Business Reorganization Under the Bankruptcy Reform Act of 1978: An Analysis of Chapter 11

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I. INTRODUCTION

The Bankruptcy Reform Act of 1978, the first major revision of the bankruptcy laws in nearly forty years, became effective on October 1, 1979. The Reform Act clarifies, simplifies, and modernizes the previous law, which had been unable to deal with the vast twentieth-century changes in the amount and treatment of debt.

Although the Reform Act includes many important changes, this Comment will focus on perhaps the most significant substantive change: the consolidation of chapter VII (railroad reorganizations), chapter X (corporate reorganizations), chapter XI (arrangements), and chapter XII (real property arrangements) of the former act into the single reorganization chapter 11 of the Reform Act.

As a background for review of chapter 11 of the Reform Act, the first Section of this Comment will briefly outline the history of the reform movement, the reasons for the Reform Act, and the rudiments of the former reorganization chapters. The second portion will proceed through chapter 11 of the Reform Act, highlighting the important changes and describing the reasons for and effects of these alterations. The final section will make some observations about the new act from the practitioner's point of view, since the Reform Act promises to involve more practitioners than did the prior reorganization chapters. Because of the relatively limited use of the railroad reorganization chapter of the former act, this Comment will not consider the changes in


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that area.

II. HISTORY AND REFORM INCENTIVES REGARDING BANKRUPTCY LEGISLATION

A. The Tremendous Increase in Bankruptcy Petitions

In the last thirty years of available statistics regarding the use of the former act, there has been a phenomenal increase in petitions for bankruptcy. In 1975, the year preceding congressional hearings on bankruptcy reform, the number of cases filed reached a new peak. Over 250,000 cases were filed that year in all types of bankruptcy proceedings, representing more than double the other 117,320 civil cases filed in federal district courts.

Among the factors leading to this increase are the great reliance American businessmen and industrialists have placed on debt as a source of capital, and the equally great dependence of consumers on credit for the purchase of goods and services. With the overwhelming increase in the amount of private debt outstanding in the American economy, it is no wonder that bankruptcies have increased so dramatically.

The vast majority of bankruptcies are straight personal or consumer liquidations. Of all the chapter X, XI, XII, and XIII proceedings filed under the former act, the largest number were filed under chapter XIII, the wage earner rehabilitation plan. Business bankruptcies, however, are not only increasing numerically, but are also accounting for a larger percentage of all bank-


8. Bankruptcy Act Revision Hearings, supra note 4, at 337 (statement of Vern Countryman).

9. Id. In 1975 about 90% of all chapter proceedings were filed under chapter XIII.
   chapter XIII ........................................ 41,178 cases in 1975
   chapter XII ........................................... 280 cases in 1975
   chapter XI ........................................... 3,506 cases in 1975
   chapter X ............................................. 189 cases in 1975
ruptcies filed,\textsuperscript{10} consuming a significant portion of court time and other resources of the bankruptcy system.

Despite the ever growing number of bankruptcies, their adverse economic impact is small when compared to the increased standard of living that credit buying has given the consumer.\textsuperscript{11} The cost is spread among all consumers, although the greatest burden is borne by "customers of business borrowers, through higher prices."\textsuperscript{12}

The spiraling number of bankruptcies is not so much a problem for the economy as it is for the bankrupt individuals and the bankruptcy court system.\textsuperscript{13} The need for reform, therefore, did not center on the reduction of the number or dollar amount of bankruptcies.\textsuperscript{14} Rather, the need focused on flexibility in the fair and equitable treatment of all parties, whether debtor or creditor, as well as on the expeditious and streamlined handling of an ever-increasing case load.\textsuperscript{15}

\textbf{B. The Inadequacy of Former Bankruptcy Legislation}

With these needs in mind, Congress in 1970 established the Commission on the Bankruptcy Laws of the United States.\textsuperscript{16} The Commission was to "study, analyze, evaluate and recommend changes" in the Bankruptcy Act and the system of bankruptcy administration.\textsuperscript{17} In July 1973 the Commission reported its findings and recommendations to Congress, including the text of a suggested bankruptcy code.

The Commission concluded that the former act did not achieve the desired purposes of bankruptcy legislation.\textsuperscript{18} One commentator summarized the purposes as follows:

\begin{quote}
The purpose of bankruptcy from the point of view of the
\end{quote}

\textsuperscript{10} Id. Business bankruptcies hovered below 10\% of all bankruptcies from 1946-1974. In 1975, however, their portion of the total was 12\%.

\textsuperscript{11} Id. at 341.

\textsuperscript{12} D. STANLEY \textsc{&} M. GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 40 (1971). This study was published by the Brookings Institution and is known as the "Brookings Report."

\textsuperscript{13} Bankruptcy Act Revision Hearings, supra note 4, at 341 (statement of Vern Countryman).

\textsuperscript{14} REPORT OF THE COMMISSION ON BANKRUPTCY LAWS, supra note 5, at 9.

\textsuperscript{15} Id. at 11-12.


\textsuperscript{17} Id.

\textsuperscript{18} See REPORT OF THE COMMISSION ON BANKRUPTCY LAWS, supra note 5, at 4-5.
man deeply in debt, is relief. The purpose of bankruptcy from the point of view of the creditor is to salvage some recovery where it appears that the debt cannot or will not be paid in full. The purposes of bankruptcy from the point of view of the public are: (1) to return to useful production a man so harassed by debt that he cannot do his work properly, and (2) to divide fairly among the man's creditors such assets as he has.19

One study, the Brookings Report, found that under the former system creditors received little from bankruptcy proceedings and consequently they had little incentive to actively pursue their claims. Instead, creditors passed their losses on to consumers and taxpayers in the form of higher prices or tax writeoffs. The debtor, on the other hand, was often denied a "fresh start" because of the large number of nondischargeable debts and security interests in essential property. Also, the debtor was often persuaded to reaffirm many of the debts discharged, either to obtain further credit or out of a sense of moral duty.20

The Commission found a general lack of uniformity in the application of bankruptcy law; similarly situated debtors were accorded unequal treatment in various judicial districts.21 Concerning this problem, the Brookings Report stated: "Even among the federal bankruptcy courts there are striking differences in policies."22

With respect to business bankruptcies, the Commission's findings showed that inordinate delay in the institution of proceedings was a major factor in the failure to meet creditor needs. Often the debtor's assets were largely depleted before bankruptcy. The requirement that a creditor prove an act of bankruptcy prior to filing an involuntary petition contributed to a general diminution of the value of a business, which generally is already depleted because of debtor delay in seeking help.23 The Commission found the business rehabilitation chapters to have "detailed and overlapping rules regarding [their] availability which frequently produce pointless and wasteful litigation as to which chapter should be used in a particular case. . . . In addition, none of the chapters is precisely suited to the needs of many common business situations."24 In sum, the Commission

24. Id. at 23.
found the former act disjointed, inflexible, and confusing. Despite frequent amendments, it was incapable of adapting to the many changes in debtor-creditor relations that have occurred since the former act's last major overhaul forty years ago.  

C. The Former Reorganization Chapters

Reorganization, as opposed to liquidation, is premised on the theory that the assets of a business are more valuable when continued in the productive capacity for which they were made than when dismantled and sold piecemeal for use in another business or for scrap. Liquidation is preferable only when the assets have little value as a continuing business relative to their liquidation value, or when it is more economical to divert the use of the assets to another form of productive capacity.

Under former law, business reorganization was completed under three separate and mutually exclusive chapters, and the application of the chapters was determined by the "needs to be served." Chapter X was enacted in 1938 as a part of the Chandler Act to efficiently accomplish, by voluntary or involuntary petition, the thorough financial reorganization of large, publicly held corporations. It required rigid supervision by the court and was a formal process involving (1) the substitution of an independent trustee for debtor's management if total debt exceeded $250,000; (2) the active participation of the Securities and Exchange Commission (SEC); (3) court approval of a plan prior to the solicitation of acceptances; (4) the ability to affect the rights of both secured creditors, unsecured creditors, and stockholders; and (5) the administration of the absolute priority rule with respect to participation in the assets of the business. Use of chap-

25. Id. at 1-5. Since the Chandler Act in 1938, see note 2 supra, debtor-creditor relations have been greatly altered by the general adoption of the Uniform Commercial Code (UCC), the Uniform Consumer Credit Code, the Uniform Consumer Sales Practices Act, Truth-in-Lending Act regulations, or other similar legislation.


29. J. Trost, L. King & K. Klee, The Proposed Federal Bankruptcy Reform Act, Resource Materials 273 (1978). Chapter X also contemplated a complete reorganization of the capital structure of the debtor corporation with the new structure based on a going-concern valuation of the enterprise, secured and unsecured creditor's interests being proportionate to the value of their claims. See Bankruptcy Act Revision Hearings, supra note 4, at 339-40 (statement of Vern Countryman). The plan formulation was supervised
ter X was limited, primarily because of the mandatory ouster of the debtor's management and the application of the absolute priority rule; also, the formal nature of the proceedings tended to lengthen the reorganization process, which increased the costs and often resulted in little return to the creditors. Thus, even though chapter X was more versatile than other chapters as to what debt could be affected in the reorganization, it was used in less than ten percent of all business reorganization cases.

Chapter XI, also added to the former act by the Chandler Act of 1938, was intended for use by smaller nonpublic businesses. Because of its relatively quick reorganization procedures, however, it was more often used by larger public companies when a speedy reorganization process was imperative. A chapter XI case was commenced by the filing of a voluntary petition by any person who could file as a bankrupt under section 22 of the former act, which defined those who could declare bankruptcy. One reason this chapter was so often employed is that debtor's management was not displaced by an independent trustee. The plan, which could only be proposed by the debtor, could directly affect unsecured debt only. Secured debt was often indirectly affected by the automatic stay provisions and by negotiations between debtor and secured creditors. Negotiation was made more attractive to creditors by the possibility of a higher or more rapid payment on the debt than would have been available under the longer, more expensive chapter X proceeding. Since there was no court approval required for acceptance solicitation, it could be done either pre-petition or post-petition. The standard imposed by the courts in confirming the plan was the "best interests of creditors" test, which meant that to be approved, the plan must provide creditors with at least what they would have

by the trustees and had to be approved by the court before it could be submitted to the stockholders for their approval. Acceptance required approval by two-thirds majority in each class of claims affected and by a majority of stockholders affected.

30. The limited application of chapter X is demonstrated by the fact that of 254,484 bankruptcies filed in the United States in 1975, only 189 were filed under chapter X. See Bankruptcy Act Revision Hearings, supra note 4, at 337 (statement of Vern Countryman).
32. Bankruptcy Act Revision Hearings, supra note 4, at 337 (statement of Vern Countryman).
received under a liquidation of the business.\textsuperscript{35} This conceivably left the difference between the liquidation value and the going-concern value for the debtor (stockholders, partners, or others).\textsuperscript{36} The SEC involvement was limited to that of a party in interest with authority to petition for a conversion to a chapter X proceeding or for a complete dismissal where, in the SEC's opinion, the "needs to be served" so required.\textsuperscript{37}

Because of a limited scope, chapter XII, like chapter X, was rarely used.\textsuperscript{38} It was available only to noncorporate entities that owned property held as security for a debt. The primary purpose required of a chapter XII plan was modification of the real property secured debt, but it could also affect unsecured debt.\textsuperscript{39} Only the debtor could propose the plan and, to be confirmed, it was required to be in the "best interests of creditors." Such a case was thus commenced by a voluntary petition only and usually contemplated leaving the debtor in possession; however, on application by a party in-interest and for cause shown, the court could appoint a trustee.\textsuperscript{40} Solicitation of acceptances for a plan was permitted anytime, since, like under chapter XI, court approval of plans was not required. The SEC could not be involved in a chapter XII proceeding.

Chapter distinctions in business reorganizations long ago lost their justification, if indeed any existed in 1938. The establishment of separate chapters at that time may have been largely attributable to the inability of Congress and the bankruptcy bar to agree on a uniform approach to reorganizations.\textsuperscript{41} Chapter X was normally too time consuming and rigid, while chapter XI was limited to unsecured debt and contained too few public protections. Chapter XII had limited applicability and could not be used by corporations. Although each chapter had separate advantages that ought to have been available to all business entities seeking rehabilitation, there could be no mixing of remedies among chapters. The consolidation of these chapters into a sin-

\begin{itemize}
  \item 35. 3 D. Cowans, supra note 19, § 936.
  \item 38. For the number of chapter XII petitions filed in 1975, as well as the number of petitions filed under the other business reorganization chapters, see note 9 supra.
  \item 41. See H.R. Rep. 95-595, supra note 36, at 223.
\end{itemize}
gle chapter in the Reform Act, together with some much-needed modernization and simplification, was a great step forward in the uniform application of bankruptcy law.

III. REORGANIZATION UNDER THE REFORM ACT

A. General Observations

Chapter 11 of the Bankruptcy Reform Act of 1978 constitutes a major overhaul of chapter proceedings. While it most closely resembles chapter XI of the former act, the new chapter 11 also represents a major innovation as it combines the advantages of the former chapters and introduces several new concepts. It is flexible enough to permit the fashioning of a proper remedy to fit the circumstances of individual cases, yet provides sufficient protection of public investors and creditors to prevent unworthy debtors from avoiding debt obligations. Its streamlined procedures resolve previous problems of unworkable and overlapping requirements among the different chapters, thereby working toward the elimination of needless litigation and the hazards of improper chapter selection. Reorganizations under the new chapter 11 will consume less time, promote greater equality of treatment among parties, retain more assets for the satisfaction of debts, and because of its simplified format, will allow more practitioners to bring cases under it. "The net effect of the series of reorganization principles is to retain the simplicity of an arrangement with unsecured private creditors while, at the same time, to make the more complex reorganization less cumbersome and quicker to process."43

B. Major Changes Introduced by the Bankruptcy Reform Act

1. Eligibility of debtors

Section 109 of the Bankruptcy Reform Act enumerates the requirements for relief under the Act.44 Basically, any individual, partnership, or corporation residing in the United States or having a domicile, a place of business, or property within this country is eligible. The Reform Act retains the former act’s exclusion of both foreign and domestic insurance companies, banks, and

savings and loan associations, and there are specific provisions for the treatment of railroads in subchapter IV of chapter 11. With these few exceptions, any entity is eligible for relief under the Reform Act.

- The adoption of these broad eligibility standards for all entities seeking rehabilitation rather than liquidation provides more uniform application of the laws, greater flexibility as to remedies, and eliminates the hazards of improper chapter selection.\(^\text{45}\) Contrary to the restricted and exclusive relief available under the various chapters of the former act, the Reform Act provides the entire panoply of remedies to all applicants regardless of size, amount of stock outstanding, or other distinguishing factors.\(^\text{48}\)

2. Commencement of a chapter 11 case

The Reform Act provides for both voluntary and involuntary petitions.\(^\text{47}\) A voluntary petition is commenced by the filing of a petition with the bankruptcy court by one who may be a debtor under chapter 11.\(^\text{48}\) Such a filing constitutes an order for relief.

An involuntary petition may be commenced only under chapters 7 or 11 and only against certain entities.\(^\text{49}\) When there are twelve or more total creditors and their claims aggregate $5000 more than the value of the liens securing their claims, three petitioning creditors must join to file a petition. If there are fewer than twelve creditors, only one need sign the petition if that creditor holds claims totaling at least $5000.\(^\text{50}\) The petition filed must allege that the debtor is generally not paying his debts as they come due or that within 120 days prior to the petition a custodian was appointed or took possession of the debtor's property. The debtor must controvert the petition in a timely manner or relief is granted. If he does controvert the petition, a

\(^{46}\) Downey, Ferriell, & Pfeiffer, supra note 34, at 582.
\(^{48}\) Id. § 301.
\(^{49}\) Id. § 303(a). The entity must be able to be a debtor under the chapter under which the case is commenced and the entity may not be a "farmer or a corporation that is not a moneyed, business, or commercial corporation." As for what is meant by the phrase "not a moneyed, business, or commercial corporation," the report of the House Judiciary Committee, H.R. Rep. 95-595, supra note 36, at 322, explains that eleemosynary institutions such as churches, schools, and charitable organizations and foundations are meant to be excluded.
\(^{50}\) 11 U.S.C.A. § 303(b) (West 1979).
trial is held to determine the debtor's viability.\textsuperscript{51}

The Reform Act draws upon the provisions of former chapter X regarding involuntary petitions, but changes the conditions of both the voluntary and involuntary petitions. Most of the differences deal with relaxation of the eligibility restrictions.\textsuperscript{52}

The allegations necessary for the court to grant an order of relief are new. Proof of one of the acts of bankruptcy\textsuperscript{53} is no longer required. Alleging and proving an act of bankruptcy under the previous law often delayed the institution of proceedings until the business was beyond help.\textsuperscript{54} Although these acts have been abolished and a creditor's burden of proof made less onerous, the court may still require the posting of a creditor's bond to compensate the debtor for damages should the court later determine that the petition was unwarranted.\textsuperscript{55}

3. Administration of the debtor's estate

a. Creditor's committees. After the order for relief, the court must appoint a committee of unsecured creditors and may, upon request of a party in interest, appoint other committees from among other types of claimants. The size or membership of any appointed committee may be challenged by a party in interest and changed after notice and hearing if it is determined that the committee is not fairly representative of the claims it was meant to represent.\textsuperscript{56}

At a meeting where a majority of the committee is present, each committee may, with the court's approval, authorize the employment of attorneys, accountants, or other professionals to perform services in its behalf. The professionals so employed are prohibited from simultaneously representing any other entity in the case by a "disinterestedness" requirement.\textsuperscript{57} They may be compensated from funds of the estate after a court hearing to

\textsuperscript{51} Id. § 303(h).
\textsuperscript{52} For example, with an involuntary proceeding available to creditors of all potential chapter 11 debtors, an individual proprietorship, a partnership, or other business entity may now be confronted with an involuntary petition. This affords greater protection to creditors, who may use this new leverage to force a debtor into reorganization before he becomes hopelessly insolvent or to negotiate concessions from the debtor in the formulation of a plan.
\textsuperscript{54} REPORT OF THE COMMISSION ON BANKRUPTCY LAWS, supra note 5, at 14.
\textsuperscript{55} See 11 U.S.C.A. § 303(e), (i) (West 1979).
\textsuperscript{56} Id. § 1102.
\textsuperscript{57} Id. § 1103(a)-(b).
determine the amount, which is to be based on a reasonable compensation standard. Limitations and guidelines on compensation are specified in the Act.

All appointed committees may actively participate in the reorganization process. They may investigate the financial condition and operation of the debtor's business, determine the desirability of the continuation of the business, consult with the debtor in possession or the trustee concerning the administration of the case, participate in plan formulation, request a trustee or examiner, and generally pursue the interests of those they represent. The committees have standing to be heard on any issue, including a right to appeal an unfavorable court order, and they may also file a plan if the debtor fails to propose or obtain a confirmation of his plan. These committees are an important part of the reorganization process, since much of the negotiation that occurs between the debtor and creditors is accomplished through them.

The Reform Act is premised on the notion that effective creditor participation and control, as opposed to lawyer and largest creditor control, will better achieve the purposes of reorganization. Under prior law the committees were generally elected. Provisions specifically allowed the creditors with the largest claims and the highest priorities to dominate the committee while those with smaller claims and lower priorities were often excluded. An attorney was permitted to represent a particular creditor and a committee as well, often increasing the influence of the large creditors or, at least, permitting the attorney to dominate the committee and weaken creditor control.

b. Appointment of a trustee or examiner. Section 1104 of the Reform Act, dealing with the appointment of a trustee or an examiner, constitutes a departure from former law. The former chapter X mandated the appointment of a trustee in every case where total debt exceeded $250,000 (this would include nearly every case for which chapter X had been used), and former

58. Id. § 330(a).
59. Id. §§ 328, 330, 331. Foremost among these limitations is that any compensation received is subject to court approval. Employment may be on any reasonable terms, including a retainer, an hourly fee, or a contingent fee. The court may deny a fee altogether if it finds the party is not disinterested.
60. Id. § 1103.
61. Id. §§ 1109, 1121.
chapter XI had no provision for the appointment of a trustee except the continuance of one appointed under another section. Former chapter XII left the debtor in possession in nearly all cases, except where a trustee was appointed under a prior filing under another chapter or where, for good cause, the debtor was replaced by a trustee.

The Reform Act takes an intermediate position. It contemplates the debtor being left in possession in most cases, but provides for a trustee or an examiner upon certain conditions. This reflects the belief that since in most cases there is no mismanagement or fraud, the debtor, who is most familiar with his business and his creditors, should retain possession.

Ousting a debtor's management in favor of a trustee requires notice and a hearing at which a party in interest must show fraud, incompetence, or gross mismanagement, or demonstrate that such an appointment would be in the best interests of the creditors, the stockholders, or the estate. If a trustee is not appointed, the court may, as an added protection to the creditors, order an examiner to investigate allegations of fraud and other irregularities if the debtor's unsecured nontrade and nontax debts exceed $5,000,000, or if otherwise warranted. Significantly, however, there are no provisions for the appointment of a receiver.

A trustee, or a debtor in possession, is entrusted with various powers and duties, including the investigation of all matters relevant to the case, the formulation and filing of an appropriate plan, the filing of all necessary reports and statements, and the continuation of the operation of the debtor's business. Other more general powers accorded the estate or the trustee are delineated in broad provisions of other chapters of the Reform Act.

65. Id. ¶ 732.
66. Id. §§ 732, 832, 844. See also 3 D. Cowans, supra note 19, ¶ 1055.
68. 11 U.S.C.A. § 1104(b) (West 1979).
69. King, supra note 42, at 26, col. 2.
71. Proper execution of the duties of a trustee, or a debtor in possession, requires an understanding of several significant sections of chapters 3, 5, and 7 as they apply to chapter 11. See id. §§ 323, 326, 345, 361-365, 521-554, 704.

Although not technically within the scope of this Comment, certain changes from the previous law involving these provisions affect chapter 11 rehabilitation and are therefore mentioned. The first are the automatic stay provisions of § 362 of the Reform Act. Id. § 362. The changes were meant to correct two main inadequacies: incomplete coverage from the debtor's point of view, and lack of provision for relief from a stay from the creditor's point of view. Under § 362 the automatic stay operates against all entities,
Proper use of the powers vested in a trustee or debtor in possession should permit the reorganization of any truly viable business.\(^\text{72}\)

c. The equipment financing provisions. One of the more significant, albeit controversial, sections in the Reform Act is the provision covering aircraft equipment, vessels, and railroad rolling stock.\(^\text{73}\) Under the former law, exceptions to the automatic stay provisions relating to transportation equipment allowed the owner or financer of heavy and expensive equipment, stock, or vessels to repossess according to the terms of the financing agreement, regardless of the commencement of bankruptcy proceedings. By providing for “bankruptcy-proof” agreements, these exceptions were designed to encourage the production and financing of that type of property. The financing industry has become dependent on this practice, and has alleged that it would cease to operate in the absence of those exceptions.\(^\text{74}\) Unfortunately, the continued use of this equipment may be essential to the operation of a debtor’s business, and may be critical to successful rehabilitation.

The Reform Act modifies but does not eliminate the financer’s absolute right to repossess. The trustee has the right to agree, within sixty days after the date of the order for relief, to whether judicial or administrative (with certain common exceptions listed in § 362(b)). This coverage will allow the debtor enough time to formulate a rehabilitation plan free from the harassment of collection efforts.

But the stay provision also allows a creditor to obtain relief from the stay if, after notice and hearing, the court finds the creditor’s interests will be harmed due to a lack of adequate protection for the collateral. *See id.* § 363. The court must act with reasonable dispatch as well, since the stay is dissolved automatically after 30 days from the creditor’s request for relief unless the court, after notice and hearing, orders its continuation.

There are also some significant changes from the previous law concerning property of the estate. Under the former act, state law determined what property passed to a trust for purposes of estate administration and whether or not such property was exempt. This policy was rejected in the Reform Act, in favor of a uniform list of exemptions and a single definition of property, *id.* § 541, which will include any property interest of value. The exemption provision, *id.* § 522, will prevent the disparities found under former law, and should provide the debtor with a “fresh start.”

Preferential transfer rules have also been altered by the Reform Act by increasing the trustee’s ability to recover funds for the estate. *Id.* § 547. The two major changes are: (1) the preference period is now 90 days instead of the previous four months, and (2) insolvency is presumed to exist for 90 days prior to filing of the petition instead of the prior requirement of knowledge (actual or constructive) of the debtor’s insolvency. These changes will especially affect trade lending and secured transactions, but will also alter the size of the estate to be reorganized in many cases.


\(^\text{74}\) *See* H.R. REP. 95-595, *supra* note 36, at 239.
perform the debtor's obligations under the financing agreement. He may also agree to cure any default occurring before the order for relief within the sixty-day period and to cure any default occurring after the order within thirty days after such default. Only if the trustee fails to comply with these conditions may the financer repossess according to the agreement.75

4. The plan

The filing of a reorganization plan is governed by subchapter II of chapter 11, which contains several significant changes from the former law. These changes may best be understood by answering six important questions with respect to the reorganization plan: (a) Who is eligible to file a formal plan? (b) What claims may the plan affect? (c) How may solicitation of acceptances be conducted? (d) What classes of interests must accept the plan, and what percentage constitutes acceptance by class? (e) What standards must the court apply in determining whether or not to confirm the plan? (f) What is the effect of a confirmed plan?

a. Who is eligible to file a formal plan? Under the former act, eligibility to file a formal plan varied under the different chapters. The formulation of a plan under chapter X was restricted to the trustee. The debtor and creditors were limited to negotiating with and suggesting plans to the trustee.76 When the trustee presented a plan, an approval hearing was held at which the plan was reviewed to determine whether or not it met confirmation standards. If approved, the plan was sent to the SEC for a report and subsequent approval or objection. These requirements were meant to protect the public investor, but made the process very lengthy, and deprived the creditors and debtor of active participation.

Former chapter XI contemplated that only the debtor would file a plan.77 The creditors' only alternative to acceptance was to refuse their consent, thereby forcing renegotiation, dismissal, or perhaps liquidation. The disclosure of information to creditors was not closely monitored and was often minimal. Former chap-

75. 11 U.S.C.A. § 1110 (West 1979). The most significant aspect of § 1110 is that the transportation equipment provisions are extended to cover all business entities filing under chapter 11. Under the former law, only financers of equipment for corporations filing under chapter X were protected.
77. Id. § 723.
ter XII specified that the debtor and certain classes of creditors could file plans but the plan could only affect certain types of debt.\textsuperscript{78} Again, disclosure of information to creditors was usually limited.

The new eligibility requirements, by contrast, are not dependent upon the chapter proceeding utilized. Instead, the Reform Act establishes uniform criteria, governed in part by whether a trustee has been appointed or the debtor has been left in possession. The debtor may file a plan with the petition or at anytime thereafter, regardless of whether the petition was voluntary or involuntary.\textsuperscript{79} When no trustee has been appointed, the debtor alone has the right to file a plan for 120 days after the relief order is issued. If he files a plan within that time he has an additional sixty days to obtain acceptances. If he fails to do so, any party in interest may thereafter file a plan. Conversely, where a trustee has been appointed, any party in interest including the debtor, creditors, trustee, or creditor's committee may file a plan.\textsuperscript{80}

Since the debtor will usually retain possession, he will be granted this exclusive right to file for the given period of time. While this is similar to chapters XI and XII under the former act, the Reform Act goes a step further by placing a time limit on that right. This limit should serve to make the debtor more willing to negotiate and accommodate his creditors.

\textbf{b. What claims may the plan affect?} The new rules regarding what debts the plan may affect are regarded as among the most significant changes found in the Reform Act, and are expected to have an important impact on plan formulation, creditor participation and treatment, and rehabilitation success.\textsuperscript{81} Under the former act, one of the key criteria in determining which chapter a debtor was to select was the nature of the claims to be affected. For example, the proper action for a corporation seeking reorganization of secured debt was to proceed under chapter X. But the threat of an ouster of the debtor's management in favor of an independent trustee, the length of the process, and the imposition of the absolute priority rule caused many debtors to avoid chapter X. Instead they relied on the less formal, but more limited chapter XI, even though the

\textsuperscript{78} Id. §§ 823, 866.
\textsuperscript{79} 11 U.S.C.A. § 1121(a) (West 1979).
\textsuperscript{80} Id. § 1121(b), (c).
\textsuperscript{81} Downey, Perriell, & Pfeiffer, supra note 34, at 579-80.
debtor's business might have been better rehabilitated through a plan affecting secured and unsecured debt.\(^{82}\) Chapter XII had other, equally unappealing limitations as an alternative to either chapter X or chapter XI, chief among which were the restrictions to real property security and the exclusion of corporations.\(^{83}\)

In sharp contrast to the former act, the Reform Act avoids these chapter selection problems by providing in section 1123(b) that a plan may impair "any class of claims, secured or unsecured, or of interests." This change, together with the broader standards of eligibility, allows the plan of any eligible debtor to affect any debt, whether secured, unsecured, equity interest, public, or private. The plan may even amend the debtor's corporate charter if necessary.\(^{84}\) The requirement that the plan be accepted by the creditors and confirmed by the court should adequately protect the creditors' and stockholders' interests. These new guidelines for plan formulation emphasize negotiation, agreement, and informed consent of all parties in place of the more inflexible approach of the former act. The alterations should greatly increase the flexibility of the reorganization procedures, a primary goal enunciated by drafters of the Reform Act.\(^{85}\)

c. How may solicitation of acceptances be conducted?
Once a plan has been formulated, it must be transmitted to holders of allowed claims or interests of each affected class for their acceptance or rejection. Specified percentages or numbers of individual claimants within each class must accept the plan before it may be submitted to the court for confirmation.

The time and manner by which acceptance of a proposed plan could be solicited from a claimant varied widely among the former reorganization chapters. Chapter X required strict compliance with all SEC regulations governing an issue of securities. Chapters XI and XII, on the other hand, had little or no regulation as to when solicitation could be conducted or what had to be contained in the information given to claim or interest holders when acceptance was solicited.\(^{86}\)

Chapter 11 standardizes the solicitation requirements

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\(^{82}\) Report of the Commission on Bankruptcy Laws, supra note 5, at 247. While the chapter XI plan could not directly affect secured debt, it could indirectly affect it in various ways. See note 34 and accompanying text supra. The more prevalent use of chapter XI as compared to chapter X is reflected in the statistics in note 9 supra.


\(^{85}\) H.R. Rep. 95-595, supra note 36, at 223.

through the introduction of an entirely new standard. Any solicitation after the commencement of a case must be accompanied by the plan or a summary of it plus a written disclosure statement approved by the court as containing "adequate information." Court approval does not require a valuation of the debtor nor of his assets. The disclosure statement itself may vary as between classes of claims, but must be the same as between members of the same class.88

"Adequate information" is defined as that amount of information necessary to provide the typical investor of the solicited class with sufficient knowledge about the debtor and the plan to make an informed judgment about the acceptability of the plan. The adequacy of the disclosure statement is governed by bankruptcy law and not by SEC standards.89

The SEC is still expected to play an important role in the application of the new standard, however. Court approval of the disclosure statement is given only after notice and a hearing as to its adequacy, and the SEC and any other interested federal or state regulatory agency have an absolute right to appear at the hearing and express their views regarding the adequacy of the information. In this new role, the SEC becomes an advisor to the court regarding the adequacy of the protection afforded the public by the disclosure statement, but will not control the court’s action in any particular case.90

89. Id.
90. A comparison with the previous law reveals a substantial alteration of the role of the SEC in a reorganization proceeding under the Reform Act. Section 1109(a) of the Reform Act grants the SEC the right to "appear and be heard" on any issue in a chapter 11 case, but it does not grant "party in interest" status to the SEC. This would prevent the SEC from appealing a court order.

Although there is no direct grant of authority to object to the confirmation of a plan, as is given to a party in interest in § 1128(b), the report of the House Judiciary Committee, H.R. REP. 95-595, supra note 36, at 409-11, expressly contemplates the SEC objecting to plans it feels do not disclose adequate information. Indeed, one of the keys to the workability of the adequate information standard of § 1125 is SEC participation. The effectiveness of the SEC’s participation would be only minimal if it did not have the ability to object. For cases involving pre-petition solicitation, the objection, if any, would take place at the confirmation hearing instead of, as normally contemplated for post-petition hearings, at the hearing on the plan.

Chapter X of the former law accorded the SEC a much more substantial role. The SEC was given the responsibility for the protection of public investors. Public investors were assumed to have had too little control over the corporation or its officers and too little knowledge of its affairs to adequately protect their own interests. In addition, the
To further insure the independence of bankruptcy courts from SEC regulations, the Reform Act also contains a "safe harbor" provision, which creates an exemption from regulations and laws governing the offer, issuance, sale, or purchase of securities. This provision permits creditors and certain others to solicit or participate in the offer, issuance, sale, or purchase of a security offered or sold under the plan free from potential liability under the securities laws.\(^1\)

The Reform Act distinguishes between solicitations made before and after the filing of a petition. Prior to commencement of a case, a solicitation must comply with any applicable nonbankruptcy regulations governing adequacy of disclosure, whether it be SEC regulations or state securities regulations. Where none are applicable, as in the case of smaller business entities, a determination of the adequacy of the information disclosed is made at the confirmation hearing. Any pre-petition solicitation acceptances obtained in contravention of these standards are simply not counted as acceptances of the plan.\(^2\)

The purposes of the new standard are twofold. First, it is thought that if adequate disclosure is provided to all affected parties they will be able to make a sufficiently informed decision about the plan without having the SEC or the court render an opinion as to the "goodness" or "badness" of the plan.\(^3\) Second, the new standard increases the flexibility of the bankruptcy courts to save large amounts of money over the strict and often overly protective requirements of the SEC under chapter X, while at the same time providing greater protection to investors.

SEC was accorded party-in-interest status, and could act as an advisor to the court either at the court's request or with its approval. The SEC also performed an analysis of the debtor's business and the plan where total debt outstanding exceeded $3,000,000. If the total debt was less, and the court approved, the SEC could perform an analysis and file a report. This scrutiny of the plan was to guarantee the "fair and equitable" treatment of all parties.

Under chapter XI, the SEC had a much less important role. Section 328 of the former act, 11 U.S.C. § 728 (1976) (repealed 1978), empowered the SEC (or any party in interest) to request a transfer of the proceeding from chapter XI to chapter X or to dismiss the proceeding if the "needs to be served," General Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956), showed that a chapter X proceeding would be more appropriate. There was a presumption in favor of chapter X when readjustment of public debt was to be included in the plan. In chapter XII, of course, there was no SEC involvement.

than was granted under chapters X or XII.  

d. What classes of interests must accept and what percent constitutes acceptance by the class? The Reform Act provides that each class of claims must either accept the plan or be unimpaired by it. A class of creditors is deemed to have accepted the plan when creditors "holding two-thirds in amount and more than one-half in number of the allowed claims of such class" have accepted it. A class of stockholders is deemed to have accepted the plan when two-thirds in amount of the allowed interests have consented to it.

These standards are more stringent than the requirements of the former reorganization chapters. In this particular aspect the Reform Act resembles a combination of chapters X and XI. Chapter X required acceptance by creditors holding two-thirds in amount of the claims filed in each class before the plan could be submitted to the court for its confirmation. Chapter XI required acceptance by creditors holding one-half in amount and number of claims filed in each class. Neither required approval of stockholders.

The requirement that one-half of the allowed claims of each class must accept the plan provides smaller creditors some protection against the potential abuses of larger creditors. It also forces the debtor to provide in its plan for some degree of satis-

94. Id.
95. 11 U.S.C.A. § 1129(a)(8) (West 1979). A claim is unimpaired if: (a) it is left unaltered as to any of claimant’s rights; or (b) any default of debtor is cured, the maturity of the claim is reinstated, the creditor is compensated for any damages occurring as a result of default, and the rights of the claimant are not otherwise altered; or (c) the plan provides that the claimant receive cash equal to the allowed amount of the claim or the greater of any fixed liquidation preference allowed or the redemption value of the claimant’s security. Id. § 1124.

This essentially means that the plan's proponent may confirm it without the consent of a secured creditor by paying cash equal to the value of the secured party's collateral. Likewise, confirmation without an unsecured creditor's or stockholder's consent may be granted by paying cash equal to the greater of the liquidation value of the claim or the redemption value of the security held by the stockholder (as determined by the terms of the security). See In re Pine Gate Assocs., [1977-1978 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 66,325 (N.D. Ga. 1976); J. Trost, L. King & K. Klee, supra note 29, at 329-35. Note also that even if a class is impaired under the plan, its acceptance for confirmation purposes is still not mandatory if, after valuation of the debtor, that class retains no interest in the reorganized value of the business.

96. 11 U.S.C.A. § 1126(c) (West 1979). Note that the two-thirds and one-half fractions are computed on the basis of two-thirds of the number of claims that were voted rather than the total number proceeding. See H.R. Rep. 95-595, supra note 36, at 410.
faction of the smaller or unsecured claimant in order to obtain their approval. A more equal treatment of creditors is thus likely to occur and greater participation by creditors is insured.

In the event that not all of the impaired classes of creditors or equity security holders accept the plan offered by the proponent, the Reform Act incorporates but clarifies a "cramdown" provision formerly found only in chapters X and XII (the two least-used reorganization chapters). Particular cramdown rules are found in section 1129 of the Reform Act. The first rule is that at least one class of claims must accept the plan before the court may confirm it. This requirement was adopted from the Senate version of the Act; "class," as used, would include creditors' claims or stockholders' interests. The "at least one class" provision prevents the approval of a plan over the dissent of all classes.

The second rule allows the court to confirm a plan over the dissent of a class upon a finding that the plan does not discriminate unfairly and that it is "fair and equitable" with respect to each impaired, dissenting class. This means that if all classes accept the plan, the "best interests of the creditor" test is employed to determine the fairness of the plan for confirmation purposes. But if a class dissents, the plan may only be confirmed over the dissenting class if the absolute priority rule ("fair and equitable" test) is applied to the dissenting class and all classes junior in priority thereto. The allowed amount of the claims of that class must be paid in full before any junior classes may share in the reorganization value of the business. The rule must, in turn, be applied in the same manner to each class of lesser priority.

99. See id. §§ 616(7), 861(11).
101. Id. § 1129(b). Specifically, the rule is applied as follows: (a) secured creditors may have the plan confirmed over their objection if they are unimpaired or they receive property equal to the "allowed amount" of their secured claim valued as of the effective date of the plan. The "allowed amount" includes only up to the value of the property securing the claim, not the full amount of the claim if it exceeds the value of that property. Thus the statute focuses on claims, not creditors. See H.R. Rep. 95-595, supra note 36, at 415. "Property" includes both tangible and intangible property so that securities of the debtor, or the reorganized debtor if a valuation has been completed, may be given to the creditor as part of the property given.

Unsecured creditors are subject to cramdown if the members of the class are unimpaired, if they will receive property equal to the allowed amount of their unsecured claims, or if no class junior to them will share in the reorganized business under the plan. This codifies the absolute priority rule from the dissenting class down.

As to stockholders, the court may confirm over the dissent of a class if it is
e. What standards must the court apply in determining whether or not to confirm the plan? As a final part of the confirmation hearing, the court must make three findings independent of the acceptances of the plan by impaired parties. First, the court must find that each holder of a claim or interest within each class has either accepted the plan (which could provide more or less than the liquidated amount as long as there is an agreement to accept the amount provided) or that under the plan they will receive or retain property of a value not less than they would receive if the debtor were liquidated under chapter 7 on the effective date of the plan. This standard, essentially a variation of the best interest test, applies to members of a class that have refused acceptance of the plan where the class has accepted it by the required percentage and number.

Second, the court must find that the confirmation of the plan is not likely to be followed by the subsequent liquidation of the business or the need for further financial reorganization of the debtor or any successor to the debtor under the plan unless the plan so provides. Such a determination would require a close examination of the financial structure of the business, the cooperation of the creditors, the likelihood that the plan will accomplish eventual rehabilitation, and perhaps even a consideration of the capability of the reorganized debtor's management. This standard is similar to the former chapter X feasibility standard and is aimed at insuring the probable success of the rehabilitation effort. By contrast, the standards of former chapters XI and XII were oriented more toward the creditors, and required only the probability that the creditors would receive the amount provided for them by the plan. No direct consideration was given to the resulting viability of the reorganized debtor.

Finally, upon the request of a governmental party, the court may not confirm the plan unless it finds that the principal purpose of the plan is not to avoid taxes or to avoid section 5 of the Securities Act of 1933.

f. What is the effect of a confirmed plan? Once a plan has
been confirmed it is important to determine who is bound by the plan and what debtor obligations are discharged. It is also necessary to know the extent to which securities and those issuing the securities held or issued under the plan are exempt from otherwise applicable securities laws.

Under the Reform Act, confirmation of a plan makes it binding upon the debtor, creditors, equity holders, partners, entities acquiring property under the plan, and entities issuing securities under the plan, whether or not the claimant or entity accepted the plan or was impaired by it. The property dealt with by the plan is at that point free and clear from all claims and interests of creditors, stockholders, partners, etc., unless the plan provides otherwise. The confirmation of a plan discharges the debtor from any debt arising before the order of relief. Unless the plan indicates to the contrary, the confirmation also operates to terminate all rights and interests of stockholders and general partners provided by the plan.

There are, however, two exceptions to the general discharge provisions. First, a confirmed plan will not discharge an individual from debts that could not be discharged if there were no reorganization plan. Second, there can be no discharge of debts under a plan if the plan liquidates the debtor's assets and the debtor would be denied discharge in a liquidation proceeding pursued under section 727 of the Reform Act.

Despite areas where the purposes of the bankruptcy and securities laws coincide, the rigidity of the securities laws may often thwart the intended flexibility of the Reform Act. In such areas of conflict, one desirable effect of a confirmed plan is that it provides exemptions from certain aspects of securities laws. Traditionally, these exemptions have been limited to the initial

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108. Id. § 1141(a).
109. Discharge does not relieve the debtor of debts that may be incurred during the reorganization process, whether in operation of the business or in the funding of the plan.
111. Id. § 1141(d)(2).
112. H.R. REP. 95-595, supra note 36, at 418-19. Section 727 grants discharge except where fraud, concealment, waste, or other wrongdoing on the part of the debtor is found, which would indicate that the debtor was using the bankruptcy laws for the purpose of avoiding his obligations.
114. For a discussion of one area of conflict involving the question of whether the solicitation of acceptances may constitute an offer of a security, see notes 86-91 and accompanying text supra.
transaction, and not to resale or redistribution. This has presented several problems, especially when the reorganized debtor attempted to issue or sell securities already contained in its portfolio under the confirmed plan. If the securities are not exempt, a creditor receiving those securities may fall within the SEC classification of an underwriter, and resale would violate section 5 of the Securities Act of 1933.\textsuperscript{115} The SEC has also argued that small classes of creditors receive securities of the debtor under a "private placement" category that limits their resale to not more than one percent every six months after an initial waiting period of two years, unless the securities are registered prior to resale.\textsuperscript{116}

The former act tended to inhibit the success of the bankruptcy plan by providing too little protection for creditors who accepted securities as part of the reorganization. Especially in a cramdown, the creditor might have had no choice but to take the securities and would have consequently been limited to a two-year waiting period, after which he could sell only a small percentage of the total at any one time. Creditors were often forced to take securities, but were able to realize very little on their claims because of the resale limitations.

This situation is alleviated under the Reform Act by the exemption from securities laws of the issuance of certificates of indebtedness (other than equity securities) and the issuance of securities where they are given primarily in exchange for claims against the debtor or equity securities of the debtor. The exercise of any conversion privilege attached to such securities is also exempt.\textsuperscript{117}

The Reform Act also provides a transactional exemption for the sale by the debtor of securities of another nonaffiliated corporation that he holds in his own stock portfolio on the date the petition is filed, if the sale is conducted pursuant to a confirmed plan. Other conditions are that the issuer of such stock must file reports pursuant to section 13 of the Securities Exchange Act of 1934,\textsuperscript{118} that the issuer be in compliance with all applicable requirements for trading that stock, and that the sale not exceed

\begin{footnotes}
\item[115] H.R. REP. 95-595, supra note 36, at 419-21. If the creditor takes more than 1% of the securities with a view to distribution, he would, under § 5 of the Securities Act of 1933, fall into the category of an underwriter. See 15 U.S.C. § 77(e) (1976).
\item[116] H.R. REP. 95-595, supra note 36, at 237.
\end{footnotes}
four percent of the total amount of the class of securities outstanding. If the debtor desires to sell more than the four percent limit, he must first sell four percent and then wait two years before selling additional blocks of one percent at six-month intervals.\textsuperscript{119}

The Reform Act also limits the definition of an underwriter for bankruptcy purposes. The current definition of underwriter in section 2(11) of the Securities Act of 1933 does not apply to creditors who take debtor's securities with a view to distribution.\textsuperscript{120} If it did apply, the creditor would be forced to register the sale of a debtor's securities or find another exemption. This exemption is limited to a creditor who receives less than ten percent of such securities, since with ten percent he becomes a "control person" within the meaning of the Securities Act. Where the debtor issues securities, the disclosure statement is used in place of the prospectus.\textsuperscript{121}

An offer or sale of securities under the plan is characterized by the Reform Act as a public offering rather than a private offering\textsuperscript{122} in order to prevent application of the restrictions of a private offering under rule 144 of the SEC.

IV. THE PRACTITIONER'S VIEW OF THE REFORM ACT

For the most part, bankruptcy practice under the former act, and especially that portion regarding business reorganization, was left to those few members of the bar specializing in the field.\textsuperscript{123} This situation was generally attributed to the complexity of the reorganization chapters and cases.\textsuperscript{124} The effect of this exclusive practice was the emergence of an exclusive "bankruptcy bar," which consisted of a relatively small group of attorneys who could and often did represent more than one party in a bankruptcy proceeding, despite potential conflicts of interest.\textsuperscript{125} This situation tended to increase lawyer control at the expense of party participation, especially by creditors. It also tended to minimize the effectiveness of the attorney's service to his clients.

\begin{itemize}
\item 120. Id. § 1145(b)(1), (2).
\item 121. H.R. REP. 95-595, supra note 36, at 238.
\item 122. 11 U.S.C.A. § 1145(e) (West 1979).
\item 123. Anderson, supra note 39, at 203.
\item 124. Id.
\item 125. Surbin & Rugheimer, A Statistical Study of Bankruptcy in Massachusetts, With Emphasis on the Bankruptcy Bar and an Examination of the Proposed Bankruptcy Acts, 50 AM. BANKR. L.J. 137, 154-59 (1976).
\end{itemize}
in his traditional role as an advocate in an adversary system. Such situations almost inevitably lead to abuses by a few attorneys.

Many of these problems will be alleviated under chapter 11 of the Reform Act. The consolidation of the reorganization chapters, together with the simplification and modernization of procedures, will allow a greater number of lawyers to participate in bankruptcy practice without the need of specialization in the field. In addition, the Reform Act requires "disinterestedness," thereby preventing a single attorney from representing two or more parties in most cases.126 Such a requirement will motivate the attorney to more actively represent his client's interests since he will not be faced with the conflicting interests of other clients in the same proceeding. A tangential advantage to the bar is the possibility that the quicker, simpler process of bankruptcy may attract more beleaguered business debtors, who have previously regarded bankruptcy reorganization as a last resort simply because of the time and expense involved.127

Finally, it is important to consider the potential improvement of public relations the bar may enjoy as a result of streamlined, more serviceable bankruptcy legislation. The Reform Act will undoubtedly serve the public better, and clients involved in bankruptcy proceedings—either as debtors or creditors—will retain better impressions of their own counsel and the entire bar.

V. CONCLUSION

The consolidation of all reorganization chapters into a single chapter under the Reform Act will have a marked beneficial impact. The benefits should be fairly immediate, but will increase as the bar becomes familiar with its improvements and the advantages available to their clients. Perhaps the greatest advantages will be the simplicity of approach and the greatly increased flexibility granted the parties. The effort to successfully rehabilitate a potentially viable debtor is not limited by unnecessary requirements. These characteristics will better enable the bankruptcy system to fulfill the purposes of bankruptcy legislation.

As with any extensive change in legislation, the implementation of the Reform Act may reveal some defects. But whatever

127. Bankruptcy Act Revision Hearings, supra note 4, at 436 (statement of Patrick A. Murphy).
the defects, the Reform Act will likely be a major improvement over its predecessor chapters.

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