Business Reorganizations under the Bankruptcy Reform Act of 1978 - A New Approach to Investor Protections and the Role of the SEC

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Chapter 11 of the Bankruptcy Reform Act of 1978 consolidates chapters X and XI of the Chandler Act and adopts a "disclosure" approach to business reorganization. This Article analyzes the effect of these changes on public investor protection and focuses upon the participation of the SEC in reorganization proceedings. The authors conclude that the automatic standing given the SEC in reorganization proceedings will provide the Commission with opportunities to function as a constructive force in securing adequate disclosure for the protection of public investors.

Business reorganization proceedings under the bankruptcy laws invariably involve complicated issues of financial analysis and disclosure that affect, in the substantial cases, significant public investor interests. In the 1930's, Congress created the Securities and Exchange Commission (SEC or Commission) "as a special agency charged with the function of protecting the investing public" under the federal securities acts. It also wrote into chapter

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The Securities and Exchange Commission supported the Senate version of the reorganization chapter in S. 2266 (95th Cong.), which included special provisions designed for a company whose securities are publicly held. As part of the House-Senate compromise leading to the enactment of H.R. 8200, as amended (Pub. L. No. 95-598), those provisions were deleted.

1. The securities of most, if not all, large debtors are held by public investors who are creditors or stockholders, or both. Thus, their securities probably will have been the subject of a registration statement under the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1976), processed by the Securities and Exchange Commission (SEC or Commission), and subject to the continuing disclosure requirements under the Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976). The contents of this Article will primarily relate to the reorganization of these types of public entities.

2. SEC v. American Trailer Rentals Co., 379 U.S. 594, 604 (1965). In this case, the Court was faced with the question of whether respondent's attempted corporate rehabilitation under
X of the Chandler Act of 1938\(^4\) the procedural means for SEC participation in bankruptcy corporate reorganization proceedings to provide similar protection for public investors.\(^4\) Thus, chapter X provided for Commission intervention and involvement as a party in interest in such proceedings.\(^5\) In 1952, chapter XI (the other chapter of the 1938 Act that addressed corporate rehabs) was amended to permit the Commission and others to seek to transfer a case under that chapter to chapter X where public debts were being adjusted, the number of public investors was great, and the adjustment was major.\(^6\)

As the United States Supreme Court characterized it, chapter X aimed to "afford greater protection to creditors and stockholders by providing . . . impartial and expert administrative assistance in corporate reorganization . . . through . . . active participation of the SEC."\(^7\) Having no financial interest in the debtor or in the outcome of its reorganization, the SEC could be an active party in the proceedings and thereby protect the interests of widespread public investors. Additionally, it could aid the court and trustee, if one was appointed,\(^8\) in an advisory capacity in the approval and confirma-

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4. This was because chapter X was considered to be a public investor protection statute. As the Supreme Court noted, "It seems clear that in enacting Chapter X Congress had the protection of public investors, and not trade creditors, primarily in mind." SEC v. American Trailer Rentals Co., 379 U.S. 594, 614 (1938).


8. Under § 156 of former chapter X, all cases involving a debtor with $250,000 or more of liabilities required the appointment of a disinterested trustee. Chandler Act, ch. X, § 156, 52 Stat. 888 (1938) (repealed 1979).
tion of the reorganization plan. Not the least significant of the SEC's statutory duties involving the public interest was its examination of and advisory report to the court on any reorganization plan deemed worthy of consideration and referred to the Commission.

With Congress' enactment of the Bankruptcy Reform Act of 1978 (Reform Act), the bankruptcy laws have been substantially revised. For business reorganizations, a new approach has been adopted: former chapters X and XI are now consolidated into a single reorganization chapter—chapter 11—and a disclosure approach, analogous to that under the securities laws, is followed in lieu of the former approach involving scrutiny and approval of a plan proposal's merits by the SEC and the court.

This Article focuses on the public-investor-protection aspects of the consolidated chapter 11 and the SEC's participation in that context. In addition to formal SEC standing and its right to be heard, such important investor protections as appointment of a disinterested trustee, creditor and equity security holder committees, investigations and plan formulations, disclosure, and confirmation standards are examined. Large public reorganization cases involve a community of participants and affect substantial financial interests. Where classes of publicly held debt and equity securities are concerned, a reorganization case transcends the rules applicable to arm's length bargaining and requires adherence to standards of conduct associated with fiduciary transactions. It is from this perspective that this Article is approached.

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9. The SEC's role under § 208 of former chapter X was described as one "charged with a responsibility to protect the public interest, the general interest of investors, and to serve in an advisory capacity to the bankruptcy court." SEC v. Krentzman, 397 F.2d 55, 57 (5th Cir. 1968) (appellate court held that district court's denial of SEC's right to put forth questions on cross-examination was outside of court's authority).


11. Pub. L. No. 95-598, 92 Stat. 2549 (to be codified in 11 U.S.C. and scattered sections of 2, 7, 12, 15, 17-20, 22, 28, 29, 31, 33, 40-43, 46, 48, 49 U.S.C.). The Bankruptcy Reform Act was enacted on Nov. 6, 1978, and became effective in substantial part on October 1, 1979. The heart of the Reform Act will be codified in title 11 of the United States Code. As this article was prepared for publication, the most current codification of the Act was the 1978 second supplement to the United States Code, in which title 11 appears in the appendix. Throughout this Article, all references to title 11 will be cited as 11 U.S.C. app. § (Supp. II 1978).


13. Id. § 1125.

14. E.g., in Young v. Higbee Co., 324 U.S. 204 (1945), the Supreme Court held stockholders, appealing a confirmation order in a chapter X reorganization proceeding, to a "representative responsibility" when they, in effect, sold their appeal for a cash payment. In a subsequent action for an accounting brought by a shareholder, the Court said that even though they did not formally seek to represent the class of shareholders, their "control of the common rights of all the preferred stockholders imposed on [them] a duty fairly to represent these common rights." Id. at 212.
Like its predecessor, the new Act expressly provides for SEC participation in chapter 11 reorganization proceedings. Section 1109(a) states: "The Securities and Exchange Commission may raise and may appear and be heard on any issue in a case under this chapter." 15 Previously, under chapter X, the SEC did not have an automatic right to appear in a reorganization proceeding. To appear, it needed either judicial approval of a motion seeking intervention or a request from the judge. 16 Also, while it was denied the right of appeal from an order of a district judge, 17 it could and often did participate in appeals initiated by other parties in interest. 18 Under the former chapter XI, on the other hand, the Commission did have a right of

15. 11 U.S.C. app. § 1109(a) (Supp. II 1978). The comparable provision in former chapter X was § 208, which read:

The Securities and Exchange Commission shall, if requested by the judge, and may, upon its own motion if approved by the judge, file a notice of its appearance in a proceeding under this chapter. Upon the filing of such a notice, the Commission shall be deemed to be a party in interest, with the right to be heard on all matters arising in such proceeding, and shall be deemed to have intervened in respect of all matters in such proceeding with the same force and effect as if a petition for that purpose had been allowed by the judge; but the Commission may not appeal or file any petition for appeal in any such proceeding.

Chandler Act, ch. X, § 208, 52 Stat. 894 (1938) (repealed 1979). While former chapter XI had neither an express general intervention provision nor prescribed statutory duties for the SEC, § 328 expressly permitted the Commission to intervene in the arrangement proceeding to seek a transfer of the case to chapter X. Chandler Act, ch. XI, § 328, as added by Act of July 7, 1952, Pub. L. No. 82-456, 66 Stat. 432 (repealed 1979). However, in certain situations, the SEC did intervene in chapter XI cases to enforce compliance with provisions of the federal securities laws when deemed necessary. SEC v. American Trailer Rentals Co., 379 U.S. 594, 612-13 (1965) (the SEC was not limited solely to seek a transfer under § 328 but also was entitled to intervene and be heard on other issues). In such instances, intervention was sought pursuant to FED. R. CIV. P. 24. See generally 43 SEC. ANN. REP. 264 (1977).


17. Chandler Act, ch. X, § 208, 52 Stat. 894 (1938) (repealed 1979). But this was not construed to prohibit review from rulings of a bankruptcy judge to a district judge, only from the latter to the court of appeals. Sup. Ct. R. BANKR. P. 10-210(c) stated that the SEC could "not appeal to the court of appeals from any order of the district court."

18. See In re Imperial "400" Nat'l, Inc., 432 F.2d 232, 234 (3d Cir. 1970) (as a party in the lower court proceedings, the SEC could become a party to an appeal); Ashback v. Kirtley, 289 F.2d 159, 162 (8th Cir. 1961), noted in In re American Nat'l Trust, 426 F.2d 1059, 1066 n.6
appeal, either from the denial of a section 328 transfer motion\textsuperscript{19} or from an order entered in a proceeding in which it had intervened generally or specifically as a party in interest.

Under the Reform Act, the participation of the SEC in corporate reorganization cases will stem from section 1109(a) of chapter 11. No longer will the Commission need to seek intervention or await court order into a case. It is statutorily authorized to intervene at any time and raise and be heard on any issue.\textsuperscript{20} Section 1109(a) appears to be patterned after former law addressing the SEC’s standing in reorganization cases. The Commission is seen in an “advisory role” enabling the court “to balance the needs of public security holders” against other “important public needs in a reorganization case.”\textsuperscript{21} While the Commission may raise any issue on its own initiative, it may also “appear and be heard on an issue that is raised by someone else.”\textsuperscript{22}

As in former chapter X, however, the SEC cannot “appeal from any judgment, order, or decree entered in the [revised chapter 11] case.”\textsuperscript{23} The reason behind the rule is that “an appeal by an agency that [has] no direct interest in the case when none of those with money involved can be persuaded to take an appeal could cause delay to the detriment of the debtor, the creditors, and the stockholders.”\textsuperscript{24} Further, while the Commission was denied the right of appeal under the old chapter X, it had sought and obtained in several cases the extraordinary remedy of mandamus to protect and/or clarify the scope of its participation in reorganization cases.\textsuperscript{25}

\textsuperscript{19} Most transfer motions were brought by the Commission. “Where a case originated in Chapter XI, the application for transfer to Chapter X under § 328 was usually made by the SEC.” 8 COLLIER ON BANKRUPTCY ¶ 4.22(2), at 470 (14th ed. 1978). Much of the law addressing whether chapter X or XI was appropriate for the rehabilitation of a particular debtor was a result of appeals initiated by the Commission from lower court denials of its transfer motions.

\textsuperscript{20} 11 U.S.C. app. § 1109(a) (Supp. II 1978).

\textsuperscript{21} 124 CONG. REC. H11,100 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards). The participation of the SEC, as well as other creditor and shareholder interests, “will enable the bankruptcy court to evaluate all sides of a position and to determine the public interest.” Id.

\textsuperscript{22} H.R. REP. No. 95-595, supra note 10, at 404.

\textsuperscript{23} 11 U.S.C. app. § 1109(a) (Supp. II 1978).

\textsuperscript{24} H.R. REP. No. 95-595, supra note 10, at 229. See also id. at 404, where it is stated: “The section, following current law, denies the right of appeal to the Securities and Exchange Commission. It does not, however, prevent the Commission from joining or participating in an appeal taken by a true party in interest. The Commission is merely prevented from initiating the appeal in any capacity.”

\textsuperscript{25} See, e.g., SEC v. Templar, 405 F.2d 126 (10th Cir. 1969) (writ denied); SEC v. Krentzman, 397 F.2d 55 (5th Cir. 1968) (writ granted).
The authors believe that in appropriate situations the Commission may be expected to do so under chapter 11.

Under section 208 of chapter X, the SEC was deemed a "party in interest" enjoying the right to be heard on all matters that arose in the case. There is no reason to assume that the Reform Act changes this perspective. Even though section 1109(a) does not include that specific language, the legislative history characterizes the SEC as a party in interest, as distinguished from a true party in interest—that is, one with a pecuniary interest, such as a creditor or stockholder.

The SEC's participation in chapter X was considered one of the important public investor protection features of that proceeding. The revised Act modifies the specific statutory duties prescribed by former chapter X for the Commission to discharge, but, in other respects, preserves the Commission's right to actively participate in all phases of chapter 11 cases. For example, in connection with the disclosure related to a plan, the House Report noted the nonapplicability of the securities acts' registration and proxy requirements, administered by the SEC under the federal securities laws, and stated that "certain [important] protection[s]" are provided so that "the public is not left entirely at the mercy of the debtor and its creditors." The first such protective device is that the court must approve the disclosure statement before acceptances can be solicited. The second is "that the Securities and Exchange Commission and any other regulatory agency or officers whose responsibility it is to enforce securities laws will have an absolute right to appear and be heard on whether a disclosure statement contains adequate information."

26. Section 1109(a), unlike § 208 of former chapter X, does not expressly refer to the SEC as a "party in interest," and it has been said that "the Securities and Exchange Commission is not a party in interest." 124 CONG. REC. H11,102 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards). That this omission and statement mean no more than to underscore the disinterested advisory role of the Commission, which carries no right of appeal in reorganization cases, seems clear. In the House Report's comment on the denial of a right to appeal in connection with the disclosure statement, reference is made to the possible detrimental delay of "[a]n appeal by an agency that had no direct interest in the case" when no one "with money involved can be persuaded to take an appeal." H.R. REP. No. 95-595, supra note 10, at 229. Additionally, in that same report on §§ 1109(a) and 1125(d), reference is made to a "true party in interest" in distinguishing the SEC's standing and role. Id. at 404, 409.

The distinction, then, is between the advisory status of the SEC and the monetary interest of others. Thus, for example, the House Report notes that "by virtue of . . . 11 U.S.C. § 1109," the Commission . . . [is a] "party[] in interest" for requesting the appointment of a trustee. Id. at 403.

27. H.R. REP. No. 95-595 supra note 10, at 228.
29. H.R. Rep. No. 95-595, supra note 10, at 228. The House Report also states that "[t]heir [SEC's or other regulatory agency's] arguments, on behalf of the public interest in an orderly securities market will undoubtedly be heard and considered by the bankruptcy judges." Id.
The SEC's involvement in chapter 11 cases should allow it to play an important role in investor protection.\(^{30}\) As a general participant with the right to be heard on any issue, a disinterested voice will be brought to bear on the many complicated matters that will arise, as they did under former chapter X, in reorganizations under chapter 11. It is the authors' belief that the Commission's participation as a general party in interest could continue to be of considerable assistance to the courts and to the other parties concerned.\(^ {31}\)

**Appointment of a Disinterested Trustee or Examiner**

In addition to allowing SEC participation in reorganization proceedings, the Reform Act provides several other important devices to ensure public investor protection. The first is the possible appointment of a disinterested trustee or examiner. To understand the Act's approach to the use of this device, it is necessary to review the role of the trustee under the 1938 law.

Under the former Bankruptcy Act, financially distressed corporations could seek rehabilitation under two chapters, each designed to deal with distinct and different economic needs,\(^ {32}\) and each "legally, mutually exclusive paths to attempted financial rehabilitation."\(^ {33}\) Chapter X was enacted for the protection of public investors\(^ {34}\) and provided a means for a pervasive reorganization, which could, and often did, require substantial changes in the debtor's capitalization. Thus, outstanding secured and unsecured debt and stock ownership, frequently involving public investor classes, were altered. Chapter X had certain procedural and substantive safeguards in the

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30. Several of the important areas are discussed in later sections.
31. In *In re* St. Charles Hotel Co., 60 F. Supp. 322 (D.N.J.), aff'd, 149 F.2d 645 (3d Cir.), *cert. denied*, 326 U.S. 738 (1945), the SEC appeared by direction of the court and presented the evidence and argument to assist the court in determining whether the chapter X petition met the good faith requirements of §146 of that chapter. 60 F. Supp. at 325. Noting that only the objecting creditors appeared in opposition to the petition and that other parties might have been "apathetic to their own interests," because of "ignorance, laxity, lack of funds or otherwise," the court said the SEC "was set up to safeguard the rights of the investing public" and its "recommendations must be considered with that object in mind." *Id.* at 327. In that regard, the district court judge stated: "In this case the Securities and Exchange Commission serves the useful purpose of presenting to the court an over-all view of the case which embraces the interests of the aforementioned absent parties." *Id.*

Likewise, in *In re* Arlan's Dep't Stores, Inc., 462 F. Supp. 1255 (S.D.N.Y. 1978), a fee case, the district court judge noted that the SEC "has been a party to this action since the transfer to Chapter X pursuant to section 208 of the Act, 11 U.S.C. § 608," and "[i]ts help and guidance . . . has been of great assistance to the court throughout these protracted proceedings" and it "could be relied upon, when requested, to provide a disinterested perspective of the events about which the court needed to be informed." *Id.* at 1260.

interest of investors. They included the mandatory appointment of a “disinterested” trustee as the “focal point” of the reorganization\textsuperscript{35} in those cases where the debtor’s liabilities were $250,000 or more,\textsuperscript{36} and close supervision by the court over the administration of the estate. While speed and economy were a statutory desideratum, under chapter X, they acceded to reasonable assessment and investigation\textsuperscript{37}—prerequisites to the formulation of a reorganization plan by the trustee—so that the extensive restructuring contemplated by that chapter could be successfully accomplished.\textsuperscript{38}

By contrast, chapter XI essentially provided for a simple composition between a debtor and its unsecured creditors,\textsuperscript{39} primarily trade claimants. Because speed and economy ostensibly were the hallmarks of chapter XI, it involved a summary procedure to facilitate the arrangement “with only a bare minimum of independent control or supervision.”\textsuperscript{40} Thus, the debtor generally was permitted to retain control of its assets and manage its own affairs,\textsuperscript{41} with no supervision by an independent trustee,\textsuperscript{42} and retained for itself the exclusive right to propose an arrangement.\textsuperscript{43} A chapter XI arrangement could not affect secured claims absent actual consent of the secured creditors.\textsuperscript{44}

\textsuperscript{36} Chandler Act, ch. X, §§ 156, 158, 52 Stat. 888 (1938) (repealed 1979); Sup. CT. R. BANKR. P. 10-202(a), 10-202(c). Under § 158 and Sup. CT. R. BANKR. P. 10-202(c)(2), a person was deemed not disinterested if he or she: (a) had been a creditor or stockholder of the debtor; (b) had been an underwriter of any of the debtor’s outstanding securities or, within five years of the filing of the petition, had been an underwriter of any of the debtor’s securities; (c) had been, or, within two years of the filing of the petition, had been an employee, officer, or director of the debtor, or an underwriter or an attorney for the debtor or such underwriter; or (d) had, either directly or indirectly any other interest materially adverse to the interests of any class of creditors or stockholders.

It is significant that those disqualifications did not presume dishonesty, but rather recognized the difficulty of determining, at the outset of the reorganization, the ability and character of individuals associated with the debtor to serve in fiduciary positions as court-appointed officials. See Wolf v. Weinstein, 372 U.S. 633 (1963) (debtor was continued in possession because its liabilities were less than $250,000).

\textsuperscript{37} In no event would the need for expediting reorganization proceedings justify abandoning proper procedural and substantive standards. See Protective Comm. v. Anderson, 390 U.S. 414, 450 (1968).
\textsuperscript{38} See text accompanying notes 142-59 infra.
\textsuperscript{41} Chandler Act, ch. XI, § 342, 52 Stat. 909 (1938) (repealed 1979); Sup. CT. R. BANKR. P. 11-18(b).
\textsuperscript{42} Chandler Act, ch. XI, § 332, 52 Stat. 908 (1938) (repealed 1979). This section provided, however, for the continuation in possession of a previously appointed trustee in bankruptcy in a pending bankruptcy case. Id.
\textsuperscript{43} Id. § 323, Sup. CT. R. BANKR. P. 11-36(a).
\textsuperscript{44} R.I.D.C. Indus. Dev. Fund v. Snyder, 539 F.2d 487, 493 (5th Cir. 1976) (secured creditor that received less than full face amount of debt allowed to participate in chapter XI
debtor, although the issuance of stock in exchange for creditors' claims would alter the degree of control and ownership of the old stockholders.

There were no automatic tests for determining the adequacy of chapter XI or the need for relief under chapter X. The test used in practice was one of determining "needs to be served." For the larger and publicly held corporations, the proper avenue of relief could be obtained by a motion, under section 328 of chapter XI and chapter XI rule 11-15(b), to transfer the case to chapter X. The Supreme Court had given pragmatic guidelines on this subject. Normally, when a debtor requiring rehabilitation had a substantial number of public investors, particularly where there was a large class of investors who were creditors, it was held that chapter X was, as a general rule, the proper avenue of relief unless the debt adjustment was "minor, consisting, for example, of a short extension of time for payment." However, in holding that neither the debtor's size nor its capital structure were necessarily controlling, the Supreme Court had pointed out in General Stores Corp. v. Shlensky that "[a] large company with publicly held securities may have as much need for a simple composition of unsecured debts as a smaller company." When Congress first divided corporate reorganizations into chapters X and XI in 1938, a hotly debated matter was the important question concerning the mandatory appointment of a disinterested trustee. In connection with


46. See Posi-Seal Int'l, Inc. v. Chipperfield, 457 F.2d 237 (2d Cir. 1972) (district court had jurisdiction to control arrangement).


49. Id.

50. Id. at 613; In re Continental Inv. Corp., 586 F.2d 241 (1st Cir. 1978), cert. denied, sub nom Wallace v. SEC, 440 U.S. 980 (1979) (SEC's transfer motion granted); Norman Fin. & Thrift Corp. v. SEC, 415 F.2d 1199 (10th Cir. 1969) (SEC's motion to transfer to chapter X granted); SEC v. People's Loan & Inv. Co., 410 F.2d 851 (6th Cir. 1969) (chapter X appropriate proceeding where proposed arrangement could result in significant reduction in claims of depositors/creditors); SEC v. Canandaigua Enterprises Corp., 339 F.2d 14 (2d Cir. 1964) (granted SEC motion to transfer to chapter X).

51. SEC v. American Trailer Rentals Co., 379 U.S. 594, 614-19. See Barnes v. Alrac Corp., 550 F.2d 1314, 1319 (2d Cir. 1977) (deferral of time within which to pay in full principal on notes, so that only timing of payments and receipt of post-petition interest was affected, "was not so substantial as to outweigh the factors favoring Chapter XI treatment").


its consideration of a consolidated reorganization chapter under the Reform Act, Congress again wrestled with the question of the mandatory appointment of a trustee. The House of Representatives determined not to require a trustee in every case.\textsuperscript{54} The Senate, on the other hand, initially was of the view that a trustee should automatically be appointed in a case involving a "public company," as that term was defined.\textsuperscript{55} But it receded from the mandatory trustee concept and agreed to a provision requiring the appointment of an examiner, upon the request of a party in interest, in certain cases where no trustee has been appointed.\textsuperscript{56}

About Congress' opting for this new approach, it was thought that displacement of management with a trustee would impose a rigid and formal procedure, much like former chapter X, upon many cases where it is not necessary—thereby sacrificing speed and simplicity.\textsuperscript{57} Moreover, it was said that certain chapter X provisions designed to protect public investors, such as those calling for a mandatory trustee, were no longer necessary due, in large part, "to the pervasive effect of the Federal securities laws and the extraordinary success of the Securities and Exchange Commission in sensitizing both management and members of the bar to the need for full disclosure and fair dealing in transactions involving publicly held securities."\textsuperscript{58}

Under these circumstances, Congress adopted a flexible approach to the appointment of a trustee in reorganization cases, and opted for a case-by-case determination.\textsuperscript{59} It leaves the debtor in possession of its business,
except where the court, upon request of an interested party and after notice and hearing, determines that a disinterested trustee is necessary. 60 Section 1104(a) envisions the appointment of a trustee either "for cause"—such cause including fraud, dishonesty, or gross mismanagement of the debtor’s affairs by current management or some other similar occurrence—or where the appointment is in the "interests of creditors, any equity security holders, and other interests of the estate." 61 In either case, however, these standards are to be applied without regard to the amount of assets or liabilities of the debtor or the number of security holders. 62

Because the disinterested trustee was the investor protection feature of chapter X most often at issue in the litigation over which reorganization chapter was applicable, the SEC may now be, as it was then, 63 the moving force in seeking the public protection afforded by the appointment of a trustee. 64 Although a "party in interest" must make the request, it is clear that the SEC may do so. 65 Whether such an application will have the same effect as the former transfer motion is difficult to project, although it surely could cause public investors and their representatives to focus on the need for this protection in a particular case. 66

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60. 11 U.S.C. app. § 1104(a) (Supp. II 1978). See § 1104(c) for a discussion of replacement for a deceased trustee or examiner. The inclusion of the language "on request of a party in interest" is designed to preclude the bankruptcy courts from acting sua sponte. 124 CONG. REC. S17,407 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini).


62. The exclusion of the size of the debtor or the number of persons owning its securities reflects one of the holdings of General Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956). It also rejects the presumption of SEC v. American Trailer Rentals Co., 379 U.S. 594, 613 (1965) ("as a general rule Chapter X is the appropriate proceeding for the adjustment of publicly held debt").

63. "Where a case originated in Chapter XI, the application for transfer to Chapter X under § 328 was usually made by the SEC." 8 COLLIER ON BANKRUPTCY ¶ 4.22(2), at 470 (14th ed. 1978). In that regard, it had been suggested that the discretionary appointment of a trustee "will only shift the controversial litigation [over whether a case should be transferred from chapter XI to chapter X] to the need for the appointment." 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. 624 (1977) (statement of SEC Commissioner Philip A. Loomis, Jr.).

64. Just as a trustee under former chapter X was required to be disinterested, see text accompanying notes 35 & 36 supra, so, too, must a trustee appointed pursuant to § 1104(a) be a "disinterested person." 11 U.S.C. app. § 1104(c) (Supp. II 1978). Section 101(13) of the Act defines "disinterested person" in a similar negative context as it was defined for purposes of the appointment of a trustee in former chapter X—that is, an individual who can demonstrate an absence of relationships with the debtor that create or give the appearance of a conflict. 11 U.S.C. app. § 101(13) (Supp. II 1978). Likewise, an examiner appointed pursuant to § 1104(b) must be a disinterested person. Id. § 1104(c). See also King, Chapter 11 of the 1978 Bankruptcy Code, 53 AM. BANKR. L.J. 107, 115 (1979) (hereinafter cited as King).

65. The House noted: "By virtue of proposed 11 U.S.C. § 1109, . . . the Securities and Exchange Commission will be [a party] in interest for the purpose of requesting the appointment of a trustee or examiner." H.R. REP. No. 95-595, supra note 10, at 403. See id. at 234; King, supra note 64, at 114, 116.

66. Because the main thrust of an SEC transfer motion involved the appointment of a disinterested trustee, stiff resistance was usually encountered from the debtor, whose manage-
Circumstances in which a trustee will be appointed “for cause” are not difficult to imagine. Because of the proposed representation of creditors and equity security holders by committees that are expected to play an active role in the case, however, it is likely that the specific criteria relating to the appointment of a trustee “in the interests of creditors, any equity security holders, and other interests of the estate” will evolve through judicial construction.


A less egregious case that could result in the appointment of a trustee for “cause” would be one where mismanagement exists and new management has not been brought in. Although the House Report seems to designate “honest mismanagement” as an insufficient cause for appointment (see H.R. Rep. No. 95-595, supra note 10, at 233), to the extent that “honest mismanagement” equates with “incompetence,” 11 U.S.C. app. § 1104(a)(1) (Supp. II 1978), such should suffice for cause. Of course, the difficulty in permitting management to remain in possession is that if a cause of action for mismanagement is discovered, public creditors and stockholders are entitled to redress against the very management that operates the debtor’s business and negotiates the plan. If a debtor has not put its house in order by replacing management before filing a petition, chapter 11 ought not to be used as a haven for discredited management.


However, in Fricke v. Daylin, Inc., 66 F.R.D. 90, 97 (E.D.N.Y. 1975), which involved a shareholders’ derivative suit commenced before bankruptcy, a non-bankruptcy court rejected a compromise offered by Daylin and the defendants, who were directors, in settlement of charges of waste, mismanagement, securities law violations, and breach of fiduciary duty. In refusing the compromise as unfair to Daylin, the court noted that the company “is being asked to relinquish meritorious causes of action for waste and breach of fiduciary duty...without visible consideration passing to the corporation.” Id. at 97-98. Proponents of the compromise essentially maintained that “since Daylin is in urgent need of liquid assets,” id. at 96, return of certain assets was justification for the compromise—an argument the court dismissed as raising a “serious question” with “fiduciaries.” Id. at 98.

BUSINESS REORGANIZATION

1979

If appointed, a trustee is charged with duties similar to those formerly imposed upon a chapter X trustee. Authority is given, inter alia, to operate the debtor’s business; conduct a thorough investigation of the affairs of the debtor, its financial condition, operation of its business and desirability of its continuation and any other matter relevant to formulating a plan; file a report of such investigation, including facts relating to fraud, mismanagement, or causes of action available to the estate, and transmit a copy or summary of the report to any appointed committees, indenture trustees, and any other entity designated by the court; and formulate a plan, file a report explaining why no plan will be submitted, or recommend conversion of the case to bankruptcy. Thus, it appears that, in those cases where a trustee is appointed, one of the major investor protections envisioned by Congress when it passed chapter X is retained.

By contrast, in a case where no trustee is appointed, the debtor would continue in possession and operate its business. Because a debtor in possession will not conduct any required investigation or submit a report thereon, Congress, as a compromise, has provided that under certain cir-

Edwards). An earlier version of § 1104(a) of the House Bill provided for a trustee “only if” that protection was “needed” and the costs would not be “disproportionately” higher than the value afforded. H.R. 8200, 95th Cong., 1st Sess. § 1104(a) (1977). On the other hand, the Senate version provided that in the case of a “public company,” the court was automatically required to appoint a “disinterested trustee,” and, in a nonpublic case, upon request, the court could order an election of a trustee or, if one is not elected, appoint a trustee “in the interests of the estate and security holders.” S. 2256, 95th Cong., 2d Sess. § 702 (1978). The Senate was no doubt thinking of chapter X: “Investor 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.” S. REP. NO. 95-989, supra note 55, at 10. The House version was premised on former chapter XI: “[T]he public and the creditors will not necessarily be harmed if the debtor is continued in possession in a reorganization case, as has been demonstrated under current Chapter XI.” H.R. REP. NO. 95-505, supra note 10, at 233. The determination of “interests” of creditors, equity security holders, and other interests in the estate sufficient to require a trustee will be influenced by a balancing of the goals of protecting public investors in a proper reorganization and facilitating the proceeding toward a successful conclusion. Perhaps such factors as the debtor’s familiarity with the business, the nature of the business reverses, prefiling changes in management, and the intensity of conflicting interests between various classes of creditors and equity security holders will be considered. The judicial task will be to interpret the Congressional compromise.


70. The Reform Act defines “entity” to include person or governmental unit. 11 U.S.C. app. § 101(14) (Supp. II 1978). In that regard, it should be noted that “ ‘person’ includes individual, partnership or corporation.” Id. § 101(30).


72. See H.R. REP. NO. 1409, supra note 53, at 43.

73. 11 U.S.C. app. § 1107(a) (Supp. II 1978). Section 156 of former chapter X and chapter X rule 10-202(a) provided for the discretionary appointment of a trustee where the requisite indebtedness was less than $250,000. Chandler Act, ch. X, § 156, 52 Stat. 888 (1938) (repealed 1979); SUP. CT. R. BANKR. P. 10-202(a).

cumstances an examiner can be appointed to conduct an investigation.\textsuperscript{75} The authors presume that the basis for this provision was the same in 1978 as it was when chapter X was passed—that is, "a debtor in possession cannot be expected to investigate itself."\textsuperscript{76}

**CREDITOR AND EQUITY SECURITY HOLDER COMMITTEES**

A second significant form of investor participation, and thus protection, in reorganization proceedings will be through committees, either investor-organized or court-appointed,\textsuperscript{77} representing classes of creditors and equity security holders.\textsuperscript{78} In the past, investor participation through committees was encouraged, and the committees and their counsel were permitted to receive compensation and expenses from the estate for services rendered.\textsuperscript{79} Moreover, the official chapter XI committee was assigned express statutory

\textsuperscript{75} Id. \S 1104(b). See also H.R. Rep. No. 95-595, supra note 10, at 234, 402. This would appear to be similar to those chapter X cases in which a debtor remained in possession and an examiner was appointed to conduct an investigation and report thereon. Chandler Act, ch. X, \S\S 156, 168, 52 Stat. 840 (1938) (repealed 1979); Sup. Ct. R. Bankr. P. 10-209(b). It is said that the examiner compromise provision "should adequately represent the needs of public security holders in most cases." 124 CONG. REC. S17,417 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 CONG. REC. H11,100 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).


\textsuperscript{77} See 11 U.S.C. app. \S 1102(b)(1) (Supp. II 1978); note 88 infra. Former chapter X provided for committees representing various groups but had no one official committee, while former chapter XI had one official committee. 6 COLLIER ON BANKRUPTCY \S 5.35(2), at 702 (14th ed. 1978).

\textsuperscript{78} Accordingly, it has been said:

In corporate reorganization the frequent necessity for representation of the individual creditor or stockholder by an agent or committee (more often the latter) is particularly evident. . . . In cases often arising, the creditors and stockholders of the debtor are widely scattered, the securities of the debtor have been sold to the public generally and large numbers of the security holders may be persons of small means holding securities in small amounts. . . . A solution for such creditor and shareholder participation, therefore, is through the medium of representative agents or committees which will act for a number of persons similarly situated. 6 COLLIER ON BANKRUPTCY \S 9.28, at 1726-77 (14th ed. 1978).

\textsuperscript{79} Because the former chapter XI committee was an official one, it was entitled to reimbursement and compensation for the services of its counsel and other court-approved agents. Chandler Act, ch. XI, \S 339(2), as added by Act of Nov. 28, 1967, Pub. L. No. 90-158, 81 Stat. 517 (repealed 1979); Sup. Ct. R. Bankr. P. 11-29(c). On the other hand, former chapter X contemplated unofficial committees, freely formed, which had the absolute right to appear in the proceeding. Section 209 of former chapter X provided that "[a]ny creditor or stockholder may . . . act in person, by an attorney at law, or by a duly authorized agent or committee." Chandler Act, ch. X, \S 209, 52 Stat. 895 (1938) (repealed 1979). The court regulated the representation, however, by requiring certain information to be disclosed, id. \S 211, 52 Stat. 895; Sup. Ct. R. Bankr. P. 10-211, and compensation from the estate depended on demonstrable benefit relating to the plan or the administration of the estate, the risk of which was on the applicant. Id. \S 242(1), 52 Stat. 900; Sup. Ct. R. Bankr. P. 10-215(c)(1)(B). In Protective Comm. v. Kirkland, 434 F.2d 804 (5th Cir. 1970), cert. denied, 402 U.S. 907 (1971) (chapter X
functions in connection with the arrangement proceeding. Chapter X committees, on the other hand, had no specific functions and always represented the general interests of the particular creditor or shareholder group authorizing the committee to represent it. It was because of this fundamental difference in the origin of chapter X committees that the court was given a measure of control in regulating their activities, such as by refusing to permit them to "be heard further" where they failed to supply the court with requisite information concerning the representation.

Committees under the Reform Act will be governed by procedures consisting of a "combination of features" from former chapters X and XI. Section 1109(b) contemplates a broad committee participation with the committee deemed a party in interest, which, like the SEC, "may raise and may appear and be heard on any issue" in the case. Together with the specific functions and rights of a committee, its official standing should develop as a potent force in protecting the rights of public investor classes, creditor or equity, in a reorganization case. With the bankruptcy judge now removed from active participation in the case and the preference for leaving the debtor in possession, a chapter 11 committee will assume a sub-case involving an active committee), the court said that "[t]he committee is entitled to participate fully in these proceedings, and if its services result in a benefit to the estate, compensation for those services is authorized." Id. at 807-08.


81. As an official committee, a committee under the former chapter XI acted for the only group it could represent, unsecured creditors, Sup. Ct. R. Bankr. P. 11-27, whereas a former chapter X committee represented only those individuals who "duly authorized" it to represent them. Chandler Act, ch. X, § 209, 52 Stat. 840 (1938) (repealed 1979).


83. H.R. REP. No. 95-595, supra note 10, at 235.

84. 11 U.S.C. app. § 1109(b) (Supp. II 1978).

85. Public investor participation in a reorganization case through committee representation of widespread investors would seem essential in a large case because there may be no trustee and the merits of the plan no longer are required to be examined by the SEC as they were under former chapter X. As the Supreme Court noted: "Public investors are . . . generally widely scattered and are far less likely than trade creditors to be aware of the financial condition and cause of the collapse of the debtor." SEC v. American Trailer Rentals Co., 379 U.S. 594, 613-14 (1965).

86. For example, § 341(c) provides that the bankruptcy judge "may not preside at, and may not attend," the official meetings of creditors and equity security holders. 11 U.S.C. app. § 341(c) (Supp. II 1978). But see S. 305, 96th Cong., 1st Sess. § 111(b) (1979), suggesting an amendment to § 341(c) that would require the court to "preside at any election of the trustee."
substantial responsibility in connection with the case, especially in the development of the terms of a plan of reorganization. The Act requires that in all cases at least one committee representing unsecured creditors be appointed "as soon as practicable" after the commencement of the case. Because chapter 11, like former chapter X, can affect the rights of secured and unsecured creditors, as well as stockholders, provision is made for other committees to represent various investor groups. Additional committees, however, are not formed automatically. On the request of a "party in interest," the court may, but need not, order the "appointment of additional committees of creditors or of equity security holders." The statutory condition for creating an additional committee is that the court find the committee "necessary to assure adequate representation" of creditors or stockholders. Hence, a large publicly held debtor with senior unsecured creditors, subordinated debenture holders, and shareholders may very well require the creation of three committees. When that occurs, each additional committee has "status equal to

87. This is emphasized by the fact that a plan participation for a particular investor group now is negotiated with the debtor, or plan proponent, and the fair and equitable standard of former chapter X, a public investor protection of that chapter, no longer is controlling. See text accompanying notes 210-39 infra.

88. 11 U.S.C. app. §§ 1102(a), 151102 (Supp. II 1978). The U.S. Trustee, an experimental administrative aspect of the Reform Act, makes the appointments in certain pilot districts (e.g., the Southern District of New York and the Central District of California), while the court acts in all other districts. Appointment, rather than election, is designed "to insure that the committees are fairly representative and not solely controlled by attorneys seeking the counsel position." H.R. REP. No. 95-595, supra note 10, at 236. This approach could make for more effective committee representation.

89. 11 U.S.C. app. § 1101(a) (Supp. II 1978). This mirrors former chapter XI. The idea is to form the committee right away, and, because unsecured creditors are usually the largest body of claimants "most in need of representation," the mandatory committee consists of unsecured creditors. H.R. REP. No. 95-595, supra note 10, at 235. In former chapter XI, committees usually were formed at the first meeting of creditors, which was required to be held between 20-40 days after filing of the petition, SUP. CT. R. BANKR. P. 11-25(a)(1), although committee creation was not mandatory. Id. at R. 11-27(a). Former chapter X had no provision regarding committee formation, other than sections regulating the activities of committees when they sought to appear and be heard in the case. See notes 77 & 79 supra.

90. 11 U.S.C. app. § 1102(a)(2) (Supp. II 1978). Thus, following the appointment approach, there may even be additional committees of secured creditors, such as first mortgage bondholders, and stockholders. H.R. REP. No. 95-595, supra note 10, at 236.

91. 11 U.S.C. app. § 1102 (a) (2) (Supp. II 1978).

92. In negotiating a plan, debentures' claims might conflict with trade debt, and equity interests are of a different legal position in any event. Should the debtor propose to affect all these classes in a plan, it would seem that separate committees should be appointed to assure "adequate representation" of the public debentures and shareholders in the plan process. In H.R. REP. No. 95-595, supra note 10, at 401, it was said that this provision "will be relied upon in cases in which the debtor proposes to affect several classes of debt or equity holders under the plan, and in which they need representation." To this extent, then, the additional committee may become a substitute for the mandatory appointment of a trustee in the larger chapter X cases, as a public investor protection feature of the Act, when no trustee is appointed.
that of the unsecured creditors' committee."

Because, as noted previously, the SEC has the right to "raise . . ., appear and be heard on any issue" in the case, like parties in interest designated in section 1109(b), the Commission should be able to request the appointment of additional committees of public creditors and equity security holders in an appropriate case. Such a step may be necessary to make the provision for additional committees an effective investor protection feature.

Through precatory language, the Act provides that the members of the mandatory unsecured creditors' committee shall "ordinarily" be the holders of the "seven largest" unsecured claims against the debtor "willing to serve." Thus, such a committee in a large public debtor could consist largely of institutional creditor representatives. On the other hand, recognizing the situation that existed in some chapter XI cases—where a committee was formed before the petition was filed—the court may continue

94. Under former chapter X the SEC supported the right of a properly formed and qualified committee to be heard, and it even opposed committee attempts at special intervention on the ground that it was unnecessary and unauthorized. See In re Flour Mills of America, Inc., 27 F. Supp. 559 (W.D. Mo. 1939) (SEC motion to vacate orders permitting intervention of security holders committee, sustained). Moreover, because Congress intended to broaden the rights of parties specified in § 206 of former chapter X to participate in corporate reorganization proceedings, In re Keystone Holding Co., 117 F.2d 1003, 1005 (3d Cir. 1941) (creditor), there was no need for such parties to seek intervention. In re South State St. Bldg. Corp., 140 F.2d 363, 366 (7th Cir. 1943), cert. denied, 322 U.S. 761 (1943) (stockholder); Rudnick v. Coney Island Boardwalk Corp., 181 F.2d 775, 776 (2d Cir. 1950) (creditor).
95. Early determination of the need for "adequate representation" of investors through additional committees will facilitate the development of the plan because committees "will be the primary negotiating bodies for the formulation of the plan of reorganization." H.R. REP. No. 95-595, supra note 10, at 401. In In re Rosenbaum Grain Co., 13 F. Supp. 600 (N.D. Ill. 1935), a reorganization under former § 77B, the debtor petitioned to have the court appoint a creditors' committee and a stockholders' committee and, on its own, designate the chairman of each committee. In granting the petition, the court noted:

In a great majority of the cases presented to the court the creditors of the corporation are widely scattered, bonds having been sold to the public generally and very frequently large numbers of persons of small means hold bonds in quite small amounts. These creditors have great difficulty in protecting their interests, and the holder of a thousand dollar bond cannot afford to employ counsel to represent him in the proceedings.

Id. at 600.
97. For example, the official creditors' committee in the chapter XI proceedings of In re Daylin, Inc., No. BK75-02958JM (C.D. Cal., filed Feb. 26, 1975), consisted of 11 members selected by the unsecured creditors and confirmed by the court. Seven of the members, including the chairman, were institutional creditors. Prospectus, In re Daylin, Inc., Aug. 19, 1976, at 16. The statutory direction, however, says "ordinarily," and this should provide the requisite flexibility. 11 U.S.C. app. § 1102(b)(a) (Supp. II 1978).
98. These cases usually involved a "pre-packaged" chapter XI proceeding for a quick run through the bankruptcy court to effect a majority acceptance of a presolicited plan. For exam-
a pre-petition committee where it determines that the membership was "fairly chosen and is representative of the different kinds of claims to be represented." When that occurs, the committee becomes the mandatory committee contemplated by the Act. The membership of additional committees representing creditors and shareholders follows the same pattern as the appointed mandatory committee's composition. Moreover, the court retains overall flexibility to insure that a committee is "representative of the different kinds of claims or interests to be represented." It may change the "membership or the size of a committee" where a need to do so develops. However, a party in interest must request the change, which can only be done "after notice and a hearing." Committees formed under the new chapter 11 also function with official standing in the case. A committee can select and, "with the court's ap-

100. It should be noted that the committee membership may differ in number and representation. A newly appointed creditors' committee ordinarily consists of seven members holding the largest claims "of the kinds represented" on the committee, whereas a continued committee may vary in number and consist of members who are "representative of the different kinds of claims to be represented." Id.
101. Id. Additional committees of creditors shall ordinarily consist of the seven largest holders of claims willing to serve, and "similar treatment" is required for shareholder committees. H.R. REP. No. 95-595, supra note 10, at 401.
102. 11 U.S.C. app. § 1102(c) (Supp. II 1978). This power would protect public investors represented by a committee from potential overreaching and conflicts of interest of the type that existed in Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262 (1941). There, the underwriter of a bond issue, which was heavily interested in the equity, and an indenture trustee, which formed the committee, dominated the five-member committee. The Supreme Court noted that "protective committees... are fiduciaries." Id. at 268.
103. 11 U.S.C. app. § 1102(c) (Supp. II 1978). An example in which circumstances may require a change would be when a bank, which is a member of the creditors' committee, is both a lender and an indenture trustee. Thus, a conflict would exist in connection with negotiating the plan.
104. Id. This permits parties in interest to "police" the representation and effectiveness of a particular committee, even though it was initially appointed by the court or U.S. Trustee. It also affords "latitude in appointing a committee that is manageable and representative in light of the circumstances of the case." H.R. REP. No. 95-595, supra note 10, at 402. Frequently, the seven largest unsecured creditors will be institutional claimants, who might not be representative of the public unsecured claims represented by the committee. This provision would authorize the court to reshape the committee. A request by the SEC, for example, could raise that issue for court scrutiny.
105. This approach follows former chapter XI, because chapter X committees were not official in any sense, although they acted in a fiduciary capacity. See Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262 (1941).
proval,” authorize the employment of “attorneys, accountants, or other agents, to represent or perform services” for it.\textsuperscript{106} This provision gives a committee the ability to function effectively in representing a class in the proceeding, while it retains a measure of court control over the expenses it will incur.\textsuperscript{107}

The new Act sets forth certain statutory functions which a committee, by virtue of its official status, is expected to discharge upon appointment.\textsuperscript{108} The “most important functions” of a committee concern the administration of the estate, investigation of the debtor, and the preparation of a plan.\textsuperscript{109}

With a debtor left in possession, these functions take on significance where public investor classes are concerned. Decisions in the administration of an estate may have a crucial bearing on a plan of reorganization, and the right of consultation with the debtor’s management (or trustee, if one is appointed) will be important.\textsuperscript{110}

Investigation of the debtor, in an appropriate case, could be of substantial importance in aiding a committee to determine whether an independent trustee is needed,\textsuperscript{111} as one can be appointed “at any time after the commencement of the case,” but before confirmation,\textsuperscript{112} and in negotiating the terms of a plan. Moreover, in assessing a plan proponent’s disclosure statement, a prior inquiry into the debtor’s affairs may be necessary and, in some

\textsuperscript{106} 11 U.S.C. app. § 1103(a) (Supp. II 1978). The committee meets at “scheduled” meetings where a majority of its members must be present. \textit{Id}.

\textsuperscript{107} Under former chapter XI, an attorney retained by the committee had to be authorized by the court. The reason was stated by the Advisory Committee’s note to chapter XI rule 11-22: “Such attorney . . . will be compensated from the estate; accordingly, there should be some supervision by the court over the original appointment.” Chapter X committees received compensation only upon a showing of benefit to the estate. \textit{Sup. Ct. R. Bankr. P. 10-215(c)(1)(B)}.\textsuperscript{108} 11 U.S.C. app. § 1103(c) (Supp. II 1978). These functions apply to “a committee appointed under section 1102,” and thus apply to the mandatory, as well as any additional committee. \textit{Id}.

\textsuperscript{109} H.R. REP. NO. 95-595, \textit{supra} note 10, at 402. In addition, the Act indicates that a committee may request the appointment of a trustee or examiner and perform other services “in the interest of those represented.” 11 U.S.C. app. § 1103(c) (Supp. II 1978).

\textsuperscript{110} Both former chapters X and XI contemplated this right. Chapter XI provided for it in \textit{Sup. Ct. R. Bankr. P. 11-29(a)}. Chapter X recognized a right to compensation for services “beneficial in the administration of the estate.” Chandler Act, ch. X, § 242(1), 52 Stat. 900 (1938) (repealed 1979); \textit{Sup. Ct. R. Bankr. P. 10-215(c)(1)(B)} (1975). Thus, for example, compensable services have included those rendered in “actively supporting proposals” of a trustee, \textit{In re National Radiator Co.}, 29 F. Supp. 804, 806 (W.D. Pa. 1939), or in connection with the “removal of . . . [an] . . . additional trustee” and in “opposition to the investment by the trustees of liquid funds of the debtor.” \textit{In re Realty Assocs. Sec. Corp.}, 65 F. Supp. 116, 119 (E.D.N.Y. 1946). \textit{See also In re TMT Trailer Ferry, Inc.}, 577 F.2d 1296, 1301, 1303 (5th Cir. 1978), where the court of appeals, among other things, \textit{raised} a fee award to a stockholders’ committee whose services included defeating unfair plans, questioning claims of certain parties, and obtaining removal of a trustee.\textsuperscript{111}


\textsuperscript{112} 11 U.S.C. app. § 1104(a) (Supp. II 1978).
cases, deemed essential. The new Act adopts the broad chapter X provision with respect to the scope of a committee investigation: "A committee . . . may . . . 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 case or to the formulation of a plan." 113

The other major role of a committee will be to "participate in the formulation of a plan" and advise those it represents of its recommendations as well as "collect and file" acceptances with the court. 114 In fact, a committee, as in former chapter X, may file a plan of reorganization with the court should it be unable to successfully negotiate a proper participation for those it represents. 115 Especially in view of the confirmation requirements for a plan, 116 a committee's vigilance in securing a fair participation in the reorganized company will be vital in preserving the rights of widely scattered public investors.

INVESTIGATION AND PLAN FORMULATION

Reorganization, as distinguished from liquidation, contemplates the continued existence of a business as a going concern. Thus, the goal of the proceeding is the development of a plan of reorganization that will be accepted by affected creditors and stockholders. This process involves, among other things, an investigation of the debtor's past and a projection of its future. Also, these steps provide additional means of investor protection.

Investigation

One of the most important factors from the point of view of investor protection found in chapter X was the provision requiring the independent trustee to conduct an investigation. 117 The trustee was required: (1) to inves-

113. Id. § 1103(c)(2). This is comparable to the trustee's investigation under § 167(1) of former chapter X and chapter X rule 10-208(a)(4), and is the same type of investigation required of a chapter 11 trustee, or examiner, when appointed. Id. §§ 1106(a)(3), 1106(b). Appendix I to the House Report indicates a rule may set "[g]uidelines for a chapter 11 creditors' committee's investigation of the acts, conduct, assets, liabilities, and financial condition of the debtor." H.R. REP. No. 95-595, supra note 10, at 302.

114. 11 U.S.C. app. § 1103(c)(3) (Supp. II 1978). These functions follow the chapter XI approach outlined in § 339(1) and chapter XI rule 11-29(a) concerning the official committee's functions in that proceeding.

115. 11 U.S.C. app. § 1121(c) (Supp. II 1978). The section, however, limits the filing of a committee plan to situations where a trustee is appointed or the debtor loses its 120- or 180-day plan exclusivity. See text accompanying notes 135-41 infra.

116. See text accompanying notes 210-40 infra.

117. Chandler Act, ch. X, § 167, 52 Stat. 890 (1938) (repealed 1979); SUP. CT. R. BANKR. P. 10-208. See Committee for Holders v. Kent, 143 F.2d 694, 686-87 (4th Cir. 1944). In Kent, the appellate court reversed the district court's order confirming the trustee's report and denying the committee's request for a more complete investigation or for the appointment of an examiner.
gate, among other things, the conduct and financial affairs of the debtor, the operation of its business and whether it should be continued, and other matters relevant to the formulation of a plan;\textsuperscript{118} (2) to report to the court the facts uncovered pertaining to fraud, mismanagement, and causes of action available to the estate;\textsuperscript{119} and (3) to transmit a report of the investigation, or summary thereof, to creditors, stockholders, indenture trustees, the SEC, and others designated by the court.\textsuperscript{120} The transmission of this information to interested parties provided them with essential facts to enable them to respond intelligently to the trustee's request for plan suggestions.\textsuperscript{121}

In order to accomplish the purpose of the investigation, it had to "necessarily [be] extensive and searching" and public.\textsuperscript{122} In any event, "any information obtained by the trustee in reorganization as a result of the investigation which the statute require[d] that he make" was to be made available to all parties in interest.\textsuperscript{123}

The importance of the investigation recently was reaffirmed in \textit{In re Farrington Mfg. Co.}, 540 F.2d 653, 659 n.11 (4th Cir. 1975).


\textsuperscript{119} Id. § 167(3); Sup. CT. R. BANKR. P. 10-208(a)(5). See Williams v. Austrian, 331 U.S. 642, 657 (1947) (chapter X trustee given investigative powers to discover wrongdoing and also expected to pursue causes of action available to the estate, and "[t]hese provisions were 'of paramount importance in the revision of Section 77B' "). For an example of a case where the facts uncovered in an investigation not only led to recoveries for the estate but also to a significant reduction in claims, see \textit{In re Farrington Mfg. Co.}, 540 F.2d 653, 658-59 (4th Cir. 1975).

\textsuperscript{120} Chandler Act, ch. X, § 167(5), 52 Stat. 890 (1938) (repealed 1979); Sup. CT. R. BANKR. P. 10-208(a)(7).

\textsuperscript{121} Although "[i]t was [the trustee's] duty to prepare the reorganization plan," Williams v. Austrian, 331 U.S. 642, 657 (1947), the trustee was also required to seek suggestions from creditors and stockholders prior to formulating a plan. Chandler Act, ch. X, § 167(6), 52 Stat. 890 (1938) (repealed 1979); Sup. CT. R. BANKR. P. 10-208(a)(8). See also 6 COLLiER ON BANKRUPTCY ¶ 7.25, at 1271-72, ¶ 7.26, at 1272-74 (14th ed. 1978).

\textsuperscript{122} United States v. Williams, 424 F.2d 344, 350 (5th Cir. 1970), rehearing denied, 431 F.2d 1168 (5th Cir. 1970), rev'd on other grounds, 447 F.2d 1285 (5th Cir. 1971) (en banc), cert. denied, 405 U.S. 954 (1972), rehearing denied, 405 U.S. 1048 (1972) (record failed to establish misuse of office by trustee); \textit{In re South State St. Bldg. Corp.}, 105 F.2d 680, 682 (7th Cir. 1939) (investigation into debtor's affairs appropriate).

\textsuperscript{123} Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 434 (1972). In the chapter X proceeding out of which that case arose, the district judge entered an order granting counsel in a class action brought on behalf of holders of publicly held debentures access to the debtor's records. \textit{In re Webb & Knapp, Inc.}, No. 65-B-365 (S.D.N.Y. Oct. 29, 1974). See \textit{In re Farrington Mfg. Co.}, 540 F.2d 653, 660 (4th Cir. 1975), and the related case of F.O.F. Proprietary Funds, Ltd. v. Arthur Young & Co., No. 73 Civ. 3262 (S.D.N.Y. Feb. 10, 1975) (trustee's sharing of fruits of investigation with party to reorganization proceeding does not make lawsuit based on such information a collusive action); \textit{In re THC Financial Corp.}, No. BK 76-0493, (D. Hawaii, filed Dec. 8, 1976) (the chapter X trustee's investigation and work product were made available to plaintiffs' counsel in collateral class action suits pursuant to an agreement with the trustee providing for costs to the estate from any recovery).
By contrast, there was no similar requirement for an extensive investigation and report in former chapter XI. That chapter did, however, provide for an examination, at the first meeting of the creditors, into "any matter relevant to the proceeding." Furthermore, the official creditors' committee could inquire into how the debtor's affairs had been conducted and was to report on the progress of the proceeding. In that context, as with a chapter X investigation, the committee could employ attorneys, accountants, or others to assist it in carrying out the investigative function.

Along with adopting the more flexible case-by-case approach to the appointment of a trustee, Congress also appears to have chosen a case-by-case determination of the nature and extent of the investigation that should be conducted. This conclusion is suggested by the legislative history of the Act dealing with the compromise reached regarding trustee appointment or debtor-in-possession retention and, in many of the latter-type cases, the appointment, upon request, of an examiner. It could be that the investigation will fall somewhere between the extensive investigation required by former chapter X and the more limited examination that was generally conducted in chapter XI cases.


126. Id. § 339(1); Sup. Ct. R. Bankr. P. 11-29(a). See Sup. Ct. R. Bankr. P. 205, 205(a), (d), (e).


128. One of the matters that could be dealt with by the Rules of Bankruptcy Procedure may include fixing "[g]uidelines regulating an examiner's or trustee's investigation of the debtor in a case under chapter 11." H.R. Rep. No. 95-595, supra note 10, at 302. While it is to be expected that in cases where a trustee is appointed, he or she will continue to file lawsuits and prosecute causes of action available to the estate, there may be a question as to what happens to such causes of action in debtor-in-possession cases. Because the filing of such actions is not listed as one of the duties to be performed by an examiner, see 11 U.S.C. app. § 1106(b) (Supp. II 1978), and because it generally can be presumed that a debtor-in-possession may not wish to pursue such actions against its officers and directors, one may expect that in an appropriate case the court will order the examiner to perform this additional duty. (S. 305, 95th Cong., 1st Sess. § 171 (1979), if passed, however, would expressly permit a court to order an examiner to perform additional duties to those prescribed in the Act.) That would be similar to the approach that was contemplated for debtor-in-possession cases by § 216(13) of former chapter X: "provisions [should be made] as to such claims not settled or adjusted in the plan, for their retention and enforcement . . . if the debtor has been continued in possession, by an examiner appointed for that purpose." Chandler Act, ch. X, § 213(13), 52 Stat. 840 (1938) (repealed 1979).

The question does arise, however, whether, in those cases in which the application of a party in interest for such authority to be given the examiner is denied, such a party could bring an action derivatively on behalf of the corporate debtor. Compare rule 23.1 of the Federal Rules of Civil Procedure, which requires that in a stockholder derivative action the plaintiff-stockholder must allege what efforts were made "to obtain the action [plaintiff] desires from the directors or
Thus, while it is true that a trustee or an examiner is to conduct an investigation covering areas similar to those set forth in section 167(1) of former chapter X, based on the legislative history of chapter 11, it is to be expected that arguments will be made that the investigation should not be so extensive as to delay the proceeding, or at least that the reorganization should proceed even before a report of investigation is made public. In that regard, section 1104(b) specifically provides that the examiner appointed in a nontrustee case is "to conduct such an investigation of the debtor as [the court finds] is appropriate." Therefore, the authors believe that interested parties, including the SEC, can continue to raise with the court issues related to what type of an investigation is appropriate and to participate in such investigations. However, the scope and extent of that investigation will be prescribed by the needs of the case and will not necessarily be automatic.

Plan Formulation

Another important factor meriting analysis is the relationship of the investigation process to plan formulation. As noted above, former chapter X required that the trustee transmit to creditors, stockholders, and other interested parties a report or summary of investigation. One of the purposes of that report was to provide information to those who could submit plan suggestions in response to the trustee's request. On the other hand, under former chapter XI, the debtor submitted an arrangement which, in most cases, had been negotiated with the official creditors' committee. That comparable authority . . . and the reasons for [the plaintiff's] failure to obtain the action." FED. R. CIV. P. 23.1. 129. See 11 U.S.C. app. § 1106(3) (Supp. II 1978).

130. Cf., e.g., statements of Senator DeConcini and Representative Edwards: "It will not be necessary for the court to consider the report of the examiner prior to approval of a disclosure statement. The investigation of the examiner is to proceed on an independent basis from the procedure of the reorganization under chapter 11." 124 CONG. REC. S17,418, S17,420 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 CONG. REC. H11,101, H11,103 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).


132. The SEC, for example, supported a committee of preferred stockholders that petitioned a reorganization court to order "a more complete investigation and report under section 167 [of former chapter X] than had been made." Committee for Holders v. Kent, 143 F.2d 684, 685-87 (4th Cir. 1943). Furthermore, the Commission's staff often played an active and important role in connection with the trustee's investigation. See, e.g., In re Commonwealth Financial Corp., 288 F. Supp. 786, 787-88 (E.D. Pa. 1968), aff'd, 408 F.2d 640 (3d Cir.), cert. denied, 395 U.S. 961 (1969) (in chapter X proceeding in which SEC was authorized to participate in contemplated investigation of debtor and its officers, president of debtor corporation not entitled to protective order restraining attempts to depose him or examine corporation's affairs); Committee for Holders v. Kent, 143 F.2d at 686; In re Federal Coal Co., (S.D.W. Va. No. 96-270), reported in 38 S.E.C. ANN. REP. 118-19 (1973). Cf. SEC v. Krentzman, 397 F.2d 55, 55 (5th Cir. 1968) (district court order denying SEC, in chapter X proceeding, right to propound questions and offer evidence, held to be outside authority of that court).

committee, without court supervision, solicited acceptance or otherwise advised the creditors whether it recommended acceptance.\textsuperscript{134}

Under subsections (a) and (c) of section 1121 of the new Act, the debtor can file a plan at any time. Moreover, when the debtor is continued in possession, it retains the exclusive right to file a plan for 120 days after the order for relief has been entered,\textsuperscript{135} or for such other period as the court may order.\textsuperscript{136} Because the examiner's investigation is to proceed independently from the other reorganization functions,\textsuperscript{137} in a case where the exclusive period has expired, it may be difficult, absent information about the debtor's affairs, for a party in interest to propose a plan.

In those cases where the debtor does not have the exclusive right to file a plan, because, for example, a trustee has been appointed,\textsuperscript{138} it also is unclear whether interested parties will have the benefit of information obtained during the investigation in order to file plan proposals.\textsuperscript{139} The legislative history does not suggest that the trustee's investigative report, which should be made "as soon as practicable,"\textsuperscript{140} need be filed or transmitted prior to the plan formulation. While it could be argued that without such facts it would be difficult to propose a plan, the reasons noted above also would suggest that the transmission of a report would not necessarily have to precede the filing of plan proposals.\textsuperscript{141}

DISCLOSURE AND SCRUTINY OF PLAN SECURITIES TRANSACTIONS

Background Perspective

As part of the overall court supervision of the reorganization under former chapter X, the filing of the plan was a most significant stage in the proceeding. Former chapter X provided for interested parties to submit suggestions for a plan to the trustee, who filed a proposed plan.\textsuperscript{142} An evidentiary hearing on that plan then was held.\textsuperscript{143} Other parties could submit a plan or propose amendments to the trustee's plan, and these were heard concur-

\textsuperscript{135} 11 U.S.C. app. § 1121(b) (Supp. II 1978).
\textsuperscript{136} Section 1121(d) permits the court, "[o]n request of a party in interest and after notice and a hearing," to reduce or increase that period "for cause." Id. § 1121(d).
\textsuperscript{138} 11 U.S.C. app. § 1121(c) (Supp. II 1978).
\textsuperscript{139} It should be noted that, under circumstances described in § 1121(c), interested parties "may file a plan" rather than submit suggestions to the trustee. Cf. Chandler Act, ch. X, § 167(6), 52 Stat. 890 (1938) (repealed 1979); Sup. Ct. R. Bankr. P. 10-208(a), 10-310(a).
\textsuperscript{141} See notes 197-98 and accompanying text infra, concerning situations where the transmission of information gathered during an investigation may be a requisite to "adequate information" for purposes of the disclosure statement required by § 1125.
rently with the trustee’s plan. At the plan hearing, evidence was introduced with respect to the future earning power as well as all other factors bearing on the debtor’s going-concern value. That valuation determined whether the debtor was solvent—that is, whether value of the estate exceeded claims against the debtor—so that stockholders could participate in the reorganized company, and whether and on what basis the various classes were entitled to participate in the reorganization. A plan also had to be feasible, which meant that the reorganized company, among other things, had to have a sound capital structure, adequate working capital, and sufficient anticipated earnings to service obligations incurred under the plan.

After the hearing and before approval, a plan, if found by the court to be “worthy of consideration,” was required to be submitted to the SEC for an advisory report if the debtor’s liabilities exceeded $3,000,000. No order approving a plan could be entered until at least one of the following events occurred: (1) receipt of the SEC’s report, (2) notification that no report would be filed, or (3) expiration of the time for filing the report. An order approving a plan was predicated on a finding by the court that the plan was fair, equitable, and feasible.

Acceptances could not be solicited until the approval order had been entered and the required materials were transmitted to creditors and stockholders affected by the plan. The package of solicitation materials had to include the approved plan, a court-approved summary, the court order

144. Id.
147. In re Equity Funding Corp. of America, 416 F. Supp. 132, 142 (C.D. Cal. 1975) (chapter X reorganization plan must satisfy absolute priority rule in order to meet statutory requirement that it be fair and equitable); In re Philadelphia & W. Ry., 51 F. Supp. 129 (E.D. Pa. 1943) (court’s discretion to approve reorganization plan is not absolute).
149. Id. §§ 173, 174 and R. 10-303(c).
150. See notes 209-14 and accompanying text infra.
151. Chandler Act, ch. X, § 176, 52 Stat. 891 (1938) (repealed 1979); Sup. Ct. R. Bankr. P. 10-303(f), 10-304, 10-211(b). Those provisions suggested, however, that a reorganization court could consent to solicitation for a plan in advance of the approved order, but this was not the practice.
152. Id. § 175 and R. 10-303(c).
approving the plan, any court opinion or summary related to the approved plan, and the SEC’s advisory report or summary thereof.\textsuperscript{153}

By contrast, under former chapter XI there was little or no court supervision of the procedures related to the solicitation of acceptances for an arrangement.\textsuperscript{154} Also, there was no requirement that an arrangement be fair and equitable.\textsuperscript{155} Unlike a chapter X plan, an arrangement was confirmed if “it [was] for the best interests of creditors and [was] feasible.”\textsuperscript{156} Further, a debtor could solicit acceptances prior to filing its chapter XI petition\textsuperscript{157} and thus present the court with a prepackaged proceeding that could be completed in an extremely short period of time.

Finally, another important distinction is that in former chapter XI there was no judicial review of the terms of the arrangement proposed by the debtor prior to solicitation of acceptances.\textsuperscript{158} Nor did the court review the

\textsuperscript{153} Id. Because of the court supervision of that solicitation, it was exempt from the SEC’s proxy rules in those cases where these rules otherwise would have applied, 17 C.F.R. § 240.14a-2(c) (1978).

It should also be remembered that prior to the solicitation, the trustee had reported on his or her investigation to creditors and stockholders. Thus, those persons who were to vote on the plan had been provided with additional information that may have been relevant to their acceptance or rejection of the plan. See text accompanying notes 117-32 supra.


\textsuperscript{156} Chandler Act, ch. XI, § 366(2), (3), 52 Stat. 911 (1938) (repealed 1979); Sup. CT. R. BANKR. P. 11-38(3),which incorporated Official Form 11-F18. In this context, the creditors’ “best interests” meant that they would get more under the arrangement than if the debtor were liquidated, and the latter was interpreted to mean that the debtor would be able to make the payments required by the arrangement. 9 COLLIER ON BANKRUPTCY ¶ 9.17, at 281-82, and ¶ 9.18, at 287-89 (14th ed. 1978).

\textsuperscript{157} Chandler Act, ch. XI, § 336(4), 52 Stat. 909 (1938) (repealed 1979); Sup. CT. R. BANKR. P. 11-37(a). In that regard, it should be noted that convertible debentures are “equity securities” under the Securities Exchange Act, 15 U.S.C. § 78c(a)(11) (1976), which, if held by more than 500 persons, must be registered under that Act, 15 U.S.C. § 78(f) (1976). Thus, a pre-chapter XI solicitation of such publicly held convertible debentures had to comply with the Act, 15 U.S.C. § 78n(a) (1976), and the Commission’s proxy rules thereunder.

For a case in which pre-chapter XI solicitations were made in compliance with the proxy provisions and a prepackaged arrangement was filed, see In re Continental Inv. Corp., 586 F.2d 241, 244 (1st Cir. 1978), cert. denied sub nom Wallace v. SEC, 440 U.S. 980 (1979). In that pre-chapter XI solicitation, Continental Investment sought acceptances from at least 95% of its debenture holders. When it received only about 82%, a chapter XI petition was filed in order to bind all the debenture holders, which section 362(1) of former chapter XI permitted. Chandler Act, ch. XI, § 362(1), 52 Stat. 910 (1938) (repealed 1979).

\textsuperscript{158} Only the debtor could propose an arrangement. See Chandler Act, ch. XI, § 323, 52 Stat. 907 (1938) (repealed 1979); Sup. CT. R. BANKR. P. 11-36(a).
Disclosure Premise of the Act

In consolidating the former reorganization chapters in the Act, Congress determined that, as under the federal securities laws, the parties in interest should be given "adequate information" to enable them to make their own informed judgments as to whether they should accept or reject a plan. The standard to be applied to determine disclosure adequacy is a

159. There was no exemption, however, from the Commission's proxy rules for a solicitation of acceptances for a chapter XI arrangement from convertible debenture holders (see note 157 supra), as there was for a solicitation of acceptances for a chapter X reorganization plan (see note 153 supra). The SEC's view that the solicitation of acceptances from convertible debenture holders during the chapter XI proceeding had to comply with the Commission's proxy rules was sustained in Esgro, Inc., (C.D., Cal., No. 73-02510), reported in 41 SEC ANN. REP. 159 (1976); 42 SEC ANN. REP. 162 (1977).

Additionally, from time to time, the SEC had found it necessary to intervene specially in chapter XI proceedings to enforce the federal securities laws. See SEC v. American Trailer Rentals Co., 379 U.S. 594, 613 (1965). In that case, the Commission had alleged, among other things, that the debtor's soliciting material had omitted certain material facts. In that regard, the 10th circuit court of appeals held that while securities issued pursuant to an arrangement were exempt from registration under the Chandler Act, ch. XI, § 393a(2), 52 Stat. 914 (1938) (repealed 1979), they were not exempt from the antifraud provisions of the Securities Act, 15 U.S.C. § 77q(e), and thus, adequate disclosure had to be made so as to enable creditors (investors) to make informed judgments. In re American Trailer Rentals Co., 325 F.2d 47, 52-53 (10th Cir. 1963). In reversing the denial of the Commission's motion to transfer that case from chapter XI to chapter X, the Supreme Court specifically agreed with that holding. In re American Trailer Rentals Co., 379 U.S. 594, 615-16 (1965). For chapter XI cases in which the SEC intervened to call the court's attention to questions arising under the federal securities laws, see, e.g., Superior Mortgage Co. (C.D. Cal. No. 74-9406) reported in 41 SEC ANN. REP. 161 (1976); Puts and Calls, Inc. (C.D. Cal. No. 73-03706), reported in 41 SEC ANN. REP. 161-62 (1976); Synergistics, Inc. (D. Mass. No. 70-1251) reported in 38 SEC ANN. REP. 126 (1973).

160. While the adequacy of the disclosure is to be determined on a case-by-case basis, frequently plan "solicitation involves an offering of securities in exchange for claims or interests." S. REP. No. 95-989, supra note 55, at 121. Although such offerings are exempt from the registration requirements of the Securities Act, 11 U.S.C. app. § 1145(a)(1) (Supp. II 1978), as a substitute the Act requires that those persons to whom the offer is made receive a disclosure statement containing "adequate information." Id. § 1125(b).

161. The premise underlying chapter 11 is disclosure, which "is the same as the premise of the securities laws." H.R. REP. No. 95-595, supra note 10, at 224, 226. In that regard, it should be remembered that on a number of occasions in cases involving questions arising under the Securities Act of 1933, 15 U.S.C. § 77a et seq. (1976), or the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976), the Supreme Court has stated that in enacting those laws, Congress sought (a) "to insure the public dissemination of information in order to provide accurate and complete information upon which investors would be able to make informed investment decisions and (b) "to substitute a philosophy of full disclosure for the philosophy of caveat emptor." Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972), quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963). Accord, Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 477-78 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (a purpose of the Securities Act is "to provide investors with full disclosure of material information"."
flexible one, taking into account the facts of a particular case, \(^{162}\) but without regard to whether or not the information provided would otherwise comply, for example, with the registration provisions of the Securities Act or with the proxy provisions of the Securities Exchange Act and the rules thereunder.\(^{163}\) Under the new Act there also will be no approval hearing concerning public offerings of securities in commerce\); A.C. Frost & Co. v. Coeur d'Alene Mines Corp., 312 U.S. 38, 40 (1941). See Preamble, Securities Act, 48 Stat. 74 (1933) (the full title of which is "An Act to provide full and fair disclosure of the character of securities sold . . . and to prevent frauds in the sale thereof").

\(^{162}\) H.R. REP. No. 95-595, supra note 10, at 226. See S. REP. No. 95-989, supra note 55, at 121.

\(^{163}\) 11 U.S.C. app. § 1125(d) (Supp. II 1978); H.R. REP. No. 95-595, supra note 10, at 227-28. In the past the SEC also has been willing to grant issuers of securities relief from strict compliance with those provisions under certain circumstances. See, e.g., Regulation A, 17 C.F.R. § 230.251 to 230.264 (1978), which provides an exemption from full-scale registration under certain conditions for offerings of securities not in excess of $1,500,000 (see Securities Act Release No. 5977 (Sept. 11, 1978), 15 SEC Docket 1054), and simplified registration on Form S-18 for initial offerings of up to $5,000,000 by certain issuers having less than $1,000,000 in assets and fewer than 500 stockholders (and thus not at the time of filing subject to the reporting provisions of the Securities Exchange Act) (see Securities Act Release No. 6049 (Apr. 3, 1979), 17 SEC Docket 153). Furthermore, in "Application of the reporting provisions of the Securities Exchange Act of 1934 to Issuers Which Have Ceased or Severely Curtailed Their Operations," Securities Exchange Act Release No. 9660 (June 30, 1972), the Commission also announced its willingness to modify, for example, filing requirements for an issuer that is the subject of a proceeding under the Bankruptcy Act when it is assured that the best available information will be provided to public investors, id. at 2. In that regard, the Commission noted that it "generally would accept reports prepared under the supervision of . . . [a court-appointed official, such as a chapter X trustee] which differ in form or content from reports required to be filed under the [Securities] Exchange Act." Id. It further pointed out that rule 12b-21 under the Securities Exchange Act, 17 C.F.R. § 240.12b-21 (1978), provides for an exemption from filing the type of information ordinarily required in reports, for example, "if . . . [such] information is . . . not reasonably available to the issuer because it would be unreasonably expensive or would take an unreasonable effort to obtain." Id.

The legislative history of the Act, however, recognizes that a disclosure statement complying with the SEC's proxy rules may be appropriate in certain cases, which is to be determined "on a case-by-case basis." H.R. REP. No. 95-595, supra note 10, at 228. Even in those cases in which complete registration- or proxy-type disclosure statements are not required, it would appear that Congress expects those persons involved in the preparation of such statements to adhere to a high standard of care: "The change [from chapter XI] is, in large part, attributable to the pervasive effect of the Federal securities laws and the fact that the Commission has "sensitized both management and members of the bar to the need for full disclosure." 124 CONG. REC. S17,418 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini; id. at H11,101 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards)).

The discussion in this section of the Article focuses on the court-approved disclosure statement used in connection with plan solicitations. Situations, however, could arise during the course of a reorganization proceeding where some form of solicitation is contemplated that would not be covered by § 1125 and thus would not be exempt from the proxy provisions. Thus, compliance with those provisions may be necessary where a committee wishes to poll members of a class to obtain a sense as to what position should be taken, as, for example, on a proposed sale of assets or some other action proposed to be taken outside of the plan but which could have an effect on the plan solicitation. See In re First Home Inv. Corp., 368 F. Supp. 597 (D. Kan. 1973) (solicitation of vote from investors on whether dismissal of chapter X petition was favored and dissemination of material by committee in an effort to obtain contributions from
for a plan, as in former chapter X. Rather, "the major procedural hearing in a reorganization case" is expected to be the one on the disclosure statement.\(^{164}\)

The shift to the concept of disclosure of "adequate information" is said to be "a [reasonable] compromise between the strict requirements of the securities laws and the near-absolute freedom of the [former] bankruptcy laws."\(^{165}\) Further, it takes into account the interests of parties who are desirous of concluding the reorganization successfully and also the public interest "in preventing securities fraud.\(^{166}\) The question whether a disclosure statement contains "adequate information" is to be determined by the court "after notice and a hearing.\(^{167}\) At that hearing, the SEC or any other regulatory agency or official who is responsible for enforcing securities laws has "an absolute right to appear and be heard" on whether a proposed statement adequately discloses the relevant facts necessary for the parties in interest to make informed decisions.\(^{168}\) Although no regulatory authority,

investors involved soliciting proxies and would be enjoined where there had been no compliance with SEC's proxy rules and false and misleading information of material facts had been disseminated. \(^{Cf.\}\) Canadian Javelin Ltd. v. Brooks, \textit{reported in} [1979] \textit{FED. SEC. L. REP. (CCH)} ¶ 96,616 (S.D.N.Y. 1978) (where purpose of a committee was to oust management, its mailings of newspaper articles were found to be "communications . . . under circumstances reasonably calculated to result in the [future] procurement, withholding or revocation' of proxies" against management's interests, \textit{id. at} ¶ 94,644-65 and n.2).

\(^{164}\) \textit{H.R. REP. No.} 95-595, \textit{supra} note 10, at 227, 229. The disclosure hearing, thus, is a substitute for the evidentiary hearing held on the plan in former chapter X.

Because \S 1125(b) only requires a court-approved disclosure statement in connection with a plan solicitation after the case has been commenced, prepackaged cases still will be possible. In that regard, \S 1126(b) provides that solicitations made prior to the commencement of the case may be used after the case has begun if they were made "in compliance with any applicable nonbankruptcy law [or] rule . . . governing the adequacy of disclosure in connection with such solicitation" or, in the absence of such compliance, if the solicitation was made after disclosing adequate information as defined in \S 1125 (a)(1). \textbf{11 U.S.C. app.} \S 1125(b) (Supp. II 1978).

\(^{165}\) \textit{H.R. REP. No.} 95-595, \textit{supra} note 10, at 228. "[T]he near absolute freedom" from disclosure applied only in former chapter XI, not in former chapter X. See text accompanying notes 154-59 \textit{supra}.

\(^{166}\) \textit{H.R. REP. No.} 95-595, \textit{supra} note 10, at 228. In that regard, in commenting on the proposed exemption from the federal securities laws in an earlier version of the Act, the Commission had advised Congress that, in its experience, "[b]ankruptcy reorganization . . . is a significant source of entry of new securities into the public trading markets" and "that the opportunity to create large quantities of securities under an exemption forms an attractive base for a securities manipulator." \textit{Hearings Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. of the Judiciary, 94th Cong., 1st Sess.} 773, 773 n.79 (1975); \textit{Hearings Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 94th Cong., 2d Sess. (Serial 27, Part 4) 2201, 2201 n.83 (1976). See also text accompanying notes 201-09 \textit{infra}, concerning the redistribution of unregistered plan-exchanged securities pursuant to the Act's securities exemption contained in \S 1145.

\(^{167}\) \textbf{11 U.S.C.} app. \S 1125(b) (Supp. II 1978).

\(^{168}\) \textit{H.R. REP. No.} 95-595, \textit{supra} note 10, at 228-29. See \textbf{11 U.S.C. app.} \S 1125(d) (Supp. II 1978); \textit{S. REP. NO.} 95-989, \textit{supra} note 55, at 121 (such an agency may "advise the court on the adequacy of [a] proposed disclosure statement").
including the Commission, will have the right to initiate an appeal from an adverse decision.169 It may "participate in an appeal [taken from such a ruling] by a party in interest."170

Also, section 1125(e) provides a "safe harbor" for any person who, "in good faith and in compliance with the applicable provisions of this title," "solicits" for a plan or "participates . . . in the offer, issuance, sale, or purchase of a security, offered or sold under the plan."171 Such person "is not liable, on account of such solicitation or participation, for a violation of any applicable law, [or] rule . . . governing the offer . . . [or] sale . . . of securities." This provision protects from any potential liability under the federal securities laws those persons who, in "good faith," solicit for a plan.172 Thus, for that purpose, the safe harbor provision codifies Ernst & Ernst v. Hochfelder.173 In that case, the Supreme Court held that a person would be subject to liability in a private action for damages for violations of section 10(b) of the Securities Exchange Act,174 and rule 10b-5 thereunder, only if he or she acted with "scienter." The Court defined scienter as a "mental state embracing intent to deceive, manipulate or defraud."175

169. 11 U.S.C. app. § 1125(d) (Supp. II 1978). See H.R. Rep. No. 95-595, supra note 10, at 229 ("The S.E.C. . . . will not have a right of appeal on the adequacy of disclosure, either in the role of an advisor to the court in reorganization cases, or in the role of the agency responsible for the enforcement of the securities laws generally"). See also S. Rep. No. 95-989, supra note 55, at 121.


172. H.R. Rep. No. 95-595, supra note 10, at 229, 231, 409-10; S. Rep. No. 95-989, supra note 55, at 122. Thus, such provisions as §§ 11, 12, and 17 of the Securities Act, 15 U.S.C. §§ 77k, 77l, 77q (1976), and §§ 10(b) and 18 of the Securities Exchange Act, 15 U.S.C. §§ 78j(b), 78r (1976), under which liability otherwise would be imposed because of the inadequacy of disclosure, would facially not appear to be applicable where a court-approved solicitation document is used. But see note 180 infra.


175. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 (1976). While the Supreme Court, in Hochfelder, left open the question of whether "scienter" is required in a Commission injunction action, § 1125(e) is an effort to close the door in this limited area of bankruptcy reorganization by requiring a showing of lack of good faith concerning the adequacy of the bankruptcy disclosures, because it provides a safe harbor against SEC injunction as well as against damage actions. See H.R. Rep. No. 95-595, supra note 10, at 230-31. Thus, it would appear that a higher burden than usual will be imposed on the Commission should it seek to obtain injunctive relief for conduct concerning § 1125(e) that otherwise allegedly violates the federal securities laws. Compare the following cases holding that "scienter" is not required in a Commission injunctive action: SEC v. Aaron, reported in [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,800, at 95,128-31 (2d Cir. 1979); SEC v. American Realty Trust Co., 586 F.2d 1001 (4th Cir. 1978) (SEC action for injunctive relief against real estate investment trust). Compare SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976), with SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978) (showing of scienter required).
The burden of full disclosure under the federal securities laws rests squarely on the issuer of securities and those connected with the offering because "the content of the . . . statement is within management's [or the proponent's] control." Therefore, the authors submit that a plan proponent or any person who participates in the preparation of the disclosure statement or in the solicitation also has the burden of providing the court and the parties with all necessary information so that an informed decision can be reached as to whether the disclosure statement contains "adequate information." Because the safe harbor provision is limited to the "good faith" of a plan proponent and those connected with the preparation of the disclosure statement, it should "not affect civil or criminal liability for defects and inadequacies that are beyond the limits of exoneration that good faith provides." Thus, in cases where a participant in the solicitation can be shown to have been aware of material information that was not disclosed to the court and to parties in interest who are asked to reach an informed decision on a plan proposal, the safe harbor provision should not be available as a defense.

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176. See Boruski v. Division of Corp. Fin. of the United States SEC, 321 F. Supp. 1273, 1276 (S.D.N.Y. 1971): "The responsibility for submitting an adequate [registration statement] that purports to comply with the disclosure and other requirements of the law is upon the issuer."

177. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976). The Court there also stated that any "doubts [should] be resolved in favor of those the statute is designed to protect" [citation omitted]. See also note 186 infra.

178. S. REP. No. 95-989, supra note 55, at 122.

179. Id. While those participating in drawing up the disclosure statement should "be fair and sensitive" to the needs of those asked to vote on a plan, they are "not require[d to] . . . be clairvoyant." Smallwood v. Pearl Brewing Co., 489 F.2d 579, 602 (5th Cir.), cert. denied, 419 U.S. 873 (1974). Also, the adequacy of the disclosure is to be determined as of the transaction "and not upon a 20-20 hindsight view long after the event." Spielman v. General Host Corp., 402 F. Supp. 190, 194 (S.D.N.Y. 1975), aff'd, 538 F.2d 39 (2d Cir. 1976).


Creditors or stockholders who may be injured by fraud in connection with the preparation of a disclosure statement or the solicitation of plan acceptances are not without remedies. In a case
"Adequate Information"—What Does It Mean?

With that general background, a discussion of what is "adequate information" is appropriate. "Adequate information," as previously noted, is to be determined according to a flexible standard depending upon the facts of a particular case. The phrase refers to information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan.

Furthermore, an "investor typical of holders of claims or interests of the relevant class" is defined as one who has:

where the plan has not been confirmed and no distribution has been made, the injured party should seek relief in the bankruptcy court. Similarly, if relief is sought "at any time before 180 days after the date of the entry of the order of confirmation," 11 U.S.C. app. § 1144 (Supp. II 1978), a party alleging the fraudulent conduct should apply to the bankruptcy court seeking to revoke the confirmation order. In the event that a plan has not been substantially consummated, see id. § 1101(2) but the confirmation order had been entered more than 180 days from the date the alleged fraud was discovered, a party should be able to apply to the bankruptcy court, as a court of equity, e.g., Pepper v. Litton, 308 U.S. 295, 304, 307 (1939), and request that any further distribution under the plan be enjoined pending the resolution of any issues raised by the application.

Where, however, confirmation occurs more than 180 days before the discovery of the alleged fraud and the plan is substantially consummated, a question may arise as to whether the "good faith" of the participants in the disclosure and solicitation process can be challenged; and, if so, what is the appropriate court in which to seek relief. We do not believe that the bankruptcy court's prior finding that the disclosure statement contained "adequate information" may be used as a defense against a claim that "good faith" was lacking in connection with the process. Nor, in our view, is a finding of good faith, 11 U.S.C. app. § 1125(a)(1) (Supp. II 1978), implicit (or even contemplated) in the bankruptcy court's finding that a disclosure statement contains "adequate information." That is so because the burden of providing the court and the parties with all necessary information for inclusion in that statement rests on the plan proponent or those who assist in the preparation of the statement (see text accompanying notes 176-79 supra) and because the court makes no independent investigation of the facts at the time it approves the disclosure statement. Thus, the question of lack of "good faith" of the participants is necessarily postponed for a subsequent inquiry, if any is required. In those cases in which the bankruptcy court has reserved jurisdiction, 11 U.S.C. app. §§ 1123(b)(5), 1141(c) (Supp. II 1978), it may be appropriate to seek relief in that court. See 28 U.S.C. § 1471(b)-(c) (Supp. II 1978). But in any event, a party, including the SEC, may allege the fraud in an action for damages or any other relief in another forum. See In re Newport Harbor Assocs., reported in [1979] BANKR. L. REP. (CCH) ¶ 67,104, at 77,037 (1st Cir. 1979) (time limitation to revoke confirmation of plan for fraud is absolute and exclusive). Cf. Bizzel v. Hemingway, 548 F.2d 505 (4th Cir. 1977) (suit for securities fraud and breach of contract).

181. See notes 160-63 supra.

(A) a claim or interest with the relevant class;
(B) such a relationship with debtor as the holders of other claims or interests of such class generally have; and
(C) such ability to obtain such information from sources other than the disclosure required by this section as holders of claims or interests in such class generally have.\textsuperscript{183}

Although the Commission's rules relating to disclosure under the federal securities laws are not per se applicable to the disclosure statement that will be used in connection with plan solicitations,\textsuperscript{184} it should be emphasized that "[t]he premise underlying [the new reorganization chapter] . . . is the same as the premise of the securities laws."\textsuperscript{185} In connection with the determination of whether a disclosure statement contains "adequate information," the legislative history suggests that something close to the materiality concept,\textsuperscript{186} the disclosure standard applicable in non-bankruptcy cases,

\textsuperscript{183} Id. See also H.R. Rep. No. 95-595, supra note 10, at 227-28; S. Rep. No. 95-989, supra note 55, at 121. This definition is to provide the flexibility in the disclosure standard because the various classes of creditors may not need "the same level of disclosure"—that is, e.g., trade creditors presumably do not need as much information as public investors. H.R. Rep. No. 95-595, supra note 10, at 226. In that connection, § 1125(c) provides, in pertinent part, that "different disclosure statements, differing in amount, detail, or kind of information, as between classes" may be transmitted to different classes. 11 U.S.C. app. § 1125(c) (Supp. II 1978).

\textsuperscript{184} Id. § 1125(d). See H.R. Rep. No. 95-595, supra note 10, at 227-28; S. Rep. No. 95-989, supra note 55, at 121. As noted at note 163 supra, however, it is recognized that a disclosure statement in compliance with the Commission's proxy rules may be appropriate in certain cases. H.R. Rep. No. 95-595, supra note 10, at 228.

A factor that may well have to be considered in connection with the determination of whether adequate information is being disclosed is the effect of an action that falls within the exceptions to the automatic stay against commencing or continuing any litigation against the debtor after the filing of the petition—for example, an action brought "by governmental unit to enforce . . . [its] regulatory power," 11 U.S.C. app. § 362(b)(4) (Supp. II 1978), or to enforce a non-money judgment previously obtained in such an action, id. § 362(b)(5). Thus, where the SEC has obtained an injunction because of past deficiencies in disclosure made by an issuer in reports to investors, the court may very well take a closer look at the proposed disclosure statement and, especially in cases where the debtor-in-possession is responsible for the disclosure, could require a statement that is in compliance with the Commission's proxy rules.


\textsuperscript{186} After recognizing that "[t]he question of materiality . . . is an objective one," in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 445 (1976) (case arising under rule 14a-9 of the SEC's proxy rules, 17 C.F.R. § 240-14a-9 (1978) (an antifraud provision)), the Supreme Court held:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . [Materiality] contemplate[s] . . . a showing of a substantial likelihood that, under all the cir-
should be applied. In addition, the definition of the hypothetical reasonable investor also is suggestive of an analogy to a concept familiar under the federal securities laws—that is, the amount of information that is adequate for disclosure purposes will depend, among other things, on the investor’s sophistication and access to other sources of information that would be adequate for making an informed decision about the plan.\footnote{187}

While the standard for disclosure is a flexible one, section 1125(d) provides that the SEC may be an active participant in the hearing on whether the disclosure statement contains adequate information\footnote{188} and its “arguments, on behalf of the public interest in an orderly securities market, will undoubtedly be heard and considered by the bankruptcy judges,”\footnote{189} even though it cannot initiate an appeal from an adverse determination.\footnote{190} Thus, the Commission can be a constructive force in the development of the case law as to what constitutes “adequate information,”\footnote{191} utilizing the expertise it has gained during the past forty-five years that it has spent administering the disclosure provisions of the federal securities law.\footnote{192} Such a role would

\begin{quote}
Id. at 449. The TSC holding appears to be similar to the language in § 1125(a)(1) that “adequate information” is that information which “would enable a hypothetical reasonable investor . . . to make an informed judgment about the plan.” 11 U.S.C. app. § 1125(a)(1) (Supp. II 1978).

\footnote{187. Compare id. § 1125(a)(2) and H.R. REP. No. 95-595, supra note 10, at 226; with, e.g., SEC v. Ralston Purina Co., 346 U.S. 119, 124-27 (1953). In Ralston Purina, the Supreme Court held that an issuer’s employees who did not have access to information about the company needed the protections afforded by registration under § 5 of the Securities Act, 15 U.S.C. § 77e (1976), in connection with an offer of securities to them. See also Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977) (offerees in a securities transaction must have access to the type of information that would be disclosed in a registration statement in order for private placement exemption from registration to be available).

\footnote{188. Section 1125(d) refers to “agency or official,” clearly a reference to the SEC, which is the agency primarily responsible for enforcing the disclosure requirements of the securities laws. 11 U.S.C. app. § 1125(d) (Supp. II 1978). See also notes 161 & 163 supra.

\footnote{189. H.R. REP. No. 95-595, supra note 10, at 228.

\footnote{190. Id. at 228, 229, 409; S. REP. No. 95-989, supra note 55, at 121. That is a change from practice under former chapter X, where, despite § 208, the Commission had taken an appeal from an adverse ruling in a case where it had intervened specially to enforce the federal securities laws. See SEC v. Bloomberg, 299 F.2d 315 (1st Cir. 1962) (SEC denied permission to intervene); Showcase Corp. (E.D. Mich. No. 71-2899), reported in 40 S.E.C. ANN. REP. 129 (1975).

The Commission will, in any event, as in its role as an advisor to the courts under § 208 of former chapter X and rule 10-210(c), see text accompanying notes 15-31 and 169-70 supra, be able to “participate in an appeal taken by a party in interest.” H.R. REP. No. 95-595, supra note 10, at 229, 409.

\footnote{191. “That standard is a substantive standard. Precisely what constitutes adequate information in any particular instance will develop on a case-by-case basis.” Id. at 409.

\footnote{192. In former chapter X, the SEC’s examination of, and report on, a plan focused on the valuation of a debtor and whether the plan met the “fair and equitable” standard. Under chap-}
be in the interests of those whose acceptances are solicited, and it also would assist the bankruptcy court in performing its duties to assure itself that “adequate information” is being disclosed and prevent the issuance of spurious securities.

Under the flexible disclosure standard, the statement, unlike that under former chapter X, may be approved “without a valuation of the debtor.” But it is recognized that there may be cases in which a valuation will “be essential to the development of adequate information.” Similarly, as previously noted, the legislative history states that the court need not consider the report of investigation prior to approving the disclosure statement.
But, like the matter of valuation, it can be anticipated that there may be cases where such a report will be an important factor in the determination of whether "adequate information" is being provided to parties in interest when asked to make an informed decision about a plan proposal. Thus, for example, where a plan contemplates the retention of the debtor's management, any information uncovered during an investigation that reflects adversely upon the management's integrity should be disclosed to those persons who are asked to vote on the plan.\textsuperscript{198} Moreover, in cases where no investigation is made, it may be necessary to disclose that fact as well as the reason for not conducting any investigation.

It may be expected that early judicial decisions in this area will provide some guidance to the practitioner as to what is "adequate information."\textsuperscript{199}

\textsuperscript{198} In addition to questions involving such matters as fraud, waste, and diversion of corporate opportunities, the view here also refers to matters that come under the rubric of corporate accountability. They would include, for example, previous nondisclosure of any interest of management in corporate transactions (that is, potential conflicts or self-dealing), of the payment of perquisites to corporate officials, and of questionable and illegal payments, the disclosure of which would provide the parties in interest with information from which they can assess the character of management officials to whom the future development of the debtor is to be entrusted. In that connection, courts recently have recognized that "information of improprieties committed" by corporate management "might be material to investor decisions" concerning the qualifications of those who exercise stewardship of the corporation. SEC v. Jos. Schlitz Brewing Co., 432 F. Supp. 824, 829-30 (E.D. Wis. 1978). See also Maldonado v. Flynn, \textit{reported in [1979] FED. SEC. L. REP. (CCH) ¶ 96,805, at 95, 148-49 (2d Cir. 1979) (remanded for a determination whether the reelection of directors should be nullified because of the false and misleading impression created by a description in a proxy statement of the amendments to a stock option plan and the facts concerning the exercise of such options); SEC v. Kalvex, Inc., 425 F. Supp. 310, 315 (S.D.N.Y. 1975) (enforcement action brought by SEC seeking permanent injunction against further violations of securities laws by former corporate director). And, fifteen years ago in Franchard Corp., 42 S.E.C. 163, 169-74 (1964), the SEC had expressed the view that information reflecting on the quality and reliability of management is material to reaching an informed investment decision.


\textsuperscript{199} As noted previously, it is anticipated that the Commission, with its 45 years of experience in administering the disclosure provisions of the federal securities laws should be a constructive force in connection with judicial interpretation of the phrase "adequate information."
As is stated in the legislative history, in determining whether a disclosure statement contains "adequate information," the court should balance the desires of the parties to the case to have an expeditious and successful reorganization with the longer-term goal of "preventing securities frauds."\(^{200}\)

**Need for Close Scrutiny of Disclosure Statements**

Section 1145 of the new Act contains an exemption from registration under the Securities Act for the distribution of certain securities issued pursuant to a plan of reorganization or held by a debtor at the time of the filing of the petition.\(^{201}\) Additionally, the plan offer and sale of securities are not governed by the proxy requirements of the Securities Exchange Act.\(^{202}\) Because both of these are important public investor protection statutes administered by the SEC, the Commission's role in scrutinizing the issuance of securities in reorganization cases should have an important bearing on the plan proposal and its confirmation. In this connection, the SEC's participation may be important, because it presumably would object to confirmation of a plan that is nothing more than a scheme to avoid the registration requirements of section 5 of the Securities Act.\(^{203}\) Where the principal purpose of the plan is to effect a public distribution of securities through a less stringent bankruptcy disclosure process than would be the case if the securities were registered under the Securities Act, an objection to confirmation by the SEC would frustrate the perpetration of such a scheme. In that context, the House Report emphasizes that securities schemes are not to be effected "through the use of section 1145."\(^{204}\)

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\(^{200}\) See text accompanying note 166 supra.


\(^{202}\) See text accompanying notes 160-68 supra.

\(^{203}\) See 11 U.S.C. app. § 1129(d) (Supp. II 1978), which provides in pertinent part that "on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance . . . . of section 5 of the Securities Act of 1933 (15 U.S.C. § 77e (1976))." This, in effect, codifies the SEC's past practice of opposing confirmation of those plans that appeared to be "motivated primarily by stock market considerations rather than by any serious desires to rehabilitate a business." E.g., Studio Creative Crafts, Inc., (E.D. Va. No. 208-70-A) and Universal Topics, Inc., (D. Md. No. 14243) both reported in 37 SEC ANN. REP. 202 (1972). Neither of the plans involved in those cases were confirmed, and the debtors were adjudicated bankrupts. Id.

\(^{204}\) H.R. REP. No. 95-595, supra note 10, at 418. While the bankruptcy registration exemption was thought necessary to facilitate consummation of reorganization plans, it was not enacted for the purpose of protecting securities promotional schemes. See 9 COLLIER ON BANKRUPTCY ¶ 12.03, at 716 n.8 (14th ed. 1978) ("The purpose of § 393 [of former chapter XI] was to facilitate the offer and consummation of plans, to avoid an undue burden on the debtor, and to prevent unduly burdensome expense.") See also 6A COLLIER ON BANKRUPTCY ¶ 10.21, at 106-07 (14th ed. 1978) ("Because of the exemption from the Securities Act of 1933, accorded by § 264 [of former chapter XI], the reorganization court [was] under the duty to scrutinize with care the securities to be issued in order to prevent the issuance of unsound or deceptive securities."); In re American Dept Stores Corp., 16 F. Supp. 977 (D. Del. 1936); In re Barum Realty Co., 62 F. Supp. 81 (E. D. Mich. 1945), aff'd, 154 F.2d 562 (6th Cir. 1946). Congress' awareness of the impact of the issuance of the bankruptcy-related securities, exempt from the registration pro-
The importance of the SEC’s and bankruptcy court’s roles in scrutinizing plan disclosure statements that provide for the issuance of unregistered securities is underscored by the scope and nature of the bankruptcy securities exemption itself. The purpose of the registration requirement is to “provide full and fair disclosure of the character of securities sold in interstate . . . commerce and through the mails, and to prevent frauds in the sale thereof.” The theory behind an exemption from registration for the distribution of securities issued under a bankruptcy reorganization plan, like those contained in the Securities Act itself, is that under the circumstances requiring court scrutiny of the disclosure statement, formal registration should not be necessary. However, because the exemption from registration now permits resales of bankruptcy-issued securities, protecting the integrity of the marketplace will be a factor that must be considered. The debtor’s interests in flexibility and economy must be carefully balanced against the potential harm to public investors in the open market.

CONFIRMATION STANDARDS

Confirmation of a plan of reorganization is a “complex subject.” Section 1129 reshapes the approach to the adoption of a plan of reorganization.
that impairs\textsuperscript{211} the rights of creditors and shareholders. As such, that section is one of the principal features for public investors in the Act’s reorganization provisions, and one of the last opportunities to protect the investor. When viewed in light of the disclosure approach to plan solicitation, where investors make their own informed decisions, the confirmation provisions will require investor vigilance in accepting or rejecting a plan proposal.

Under former chapter X, the “fair and equitable” standard—otherwise known as the absolute priority rule—was one of the key public investor protection features of that proceeding.\textsuperscript{212} That doctrine\textsuperscript{213} essentially required that senior classes be paid in full before junior interests could participate.\textsuperscript{214} In some cases, it has been stated that compliance with this requirement effectively eliminated participation by public shareholders where the debtor’s valuation was insufficient to reach that far down.\textsuperscript{215}

Under former chapter XI, on the other hand, because the confirmation standard of “best interests of creditors” meant that creditors received more than in liquidation, a negotiated arrangement usually worked to retain enhanced value for the shareholders at the expense of the unsecured creditors.\textsuperscript{216} Thus, public debenture holders under former chapter XI could receive less than their absolute priority vis-à-vis stockholders. Considering

\textsuperscript{211} “Impairment” is the new terminology for a claim or interest that is affected by a plan in the sense that rights are modified and altered in the interest of the reorganization. 11 U.S.C. app. § 1124 (Supp. II 1978). As under § 216(6) of former chapter X, a plan must specify “any class of claims or interests that is not impaired under the plan.” Id. § 1123(a)(2).

\textsuperscript{212} In SEC v. American Trailer Rentals Co., 379 U.S. 594, 612 n.11 (1965), the Supreme Court compared chapters X and XI in this respect, and noted “Chapter X’s greater protection for public investor creditors in this regard.”

\textsuperscript{213} Up until 1952, both chapters X and XI contained this requirement for confirmation. In that year, it was deleted from chapter XI, leaving the requirement that the arrangement be “for the best interests of the creditors.” “Best interests” meant that the creditors would get more under the plan than in liquidation, which provided flexibility for negotiating a relative participation under the arrangement between the unsecured creditors and the debtor, representing shareholders. See notes 155-56 supra.

\textsuperscript{214} As explained by the Supreme Court, “The words ‘fair and equitable’ are ‘words of art’ which mean that senior interests are entitled to full priority over junior ones.” SEC v. American Trailer Rentals Co., 379 U.S. 594, 611 (1965). A valuation of the debtor was required to determine where the cut-off occurred down the list of priorities. See Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 115-22 (1939).

\textsuperscript{215} The House Report noted that, in 1938, when public investors usually held senior bonds and corporations were privately owned, the absolute priority rule “prevented abuses of the public’s rights by insiders of a corporation in reorganization.” But today the public classes “are more likely to be subordinated debenture holders and stockholders,” and this protection “inures to the benefit of private creditors,” who are “often financing consortiums.” In this context, the Report continues, “[a]pplication of the absolute priority rule under Chapter X has more recently led to the exclusion rather than the protection of the public.” H.R. Rep. No. 95-595, supra note 10, at 222.

\textsuperscript{216} This was based on the premise that a reorganized going concern was worth more than if liquidated, and the debtor’s plan attempted to keep as much of the excess value for the shareholders as the debtor’s management could negotiate with the official creditors’ committee.
that the debtor was the only one that could propose a plan, creditors had to negotiate with management for a larger share of the company. 217

Section 1129 of the Act sets forth a comprehensive set of standards the bankruptcy court must apply when a plan, to which acceptances have been solicited, is presented for confirmation. 218 Essentially, it applies the former chapter XI "best interests" test but preserves a "fair and equitable" treatment for dissenting classes of creditors and stockholders who, by requisite vote, reject the plan. 219 The key provision is section 1129(a)(8), which provides that the court shall confirm a plan if, inter alia, either "each class . . . has accepted" or "is not impaired under the plan." 220

When a plan is accepted by each class, 221 the court must confirm it if certain other requirements are met, 222 one of which reflects on the absolute
priority rule. The court must examine the acceptance of the plan by each impaired class in order to determine if each member of the class has ac-

success.” 6A Collier on Bankruptcy ¶ 11.07, at 235 (14th ed. 1978). In Finn v. Childs Co., 181 F.2d 431 (2d Cir. 1950), the reorganized company appealed an award of final compensation, and the court noted the somewhat bitter dispute as to the drain upon the working capital of the newly organized company and its present vicissitudes only to suggest that a successful reorganization placed in jeopardy by high fees allowed can point only to a dreary round with the debtor emerging from bankruptcy only to re-enter it after the lawyers are paid. Id. at 435.

The payment of administration costs, particularly fees, can loom large in a reorganization case and thus affect the plan’s feasibility. Under §§ 241-43 of former chapter X, awards of compensation, which were made at the conclusion of the proceeding, had to be reasonable, reflect the public interest nature of bankruptcy matters, see, e.g., Massachusetts Mut. Life Ins. Co. v. Brock, 405 F.2d 429, 432-33 (5th Cir. 1968), cert. denied, 395 U.S. 906 (1969) (appeal from award of interim fees to trustee), and were not to be made at the same rates prevailing in private litigation. See, e.g., In re First Colonial Corp. of America, 544 F.2d 1291, 1299 (5th Cir.), cert. denied, 431 U.S. 904 (1977); In re York Int’l Bldg., Inc., 527 F.2d 1061, 1069 (9th Cir. 1975). In that connection, it had been held that the court should consider such factors as the time required, the novelty and difficulty of the issues, the skill required to deal with those issues, the preclusion of other employment, and the experience and reputation of those involved. See In re First Colonial Corp., 544 F.2d 1299, making applicable to bankruptcy cases the guidelines laid down in Johnson v. Georgia Highway Express, Inc., 488 F.2d 714 (5th Cir. 1974), cert. denied, 431 U.S. 904 (1977). Thus, the courts balanced these factors in awarding fees in reorganization cases.

By contrast, under § 328(a) of the Act, professional persons may be retained, with court approval, at a particular hourly rate or on other reasonable terms (including a retainer). But that compensation is to be reasonable, taking into account such factors as the nature of the services and their value, and the actual time necessary, as well as the “cost of comparable services” in non-bankruptcy cases. 11 U.S.C. app. § 330(a)(1) (Supp. II 1978); H.R. Rep. No. 95-595, supra note 10, at 329-30. This change is designed to overrule the prior principles of reasonableness and economy of administration in such cases as Massachusetts Mut. Life Ins. Co. v. Brock, 405 F.2d 429 (5th Cir. 1968), because it is said that “inotions of economy of the estate in fixing fees are outdated and have no place in a bankruptcy code.” 124 Cong. Rec. S17,408 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 Cong. Rec. H11,092 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards). It should be noted that under § 328(a) the court may reduce the compensation previously agreed upon, if, at the conclusion of the case, “in light of developments unanticipatable at the time” the fees were fixed, it should appear that the compensation agreement was “improvident.” 11 U.S.C. app. § 328(a) (Supp. II 1978).

It may be expected that participants in reorganization cases will seek, and may receive, higher compensation than in the past. Such awards will have to be reviewed carefully to determine what effect, if any, they will have on the feasibility of reorganization plans. In those cases where the payment of fees in cash may have an adverse effect on the plan’s feasibility, the court could reduce the cash awards and supplement them with an award of securities for the balance. See id. § 1145(a)(1)(A), which unlike §§ 393 & 264 of former chapters X and XI, exempts from registration under the Securities Act the issuance of securities “in exchange for... a claim for an administrative expense.”

Under former chapter X, in cases where there was insufficient cash to pay all allowed administrative fees and expenses, in some cases securities were issued and treated as a private placement transaction, exempt under § 4(2) of the Securities Act, 15 U.S.C. § 77d(2) (1978). See Jade Oil & Gas Co., (C.D., Calif. Nos. 17312-F & 17313-F), reported in 39 Sec. Ann. Rep. 126 (1974) (applicants allowed more than $10,000 were paid 75% in cash and 25% in newly issued stock of the reorganized company).
cepted the plan or, if not, whether a person rejecting the plan will receive under the plan "not less than the amount" he or she would have received in liquidation. However, unlike the absolute priority rule of former chapter X, in this situation, an accepting class majority can bind the dissenting minority members to a distribution differing from that which the "fair and equitable" standard would otherwise mandate as long as it is not less than what the minority member would have received if the debtor were liquidated under the liquidation provisions of chapter 7 of the Act. The effect of this approach to a plan and its confirmation will have a significant impact on public classes of debt security holders because they will be bound to a distribution where only two-thirds in amount and one-half in number of allowed claims of the class actually voting decide to accept the planponent's offer. Thus, the interests of a public investor class may be controlled by the interests of the few, larger class claimants.

It is only with respect to a class voting to reject the plan that a form of "fair and equitable" treatment may become relevant. Ordinarily, a rejected plan would fail for confirmation. However, "on request of the proponent of the SEC "retains a right to file an advisory report [on fees] under section 1109.”

The SEC “retains a right to file an advisory report [on fees] under section 1109.” 124 CONG. REC. S17,408 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 CONG. REC. H11,092 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards). Section 330(a)(2) of the Senate Bill, S. 2266, had language specifically referring all applications for compensation and reimbursement in a case involving a public company to the Commission “for a report” which would be “advisory.” In this regard, the Senate Report commented that “[i]n such a situation, courts have accorded the SEC’s views substantial weight, as representing the opinion of a distinguished agency skilled and experienced in reorganization affairs.” S. REP. No. 95-989, supra note 55, at 41. Under former chapter X, the Commission’s recommendations on allowances and reimbursement were accorded “great weight.” E.g., In re Farrington Mfg. Co., 540 F.2d 653 (4th Cir. 1976); In re Imperial “400” Nat’l, Inc., 432 F.2d 232 (3d Cir. 1970); In re Coast Investors, Inc., 388 F.2d 622 (9th Cir. 1968); Finn v. Childs Co., 181 F.2d 431 (2d Cir. 1950); In re Arlan’s Dep’t Stores, Inc., 462 F. Supp. 1255, 1260 (S.D.N.Y. 1978); In re Investors Funding Corp., 422 F. Supp. 461 (S.D.N.Y. 1976), modified, 547 F.2d 13 (2d Cir. 1976). Cf. SEC v. United Financial Group, Inc., 404 F. Supp. 908, 914 (D. Or. 1975) (SEC receivership).

223. Based on experience under former law, the authors feel it is highly unlikely that such a level of acceptance will be obtained from public creditor or shareholder classes.


225. Thus, "[a] particular holder [of a claim or interest] is permitted to accept less than liquidation value, but his acceptance does not bind the class.” H.R. REP. NO. 95-595, supra note 10, at 412-13. This provision is designed to "insure that the dissenting members of an accepting class will receive at least what they would otherwise receive under the best interest of creditors test.” 124 CONG. REC. H11,103 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

226. Of some potential protection is 11 U.S.C. app. § 1128(e) (Supp. II 1978), which permits the court, upon request of a party in interest, to exclude the vote of a person not voting in good faith, such as where a voting claimant is also an equity holder who would receive a greater benefit from the plan as a shareholder than as a claimant because the plan allocates to the creditor class less than full payment and preserves substantial values for the equity holders (a result which would not be permissible under the fair and equitable test). See Consolidated Rock Prods. v. DuBois, 312 U.S. 510 (1941).
the plan,” where all of the requirements for confirmation are met except acceptance by one or more classes, the court must still confirm the plan over the wishes of a dissenting class if the plan is found to be “fair and equitable” to each such class. This is known as the “cram down” provision, a term used for an analogous procedure under former chapter X, which, at the option of the proponent, provides a means to save the plan despite its rejection. Since it is derived from the fair and equitable public investor protection requirement of that chapter, it may become an important “backstop” against which any public investor class will initially assess the plan proposal in making the informed, independent judgment contemplated by the solicitation of consents through the disclosure process.

Essentially, the new chapter 11 “fair and equitable” cram down gives a dissenting class, at the option of the plan proponent, that participation it would have received had the plan initially been developed, much as a trustee was required to do under former chapter X where, first, a valuation of the debtor’s business and assets is made, and, then, the resulting value is distributed from the top priority down in the order of absolute priorities until it is exhausted. At this point, a pro rata distribution to the last class is made, and any junior interests are deemed worthless and do not participate in the reorganized company.

If requested by the proponent to confirm despite the rejection, the court merely applies certain fair and equitable guidelines set out to deal with dissenting secured and unsecured creditor and equity security classes. If the plan is then found to provide the requisite fair and equitable treatment for the dissenting class, it must be confirmed. If not, the proponent’s

227. This would include the debtor or trustee, or possibly a third party in other situations. The “court may not rewrite the plan,” H.R. REP. No. 95-595, supra note 10, at 414, and cannot confirm unless the proponent requests it to do so. 11 U.S.C. app. § 1129(b) (Supp. II 1978).

228. Id. An additional requirement is that the plan not "discriminate unfairly" with respect to dissenting classes. This provision is new and is "not derived from the fair and equitable rule or from the best interests of creditors test. Rather, it preserves just treatment of a dissenting class from the class's own perspective," H.R. REP. No. 95-595, supra note 10, at 417, that is, "that a class not be unfairly discriminated against with respect to equal classes." Id. at 416 (emphasis added).


230. See text accompanying notes 152-68, 175-96 supra. Important principles of disclosure in a particular case may include the plan proponent's intention to elect the cram down in the event it is not accepted and an estimate of what the dissenting public class could expect to receive under a cram down—it could be more or less than offered in the plan.

231. The result is a "partial application of the absolute priority rule . . . applied under [former] chapter X. . . . The important difference is that . . . senior classes [are permitted] to take less than full payment, in order to expedite or insure the success of the reorganization." H.R. REP. No. 95-595, supra note 10, at 224. But, it is important to note that "the fair and equitable requirement applies only with respect to dissenting classes," 124 CONG. REC. H11,104 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards), and does not disturb the other classes.


233. Id. § 1129(b)(1).
The request to confirm is denied. The court cannot rewrite a rejected plan. While no valuation is essential if all impaired classes accept the plan, it will "almost always be required" on a cram down request "in order to determine the value of the consideration to be distributed under the plan."

What is fair and equitable treatment is spelled out separately for secured and unsecured claims and equity interests. Thus, for example, if all the members of a dissenting class of public debenture holders will receive under the plan "property of a value, as of the effective date of the plan, equal to the allowed" amounts of their claims, that is, payment in full, the plan may still be confirmed. It may also be confirmed where the dissenting class is not paid in full, provided that "the holder of any [junior] claim or interest" receives no participation.

The importance of adequate and effective public investor representation and participation in a reorganization case is underscored by the approach to confirmation followed by the new Act. Under former chapter X, public investors had the independent trustee, the SEC, and the court to ensure them of a fair and equitable participation under the plan. Thus, they were not left to negotiate a relative participation on their own. The Act now places this responsibility on the investors with a "fairness" backstop possible only if the class dissents and the proponent elects to go forward and not withdraw.

234. Id.
236. Id. See note 196 supra for consideration of valuation in connection with adequate disclosure.
239. Id. The key word is "property," which includes the use of securities to pay the class in full; in such a situation the court "need only determine that there is a reasonable likelihood that the [securities] given the dissenting class of impaired unsecured claims equals the present value of [their] allowed claims." 124 CONG. REC. S17,421 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 CONG. REC. H11,104-05 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

As a further example, an accepting class senior to a dissenting class is allowed to give up value to a junior intervening class; the plan still remains fair to the dissenting class so long as no class senior to it has received "more than 100 percent of the amount of its claims," 124 CONG. REC. H11,104 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards). The senior class may, however, give up value to a class junior to the dissenting class if the intervening dissenting class "receives the full amount," as opposed to value, of its claims or interests." Id. at H11,105.

In that connection it is significant to note that § 1126(g) provides that any class whose claims or interests do not participate under the plan is "deemed not to have accepted" the plan. 11 U.S.C. app. § 1126(g) (Supp. II 1978). Thus, a class for which no participation is provided in the plan is automatically treated as a dissenting class. Such a class can only be excluded from the plan if, after the hearing on confirmation, its exclusion is found to be proper under the fair and equitable standard (§ 1129(b)). In substance, though not in form, the same result would have been obtained under the fair and equitable standard in former chapter X. Chandler Act, ch. X, § 216(8), 52 Stat. 896 (1938) (repealed 1979).
A duly noticed hearing on confirmation must be held by the court, and any "party in interest" may file objections. Because the court will previously have seen the plan in connection with its approval of the disclosure statement, the confirmation hearing likely will focus only on a determination of whether the standards for confirming the plan are "met." Although the main inquiries at confirmation will be the plan's acceptance, the liquidation inquiry, and—when necessary—a fair and equitable determination, the court must refuse confirmation "on request of a party in interest that is a governmental unit" when the "principal purpose" of the plan is "avoidance" of taxes or section 5 of the Securities Act of 1933. In that connection, a plan involving an issuance of securities to public investors probably will be scrutinized by the SEC's staff.

CONCLUSION

With the Bankruptcy Reform Act of 1978, Congress has adopted a new approach to the means by which investor protections are achieved in business reorganizations of public entities. The prior focus on the disinterested trustee, the required investigation, the independent formulation of a plan, and SEC scrutiny and court approval of the plan, now is shifted to an emphasis on investor initiative and vigilance and the disclosure of "adequate information" in order that the interested parties themselves can reach informed judgments. The flexibility of former chapter XI and the rigidity of former chapter X have given way to a single reorganization chapter under which the presumption is that the debtor generally will remain in possession.

However, with disclosure of "adequate information" drawing closer to securities laws concept than was the case under former law, debtor control over plan formulation and confirmation will have to be balanced against the protection of public investors. SEC participation in the disclosure process and prior court approval of the disclosure statement are two important public investor protection features designed to assure continued investor protection and informed judgments.

Because the premise of reorganization cases is the same as the disclosure premise of the securities laws, the SEC should be expected to play a sig-

240. 11 U.S.C. app. § 1128 (Supp. II 1978). This includes the SEC, for "[u]nder section 1109, the SEC and indenture trustees, even though not true parties in interest, may also object to confirmation." H.R. REP. No. 95-595, supra note 10, at 411.

241. 11 U.S.C. app. § 1129(d) (Supp. II 1978). This provision of § 1129(d) would seem to emphasize that the issuance of unregistered securities is a means to facilitate a legitimate reorganization of the debtor, and the bankruptcy courts are not to be used to circumvent the investor protection policy of the Securities Act, such as the scheme involved in SEC v. Century Inv. Transfer Corp., reported in [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,232 (S.D.N.Y. Oct. 5, 1971).

242. See text accompanying notes 176-98 supra with respect to adequate disclosure.
significant role in assisting the court in that regard, primarily as a constructive force in securing adequate disclosure to public investors. Thus, the Commission will be able to benefit the investor through the wide experience it has gained over the years in administering the securities laws.