REORGANIZATION AND THE SECURITIES AND EXCHANGE COMMISSION *

An Address by

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The Securities and Exchange Commission has important functions assigned to it under Chapter X of The Bankruptcy Act. This is by no means fortuitous. The Commission has regulatory responsibilities under the Securities Act of 1933, which relates to securities offerings, and under the Securities Exchange Act of 1934, concerning trading in securities, national securities exchanges, and brokers or dealers in securities. Under the Public Utility Holding Company Act of 1935, the Commission has regulatory functions with respect to public-utility holding companies and subsidiaries, including their financial reorganization under Section 11(b)(2) of that statute. Preceding the passage of Chapter X, the Commission, under the supervision of Mr. (now Justice) Douglas, had made an extensive investigation, at the direction of Congress, into the functions and personnel of protective and reorganization committees.

The role of the Commission in Chapter X reorganization is somewhat unique. The Commission holds no hearings on Chapter X matters; it has no quasi-judicial or regulatory functions. When under Section 208 the Commission enters its appearance in the proceeding, either on its own motion or at the request of the judge, the Commission is a party to the proceedings for all purposes except that it has no right of appeal. The Congress has provided for such participation so that the court, the trustee and other parties in interest may have available the expert advice and assistance of a disinterested Federal agency for the better protection of public investors and for the effective administration of a complex statute. To speak of the Commission's role in Chapter X is to touch upon every significant phase of the proceeding. Inevitably, therefore, much that I have to say today has been said by others before. I shall feel amply rewarded if some of the things I say here will hereafter be said again by others.

The Commission does not and cannot participate in all Chapter X cases. Its participation is necessarily selective and so it must be. Otherwise the limited staff of accountants, attorneys and financial analysts in Washington and in our Regional Offices specially assigned to Chapter X cases could not work effectively and efficiently.

There are no hard and fast rules by which the question of participation is decided. The basic consideration is whether there is a significant public investor interest. If the debt and equity securities are closely or privately held the Commission generally will not seek intervention. In the typical case, in which the Commission enters its appearance, the debtor's securities, either stock or debt, are publicly held. There are some exceptions, of course, but there is no need to discuss them. I want only to note that if the judge requests the Commission's appearance, the request is always and promptly honored.

The door to Chapter X is wide open, but there is no assurance that those who enter may remain. The statute requires certain credentials; in the words of Section 146, the petition for reorganization must be filed in "good faith". This is an issue the court must resolve even if it is not raised by any party in interest.

The words "good faith" are not generally defined. Subsections (1) to (4) of Section 146 give four definitions of what is <u>not</u> "good faith", but these are only illustrative, not exhaustive. I shall comment briefly on two of these definitions.

Subsection (3) states that a petition is not filed in "good faith" if "it is unreasonable to expect that a plan of reorganization can be effected".

Such a forecast at the very outset of the proceeding is rather difficult. To require at this stage a demonstration of feasibility that is too exacting would defeat the purpose of Chapter X, namely, the preservation of economic values that a forced liquidation may dissipate. Those who oppose the petition are apt to emphasize past losses and to ignore that upon relief from the immediate pressure of excessive debt a losing business, given time, may become profitable. They are also apt to ignore that a reorganization often results in a shift in control and management and that a prudent management may succeed where an inept one has failed. Indeed, a plan of reorganization may provide for a merger or an acquisition of the debtor into or by a financially stronger enterprise.

Further, it cannot be too strongly emphasized that a finding under Section 146 that a reorganization is not unreasonable is only preliminary and provisional. For feasibility of reorganization is a recurrent theme throughout the proceeding, and is or may be reexamined at every crucial stage of the reorganization process. After a trustee has completed his investigation and has filed his report, the statute requires that the trustee file a plan or report to the court "why a plan cannot be effected". The judge may not approve or confirm a plan unless, among other things, he finds the plan feasible. If within the time allowed by the judge no plan is proposed, accepted, or consummated, Section 236 provides that the judge, in his discretion, may dismiss the proceeding or adjudicate the debtor a bankrupt. The inquiry into good faith under sub-paragraph (3) of Section 146 is only a tentative exploration of probabilities. A finding of good faith thereunder is simply a determination that the prospects of reorganization are not so conjectural as to require dismissal of the petition at the very threshold of the proceeding.

This issue can sometimes be of critical importance, and the stakes may be very high from the viewpoint of those that oppose the petition as well as those who support it. In the Magnolia Park case pending before Judge Wright, in which case the Commission has been an active participant, dismissal of the petition would have meant a forfeiture of the ground lease together with the improvements upon which the debtor had spent over $2 of the $3 million obtained from public investors. In such interplay of economic interests the hearing may often abound with complexities and sometimes is charged with high feeling and uncommon zeal. I venture to suggest that were this issue of good faith better understood, much could be done to avoid the searching examination of detail that is more relevant to the feasibility of a specific plan rather than of its general and preliminary counterpart.

The relationship of Chapter X to Chapter XI is of substantial interest to the Commission as well as to members of the bankruptcy bar. Subparagraph (2) of Section 146 states, in effect, that a petition is not filed in "good faith" if adequate relief for the debtor may be obtained through a plan of arrangement with unsecured creditors under Chapter XI. Conversely, the Commission has taken the position that a corporate debtor may not seek relief under Chapter XI where it appears that a full reorganization under Chapter X is more appropriate for its financial rehabilitation. This position was sustained by the Supreme Court in 1940 in the U. S. Realty case, 310 U.S. 434.

This ruling is now codified in Section 328 of Chapter XI adopted in 1952. It provides that the Commission or any other party in interest may move to dismiss on the ground that Chapter XI is not appropriate. The debtor may amend its petition to comply with the requirements of Chapter X, and creditors, too, may file a petition complying with Chapter X. Otherwise, if the motion is granted, the Chapter XI petition will be dismissed.

Professor Moore has explained to you in detail the essential differences between Chapter X and Chapter XI. The latter, if I may say so, provides for clinical treatment for the debtor's financial ailment. Chapter X may be likened to surgery. This does not mean that either one of these modes of rehabilitation must be available. The debtor's financial complications may be such that Chapter XI is not appropriate, and they may be of such magnitude and so hopeless that reorganization under Chapter X is not possible. In that event, liquidation may be the only realistic solution.

It is not always easy to determine which may be the necessary or appropriate route of rehabilitation, and litigation for settling the controversy may, of course, be time-consuming. In 1940 the Commission had proposed an amendment under which Chapter XI would be unavailable to debtor corporations whose outstanding securities were owned beneficially by 100 persons. The Report of the House Judiciary Committee was favorably inclined, but no further action was taken after the announcement of the decision in the U. S. Realty case. That case was generally interpreted as holding that publicly-held corporations were barred from Chapter XI. The General Stores case (350 U.S. 462) has indicated that the controlling criterion is "the needs to be served". A similar amendment was proposed by the Commission 1958, but it was not reported out by the House Committee. As nearly as I can determine, except for about 14 cases, the very many cases in Chapter XI involving corporate debtors since 1953 would not have been affected if the Commission's proposed amendment had been enacted into law.

All of the foregoing present only preliminary matters. The center of interest is, of course, on the reorganization process itself. Here the Commission's participation is not limited to formal court hearings, to supporting or objecting to matters submitted for adjudication to the court. The Congress intended that the Commission serve as adviser to the court and the parties in interest, and the Commission makes every effort to discharge that responsibility. In many cases, the Commission's staff has been of substantial assistance to the trustee in the conduct of his investigation, in the preparation of the trustee's report, in the drafting of a plan of reorganization, and in the negotiations for settling of controversies. In these and other matters our collective experience is available to the trustee and his counsel as well as to the other parties in interest. Such cooperation and interchange of views often relieve the court of unnecessary burdens and tasks. I should emphasize, however, that we are not like a coy maiden waiting to be asked. The Commission is party to the proceeding, and, where necessary, will take the initiative informally or by formal petition filed with the court.

A subject of perennial interest to the Commission is the office and qualifications of the trustee and his functions. Here major innovations were made by Chapter X. A debtor may remain in possession only if the liabilities are less than $250,000; otherwise the statute requires that a disinterested trustee be appointed, for the trustee plays a central role in the reorganization, both as regards the plan and his investigation. Persons with divided loyalties or with potential conflicts of interest may not assume these basic responsibilities. As the Supreme Court said in Mosser v. Darrow, 341 U.S. 267: "Equity tolerates in bankruptcy trustees no interest adverse to the trust. This is not because such interests are always corrupt but because they are always corrupting . . . ." To be disinterested, as one court put it, a person must be free "of any scintilla of personal interest which might be reflected in his decision concerning estate matters."

Section 158 does not define affirmatively who is a disinterested person. The definition is cast in a negative form, that is, who is not disinterested. Among those that are not disinterested are directors and officers of the debtor who probably know a good deal about the debtor's affairs. For one of the trustee's duties is to make a searching inquiry into the prior management of the debtor's affairs and to report, as Section 167 provides, all matters "pertaining to fraud, misconduct, mismanagement and irregularities, and to and to any causes of action available to the estate". An underwriter of any of the outstanding securities of the debtor, or one who was an underwriter of the debtor's securities within five years of the filing of the petition, is also not qualified. To make sure that no one has been slighted or ignored, subparagraph (4) states broadly that a person is not disinterested who had a direct or indirect connection with the debtor or for any reason an interest "materially adverse to the interests of any class of creditors or stockholders".

The first disqualifications are simple, clear and direct. Departures therefrom generally, though surprisingly not always, are the result of inadvertence. The last or catch-all disqualification may be subtle, and its proper application may require vigilance and judgment. The case of F. L. Jacobs Co., pending in the Federal Court in Detroit, is an interesting illustration. Sometime prior to the filing of the Chapter X petition, the Commission had filed suit in New York against the debtor and its management for alleged violations of the Federal Securities Acts, and sought the appointment of receivers to preserve the assets and to protect public investors. The management resisted the request for receivers and promptly appealed from the order of appointment. Within hours after the receivers were appointed, a creditors' petition under Chapter X was filed in Detroit; the debtor promptly consented; trustees were appointed and the attorney for the petitioning creditors was appointed counsel for the trustees. Subsequent inquiry disclosed that the Chapter X proceeding was initiated in collaboration with the management which, for reasons best known to itself, wished to escape the receivership in New York, and that, in fact, two of the petitioning creditors were supplied by the management. The Commission filed a petition for the removal of the attorney for the trustees. After a hearing and while the matter was sub judice, counsel resigned.

The course and the extent of the trustee's investigation occasionally present some difficulties. In general, his investigation has a dual purpose. The first is designed to ascertain the real assets and liabilities of the debtor as well as the sources of the debtor's financial failure. The other is to uncover acts of mismanagement, self-dealing and improper diversion of assets, with a view to their recovery for the benefit of the estate and its security holders. This critical survey of the past is highly essential.

As a philosopher once put it, those who ignore the past are bound to repeat its mistakes.

In many a case the recovery has been substantial, and by thus augmenting the assets of the estate may yield a participation in the reorganized company for those who otherwise would be excluded. Such recovery may also produce funds for necessary working capital or for capital improvements, and thereby give additional support for feasibility of the plan. In an extreme case, there may be no reorganization without such recoveries. When the petition was filed in the Swan Finch case in the Southern District of New York, the debtor had virtually no assets. The vigorous investigation by the trustees and their counsel has led to recoveries of stocks of subsidiaries that had been misappropriated, and other assets, all valued at over $900,000, and the task is not yet finished.

An investigation that is inept or perfunctory has the name but not its substance. An investigation that is biased and partisan is the corruption of its substance. Where the investigation has been incomplete, the Commission has joined with others to insist that the job be done right, Committee, etc. v. Kent, 143 F. 2d 684 (C.A. 4). Where the report indicated a compromising bias, the Commission has taken steps to remove the trustee or his counsel. The Pittsburgh Railways reorganization is an interesting though unusual situation. In that proceeding the parent company of the debtor was asserting a claim of over $76,000,000, to which objections were filed, and subordination or limitation to cost was urged. The trustee filed a brief report concluding that the claim should not be subordinated. It was subsequently discovered that the trustee had permitted an officer of the debtor, who was also associated with the parent company, to assist him in the preparation of his report. The trustee resigned after a special master had recommended his removal from office.

The climactic stage of the reorganization is the plan, with respect to which the statute assigns a special function to the Commission. Section 172 provides that, if after a hearing the judge finds the plan worthy of consideration he must refer the plan to the Commission for a report, if the scheduled indebtedness of the debtor exceeds $3,000,000; otherwise, the reference to the Commission is discretionary. The Commission is allowed a reasonable time within which to file a report. Section 173 provides that the judge may not approve the plan until after the Commission has filed its report, or the Commission has notified the judge that no report will be filed, whichever first occurs. Sometimes more than one plan may be involved since parties other than the trustee may file a plan. The order of reference is made after a hearing in which Commission counsel often assists in the development of the pertinent facts.

When the Commission is a party to the proceeding, it generally submits a formal report where the facts or the issues are novel or complex. The report usually includes a summary history of the debtor followed by an analysis of the debtor's assets and liabilities and capitalization; prospective earnings and valuation; the fairness and feasibility of the plan and other features of the plan. The Commission may recommend approval of the plan with or without modifications, or its disapproval. The Commission's report is advisory only. If the judge approves the plan, a copy of the Commission's report, or a summary thereof prepared by the Commission, must be mailed to security holders when the plan is mailed to them for a vote.

The words "plan of reorganization" are not defined in the statute. Reorganization denotes financial rehabilitation as a going concern and is usually contrasted with liquidation in bankruptcy. In Fidelity Assurance Association v. Sims, 318 U.S. 608, the Supreme Court held that a petition filed under Chapter X for the express purpose of liquidation is not filed in good faith and should be dismissed. On the other hand, if afterwards in the course of the proceeding it ultimately turns out that liquidation is the only solution, a plan may propose a liquidation. In re Solar Mfg. Co., 176 F. 2d 493 (C.A. 3).

Further, under Section 216, paragraph (10), a plan may provide for a sale of all the debtor's assets, but this is not necessarily a liquidation. The corporate entity may be liquidated but the business enterprise may be sold as a unit, for cash or securities of the acquiring company, or both, and in that event going-concern values are conserved and the fairness of the price is measured on the basis of such values. A plan may call for a merger or consolidation, or for a sale of the stock of the reorganized debtor to another corporation in the same business. Under such plans, what is lost or affected is the corporate identity or autonomy of the debtor; economic values are not. Such plans are truly plans of reorganization.

The statute requires that the plan must be fair and equitable and feasible. The words "fair and equitable" are words of art. A plan is "fair and equitable" if each class, in accordance with its rank, receives in new securities the equitable equivalent of the rights it is required to surrender. Incorporated therein is the rule of absolute priority under which no participation may be accorded to junior interests unless the claims of those senior in rank are satisfied in full. A plan is feasible if the new capital structure is reasonably adapted to prospective earnings that the reorganized company, with adequate working capital and under prudent management, may be expected to realize. These formulae are deceptively simple; but anyone who tries his hand at their practical application soon discovers the full extent of the underlying complexities. Perhaps the law student showed profound insight when he wrote in his examination book: "The words 'fair and equitable and feasible', as I understand them, are not understood at all".

This is not the occasion for any detailed discussion of this subject. The case law and the legal and financial literature are extensive. I merely wish to emphasize that an earnings valuation for purpose of reorganization is an indispensable prerequisite for approval of the plan, and to note that there is one single exception, to wit, where the debtor is an investment company with portfolio securities in various companies not under its control. Since the investment company is engaged in the purchase and sale of marketable securities, the more realistic measure of value is the market value of its portfolio. In short, value for purposes of reorganization is there calculated on an assumed instantaneous liquidation of its investments into cash. In re Central States Electric Corp. 182 F. 2d 879 (C.A. 4)

The administration of the estate sometimes brings into play the enforcement of the Securities Acts. The case of Hooper v. Mountain States Corp., 282 F. 2d 195 (C.A. 5), is a good illustration. This was a suit brought by a bankruptcy trustee, alleging that the debtor, a victim of a fraudulent scheme, had been induced to issue 700,000 shares of its own stock in exchange for worthless property. The suit was based on Rule 10b-5 promulgated by the Commission pursuant to Section 10(b) of the Securities Exchange Act of 1934. This Rule makes it unlawful, by use of the mails or interstate facilities, to engage in the purchase or sale of any security by fraudulent measures or misrepresentations. In an opinion written by Judge Brown, the Court of Appeals sustained the trustee's action, holding that the Rule was intended for the protection of all sellers and purchasers of securities and that the issuance of the securities by the corporate debtor was a sale under the Rule. The Commission supported the trustee, amicus curiae, and we like to think that our brief was helpful to the court in arriving at that significant decision.

The ruling in that case establishes an important route for marshalling assets of the estate. For a suit under Rule 10b-5 the trustee need not show all the prerequisites for common law fraud; service of process is nation wide; and if significant elements of the fraudulent transaction occurred where the principal place of the debtor's business is located, the plenary action may even be brought in the same court where the Chapter X proceeding is pending.

Corporate issuers are not always the victims of fraud. From time to time the investor may be the defrauded purchaser, and he may file suit against the corporate issuers for damages or for rescission, based on alleged fraud, under the Securities Act of 1933. In at least two cases under Chapter X, stockholders have filed proofs of claim for rescission, alleging that the registration statement or the offering circular was false and misleading. Since the debtor was insolvent, the stockholders would receive no participation under the plan as stockholders. However, if the claim for rescission were allowed, the stockholders would be elevated to the position of creditors and would participate under the plan on a parity with other unsecured creditors. In one case the issue was compromised; in at least one other, the matter is still pending.

Times does not permit discussion of other aspects of Chapter X. There is, of course, much more, both in text and commentary. Permit me, in conclusion, to make reference to the question of fees--a subject of understandable interest to all lawyers. Sections 241-244 make provisions for allowances to the trustee, his counsel and for other participants in the proceeding. The Commission is expressly excluded from these provisions. Judges, I should add, should not be inclined to vicarious generosity, and should award only modest but reasonable allowances to those who have served faithfully and have rendered valuable services in the reorganization. As someone aptly said, Chapter X was designed for the relief of debtors, not for the relief of lawyers.