OBSTACLES TO SUCCESSFUL REORGANIZATION.*

By
J. Kirk Windle
Chief, Branch of Reorganization
Chicago Regional Office
Securities and Exchange Commission

Before

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OBSTACLES TO SUCCESSFUL REORGANIZATION

Judge Whitehurst, Dr. Cecil, Judge Huffstutler, distinguished members of the Association, and guests: It is indeed a pleasure and an honor to be invited to appear here this afternoon.

The subject which I have chosen for my talk - Obstacles to Successful Reorganization - could, without too much effort, be expanded to cover the entire two days of this Conference. Each case is different and each has its own peculiar problems which might impede a successful reorganization. Since I can't cover the whole field, I have selected a few acres which, in my opinion, have been the most troublesome in recent years. While at first glance the various sub-headings shown in the program may appear to have little in common, they all are concerned, either directly or indirectly, with putting a corporation into reorganization and keeping it there until it either has been successfully reorganized or until it has been demonstrated beyond any reasonable doubt that reorganization is impossible.

At the threshold of a Chapter X proceeding we frequently are met with one of the basic difficulties - reluctance of management to file a petition under one of the "Relief" chapters until the corporation's financial affairs have deteriorated to such a

degree that reorganization may be next to impossible. This may be the result of a sincere belief that conditions will improve or that voluntary adjustments with creditors can be worked out. All too frequently, however, the corporate affairs have been managed - or mismanaged - for the primary benefit of an inside few rather than the public investors. Reluctance to file under Chapter X, with its provisions for full investigation, under such circumstances is understandable. Obviously the Court can do nothing to prevent this situation in advance. You who are attorneys advising corporate clients, however, may be in a position to advise your clients to seek the proper relief while there is still enough life in the corporation to give it a fighting chance for survival.

Faced with the situation where a corporation's financial affairs have been permitted to degenerate to a point where reorganization is difficult before the petition is filed, what can the Court do? The one thing which must be kept ever in mind - and I can't emphasize this too strongly - is that the financial condition brought about by years of mismanagement or by reluctance to face the facts cannot be cured in days or even several months. The Court must be "Reorganization-minded" and not be stampeded by the seemingly hopeless situation into quickly liquidating the corporation. I am not unmindful of the repeated admonitions that reorganizations are to be carried through with reasonable promptitude and that they should not be viewed as "nursing" receiverships.[1/] There is no question that reorganizations should not be unnecessarily prolonged. The considera-

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1/ 6 Collier on Bankruptcy (14th Ed. 1947) 4245, ¶12.02 and cases cited; In re McGann Mfg. Co., 190 F. 2d 845 (C.A. 3, 1951).

tion of speed, however, is more than balanced by the need for thorough exploration of all possibilities for rehabilitation which is implicit in Chapter X.[2/] It has been the Commission's experience that it usually required a substantial amount of time, ranging up to a year, for the participants and the Court to acquire a sound knowledge of the enterprise being reorganized and evaluate conflicting interests sufficiently to permit intelligent negotiations on reorganization. This does not mean that the intervening time is wasted. On the contrary, it means that a vast amount of generally constructive work is done to lay the groundwork for reorganization. Particularly is this true in those cases where there is evidence of fraud or mismanagement. About two out of three cases which I have handled in the last few years fall in this category.

Many examples could be cited to show that "justice delayed" is not necessarily a form of denial of justice in Chapter X reorganizations. The prime example is the reorganization of Inland Gas Corporation and associated companies, collectively known as the American Fuel System.[3/] Two of the three principal companies were placed in receivership in Kentucky on December 1, 1930. A Receiver was appointed for American, the parent company, on March 21, 1934. After the enactment of Section 77B, involuntary petitions under that statute were filed and approved against all three companies, and upon the amendment of the Bankruptcy Act in 1938, the three

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2/ Id. at 4246.

3/ E.D. Kentucky, Bankruptcy Nos. 989-B, 991-B, and 115.

proceedings were placed under Chapter X. Initially, Inland's earning power had been insufficient to pay the interest charges on its heavy debt structure. Good management by the Trustee, aided by favorable economic conditions, enabled the Debtors to generate enough cash to pay off class after class of creditors. By the time a plan of reorganization was finally consummated in June, 1960, there had been paid to the public creditors, in cash, more than $18,100,000 - payment in full for principal and interest to the extent allowed. The common stock of the reorganized company, having a value of more than $3,000,000, was issued to Columbia Gas System, Inc. - the company whose claims against the Debtors originally had been subordinated because, as the Court of Appeals for the 6th Circuit said,

> "[its] conduct was for the purpose of destroying the debtors . . . and . . . by its acts . . . it drew to itself the life-blood of all the debtors and picked the flesh from the bones of these corporate entities . . ." 4/

While I do not suggest that reorganizations normally should last thirty years or anywhere near that long, it should be noted that had a compromise suggested early in the proceeding been approved, thousands of public investors would have been wiped out.

Another example, closer to home for most of you, is the reorganization of Texas Portland Cement Company, pending in Judge Sheehy's Court in the Eastern District of Texas.5/ The Debtor was organized in 1955 to construct and operate a cement plant. From the outset it was inadequately capitalized and it operated for about a year and a half on - hand-to-mouth financing before filing a Chapter X petition on July 7, 1958. The Trustees have placed its operations on a profitable basis, improved the plant substantially and built up adequate working capital. They are in the process of

4/ In re American Fuel & Power Co., 122 F. 2d 223,228 (C.A. 6, 1941)

5/ E.D. Texas, No. 1606.

settling and refunding secured debts on what we hope will be favorable terms. The Trustees' investigation, with the aid of the Commission's staff and the office of the Attorney General of Texas, resulted in cancellation of a large bloc of promoters' stock and filing of an action to recover approximately $2,000,000 from former officers and directors. Soon the Trustees will be in a position to file a plan of reorganization.

Other successful reorganizations and the length of time elapsed from initiation of the proceeding to final decree include: In re Muntz TV, Inc.,[6/] nearly 7 years; In re Texas Gas Utilities Company,[7/] 4 1/2 years; In re Empire Warehouses, Inc.,[8/] 3 1/2 years; In re Minnesota and Ontario Paper Company,[9/] 11 years; and In re Selected Investments Trust Fund,[10/] 3 years.

Devotees of Chapter XI as a vehicle for rehabilitating corporations often claim speed as one of its principal advantages over Chapter X. I submit, however, that even under Chapter XI time and patience are required adequately to work out the financial affairs of a distressed corporation. Thus the Financial Editor of the Chicago Sun-Times on April 25, 1961, quoted from a letter to stockholders of Wilcox-Gay Corp. that "The rehabilitation of the Wilcox-Gay Corp. is now complete." The Editor went on to say that

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6/ N.D. Ill., No. 54B 437 (1954)

7/ W.D. Tex., No. 2238 (1951)

8/ N.D. Ill., No. 56B 2539 (1956)

9/ 4th D. Minn., No. 11640 (1931)

10/ W.D. Okla. No. 10680 (1958)

"Six years ago Wilcox-Gay was forced into bankruptcy court . . . By last month the company had worked itself completely out of bankruptcy court and the Chapter XI proceedings had been terminated."

I do not contend that every reorganization proceeding should last thirty years or anything like it. Admittedly the Inland Gas case is sui generis in this respect. I do say, however, that Chapter X is not intended to "place crutches under corporate cripples,"[11/] and Courts and counsel must not lose sight of the fact that the purpose of a Chapter X proceeding is rehabilitation.[12/] It is a rare case indeed in which creditors and stockholders suffer from the lapse of time necessary to determine intelligently whether or not the Debtor can be rehabilitated. In most cases, as in the Inland Gas case, substantial benefits can be demonstrated through inclusion of classes of creditors or stockholders who otherwise would have been wiped out.

The "Good Faith" Issue and Burden of Proof.

Turning now to more specific problems, the first obstacle to a successful reorganization is the necessity for proving that the petition is filed in good faith. Section 141 provides that:

> "Upon the filing of a petition by a debtor, the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied."

11/ Price v. Spokane Silver & Lead Co., 97 F. 2d 237 (C.A. 8, 1938).

12/ 6 Collier, op. cit. supra note 1, at 233 ¶1.05 [4].

In the normal course of events a voluntary petition, in proper form and filed in good faith, will be approved immediately, usually in an ex parte hearing.[13/] The question of good faith usually is determined by the Judge on the facts as stated in the petition supplemented by representations of counsel. This, in my opinion, is the appropriate way to handle the preliminary approval of a voluntary petition since Section 137 provides ample opportunity for controverting answers by creditors, indenture trustees, and stockholders, if the Debtor is not insolvent, and Section 144 provides for a hearing on such answers. In the absence, therefore, of some patent indication that Chapter X is being misused, it seems a waste of time to require a Debtor to prove good faith at this stage of the proceeding by additional evidence. And yet, in one pending case, the Debtor was required, by the Referee to whom the matter had been referred, to sustain an almost impossible burden of proof. The Judge refused to follow the recommendation of the Referee and approved the petition. Answers having been filed by certain creditors, the whole procedure had to be repeated.

Section 146 defines "good faith" as follows:

> "Without limiting the generality of the meaning of the term 'good faith,' a petition shall be deemed not to be filed in good faith if -
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> (1) the petitioning creditors have acquired their claims for the purpose of filing the petition; or
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> (2) adequate relief would be obtainable by a debtor's petition under the provisions of chapter XI of this Act; or
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> (3) it is unreasonable to expect that a plan of reorganization can be effected; or

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13/ Id. at 1749, ¶6.02 and cases cited.

(4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding."

The burden of proving good faith is on the petitioner or petitioners.[14/] All too often, however, Courts have imposed too great a burden of proof and have applied erroneous standards in dismissing petitions for failure to prove good faith.

Subsections (1) and (2) normally cause little difficulty. Occasionally it may appear that a prior proceeding would be better. Most of the Good Faith problems seem to arise under sub-paragraph (3) and it is in finding that "it is unreasonable to expect that a plan of reorganization can be effected" where courts are most prone to go astray. Chapter X contemplates a thorough investigation by a trustee, if one is appointed, before a plan is proposed or before it is determined that a plan cannot be proposed.[15/] Others may propose plans even if the Trustee does not.[16/] These provisions would indicate that Section 146(3) should bar approval of a petition only if the proof of inability to effect a plan admits to no alternative. Rather, the assumption should be to the contrary, for who can normally tell at the time a petition for reorganization is filed, or even within the thirty to sixty days for filing answers, that it is unreasonable to expect that a plan can be effected? It has been our experience that debtors whose financial situations look most hopeless are frequently successfully

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14/ Id. at ¶6.05, 1760; Marine Harbor Properties, Inc. v. Manufacturers' Trust Co., 317 U.S. 78 (1942).

15/ Sections 167, 169.

16/ Section 169; Windle, The Securities and Exchange Commission and Corporate Reorganizations under Chapter X, 34 Jnl. of Nat'l. Assn. of Ref. in Bank. 37, 39 (1960).

reorganized. As a practical matter, the information developed in the investigatory phase of the proceedings is essential before plans can be intelligently formulated. In particular, at this stage of the proceedings, assertions by creditors that they will not consent to any plan are premature and should not be considered.[17/]

In the pending case to which I referred a moment ago, the Referee filed a report, after a summary hearing on a voluntary petition for reorganization, finding that the petition was not filed in good faith because it was unreasonable to expect that a plan could be effected. In reaching this conclusion he stated that:

> " . . . the evidence conclusively establishes that the debtor has only vague hopes, born of wishful thoughts, that some where and some how somebody will be found who will furnish the very large sum which the company needs. This is visionary, chimerical, and if the petition be approved under such circumstances, Chapter X would be thereby converted into a means of hindering and delaying creditors. The secured and unsecured creditors of the debtor ought not to be postponed in a collection of their just debts unless there is a reasonable chance that reorganization will be effective."

The underlying reasons for the conclusion that there was no reasonable chance that a reorganization could be effected were: (1) that since the Debtor made no attempt to establish current values by the evidence of qualified appraisers or to project possible earnings, there was no evidence upon which a finding of present value or projected earnings could be based; (2) the evidence was clear that,

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17/ In re General Stores Corporation, 150 F. Supp. 868 (S.D. N.Y. 1957), aff'd. per curiam, 250 F. 2d 875 (C.A. 2, 1958).

in its uncompleted condition, the Debtor's plant could not be operated profitably; (3) there were numerous lawsuits pending against the Debtor (although he did not find that these prior proceedings would best subserve the interests of creditors and stockholders); (4) that the more than $3,000,000 paid in by stockholders had been substantially diminished or perhaps wiped out; and (5) that the officers testified in effect that the proceeding was filed in order to stave off creditors so further efforts might be made to find new capital to refinance Debtor's obligations and complete its facilities. The conclusion was reached in spite of (1) the fact that the books did indicate an equity for the 12,000 stockholders; (2) indications of improper business practices of the Debtor and of many transactions with officers and directors; and (3) evidence that many duplications of claims existed which, if eliminated, would increase the book equity for stockholders.

I am sure the Referee was sincere in believing that reorganization was impossible and he may ultimately prove to be right. I submit, however, that most - if not all - of the reasons given for concluding that it was unreasonable to expect that a reorganization could be effected were immaterial to the issue involved. To throw out a Chapter X petition because it seeks to restrain creditors while the Debtor seeks financing to rehabilitate itself and complete its plant, is to completely disregard the intent and purpose of Congress in drafting this statute for the relief of financially embarrassed corporations, since seldom does a corporation resort to judicial

devices for reorganization except to obtain relief from pressure by its creditors.[18] To expect a debtor to furnish evidence of going concern value or to prove with certainty which claims are duplications or to demonstrate with certainty that necessary financing will be obtainable, places too great a burden of proof on the petitioner at the "Good Faith" stage.

Contrast the finding I have just discussed with the language of the Court of Appeals for the 7th Circuit in affirming a finding that a petition was filed in good faith:

> " . . . we cannot say that the District Court was clearly in error in finding that the petition was filed in good faith. Here was an insolvent corporation with but a temporary permit to pursue the activities upon which its financial existence depended. And it was unable to obtain needed financing . . . The District Court was justified in approving the petition and awaiting the facts that arise from a plan of reorganization. That plan must be fair and equitable, and feasible." [19]

There may be occasional petitions filed under Chapter X where it is readily apparent that reorganization is impossible, although I cannot recall any which have come across my desk in recent years. In view of the reluctance of appellate courts to find clear error and to reverse findings of good faith or lack thereof, I would urge upon each of you the necessity to resolve every possible doubt in favor of approving a petition. If all that Chapter X offered were

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18/ 2 Dewing, Financial Policy of Corporations (5th Ed. 1953) 1215.

19/ In re Evansville Television, Inc., C.C.H. Bankruptcy Reports ¶60,081 (C.A. 7th, 1961). (Emphasis added)

an opportunity for the debtor "to put off its creditors while it waits and hopes, Micawber-like, that something will turn up," then you might be justified in finding that no plan could be effected where the source of needed new money was not apparent. Experience has shown, however, that in many reorganization proceedings the combined effort of the Trustee and other parties has led to the addition of new capital which made reorganization possible.

In the Northeastern Steel Corporation case,[20/] the Debtor filed a voluntary petition for reorganization less than two years after it commenced operations. Losses continued while the operations were conducted by the Trustees to the extent of a net loss of more than $1,500,000 for a five month period. Nevertheless, the Trustees received an offer which enabled them to consummate a plan whereby the first mortgage bondholders were left intact and a substantial distribution was made to junior creditors.

In the Green River Steel Corporation case,[21/] a similar situation existed. A successful reorganization was consummated as a result of new financing, and as a result even the common stockholders of the Debtor received a participation after the creditors were compensated.

In the New Haven Clock and Watch Company case,[22/] many persons in the proceeding expressed the opinion that the Debtor's plant

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20/ D. Conn. No. 27825 (1957).

21/ D. Ky. No. 1940 (1956).

22/ D. Conn. No. 27761 (1958).

was outmoded and that successful operations were impossible. It was estimated that $400,000 in new capital was required. Yet, the court approved the Debtor's petition and the Debtor was subsequently reorganized with new capital invested by strangers under a plan of reorganization which gave all the Debtor's creditors and stockholders a participation. Successful reorganizations were also consummated in Third Avenue Transit Corporation[23/] and Texas City Chemicals, Inc.,[24/] due to investment of outside capital.

The Stardust, Inc. case,[25/] involved a reorganization of a hotel. The Debtor ran out of funds before its building was completed and had not commenced operations when Chapter X proceedings began. Although the Debtor had no earnings history, a sale to third persons was accomplished and the creditors and preferred stockholders shared in the distribution under the plan. A similar result was achieved in the Frank Fehr Brewing Company case.[26/]

Pessimism of creditors at the commencement of Chapter X proceedings has no bearing on good faith under Section 146(3).[27/]

23/ D. N.Y. Nos. 85851, 86410, 86412, 86413, 86537 (Consolidated) (1949).

24/ D. Tex. No. 1997 (1956).

25/ D. Nev. No. 955 (1957).

26/ W.D. Ky. No. 19-515 (1958).

27/ In re Castle Beach Apts., Inc., 113 F. 2d 762 (C.A. 2, 1940); White v. Penelas Co., 105 F. 2d 726 (C.A. 9, 1940); In re Julius Roehrs Co., 115 F. 2d 723 (C.A. 3, 1940); Rickles, What is "Good Faith" in Chapter X Proceedings? 29 Journal of the National Association of Referees in Bankruptcy 60,62 (1955).

Pessimism of the Referee or Judge should have no greater bearing. It should be remembered that Chapter X represents the culmination of a long struggle to resolve the legal, economic and social difficulties inherant in the search for a procedure that achieves an equitable reorganization,[28/] and those seeking to avail themselves of the chance for rehabilitation given by Congress should be granted every opportunity. Certainly where public security holders are involved, a voluntary petition for reorganization should not be cavalierly brushed aside after a summary hearing at which, normally, no one but the Debtor may be heard.

Problems Arising Under Section 236.

Closely akin to the "Good Faith" problems I have just discussed are those arising under Section 236. That Section provides that:

> "If no plan is proposed within the time fixed or extended by the judge, or if no plan proposed is approved by the judge and no further time is granted for the proposal of a plan, or if no plan approved by the judge is accepted within the time fixed or extended by the judge, or if confirmation of the plan is refused, or if a confirmed plan is not consummated, the judge shall -
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> (1) where the petition was filed under section 127 of this Act, enter an order dismissing the proceeding under this chapter and directing that the bankruptcy be proceeded with pursuant to the provisions of this Act; or
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> (2) where the petition was filed under section 128 of this Act, after hearing upon notice to the debtor, stockholders, creditors, indenture trustees, and such other persons as the judge may designate, enter an order either adjudging the debtor a bankrupt and directing that bankruptcy be proceeded with pursuant to the provisions of this Act, or dismissing the proceeding under this chapter, as in the opinionof the judge may be in the interests of the creditors and stockholders."

28/ 6 Collier, op. cit. supra note 1, at 7, ¶ 0.01

Predilection toward bankruptcy liquidation techniques, impatience because of crowded dockets, or other reasons, often cause too hasty a decision to dismiss or adjudicate upon failure of a plan to materialize. As at the "Good Faith" stage, the decision to terminate the proceeding frequently is accelerated by pressure from secured creditors who desire to pursue their separate remedies. I might add, although I am sure it would be denied, that inability to see any sure source of compensation sometimes has a dampening effect upon the ardor with which trustees and their attorneys attack the job of trying to reorganize a debtor.

As I have said earlier, the need to be "reorganization-minded" is paramount. Failure of one plan to be approved, accepted or confirmed does not mean that no plan will succeed. Thus, in the Inland Gas case approximately ten plans were proposed before one was consummated. To be reorganization-minded does not mean that you, as an attorney, should not diligently represent your client's interests. It does mean, in my opinion, that you should not insist on the right to foreclosure or to repossess your client's security when to do so would work to the detriment of other creditors and stockholders and possibly your own client, and would doom the reorganization. Chapter X, as interpreted by the courts, contains adequate safeguards to preserve the rights of creditors and stockholders. The best way to protect those rights is to cooperate toward the ultimate goal - reorganization.

Dismissal or adjudication pursuant to Section 236 should be a last resort - turned to only after all efforts to reorganize have

failed. Yet, in many cases, the order approving the petition for reorganization simultaneously fixes a date for hearing on approval of a plan and for a hearing pursuant to Section 236(2) if no plan is approved. A blanket notice is given to creditors and stockholders advising them that: (1) the petition has been filed and approved, (2) a hearing will be held on retention of the trustee, (3) they may submit suggestions for a plan by a date certain, (4) the trustee will file a plan on the same date, (5) a hearing will be held on approval of the plan on a date certain, and (6) if a plan is not approved, a hearing will be held on the same date to determine whether the proceeding should be dismissed or the debtor adjudicated. Assuming that the plan is approved, common practice is to fix a date for hearing on confirmation or for hearing on dismissal or adjudication if the plan be not confirmed. This procedure has been encouraged by the standard forms suggested by one of the recognized authorities on Bankruptcy and Reorganization.[29/] I do not quarrel with the desire to economize by combining notices wherever possible. Section 120 of Chapter X expressly permits it. I submit, however, that the procedure I have just outlined is psychologically all wrong since it emphasizes the possibility - or probability - that reorganization will fail. It may be contended that such combining of notices means nothing and is justified by the saving in costs. I can assure you, however, that such is not the case when a proceeding is pending before a Judge or Referee who is steeped in liquidation traditions! It then becomes a constant

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29/ 7 Collier, op. cit. supra note 1, Forms 2024,2443,2444.

struggle to prevent the Court from lowering the boom with a sudden adjudication or dismissal. In all fairness to creditors and stockholders, they should be given a separate and distinct notice when a hearing is to be held to determine whether the Chapter X proceedings are to be dismissed or the Debtor adjudicated a bankrupt.

There are subtle ways in which the Referee or Judge before whom the Chapter X proceeding is pending may influence the outcome of the case. Thus, in one case, an announcement by the Referee at an open hearing that unless a plan was submitted by a date approximately a month later he would recommend adjudication, effectively killed any chance for successful reorganization. The Debtor's business was the manufacture and sale of a product which carried a one-year guarantee. Reorganization proceedings had been pending only four months. The Trustee had succeeded in reducing expenses, increased sales, almost overcome the reluctance of customers to rely on a guarantee by a company in reorganization, improved the cash position of the Debtor, speeded up collections, and had operated at a small cash profit. He also had effected a change in management and the new manager (who had just taken over) had expressed the opinion that sales could be improved if he could inform the customers that no date was set for termination of the proceedings. The attitude of the Trustee, an attorney whose background was primarily Bankruptcy, undoubtedly affected the judgment of the Referee. In his recommendations to the Court, the Trustee emphasized the need for "new money" to be forthcoming in thirty or forty days and said he would recommend adjudication

if it were not forthcoming. This attitude completely overlooked the favorable aspects of the case. I am sure that both the Referee and the Trustee sincerely believed they were doing the right thing. However, had they been "reorganization-minded," I believe this company could have been saved as a going concern. A statement by the Court that the proceedings would continue as long as there was improvement in the Debtor's financial position would have given the new manager the ammunition needed to increase sales, would have enabled the Trustee to negotiate for new money (if he needed it) from a stronger position, and would have given the Trustee more time in which to investigate indicated causes of action against officers and directors.

As I said earlier, Section 236 is a last-ditch device. Far preferable is liquidation by plan if it becomes apparent that reorganization as a going concern is impossible. This would be particularly true where the Debtor is not insolvent in the Bankruptcy sense. While it is true that bankruptcy procedure is sufficiently flexible to permit orderly liquidation, the normal practice and time schedules in bankruptcy are directed to quick public auctions. Also, the stockholders have only limited rights to participate in bankruptcy proceedings. Hence, there is real danger that bankruptcy will result in substantial loss to stockholders. Liquidation by plan, too, permits greater flexibility. Liquidation may be consummated by sales in the Chapter X proceedings;[30/] or, if it appears appropriate, a liquidating corporation

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30/ In re Automatic Washer Co., S.D. Iowa, No. 5-426 (1956); In re U.S. Durox Corporation of Colorado, D.Colo., No. 22895 (1959).

may be formed as the reorganized company.[31/]

If there are causes of action which should be investigated further, the Debtor should be kept under Chapter X. Theoretically, such potential lawsuits can be investigated by a bankruptcy trustee, but he does not have the broad investigatory machinery of Section 167. Even more important, the bankruptcy trustee does not have the power to sue in a federal court which a Chapter X trustee has.[32/] Since potential judgments often constitute the only hope for unsecured creditors and stockholders, these factors should be considered carefully before Section 236 is invoked.

The Commission does not participate in straight bankruptcy proceedings. Hence, we normally do not know how vigorously bankruptcy trustees pursue causes of action unearthed in superseded Chapter X cases. In two recent cases with which I am familiar, one bankruptcy trustee filed suit and obtained a substantial judgment;[33/] the other proceeding was closed within a few months with no action taken.[34/]

One other problem which should be discussed briefly is the allowance and allocation of fees upon a dismissal or adjudication of a debtor pursuant to Section 236. Section 246 specifically empowers the judge to make allowances even though reorganization fails. It

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31/ In re Porto Rican American Tobacco Co., 7 S.E.C. 301 (1940), 112 F. 2d 655 (C.A. 2, 1940).

32/ Williams v. Austrian, 331 U.S. 642 (1947).

33/ Dwyer v. Tracy, 118 F. Supp. 289 (N.D. Ill., 1954).

34/ In re South Texas Oil and Gas Co., S.D. Tex., No. 607 (1958).

seems clear that the purpose of Section 246 was to expand the power of the Court to make allowances in abortive Chapter X cases.[35/]

When it comes to the question of assessing fees and expenses against secured creditors where there are few or no free assets, the courts generally have not gone far enough in their modification of the old restrictive rules. Thus in First Western Savings and Loan Association v. Anderson, the Court stated that, since Section 246 contained no limitation upon "the property which may be drawn upon" in making allowances, "the former restrictive rule no longer obtains" and that "The court is required only to do what is reasonable and fair, having in view the rights and interests of all concerned." [36/] However, in reversing and remanding the case, the Court concluded that allowances should be granted lien priority only for "services for the direct preservation and protection of the mortgaged property . . ." [37/] The Court noted that "By far the major part of the services [of the trustee and counsel] concerned the business affairs of the debtor and the efforts to develop a reorganization plan . . . Activities of this kind had nothing to do with the protection of the property, and, under the circumstances, were of no benefit to the secured creditors." [38/]

In United States v. Henderson, the Court similarly concluded that the old restrictive rule had been modified and "that costs and expenses from which the mortgagee benefited or which might reasonably

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35/ United States v. Henderson, 274 F. 2d 419 (C.A. 5, 1960); First Western Savings and Loan Association, et al., v. Anderson, 252 F. 2d 544 (C.A. 9, 1958).

36/ Id. at 548

37/ Id. at 550

38/ Id. at 549

be expected to benefit the mortgagee, may in the discretion of the district court be properly charged against the mortgaged property." 39/ The Court reversed and remanded since it could not determine what part of the costs met the prescribed test. In commenting on the record, the Court stated that "the bulk of the activities of the trustee and his attorney . . . was directed toward exploring the possibilities for reorganization, rather than toward preserving the assets of the debtor. Similarly, the other costs here involved seem clearly to arise . . . out of activities directed toward that broader aim." 40/ On application for rehearing, the Court expressly disavowed any intention to influence the District Court in the exercise of its discretion by this language. It is to be hoped that the District Court was not influenced since the effect of such a holding, as well as the effect of the holding in First Western, is to penalize the Trustee and his attorney for doing that which they are charged by the statute with a duty to do. Since reorganization is the ultimate goal of a Chapter X proceeding, the "broader aim" of exploring the possibilities of reorganization is a duty which the Trustee cannot escape. The reasonable costs of carrying out such duties - including costs of hiring accountants, appraisers, and other experts to the extent necessary - should be proper costs of administration and should have priority over lien claimants as well as general creditors. As was stated by the National Bankruptcy Conference in its report to the House Committee on the Judiciary with regard to Section 246, "If it

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39/ Id. at 423.

40/ Id. at 422.

is to be expected that responsible parties are to render effective service in a reorganization proceeding, provision must be made for reasonable compensation to them, regardless of the outcome of the proceedings. To do otherwise may invite into the proceedings less efficient and responsible persons." 41/ Experience has shown, moreover, that cases such as First Western and Henderson have a very serious effect upon the course of the reorganization proceedings. In order to avoid any implication of consent to the proceedings, secured creditors, in many cases, object at every stage. The result is delay and increased costs while the secured creditors, by their "heads I win, tails you lose" attitude stand to gain if the proceedings are dismissed and, because of the absolute priority rule, will lose nothing if reorganization is successful.

Security-Holder Lethargy

One of the primary aims of Chapter X was "democratization" of the reorganization process.42/ To implement this objective, a broader right to be heard was given, the rights of creditors and stockholders to file plans was expanded, plan suggestions by creditors and stockholders are encouraged, and provisions for allowance of compensation to individuals and committees were liberalized. It is amazing, therefore, to find that in many cases creditors and stockholders who have large sums

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41/ Analysis by National Bankruptcy Conference of H.R. 12889, 74th Cong., 2d Sess. (1936), c.3, §12(II)(d)(7). And see Rubin, Allocation of Reorganization Expenses, 51 Yale Law Journal 418.

42/ See, e.g., remarks of Commissioner (now Justice) Douglas, hearings before House Judiciary Committee or H.R. 6439 (amended and reported as H.R. 8046), 75th Cong., 1st Sess. (1937), 185-188.

bf money at stake display almost complete lack of interest in the reorganization proceedings. In almost half the cases in which the Chicago office of the Commission participated during the past year there was no representation of one or more classes of creditors or stockholders! What the reason is, I don't know. In part it may result from reliance on the Trustee or the Commission to represent their interests. I suspect that in most cases it is just plain lethargy.

An active committee, represented by able counsel, can be of tremendous help in bringing about a successful reorganization. On the other hand, failure of creditors and stockholders to show any interest in protecting their investment can seriously jeopardize the proceeding. In ordering the dismissal of the proceedings in one case, the Judge stated that he was impressed by the fact that none of the twelve thousand stockholders and no creditors were in Court to support the Commission in objecting to dismissal of the petition. The order of dismissal was based on a finding that the voluntary petition under Chapter X was not filed pursuant to duly authorized corporate authority. There were conflicting statements as to whether or not there had been a meeting of the board of directors. However, three of the four directors knew of and assented to the filing of the petition and the Judge stated that the president may have had apparent authority to file since the Debtor had always been a "one-man" corporation. Had any unsecured creditors or stockholders appeared and urged retention of the proceedings I believe the result might have been different. Because of their own

apathy, however, the creditors and stockholders lost an opportunity to have an investigation of the Debtor's management by an independent trustee and if there ever was a case which called for investigation, that was it. Furthermore, dismissal resulted in the probable loss of an opportunity to recover assets of the Debtor which had been transferred to repurchase 51% of the stock. Since the purchasing stockholder had used corporate assets to repurchase the stock, he too might have been liable in a suit brought by a trustee. Other possible causes of action which probably were lost included an accounting for funds of the Debtor disbursed during the months prior to the filing of the Chapter X petition and recovery for stock issued for worthless assets. The consequences of failure to look out for their own interests were costly to stockholders and creditors.

One recent case illustrates both the effectiveness of an active committee and the possible consequences of a momentary lapse in the proper representation of a committee's clients. In the Automatic Washer case, the Trustee filed and brought on for hearing a petition for instructions regarding an offer to settle a judgment of more than $500,000 for about $100,000. The Commission and the Creditors' Committee objected, primarily on the ground that the Trustee and his attorneys had not adequately investigated the possibility of collecting the judgment. The Stockholders' Committee did not appear at the hearing although notified. The District Court directed acceptance of the settlement offer. Upon appeal by the

Stockholders' Committee and the Creditors' Committee, supported by the Commission, the Court of Appeals reversed.[43/] The Court did not rule on the contention made by the Appellee Trustee that the Stockholders' Committee had no standing since it had not appeared below and permitted its counsel to argue and file briefs. However, since the Commission has no right to appeal, the result might have been different had the Creditors' Committee not been more wide-awake.

CONCLUSION

In conclusion, I would again urge the need to be "reorganization-minded." Rehabilitation of a corporation in financial difficulties will have little chance to succeed unless all parties - the Court, the Trustee, secured creditors, general creditors, and stockholders cooperate to utilize to the maximum the machinery provided by Congress in Chapter X. The best interests of creditors and stockholders and, often, of the community itself depends upon such cooperation.

43/ Ashbach v. Kirtley, 289 F. 2d 159 (C.A. 8, 1961).