.S.C.A. app. R. 10-307(a)(1) (1976).

162. Bankruptcy Rule 10-307(a)(2), 11 U.S.C.A. app. R. 10-307(a)(2) (1976).

with the expressed preference of those with a stake in the reorganization so long as the preferred plan meets all of the other requirements of the statute.

After confirmation, the final step in the reorganization process is the execution or consummation of the plan. Consummation of the plan discharges the debtor from the unpaid balance of its debts and finally alters the interests of the stockholders.[163]

Probably the most important step in the consummation process is the point at which a plan is deemed "substantially consummated." At any time after a plan is approved up until the time the plan is substantially consummated, the plan can be modified. If the modification adversely affects the interests of creditors and stockholders, it must be approved by the requisite majority.[164] There is a limit, however, to the extent to which the plan may be changed. After a plan is substantially consummated, a modification which materially and adversely affects the interests of creditors or stockholders *cannot* be confirmed by the court even if approved by the requisite majority of the affected class.[165] Substantial confirmation occurs under rule 10-306(c)[166] when all of the property to be dealt with by the plan has been substantially transferred, the designated operators of the reorganized corporation have taken control and commenced operation of the business, and distribution to creditors and stockholders has begun.

Part III of the Rules also contemplate the procedure to be followed in the event the reorganization effort fails. In such cases, the court is given similar, but somewhat broader, discretion than under the statute to continue the reorganization effort.[167] Alternatively, the court can, upon failure to propose, approve, confirm, or consummate a plan, dismiss the chapter X, convert it in appropriate cases to straight bankruptcy or, under a newly added provision, convert the case to chapter XI with the consent of the debtor.[168]

163. Bankruptcy Act § 228, 11 U.S.C. § 628 (1970); Bankruptcy Rule 10-307, 11 U.S.C.A. app. R. 10-307 (1976).

164. Bankruptcy Act §§ 222-223, 11 U.S.C. §§ 622-623 (1970); Bankruptcy Rule 10-306(b), 11 U.S.C.A. app. R. 10-306(b) (1976). "Materially" and "adversely affected" is defined by section 107. 11 U.S.C. § 507 (1970). One difference in voting on a modification of an approved or confirmed plan and voting to approve a claim is that while an abstention is of no force with respect to voting on the plan under rule 10-305, with respect to a modification, an abstention is a "yes" vote since failure to reject is deemed an acceptance. 11 U.S.C.A. app. R. 10-305, 10-306(b) (1976).

165. 6A COLLIER, *supra* note 14, at 722-24. A cosmetic amendment which does not materially or adversely affect any class can be implemented even after substantial confirmation. Presumably, an amendment which does materially and adversely affect a class of creditors or stockholders could be confirmed even after substantial consummation of the plan if no one objected. However, the amendment could not be confirmed if a single member of the affected class objected.

166. Bankruptcy Rule 10-306(c), 11 U.S.C.A. app. R. 10-306(c) (1976).

167. *Compare* Bankruptcy Rule 10-308, 11 U.S.C.A. app. R. 10-308 (1976) *with* Bankruptcy Act §§ 236-238, 11 U.S.C. §§ 636-638 (1970).

168. The consent of the debtor is necessary because chapter XI is strictly a voluntary proceeding. Bankruptcy Act §§ 321-322, 11 U.S.C. §§ 721-722 (1970). Considering the alternatives

Conversions to straight bankruptcy should result only in extreme cases. In most cases, if reorganization proves impossible, the court should exercise the discretion given it to continue the chapter X case and direct the trustee to prepare a plan of orderly liquidation.[169] A plan of orderly liquidation is preferable to straight bankruptcy by preserving such going concern values as might exist for creditors, and by permitting negotiated sales of assets which will generate more for creditors than auction block, straight bankruptcy liquidation. In addition, the orderly liquidation approach avoids the unnecessary duplication of expenses of administration occasioned by the election of a straight bankruptcy trustee to succeed the chapter X trustee to carry out the liquidation.

Part IV of the chapter X rules relates to the claims of creditors and stockholders. The most significant provision of this is rule 10-401, which does away with the formal requirement of proof of allowance of claims in most cases.[170] Unless the claim of a creditor is disputed, unliquidated, contingent, or unscheduled, or the claim of a stockholder is somehow disputed or not of record, the creditor or stockholder does not need to file a proof of claim. Therefore, in most situations, the schedules and lists will control and few, if any, creditors or stockholders will have to file proofs of claim. This should reduce a high volume of useless paperwork.

One other rule practitioners should be aware of in Part IV is rule 10-404 which governs the right of a creditor to withdraw a claim.[171] Once a creditor has participated significantly in a chapter X case, the creditor loses the right to withdraw. In light of the United States Supreme Court's decision in *Katchen v. Landy*,[172] a creditor should carefully measure his exposure to the trustee's avoiding powers before significantly participating in a chapter X proceeding, *e.g.*, by voting on a plan or accepting a distribution under a plan. Otherwise, such a creditor might find himself submitting to the bankruptcy court's summary jurisdiction and be liable to the trustee not just for a setoff but for an affirmative judgment. A creditor client is hardly going to be elated with such a result.

Part V of the chapter X rules, dealing with the role of bankruptcy judges simply adopts Part V of the straight bankruptcy rules.[173] Part VI of the chapter

facing the debtor on failure of the chapter X, such consent should be a mere formality. The only reference to conversion in chapter XI is found in section 147 which contemplates a transfer at the outset, not after the failure of the chapter X. 11 U.S.C. § 547 (1970). *See also* Bankruptcy Act § 146(2), 11 U.S.C. § 546(2) (1970) and Bankruptcy Rule 10-117, 11 U.S.C.A. app. R. 10-117 (1976).

169. Bankruptcy Act § 216(10) permits such a plan. 11 U.S.C. § 616(10) (1970).

170. Bankruptcy Rule 10-401, 11 U.S.C.A. app. R. 10-401 (1976).

171. Bankruptcy Rule 10-404, 11 U.S.C.A. app. R. 10-404 (1976).

172. 382 U.S. 323 (1966).

173. *See* Bankruptcy Rule 10-103 which in effect transfers chapter X cases from district judges to bankruptcy judges. 11 U.S.C.A. app. R. 10-103 (1976). *See* text accompanying note 125 *supra*.

X rules tracks closely with Part VI of the straight bankruptcy rules. It contains numerous provisions with respect to the administration of the estate outside of the plan. Most notable here is rule 10-601 which provides that the filing of a petition operates as an automatic stay of the commencement or continuation of any proceeding against the debtor.[174] Any creditor wishing to proceed against the debtor or its property in a non-bankruptcy court must first seek the permission of the bankruptcy court. Since chapter X empowers the bankruptcy court to deal with the claims of secured creditors, unsecured creditors and stockholders, it would seem unlikely that the creditor would be allowed to proceed outside of chapter X. The stay is automatic and applies to everything from foreclosure or enforcement of any consensual, statutory, or judicial lien to arbitration.

Parts VII and VIII of the chapter X rules generally incorporate the straight bankruptcy rules dealing with adversary proceedings and appeals to the district court.[175] Part IX of the chapter X rules incorporates Part IX of the straight bankruptcy rules with some minor changes.

Chapter XII Rules

The chapter XII rules are not organized like the chapter X or straight bankruptcy rules. Instead, they are set up in a pattern similar to that of the chapter XI rules. There are sixty-two chapter XII rules, not broken out into organized parts, covering a variety of different subjects. The order of the rules, ranging from the petition, through the selection of a trustee and compensation to the parties, to the plan process and to matters of administration outside of the plan, is similar to, although not precisely the same as, the order of the straight bankruptcy, chapter X and chapter XI rules.

Chapter XII of the Act provides relief for unincorporated entities which own interests in real property and have difficulties with creditors secured by those real property interests.[176] Corporations are specifically excluded from chapter XII.[177] The proceeding is strictly voluntary and can be initiated by the debtor either on an original petition or in a pending bankruptcy proceeding before or after adjudication.[178] The filing of a chapter XII petition stays any straight bankruptcy proceeding involving the debtor[179] as well as the com-

174. Bankruptcy Rule 10-601, 11 U.S.C.A. app. R. 10-601 (1976).

175. Although section 208 and Rule 10-210(c) limit the appellate rights of the SEC, that limitation applies only to appeals from the district court to the court of appeals. Bankruptcy Act § 208, 11 U.S.C. § 608 (1970); Bankruptcy Rule 10-210(c), 11 U.S.C.A. app. R. 10-210(c) (1976). Thus, the SEC may appeal from the bankruptcy judge to the district court.

176. Bankruptcy Act § 406(1), 11 U.S.C. § 806(1) (1970).

177. Bankruptcy Act § 406(6), 11 U.S.C. § 806(6) (1970).

178. Bankruptcy Rules 12-6, 12-7, 11 U.S.C.A. app. R. 12-6, 12-7 (1976).

179. Bankruptcy Rule 12-7, 11 U.S.C.A. app. R. 12-7 (1976); *cf.* Bankruptcy Act § 425, 11 U.S.C. § 825 (1970).

mencement or continuation of any other proceeding against the debtor.[180]

The chapter XII case is automatically referred to a bankruptcy judge who handles the entire proceeding.[181] If the chapter XII case is by original petition, or in a pending bankruptcy before a trustee has been elected and qualified, the court may, on motion by any party for cause shown, appoint a trustee, or it may leave the debtor in possession.[182] If a straight bankruptcy trustee has qualified at the time of the chapter XII petition, that person *must* be appointed chapter XII trustee.[183] Receivers are rarely, if ever, appointed under chapter XII.[184]

As with any other reorganization proceeding, the heart of chapter XII is the plan. The purpose of chapter XII is to save the debtor's assets by financial rehabilitation, not liquidation. The plan may be proposed by the debtor with the petition or thereafter.[185] Also, a plan may be proposed by a secured creditor who has a security interest in realty and is affected by the plan. An unsecured creditor cannot propose a plan.[186] While the plan of arrangement must contain certain provisions under section 461,[187] basically a plan *must* affect creditors secured by realty and *may* contain provisions affecting unsecured creditors as well.

Since 1952, chapter XII has not contained a requirement that the plan be fair and equitable. For this reason the chapter XII plan is not subject to the absolute priority rule.[188] The plan must be in the best interests of creditors and feasible.[189] This simply means that the creditors must receive more under the

180. Bankruptcy Rule 12-43, 11 U.S.C.A. app. R. 12-43 (1976). *See also* Bankruptcy Act §§ 414, 427, 428, 507, 11 U.S.C. §§ 814, 827, 828, 907 (1970).

181. Bankruptcy Rule 12-5, 11 U.S.C.A. app. R. 12-5 (1976). The reference was formerly discretionary with the district judge.

182. Bankruptcy Rule 12-17(b), 11 U.S.C.A. app. R. 12-17(b) (1976). A debtor in possession has the avoiding and other powers of a bankruptcy trustee. Bankruptcy Act § 444, 11 U.S.C. § 844 (1970). *See also* Rule 12-22 regarding the operation of the business by a debtor in possession. 11 U.S.C.A. app. R. 12-22 (1976).

183. Bankruptcy Rule 12-17(a), 11 U.S.C.A. app. R. 12-17(a) (1976).

184. Although there is no authority by statute to appoint a receiver in chapter XII, there is some support for the notion that the court has the power to do so under section 2a(3). 11 U.S.C. § 11(a)(3) (1970). *See* 9 COLLIER, *supra* note 14, at 905-07. *See also* Advisory Committee Note to Bankruptcy Rule 12-17, 11 U.S.C.A. app. R. 12-17 (1976).

185. Bankruptcy Rule 12-36(a), 11 U.S.C.A. app. R. 12-36(a) (1976). This contrasts with section 423 which *required* the plan to be filed with the petition. 11 U.S.C. § 823 (1970). The rules continue the requirement of section 423 that schedules, statements of affairs, and a statement of executory contracts accompany or immediately follow the petition. Bankruptcy Rule 12-11, 11 U.S.C.A. app. R. 12-11 (1976).

186. Bankruptcy Rule 12-36(b), 11 U.S.C.A. app. R. 12-36(b) (1976). Unlike section 466 (11 U.S.C. § 866 (1970)), the rule does not require the creditor proposing the plan to have the backing of some given percentage of creditors.

187. Bankruptcy Act § 461, 11 U.S.C. § 861 (1970).

188. 9 COLLIER, *supra* note 14, at 1141-44. *See also* Bankruptcy Act § 472, 11 U.S.C. § 872 (1970). The plan *may*, however, take the absolute priority approach and exclude the debtor from retaining any interest in the property dealt with in the plan if the debtor has no equity in his property. *In re* Hamburger, 117 F.2d 932 (6th Cir.), *cert. denied*, 313 U.S. 572 (1941).

189. Bankruptcy Act § 472(2), 11 U.S.C. § 868 (1970).

chapter XII plan than they would in liquidation[190] and that the debtor will be able to make the payments required by the plan.[191]

The plan must then be approved by two thirds in amount of each class affected by it.[192] Only votes for or against the plan are counted in determining the vote. An abstention has no effect.[193] Once the plan is approved by the creditors, the debtor makes a deposit of cash to cover the costs of the proceeding and any initial cash distribution under the plan.[194]

If the court is satisfied that the plan meets the requirements of the statute,[195] that it has been proposed and accepted by the creditors in good faith, and that the plan is in the best interests of creditors and feasible, the court then confirms the plan.[196] If there is no objection to confirmation, the court may confirm the plan on the record without taking additional evidence.[197] If more than one plan has received the requisite creditor approval, the court chooses between the accepted plans. The court is to consider, but is not bound by, the weight of the creditor acceptances choosing which plan to confirm.[198] The confirmation of the plan operates as a discharge of the debtor from all dischargeable obligations provided for in the plan.[199]

If no plan is proposed or confirmed, the court may dismiss the case or adjudicate the debtor a bankrupt. If a creditor has filed a plan, the debtor cannot, as of right, have the case converted to straight bankruptcy; otherwise, the debtor has a right to insist on conversion to straight bankruptcy under any

190. Meyer v. Bowen, 195 F.2d 263 (10th Cir. 1952).

191. 9 COLLIER, *supra* note 14, at 1139-40. *See* Bankruptcy Form 12-F18, 11 U.S.C.A. app. Form 12-F18 (1976).

192. Bankruptcy Act § 468, 11 U.S.C. § 868 (1970); Bankruptcy Rule 12-37(d), 11 U.S.C.A. app. R. 12-37(d) (1976). Only the *amount* of the claims in a class is considered. The number of creditors in the class is irrelevant.

193. Actually, the way rule 12-37(d) is worded, if a creditor files a proof of claim and then abstains, the abstention would amount to a rejection. 11 U.S.C.A. app. R. 12-37(d) (1976). However, since rule 12-30 generally does away with the need to file a proof of claim in a chapter XII proceeding (11 U.S.C.A. app. R. 12-30 (1976)), the language of rule 12-37(d) should not be of significance.

194. Bankruptcy Act § 437(2), 11 U.S.C. § 837(2) (1970); Bankruptcy Rule 12-38, 11 U.S.C.A. app. R. 12-38 (1976). If the plan is proposed by a creditor or group of creditors, the deposit may be required of the creditor. 9 COLLIER, *supra* note 14, at 932-33. A disbursing agent may be appointed to receive the deposit. Bankruptcy Rule 12-38(a), 11 U.S.C.A. app. R. 12-38(a) (1976). If a trustee is appointed, the trustee must be appointed as disbursing agent. Thus, a disbursing agent is only used, if at all, when the debtor is in possession.

195. Section 461 of the Bankruptcy Act contains a rather elaborate list of requirements. 11 U.S.C. § 861 (1970).

196. Bankruptcy Act § 472, 11 U.S.C. § 872 (1970).

197. Bankruptcy Rule 12-38(d), 11 U.S.C.A. app. R. 12-38(d) (1976).

198. *Id.*

199. Bankruptcy Act § 476, 11 U.S.C. § 876 (1970); Bankruptcy Rule 12-42, 11 U.S.C.A. app. R. 12-42 (1976). Section 17 applies in chapter XII. 11 U.S.C. § 35 (1970). However, the provisions of section 17c(2) requiring the court to fix a time for filing section 17a(2), (4) or (8) objections are not mandatory but are merely permissive in chapter XII. Bankruptcy Rule 12-47, 11 U.S.C.A. app. R. 12-47 (1976). *See generally*, 9 COLLIER, *supra* note 14, at 1164-72.

circumstance.[200] Also, the rules permit optional adjudication or dismissal by the court sua sponte or at a creditor's request at any time prior to or after the confirmation of a plan under appropriate circumstances.

Finally, rule 12-28 provides for awards of compensation to be made by the court from the estate to the various parties in interest, their attorneys, and accountants.[201] The rule follows the general approach in the other chapters, such as chapter X, to encourage democratization of the reorganization process by taking a generous approach to the question of who may receive compensation for services rendered in the rehabilitation effort.[202] The court has the power to control the allowance process by examining transactions between the debtor and its attorney. Thus, the court may disallow any unreasonable amount of compensation paid by the debtor to an attorney in contemplation of and during bankruptcy.[203] The court can also deny awards of compensation to anyone acting in a representative or fiduciary capacity who at any time after begining to act in such capacity has traded in claims against the debtor.[204]

In light of the rapidly increasing popularity of chapter XII proceedings,[205] the chapter XII rules should make this previously overlooked chapter of the Bankruptcy Act more readily comprehensible to practitioners. Chapter XII is an attractive vehicle for an individual or unincorporated debtor who has trouble with creditors secured by realty, usually the most difficult class of creditors to be dealt with by a debtor. The Rules provide a simple, efficient procedure for such cases and should make counsel more willing to turn to chapter XII in appropriate cases.

CASE DEVELOPMENTS

United States Supreme Court

There have also been some significant developments in the area of bankruptcy case law. Late in the 1974-75 term, the United States Supreme Court considered and affirmed the decision of the Court of Appeals for the Seventh Circuit in *Phelps* v. *United States*.[206] The case involved a dispute

200. Bankruptcy Rule 12-41, 11 U.S.C.A. app. R. 12-41 (1976). This apparently is a change in prior law under sections 481-482. 11 U.S.C. §§ 881-882 (1970). Remember that chapter XII is strictly voluntary. A debtor can, however, be adjudicated without his consent, unless he is a farmer or a wage earner, as defined in Bankruptcy Act § 1(32), 11 U.S.C. § 1(32) (1970); Bankruptcy Rule 12-41(e), 11 U.S.C.A. app. R. 12-41(e) (1976).

201. Bankruptcy Rule 12-28, 11 U.S.C.A. app. R. 12-28 (1976).

202. *See* Bankruptcy Act §§ 241-243, 11 U.S.C. §§ 641-643 (1970); Bankruptcy Rule 10-215, 11 U.S.C.A. app. R. 10-215 (1976).

203. Bankruptcy Rule 12-29, 11 U.S.C.A. app. R. 12-29 (1976).

204. Bankruptcy Rule 12-28(d), 11 U.S.C.A. app. R. 12-28(d) (1976). *See also* Bankruptcy Act § 249, 11 U.S.C. § 649 (1970) and Bankruptcy Rule 10-215(c)(4), 11 U.S.C.A. app. R. 10-215(c)(4) (1976).

205. Wall St. J., Sept. 29, 1976, at 48, col. 1.

206. 421 U.S. 330 (1975).

between a bankruptcy receiver and the Internal Revenue Service over the right to possession of the proceeds of the bankrupt's assets. In between March and June of 1971, the government had assessed some $140,000 in taxes against the debtor, Chicagoland Ideel Cleaners, Inc. Instead of paying the taxes, the debtor made an assignment for the benefit of creditors in late June 1971. The assignee liquidated the assets for $38,000 and, in August 1971, the government filed a notice of tax lien against the debtor and served a notice of levy on the assignee. In September 1971, an involuntary bankruptcy petition was filed against the debtor and it was adjudicated a bankrupt. Phelps was appointed receiver and demanded that the assignee turn over the $38,000 to the bankruptcy court for its administration and distribution. The government challenged the turnover petition, claiming it was entitled to possession of the money by virtue of its pre-bankruptcy notice of levy on the assignee.[207] The bankruptcy judge and district court held for the receiver. The Seventh Circuit reversed and held that the government was entitled to the $38,000.[208] Since the Ninth Circuit had held that the bankruptcy trustee, not the government, was entitled to the fund under similar circumstances,[209] the Supreme Court granted certiorari.[210]

Phelps presented several questions concerning the law surrounding assignments for the benefit of creditors, federal taxes, and bankruptcy. Before considering the Supreme Court's opinion, however, the following concepts concerning bankruptcy assignments for the benefit of creditors should be noted.

In an assignment for the benefit of creditors, a debtor makes a complete transfer of all right, title and interest in all of his non-exempt property to a third party who is to liquidate the property and distribute the proceeds to the transferor's creditors. The transferee, the assignee for the benefit of creditors, takes only such interest in the debtor's property as the debtor had. Thus, if the debtor had subjected the property to security interests or liens, the assignee takes the property subject to those liens.[211] Normally, the assignment cuts off the opportunity of the debtor's unsecured creditors to obtain security interests and liens in the debtor's property.[212] For example, if a creditor obtains a judgment against the debtor and executes against the debtor's property after the debtor has made an assignment for the benefit of creditors, the execution will not serve to give the judgment creditor a lien in the property of the debtor

207. The assignee was a neutral party, not caring whether the government or Phelps got the money.

208. United States v. Phelps (*In re* Chicagoland Ideel Cleaners, Inc.), 495 F.2d 1283 (1974), *aff'd*, 421 U.S. 330 (1975).

209. Clements v. IRS (*In re* United General Wood Prods. Corp.), 483 F.2d 975 (1973).

210. 419 U.S. 1068 (1974).

211. Friedman v. First Nat'l Bank, 344 Mass. 593, 183 N.E.2d 722 (1962).

212. Brashear v. West, 32 U.S. (2 Peters) 607 (1833).

in the hands of the assignee.[213] However, when a debtor makes an assignment and then is adjudicated a bankrupt, ordinarily the assignee must yield to the bankruptcy trustee.[214] Further, a bankruptcy court has summary jurisdiction to compel the assignee to turn the property over to the bankruptcy trustee.[215]

This concept is a traditional one in bankruptcy law. The bankruptcy court has summary jurisdiction over all disputes surrounding claims against property which is in the actual possession of the debtor at the time of the petition. If the property in question is in the hands of a third party who asserts a bona fide adverse claim against that property, disputes respecting the debtor's title to or claims against that property must be resolved in plenary proceedings. However, even if a third party is in possession of the debtor's property at bankruptcy, the debtor will be deemed to be in constructive possession of property and, thus, summary jurisdiction will exist, where: (1) the third party is merely "the bankrupt's agent or bailee; (2) the property is held by some other person who makes no claim to it; and (3) the property is held by one who makes a claim, but the claim is colorable only."[216]

The assignee in *Phelps* had been in possession for less than four months and had made no claim to the property in its possession. Here, the assignee was a mere naked legal title holder for the benefit of creditors. For these reasons, the ordinary rule of section 2a(21)[217] and application of traditional bankruptcy doctrine would seem to be applicable and to require the assignee to hand the money in his possession over to the bankruptcy court for its summary jurisdiction and administration.

This was a result the government desperately wanted to avoid, however. Although its federal tax lien was properly perfected against bona fide purchasers and, thus, was good against the bankruptcy trustee under sections 67b and 67c of the Act,[218] the government feared a relatively obscure provision of the Act, section 67c(3). This section provides that *only* in the situation of a tax lien on personalty *not* reduced to possession, the tax lien (a secured claim) is subordinated to the costs of administering the estate and the

213. Reed v. McIntyre, 98 U.S. 507, 513 (1878). *See also* U.C.C. § 9-301.

214. Bankruptcy Act §§ 2a(21), 70a(8), 11 U.S.C. §§ 11(a)(21), 110(a)(8) (1970). Section 2a(21) operates only if bankruptcy follows within four months of the assignment.

215. Bankruptcy Act § 2a(21), 11 U.S.C. § 11(a)(21) (1970). "Summary jurisdiction" refers to the bankruptcy courts' exclusive jurisdiction over certain matters. "Plenary jurisdiction" on the other hand refers to disputes arising in the context of a bankruptcy proceeding which must be litigated in non-bankruptcy courts unless the defendant voluntarily allows the litigation to proceed in the bankruptcy court. Bankruptcy Act §§ 2a(7), 23, 11 U.S.C. §§ 11(a), 46 (1970). *See generally* Katchen v. Landy, 382 U.S. 323 (1966).

216. Taubel-Scott-Kitzmiller Co. v. Fox, 264 U.S. 426, 433 (1924).

217. Bankruptcy Act § 2a(21), 11 U.S.C. § 11(a)(21) (1970).

218. Bankruptcy Act § 67, 11 U.S.C. § 107 (1970). This was true because the government had filed a notice levy and served a demand on the assignee for the proceeds. I.R.C. § 6331. *See also* United States v. Pittman, 449 F.2d 623 (7th Cir. 1971).

pre-bankruptcy wage claims entitled to priority under sections 64a (1) and (2)[219] of the statute (unsecured claims). Here the IRS had a tax lien on personalty which it *had not* reduced to possession.

This is an alteration of the normal rule in bankruptcy that *all* valid secured claims come ahead of *all* unsecured claims[220] and that section 64 merely affects the order of distribution among unsecured creditors *after* all valid security interests have been satisfied. However, section 67c(3) contemplates the situation where the tax lien is not reduced to possession and where the debtor has actual or constructive possession of the property. In other words, 67c(3) applies only if the personalty subject to the tax lien is also subject to the bankruptcy court's summary jurisdiction. This is what the battle in *Phelps* was all about.

The government argued, and the Supreme Court agreed, that as a result of the federal tax lien law, as opposed to bankruptcy law, the property did not pass to the bankruptcy court's summary jurisdiction. The reasoning behind this argument is that when the government assessed taxes and demanded payment from the debtor *before* the assignment, it obtained an unfiled tax lien against the debtor's assets.[221]

While the unfiled tax lien could be cut off by a transfer to a bona fide purchaser, or by various subsequent lien creditors, it was not cut off by transfer to an assignee for the benefit of creditors.[222] Therefore, the assignee took the debtor's property subject to the unfiled tax lien.[223] Subsequently, the government served a notice of levy and demand[224] on the assignee. As the Supreme Court viewed it, the effect of the notice of demand was tantamount to constructive seizure and subsequently the assignee held the property on behalf of the government, not for the benefit of the debtor or its other creditors. Thus, at bankruptcy, the property was held by neither the debtor nor the one holding on the debtor's behalf. It was held by a third party, the assignee, who was holding on behalf of a claimant with a substantial adverse claim, the government. Where property is held by one asserting a real adverse claim, the property and disputes surrounding it do not pass to the bankruptcy court's summary jurisdiction for administration and, therefore, the subordination rule of section 67c(3) does not apply.

The *Phelps* decision seems to conflict with some basic bankruptcy notions. The general rule is that a secured creditor (whether the security

219. Bankruptcy Act § 64, 11 U.S.C. § 104 (1970).
220. Emil v. Hanley, 318 U.S. 515 (1943).
221. I.R.C. §§ 6321-6322.
222. I.R.C. § 6323.
223. The transfer by the *assignee* to a bona fide purchaser cut off the lien in the assets by the debtor. However, the tax lien was not lost. It merely shifted to the proceeds in the assignee's hands. *See* Loeber v. Leininger, 175 Ill. 484, 51 N.E. 703 (1898).
224. *See* I.R.C. § 6331.

interest arises by consent, operation of law, or legal proceedings) must have done everything possible to perfect and protect his security interest for bankruptcy.[225] It is true that for public policy reasons an exception to this rule has been carved out to protect certain statutory lienors who have been less than diligent in perfecting their liens before bankruptcy.[226] However, in section 67c(3), Congress required a higher degree of diligence of *governmental* statutory lienors than of other statutory lienors. After all, the government can be presumed to be far more capable of protecting its financial interests vis-a-vis its debtors than an auto mechanic, for example. Therefore, Congress stated a rather clear rule of public policy in section 67c(3). Unless the government was diligent in reducing its tax lien on personalty to possession before bankruptcy, then two other interests entitled to protection on public policy grounds (the costs of administration and the priority wage claims of the debtor's employees) would be promoted ahead of the less than perfect tax lien.

In *Phelps*, the government had been less than diligent. Had the debtor remained in possession of its assets during the assessment, demand and filing of the notice of tax lien, and then had been adjudicated a bankrupt without actual levy by the government, it is clear that section 67c(3) would have been applicable. Further, under section 70a(8), assignees for the benefit of creditors are denominated "agents for the bankrupt,"[227] so the result should be the same whether or not the debtor has made an assignment for the benefit of creditors.

However, the Supreme Court found the crucial point to be that the government had served a *notice of levy* on the assignee under section 6331 of the Internal Revenue Code[228] even though it admitted that it had not yet seized. Under the Treasury Regulations, "levy", *i.e.*, seizure, includes service of a notice of levy.[229] Regardless of whether the Treasury Department's broad redefinition of this statutory requirement was legitimate, suppose that instead of making an assignment, the debtor remained in control of the assets, that the government served a notice of levy on the debtor and that before actual seizure could be effected by the government, the debtor filed a bankruptcy. Clearly the rule of section 67c(3) would apply in such circumstances. It can be inferred that the result would not change when the notice is

225. *See generally* Bankruptcy Act §§ 70c, 70e, 11 U.S.C. §§ 110c, 110e (1970). Sometimes, even if a diligent creditor does everything possible to obtain, perfect, and protect a security interest or lien before bankruptcy, the perfected security interest is nevertheless subject to defeat by the trustee's avoiding powers. *See, e.g.*, Bankruptcy Act §§ 60, 67a, 67c(1)(A), 67c(1)(C), 11 U.S.C. §§ 96, 107(a), 107(c)(1)(A), 107(c)(1)(C) (1970).

226. *See* Bankruptcy Act § 67c(1)(B), 11 U.S.C. § 107(c)(1)(B) (1970).

227. Bankruptcy Act § 70a(8), 11 U.S.C. § 110(a)(8) (1970).

228. I.R.C. § 6331.

229. 26 C.F.R. 301.6331-1(a)(1) (1976).

served on a party deemed an agent of the debtor but actual seizure is not effected.[230]

In *Phelps*, the Supreme Court glossed over the implication of section 70a(8) in a footnote. Since sections 70a(8) and 67c(3) are federal *statutes*, it hardly appears appropriate that the policy implications embodied therein should be altered by a federal agency's own regulations which serve to relax and forgive an obligation of diligence which Congress has seen fit to impose on the tax collector.[231]

Seventh Circuit Cases

Several recent decisions handed down by the Court of Appeals for the Seventh Circuit are worth noting. *In re Browy*[232] involved a dispute between a trustee and an attorney who had represented the bankrupts prior to the bankruptcy. The attorney had possession of certain records of the bankrupts which the trustee wanted. The trustee brought a turnover proceeding and the attorney, who had not yet been paid his pre-bankruptcy fees, responded by asserting an attorney's lien on the records in his possession. The bankruptcy judge then dismissed the trustee's turnover petition.

Failing to succeed in the turnover proceeding, the trustee persevered. He next pursued an order requiring the attorney to appear for examination under rule 205.[233] Upon doing so, the trustee also served a subpoena duces tecum on the attorney requiring him to bring the same records of the bankrupts in which he asserted an attorney's lien to the examination. The bankruptcy judge refused to quash the subpoena and the district judge affirmed.[234] On appeal, the Seventh Circuit reversed.

The case is noteworthy for two reasons. First, it apparently marks the first time that the Seventh Circuit has considered the question of the validity of an attorney's lien in bankruptcy. The case arose in Illinois where attorneys, by following a notice procedure, can obtain a statutory lien for their fees on funds

230. The inference could arguably be the contrary in light of section 6332 of the Internal Revenue Code which would make any person holding property levied on by the government who fails to surrender it, personally liable for the tax. I.R.C. § 6332. However, suppose the taxpayer filed bankruptcy before the government seized the bankrupt taxpayer's property which was in the hands of a third party on whom a notice of levy had been served. In addition, suppose the bankruptcy court ordered the third party to turn over the property to the bankruptcy trustee. Under such circumstances, it is hard to imagine that the third party would be held personally liable for the bankrupt's tax under section 6332.

231. The author questions whether the result would have been different if the tax collector here was the state instead of the federal government and a state regulation or a state statute made service of a notice of levy tantamount to levy.

232. 527 F.2d 799 (7th Cir.1976).

233. Rule 205(d) permits the trustee or any party in interest to seek the examination of any person with respect to "the acts, conduct, or property of the bankrupt, or to any matter which may affect the administration of the bankrupt's estate . . . ." 11 U.S.C. app. R. 205(d) (Supp. IV 1974).

234. 527 F.2d at 800.

recovered or collected on behalf of a client.[235] However, attorneys in Illinois are also afforded a second, independent lien for unpaid fees, the attorney's common law or retaining lien. This permits an attorney to retain until fees are paid any property of a client which has come into the attorney's possession within the scope of his employment.[236] Since the lien is possessory and passive, the attorney cannot foreclose on it and simply is permitted to hold the documents or other property until he is paid. This retaining lien is strictly a common law possessory lien and is lost when the attorney surrenders the property.[237] It was this latter type of lien which was in issue in *Browy*.

The Seventh Circuit recognized the common law attorney's lien and enforced it against the trustee in bankruptcy.[238] The attorney's lien survived an attack under the trustee's "strongarm" clause, section 70c(3).[239] This provision gives the trustee the status of a creditor who obtained a lien by legal proceedings against all of the debtor's property on the date of bankruptcy.[240] Thus, "[w]henever under the applicable law such a creditor might prevail over prior transfers, liens, encumbrances or the like, the trustee will also prevail."[241] The validity of the attorney's retaining lien, therefore, was to be measured under Illinois law. The question to be answered was whether the attorney would have prevailed over the subsequent levying creditor if, on the date of bankruptcy, another creditor of *Browy* had levied on the documents in the attorney's hands. The answer under Illinois law is yes,[242] and, therefore, the attorney's lien was not vulnerable under section 70c of the Act. The court dismissed the trustee's section 70e attack on the attorney's lien since the creation of a common law attorney's lien could hardly be a transfer fraudulent or otherwise voidable by another creditor of the client under state law.[243] Thus, the court held that the common law attorney's lien would stand up against the bankruptcy trustee's avoiding powers.

235. ILL. REV. STAT. ch. 13, § 14 (1975).

236. Jovan v. Starr, 87 Ill. App. 2d 350, 231 N.E.2d 637 (1967).

237. Illinois case law actually recognizes a third type of attorney's lien, an equitable lien, which arises, if at all, in the contingent fee context. *See* Lewis v. Braun, 356 Ill. 467, 478, 191 N.E. 56, 61 (1934); Smith v. Young, 62 Ill. 210 (1871).

238. Other circuits have long recognized the validity of such liens in bankruptcy. *See, e.g.*, Davison v. Callaghan (*In re* Allied Owners' Corp.), 72 F.2d 255 (2d Cir. 1934).

239. Bankruptcy Act § 70c(3), 11 U.S.C. § 110(c)(3) (1970).

240. Lewis v. Manufactures Nat'l Bank (*In re* Lewis), 364 U.S. 603 (1961).

241. 4A COLLIER, *supra* note 14, at 559-60.

242. Great American Ins. Co. v. Dept. of Rev., 226 F. Supp. 512 (N.D. Ill. 1963).

243. The trustee apparently did not attack the creation of the lien as a preferential transfer vulnerable under section 60. 11 U.S.C. § 96 (1970). Whether the facts permitted such an attack is not clear. However, it is not difficult to conceive of a situation where such an attack would be possible. *See, e.g., Retention of Moneys Collected by Attorney in Payment of Fees Owed the Attorney on Account of Legal Services in Unconnected Cases,* 52 CHI. BAR REC. 264 (1971). While in such circumstances a statutory attorney's lien would be saved from being voided under section 60 by the operation of section 67b, a *common law attorney's* lien would not appear to come within the saving provision. *See also* Bankruptcy Act §§ 1(29a), 60d, 11 U.S.C. §§ 1(29a), 96(d) (1970).

The second noteworthy point in *Browy* is the remedy which the court fashioned. The court recognized that it was the policy of the Act to require the trustee to investigate dealings between the bankrupt and his creditors with a view toward finding transactions vulnerable to the trustee's avoiding powers. This policy would be frustrated unless the trustee had access to all of the bankrupt's records, including those in the hands of an attorney for the bankrupt. Yet, if the attorney turned over the records, the lien would be lost. Also, if he permitted the trustee to inspect or copy the documents, the bargaining advantage of the lien would be destroyed.[244] The court attempted to balance these conflicting considerations by holding that if the trustee wished to require the attorney to produce the bankrupt's documents in his possession for inspection, the trustee would have to recognize the claim of the attorney as fully secured. The effect of this is to create, in essence, a super-priority class of unsecured creditor.[245]

Obviously, the documents cannot be sold to produce proceeds to satisfy the attorney's claim because the monetary value of the documents is negligible.[246] Therefore, as the Seventh Circuit recognized, the attorney can be paid only out of the assets which would otherwise be available to unsecured creditors and if there are no such assets, "he would not be paid in any event."[247]

The logic of *Browy* is compelling. There seems to be no reason why attorneys' liens, both statutory and common law, should not be recognized in bankruptcy if such are recognized under state law. After all, a basic premise of bankruptcy is that valid secured claims are not affected by the proceeding.[248] *Browy* does an effective balancing of this policy and the trustee's need for access to the bankrupt's books and records. It, in effect, leaves it up to the trustee whether he is willing to pay the price of the attorney's pre-bankruptcy fee in order to inspect the documents of the bankrupt in the attorney's hands. In answering that question, the court asserts that the trustee can measure the importance of that inspection in terms of dollar recoveries that such documents are likely to produce for the estate. Practically speaking this is the value

244. Comment, *Compensation and Lien of Attorney: Whether Attorney is Entitled to Assert Lien as Basis for Refusal to Produce Records and Papers Subpoenaed in Case Against Client for Fees*, 34 CHI.-KENT L. REV. 181 (1956).

245. Under the court's analysis, the attorney is to be paid as a secured creditor and must be paid before any distribution can be made to unsecured creditors. 527 F.2d at 802. That apparently means that the attorney comes ahead of all such claims, including the trustee's expenses in administering the estate.

246. *But see* Bankruptcy Act § 57h, 11 U.S.C. § 93(h) (1970). It could be argued that in dollar terms the attorney's claim was in fact unsecured. That would certainly be the case if the trustee abandoned the documents. *See* Bankruptcy Rule 306(d), 11 U.S.C. app. R. 306(d) (Supp. IV 1974).

247. 527 F.2d at 802.

248. *See* Emil v. Hanley, 318 U.S. 515, 519-21 (1943).

of the security which the lawyer ultimately holds.[249]

Finally, the Seventh Circuit decided two cases which dealt with a problem which has perplexed bankruptcy courts for many years; the question of the dischargeability in bankruptcy of obligations arising out of familial disputes and duties.[250] The basic rule is relatively simple. Section 17a(7) on dischargeability provides an exception from discharge for liabilities "for alimony due or to become due, or for maintenance or support of wife or child. . . ."[251] The problem is determining just what obligations fit within the rule. The focus is one of purpose. If the purpose of the judgment or agreement is to fulfill duties of support, it is not dischargeable. If the purpose of the underlying obligation is a division of property, it is dischargeable.[252] Unfortunately which side of the line a given domestic debt falls on is often far from clear.

In *Nichols v. Hensler*,[253] the Seventh Circuit was confronted with the question of whether a debt which an Indiana divorce decree labelled as "alimony" was in fact a property settlement and, thus, dischargeable.[254] *In re*

249. A number of recent Seventh Circuit bankruptcy decisions involved questions of attorney's fees and activities in bankruptcy and insolvency proceedings. Attorney's fees cases included: SEC v. First Sec. Co., 528 F.2d 449 (7th Cir. 1976); Limperis v. United Merchants & Mfr., Inc. (*In re* Peerless Mfg. Co., 523 F.2d 110 (7th Cir. 1975)); Anastos v. M.J.D.M. Truck Rentals Co., 521 F.2d 1301 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976) (involving a malpractice action by a creditor against his attorney for failing to perfect a judgment lien before the debtor's bankruptcy. The creditor's malpractice action shared the same fate as its judgment lien). *See* Hamilton Steel Prods., Inc. v. Yorke, 376 F.2d 463 (7th Cir. 1967).

250. Actually, the problem is not confined to bankruptcy courts. By virtue of section 17c(1), the bankruptcy courts and state courts have concurrent jurisdiction to determine the dischargeability of certain kinds of debts, including familial obligations. 11 U.S.C. § 35(c)(1) (1970). Thus, state courts also have to deal with the question of whether a given claim arising out of a domestic relations dispute was discharged in a subsequent bankruptcy case. *See, e.g.*, Abrams v. Burg, 327 N.E.2d 745 (Mass. 1975); Morrey v. Morrey, 24 Ill. App. 3d 77, 320 N.E.2d 503 (1974); Pelusio v. Pelusio, 130 N.J. Super. 538, 328 A.2d 10 (1974).

251. Bankruptcy Act § 17a(7), 11 U.S.C. § 35(a)(7) (1970). No distinction is drawn between obligations based on contract, court decree or statute. The same approach is used. However, the question of whether such obligations are non-provable and, thus, per se non-dischargeable presents somewhat different issues. *See* 3A COLLIER, *supra* note 14, at 1838.

252. Joslin, *Bankruptcy From a Family Law Perspective*, 4 VAND. L. REV. 789, 798 (1956).

253. 528 F.2d 304 (7th Cir. 1976).

254. The litigative posture in *Nichols* is interesting. The divorce was granted in 1960. It provided for several different payments to the wife, all characterized as alimony. It included support for the wife, support for a child, and apparently a property settlement as well. Some of the payments were to stop on the wife's remarriage. The wife remarried and the former husband stopped all payments, not just those terminable on remarriage. At this time both parties were living in California where the wife obtained a state court judgment against her ex-husband which again was characterized as alimony. The ex-husband now deemed it propitious to go back home to Indiana. The ex-wife followed him there and brought a diversity action based on the California judgment. After she obtained a judgment for the "alimony" in a federal court, he filed bankruptcy, scheduling the judgment. The question of dischargeability arose when she sought to enforce her Indiana federal judgment after his bankruptcy. After the district court denied his motion to dismiss her supplemental proceeding, he agreed to the entry of the order denying the motion and providing for a further evidentiary hearing to be held later. He then appealed. The Seventh Circuit first had to consider whether this order denying the motion to dismiss was final

Cornish[255] involved the question of whether an award of fees to a wife's attorney in a divorce payable directly by her ex-husband to her attorney was dischargeable in the husband's subsequent bankruptcy. The court's approach in these cases was both internally consistent and in accord with prior case law in the area. In both cases, the court first held that "'alimony' under section 17a(7) means payments in the nature of support for a former spouse."[256] The court then went on to observe in *Nichols* that "[i]f the debt is determined to be one arising under a property settlement, it is discharged in bankruptcy."[257]

Whether a debt is dischargeable in bankruptcy is a federal question.[258] The issue to be determined is simply whether the obligation in question is one of the types which Congress intended to be excepted from the operation of the bankruptcy discharge and thus included as part of the list in section 17. What a state denominates as an obligation is not relevant in making this determination. A state cannot make an apple into an orange by saying hereafter all red fruit will be called "oranges." Similarly, it cannot transform a property settlement into non-dischargeable alimony by calling it "alimony." The question of dischargeability of debts in bankruptcy is within the exclusive province of Congress and states cannot usurp this function by broadening or altering the definition of terms which Congress has used. In using the term "alimony" Congress meant alimony in its traditional support function.[259] The question is whether *in fact* the debt is one for the provision of support or the division of property, no matter what the state calls it.

Applying that philosophy in *Nichols* and *Cornish*, the Seventh Circuit held that it was not bound by the state legislature's or court's characterization of an award as "alimony." Instead, it made an attempt to determine whether the purpose of the decree was support or property division. In this regard, however, the court started with the statutory and decisional law of the state creating the debt. The state statute and case law were relevant only insofar as they provided a clue as to whether the definition of "alimony" was to be limited to support payments. Although the court did not articulate it, a logical inference can be made that if local law limited awards of alimony to support situations, the bankruptcy court would assume that the state court adhered to local law and that, therefore, the obligation would be for support and non-dischargeable.[260]

and appealable. The court determined it was because the district court did not intend to consider further the question of dischargeability. Instead, the contemplated evidentiary hearing was merely a supplemental proceeding for determining his financial condition and to work out a method of paying her judgment.

255. Schiller v. Cornish (*In re* Cornish), 529 F.2d 1363 (7th Cir. 1976).
256. 528 F.2d at 307; 529 F.2d at 1364.
257. 528 F.2d at 307.
258. Note, *In Re Waller*, 50 AM. BANKR. L.J. 175 (1976).
259. Merriman v. Hawbaker, 5 F. Supp. 432 (E.D. Ill. 1934).
260. Waller v. Waller (*In re* Waller), 494 F.2d 447 (6th Cir. 1974).

However, state statutes and case law are rarely so limited. Thus, in both *Cornish* and *Nichols*, it was incumbent on the court to examine whether the award was in fact one for support. The court was able to determine on the face of the record in *Cornish* that the award of counsel fees was in fact for support. This is in accord with a virtually unbroken line of decisions.[261] The record in *Nichols* was not so clear. A variety of debts were involved and it was difficult to tell which fell into which category. Therefore, the Seventh Circuit returned the case to the trial court for further examination. The Seventh Circuit carefully told the trial court where to look.[262] Unfortunately, it did not tell the trial court *what* to look for.

The search for objective standards in this area has been a major source of frustration to bankruptcy and domestic relations lawyers alike.[263] Among the criteria which have been applied in determining whether an "alimony" obligation was for support or property division are: (1) whether the obligation called for periodic payments or a lump sum; (2) whether those payments were for a fixed term without regard to the recipient's death or remarriage; (3) whether the obligee was a former spouse or a third party; and (4) whether on the record as a whole there is extrinsic evidence of the parties' or court's intentions to effect a property settlement or provide for support.[264]

None of these criteria seem satisfactory in planning domestic relations litigation. Instead, it would be better for Congress to adopt the approach proposed in the Commission's bill which would provide an exception from the discharge of "any liability to a spouse or child for maintenance or support, for alimony due or to become due, or *under a property settlement in connection with a separation or divorce decree*."[265] While such a solution

261. 1A COLLIER, *supra* note 14, at 1669. It should be noted that, in reversing the district court on the question of dischargeability of these counsel fees, the Seventh Circuit relied heavily on Illinois precedent. It did so, however, merely to support its conclusion that the obligation derived in fact from the husband's support duties to his wife. This is an entirely proper approach since Illinois precedent interpreted the statute permitting awards of counsel fees in a divorce from a purpose perspective. *See* Merriman v. Hawbaker, 5 F. Supp. 432 (E.D. Ill. 1934); Morrey v. Morrey, 24 Ill. App. 3d 77, 320 N.E.2d 503 (1974).

262. Specifically, the court of appeals suggested that: "The transcript of the divorce hearing, if one exists, and other evidence of the parties' intentions should be considered. Of greatest significance will be evidence of the existence or non-existance of other marital properties not specifically described and allocated in the agreement." 528 F.2d at 309.

263. *See, e.g.*, Labovitz, *Alimony, . . . A Rose by Any Other Name May Not Provide the Same Cent*, 80 COM. L.J. 359 (1975); Branca, *Dischargeability of Financial Obligations in Divorce: the Support Obligation and the Division of Marital Property*, 9 FAM. L.Q. 405 (1975) [hereinafter cited as Branca].

264. Branca, *supra* note 263, at 413-18; Loiseaux, *Domestic Obligations in Bankruptcy*, 41 N. CAR. L. REC. 27 (1962).

265. H.R. 31, 94th Cong., 1st Sess. § 4-506(a)(6) (1975) (emphasis added). Contrast the judges' bill which provides as an exception to discharge "any liability to a spouse or child for maintenance or support, or for alimony due or to become due: *Provided however*, That a debt shall not be excepted from discharge hereinunder merely to hold the spouse harmless from her [sic] obligation in any manner to pay the debt." H.R. 32, 94th Cong., 1st Sess. § 4-506(a)(6) (1975). The "provided, however" clause is meant to overrule *In re* Waller, 494 F.2d 447 (6th Cir. 1974). Otherwise the judges' bill leaves the prior law undisturbed and unresolved.

may be Draconian, it would at least put an element of predictability into an area replete with vagueness and inconsistency. Since domestic relations lawyers often know little of bankruptcy and its possible consequences and since bankruptcy courts are ill-equipped to deal with domestic squabbles, such a clear rule will hopefully put an end to the substantial volume of wasteful litigation.