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Issuing Securities under the New Bankruptcy Code: More Magic for the Cryptic Kingdom Selected Articles on the Bankruptcy Reform Act of 1978.

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ISSUING SECURITIES UNDER THE NEW BANKRUPTCY CODE: MORE MAGIC FOR THE CRYPTIC KINGDOM

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Sorcerers from the dawn of the Hyborian Age,[1] in their quest to turn base metal into gold, should have taken lessons from the trustee in the *W. T. Grant* case.[2] He turned the activities of the secured creditor into a $30,000,000 bonanza for the benefit of unsecured creditors. Likewise, bankruptcy practitioners often resuscitate insolvent hulks through the alchemy of issuing pieces of paper and other forms of promises, often referred to as securities by the Securities and Exchange Commission. These practices provide hopeless creditors a potential for recovery, and, not incidentally, often afford equity owners and third-party funders the opportunity for profit. Since the opportunity for benefits usually requires the assumption of risk, issuing securities in bankruptcy proceedings can be accompanied by liability. Although certain commentators have indicated a desire to wish the problem away,[3] other commentators[4] and the New Bankruptcy Code[5] recognized the need for adequate disclosure in connection with the issuance of securities in rehabilitation proceedings. The New Code codifies what is essentially good existing practice and substantially liberalizes the ability of recipients of securities in rehabilitation proceedings to resell these securities.

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1. *See Conan the Barbarian,* by Robert E. Howard (syndicated cartoon series).

2. *See generally* Morgan Guar. Trust Co. v. Rodman, 4 BANKR. CT. DEC. 597 (S.D.N.Y. 1978).

3. MacDonald, *Service by Banks on Creditors' Committees, Banks and Bankruptcy: Strategies for Dealing with Troubled Situations,* 275 CORP. L. PRAC. TRANS. SER. 595, 608-09 (PLI 1978).

4. *See generally* Corotto, *SEC Reporting, Proxy and Antifraud Compliance — An Additional Perspective On Bankruptcy Reorganization Proceedings,* 63 CALIF. L. REV. 1563 (1975) [hereinafter cited as Corotto, *SEC Reporting*]; Phelan, *The Issuance of Securities in Bankruptcy Proceedings: The Magic World Meets the Cryptic Kingdom,* 51 AM. BANKR. L.J. 99 (1977).

5. The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (to be codified in 11, 28 U.S.C., and scattered other titles). With few exceptions, this Act becomes effective on October 1, 1979. "New Bankruptcy Code," "New Code," or simply "Code" will be used interchangeably in textual references to the Bankruptcy Reform Act of 1978.

"WHAT'S A 10-Q?"

The New Code does not alter the continuing disclosure requirements of a publicly-held debtor. As was true under the Bankruptcy Act,[6] the publicly-held debtor in a Chapter 11 proceeding under the New Code must evaluate the continuing reporting requirements of the Securities and Exchange Commission (SEC).[7] The SEC position has been that the reporting obligations pursuant to sections 13 or 15(d) of the Securities Exchange Act of 1934 (1934 Act) are not suspended by the institution of rehabilitation proceedings.[8] A change in this position is not likely. The trustee, or debtor in possession, will step into the shoes of the debtor and become responsible for continuing SEC compliance.[9] Although sections 1106 and 704(6) of the New Code seem to indicate that the principal responsibility for complying with the continuing reporting requirements of the SEC belongs to the trustee, it would be advisable for the trustee and the debtor to coordinate with debtor's counsel to ensure accurate preparation of reports required by SEC regulations. Often, securities counsel for the debtor, as the person most familiar with the previous filings and current status of the debtor, will continue to prepare the required reports. In other circumstances, particularly in instances involving significant allegations of wrongdoing by man-

6. *See* Bankruptcy Act §§ 264, 393 (repealed 1978, previously codified as 11 U.S.C. §§ 664, 793) (these sections related to Chapters X, XI, and XII respectively). *See generally* Corotto, *SEC Reporting, supra* note 4; Phelan, *The Issuance of Securities in Bankruptcy Proceedings: The Magic World Meets the Cryptic Kingdom*, 51 AM. BANKR. L.J. 99 (1977).

The Bankruptcy Reform Act of 1978 repeals the Bankruptcy Act of 1898, *as amended by* the Chandler Act of 1938. *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, sec. 401-411, 92 Stat. 2682-88. In the text of this article, the terms "Act," "Former Act," "Repealed Act," and "Bankruptcy Act" will be used interchangeably in references to the Bankruptcy Act of 1898 *as amended by* the Chandler Act of 1938. In footnotes the Bankruptcy Act will be cited in the following form: Bankruptcy Act § ___ (repealed 1978, previously codified as 11 U.S.C. § ___).

7. *See* 11 U.S.C.A. § 1145 (West Supp. 1979). *See generally* Corotto, *SEC Reporting, supra* note 4; Phelan, *The Issuance of Securities in Bankruptcy Proceedings: The Magic World Meets the Cryptic Kingdom*, 51 AM. BANKR. L.J. 99 (1977). The New Code has combined Chapters VIII, X, XI and XII of the Bankruptcy Act into a single rehabilitation section, Chapter 11.

8. Wexler, *Redistribution*, in THE SEC SPEAKS AGAIN, 20 CORP. L. PRAC. TRANS. SER. 209, 212 (PLI 1973).

9. *See* Corotto, *SEC Reporting, supra* note 4 at 1567; Phelan, *The Issuance of Securities in Bankruptcy Proceedings: The Magic World Meets the Cryptic Kingdom*, 51 AM. BANKR. L.J. 99, 99-100 (1977). While reporting provisions may be relaxed for trustees operating a corporation in bankruptcy, "as soon as the conditions merit, the full requirements of the reporting procedure will apply." Securities Exchange Act Release No. 9660 [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,872.

agement or counsel for the company, it may be necessary for the trustee to retain new securities counsel.

Formal compliance with SEC requirements often results in inordinate expense to the debtor in a rehabilitation proceeding. Consequently, when strict compliance with detailed SEC reporting requirements becomes impractical, the SEC may modify such requirements, if the modifications are consistent with the public protection purposes of federal securities laws.[10] For example, the SEC may suspend the requirement of audited financials normally required in certain types of SEC reports and, in some instances, will accept as satisfactory the reports given by the trustee or debtor in possession to the Bankruptcy Court.[11] It is advisable to discuss these matters with the SEC and ascertain their requirements in connection with the rehabilitation proceeding.[12]

Debtors involved in rehabilitation proceedings may also be required to comply with certain proxy requirements of section 14 of the 1934 Act[13] since section 1145 of the New Code only negates the applicability of section 5 of the Securities Act of 1933 (1933 Act).[14] If the debtor has equity securities registered under section 12 of the 1934 Act, the proxy rules promulgated by the SEC may apply to the solicitation of acceptances of a plan of reorganization. Rule 14a-2(e) of the proxy rules states that a solicitation under Chapter X of the Bankruptcy Act need not comply with SEC proxy requirements because of inherent safeguards in Chapter X which provide essentially the same protection as the SEC proxy requirements.[15] A Chapter XI solicitation under the Bankruptcy Act, however, is not exempted from the proxy rules.[16]

Section 1125 of the New Code, governing postpetition disclosure and solicitation, provides that the question of adequate disclosure is to be determined by the Bankruptcy Court rather than by section 14 of the 1934 Act and the rules and regulations promulgated there-

10. *See* Securities Exchange Act Release No. 9660 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,872.

11. *See id.*

12. *See id.;* Corotto, *SEC Reporting, supra* note 4, at 1576.

13. *See* Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78n (1976).

14. *See* 11 U.S.C.A. § 1145 (West Supp. 1979).

15. *See* SEC Rule 14a-2(e), 17 C.F.R. § 240.14a-2(e) (1978). *But see In re* First Home Inv. Corp., 368 F. Supp. 597, 602 (D. Kan. 1973) (solicitation by creditors' committee in Chapter X proceeding held within the purview of Section 14 of Securities Exchange Act of 1934).

16. *See* Corotto, *SEC Reporting, supra* note 4, at 1582.

under.[17] This negates much of the practical impact of the proxy requirements.[18] Section 1125(b) of the New Code provides that no postpetition acceptance or rejection of a plan may be solicited from a holder of a claim or interest of the relevant class unless, "at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information . . . ."[19] The New Code recognizes, however, that the information needed for an informed judgment about the plan may differ among classes of holders of claims or interests,[20] permitting, for example, the omission of information that would not be relevant to or affect a class whose rights under the plan center on a particular fund or asset.

Subsection (d) of section 1125 excepts disclosure statements from compliance with the requirements of both federal and state securities laws including section 14 of the 1934 Act and section 5 of the 1933 Act.[21] Section 1125(e) of the Code provides a safe harbor for persons who solicit acceptances of a plan of reorganization in good faith and in compliance with the applicable Code provisions.[22] Section 1125(e) is intended to protect such good faith solicitors from any applicable law, rule, or regulation governing the offer, issuance, sale, or purchase of securities.[23]

It can also be argued that the proxy requirements apply to solici-

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17. Section 1125(d) provides in pertinent part: "Whether a disclosure statement contains adequate information is not governed by an otherwise applicable nonbankruptcy law, rule, or regulation . . . ." 11 U.S.C.A. § 1125(d) (West Supp. 1979).

18. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 409, *reprinted in* [1978] U. S. CODE CONG. & AD. NEWS 5963, 6365.

19. 11 U.S.C.A. § 1125(b) (West Supp. 1979). The full text of section 1125 is set forth at note 133 *infra*. Under the Code, "after notice and a hearing" —

> (A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but
>
> (B) authorizes an act without an actual hearing if such notice is given properly and if—
>
> (i) such a hearing is not requested timely by a party in interest; or
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> (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act . . . .

11 U.S.C.A. § 102(1) (West Supp. 1979). Thus, notice and a hearing may not actually be required.

20. *See id.* § 1125(c).

21. *See id.* § 1125(d).

22. *See id.* § 1125(e).

23. H.R. REP. No. 595, 95th Cong., 1st Sess. 408, *reprinted in* [1978] U. S. CODE CONG. & AD. NEWS 5963, 6364. See notes 144 through 179 and accompanying text *infra* for a discussion of the application of section 1125 in a reorganization proceeding.

tation by a creditors' committee for proxies from the creditors in connection with voting on any matter in the proceeding.[24] When the particular creditors or stockholders to be represented by the committee are holders of securities registered pursuant to section 12 of the 1934 Act,[25] compliance with the proxy provisions may be required in order to secure authorization to act on behalf of those creditors or stockholders.[26] Proxy solicitations in chapter proceedings are currently governed by Bankruptcy Rules 208(b) and 10-211.[27] Until rules are promulgated covering proxy solicitation procedures under the New Code, the old Bankruptcy Rules will continue to apply, to the extent not inconsistent with the New Code.[28] In the event a committee of creditors is attempting to solicit the right to act in a particular fashion from a group holding securities registered under section 12 of the 1934 Act, compliance with the proxy rules will apparently still be required. Since many safeguards attendant to former Chapter X of the Bankruptcy Act have been incorporated into Chapter 11 of the New Code,[29] it appears that an amendment to rule 14a-2(e) exempting solicitations pursuant to Chapter 11 of the Code from SEC proxy requirements would effectuate the purpose of section 1125(d).[30]

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24. In an unreported case, the creditors' committee in a Chapter XI proceeding solicited conditional acceptances from the creditors to authorize a plan of arrangement by the creditors' committee if certain conditions were met by the debtor on the date of the acceptance hearing. *See In Re* American Grain & Cattle, Inc., No. BK 5-75-14F (N.D. Tex. Nov. 25, 1975). In that case the creditors were equity security holders because the nature of their creditor interest arose from their participation in an agricultural cooperative. *See id.* However, the securities were not registered under section 12 of the 1934 Act and, consequently, the proxy rules were inapplicable. *See id.* If the securities had been registered under the 1934 Act, compliance with the proxy rules would have been required. *Cf. In re* First Home Inv. Corp., 368 F. Supp. 597, 602 (D. Kan. 1973) (held similar solicitation by creditors' committee in Chapter X proceeding constituted a proxy within purview of section 14 of Securities Exchange Act of 1934).

25. Securities Exchange Act of 1934 § 12, 15 U.S.C. § 782 (1976).

26. *See* Corotto, *SEC Reporting, supra* note 4, at 1583-84. *See generally* BANKR. PROC. R. 208 & 10-211.

27. *See* BANKR. PROC. R. 208 & 10-211.

28. *See* Bankruptcy Reform Act, Pub. L. No. 95-598, sec. 247, 92 Stat. 2672 (1978) (amending 28 U.S.C. § 2075 (1976)). The New Code amends 28 U.S.C. § 2075 by deleting its reference to the Bankruptcy Act and removing the final sentence that previously provided: "All laws in conflict with such rules shall be of no further force or effect after such rules have taken effect." *See id.*

29. *See* 11 U.S.C.A. §§ 1125, 1129, 1145 (West Supp. 1979).

30. *Compare id.* § 1125(d) *with* SEC Solicitation of Proxies, Rule 14a-2(e), 17 C.F.R. § 240.14a-2(e) (1978). The house report states "The bill also permits the disclosure statement to be approved without the necessity for compliance with the very strict rules of § 5 of the

"THAT ORANGE GROVE DON'T LOOK LIKE NO SECURITY I EVER SAW"

Under the Bankruptcy Act, the determination of what constitutes a security is governed by section 2(1) of the 1933 Act, which states:

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[31]

Section 2(1) is an all-encompassing definition and includes not only stocks and bonds but also promissory notes and investment contracts. The catch-all phrase "investment contract" may include any interest in which the possibility of monetary gain is dependent upon the efforts of others. For example, a loan participation agreement[32] and the guarantee by a parent corporation of the debt obligation of its subsidiary[33] have been held securities. Another example of a security is the offer of undivided interests in real estate activities.

The case most often cited involving non-obvious securities is *SEC v. W. J. Howey Co.*,[34] in which the defendant offered units of a Florida citrus grove development coupled with a contract for cultivating, marketing, and remitting the net proceeds to the investors. Prospective customers were offered both land sales contracts with the defendant and service contracts with a service company under the control of the defendant.[35] The service contract gave the service

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Securities Act of 1933, § 14 of the Securities Exchange Act of 1934 or relevant State securities laws." H.R. REP. No. 595, 95th Cong. 1st Sess. 227-28, *reprinted in* [1978] U. S. CODE CONG. & AD. NEWS 5963, 6187.

31. Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1976). It should be noted that liability under the 1934 Act, and particularly Rule 10b-5 thereunder, is predicated upon a finding that a "security," as defined in section 3(a)(10) of the 1934 Act, was the subject of a purchase and sale. The definitions are, however, virtually identical except for the short-term note exclusion in the 1934 Act. *See* McClure v. First Nat'l Bank, 497 F.2d 490, 495 (5th Cir. 1974); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1116 (5th Cir. 1974); Lipton & Katz, *"Notes" Are (Are Not?) Always Securities — A Review*, 29 BUS. LAW. 861, 863-64 (1974).

32. *See* Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 992 (5th Cir. 1969).

33. *See* The Rouse Co., [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,073.

34. 328 U.S. 293 (1946).

35. *Id.* at 295.

company a leasehold interest and full and complete possession of the acreage as well as full authority concerning cultivation, harvesting, and marketing of the crop.[36] In holding that the arrangements were "investment contracts" within the meaning of section 2(1) of the 1933 Act, the Court emphasized: (i) the expectation of a profit could be derived solely from the efforts of the promoters; (ii) the element of a common enterprise; (iii) the lack of economic feasibility of individual development by the purchaser; (iv) the lack of the purchaser's skill or equipment; and (v) the defendant's retention of possession.[37] The Court looked through the form to the substance of the investment to determine that what was actually sold were interests in the issuer's development activities, not interests in the land itself.[38]

The test derived from *Howey* is whether the scheme involves the investment of money in a common enterprise with profits to come solely from the efforts of others.[39] Courts have interpreted the *Howey* requirement, that profits not come solely from the efforts of others, to mean the investors must contribute substantially to the nature of the common enterprise.[40] If the success of the enterprise is principally dependent upon the activities of the investor, the arrangement probably will not be an investment contract,[41] but if the prospect of profit comes principally from the activities of the promoter, the arrangement will generally be held to be a security.[42] Such diverse arrangements as whiskey warehouse receipts,[43] pyramid sales plans,[44] condominium sales promotions,[45] cooperative housing corporations,[46] memberships in agricultural cooperatives,[47] member-

36. *Id.* at 296.

37. *See id.* at 299-300.

38. *See id.* at 300.

39. *Id.* at 301. If the *Howey* test is satisfied it is not material whether the anticipated investment return is speculative or non-speculative. *See id.* at 301.

40. *See* SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973).

41. *See* Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666, 670-71 (10th Cir. 1972).

42. *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 484-86 (5th Cir. 1974).

43. *See* Glen-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027, 1034 (2d Cir. 1974); Exchange Act Release No. 5018, [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,757.

44. *See* Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262, 1267 (N.D. Ill. 1973).

45. *See* Securities Release No. 5382, [1973 Transfer Binder] FED SEC. L. REP. (CCH) ¶ 79,309; SEC Securities Act Release No. 5347, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,163.

46. *See* 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171, 1175 (S.D.N.Y. 1973).

47. *See* United States v. Davis, 40 F. Supp. 246, 246 (N.D. Ill. 1941).

ships in organizations,[48] commodity futures contracts,[49] and rare coin contracts have been held to be securities.[50] Certain real estate syndications and oil drilling ventures are normally securities. An identifiable writing is not necessary for an investment arrangement to constitute a security; an oral contract will suffice.[51]

The latest consideration of the matter by the Supreme Court was in *United Housing Foundation, Inc. v. Forman*,[52] in which the Court considered the question of whether stock in a cooperative housing association was a "security" for purposes of imposing liability for its sale under the fraud provisions of the 1933 Act and 1934 Act. The Court disregarded form for substance and focused on the economic realities of the transaction. The contention that the shares of "stock," which were actually membership certificates in a cooperative housing association, were "securities" within the statutory definition that includes the words "any . . . stock," was rejected.[53] The shares of "stock" in question possessed none of the characteristics traditionally associated with stock: (1) they conferred no right to receive dividends contingent upon an apportionment of profits; (2) they were not negotiable; (3) they could not be pledged or hypothecated; (4) they conferred no voting rights in proportion to the number of shares owned; and (5) they could not appreciate in value.[54] The Court next implemented the *Howey* test, analyzing the shares of "stock" to determine if they were "investment contracts," and held that no "profits" could be expected from the investment in a cooperative housing project.[55] What distinguishes a securities transaction—and what was absent in the *United Housing* case—was an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a

48. *See In re* Jetset Travel Club, 3 BLUE SKY L. REP. (CCH) ¶ 71,175 at 67,654 (1974); Silver Hills Country Club v. Sobieski, 13 Cal. Rptr. 186, 189, 361 P.2d 906, 909 (1961).

49. *See* Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 709 (D. Minn. 1968).

50. *See* SEC v. Brigadoon Scotch Distribs., Ltd., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,980 (S.D.N.Y. 1975).

51. *See* Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 708 (D. Minn. 1968); SEC v. Addison, 194 F. Supp. 709, 722 (N.D. Tex. 1961). The SEC, however, has largely ignored payout arrangements to trade creditors of a financially distressed debtor when no writing exists to evidence such debt. *See* MacDonald, *Service by Banks on Creditors' Committees, Banks and Bankruptcy: Strategies for Dealing with Troubled Situations*, 275 CORP. L. PRAC. TRANS. SER. 595, 608-09 (PLI 1978).

52. 421 U.S. 837 (1975).

53. *See id.* at 848.

54. *See id.* at 851.

55. *See id.* at 852-53.

commodity for personal consumption or living quarters for personal use.[56]

It has been contended that a certificate of participation in a creditors' trust, being a certificate of interest or participation in a profit-sharing agreement, is a security.[57] In addition, a promissory note will often constitute a security. The Fifth Circuit, however, in two decisions has disregarded the express language of the 1933 Act and held that promissory notes were not securities when issued in connection with commercial loans rather than as an investment.[58] In one of these cases, the promissory note was issued to the bank and secured by a deed of trust on real property. The court held that the note was not a security since it was issued in the course of a purely commercial loan transaction and determined that the fact that it matured more than nine months from its date of issuance was not controlling, notwithstanding the language of section 3(a)(3) of the 1933 Act.[59] In a normal rehabilitation proceeding under the Bankruptcy Act, promissory notes, when offered to investor-type creditors, rather than commercial institutions such as banks, probably constitute securities. The broad scope of the definition of "security" in the 1933 Act includes almost anything other than cash normally given to a creditor in a rehabilitation proceeding.[60]

The New Code contains its own definition of what constitutes a security.[61] Although the Code definition of "security" is modeled on

56. *Id.* at 858. The Court, however, expressed no view on whether the word "solely" should be read as a strict or literal limitation in the definition of an investment contract, or whether the word should be construed realistically to include within the definition those schemes involving securities in substance, if not form. *See id.* at 852 n.16. The circuits are presently split on the question. *See id.* at 857 n.24.

57. *See* Phelan, *The Issuance of Securities in Bankruptcy Proceedings: The Magic World Meets the Cryptic Kingdom*, 51 AM. BANKR. L.J. 99, 103 (1977).

58. *See* McClure v. First Nat'l Bank, 497 F.2d 490, 495 (5th Cir. 1974); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1116 (5th Cir. 1974); Lipton and Katz, *"Notes" Are (Are Not?) Always Securities — A Review*, 29 BUS. LAW. 861, 863-64 (1974).

59. *See* Securities Act of 1933 § 3(a)(3), 15 U.S.C. § 77c(a)(3) (1976).

60. *See* Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1976).

61. Section 101(35) of the New Code defines the term "security" as follows:

(35) "security" —

(A) includes—

(i) note;

(ii) stock;

(iii) treasury stock;

(iv) bond;

(v) debenture;

the most recent draft of the American Law Institute's (ALI) Proposed Federal Securities Code,[62] the definition in the New Code

(vi) collateral trust certificate;
(vii) pre-organization certificate or subscription;
(viii) transferable share;
(ix) voting-trust certificate;
(x) certificate of deposit;
(xi) certificate of deposit for security;
(xii) investment contract or certificate of interest or participation in a profit-sharing agreement or in an oil, gas, or mineral royalty or lease, if such contract or interest is the subject of a registration statement filed with the Securities and Exchange Commission under the provisions of the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), or is exempt under section 3(b) of such Act (15 U.S.C. 77c(b)) from the requirement to file such a statement;
(xiii) interest of a limited partner in a limited partnership;
(xiv) other claim or interest commonly known as "security"; and
(xv) certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase or sell, a security; but

(B) does not include—
(i) currency, check, draft, bill of exchange, or blank letter of credit;
(ii) leverage transaction, as defined in section 761(13) of this title;
(iii) commodity futures contract or forward commodity contract;
(iv) option, warrant, or right to subscribe to or purchase or sell a commodity futures contract;
(v) option to purchase or sell a commodity;
(vi) contract or certificate specified in clause (xii) of subparagraph (A) of this paragraph that is not the subject of such a registration statement filed with the Securities and Exchange Commission and is not exempt under section 3(b) of the Securities Act of 1933 (15 U.S.C. 77c(b)) from the requirement to file such a statement; or
(vii) debt or evidence of indebtedness for goods sold and delivered or services rendered;

11 U.S.C.A. § 101(35) (West Supp. 1979).

62. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 313-14, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6270-71. The American Law Institute's Proposed Federal Securities Code defines "security" as follows:

Sec. 299.53. [*Security.*] (a) [*General.*] "Security" means a bond, debenture, note, evidence of indebtedness, share in a company (whether or not transferable or denominated "stock"), preorganization certificate or subscription, investment contract, certificate of interest or participation in a profit-sharing agreement, collateral trust certificate, equipment trust certificate (including a conditional sale contract or similar interest or instrument serving the same purpose), voting trust certificate, certificate of deposit for a security, or fractional undivided interest in oil, gas, or other mineral rights, or, in general, an interest or instrument commonly considered to be a "security" or a certificate or interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or buy or sell, any of the foregoing.

(b) [*Exclusions.*] Notwithstanding section 299.53(a), "security" does not include (1) currency, (2) a check (whether or not certified), draft, bill of exchange, or bank letter of credit, (3) a note or evidence of indebtedness issued in primarily mercontains significant differences from that of the ALI Proposed Securities Code. The New Code includes in its definition of security a certificate of deposit while the ALI Proposed Securities Code excludes bank certificates of deposit that "rank on a parity with an interest in a deposit account with the bank."[63] In addition, the interest of a limited partner in a limited partnership is specifically designated as a security under the New Code but is presumably included within the more general definitions of the Proposed Securities Code.[64]

The most significant distinction between the New Bankruptcy Code and the ALI Proposed Securities Code, however, is the treatment of the term "investment contract." Under the 1933 Act and 1934 Act, the term "investment contract" has been held to encompass a variety of investment arrangements.[65] The ALI Proposed Securities Code retains the phrase "investment contract" in its definition of a security, while the New Code limits its definition of security to those investment contracts and certificates of interest or participations in profit-sharing agreements that are the subject of a registration statement filed with the SEC under the provisions of the 1933 Act or exempt under section 3(b) of the 1933 Act.[66] In

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> cantile or consumer, rather than investment, transaction not involving a distribution (see also sections 226 and 302(k)), (4) an interest in a deposit account with a bank (but not a participation in such interests), (5) (except for purposes of parts XII and XIV) a bank certificate of deposit that ranks on a parity with an interest in a deposit account with a bank, (6) an insurance policy (including an endowment policy) issued by an insurance company, (7) an annuity contract (including an optional annuity contract) under which an insurance company promises to pay one or more sums of money that are fixed or vary in accordance with a cost-of-living index or on any other basis specified by rule, (8) a commodity contract (whether for present or future delivery) or warrant or right to buy or sell such a contract, or (9) the interest of a mini-account client in a mini-account under advisement if section 914(c) is effective.

ALI Proposed Fed. Sec. Code § 299.53 (July 15, 1978).

63. ALI Proposed Fed. Sec. Code § 299.53(b)(5) (July 15, 1978).

64. *See id.* § 299.53.

65. See notes 32 through 56 *supra* for an examination of judicial construction of the term "investment contracts."

66. Section 3(b) of the 1933 Act exempts small offerings and states as follows:

> (b) The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $500,000.

Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1976).

addition, section 101(35)(B)(vi) of the New Code specifically excludes, from the definition of a security, investment contracts and certificates of interest or participations in profit-sharing agreements that are not the subject of a registration statement filed under the 1933 Act. Unless the New Code's use of the term "investment contract" is read to include all investment arrangements which *should be* the subject of a registration statement under the 1933 Act, the Code definition of security will be significantly less than complete, since, read literally, it would not include the type of arrangement held to be a security in the *Howey* case.[67] A proposed amendment to the New Code to correct this ambiguity is currently pending in Congress.

Another interesting difference between the ALI Proposed Securities Code and the New Bankruptcy Code is the inclusion in the ALI Proposed Securities Code of, "in general, an interest or instrument commonly considered to be a 'security.'" The New Bankruptcy Code contains a similar definition which states "other claim or interest commonly known as 'security.'" Presumably, the definition in the New Bankruptcy Code should be read as "other claim or interest commonly known as *a* security." The elimination of the article "a" from the New Bankruptcy Code was apparently inadvertent. Consequently, any restriction in the New Bankruptcy Code upon the term "investment contract" may be negated by the inclusion in the Code definition of security of other claims or interests commonly known as securities.[68]

Another divergence between the ALI Proposed Securities Code and the New Bankruptcy Code arises from their respective treatments of promissory notes. In the Proposed Securities Code, a note is included in the definition of "security." Specifically excluded from such definition, however, is a note or evidence of indebtedness issued in primarily mercantile or consumer, rather than investment, transactions not involving a distribution. The New Bankruptcy Code includes a promissory note in its definition of security, but specifically excludes a debt or evidence of indebtedness for goods sold and delivered or services rendered. Arguably, a promissory note issued for services rendered in connection with an invest-

67. *Compare* SEC v. W. J. Howey Co., 328 U.S. 293, 299-301 (1946) *with* 11 U.S.C.A. § 101(35)(B)(vi) (West Supp. 1979).

68. An interest which constitutes an investment contract under the ALI Proposed Securities Code may also be commonly known as "security" for purposes of the New Bankruptcy Code.

ment transaction would be excluded from the definition of securities under the New Bankruptcy Code.[69]

It is interesting to contemplate whether a promissory note, investment contract, certificate of interest or participation in a profit-sharing agreement that does not constitute a security pursuant to the New Bankruptcy Code, but is determined to be a security pursuant to securities laws, is exempt from registration pursuant to Code section 1145 since the New Code only exempts those "securities" defined therein. It is also uncertain whether the safe harbor provision of section 1125(e) of the New Code will apply to such transactions. Consequently, a certificate of participation in a creditors' trust under the New Code, if held to be a security under the securities laws because it is a certificate of interest or participation in a profit-sharing agreement, may not be exempted from registration or protected by the New Code from the antifraud provisions of the 1933 and 1934 Acts.[70]

"But These Warrants for Subordinated Debentures Convertible into Non-voting Class 'B' Stock Are as Good as Gold."

Once the debtor has complied with the securities laws' requirements concerning its continued operation during a rehabilitation proceeding, it must formulate a plan of rehabilitation. The SEC, under the Bankruptcy Act, performs a statutory function participating fully in a Chapter X proceeding and may, under appropriate circumstances, participate in other Chapter proceedings. Courts normally attach great significance to SEC opinions and objections in Chapter proceedings. Of the entire panoply of securities that could conceivably be issued, certain types are generally regarded by the SEC as being inappropriate for issuance in a bankruptcy rehabilitation.

One of these disfavored securities is a subordinated note or debenture, since the SEC views subordination of future claims as being inconsistent with the apparent nature of a debt obligation.[71] Even

69. For example, one party to an entrepreneurial endeavor could contribute services in exchange for several promissory notes that the holder intends to redistribute. Such an investment activity would constitute a security under the ALI Proposed Securities Code but may be excluded from the definition of a security under the New Bankruptcy Code as evidence of indebtedness for services rendered.

70. It should be noted that commodities futures contracts are excluded from the definition of security under both the Bankruptcy Code and the ALI Proposed Securities Code.

71. *See In re* Griess-Pfleger Tanning Co., 5 S.E.C. 72, 83-84 (1939); King, *Feasibility in Chapter X Reorganizations*, 49 Am. Bankr. L.J. 323, 340 (1975).

more disfavored by the SEC are so-called "income bonds,"[72] which the SEC would prefer to be labeled preferred stock since there really exists no fixed contractual obligation to repay the income bond.[73]

Section 216(9) of the Bankruptcy Act provides that a plan of reorganization may include sinking fund provisions where indebtedness is created or extended for a period of more than five years.[74] Although the language of section 216(9) is permissive, the SEC has taken the position that a plan of reorganization is not feasible unless it provides that all indebtedness will be retired by maturity or by the time the major income producing assets of the company are exhausted.[75] This provision has not received unanimous judicial support and is one example where the position of the SEC is completely contradictory to the express language of the statute.[76] The New Bankruptcy Code does not appear to contain a provision equivalent to section 216(9) of the Act.

The SEC has historically opposed the issuance of warrants in connection with a plan of rehabilitation contending that section 216 (12)(a) of the Bankruptcy Act prohibits the issuance of non-voting stock, and that warrants, in effect, constitute non-voting stock.[77] In addition, the SEC has contended that warrants are inherently deceptive and are usually exercised when a company does not need new capital.[78] The SEC also argues that warrants operate to stifle the upward market price potential of the outstanding common stock and are not in the public interest since they are likely to be subject to extremely wide market fluctuations.[79]

Although section 1123(a)(6) of the New Bankruptcy Code contains a provision very similar to section 216(12) of the Bankruptcy

72. Income bonds are payable only if sufficient income is earned to cover payments to the bondholder. They do not constitute true fixed obligations of the issuer.

73. *See In re* Green River Steel Corp., 37 S.E.C. 507, 525-26 (1957); King, *Feasibility in Chapter X Reorganizations*, 49 AM. BANKR. L.J. 323, 342 (1975).

74. *See* Bankruptcy Act § 216(9) (repealed 1978, previously codified as 11 U.S.C. § 616(9)).

75. *See In re* Broadway-Exchange Corp., 15 S.E.C. 256, 261-62 (1944); *In re* Philadelphia & W. Ry., 13 S.E.C. 330, 332 (1943); King, *Feasibility in Chapter X Reorganizations*, 49 AM. BANKR. L.J. 323, 353 (1975).

76. *See In re* Quaker City Cold Storage Co., 71 F. Supp. 124, 131 (E.D. Pa. 1947).

77. *See In re* Childs Co., 24 S.E.C. 85, 120-22 (1946); King, *Feasibility in Chapter X Reorganizations*, 49 AM. BANKR. L.J. 323, 357-60 (1975).

78. *See* King, *Feasibility in Chapter X Reorganizations*, 49 AM. BANKR. L.J. 323, 357-58 (1975); *cf.* Niagara Hudson Corp. v. Leventritt, 340 U.S. 336, 346-47 (1951) (warrants analyzed in context of reorganization under Public Utility Holding Co. Act of 1935).

79. *See* King, *Feasibility in Chapter X Reorganizations*, 49 AM. BANKR. L.J. 323, 357 (1975).

Act, the specific mention of warrants in section 1145 of the New Code may effectuate a change in the position of the SEC.[80]

Preferred stock has also attracted the SEC's attention. The Commission has required that preferred stock be afforded voting rights in accordance with section 216(12)(a) of the Bankruptcy Act, that preferred shareholders be granted preemptive rights,[81] and, in appropriate cases, that provisions be made for protective bans upon any extraordinary borrowing by the reorganized debtor without at least two-thirds approval of the preferred shareholders.[82] In addition, in accordance with section 216(12)(a) of the Bankruptcy Act, the proposed preferred shareholders are required to gain voting control of the corporation in the case of a dividend default.[83] In light of the specific provisions of Code section 1123(a)(6), a change in SEC position is unlikely.[84] The effect, however, of SEC displeasure may be ameliorated by section 1125(d) of the New Code which limits the SEC's right to appeal from an order approving a disclosure statement.[85]

"If I Don't Have to Register Then I'm Home Free — Right?"

Section 5 of the 1933 Act generally requires securities to be registered with the SEC prior to their sale or offer for sale.[86] In order to fully understand the registration requirements it must be kept in mind that the 1933 Act is founded upon the concept of disclosure. Theoretically, a totally worthless security may be offered and sold provided its worthlessness is fully disclosed to prospective purchasers. The SEC does not pass upon the merits of the security. Registration simply gives the SEC an opportunity to discuss with the issuer whether appropriate disclosure has been made in the disclosure documents and, if necessary, to take action under the securities laws to prevent the sale of a security when the appropriate disclosure requirements have not been met.[87]

80. *Compare* 11 U.S.C.A. § 1123(a)(6) (West Supp. 1979) *and id.* § 1145 *with* Bankruptcy Act § 216(12) (repealed 1978, previously codified as 11 U.S.C. § 616(12)).

81. *E.g., In re* Childs Co., 26 S.E.C. 362, 367 (1947).

82. *See In re* Childs Co., 26 S.E.C. 511, 512 (1947).

83. *See* King, *Feasibility in Chapter X Reorganizations,* 49 AM. BANKR. L.J. 323, 367-68 (1975).

84. *See* 11 U.S.C.A. § 1123(a)(6) (West Supp. 1979).

85. *See id.* § 1125(d).

86. Securities Act of 1933 § 5, 15 U.S.C. § 77d (1976).

87. *See* Comment, *The Issuance of Securities in Reorganizations and Arrangements*

As a general rule, this registration requirement does not apply just to big, publicly-held companies, but applies to the offer and sale of any security, however small. Section 4 of the 1933 Act, however, exempts certain transactions from this general rule, including transactions by persons other than an issuer, underwriter, or dealer, transactions by an issuer not involving any public offering, certain transactions by dealers and underwriters in connection with a public offering, and brokers' transactions.[88]

In addition to the section 4 exemptions, section 3 of the 1933 Act exempts certain securities and certain additional transactions from the registration requirements and includes section 3(a)(10),[89] discussed in detail below. But compliance with the securities laws is a two-stage proposition; therefore, even if a security issued by a debtor is exempt from registration, it will not be exempt from the antifraud provisions of sections 12 and 17 of the 1933 Act,[90] section 10 of the 1934 Act,[91] or rule 10b-5 promulgated thereunder.[92] Consequently, if a debtor sells a security, even in an exempt transaction, he can still be liable if he makes a materially untrue statement of fact to an offeree or fails to tell the offeree something material in connection with the transaction.[93]

Even if an exemption from registration is available, or if the securities are registered with the SEC, the offerees must receive adequate disclosure with respect to information regarding the transaction and the issuer. The Supreme Court made this very clear in the case of *SEC v. American Trailer Rentals Co.*,[94] when it stated:

> If the stock involved here were not part of an arrangement, the disclosures made with regard to it . . . would be clearly inadequate. 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 those persons acquiring stock under ordinary conditions.[95]

Under the Bankruptcy Act and the Proposed Bankruptcy Act, 36 OHIO ST. L.J. 380, 382-84 (1975).

88. Securities Act of 1933 § 4, 15 U.S.C. § 77e (1976).

89. *See id.* § 3, 15 U.S.C. § 77c (1976).

90. *See id.* §§ 12, 17, 15 U.S.C. §§ 77l, 77q (1976).

91. *See* Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (1976).

92. *See* SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1978).

93. Material information is generally that information relevant to a prudent investor in connection with his investment decision. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).

94. 379 U.S. 594 (1965).

95. *Id.* at 615-16.

Consequently, offerees in a Chapter proceeding, in most cases the creditors or stockholders of the rehabilitated company, are entitled to all information about the debtor, the issuer, and the transaction that is necessary to enable them to make an informed decision whether to accept or reject the plan.[96] Whether an exemption is available or the securities must be registered with the SEC, an issuer must provide the offeree with some type of disclosure document containing material information about the transactions, since disclosure to the court or the availability of an exemption do not satisfy the need for some mechanism for adequate disclosure of information to the offerees.

A recent case, which may not be followed by subsequent courts, has stated that a creditors' committee does not deal with the investing public and, therefore, is not liable for recommending a plan of arrangement that failed to comply with the disclosure requirements.[97] Nevertheless, unless complete compliance with the disclosure requirements of the securities laws is achieved, all those participating in the offer and sale of the securities under the plan risk civil and criminal liability.[98] For example, the 1933 Act carries penalties of criminal fines of $10,000 and imprisonment for up to five years.[99]

If a creditor feels that adequate disclosure has not been made, he may be able to persuade the SEC to intervene specially before the bankruptcy court. This is particularly true in a Chapter XI proceeding under the Bankruptcy Act where the SEC normally does not take an active role.[100] If the SEC contemplates criminal prosecution, it may not want to intervene, since section 7a(10) of the Bankruptcy Act provides that any testimony or evidence directly or indirectly derived from testimony of the bankrupt, or an officer or other representative of the bankrupt designated to testify, at an official meeting during the proceeding may not be used against him

96. *See* Corotto, *SEC Reporting, supra* note 4, at 1586; Corotto, *Debtor Relief Proceedings Under the Bankruptcy Act and the Securities Act of 1933: The Registration Requirement and Its Implications*, 47 AM. BANKR. L.J. 183, 185 (1973) [hereinafter cited as Corotto, *Debtor Relief (1973)*]; Corotto, *Debtor Relief Proceedings Under the Bankruptcy Act and the Securities Act of 1933 — The Registration Requirement and Its Implications*, 25 HASTINGS L. REV. 389, 392 (1974) [hereinafter cited as Corotto, *Debtor Relief (1974)*]; Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 OHIO ST. L.J. 380, 406 (1975).

97. *See In re* Gilchrist, 410 F. Supp. 1070, 1078 (E.D. Pa. 1976).

98. *See* Securities Exchange Act of 1934 §§ 10, 20, 32, 15 U.S.C. §§ 78k, 78t, 78ff (1976); Securities Act of 1933 §§ 12, 15, 17, 24, 15 U.S.C. §§ 77l, 77o, 77q, 77x (1976).

99. *See* Securities Act of 1933 § 24, 15 U.S.C. § 77x (1976).

100. *See* Corotto, *SEC Reporting, supra* note 4, at 1597-98, 1602.

in a criminal proceeding.[101] Section 344 of the New Code repeals section 7a(10) of the Act but provides that immunity may be granted under Part V of Title 18 of the United States Code.[102]

"THERE'S GOT TO BE AN EXEMPTION."

The principal exemptions from SEC registration available in a rehabilitation proceeding under the Bankruptcy Act are section 3(a)(10) of the 1933 Act, and sections 264, 393 and 518 of the Bankruptcy Act.[103]

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101. *See* Bankruptcy Act § 7a(10) (repealed 1978, previously codified as 11 U.S.C. § 25(a)(10) (1976); Corotto, *SEC Reporting, supra* note 4, at 1606-07.

102. *See* 11 U.S.C.A. § 344 (West Supp. 1979).

103. Section 3(a)(10) of the Securities Act of 1933 provides:

(3) Exempted Securities

(a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

. . . .

(10) Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval . . . .

Securities Act of 1933 § 3(a)(10), 15 U.S.C. § 77c(a)(10) (1976).

Section 264 of the Bankruptcy Act provides:

a. The provisions of section 5 of the Securities Act of 1933 shall not apply to—

(1) any security issued by the receiver, trustee, or debtor in possession pursuant to paragraph (2) of section 116 of this Act; or

(2) any transaction in any security issued pursuant to a plan in exchange for securities of or claims against the debtor or partly in such exchange and partly for cash and/or property, or issued upon exercise of any right to subscribe or conversion privilege so issued, except (a) transactions by an issuer or an underwriter in connection with a distribution otherwise than pursuant to the plan and (b) transactions by a dealer as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in a distribution of such securities by the issuer or by or through an underwriter otherwise than pursuant to the plan.

b. As used in this section, the terms "security," "issuer," "underwriter," and "dealer" shall have the meanings provided in section 2 of the Securities Act of 1933, and the term "Securities Act of 1933" shall be deemed to refer to such Act as heretofore or hereafter amended.

Bankruptcy Act § 264 (repealed 1978, previously codified as 11 U.S.C. § 664).

Section 393 of the Bankruptcy Act provides:

a. The provisions of section 5 of the Securities Act of 1933 shall not apply to—

(1) any security issued by a receiver, trustee, or debtor in possession pursuant to section 344 of this Act; or

(2) any transaction in any security issued pursuant to an arrangement in ex-

The SEC has contended that section 3(a)(10) is *not* available in a proceeding under the Old Act and has been superseded by the specific bankruptcy exemptions.[104] Although commentators have discussed the reconciliation of section 3(a)(10) and the bankruptcy exemptions under the Old Act,[105] it may be argued that if section 3(a)(10) were available in a bankruptcy proceeding, it need *not* be complied with as long as the specific exemptions provided by the Bankruptcy Act are followed.

The basic differences between section 3(a)(10) and the Bankruptcy Act exemptions are that the Bankruptcy Act exemptions restrict the exchange to securities for claims of the debtor while section 3(a)(10) contains no such restriction and that section 3(a)(10) permits an exchange solely for a property interest. This is

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> change for claims issued against the debtor or partly in exchange and part[l]y for cash and/or property, or issued upon exercise of any right to subscribe or conversion privilege so issued, except (A) transactions by an issuer or an underwriter in connection with a distribution otherwise than pursuant to the arrangement, and (B) transactions by a dealer as to securities constituting the whole or part of an unsold allotment to or subscription by the dealer as a participant in a distribution of such securities by the issuer or by or through an underwriter otherwise than pursuant to the arrangement.

Bankruptcy Act § 393 (repealed 1978, previously codified as 11 U.S.C. § 793).
Section 518 of the Bankruptcy Act provides:

> a. The provisions of section 5 of the Securities Act of 1933 shall not apply to—
>
> (1) any security issued by a trustee or debtor in possession pursuant to section 446 of this Act; or
>
> (2) any transaction in any security issued pursuant to an arrangement in exchange for securities of or claims against the debtor or partly in such exchange and partly for cash and/or property, or issued upon exercise of any right to subscribe or conversion privilege so issued, except (a) transactions by an issuer or an underwriter in connection with a distribution otherwise than pursuant to the arrangement, and (b) transactions by a dealer as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in a distribution of such securities by the issuer or by or through an underwriter otherwise than pursuant to the arrangement.
>
> b. As used in this section, the terms "security," "issuer," "underwriter," and "dealer" shall have the meanings provided in section 2 of the Securities Act of 1933, and the term "Securities Act of 1933," shall be deemed to refer to such Act as heretofore or hereafter amended.

Bankruptcy Act § 518 (repealed 1978, previously codified as 11 U.S.C. § 918).

104. *See* SEC No-Action Letter, Cavanaugh Communities Corp. (July 21, 1976). *See generally* Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 OHIO ST. L.J. 380 (1975).

105. *See generally* Phelan, *The Issuance of Securities in Bankruptcy Proceedings: The Magic World Meets the Cryptic Kingdom*, 51 AM. BANKR. L.J. 99 (1977); Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 OHIO ST. L.J. 380 (1975).

broader than the Bankruptcy Act exemptions and may provide a vehicle for possible fraudulent activities.[106] Also, section 3(a)(10) requires a fairness hearing while the bankruptcy exemptions of the Act do not. One of the reasons that the exemptions do not exactly match is that prior to 1934 the dominant mode of corporate reorganization was the equity receivership, and receivership remained an alternative form of reorganization until approximately 1944. Consequently, when section 3(a)(10) was enacted in 1934, it was designed to provide an exemption in connection with equity receiverships.[107] When the Chandler Act was passed in 1938, amending the Bankruptcy Act of 1898, it contained exemptions for a bankruptcy proceeding that were not coordinated with then-existing section 3(a)(10). Section 3(a)(10) still retains some validity and has been used in federal class actions when securities are sometimes issued in connection with a settlement or in connection with a ruling by the court.[108]

The coordination of section 3(a)(10) and section 264 in a Chapter X proceeding under the Old Act is essentially automatic since the approval and fairness hearings and the section 167 report normally provide the adequate judicial scrutiny and the complete information necessary to support a section 3(a)(10) exemption.[109] However, compliance with section 393, the applicable exemption provision for Chapter XI, does not ensure that the requirements of section 3(a)(10) will be met.

While Chapter X of the Old Act statutorily mandates a hearing to determine that the plan of reorganization is fair, equitable, and feasible,[110] Chapter XI does not specifically require a determination by the court that the plan is fair, but merely requires that it be "for the best interest of the creditors and is feasible."[111] Thus, it has been contended that a separate fairness hearing is required to provide for

106. *See* Levy, *Introduction to Pt. VIII, Division of Corporate Regulation*, in THE SEC SPEAKS AGAIN, 20 CORP. L. PRAC. TRANS. SER. 201 (PLI 1973).

107. *See* Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 OHIO ST. L.J. 380, 384 (1975).

108. *See id.* at 411.

109. *See* Corotto, *Debtor Relief (1974)*, *supra* note 96, at 396; Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 OHIO ST. L.J. 380, 409 (1975).

110. *See* Bankruptcy Act § 221 (repealed 1978, previously codified as 11 U.S.C. § 621).

111. Bankruptcy Act § 366 (repealed 1978, previously codified as 11 U.S.C. § 766).

an exemption in a Chapter XI proceeding.[112] This position is not entirely supportable, since section 393 is a separate, independent exemption from the registration requirements of the 1933 Act, equal in stature to section 3(a)(10).[113] Consequently, it seems that upon compliance with section 393 (and section 393 does *not* require a separate fairness hearing) registration is not required, notwithstanding the provisions of section 3(a)(10). Of course, as previously mentioned, the SEC maintains that section 3(a)(10) is not available in a Chapter XI proceeding and that section 393 controls.

This is not to say that some standard of fairness is not imposed in the context of Chapter XI. Although Chapter XI does not require the same "fair, equitable and feasible" tests required by Chapter X, it must be recognized that the term "fair and equitable" has a special meaning in Chapter X, essentially synonymous with the absolute priority rule.[114] A strong argument could be made that the good faith, best interest of creditors, and feasibility tests of Chapter XI essentially approximate the fairness standard contemplated by section 3(a)(10).[115] Also, application of this concept of fairness may vary depending upon the identity of the recipients of the securities to be issued. For example, trade creditors, who may profit from future dealings with the debtor, require a different type of protection than widely scattered public creditors.[116] Another example of flexibility of the fairness concept is the inherent unfairness of retention by holders of equity interests in an insolvent debtor of an equity interest in the rehabilitated debtor if the rehabilitated debtor did not require future services from the equity interest holders.[117]

112. *See* Corotto, *Debtor Relief (1973), supra,* note 96 at 189; Corotto, *Debtor Relief (1974), supra,* note 96 at 394. *See also* Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act,* 36 OHIO ST. L.J. 380, 397 n.97 (1975) (citing an unpublished letter from the SEC Division of Corporate Regulation to Referee James Yacos, regarding Meter Maid Industries, Inc., January 14, 1971, at 5-6).

113. *See* Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act,* 36 OHIO ST. L.J. 380, 397-98 (1975).

114. *See generally id.* at 397-412.

115. *See* Corotto, *Debtor Relief (1973), supra* note 96, at 189-91; Corotto, *Debtor Relief (1974), supra* note 96, at 394-96; Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act,* 36 OHIO ST. L.J. 380, 397-412 (1975).

116. *See generally* MacDonald, *supra* note 3.

117. If the sole assets of the rehabilitated debtor were operating real estate properties, oil and gas wells, or a wholly owned subsidiary with separate management, creditors should be paid in full before former equity interest holders are allowed to participate.

Commentators have indicated that the confirmation hearing in a Chapter XI would not satisfy the requirements of a fairness hearing under section 3(a)(10),[118] and the SEC has stated that a separate fairness hearing in a straight bankruptcy would be *ultra vires* and would not satisfy the requirements of section 3(a)(10).[119] It should be noted, however, that section 3(a)(10) requires only that the fairness hearing be held prior to the *issuance* of the securities rather than prior to any *offer* or prior to any solicitation of acceptances. In light of the SEC's position that section 3(a)(10) is not available, compliance with section 393 alone should provide the necessary exemption, and the timing of the fairness hearing is largely academic.[120] The most logical analysis is that compliance with section 393, which does *not* require a fairness hearing, is advisable. Nevertheless, the confirmation hearing provided for in Chapter XI and the various findings that the court must make in that confirmation hearing probably *do* satisfy the fairness requirements of section 3(a)(10). Whether the fact that the confirmation hearing comes after acceptance of the plan of arrangement nullifies the effectiveness of the confirmation hearing as a fairness hearing is open to question.

Following consideration of the relationship between section 3(a)(10) and the bankruptcy exemptions under the Old Act, it is important to consider certain limitations upon the availability of the bankruptcy exemptions. For example, the Bankruptcy Act exemptions are not available for an issuance of securities wholly in exchange for cash, property, or for some other type of consideration. The exchange must be for some type of a claim against, or in the case of a Chapter X debtor, an equity interest in, the debtor.[121] Likewise, an exchange by equity holders of stock plus cash in a Chapter X proceeding in which the debtor was insolvent would not be exempt because the stock was worthless.[122] In addition, the sec-

118. *E.g.*, Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 OHIO ST. L.J. 380, 398-99 (1975).

119. *See id.* at 410; SEC No-Action Letter, O'Neill Bondholders Committee (Aug. 9, 1974). *See also* SEC No-Action Letter, O'Neill Bondholders Committee (June 17, 1974).

120. Corotto, *Debtor Relief (1973)*, *supra* note 96, at 204.

121. *See* Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 OHIO ST. L.J. 380, 392-93 (1975).

122. *See* SEC v. Bloomberg, 299 F.2d 315, 318 (1st Cir. 1962); Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 OHIO ST. L.J. 380, 392 (1975).

tion 393 exemption may not be available in a Chapter XI proceeding for an exchange with secured creditors since such exchange is arguably not within the scope of a Chapter XI proceeding.[123] That position may not be completely defensible.[124]

There is also some question under the Old Act whether bankruptcy exemptions are available for the issuance of securities to administrative claimants. For example, when one of the attorneys in the proceeding wants to take stock of the debtor in exchange for his administrative claim for fees, the SEC has questioned the availability of the bankruptcy exemption. This is largely a theoretical problem since normally the private offering exemption of section 4(2) of the 1933 Act would be available.[125] Also, the bankruptcy exemptions under the Old Act do not extend to a distribution or sale of portfolio securities held by a debtor.[126]

As suggested above, counsel should remember that the Bankruptcy Act exemptions and section 3(a)(10) are not the only exemptions available to a debtor under the Bankruptcy Act. Section 3 of the 1933 Act provides several other exemptions which may, in a particular situation, be applicable.[127] For example, a commercial note may be exempt from registration under section 3(a)(3), which exempts certain types of high-grade, short-term promissory notes issued to banks and other financial institutions.[128] Likewise, section 3(a)(9) exempts "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given" for soliciting such an exchange.[129] This may sometimes be used in connection with the issuance of new notes for old notes, new stock for old stock or some combination thereof. The SEC, however, has questioned the availability of section 3(a)(9) in a Chapter proceeding under the Old Act.[130] The

123. *See* Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act,* 36 Ohio St. L.J. 380, 392 (1975).

124. *See* Corotto, *Debtor Relief (1974), supra* note 96, at 404.

125. *See* Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(4) (1976); Corotto, *Debtor's Relief (1974),* note 96 *supra,* at 405; Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act,* 36 Ohio St. L.J. 380, 393 (1975); SEC No-Action Letter, Hydrodyne Indus., Inc. (May 26, 1976).

126. *See* Corotto, *Debtor Relief (1974), supra* note 96, at 410.

127. *See generally* Securities Act of 1933 § 3, 15 U.S.C. § 77c (1976).

128. *See id.* § 3(a)(3), 15 U.S.C. § 77c(3) (1976).

129. *Id.* § 3(a)(9), 15 U.S.C. § 77c(9) (1976).

130. *See* SEC No-Action Letter, Cavanaugh Communities Corp. (July 21, 1976).

private offering exemption of section 4(2) may also be available.[131]

Since the rehabilitation chapters have been combined under the New Code,[132] the exemptions from SEC registration are now contained in sections 1125 and 1145 of the Bankruptcy Code.[133] These

131. *See* Securities Act of 1933 § 4(2), 15 U.S.C. 77d(4) (1976).

132. Chapters VII, X, XI and XII of the Bankruptcy Act have been combined under the New Code into a single rehabilitation Chapter 11. *See* 11 U.S.C.A. §§ 1101-1174 (West Supp. 1979).

133. Section 1125 of the New Code provides:

§ 1125. Postpetition disclosure and solicitation:

(a) In this section—

(1) "adequate information" means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan; and

(2) "investor typical of holders of claims or interests of the relevant class" means investor having—

(A) a claim or interest of the relevant class;

(B) such a relationship with debtor as the holders of other claims or interests of such class generally have; and

(C) such ability to obtain such information from sources other than the disclosure required by this section as holders claims or interests in such class generally have.

(b) An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information. The court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets.

(c) The same disclosure statement shall be transmitted to each holder of a claim or interest of a particular class, but there may be transmitted different disclosure statements, differing in amount, detail, or kind of information, as between classes.

(d) Whether a disclosure statement contains adequate information is not governed by any otherwise applicable nonbankruptcy law, rule, or regulation, but an agency or official whose duty is to administer or enforce such a law, rule, or regulation may be heard on the issue of whether a disclosure statement contains adequate information. Such an agency or official may not appeal from an order approving a disclosure statement.

(e) A person that solicits, in good faith and in compliance with the applicable provisions of this title, or that participates, in good faith and in compliance with the applicable provisions of this title, in the offer, issuance, sale, or purchase of a security, offered or sold under the plan, of the debtor, of an affiliate participating in a joint plan with the debtor, or of a newly organized successor to the debtor under the plan, is not liable, on account of such solicitation or participation, for violation of any applicable law, rule, or regulation governing the offer, issuance, sale, or purchase of securities.

11 U.S.C.A. § 1125 (West Supp. 1979).

Section 1145 of the Code provides:

§ 1145. Exemption from securities laws:

(a) Except with respect to an entity that is an underwriter as defined in subsection (b) of this section, section 5 of the Securities Act of 1933 (15 U.S.C. 77e) and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to—

(1) the offer or sale under a plan of a security of the debtor, of an affiliate participating in a joint plan with the debtor, or of a successor to the debtor under the plan—

(A) in exchange for a claim against, an interest in, or a claim for an administrative expense in the case concerning, the debtor or such affiliate; or

(B) principally in such exchange and partly for cash or property;

(2) the offer of a security through any warrant, option, right to subscribe, or conversion privilege that was sold in the manner specified in paragraph (1) of this subsection, or the sale of a security upon the exercise of such a warrant, option, right, or privilege;

(3) the offer or sale, other than under a plan, of a security of an issuer other than the debtor or an affiliate, if—

(A) such security was owned by the debtor on the date of the filing of the petition;

(B) the issuer of such security is—

(i) required to file reports under section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m); and

(ii) in compliance with all applicable requirements for the continuance of trading in such security on the date of such offer or sale; and

(C) such offer or sale is of securities that do not exceed—

(i) during the two-year period immediately following the date of the filing of the petition, four percent of the securities of such class outstanding on such date; and

(ii) during any 180-day period following such two-year period, one percent of the securities outstanding at the beginning of such 180-day period; or

(4) a transaction by a stockholder in a security that is executed after a transaction of a kind specified in paragraph (1) or (2) of this subsection in such security and before the expiration of 40 days after the first date on which such security was bona fide offered to the public by the issuer or by or through an underwriter, if such stockbroker provides, at the time of or before such transaction by such stockholder, a disclosure statement approved under section 1125 of this title, and, if the court orders, information supplementing such disclosure statement.

(b) (1) Except as provided in paragraph (2) of this subsection, an entity is an underwriter under section 2(11) of the Securities Act of 1933 (15 U.S.C. 77b(11)), if such entity —

(A) purchases a claim against, interest in, or claim for an administrative expense in the case concerning, the debtor, if such purchase is with a view to distribution of any security received or to be received in exchange for such a claim or interest;

(B) offers to sell securities offered or sold under the plan for the holders of such securities;

(C) offers to buy securities offered or sold under the plan for the holders of such securities, if such offer to buy is —

(i) with a view to distribution of such securities; and

(ii) under an agreement made in connection with the plan, with the consummation of the plan, or with the offer or sale of securities under the plan; or sections exempt the offer of a security in a Chapter 11 reorganization from section 5 of the 1933 Act and any other registration law. Section 1145(a)(2) also exempts the offer of a security through any warrant, option, right to subscribe or conversion privilege, or the sale of a security upon the exercise of such warrant, option, right, or privilege.

The New Code exemption is not available for an issuance of securities wholly in exchange for cash, property, or some other form of consideration. The exchange must be *principally* for a claim against, or an interest in, the debtor or an affiliate participating in a joint plan with the debtor. Presumably, the exchange by an interest holder involving stock plus cash when the debtor is insolvent would still meet opposition.[134]

The issuance of securities to administrative claimants is specifically authorized under section 1145 of the New Code and it should also be remembered that non-bankruptcy exemptions of the 1933 Act remain applicable under the New Code. Sections 3(a)(9) and 3(a)(10) of the 1933 Act, however, were amended by Section 306, Title III, of the Bankruptcy Reform Act of 1978, effective October 1, 1979, to make such sections inapplicable to a security exchanged

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(D) is an issuer, as used in such section 2(11), with respect to such securities.

(2) An entity is not an underwriter under section 2(11) of the Securities Act of 1933 or under paragraph (1) of this subsection with respect to an agreement that provides only for—

(A) (i) the matching combination of fractional interests in securities offered or sold under the plan into whole interests; or

(ii) the purchase or sale of such fractional interests among entities receiving such fractional interests under the plan; or

(B) the purchase or sale for such entities of such fractional or whole interests as are necessary to adjust for any remaining fractional interests after such matching.

(3) An entity other than an entity of the kind specified in paragraph (1) of this subsection is not an underwriter under section 2(11) of the Securities Act of 1933 with respect to any securities offered or sold to such entity in the manner specified in subsection (a)(1) of this section.

(c) An offer or sale of securities of the kind and in the manner specified under subsection (a)(1) of this section is deemed to be a public offering.

(d) The Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.) does not apply to a commercial note issued under the plan that matures not later than one year after the effective date of the plan.

11 U.S.C.A. § 1145 (West Supp. 1979).

134. *See* SEC v. Bloomberg, 299 F.2d 315, 319 (1st Cir. 1962); Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act*, 36 OHIO ST. L.J. 380, 392 (1975).

under the New Code.[135]

Section 1145(a)(3) of the New Code provides a specific exemption for the sale of portfolio securities owned by the debtor on the date of filing the petition. Under the Code, any person (other than an underwriter as defined in section 1145(b)) is authorized to distribute, during a two-year period immediately following the date of filing of the petition, up to 4% of the outstanding securities of any class of security held by the debtor at the date of filing the petition. In addition, such person may distribute an additinal 1% of such securities during any 180-day period following such two-year period. This exemption for sale of portfolio securities is only available if the issuer of the security is required to report under section 13 of the 1934 Act[136] and is in compliance with all applicable requirements for the continuation of trading in such security on the date of such offer or sale.[137] The 4% limitation of section 1145(a)(3) of the New Code is more expansive than the general limitations provided by SEC Rule 148.[138] The exemption afforded by section 1145(a)(3) is only available for the offer or sale of portfolio securities otherwise than pursuant to a plan of arrangement. It may be argued that the New Code should be amended to enable a trustee also to sell portfolio securities in a Chapter 7 liquidation proceeding.

"I REALLY WISH I'D READ THAT DEFINITION."

One really interesting slight of hand is the SEC definition of what

135. *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, sec. 306, 92 Stat. 2674.

136. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 420, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6376. One should note the exemption is not available for issuers filing identical reports pursuant to section 15(d) of the 1934 Act.

137. The House Report states that "the purpose of this exemption is to allow the debtor or trustee to sell or distribute, without allowing manipulation schemes, restricted portfolio securities held or acquired by the debtor." H.R. REP. No. 595, 95th Cong., 1st Sess. 420, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6376. The amount available for sale is similar to but less extensive than the exemptions granted for the estates of deceased holders of securities. The authors unfortunately regret their inability to direct persons who may in the future be called upon to express legal opinions as to compliance with section 1145(a)(3)(B)(ii) to any source for confirming an issuer is "in compliance with all applicable requirements for the continuance of trading in such security . . . ," nor to any source that lists "all applicable requirements for the continuance of trading." 11 U.S.C.A. § 1145(a)(3)(B)(ii) (West Supp. 1979). Read literally, the fact that the Security is trading would not fulfill the requirement for exemption.

138. *See* 43 Fed. Reg. 14,449 (1978), *as revised by id.* at 43,711 (amending SEC Rule 148) (to be codified in 17 C.F.R. § 230.148); H.R. REP. No. 595, 95th Cong., 1st Sess. 420, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6376. *See generally* 124 CONG. REC. H11,089 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

constitutes an "issuer" in a rehabilitation proceeding for purposes of the duties and liabilities imposed upon an "issuer" by the securities laws. Generally, an "issuer" is defined as anyone who issues any type of security.[139] Since the term "security" encompasses almost anything that would constitute an investment arrangement, it logically follows that the concept of who is the issuer is one of wide scope. In addition, section 2(11) of the 1933 Act, in its definition of the term "underwriter," states that for purposes of determining who is an underwriter, the term "issuer" includes, in addition to the issuer, any person directly or indirectly controlling or controlled by the issuer or under direct or indirect common control with the issuer.[140] This circular definition, in essence, means that, for certain purposes, an issuer also includes affiliates of the issuer. All conceivable "issuers" should be extremely careful with respect to the circumstances surrounding the issuance of securities to ensure that an exemption is available for the issuance of the security and to determine that appropriate disclosure is made in connection with such issuance. Under the Bankruptcy Act, some question was presented regarding the applicability of the bankruptcy exemptions to the issuance of securities in a rehabilitation proceeding by nondebtors.[141] The exemptions from registration in connection with rehabilitation proceedings under the Bankruptcy Act made no reference whatsoever to whom the issuer must be in order to qualify for the exemption and there is no statutory requirement in the Bankruptcy Act that the issuer be the debtor.[142] Although there was little doubt that an exemption was available for a nondebtor issuer in a Chapter X proceeding, the availability of an exemption in Chapter XI was less than clear.[143] Section 1145(a)(1) of the New Code clarifies this question by specifically providing that the exemption applies to a successor to the debtor under the plan.

"NEW STUFF"

One of the key considerations in the consolidation of the rehabili-

139. *See* Securities Act of 1933 § 2(4), 15 U.S.C. § 77b(4) (1976).

140. *See id.* § 2(11), 15 U.S.C. § 77b(11) (1976).

141. *See* 1 L. Loss, SECURITIES REGULATION 585 (2d ed. 1961); Corotto, *Debtor Relief (1973), supra* note 96, at 198.

142. *See* 1 L. Loss, SECURITIES REGULATION 585 (2d ed. 1961); Corotto, *Debtor Relief (1973), supra* note 96, at 198.

143. Phelan, *The Issuance of Securities in Bankruptcy Proceedings: The Magic World Meets the Cryptic Kingdom*, 51 AM. BANKR. L.J. 99, 114 (1977).

tation chapters under the New Code is the adoption of provisions requiring adequate disclosure to all creditors and stockholders whose rights are to be affected. If adequate disclosure is provided, then interested parties should be able to make an informed judgment.[144] Section 1125(a)(1) defines the phrase "adequate information" to provide maximum flexibility on a case by case basis and is applicable in all reorganization cases, whether involving a public or private corporation, a partnership, or an individual debtor.[145] For example, trade creditors will not need the same level of disclosure as public debentureholders or stockholders,[146] and it is contemplated that the amount of disclosure required will often be dependent upon the availability of such information. In many instances, the debtor's books and records are not sufficiently complete to provide the type of information required in typical SEC disclosure documents. It is suggested that the courts should consider such factors in determining the adequacy of disclosure in a particular case. For example, in many instances, a certified financial statement would not be required.[147]

After a Chapter 11 case is filed, acceptances of a plan of reorganization may not be solicited until after there has been transmitted to each holder of a claim or interest a disclosure statement approved by the court and containing adequate information.[148] If acceptances of a plan of reorganization were solicited prior to the filing of the Chapter 11 case, they may only be utilized if the solicitation was in compliance with any applicable non-bankruptcy law requiring the adequacy of disclosure in connection with such solicitation[149] or, if no such law existed, the acceptances were solicited with adequate disclosure of relevant information.[150]

The disclosure hearing will be one of the major procedural hearings in a reorganization case and will take the place of the approval hearing now conducted in a Chapter X case. Unlike old Chapter X, the disclosure hearing under the New Code will only require a valua-

144. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 226, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6185-86.

145. *See id.* at 226, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6185-86.

146. The SEC has largely ignored payout arrangements to trade creditors where no piece of paper is given to such creditors. *See generally* MacDonald, *supra*, note 3.

147. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 226, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6185-86.

148. *See* 11 U.S.C.A. § 1125(b) (West Supp. 1979).

149. These laws would include federal securities laws and state "blue sky" laws.

150. *See* 11 U.S.C.A. § 1126(b) (West Supp. 1979).

tion of the debtor when such a valuation is necessary to provide adequate information.[151] Although section 1129(a)(7) of the New Code requires some valuation of the business in order to determine whether creditors will receive more under the plan of reorganization than upon liquidation, it is clear from the legislative history that a going concern valuation is not required.[152] The liquidation valuation hearing, which is part of the Chapter XI confirmation process under the Old Act, is not ordinarily time-consuming or expensive. The going concern valuation of Chapter X, on the other hand, is often expensive and lengthy. Whether a going concern valuation will be required is determined under the New Code on a case by case basis. Since a going concern valuation will often be necessary in order to confirm the plan of reorganization under section 1129(b) of the New Code, the disclosure hearing may often be the appropriate time to determine such valuation.[153]

151. *See id.* § 1125(b). Section 1125(b) specifically states the court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets. *See id.* § 1125(b).

152. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 412, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6368-69. Section 1129(a)(7) of the New Code provides:

> § 1129. Confirmation of plan.
>
> (a) The court shall confirm a plan only if all of the following requirements are met:
>
> . . . .
>
> (7) With respect to each class—
>
> (A) each holder of a claim or interest of such class—
>
> (i) has accepted the plan; or
>
> (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under Chapter 7 of this title on such date; or
>
> (B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such creditor's interest in the estate's interest in the property that secures such claims . . . .

11 U.S.C.A. § 1129(a)(7) (West Supp. 1979). Going concern value is the value of an entity as an operating concern rather than its value in a forced liquidation.

153. Section 1129(b) of the New Code permits confirmation of a plan of reorganization, despite the non-acceptance of such plan by a class of impaired creditors or interest holders if the plan is "fair and equitable." Determination that a plan is "fair and equitable" requires a going concern valuation. This will often be the case in a plan of reorganization that does not provide for any distribution to equity owners since non-participating equity owners will be protected by the fair and equitable rule. In short, this section constitutes the "cram down" provision of the New Code requiring simply that any plan comply with specific standards of fairness to dissenting creditors or equity security holders. *See* 11 U.S.C.A. § 1129(b) (West Supp. 1979); H.R. Rep. No. 595, 95th Cong., 1st Sess. 413, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6639.

It should be kept in mind that the disclosure requirement of section 1125 of the New Code is applicable even if no securities will be issued. In such an instance, valuation would be unnecessary for purposes of the disclosure hearing, even if there are public securities holders that are unimpaired under the plan.[154] The flexible approach intended by Congress requires a determination by the court, on a case by case basis, of whether a going concern valuation is necessary and the amount, detail, and kind of information to be required in the disclosure statement.[155] Conceivably, the court may determine, in a simple composition-type Chapter 11 proceeding, that little more need be disclosed than the fact that the creditors will receive more under the plan of reorganization than they would receive upon liquidation.

The SEC, and any other regulatory agency, has the right to appear and be heard on whether a disclosure statement contains adequate information.[156] Since appeal by the SEC or other regulatory agency could cause an inordinate delay to the detriment of parties involved in a reorganization proceeding, such agencies will not have the right of appeal on the adequacy of disclosure, but may participate in an appeal taken by a party in interest.[157] The adequacy of disclosure is not to be determined by the formal requirements of the SEC but is to be determined on a case by case basis depending upon the needs of the participants in the proceeding.[158]

Since disclosure statements will often be prepared from inadequate records of a financially troubled debtor, the New Code contains a "safe harbor" provision that permits honest mistakes without imposing liability under the securities laws. Section 1125(e) provides that a person soliciting acceptances to a plan "in good faith" is not liable for violation of any applicable law, rule, or regulation governing such solicitation.[159] The "safe harbor" provision is intended to codify the holding in *Ernst & Ernst v. Hochfelder*[160] and insulates creditors, creditors' committees, counsel for committees, and others involved in the case from potential civil and injunctive

154. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 277, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6234.

155. *See id.* at 229-31, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6188-91.

156. *See* 11 U.S.C.A. § 1125(d) (West Supp. 1979).

157. *See id.*

158. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 229-31, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6188-91.

159. *See* 11 U.S.C.A. § 1125(e) (West Supp. 1979).

160. 425 U.S. 185 (1976).

liability under the securities laws for soliciting acceptances of a plan by use of an approved disclosure statement.[161] It should be noted that the safe harbor provision includes immunity from SEC injunctive liability.[162]

The safe harbor provision is intended to extend to good faith, though negligent, omissions or misstatements and permits reliance by parties to the proceeding upon the bankruptcy court's determination that the disclosure statement contains adequate information.[163] It should be noted, however, that the legislative history speaks mostly in terms of creditors, creditors' committes, and other parties removed from the actual inside operations of the debtor,[164] and it may be argued that a higher standard of diligence may be applied to the debtor, its counsel and plan proponents. Section 1125 does not contain a definition of "good faith" and it is entirely possible that courts may determine that a party who knew or should have known of a material omission or misstatement of fact, and failed to disclose such fact to the court, is not acting "in good faith" and is subject to liability under the securities laws. A close reading of the legislative history appears to indicate that the safe harbor provision is intended to protect the honest participant in the solicitation process who utilizes a misleading disclosure document in connection with solicitations of acceptances of the plan of reorganization rather than those actively involved in the preparation of the disclosure document.[165] Presumptively, the "solicitation" of section 1125(e) is equivalent to an "offer" under the securities laws and would extend to potential liability of a major lending institution of the debtor for aiding and abetting in connection with a securities violation.[166]

It is interesting to note that while section 1145(a)(1) exempts *all* successors to the debtor under the plan from section 5 of the 1933 Act and the registration provisions of the various Blue Sky laws, the safe harbor provision of Code section 1125(e) applies only to the

161. *See id.* at 201.

162. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 229-31, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6188-91.

163. *See* 11 U.S.C.A. § 1125(e) (West Supp. 1979).

164. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 230, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6189-90.

165. *See id.* at 229-31, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6188-91.

166. *See generally* Nelson v. Quinby Island Reclamation Dist. Facilities Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,328 (N. D. Cal. 1978); *In re* Falstaff Brewing Corp., 441 F. Supp. 62, 68-69 (E. D. Mo. 1977); Morgan Guar. Trust Co. v. Rodman, 4 BANKR. CT. DEC. 597 (S.D.N.Y. 1978).

issuance, sale, or purchase of the security offered or sold under the plan of the debtor, of an affiliate participating in a joint plan with the debtor, or of a *newly organized* successor to the debtor under the plan. Thus, it may be argued that the safe harbor provision is not available for the issuance of securities by a previously existing nondebtor issuer who purchases the assets or securities of the debtor in exchange for the nondebtor issuer's securities pursuant to the plan of reorganization.

"I CAN'T TELL THEM THAT!"

Precisely what constitutes adequate information in any particular case is not specified in the New Code. The House Report admonishes courts to take a practical approach concerning what is necessary under the circumstances of each case, such as the costs of preparation of the statement, the need for relative speed in solicitation and confirmation, and the need for investor protection.[167] Adequate information is defined in Code section 1125(a) as "information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan . . . ."[168] Although such practicability is necessary in connection with rehabilitation proceedings, the disclosure memorandum should contain, to the extent possible, substantially all the applicable information which would be contained in the prospectus or proxy statement of a company registering with the SEC. Therefore, the drafting of a disclosure memorandum should only be undertaken by an attorney who is qualified to draft a prospectus or proxy statement in connection with a normal SEC registration. This is true because, whether an offering is registered with the SEC or issued pursuant to the New Bankruptcy Code, all material information must be disclosed to the offerees and all information that might influence someone to accept or reject the proposed plan of reorganization should be included in the disclosure documents.[169] It is entirely possible that the courts will determine that "good faith" en-

167. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 409, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6365.

168. 11 U.S.C.A. § 1125(a) (West Supp. 1979).

169. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972).

compasses a reasonable effort to ascertain and place in the disclosure memorandum the requisite "material" information and prudent counsel should approach the task of the preparation of the disclosure memorandum with no less care than that taken in connection with the preparation of an SEC prospectus or proxy statement. It must be kept in mind, however, that the condition of the books and records of the debtor, the funds available for preparation of the disclosure document, and other circumstances surrounding the rehabilitation may limit the amount of information that can reasonably be presented in the disclosure memorandum.

The best guides for drafting a disclosure memorandum are: the Form S-1, the general form used in connection with the registration of securities under the 1933 Act; the Form S-2, used to register the securities of new companies; and Form 10, utilized in connection with the registration of issuers under the 1934 Act.[170] There are several services which can provide copies of registration statements and prospectuses for companies similar to the type of company that is the subject of the disclosure memorandum.[171] SEC Securities Act Release No. 4936 is also a helpful guide for the preparation of disclosure documents.[172]

Many of the items of the Form S-1, Form S-2, and Form 10[173] are, of course, not relevant to a bankruptcy proceeding, as, for example, the items regarding the underwriting. It is important to remember, however, that the various SEC forms constitute excellent evidence of what information the SEC believes to be the minimum required for protection of investors, and to vary widely from such information may materially impair the ability of a person to establish "good faith" under section 1125(e). Consequently, most of the items contained in such forms, to the extent possible in light of the debtor's books and records, and the facts and circumstances of the case, should be contained in a disclosure memorandum, including:

(1) A complete description of the capital structure of the rehabilitated debtor (including new infusions of capital and new funding agreements) and use of proceeds (if any);

(2) A history of the business activities of the debtor (and the

170. *See* 17 C.F.R. §§ 239.11-.12 (1978). Copies of these forms may be found at 2 FED. SEC. L. REP. (CCH) ¶¶ 7121, 7141 (1979) (Forms S-1 and S-2 respectively).

171. For example, FACS, Inc., 747 National Press Bldg., Washington, D.C. 20045.

172. *See* [1968] 1 FED. SEC. L. REP. (CCH) ¶¶ 3760-3813.

173. *See* 17 C.F.R. § 249.210 (1978). A copy of form 10 may be found at 4 FED. SEC. L. REP. (CCH) ¶ 27,301 (1978).

issuer in the case of a nondebtor issuer);

(3) A list of parents, controlling persons and subsidiaries of the issuer;

(4) A complete description of the issuer's business, including, but not limited to, the following:

(a) The competitive conditions in the industry or industries in which the issuer competes and the issuer's competitive position in such industries;

(b) The dependence of the issuer upon one or more customers;

(c) The principal products produced or services rendered by the issuer and the methods of distribution of such product or services;

(d) The current backlog of the issuer and comparable figures for the previous year;

(e) The source and availability of raw materials essential to the issuer's business;

(f) The importance of all patents, trademarks, licenses, franchises, and concessions held by the issuer;

(g) Information regarding research and development;

(h) The number of persons employed by the issuer;

(i) Information regarding the seasonal nature of the issuer's business; and

(j) Information regarding foreign operations, regulatory problems, and working capital position. In addition, sales and revenue figures for each industry segment of the issuer and each class of similar products or services are required;

(5) A description of all physical properties held by the issuer;

(6) A complete description of major litigation involving the issuer;

(7) Descriptions of each of the securities being issued;

(8) Complete information regarding the officers and directors of the rehabilitated debtor;

(9) Complete information regarding all remuneration to be paid or other transactions with insiders and controlling persons of the issuer or debtor;

(10) A description of the major shareholders and controlling persons after the reorganization;[174]

(11) A description of any options or warrants to purchase securities of the issuer which remain outstanding;

174. It is often difficult to determine in a stock plan who the major shareholders will be since the exact amount of claims is unknown until confirmation.

(12) A description of any pledges or other financing arrangements which conceivably could change control of the issuer at such date;

(13) A complete description of the tax ramifications of the transaction;

(14) Any attorneys' fees to be paid in connection with the proceeding;

(15) The anticipated liquidity of the reorganized debtor.

The elimination of any one of the above items from the disclosure memorandum may constitute a material nondisclosure and subject all parties to securities law liabilities.

Although extensive historical financial data is normally included in a securities compliance disclosure document, the preparation of a disclosure memorandum in a bankruptcy is usually more difficult than the preparation of a normal prospectus because such historical data may not be particularly relevant. If the rehabilitation involves only minor changes in operation, or if the plan contemplates the acquisition of the debtor's assets by a third party with some continuity of historical operations, then the task is relatively simple. The real problems develop when the plan of rehabilitation involves a radical change in the debtor's operation or the acquisition of the debtor and the issuance of securities by a newly formed proponent of the plan, since the information which must be disclosed in these cases relates not only to the debtor but also to any nondebtor issuer.

Since there is incentive for the creditors to accept the plan of reorganization, and since majority acceptance by creditors will legally bind a dissenting minority, a higher than ordinary duty of investigation and care may be required if a person is to fall within the "good faith" category of the safe harbor provision.[175] In this context, it may be remembered that controlling persons of the debtor are in a much better position to evaluate the material facts than creditors and other interested parties. Both the 1933 Act and, presumably, the New Bankruptcy Code, impose a type of fiduciary duty upon such insiders to disclose all material information at their disposal to the offerees. If the proponents of the plan know that the ultimate value, after rehabilitation, will be more than what is offered to the creditors and other interested parties, disclosure of such

175. *See* White v. Abrams, 495 F.2d 724, 734-36 (9th Cir. 1974); 11 U.S.C.A. § 1125(e) (West Supp. 1979); Corotto, *SEC Reporting*, *supra* note 4, at 1593.

inadequate consideration may be required. Such situations raise the possibility that inadequate or unfair consideration, in and of itself, may constitute a scheme to defraud in violation of section 10(b) of the 1934 Act[176] and would not be protected by the safe harbor provision of section 1125(e) of the New Bankruptcy Code.

Some disclosure documents have been attacked because they did not highlight material information, but buried such information in complex financial statements. Thus, undue complexity may result in liability even if all material information is included in the disclosure document. Not only must all such information be disclosed, but it must be disclosed in understandable form. Consequently, it is advisable to put the principal features of the plan in a separate section at the beginning of the disclosure memorandum followed by a section devoted to the risk factors of the offering. Bankruptcy courts under the New Code must be cognizant not only of the existence of items of information but sensitive to the placement of such items in disclosure material to ensure maximum understandability.

A difficult problem is the inclusion of projections in a disclosure document. In the case of a radically reorganized debtor, the only relevant financial information would be projections of the issuer regarding the future performance of the rehabilitated debtor. Although the SEC has released certain guidelines regarding projections,[177] exact standards for projection disclosure have yet to be satisfactorily tested by the courts.[178] Consequently, any projections included in a disclosure memorandum (and in many instances, it is almost impossible to avoid projections) should be based upon sound assumptions. Any assumptions forming bases for projections should also be disclosed.

Section 1129(a)(4) of the New Code specifically provides that disclosure must be made of any payment made by the debtor or plan proponents for services, costs, or expenses in connection with the plan. In addition, section 1129(a)(5) requires the disclosure of the identity of directors, officers or voting trustees of the debtor, successors to the debtor, any insider of the debtor that will be employed or retained by the reorganized debtor, and the nature of any compensation for such insider.

176. *See* Securities Exchange Act of 1934 § 10(b), 15 U.S.C.A. § 78i(b) (1976).

177. *See* SEC Securities Exchange Act Rel. No. 9984, 2 FED. SEC. L. REP. (CCH) ¶ 23,508 (1974); SEC No-Action Letter, Hendricks & Tomlinson, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80.664.

178. *See* Beecher v. Able, 374 F. Supp. 341, 374 (S.D.N.Y. 1974).

Several steps can be taken by the issuer to avail itself of an exemption and protect itself from future liability. Counsel should first obtain as much information about the issuer as is possible, basically tracking the procedure utilized in connection with registration. For example, the issuer should send questionnaires to its principals, officers, and directors soliciting the type of information that should be included in the disclosure memorandum. Counsel should read the minutes, documents, and major contracts of the issuer. The issuer should exercise maximum possible care in preparing the disclosure memorandum and formulating the plan of arrangement. The watchword in connection with the arrangement plan is to keep it as simple as possible, and the disclosure memorandum should be as complete and understandable as possible. The principals should sign every page of the disclosure memorandum and counsel should retain a signed copy in his files. Some firms use a rubber stamp on every page of the principal's copy to be initialed by the principal, indicating that the principal has read everything on that page and that it is true and correct.

If the reorganized debtor qualifies as a reporting company under the 1934 Act, steps must be taken to file the appropriate disclosure documents with the SEC as a 1934 Act reporting company. One thought which should be kept in mind is that it costs a lot of money to be a public company and the rehabilitated debtor must provide for the additional costs. Although section 1125(c) permits the transmittal of disclosure documents, differing in amount, detail, or kind of information to different classes of creditors and interest holders, it is often less costly to send the most complete disclosure documents to all classes, rather than preparing separate disclosure documents.[179]

"BUT I'M NOT MERRILL LYNCH"

What about resales by creditors? Section 3(a)(10) is simply a transactional exemption despite the fact that literally the entire security is exempted.[180] The 1933 Act exemptions afforded by section 3 are entitled "Exempted Securities," while the exemptions afforded by section 4 are entitled "Exempted Transactions."[181] Unfortunately, as is often true with the 1933 Act, the statute does not

179. *See* 11 U.S.C.A. § 1125(c) (West Supp. 1979); H.R. REP. No. 595, 95th Cong., 1st Sess. 227, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6186-87.

180. *See* Securities Act of 1933 § 3(a)(10), 15 U.S.C.A. § 77c(a)(10) (1976).

181. *Compare id.* § 3, 15 U.S.C. § 77c (1976) *with id.* § 4, 15 U.S.C. § 77d (1976).

really mean what it says, and although one court has held that a security issued under section 3(a)(10) is truly an exempt security,[182] it is well settled that due to the legislative history of section 3(a)(10), transactional exemption status *only* will be afforded to a security issued in a rehabilitation proceeding.[183] This conclusion is further bolstered by the clear transactional nature of the Bankruptcy Act exemptions.[184] Consequently, pursuant to the Bankruptcy Act redistribution of securities received in a rehabilitation proceeding depends, to a large extent, upon whether, under the particular circumstances, the original offeree is an "underwriter" as defined in section 2(11) of the 1933 Act, since section 4(1) of the 1933 Act exempts transactions not involving an issuer, underwriter, or dealer.[185] Simplisticly stated, a person is an underwriter of a security when he takes that security *from* an issuer with a *view to distribution.* The congressional history of the 1933 Act makes it clear that Congress intended to define the term "underwriter" in its broadest sense and to include not only professional investment bankers but also rank amateurs.[186]

A strict interpretation of the term "underwriter" in connection with a rehabilitation proceeding would probably make every recipient of a security an underwriter since most creditors or stockholders take a security distributed in the bankruptcy proceeding with a view to conversion of that security to cash as soon as is practicable. A good argument can be made, however, that a small creditor, although he takes the security with a view to resale, does not take the security with a view to "distribution" since the term "distribution" implies a transaction involving a significant amount of the issuer's securities. In the case of a small creditor, it may be argued that his resale of a small number of shares does not constitute a "distribution" unless he acts in concert with other creditors. SEC

182. Shaw v. United States, 131 F.2d 476, 480 (9th Cir. 1942).

183. *In re* Decicom Systems, Inc., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,318; Comment, *The Issuance of Securities in Reorganizations and Arrangements Under the Bankruptcy Act and the Proposed Bankruptcy Act,* 36 OHIO ST. L.J. 380, 381 (1975).

184. *But see* Cohen, Levy, Sommer, *Specific Problems,* THE SEC SPEAKS AGAIN, 20 CORP. L. PRAC. TRANS. SER. (PLI 1973). *But see also* SEC No-Action Letter, Cavanaugh Communities Corp. (July 21, 1976), which seems to indicate the conversion of convertible debentures, issued in a Chapter XI, into common stock subsequent to confirmation would be exempt pursuant to Section 393.

185. *See* Securities Act of 1933 §§ 2(11), 4(1), 15 U.S.C. §§ 77b(11), 77d(1)-(3) (1976).

186. *See* 4 L. LOSS, SECURITIES REGULATION 547 (Supp. 1969); Corotto, *Debtor Relief (1974), supra* note 96, at 412.

rule 148, which deems persons that meet all its conditions not to be underwriters, permits resales by small creditors of one percent of the shares of the class issued and outstanding every three months and provides for resale without limitation by non-affiliates under certain conditions. Sales pursuant to rule 148 must be "brokers' transactions" within the meaning of section 4(4) of the 1933 Act or transactions directly with a "market maker," as that term is defined in section 3(a)(38) of the 1934 Act, and adequate public information regarding the issuer must be available.

When a distribution by a number of small creditors is arranged, the availability of the section 4(1) exemption for resale is questionable.[187] For example, if notes or stock are distributed to creditors, and the debtor arranges for these securities to be resold to the public by an underwriter, the exemption would not be available.[188] Large redistributions by holders of a significant percentage of the stock of the rehabilitated debtor probably do *not* qualify for the section 4(1) exemption since the recipient took from the issuer with a view to distribution and probably would be an underwriter.[189] Presumably, SEC Rule 144 would be available for resales by larger holders, however, it has been argued that, although the securities issued to insiders and large creditors in a rehabilitation proceeding are restricted, they were issued in a "public" offering, albeit exempt.[190]

To eliminate the problem of resales by creditors or equity security holders, section 1145(b) of the New Code exempts from the definition of "underwriter" those parties who receive securities in a bankruptcy reorganization, with the exception of those parties who participate in a classical underwriting.[191] For purposes of a Chapter 11 reorganization, section 1145(b) provides that a person is an underwriter if he purchases a claim against, interest in, or claim for an administrative expense in the case with a view to distribution of any security received or to be received in exchange for the claim or interest.[192] A person is also an underwriter if he offers to sell securi-

187. *See generally* SEC v. Granco Prods., Inc., 236 F. Supp. 968, 971 (S.D.N.Y. 1964); Corotto, *Debtor Relief (1974), supra* note 96, at 413.

188. *See* SEC v. Bloomberg, 299 F.2d 315, 319 (1st Cir. 1962); SEC v. Century Inv., [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,232 (S.D.N.Y. 1971); SEC v. Granco Prods., Inc., 236 F. Supp. 968, 971 (S.D. N.Y. 1964); *In re* Sequential Information Syss., [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,139.

189. *See* Corotto, *Debtor Relief (1973), supra* note 96, at 210; Wexler, *Redistribution*, in THE SEC SPEAKS AGAIN, 20 CORP. L. PRAC. TRANS. SER. 209, 211 (PLI 1973).

190. *See* 17 C.F.R. § 230.144 (1978) (SEC Rule 144).

191. *See* 11 U.S.C.A. § 1145(b) (West Supp. 1979).

192. *See id.*

ties offered or sold under the plan for the holders of such securities, or offers to buy securities offered or sold under the plan from the holders of such securities, if the offer to buy is with a view to distribution.[193] Finally, a person is an underwriter if he is an issuer, as that term is used in section 2(11) of the Securities Act of 1933.[194] As noted above, section 2(11) of the 1933 Act defines an issuer to include affiliates of the issuer.[195] Section 1145(b)(2) of the New Code excludes from the definition of "underwriter" any entity which enters into an agreement that provides only for matching combinations of fractional interests in covered securities, or the purchase or sale of fractional interests.[196] The house report notes that any creditor with at least 10% of the securities will be a "controlling person" and, therefore, an "issuer" who will be subject to the requirements of section 5 of the 1933 Act regardless of any exemption as an underwriter.[197] Consequently, the exemption afforded by section 1145(b) only concerns creditors or interest holders with less than 10% of a class of the debtor's securities. As a result, section 1145(b) of the New Code modifies SEC Rule 148 to permit more liberal resale by creditors receiving securities in an approved reorganization and allows unlimited resale by holders of less than 10% of a class of securities of the reorganized debtor.[198] Creditors acquiring in excess of 10% of a class of securities of the reorganized debtor would constitute "issuers" pursuant to section 2(11) of the 1933 Act and section 1145(b)(1)(B) of the New Bankruptcy Code.[199] Therefore they are subject to the normal SEC registration requirements upon resale of securities of the reorganized debtor.

Section 1145(c) of the New Code specifically states that the securities issued in connection with a plan of reorganization are issued in a "public" offering.[200] This statement is necessary to ensure that resale will not be restricted by SEC Rule 144, which governs the

193. *See id.*

194. *See id.*; H.R. REP. No. 595, 95th Cong., 1st Sess. 420, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6376.

195. *See* Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1976).

196. *See* 11 U.S.C.A. § 1145(b)(2) (West Supp. 1979); H.R. REP. No. 595, 95th Cong., 1st Sess. 420, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6376.

197. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 238, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6197-98.

198. *See* 43 Fed. Reg. 14,449 (1978), *as revised by id.* at 43,711 (amending SEC Rule 148) (to be codified in 17 C.F.R. § 230.148); A.M. QUITNER, BANKRUPTCY REFORM ACT OF 1978 299 (PLI 1978).

199. *See* 11 U.S.C.A. § 1145(b)(1)(B) (West Supp. 1979); Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1976).

200. *See* 11 U.S.C.A. § 1145(c) (West Supp. 1979).

resale of restricted securities acquired in private offerings.[201] Section 1145(a)(4) of the New Code exempts a transaction by a stockbroker occurring within forty days after the offer of securities pursuant to the plan of reorganization.[202] In order to avail himself of this exemption, a stockbroker must provide the purchaser with the disclosure statement approved at the section 1125 hearing and, if the court orders, information supplementing such disclosure statement. Absent this requirement for delivery of the disclosure statement, the stockbroker could act as a broker in connection with the sale of such securities, during the 40-day period, without a requirement to deliver the disclosure statement. After the expiration of the 40-day period, no such delivery is required.[203]

"Why Can't I Do It Out Of Court?"

Unlike the current Bankruptcy Act, the New Bankruptcy Code exempts the issuance of securities in connection with the plan of reorganization from the state Blue Sky statutes.[204] However, three other federal acts that deserve mention and which may be applicable to a rehabilitation proceeding are the Trust Indenture Act of 1939,[205] the Investment Company Act of 1940[206] (1940 Act), and the Interstate Land Sales Full Disclosure Act.[207]

Section 1145(d) provides that the Trust Indenture Act of 1939 does not apply to a commercial note issued under the plan that matures not later than one year after the effective date of the plan.[208] In addition, section 364, which governs obtaining credit during a proceeding under the New Code, provides that, except with respect to an underwriter as defined in section 1145(b), section 5 of the 1933

201. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 238, *reprinted in* [1978] U.S. Code Cong & Ad. News 5963, 6197-98.

202. *See* 11 U.S.C.A. § 1145(a)(4) (West Supp. 1979).

203. The original release of the New Code contains the word stockholder in § 1145(a)(4). The Technical Amendments Bill will change the word "stockholder" to "stockbroker." *See* S. 658, 96th Cong., 1st Sess. sec. 106 (1979).

204. *See* 11 U.S.C.A. § 1145(a) (West Supp. 1979).

205. See 15 U.S.C. §§ 77aaa-bbb (1976) (providing that issues of debt securities may not be offered for sale to public unless issued under trust indenture conforming to specific statutory standards designed to safeguard interests of purchasers).

206. *See* 15 U.S.C. §§ 80a-1 to -52 (1976) (requires registration of investment companies and provides for their regulation).

207. *See* 15 U.S.C. §§ 1701-1720 (1976) (promulgates disclosure requirements for interstate sales of land).

208. *See* 11 U.S.C.A. § 1145(d) (West Supp. 1979).

Act, the Trust Indenture Act of 1939, and the state and local Blue Sky laws, do not apply to the offer or sale under section 364 of a security that is not an equity security.[209]

Some companies inadvertently become investment companies for purposes of the 1940 Act, since an investment company is defined in the 1940 Act to include not only those companies that hold themselves out to be investment companies, but also those companies that acquire investment securities having a value exceeding 40% of the value of their total assets on an unconsolidated basis.[210] Consequently, a company that holds over 40% of its total assets in investment securities must register under the 1940 Act.

A real problem exists when an out-of-court composition is attempted because the exemptions discussed above are not applicable. Anything other than a straight 30¢ on the dollar type composition out of court may create insurmountable problems under the securities laws. Even an out-of-court extension may constitute an investment contract.[211]

"WHY! I DIDN'T KNOW THEY WERE WORKING ON THAT"

Section 512(f) of the ALI Proposed Securities Code has consolidated its rehabilitation exemptions into one section.[212] Proposed section 512(f) exempts any

> transaction incident to the issuance of a security . . . to existing security holders or creditors of the issuer if (1) the issuance is pursuant to a reorganization or arrangement under section 77 or Chapters X, XI or XII of the Bankruptcy Act or (2) the terms and conditions of the issuance are approved, after a hearing on their fairness at which all proposed offerees have the right to appear, by a court of competent jurisdiction, an official or agency of the United States or a banking or insurance commission or other governmental authority of the state expressly authorized by a law to grant such approval . . . .[213]

Assuming that section 512(f) is revised to refer to the appropriate

209. *See id.* § 364.

210. *See* 15 U.S.C. § 80a-3(a) (1976).

211. *See* Phelan, *The Issuance of Securities in Bankruptcy Proceedings: The Magic World Meets the Cryptic Kingdom,* 51 AM. BANKR. L.J. 99, 124 (1977). *But see* Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 708 (D. Minn. 1968); SEC v. Addison, 194 F. Supp. 709, 722 (N. D. Tex. 1961).

212. *See* ALI FEDERAL SECURITIES CODE — PROPOSED OFFICIAL DRAFT § 512(f) (1978).

213. *Id.*

sections of the New Bankruptcy Code, a question would still exist concerning the availability of an exemption under the ALI Proposed Securities Code to the issuance of a security by a nondebtor issuer, since such securities would not be issued to existing security holders or creditors of the nondebtor issuer, but, instead, would be issued to existing security holders or creditors of the debtor. In addition, it could be argued that the specific reference to the Bankruptcy Code would preclude utilization by the nondebtor issuer of the second alternative of section 512(f), which provides for a fairness hearing by a court or other agency. This question, however, may have been answered by the amendment to section 3(a)(10) of the 1933 Act discussed above, and it can reasonably be anticipated that section 512(f) will be similarly revised. Section 512(f) should be revised to simply exclude the issuance of any security pursuant to a reorganization under Chapter 11 of the Bankruptcy Code.

"THAT ISN'T SO BAD"

The New Bankruptcy Code essentially codifies what constituted careful practice under the Bankruptcy Act.[214] Under the Bankruptcy Act, a disclosure memorandum should have been prepared in connection with the offer of securities. Careful bankruptcy counsel presented the disclosure memorandum to the court and the Securities and Exchange Commission Reorganization Branch for approval prior to the solicitation of acceptances.[215] In some parts of the country, however, the securities problems revolving around bankruptcy proceedings have been largely ignored and the New Code will provide substantially greater information to creditors and equity security holders in connection with rehabilitation proceedings.

214. *See generally* Phelan, *The Issuance of Securities in Bankruptcy Proceedings: The Magic World Meets the Cryptic Kingdom,* 51 AM. BANKR. L.J. 99 (1977).

215. Such a practice has long been recognized and compiled with in connection with Chapter XI proceedings in the Northern District of Texas.