Washington Law Review

Volume 13 | Issue 4

11-1-1938

Reorganization Under the Chandler Act: Features of the New Revised Bankruptcy Law That Pertain to Corporate Reorganization

Roger L. Shidler

Reorganization Under the Chandler Act

Features of the New Revised Bankruptcy Law That Pertain to Corporate Reorganization

By ROGER L. SHIDLER *of the Seattle Bar*

The Chandler Act, which makes a complete revision of the bankruptcy laws, became effective on September 22, 1938. In this act there are incorporated some very substantial changes in the law relating to corporate reorganizations. The corporate reorganization provisions in former Section 77-B of the Bankruptcy Act have been changed and revised, and have been incorporated in the new bankruptcy act as Chapter X. Most of the changes were made as a result of the recommendations of the Securities and Exchange Commission, after a study of corporate reorganizations made by direction of Congress.

While many of the changes are purely procedural, yet other provisions make substantive changes of importance. Under Section 77-B, the emphasis was on creditor control; that is, by creditors and committees. Under the new act, the court itself, and the Securities and Exchange Commission will play a major part in the proceedings.

Changes in the Jurisdictional Requirements

The jurisdictional requirements have been substantially changed. Section 130 of the new act requires that the petition show why adequate relief cannot be obtained under Chapter XI of the Bankruptcy Act, which makes provision for the composition of unsecured indebtedness of corporations upon voluntary petition by the debtor. A substantial number of petitions have been filed for corporate reorganization where the debtor corporation had only unsecured indebtedness, and such cases have constituted a very great administrative problem for the courts. Where a corporation, without a funded indebtedness, cannot pay its unsecured indebtedness in the ordinary course of business, it usually has but little chance of survival, even though its unsecured indebtedness is cut down, or the period for payment extended. Seldom in such cases has a plan of reorganization been confirmed, so that the effect of filing the petition is merely to hold creditors at bay while the corporation is incurring additional indebtedness. Chapter XI of the new act makes adequate provision for the composition of unsecured indebtedness for corporations having no funded debt. Under the provisions of this chapter, closer supervision of the affairs of the debtor corporation is provided for under the direction of the Referee in Bankruptcy. Hereafter, in order to give the court jurisdiction under Chapter X, it will be necessary to allege in the petition that the corporation desires to make some adjustment of its secured indebtedness, or in case the corporation has only unsecured indebtedness, that it desires to make some adjustment of the interests

of the stockholders. The effect of this requirement should be to cut down materially the number of voluntary petitions filed under Chapter X.

The provisions of Chapter X materially expand the right of creditors to file involuntary petitions. Section 77-B provided that three creditors, holding claims in the aggregate amount of $1,000 or more, in excess of the security held by them, might file a petition, if they met the other requirements. Bondholders hesitated to file an involuntary petition under Section 77-B, as they were loath to allege that the value of the security for their bonds was less than the face amount thereof, for fear that it would prejudice the position of their securities in connection with any proposed plan of reorganization. There was the further difficulty of proving that the value of their security was less than the amount of the debt owing them, in case of a contest on their petition. Consequently, it was only in extreme situations that bondholders filed a petition. Under Section 126 of the new act, three creditors holding aggregate claims in the amount of $5,000 or over are allowed to file a petition, without the requirement that their claims must be in excess of the security held by them. This section further provides that an indenture trustee may file a petition for corporate reorganization.

Creditors holding the requisite amount of claims, or an indenture trustee, may file a petition when (a) a receiver or trustee has been appointed for all or a greater portion of the property of the debtor in a pending bankruptcy proceeding, or (b) an indenture trustee or a mortgage trustee is, by reason of default, in possession of all or the greater part of the property of the corporation, or (c) a proceeding to foreclose a mortgage or to enforce a lien against all or the greater portion of the property of the corporation is pending. By reason of these changes, it is expected that the proportionate number of petitions filed by creditors will be substantially increased.

The Increased Importance of Trustees in Connection With the Proceedings

Under the provisions of Section 77-B, the courts generally allowed the debtor to stay in possession and operate its business during the pendency of the proceedings. Under Chapter X, the court can no longer do so in any case where the total liquidated indebtedness amounts to $250,000 or over, but must appoint a disinterested trustee for the properties of the debtor corporation. Where the liquidated indebtedness is in a lesser amount, the court may leave the debtor in possession with power to operate its business. In order to be disinterested, the trustee must not be an officer, director, creditor, or stockholder of the debtor, or have had any connection with the underwriting of its securities. The attorney for the trustee must also be disinterested. The court may appoint an additional trustee, who may be an officer or stockholder of the debtor, but the duties of such additional trustee are

limited strictly to the operation of the business.

The trustee, or the debtor, if the debtor is left in possession, must file schedules which shall include a list of the debtor's creditors and stockholders, together with their addresses. The new act also makes provision for obtaining such lists from third parties. This is a very necessary provision, as in many instances the debtor has no list of its bondholders, and such a list is obtainable only from the trustee for the bonds or the underwriter who sold the securities.

Where a trustee is appointed, he must make an investigation of the acts, conduct, property, liabilities, and financial condition of the debtor, and must file a statement of his investigation, and submit the same to creditors, stockholders, indenture trustees, and the Securities and Exchange Commission. The theory behind this provision is two-fold; firstly, that fraud in the past conduct of the business will be exposed, and secondly, that the parties in interest will have adequate information upon which to judge any plan which may be proposed. Where a debtor is kept in possession, it is provided that an examiner may be appointed by the Court to make such investigation and report.

Changes in the Manner of Submission of Plans

The method of formulation and submission of a plan of reorganization has been materially changed. When a trustee is appointed, he must give notice to creditors and stockholders, that they may submit suggestions for the formulation of a plan or proposals in the form of plans within a time specified by the court. Thereafter, the trustee must file a plan with the court or a report of his reasons why a plan cannot be effected. The court then gives notice of a hearing on the trustee's plan, and for the consideration of any objections which may be made, or of such amendments or plans as may be proposed by the debtor or by any creditor or stockholder. In case the trustee does not file a plan, then a hearing is had on his report of his reasons why a plan cannot be effected.

When a debtor is continued in possession, a plan or plans may be filed within a time fixed by the judge

1. By the debtor,
2. By any creditor or indenture trustee,
3. By any stockholder if the debtor is not found to be insolvent,
4. By the examiner, if one is appointed, and he is directed to do so by the judge.

The judge fixes a time for a hearing on the plan, or plans, filed, and on any amendments thereto.

The Duties and the Responsibilities of the Securities and Exchange Commission in the Proceedings

If the liquidated indebtedness of the debtor exceeds three million dollars, the plan must be submitted to the Securities and Exchange Commission for an advisory report. If the liquidated indebtedness is less than three million dollars, the judge may, in his discretion, submit the plan to the Securities and Exchange

Commission for a report. After the report, if any, of the Securities and Exchange Commission is filed, the judge may enter an order approving the plan, or in case more than one plan has been filed, he may approve two or more. After approval by the judge, the trustee, in case there is one, or otherwise the debtor, submits the plan or plans to the creditors and stockholders, together with the opinion of the judge approving of the plan, and the report thereon, if any, of the Securities and Exchange Commission. After such submission, the creditors and stockholders have their first opportunity to file acceptances of the plan. Any acceptances obtained prior to such submission are void. After sufficient acceptances are filed by creditors and stockholders, the court fixes a date for a hearing, at which time the plan having the requisite number of acceptances may be confirmed. Chapter X makes no change in the required number of acceptances by creditors and stockholders.

Chapter X makes clear that the claim of an indenture trustee is not to be included in computing the majority necessary for confirmation of a plan. Under Section 77-B, the trustee for a bond issue has always filed a claim on behalf of all of the outstanding bonds secured by the mortgage under which the trustee was acting, and because of this fact, it was deemed necessary to secure the consent to a plan of two-thirds in amount of all of the outstanding bonds.

Under the new act, it will not be necessary to secure the consent of two-thirds in amount of all outstanding securities, but only the consent of two-thirds in amount of the claims filed by individual holders. It will be extremely difficult to get security holders to file claims because, under Section 204, they may participate in the distribution of the securities under the plan at any time within five years after the entry of a final decree in the proceedings, whether or not they file claims. The only reason for a security holder's filing a claim is so that he may accept a plan proposed. Against this advantage, there is the obvious disadvantage of having the securities out of his possession and in the hands of the court depositary for a period of several months or years. As a consequence, it is likely only a small proportion of the outstanding securities will be voted in favor of a plan, and yet the court may confirm the plan on the basis of the acceptances filed, as they will constitute the requisite majority of the claims actually filed. If in practical operation it works out in this manner, it will mean that a heavy burden will fall upon the court in seeing that the plan is fair and feasible.

Undoubtedly, it will be very difficult to have a plan confirmed where the report of the Securities and Exchange Commission thereon is adverse. If, after the filing of an adverse report by the Securities and Exchange Commission, the judge nevertheless approves the plan, which he has the right to do, it will place the creditors and stockholders in rather a dilemma, as they will have to choose as to whether they will follow the advice of the judge, or of the Securities and Exchange Commission. It is to be anticipated, however, that the judge will, except in unusual circum-

stances, be governed by the report of the Securities and Exchange Commission, and therefore, as a practical matter, it will be necessary to secure the approval of the commission in order that a plan may finally be made effective.

The act makes no provision for an open hearing before the Securities and Exchange Commission on the plan, and the commission has made no statement of its policy with respect thereto. Even though no open hearing is held, it will be essential that interested parties take the matter up with the commission in person, in order to explain adequately the various features of the plan. The Securities and Exchange Commission has an attorney in each of its regional offices to take care of matters arising in connection with procedure under Chapter X, but as to whether such attorneys for the commission will conduct hearings on plans on behalf of the commission has not been determined. If plans are passed on in the Washington, D. C., office of the commission, it will work a great hardship on Western attorneys, as it will necessitate traveling to Washington in order to take the matter up with the proper officials in person.

Charter Provisions for the Protection of Security Holders

Section 216 contains some rather interesting provisions. It requires that a plan shall provide that the charter of the corporation which will carry out the plan provide for the election of the directors representing the preferred stock (in case preferred stock is issued) in the event of default in payment of dividends. Does this require that preferred stockholders have the power to elect a majority of the directors in the event of default in the payment of dividends? From a literal reading of the act, this does not seem to be true. On the other hand, if it means that provision need only be made for representation of the preferred stockholders on the board in the event of default, then it would seem that the provision is totally ineffectual, as minority representation on a board of directors is of but little practical benefit.

Section 216 also provides that the charter of the corporation which is to carry out the plan shall contain "provisions which are fair and equitable, and in accordance with sound business and accounting practice with respect to the terms, position, rights, and privileges of the several classes of securities of the debtor". The word "securities" is defined in Chapter X to include bonds or debentures. This seems a rather curious provision, as it is highly unusual to set forth the position, rights, and privileges of bondholders or debenture holders in the charter of a corporation.

Changes in the Provisions for Fees and Allowances

Substantial changes have been made in the provisions for compensation and allowances. Compensation may be allowed to creditors and stockholders, and their attorneys, for suggestions made to the trustee in connection with a plan, and compensation may be awarded in connection with objections to the plan, and in connection with the administration of the estate. However, the judge is instructed to consider only those services which contributed to the plan as confirmed, or to the refusal of confirmation of any plan,

or which were beneficial in the administration of the estate. It may be anticipated that a multitude of suggestions in connection with plans will be submitted and the court may have a great deal of difficulty in deciding just whose "suggestions" were incorporated in the plan.

Clarification of Income Tax Problems in Reorganization Proceedings

Another provision which is of substantial importance is contained in Section 268, which provides that no income or profit shall be deemed to have accrued to, or to have been realized by, the debtor or by the trustee provided for in the plan under Chapter X, or by the newly organized corporation, by reason of cancellation or modification of any indebtedness of the debtor in a proceeding under Chapter X. Prior to the inclusion of this provision, attorneys have been fearful that where indebtedness is cancelled by a plan, the corporation will be deemed to have received income to the extent of the interest cancelled, which would, in many instances, require the payment of very heavy income taxes in connection with the rearrangement of the indebtedness. To avoid this difficulty, it has been considered necessary to organize a new corporation to take over the property and assets of the debtor corporation, and to issue the new securities. This hazard has been removed, and it will now be possible to use the same corporate structure without danger of incurring liability for income taxes.

Conclusion

Generally speaking, the result of the changes in corporate reorganization procedure will be that the number of voluntary petitions by corporations will be materially reduced. A corporation in financial difficulties will avail itself of every means to adjust its indebtedness outside of court, or in state court proceedings, rather than hazard the risk of losing control of its properties and assets in a proceeding under Chapter X. The number of involuntary petitions by creditors and indenture trustees may be increased, although this is somewhat doubtful. The revised act gives no incentive to committees to organize for the protection of security holders, and such committees have usually taken the initiative in revamping the affairs of a corporation in distress. Owing to the increased opportunities for fees, it is probable that legal entrepreneurs will file involuntary petitions on behalf of creditors wherever the opportunity suggests itself. In practical operation, it will be interesting to see whether the fundamental changes in reorganization procedure, as made by Chapter X, will constitute an improvement over the procedure provided for in former Section 77-B.

The Lookout

This feature of the BAR JOURNAL, inaugurated in the issue of April, 1938, for the purpose of apprising the bar in advance of questions of law pending determination in the Supreme Court, has been taken over by the agency reporting the decisions of the Supreme Court and this material is now furnished to the bar through the Bancroft-Whitney Company Washington Advance Sheets at the opening of each term of court. It will be discontinued as a part of the STATE BAR JOURNAL.