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Bankruptcy - Limitations on Availability to Corporations of Arrangement Proceedings

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RECENT DECISIONS

BANKRUPTCY — LIMITATIONS ON AVAILABILITY TO CORPORATIONS OF ARRANGEMENT PROCEEDINGS—General Stores Corporation filed a chapter XI petition for an arrangement[1] of its unsecured debts, none of which were publicly held debentures, as allowed by section 322 of the Bankruptcy Act.[2] The debtor corporation's capital account consisted of over two million outstanding shares of common stock held by 7,000 stockholders and traded on the American Stock Exchange. A shareholder and the SEC moved under section 328 that the petition be dismissed[3] unless amended to comply with chapter X of the Bankruptcy Act,[4] calling for reorganization. The district court granted the motions,[5] and its action was affirmed by the court of appeals.[6] On appeal, *held,* affirmed, two justices dissenting. The needs of the corporate debtor determine which chapter is applicable. Where a complicated debt structure requires readjusting, and where there is a need for an accounting from management, or for new management, the controls offered by chapter X must be used. *General Stores Corp. v. Shlensky,* 350 U.S. 462, 76 S. Ct. 516 (1956).

Since the adoption of chapters X and XI in the Chandler Act of 1938, their application has been a puzzle to businessmen, lawyers, judges, the SEC, and writers. There are no definite legislative standards from which to ascertain the applicability of one in lieu of the other. Chapter X, promoted by the SEC,[7] provides more safeguards for the investing public by the appointment of a disinterested trustee with broad investigatory powers and the duty to draw a plan, by requiring the SEC to submit an advisory report on the plan, and by requiring the plan to be "fair and equitable."[8] But proceedings under chapter X are slow and costly. Chapter XI proceedings, though speedy and economical, leave the plan in the hands of the debtor, subject to acceptance by a majority of the creditors affected[9] and confirmation by the court.[10] Thus not as much protection is afforded public investors under chapter XI. Some courts felt that large debtor corporations with publicly held securities were limited to chapter X.[11]

1 An arrangement includes either a reduction of indebtedness or an extension of the time of payment. See In re Thompson, (D.C. Va. 1943) 51 F. Supp. 12.

2 52 Stat. L. 907 (1938), 11 U.S.C. (1952) §722. Section 306 of the act, 52 Stat. L. 906 (1938), 11 U.S.C. (1952) §706, limits arrangements under chapter 11 to unsecured debts.

3 66 Stat. L. 432 (1952), 11 U.S.C. (1952) §728.

4 52 Stat. L. 883 (1938), 11 U.S.C. (1952) §501.

5 In re General Stores Corp., (D.C. N.Y. 1955) 129 F. Supp. 801.

6 General Stores Corp. v. Shlensky, (2d Cir. 1955) 222 F. (2d) 234.

7 See discussion in 50 N. W. UNIV. L. REV. 761 at 763, 764 (1956).

8 Principal case at 466. Chapter X is derived from §77B of the old bankruptcy act. COLLIER, BANKRUPTCY MANUAL, 2d ed., p. 1079 (1954). The "fair and equitable" requirement was deleted from chapter XI in 1952. 66 Stat. L. 433 (1952), 11 U.S.C. (1952) §766.

9 52 Stat. L. 911 (1938), 11 U.S.C. (1952) §762.

10 52 Stat. L. 911 (1938), 11 U.S.C. (1952) §766. Chapter XI is derived from §§12 and 74 of the old act. See Rostow and Cutler, "Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act," 48 YALE L. J. 1334 at 1353 (1939).

11 In re Reo Motor Car Co., (D.C. Mich. 1939) 30 F. Supp. 785.

Others condemned the public securities test as judicial legislation and granted chapter XI proceedings where all that was sought was an arrangement of unsecured debts.[12] The Supreme Court, in *SEC v. United States Realty & Improvement Co.*,[13] apparently resolved the matter by dismissing a chapter XI proceeding in favor of chapter X where the latter would better serve the public and private interests, and where an arrangement could not be "fair and equitable." The requirement that an arrangement be fair and equitable was interpreted as requiring absolute priority of secured and unsecured creditors over stockholders in any corporate reorganization, except where the corporation is small, or where the subordinate creditors or stockholders are the managers of the corporation.[14] The basis for the distinction as to small corporations and those where management and debt were identical is not clear, but some distinction had to be made by the Court. If it outlawed all corporations from arrangements because of the fair and equitable rule, it would be acting in the face of the statute allowing corporations to petition under chapter XI.[15] In 1952 Congress amended section 366[16] to eliminate the fair and equitable requirement from chapter XI. Standing alone this would indicate a rejection of the *United States Realty* case, but Congress also added to the act section 328[17] providing for removal of chapter XI proceedings to chapter X in accord with the *United States Realty* decision.[18] Confusion ensued. The courts were not sure what standard to apply. Judge Medina, in *In re Transvision, Inc.*,[19] said that chapter XI proceedings should be allowed where ". . . there is a reasonable likelihood that the desired financial recovery will be effected without unduly prejudicing the rights of any interested parties."[20] Judge Dimock, in the district court opinion in the principal case,[21] relied primarily on the fact that there were 7,000 public holders of the debtor's stock whose interests could be protected only under chapter X, i.e., the public securities test. Judge Clark, in the court of appeals, followed Judge Dimock, saying, ". . . [A] widespread stockholder interest. . . is in itself sufficient ground for the invocation of chapter X

12 In re United States Realty & Improvements Co., (2d Cir. 1940) 108 F. (2d) 794, revd. 310 U.S. 434 (1940).

13 310 U.S. 434, 60 S.Ct. 1044 (1940).

14 Id. at 454. The Court relied on Northern Pacific R. Co. v. Boyd, 228 U.S. 482, 33 S.Ct. 554 (1913) and Case v. Los Angeles Lumber Co., 308 U.S. 106, 60 S.Ct. 1 (1939). The "fair and equitable" requirement is derived from §77B but is not to be found in §§12 or 74 from which chapter XI is derived. See Rostow and Cutler, "Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act," 48 YALE L.J. 1334 at 1353 (1939).

15 52 Stat. L. 906 (1938), 11 U.S.C. (1952) §706.

16 66 Stat. L. 433 (1952), 11 U.S.C. (1952) §766.

17 66 Stat. L. 432 (1952), 11 U.S.C. (1952) §728.

18 H. Rep. 2320, 82d Cong., 2d sess., p. 19 (1952); S. Rep. 1395, 82d Cong., 2d sess., p. 10 (1952).

19 (2d Cir. 1954) 217 F. (2d) 243, cert. den. SEC v. Transvision, Inc., 348 U.S. 952 (1955).

20 217 F. (2d) 243 at 246.

21 In re General Stores Corp., note 5 supra.

proceedings,"[22] and he rejected the tests urged by Judge Medina.[23] Both the majority opinion, by Justice Douglas, and the dissenting opinion of Justice Frankfurter, reject the public securities test in determining the applicability of chapters X and XI.[24] Justice Douglas states that "The character of the debtor is not the controlling consideration in a choice between c. X and c. XI,"[25] rather the needs of the debtor are determinative. He sets out three examples of his "needs test." Chapter X should be used where a complicated debt structure must be readjusted, where an accounting from management or new management is needed, and where a fair and equitable plan is required. It is the use of the fair and equitable requirement that is startling. Although Justice Douglas refers to it as a test under chapter X, he in effect applies it in considering the applicability of chapter XI. As Justice Frankfurter points out, Congress has eliminated this test from chapter XI.[26] The principal case seems likely to perpetuate it. For this reason, it is most desirable that Congress amend the reorganization laws, to establish definite lines of demarcation in the applicability of these two chapters.[27]

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22 General Stores Corp. v. Shlensky, note 6 supra, at 236.

23 Id. at 237.

24 Justice Douglas overlooks the fact that Judges Dimock and Clark applied the public securities test, and says they were within the bounds of their discretion. Justice Frankfurter would reverse for the reason that they applied inappropriate standards in their determination.

25 Principal case at 519.

26 66 Stat. L. 433 (1952), 11 U.S.C. (1952) §766.

27 See Rostow and Cutler, "Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act," 48 YALE L.J. 1334 (1939); 39 MICH. L. REV. 102 (1940); 69 HARV. L. REV. 352 (1955).