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A SEQUEL TO CHAPTER X OR CHAPTER XI: COEXISTENCE FOR THE MIDDLE-SIZED CORPORATION

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THE practicing lawyer, confronted with the problem of reorganizing an insolvent debtor, finds that the Bankruptcy Act offers his client a choice of two proceedings, namely, Chapter X[1] or Chapter XI.[2] In a previous article,[3] the history of these chapters and some of their salient features were discussed.

The choice of chapters is not a difficult one in the everyday type of close corporation which ostensibly desires to effectuate an arrangement with its unsecured creditors and has no securities outstanding to the public. This corporation would choose the Chapter XI proceeding. On the other hand, the open corporation with securities outstanding in the hands of the public will seek relief under Chapter X. But the middle-sized corporation[4] having a small issue of stock outstanding to the public and having unsecured liabilities of two to three million dollars, may find difficulty in adjusting its unsecured liabilities in Chapter X.

As indicated in the original article, the debtors in the principal cases[5] filed petitions under Chapter XI seeking only to adjust their unsecured liabilities, leaving their stock holdings unaffected and preferring the simpler and more expeditious procedure of Chapter XI. The Securities and Exchange Commission, however, has generally taken the position in these borderline cases that the Chapter XI proceeding is inadequate and that the proceeding should be transferred to Chapter X or be dismissed, contending that the public interest involved requires a Chapter X trustee's supervision, investigatory processes and recommendations.

It must not be overlooked that the determination of whether a debtor is properly within Chapter X or Chapter XI can take place in either proceeding. For example, assume that a debtor files a petition under Chapter X. The debtor must, among other things, state in its petition

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1. Bankruptcy Act §§ 101-276 (1956), 11 U.S.C.A. §§ 501-676 (1946, Supp. 1956).

2. Bankruptcy Act §§ 301-99 (1956), 11 U.S.C.A. §§ 701-99 (1946, Supp. 1956).

3. Weintraub, Levin and Novick, Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation, 24 Fordham L. Rev. 616 (1956).

4. Cf., e.g., General Stores Corp. v. Shlensky, 350 U.S. 462 (1956); SEC v. Liberty Baking Corp., 240 F.2d 511 (2d Cir.), cert. denied, 353 U.S. 930 (1957); SEC v. Wilcox-Gay Corp., 231 F.2d 859 (6th Cir. 1956); In re Transvision, Inc., 217 F.2d 243 (2d Cir. 1954), cert. denied, 348 U.S. 952 (1955).

5. See note 4 supra.

"why adequate relief cannot be obtained under chapter XI."[6] Any party in interest, as set forth in the Act,[7] may interpose an answer to this petition and the judge, having supervision of the proceeding, will hear and determine the issue shortly after the filing of the petition.[8] If he finds adequate relief can be obtained under Chapter X, he will approve the petition as having been filed in good faith. Otherwise, he will direct a dismissal or a transfer to Chapter XI.[9]

Under Chapter XI the procedure is different. When the debtor files its petition no allegation as to the adequacy of relief under Chapter XI is necessary. The judge usually refers the Chapter XI proceeding to a referee in bankruptcy who then supervises the arrangement proceeding. Any party in interest, who feels that the proceeding should be under Chapter X because relief under Chapter XI is inadequate, may then make application to the district judge for an order dismissing the proceeding.[10] The judge will then make a determination upon the facts before him whether the proceeding should be transferred to Chapter X.[11]

The latter procedure is by far the more common, for the reason that a debtor's choice of Chapter X is seldom challenged, whereas, its choice of Chapter XI is subject to the constant surveillance of the Securities and Exchange Commission. Assuming, therefore, that application has been made to transfer the proceeding from Chapter XI to Chapter X, the primary factors necessary to show the basis for relief for a transfer of the proceeding are virtually the same (even though different in degree) as are necessary to confirm a reorganization under Chapter X. Thus, in order to confirm a plan of reorganization, it must be shown that the plan is fair, equitable and feasible.[12] This is so even though the fair and equitable requisite has been eliminated from Chapter XI.[13] Thus, in *SEC v. Liberty Baking Corp.*, the court of appeals commented:

"We might assume, arguendo, that, if a plan is properly within Chapter XI, it need no longer measure up to that standard [fair and equitable] . . . or to anything equivalent. Even so, in determining whether a proceeding properly comes within that Chapter, it is necessary, of course, to determine, among other things, whether the proposed arrangement contains features which bring it within Chapter X where the 'fair-and-equitable' standard is applicable and where alone the facts relevant thereto will be fully investigated."[14]

6. Bankruptcy Act § 130(7) (1956), 11 U.S.C.A. § 530(7) (1946).
7. Bankruptcy Act § 137 (1956), 11 U.S.C.A. § 537 (1946).
8. Bankruptcy Act §§ 141-44 (1956), 11 U.S.C.A. §§ 541-44 (1946).
9. Bankruptcy Act § 147 (1956), 11 U.S.C.A. § 547 (1946).
10. Bankruptcy Act § 328, 11 U.S.C.A. § 728 (Supp. 1956).
11. Ibid.
12. See, e.g., Bankruptcy Act §§ 221(2)-(3) (1956), 11 U.S.C.A. §§ 621(2)-(3) (1946).
13. See, e.g., Bankruptcy Act § 366 (1956), 11 U.S.C.A. § 766 (Supp. 1956); and former subsection 3, eliminated by 66 Stat. 433 (1952).
14. 240 F.2d 511, 515 n.4b (2d Cir. 1957).

Therefore, in discussing the plan of arrangement of the *Liberty* case in the Chapter XI proceeding, the court of appeals considered ". . . whether the plan would deprive creditors of their 'absolute priority' rights as against stockholders. . . ."[15] Again, the court considered whether loans made by management would rank subordinate to the claims of creditors on principles established in corporate reorganization proceedings.[16]

The court, in effect, reexamined the Chapter XI proceeding at the threshold to determine whether it was properly instituted under Chapter XI, not on the basis of Chapter XI standards or requirements for relief,[17] but on an analysis of whether the Chapter XI plan matched up to Chapter X standards.

This problem has been the subject of much litigation. Recent decisions by higher courts in three of the cases discussed in our original article suggest further comment.[18] Our original thesis, that a determination of whether a corporation should be within Chapter X or Chapter XI was a problem which could not be determined by mechanical rule, but was dependent upon numerous variable factors, was again reiterated by the courts. This determination, as was indicated at that time, would depend upon such considerations as:

". . . assets, liabilities, stock outstanding to the public, intricacy of corporate structure, need for investigation, and management's contribution, all properly evaluated by the exercise of judicial discretion."[19]

It is interesting to note that in *General Stores Corp. v. Shlensky*, *SEC v. Wilcox-Gay Corp.*, and the *Liberty* case,[20] the higher courts substantially adopted this reasoning. Following these principles, it was held in the *General Stores* and *Liberty* cases that the proceedings belonged under Chapter X; and in the *Wilcox-Gay* case that the proceeding belonged under Chapter XI.

The General Stores Case

In the *General Stores* case the Supreme Court was divided on the question of whether the debtor should be allowed to continue its Chapter XI proceeding. Both the district court and the court of appeals had concluded that the debtor was not properly within Chapter XI and that the proceeding should be transferred to Chapter X. Mr. Justice

15. Id. at 515.

16. Id. at 515, citing Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939); cf. Consolidated Rock Co. v. Du Bois, 312 U.S. 510, 523-24 (1941); Pepper v. Litton, 308 U.S. 295 (1939).

17. See, e.g., Bankruptcy Act § 366 (1956), 11 U.S.C.A. § 766 (1946).

18. General Stores Corp. v. Shlensky, 350 U.S. 462 (1956); SEC v. Wilcox-Gay Corp., 231 F.2d 859 (6th Cir. 1956); SEC v. Liberty Baking Corp., 240 F.2d 511 (2d Cir. 1957).

19. Weintraub, Levin and Novick, supra note 3, at 633.

20. See note 18 supra.

Douglas, writing for the majority, affirmed. His holding was based, as were all prior decisions of the court of appeals, upon an analysis made in *SEC v. United States Realty and Improvement Co.*[21] He indicated that a choice as to the propriety of the chapters would be dependent upon the *needs* dictated by the particular facts of each case, that is, whether the formulation of a plan under Chapter XI by the debtor or the formulation of a plan by disinterested trustees as provided by Chapter X "would better serve the 'public and private interests concerned, including those of the debtor.' "[22]

New terminology now appears in the analysis made in the *United States Realty* case. The *needs* of the particular proceeding are the discretionary guides for the lower courts. These needs, the Supreme Court held, are substantially the factors which have been outlined above: (1) readjustment of debts of an insolvent debtor without sacrifice by the stockholders may violate the principle requiring a plan to be fair and equitable as enunciated in *Case v. Los Angeles Lumber Co.*,[23] (2) standing alone, readjustment of the debt structure may be inadequate unless there is an accounting by management for the causes of insolvency; (3) readjustment without new management may not be feasible; (4) other needs equally compelling in nature and which may depend on the factors of each case, are to be considered.

Applying these needs to the *General Stores* case, the Court found that there had already been one reorganization; heavy short-term loans were pressing; the company had been changed from an operating company to a holding company; shares of stock of the subsidiaries, a most valuable asset, had been pledged; the plan was not feasible because it did not include a merger of the parent with the subsidiaries; a funding of unsecured debts, "and a realignment of debt and stock so as to give a balanced capital structure,"[24] did not exist; and, finally, the new business had "been launched with heavy borrowings on a short-term basis."[25]

Moreover, the evaluation of these needs was to be made by the lower courts. Their discretion was the catalyst which fused the various elements or factors. Here, again, the Supreme Court emphasized the function the lower courts played in a determination of the propriety of chapters by the use of their discretion:

"We could reverse [the lower courts] . . . only if their exercise of discretion transcended the allowable bounds. We cannot say that it does."[26]

21. 310 U.S. 434 (1940), reversing 108 F.2d 794 (2d Cir. 1940).
22. General Stores Corp. v. Shlensky, 350 U.S. 462, 465 (1956).
23. 308 U.S. 106 (1939).
24. General Stores Corp. v. Shlensky, 350 U.S. 462, 468 (1956).
25. Ibid.
26. Ibid.

The "allowable bounds" are, of course, the needs or factors which have been discussed. Furthermore, in itemizing the needs which would be determinative, no attempt was made by the Court to set up a complete list or draw a fine line of demarcation. Those that were itemized by the Court were only examples of some of the needs to be considered and did not foreclose the use of other guides. The Court made it clear that the enumerated needs were only some of the "typical instances where c. X affords a more adequate remedy than c. XI."[27]

One of the two startling features of the majority opinion was its conclusion that the character of the debtor, that is, that it had public security holders, was not a controlling consideration in the choice of chapters. The Commission on the other hand, argued, as it had in the *United States Realty* case, that the character of the debtor, the nature of its capital structure, and the fact that its securities were publicly held, necessitated a finding that Chapter X was the only haven for the debtor. The Court rejected this argument and observed:

"A large company with publicly held securities may have as much need for a simple composition of unsecured debts as a smaller company. And there is no reason we can see why c. XI may not serve that end. The essential difference is not between the small company and the large company but the needs to be served."[28]

Furthermore, in our previous article, the fact was emphasized that size was not a determinative factor, and that many corporations with larger assets and liabilities than the debtors possessed either in the *General Stores* or *United States Realty* cases had availed themselves of Chapter XI. The object which these debtors sought was an extension or composition of their unsecured obligations. However, as the Court determined in the *General Stores* case, the needs of each case would determine the choice of chapters. Thus, in the *General Stores* case, the Supreme Court held the needs necessitated a finding that the case was improperly instituted under Chapter XI.

Consistent with the interpretation of the *United States Realty* case, the dissent written by Justice Frankfurter was also based upon an inquiry as to whether the district court had overstepped the bounds of discretion. Justice Frankfurter indicated that the exercise of this discretion was based upon an erroneous application by the district court of principles which had been enunciated in the *United States Realty* case, and was in disregard of the 1952 amendment to section 366 of Chapter XI, eliminating the fair and equitable requisite.[29] The elimination of this requisite made it possible for a debtor to file an arrangement in a Chap-

27. Id. at 467.
28. Id. at 466.
29. 66 Stat. 433 (1952).

ter XI proceeding where the purpose was to leave unaffected the position of the stockholders. Since, the dissent continued, the *United States Realty* case in a small degree turned upon the fact that the application of the fair and equitable clause was a necessary element of the confirmation of a proceeding under Chapter XI, there was error by the lower courts in not considering its elimination.

Justice Frankfurter emphasized the fact that no consideration was given in the majority opinion to the "significance of this amendment by Congress."[30] Discussing the exercise of the discretion by the district court, he indicated that the basis of all discretion must of necessity depend upon standards. Moreover, in his opinion, the "needs" which the majority found so compelling to sustain the discretion of the district court were overemphasized at the expense of others, which, if adopted, would swing the pendulum in favor of the applicability of Chapter XI. Thus, he observed that the majority opinion failed to give proper weight to the "informal, efficient and economical procedure"[31] involved in a Chapter XI proceeding, particularly where there was no change in the capital structure involved; to the fact that no impropriety in corporate management had been shown to exist; and to the fact that creditors' approval of the arrangement indicated that it was in their best interests.

The second startling feature of the opinion is that for the first time since the *United States Realty* case, the "fair and equitable" doctrine, as a criterion for a determination of the propriety of the chapters, was relegated to a secondary position, the Supreme Court inserting as a primary criterion a determination as to whether the Chapter XI plan was "feasible." It must be remembered that in the *General Stores* case unsecured creditors were being offered forty per cent of their claims instead of one hundred per cent. This settlement would not have constituted full priority if the "fair and equitable" doctrine was applied. Notwithstanding this plan of forty per cent and this preemption of priority, the Supreme Court held that this factor was not the controlling consideration:

"A question as to what is 'fair and equitable' between creditors and stockholders may eventually be reached in the reorganization. But the paramount issue at present concerns what is 'feasible.' "[32]

Thus, the Supreme Court left the determination of the amount of the settlement between the stockholders and the creditors of the debtor open for future consideration. Moreover, a reduction in the claims of un-

30. General Stores Corp. v. Shlensky, 350 U.S. 462, 472 (1956).
31. Id. at 471.
32. Id. at 467.

secured creditors was held not to be a vital factor in the determination of the propriety of the chapters even though the unsecured creditors had a superior position to the stockholders whose stock position was not being affected. Indeed, in the *Wilcox-Gay* case, the plan provided for a reduction of the claims of creditors to fifty per cent of their face amount without any corresponding reduction or elimination of the stock. Nevertheless, the plan was not rejected as being unfair and inequitable. Moreover, even though in the *Transvision*[33] case the claims of creditors were not reduced, they were extended over a period of time which for all practical purposes affected prompt payment and preempted priority by stockholders.

This seeming departure by the courts from the application of the "fair and equitable" doctrine in determining the propriety of the chapters was arrested, however, in the *Liberty* case, where the court held that only within a Chapter X proceeding could it be determined whether "the plan is fair and equitable as well as feasible."[34]

The Wilcox-Gay Case

Turning now to the *Wilcox-Gay* case, it will be recalled that the district court denied the application by the Securities Exchange Commission to transfer the Chapter XI proceeding to Chapter X pursuant to the provisions of section 328 of the Bankruptcy Act. The Court of Appeals for the Sixth Circuit unanimously affirmed this decision. The court frankly stated that it had withheld its decision until the determination of the Supreme Court in the *General Stores* case. Having analyzed this decision, the court stated that the ". . . discussion by Mr. Justice Douglas [in the *General Stores* case] indicates that the district court in this case [the *Wilcox-Gay* case] applied appropriate considerations and was privileged to exercise—as in our judgment he did—sound discretion in this matter."[35] The court noted that the district court had relied upon the decision of the *Transvision* case and had followed this decision in its assertion that the determination of the proper chapter was within the sound discretion of the district court, and that unless this discretion had been abused, its determination should be sustained.

The court of appeals then proceeded to analyze the basis of this discretion and indicated that the district court's disposition of the case was based upon the following factors, among others: the plan was feasible; there was a reasonable likelihood of rehabilitation of the debtor; the stockholders' interest could only be beneficial in the event continued

33. In re Transvision, Inc., 217 F.2d 243 (2d Cir. 1954), cert. denied, 348 U.S. 952 (1955).
34. 240 F.2d at 516.
35. SEC v. Wilcox-Gay Corp., 231 F.2d 859, 860 (6th Cir. 1956).

operations were profitable; creditors contended that existing management was necessary for the continuation of the business; an opportunity was open at all times for interested parties to call any irregularities to the attention of the court; the transfer to Chapter X might be prejudicial to the ultimate success of the proposed plan and was not necessary; there was no public interest as distinguished from public ownership, which required the intervention of the Commission; further investigation was unnecessary in view of the activities of the various interests, including a creditors' committee.

The court of appeals concluded its decision in the *Wilcox-Gay* case by indicating that the considerations which had actuated the exercise of discretion by the district court in allowing the proceeding to remain within Chapter XI were in harmony with the principles set forth by the Supreme Court in the *General Stores* case. It observed that the Supreme Court in the *General Stores* case had indicated that the lower courts had reasonably concluded that the debtor in that case "needed a more pervasive reorganization than is available under c. XI."[36] However, there was nothing in the opinion of the Supreme Court in the *General Stores* case that would indicate that an application of the principles therein set forth would require reversal in the *Wilcox-Gay* case. On the contrary, the court of appeals continued, the exercise of the district court's discretion was within the allowable bounds as later set forth by the Supreme Court in the *General Stores* case.

The Liberty Case

In the *Liberty* case, as in the *Wilcox-Gay* case, the district court had held the proceeding was properly within Chapter XI. Nevertheless, while in the *Wilcox-Gay* case, the Court of Appeals for the Sixth Circuit upheld the district court's exercise of discretion as sound and in accord with the subsequent decision of the Supreme Court in the *General Stores* case, in the *Liberty* case the Court of Appeals for the Second Circuit reversed the district court, emphasizing that the district court's decision antedated the decision of the Supreme Court in the *General Stores* case.

The Second Circuit distinguished the *Wilcox-Gay* and *Liberty* cases by indicating among other things that the *Wilcox-Gay* case had originally been a Chapter X proceeding and that its decision rested ". . . on the ground that the analytical procedures available under Chapter X had in fact been carried out. . . ."[37] This comparison appears to be based on a fallacious assumption, namely, that since the debtor had previously undergone Chapter X proceedings, it had been subjected to some corrective treatment and Chapter XI therefore was available to it. The

36. 350 U.S. at 468.

37. 240 F.2d at 516 n.10.

assumption overlooked the fact that no plan was presented in the Chapter X proceeding and also that Chapter XI has no provision for an active trustee who has powers similar to that of a Chapter X trustee.[38] The transfer to Chapter XI left the debtor without the aid of the functional activity of a trustee, and the comparison is an analogy with a sound difference.

Another alleged distinguishing feature between the *Wilcox-Gay* and *Transvision* cases on the one hand, and the *Liberty* case on the other, lay in the fact that the plans of the former would affect trade and commercial creditors, whereas the plan of the *Liberty* case would affect public debenture holders. These debenture holders were nothing more than unsecured creditors and such distinction between public and private unsecured creditors is not sound. Both the public debenture holders and the private trade creditors are unsecured; both can be equally affected in a Chapter XI proceeding.[39] Nowhere under either Chapter X or Chapter XI is there provided preferential treatment for public unsecured creditors as against private unsecured creditors. Indeed, the Supreme Court in the *General Stores* case discussed public and private interests and dealt with " 'the public and private interests concerned' "[40] as if they were on an equal plane.

As for the district court's exercise of its discretion, the court of appeals in the *Liberty* case stated that it "overlooked the very narrow scope of Chapter XI."[41] There was very little left for Liberty Baking Corporation to do but to comply with the provisions of section 328 of the Bankruptcy Act[42] and file an amended petition under Chapter X.[43]

Conclusion

The seeming inconsistency of evaluating Chapter XI proceedings by Chapter X standards was perceived by the Court of Appeals for the Second Circuit, for in the *Liberty* case, the court did state:

"Conceivably, under Chapter XI proceedings, a plan of arrangement might be presented which would unmistakably satisfy the requirements of Chapter X and would be as favorable to the creditors as what they could obtain under Chapter X. In such exceptional circumstances, we might not disturb the arrangement merely because it had been reached by Chapter XI proceedings."[44]

It is difficult to see how a plan of arrangement under Chapter XI could fulfill the requisites of Chapter X and be as favorable in result

38. See Bankruptcy Act § 338 (1956), 11 U.S.C.A. § 738 (1946); and compare with Bankruptcy Act §§ 167-69 (1956), 11 U.S.C.A. §§ 467-69 (1946).

39. Bankruptcy Act § 306(1) (1956), 11 U.S.C.A. § 706(1) (1946).

40. 350 U.S. at 465.

41. 240 F.2d at 516.

42. 11 U.S.C.A. § 728 (Supp. 1956).

43. Bankruptcy Docket No. 91173 (S.D.N.Y. 1957).

44. 240 F.2d at 516.

to creditors as a Chapter X proceeding, for while the fair and equitable doctrine is applicable under Chapter X, there would be other standards under Chapter XI, namely, the retention of stockholdings and modification of creditors' interests.[45]

Actually this line of demarcation between Chapter X and Chapter XI should receive more practical application. The borderline case, that is, the middle-sized corporation, depends to a great extent upon management for its success in operation. To relegate management to a subordinate position and to overrule the negotiations between the debtor and a majority of its creditors, as was done in the *Liberty* case, may result in doubtful future advantages under Chapter X, particularly where management plays an important role in the debtor's operations. These debtors, as the facts certainly show in the *Wilcox-Gay, Transvision, General Stores* and *Liberty* cases, appear to be closer in general adaptability to a Chapter XI proceeding than to a Chapter X proceeding.

Indeed, the history of the *General Stores* case[46] under Chapter X indicates at the time of this publication that the plan of reorganization proposed by the trustee provides for a settlement with unsecured creditors of forty per cent in cash or corporate stock or an alternative of one hundred per cent over seven years.[47] This settlement of forty per cent in cash is substantially the plan offered to unsecured creditors in the Chapter XI proceeding of the *General Stores* case.[48] The transfer to Chapter X has, therefore, apparently resulted in no change of plan or alteration of the rights of secured creditors or stockholders,[49] but rather in a Chapter XI composition or extension with creditors with additional expense and delay. It would therefore appear that the application of the "fair and equitable" doctrine resulted in this borderline case turning into a "fair and practical" case in the best interests of creditors;[50] and that the standards of sound discretion were more exactly defined by Justice Frankfurter in the dissent in the *General Stores* case.[51]

45. Id. at 514.

46. The history of the development of the Liberty case in Chapter X has yet to be written.

47. Daily News Record, May 17, 1957, p. 29, col. 1.

48. "[U]nsecured creditors are now offered the equivalent of 40 per cent of their claims in full satisfaction." 350 U.S. at 465.

49. Cf. In re Camp Packing Co., 146 F. Supp. 935 (N.D.N.Y. 1956), citing SEC v. United States Realty and Improvement Co., 310 U.S. 434, 452 (1940), as to the distinction between the objectives of a Chapter X and Chapter XI proceeding.

50. Cf. Bankruptcy Act § 366(2), 11 U.S.C.A. § 766(2) (Supp. 1956), which requires the court to be satisfied that a plan is "for the best interests of creditors. . . ." Cf. also Adler v. Jones, 109 Fed. 967 (6th Cir. 1901) which held that in Chapter XI proceeding creditors must not receive considerably less than they would upon a liquidation of the assets.

51. See page 296 supra.