

No. 796, Securities and Exchange Commission
v. U. S. Realty & Improvement Company

Chapter X and Chapter XI are mutually exclusive. They embrace not competing systems of reorganization but two distinct types of situations. The Act contains no specific standards or rule of thumb for use in determining which Chapter applies to a given situation. But as Holmes once said, we cannot say, “We see what you are driving at, but you have not said it, and therefore we shall go on as before.” Our problem is to find the guides to the exercise of discretion which the district court must follow in determining whether or not a petition has been properly filed under Ch. XI and to apply them to the facts of this case.

I put it in terms of discretion because I do not feel that the government’s position that all cases where a debtor has outstanding public offerings of securities automatically fall under Ch. X. For reasons hereafter stated, I think that will be generally true. But it is not an absolute, for the Act permits a corporate debtor to file under Ch. XI to readjust its unsecured debt; and Ch. XI makes no distinction between unsecured debt held by 12 wholesalers and unsecured debt held by 1200 investors. Rather the key to the problem is to be found in the concept of “adequate relief” in Ch. X, § 130 (8). Where a petition is filed under Ch. X the petitioner must show “why adequate relief cannot be obtained under Ch. XI.” If creditors of this holding company filed under Ch. X, that burden would seem to be satisfied if they stated the following: “Under Ch. XI only unsecured debt can be readjusted – not the entire capital structure. This company is insolvent. If the company files under Ch. XI the stock remains unmolested and we alone of all the security holders make a sacrifice. Under the Boyd case such a plan would be unlawful for the stockholders retain their full interest in the business while we reduce our claims. We need the relief afforded by Ch. X so that the whole community of interests in the capital structure can

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be readjusted. Only in that way can we be assured of being paid before the old stockholders receive anything.” Or the creditors might state it differently in these words: “There is no adequate relief under Ch. XI because there is no plan which can be confirmed under that chapter. That chapter provides only for readjustment of unsecured debts. That relief is not adequate due to the distressed financial condition of the debtor.”

Ch. XI contains no comparable provision. But the prospective inadequacy of relief under Ch. XI should be the same when presented as an issue in a Ch. XI proceeding as when it arises in a Ch. X proceeding. That seems necessary for the following reasons:

The antecedents of Ch. XI were §§ 12 and 74, traditionally used by and available for individuals and corporations with debts owing commercial creditors. There is not a word in the hearings or reports which indicates that Congress desired to enlarge the types of cases for which Ch. XI was designed. Under the old § 12 there were, to be sure, some few cases of corporations with large outstanding unsecured issues. But at least 99% were corner grocery stores and the like. And the others were companies peculiarly dependent, as is the corner grocery store, on the proprietorship of the two or three so-called owners for maintenance and realization of a going concern value.

Ch. XI must be taken to express the philosophy of the old § 12. That was that the only feasible alternative to composition in case of the average commercial enterprise was liquidation. But it was impossible to arrange a sale in which creditors might realize on the going concern value of the business, for the obvious reason that going concern value inhered in the personality, experience and skill of the owner. Hence the Act permitted the debtor to reduce his debts, refinance them, and retain his business. The transaction

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met the § 12 standard of being “in the best interest of creditors” because it gave creditors the equivalent of the maximum recovery available to them.

But in this type of case that standard cannot be met. § 366 of Ch. XI provides, as did the old § 12, that the arrangement must be “for the best interests of the creditors.” This arrangement cannot be held to be in the best interests of the creditors unless it can be said that here, as in the old composition case, it is necessary for the creditors to let the position of the stockholders remain unmolested in order to get the maximum recovery available to them. But that cannot be shown here. Rather it is obvious that it makes little or no difference to the success of this corporation who owns the debtor’s 900,000 shares of no par stock. They are listed on the New York Stock Exchange, are widely held and constantly traded in. Their holders are nowhere near the status of proprietorship present in the § 12 type of case.

The addition of “fair and equitable” to Ch. XI is of some importance to the present problem. It does not seem plausible that Congress intended to permit corporations like this debtor to effectuate in Ch. XI a plan admittedly not “fair and equitable” under Ch. X. As we indicated in the Los Angeles Lumber case, “fair and equitable” are words of art. There is not the slightest indication in the hearings or reports that they mean something different when used in Ch. XI then when used in Ch. X. Consistency in their meaning is only adduced if the types of situations embraced in Ch. X and Ch. XI respectively are kept distinct. “Fair and equitable”, as indicated in the Boyd case, means, inter alia, applying the full value of the property to the claims of creditors before stockholders receive anything. In cases where management and stockholdings are blended as in the corner grocery case, this could be done by leaving the old proprietors in,

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preserving the going concern value of the enterprise, and giving creditors the maximum recovery available to them on liquidation. But where as here management is separate and distinct from stockholdings, stock control is a valuable asset to creditors. To allow it to remain unmolested while creditors take sacrifices is not fair and equitable.

On the other hand, Ch. X provides machinery for revamping complicated capital structures under close scrutiny of the court as in former 77B. The type of case to which its machinery is suited is the one (a) where preservation of proprietorship is not important; (b) where adequate relief involves revamping the capital structure and dealing with the whole community of interests; or (c) where it is clear that the readjustment plan sought or needed could not be approved under Ch. XI. To generalize – Ch. X is designed for the typical case previously in equity receivership; Ch. XI for the typical case previously under § 12.

The necessity of showing that adequate relief is not available under Ch. XI in order to come under Ch. X does not indicate a shift by Congress in the basic scheme of the old § 77B and the former § 12. It was put in to keep the corner grocery stores which had flooded 77B out of Ch. X. It clearly was not designed to broaden the base of Ch. XI.

This analysis suggests some of the guides for exercise of discretion in permitting or refusing the filing of a petition under Ch. XI:

- (a) In general (but not absolutely) corporations with securities publicly held cannot file under Ch. XI
- (b) Where a debtor is in distressed condition with a complicated capital structure, Ch. XI is not usually available

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- (c) Where preservation of proprietorship is not important, as in the case where the stock is publicly held, Ch. XI is usually not available
- (d) If the plan proposed probably cannot be confirmed under Ch. XI, the court should not take jurisdiction

Such considerations lead to the conclusion that in this case the District Court abused its discretion in allowing the petition to be filed under Ch. XI. On the facts here present the arrangement proposed never could be confirmed. 1. It clearly is not in the best interests of the creditors. 2. It clearly is not fair and equitable. It meets neither test because there is no showing that preservation of the stock intact is necessary for realization by the creditors of the equivalent of the maximum available to them.

The inability to confirm, if not going to jurisdiction, does indicate an abuse of discretion in permitting the petition to be filed. Cf. Pennsylvania v. Williams, 294 U. S. 176.