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BANKRUPTCY

COMMENTARY

THE ELECTION OF DIRECTORS AND CHAPTER 11—THE SECOND CIRCUIT TELLS STOCKHOLDERS TO WALK SOFTLY AND CARRY A BIG LEVER

*Michael A. Gerber**

INTRODUCTION

In 1980, when District Judge Duffy was presiding over the Chapter X reorganization of what was at the time known as the Duplan Corporation,[1] he received a number of letters from shareholders who were distressed about the direction in which the then three year-old case seemed to be headed. The court-appointed trustee had proposed a plan of reorganization that provided for a distribution of some cash and some shares of stock in the reorganized company to general creditors, noteholders, and debentureholders, but provided nothing for existing stockholders, whose equity interest was to be extinguished. One letter writer complained that no one seemed to be minding the case on behalf of stockholders; that no one — not the court, not the trustee, not the company's creditors, not even the Securities and Exchange Commission (SEC) — was "protecting the small investor."[2]

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* Associate Professor of Law, Brooklyn Law School. The author gratefully acknowledges the research assistance of Bruce Weiser, Class of 1987. For their valuable insights, the author also acknowledges nondischargeable debts of gratitude to Lawrence M. Powers, Esq., Marcia Goldstein, Esq., Lawrence Y. Solarsh, Esq., Judge Roy Babitt, and Brooklyn Law School Professors Arthur Pinto, Roberta Karmel, and Barry Zaretsky.

[1] In re Duplan Corp., Duplan Fabrics, Inc., Nos. 76 B 1967, 76B 1968 (Bankr. S.D.N.Y. Dec. 15, 1980).

[2] The letter read, in part:

April 10, 1980

Dear Judge Kevin T. Duffy,

As a judge, it is you who has the last word — but it is the judge who must accept the fact that "the buck stops here".

In 1985, when a group of stockholders of the Johns-Manville Corporation balked at a management-proposed and creditor-supported reorganization plan, which threatened to dilute their interest in the corporation by some 90%, they did not comfort or content themselves with letters. Instead, they took steps to compel Manville to convene an annual meeting of stockholders for the purpose of electing new directors, who, theoretically, might have negotiated a plan more favorable to stockholder interests. In so doing, they gave the Second Circuit Court of Appeals an opportunity to consider the extent to which the filing of a petition under Chapter 11 of the Bankruptcy Code,[3] and the

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It is quite easy for some involved individuals at the S.E.C. to make an analysis on paper and then submit their findings to you, based upon cold numbered facts.

It is the judge who must look into his own [conscience] and consider certain matters, not just the cold numbers.

The S.E.C. is truly not the protector of the investor — when it really mattters it is the judge who will, in the end, be responsible for the little man's plight.

As you can realize my letter is just an appeal to reason and fairness regarding your final decision in the Duplan Corp. case.

I know all about the greater debits vs. the assets — but I also know that the company has been making giant strides in its recovery. It is also quite obvious that if the company had been left to survive in its present state, it would have fully recovered and been able to be a viable organization.

However, this is water under the bridge. All I ask is that you do not wipe out completely the rights of the present stockholders. The least that can be done, is to give them some option to partake in the new organization.

To wipe them out altogether would truly be an injustice. These were investors who believed in our principles of business and in most cases understood the risks of investing.

Common stocks go up and down, but still they represent an equity in a public company. If a company fails, there still remain[] some values — whether it be good will or the potential [for] future earnings.

Therefore, to say that the common stockholders own nothing is not logical — it is a sell out to the professionals and bankers.

You as the judge, will be the only one who will be responsible. They will point to you and say it was his decision — "we only gave him our opinions based on facts."

The investor must be protected, just as the creditor is. He also takes risks and should have a chance to recover his losses.

Sincerely,
David Gilder

[3] The Bankruptcy Code (Bankruptcy Code or Code) was enacted pursuant to the Bankruptcy Reform Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978). The provisions of the Bankruptcy Code are codified in Title 11 of the United States Code. Chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 101-1174 (1982 & Supp.), contains the procedural and substantive framework for business reorganization cases.

continuation of a debtor in possession alters the right of stockholders to compel an annual meeting for the election of directors.[4] The question is not a novel one. It has come up, albeit infrequently, before.[5] Recently, however, the question has surfaced repeatedly,[6] suggesting that the issue of corporate governance, once rarely encountered in bankruptcy cases, may be becoming commonplace.

Precisely why the issue of corporate governance has become such a looming presence in reorganization cases is open to speculation. Although the phenomenon has not been studied empirically, it is probable that this heightened shareholder activism is a by-product of the interplay of several factors, most of which can be traced to changes wrought by the new Bankruptcy Code. Since these factors provide a useful backdrop for analyzing whether and how corporate democracy ought to be preserved while a Chapter 11 case is pending, they are worth examining at the outset.

I. Factors Contributing to Recent Shareholder Activism

A. *The Bankruptcy Code's Preference for Debtors in Possession*

One reason for the recent outbreak of these cases may be the fact that in reorganization cases governed by Chapter 11 of the Bankruptcy Code, the presumption is that management will not be supplanted by a trustee, and that the continuation of the debtor in possession will be the norm. As a result, in the vast majority of Chapter 11 cases, the corporate persona is left intact, managerial responsibility remains vested in the officers and the board, the basic allocation of corporate powers and duties is unaltered, and stockholders continue to expect officers and directors to function in their behalf.

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[4] *See In re* Johns-Manville Corp., 52 Bankr. 879 (Bankr. S.D.N.Y. 1985), *aff'd*, 60 Bankr. 842 (Bankr. S.D.N.Y. 1986), *rev'd and remanded*, 801 F.2d 60 (2d Cir.).

[5] *See In re* Potter Instrument Co., Inc., 593 F.2d 470 (2d Cir. 1979); *In re* Public Service Holding Corp., 141 F.2d 425 (2d Cir. 1944); *In re* J.P. Linahan, Inc., 111 F.2d 590 (2d Cir. 1940); *In re* Bush Terminal Co., 78 F.2d 662 (2d Cir. 1935); Graselli Chemical Co. v. Aetna Explosives Co., 252 F. 456 (2d Cir. 1918); *In re* Alrac Corp., 1 Bankr. Ct. Dec. (CCR) 1504 (Bankr. D. Conn. 1975).

[6] *See In re* Lionel Corp., 30 Bankr. 327 (Bankr. S.D.N.Y. 1983); Saxon Industries v. NKFW Partners, 488 A.2d 1298 (Del. 1984); *In re* Lifeguard Industries, Inc., 37 Bankr. 3 (Bankr. S.D. Ohio 1983).

It was not always thus. Chapter 11 of the Bankruptcy Code represents a hybrid of the business rehabilitation chapters of the former Bankruptcy Act — primarily Chapters X and XI.[7] Chapter X, which was enacted pursuant to the 1938 Chandler Amendments to the 1898 Bankruptcy Act,[8] was designed for the rehabilitation of large corporations having many strata of public and private debt, and thus it contained provisions intended to achieve this result while protecting the interests of public-debt holders and security holders. A reorganization plan under Chapter X could modify the rights of stockholders of the debtor corporation, and it could stretch out and scale down claims of secured and unsecured creditors.[9] Chapter X conferred standing upon the SEC to participate in reorganization cases both as an advocate on behalf of public-security holders and as an advisor to the court on many matters, including the fairness of reorganization plans.[10] Last, but not least of all, Chapter X required that management be displaced by a court-appointed trustee if the amount of the debtor's uncontingent liabilities was $250,000 or more.[11]

The presence and role of both the trustee and the SEC in the reorganization process were the products of depression-era reforms urged by William O. Douglas, who, while an SEC commissioner, had chaired a study of the treatment of public investors in corporate reorganizations.[12] The study focused on the two

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[7] Prior to the effective date of the Bankruptcy Code, bankruptcy cases were governed by the Bankruptcy Act of 1898, 30 Stat. 544 (1898). Chapter X ("Corporate Reorganizations") and Chapter XI ("Arrangements") were added to the Bankruptcy Act by the Chandler Act amendments, 52 Stat. 840 (1938). Bankruptcy Rules governing practice and procedure in Chapter XI cases became effective in 1974, and rules applicable in Chapter X cases became effective in 1975. The Rules were promulgated pursuant to 28 U.S.C. § 2075. The Bankruptcy Act of 1898, as amended, and the Bankruptcy Rules were repealed as of Oct. 1, 1979 by section 401 of the Bankruptcy Reform Act, Pub. L. No. 95-598, Tit. IV, sec. 401, 92 Stat. 2682 (1978). Hereinafter, the Bankruptcy Act of 1898 (as amended) will be referred to as the "Bankruptcy Act," or the "Act," and provisions thereof will be cited as "Former Act § __." Chapter X and Chapter XI Rules will be cited as "Former Bankruptcy Rule __."

[8] 52 Stat. 840 (1938).

[9] *See* Former Act § 216(1).

[10] Former Act §§ 172, 173, 175; Former Bankruptcy Rule 10-303.

[11] Former Act § 156; Former Bankruptcy Rule 10-202.

[12] The study generated a report, entitled "Securities and Exchange Commission Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees," which was published over the period 1937 to 1940 in eight parts, as follows: Part I, "Strategy and Techniques of Protective and

important corporate reorganization vehicles of yore, the federal equity receivership proceeding and its successor, the section 77B reorganization.[13] The Douglas study group was sharply critical of abuses that it believed were being committed on far-flung and hapless public security holders by corporate "insiders" and their bankers, whose common goal was to maintain control over the company.[14] To curb the potentially undesirable control of man-

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Reorganization Committees" (May 10, 1937); Part II, "Committees and Conflicts of Interest" (June 21, 1937); Part III "Committees for the Holders of Real Estate Bonds" (June 3, 1936); Part IV "Committees for the Holders of Municipal and Quasi-Municipal Obligations" (April 30, 1936); Part V "Protective Committees and Agencies for Holders of Defaulted Foreign Governmental Bonds" (May 14, 1937); Part VI "Trustees Under Indentures" (June 18, 1936); Part VII "Management Plans Without Aid of Committees" (May 10, 1938); and Part VIII "A Summary of the Law Pertaining to Equity and Bankruptcy Reorganizations and of the Commission's Conclusions and Recommendations" (Sept. 30, 1940). Hereinafter, the report will be cited as "Part ___, Douglas Report at ___."

An analysis of Justice Douglas's work on the report is contained in Hopkirk, *William O. Douglas — His Work in Policing Bankruptcy Proceedings*, 18 VAND. L. REV. 663 (1965).

[13] The equity receivership proceeding (a description of which appears in 6 COLLIER ON BANKRUPTCY ¶ 0.04 at 28-61 (14th ed. 1978) [hereinafter COLLIER]) was employed prior to 1934, when section 77B, the first federal statute governing the reorganization of financially distressed corporations, was added to the Bankruptcy Act. *See* 48 Stat. 911 (June 7, 1934). The enactment of section 77B was preceeded by the adoption of section 77A, which governed railroad reorganizations. *See* 47 Stat. 1467 (March 3, 1933). Accounts of the early history of corporate reorganization may be found in 2 A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 1228-1297 (5th ed. 1953) and COLLIER, *supra*, ¶ 0.01-0.13.

[14] The report stated:

> [R]eorganizers and investors will at times have different objectives in reorganizations. Investors will be interested in an expeditious, economical, fair, and honest readjustment of their company's affairs.
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> . . . .
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> Reorganizers at times have not been interested in fair reorganization, since fairness might seriously intrude into their own plans and affairs. Reorganizers at times have not desired honest reorganizations, in the investors' sense of the word, because such reorganizations would be costly to them. They have been motivated by other factors. And they have endeavored — in large measure with success — to mould the reorganization process so as to serve their own objectives.
>
> Reorganizers' objectives are significant largely in terms of control of the reorganization. The emoluments of control are the stakes of reorganization. Control means profits and protection. He who controls the reorganization controls in large measure the assertion of claims based on fraud or mismanagement which the company or the security holders may have against the management or the bankers. Thus he may be able to protect himself, his associates, his affiliated interests, his friends, if he has that control. He who controls the reorganization controls the dispensation of the vast amounts of business pa-

agement over the reorganization process, the Douglas study urged that a trustee be appointed in every reorganization case.[15]

As a practical matter, Congress adopted the recommendation. As enacted in 1938, Chapter X required that a disinterested trustee be appointed by the court to serve in any case in which the debtor's liabilities exceeded $250,000[16] — which meant in virtually every case. The trustee was obliged to take charge of the debtor's business; investigate the conduct of the debtor; report on any acts of misconduct, fraud, or mismanagement; prepare a report on the condition of the business for creditors, stockholders, and other interested persons; and formulate and propose a plan of reorganization.[17] Although parties other

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> tronage present in any reorganization . . . . He who dominates the reorganization will commonly be possessed of valuable inside information on which he can trade in the defaulted securities. He who controls the reorganization controls the selection of the underwriters for the new securities. This means in effect selection of the bankers for the new company. This in turn involves the large amount of business patronage customarily attaching to that position. He who controls the reorganization dominates the selection of the new management of the company. The management is the key to control of the company until the next reorganization. It is largely self-perpetuating due to its control over the proxies by which directors are annually elected . . . . In any event control of the new company means as a practical matter control over a vast amount of business patronage.

Part I, Douglas Report, *supra* note 12, at 2-5.

[15] Part VIII, Douglas Report, *supra* note 12, at 336-338.

[16] Former Bankruptcy Act § 156; Former Bankruptcy Rule 10-202(a).

[17] Former Bankruptcy Act § 167; Former Bankruptcy Rules 10-208 & 10-202. Echoing the words of the Douglas Report, the Act's legislative history described the role of the trustee as follows:

> These functions of the independent trustee appointed in the larger cases are difficult to overemphasize. In the first place, the trustee is required to assemble the salient facts necessary for a determination of the fairness and equity of a plan of reorganization. He assembles the necessary ingredients, so to speak, of a plan. For the first time such information will be available to the court and the investors as a routine matter. On the basis of such information, the court and the investors can intelligently decide whether or not proposed plans are fair, equitable, and sound — whether assets are being wasted or overlooked; whether there is a complete accounting for the old venture before the new one is launched; whether the old management should be restored to power; whether the allocation of assets, earnings, and control are fair. Through an impartial trustee, such facts will be assembled and apprised . . . . Without its own agent being fully informed and appraised, the court remains too much at the mercy of the competency, vigilance, and integrity (or lack of them) of those who happened to be active in the case. In sum, the independent trustee will put the court in a position to perform its functions adequately in . . . large, complex cases.
>
> In the second place, it is necessary to have an arm of the court perform

than the trustee could propose a plan,[18] the Act's legislative history makes it clear that the trustee was to bear ultimate responsibility for formulating and negotiating a plan.[19] Clearly, the trustee's was the laboring oar.

Chapter XI of the Bankruptcy Act was considerably less elaborate than Chapter X. Chapter XI was written with smaller, closely-held, "mom-and-pop" businesses in mind. Its provisions were consistent with the Douglas Report's finding that in cases involving small businesses, the interests of management and stockholders would normally be aligned and allied, and that in such cases the appointment of a trustee would be costly and superfluous.[20] Hence, in a Chapter XI case, the presumption was

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the functions which the bill places on the independent trustee, if there is to be a greater democratization in these proceedings. No significant progress can be made toward that end, however, unless machinery is set up in these proceedings whereby investor participation can be provided, the investor viewpoint can be articulated, and the investor interest be represented. It would be idle for example to provide that any bona-fide investor may propose plans without like-wise providing machinery for handling the proposals when they are made . . . .

It would be futile to attempt to return these bankrupt estates to their real owners without providing the mechanism whereby the real owners could come into possession and power. There must be power and responsibility in the hands of a qualified representative of investors. Otherwise disorganization may result. Investors must be afforded a "focal point" for organization. Such a device as the independent trustee furnishes them with one in the cases big enough to possess an appreciable investor interest. Without such a trustee, the desired power will not lie in investors' hands; it will rest where it always has, outside the proceedings in the hands of reorganizers.

H.R. REP. No. 1409 on H.R. 8046, 75th Cong., 1st Sess. 43-45 (1937), *reprinted in* COLLIER, *supra* note 13, ¶ 7.01 at 1178-1180 n.44.

[18] *See* Former Bankruptcy Rule 10-301(c)(1).

[19] For example, at Committee hearings, Douglas stated:

Under the Chandler bill the independent trustee would be the formulator, so to speak, of the plan of reorganization. Any security holder, creditor, or stockholder could submit to him his ideas as to what should go into the plan, or he could submit to him a full-fledged plan of reorganization. The independent trustee might call a meeting . . . . He would bring the various parties together, or see that they got together, and after he had gotten the benefit of their ideas and gotten them together and they traded out various provisions as to bonds and stocks and unsecured debts, and what not, he would then bring out a plan or plans and submit it to the court.

Hearings on H.R. 6439, 75th Cong., 1st Sess. 169 (1937) (Statement of William O. Douglas, SEC Comm.), *reprinted in* COLLIER, *supra* note 13, ¶ 7.26 at 1273 n.5.

[20] The report observed:

In ordinary bankruptcy proceedings, concerned with the insolvent individual, the debtor's role is understandably important in the working out of his fortunes, whether these proceedings be directed to liquidation or to composi-

that management would remain in possession of a debtor's assets and in control of its affairs unless a receiver was appointed for cause.[21] A Chapter XI plan could contain provisions stretching out or scaling down unsecured claims, but it could not modify the rights of secured creditors or stockholders.[22] Chapter XI gave the SEC special standing and gave the debtor the exclusive right to propose a reorganization plan.[23]

Not surprisingly, Chapter XI became the rehabilitation vehicle-of-choice not only of the managers of the small companies for which it was intended, but for the managers of large, publicly-held companies as well. Managers of financially beleagured corporations found the Chapter XI environment more congenial for several reasons. Since Chapter XI contemplated the continuation of the debtor in possession, it minimized the risk that management could be ousted from control. Since Chapter XI gave the debtor the exclusive right to propose a plan, it maximized management's leverage in plan negotiations. Since Chapter XI purported to deal with unsecured debt only, it offered a quicker and cheaper — if less comprehensive — financial fix than did Chapter X. No doubt some managers also wanted to avoid having their prior actions scrutinized by an independent trustee. As a result of this preference, by the mid-1970s fewer than 10% of all business reorganization cases were commenced under Chapter X.[24] Often, when a large public company sought refuge in Chapter XI, the SEC or a creditors' committee would

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> tion. Similarly, where the bankrupt is a small corporation with stock closely held by those who have managed the enterprise, the interposition of a corporate entity does not obscure the realities; there is a practical identity between the bankrupt corporation and its stockholders. Management and ownership are substantially one, and the case, at least in these respects, differs little from that of the individual debtor.
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> The large corporate debtor is far removed from such a state of facts. With stock widely scattered in a multitude of small holdings, and management and stockholders distinct groups, little identity may remain between ownership and control. When such a corporation is in bankruptcy or equity receivership it is irrelevant and confusing to speak of it as the debtor or bankrupt in the same way that these terms are applied to individuals.

Part VIII, Douglas Report, *supra* note 12, at 98.

[21] *See* Former Bankruptcy Act § 332. In some jurisdictions it took little to overcome the presumption favoring the debtor. In others, receivers rarely were appointed.

[22] Former Bankruptcy Act §§ 356 & 357.

[23] Former Bankruptcy Act § 306(1).

[24] H.R. REP. No. 595, 95th Cong., 1st Sess. 222 (1977) (hereinafter HOUSE REPORT).

seek to have the case converted to Chapter X. Typically, the movants would contend that the company could not be rehabilitated in the absence of a Chapter X-scale restructuring or the replacement of management by a trustee.[25] Sometimes the issue was litigated, sometimes the threat of conversion was applied merely to exact some concession from the debtor.[26]

When, in the 1970s, Congress began to think about overhauling the bankruptcy laws, there was much discussion as to whether a two-track reorganization system was necessary and whether litigation over the propriety of filing under one chapter or another might be avoided by the creation of a single rehabilitation chapter. Part and parcel of this debate was the question of whether a trustee was needed in every case. The Commission on the Bankruptcy Laws of the United States, which had been established by Congress in 1970 to study and recommend changes in the bankruptcy laws, urged that Chapters X and XI be merged into a single rehabilitation chapter.[27] Additionally, it recommended that a trustee be appointed in any case involving a corporate debtor having debts of $1,000,000 or more, and 300 or more security holders, unless the protection afforded by a trustee was found to be "unnecessary" or the expense of such protection "would be disproportionate to the protection afforded."[28]

The SEC believed that the need for a trustee in every case

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[25] *See, e.g.*, Securities and Exchange Commission v. American Trailer Rentals, 379 U.S. 594 (1965); General Stores Corp. v. Schlensky, 350 U.S. 462 (1956).

[26] HOUSE REPORT, *supra* note 24, at 223.

[27] The Commission found:

> An independent trustee is often desirable, especially in a case involving the reorganization of a corporate debtor having substantial indebtedness and publicly held securities. At the other end of the spectrum is the closely held corporate debtor whose existing management is essential to the continued operation; in such a case an independent trustee is not always needed and is often counterproductive. An arbitrary dividing line, such as the dollar formula of Chapter X of the present act, is undesirable. Indebtedness alone is not an adequate criterion. It does not take into consideration the nature of the ownership of the debtor or a need to continue existing management. This arbitrary approach has been a strong motive behind the expanded utilization of Chapter XI. It also has probably been a factor in delaying the commencment of reorganizations, to the ultimate detriment of security holders . . . .

REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess. Part I at 252-253 (1973). The report was published in two parts. Hereinafter it will be cited as "Part __, BANKRUPTCY COMMISSION REPORT, at __".

[28] Part II, BANKRUPTCY COMMISSION REPORT, *supra* note 27, at 221.

involving a public company was as great in 1976 as it had been in 1936. Echoing the words of the House Report that had accompanied the Chandler Amendments, the SEC asserted that a trustee was essential to enable "investors [to] intelligently decide whether or not proposed plans are fair, equitable, and sound — whether assets are being wasted or overlooked; whether there is a complete accounting for the old venture before the new one is launched; whether the allocation of assets, earnings, and control are fair."[29] The Commission viewed the trustee as the "machinery . . . whereby investor participation can be provided [and] the investor viewpoint can be articulated."[30]

The Senate version of the bankruptcy bill followed the SEC's recommendation. It provided for mandatory appointment of a trustee in any case involving a public company.[31] The Committee Report accompanying the bill explained:

> In a large public company, whose interests are diverse and complex, the most vulnerable today are public investors who own subordinated debt or equity securities. The bill, like chapter X, is designed to counteract the natural tendency of a debtor in distress to pacify large creditors, with whom the debtor would expect to do business, at the expense of small and scattered public investors.
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> . . . .
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> [I]nvestor protection is most critical when the company in which the public invested is in financial difficulties and is forced to seek relief under the bankruptcy laws . . . . As public investors are likely to be junior or subordinated creditors or stockholders, it is essential for them to have legislative insurance that their interests will be protected. Such assurance should not be left to a plan negotiated by a debtor in distress and senior or institutional creditors who will have their own best interest to look after.[32]

The House version was more liberal. The House drafters believed that management's preference for Chapter XI and the successful rehabilitation of many large companies in Chapter XI demonstrated that, in most cases, neither the public nor credi-

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[29] *Hearings Before the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary on H.R. 31 and H.R. 32*, 94th Cong., 2d Sess., Part 4, 2178 (1976).

[30] *Id.* at 2178-79.

[31] The Senate version provided: "In the case of a public company, the court, within ten days after the entry of an order for relief under this chapter, shall appoint a disinterested trustee." S. 2266, 95th Cong. 2d Sess. § 1104 (1978).

[32] REPORT OF THE COMMITTEE ON THE JUDICIARY, UNITED STATES SENATE, TO ACCOMPANY S. 2266, S. REP. No. 989, 95th Cong., 2d Sess. 10 (1978).

tors would necessarily be harmed by the continuation of debtors in possession. On the contrary, they believed that investors and creditors might benefit from the retention of management "because the expense of a trustee is not required and the debtor, who is familiar with his business will be better able to operate it."[33] Nevertheless, the House Committee acknowledged that there would be "cases where a trustee is needed, because cases of fraud or gross mismanagement do arise."[34] Therefore, the House version directed the court to order the appointment of a trustee "only if the protection afforded by a trustee is needed and the costs and expenses of a trustee would not be disproportionately higher than the protection afforded."[35]

The House and Senate compromise is embodied in section 1104(a) of the Bankruptcy Code, which provides that the debtor will be continued in possession unless, on motion of a party in interest or the United States trustee, the court shall order the appointment of a trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management," or "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate."[36] The circumstances in which courts have ordered the appointment of trustees are as varied as the misbehavior of business managers in trouble. For example, management has been ousted and a trustee has been appointed: where management's time and loyalty were divided between the debtor and other business interests;[37] where management had ineptly managed the company, had paid itself excessive compensation, had failed to remit taxes to the government, and had a history of failing in an industry where others were succeeding nicely;[38] where management failed to supervise bookkeeping operations with the result that sales proceeds were misused and the entire accounting system collapsed;[39] where the controlling shareholders admitted that they had mismanaged the debtor

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[33] HOUSE REPORT, *supra* note 24, at 233.
[34] *Id.*
[35] HOUSE REPORT, *supra* note 24, at 402.
[36] 11 U.S.C. § 1104(a) (1982 & Supp. 1986).
[37] *See In re* Concord Coal Corp., 11 Bankr. 552 (Bankr. S.D. W. Va. 1981).
[38] *See In re* La Sherene, Inc., 3 Bankr. 169 (Bankr. N.D. Ga. 1980).
[39] *See In re* Anchorage Boat Sales, Inc., 4 Bankr. 635 (Bankr. E.D.N.Y. 1980).

and also asserted claims against the debtor;[40] where it was alleged that the where debtor had fraudulently conveyed important assets on the eve of filing;[41] and where the president of the debtor had engaged in "faithless conduct," by converting corporate assets to his own use.[42] In at least one reported decision, minority stockholders sought and obtained the appointment of a trustee in order to prevent the debtor's controlling stockholder from proposing a plan to sell the debtor's assets to himself at a bargain price, which would have yielded enough to pay off all pre-petition claims and administration expenses, but would have provided nothing for stockholders. The minority stockholders showed that the controlling stockholder was ignoring higher bids, which would have netted something for the equity shareholders.[43]

The appointment of a trustee short-circuits the corporate chain of command. Generally speaking, a corporation is managed by its board of directors,[44] who are elected by the corporation's owners, the stockholders.[45] Although directors are the ultimate managers of a corporation, the officers, who serve at the pleasure of the board, normally manage and operate the business on a day-to-day basis.[46] When a trustee is appointed, all management functions and discretion are taken away from the officers and directors and are transferred to the trustee. As the Supreme Court recently observed, in holding that the trustee of a bankrupt corporation had the power to waive the debtor's attorney-client privilege:

> The powers and duties of a bankruptcy trustee are extensive. Upon the commencement of a case in bankruptcy, all corporate property passes to an estate represented by the trustee . . . . He is directed to investigate the debtor's financial affairs, and is empowered to sue officers, directors, and other insiders to recover, on behalf of the estate,

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[40] *See In re* Antilles Yachting, Inc., 4 Bankr. 470 (Bankr. D.V.I. 1980).

[41] *See In re* Russell, 60 Bankr. 42 (Bankr. W.D. Ark. 1985).

[42] *See In re* Colby Constr. Corp., 51 Bankr. 113 (Bankr. S.D.N.Y. 1985).

[43] *See In re* Philadelphia Athletic Club, 15 Bankr. 60, 62 (Bankr. E.D. Pa. 1981) ("Although the primary purpose of the bankruptcy courts is to preserve the debtor's estate in order to protect its creditors, where, as here, the rights of all creditors are fully protected, it is incumbent on the court to seek to protect the interests of the equity holders as well.").

[44] *See, e.g.*, DEL. CODE ANN. tit. 8, § 141 (1983).

[45] *See, e.g.. id.* § 211 (1983).

[46] *See, e.g., id.* § 142 (1983).

fraudulent or preferential transfers of the debtor's property. Subject to court approval, he may use, sell or lease property of the estate.

Moreover, in reorganization, the trustee has the power to "operate the debtor's business" unless the court orders otherwise.

As even this brief and incomplete list should indicate, *the Bankruptcy Code gives the trustee wide-ranging management authority over the debtor. In contrast, the powers of the debtor's directors are severely limited. Their role is to turn over the corporation's property to the trustee and to provide certain information to the trustee and to the creditors. Congress contemplated that when a trustee is appointed, he assumes control of the business, and the debtor's directors are "completely ousted" . . . . [T]he debtor's directors retain virtually no management powers . . . .*[47]

Since the appointment of a trustee renders management powerless, stockholders have little to gain by exerting what influence they have over directors. The focus of their attention tends to be fixed on the trustee. In contrast, when a debtor is continued in possession, business "continues as usual."[48] Management authority remains vested in the debtor's officers and directors,[49] and the attention of the investors remains fastened on them. Thus, when stockholders believe that a case is not going their way, they are now, more than ever, likely to apply pressure to the directors whom they elected and who, they presume, are still in place to represent their interests.

B. *The Relaxation of the Absolute Priority Rule and Other Changes in the Financial Standard for Confirmation*

Another reason for the recent spate of stockholder insurgencies may be certain changes in the law that have given stockholders considerably more leverage than they possessed in Chap-

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[47] Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343, 352-353 (1985). (citations omitted) (emphasis added). *See also* HOUSE REPORT, *supra* note 24, at 220-21. ("If a trustee is appointed, the management is completely ousted, although occasionally a trustee hires former management to handle day-to-day operations. The trustee is put completely in control of the business.").

[48] HOUSE REPORT, *supra* note 24, at 221.

[49] *Id.* Outside the Second Circuit, in a case involving a debtor whose directors had resigned en masse after the company had filed its Chapter 11 petition, the court designated an individual "responsible officer" of the companies to exercise the rights and perform the duties of a debtor in possession. *See In re* FSC Corp., 38 Bankr. 346 (Bankr. W.D. Pa. 1983). *See also In re* Gaslight Club, Inc., 782 F.2d 767 (7th Cir. 1986) (where the court entered a similar order with the consent of the president, controlling shareholder, directors and creditors of the debtor).

ter X, but which have, at the same time, rendered their equity interests considerably more vulnerable than they were in Chapter XI. The aim of Chapter XI was to allow a debtor to work out an arrangement with its unsecured creditors.[50] In order to become effective, a Chapter XI plan had to be accepted by the requisite number of creditors and confirmed by the court.[51] In order to be confirmed by the court, a plan had to pass what was known as the "best interests of creditors test."[52] A plan was said to be in the best interests of creditors if it would yield no less than what the creditors would receive if the debtor was liquidated.[53] Since, in a typical case, the assets of a debtor tended to be encumbered, this standard was not very difficult to satisfy. For the same reason, unsecured creditors had little incentive to have the case dismissed or converted to straight bankruptcy since liquidation would yield them little or nothing. Chapter XI contained no provisions authorizing the modification of equity interests,[54] and it gave the debtor the exclusive right to file a plan.[55] Working in tandem, these factors gave the Chapter XI debtor a considerable amount of leverage. Since the debtor's right to file a plan was exclusive, time was on the debtor's side. Since the best interests standard was easy to meet and since the debtor could not be compelled to give creditors an equity stake in the company, it was often possible for debtors to hold creditors (or at least their claims) hostage until they assented to the debtor's terms.

This is not to say that creditors never received stock in the debtor in exchange for the cancellation of indebtedness. Sometimes — particularly in the later cases involving large public

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[50] A plan of arrangement was to include "provisions modifying or altering the rights of unsecured creditors generally or of some class of them, upon any terms or for any consideration." Former Bankruptcy Act § 356.

[51] A Chapter XI plan had to be accepted by a majority in both number and amount of each class of creditors affected thereby. Former Bankruptcy Act § 362(1).

[52] Former Bankruptcy Act § 366(2) provided that "[t]he court shall confirm an arrangement if satisfied that . . . it is for the best interests of the creditors and is feasible."

[53] *See, e.g.*, Technical Color & Chem. Works, Inc. v. Two Guys From Massapequa, Inc., 327 F.2d 737 (2d Cir. 1964). *See generally* 9 COLLIER, *supra* note 13, ¶ 9.17.

[54] *Compare* Former Bankruptcy Act §§ 356 and 357 (which governed Chapter XI plans of arrangement) *with* Former Bankruptcy Act § 216(1) (which governed Chapter X plans of reorganization).

[55] Former Bankruptcy Act § 306(1).

companies — they did. Just as creditors in some cases realized that without "mom and pop" there would be no company and no recovery, debtors in some cases realized that the price of garnering creditor assent to a plan might be relinquishing some equity in the on-going enterprise. In such cases, stockholder approval of the recapitalization scheme was a necessary condition precedent to the confirmation of the plan, although not a component of the plan. Unless stockholders approved the recapitalization plan by the majorities required by applicable state law, the plan could not be confirmed.[56]

The dynamics were very different in Chapter X cases. As discussed in the preceding section, formulation of a plan of reorganization was the province of the trustee. Unlike Chapter XI, Chapter X expressly contemplated that stockholder's rights would be altered by a reorganization plan.[57] Moreover, in order to be confirmed by the court, a reorganization plan not only had to be accepted by the required majorities,[58] it also had to satisfy a financial standard far more stringent than the "best interests" test. A Chapter X plan had to conform to the "absolute priority rule." The rule was first articulated by the Supreme Court nearly a century ago in an equity receivership case, *Northern Pacific Railway v. Boyd*.[59] In that case, the Court held that a reorganization plan could not preserve the interests of stockholders unless creditors' claims were first satisfied in full.[60] A

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[56] *See, e.g.*, Posi-Seal Int'l Inc. v. Chipperfield, 457 F.2d 237 (2d Cir. 1972), and *In re* Potter Instrument Co. and *In re* Alrac Corp., discussed in text accompanying notes 120-24 and 118-19 *infra*. The modification of equity interests in Chapter XI is discussed in Blum & Kaplan, *Affecting Rights to Equity Interests Under Chapter XI of the Bankruptcy Act*, 1972 WIS. L. REV. 978.

[57] Former Bankruptcy Act § 216(1) provided:

> A plan of reorganization under this chapter . . . shall include in respect to creditors generally or some class of them, secured or unsecured, and may include in respect to stockholders generally or some class of them, provisions altering or modifying their rights, either through the issuance of new securities of any character or otherwise.

[58] A Chapter X plan had to be accepted by holders of two-thirds in the amount of claims of each class of creditors affected by the plan. If the company was found to be solvent, the plan also had to be approved by the majority of stockholders of each class of stock affected by the plan. Former Bankruptcy Act § 179.

[59] 228 U.S. 482 (1913).

[60] The Court explained that its holding did not "require the impossible, and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company." *Northern Pacific*, 228 U.S. at 508. The Court observed that claims could be satisfied by bonds or stock. *Id.*

plan did not pass muster under what came to be known as "the absolute priority rule"

> unless it provide[d] participation for claims and interests in complete recognition of their strict priorities, and unless the value of the debtor's assets support[ed] the extent of the participation afforded each class of claims or interests included in the plan. . . . Beginning with the topmost class of claims against the debtor, each class in descending rank must receive full and complete compensation for the rights surrendered before the next class below may participate. Thus the principle is applied as between senior and junior secured creditors, between secured creditors and unsecured creditors, between unsecured creditors and stockholders, between different classes of stockholders, and, of course, between secured creditors as a whole and stockholders.[61]

Three decades later, Justice Douglas concluded that when Congress provided that a plan had to be "fair and equitable,"[62] it intended to import the absolute priority rule of *Northern Pacific* into Chapter X. In *Case v. Los Angeles Lumber Co.*,[63] the Court refused to confirm a plan that permitted stockholders of an insolvent corporation to retain a 23% post-confirmation interest in the debtor. Writing for a unanimous court, Justice Douglas rejected the contention that the continued participation of the stockholders was justified by their familiarity with the business, their standing and influence in the financial community, and their promise of continuity of management. He reasoned that if stockholders were to retain an interest, a larger, more concrete contribution would be required.[64] Moreover, the

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[61] 6A COLLIER, *supra* note 13, ¶ 11.06 at 210-214 (footnotes omitted).

[62] Former Bankruptcy Act §§ 174, 221(2).

[63] 308 U.S. 106 (1939).

[64] Justice Douglas explained:

[W]e believe that to accord "the creditor his full right of priority against the corporate assets" where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.

The alleged consideration furnished by the stockholders in this case falls short of meeting those requirements.

The findings below that participation by the old Class A stockholders will be beneficial to the bondholders because those stockholders have "financial standing and influence in the community" and can provide a "continuity of management" constitute no legal justification for issuance of new stock to them . . . . On the facts of this case they cannot possibly be translated into money's worth reasonably equivalent to the participation accorded the old

Court held that the reorganization plan ran afoul of the absolute priority rule even though 80% of the bondholders and 90% of the stockholders had assented to it. Absolute meant absolute. Classes of senior creditors could not give up value to junior creditors and interests even if they chose to do so. The Court feared that even the mere possibility of such an arrangment would give insider stockholders leverage to demand the kind of treatment that led to the passage of Chapter X in the first place.[65]

That Justice Douglas was a principal exponent of the absolute priority rule in Chapter X cases should come as no surprise, given his long history as champion of the rights of public investors and as the nemesis of insiders. To be sure, in the early days, the absolute priority rule did protect public investors, for at that time public investment tended to be in senior bonds, and stock

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> stockholders. They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities. As such, they cannot be the basis for issuance of stock to otherwise valueless interests. The rigorous standards of the absolute or full priority doctrine of the *Boyd* case will not permit valueless junior interests to perpetuate their position in an enterprise on such ephemeral grounds.

Id. at 122-23.

[65] Justice Douglas wrote:

> If the reorganization court were bound by such conventions of the parties, it would be effectively ousted of important duties which the Act places on it. Federal courts . . . would be required to place their imprimatur on plans of reorganization which disposed of the assets of a company not in accord with the standards of "fair and equitable" but in compliance with agreements which the required percentages of security holders had . . . made. Such procedure would deprive scattered and unorganized security holders of the protection which the Congress has provided them . . . . The scope of the duties and powers of the Court would be delimited by the bargain which reorganizers had been able to make with the security holders before they asked the intercession of the court in effectuating their plan. Minorities would have their fate decided not by the court in application of the law of the land . . . but by the forces utilized by reorganizers in prescribing the conditions precedent on which the benefits of the statute could be obtained. No conditions precedent to enjoyment of the benefits of [bankruptcy law] can be provided except by the Congress. To hold otherwise would be to allow reorganizers to rewrite it so as to best serve their own ends.

Id. at 128-29. *Compare* Former Bankruptcy Act § 366, which provided that "Confirmation of an arrangement shall not be refused solely because the interest of a debtor, or if the debtor is a corporation, the interests of its stockholders or members will be preserved under the arrangement." This provision was added to the Act in 1952 in recognition of the fact that if the absolute priority rule were to be applied in Chapter XI cases, "no individual or corporate debtor (where stock ownership is substantially identical with management) . . . can effecutate [a] . . . plan." S. Rep. No. 1395, 82d Cong., 2d Sess. 11-12 (1952).

tended to be in the hands of insiders. By the 1970s, however, non-insider public investors were more likely to own subordinated debentures and stock, and the absolute priority rule operated to their disadvantage. Indeed, the rule seemed to favor large institutional investors who held senior and secured bonds, and who exercised as much influence over the operation of the debtors as the insiders of the earlier era.[66] Thus the rule was said to "strike[] hardest at those it was designed to protect — the public investor and the public creditor."[67]

Another problem with the rule was that it was difficult to apply. To determine whether equity holders were entitled to retain an interest in the reorganized company, it was necessary to determine whether the going concern value of the debtor exceeded the debtor's liabilities. If it did, equity holders would be entitled to participate in the reorganization; if it did not, equity interests would be wiped out. Determining the going concern value of a business requires capitalizing projected earnings at the appropriate rate. While theoretically precise, the valuation process does not always work very well in practice. Critics have characterized it as inherently uncertain[68] and as "a guess compounded by an estimate."[69]

The *Duplan* case[70] demonstrates both the difficulty of applying the absolute priority rule and its adverse impact on stockholders. In August 1976, when the double-knit leisure suit market unraveled, Duplan Corp., a manufacturer of double-knit fabrics, sought refuge in Chapter XI. The SEC moved the case into Chapter X in October of that year, and a trustee was appointed. Three years later, the trustee proposed a reorganization plan which provided that, in satisfaction of their claims, general creditors would receive a combination of cash and stock in the reorganized company, that noteholders would receive only stock, and that existing stockholders would be eliminated. The noteholders objected to the plan on the ground that in determining the going concern value of the reorganized company (and thus the value of its shares) the trustee had either inflated projected

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[66] HOUSE REPORT, *supra* note 24, at 222.

[67] Part I, Bankruptcy Commission Report, *supra* note 27, at 256.

[68] Consol. Rock Prod. Co. v. Du Bois, 312 U.S. 510, 526 (1941).

[69] HOUSE REPORT, *supra* note 24, at 222.

[70] 9 Bankr. 921 (Bankr. S.D.N.Y. 1980). *See* text accompanying notes 1-2 *supra*.

earnings or had used an excessive capitalization rate, overstating the net worth of the reorganized company.[71] Duplan stockholders, not surprisingly, believed that the value of the reorganized company had been underestimated.[72] The SEC suggested a capitalization rate somewhere in between.[73] After hearing several days of testimony from expert investment bankers and the SEC,[74] Judge Duffy found that the trustee's analysis, which proved the emerging company to be insolvent, was the most realistic.[75] As a result, the noteholders took stock and the stockholders took nothing, except umbrage which they expessed to the court in a series of letters.[76] To the erstwhile stockholders, Judge Duffy offered this gloss on the absolute priority rule by

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[71] To determine the going concern value of the reorganized company — and thus the value of the stock that was being traded to general creditors and noteholders — the trustee multiplied projected earnings by a capitalization rate of 0.5. The multiple was determined by reference to the average earnings per share of 15 "comparable" companies. The noteholders maintained that the calculation overstated earnings and produced a going concern value that was too high. They took the position that since both the trustee's earnings projections and capitalization rate reflected a performance expectation, the "expectency" factor had been counted twice. They argued that either historical earnings (rather than projected earnings) or a lower ratio should be used to avoid this double dipping effect. *See Duplan*, 9 Bankr. at 926-27.

[72] Shareholders were joined in their opposition to the valuation by Edward I. Altman, a professor of finance at New York University's Graduate School of Business. He insisted that Duplan's future was even brighter than the trustee's projections suggested. Based on the company's earnings during the months following the filing of the proposed reorganization plan, he predicted that future earnings would surpass the trustee's estimates and that the value of the company's tax loss carryover would be enhanced as a result. He concluded that Duplan's going concern value was about $10 million more than the trustee estimated — enough to allow the stockholders to retain an interest and participate in the future of the company. Metz, *A Restructured Plan for Duplan*, N.Y. Times, Aug. 15, 1980, at D6, col. 3.

[73] The SEC believed that the capitalization rate should reflect the emerging company's debt free capital structure and, therefore, the trustee should have employed a rate slightly higher than the one employed by the trustee's investment bankers. *See Duplan*, 9 Bankr. at 927.

[74] *Id.* at 925-6.

[75] Judge Duffy found that historical earnings might be a useful reference point for calculating future earnings, but that they were a starting point only. He found that the trustee's earnings projections properly took into account market position, inflation rates, an anticipated recession, and the company's business plan. He also found that the trustees capitalization rate was appropriate in light of the trustee's "conservative earnings projections." Judge Duffy rejected the SEC's contention that a higher capitalization rate should be used to reflect the company's debt-free capital structure, reasoning that the SEC's approach failed to take into account "the uncertainties which underly the trustee's projections." 9 Bankr. at 927-929.

[76] *See* note 2 and accompanying text *supra*.

way of explanation and consolation:

> I have received several letters from stockholders reminding me of their investment in Duplan and their exclusion from the plan. Unfortunately, I cannot change the fact that the debtor is insolvent, nor the fact that the law excludes shareholder participation in a reorganization plan where insolvency exists. I recognize that the stockholders have invested large sums of money into a company whose prospects now seem bright. For many stockholders, that investment constituted a major portion of their savings. But, as anyone who purchases stock understands, their investment is not guaranteed. Furthermore, it is clear that creditors of the company must come before stockholders when distributing assets in reorganization under bankruptcy laws. If this were not so, it would be impossible for even the healthiest of companies to raise needed capital. The fact remains that despite the new Duplan's encouraging earnings figures, there are not enough funds to pay creditors. Regrettably, the Trustee's plan must exclude former stockholders of Duplan.[77]

The trustee's valuation approach was not validated by time. Soon after confirmation, the company, which had changed its name to Panex, was transformed from a black hole to a shining star of the domestic apparel industry. The company was operating profitably and management was offering to buy back 1 million of the company's 21.7 million outstanding shares for $12 a share — cash.[78] The performance of the resuscitated company led some observers to believe that the higher valuation had indeed been the correct one, and that the reorganization plan could have allowed stockholders to retain an interest.

Certainly, it makes sense to eliminate junior interests when a going concern valuation fails to find even a conjectural value in excess of senior claims. However, as the *Duplan* case demonstrates, the valuation process is so inherently uncertain that it does not always produce a fair result. Also, the absoluteness of the rule tended to harden parties into recalcitrance. Since the rule had to be observed, there was no incentive or freedom on the part of senior interests to negotiate with junior interests. Even seniors who might for the sake of moving the case along choose to give junior interests a continued stake in the debtor's future could not do so, unless a valuation demonstrated that the net worth existed.

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[77] 9 Bankr. at 935.

[78] Metz, *A Vital Panex From Duplan*, N.Y. Times, Apr. 29, 1982, at D8, col. 1.

The drafters of the Bankruptcy Code sought to preserve the speed and flexibility of Chapter XI, while creating a procedure that would allow a more pervasive restructuring of the debtor than Chapter XI contemplated. The drafters also sought to avoid the rigidity of Chapter X, while retaining some of the creditor and public protection devices.[79] The result, of course, was Chapter 11, which might more aptly have been named Chapter X-½.

Chapter 11 gives a debtor in possession the exclusive right to propose a reorganization plan, but only for a limited time.[80] The Code incorporates the "best interest" standard of Chapter XI, but in a substantially modified form. The Code version of the "best interests" standard need only be satisfied with respect to classes of creditors and interest holders whose members do not vote unanimously to accept a plan.[81] Although the Code

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[79] Part I, BANKRUPTCY COMMISSION REPORT, *supra* note 27, at 237; HOUSE REPORT, *supra* note 24, at 224.

[80] 11 U.S.C. § 1121 (1979) provides that the debtor loses its exclusive right to file a plan if a trustee is appointed, or 120 days passes without the debtor filing a plan, or 180 days passes before the debtor files a plan which is accepted. If exclusivity terminates, any party in interest, including a creditor or equity security holder may file a plan. The Code contemplates the possibility that once the exclusivity period is terminated, competing plans may be proposed by parties in interest who may then lobby for votes among claim and interest holders. *Id. See In re* East Redley Corp., 16 Bankr. 429 (Bankr. E.D. Pa. 1982); *In re* Rolling Green Country Club, 26 Bankr. 729 (Bankr. D. Minn. 1982).

However, in the absence of any objections, courts seem to extend the exclusivity period fairly routinely. Even where objections have been interposed, courts have not been reluctant to grant extensions where, for example, the debtor needed more time to negotiate the sale of assets, or where the case was a complex one, requiring negotiations on many fronts and sophisticated business planning. *See, e.g., In re* United Press Int'l, Inc., 60 Bankr. 265 (Bankr. D.D.C. 1986); *In re* Swatara Coal Co., 49 Bankr. 898 (Bankr. E.D. Pa. 1985); *In re* Trainer's Inc., 17 Bankr. 246 (Bankr. E.D. Pa. 1982). In the *Manville* case, the debtor's exclusivity period was extended numerous times. All of this is consistent with the intent of the Code drafters who wrote, "if an unusually large company were to seek reorganization under Chapter 11, the court would probably need to extend the time in order to allow the debtor to reach an agreement." HOUSE REPORT, *supra* note 24, at 232.

[81] To become effective, a reorganization plan must be accepted by a debtor's claim and interest holders and be confirmed by the court. The Bankruptcy Code, similar to the Act before it, contemplates a sort of Hamiltonian democracy. (Hamiltonian Federalist leader John Jay is reported to have remarked, "Those who own the country ought to govern it.") A plan is required to group claims and interests in "classes," 11 U.S.C. § 1123(a)(1) (1979 & Supp. 1987), and to specify the treatment of any class that is "impaired" under the plan. 11 U.S.C. § 1123(a)(3) (Supp. 1987). (Generally speaking, if a plan alters the rights of a claim or interest holder in any way, the claim or interest is impaired. *See* 11 U.S.C. § 1124 (1979 & Supp. 1987)). In order for a plan of reorganization to be approved, each class of claims that is impaired under the plan must vote to

standard applies to every member of a class in which there are dissenters and not merely to the dissenters, members of the class may agree to take less than what they would receive on liquidation.[82] Chapter 11 contemplates that, as in old Chapter X, a plan may alter the interests of stockholders, as well as secured and unsecured creditors,[83] but it also provides that the absolute priority rule will come into play only when a class of claims or interests that is entitled to vote on a plan votes against the plan. Thus, Chapter 11 ensures that members of the dissenting class are fairly and equitably treated.[84] By giving senior classes the

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accept the plan. *Id.* § 1129(a)(8). A class of claims accepts a plan if acceptance is voted by holders of at least two-thirds in dollar amount and more than one-half in number of allowed claims in the class. *Id.* § 1126(c). A class of interests accepts a plan if acceptance is voted by holders of at least two-thirds in dollar amount of interests. *Id.* § 1126(d). For purposes of determining whether the majorities are achieved, only those who actually vote are counted. *Id* § 1126(c), (d). A class which is not impaired is deemed to have accepted the plan. *Id.* § 1126(f). A class for which no provision for payment or other compensation is made is deemed to have rejected the plan. *Id.* § 1126(g).

Code section 1129(a)(7) provides that unless a class of claims or interests accepts a plan unanimously, the Court must find that each class member "will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date." 11 U.S.C. § 1129(a)(7). *See In re* Merrimack Valley Oil Co., 32 Bankr. 485 (Bankr. D. Mass. 1983).

[82] 11 U.S.C. § 1123(a)(4) (1979).

[83] *Id.* § 1123(a).

[84] As explained in note 80 *supra*, in order for a plan to be confirmed, the required majority of each class of claims or interests that is impaired under the plan must accept it. Even if this requirement is not met, a plan may nevertheless be confirmed, or, in the parlance of bankruptcy specialists, "crammed down" on dissenting classes, "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1) (1979). Under Code section 1129(b)(2)(B), a plan is "fair and equitable" with respect to a dissenting class of unsecured claims if either: (i) each claim holder will receive "property of a value, as of the effective date of the plan, equal to the allowed amount of such claim" or (ii) no holder of a claim or interest that is junior will receive or retain any property under the plan on account of that junior interest. *Id.* § 1129(b)(2)(B). Thus, for example, in the face of majority creditor dissent, a plan could not provide for the extended payout of unsecured claims, and the retention by stockholders of an interest in the company, unless the deferred payments had a present value equal to the allowed amount of the unsecured claims.

Although the Code is silent on the point, the legislative history also makes it clear that a plan that allows senior classes to receiver more than 100 percent recovery is not "fair and equitable" and may not be confirmed if junior classes of claims or interests oppose it. *See* 124 CONG. REC. H.11047-117 (daily ed. Sept. 28, 1978).

For a thorough discussion of the cram down power under the Code, see Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53

option of relinquishing value to junior classes, the Code attempts to encourage a negotiated, consensual plan and eliminate the necessity of establishing the going concern value of a company in every case.[85]

One result of these changes has been to make stockholders more interested in the outcome of a case and more difficult to ignore. The relaxation of the absolute priority rule has given stockholders more power to bargain with seniors than they possessed under Chapter X, with the result that stockholders can no longer be shunted to a backburner for the duration of the case on the theory that their fate will be determined by simple arithmetic. But stockholders are still subject to the absolute priority rule, albeit relaxed. By providing that a Chapter 11 plan may modify or dilute or even cancel their interests without their consent, the Code has made stockholders much more dependent on management to negotate a plan that protects their perceived interests. As a result, even in, or perhaps especially in, cases involving debtors with dubious net worth, stockholders have an interest in electing a board that is responsive to the needs they assert.

C. *The Possibility of Equity Committees and the Promise of Fees*

Chapter X permitted and perhaps encouraged shareholders to organize committees to represent them in reorganization cases,[86] while Chapter XI contained no provision whatsoever for

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AMER. BANKR. L.J. 133 (1979) and Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. REV. 925 (1980).

[85] HOUSE REPORT, *supra* note 24, at 224.

[86] To the Douglas Commission, one of the more disturbing aspects of pre-Chapter X reorganizations was that no one was speaking, or listening, on public investors' behalf. As discussed earlier, in both equity receiverships and section 77B cases, management remained in control. Control of the company gave management what the Douglas study characterized as a "monopoly" on the lists of the debtor's public debt and security holders. Consequently, management was usually the first to contact and convince security holders to deposit their securities with so-called "protective committees." Although ostensibly organized to negotiate a reorganization plan on the depositors' behalf, management-dominated committees did not always operate in their constituencies' interests. The Douglas study explained, "Control over committees facilitates control of legal proceedings . . . . It also insures to the inside group control over the negotiation of the reorganization plan . . . and a certain amount of control over investigations and litigation concerning the past conduct of the management and the bankers." Part I, Douglas Report, *supra* note 12, at 873-74. To solicit deposits, management would retain agents

stockholders' committees.[87] In contrast, Chapter 11 authorizes the court to order the appointment of an official equity holders' committee "if necessary to assure adequate representation of . . . equity security holders."[88] According to the drafters of the Code, equity security holders' committees are to serve as "the primary negotiating bodies for the formulation of the plan of reorganization. They will represent the various classes of creditors and equity security holders from which they are selected. They will also provide supervision of the debtor in possession and of the trustee, and will protect their constituents' interests."[89] The Code provides that committee members are to be appointed by the United States trustee,[90] and that equity committees "shall ordinarily consist of the persons, willing to serve, that hold the seven largest amounts of equity securities of the debtor of the

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who worked on a commission basis, and whose high pressure tactics gave the solicitation drive "most of the characteristics of old-time stock selling campaigns." *Id.* at 884. Even if committee conscripts later had doubts about whether the committee leadership had worked out a favorable plan, it was usually too late or too expensive to do anything about it. Most deposit agreements provided that dissenting holders could withdraw from the committee, however, it was costly for them to exercise this perrogative. Withdrawal was usually conditioned on payment by the holder of a pro rata share of the committee's expenses. *Id.* at 889.

Chapter X also required that any committee comply with certain disclosure requirements designed to preserve the committee integrity and weed out conflicts of interest. Former Bankruptcy Rule 10-211 required that a committee file a statement setting forth the names and addresses of creditors or stockholders represented by the committee; the nature, amount and time of acquisition of committee members' claims; and the identities of the persons at whose instance the committee was organized. If the court found that a committee had failed to satisfy these filing requirements, the court was empowered to deny the committee the opportunity to appear or be heard in the case. *See* 5 COLLIER, *supra* note 13, ¶ 1102.01.

[87] This was consistent with the notion that Chapter XI plans were supposed to affect the interests of unsecured creditors only.

[88] 11 U.S.C. § 1102(a)(2) (Supp. 1987). Section 1102(a)(1) requires the appointment of a committee of unsecured creditors in every case.

[89] HOUSE REPORT, *supra* note 24, at 401. Code section 1103(c) authorizes committees to: (1) consult with the trustee or debtor in possession concerning administration of the case; (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the formulation of a plan; (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan; (4) request the appointment of a trustee or examiner; and (5) perform such other services as are in the interest of those represented. 11 U.S.C. § 1103 (1982 & Supp. III 1985).

[90] 11 U.S.C. § 1102(a)(2) (Supp. 1987).

kinds represented on such committee."[91] Nevertheless, some courts have been willing to depart from the "ordinary," and appoint both large and small holders in order to obtain a representative committee.[92] In determining whether there is need for a committee, courts usually have considered the number of stockholders, the complexity of the case, the possibility that equity interests would be affected by the reorganization plan, and the cost to the estate.[93] Cost to the estate is a relevant consideration

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[91] 11 U.S.C. § 1102(b)(2) (1979). "Person" as defined in Code section 101(35) includes "individual, partnership, and corporation," and, for purposes of section 1102, a "government unit." *Id.* § 101(35).

[92] For example, in the course of the *White Motor* Chapter 11 case, *In re* White Motor Credit Corp, 27 Bankr. 554 (Bankr. N.D. Ohio 1982), members of the official unsecured creditors' committee and members of an unofficial group of bank creditors asked an Ohio district court to reverse the bankruptcy judge's order appointing both large and small shareholders to an equity holders' committee. (The SEC had moved for appointment of the committee.) The court refused to do so. The appellants argued that four of the six appointees did not have a sufficient "stake in the outcome to adequately represent the class of shareholders." *Id.* at 558. The court noted that the composition of the committee reflected a 2 to 1 ratio of small shareholders to large shareholders, which, in turn, "loosely" reflected a 100 to 2 ratio among all White Motor shareholders. The court stated:

> This Court does not read section 1102 to limit the composition of an equity security holders' committee to those persons who hold the seven largest amounts of equity securities of the debtor . . . . This Court does not believe Congress intended that only large shareholders should be represented on an equity committee.
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> This Court rejects appellants' argument that the four small shareholders have an insufficient stake in the outcome to adequately represent the class of shareholders. The mere fact that these persons had sufficient interest to respond to the search for committee members makes them better representatives than the thousands of shareholders who did not respond.

Id. at 557-58.

[93] *See, e.g., In re* Beker Indus. Corp., 55 Bankr. 945 (Bankr. S.D.N.Y. 1985). The court stated:

> [T]he presence of at least 400 holders of small amounts indicates the need for their representation through an official committee having the fiduciary responsibility of acting on their behalf. . . . The position that some members of the class may have resources sufficient to protect their interests is of little significance . . . at least where the security is widely held. They do not have the fiduciary duty to represent their fellow security holders.
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> . . . .
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> In addition, the complex nature of this large case requires representation of Debenture holders and shareholders . . . . A large case brings with it not only a varied debt structure but a complex business requiring significant post-petition financing and a heavily negotiated plan.
>
> In short, this is not a case where the Debenture holders and shareholders will be asked merely to vote on a plan. This is a case requiring active participa-

because the Code authorizes committees to retain lawyers, accountants, and other professional assistants[94] at the debtor's expense.[95] Professional fees and expenses are allowable and entitled to priority as an expense of administration.[96]

Thus, the Code has not only equipped stockholders with an incentive for action, but with a vehicle for action as well, and, it also has supplied the fuel. Interestingly, in all three of the recent cases in which stockholders pressed for a special meeting, equity committees had been appointed. In two cases, the committee it-

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tion by Debenture holders and shareholders.

Id. at 949. *See also In re* Baldwin United Corp., 45 Bankr. 375, 376 (Bankr. S.D. Ohio 1983) ("The Court finds that a committee of common stockholders is necessary to assure adequate representation and protect the interest of the 15,000-plus holders of Baldwin-United common stock."). *See also* 5 COLLIER, *supra* note 13, ¶ 1102.02 at 1102-18.

[94] 11 U.S.C. § 1103(a) (1979).

[95] 11 U.S.C. § 330(a)(1) provides that, after notice and a hearing, "the court may award to . . . a professional person employed under section . . . 1103 of this title . . . (1) reasonable compensation for actual, necessary services rendered by such trustee, examiner, professional person, or attorney, as the case may be, and by any paraprofessional persons employed by such . . . professional person, or attorney, as the case may be, based on the nature, the extent, *and the value of such services, the time spent on such services, . . . and the cost of comparable services other than in a case under this title*; and (2) reimbursement for actual, necessary expenses." 11 U.S.C. § 330(a)(1), (2) (1979) (emphasis added).

The emphasized language represents a marked departure from the practice of awarding fees under the former Bankruptcy Act. Under the former Act, fee awards were governed by the notion that the reorganization and rehabilitation chapters were "for the relief of debtors rather than . . . for the relief of attorneys and court officers." 3A COLLIER, *supra* note 13, ¶ 62.05 at 1427 n.2. Accordingly, attorneys were expected to charge something less than the going rate for services rendered in bankruptcy cases. This expectation was particularly keen in public company cases, where, as one court put it:

> [I]n a reorganization proceeding, where the lawyers look for compensation to the debtor's estate which may belong, in equity, largely to others than who have requested their services, they should have in mind the fact that the total aggregate of fees must bear some reasonable relation to the estate's value. Under these circumstances they cannot always expect to be compensated at the same rate as in litigation of the usual kind.

Finn v. Childs Co., 181 F.2d 431, 435-36 (2d Cir. 1950). The rationale for the change is explained in the Code's legislative history:

> If that [rule] were allowed to stand, attorneys that could earn much higher incomes in other fields would leave the bankruptcy arena. Bankruptcy specialists, who enable the system to operate smoothly, efficiently, and expeditiously, would be driven elsewhere, and the bankruptcy field would be occupied by those who could not find other work and those who practice bankruptcy law only occasionally almost as a public service.

HOUSE REPORT, *supra* note 24, at 330 (1977).

[96] 11 U.S.C. §§ 503(b)(2) & 507(a)(1) (1979 & Supp. 1987).

self petitioned for the meeting.[97] In the third, the petition was brought by an individual stockholder with the support of the committee.[98]

D. *Increasing Case Volume*

One other factor not to be discounted is the sheer volume of Chapter 11 cases that have been commenced since the adoption of the Code. The Code went into effect, and governs bankruptcy cases commenced on or after October 1, 1979.[99] During the fiscal year that ended June 30, 1979 a total of 3,762 Chapter X, XI, and XII cases were commenced.[100] During the fiscal years that ended June 30, 1982 and June 30, 1983 (the years in which the major cases discussed here were filed), respectively, 14,058 and 21,206 Chapter 11 cases were voluntarily commenced.[101]

II. *Case Law*

A. *The Early Cases*

Generalizing about the pre-Code cases is somewhat misleading, because they were so few and far-between and each presented its own, distinctive set of facts. What can be fairly said about most of the cases is that they demonstrate the courts' reluctance to suspend corporate democracy, except when directorial elections were sought by rogue or renegade stockholders who had cut away from the pack and were acting with some degree of malevolence. Either their purpose in calling the meeting was at odds with the interests of other stockholders or their willingness to undermine the reorganization effort suggested that their instinct for self-aggrandizement had overcome their instinct for self-preservation.

In *Graselli Chemical Co. v. Aetna Explosives Co.*,[102] a

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[97] *See* the discussion of *In re* Lionel Corp. and *In re* Johns-Manville Corp. in text accompanying notes 124-31 *infra*.

[98] *See* the discussion regarding *In re* Saxon Industries in text accompanying notes 132-38 *infra*.

[99] *See* note 3 *supra*.

[100] Bankruptcy Statistical Tables, Twelve Month Period Ended June 30 1979, *Annual Report of the Administrative Office of the U.S. Courts 1970-1979* 68 (1982).

[101] Bankruptcy Workloads, 1, prepared by the Administrative Office of the United States Courts Statistical Analysis and Reports Division (Jan. 1986). The *Saxon, Manville,* and *Lionel* cases were commenced in 1982.

[102] 252 F. 456 (2d Cir. 1918).

World War I-era equity receivership case involving a munitions company, a group of common stockholders sought to enjoin an election of directors. In April 1917, when receivers were appointed for Aetna, the company appeared to be solvent. Its problems stemmed from the fact that a broker, who allegedly arranged for the sale of munitions to the French government, had sued the company to collect a multi-million dollar commission. Although the claim was disputed, it had impaired Aetna's credit, leaving the company "unable to obtain money with which to meet its obligations as they matured . . . or to conduct its business in an efficient manner."[103] Moreover, Aetna's management had been accused of acting improvidently, and perhaps improperly, in assuming the brokerage contract. Thanks to the war and the receivers' business acumen, Aetna operated profitably while in receivership. The broker's claim was settled, and, by the end of 1917, the receivers reported that all claims would be paid in full and that the property would be "returned to stockholders free of debt, with unimpaired credit, and with ample working capital."[104] During the period of the receivership, however, no dividends had been paid, and, as a result, preferred stockholders had become entitled to vote for directors at the ratio of nine votes for each preferred share. As the time for an annual meeting neared, a contest for control loomed. A group of preferred stockholders, consisting of "the same group of men who so mismanaged the company as to result in receivership,"[105] plotted to vote their shares in favor of directors who would propose a plan that would transfer control of the reorganized company to the preferred stockholders. At the request of common stockholders,[106] the district court enjoined the meeting. The Court of Appeals affirmed:

> The property is being successfully managed by the receivers; it has very profitable contracts, and is, or will very shortly, be able to pay all its indebtedness . . . . It can pay the arrears of dividends on the pre-

[103] *Id.* at 457.

[104] *Id.*

[105] *Id.* at 461.

[106] The common stockholders complained that a meeting and election of directors would "place in control a board of directors who would be unfavorable and unjust to the interests of the common stockholders, and who will assist in the adoption of the readjustment plan, with the result that great and irreparable injury will be done . . . the common stockholders." *Id.* at 459.

> ferred stock, and may retire the preferred stock. If the dividends are paid, the right of the preferred stock to vote on the basis of nine for one is eliminated, and, when a meeting is held, the business policy of the corporation can be determined by the will of the majority of common stockholders. Therefore, the right of the preferred stockholders to vote being but temporary, with every prospect of the common stockholders regaining control of the corporation, the court should not lend its aid nor permit a group of preferred stockholders electing a board of directors who would permit this plan of readjustment to be adopted.[107]

Judge Manton appears to have enjoined the meeting in *Graselli* not merely because the preferred stockholders were acting in their self-interest, but because they also were insiders attempting to use their evanescent voting power to impose an unfair plan on the common stockholders.[108] Indeed, in a later section 77B reorganization case, *In re Bush Terminal*,[109] Judge Manton exhibited no qualms whatsoever about allowing a meeting and election to be held, even though the spirit that moved the stockholder who called it was nothing loftier than a desire to protect his equity stake.

In *Bush Terminal*, Bush, who was president, majority stockholder, and a director of the debtor, proposed a reorganization plan which, for unspecified reasons, failed to elicit the support of either the trustees or the board of directors. Bush sought to call a meeting of the stockholders for the avowed purpose of electing a board that would support his plan. The district court refused to order the trustees to give Bush access to the company's stockholder list, and, furthermore, enjoined the meeting on the ground that it "would tend to obstruct the debtor's reorganization."[110] Bush appealed, and the Second Circuit reversed. Judge Manton, held that this meeting should not be stayed, because the debtor had failed to show that either the rights of common stockholders or the reorganization effort would be undermined if it were allowed to occur:

> It was the opinion of the District Court that a meeting to elect new

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[107] *Id.* at 461.

[108] Indeed, in a dissenting opinion in *Graselli*, a member of the panel accused Judge Manton of obliquely and prematurely passing on the merits of a reorganization plan yet to be proposed. *Id.* at 465 (Ward, J., dissenting).

[109] 78 F.2d 662 (2d Cir. 1935).

[110] *Id.* at 663.

> directors would possibly interfere with appellee's management of the business, and reasonably tend to obstruct a reorganization of the debtor. But . . . to refuse the stockholders free action in the matter of voting for directors may cause the stockholders to be represented by directors who did not truly represent them, and the stockholders are the real parties in interest . . . .
>
> Obviously, the stockholders should have the right to be adequately represented . . . especially in such an important matter as the reorganization of the debtor. Such representation can be obtained only by having as directors persons of their choice . . . .
>
> If the right of stockholders to elect a board of directors should not be carefully guarded and protected, the statute giving the debtor a right to be heard or to propose a plan could not truly be exercised, for the board of directors is the representative of the stockholders.[111]

A similar conclusion was reached in *In re J.P. Linahan*,[112] an early Chapter X opinion. In that case, an involuntary Chapter X petition had been filed against the debtor and the debtor (by its board) answered, admitting the allegations of the petition. A few days later, the debtor's majority stockholder sought to compel an annual meeting to elect directors who would resist the petition and support conversion of the case from Chapter X to Chapter XI (the better to shield his equity, presumably). Over the objection of both the creditors who had filed the involuntary petition and the directors, the Second Circuit allowed the meeting to go forward:

> It is the court's concern that the management of the business does not pass into the hands of incompetent or untrustworthy persons. The debtor has other parts to play, however, in a proceeding for reorganization or for arrangement, parts not directly concerned with management of the property during the period of court control, such as submission to involuntary proceeding and filing of plan, and over these the court ordinarily exercises no restraint. As to such matters the right of the stockholders to be represented by directors of their own choice and thus to control corporate policy is paramount and will not be disturbed unless a clear case of abuse is made out.[113]

Other than to say that the facts of *Linahan* did not present "a clear case of abuse," the court did not explain how to identify such a case, believing, perhaps not altogether unreasonably, that if abuse were clear it would be visible and palpable. However,

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[111] *Id.* at 664-65.

[112] 111 F.2d 590 (2d Cir. 1940).

[113] *Id.* at 592.

before anyone's ability to diagnose a case of clear abuse could be tested, the court articulated yet another, arguably weaker, criterion.

In *In re Public Service Holding Corp.*,[114] the Second Circuit stayed a shareholders' meeting pending the outcome of a motion to dismiss an involuntary Chapter X petition. At the time the petition was filed, the debtor was being operated by a state court appointed receiver, and in the event the petition was dismissed, the receivership proceeding would have been reinstated. While acknowledging that the pendency of a reorganization case did not deprive stockholders of their right to hold a meeting, the court cautioned that the right "is not absolute," and may be suspended "when other considerations require . . . it."[115] The Court of Appeals found that in all likelihood the Chapter X petition would be dismissed and the receivership restored and that the control of the Delaware chancery court over the receivership proceeding might be hampered if management of the debtor changed in the interim. This, the Court of Appeals concluded was an "other consideration" warranting suspension of the right to call a meeting.

"Other considerations" also were found to be present in *In re Alrac Corp.*[116] In that case, the bankruptcy judge refused to allow stockholders of an insolvent Chapter XI company to compel a meeting that had been sought by two stockholders after a plan of arrangment had been voted on, accepted, and confirmed, and while an appeal from the order of confirmation was pending. The plan provided for the issuance of stock to creditors, and if the confirmation order were affirmed on appeal, the creditors would receive majority control. The bankruptcy judge thus concluded that

> [i]n a real sense, the creditors are equitable stockholders; and they would be prejudiced if a meeting of stockholders was held at which they were not privileged to vote.
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> . . . .
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> It is the creditors who have the greatest stake in the viability of the debtor. If the confirmation is affirmed, they will undoubtedly control the election of directors and officers. To permit an election which would surely be overturned at the next annual meeting would not

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[114] 141 F.2d 425 (2d Cir. 1944).
[115] *Id.* at 426.
[116] 1 Bankr. Ct. Dec. (CCR) 1504 (Bankr. D. Conn. 1975).

> make sense and might be severely prejudicial to the real parties in interest — the creditors.
>
> If, on the other hand, the order of confirmation is reversed, and the plan is rejected, the stockholders have lost a short period of time . . . . Unless they planned a radical change in the operation, there would be no reason for insisting on an annual meeting. If so, there is every reason to maintain the status quo until the appeal is decided.[117]

These "considerations," the court said, required a temporary suspension of the stockholders' right to force an annual meeting.

Nearly a half-century would pass before the question would reach the Second Circuit again, and, when it did, the court resurrected the clear case of abuse standard, and found that it had been met. In *In re Potter Instrument Co.*,[118] the Second Circuit put down an insurrection waged by a lone, rogue stockholder. Potter Instrument Company filed a Chapter XI petition in mid-1975. Three years later, creditors accepted a plan of arrangement, which provided that they would receive a combination of cash and stock in settlement of their claims. Since the plan altered existing stockholders' positions, the bankruptcy court scheduled a stockholders' meeting for the purpose of amending the certificate of incorporation. At that point, John Potter, the founder, former chairman, and owner of 45% of the common stock of the company, demanded a special meeting for the election of directors. His aim, of course, was to elect directors who would attempt to modify the plan to avoid any redistribution of equity. The bankruptcy court barred the meeting. It found that Potter had been instrumental in the company's collapse, that he had entered into an SEC consent decree that limited his role in the company and obliged him not to vote against any action recommended by a majority of the board, and that he already had approved a settlement agreement that was incorporated into the plan. Moreover, Potter had pledged his shares to secure a loan to the company, which was in default, and pursuant to the loan agreement the pledgees were entitled to vote the shares as they chose. The bankruptcy court observed:

> Here we have a situation of a disgruntled stockholder who is frustrated in his efforts to smash the Companies which he brought into being because he has been ousted from management and control.

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[117] *Id.* at 1505-06.

[118] 593 F.2d 470 (2d Cir. 1979).

> . . . .
>
> [T]o permit Potter to control the Debtors through the election of a majority of the Board of Directors would sound the death knell to the Debtors. His objection to the issuance of stock to secured and unsecured creditors would require an Amended Plan, new notice to creditors and new acceptances solicited. There is no showing that interested parties would approve a plan without the issuance of stock.[119]

The district court and the Court of Appeals affirmed. Judge Oakes held that the debtor had met the clear abuse standard by showing that "an election might result in unsatisfactory management and would probably jeopardize [the debtor's] rehabilitation and the rights of creditors and stockholders — sounding the 'death knell' to the debtor as well as to [the stockholder] himself."[120] The court did not say whether either threat, standing alone, would have justified staying Potter from calling his meeting. Nor did the court suggest what, if any other kind of behavior might constitute a clear case of abuse. The court made no reference whatsoever to the "other circumstances" standard that it had applied in the *Public Service* case, leaving unclear whether the court viewed the standards as one and the same, or whether it intended to repudiate the "other considerations" standard, or whether the court simply believed that any mention of it would be superfluous, inasmuch as the seemingly more rigorous clear abuse standard had been met. The answers to these questions would have to abide the next generation of corporate governance cases, in particular, *In re Johns-Manville Corp.*

B. *New Wave Cases*

At this juncture it is important to note that although the *Manville* case is in many respects unique insofar as the issue of corporate governance is concerned, the case is more indicative of the continuation of a trend than the start of one. Twice in the 18-month period preceding the Manville stockholder revolt, the bankruptcy judge who was presiding over the Lionel[121] and Saxon Industries[122] Chapter 11 cases, also pending in the Southern District of New York, found himself confronting the same

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[119] *Id.* at 474.
[120] *Id.* at 475.
[121] *In re* The Lionel Corp., et al., Nos. 82 B 10318 to 82 B 10320 (Bankr. S.D.N.Y.).
[122] *In re* Saxon Industries, Inc., No. 82 B 10697 (Bankr. S.D.N.Y.).

question.

Lionel, like Manville, entered Chapter 11 in 1982 and continued to operate the business as a debtor in possession.[123] A year later, the committee representing Lionel's equity security holders commenced an adversary proceeding in bankruptcy court to compel the debtor to call and hold the 1982 and 1983 shareholder meetings for the election of directors. While the bankruptcy proceeding was pending, the committee commenced an almost identical state court action. Lionel asked the bankruptcy court to enjoin the stockholders from pursuing the state court proceeding. Bankruptcy Judge Ryan not only refused to issue the injunction,[124] but he chose to refrain from deciding the merits of the petition, preferring instead to let the state court decide what he characterized as "a strictly corporate governance controversy."[125] Judge Ryan said that he found "nothing in the record that demonstrates how the reorganization is going to be impeded here by the holding of an annual meeting."[126] Moreover, he even seemed to welcome the possibility that a change in management might advance the progress of the case, observing, "if the defendants are able to elect a new board it may be that the reorganization here will take an entirely different turn."[127] The court also found that "the balance of hardships" tipped "heavily in favor of Lionel's approximately 16,000 shareholders . . . [who] have been deprived of the opportunity of electing directors of their choice at regularly held annual meetings."[128]

Ultimately, the state court ordered the Lionel board to call the meetings, reasoning that:

> [During bankruptcy] it is more important than in less turbulent and more normal times that the shareholders have a voice in the crucial decisions affecting their company's destiny. A period of crisis does not justify officeholders retaining their positions indefinitely. Democracy, whether political or industrial, is capable of dealing with difficulty and

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[123] *In re* Lionel Corp., 30 Bankr. 327 (Bankr. S.D.N.Y. 1983).

[124] This he did solely on the basis of the standards for granting a preliminary injunction in the Second Circuit: a showing of irreparable harm, and either likelihood of success on the merits or sufficiently serious questions going to the merits to make them fit for litigation, and a balance of hardships tipping decidedly in favor of the party requesting preliminary relief. *Id.* at 329.

[125] *Id.* at 329.

[126] *Id.* at 330.

[127] *Id.*

[128] *Id.*

crisis, and is not to be suspended on the pretext of exigency.[129]

Judge Ryan reached the same conslusion in the *Saxon Industries* reorganization case. Saxon, like Manville and Lionel, was a Delaware corporation that in 1982 filed a Chapter 11 petition in the Southern District of New York. An equity committee was appointed. Saxon's last shareholder meeting had been held the prior June. After the filing, several of Saxon's top officers resigned, and their posts were filled by new management with experience in rehabilitating financially strapped companies. The defections had, however, left five vacancies on the board. In October 1982, the equity committee commenced an action to compel the company to hold a shareholders' meeting for the election of directors.[130] Under Delaware law, when vacancies on a board occur between stockholder meetings, the board may elect directors to fill them.[131] In exchange for agreeing to withdraw the pending suit and to refrain from seeking a meeting for at least a year, the board permitted the Equity Committee to fill two of the five vacancies.

Over the next two years, Saxon trimmed away several unprofitable operations and, for the first six months of fiscal year 1984, reported operating profits of $4 million on annual sales of about $400 million. However, the company still had a negative net worth of $200 million. By this time, the board had decided that the most realistic means of funding a reorganization plan would be to sell Saxon to a company with a deeper, fuller pocket. A board committee studied the proposals of several suitors and recommended that the company accept the offer of Alco Standard Corporation. Pursuant to this proposal, Saxon's unsecured creditors would receive cash plus stock in Alco, and Saxon shareholders would receive shares of Alco preferred. The

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[129] Committee of Equity Security Holders of the Lionel Corp. v. Lionel Corp., N.Y.L.J., June 28, 1983, at 6, col. 4.

[130] Section 211 of the Delaware General Corporation Law, DEL. CODE ANN. tit. 8, § 211 (1985), provides, in part:

> If there be a failure to hold the annual meeting for a period of 30 days after the date designated therefor, or if no date has been designated, for a period of 13 months after the organization of the corporation or after its last annual meeting, the Court of Chancery may summarily order a meeting to be held upon the application of any stockholder or director.

[131] Section 223 of the Delaware General Corporation Law, DEL. CODE ANN. tit. 8, § 211 (1985).

equity committee balked at the proposal and reinstituted its demand for a stockholders' meeting. Once again, Bankruptcy Judge Ryan gave his blessing to the committee's efforts and authorized the committee to retain special counsel to represent it in a new state court action.[132]

At the conclusion of that action, the Delaware Chancery Court directed the board to call a stockholders' meeting and Saxon appealed. The Supreme Court of Delaware affirmed.[133] The court found that, under Delaware law, the shareholders had a "clear" and "virtually absolute" right to compel a meeting, which could only be overcome by an "adequate affirmative defense."[134] Moreover, the court, citing *Linahan*, observed that "normal corporate governance . . . continues" even in bankruptcy,[135] and that it was only in the rare case that the Second Circuit had interfered with the stockholders' franchise during bankruptcy.

The court distinguished the situation in *Saxon* from the situation in *Potter* on the ground that there was no evidence that Saxon stockholders were bent on "smashing" the company and because no reorganization plan had yet been approved by the bankruptcy judge. The court presumed that the equity committee's aim was to "increase the payment they will receive in reorganization," but found their objective to be irrelevant. "Motive," the court said, "whatever its inspiration, is immaterial."[136] The court found that the facts bore no resemblence to those in *Alrac*, since Saxon had yet to formally propose a plan, let alone have it approved or confirmed by the court. The court rejected as too conjectural the fears expressed by Saxon management that any delay imposed by a meeting would jeopardize the reorganization effort. "No proxy contest had yet materialized, Alco had not threatened to 'walk away,' no employees had threatened to resign, and no trade creditor had threatened to terminate its relationship with the company," the court reasoned.[137] Finally, the court rejected the contention that Saxon's $200 million net worth deficit should be dispositive of the right of shareholders to

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[132] *In re* Saxon Industries, 39 Bankr. 49 (Bankr. S.D.N.Y. 1984).

[133] Saxon Indus. v. NKFW Partners, 488 A.2d 1298 (Del. 1985).

[134] *Id.* at 1301.

[135] *Id.* at 1302. *See also* text accompanying notes 114-15 *supra*.

[136] 488 A.2d at 1301.

[137] *Id.* at 1302.

call a meeting. The court explained, "Since Saxon remained in control of its affairs, insolvency did not divest the stockholders of their right to elect directors."[138]

On August 26, 1982, Johns-Manville Corporation (now known as Manville Corporation) and twenty subsidiaries and affiliates filed for reorganization under Chapter 11 in the United States Bankruptcy Court for the Southern District of New York. The impetus for the filing was Manville's actual and contingent liability to tens of thousands of victims of asbestos-related diseases, primarily asbestosis, a condition similar to emphysema, and mesothelioma, a fatal cancer of the lining of the chest, abdomen, or lungs.[139] At the time of the Chapter 11 filing, some 15,500 asbestos claims were pending against the company. Asbestos-related diseases have a long latency period, and epidemiological studies foretold that from 1980 to 2009, between 35,000 and 120,000 additional disease claims would be asserted. Manville's contingent liability on these claims was estimated to be approximately $2 billion. Also pending against Manville were a number of claims brought by schools and school districts seeking recovery for damages incurred as the result of having to remove asbestos-containing products from school buildings. The United States Department of Education predicted that the cost of removing asbestos from the nation's schools would be approximately $1.4 billion. When Manville's insurance carriers refused

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[138] The court said:

> [A]bsent other compelling legal or equitable factors, insolvency alone, irrespective of degree, does not divest the stockholders of a Delaware corporation of their right to exercise the powers of corporate democracy.
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> . . . .
>
> Since Saxon remained in control of its affairs, insolvency did not divest the stockholders of their right to elect directors. Normal corporate governance therefore continues.

Id. at 1300-02.

[139] This brief summary of the history of the Johns-Manville Chapter 11 saga is culled from a number opinions in addition to those that are the subject of this commentary. *See In re* Johns-Manville Corp., 36 Bankr. 727 (Bankr. S.D.N.Y.), *appeal denied,* 39 Bankr. 234 (S.D.N.Y.), *reh'g denied,* 39 Bankr. 998 (Bankr. S.D.N.Y. 1984), *mandamus denied,* 749 F.2d 3 (2d Cir. 1985); *In re* Johns-Manville Corp., 36 Bankr. 743 (Bankr. S.D.N.Y), *reh'g denied,* 39 Bankr. 998 (S.D.N.Y. 1984); *In re* Johns-Manville Corp. (G.A.F. Corp. v. Johns-Manville Corp.), 26 Bankr. 405 (Bankr. S.D.N.Y. 1983), *aff'd,* 40 Bankr. 219 (Bankr. S.D.N.Y. 1984); *In re* Johns-Manville Corp. (Asbestos Litig. Group v. Johns-Manville Corp.), 26 Bankr. 420 (Bankr. S.D.N.Y. 1983), *aff'd in part,* 40 Bankr. 219 (Bankr. S.D.N.Y.), *rev'd in part,* 41 Bankr. 926 (S.D.N.Y. 1984).

to defend or indemnify the company,[140] Manville's accounting firm advised it to book a reserve of at least $1.9 billion for asbestos health liability. Anticipating that the booking of such a reserve would would trigger the acceleration of approximately $450 million of outstanding debt, Manville sought relief in Chapter 11 and thereafter continued to operate as debtor in possession.

Exercising its authority under section 1102(a) of the Bankrupcy Code, the bankruptcy court ordered the appointment of several committees to represent Manville's varied claim and interest holder constituencies. These included the usual committee to represent Manville's unsecured trade and institutional creditors (the "unsecured creditors committee"); a committee to represent other asbestos manufacturers asserting claims for contribution or indemnity against Manville (the "co-defendants committee"); a committee to represent existing victims of asbestos-related disease (the "Committee of Asbestos-Related Litigants and/or Claimants," aka "the asbestos committee"); a committee to represent schools which had used asbestos building materials (the "school committee"); and a committee to represent holders of common and preferred stock (the "equity committee").[141]

For the next several years, as the bankruptcy court repeatedly extended the time of the debtor's exclusive right to file a reorganization plan, the court and the parties grappled with the many unusual questions presented by the case, and with each other. The tortuous path of the case was attributed in part to its complexity and in part to the recalcitrance of Manville's managers, who, according to one news account, "violated the unwritten law of bankruptcy proceedings: compromise."[142] Among the novel issues that the court had to decide were the question of

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[140] Most of Manville's insurance carriers disclaimed coverage and refused to conduct the defense or indemnify Manville in the asbestos litigation. At issue in the litigation was coverage in excess of $600 million. *See In re* Johns-Manville Corp., 26 Bankr. 408 (S.D.N.Y. 1983); *In re* Johns-Manville Corp., 26 Bankr. 422 (S.D.N.Y. 1983).

[141] Consistent with section 1102(b)(2) of the Code, the equity committee consisted of the seven largest stockholders willing to serve: (1) Bankers National Life Insurance Co., (2) Centerre Trust Company of St. Louis; (3) Leon B. Dubin; (4) Independent Insurance Group, Inc.; (5) Raytheon Financial Corp., (6) Hopper Soliday & Co., Inc.; and (7) Morton J. Macks.

[142] Mitchell, *Manville's Bid to Evade Avalanche of Lawsuits Proves Disappointing*, Wall St. J., July 15, 1986, at 1, col. 6.

whether the *Manville* Chapter 11 case had been commenced in good faith and whether victims of asbestos-related illness who had not yet manifested symptoms — so called "future claimants" — held claims cognizable in bankruptcy. On January 23, 1984, Bankruptcy Judge Lifland handed down two opinions. One held that the Manville filing did not abuse the jurisdiction of the bankruptcy court.[143] The other held that regardless of whether so-called future asbestos claimants were actually creditors holding dischargeable claims, they were "parties in interest" who could and should be represented in the case by a court-appointed "legal representative."[144]

On August 2, 1985, Manville announced that its board of directors and the legal representative had reached agreement on the principal elements of a reorganizaton plan. The agreement was called a "milestone in the history of this reorganization" by the bankruptcy judge, who observed that it represented "the first time that the Debtor was able to reach an accord with any health claimant representative."[145] As far as the equity committee was concerned, however, the milestone was a millstone. The plan proposed to establish two asbestosis claim "settlement trusts," wholly separate from Manville's operating companies, to deal with asbestos health and property claims. The health trust was to be funded with a combination of cash, accounts, notes, and between 50% and 80% of equity in the emergent company.[146]

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[143] *In re* Johns-Manville Corp., 36 Bankr. 727 (Bankr. S.D.N.Y.), *appeal denied*, 39 Bankr. 234 (S.D.N.Y.), *reh'g denied*, 39 Bankr. 998 (S.D.N.Y. 1984), *mandamus denied*, 749 F.2d 3 (2d Cir. 1985). Four separate motions to dismiss the Manville petitions were filed by various parties. Three of the movants were co-defendants with Manville in pending state court actions. The fourth motion was made by the Asbestos Committee, which represented the victims of asbestos-related disease. The motions were opposed not only by Manville, but by the unsecured creditors' committee and, ironically, the equity committee.

[144] *In re* Johns-Manville Corp., 36 Bankr. 743 (Bankr. S.D.N.Y.), *appeal denied*, 39 Bankr. 234 (S.D.N.Y.), *reh'g denied*, 39 Bankr. 998 (S.D.N.Y. 1984), *aff'd*, 52 Bankr. 940 (S.D.N.Y. 1985).

[145] *In re* Johns-Manville Corp., 52 Bankr. 879 (Bankr. S.D.N.Y. 1985).

[146] The health trust would be funded with a combination of $615 million in insurance proceeds, $150 million in cash and accounts receivable, a $50 million note, a $1.65 billion bond, and a $150 million bond providing for annual payments over a period of roughly three decades, and between 50% and 80% of Manville's equity. According to the plan, the trust will assume all present and future asbestos disease liabilities, and operate as an "alternative health claims resolution facility." The notion is that asbestos health claimants will have their claims liquidated through the facility, rather than through con-

Two weeks later, on August 16, the equity committee, which had not participated in the negotiations between the debtor and the legal representative (indeed, it asserted that it had been shut out of them), authorized its counsel to bring an action in Delaware Chancery Court to compel Manville to hold a shareholders' meeting. At that time Manville, a Delaware corporation, had approximately 20,100 common and 19,300 preferred shareholders of record. Although Manville's certificate of incorporation provided that an annual meeting of shareholders for the election of directors was to be held in May of each year, no meeting had been held since May 1982, three months before the Chapter 11 filing. The equity committee moved in the bankruptcy court for permission to retain Delaware counsel to represent it in the Chancery Court action. The committee also sought an order directing Manville to reimburse it for all expenses incurred in holding the meeting and waging a proxy fight if one occurred. While that application was pending, an individual member of the equity committee who owned 1,600 shares of Manville common stock commenced an action in Delaware to compel Manville to hold a meeting. Manville responded by filing a complaint in bankruptcy court seeking to enjoin the stockholders from continuing the state court action, or alternatively, to bar any newly elected director from taking office without the prior approval of the bankruptcy court.

The equity committee maintained that the stockholders' right to a meeting was clear under the holdings of *Saxon* and *Lionel*. However, Judge Lifland believed that the *Manville* case was different. While acknowledging the general rule that "the right of the majority of stockholders to be represented by directors of their choice . . . will not be disturbed unless a clear case of abuse is made out," Judge Lifland warned that "the right to compel a shareholders' meeting is not absolute," and must give way in the face of "various circumstances, including the parties'

ventional litigation. The plan provides, however, that a claimant may eschew the dispute resolution procedures established by the trustee and sue the trust instead. What the plan seeks to avoid, however, are suits against the operating entities that emerge from Chapter 11. The plan provides that the debtors will be discharged from present (as opposed to future) asbestos claims. It provides that future claims will not be discharged but that future claimants will be barred from asserting claims against any of the operating companies by virtue of a permanent injunction that must be in place as a condition precedent to the effectuation of the plan.

progress in plan negotiations."[147] Then, in a sort of blending of the *Linahan* "clear abuse" and *Public Service* "other considerations" approaches, the bankruptcy judge found that in the *Manville* case critically important "other considerations" were at stake. He found that to allow the stockholders to call a meeting and initiate a proxy fight in an effort to elect directors who would withdraw the plan and attempt to negotiate a new one just at the moment when, "after three years of fractious negotiating" the parties had reached "a major breakthrough . . . ha[d] the potential to derail the entire Manville reorganization with devastating consequences or at least to delay or halt plan negotiations."[148] Judge Lifland based this finding on the statement, made by a Manville officer in an affidavit, that "[n]o juncture of these proceedings has been more critical or sensitive than that which now exists . . . . The consequences flowing from yet another stalemate would place in jeopardy the ability of the Debtors ever to confirm a plan of reorganization or to pay its just debts."[149] Furthermore, he found that the equity committee's purpose in pressing for the meeting constituted an improper attempt by the equity committee "to enhance and elevate its role over those other constituencies who are statutorily stayed from dealing with Manville in a non-Chapter 11 setting . . . and who enjoy a higher position in the distribution scheme of bankruptcy."[150] In other words, Judge Lifland believed that the equity committee was attempting to improve its bargaining position vis-a-vis creditors who held senior claims, but who were stayed from enforcing them by virtue of the section 362 automatic stay.[151] The equity committee conceded as much.[152] The

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[147] 52 Bankr. at 887.

[148] *Id.* at 887-88.

[149] Affidavit of G. Earl Parker, Senior Vice President of Manville, Sept. 6, 1985, at 3-4, *In re* Johns-Manville Corp., 52 Bankr. 879, 888 (Bankr. S.D.N.Y. 1985). The court found that the statement had not been effectively controverted.

[150] 52 Bankr. at 887.

[151] Generally speaking, Code section 362(a) provides, upon the filing of a bankruptcy petition, for an automatic stay of all actions against the debtor and its property. 11 U.S.C. § 362(a) (1982 & 1985 Supp. III).

[152] In a memorandum filed with the Bankruptcy Court, the Committee stated:

> Manville has alleged nothing more than that the Equity Committee rejects the Principal Elements Agreement made by the incumbent Board with the Legal Representative and desires a shareholders' meeting to enable shareholders if they wish, to elect a Board which may in turn act to reconsider the Principal Elements Agreement. *To this the Equity Committee pleads guilty.* Sharehold-

bankruptcy judge granted summary judgment denying the equity committee's request for permission to retain Delaware counsel, and, further, restraining the committee and its members from taking any action to compel the meeting.[153]

The equity committee appealed, and the district court affirmed.[154] The district court expressed some doubts about the bankruptcy court's characterization of the fiduciary duties of the debtor's directors,[155] and it acknowledged that "the precise circumstances that will make out a showing of 'clear case of abuse' have yet to be precisely delineated."[156] Nevertheless, the court found that Judge Lifland's decision was correct because it was premised on a finding that "[t]he election of a new board, at this juncture, would not only force the negotiation back to square one and remove any short-term prospects for successfully reorganizing Manville, but it would substantially reduce the ultimate prospects for a successful reorganization."[157] The district court cautioned, however, that neither confusion, nor threatened delay in achieving a successful reorganization, nor alteration in the course of a case would support the issuance of an injunction. Evidence of serious jeopardy to a successful reorganization was required. But the district court's analysis of the clear abuse standard did not end with an examination of the effect of a meeting and election on the case. The court also questioned the good faith of the stockholders and found it lacking. This combination of effect and affect supported a finding that this case was a case of clear abuse:

> By its own admission, the Equity Committee brought the Delaware action in order to derail the proposed plan. Either the appellants seek to destroy any prospect for a successful reorganization, or they wish to

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> ers have the right to elect a Board. This may be a new Board; and it may be a new Board because shareholders were not satisfied with the Principle Elements Agreement.

Reply Memorandum of Law of the Committee of Equity Security Holders, Sept. 10, 1985, at 5, *In re* Johns-Manville Corp., 52 Bankr. 879, 887-88 (Bankr. S.D.N.Y. 1985) (emphasis in original).

[153] The injunction was issued pursuant to Code section 105(a), which provides in part that "The Bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a) (1982).

[154] *In re* Johns-Manville Corp., 60 Bankr. 842 (S.D.N.Y. 1986).

[155] *Id.* at 853 n. 22.

[156] *Id.* at 850.

[157] *Id.* at 852.

use the threat of a new board as a lever vis-a-vis other interested constituencies and vis-a-vis the current Manville board. *Neither the interest in torpedoing the reorganization nor in acquiring a chip to be bargained away are legitimate.*

. . . .

Together with the fragile nature of this reorganization and the likelihood that a meeting of shareholders would doom that process, the appellants' questionable motivation makes out the requisite clear case of abuse. Any potential benefit from the Delaware litigation is easily outweighed by the concomitant danger to the reorganization process.[158]

The Second Circuit reversed.[159] Possibly ending the confusion over whether the presence of "other considerations" or only a showing of "clear abuse" would justify the imposition of martial law, the court held that "the well-settled rule [is] that the right to compel a shareholders' meeting for the purpose of electing a new board subsists during reorganization proceedings," and that "the equity committee's right to call a meeting may be impaired only if the equity committee is guilty of 'clear abuse.' "[160] Next, the court found that the clear abuse standard had not been satisfied. It flatly rejected the notion that the equity committee's "professed desire to arrogate more bargaining power in the negotiation of a plan — in contrast to some secret desire to destroy all prospects for reorganization — may in itself constitute clear abuse."[161] Indeed, recalling its earlier opinion in *Bush Terminal*,[162] the court found that one, if not the primary, purpose for allowing stockholders of financially beleaguered corporations to call meetings and challenge directors, is to gird stockholders with enough leverage to ensure that they will be adequately represented in the plan negotiating process. Thus, the court held that an attempt by stockholders to garner leverage, "whether by actually replacing the directors or by 'bargaining away' their chip without replacing the board," is not reproachable, "so long as leverage means only the improvement of their bargaining position or the assurance of their participation in negotiations."[163] According to the court, a finding of "clear

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[158] *Id.* at 852-53 (emphasis added).

[159] 801 F.2d 60 (2d Cir. 1986).

[160] *Id.* at 64.

[161] *Id.*

[162] *See* text accompanying notes 111-13 *supra*.

[163] 801 F.2d at 65.

abuse" could only be premised on a showing that the stockholders were bargaining in bad faith. As an example of bad faith, the court cited "a willingness to risk rehabilitation altogether in order to win a larger share."[164] Moreover, the court ruled that a finding that the stockholders were on a suicide mission was not, in itself, sufficient grounds for denying them the right to call, or threaten to call, a meeting. The court held that an injunction barring a meeting would only be warranted if, in fact, "such a meeting would cause irreparable harm to Manville's reorganization."[165] Any lesser showing would not suffice:

> [T]he determination whether the Equity Committee is guilty of clear abuse turns on whether rehabilitation will be seriously threatened, rather than merely delayed, if Manville's present plan is not submitted for confirmation now . . . .
>
> While delay to rehabilitlation would not by itself provide a ground for overriding the shareholders' right to govern Manville — delay being concomitant of the right to change boards — real jeopardy to reorganization prospects would provide such a ground.[166]

The court found that the only evidence adduced by Manville in support of its application for an injunction — the affidavit of the very much interested Manville officer (who might be replaced in the event of a meeting) — even supplemented by "the cumulative record," provided an insufficient basis for the court's grant of summary judgment on the issue of clear abuse.[167] Concluding that the nature of the equity committee's motivation and the effect of a meeting on the reorganization were triable issues of fact, the Court of Appeals reversed and remanded to the bankruptcy court with directions to "undertake a more elaborate inquiry into clear abuse and irreparable harm."[168] Finally, the Court of Appeals admonished the bankruptcy court to shift its focus from "the equity committee's conceded desire to enhance its bargaining position [to] analyze the

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[164] *Id.*

[165] *Id.* at 69.

[166] *Id.* at 66-67.

[167] The Court of Appeals affirmed that it was proper for the bankruptcy court to have considered the entire record in determining whether summary judgment was appropriate, but explained that "without being told which portions of the bankruptcy court's accumulated knowledge it relied on for decision, we cannot agree that no material issues of fact remain to be determined." *Id.* at 67.

[168] *Id.* at 69.

real risks to rehabilitation posed by permitting the equity committee to call a meeting of shareholders for the purpose of compelling reconsideration of Manville's presently proposed plan."[169]

After conducting what it characterized as "an extensive trial," the bankruptcy judge issued an 80-page opinion,[170] presenting in toxic detail the history of the case and at least some facts supporting his belief that the meeting was being sought by kamikaze stockholders who would — and, what is more could — scuttle the reorganization effort if they did not have their way. Whether Judge Lifland strictly adhered to the Second Circuit's direction to shift his focus from the motivation of the committee to the risks inherent in calling an election is questionable. A substantial portion of the opinion on remand is devoted to a rehash of the obvious fact that the stockholders' objective was the withdrawal of the plan and to discrediting the committee's contention that it had been shut out of negotiations. Possibly this is because a finding of bad faith on the part of stockholders seems to presuppose a finding of good faith on the part of creditors and the debtor.[171]

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[169] *Id.* The majority conceded that "given its greater knowledge about this complex and perhaps fragile reorganization, the bankruptcy court may exercise its legitimate injunctive powers to control the future course of rehabilitation pursuant to appropriate legal standards and evidentiary showings." *Id.* Judge Oakes (who wrote the opinion in *Potter Instrument*) dissented, suggesting that the only thing the majority could hope to accomplish by remanding was to compel the bankruptcy judge to make a better record. The eleventh-hour attempt of the committee to force the negotiations back to square one struck Judge Oakes as "the very essence of abuse," and a waste of the estate's resources. *Id.* at 70. He believed that the bankruptcy judge, who had "been living with [the case] for a long time," was in the best position to judge the impact of calling a meeting on the progress of the case:

> He is fully sensitive to the enormity of the problems imposed by the billions of dollars of future claims, as well as by billions of dollars of present claims for personal injury, death, and property damage — claims on a scale never before to hit the courts — as well as claims for punitive damages that, given those that have so far been imposed in the tiny fraction of cases that have been decided, are staggering to say the least. I repeat, no more complex reorganization has ever come before any bankruptcy court, and I include the railroad reorganization of recent past as well as of yore.

Id. Judge Oakes also believed that the thousands of asbestos victims whose recoveries had been postponed by the reorganization proceedings should not be subjected to any further delay. *Id.*

[170] 66 Bankr. 517 (Bankr. S.D.N.Y. 1986).

[171] Perhaps the bankruptcy judge felt that this finding was necessary to lay to rest the Court of Appeals' warning that "if rehabilitation is placed at risk as a result of the

The opinion does, however, marshal some evidence — primarily testimony by Manville officers, the legal representative, and counsel to various creditors' committees — in support of the bankruptcy court's stay of the stockholders' meeting. Based on such testimony, the court found consensus of the parties in support of the existing plan so fragile and the possibility of developing another acceptable plan so slight, that withdrawing the plan would destroy the prospects for reorganizing Manville. The result, he predicted, would be a motion to liquidate Manville, which he believed "would put everybody in a worse position, including the common shareholders."[172] On the basis of the testimony of Manville's president and chief ececutive officer, Judge Lifland found that prolonging the reorganization would have "a negative impact on employee morale and the business opportu-

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other committee's intransigent unwillingness to negotiate with the Equity Committee, as opposed to their real inability, within some reasonable amount of time, to formulate any confirmable plan more satisfactory to equity, the Equity Committee should not alone bear the consequences of a stalemate by being deemed guilty of clear abuse." 801 F.2d at 65.

Judge Lifland also took pains to point out, both in his opinion on the motion for summary judgment and in his opinion on remand, that among the stockholders who were pressing for a meeting were some who had purchased their shares after Manville had filed its Chapter 11 petition. Thus, he observed that "a major distinction between the equity and other committees should be noted. This committee's representation uniquely embraces individuals or shareholders who may have voluntarily acquired their interests *after* the filing of the petition." 52 Bankr. at 881 (emphasis in original). *See also* 66 Bankr. at 522-33. The idea that the quality of the interests of those "equity players" who took a gamble on Manville stock is somehow less than the quality of the interests of creditors is, at least facially, appealing. However, to disenfranchise stockholders on that ground alone could only have a depressing effect on the value of the stock of a Chapter 11 company and, quite possibly, deprive pre-petition stockholders of a very important escape hatch.

[172] *Id.* at 538. Leon Silverman, the attorney appointed to represent the future asbestos claimants, testified:

> I do not think that Manville in its present guise can put forward a plan that will muster the support of any of the constituencies. And I know that to be an extravagant statement. But I have now been engaged in this process for two years. In the course of it, from having been told that a resolution was impossible by every constituency now involved, we have come to a point where each of the constituencies has given up and accomodated itself so that we have in a sense a mosaic or a jigsaw puzzle which at its best is fragile.
>
> For that to now be tampered with by the withdrawl of a plan so that major negotiations to realign positions can be undertaken, is to put us back for two years, with not only no promise of success but with a virtual promise of lack of success.

Id. at 536.

nities available to the corporation."[173] This, in turn, would make it more difficult for the company to formulate an acceptable plan. The court stated that "the consequence of the failure of this consensus are obvious to all," including, presumably, stockholders. The court found further evidence of the stockholders' willingness to jeopardize the reorganization in a newsletter circulated among certain Manville shareholders. The newsletter contained a report by a litigation analyst for that group. The report read as follows:

> [I]t appears questionable whether a litigation strategy will be effective in improving the position of shareholders to any great extent . . . current shareholders might do well by simply torpedoing the agreement altogether, if possible, and then by paying off all existing claimants who have valid claims.
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> . . . .
>
> [S]hareholders have little to lose and lots to gain by settling in for a long but well-orchestrated campaign to annihilate the current plan.[174]

Finding that the equity committee had introduced no evidence to rebut Manville's showing of irreparable harm, the court found that Manville had met its burden of proof and again enjoined the committee from prosecuting an action to compel a meeting and election.

III. COMMENTARY

Although none of the courts so framed it, the essence of the question before them in these cases is an issue that arises perenially in bankruptcy cases: When should the pendency of a bankruptcy case suspend or interfere with the operation of nonbankruptcy law or, more particularly, with the enjoyment of state-created property interests? The rule is well-settled that nonbankruptcy laws, to the extent that they conflict with bankruptcy laws or policy, may be suspended.[175] However, a corollary of this rule is that "[u]nless some federal interest requires a different result, there is no reason why [property interests created by state law] should be analyzed differently simply because an

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[173] *Id.* at 539.

[174] *Id.* at 535.

[175] *See, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198 (1983); Stellwagen v. Clum, 245 U.S. 605 (1918); Ogden v. Saunders, 25 U.S. (12 Wheat) 213 (1827); Sturges v. Crowinshield, 17 U.S. (4 Wheat.) 122 (1819).

interested party is involved in a bankruptcy proceeding."[176] Accordingly, the Bankruptcy Code includes provisions enabling trustees and debtors in possession to avoid certain transfers and liens (even though they may be valid under state law),[177] to recover property of the estate from the hands of secured creditors (even though they may hold it pursuant to nonbankruptcy law),[178] and to reject executory contracts and unexpired leases (even though they are enforceable under state law).[179]

Such tinkering with the interests of individual creditors furthers at least two important bankruptcy policies. It maximizes the size of the bankruptcy estate for the benefit of all creditors, and, in a reorganization case, it serves the further purpose of enhancing the debtor's prospects for rehabilitation. As one judge has observed:

> The purpose of [the debtor rehabilitation chapters] is to restore, not to dismantle, the economically distressed debtor. The power to prevent secured creditors from availing themselves of their contractual remedies on default, and to compel those creditors who have acted with sufficient celerity to be in possession at the time of filing to return the debtor's property, is essential to preserve the possibility of a successful rearrangement of the debtor's affairs. Little hope of resuscitation would remain for the debtor disembowled just prior to filing.[180]

Nor would any hope of resuscitation remain for the debtor disembowled just *after* filing. Hence, the Code also provides for the

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[176] Butner v. United States, 440 U.S. 48 (1979). (mortgagee's right to rents generated by property during mortgagor's bankruptcy would be determined by reference to state law, not federal rule of equity). *See also* Penn Terra Ltd. v. Dep't of Envtl. Resources, 733 F.2d 267, 272-23 (3d Cir. 1984) (citations omitted) wherein the court said:

> While Congress, under its Bankruptcy power, certainly has the constitutional prerogative to pre-empt the States even in their exercise of police power, the usual rule is that congressional intent to pre-empt will not be inferred lightly. Pre-emption must either be explicit, or compelled due to an unavoidable conflict between the state law and the federal law. Consideration of whether a state provision violates the supremacy clause starts with the basic assumption that Congress did not intend to displace state law.

[177] *See, e.g.*, 11 U.S.C. § 545 (governing the ability of a trustee to avoid the fixing of statutory liens); § 547 (governing the ability of a trustee to recover a preference); § 549 (governing the avoidance of postpetiton transfers); § 552 (governing the postpetition effect of security interests granted prior to filing) and § 553 (limiting the exercise of the state right of setoff).

[178] *See* 11 U.S.C. §§ 542(a), 541 (Supp. III 1985). *See also* United States v. Whiting Pools, Inc., 462 U.S. 198 (1983).

[179] 11 U.S.C. § 365 (Supp. III 1985).

[180] *In re* Colonial Realty Investment Co., 516 F.2d 154, 158 (1st Cir. 1975).

automatic stay of actions against the debtor or property of the estate to enforce claims or liens that arose prior to the filing.[181]

Unlike the kinds of transfers that may be undone pursuant to the avoiding powers and unlike the kinds of actions that are barred by the automatic stay, a stockholders' action to compel a meeting and election will not, per se, affect the size of the bankruptcy pie or the debtor's prospects for rehabilitation.[182] Certainly, if the stockholders have their way, they may influence the size of the slice they receive, but this contravenes no federal bankruptcy policy and does not justify a declaration of corporate martial law.[183]

If anything, articulated federal policy is to the contrary. When a company continues to operate after the filing of a Chapter 11 petition, a trustee or debtor in possession is required to "manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated."[184] Moreover, a Chapter 11 trustee and debtor in possession "may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property."[185] Nothing suggests that Congress ever intended to exclude corporate law from the array of state laws with which debtors in possesion would have to comply. Nor is there any reason to believe that an action by stockholders to compel a debtor to hold a meeting is not among the types of actions against a debtor au-

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[181] 111 U.S.C. § 362 (Supp. III 1985).

[182] Shares of stock in a debtor corporation that are issued and outstanding are not property of the estate. *See In re* Calamity Jane's, Inc., 22 Bankr. 5 (Bankr. D. N.J. 1982).

[183] *See* Baird & Jackson, *Corporate Reorganization and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97 (1984). Baird and Jackson conclude that only the size of the pie — not the size of the slices — is an appropriate bankruptcy concern. Judge Lifland believed that the Manville equity committee was "using the Delaware action to enhance and elevate its role over those other constituencies who are statutorily stayed from dealing with Manville in a non Chapter 11 setting and who enjoy a higher position in the distribution scheme of bankruptcy." 52 Bankr. at 887. Unquestionably, the aim of the stockholders was to "enhance" their position, but, strictly speaking, they could not "elevate" it to a rung above that occupied by more senior claims and interests. The stockholders could only enhance their position with the consent of the seniors. If seniors objected to a plan that gave better treatment to stockholders, the plan would not pass muster under the absolute priority rule.

[184] 28 U.S.C. § 959(b) (Supp. V 1981).

[185] 28 U.S.C. § 959(a) (1976).

thorized by the statute. The aim of Chapter 11 is "to restructure a businesses' finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for stockholders."[186] The purpose of Chapter 11 is not to provide a sinecure for top management. Thus, bankruptcy policy is not offended by a presumption favoring the right of stockholders to call a meeting and elect directors and, in fact, such a presumption may even advance the Code's policy objective of encouraging the negotiation of consensual reorganization plans.

The Code contains a number of carrots and sticks designed to encourage the parties to a Chapter 11 case to work out a plan of mutual accomodation. For current purposes, the most relevant among them are the provision that grants the debtor the exclusive right, for a limited time, to propose a reorganization plan[187] and the provision that relaxes the absolute priority rule.[188] The mainspring that drives both of these provisions is the time value of money. As a representative of the banking industry testified during hearings on the Bankruptcy Reform Act:

> [D]elay . . . is the most costly element in any bankruptcy proceeding and particularly in a business reorganization. The same amount of money received by the senior creditors 4 years from now is worth probably less than half of what would be an amount of money received today. In other words, if [a creditor] can anticipate, after this elaborate procedure, [that he] will receive $1 million, then he would be well advised and usually is anxious to take $500,000 today because it's worth more to him. He has to consider the investment value and the ravages of inflation. This is worth more than the prospect of getting $ 1 million 4 years from now.[189]

To the extent that the Code gives a debtor in possession the exclusive right to file a reorganization plan,[190] the Code gives creditors an incentive to bargain in good faith in order to reach a

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[186] House Report, *supra* note 24, at 220.

[187] 11 U.S.C. § 1121 (1982). *See* note 82 *supra*.

[188] 11 U.S.C. § 1129 (1982 & Supp. III 1985). As earlier explained, by relaxing the absolute priority rule, the Code gives senior interests both authority and incentive to relinquish value to junior interests in order to garner their support for a plan and avoid the need for a costly and time consuming going concern valuation of the debtor. *See* notes 86-87 and accompanying text *supra*.

[189] *Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong., 1st Sess. 490 (1977).

[190] *See* note 82 *supra*.

consensus as swiftly as possible. To the extent that the Code limits this period of exclusivity, it prevents debtors from acting in bad faith and holding reorganization plans hostage to unreasonable demands.[191]

The leverage that stockholders gain from their ability to hold an election of directors derives not only from their ability to pry management loose (which may be questionable), but also from their ability to slow the progress of a case with a meeting. Earlier cases such as *Bush Terminal* and *Linahan* involved stockholders who held controlling interests in the debtor corporations and who, thus, were clearly in a position to dislodge directors. In the latter day cases, the stockholder's ability to muster enough votes to replace any directors was, at best, problematic. Although it may well be that, given the need to do so, the Lionel and Saxon stockholders would have gone forward with the meetings, they did not. The mere threat of a meeting was enough to exact concessions from other parties. Participants in the *Saxon* case believe that stockholders received "somewhat" or "slightly" better treatment under the plan in exchange for forbearing from holding the meeting. In *Lionel*, the price of forbearance was allowing the equity committee to name several directors to serve on the board for the first year after confirmation.[192]

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[191] Where, for example, the debtor had adopted a "take it or leave it attitude," and was attempting to use the exclusivity period not as a lever but as a bludgeon with which to bludgeon creditors into submission, the district court held that the bankruptcy judge erred when he extended the debtor's exclusivity period for the seventh time. The district court said, "Although Congress intended Section 1121 as a device to promote a more equal relationship between debtors and creditors it has been applied by the court here as a means of allowing the debtor to drag out the reorganization, continue in operation of the [apartment] complex, and pressure the creditor for concession in the status of its rights." *In re* Lake in the Woods, 10 Bankr. 338, 346 (E.D. Mich. 1981). *See also In re* Tony Downs Foods Co., 34 Bankr. 405 (Bankr. D. Minn. 1983), in which the court refused to extend the period in the absence of a showing of special circumstances warranting an extension. The court explained, "I see nothing special in this case to alter the Congressional policy nor any cause to increase the time as requested by the debtor. . . . Section 1121 does not create a deadline for filing a plan; the debtor is free to take as much time to develop and file its plan as it feels appropriate. The risk is, of course, that while it is developing its plan, another party in interest will file a plan." *Id.* at 408.

[192] Debtors' Third Amended Consolidated Plan of Reorganization at 62, *In re* The Lionel Corp., Nos. 82 B 10318-10320 (Mar. 15, 1985). Ironically, and reportedly at the insistence of the equity committee, the plan expressly provided that "[e]xcept for elections to fill any vacancies that may occur, until the 1986 annual meeting of shareholders of Lionel, neither the shareholders nor the Board of Directors of Lionel shall take any

Judge Lifland was greatly disturbed by this apparent gap between the theory and reality of the stockholders' action.[193] What Judge Lifland viewed as some sort of confidence trick did not bother the Second Circuit. In the course of oral argument before the Court of Appeals, the attorney for the equity committee, endeavoring to explain why the stockholder action would not have a serious adverse impact on the proceedings, pointed out:

> We have had two other cases where this type of situation has arisen involving the rights of shareholders; the Saxon case and the Lionel case. In both of those cases, after the [courts] sustained the right to shareholder election, the partners got together and they worked out a consensual plan and both of those cases were successfully reorganized, because that is what has been the end effect of that type of situation.[194]

The Second Circuit expressly approved the use of the threat of a meeting and election as a bargaining chip,[195] possibly because it recognized that without bargaining chips there can be no bargain. To curtail the ability of stockholders to exercise their right to attempt or threaten to replace directors would be to leave only one lever in the stockholders' arsenal: the ability to force a going concern valuation of the debtor in order to demonstrate that a plan treats them unfairly by giving senior classes more than 100% of the amount of its claims. Subjecting the parties to a lengthy, expensive, and inconclusive battle to establish going concern value (during which the debtor might die on the vine) could produce more delay and jeopardize the reorganization effort more than any stockholders' meeting, real or threatened. Certainly it would do little to foster the Code's goal of encouraging consensual arrangements.

The presumption favoring the right of stockholders to meet and elect directors also facilitates the negotiation process by lodging the struggle where it belongs, in the hands of those who have the greatest economic interest in the case: creditors and stockholders. One of the ironies of bankruptcy, at least in the

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action to change the composition of the Board . . . ." *Id.*

[193] *See* text accompanying notes 149-54 *supra.*

[194] Transcript of Oral Argument before the Court of Appeals at 19-20, June 12, 1986, *In re* Johns-Manville Corp., 801 F.2d 60 (2d Cir. 1986) [hereinafter Transcript].

[195] *See* text accompanying note 168 *supra.*

public company case, is that those who speak for the debtor in possession, and who, for all practical purposes, *are* the debtor in possession, are often those who can claim the least, and least legitimate, economic interest in the case — i.e., management.[196] Admittedly, there are good reasons for leaving management at the helm, including its familiarity with the business and the cost of replacing it with a trustee. But, as the preceding discussion illustrates, one result of leaving management in place is to create an expectation on the part of stockholders that management will negotiate on their behalf, even though bankruptcy is precisely the time when the ills commonly attributed to the separation of corporate ownership from control — managerial unaccountability and self-interest[197] — are likely to be most exacerbated. When the company is in Chapter 11, the zeal with which management advocates on behalf of stockholders is likely to be tempered by the desire of managers to keep their jobs, to elicit the support of creditors, and to maintain trade and bank credit. Justice Douglas and other commentators recognized this fact of bankruptcy life. In light of it, they urged the appointment of a trustee in every public company case.[198] State Supreme Court Justice Greenfield also recognized it when he ordered Lionel to convene an annual meeting for the election of directors.[199]

This is not an argument in favor of appointing a trustee in every case. Indeed, except in an advanced case of corruption or mismanagement, most stockholders, like creditors, would probably rather deal with a "devil that they know" and can bargain with than a trustee who may be a bit too immunized from pressure politics.[200] Rather, this is an argument against unduly restricting the right of stockholders to hold elections, for to do so would widen the gulf between stockholders and directors even further. It is also important to bear in mind that, in many Chapter 11 cases, creditors are able to employ the leverage they pos-

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[196] For example, the attorney for Manville acknowledged, during oral argument before the Court of Appeals, that the directors of Manville owned "a miniscule portion of the stock" of the corporation. Transcript, *supra* note 194, at 41.

[197] *See generally* M. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 30-36 (1976).

[198] *See* text accompanying note 15 *supra*.

[199] *See* text accompanying note 129 *supra*.

[200] The fact that creditors would often prefer to deal with "a devil that they know" than an unknown trustee is noted in Coogan, Broude & Glatt, *Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills*, 30 BUS. LAW. 1149, 1150 (1975).

sess as suppliers, lenders, and voters on forthcoming reorganization plans and to pressure duly elected or appointed management staff into resigning in favor of a more amenable crew.[201] A reorganization case has been described as a "turbulent rivalry of interests."[202] Allowing stockholders to meet and vote on directors may calm some of the turbulence by revealing whose interests management actually represents: its own, the creditors', or the stockholders'.

Still, to say that stockholders expect management to represent their interests in negotiating a reorganization plan begs the more fundamental question of whether they should. En route to denying the Manville equity committee's request for authority to bring the Delaware action, Judge Lifland found that even if the stockholders had been able to pack the board with directors who vowed to renounce the existing plan in favor of one that gave equity holders a better shake, the new directors would be prohibited from doing so. He believed that upon taking office, the new directors would become bound by a new fiduciary duty to creditors. He reasoned that this duty would devolve upon the new directors, whoever they were and by whomever they were elected, because "when a company becomes insolvent or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency *become trustees for the creditors*."[203] "Thus," he concluded, "Manville's directors, in negotiating any plan of reorganization . . . are required by the Code to act as fiduciaries of the estate."[204] Although he stopped just short of finding Manville insolvent, Judge Lifland did characterize the company's financial

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[201] For example, shortly after Lionel entered Chapter 11, its two top officers and directors were forced to resign. According to a news report published at the time: "The top-level management shake-up was linked to Lionel's creditors committee, made up of toy makers, commercial banks and other companies that extended credit to Lionel. There was 'a lot of pressure from the creditors for some changes,' said George Padgett, Lionel's corporate secretary." Hertzberg, *Lionel Corp. Replaces Saypol and Schilling, Its Two Top Officers*, Wall St. J., July 9, 1982, at 29, col. 1. By the time the Manville case was nearing the plan stage, its chairman had announced his retirement, and its president had "resigned after a dispute with creditors." Mitchell, *Manville's Bid to Evade Avalanche of Lawsuits Proves Disappointing*, Wall St. J., July 15, 1986, at 1, col. 6.

[202] *In re* Alyucan Interstate Corp., 12 Bankr. 803, 805 (Bankr. D. Utah 1981).

[203] 52 Bankr. at 885 (quoting Davis v. Woolf, 147 F.2d 629, 633 (4th Cir. 1945)).

[204] *Id.*

condition as "highy precarious," and suggested that the same fiduciary principles should come into play.[205] Although the district court expressed some doubts about this analysis of the directors' fiduciary duties, it did not view it as the basis of the bankruptcy court's opinion and did not dwell on it.[206] The Court of Appeals did not consider the issue at all, which is unfortunate, because it really is the heart of the matter.

The Code defines the rights and duties of a debtor in possession in terms of the duties of a trustee.[207] It is well established that a trustee in a reorganization case is required to behave in accordance with the highest fiduciary standards. Thus, in one leading case, the Supreme Court held a trustee personally liable for permitting his employees to profit by trading in the securities of the debtor's subsidiaries, even though the trustee, himself, did not profit.[208] In another case, the Ninth Circuit held that the settlement of a claim between the debtor and the trustee's brother amounted to a breach of trust, even though the district court had approved the settlement with the knowledge of the relationship.[209]

The same duty of loyalty has been held to devolve upon debtors in possession. Holding that the president and general manager of a debtor in possession had breached their duties to creditors and shareholders by trading in the debtor's stock, the Supreme Court explained:

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[205] *Id.*

[206] 60 Bankr. at 853 n.22.

[207] Section 1107 of the Code provides, in part, that "a debtor in possession shall have all the rights . . . and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter." 11 U.S.C. § 1107 (1982 & 1985 Supp. III).

[208] Mosser v. Darrow, 341 U.S. 267 (1951).

[209] *In re* Combined Metals Reduction Co., 557 F.2d 179 (9th Cir. 1977). The Ninth Circuit adopted the standard articulated by the New York Court of Appeals in another context many years earlier. Chief Judge Cardozo (as he was then known) put it this way:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. (citation omitted). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

Id. at 196 (quoting Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928)).

> [So] long as the Debtor remains in possession, it is clear that the *corporation* bears essentially the same fiduciary obligation to the creditors as does the trustee for the Debtor out of possession. Moreover, the duties which the corporate debtor in possession must perform during the proceeding are substantially those imposed upon the trustee . . . . It is equally apparent that in practice these fiduciary responsibilities fall not upon the inanimate corporation, but upon the officers and managing employees who must conduct the Debtor's affairs . . . . If, therefore . . . the trustee is himself a fiduciary . . . logic and consistency would certainly suggest that those who perform similar tasks and incur like obligations to the creditors and shareholders should not be treated differently under the statute for this purpose.[210]

Thus, officers and directors of debtors in possession have been found to have violated their fiduciary duties by, for example, failing to protect or fraudulently transferring property of the debtor,[211] by engaging in kickback schemes with consultants of the debtor,[212] and, as previously mentioned, by trafficking in the securities of the debtor.[213] However, the suggestion that the duty extends so far as to oblige management to tailor a plan to fit the demands of creditors is unwarranted and unrealistic. The formulation of a reorganization plan is an exercise in business prognostication, valuation, and, most of all, negotiation.

There may be a bankruptcy Valhalla where creditors and debtors are in perfect accord as to when and how much creditors will be paid; the form that compensation will take; the size of the interest that stockholders will retain; and which assets will be sold off to fund a plan and which will be deployed in the ongoing businessss. In the Second Circuit, however, these are the issues that routinely arise in the course of negotiating a reorganization plan and that divide the parties not only along debtor/creditor/stockholder lines, but cause splits within those interest groups as well. The possibilities for conflict are legion, and although equity may bar officers and directors from engaging in

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[210] Wolf v. Weinstein, 372 U.S. 633, 649-650 (1963) (citations omitted). This result should be no different under the Code, section 1107 of which provides that "a debtor in possession shall have all the rights . . . and powers, and shall perform all the functions and duties . . . of a trustee." 11 U.S.C. § 1107 (1982 & Supp. III 1985).

[211] *See, e.g., In re* Walmar Screen Printing Co., 184 F. Supp. 858 (E.D.N.Y. 1960).

[212] Governor Clinton Co. v. Knott, 120 F.2d 149 (2d Cir. 1941).

[213] Philadelphia & Western Ry., 64 F. Supp. 738 (E.D. Penn. 1946); *In re* Consolidated Rock Products Co., 36 F. Supp. 912 (S.D. Cal. 1941).

waste or self-dealing, equity does not not command directors to yield to every demand that creditors make.

The Second Circuit acknowledged this in yet another opinion handed down in the *Lionel* reorganization case, this one involving the propriety of the sale of Lionel's most valuable asset, its controlling interest in Dale Electronics, Inc.[214] Although Lionel had applied to the bankruptcy court for authority to sell, it was clear that "the sole reason for Lionel's application to sell was the creditors' committee's insistence upon it. The creditors wanted to turn this asset of Lionel into a 'pot of cash' to provide the bulk of the $70 million required to repay creditors under the proposed plan of reorganization."[215] The Lionel equity committee opposed the sale outside of a reorganization plan, at least in part because they believed that if they could obstruct the sale they would position themselves to trade their aquiesence for better treatment under the plan.[216] Holding that any delay in the sale "would set the reorganization process back a year or longer," the bankruptcy judge authorized the debtor to go forward.[217]

The Second Circuit reversed. It found that the asset was not being wasted and that there was no business compulsion to rush the sale. The court also suggested that "appeasement of major creditors" was no justification for the sale, especially in light of the Code's goal "to counteract 'the natural tendency of a debtor in distress to pacify large creditors with whom the debtor would expect to do business, at the expense of small and scattered public investors.' "[218] Clearly then, in negotiating a plan, the relationship of the debtor and its creditors is essentially adverserial. Courts and creditors readily acknowledge this. The role of creditors' committees vis-a-vis debtors has been described as that of a "partisan which will aid, assist, and monitor the debtor pursu-

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[214] *In re* The Lionel Corp., 722 F.2d 1063 (2d Cir. 1983).

[215] *Id.* at 1065.

[216] *Id.* at 1072. In addition, they may have feared that the sale would "freeze" the value of the asset, thereby depriving them of the opportunity to demand better treatment under a plan on the basis of any real or predicted appreciation in the debtor's assets.

[217] *Id.* at 1066. This was the same bankruptcy judge who had allowed the equity committee to seek a meeting and election.

[218] *Id.* at 1070 (citing S. Rep. No. 989, 95th Cong., 2d Sess. 9 (1978)). *See also* text accompanying note 33 *supra*.

ant to its own self-interest."[219] That is not to say that stockholders should be allowed to pack the board of a Chapter 11 company with directors whose sole qualification for office is their commitment to cutting the best possible deal for their shareholder constituents. Stockholders who would risk putting management of the business in the hands of inexperienced or incompetent directors are no less kamikazes than are stockholders who would jeopardize the reorganization of the business by causing delay, and their actions should be no less subject to restraint.[220]

There is a plausible argument that the Code drafters implicitly emancipated management from stockholder rule by providing for the appointment of equity security holders' committees to negotiate on stockholders' behalf. The Code's legislative history indicates that the drafters recognized that the interests of management and stockholders were potentially divergent. However, nothing in the legislative history suggests that the drafters ever intended to abrogate the right of stockholders to meet and vote in the shadow of bankruptcy.[221] In fact, to do so would have been perverse. During a Chapter 11 case, stockholders who are allowed to form committees, but who are denied the right to vote for directors. are no better off than stockholders who are allowed to vote, but who are deprived of a vehicle for concerted action. In the first instance stockholders are given a place to stand but no lever, in the second they are given a lever but no place to stand.[222]

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[219] *In re* Daig Corp., 17 Bankr. 41, 43 (Bankr. D. Minn. 1981).

[220] In *In re Lifeguard Industries, Inc.*, 37 Bankr. 3 (Bankr. N.D. Ohio 1983), a case involving a small family-owned business torn by internecine strife, the bankruptcy judge enjoined two new, duly elected directors from taking office for a period of four months in order to give the debtor's president time to conclude plan negotiations with creditors. The court was obviously dubious of the qualifications of the two directors, consultants who seemed to hold Svengali-like sway over two naive family members. Moreover, creditors and key employees strongly favored the continuation in office of incumbent management. The court did not squelch the stockholders completely. The court authorized the new directors to propose an alternative reorganization plan if they could devise one.

[221] The drafters envisioned that equity committees would "serve as the primary negotiating bodies for the formulation of the plan of reorganization," and "represent the various classes of . . . equity security holders from which they are selected." *See* text accompanying note 91 *supra*.

[222] In praise of levers and fulcrums, Archimedes said, "Give me but one firm spot on which to stand, and I will move the earth." Pappus Alexandr, Collectio, lib. viii, prop. 10, section xi (1878), cited approvingly in THE OXFORD DICTIONARY OF QUOTATIONS 14 (2d ed. 1954).

The notion that the interests of stockholders ought to be represented by management in a Chapter 11 cases raises an important question that was barely grazed by the Second Circuit's opinion in *Manville*: In a case in which the debtor corporation is insolvent, do stockholders have an interest that deserves to be represented? The Court of Appeals hinted at what it believed was the answer to this question in a footnote:

> We note that if Manville were determined to be insolvent, so that the shareholders lacked equity in the corporation, denial of the right to call a meeting would likely be proper, because the shareholders would no longer be real parties in interest.[223]

Such an exception to the general rule would have made eminent good sense in the context of Chapter X, but it is more questionable now. Under Chapter X, stockholders of an insolvent debtor had no right to vote on a plan, and their acceptance of the plan was not a prerequisite to confirmation.[224] The rule limiting the right of shareholders to vote on a plan was a logical corollary of the absolute priority rule, which absolutely barred the stockholders from "retaining" an interest in the debtor unless they had some equity in it. If stockholders had no equity in the company, they had no interest that could be affected by the reorganization plan, and their consent was superfluous. But Chapter 11 is different. As discussed in Part I,[225] the absolute priority rule is considerably relaxed in Chapter 11, and insolvency no longer bars stockholders from voting on a plan or from retaining or receiving an interest in a reorganized company if

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[223] 801 F.2d at 65 n.6. The court went on to say that

> [a]lthough the bankruptcy court discussed the possibility of Manville's insolvency in connection with its treatment of the Equity Committeee's request for retention of special counsel and reimbursement of expenses . . . an issue that is not a subject of this appeal, the district court did not uphold the determination of clear abuse on that basis, and the parties have not briefed the issue.

Id. The Supreme Court of Delaware reached the opposite conclusion. It held that stockholders of Saxon were entitled to a meeting, even though the debtor had a net worth deficit of some $200 million. *See* note 133 and accompanying text *supra*.

[224] Former Bankruptcy Act § 179 provided that:

> After a plan has been accepted . . . by or on behalf of creditors holding two-thirds in amount of the claims filed and allowed of each class, and, *if the debtor has not been found to be insolvent, by or on behalf of stockholders holding the majority of stock . . . of each class* . . . the judge shall fix a hearing . . . for the consideration of the confirmation of the plan . . . .

(emphasis added). *See also* Former Bankruptcy Rule 10-305(e).

[225] *See* text accompanying notes 85-87 *supra*.

creditors agree to relinquish it. By "soften[ing] the regime of Chapter X and favor[ing] consensual compositions at the expense of the fair and equitable standard,"[226] Chapter 11 gives stockholders an interest in a case even though they may appear to lack an economic interest in the company. Hence, to suggest — as the Second Circuit did — that stockholders of an insolvent debtor are not parties in interest, is bad law, even if it is good economics.[227] Moreover, the reasons for relaxing the absolute priority rule militate against using it as a litmus test of the right of stockholders to call a meeting. One reason for softening the absolute priority rule was to eliminate the need for a highly conjectural going concern valuation in every case and to avoid the kind of unfair result produced in *Duplan*.[228] If solvency once again becomes a poll tax on stockholder suffrage, going concern valuations may once again become a standard feature of reorganization cases, and the right of stockholders to exercise their franchise may, for all practical purposes, be eviscerated. Neither hypothesis suits bankruptcy or nonbankruptcy policy.

On the other hand, the debtor's financial condition should not be completely disregarded. While a bankruptcy case is pending, creditors who are stayed from enforcing their claims are, in essence, involuntary stockholders and, as one bankruptcy judge laconically observed in another context, "even . . . [creditors] have rights."[229] There will be cases in which a debtor is so obviously and hopelessly insolvent that experts can agree that stockholders have no equity in the company and no prospect of ever having any. In such cases creditors should not be subjected to the expense and delay of a meeting.[230] Where, however, the

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[226] *In re* Barrington Oaks Gen. Partnership, 15 Bankr. 952, 958 (Bankr. D. Utah 1981).

[227] *Cf.* CTS Corp. v. Dynamics Corp. of America, ___ U.S. ___, 107 S. Ct. 1637, 1653, ___ L. Ed. 2d ___ (1987), wherein Justice Scalia, in another context, observed that a "law can be both economic folly and constitutional."

[228] *See* text accompanying notes 71-79 *supra*.

[229] *In re* Groundhog Mountain Corp., 4 Collier Bankr. Cas. 2d (MB) 387, 394 (Bankr. S.D.N.Y. 1975).

[230] *See In re* Emmons Indus., Inc., 50 Bankr. 692, 694 (Bankr. S.D.N.Y. 1985), wherein the court reasoned that where a debtor was "hopelessly insolvent," appointment of an equity security holders committee might be unwarranted. The court explained: "Indeed, this court is of the view that generally no equity committee should be appointed when it appears that a debtor is hopelessly insolvent because neither the debtor nor the creditors should have to bear the expense of negotiating over the terms of what is in essence a gift." Certainly in cases involving debtors who plainly are solvent — such as

question of the debtor's solvency is open to debate, the court should not order a going concern valuation, but should resolve the doubt in favor of stockholders and allow the meeting to go forward.

It would have been interesting to see what would have happened if the Saxon or Lionel stockholders had actually held a meeting. Saxon's president testified that, in his judgment, allowing stockholders to meet could lead to a proxy contest, with disastrous results. The Delaware Supreme Court found that his beliefs were "born of supposition" and not supported by any credible evidence.[231] Nevertheless, it seems very likely that one of these days the parties are not going to be able to "get together," a meeting will, in fact, be called, and a proxy contest will ensue. As one commentator has remarked, "[R]ealistically, the solicitation of proxies is today the stockholders' meeting."[232] Proxy contests can be expensive.[233] If hard fought, they can also be terribly distracting. A contest that threatens to be so expensive and so distracting that it could impede the reorganization effort by draining financial resources and by diverting management's attention from the task of running and reorganizing the businesss ought to be enjoinable. If such a situation materializes, management should have the opportunity to return to court and seek an injunction on the basis of the change in circumstances. Enjoining stockholders from waging a proxy fight (or, for that matter, a meeting) need not mean disenfranchising them entirely. If insurgent stockholders wield enough votes to elect at least some directors, the court could stay the election while authorizing stockholders to designate an appropriate number of directors.[234]

Texaco Inc., whose Chapter 11 case is now pending in the Southern District of New York (87 B 20142 (Bankr. S.D.N.Y.)) — the right of stockholders to meet and elect directors, should not be open to question.

[231] 488 A.2d at 1302.

[232] Bernstein & Fischer, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy*, 7 U. CHI. L. REV. 226, 227 (1940).

[233] Generally speaking, if the fight is over policy, and not a purely personal power play, corporate directors have the right to make "reasonable and proper" expenditures to wage a proxy contest. Furthermore, successful insurgents may be reimbursed by the corporation for expenses incurred in a proxy fight. *See, e.g.*, Rosenfield v. Fairchild Engine & Airplane Co., 309 N.Y. 168, 128 N.E.2d 291, 293 (1955); Campbell v. Lowes, Inc., 36 Del. Ch. 563, 134 A.2d 852 (1957).

[234] This would seem to be within the scope of the court's equitable authority under section 105(a) of the Code, quoted in note 153 *supra*.

CONCLUSION

The *Manville* case was unusually complex and the consensus reached by the parties was extremely fragile. Therefore, Judge Lifland's decision on remand to again squelch the shareholder insurrection is not likely to diminish the wind that the Second Circuit has put in the sails of stockholders whose companies are floundering around on the wilder shores of bankruptcy. This does not necessarily mean that actions by stockholders to compel meetings and elections will become familiar features of the Chapter 11 terrain. More likely it means that now that the right of such stockholders to be represented by directors they choose has been established, the right really will become another bargaining chip — like the right of creditors to seek appointment of a trustee or the right of creditors to seek or oppose consolidation — that may be more valuable when it can be traded away for a desired concession than when it actually is exercised.