SEC Reporting, Proxy and Antifraud Compliance — An Additional Perspective On Bankruptcy Reorganization Proceedings

Allen F. Corotto†

In this Article, the author analyzes the relationship between bankruptcy reorganization proceedings and the federal securities laws, noting in particular the effect which the proposed new bankruptcy act may have upon this relationship. He argues that many of the actions taken to rehabilitate the debtor or safeguard the creditor during a Chapter X reorganization proceeding or a Chapter XI arrangement proceeding necessitate compliance with the reporting, proxy and antifraud provisions of the federal securities acts. Accordingly, he concludes that all participants in Chapter proceedings must carefully comply with the securities laws during the proceedings in order to avoid SEC enforcement actions and potential personal liability.

In contrast to proceedings conducted under Chapters I through VII of the Bankruptcy Act,¹ which provide for paying creditors from a

† B.A. 1957, Stanford University; L.L.B. 1960, University of San Francisco; Trial Attorney and Chief, Bankruptcy Reorganization Section, San Francisco office, Securities and Exchange Commission.

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Also before the Congress is a companion bill proposed by the National Conference of Bankruptcy Judges, H.R. 32, 94th Cong., 1st Sess. (1975) [hereinafter referred to as the Judges' Bill]. The Judges' Bill differs from the Proposed Act in that it preserves the separate Chapter X and XI concept and retains not only the SEC's function in filing
liquidation of the assets of the bankrupt, debtor relief proceedings conducted under the corporate reorganization sections of the Act are designed to rehabilitate a corporate debtor so that it emerges from the bankruptcy proceedings as a revitalized, competitive entity. Reorganization and arrangement proceedings under Chapters X and XI thus deal with enterprises in which daily business operations continue during the course of the bankruptcy proceedings. Indeed, the primary goals of the proceedings are to preserve the business, revitalize and restructure its debt and capital, and use the statutory machinery available to resurrect and resuscitate the ailing business in the interests of the creditors and stockholders.

To accomplish these objectives, many changes must be made in a particular business enterprise during the reorganization proceeding. For example, assets may be sold, existing debts modified, new debts incurred, accounting practices altered, management shuffled, lawsuits settled or initiated, and new capital raised. The reorganized corporation may not resemble the original one. Effecting these changes, however, requires interaction with other laws found both within and without the Bankruptcy Act, and compliance with these laws is necessary in achieving the reorganization.

This Article deals with the interaction between Chapter X and XI proceedings and certain statutes, rules and regulations which are found outside the Bankruptcy Act but within the domain of the Securities and Exchange Commission. As one court has noted:

reports but also the SEC's authority to transfer a case from the arrangement chapter to the reorganization chapter. Under the Judges' Bill, responsibility for the administrative aspects of bankruptcy proceedings is placed with the existing Administrative Office of the United States Courts, the Director of which will have expanded powers and duties to permit him to act as the principal executive officer of the bankruptcy system. For a comparison of the two pending bills, see Lee, A Critical Comparison of the Commission Bill and the Judges' Bill for the Amendment of the Bankruptcy Act, 49 AM. BANKR. L.J. 1 (1975).


3. Accordingly, a petitioner is referred to as a "bankrupt" in "straight bankruptcy" if the petition is filed under Chapters I-VII but is referred to as a "debtor" under Chapters X or XI.

4. Before confirming a plan, the court must investigate and make findings as to its "feasibility." Bankruptcy Act §§ 221(2), 366(2), 11 U.S.C. §§ 621(2), 766(2) (1970). Otherwise, the plan cannot be confirmed. Chapter VII of the Proposed Act would require a finding that the "plan is feasible and not likely to be followed by the liquidation of, or a need for further financial reorganization by, the debtor or any successor under the plan." Proposed Act § 7-310(d)(2)(A), in REPORT: PART II, supra note 1, at 254.
Both the Securities Exchange Act of 1934, 15 U.S.C.A. § 78a et seq., and the Bankruptcy Act, 11 U.S.C.A. § 1 et seq., are statutory enactments, grounded primarily upon protection of the public interest in two different but overlapping areas of our economic existence. To the extent that the fields mingle, it is apparent to the Court that Congress has determined that there will be an embracing co-operation. Accordingly, this Article will discuss the following: (1) the control of the bankruptcy court and the federal district courts over the business activity of the debtor; (2) the applicability of SEC-enforced laws to the debtor's business operation; (3) the reporting status of the debtor during the reorganization proceeding; (4) proxy compliance in soliciting powers to act during promulgation of a plan of reorganization or arrangement; (5) an assessment of the potential liability of the participants in debtor relief proceedings arising out of the offer and sale of securities in connection with the proceeding, with significant reference to the antifraud provisions of both the Securities Act of 1933 and the Securities Exchange Act of 1934; and (6) the application of SEC enforcement actions against a debtor.

I

JUDICIAL AUTHORIZATION FOR BUSINESS CONTINUATION

The filing of a debtor relief petition does not in itself permit the continued operation of a debtor's business. Authorization to operate the enterprise must be obtained from the bankruptcy court, although in most instances such authorization is routinely granted.

5. In re Otis & Co., 104 F. Supp. 201, 203 (N.D. Ohio 1952). For example, the securities registration exemptions contained in Section 264 of Chapter X and Section 393 of Chapter XI expressly incorporate the definitions of "security," "issuer," "underwriter" and "dealer" provided in Section 2 of the Securities Act of 1933, 15 U.S.C. § 77b (1970). See also the SEC's statement in its amicus curiae brief in In re Cavanagh Communities Corp., No. 75-B-243 (S.D.N.Y. 1975) involving the issue of the power of a bankruptcy judge to stay the application of the delisting process of a Chapter XI debtor's securities on the New York Stock Exchange:

The Commission's position is that the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq. embodies a comprehensive statutory pattern whereby national securities exchanges registered with the Commission are placed under its regulatory control, and that Section 12(d) of the [Securities Exchange] Act vests exclusive jurisdiction over the exchange delisting process in the Commission, subject to judicial review of Commission orders by federal courts of appeals.

Brief for SEC as Amicus Curiae at 2.

6. Ct. X R. 10-207; Ct. XI R. 11-23. Under the Proposed Act, an "Administrator" would be appointed as the principal executive officer of a "United States Bankruptcy Administration," which would administer the Act "as an independent establishment in the executive branch of the government . . . ." Proposed Act §§ 3-101, 3-102, in REPORT: PART II, supra note 1, at 51. Section 7-104 of the Proposed Act would permit the Administrator to authorize the continued operation of the debtor's business.

7. "Continuation of the business represents the norm in Chapter X cases as
Because the commencement of a reorganization proceeding places a business and its property in *custodia legis*, the continued operation of a debtor corporation and the management of its property must be conducted by an officer appointed by the bankruptcy court. In a Chapter X proceeding, the court may continue the debtor in possession or appoint a disinterested trustee. Reports will then be made to the court as required by the authorization. In a Chapter XI proceeding, however, the debtor remains in possession unless a receiver is appointed.

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8. Bankruptcy Act § 111, 11 U.S.C. § 511 (1970) provides: "Where not inconsistent with the provisions of this chapter, the court in which a petition is filed shall, for the purposes of this chapter, have exclusive jurisdiction of the debtor and its property, wherever located." Bankruptcy Act § 311, 11 U.S.C. § 711 (1970), is virtually identical.

9. While either an individual or a corporation may petition for relief under Chapters I through VII or Chapter XI, only corporations, as defined in the Bankruptcy Act, may petition for relief under Chapter X. Bankruptcy Act § 126, 11 U.S.C. § 526 (1970). The provisions of the Proposed Act contemplate individual as well as business and corporate petitioners. Report: Part I, supra note 1, at 237. This Article assumes that the operation of the particular business activity in question is conducted in the general corporate form.

10. Upon approval of the petition, the court may leave the debtor in possession where the indebtedness, "liquidated as to amount and not contingent as to liability," is less than $250,000, or it may appoint one or more trustees. If this indebtedness exceeds $250,000, one or more trustees must be appointed. Ch. X R. 10-202(a). The Proposed Act contemplates the appointment of a trustee by the Administrator subject to the approval of the court, but the appointment would be discretionary with the court. In cases where the debtor corporation has debts of $1,000,000 or more and 300 or more security holders, the Administrator would be required to apply to the court to determine the necessity of appointing a trustee, and in these larger cases the court would order such appointment "unless it finds that the protection afforded by a trustee is unnecessary or that the expense would be disproportionate to the protection afforded." Similarly, the court might order the removal of a trustee "if the protection afforded by a trustee is unnecessary and there is compelling reason . . . ." If the court failed to order the Administrator to appoint a trustee, existing management would continue. Proposed Act § 7-102, in Report: Part II, supra note 1, at 221.

11. Ch. X R. 10-208(a) (3).

12. Ch. XI R. 11-18. Subdivisions (a) and (b) of the Rule provide for the proper procedure to establish who under Chapter XI is the responsible officer of the court in charge of the debtor's business and assets. Except where a Chapter XI petition is filed in a pending straight bankruptcy proceeding after qualification of a trustee, "the debtor shall continue in possession" although on the "application of any party in interest, the court may, for cause shown, appoint a receiver to take charge of the property and operate the business of the debtor." Ch. XI R. 11-18(b). No doubt this difference in approach as to who should continue to operate the business in a particular debtor relief proceeding stems from the nature of a Chapter X proceeding as opposed to one under Chapter XI. The former was designed for corporations with complicated debt and capital structures requiring material adjustment or modification of publicly held securities, whereas Chapter XI generally applies to a debtor which requires only a settlement or extension of unsecured debt, primarily trade claims. For an analysis of this difference
Although receivers have been appointed by the court as a matter of course in some jurisdictions, the effect of Chapter XI Rule 11-18 (b) may be to curtail this practice since a receiver is now the exception.\textsuperscript{13}

Because the court enjoys specific statutory control over the continuation of the business, court-appointed officers without other judicial authorization may only take custody and possession of the property.\textsuperscript{14}

As a practical matter, however, in order to restore the business to a financially sound basis, the court will almost always authorize the appointed officer to continue to operate the enterprise regardless of whether the officer is a trustee, a receiver or the debtor in possession.\textsuperscript{15}

Operation of the business, as distinguished from mere custody and possession, is significant because it subjects the assets really belonging to creditors and stockholders to the business risks and judgments of those authorized to manage.

II

NECESSITY OF COMPLIANCE WITH FEDERAL SECURITIES LAWS

Even though a debtor enters the jurisdiction of a bankruptcy court, compliance with otherwise applicable laws, rules and regulations is not automatically suspended. Instead, the trustee, receiver, or debtor in possession appointed to operate the business steps into the shoes of the debtor and becomes responsible for compliance.\textsuperscript{16} Therefore, the reor-

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\textsuperscript{13} Hence the Revision Commission's Note to § 7-102(a) of the Proposed Act states that Rule 11-18(b), "in recognition of the fact that in certain areas of the United States the appointment of a receiver is automatic, attempts to reverse that policy by requiring cause to be shown before a receiver can be appointed." \textit{REPORT: PART II, supra} note 1, at 222.

\textsuperscript{14} \textit{6A COLLIER ON BANKRUPTCY} ¶ 812, at 47 (14th ed. 1972).

\textsuperscript{15} Like a trustee or receiver, a debtor continued in possession is an officer of the court, which means that its management acts on its behalf in the same court-appointed fiduciary capacity as an individual trustee or receiver, with the same "rights . . . duties and . . . powers." \textit{Bankruptcy Act} § 188, 11 U.S.C. § 588 (1970); cf. \textit{Bankruptcy Act} § 342, 11 U.S.C. § 742 (1970). \textit{See 8 COLLIER ON BANKRUPTCY} ¶ 6.32(2), at 931 (14th ed. 1972). In \textit{Wolf v. Weinstein}, 372 U.S. 633, 649-50 (1963), the Supreme Court noted that so long as the debtor remains in possession, "the corporation bears essentially the same fiduciary obligation to the creditors" as does a trustee, and in practice "these fiduciary responsibilities fall not upon the inanimate corporation, but upon the officers and managing employees. . . ."

\textsuperscript{16} One commentator has described the situation as follows:

In the conduct of the debtor's business, the trustee or debtor continued in possession has much the same status of an operator as the debtor had prior to reorganization. Thus taxes accruing on the property and by virtue of doing business must be paid, and the requirements of applicable state and federal laws must be complied with.

\textit{6A COLLIER ON BANKRUPTCY} ¶ 8.12, at 47-50 (14th ed. 1972).
ganization or arrangement plan must be drawn with other state and federal laws in mind.\(^{17}\)

Inasmuch as the goal of Chapters X and XI is to revitalize the indebted corporation, Chapter proceedings, especially those conducted under Chapter XI, often involve plans of reorganization or arrangement which offer securities in settlement of indebtedness. Chapter X states that a reorganization plan must provide adequate means for its execution, which may take various forms, including “the issuance of securities of the debtor.”\(^{18}\) Chapter XI, although limited to modifying the rights of unsecured creditors only,\(^ {19}\) contemplates an arrangement which may provide for the “continuation of the debtor's business”\(^ {20}\) and contain “appropriate provisions not inconsistent” with the rest of Chapter XI.\(^ {21}\) Consequently, to the extent that securities laws are concerned, both the Securities Act of 1933 and the Trust Indenture Act of 1939 are applicable to debtor relief proceedings involving the offer and sale of securi-

Since the federal securities laws and rules were applicable before the proceeding and will be after it concludes, there seems little reason to exclude their applicability during the rehabilitation and restructuring process. Moreover, the applicability of the securities laws enhances the public interest nature of the bankruptcy proceedings. See In re Traders International, Ltd., CCH Fed. Sec. L. Rep. [1973-74 Transfer Binder] ¶ 94,529 (D. Nev. 1974), appeal dismissed as moot sub nom. Traders International, Ltd. v. Young, Civil No. 74-1724 (9th Cir. Nov. 6, 1975) (Chapter XI receiver ordered to terminate the debtor's business because of failure to comply with the securities laws). In Cullen v. Bowles, 148 F.2d 621, 623 (2d Cir. 1945), a Chapter X proceeding, the court said that “It has been generally held that federal statutes regulating business in the public interest are equally applicable when the business is run by trustees or receivers.”

\(^{17}\) Id. ¶ 10.19, at 495-96; \(^{18}\) id. ¶ 1.15, at 30. For example, the fact that a public reporting company is bankrupt does not exempt it from complying with the reporting requirements in the public interest. See SEC Securities Act Release No. 9660 (June 30, 1972). The reporting requirements for public companies are designed for the “protection of investors and to insure fair dealing in the security.” Securities Exchange Act of 1934 § 13(a), 15 U.S.C. § 78m (1970). This goal survives the commencement of a debtor proceeding in view of the fact that the business operates and trading continues in the debtor's securities, even if delisted from an organized exchange, as well as when trading is suspended. With regard to the “necessity” of the federal securities laws, see Securities Act of 1933, Ch. 38 Preamble, 48 Stat. 74; Securities Exchange Act of 1934, Ch. 404 Preamble, 48 Stat. 881. In some cases, compliance goes to the heart of the matter, the right of the debtor to continue doing business. In In re Dolly Madison Industries, Inc., 504 F.2d 499 (3d Cir. 1974), the Virginia State Corporation Commission revoked the debtor's certificate of authority to transact business in the state, which affected the operation of the company's manufacturing plant there. The company had failed to file required annual reports and pay certain related fees. Upon his appointment, the Chapter X trustee also failed to comply on a timely basis. The district court's order directing the state commission to reinstate the certificate of authority was reversed on appeal. The Third Circuit said that “[t]he mere fact that the debtor's property may be affected by state law does not constitute a 'claim' against [the debtor's] 'property'” to support summary jurisdiction. Id. at 503.

\(^{18}\) Bankruptcy Act § 216(10), 11 U.S.C. § 616(10) (1970). This section lists additional powers, including the power to amend the charter of the debtor.

\(^{19}\) Id. § 356, 11 U.S.C. § 756.

\(^{20}\) Id. § 357(5), 11 U.S.C. § 757(5).

\(^{21}\) Id. § 357(8), 11 U.S.C. § 757(8).
ties. The same is true for the Securities Exchange Act of 1934. Furthermore, the General Rules and Regulations of the SEC under these Acts have the force of law and therefore also apply.

When authorized to continue a debtor's business, the court-appointed officer should immediately analyze the nature of the business activity. Frequently the activity in itself may require compliance with the securities laws. For example, a distinction must be made between a business that involves the issuance of securities to generate revenues and one that manufactures a proprietary product for this purpose. In the former situation, the "security" or "investment contract" that is issued constitutes the business product itself, whereas in the latter situation the securities are issued to raise capital to manufacture a product that is then sold to generate the revenues.

Recently, the number of debtor business failures involving the issuance of investment contracts has increased, primarily under Chapter

22. Id. at 496 n.8. For example, the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1970), would have to be considered when long-term notes are issued under an indenture-type instrument; if applicable, qualification of the indenture with the SEC would be required. Bankruptcy Act (Ch. X) § 264, 11 U.S.C. § 664 (1970) and Bankruptcy Act (Ch. XI) § 393, 11 U.S.C. § 793 (1970) specifically provide that the registration provisions of Section 5 of the Securities Act of 1933, 15 U.S.C. § 77e (1970), do not apply to certain transactions in securities pursuant to a plan exchange. But these exemptions do not cover all situations. For example, they do not apply "to the provisions of Section 306 of the Trust Indenture Act of 1939 requiring the qualification of an indenture in respect of any debt security." SEC Trust Indenture Act of 1939 Release No. 30 (August 28, 1944).

Proposed Act § 7-314 contains an exemption from "any law requiring registration of securities" for "any security" issued by a trustee or debtor in a "transaction approved by the administrator or the court" or issued "pursuant to a plan in exchange for securities of the debtor or for allowed claims" or "any transaction in any security" so issued. Report: Part II, supra note 1, at 257. This provision is derived from the present Chapters X and XI. Bankruptcy Act §§ 264, 393, 11 U.S.C. §§ 664, 793 (1970).

23. 6A COLLIER ON BANKRUPTCY ¶ 9.32, at 353 n.2 (14th ed. 1972); id. ¶ 15.12, at 1276.


XI, where receivers have been faced with the task of deciding how to proceed with the business activity. Investment contract operations are speculative and high risk; yet the principals, who usually own the company, frequently enjoy a substantial cash flow from sales to public customers and therefore pressure the receiver to continue selling the contracts. Although these tax shelters and other speculative hedge operations usually have been offered to sophisticated investors who had access to their own evaluative experts, more recently these offerings have been made to the general public, which has neither sufficient objective information nor access to evaluative protection. As a result, investment contract debtors entering Chapter proceedings often file long lists of "customer creditors."

A court order authorizing the continued operation of a business can only relate to a lawful business activity—one which complies with all applicable laws. In the situation where an "investment contract" is involved the continued issuance and sale of the contract would be "unlawful" if compliance with the registration and antifraud provisions of the federal securities laws were not observed. It is the responsibility of the court-appointed officer to make this determination since he gains little immunity, if any, from a general authorization to conduct the business. A court officer takes an unwarranted risk in continuing a business involving the public, and a prudent trustee or receiver should therefore first consider the legality of continuing to sell these interests to the public. In particular, he should weigh his potential personal liability to the purchasers should he continue to sell without specific court authorization. It would also be wise for the trustee to advise the Securities and Exchange Commission of the situation.

In Mosser v. Darrow a reorganization trustee was surcharged $43,000 for profits made by his employees from trading in securities of the debtor's subsidiaries with his approval, even though he did not personally profit. The reorganization trustee had been authorized to operate and continue the business of the debtors and to manage their property; to further this end, he retained certain employees on the undisclosed condition that they could continue to trade in the securities. As a result, the trustee repurchased bonds from these retained employees who had previously purchased them at a discount. After the SEC intervened and demanded an investigation, a special master ruled that the trustee had failed to exercise due care and prudence in the adminis-

26. This was done in In re Traders Int'l, Ltd., CCH Fed. Sec. L. Rep. ¶ 94,529 (D. Nev. 1974), appeal dismissed as moot sub nom. Traders International, Ltd. v. Young, Civil No. 74-1724 (9th Cir. Nov. 6, 1975), where the SEC then moved to specially intervene in the Chapter XI proceeding and specifically raised the "investment contract" security question.
tration of the trust estates. In affirming the district court's surcharge and reversing the court of appeals, the United States Supreme Court suggested what a more prudent court-appointed officer would have done: "The practice is well established by which trustees seek instructions from the court, given upon notice to creditors and interested parties, as to matters which involve difficult questions of judgment."28

In view of the risk of personal liability, a court-appointed officer must carefully consider management's desire to continue the business without further analysis.29 This is management's natural inclination, particularly where the principals own the company, have promoted it and will reap the benefits of the large cash flow generated by sales of unregistered "investment contract" securities. A trustee or receiver should remember that creditors' funds are put at the risk of a continued operation; and in the case of the offer and sale of "investment contract" securities, new investors also become involved during a court-supervised operation.

III

SEC Reporting Requirements

Continuing the operation of a debtor's business also requires reporting on the results of the endeavor. The necessity to report emanates both from the provisions of the Bankruptcy Act itself and from the federal securities laws; and the bankruptcy court will direct periodic reports to be filed, usually on a monthly basis.30 Just as disclosure is the

28. 341 U.S. at 274. The Supreme Court's statement concerning the personal liability of a trustee should also be noted:

Trustees are often obliged to make difficult business judgments, and the best that disinterested judgment can accomplish with foresight may be open to serious criticism by obstreperous creditors aided by hindsight. Courts are quite likely to protect trustees against heavy liabilities for disinterested mistakes in business judgment. But a trusteeship is serious business and is not to be undertaken lightly or so discharged. The most effective sanction for good administration is personal liability for the consequences of forbidden acts . . . .

Id. at 273-74.

29. Generally, replacement of management by a trustee or by a receiver, when not otherwise required, will occur in cases of incompetence, fraud, mismanagement, or where securities violations are possible. The latter situation may also involve a collateral SEC enforcement action against management. The same prudent judgment a trustee or receiver should exercise in considering the business activity would also dictate caution in utilizing old management in a continuing operation.

30. CH. X R. 10-208(a)(3). Moreover, under Chapter X the SEC "may recommend the form of such reports and summaries." CH. X R. 10-208(c). Chapter XI requires written reports of the financial condition of the estate to be made "every month." CH. XI R. 11-30. Usually, a monthly report is filed by the 15th day of the month covering the preceding month's operation. The Proposed Act would require a trustee or debtor to file with the Administrator, in the form and within the times fixed by the Administrator, "periodic reports and summaries of the operations of the business."
key under the federal securities acts, so should disclosure be the rule under the Bankruptcy Act, especially when publicly held debtors are involved and trading in their securities continues. In order to protect the public interest, the Securities and Exchange Commission may become involved in enforcing compliance with all reporting requirements. Although there is no established form to be followed, the report should be meaningful and should contain, at a minimum, sufficient information to permit fair and adequate surveillance and disclosure of the ongoing business effort. A periodic balance sheet and profit-and-loss statement should be developed and maintained; statements of bank deposits should be provided, especially when funds are put in time certificates; the financial condition of subsidiaries should be separately stated; and annual reports should be prepared. One of the first things a prudent court-appointed officer should do is open new books of account as a departure for accountability, commencing with his appointment. Thereafter, the books and reports will reflect only the operation by the court-appointed officer.

Large, publicly held debtors will usually have securities traded on national securities exchanges and registered under Section 12(b) of the Securities Exchange Act of 1934. Such securities will most likely also have been issued by a registered offering under the Securities Act of 1933. In addition, Section 12(g) of the Securities Exchange Act of 1934 requires every issuer engaged in interstate commerce or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce, which has total assets exceeding $1,000,000 and a class of "equity security" held of record by 500 or more persons, to register such security by filing a registration statement with the SEC containing such information and documents which the SEC may specify. These provisions apply to many debtors entering Chapter X or XI proceedings.

Proposed Act § 7-103(a), in Report: Part II, supra note 1, at 223. This function may also be performed by the Administrator when no trustee is appointed. Id. § 7-103(b).

31. The SEC has no fixed form of debtor proceeding reports for filing with the court.

32. Chapter VII of the Proposed Act provides that periodic reports in such form as fixed by the Administrator shall include a "statement of receipts and disbursements, and such other information as may be required by the administrator." Proposed Act, § 7-103(a)(4), in Report: Part II, supra note 1, at 223.


34. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1970). Generally, sales of securities to the public by means or instruments of interstate commerce or the mails are "unlawful" unless the issue is registered for sale or an exemption from registration is applicable.

Once a security has been registered under the Securities Act of 1933 or under Section 12(g) of the Securities Exchange Act of 1934, an issuer becomes a reporting company and is thereafter required by law to file current and periodic reports with the SEC pursuant to Section 13(a) of the Securities Exchange Act of 1934. The information required to be filed relates to transactions which must be disclosed in order to keep the previously filed registrations "reasonably current."

SEC Form 10 is the general form for registration pursuant to Section 12(g), SEC Form 10 includes: a summary of operations, properties, parents, and subsidiaries; principal security holders and security holdings of management; directors and executive officers; remuneration of directors and officers; management options to purchase securities; interest of management and others in certain transactions; legal proceedings; number of equity security holders; nature of trading market; recent sales of unregistered securities; capital stock to be registered; debt securities to be registered; other securities to be registered; indemnification of directors and officers; [audited] financial statements and exhibits; and general information relating to the business.

These are important requirements adopted by Congress "for the proper protection of investors" by the Commission. Securities and Exchange Act of 1934 § 13, 15 U.S.C. § 78m (1970). The requirements were also adopted "to insure the maintenance of fair and honest markets in [securities] transactions." Id. § 2, 15 U.S.C. § 78b (1970). Upon registration under Section 12(g), "the reporting and other disclosure requirements and the insider trading provisions of the Act apply to these companies to the same extent as to those with securities registered on exchanges." 39 SEC Ann. Rep. 36 (1973). Reports are deemed filed with the Commission upon receipt at its headquarters in Washington, D.C.

SEC Form 8-K, in Practicing Law Institute, Securities Regulation Sourcebook 7-83 (R.L. Krauss ed. 1972-73) [hereinafter cited as Sourcebook], is the current report form used to keep the 12(g) registration reasonably current. The items required to be reported are transactions relating to changes in control of the registrant; acquisitions or dispositions of assets; legal proceedings; changes in securities; changes in security for registered securities; defaults upon senior securities; increases in amount of securities outstanding; decreases in amount of securities outstanding; options to purchase securities; extraordinary item charges and credits, other material charges and credits to income of an unusual nature, material provisions for loss, and restatements of capital share account; submission of matters to a vote of security holders; changes in registrant's certifying accountant; other materially important events; and financial statements and exhibits. For example, the filing of a Chapter X or XI petition (or a Chapter VII petition under the Proposed Act) should be reported on Form 8-K under "legal proceedings." Form 8-K reports are to be filed within 10 days after the close of each month during which any of the specified events occurs.

SEC Form 10-Q, in Sourcebook at 7-73, is the form of quarterly report which must be filed within 45 days after the end of each of the first three fiscal quarters of each fiscal year. No quarterly report need be filed for the fourth quarter of any fiscal year. Form 10-Q report information consists of summarized financial information, capitalization and stockholders' equity, and sales of unregistered securities (debt or equity). This form calls for summarized financial information which is not required to be certified. 36 SEC Ann. Rep. 11 (1970).

The Annual Report is filed on SEC Form 10-K, in Sourcebook at 7-44, which lists the following items: business; summary of operations; properties, parents, and subsidiaries; legal proceedings; increases and decreases in outstanding securities; approximate number of equity security holders; executive officers of the registrant; indemnification of
The registered reporting status of a corporate debtor thus creates additional disclosure and reporting responsibilities.

The importance of a registered corporation's compliance with its reporting requirements is reflected in the fact that a reporting debtor is a public company in whose securities trading usually continues. The commencement of the proceeding does not affect the trading in these securities per se, especially on the over-the-counter market. Accordingly, trading by the unwary in securities of a debtor undergoing reorganization or an arrangement is risky and can be unprofitable even to knowledgeable speculators. In addition, the allowance by the SEC of directors and officers; financial statements and exhibits filed; principal security holders and security holdings of management; directors of the registrant; remuneration of directors and officers; options granted to management to purchase securities; and interest of management and others in certain transactions. Reports on this form shall be filed within 90 days after the end of the fiscal year covered by the report. Form 10-K financial statements must be certified by independent auditors.

38. Under a Chapter XI arrangement proceeding, neither secured debt, nor stockholders equity, can be affected by the terms of the arrangement. In re Camp Packing Co., 146 F. Supp. 935 (N.D.N.Y. 1956); In re May Oil Burner Corp., 38 F. Supp. 516 (D. Md. 1941). Even the stock of an insolvent debtor remains intact upon confirmation of the arrangement; thus, purchases on the market during the proceeding would not be affected. On the other hand, a Chapter X plan may alter the rights of the stockholders as well as the secured debt holders. Bankruptcy Act § 216(1), 11 U.S.C. § 616(1) (1970). And, under the “absolute priority rule” applicable in Chapter X, a junior interest may not participate in the plan until senior interests have been paid to the full extent of the court-approved valuation. Accordingly, a reorganized debtor with public bonds and stock may undergo a shift in ownership from the old stockholders to the old bondholders (creditors) where an order has been entered finding the debtor insolvent. See In re Yuba Consol. Indus., Inc., 242 F. Supp. 561 (N.D. Cal. 1965) (plan of reorganization found to be fair and equitable which excluded any participation by the old stockholders and provided for issuance of new stock to the unsecured creditors, including public debenture holders). Despite the danger to prospective purchasers, however, the court has no jurisdiction to restrain stockholders from selling their shares. In re Journal-News Corp., 193 F.2d 492 (2d Cir. 1951).

39. Cf. In re Four Seasons Nursing Centers of America, Inc., 472 F.2d 747 (10th Cir. 1973). Four Seasons common stock was listed on the American Stock Exchange prior to the commencement of the Chapter X proceeding. The Exchange had suspended trading, and thereafter an active over-the-counter market developed, which in turn was suspended by the SEC. The Commission also had issued a press release in which it called attention to the company's severe financial difficulties and “cautioned prospective purchasers of the stock concerning trading in these securities.” 472 F.2d at 748. In the interim, class action damage suits were filed by security holders who purchased prior to the Chapter X proceeding alleging violations of the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. These stockholder actions became claims in the subsequent reorganization proceedings and were accorded creditor status under the plan of reorganization. The court-approved valuation of the reorganized debtor was insufficient to cover all claims of creditors in full because of the substantial increase in creditor claims by such recognition of the defrauded pre-Chapter X shareholders. Appellants had purchased shares subsequent to the commencement of the Chapter proceeding, the Commission's suspension of trading having expired. In denying participation by these shareholders, the court characterized their status as being vastly different from the pre-Chapter X creditor shareholders:
continued trading in a debtor's shares after the commencement of the proceeding will not provide any basis for a claim by those who speculate in the security during reorganization. The SEC has stated that "[t]he disclosures required in reports filed with the Commission are essential to the preservation of free, fair and informed securities markets." These reporting requirements were designed by Congress as a way of "securing proper information for the investor." Consequently, it is not surprising to find no exemption from these provisions of the federal securities laws for an issuer that becomes a debtor and falls under the jurisdiction of the bankruptcy court.

Compliance with the reporting provisions is the responsibility of the "issuer" of the registered securities. This issuer is the debtor corporation as the legal entity having made the issuance. Whether or not the debtor is continued in possession and management of its property, it does have "other parts to play" in the reorganization or arrangement proceeding "not directly concerned with management of the property during the period of court control." It thus remains liable for filing the necessary reports with the SEC.

Although primary responsibility rests with the issuer of the registered security, trustees and receivers should concern themselves with ascertaining the reporting status of the debtor, the debtor's ability to continue compliance, and the most economical and expeditious way in which compliance can be accomplished. Where a debtor is current in its reports and certified audits, problems are usually not encountered; and in the larger cases securities counsel for the debtor will continue to make the required filings. However, where a debtor's management is inept or untrustworthy and the books and records are not current or the auditors have refused to certify (or have withdrawn previous certifications), a real problem may exist as to the ability to file necessary reports, especially the required financial material. Ironically, it is in these instances that the public maraketplace most needs current and accurate material information.

[Appellants] acquired their stock in over-the-counter trading after the Chapter X proceedings had been instituted. Necessarily they had full knowledge of the hazards involved and their purchase of shares was motivated by opportunism.

They introduced no fresh money and did not directly or indirectly contribute substance to either the debtor corporation or the reorganized corporation.

472 F.2d at 750.

40. In re Four Seasons Nursing Centers of America, Inc., 472 F.2d at 750.


42. H.R. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934).


44. In re J.P. Linahan, Inc., 111 F.2d 590, 592 (2d Cir. 1940).

45. In a smaller case, debtor's (or trustee's) counsel will determine what should be done and will undertake to do it.

46. "Material" information has been defined as that to which "a reasonable man

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Recognizing this problem facing trustees and receivers, the SEC has indicated that when "not inconsistent with the protection of investors," it "would modify the reporting requirements" as they may apply to issuers which have ceased or severely curtailed their operations.\footnote{SEC Securities Act Release No. 9660 at 2 (June 30, 1972).} For example:

Where an issuer is subject to proceedings under Chapter X of the Bankruptcy Act and a court appointed trustee has possession of the issuer's books and records, or where a receiver or other judicially appointed officer has possession of such books and records, the Commission generally would accept reports prepared under the supervision of the trustee or other judicially appointed officer which differ in form or content from reports required to be filed under the Exchange Act.\footnote{SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).}

Furthermore, the Commission has pointed out that provisions of its rules, regulations and forms adopted to implement the reporting requirements provide "limited relief from those provisions under certain circumstances."\footnote{SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).} Hence, unaudited financial statements might be acceptable during the period of the debtor relief proceeding only, provided that every effort is made to inform the public during the bankruptcy. Lest this apparent flexibility be misconstrued, the Commission's caveat should be noted:

The foregoing discussion should not be taken as an invitation for evasion of the reporting requirements. Issuers will be required to demonstrate that relieving them of the necessity for complying with certain reporting requirements would be consistent with the protection

\footnote{Id. at 3. The following example is given: "where a company has ceased, or severely curtailed its operations, it might be unreasonable to require it to undergo the expense of obtaining the opinion of an independent auditor on its financial statements." Id.}
of investors. This includes advising the Commission of the difficulties which serve as a basis for such relief.\textsuperscript{50}

IV

SOLICITATION OF POWERS AND CONSENTS

The goal of a debtor relief proceeding is to confirm a plan of reorganization that settles the rights of creditors and stockholders who will participate in the new company. Accordingly, both Chapters contemplate the solicitation of consents from affected creditors and/or stockholders and permit a dissenting minority to be bound only by the affirmative acceptance of the requisite majority.\textsuperscript{51} When securities are offered to the creditors and/or stockholders in the settlement plan, as is often the case, the solicitation also involves a public offering in which the parties in interest are numerous and widespread.\textsuperscript{52}

\textsuperscript{50} Id. at 4. For a discussion of SEC enforcement of the reporting provisions, see note 137 infra.

\textsuperscript{51} A Chapter X plan of reorganization must be “accepted in writing, filed in court, by or on behalf of creditors holding two-thirds in amount of the claims filed and allowed of each class, and, if the debtor has not been found to be insolvent, by or on behalf of stockholders holding the majority of stock, of which proofs have been filed and allowed, of each class . . . .” Bankruptcy Act § 179, 11 U.S.C. § 579 (1970). An arrangement under Chapter XI must be “accepted in writing by a majority in number of all creditors . . . whose claims have been proved and allowed . . . which number shall represent a majority in amount of such claims . . . .” Bankruptcy Act § 362(1), 11 U.S.C. § 762(1) (1970). Chapter VII of the Proposed Act would fix the requisite amount for acceptance of a plan as a “majority in amount of the creditors of each class” affected and as the “holders of a majority in number of the equity securities of each class” affected. Proposed Act § 7-310(d)(1), in REPORT: PART II, supra note 1, at 252. With regard to computing the statutory majority, see Ch. X R. 10-305(e) and Ch. XI R. 11-37.

\textsuperscript{52} In a Section 12(g) reporting company, by definition there are at least 500 holders of record of a registered security, to which the plan may offer an exchange for a new security in the reorganized debtor. In SEC v. Sunbeam Gold Mines Co., 95 F.2d 699 (9th Cir. 1938), the court considered what constitutes a “public offering” under the registration exemption for “transactions by an issuer not involving any public offering.” Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970). In Sunbeam an issuer utilized the mails to circulate promissory notes in the form of “shareholder receipts” to the stockholders of the issuer and to a constituent corporation in connection with a consolidation of the two companies. The issuer was enjoined from violating the registration provisions of the Securities Act of 1933 after the court rejected its claim that no public offering was being made because the issue was limited to an identifiable group, the 530 individual stockholders of the corporations. The court stated:

\[\text{M}anifestly, an offering of securities to all redheaded men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation or the American Telephone & Telegraph Company, is no less “public,” in every realistic sense of the word, than an unrestricted offering to the world at large.\]

\[\text{. . . . .} \]

We therefore hold that an offering of securities under the Securities Act of 1933 may be a public offering though confined to stockholders of an offering company. . . .
To appreciate the application of the federal securities laws to the public solicitation of consents, the differences in the procedures prescribed by Chapters X and XI for obtaining consents must be considered. Under Chapter X, no solicitation to a plan of reorganization shall be made until the court has first approved the plan and all relevant information for consideration of acceptance has been transmitted to the creditors and stockholders affected. Any solicitation otherwise obtained may be held "invalid." The Chapter X disclosure material which must be transmitted to the creditors and stockholders includes the plan(s) of reorganization, together with a summary of the plan(s) approved by the court; a summary of any opinion of the court approving the plan; a summary of any report prepared by the SEC; notice of any confirmation hearing date; and any other information the court may direct. This information gives creditors and stockholders the "benefit of the analysis" resulting from court and SEC scrutiny, and it provides "relevant data" for casting their votes so that the solicited acceptance or rejection of the plan may be the result of an "independent judgment, freely exercised, and based upon an intelligent appraisal of the situation." Solicitations consistent with this protective procedure are not subject to the proxy requirements of the Securities Exchange Act of 1934, although the antifraud provisions of that Act and the Securities Act of 1933 remain applicable.


54. This is true unless the court directs that only a summary of the plan be mailed. Ch. X R. 10-303(e)(1).

55. Ch. X R. 10-303(e). The court may order its full opinion on the plan and the complete report of the SEC to be transmitted in place of the summaries or in addition to them. If only summaries are mailed, copies of the plan, opinion and SEC report shall be provided upon request without charge. Cf. Bankruptcy Act § 175, 11 U.S.C. § 575.

56. COLLIER ON BANKRUPTCY ¶ 7.32, at 1275 (14th ed. 1972). This approach has additional significance in that one accepting or rejecting a plan does not act only on his own behalf since the majority will bind a dissenting minority. The SEC's advisory report is based on an examination of the evidence and record presented at the plan approval hearing. In fact, upon resumption of the hearing after the Commission's advisory report is filed, if "additional evidence" is received, the court may "resubmit" the plan to the SEC. Ch. X R. 10-303(c).

Under the Proposed Act, the Administrator, rather than the SEC, would file an "advisory report." Moreover, under the present practice the court submits the plan to the SEC for its "examination and advisory report" and then adjourns until resuming the hearing to consider the approval of the plan after the filing of the report. Ch. X R. 10-303(a)(b)(c). According to the Proposed Act, however, the Administrator would just file his advisory report "prior to the date set for the hearing on approval" of the plan. Proposed Act § 7-306(b), in REPORT: PART II, supra note 1, at 248.

57. The court is not without power, however, to fine or punish persons for
Solicitations to a plan under Chapter XI are markedly different from solicitations under Chapter X. First, the solicitation is limited to "unsecured creditors." Secondly, acceptances may be obtained even before the filing of the Chapter proceeding, and they must be obtained in the requisite majority before the hearing on confirmation, which is the first time the court judicially considers the arrangement and its acceptance. Finally, the court generally exercises no control or scrutiny over the content of the solicitation material and makes no preliminary approval of the plan before acceptance. Under Chapter XI, solicitation of consents is left to the debtor, and since only the debtor may propose a plan, the disclosure is usually less objective than when a disinterested third party weighs the plan provisions and evidence beforehand.

Chapter XI does provide for the election by creditors of a creditors' committee, which may consult with the receiver or debtor in possession in connection with the administration of the estate. The commit-
tee may employ attorneys, accountants, and "other agents" necessary to assist it in performing its functions. Thus, a creditors' committee should be able to analyze the proposed plan through the use of experts and then communicate its report to the creditors when acceptances are solicited by the debtor. While this approach may be desirable, however, it is not usually followed. A creditors' committee normally does not actively participate in the solicitation process because it will have analyzed and passed on the plan in the negotiation stages during formulation of the proposal, and solicitation is thereafter handled primarily by the debtor.

It is in this light, therefore, that the pertinent provisions of the securities laws applicable to Chapter X and XI plan solicitations must be viewed. The SEC proxy requirements will be considered first.

A. SEC Proxy Requirements Applicable to Chapter X and XI Plan Solicitations

Once a Chapter X plan of reorganization has been approved by the court and the information required to be sent to the creditors and stockholders has been mailed, solicitations may be made by any party or committee seeking acceptance or rejection of the plan. Such solicitations investigate the causes of the debtor's insolvency or inability to pay its debts; consider whether the proposed plan is feasible and in the best interests of the creditors; negotiate with the debtor concerning the terms of the proposed plan; advise the creditors of the committee's recommendations with respect to the proposed plan; report to the creditors concerning the progress of the case; collect and file with the court acceptances of the proposed plan; and perform other services in the interest of creditors.

CH. XI R. 11-29(a).

64. CH. XI R. 11-29(b).

65. It is desirable, for example, where the debtor solicits acceptances despite the committee's failure to completely concur in the plan.

66. One of the functions of the committee is to "negotiate with the debtor concerning the terms of the proposed plan . . ." CH. XI R. 11-29(a). A continuing interest by the committee in scrutinizing the content of the debtor's solicitation material when securities are offered is certainly desirable. The committee's consideration of the feasibility of the plan and whether it is in the best interests of creditors "should prove helpful to the court" in considering confirmation. 8 COLLIER ON BANKRUPTCY ¶ 5.50(2), at 760 (14th ed. 1972). The importance of a committee in Chapter XI was recognized by Congress when it amended the Bankruptcy Act in 1967 to provide a better statement of the rule regarding committee expenses and reimbursement:

The proposed amendments will carry out the purposes of dealing fairly and realistically with the creditors' committee which performs a most important function in arrangement proceedings, i.e., in passing judgment on a plan and making that judgment known to creditors. Without the countervailing position of a creditors' committee, chapter XI would be a unilateral proceeding proposed by a debtor and approved by an uninformed creditor group.


67. Cf. CH. X R. 10-304. Chapter X Rule, 10-211(b) applies to violation of this procedure. Chapter VII of the Proposed Act, in addition to prohibiting solicitation of acceptances or rejections without the consent of the Administrator prior to approval of
need not comply with the proxy requirements under the Securities Exchange Act of 1934 because the Commission has exempted such solicitations from compliance. This limited exemption is largely due to the fact that a material part of the information required to be mailed to creditors and stockholders may be the Commission's own report and substantive recommendations on the merits of the plan, which focus primarily on whether it meets the statutory test and is "fair and equitable, and feasible." On the other hand, the proxy requirements may apply to a solicitation of consents by the debtor to an arrangement under Chapter XI. The proxy requirements of the Securities Exchange Act of 1934 and the SEC's Rules and Regulations apply to solicitations "in respect of any security (other than an exempted security) registered pursuant to section 12" of the Securities Exchange Act of 1934. Thus,
for example, if the debtor has an "equity security" registered pursuant to Section 12(g) and proposes to solicit consents to the arrangements from these security holders, compliance with the proxy solicitation provisions is required. This situation usually occurs in Chapter XI when a debtor has issued outstanding convertible debentures registered pursuant to Section 12(g). Other situations under Chapter XI which might require compliance with proxy solicitation procedures would be arrangements which are conditioned on a reverse split of the common stock or plans in which some action must be taken by the shareholders in order to effect the arrangement. Once again, however, as in the case of convertible debentures, the proxy rules and requirements would only apply if the security involved in the proceeding is registered pursuant to Section 12 of the Securities Exchange Act of 1934.

material facts concerning the matters on which security holders are asked to vote. . . ."


No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

See, e.g., In re First Home Inv. Corp., 368 F. Supp. 597 (D. Kan. 1973). When preliminary material fails to meet the prescribed disclosure standards, the management or other group responsible for its preparation is notified by the SEC staff and given an opportunity to correct the deficiencies in the preparation of the definitive proxy material to be furnished to security holders. 39 SEC ANN. REP. 36 (1973). Although the proxy material may be ultimately "cleared" by the SEC, the Commission does not "approve" the content of a proxy statement. This distinction is important; for the filing or examination of a proxy statement, form of proxy, and other soliciting material is not deemed a finding that the Commission has passed on the merits of it or approved its material or certified that it is accurate, complete, or not false and misleading. Securities Exchange Act of 1934 R. 14a-9(b), 17 C.F.R. § 240.14a-9(b) (1974).

72. The definition of "equity security" under the Securities Exchange Act of 1934, to which Section 12(g) of that Act applies, includes "any stock or similar security: or any security convertible, with or without consideration, into such a security. . . ." Securities Exchange Act of 1934 § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1970). Thus, debentures convertible into common stock of the debtor are included in the definition and would be registered under Section 12(g) of the Securities Exchange Act of 1934, which would then subject to the proxy requirements any solicitation of consents to an arrangement affecting the debenture holders. In re Esgro, Inc., No. 73-025-10, (C.D. Cal. 1973) was such a situation. The debtor's proxy statement dated October 17, 1974, was cleared by the Commission, and consents to an arrangement were solicited. See Esgro, Inc., SEC File No. 0-1659-2.

73. Technically, if the security is not registered but should have been, the proxy requirements would not be applicable, although the issuer would be in violation of the registration requirements of Section 12 of the Securities Exchange Act of 1934. Cf. Posi-Seal Int'l v. Chipperfield, 457 F.2d 237 (2d Cir. 1972), where the arrangement was con-
B. SEC Proxy Requirements Applicable to Chapter X and XI Committee Authorization Solicitations

In addition to controlling the solicitation of approvals for Chapter XI arrangement plans involving registered securities, the proxy requirements of the Securities Exchange Act of 1934 may apply to solicitations seeking authorization for a committee to act on behalf of creditors or stockholders. Since Chapter X permits the formation of committees representing creditors and stockholders in most phases of the proceeding and Chapter XI similarly provides for committees representing unsecured creditors, the proxy rules potentially affect both Chapters in this regard.

A Chapter X committee may organize and seek authority to act on behalf of the creditors or stockholders to be represented by soliciting powers or authority to represent them in the reorganization proceeding. A copy of the instrument empowering the committee to act must be filed with the court. Where the particular creditors or stockholders are security holders whose securities are registered pursuant to Section 12 of the Securities Exchange Act of 1934, the proxy provisions and rules under that Act must be complied with in securing the authorizations to act. Thus, for example, a committee seeking authorizations to act on behalf of convertible debentures registered pursuant to Section 12(g) must file proxy material with the Commission. By contrast, solicitation ditioned on a reverse split of the common stock accomplished according to the requirements of state law.

74. Ch. X R. 10-211(a).

75. Creditors and stockholders may act in a Chapter X proceeding by a "duly authorized" committee. Bankruptcy Act § 209, 11 U.S.C. § 609 (1970). This committee must file a statement with the court setting forth pertinent information concerning its formation, representation, and authority to act. Ch. X R. 10-211. The court may then "determine whether there has been a failure to comply with the provisions of [Rule 10-211] or with any other applicable law regulating the activities" of a committee. Ch. X R. 10-211(b). This determination "clearly includes other federal laws dealing with representatives of claimants or security holders." 6A COLLIER ON BANKRUPTCY ¶ 9.32(1), at 353 (14th ed. 1972).

In the case of In re First Home Inv. Corp., 368 F. Supp. 597 (D. Kan. 1973), a committee and its agents distributed material designed to solicit authorizations from investors to represent them in a Chapter X proceeding, to obtain contributions from the investors for this purpose, and to solicit their votes concerning a motion to dismiss the proceeding. The judge found this material constituted a proxy within the meaning of Section 14 of the Securities Exchange Act of 1934 and that the parties violated Section 14(a) of the Act since required proxy material had not been filed with the SEC. The judge also specifically noted that the material distributed was "clearly violative" of the Commission's proxy anti-fraud rule. Securities Exchange Act of 1934 R. 14a-9, 17 C.F.R. 240-14a-9 (1974). Similarly, in Imperial-American Resources Fund, Inc., No. 72-B-556 (D. Colo. 1972), an individual sought to form a protective committee to represent limited partners in 13 partnerships in which the Chapter X debtor was the general partner. The SEC objected on the grounds that, inter alia, the solicitation of authority to act for the limited partners had not complied with the Commission's proxy rules. Upon
and voting of proxies under Chapter XI, other than on the solicitation of the acceptance of a plan or related proof of claim, is governed by Bankruptcy Rule 208, which regulates the solicitation and voting of proxies in straight bankruptcy proceedings. Under Rule 208, a committee which holds two or more proxies and is further soliciting proxies to act on behalf of creditors "must file with the court a verified list of the proxies to be voted and a verified statement of the pertinent facts and circumstances in connection with the execution and delivery of the proxies . . . ." The court may inquire into compliance with Rule 208 and take any appropriate action, including rejection of a proxy for cause. Whether the application of Bankruptcy Rule 208 to committees in Chapter XI proceedings seeking authorization to act supersedes compliance with the proxy requirements of the Securities Exchange Act of 1934, if otherwise applicable, is not specifically covered. However, the SEC has not exempted such solicitations.

Despite the uncertainty surrounding the applicability of Bankruptcy Rule 208 to certain Chapter XI proceedings, public policy should dictate its subordination to other laws regulating solicitation of proxies. Bankruptcy Rule 208 essentially outlines a procedure for "reporting" to the court the matters and information required. Rather than providing a means for scrutinizing the disclosures before creditors are solicited, it permits inquiry only after the solicitation has occurred. Although the same approach is followed in Chapter X, that Chapter solves the problem by expressly requiring compliance "with any other law regulating" committee activities. It would seem desirable to have the SEC

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application by the SEC, the District Court ordered the individual to make no further solicitations. 39 SEC ANN. REP. 119 (1973). Other cases involving clearance of proxies in forming committees include Arlans Dept. Stores, Inc., SEC File No. 0-7374-2; Equity Funding Corp., SEC File No. 0-2120-2.

76. A Chapter XI committee is either elected at the first meeting of creditors or appointed by the court. CH. XI R. 11-27(a).

77. Chapter XI Rule 11-28 incorporates Bankruptcy Rule 208 with minor modifications. The Bankruptcy Rules govern procedural matters in Chapters I-VII.

78. Proxies are defined to include a "writing authorizing any person who does not then own a claim to vote the claim or otherwise act as the owner's attorney in fact in connection with the administration of an estate in bankruptcy." BANKR. R. 208(a)(1).

79. BANKR. R. 208(d).

80. The Advisory Committee on Bankruptcy Rules states that Rule 208 is a "comprehensive regulation of solicitation and voting of proxies in bankruptcy cases." A comment on Rule 208 states:

The Rule requires various information regarding parties to a proxy solicitation which, under § 77p of the Act, is required or could be required by rules and regulations promulgated by the Securities and Exchange Commission. As Rule 208 applies only to the first seven chapters of the Act (Cf. Rule 1), dual reporting of solicitations (i.e., to both the bankruptcy court and the SEC) is not required. Such information must be filed with the court.


81. See note 75 supra. While Bankruptcy Rule 208(c) does not contain a similar
scrutinize Chapter XI committee solicitations of powers according to its proxy clearance provisions in cases where proxy compliance would otherwise be required. This would be done before the solicitation and would thereby avoid placing the burden upon a bankruptcy judge who has neither the staff nor the expertise to investigate. An interpretation of Bankruptcy Rule 208 to require compliance under Chapter XI with other applicable laws regulating committee activity seems not only reasonable but also necessary to protect the public interest.

Committee solicitations of acceptances or rejections of a Chapter XI arrangement may also require compliance with the proxy provisions of the Securities Exchange Act of 1934. As discussed earlier, there is no SEC exemption from the proxy provisions for solicitations in connection with the approval of an arrangement plan. Thus, like a Chapter XI approval, of solicitations initiated by the debtor itself, a committee solicitation for acceptance or rejection of an arrangement will necessitate the filing of material with the Commission whenever registered securities are involved. Although one of the functions of the committee is to

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The purpose of the SEC's proxy rules, among other things, is to adequately inform public investors about the background of persons who propose to represent them and their interests in the debtor. For instance, disclosure of potential conflicts, such as claims against a debtor which may fall in more than one class, should be known to those whose representation is sought. Prior SEC scrutiny and clearance of this material is designed to ensure such disclosures. The Commission staff endeavors to give clearance to proxy submissions as promptly as possible. Delays in responding are normally due to the material submitted and the nature of the delinquency comments.

The Proposed Act would provide for the appointment by the Administrator of an "official creditors' committee," including additional such committees when necessary. Proposed Act § 7-101, in REPORT: PART II, supra note 1, at 217. It would also provide for the regulation of representation by unofficial committees of creditors and equity security holders, and it states that every unofficial committee "shall furnish the information relevant to . . . its representation required by rules of the administrator," who "shall promulgate rules regulating the solicitation of authorizations of representation, including . . . proxies . . ." Id. § 7-111, at 231. The Proposed Act further provides that the court may refuse to allow a committee to be heard "unless satisfied that such [committee] has complied with all rules promulgated by the administrator and other federal laws applicable to such representation." Id. It is stated in the Revision Commission's Notes to Section 7-111 that: "The provision of § 213 [of Chapter X] is continued which requires compliance with provisions of other federal laws restricting solicitations and the terms of representation by unofficial committees." Id. at 232. See discussion of Section 213 and Chapter X Rule 10-211(b) in note 75 supra.

Securities Exchange Act of 1934 R. 14a-2(a), 17 C.F.R. § 240.14a-2(a) (1974), provides that the proxy solicitation rules "apply to every solicitation of a proxy with respect to securities registered pursuant to section 12 of the Act . . . except . . . (a) [a]ny solicitation made otherwise than on behalf of the management of the issuer where the total number of persons solicited is not more than 10." Negative solicitations are also covered; for "solicitation" and "solicit" include, inter alia, "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."
"collect and file with the court acceptances of the proposed plan," and neither this nor any other provision of Chapter XI specifically exempts a solicitation by the committee concerning acceptance or rejection of a plan.

V

CIVIL LIABILITY FOR ANTIFRAUD VIOLATION IN OFFER AND SALE OF SECURITIES

The offer and sale of securities by means of a plan of reorganization or arrangement are subject to the antifraud provisions of the federal securities acts. These provisions remain applicable even though the particular security is registered under Section 5 of the Securities Act of 1933 or is exempt from registration by virtue of the Bankruptcy Act exemptions found in Section 264 of Chapter X and Section 393 of Chapter XI.

A. The Antifraud Provisions

The antifraud provisions include Sections 12 and 17a of the Securi-
ties Act of 1933,87 Section 10b of the Securities Exchange Act of 1934,88 and Rules 10b-5 and 14a-9 of the General Rules and Regulations under the Securities Exchange Act of 1934.89 Under Section 12, the purchaser may have a civil cause of action against the seller for offering or selling securities in violation of Section 5 or for distributing a false and misleading prospectus or communication involving material facts or omissions. Section 17(a) makes it unlawful to engage in certain proscribed acts and practices which operate or would operate as a fraud or deceit upon the purchaser.90 Furthermore, Section 10b makes it unlawful for "any person" by means of the mails or interstate commerce, to employ in connection with the "purchase or sale" of a security "any manipulative or deceptive device or contrivance" that would violate such rules and regulations as the SEC has found "necessary or appropriate in the public interest or for the protection of investors."91

The above provisions relate to the general antifraud liability that could be incurred in connection with the offer and sale of securities in the plan. However, a false and misleading proxy statement, when subject to Section 14a of the Securities Exchange Act of 1934, is equally

90. In In re American Trailer Rentals Co., 325 F.2d 47 (10th Cir. 1963), rev'd on other grounds sub nom., SEC v. American Trailer Rentals Co., 379 U.S. 594 (1965), the 10th Circuit recognized that "while securities issued under Chapter XI proceedings are exempt from Section 5 (registration) under the Securities Act of 1933, . . . they are not exempt from Section 17. . . ." Id. at 52. Similarly, it has been said that "[I]n solicitation [to a plan of reorganization], the terms of § 17 of the Act (15 U.S.C. § 77q) should be borne in mind." 6 COLLIER ON BANKRUPTCY ¶ 7.33, at 1279 n.16 (14th ed. 1972).
91. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1970). Rule 10b-5 under the Exchange Act is a key securities antifraud provision and provides as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
(a) to employ any device, scheme, or artifice to defraud,
(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) to use any device, scheme, or artifice in connection with the purchase or sale of any security.
17 C.F.R. § 240.10b-5 (1975). A 10b-5 plaintiff must be a purchaser or seller. Blue Chip Stamps v. Manor Drug Stores, Inc., 95 S. Ct. 1917 (1975). This would include a trustee in bankruptcy where the debtor corporation is the actual purchaser or seller. Thomas v. Roblin Industries, Inc., 520 F.2d 1393 (3d Cir. 1975); see Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960).
actionable on antifraud grounds. The fact that a proxy statement, form of proxy, or other soliciting material has been filed with the SEC or examined by it does not mean that the Commission has passed upon the merits of the material or given approval to the security or the matter to be acted upon; and it is “unlawful” to so represent.

Not only do the civil antifraud provisions of the Securities Acts apply in reorganization and arrangement proceedings, but the criminal penalties for wilful violations of the provisions in the Securities Act of 1933 also apply in an appropriate situation. While criminal liability

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No action or failure to act by the Commission . . . shall be construed to mean . . . [it] . . . has in any way passed upon the merits of, or given approval to, any security or any transaction or transactions therein, nor shall such action or failure to act with regard to any statement or report filed with or examined by . . . [it] . . . be deemed a finding by . . . [it] . . . that such statement or report is true and accurate on its face or that it is false or misleading. It shall be unlawful to make, or cause to be made, to any prospective purchaser or seller of a security any representation that any such action or failure to act by . . . [the Commission] . . . is to be so construed or has such effect.

Section 23 of the Securities Act of 1933, 15 U.S.C. § 77(w) (1970), is similar with respect to a registration statement filed with the Commission.

In I. I. Case Co. v. Borak, 377 U.S. 426 (1964), a suit involving violation of Section 14(a) of the Securities Exchange Act, the United States Supreme Court noted that:

The Commission advises that it examines over 2000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission’s acceptance of the representations contained therein at their face value, unless contrary to other material on file with it.


94. Thus, just as there are no exemptions from the provisions of Sections 12(2) and 17 of the Securities Act of 1933, there is no exemption from “§ 24 of that Act as it relates to the provisions just named.” 6A COLLIER ON BANKRUPTCY ¶ 15.05, at 1196 (14th ed. 1972). Section 24 of the Securities Act of 1933, 15 U.S.C. § 77x (1970), provides for a fine of up to $5,000 or imprisonment up to five years or both for wilful violations. A 1975 amendment to the Securities Acts, Section 27(a) of the Securities Acts Amendments of 1975, Pub. L. No. 94-29, (June 4, 1975), made uniform the criminal sanctions imposed for violations of the six statutes administered by the SEC. Those convicted for violations may now be fined up to $10,000 and imprisoned not more than five years or both. Section 24, Securities Act of 1933, 15 U.S.C. § 77x (1970); Section 32(a), Securities Exchange Act of 1934, 15 U.S.C. § 78ff (1970); Section 29 Public Utility Holding Company Act of 1935, 15 U.S.C. § 79z-3 (1970); Section 325,
seems somewhat remote in view of the existence of court proceedings, it is not inconceivable.\footnote{95}

B. Debtor Liability

As discussed earlier,\footnote{96} the chief purpose of the form of relief provided by Chapters X or XI is to modify a debtor's financial structure in order to permit it to reenter the business community as a competitively healthy and financially sound business enterprise. To further this end, Chapter X deals with all claims of "whatever character" against the debtor, including those secured or unsecured, liquidated or unliquidated, fixed or contingent.\footnote{97} Thus, securities fraud claims existing at the commencement of the proceeding may be dealt with by the bankruptcy court and discharged by confirmation of the reorganization plan.\footnote{98} Such claims, however, may not be dischargeable under Chapter XI.\footnote{99} This undoubtedly casts a considerable cloud over the use of Chapter XI by debtors with serious pre-Chapter XI securities fraud problems because violations of the securities antifraud provisions afford a purchaser the right to rescind the transaction and recover his money. Therefore, a contingent fraud claim arises which must be disposed of. If the claim is not dischargeable in Chapter XI, the debtor might have to resort to a Chapter X proceeding where such claims may be adjudicated and included in a plan of reorganization.\footnote{100}

\begin{footnotes}
\item[95] For example, fee fixing in bankruptcy proceedings is a crime. 18 U.S.C. § 155 (1970).
\item[96] See text accompanying note 3 supra.
\item[99] See Bankruptcy Act § 366(3), 11 U.S.C. § 766(3) (1970); Bankruptcy Act § 17(a)(2), 11 U.S.C. § 35a (1970). The latter provision states: "A discharge in bankruptcy shall release a bankrupt from all of his provable debts . . . except such as . . . (2) are liabilities for obtaining money or property by false pretenses or false representations . . . ."
\item[100] Cf. Wright v. Lubinko, 515 F.2d 260 (9th Cir. 1975) (bankrupt's sale of stock without required California permit not a "false representation" such as would bar a discharge under Section 17a(2) of the Bankruptcy Act). Moreover, in a straight bankruptcy proceeding, "[c]reditors' claims under Rule 10b-5 of the [Securities] Exchange Act [of 1934], asserted in a complaint which is the subject of a pending multidistrict litigation, are not provable claims within the meaning of Section 63 of the Bankruptcy Act." In re Crimmins (S.D.N.Y. 1975), CCH BANKR. L. REP. ¶ 65,747 (summary of opinion of bankruptcy judge). The court said that the Securities Act claims could be prosecuted notwithstanding the bankruptcy proceeding and that the claims could not be discharged.
\end{footnotes}
Despite the possible use of Chapter X to avoid liability for pre-existing antifraud violations, a debtor may incur new and substantial contingent liability under either Chapter X or XI if the antifraud provisions of the securities acts are violated in connection with a public offering of securities under the reorganization or arrangement plan. This is true whether the offering is for cash or in exchange for creditor and stockholder claims and interests. Thus, the rehabilitation effort might be jeopardized by the very manner in which the existing indebtedness was settled, and the reorganized company would be released from the reorganization or arrangement proceeding saddled with potential new claims that could surface as securities class action suits. It is this possibility that should caution debtor and non-debtor issuers to comply with the general rule of full disclosure of all material facts. Appropriately, the United States Supreme Court, speaking of an arrangement under Chapter XI, has stated: "No authority has been found which would indicate that recipients of stock issued in connection with an arrangement are not entitled to as much information as are those persons acquiring stock under ordinary conditions."102

1. Disclosure

Full disclosure of all material facts to creditors and stockholders must therefore be the goal of an issuer involved in a Chapter X or XI proceeding, just as it should be the goal of an issuer not involved in a reorganization action.108 Given the varied securities situations that arise in Chapter proceedings, however, attempting to define the disclosure requirement in this context in more than a general manner would not be meaningful. In general, considering full disclosure to be the goal, the concept of "due diligence" and the factors considered relevant to a "due diligence defense" should guide the achievement of adequate disclosure and minimize the possibility of civil liability and SEC injunction action. For no matter how much impact court scrutiny of the securities offered may have on full disclosure,104 the fact remains that the reorganized

101. It should be noted that a debtor may also become a public, reporting company as a result of the issuance of securities pursuant to a plan where there are over 500 trade creditors that receive an "equity security" in exchange for their claims, and the assets exceed $1,000,000. Section 12(g) of the Securities Exchange Act of 1934 would then require registration of the security. 15 U.S.C. § 78l(g) (1971).


103. One bankruptcy court has stated: "While a Chapter XI solicitation letter involving a stock distribution need not give the extensive detail that an SEC registration would, it should give basic financial data concerning the corporation whose stock is being issued under the plan in order that the creditors may make an informed judgment as to accepting or rejecting the plan, or objecting to confirmation thereof." In re Transystems, Inc., No. 71-164Bk-JE-Y (S.D. Fla., Feb. 8, 1973), cited in 37 SEC ANN. REP. 200 (1971).

104. One authority describes this court scrutiny as follows: "... the exemption
company, as the issuer, and those participating in the offer and sale of the securities under the plan remain exposed to potential liability unless there is full disclosure of all material facts to those asked to take or purchase the security.\textsuperscript{105}

A significant case that is instructive in the disclosure process is \textit{Escott v. Bar Chris Construction Corporation},\textsuperscript{106} which dealt with a private action for recovery of damages due to a false and misleading prospectus. This suit was a class action by debenture holders against the issuer, its officers and directors, and its underwriters and auditors. Plaintiffs challenged the accuracy of a number of figures contained in the financial statements as well as statements in the text of the prospectus. Four days after the securities suit was filed, the issuer filed a Chapter XI petition. After completing an exhaustive analysis of the challenged items\textsuperscript{107} and concluding that an “abundance of material

\begin{itemize}
  \item accorded by § 264 [of Chapter X] imposes upon the reorganization judge the duty of scrutinizing with care the securities proposed to be issued under a plan of reorganization.” 6A \textsc{Collier on Bankruptcy} ¶ 15.05, at 1196 (14th ed. 1972). \textit{See In re Barlum Realty Co.}, 62 F. Supp. 81 (E.D. Mich. 1945), \textit{aff'd}, 154 F.2d 562 (6th Cir. 1946); \textit{In re American Dept Stores Corp.}, 16 F. Supp. 977 (D. Del. 1936); 1 L. Loss, \textsc{Securities Regulation} 585 (1951).


A final decree does not “discharge the debtor or its successor from liability imposed by another federal statute . . . where the discharge would be manifestly against the public interest and the plain intent of that statute.” 6A \textsc{Collier on Bankruptcy} ¶ 11.18, at 694 (14th ed. 1972). \textit{See}, e.g., NLRB v. Baldwin Locomotive Works, 128 F.2d 39 (3d Cir. 1942) (discharge did not affect liability of reorganized company for unfair labor practices allegedly committed by debtor in possession). Whether an order of discharge could be used as a successful defense to a Securities Act civil suit brought against the issuer and other parties arising as a result of alleged violations of the antifraud provisions in connection with the offer and sale of securities pursuant to consummation of a plan is questionable. Consider the explicit language of the Court of Appeals in \textit{In re American Trailer Rentals Co.}, \textit{supra} note 90, regarding the applicability of the antifraud provisions of Section 17 of the Securities Act of 1933.


107. The court in \textit{Bar Chris} examined the relevant disclosures in the case to determine if they were false or misleading and, if so, whether the statements or omissions were material. For example, the judge scrutinized the income statement and accounting work papers to assess whether earnings had been overstated, and he even evaluated the method of computing sales. Turning to the balance sheet, the judge analyzed the corporation’s current assets, its contingent liabilities, the reserves for doubtful accounts receivable and contingent liabilities, and the backlog of unfilled orders. With regard to the text of the prospectus, the court considered various statements relating to officers’ loans; application of the use of the proceeds of the debenture issue; the company’s favorable experience in having to repurchase a low rate of delinquent customer accounts previously discounted to a factor; the description of Bar Chris’ business; and a statement
misstatements" had occurred, the court investigated whether some of the defendants could be exonerated from liability by the exercise of "due diligence." The court denied, for the following reasons, that the individual defendants had demonstrated sufficient diligence: (1) the principal "knew all the relevant facts;" (2) the founders knew or must have known or at least did not investigate; (3) the treasurer and chief financial officer likewise "must have known;" (4) the controller, who signed the registration statement, "could not avoid responsibility by leaving it up to others to make it accurate;" (5) company counsel "made no investigation and relied on the others to get it right;" (6) an outside director, who became a director "on the eve of the financing" relied upon representations of others and upon general information which did not purport to cover the particular case; (7) counsel who prepared the registration statement did not make a "reasonable investigation;" (8) the underwriters made "no effectual attempt at verification" of data presented by the company; and (9) the auditors for the "S-1 review" "did not spend an adequate amount of time on a task of [such] magnitude" and were "too easily satisfied with glib answers" to their inquiries.

Bar Chris should establish the general scope of an inquiry into the adequacy of disclosure and the defense of "due diligence." Although Bar Chris dealt with a registration statement and prospectus, a similar investigation and analysis should be followed by the potentially liable parties in a Chapter X or XI securities offering even though no formal registration is involved. Those who are appointed by the bankruptcy relating to the "customary practice" of the company for obtaining downpayments on its customers' contracts. Id. at 661-78.

108. Id. at 681.
109. Id. at 682. The "due diligence" defense asserted by the defendants other than the issuer (to whom the defense is not available, Securities Act of 1933 § 11(b), 15 U.S.C. § 77k(b) (1970) ), pertains to exoneration from liability of those signing the registration statement. The burden of proof differs according to whether the statements or omissions relate to portions of the registration statement concerning expert or nonexpert information. Id. § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1970).

110. 283 F. Supp. at 682-703.
111. In Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970), the Second Circuit found liability under Sections 17(a) of the Securities Act of 1933 and 10(b) of the Securities Exchange Act of 1934 for an issue offered pursuant to the Regulation A exemption from registration, which permits an issuer of stock to make a small public offering ($500,000 or under) without filing the complex registration statement and prospectus normally required by law. Globus and its underwriter, however, had distributed an offering circular which prominently featured a contract with Sperry Rand Corporation relating to computer services to be furnished to the company's law research business, but which omitted to disclose the existence of a dispute and lawsuit between the two parties materially bearing on the offering. After finding the defendants liable, the Globus court did not allow the issuer to indemnify the underwriter against liability, for it noted the SEC's view "that indemnification of
court to rehabilitate a debtor or those who, as representatives of other parties in interest or of themselves, participate in the offer and sale of securities in connection with a reorganization or arrangement, would do well to consider the potential liability they may incur by failing to make reasonable inquiries and to secure full and proper disclosure.\textsuperscript{112} It is also worth bearing in mind that liability for Securities Act fraud violations may not be circumscribed by traditional common law concepts. Consequently, intent to deceive is not a necessary element of nondisclosure. This exposure should prompt an effort at full and adequate securities disclosure in debtor relief offerings.\textsuperscript{113}

The special relationship between a debtor seeking rehabilitation through a bankruptcy proceeding and the investors who are asked to accept something less than or different from what they originally owned may give rise to a higher than ordinary duty of investigation and care. Since a majority acceptance of a reorganization plan by creditors or stockholders will legally bind a dissenting minority, a duty may be recognized which requires use of "extreme care in assuring that all material information is accurate and disclosed."\textsuperscript{4} Such a standard is particularly likely in the context of a bankruptcy proceeding since many

directors, officers and controlling persons for liabilities arising under the 1933 Act is against the public policy of the Act." \textit{Id.} at 1288.

\textsuperscript{112} Perhaps the psychological deterrent of becoming involved in such a situation should be sufficient to impel disclosure, especially "in an industry where, as the sages put it, a good name is worth more than a crown." \textit{Id.} at 1285. Many practitioners proposing stock plans realize the disclosure aspects of soliciting consents to a plan which involves proxy and/or antifraud disclosure problems and often will consult securities counsel. However, many times debtor's counsel in small, public Chapter XI proceedings become quite zealous in offering creditors a choice between nothing in liquidation as opposed to securities in the debtor or nondebtor, regardless of the condition of the issuer. In the nondebtor situations, even the debtor and its counsel, which may be eager to put a plan together, will not have all material information about the nondebtor issuer; yet it is the debtor's plan proposal and therefore it is responsible for antifraud compliance.

\textsuperscript{113} "We have gone far beyond the limits of the common law in imposing liability under 10b-5 and thus may not import all the other aspects of common law fraud without scrutiny." Green v. Wolf Corporation, 406 F.2d 291, 303 (2d Cir. 1968). "[T]he trend is clearly away from enforcing a scienter requirement equal to the 'intent to defraud' required for common law fraud. Before there may be a violation of the securities acts there need not be present all of the same elements essential to a common law fraud." Globus v. Law Research Service, Inc., 418 F.2d 1276, 1291 (2d Cir. 1969). The shift is from a \textit{scienter} requirement in 10b-5 cases to a "flexible duty standard." White v. Abrams, 495 F.2d 724 (9th Cir. 1974). In \textit{White}, the Ninth Circuit stated:

\begin{quote}
The proper standard to be applied is the extent of the duty that rule 10b-5 imposes on [the] particular defendant . . . [including such factors as] the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.
\end{quote}

\textit{Id.} at 734-36.

\textsuperscript{114} White v. Abrams, 495 F.2d 724, 736 (9th Cir. 1974).
hours of negotiation and other work will have preceded any plan proposed and filed with the bankruptcy court. Additionally, provisions of the plan may be contingent on a determination of the debtor's financial condition and its ability to fund the plan. Moreover, as is the general rule in Chapter X, a projection of the company's probable future business activity and earnings may be necessary. Consequently, full disclosure of all material facts regarding a reorganization securities offering is imperative, and a higher standard of care may be justified.

2. Liability of Secondary Participants

As Bar Chris pointed out, secondary participants in securities offerings are not free from responsibility. A recent SEC enforcement case emphasizes this point with regard to attorneys. In Securities and Exchange Commission v. Spectrum, Ltd., an attorney was charged with participating in a scheme to distribute unregistered shares of common stock in violation of the registration and antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. Although permanent injunctions were issued against the company and most of the other defendants, the lower court had concluded that the attorney did not violate the securities laws by negligently giving an opinion letter which formed the basis for the unregistered securities sales. The Second Circuit reversed and ordered an evidentiary hearing on the writing of the disputed opinion letter and the use to which it was put in facilitating the scheme to sell unregistered Spectrum stock. The Second Circuit spelled out the "appropriate rule of law" to be applied to

115. Projections and estimates of future earning power play a key role in deciding feasibility of the plan. Bankruptcy Act (Ch. X) § 221(2), 11 U.S.C. § 621(2) (1970); id. § 366(2), 11 U.S.C. § 766(2) (1970). However, offering securities to the public on the basis of earnings projections requires a most careful exercise of due diligence and full disclosure. Therefore, note the caution with which public disclosure of earning projections is made under the Securities Acts. Moreover, note that "the Commission has never required a company to publicly disclose its projections and does not intend to do so now." Disclosure of Projections of Future Economic Performance, SEC Securities Act Release No. 34-9984 and 33-5362 (Feb. 2, 1973). The leading Supreme Court cases are Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414 (1968), and Consolidated Rock Products Co. v. DuBois, 312 U.S. 510 (1941). Chapter XI § 366(2), 11 U.S.C. § 766(2) also requires a finding that the arrangement is "feasible," which centers on "whether the things which are to be done after confirmation can be done as a practical matter under the facts." 9 COLLIER ON BANKRUPTCY ¶ 9.18[1], at 288 (14th ed. 1972).

116. See text following note 108 supra.

117. 489 F.2d 535 (2d Cir. 1973).

118. The hearing would resolve "a sharp factual conflict bearing heavily on the critical question of Schiffman's actual knowledge of the scheme to illicitly distribute unregistered Spectrum stock at the time [he] agreed to draft the . . . opinion letter." Id. at 540.
those who may be considered an "aider and abettor." A "negligence standard with respect to secondary participants" was deemed proper for lawyers' securities opinion letters often an element in Chapter plan offerings. To be sure, the Court of Appeals was speaking about an attorney's duty as an "aider and abettor" or so-called secondary participant in connection with an SEC enforcement action seeking to enjoin further violations of the Securities Acts. However, the Second Circuit's opinion might be heeded as a warning, since public investors can be misled and injured by taking securities through a bankruptcy proceeding just as easily as they can be harmed under ordinary circumstances.

Addressing the lawyer's responsibility in securities matters generally, the Spectrum court noted that:

The legal profession plays a unique and pivotal role in the effective implementation of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters.

The Spectrum decision raises the question of the potential exposure of attorneys and other peripheral participants to civil actions for damages. As one commentator has noted, "[r]equiring higher standards of conduct from attorneys in [SEC] injunctive proceedings may alert private plaintiffs that they have a cause of action and raises fears of 'deep pocket' liability for the securities bar." The Spectrum court cautioned

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120. Even this liability is not remote in bankruptcy proceedings. For a discussion of the SEC's special interventions to enforce the Securities Acts in reorganization proceedings, particularly Chapter XI proceedings, see text following note 148 infra.
121. As cogently observed by the bankruptcy judge in In re Synergistics, Inc., Civil No. 70-1251 (D. Mass. 1971) (unpublished order of Referee confirming a stock plan of arrangement), the bankruptcy court has a duty to make "sure it does not confirm a Plan that aids in foisting stock of highly doubtful value on an unsuspecting public, the members of which may believe that the order confirming the Plan gives a validity to the issued stock beyond its real worth."
122. 489 F.2d at 541-42. The court did not find "persuasive," an argument made by one commentator to the effect that:

[since] the alleged aider and abettor . . . will merely be engaging in customary business activities, such as loaning money, managing a corporation, preparing financial statements, distributing press releases, completing brokerage transactions, or giving legal advice, [a requirement that he] investigate the ultimate activities of the party whom he is assisting [may impose] a burden . . . upon business activities that is too great.

123. Note, Securities Regulation—Professional Responsibility—An Attorney May
that “the standard of culpability . . . appropriate for the author of an opinion letter in an action for injunctive relief only should not be construed to apply to more peripheral participants in an illicit scheme or, for that matter, to criminal prosecutions or private suits for damages.” 124 Despite the Spectrum court’s assurances, however, the liability of peripheral participants to civil actions for damages is a matter of genuine concern. 125 The implications of the Bar Chris analysis in pointing toward liability in securities offerings, not as a result of the statutory false registration and prospectus liability, but as a consequence of the rather amorphous Rule 10b-5 liability, appear to be becoming more pronounced; and those involved in bankruptcy securities offerings should take notice. 126

VI
SEC Enforcement Actions

When a bankruptcy court authorizes the continued operation of a debtor’s business by a trustee, receiver or debtor in possession, this authorization comes to the attention of the Securities and Exchange Commission. The provisions of the Bankruptcy Act and the Chapter Rules require that copies of every Chapter X petition 127 and every

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124. 489 F.2d at 542.
125. The Spectrum decision established guidelines on the duty of an attorney to serve two masters—his client and the investing public—only for registration exemption opinion letters. But it employs a mode of analysis which may have more general application in resolving future cases in an area which remains uncertain. Spectrum seems to suggest that the securities bar would be wise to pay heed to [SEC] Commissioner Sommer’s advice to develop a skeptical and independent attitude toward the representations of management and thus demonstrate a coguainze of its duties to the investing public.
127. Ch. X R. 10-104(a) (voluntary petition) and Ch. X R. 10-105(a) (creditors’ petition). The SEC would have “no prescribed duties” under the Proposed Act. Revision Commission’s Note to Proposed Act § 2-205, in REPORT: PART II, supra note 1, at 44. However, the SEC would be given written notice by the Administrator of the commencement of every Chapter VII case where the debtor is a corporation having 300 or more security holders. It would also receive such other notices as it might request in
corporate Chapter XI petition be transmitted by the clerk to the SEC. The Commission's review of a Chapter X petition indicates the nature of the debtor's business as well as its capital structure and financial condition; this permits an analysis and assessment of its size and the public nature of its debt and stock. Receipt of an order approving the petition then usually apprises the Commission of the identity of the responsible court-appointed officer who will be conducting the business operation. Similarly, the Commission's review of a Chapter XI petition shows any public investor interest in a corporate debtor and indicates whether it is a registered reporting company under Section 12 of the Securities Exchange Act of 1934. On the basis of this information, the Commission may become a party in interest in a Chapter X proceeding and may intervene and be heard in a Chapter XI case.

Businesses entering debtor relief proceedings may be generally classified into ordinary financial failures and those resulting from promotional abuses. Failures attributable to management promotional connection with a particular case or class of cases. Id. § 7-107(c), in REPORT: PART II, supra note 1, at 227.

128. Ch. XI R. 11-6 and 11-7.
130. Copies of orders approving petitions and appointing trustees or continuing a debtor in possession must also be transmitted to the SEC. Ch. X R. 10-210(d).
131. Chapter XI Rules 11-6, pertaining to original petitions, and Chapter XI Rule 11-7, pertaining to those filed in pending bankruptcy cases, require the petition to comply "substantially" with the official forms (Official Form, No. 11-F1 or 11-F2), which must include an Exhibit "A" showing specifically, inter alia, whether any of the debtor's securities are registered under Section 12 of the Securities Exchange Act of 1934 and, if so, the SEC file number and the approximate number of holders of debt and equity. The purpose of Exhibit "A" is to supply the Securities and Exchange Commission with the information it requires at the beginning stages of a Chapter XI case in order to enable it to determine whether it should intervene to enforce the securities laws or file a motion to seek a transfer to Chapter X pursuant to Chapter XI Rule 11-15.
132. Ch. X R. 10-210(c). The present Chapter X functions of the SEC, such as reporting on the plan, are to be performed by the Administrator under the Proposed Act. Revision Commission's Note to Proposed Act § 7-306, in REPORT: PART II, supra note 1, at 248-49.
133. Fed. R. Civ. P. 24(b); SEC v. United States Realty & Improvement Co., 310 U.S. 434, 458 (1940). Cf. SEC v. American Trailer Rentals Co., 379 U.S. 594, 613 (1964), which held that "under the statutory scheme, while not charged with express statutory rights and responsibilities as in Chapter X, the SEC is entitled to intervene and be heard in a Chapter XI proceeding." This right to intervene and be heard "should not be equated with the SEC's full power to investigate and report under Chapter X . . . ." Manufacturers' Credit Corp. v. SEC, 395 F.2d 833, 842 (3d Cir. 1968). The SEC has been permitted to intervene in a Chapter XI proceeding for the purpose of removing a debtor continued in possession and securing the appointment of a receiver. In re Investors' Equity, Inc., No. 74-464-C (S.D. Iowa May 28, 1975) (unpublished order of bankruptcy judge approving SEC intervention and appointing Chapter XI receiver pursuant to Chapter XI Rule 11-18(b)). See also In re People's Loan & Inv. Co., 410 F.2d 851, 854 (8th Cir. 1969); In re Scott, Gorman Mnicipals, Inc., No. 75-B-1538, (S.D.N.Y. September 9, 1975).
abuses often result in violations of the federal and state securities laws. They may involve the offer and sale of unregistered investment contracts or other securities in a nonmanufacturing business, or they may involve the unlawful issue and trading in securities in connection with the operation of a manufacturing business. Frequently, they will lead to an SEC investigation and enforcement action before or during the Chapter X or XI proceeding. Consequently an SEC enforcement action may be pending at the time a reorganization petition is filed, or a private SEC investigation may be in progress with a view to filing the enforcement action after the commencement of the debtor proceeding. In either event, the relation between the Bankruptcy Act and the securities laws must be considered.

A. The Bankruptcy Act and the Securities Laws

The SEC may sue to enforce Section 5 (registration provisions) and Section 17 (antifraud provisions) of the Securities Act of 1933 or Section 10b and Rule 10b-5 (antifraud provisions) of the Securities Exchange Act of 1934. Furthermore, an enforcement action may involve Section 14a and Rule 14a-9 (proxy compliance and antifraud provisions) and Section 13 (reporting provisions) of the Securities

134. See text accompanying note 25 supra.
135. An enforcement action suspends the source of cash flow enjoyed from public offerings of securities in violation of the securities laws, and this suspension often precipitates a Chapter petition. In In re Los Angeles Land & Inv., Ltd., 282 F. Supp. 448 (D. Hawaii 1968), aff’d per curiam, 447 F.2d 1366 (9th Cir. 1971), the Commission filed an action to enjoin sales of land sales contracts pursuant to which public purchasers were making installment payments to enable the company to service its mortgages on the property. When the SEC discovered that a stipulated permanent injunction permitting collections was being violated, it moved both to modify the injunction by terminating collections and to appoint a receiver. The debtor, in lieu of having a receiver appointed to protect the investors, agreed to file a voluntary petition under Chapter X. An SEC enforcement action, which had precipitated abortive bankruptcy proceedings, has also led to a private class action for damages. Diligent plaintiffs’ counsel recovered substantial sums for defrauded public investors who had purchased notes and mortgages, found to be securities, which were sold by a land development corporation. Hall v. Security Planning Service, Inc., 371 F. Supp. 7 (D. Ariz. 1974).

It would take a pretty smart operator to conceive of a scheme to unload unregistered shares upon the public without exposing himself and those participating with him, aiding and abetting or otherwise joining in the common effort, to the operation of the injunctive and other powers of the SEC and the federal courts.

(424 F.2d at 72.)
Exchange Act of 1934.\textsuperscript{137} When a Commission enforcement action is pending before or filed during a debtor proceeding, it must be considered in the light of the stay provisions of Chapters X and XI, which provide that a petition filed under either Chapter "shall operate as a stay of the commencement or the continuation of any court or other proceeding against the debtor . . . or to enforce any lien against its property. . . ."\textsuperscript{138} This is an \textit{automatic stay} effective as a result of the filing of the petition. The stay will continue until the Chapter proceeding is closed, dismissed or converted to straight bankruptcy.\textsuperscript{138} Relief from the effect of the stay requires the filing of a complaint with the bankruptcy court, where it is set for trial for the earliest possible date.\textsuperscript{140}

A question exists concerning whether these stay provisions apply to all suits in which the debtor is named a defendant, regardless of the nature of the action, since any lawsuit may affect the property of a debtor within the jurisdiction of the bankruptcy court.\textsuperscript{141} Generally, for the purposes of the Chapter proceedings, the bankruptcy court has

\begin{footnotesize}
\begin{enumerate}
\item<sup>137</sup> While the common SEC enforcement actions will involve the registration, antifraud and proxy provisions, actions enforcing the reporting requirements are also initiated by the Commission. For example, in SEC v. S & P Nat'l Corp., 360 F.2d 741 (2d Cir. 1966), the defendant was charged, \textit{inter alia}, with alleged violations of the reporting requirements of the Securities Exchange Act of 1934 and the rules and regulations thereunder. Previously, the Commission had obtained a mandatory injunction compelling S & P to file annual and semi-annual reports which were then up to two years overdue; upon the issuance of a contempt order directing compliance, the reports were filed. Likewise, in SEC v. Realty Equities Corp., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,545 (D.D.C. June 15, 1972), a mandatory injunction was issued requiring the filing of report Forms 10-K, 9-K and 10-Q with the Commission. The court stated that “[i]nvestors and the public are entitled to timely information or the statutory scheme will be frustrated, contrary to the public interest.” \textit{Id.} at ¶ 92,588. In SEC v. First Wisconsin Mortgage Trust, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,793 (D.D.C. Sept. 12, 1974), the court noted the volume of these cases filed before it and recommended legislation providing for “severe sanctions” and “mandatory penalties . . . without dispensation . . . .” \textit{Id.} at ¶ 96,632. See also SEC v. Atlas Tack Corp., 93 F. Supp. 111 (D. Mass. 1950).
\item<sup>138</sup> CH. XII R. 10-601(a); CH. XI R. 11-44(a) (emphasis added). The two rules may be considered basically identical so far as the present discussion is concerned. Section 4-501(a)(1) of the Proposed Act would spell out the stay under Proposed Chapter VII as follows:

\begin{quote}
A petition filed by or against a debtor under [Chapter VII] shall operate as a stay of (A) the commencement or continuation of any civil action by or against the debtor seeking recovery of money or affecting property of the estate, except an action authorized by Title 28, United States Code, section 959; (B) . . . and (C) any act to create or enforce any lien against the property of the estate.
\end{quote}

\item<sup>139</sup> CH. XII R. 10-601(b); CH. XI R. 11-44(b).
\item<sup>140</sup> CH. XII R. 10-601(c); CH. XI R. 11-44(d).
\item<sup>141</sup> The express language of the stay provision under the Proposed Act is more explicit in limiting the stay to civil actions affecting the property of the debtor than either the Chapter X or Chapter XI rules. Proposed Act § 4-501(a)(1), quoted in note 138 \textit{supra}.
\end{enumerate}
\end{footnotesize}
“exclusive jurisdiction over the debtor and its property wherever located,” and the stay rules are predicated on this grant of jurisdiction. Since the purpose of the Chapters is rehabilitation, staying actions affecting property seem to be the main thrust of the stay provisions.

Is the continuation or commencement of an SEC enforcement action against a debtor automatically stayed by the filing of a Chapter petition? As noted previously, many debtors, especially those filing Chapter XI petitions, frequently are involved in possible violations of the federal securities laws which precipitate the Chapter proceeding. In some cases, management may even attempt to frustrate an enforcement action by filing a Chapter proceeding. Cognizant of the existence of the automatic stay provisions, the Commission has pursued its duties by petitioning the bankruptcy court to clarify the scope of the stay as not precluding the Commission from commencing or continuing its enforcement action. The bankruptcy courts have generally been most cooper-


143. See Mid-Jersey Nat'l Bank v. Fidelity-Mortgage Investors, No. 74-1544 (3d Cir. June 6, 1975). The court held that upon the filing of a Chapter XI petition, Chapter XI Rule 11-44(a) did not operate to stay an appeal by the debtor from a nonbankruptcy judgment where the debtor posted a bank certificate of deposit in lieu of a supersedeas bond because the certificate was not property of the debtor within the scope of Chapter XI Rule 11-44(a). In construing the “sweeping language of Rule 11-44 to accord with the substantive provisions of Chapter XI,” primarily the exclusive jurisdiction provision of Section 311, the court said “... it is apparent that the automatic stay of Subsection (a) of Rule 11-44 extends only to proceedings which could divest the debtor of property over which the Chapter XI court has jurisdiction.” (emphasis added).

In In re Cavanagh Communities Corp., No. 75-B-243 (S.D.N.Y. May 6, 1975), a Chapter XI court entered an order enjoining the New York Stock Exchange from commencing or continuing any actions or proceedings to make an application to the Securities and Exchange Commission to delist stock and debentures of the debtor. On appeal to the district court, the SEC filed an amicus curiae brief which took the position that since the Securities Exchange Act of 1934 grants “exclusive jurisdiction over the exchange delisting process in the Commission, subject to judicial review of Commission orders by federal courts of appeals,” the bankruptcy judge was without jurisdiction to grant the injunctive relief which “in effect, attempted to enjoin the operation of the statutory [delisting] procedure...” Brief for SEC as Amicus Curiae at 2. The Exchange disputed the bankruptcy judge's holding that the stock exchange listing was “property” of the debtor and thus within the jurisdiction of the bankruptcy court. The SEC did not deal with this question since it took the position that “even assuming arguendo that [the exchange listing] is property, a bankruptcy judge's jurisdiction over stock exchange listings is preempted by the grant of exclusive jurisdiction in Section 12 of the Securities Exchange Act.” Id. at 2 n.1.

144. See text accompanying note 134 supra. A debtor may be the subject of a private SEC investigation or may be a defendant in an enforcement action filed against it. When the latter happens, usually a temporary restraining order will be sought, followed by a request for a preliminary injunction. Many times an equity receiver will be requested by the Commission as a form of ancillary relief in the public interest. When this happens, creditors begin to press and the cash flow becomes restricted.

145. In re Otis & Co., 104 F. Supp. 201 (N.D. Ohio 1952). When Otis filed a Chapter X petition, the SEC had pending a statutory enforcement action it had brought
ative in permitting the Commission to enforce the federal securities acts against the debtor in the public interest.\(^{146}\)

As noted, the bankruptcy court in debtor relief proceedings has "exclusive jurisdiction" over the debtor and its property for "purposes" of the reorganization or arrangement proceeding. On the other hand, the Securities Act of 1933 grants to the district courts of the United States jurisdiction over suits brought by the SEC "to enjoin" any "acts or practices which constitute or will constitute" a violation of that Act or any of its rules or regulations.\(^{147}\) Similarly, the Securities Exchange Act of 1934 provides that the SEC may exercise its discretion to bring an action in the proper district court of the United States "to enjoin" any acts or practices which "constitute or will constitute" a violation of this act.\(^{148}\)

against the debtor in the district court. Additionally, two administrative actions before the Commission were pending concerning the continuation of the debtor's business as a broker-dealer in securities. The Commission appeared specially in the bankruptcy court and moved for an order clarifying or, in the alternative, modifying a comprehensive stay order entered upon approval of the debtor's Chapter X petition, which, *inter alia*, stayed "all . . . persons . . . from commencing or continuing any action at law or suit or proceeding in equity against" the debtor or its property. *Id.* at 202. Recognizing that the "fundamental basis for temporarily staying an action or proceeding outside of the reorganization court is that it unduly hinders, delays, burdens, or is otherwise inconsistent with the pending corporate reorganization," the district court concluded that the two administrative actions affecting the business should be stayed "at this stage" since the trustee was inquiring into the feasibility of reorganization, but it saw "no harm to the estate if the prohibition upon further disposition of [the enforcement] suit is removed." *Id.* at 201, 203-04. The court had noted that the enforcement suit sought "to enjoin the debtor from entering into transactions in securities without disclosing to the other party its financial position, and from permitting any withdrawal of funds or securities by its officers, and . . . to permit agents of the Commission to make reasonable examinations of [the debtor's] records." *Id.* at 204. The district court's ruling was subsequently vacated on appeal "on the ground that the controversy is moot." No. 11596 (6th Cir. Feb. 2, 1953).

146. Generally, an SEC enforcement action will aid the bankruptcy court investigation; and although it is not specifically directed at the recovery of assets, it will be of assistance to a trustee or receiver in this regard. Enforcement actions do not interfere with the debtor's property, the protection of which was the specific purpose of the stay provisions. Whether the debtor should continue to issue a security should be investigated in any event.

147. The Commission may bring an enforcement action "in its discretion" and obtain, upon a "proper showing," a permanent or temporary injunction or restraining order. Securities Act of 1933 § 20(b), 15 U.S.C. § 77t(b) (1970). The district courts of the United States have jurisdiction, concurrent with state courts, over all "suits in equity and actions at law" brought to enforce any "liability or duty" under that Act. Securities Act of 1933 § 22(a), 15 U.S.C. § 77v(a) (1970).

B. Special Intervention

When an existing or threatened securities act violation occurs during and as a result of a Chapter proceeding, such as in connection with the solicitation of powers to act for security holders or the solicitation of consents to a plan or even a public offering of securities for cash, the Commission's duty to enforce the securities laws in the public interest must be recognized. In cases where this duty has arisen, the Commission has sought to intervene "specially" before the bankruptcy court handling the Chapter proceeding, as opposed to initiating a separate civil action in the district court. Intervention appears to be the correct procedure in this situation, and it is independent of the Commission's role in Chapter X⁴⁴⁹ or Chapter XI⁴⁵⁰ proceedings as a general party in interest to the merits of the proceeding and plan. The purpose and basis of the intervention in the two situations are separate and distinct.¹⁵¹


On the other hand, it may, and frequently does, appeal to the district court from orders of the bankruptcy judge. Ch. X R. 10-301 (incorporating Bankruptcy Rules 801-814 regarding appeals to the district court from orders or judgments of the bankruptcy judge). The prohibition on the right of the SEC to initiate an appeal from an order of the district court does not prevent the Commission from seeking mandamus. SEC v. Templar, 405 F.2d 126 (10th Cir. 1969); SEC v. Krentzman, 397 F.2d 55 (5th Cir. 1968). Nor does it prevent the Commission from participating as an appellee or respondent in appeals initiated by others. Caplin v. Marine Midland Trust Co., 406 U.S. 416, 419 n.8 (1972); In re Imperial "400" National, Inc., 432 F.2d 232, 234 (3d Cir. 1970); In re American National Trust, 426 F.2d 1059, 1066 (7th Cir. 1970); In re Commonwealth Financial Corp., 408 F.2d 640 (3d Cir. 1969), cert. denied, 395 U.S. 961 (1969). Ashbach v. Kirtley, 289 F.2d 159, 162 (8th Cir. 1961).

¹⁵⁰. The SEC has no official administrative role in Chapter XI proceedings as it does in Chapter X proceedings. However, it may file a motion to transfer the Chapter XI proceeding to Chapter X. Ch. XI R. 11-15. In SEC v. American Trailer Rentals Co., 379 U.S. 594 (1965), the Supreme Court addressed the SEC's contention that a Chapter X proceeding is required in all cases involving public investor creditors because "its right to intervene in a Chapter XI proceeding is limited solely to moving" the proceeding to Chapter X. Id. at 612. The Court rejected this argument and held that the Commission could intervene in Chapter XI although it was "not charged with express statutory rights and responsibilities as in Chapter X . . . ." Id. at 613. Unlike Chapter X, there is no restriction on the Commission's right to appeal in Chapter XI.

¹⁵¹. The SEC has recognized the distinction:

Attempts are sometimes made to misuse Chapter XI so as to deprive investors of the protection which the Securities Act of 1933 and the Securities Exchange Act of 1934 are designed to provide. In such cases the Commission's staff normally attempts to resolve the problem by informal negotiations. If this proves fruitless, the Commission intervenes in the Chapter XI proceeding to
Rule 24 of the Federal Rules of Civil Procedure permits intervention by a Government agency administering any statute relied on for a claim or defense.\(^\text{102}\) In *SEC v. United States Realty & Improvement Co.*,\(^\text{103}\) the Supreme Court declared that "[s]uch right as the Commission may have to intervene in a Chapter XI proceeding is . . . governed by the Rules of Civil Procedure and the general principles governing intervention."\(^\text{104}\) Additionally, in *SEC v. Bloomberg*,\(^\text{105}\) a Chapter X proceeding, although a Commission motion to intervene under Rule 24(b) was denied as untimely, the Court of Appeals for the First Circuit indicated that intervention was the correct procedure for the Commission to utilize in raising the securities compliance problem.\(^\text{106}\)

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develop an adequate record and to direct the court's attention to the applicable provisions of the Federal Securities laws and their bearing upon the particular case.

152. FED. R. CIV. P. 24(b).
153. 310 U.S. 434 (1940).
154. Id. at 438.
155. 299 F.2d 315 (1st Cir. 1962).
156. "We believe that in this case with the position of the Commission already firm and having brought the implications thereof to the attention of the court at the July 26 hearing, it was clearly in a position to seek—and in our view should have sought—intervention long before September 8." Id. at 320. One commentator states that "[a]s a matter of procedure, it is implicit in the *Bloomberg* opinion that an application to intervene was the proper method for the SEC to raise the issue of registration . . . ." 4 L. LOSS, SECURITIES REGULATION 2599 (2d ed. 1961, Supp. 1969).

In re Puts & Calls, Inc., in 40 SEC ANN. REP. 131 (C.D. Cal. 1961) is another case in point. The company's business of issuing naked options on unregulated commodities was deemed a security by a California court, which terminated the company's business. It then entered Chapter XI with approximately $600,000 in cash, few other assets, and over 4,000 public investor customers. A plan of arrangement was proposed which provided for a privately held commodity broker to acquire the debtor's assets in exchange for the issuance of the broker's unregistered stock to the customer and other claimants of the debtor. The SEC moved to "intervene specially to enforce the Federal securities laws" by developing a "record as to the adequacy of the disclosure of material facts and to assist the court in its task of scrutinizing securities which were to be issued pursuant to the arrangement" and to "thus prevent the distribution of stock of doubtful value to an unsuspecting public." Id. at 132. The bankruptcy court permitted intervention, and during the hearing the proposed arrangement was withdrawn. The debtor was subsequently adjudicated a bankrupt. In In re Traders Int'l, Ltd., [1973-74 Transfer Binder] CCH Ped. Sec. L. Rep. ¶ 94,529 (D. Nev. 1974), appeal dismissed as moot sub nom. Traders International, Ltd. v. Young, Civil No. 74-1724 (9th Cir. Nov. 6, 1975), the Commission was permitted to intervene specially in a Chapter XI proceeding to raise the registration requirement concerning the debtor's continued issuance, through the receiver, of naked options on unregulated commodities. The bankruptcy court had found these to be a "security" under the Securities Act of 1933 and to require registration under the circumstances. The business was ordered terminated, and a proposed arrangement was withdrawn. For an intervention enforcing the Securities Exchange Act of 1934 proxy requirements, see In re First Home Inv. Corp., 368 F. Supp. 597 (D. Kan. 1973).

Under the Proposed Act, the SEC "may appear and be heard in the bankruptcy court respecting any matter that arises in the administration of a case under Chapter VII." Proposed Act § 2-205(b), in REPORT: PART II, supra note 1, at 43. The Revision
Whether the Commission decides to intervene specially in a Chapter proceeding or move for permission to sue in a separate civil action in order to stop a breach of the securities laws arising as a result of the Chapter proceeding, seeking special intervention before the bankruptcy court having jurisdiction over the issuer and other parties is both sensible and practical. The major consideration is that the Commission have ultimate access to a forum to litigate and resolve debtor proceeding securities problems, including the right to appeal an adverse Securities Act ruling. Consequently, parties attempting to rehabilitate a debtor by the issuance of securities should always keep the Commission's enforcement interests in mind, for otherwise they may see carefully laid plans to issue securities through the bankruptcy proceeding contested by a Com-

Commission's Note to Section 2-205 states that "[t]o the extent participation is authorized by other legislation, this section does not limit the role of the Securities and Exchange Commission." Id. Thus, the SEC "in its regulatory role" would have the right to be heard under Proposed Chapter VII even though its role "has been altered" and it has "no prescribed duties" as it had under Chapter X. Id. at 43-44. This provision respecting the SEC is derived from Section 208 of Chapter X, including retention of the limitation on the Commission's right of appeal. Id.

157. It is an open question whether the Commission could be foreclosed from suing in a separate civil action in a United States district court, although seeking leave to commence such a suit may be prudent. In SEC v. Bloomberg, 299 F.2d 315 (1st Cir. 1962), the Commission sought to compel registration of stock to be issued by a reorganized corporation pursuant to a Chapter X trustees' plan which had been approved by the court and accepted by the creditors. The plan contained a provision which afforded the stockholders an opportunity to exchange their old shares for new shares plus cash; it also stated that the shares exchanged were exempt from registration under Section 264 of Chapter X. The trustees sought a determination that the debtor was insolvent. The Commission took the position that the exemption did not apply because giving up worthless stock was not an "exchange" within the language of Section 264a(2) of the Bankruptcy Act. The court's order approving the trustees' plan did not expressly find that the stock was exempt from registration, but a provision that the exchange was exempt remained in the plan as approved. The plan was accepted by creditors and "well received" by the stockholders, who sent exchange offers to an escrow agent. Thereafter, the Commission moved for leave to intervene in the reorganization proceeding to force the trustees to file a registration statement. After hearing, this motion was denied. The Commission then filed a complaint against the trustees and the president of the debtor seeking a preliminary injunction against violation of Section 5 of the Securities Act of 1933; the trustees moved to dismiss on the ground that the SEC had not obtained leave of the reorganization court to sue the trustees. "Without acknowledging that leave to sue is required," the SEC moved for leave to file its complaint nunc pro tunc, which was denied, and the motion to dismiss granted. The district court denied intervention on the grounds that registration would frustrate the plan and because the SEC intervention was untimely. The court denied the motion for leave to sue the trustees as a matter of discretion. On appeal of both orders by the SEC, the First Circuit disapproved the district court's determination that registration would frustrate the plan; but it affirmed the decision on the basis that the district court did not abuse its discretion in denying the motion to intervene as untimely under Rule 24 of the Federal Rules of Civil Procedure. With regard to the denial of the petition for leave to sue the trustees, it said: "The same considerations [of timeliness] are equally applicable to the motion for leave to sue, which was also addressed to the court's discretion." Id. at 320.
mission suit before the bankruptcy court or, if necessary, in a separate civil proceeding.¹⁵⁸

C. SEC Investigations

Under the Securities Acts, the SEC is authorized in the public interest to commence an investigation into any facts which may involve a violation or threatened violation of those Acts or any of their rules and regulations.¹⁵⁹ A Commission investigation is generally private, not public, and will usually include sworn testimony and the production of documents, books and records pursuant to administrative subpoena powers.¹⁰⁰ A Chapter X trustee and a Chapter XI creditors’ committee may also conduct an investigation of the debtor;¹⁶¹ and particularly in Chapter X, a trustee is directed by the court to “investigate the acts, conduct, liabilities and financial condition of the debtor, the operation of its business and the desirability” of continuing it, as well as any other matter relevant to the case or to the formulation of a plan.¹⁶² Moreover, a Chapter X trustee will usually file a report with the court concerning any facts discovered by his investigation pertaining to “fraud, misconduct, mismanagement and irregularities” as well as any causes of action

¹⁵⁸. The implications of the procedure followed may be important. A special SEC intervention in a Chapter proceeding to enforce the securities laws for possible violations arising out of the conduct of the reorganization or arrangement will usually not be a formal injunctive enforcement intervention in the same way, and with the same sanctions and implications, as a collateral civil suit for injunction. Generally, the SEC moves to intervene to point out to the court the applicable laws that must be followed and to request that the court not approve the plan or permit the conduct without such compliance. Generally, no permanent injunction is obtained, and no parties are named defendants as such. For an example of a separate civil action brought by the SEC to enjoin the distribution of securities issued pursuant to a Chapter XI plan, see SEC v. Granco Products, Inc., 236 F. Supp. 968 (S.D.N.Y. 1964).


¹⁶⁰. The court described the statutory SEC investigation in E. F. Hutton & Company v. Brown, 305 F. Supp. 371, 385 (S.D. Texas 1969), which was collateral to a Chapter X trustee’s § 167 investigation:

The formal SEC investigation into trading in Westec stock was commenced shortly after trading was suspended. Proceedings were conducted by an investigating officer of the SEC, who examined witnesses under oath. Pursuant to regulation, the hearings were nonpublic: only the witness, his attorney, and representatives of the Texas State Securities Board and the SEC were allowed in the hearing room. Witnesses called by the investigating officer included the former officers and directors of Westec and parties to business transactions involving transfers of Westec stock.


¹⁶². The committee may “examine into the conduct of the debtor’s affairs and the causes of his insolvency or inability to pay his debts as they mature.” Ctr. X. R. 10-208(a)(4); Ctr. XI R. 11-29(a).
available to the estate.\footnote{163}

Clearly, then, some overlap exists between an SEC investigation and a Chapter proceeding investigation. While the specific purpose of the two investigations is different—actual or threatened securities violations as opposed to discovery of assets and causes of action—the inquiries and information developed are not dissimilar.\footnote{164} Frequently the Commission's investigation may be helpful to a trustee in commencing his investigation.\footnote{165} Moreover, the SEC, as a party in interest to a Chapter X proceeding, may even assist the trustee in his investigation and participate in the Section 167 examination,\footnote{166} although this partic-

\footnote{163} CH. X R. 10-208(a)(5).


\ldots we agree that it is quite possible that the scope of the S.E.C. investigation may, to some extent, encompass the same subject matter as the Section 167 investigation conducted under the auspices of the trustees. Both statutes [Securities Acts and Bankruptcy Act] essentially contemplate to some extent, the devolution of fraudulent practices by persons in control and operation of the debtor corporation.

\footnote{165} The Commission's investigation may be helpful in that it discovers improper disclosures and omissions relating to the manner in which the company's business was financed through the offer and sale of securities. It also develops information regarding the nature and background of the business operation, the use and disposition of the proceeds received from the public sale of securities, and the related acquisitions or dispositions of business property. An SEC investigation, however, should not be considered as a substitute for the trustee's investigation. Moreover, while the former is conducted privately, the trustee's investigation is properly "public." United States v. Williams, 424 F.2d 344 (5th Cir. 1970).

\footnote{166} E. F. Hutton & Co. v. Brown, 305 F. Supp. 371, 384 (S.D. Texas 1969); \textit{In re Commonwealth Financial Corp.}, 408 F.2d 640 (3d Cir. 1969), \textit{cert. denied}, 395 U.S. 961 (1969). In the latter case, on petition by the trustee, the Chapter X court authorized the SEC, a party in interest under Section 208 of the Bankruptcy Act, to participate in the trustee's Section 167 examination of witnesses. When called, the debtor's president refused to testify because of the Commission's intention to examine him. The court held that Section 208 permitted the Commission, as a party in interest, to examine the witness; and it rejected his self-incrimination argument by stating:

\begin{quote}
It is suggested that information obtained by the Commission through its examination of the appellant might later be used against him in a related criminal proceeding. Of course the same danger would be inherent in examination by the trustees. However, in either event the witness is free to resist examination by asserting his privilege against self-incrimination. This the appellant has not done.
\end{quote}

408 F.2d at 642. \textit{See also} United States v. Williams, 424 F.2d 344 (5th Cir. 1970); SEC v. Templar, 405 F.2d 126 (10th Cir. 1969); SEC v. Krentzman, 397 F.2d 55 (5th Cir. 1968).

Under the Proposed Act, written notice of the commencement of a Chapter VII case would have to be given by the Administrator to the SEC when the debtor is a corporation having 300 or more security holders. The Revision Commission's Note to Section 7-107(c) states that such notice "will alert the [SEC] to the pendency of the case and enable [it] to participate in any investigation where violations of the federal securities law may have occurred and to make available to the trustee the information accumulated from any prior investigation by the [SEC]." \textit{REPORT: PART II, supra note 1,}
pation may be tempered as a result of the expanded immunity provisions granted the bankrupt by a 1970 amendment to Section 7a(10) of the Bankruptcy Act.\footnote{167}

The pertinent provision of Section 7a(10) provides that the “bankrupt” shall submit to an examination concerning his affairs but “no testimony, or any evidence which is directly or indirectly derived from such testimony, given by him shall be offered in evidence against him in any criminal proceeding. . .”\footnote{168} Thus, Section 7a(10) provides an automatic “use and derivative use” immunity which protects the defendants in a subsequent criminal proceeding against evidence derived from leads obtained as a result of the direct testimony in the bankruptcy proceeding given under Section 7.\footnote{169} Since an increasingly substantial number of Chapter proceedings are related to cases involving possible criminal violations of the federal Securities laws, SEC participation in future bankruptcy investigations may be more circumscribed because the Government must now affirmatively demonstrate at criminal proceedings that none of its evidence is tainted under Section 7a(10) from leads obtained through the defendant’s testimony.\footnote{171}


\footnote{168} Id. This language was added to Section 7a(10) by Title II of the Organized Crime Control Act of 1970, Pub. L. No. 91-452, § 207, 91st Cong., 2nd Sess. (1970).

\footnote{169} “Under the bankruptcy immunity the bankrupt receives an automatic grant for any testimony (and leads) given by him at a hearing which he was directed to attend. There is no prerequisite, to the conferring of immunity, that a claim be made by the witness that the answer will tend to incriminate and a refusal to answer on that basis.” Keeney and Serino, The Effect of the Organized Crime Control Act of 1970 in Bankruptcy Proceedings, 46 AM. BANKR. L.J. 1, 10 (Winter 1972).

Where the “bankrupt” is a corporation, Bankruptcy Act Section 7b, 11 U.S.C. § 25(b), places the duty to testify on, \textit{inter alia}, the debtor's “officers” or “members of its board of directors” or “such of them as may be designated by the court.” \textit{In re U.S. Hoffman Can Corp.}, 373 F.2d 622 (3d Cir. 1967). However, see United States v. Castellana, 349 F.2d 264, 274 (2d Cir. 1965), where the court stated: “... we believe that Section 7, sub. b cannot be read in a vacuum and must be considered in the light of Section 7, sub. a as conferring immunity only if the director or shareholder is specifically designated to perform the bankrupt's duties.”

\footnote{170} See, \textit{e.g.}, United States v. Williams, 424 F.2d 344 (5th Cir. 1970) (a prosecution of the former Chairman of the Board of Westec Corporation for, \textit{inter alia}, criminal violations of the federal securities laws); E. F. Hutton & Co. v. Brown, 305 F. Supp. 371, 384 (S.D. Texas 1969) (“As a direct result of the SEC investigation, a federal grand jury indicted eight persons for violations of the securities acts and regulations.”)

\footnote{171} In Kastigar v. United States, 406 U.S. 441, 443 (1972), the Supreme Court considered “whether testimony may be compelled by granting immunity from the use of compelled testimony and evidence derived therefrom (‘use and derivative use’ immunity), or whether it is necessary to grant immunity from prosecution for offenses to which
compelled testimony relates (‘transactional’ immunity).” Noting that the fifth amend-
ment privilege against self-incrimination “grants neither pardon nor amnesty,” the court
held that “use and derivative use” immunity is “co-extensive with the privilege and
suffices to supplant it” so that testimony may be compelled. However, the Supreme Court
pointed out the burden placed on the Government in a subsequent prosecution because of
the compelled testimony:

This burden of proof, which we reaffirm as appropriate, is not limited to a
negation of taint; rather, it imposes on the prosecution the affirmative duty to
prove that the evidence it proposes to use is derived from a legitimate source
wholly independent of the compelled testimony.

One raising a claim under this statute need only show that he testified under
a grant of immunity in order to shift to the government the heavy burden of
proving that all of the evidence it proposes to use was derived from legitimate
independent sources.

What Kastigar “teaches” was applied in United States v. Seiffert, 463 F.2d 1089
(5th Cir. 1972). In that case, Seiffert was the chairman of the board of a bank at the
time it failed and was liquidated by the Federal Deposit Insurance Corporation. The FBI
was concerned with possible related criminal violations. After the bank failed, Seiffert
filed voluntary petitions in bankruptcy for himself and three corporations. When he
testified as the bankrupt at the first meeting of creditors, representatives of the FDIC
were present. Seiffert was ultimately convicted for misappropriating funds of a federally-
insured bank. In seeking a reversal, he claimed “error in the Government’s alleged use of
his bankruptcy testimony in violation of 11 U.S.C.A. § 25(a)(10),” the bankruptcy
immunity provision as amended in 1970. Because it found “that a sufficient showing was
not made concerning the source of the Government’s evidence,” the Fifth Circuit
remanded with instructions that the district court “conduct an inquiry” and if the
Government’s evidence was not acquired through the “direct or indirect use” of the
bankrupt’s testimony, the conviction would stand; on the other hand, if “any of the
evidence is found to be tainted,” the conviction would be reversed. The Government had
attempted to affirmatively show that it did not use defendant’s bankruptcy testimony as a
lead to obtain its evidence by offering the testimony from the prosecutor, the FBI agent
who investigated the case, and the FDIC attorney that they did not do so. The court
rejected such “conclusory statements” as “simply not enough to carry the burden” laid
down in Kastigar, and it stated that “[t]he Government must show how it acquired all of
the evidence admitted below,” 463 F.2d at 1092.

Section 4-313 of the Proposed Act contains a revised immunity provision which
departs from Section 7a(10) of the present Act. REPORT: PART II, supra note 1, at 93-94.
If “any person” required to testify “properly invokes” his privilege against self-incrimina-
tion, he cannot be compelled to testify “unless an order is issued” granting immunity
pursuant to 18 U.S.C. §§ 6002, 6003 or 6004. The Revision Commission’s note states:

This section is derived from § 7a(10) of the present Act, but departs from
it in several particulars. It is not confined to the debtor, but applies to any-
one required to submit to examination or to testify before the administrator
or the court, or to provide information to the administrator or the court.
Instead of the automatic immunity conferred by § 7a(10), this section requires
that the privilege against self-incrimination be properly invoked, as contem-
plated by the pertinent immunity provisions of the Crime Control Act of 1970
for proceedings before courts or agencies of the United States.

94.

For cases dealing with the interplay between pending securities acts criminal
prosecutions and a Chapter X trustee’s civil action for damages, see United States v.
Simon, 373 F.2d 649 (2d Cir. 1967) (defendants unsuccessfully sought to enjoin trustee
from taking their depositions for use in a pending civil action for damages); United
to enjoin trustee from using certain files and documents in civil action for damages). The
CONCLUSION

Bankruptcy proceedings providing for debtor relief are markedly different in procedure and concept from straight bankruptcy liquidations. Most debtor corporations are also different. Debtors with widespread business operations, ongoing business prospects and a substantial number of creditors and stockholders are the entities for which these Chapters were designed to provide relief. The Chapter proceedings allow them a breathing spell within which to put their affairs in order.

The reorganization of Chapter X and Chapter XI debtors, however, often has a significant impact on the public. Accordingly, the federal securities laws may apply in addition to the Bankruptcy Act to regulate actions taken to rehabilitate the debtor. The interrelation of the corporate reorganization sections of the Bankruptcy Act and the applicable provisions of the federal securities acts is a unique aspect of debtor relief proceedings which can have a substantial bearing on the ultimate disposition of the proceeding. This was recognized by Congress not only when it provided for SEC participation in Chapter X proceedings but also when it gave the Commission the right to seek a transfer of a Chapter XI proceeding to Chapter X. Moreover, the SEC’s enforcement responsibility has been reinforced by bankruptcy courts allowing SEC intervention in Chapter proceedings to discharge its duties to the public.

Both securities attorneys and bankruptcy practitioners would do well to consider carefully the full effect of particular actions they may take in a reorganization proceeding. Prudent practitioners should not ignore the interaction between these federal acts; for when the public interest is at stake, neither the need for compliance with the securities acts nor the SEC’s role in debtor proceedings should be taken lightly.

court in Birrell stated that “[t]he present motion involves the reconciliation of important competing interests and policies: the right of a defendant in a criminal case to a fair and impartial trial vis-a-vis the right of the Chapter X trustee, representing many large and small creditors, to vindicate pecuniary and economic rights in an expeditious manner.” 276 F. Supp. at 810.