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BANKRUPTCY-CORPORATE REORGANIZATION-PUBLICLY HELD SECURITIES AS A TEST OF AVAILABILITY OF RELIEF UNDER CHAPTERS X AND XI OF THE CHANDLER ACT

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COMMENTS

BANKRUPTCY — CORPORATE REORGANIZATION — PUBLICLY HELD SECURITIES AS A TEST OF AVAILABILITY OF RELIEF UNDER CHAPTERS X AND XI OF THE CHANDLER ACT — Chapter X of the amended

Bankruptcy Act of 1938 was mainly the product of the investigation by the Securities and Exchange Commission[1] of reorganization practices under the old equity procedure and under section 77B.[2] The chief aim of the sponsors of this new chapter was to preclude the control of reorganization proceedings by "inside" groups, and thereby more adequately protect the interests of investors.[3] Contemporaneously with the overhauling of section 77B, however, other sections of the old Bankruptcy Act were being revised. Among the changes effected, old sections 12 and 74, dealing with extensions and compositions, were remodelled and combined into a new Chapter XI, purporting to comprehend debtor-creditor "arrangements."[4] Significant features of this chapter were the inclusion of corporations among the debtors who might petition for relief,[5] and the absence of provisions for strict judicial control of negotiations between the debtor and its creditors. It was soon recognized that a large corporation, seeking to avoid a reorganization under the restricted procedure of Chapter X, might in effect accomplish the same thing under the more lenient rules of Chapter XI.[6] And in three recent cases, this question was presented to the lower federal courts.

In re Reo Motor Co.[7] concerned proceedings on a debtor corporation's petition under Chapter X. Before the trustee's plan had been approved, a controlling group of stockholders raised an objection to the court's jurisdiction; they contended that, since only unsecured claims were involved, the proceedings properly belonged under Chapter XI. Although there were no debentures or shares of preferred stock outstanding, a considerable amount of common stock was apparently[8] in the hands of the public. On these facts, the court denied the motion

[1] Hereinafter called "S. E. C." or the "commission."

[2] See minority report of Senator King, S. REP. 1916, part 2, 75th Cong., 3d sess. (1938) (Senate Judiciary Committee, Revision of the National Bankruptcy Act).

[3] See letter of former Chairman Landis, HEARINGS ON H. R. 6439 (passed as H. R. 8046), 75th Cong., 1st sess. (1937), pp. 423-426 (House Judiciary Committee, Revision of National Bankruptcy Act). See also, Chandler, "The Revised Bankruptcy Act of 1938," 24 A. B. A. J. 880 at 883 (1938).

[4] See H. REP. 1409, 75th Cong., 1st sess. (1937), p. 48 et seq. (House Judiciary Committee, Revision of the National Bankruptcy Act).

[5] Amended Bankruptcy Act of 1938, § 306 (3), 11 U. S. C. (Supp. 1939), § 706 (3). This chapter only provides for the modification of unsecured claims. Ibid., § 356, 11 U. S. C. (Supp. 1939), § 756.

[6] This feature of the act has been the subject of several articles in legal periodicals. See especially, Rostow and Cutler, "Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act," 48 YALE L. J. 1334 (1939), and Heuston, "Corporate Reorganizations under the Chandler Act," 38 COL. L. REV. 1199 (1938).

[7] (D. C. Mich. 1939) 30 F. Supp. 785.

[8] The nature or amount of the publicly-held securities is not made clear in the reported opinion.

to transfer the proceedings, ruling that "The only . . . proper chapter which may be utilized for the reorganization of corporations with publicly held securities . . . is Chapter X."[9] No specific provision of the act was cited in support of this pronouncement, the court deeming it sufficient to rely on the broad grounds of legislative intent, deducible from the "language and content of Chapters X and XI . . . and . . . the Congressional hearing and reports."[10]

The next case chronologically was *In re United States Realty & Improvement Co.*[11] There, the debtor petitioned under Chapter XI, with a view to effecting a modification of one class of its unsecured obligations, namely a guaranty of the mortgage certificates of a subsidiary corporation. After obtaining permission to intervene, the S.E.C. contested the court's jurisdiction under Chapter XI, invoking the publicly-held-securities test applied in the *Reo Motor Co.* case. The district court denied the motion to dismiss, and on appeal, this decision was affirmed by the circuit court of appeals, that court being unable to find any basis in the language of the Chandler Act for the test proposed by the commission. A dissenting judge expressed the belief, however, "that X and XI are mutually exclusive,"[12] and that the proper place for the debtor was in a Chapter X proceeding.

The last case, *In re Credit Service, Inc.*,[13] also involved a corporation's petition under Chapter XI. Again, securities were outstanding in the hands of the public. The S. E. C. moved for permission to intervene and, at the same time, moved the dismissal of the debtor's petition. Both motions were denied, the court stating that the only "critical question" was whether the petitioner came within the express jurisdictional requisites of Chapter XI.

With the lower courts thus divided in opinion as to the interrelation of Chapters X and XI, it was apparent that the determination of the controversy would rest with the Supreme Court. And on the appeal taken from the decision of the circuit court of appeals in *In re United States Realty & Improvement Co.*,[14] the Court gave what purports to be the final answer. In reversing the decision of the lower court, the majority of the Court, speaking through Justice Stone, ruled that a large corporation with publicly held securities was incapable of obtaining "fair and equitable relief" under Chapter XI. The reasoning of the opinion was to the effect that a bankruptcy court, in the exercise

[9] In re Reo Motor Co., (D. C. Mich. 1939) 30 F. Supp. 785 at 789.

[10] Id., at 789.

[11] (C. C. A. 2d, 1940) 108 F. (2d) 794.

[12] In re United States Realty & Improvement Co., (C. C. A. 2d, 1940) 108 F. (2d) 794 at 799.

[13] (D. C. Md. 1940) 30 F. Supp. 878.

[14] Securities & Exchange Comm. v. United States Realty & Improvement Co., (U. S. 1940) 60 S. Ct. 1044.

of its "equitable powers," could refuse to entertain a petition under Chapter XI, even though the petitioner satisfied the jurisdictional requirements of that chapter. It was further stated that where a case involves a high degree of public interest it is the duty of the court to so exercise its discretion as to bar the operation of Chapter XI. And finally, it was held that the S. E. C. could intervene in any proceeding brought under Chapter XI to test whether it was properly brought thereunder. Justice Roberts, in a dissenting opinion, contended that the decision was not justified by either the language or the legislative history of the Chandler Act, and that the Court was encroaching upon the policy-determining functions of Congress.

Although the decision in *In re United States Realty & Improvement Co.* has the virtue of resolving a troublesome dispute, it may well be doubted whether a satisfactory solution has yet been attained. The result obtained seems vulnerable to criticism of both a theoretical and a practical nature.

The contention that Chapter XI is available to all corporations, regardless of size or of amount of outstanding securities, is unquestionably supported by a literal construction of the language of the Chandler Act.[15] A debtor is defined, in Chapter XI,[16] as one who could become a bankrupt under section 4 of the act; and this clearly includes all ordinary business corporations.[17] An "arrangement" may mean any plan for the settlement or extension of unsecured debts, on any terms.[18] Although an arrangement, to become effective, must be confirmed by the court as being fair, equitable, and feasible,[19] there is no hint that a plan dealing with publicly-held securities will be specially treated. If any legislative preference is to be found as between Chapters X and XI it would seem to favor the latter. For, while a petitioner under Chapter X must show that he cannot obtain adequate relief under XI,[20] a

[15] This has been admitted by W. Randolph Montgomery, a principal sponsor of Chapter XI before the House Judiciary Committee. Writing recently in the Virginia Law Review, he said: "But no matter how large a corporation may be . . . it cannot seek relief under Chapter X if it does not require more than an adjustment of unsecured debts." Montgomery, "Defects in Chapter XI of the Bankruptcy Act and Suggested Amendments," 25 VA. L. REV. 881 at 882 (1939). A similar admission as to the literal construction of Chapter XI is found in the brief of the S. E. C., on the writ of certiorari to the Second Circuit Court of Appeals, in S. E. C. v. United States Realty & Improvement Co., No. 796, Oct. Term 1939, Brief for Petitioner, at p. 13.

[16] See note 5, supra.

[17] Bankruptcy Act of 1938, § 1, 11 U. S. C. (Supp. 1939), § 22. Municipal, railroad, banking, and insurance corporations, and building and loan associations are excluded.

[18] Id., § 356, 11 U. S. C. (Supp. 1939), § 756.

[19] Id., § 366 (3), 11 U. S. C. (Supp. 1939), § 766 (3).

[20] Id., § 130 (7), 11 U. S. C. (Supp. 1939), § 530 (7).

converse requirement is not imposed upon the petitioner under XI. And while machinery is prescribed for switching a Chapter X petition into Chapter XI,[21] no provision is made for an opposite transfer.[22]

The majority of the Court seeks to avoid the difficulties presented by the statutory language by invoking the more pliable concepts of legislative policy and the equitable powers of a court of bankruptcy.[23] But here, again, all is not smooth sailing. The so-called equitable powers of a bankruptcy court have traditionally been considered to relate to the court's ability to complement the statutory language where this was necessary for the effective administration and distribution of a bankrupt's estate.[24] It is quite a different matter, however, to say that the court may deny relief to which a petitioner is expressly entitled by the language of the statute. To affirm such power is to say that the stated jurisdictional requisites of Chapter XI are advisory only, and that the court of bankruptcy, moved by its conception of proper legislative policy, may arbitrarily adopt or reject the procedure provided by Congress. This is the doctrine of "equitable powers" used in an entirely new sense; "judicial legislation" might be deemed a more appropriate term.

Even conceding, for purposes of argument, that a bankruptcy court may disregard the language of the statute where the legislative intent seems to indicate a different approach, there remains the perplexing task of determining what Congress intended. It is true that Chapter X was designed to effect reforms in reorganization procedure. The debtor is to be replaced in possession of the business by a trustee, appointed by the court.[25] This independent officer is to formulate the plan of reorganization,[26] on the basis of information received from his own investigation.[27] Interested groups are prevented from soliciting prior assents to other plans.[28] And in deciding upon the desirability of the

[21] Id., § 147, 11 U. S. C. (Supp. 1939), § 547.

[22] Where an arrangement cannot be effected under Chapter XI, the court will either dismiss the proceedings or adjudicate the debtor a bankrupt. Id., § 376 (2), 11 U. S. C. (Supp. 1939), § 776 (2).

[23] S. E. C. v. United States Realty & Improvement Co., (U. S. 1940) 60 S. Ct. 1044 at 1053.

[24] See dissenting opinion of Roberts, J., id., 60 S. Ct. at 1056.

[25] Appearing before the House Judiciary Committee, Commissioner (now Supreme Court Justice) Douglas characterized the independent trustee as "the keystone of this reform program." HEARINGS ON H. R. 6439, 75th Cong., 1st sess. (1937), p. 175.

[26] Bankruptcy Act of 1938, § 169, 11 U. S. C. (Supp. 1939), § 569.

[27] Id., § 167, 11 U. S. C. (Supp. 1939), § 567.

[28] Id., § 176, 11 U. S. C. (Supp. 1939), § 576. It was felt that the previous solicitations of assents had in some cases prevented the courts from exercising an independent judgment on the fairness of the plans presented. See H. REP. 1409, 75th Cong., 1st sess. (1937), p. 47. For an admission as to the influence of previously

plan or plans finally proposed, the court is to have the benefit of S. E. C. advice and counsel.[29] In view of these efforts to secure effective judicial supervision of reorganization proceedings, it may seem unlikely that Chapter XI was intended to offer an alternative mode of relief to any corporation seeking to reorganize. No attempt is made to give the court control over all the aspects of a Chapter XI proceeding. The debtor is allowed to remain in possession;[30] creditor assents may be obtained before a plan is presented for judicial confirmation;[31] and no function is provided for the S. E. C. Far from being conceived as a means by which Chapter X might be avoided, Chapter XI was itself intended to fit into the scheme of reform. It was originally thought that this chapter would serve the needs of small corporations, having only unsecured debts, and would thus save overburdening the courts with elaborate Chapter X proceedings.[32] But regardless of the fact that Chapters X and XI were originally designed for different business situations, the Congressional hearings and reports disclose no attempt to delimit the cases to which these chapters are respectively applicable in order to carry out the original design. Certainly there is no expression to the effect that the availability of relief under either chapter is to be determined by the existence of securities outstanding and in the hands of the public. The truth of the matter seems to be that the framers of X and XI did not foresee the potential overlapping of these chapters.[33] The only mention of their interconnection deals with the effort to exclude corporations having only unsecured debts from Chapter X proceedings.[34] As to the matter of confining large corporations to either one of the two chapters, legislative intent seems to have been nonexistent. When, therefore, the majority speak of Congressional policy, allusion is really being made to a wholly fictional view which the Court believes that Congress ought to have entertained.

Aptly illustrating this use of a presumed legislative policy is the

obtained assents, see Jameson v. Guaranty Trust Co. of New York, (C. C. A. 7th, 1927) 20 F. (2d) 808 at 815.

[29] Bankruptcy Act of 1938, § 172, 11 U. S. C. (Supp. 1939), § 572.

[30] Id., § 313, 11 U. S. C. (Supp. 1939), § 713. A receiver will be appointed, "if necessary."

[31] Id., § 336 (4), 11 U. S. C. (Supp. 1939), § 736 (4).

[32] H. REP. 1409, 75th Cong., 1st sess. (1937), p. 41: "This . . . will remedy the present abuse and divert to Chapter XI the large number of debtors who are now resorting to section 77B for the sole purpose of adjusting their unsecured debts."

[33] In his statement before the House Judiciary Committee, W. Randolph Montgomery, attorney for the National Association of Credit Men, a chief sponsor of Chapter XI, said: "Subsection II (Chapter XI) is hardly comparable, I think, with subsection I (Chapter X). Subsection I deals with corporate reorganization. This (Chapter XI) is the statute which opens the relief to individuals and small corporations." HEARINGS ON H. R. 6439, 75th Cong., 1st sess. (1937), p. 1239.

[34] See note 32, supra.

Court's ruling that the S. E. C. may intervene in a Chapter XI proceeding for the purpose of moving a dismissal. No provision for such intervention is to be found in Chapter XI; the commission can show no pecuniary or property interest such as is customarily required of an intervenor;[35] and it has no claim or defense which would be affected by the decision of the court.[36] The holding of the Court necessitates, therefore, a shift in the premises upon which intervention is ordinarily rested. Again, to support its position, the Court calls upon the unwritten legislative policy, saying that intervention must be allowed to protect "the public interests which the Commission was designated to represent."[37] But this is tantamount to an acknowledgment that the S. E. C. has power to police all corporate arrangements and reorganizations. That Congress intended to grant such extensive dominion to that agency is extremely doubtful. Even under Chapter X, the commission is not accorded full rights of a party litigant. It may not dispute the jurisdiction of the court, and it is expressly denied the right to appeal.[38] Its function, in Chapter X proceedings, is essentially that of an expert disinterested advisor to the trial judge.[39] It seems strange to construe Chapter XI so as to give greater rights of intervention than are expressly set out in the reorganization chapter. More reasonably, it may be supposed that Congress purposefully neglected to provide for intervention by the S. E. C. in arrangement proceedings. The almost complete control over railroad reorganizations which is accorded to the Interstate Commerce Commission under Chapter XV of the Bankruptcy Act[40] furnishes basis for the conclusion that Congress is willing

[35] It is usually said that the petitioner must have a legal interest in the subject matter of the suit. 2 MOORE, FEDERAL PRACTICE 2332 (1938). Pennsylvania v. Williams, 294 U. S. 176, 55 S. Ct. 380 (1934), which is cited by the majority opinion in S. E. C. v. United States Realty & Improvement Co., is distinguishable because of the presence of the Pennsylvania statute, giving the state superintendent of banking a right to the possession and control of the assets of the insolvents.

[36] See dissenting opinion of Roberts, J., S. E. C. v. United States Realty & Improvement Co., (U. S. 1940) 60 S. Ct. 1044 at 1056.

[37] S. E. C. v. United States Realty & Improvement Co., (U. S. 1940) 60 S. Ct. 1044 at 1055.

[38] Bankruptcy Act of 1938, § 208, 11 U. S. C. (Supp. 1939), § 608.

[39] Writing in the American Bar Association Journal, Chairman (now Justice) Douglas has referred to the commission as "a standing 'amicus curiae' . . . with the technical facilities . . . in business and financial matters at the constant . . . disposal of the Federal courts. . . ." He said further: "The commission shares no power with the court . . . and its function is limited to furnishing the court with administrative assistance and advice." Douglas, "Improvement for Federal Procedure for Corporate Reorganizations," 24 A. B. A. J. 875 at 878 (1938).

[40] A plan of reorganization may not be filed with the district court until the approval of the Interstate Commerce Commission has been obtained. Bankruptcy Act of 1938, § 710, 11 U. S. C. (Supp. 1939), § 1210.

to provide for administrative supervision wherever and whenever the need is felt. Consequently, where such provision is entirely absent, the implication of a conscious omission seems unavoidable.

Laying aside the theoretical, legal objections to the decision in *In re United States Realty & Improvement Co.*, certain practical problems must still be faced. It may be that the Court's attempt to fill the gap in the Chandler Act has left unsettled almost as many questions as it has answered. Most important, the test proposed—the presence of publicly-held securities—may prove uncertain, and therefore unsatisfactory in its application. Will any public issue of securities bar access to Chapter XI? Or will a distinction be drawn on the basis of the aggregate value of the securities outstanding? Will the facts of the particular case be ignored, an arbitrary standard being observed? Or, if it is made to appear that the investors will be amply protected under a plan filed with a Chapter XI petition, may the court elect to proceed under that chapter? Questions of procedure will also be troublesome. As has been mentioned, no provision is made in the act for a transfer of proceedings from Chapter XI to Chapter X. If a court should find that a petition has been improperly filed under Chapter XI, a dismissal of the proceedings will therefore be necessitated, with the consequent delay and expense of instituting entirely new proceedings under the preceding chapter.

Considerable doubt may be felt as to the wisdom of a court's attempting to supply the statutory deficiencies, or supposed deficiencies. That the judicial process is not suited for the promulgation of working business principles is brought out by the language of the majority opinion limiting the scope of the Court's ruling: "While this means that arrangements of unsecured debts of corporations, like respondent, may not be 'in the best interests of creditors' and 'feasible' under Chapter XI, it does not mean that there is no scope for application of that chapter in many cases where the debtor's financial business and corporate structure differ from respondent's."[41] Here, indeed, is an uncertain guide for future conduct. Since reorganization is primarily a business matter, the governing rules of action should be definite and comprehensible. For this reason, it is believed that any correction of defects appearing in the act would best be accomplished by Congressional action. The inclusion of a few new sections, and the revision of others, would suffice for the purpose.

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[41] S. E. C. v. United States Realty & Improvement Co., (U. S. 1940) 60 S. Ct. 1044 at 1052.