SECURITIES TRADING AND FEE SHARING UNDER CHAPTER X OF THE BANKRUPTCY ACT

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Before

The Association of the Bar of the City of New York
Section on Banking, Corporation and Business Law

March 16, 1960
New York, New York

At the outset, my thanks to Mr. Raben, Chairman of your Committee on Banking, Corporation and Business Law, for the invitation. I am very pleased to be here this evening to talk to you about some problems and pitfalls in Chapter X[1/] reorganization proceedings arising out of (1) trading in securities as that may affect allowance of compensation and (2) fee-sharing arrangements. I shall not attempt to cover the entire field but rather particular areas and some of the policy and thinking involved.

I must inform you that the Commission, as a matter of policy, disclaims responsibility for the private remarks or publications by any of its staff. The views expressed tonight are my own; they do not necessarily reflect the views of the Commission or of any of my colleagues on the staff.[2/]

The provision of Chapter X dealing with the effect of transactions in the debtor's securities upon allowances is Section 249. Before discussing the particular problems I have in mind I shall briefly review the origin and development of that provision. It is one of a number of provisions of Chapter X, which was enacted in 1938 as a broad reform

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1/ 11 U.S.C. 501 et seq.

2/ Under Section 208 of Chapter X the Commission appears in proceedings on its own motion or at the request of the judge; the Commission has no right to appeal.

program in the field of corporate reorganization. Studies made by the Commission, pursuant to authorization of the Congress under the Securities Exchange Act of 1934, [3] showed that serious conflicts of interest had arisen between those in representative and fiduciary capacities and the persons whom they were representing arising from transactions in securities by the fiduciaries. In its report the Commission pointed out that while some courts had imposed penalties based upon general trust principles, notably here in the Southern District by Judges Coxe and Caffey in the reorganizations of Paramount-Publix Corporation and Republic Gas Corporation, [4] "Section 77B [the predecessor of Chapter X] contains no express mandate requiring courts to adopt this enlightened approach to the trading problem, nor have the courts pursued any rigid and consistent policy in this respect." [5] Accordingly, dealing specifically with committees, the Commission expressed the view that "The vicious situation which has arisen as a result of trading by committee members calls for complete outlawry and prohibition of such practices. Anything short of that will result in too great concessions in the interests of expediency; too dangerous recessions from

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3/ Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1936-1940) ("Protective Committee Study"), which was submitted in eight parts.

4/ In re Paramount-Publix Corporation, 12 F. Supp. 823 (1935), rev'd on other grounds 83 F. 2d 406 (C.A. 2, 1936); In re Republic Gas Corporation, 35 F. Supp. 300 (1936).

5/ Part II, Protective Committee Study, supra, n. 3, at 348.

the ethical and moral requirements for trustees and fiduciaries.[6] . . Such reform measures will go far towards restoring in this field some of the ancient ethical standards for trustees or fiduciaries."[7] In making a particular recommendation with respect to amending Section 77B, the Commission said: "Those who have purchased or sold securities in contemplation or after the commencement of the proceeding should not be allowed compensation or reimbursements for expenses from the estate."[8]

The bill introduced in the House of Representatives in April 1937 provided first, quite simply, that any person seeking compensation or reimbursement was required to file an affidavit showing the claims or stock purchased, acquired or transferred in contemplation of or during the proceeding, and, second, that no compensation would be allowed to one who had so purchased, acquired or transferred securities. This provision was presented to the House of Representatives as "a step toward the codification" of the Paramount and Republic Gas decisions. Commissioner (now Supreme Court Justice) William O. Douglas pointed to the "administrative difficulties in determining in a particular case whether or not actual inside information was used" and the Commission's recommendation "that the best practical way of doing it was to broaden the base a little

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6/ Id. at 349-50.

7/ Id. at 351.

8/ Part I, Protective Committee Study, supra, n. 3, at 901.

bit and establish a rule of thumb."[9] In a later revision of Section 249, while the first part requiring the filing of an affidavit remained the same, the denial of compensation was limited to committees, attorneys or other persons acting in the proceeding in a representative or fiduciary capacity -- and in this form the Section was passed by the House of Representatives. The fact that attorneys were named specifically is flattery in a sense since presumably it reflected the important role played by the attorney in the reorganization process.[10]

When the bill came before a subcommittee of the Senate Judiciary Committee it was pointed out that acquisitions and transfers might occur, by bequest for example, which while not purchases or sales, would act to deprive an applicant of compensation. The National Bankruptcy Conference proposed that the section be amended to provide for "consent and approval of the court". It was pointed out, however, that this would empower the judge completely to disregard and nullify the intent of the section.[11] The Commission then suggested substantially the language in which Section 249 was enacted, i.e., that no compensation would be allowed a committee, attorney or other person acting in a representative capacity who, after he had assumed to act in that capacity, had purchased or sold securities

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9/ H. Hearings on H. R. 8046, 75th Cong., 1st Sess. (1937) 184.

10/ See Part II, Protective Committee Study, supra, n. 3, at 519-522.

11/ S. Hearings on H. R. 8046, 75th Cong., 2d Sess. (1937-38) 80-81.

or "by whom or for whose account" securities have "without the prior consent or subsequent approval of the judge been otherwise acquired or transferred".[12/] While it seemed that the framers at the time intended that "otherwise acquired or transferred" was to mean something different than "purchased or sold", there has been significant litigation, some recently to which I shall refer, with respect to this provision.

The Commission's interest in Section 249 quite obviously did not cease with its enactment for without alert watchfulness and rigorous application the intent of the provision could be frustrated. Thus, throughout the years the Commission has been active in proceedings involving its application and has participated in most proceedings on the appellate level;[13/] the Commission's Annual Reports, with few exceptions, discuss Section 249 problems and the position taken by the Commission. I must note here that the Commission has often felt quite lonesome in this area; ofttimes it is the only part to a proceeding to raise the question of disqualification. Attorneys and other parties are content to sit back and allow the Commission to do the necessary job, apparently feeling little responsibility either as parties to the proceeding or as members of the bar. I can only state my view that Section 249 is as much a part of Chapter X as, for example, Sections 241-243 under which

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12/ Id. at 124-125; 83 Cong. Rec. 8703 (75th Cong., 3rd Sess., June 10, 1938).

13/ Although the Commission has no right under Chapter X to initiate appeals it can and does participate as a party in appeals taken by others. See e.g., Scribner & Miller v. Conway, 238 F. 2d 905 (C.A. 2, 1956).

applications for fees are made; and Section 249 is no more the Commission's private preserve than those sections are the exclusive interest of applicants.

For the most part, Section 249 has been rigorously applied by the district and appellate courts.[14/] The disqualification does not rest upon trading, i.e., buying and selling, but will result from either a purchase or a sale and a single transaction will suffice to invoke the bar of the statute.[15/] It has been held that among the proscribed securities are those of subsidiaries as well.[16/] To be covered by the statute an attorney need not appear for a committee; appearance for an individual will suffice.[17/] Transactions after an attorney has assumed to act in that capacity, although as yet he may not have acted in the proceeding, will bar him from a fee.[18/]

14/ Allowance appeals are by leave of the Court of Appeals. See Section 250 of the Bankruptcy Act; Dickinson Industrial Site, Inc. v. Cowan, 309 U. S. 382 (1940).

15/ In re 188 Randolph Bldg. Corp., 151 F. 2d 357 (C.A. 7, 1945); In re Arcade Malleable Iron Co., 35 F. Supp. 461 (D. Mass., 1940); In re Norwalk Tire & Rubber Co., 96 F. Supp. 274 (D. Conn., 1951).

16/ In re Midland United Co., 64 F. Supp. 399 (D. Del., 1946), aff'd 159 F. 2d 340 (C.A. 3, 1947); In re Central States Electric Corp., 206 F. 2d 70 (C.A. 4, 1953).

17/ In re 188 Randolph Bldg. Corp., supra, n. 15.

18/ See In re Equitable Office Building Corp., 83 F. Supp. 531, 562 (S.D.N.Y., 1949); In re Cosgrove-Meehan Coal Corp., 136 F. 2d 3 (C.A. 3, 1943).

And an attorney who traded while he appeared in one capacity was denied compensation for services rendered later in the proceeding in another capacity.[19/] Also, an attorney whose law partner engaged in transactions in the securities of the debtor was barred from compensation even though the purchases had been made at prevailing market prices in open market transactions.[20/]

In brief, the purposes for which the section was enacted have been borne in mind. It has been recognized that "those who volunteer their assistance in the expectation of compensation under the Act must be deemed to do so subject to the rigid conditions which the Act imposes."[21/] And the Court of Appeals for the First Circuit has stated:

> "The existence of good or bad faith, the fact that there is, on the face of the transaction, a profit or a loss, is immaterial. No approval by the judge can alter the situation. It is doubtless true that the statute, thus construed, may work a hardship in some cases. . . but such sporadic cases are inconsiderable compared to the large object sought to be achieved by the law, which is to fix a standard of conduct by persons acting in fiduciary capacities, in these cases, so high as to prevent any possible clash between selfish interest and faithful performance of duty." 22/

19/ In re Reynolds Investing Co., Inc., 130 F. 2d 60 (C.A. 3, 1942).

20/ In re Los Angeles Lumber Products Co., Ltd., 37 F. Supp. 708 (S.D. Cal., 1941).

21/ In re Norwalk Tire & Rubber Co., supra, n. 15 at 277.

22/ Otis & Co. v. Insurance Bldg. Corporation, 110 F. 2d 333, 335 (C.A. 1, 1940).

Now I shall proceed to consider some specific problem areas.

The Commission has with regularity urged the view that a transaction by one closely related to the attorney or fiduciary will serve to bar him from compensation. It has argued that any other approach could lead to widespread abuse by applicants for it would permit the easy circumvention of trading restrictions; and that to impose upon the Commission the burden of proving an applicant's direct beneficial interest in such a situation would be tantamount to a denial of its objection. The courts, however, have expressed differing viewpoints on the subject.

In the Equitable Office Building Corporation proceeding it was shown that the applicant, an attorney, had divulged vital information to his brother-in-law on the basis of which the brother-in-law had engaged in transactions in the debtor's stock with the applicant's knowledge. The Commission urged, among other grounds, that these transactions by the brother-in-law invoked the absolute bar of Section 249 and the district court agreed. On appeal, however, the Court of Appeals viewed the matter differently.[23/] It saw the action of the applicant as a breach of trust on the basis of which the court could reduce the amount of his fee or, indeed, extinguish it completely. As for Section 249, the court held that the objectors (in that case the trustee and the Commission) had the burden of showing that the applicant had an interest in the relative's

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23/ Berner v. Equitable Office Building Corp., 175 F. 2d 218 (C.A. 2, 1949).

transactions; since they did not sustain the burden the section did not apply.[24/]

Thereafter in Nichols v. Securities and Exchange Commission,[25/] the Court of Appeals for this circuit again expressed itself on the subject of the extent to which applicants may be affected by the transactions of relatives. That case arose under Rule 62(g) promulgated pursuant to the Public Utility Holding Company Act of 1935,[26/] which rule, broadly speaking, is the counterpart of Section 249. Involved were transactions by the wife and daughter of one applicant and the sister of another, all apparently engaged in without the applicants' knowledge. The Commission denied compensation. The court equated Rule 62(g) with Section 249 and held basically that compensation would not be denied where the applicant "is ignorant of his relatives dealings." In the course of its decision the court went on to express fairly broad views on the subject. It characterized the Commission's contentions as "a revival of the unitary liability of the archaic sib. . ." and stated that

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24/ For a critical discussion of this holding see Ferber, Blasberg and Katz "Conflicts of Interest in Reorganization", 28 Geo. Wash. L. Rev. 319, 377-9 (1959).

25/ 211 F. 2d 412 (1954).

26/ 17 C.F.R. 250.62 (1949); 15 U.S.C. 79k, et seq.

"In modern times a man's wife is independent economically, and her profits are as a little his as are his neighbors'."[27/] Also, it apparently imposed in this situation, where a wife and daughter were involved, the test which it had applied in the Berner case, i.e., had the objector shown that the applicant had a beneficial interest in the transaction.

This situation arose here recently in the reorganization of Third Avenue Transit Corporation. In making its recommendations for allowances the Commission urged that an attorney whose wife had sold bonds of the debtor with his knowledge should be denied a fee. It showed that the attorney was at all times aware of the situation, had in fact transmitted the securities to the broker in consummation of the sale, and had received and deposited the proceeds of the sale to his wife's account. Further, the loss on the sale had been applied on the joint income tax return filed by the husband and wife.

In support of its view, the Commission pointed to decisions in the Third and Fourth Circuits and in district courts holding uniformly that a transaction by a wife with the knowledge of the applicant will bar a fee.[28/] It distinguished the Berner case on the basis of the relationship,

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27/ 211 F. 2d at 416.

28/ In re Midland United Co., In re Central States Electric Corp., supra, n. 16; In re Inland Gas Corp., 73 F. Supp. 785 (E.D. Ky., 1947); also S.E.C. v. Dumaine, 218 F. 2d 308 (C.A. 1, 1954) under Rule 62(g).

i.e., wife as against brother-in-law, and the Nichols case on the basis of knowledge. In contrast to the view expressed in the Nichols case, the Commission pointed to the statement by the Court of Appeals for the First Circuit in S.E.C. v. Dumaine, 218 F. 2d 308 (1954), which also arose under Rule 62(g), that "as a practical matter an economic benefit to a wife is indirectly an economic benefit to a husband, at least when husband and wife are living together as a family unit. . ." (218 F. 2d 315), a somewhat more realistic view even in our "modern times".

Judge Dimock, in charge of the Third Avenue proceeding and who, it may be noted parenthetically, sat on the panel of the Court of Appeals which had decided the Nichols case, granted compensation. He concluded that the Berner and Nichols decisions imposed upon the objector -- the Commission -- the burden of showing a beneficial interest and that no conclusive presumption of beneficial interest existed. He then went on, as the Court had in the Berner case, to consider the matter from the viewpoint of a breach of trust and concluded that there had been none.[29/]

The Court of Appeals reversed. It stated that the language of the Berner and Nichols cases "on which the court below relied, is perhaps broader than those decisions warrant". It found the applicant disqualified "on the reasoning of the . . . decisions" in other circuits cited by the

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29/ In re Third Avenue Transit Corporation, CCH Bankruptcy Law Rep. ¶ 59165 (1958).

Commission, including the Dumaine case.[30/]

It would appear clear on the basis of this latest determination that transactions in securities by the spouse of an applicant with his knowledge sufficiently raises a presumption of beneficial interest in the applicant so as to disqualify him from compensation. For one examining into the propriety of a fee, this is indeed a welcome result; the investigative areas to be covered and techniques to be employed in discovering the extent to which each spouse has a beneficial interest in the assets of the other -- let alone the intangibles -- are too much to contemplate. Also it would seem from the reasoning of the Dumaine case, upon which the Court of Appeals relied, that the same would apply to transactions by all members of the applicant's immediate household. Where, however, the relative is not such a member, presumably the burden would be upon an objector to show something more than the mere existence of the relationship.

When there is no knowledge on the part of the applicant -- the transaction by a non-member of the applicant's household would not appear to disqualify. Where, however, lack of knowledge of the transactions by a member of the applicant's immediate household is asserted, I would again urge that unless such transactions are disqualifying, a wide avenue for evasion is open. This view appears more nearly to accord with the

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30/ Surface Transit, Inc. v. Saxe, Bacon & O'Shea, 266 F. 2d 862, 868 (1959), cert. den., 80 Sup. Ct. 120 (1959).

broad purpose of preventing the use of insider information intended by the Congress in the enactment of Section 249.[31/] In light of the intimacy of the relationship among the members of the same household, the burden of demonstrating knowledge should not be placed upon an objector. And, the attorney or fiduciary is in a good position to avoid all problems by advising members of his family to avoid all transactions in the particular securities.

I should like to consider now the position of the individual security holder and his attorney. It has been suggested that Section 249 may apply to the individual security holder who appears and acts in the proceeding but who does not assume to act as a representative based on the theory that to receive compensation from the estate for a contribution one "incurs concomitant obligations and responsibilities and occupies at least a representative if not a fiduciary position".[32/] Some weight is lent to this view by statements of the Supreme Court. Thus, in the Dickinson case the Court said "Fee claimants are either officers of the court or fiduciaries" and in Brown v. Gerdes, "in all cases persons who seek compensation for services or reimbursement for

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31/ For a recent exposition of this view see Ferber, Blasberg and Katz, supra, n. 24, at 376-7.

32/ Note 18 N.Y.U.L. Rev. 399, 475 (1941).

expenses are held to fiduciary standards. . ."[33] On the other hand, it has been urged that Chapter X in its liberal provisions for the appearance of individual creditors and stockholders in person or by counsel, including their right to be heard on all matters and to apply for compensation for contributing services,[34] points to a democratization of the reorganization process; thus an individual security holder who has not overtly assumed representative status would tend to be discouraged from putting forth the effort needed to make a contribution if a casual transaction would disqualify him from compensation.[35]

While no court has gone so far as to disqualify the individual security holder, as such, where he has dealt in the debtor's securities, it appears clear that courts have looked upon such applicants strictly, seeking to find if they have not passed over the line to the status of a representative. Concededly it is not the usual situation for an individual security holder to appear, trade in the securities and seek compensation; and usually such person occupies a somewhat more significant position than that of merely a security holder.[36] In Finn v. Childs,

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33/ Dickinson Industrial Site, Inc. v. Cowan, 309 U. S. 382, 388 (1940); Brown v. Gerdes, 321 U. S. 178, 182 (1944).

34/ Sections 206, 209 and 243.

35/ 6 Collier, Bankruptcy 4594 (14th ed. 1947).

36/ 181 F. 2d 431 (1950).

while the Court of Appeals for this circuit took note of the differing views of Section 249 just stated, it declined to go as far as to hold (as had been urged by the reorganized company) that any individual who had traded should be barred. It did hold that, while the persons there concerned had formally professed to be appearing solely for themselves, they had molded a large group of security holders whom they, in fact, represented and this pattern of activity had constituted them fiduciaries within the meaning of Section 249. Also, in Young v. Higbee[37/] the Supreme Court held that security holders who appealed individually from an adverse determination to their class did so on behalf of the class and therefore represented it and owed it fiduciary obligations and that sums derived on a sale of their securities in excess of market price in connection with the abandonment of their appeal thus belonged to the entire class. And in a subsequent proceeding it was held that Section 249 would bar these holders from charging their expenses, including legal fees on the appeal, against the proceeds of the sale of stock.[38/]

As for the attorney for the individual security holder, his own transactions in the debtor's securities would of course bar him.[39/] Nor may he avoid the statute by having the client apply for the fee as an expense.[40/] A more interesting question is, does the purchase or sale of

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37/ 324 U. S. 204 (1945).

38/ Young v. Potts, 161 F. 2d 597 (C.A. 6, 1947).

39/ In re 188 Randolph Bldg. Corp., supra, n. 15.

40/ In re Arcade Malleable Iron Co., supra, n. 15.

securities by the individual security holder bar his attorney from a fee. Some courts have dealt with this problem.

In Mortgage Cuarantee Co., 41/ it was held that where the client had engaged in "certain transactions, though relatively small," the attorney was not barred from a fee. In Inland Gas Corporation 42/ a group of individual security holders engaged counsel to participate in the so-called "interest on interest" question. Along with others, counsel was successful. The clients had actively dealt in the debtor's securities and had in fact paid the attorney out of their profits; any fee allowed by the court was to be in reimbursement to the clients. On the Commission's recommendation, the court refused to allow a fee to the attorneys, holding that the clients should properly bear the expense out of their profits and that the benefit to the estate was merely collateral. The court found that the "participation [of the clients] in the proceeding through their attorneys merely constituted an effort to promote their speculative venture." Parenthetically, it can be noted that the clients had also applied for a fee; while their application was denied for failure to file the affidavit required by Section 249, the court nevertheless went on to find that they had probably constituted themselves as representatives within the meaning of Section 249.

In this circuit, in Silbiger v. Prudence Bonds, 43/ the court

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41/ 40 F. Supp. 226, 238 (D. Md., 1941).

42/ Supra, n. 28, at 792.

43/ 180 F. 2d 917, 922-3.

refused to deny compensation to two sets of counsel whose clients "bought and sold bonds. . . indiscriminately from time to time as it seemed to them to offer opportunities for speculative profit". The court relied upon the opinion in Mortgage Guarantee Co. where relatively small transactions had taken place. It noted that while one client had agreed to pay his attorney, the other had not. In reliance upon the Inland case, it suggested the possibility that where there was an agreement, recourse might be had against the client on the theory that the client who might have assumed a fiduciary status had been benefited from the allowance to the attorney. In an application to the Supreme Court for a writ of certiorari on another aspect of the case, in which the Commission joined, amicus curiae, the view was expressed by the Commission that the Court of Appeals "went too far in suggesting that attorneys' allowances are not at all affected by their clients' trading activities".

It seems to me that to a certain extent the opportunities improperly to profit from inside information during a proceeding may be minimized. There are those who appear in a proceeding as representatives, against whom the sanction clearly may be applied; and others appear without assuming a fiduciary status. The distinction should not be overlooked. Thus, the fiduciary may be allowed to participate in all phases of the proceeding including those of a non-public nature; the non-fiduciary should for the most part be limited in his participation to the public proceeding. Where, as in the Childs case, the security holders assume a larger role, participating actively in the plan promulgation and in other activities not

generally open to public security holders at large, they may take on fiduciary obligations to the entire class with all the attendant implications. As the court said (181 F. 2d at 441):

> "Large stockholders have a perfectly legitimate right to attempt to shape a reorganization in the manner they think most desirable. And they have an equally legitimate right to trade in the securities of the debtor during the reorganization. But when they do, and thus embrace an opportunity to profit from their knowledge of the course of the reorganization, they forfeit their right to be compensated for their activity from the estate."

So too, it seems to me that the attorney for the individual security holder, who may owe an obligation for the disclosure of information derived from the proceeding, should to a great extent be confined to the public aspects of the proceeding. The distinction suggested by the court in the Silbiger case between the attorney, on the one hand, who has an agreement for his client to pay him a fee and the attorney, on the other hand, who has no such agreement, appears to place greater emphasis upon assuring the attorney his compensation than upon the basic policy involved. Rather than the existence of an agreement with the client, it seems to me that the nature and existence of the client's activities should be the compelling factor. Thus, if in fact, as in the Inland case, the security holder appears through counsel and participates principally in order to buy and sell securities for profit, then properly the attorney should be denied a fee even if, as in that case, the attorney is ignorant of the client's activities.[44/] On the other hand,

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44/ Supra, n. 28 at 792.

if the client's securities transactions are relatively few, do not appear to be a material factor in the participation in the proceeding and the attorney has no knowledge, then the client's trading should not affect the attorney's compensation. Here too, we must be aware of the intimate relationship enjoyed by attorneys and clients; and prudence might well dictate that the client be advised that if the attorney is to look to the estate for a fee there should be no transactions in the securities.

Next I shall turn to the last clause of Section 249. You will recall that the section provides for denial of compensation to one who has purchased or sold "or by whom or for whose account such claims or stock have, without the prior consent or subsequent approval of the judge, been otherwise acquired or transferred". What transactions may receive the approval of the court and what transactions may not? In reliance upon this provision applicants have sought judicial approval of sales and purchases of securities contending that it grants the judge such broad power.

In Otis & Co. v. Insurance Building Corporation[45/] the Court of Appeals for the First Circuit analyzed both the face of the statute and the legislative history, generally as I have already stated it, and concluded that the power to approve was limited to securities which were "otherwise acquired or transferred"; sales or purchases represent an

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45/ Supra, n. 22.

absolute prohibition to compensation, while securities "otherwise acquired or transferred" represent a bar unless the transaction is approved. 46/

In the Third Avenue proceeding, the question arose as to the effect of a pledge and subsequent sale of securities. Counsel for a committee for adjustment bondholders was at the inception of the proceeding the owner of bonds of the same class. Some two years later, after having participated in the proceeding to some extent, he pledged his Third Avenue bonds with a bank, along with other bonds and stock, as collateral for a loan. Within a relatively few months the market value of some of the pledged securities had declined and the bank demanded, in effect, that some action be taken to place the loan in balance. The attorney conceived of the demand as a "margin call" and directed the Third Avenue bonds sold and the proceeds applied to reduce the loan. No disclosure of the transaction was made and in the later stages of the proceeding the attorney became quite active and participated in rendering what was characterized by Commission counsel and the court as probably the most significant single contribution to the case. When allowance time drew nigh, over five years after the bonds had been sold, the attorney applied for approval of the sale under the latter clause of Section 249.

46/ To the same effect see In re Consolidated Rock Products Co., 36 F. Supp 912 (S.D. Cal., 1941).

The Commission, albeit reluctantly, recommended denial of compensation. It urged that, notwithstanding the striking service rendered by the attorney, he had sold securities and Section 249 represented a complete bar to a fee. It viewed the existence or non-existence of other assets as immaterial, but pointed out that the attorney could have satisfied the bank by any number of means including the sale of the other bonds in the bundle of collateral. The attorney argued that since the bank's demand was in effect a margin call, his sale was "involuntary" and the same as if made by the bank-pledgee; in these circumstances he urged that the court had the power to approve the transaction as not being a sale by him.

Judge Dimock denied compensation. As he read the statute, only a sale by the applicant would represent an absolute bar; a sale for the account of an applicant in which the applicant did not participate would be approvable. Thus, sale by a pledgee pursuant to a power given by the pledgor would not absolutely disqualify an applicant. He went on to find, however, that the sale by the attorney was not tantamount to sale by the bank; in light of the existence of the remaining collateral the sale of the Third Avenue bonds was not inevitable.[47/]

Upon appeal, while urging affirmance, the Commission respectfully disagreed with the lower court. It argued:

47/ In re Third Avenue Transit Corporation, 159 F. Supp. 440 (1958).

> "Where a pledgor voluntarily and knowingly (perhaps deliberately because of the restrictions of Section 249) places his securities of a debtor in a position where the normal flux of the market will affect the margin and may cause the securities to be sold -- having essentially the effect of a stop-loss order -- he should be chargeable with the sale. Moreover, the pledgor may permit the loan to be defaulted and in this way cause the securities to be sold. If such a pledge and subsequent sale were deemed to be encompassed within the language 'otherwise acquired or transferred' so as to permit approval by the judge, a convenient device would be created to circumvent the objective standards of the section. The natural and logical consequences of a voluntary act are not involuntary."

The Court of Appeals affirmed. As urged by the Commission it held:

> "It would seem that any disposal of securities of the debtor pursuant to a pledge arrangement instituted after the applicant had assumed a representative or fiduciary capacity in a reorganization must fall within the class of transactions absolutely prohibited. Sale by the pledgee is of course pursuant to a power of sale granted by the owner; and such a pledge may often operate in practical effect as a 'stop loss order' -- an order to a broker to sell if the market value of the securities drops below a specific price. If one exercising the prerequisites and receiving the benefits of ownership can thus easily avoid the statutory bar by the form chosen for the particular transaction, its deterrent effect is largely dissipated." 48/

Alternatively, the court found that the attorney could have met the demand of the bank without sale of the Third Avenue bonds and that, therefore, the decision to sell was his own.

48/ Surface Transit, Inc. v. Saxe, Bacon & O'Shea, 266 F. 2d 862, 867 (1959), cert. den., 80 Sup. Ct. 125 (1959).

This determination would seem to establish the law where there is a sale by a pledgee under a pledge made after the attorney or fiduciary assumed to act in that capacity. Some questions remain. What if the pledged securities are not sold, but are redeemed? In that case it would appear that since no sale or purchase had occurred, no absolute bar to compensation would exist. Even here, however, under compelling circumstances, a court could, for example, invoke general trust principles to correct an abuse by the applicant of his fiduciary obligations. And what if the pledge was made long before there is any assumption to act as an attorney or fiduciary and there is a later sale by the pledgee? It is my view, since the sale was for the account of the pledgor that it would operate to bar him.[49/] Exemption of this transaction from the absolute bar of the section would necessarily rest upon the assumption that the applicant's financial situation necessitated the sale by the pledgee. Certainly if the applicant clearly was possessed of other assets and yet permitted the pledged securities to go down the drain, so to speak, he should be deemed to have effected the sale. Should then the burden of showing the extent or degree of financial stringency when the loan becomes due be placed upon an objector or upon the judge? Should the financial stringency of an applicant ever be the basis of an excuse for a sale of securities under Section 249? It seems to me that the answer to both

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49/ Cf. In re Cosgrove-Meehan Coal Corp., 136 F. 2d 3 (C.A. 3, 1943).

questions must be in the negative -- otherwise courts would be required to engage in subjective tests in order to enforce the statute. What is one man's stringency may well be the other fellow's affluence. Only an objective standard, that no fee will be allowed when the sale is for the applicant's account, will suffice.

Is there then some guide as to which securities transactions are approvable under Section 249 and which are not. This is most difficult since I know of no case where an applicant has successfully sought approval of an acquisition or transfer of securities. On the basis of the legislative history and the few decided cases, however, it would appear to me that if the essence of the transaction is commercial and the acquisition or disposition is for the applicant's account it probably should be viewed as a purchase or sale and serve as an absolute bar to compensation. If on the other hand, it is not of the commercial variety, such as a gift, bequest or by operation of law through intestacy, then it is probably within the class of approvable transactions. And even in these cases the applicant would be prudent to present the matter to the judge for prior consent, or, if that is impractical, then for subsequent approval soon after the event.

So much for trading problems.

The practice of the sharing of compensation by attorneys in bankruptcy and reorganization proceedings is undoubtedly as old as the practice of receiving compensation. More recent, however, is the

recognition that, unless strictly controlled, fee sharing arrangements tend to evil and lead to serious abuse.

Collier puts it this way:

> "Any division of fees or other compensation represents, above all, an incentive for the applicant to claim a compensation high enough to make his own share in it a worth-while remuneration. It thereby tends toward extravagence of expenditure. Another evil is that it subjects the officer or attorney entitled to compensation to outside influences, over which the court has no control and which may affect the administration by depriving the court's functionaries of their requisite independence of judgment." 50/

And in Weil v. Neary, 278 U. S. 160 (1928), the Supreme Court struck down an agreement by an attorney for creditors to share in the compensation of the attorneys for the trustees. It held such a contract "in violation of public policy and professional ethics" (278 U. S. at 174) and stated that a finding of actual fraud was unneeded; it was not only the actual evil that was being condemned "but their tendency to evil in other cases" (278 U. S. at 173).

Several years prior to that decision the Supreme Court had promulgated General Order in Bankruptcy No. 42 requiring allowance applicants to swear in substance that no agreement or understanding for division of compensation exists with the receiver, trustee or bankrupt or the attorney for any of them; inability so to affirm would result in a denial of compensation. And in 1938 the principle of the General Order

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50/ 3 Collier, Bankruptcy 1614 (14th ed. 1947).

was enacted into law and broadened as subdivisions (c) and (d) of Section 62 of the Bankruptcy Act.[51/] Section 62(c) declares that a custodian, receiver, trustee, or any attorney in the proceeding may not share or agree to share his compensation with one not contributing to it, provided that an attorney-at-law may share with his law partners or with a forwarding attorney. Section 62(d) calls for an affidavit as to all fee-sharing arrangements and provides for denial of compensation where the court finds an agreement to share in contravention of subdivision (c).

First, as to court officers -- trustees and receivers -- under Chapter X. It has been suggested that there may be some impropriety in the employment by trustees of their law partners or firms as counsel in ordinary bankruptcy.[52/] Whether that be so or not the fact is that in a number of Chapter X proceedings attorney-trustees have employed their firms as counsel, pursuant to order of the court.[53/] Moreover, the Commission has from time to time, in appropriate situations, recommended that trustees who are attorneys act as their own counsel, utilizing

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51/ 11 U.S.C. 102(c)(d).

52/ See 3 Collier, Bankruptcy 1616 (14th ed. 1947); In re Levinson, 19 F. 2d 253, 256 (W.D. Wash., 1927).

53/ General Order in Bankruptcy No. 44 requires that attorneys for a trustee, receiver, or debtor in possession be appointed upon order of the court.

where necessary the services of their law partners or associates. Certainly this would tend to promote more economical administration of estates.

Where trustees have employed their partners or firms as counsel they have sometimes presented separate applications and sometimes a joint application for compensation. In the Childs Company proceeding,[54/] where the trustee was administering an active business throughout the proceeding, it was considered desirable and proper for him and his law firm to submit separate fee applications. On the other hand, in the General Stores Corporation proceeding,[55/] where the affairs of the estate were mainly legal as against operational, the staff recommended that a single application be filed since no real division could be made between the services of trustee and counsel.

The proviso of Section 62(c) permits an attorney-at-law to share with his law partners or with a forwarding attorney. Does this prevent a trustee who is an attorney-at-law from sharing his fee with his law partners? I do not believe so although the contrary view has been strongly urged. Collier states that the proviso

> ". . . should not be understood to authorize a receiver or trustee, who happens to be a member of the bar, to share his compensation qua receiver or trustee with his law partner. The exception refers only to the fees of an attorney-at-law earned qua attorney." 56/

54/ S.D.N.Y., Docket No. 82868.

55/ S.D.N.Y., Docket No. 90594.

56/ 3 Collier, Bankruptcy 1616 (14th ed., 1947).

It seems to me that this interpretation of the proviso is at least open to question. It could well be argued that attorneys were exempted as a profession - the expression used is "attorney-at-law" not "attorney" - since by their very nature they are officers of the court subject to high standards under the Canons of Professional Ethics; and partnership arrangements are specifically recognized by the Canons. But without considering the appropriateness of this interpretation as it may apply in ordinary bankruptcy, it is clear as a matter of practice that attorney-trustees in Chapter X have been permitted to share their fees with their partners and that non-attorney trustees have not been permitted to share with their business or professional partners.

As an illustration, I may point to the reorganization of Northeastern Steel Corporation.[57/] There two trustees were appointed - one an attorney, member of a large New York law firm, and the second an accountant, member of a Connecticut accounting firm. At allowance time it was pointed out to the accountant-trustee that Section 62(c) would prohibit the sharing of his fees with the members of his firm. Accordingly, his affidavit recited that he would not share his fees - period; the other trustee's affidavit stated that he would not share his fees except with his law partners. Also, in the Third Avenue Transit proceeding[58/] one of the trustees was an attorney and another a partner in a

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57/ D. Conn., Docket No. 27825.

58/ S.D. N.Y., Docket No. 85851.

stock brokerage firm; the first shared with his partners and the other did not. Of course, where a law partnership arrangement is formed clearly in order to permit other attorneys to share in the compensation of either the trustee or trustee's counsel it would appear to be a clear evasion of the intent of the statute. Experience has not shown that the practice that has been followed here, and in other regions, has resulted in any evil or abuse requiring correction.

Some questions have arisen as to sharing of fees by trustees with others than partners. Recently in the reorganization proceeding for F. L. Jacobs Co.[59/] it became known, in connection with an application for interim compensation, that one of the trustees, an officer of a bank, intended to turn over his entire fee to the bank. It was stated that the trustee-bank officer drew a regular salary from the bank, acted in many such proceedings in both federal and state courts and turned over all his fees to the bank; we were also told that this was a regular practice in the Detroit area and that other banks and bank officers acted similarly. The Commission took the view that this would contravene both the letter and spirit of Section 62(c); it advised the trustee that it would object to the payment of any fee unless an appropriate arrangement were made under which (1) he would retain his fee, (2) the bank would free him from bank responsibility as required, so as to permit him to devote himself to estate business, and (3) his salary at the bank would not be affected by the amount of his allowance, although it

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59/ E.D. Mich., So.Div., Docket No. 42235.

might reflect a reduction in the amount of time spent on bank affairs. Appropriate arrangements were made prior to the hearing and the objection avoided.

I should like now to discuss fee-sharing arrangements between or among attorneys who appear jointly in a proceeding. From time to time, as the situation has warranted, the Commission has made recommendations for separate fees to such attorneys where it has appeared that the agreement would result in a division of compensation highly disproportionate to the services rendered or contribution made. And, without challenge, courts have awarded separate compensation in a number of proceedings following the Commission's recommendation.

The first challenge to this approach occurred in the reorganization of Pittsburgh Railways Company.[60/] There, upon the recommendation of the Commission, the court, without opinion, allowed separate fees in proportions different from those agreed upon by the applicants. In an application for leave to appeal the affected applicants urged that the court had no power to disturb the voluntary agreement of the parties. Although pointing out that the parties had stipulated that their agreement would be "subject to the approval of the court", the Commission strongly urged that, in any event, the broad powers of the reorganization court over allowances enunciated by the Supreme Court in Brown v. Gerdes, 321 U.S. 178 (1944), and Leiman v. Guttman, 336 U.S. 1 (1949), embraced as well the power to

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60/ W.D. Pa., Docket No. 20225.

review agreements among counsel. In its brief it stated:

> "To hold that the reorganization court may not examine into and disregard unreasonable or unconscionable agreements between counsel might well result in unnecessary depletion of the assets of estates in reorganization to the detriment of public investors. This is because such agreements have a tendency to produce a climate favorable to extravagant requests and excessive awards. An applicant laboring under the burden of an unfavorable percentage agreement may well overevaluate the services contributed by himself and his associates in the hope that a larger award will result in a more equitable fee for himself. Similarly, in such a situation the reorganization court is itself under pressure to award an aggregate allowance in an amount larger than it would otherwise find fair in order to assure a reasonable fee to the individual participant who has made the substantial contribution."

It also pointed out that under Sections 241-243 applicants are to be compensated only for services "which contributed" or "which were beneficial".

> "Unless persons actually performing the services are compensated on the basis of their contributions, rather than on the basis of agreements unrelated to that factor, it cannot be expected that they will render the efficient and diligent service which the security holders they represent are entitled to receive."

After leave to appeal was denied, the affected applicants moved before a successor judge (the judge who made the awards having died) to compel the pooling of the fees awarded separately. Although feeling bound by the ruling of his deceased brother, the judge quite strongly and unreservedly stated:

> "I believe that the sanctity of contract must remain untrammeled, and that any legitimate agreement, spoken

> or written, between lawyers is sacrosanct and should be observed without equivocation. . ."

otherwise "the practice of law would degenerate to the era of the Neanderthal man."[61/]

Not until the Third Avenue Transit proceeding did a court fully consider the subject. There an attorney who represented holders of the debtor's refunding bonds entered into an agreement with a law firm for the purpose of representing those and perhaps other refunding bondholders as petitioning creditors in the filing of an involuntary Chapter X petition. The petition was so filed and, while the firm rendered significant services during the early stages of the proceeding, increasingly the entire burden was borne by the individual attorney until, for all practical purposes, the firm was no longer in the picture - that is until the time approached for the filing of applications for fees.

At that time the firm insisted that the agreement provided for an equal division of the compensation and that the court had no power to disturb it in the absence of a showing of bad faith at the inception of the agreement or in its execution. Additionally, it insisted that the fee had to be allowed to it since it alone had formally appeared as attorney of record - the individual lawyer was only counsel to the firm. I shall not refer to the firm's arguments that the individual attorney would be disqualified if allowed a separate fee but not disqualified if allowed a joint fee under the agreement.

61/ In re Pittsburgh Railways Co., 121 F. Supp. 948, 949 (W.D. Pa., 1954).

The Commission recommended separate fees. It found that the agreement between the attorneys contemplated that each would contribute fairly equally to the rendering of the services, that it was understood by the parties to be subject to the approval of the court and that, in any event, the court had ample power and should exercise it in a situation such as this. The Commission did not urge an "arithemetical formula applied with rigidity"; it recognized that the contribution of each participant need not be the same. Thus, one participant might contribute more in direct services and the other more in the furnishing of office facilities and over-all responsibility; but it pointed out that the responsibility, to be meaningful, must be actual and closely related to the conduct of the proceeding and not of a nebulous or hypothetical variety. As for the attorney of record argument the Commission viewed it as a mere formality; as a matter of fact, the attorneys were at least equal associates. If the court was bound by the formalism and required to make the entire fee payable to the firm, it had the power to direct the firm to pay over the appropriate amount to the individual attorney.

Reliance was placed not only upon the broad supervising power of the reorganization court over all allowances and fees as enunciated by the Supreme Court but also upon Section 62(c) of the Bankruptcy Act, to which I referred a while back, and Canon 34 of the Canons of Professional Ethics which provides:

> "No division of fees for legal services is proper, except with another lawyer, based upon a division of service or responsibility."

Judge Dimock made separate awards. He held:

> "Even if the parties had not so provided in their agreement, [i.e., that it was subject to court approval] the court in a reorganization proceeding has the power to determine the amount of awards where judicial sanction of the alleged agreement would result in awards grossly disproportionate to the attorney's contribution to the estate." 62/

As for Section 62(c) he stated:

> "It would be a clear evasion of the intent of this section if the court were to sanction a fee sharing arrangement whereby an attorney, having performed some service, received an allowance far in excess of that to which his contribution to the estate entitled him." 63/

On appeal, the Court of Appeals affirmed. Relying specifically on the Supreme Court cases referred to, it reaffirmed the court's power to make separate awards. While noting that the parties had agreed "upon an equal division of work as well as of compensation" it apparently found no need to refer to the fact that the parties had understood their arrangement to be subject to the court's approval. 64/

The Third Avenue proceeding illustrates the selective approach taken by the Commission and the courts - usually on the Commission's recommendation - to the problem of allocation of fees among joint participants. In that proceeding there were a number of groups of attorneys requesting joint compensation and in all instances the Commission examined

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62/ In re Third Avenue Transit Corporation, CCH Bankruptcy Law Rep. Par. 59259 p. 65873(1958).

63/ Id. at 65874.

64/ Surface Transit, Inc. v. Saxe, Bacon & O'Shea, 266 F. 2d 862,866 (1959), cert. den., 80 Sup. Ct. 125 (1959).

into the fee arrangements. Where the arrangement, if followed, would allow each individual participant in the joint fee a share reasonably commensurate with his contribution, the Commission recommended a single joint fee; where, however, as I have described, the Commission found that to follow the agreement would result in grossly disproportionate fees to the participants, it made separate fee recommendations. In essence this is the Commission's approach. And in the Third Avenue proceeding the approach and the power to implement it were affirmed.

As I stated at the outset it was my intention to discuss particular areas rather than attempt fully to cover the entire field - and this I trust I have done. We've undoubtedly come a long way from the evils and abuses of the past such as reported by the Commission in the Protective Committee Study or considered by the Supreme Court in Weil v. Neary. There is not only a passive acceptance but a deep recognition that reorganization proceedings are in the nature of public proceedings and that "the punctilio of an honor the most sensitive is the standard of behavior". Whether by inadvertence or because of ingenuity questions will continue to present themselves. So long, however, as we continue to approach these questions in light of the spirit in which the policies were developed, as the courts generally have, we cannot stray too far.

Thank you.