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CLINICAL ANALYSIS OF ARRANGEMENTS UNDER CHAPTER XI OF THE CHANDLER ACT

THE enactment in 1938 of Chapter XI[1] of the Chandler Act represented another attempt of Congress to provide workable composition proceedings for the relief of small commercial debtors.[2] The defects of earlier composition statutes had forced such debtors either into reorganization sections of the Bankruptcy Act, or into state court proceedings, or back upon the informal techniques of out-of-court settlements with creditors.[3] From the

1. 52 STAT. 905 (1938), 11 U. S. C. §§ 701-99 (Supp. 1939).

2. The bill presented to Congress was largely the progeny of the National Bankruptcy Conference and national credit organizations. Mr. W. Randolph Montgomery sponsored the bill at committee hearings. *Hearings Before Committee on the Judiciary on H. R. 6439* (reintroduced and adopted in 1938 as H. R. 8046), 75th Cong., 1st Sess. (1937) 28, 35.

3. For a summary analysis of the defects of former Sections 12 and 74 of the Bankruptcy Act, see MOORE'S BANKRUPTCY MANUAL (1939) 636-45. For a discussion of the relation of the Bankruptcy Act and state insolvency statutes, see (1940) 49 YALE L. J. 1090. The role of credit bureaus in out-of-court adjustments with creditors is discussed in Mulder and Solomon, *Effect of the Chandler Act Upon General Assignments and Compositions* (1939) 87 U. OF PA. L. REV. 763.

start the simplicity and flexibility of the Chapter XI arrangement augured well for its usability and popularity.[4] But in the course of its three year operation dramatic instances of abuse have suggested certain weaknesses. In an effort to evaluate the overall operation of Chapter XI a clinical analysis is presented of a cross section of debtor arrangements completed in the District of Connecticut and the Southern District of New York. Since criticism of Chapter XI has centered upon its availability to large corporate debtors, the New York area was chosen as the forum of investigation most likely to reveal the significance of this problem. On the other hand, the diversity of its commercial and industrial life[5] made Connecticut a laboratory for observing the operation of Chapter XI in the average business community. In Connecticut all the Chapter XI proceedings, numbering 87, were examined that had been instituted up to October 1, 1941. In the Southern District of New York a representative six month period, January 1 to June 30, 1940, was chosen for analysis, during which time 152 petitions were filed. The data accumulated have been classified in terms of three major problems: (1) the initiation of proceedings, including the scope of relief available in Chapter XI and the confusion surrounding the jurisdictional relation between Chapter X and Chapter XI; (2) problems of administration, particularly the effectiveness of creditors' protection against undue debtor domination; (3) control of results, involving the standards of "fairness" required for confirmation of the final arrangement.

Initiation of Proceedings: Jurisdictional Relation of Chapter X and Chapter XI.

Types of Debtors. Although the effective administration of the former reorganization procedure of the Bankruptcy Act, Section 77B,[6] was hampered by the sheer volume of cases handled, it is clear that under the Chandler Act the great bulk of debtor readjustments have not been accomplished by Chapter X[7] reorganizations but rather by arrangement proceed-

4. The operation of Chapter XI, however, has enjoyed steady criticism by bankruptcy experts. See Rostow and Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act* (1939) 48 Yale L. J. 1334; Jackson, *Need for Amendment of the Chandler Act* (1939) A3 Corp. Reorg. 35; Montgomery, *The Chandler Act Again: Two Criticisms* (1939) 25 Va. L. Rev. 881; Hunt, *Proper Use of Chapters X, XI and XII of the Bankruptcy Act* (1939) 44 Com. L. J. 72; Levin, Weintraub and Singer, *The Third Year of Arrangements under the Bankruptcy Act: Crossroads and Signposts* (1941) 18 N. Y. U. L. Q. Rev. 375. *Report of Committee on Creditors and Arrangements With Creditors, National Bankruptcy Conference* (1940) A4 Corp. Reorg. 80.

5. See Biennial Census of Manufactures (U. S. Dep't Com. 1937) Pt. 1, p. 1339.

6. 48 Stat. 912, 11 U. S. C. § 207 (1934).

7. 52 Stat. 883 (1938), 11 U. S. C. §§ 501-676 (Supp. 1939).

ings under Chapter XI. During 1940, 260 debtors in the Southern District of New York petitioned for relief under Chapter XI while only 22 proceedings, four of which involved the same organization, were instituted under Chapter X.[8] Despite this heavy use, the arrangements studied indicate that Chapter XI has been used mainly by debtors for whom it was designed.

The heavy majority of Connecticut cases involved small retail merchants, having liabilities of less than $30,000.[9] Of the 87 cases in Connecticut, 64 debtors were retail merchants, 13 were from wholesale and service industries, and 10 were manufacturers. Groceries, clothing stores, drug stores and furniture stores constituted the predominant types of retail business. Of the 75 debtors whose scheduled assets were less than $30,000, the assets of 37 were less than $5,000. Similarly, the schedules of 64 debtors showed liabilities of less than $30,000, and 20 of these were under $5,000. In fact only three of the enterprises studied had either assets or liabilities of over $100,000. Classified in terms of forms of business organization, the cases included 40 individuals, six partnerships, 30 family corporations, ten private corporations and one wholly-owned subsidiary. In 81 of the 87 cases, management and predominant ownership were identical.[10]

Despite the differing business environment, the New York data are similar.[11] Although three New York debtors had assets of more than $1,000,000, the greatest difference between the Connecticut and New York cases was not the financial size of debtors but rather the predominant forms of business enterprise. In Connecticut 94% of the petitions were filed by individuals, partnerships or family corporations, while in New York such debtors represented 54% of the total.[12] Since the remaining 46% of the New York petitions were filed mainly by small private corporations, the figures from both states indicate that Chapter XI has been used almost entirely, as was intended, by small, closely held corporate and non-corporate enterprises.

Numbers of debtors, however, are not decisive of the proper use of Chapter XI. The interest of the community in arrangements varies directly

8. In Connecticut during the period Oct. 1, 1938, to Sept. 30, 1941, 87 debtors filed under Chapter XI and 15 Chapter X petitions were filed.

9. For a tabular presentation of the data on the New York and Connecticut cases, see Tables I-IX, *infra* pp. 278–81.

10. Of 60 enterprises reporting, the number of years in business averaged 9.2 years, and of the 51 debtors in business less than 15 years, the average was 5.1 years.

11. Of 146 debtors, 91 were retail merchants, 27 represented wholesale work and service, and 28 were manufacturers. The scheduled assets of 113 enterprises were under $30,000, and of these the assets of 50 amounted to less than $5,000. The debtors whose scheduled liabilities were less than $30,000 numbered 103, and 14 debtors had liabilities of less than $5,000. Only 11 petitions involved assets or liabilities in excess of $100,000. See Tables IV and VI, *infra* pp. 279–80.

12. Specifically there were 31 individuals, 11 partnerships, 38 family corporations, 64 private corporations and two wholly-owned subsidiaries.

with the amount of debt involved. If several large corporations with publicly held securities were able, despite the general trend, to take advantage of the informal machinery of Chapter XI, it might be said that a serious jurisdictional problem existed, for Chapter XI offers little assurance that the interests of security investors will be protected. Examination of the few large corporate debtors that did seek arrangements during the period studied suggests little justification for their presence in a Chapter XI proceeding. In Connecticut one corporation secured an arrangement although its size and financial problems indicated the need for the supervision and inquiry of a Chapter X trustee.[13] Another case[14] was transferred to Chapter X after the decision in *SEC v. United States Realty & Improvement Company.*[15] Similarly, in New York three debtors filed under Chapter XI despite assets of over $1,000,000 and financial situations involving public investor interests. Two of these enterprises secured confirmations,[16] while the third case was transferred to Chapter X.[17] In 238 cases studied, therefore, five debtors with liabilities totaling $10,393,399 appear to have needed the more elaborate machinery of Chapter X.[18]

Prior to the *Realty* decision, two factors allowed the choice between Chapter X and Chapter XI to rest solely with the debtor. First, the courts were generally agreed that there was no statutory or judicial authority by which to exclude debtors from Chapter XI. Hence, the five New York and Connecticut debtors mentioned above were able, regardless of size and the public investor interest involved, to use Chapter XI so long as they intended only to scale down unsecured claims. Secondly, Chapter X was available because courts were prone to accept without question the statements of debtors filing under Chapter X as to why adequate relief could not be had

13. Metropolitan Body Corp., Bankr. Docket No. 19636 (D. Conn. 1939). Assets were scheduled at $285,115 and liabilities at $332,703.

14. Jewett City Textile Novelty Co., Bankr. Docket No. 20080 (D. Conn. 1940), discussed *infra* p. 258.

15. 310 U. S. 434 (1940), 49 YALE L. J. 927, 40 COL. L. REV. 1245.

16. Burland Printing Co., Bankr. Docket No. 75625 (S. D. N. Y. 1940); Lydia Koch, Bankr. Docket No. 76163 (S. D. N. Y. 1940). For discussion of *Koch* case, see *infra* p. 257.

17. Ulen & Co., Bankr. Docket 75734 (S. D. N. Y. 1940), discussed *infra* p. 258.

18. Prior to the period studied there were four outstanding instances of large corporations that filed under Chapter XI in the Southern District of New York: Haytian Corporation of America, Bankr. Docket No. 72310 (S. D. N. Y. 1938) (arrangement exchanged secured bonds, new debenture bonds and common stock for $2,964,225 worth of matured debenture bonds); Newark Factory Sites, Bankr. Docket No. 75225 (S. D. N. Y. 1939) (total indebtedness of $2,058,574); American Sealcone Co., Bankr. Docket No. 73638 (S. D. N. Y. 1939) (total liabilities of $200,960). Having liabilities of $9,262,000 and 900,000 shares of publicly held stock, United States Realty & Improvement Co., Bankr. Docket No. 74023 (S. D. N. Y. 1939), filed under Chapter XI thus inspiring the intervention of the SEC to protest jurisdiction. See 310 U. S. 434 (1940), 49 YALE L. J. 927; *Hearings before Committee on the Judiciary on H. R. 9864*, 76th Cong., 3d Sess. (1940) 34-49.

under Chapter XI.[19] Even in terms of relief sought, therefore, the existing statutory test for determining jurisdiction was of little use in segregating debtors. In the New York area, for example, a few small retail merchants confusedly filed under Chapter X in the belief that the existence of secured debts barred them from an arrangement proceeding. Filing under Chapter X, the *Whitehall Lunch Company*,[20] having a secured debt of $300, stated that adequate relief could not be obtained under Chapter XI because "the petitioner has one secured creditor, namely the landlord, who has a chattel mortgage upon the fixtures in the store." The court mechanically approved the petition as properly filed although the major problem of this debtor seemed to center about $15,539 worth of unsecured claims. Two other corporations, having liabilities of $13,000 the greatest portion of which were unsecured claims, filed under Chapter X and then moved for dismissal and then filed under Chapter XI within ten days of the original petition.[21]

After attorneys comprehended the scope of an arrangement proceeding, the use of Chapter X by very small debtors ceased. But since debtors still had the option of seeking relief under Chapter XI instead of under Chapter X, the most important jurisdictional defect of Chapter XI remained. Some large corporate debtors employed this jurisdictional freedom to escape the strict supervision of Chapter X. Of course such a purpose was not present in every case, but it is possible that *Grand National Pictures Corporation*,[22] a subsidiary of Educational Pictures Company, sought an arrangement to avoid close scrutiny of the distribution contracts between its branches and the parent company. More spectacular as an instance of the misuse of Chapter XI was the case of *Lydia Koch*.[23] There an individual, whose scheduled assets of over $1,000,000 included large claims against, and dominant ownership of, a large corporation and its subsidiary, secured confirmation of an arrangement which allowed an escape from a New York Martin Act receivership. To prevent liquidation by the state receiver of her personal assets and those of the corporation for the benefit of defrauded purchasers

19. Every Chapter X petition must state "the specific facts showing the need for relief under the Chapter and why adequate relief cannot be obtained under Chapter XI of this Act." BANKRUPTCY ACT, § 130(7), 52 STAT. 886 (1938), 11 U. S. C. § 530(7) (Supp. 1939). The Act will hereafter be cited only by section number.

20. Bankr. Docket No. 75392 (S. D. N. Y. 1940).

21. Piggly-Wiggly Co. of New York, Bankr. Docket No. 74935 (S. D. N. Y. 1939); Bronx Montre Theatre Corp., Bankr. Docket No. 72212 (S. D. N. Y. 1938).

22. Bankr. Docket No. 75000 (S. D. N. Y. 1939).

23. Bankr. Docket No. 76163 (S. D. N. Y. 1940). The state court receiver, who had title to certain property that the debtor had obtained by fraudulent stock sales in violation of the New York Martin Act, challenged the jurisdiction of the federal court. The Circuit Court of Appeals affirmed the referee's confirmation of the debtor's Chapter XI arrangement and his issuance of an injunction restraining the state court receiver from enforcing the state court judgment. *In re* Koch, 116 F. (2d) 243 (C. C. A. 2d, 1940), (1941) 50 YALE L. J. 1100.

of the corporation's stock, the individual and the parent corporation successfully filed separate Chapter XI petitions in New York and Delaware respectively. The public interest involved in the debtor's large estate and the transactions between the debtor and the two corporations, as well as in the collateral fraud, seemed to require the protective devices offered by Chapter X.

By statutory reconstruction the decision in the *Realty* case provided courts with the power to restrict the jurisdiction of Chapter XI to certain types of debtors. Jurisdictional emphasis was thus shifted from the type of relief sought to the financial nature of the enterprise and the possibility of achieving a "fair and equitable" as well as "feasible" solution of its problems in Chapter XI. While it is not entirely clear, the criteria of segregation set out in the *Realty* case seem to include several factors—financial size and structure, dispersal of ownership, the amount of publicly held securities and the need for modification of secured indebtedness. In Connecticut the *Realty* decision forced at least one pending case into Chapter X. Having liabilities of $110,816, *Jewett City Textile Novelty Company*[24] sought a long term extension of its debts under Chapter XI. Upon examination it was determined that in order to secure additional capital a reorganization was necessary and the court required transfer of the case to Chapter X. In New York the effect of the decision upon a pending case reveals more pointedly the importance of the problem which it alleviated. *Ulen & Company,*[25] an engineering construction and service corporation with scheduled liabilities of $9,084,694, became insolvent when the Polish and Greek governments defaulted upon interest payments of bonds issued to the debtor as payment for services. To remedy its plight, the corporation proposed in a Chapter XI proceeding the conversion of $3,897,000 worth of debentures into prior preferred stock. Analysis of the proposed arrangement suggests that it was not "fair and equitable" in terms of the doctrine of the *Boyd* case,[26] for the interests of the old stockholders were to be preserved despite the insolvency of the corporation. The court denied the motion of the debenture holders' committee for dismissal to Chapter X and withheld judgment upon the fairness of the plan until the confirmation hearing. Faced, however, with insurmountable creditor opposition, the debtor corporation transferred the

24. Bankr. Docket No. 20080 (D. Conn. 1940).

25. Bankr. Docket No. 75734 (S. D. N. Y. 1940).

26. Northern Pac. Ry. v. Boyd, 228 U. S. 482 (1913). The implications of the "absolute priority" doctrine in Chapter X and Chapter XI have been widely discussed. See Rostow and Cutler, *supra* note 4, at 1345-62; Dodd, *The Los Angeles Lumber Products Company Case and Its Implications* (1940) 53 HARV. L. REV. 713; Dean, *Corporate Reorganization* (1941) 26 CORN. L. Q. 537; Fennell, *Some Reflections on the Los Angeles Lumber Company Case* (1940) 29 GEO. L. J. 36. The significant cases are Case v. Los Angeles Lumber Prod. Co., 308 U. S. 106 (1939), (1940) 49 YALE L. J. 1099; SEC v. United States Realty & Impr. Co., 310 U. S. 434 (1940), 49 YALE L. J. 927; Consolidated Rock Prod. Co. v. DuBois, 312 U. S. 510 (1941), 39 MICH. L. REV. 1222. See generally Comment (1941) 51 YALE L. J. 85.

action to Chapter X after the decision in the *Realty* case. Under the supervision of the SEC, the Chapter X trustee effected a ten year liquidation plan which eliminated stockholder equities and assured to the debenture holders and general creditors all the assets of the old corporation.[27]

Power to Affect Stockholders' Interests. The most important jurisdictional problem remaining after the *Realty* decision centers about the power to modify or eliminate the interests of stockholders in Chapter XI.[28] To be confirmed as "fair and equitable" an arrangement must allot to the full satisfaction of creditors' claims all the available assets of the debtor. In many instances, therefore, the adjustment of stock interests becomes inextricably linked with the achievement of full creditor priority. Recently, however, a federal court has held in the *May Oil Burner* case[29] that it had no power under Chapter XI to confirm an arrangement which proposed the formation of a new corporation, the major part of whose stock was to go to noteholders while stockholders of the old corporation received 26% of the new stock. The court did not consider the fairness of the plan but merely said that "the determining question is whether stockholders' rights are affected at all; not whether they are adversely affected."[30] Because absence of power to alter stock interests necessarily would make the need for such alteration a preliminary issue in a Chapter XI proceeding, the decision is significant jurisdictionally. If this position continues to receive judicial approval, corporate debtors who are forced to adjust stock interests either by practical financial circumstances or by the mandate of a fair plan, may once again be needlessly driven into a reorganization under Chapter X. When cash settlement with creditors is not feasible, debtors will no longer be able to form a new corporation and distribute shares of ownership to creditors.[31] The requirement of full creditor priority, moreover, will restrict the machinery of Chapter XI mainly to small enterprises in

27. The importance of the role of the SEC in achieving a feasible as well as a fair reorganization under Chapter X is illustrated by the *Ulen* case. The first plan of the Chapter X trustee provided for the formation of a liquidation company, Ulen Realization Corp., which was to receive all the assets of the debtor, except certain executory contracts to be completed by Ulen & Co. Creditors were to receive common stock and debenture bonds of the Realization Corp. Upon analysis the SEC found the plan to be fair but held that the new $800,000 debenture bond issue was unsound in view of the uncertainty of prospective income. The final arrangement approved by the SEC limited the securities of the Realization Corp. to one class of common stock to be issued to all creditors. See Ulen & Co., Corporate Reorganization Release No. 43, June 21, 1941.

28. The statute specifically provides for the adjustment of unsecured debts but does not mention stock interests or secured debts. § 306(1).

29. 38 F. Supp. 516 (D. Md. 1941), 51 YALE L. J. 150.

30. 38 F. Supp. 516, 519 (D. Md. 1941). This decision applies certain dicta in the *Realty* case which now seem unfortunate. 310 U. S. 434, 453-54 (1940).

31. In ten of the arrangements studied, four in Connecticut and six in New York, the debtor's assets were transferred to a new corporation in which creditors received shares of stock. See *infra* p. 272.

which management and ownership are identical and the going concern value of which can only be preserved by the continued management of the owners. Under the *Realty* doctrine a "fair and equitable" plan can be achieved in such cases without the alteration of stock interests, for without the goodwill and services of the owners the going concern value to creditors would be slight.[32]

While the large majority of New York and Connecticut petitions were filed by enterprises in which the going concern contribution of the manager-owners was of such importance that stock interests would probably not have to be affected, the *May Oil Burner* decision would unnecessarily exclude from Chapter XI the remaining small corporations in which the ownership was not so closely held. The most serious consequence of the decision, however, is that the initial determination of jurisdiction will be saddled with the complexities of a financial analysis and valuation in order to find whether a "fair and equitable" plan can be offered under Chapter XI without the modification of stockholders' interests. While the remedy to the problem may lie in a statutory amendment, intelligent judicial construction could provide an easier solution.[33] Statutory interpretation allowing alteration of stock interests would permit complete rehabilitation of those corporate debtors for which Chapter XI was intended.

Need for Secured Debt Provisions. The restriction of Chapter XI to the scaling down of unsecured debts has caused critics to say that it was intended for only "mildly afflicted debtors."[34] If the compromise of secured claims is vital to the achievement of a "feasible" plan, the enterprise must necessarily resort to Chapter X, if a corporation, or to Chapter XII,[35] if the debtor is unincorporated and burdened with real property mortgages. Examination of the New York and Connecticut cases indicates, however, that the amount of secured debt was not large. Of the 87 Connecticut debtors, 16 had no secured debts and another 30 scheduled such debts at less than 10% of total liabilities. In only seven cases did secured claims amount to over 50% of total indebtedness. Analysis in terms of the predominant types of secured debt revealed conditional bills of sale in 37 instances, chattel mortgages in five cases, 14 instances of real property mortgages, and 14 notes secured by the pledge of insurance policies or open

32. SEC v. United States Realty & Impr. Co., 310 U. S. 434, 454 (1940).

33. In view of the background of the Chapter, necessary inference prevents the adjustment of secured debts. On the other hand, the court under Chapter XI is commanded to achieve a "fair and equitable and feasible" arrangement [§ 366(3)], a command which should by implication include the power when necessary to affect stock interests, especially in the light of the provisions of Chapter XI [§§ 395, 397] which contemplate that new corporations may be organized to effectuate plans. See (1941) 51 YALE L. J. 150.

34. Levi and Moore, *Bankruptcy and Reorganization: A Survey of Changes. III* (1938) 5 U. OF CHI. L. REV. 398, 408.

35. 52 STAT. 916 (1938), 11 U. S. C. §§ 801-926 (Supp. 1939).

accounts. The data on 126 New York enterprises indicate that the use of chattel mortgages in that area was more common, there being 33 debtors with chattel mortgages, 30 with conditional bills of sale and 16 with real property mortgages. A total of 29 New York debtors had no secured debt, and in 69 cases the secured claims amounted to less than 20% of total liabilities.

The need for provisions allowing the adjustment of secured claims in Chapter XI proceedings does not therefore seem great. Assuming that the enterprises studied are representative of small commercial debtors, the data reveal that the secured liabilities of such debtors are not usually large. In the main they are commercial, short term claims and not long term debts secured by real property mortgages. Moreover, in a "fair and equitable" plan the priority rights of secured claims would have to be fully respected before any payment of unsecured creditors would be possible. In most cases this requirement would merely allow alternative methods of full payment. Since stock would rarely be acceptable to commercial creditors of a small retail enterprise, little advantage would be offered by such a change.[36]

As an alternative to Chapter XI, Chapter XII, enacted mainly for the relief of a Chicago real estate area,[37] has been little used. Over the country in the year ending June 30, 1939, 378 Chapter X petitions were filed, 683 Chapter XI petitions and 106 Chapter XII, of which 51 were filed in the Northern District of Illinois. In the Southern District of New York only two Chapter XII petitions were filed during 1940.[38] Although Chapter X does offer relief to small corporate debtors who are heavily burdened with secured debts, the complexity and expense may discourage its use. In actual practice it is probable that such debtors supplement Chapter XI arrangements by private, out-of-court negotiations with banks and merchants holding secured claims.

Proposed Statutory Amendment. In a proposed bill to amend the statute, the original draftsmen of Chapter XI[39] provide a mechanical jurisdictional marker between Chapter X and Chapter XI. While the *Realty* decision set

36. Power to affect secured debt would, of course, allow the extension of such claims by the issuance of notes payable over a period of time. But the cases studied revealed that such extensions were often granted by creditors independently of statutory authority.

37. H. R. REP. No. 1409, 75th Cong., 1st Sess. (1937) 51.

38. To date in the District of Connecticut there have been no petitions filed under Chapter XII of the Chandler Act.

39. The tentative amending bill is the result of extended study of Chapter XI by the National Bankruptcy Conference. Actual draftsmanship was delegated to Mr. W. Randolph Montgomery, Counsel for the New York Credit Men's Association. It should be noted that the draft of the bill discussed has not as yet been presented to the National Bankruptcy Conference for final approval. Bill To Amend Chapter XI, Communication to the YALE LAW JOURNAL from Mr. W. Randolph Montgomery, Oct. 15, 1941.

out certain factual standards for consideration,[40] this amending bill seeks to eliminate any remaining confusion by the adoption of a simple test of jurisdiction based upon the number of holders of the debtor's "securities." Premised on the theory that financial size and public investor interest are closely related to the dispersal of the ownership of the corporation's obligations and stock, this test excludes from Chapter XI any corporation whose "securities" of any class are held by more than 100 persons. An important exception is that the term "securities" does not include secured and unsecured claims or notes and guaranties "issued in the ordinary course of business, for merchandise . . . or other consideration."[41]

However useful, this mechanical test has certain defects. Classified upon this basis, only one of the five largest New York and Connecticut debtors discussed above would be forced into Chapter X.[42] Very large but closely held or subsidiary corporations without bonded indebtedness would be free to seek Chapter XI arrangements. Courts, moreover, would probably hold such a statutory standard to be final and not subject to discretionary modification. The amending bill should therefore expressly force upon courts, in the name of a requirement that petitions be filed "in good faith," a discretionary power to exclude corporate debtors of such large size or other special circumstances that they require the scrutiny of independent court trustees or the supervision of the SEC as provided in Chapter X. This could be done by a provision directing the court to rule upon jurisdiction in the light of both an arbitrary statutory rule and the specific factual criteria provided by the *Realty* decision.[43] The problem presented by the *May Oil Burner* case is not considered in the amending bill. No effort is made to clarify the present provision by either permitting or banning the affecting of stock interests in a Chapter XI proceeding. To provide satisfactory settlement of the present jurisdictional confusion, any amendment should specifically allow alteration of stockholders' interests and thus eliminate the clumsy and elaborate problem of the *May Oil Burner* case as an issue in the initial stages of a Chapter XI proceeding.

40. See *supra* p. 258.

41. In 1940 a similar provision was appended to H. R. 9864, the McLaughlin Bill to amend the Bankruptcy Act with respect to the basis of property for tax purposes. The "merchandise claims" qualification to the term "securities," however, did not appear in the McLaughlin Bill. When the *Realty* case removed the immediate need for a jurisdictional marker between Chapter X and XI, it was decided at committee hearings to postpone any amendment to Chapter XI until a complete revision of its provisions could be considered. *Hearings before Committee on the Judiciary on H. R. 9864*, 76th Cong., 3d Sess. (1940) 2-6.

42. See *supra* p. 256.

43. The amending bill allows the SEC to intervene in a Chapter XI proceeding for only one purpose—to seek dismissal of the debtor's petition on the ground that the enterprise does not qualify under the mechanical rule of jurisdiction.

ADMINISTRATION: CONTROLLING POSITION OF THE DEBTOR AND CREDITORS' SAFEGUARDS

Consistent with a composition tradition of speedy and economical relief, a Chapter XI arrangement is in effect a voluntary bargaining settlement by the debtor with his general creditors. Since the controlling procedural position in Chapter XI is granted to the debtor,[44] the fairness of the bargain in large degree depends upon the extent to which active creditor participation and court supervision prevent undue debtor domination. The statute offers certain procedural safeguards to creditors, which are designed to facilitate their organization and assure preservation of the debtor's assets. The provisions allowing court appraisal,[45] appointment of receivers,[46] the filing of indemnity bonds,[47] and the election of creditors' committees[48] offer the greatest protection. Although not conclusive of the extent of debtor domination, the cases surveyed set out the major problems which may block the effective operation of these safeguards.

Debtors' Petitions. At the start it should be noted that the absence of involuntary Chapter XI petitions forces the diligent creditor to utilize traditional methods to protect his claim. Many debtors resort to Chapter XI proceedings to short-circuit attachments or involuntary bankruptcies instituted by creditors. The voluntary petition for an arrangement may be filed by the debtor either originally under Section 322, thus allowing escape from creditors' judgments and attachments, or it may be filed under Section 321 in a pending voluntary or involuntary bankruptcy proceeding. Of the 152 New York cases, 141 were begun by original petitions, while eight petitions were filed during involuntary bankruptcies and two during voluntary bankruptcy actions. Moreover, of the 141 original petitions, 17 were precipitated by pending creditors' suits in state courts, five followed actual attachment, two followed unsuccessful assignments for the benefit of creditors and in one case the debtor's property was in a state court receivership. In Connecticut, seven petitions were filed in pending bankruptcies, five voluntary and two

44. Four provisions contribute heavily to this controlling position. Only the debtor may petition for relief under Chapter XI. §§ 321, 322. Pending the arrangement, the debtor may continue in possession of his property when no receiver or trustee is appointed. § 342. The debtor may solicit creditor acceptances of his plan both before and after the petition is filed. § 336(4). Only the debtor may propose amendments or modifications to the original plan. § 363.

45. Section 333.

46. Section 332.

47. Section 326. If the proceeding has been instituted by an original petition under Section 322, the court may order the debtor to file a bond to indemnify the estate against subsequent loss.

48. Section 338. At the first court meeting, held upon ten days notice to creditors, creditors may appoint an official creditors' committee.

involuntary, while of the 80 original petitions, six were filed to escape creditor attachments and two followed assignments for the benefit of creditors.

Because the information in the petition constitutes the basis of early negotiation,[49] the accuracy of the debtor's business schedules and the feasibility of the plan are important factors in the speedy operation of the Chapter. For example, in *Federated Purchaser, Inc.*,[50] five weeks' time was consumed in consideration of a plan of 100% payment that was offered by the debtor in bad faith. 100% deferred payment was proposed by some debtors who were either misinformed of their financial condition or were utilizing a "fake" plan as a dilatory tactic.[51] In eight Connecticut cases such 100% offers were followed by confirmation of much smaller settlements or bankruptcy adjudications for lack of cash. In New York seven 100% extension plans preceded adjudications, while six resulted in small cash payments.[52] In *Lester's Food Market*[53] the debtor incorrectly analyzed his situation, for an offer of 100% payment over one year was amended after court appraisal to a 10% payment over fourteen weeks. One corporation, while filing an amended plan of 15% cash, expressly stated that the first offer had been made merely to comply with the statutory requirement of a "plan."[54] That such false plans are not justifiable is emphasized by the fact that if petitions are hurriedly filed to escape attachment, courts are lenient in allowing extensions of time to enable the debtor to complete schedules and draw up a plan.[55]

Appraisals. To provide a check upon the accuracy of the debtor's schedules and allow determination of the liquidation value of the enterprise, independent court appraisals may be ordered by the court. Of 55 Connecticut

49. The court must mail to creditors with the notice of the first meeting a copy of the proposed arrangement and a summary of the assets and liabilities as scheduled by the debtor. § 335.

50. Bankr. Docket No. 76339 (S. D. N. Y. 1940).

51. One referee has reported that some debtors offer 100% plans to pacify creditors and to forestall early creditor organization so that they may ascertain the reaction and demands of creditors at the first meeting before offering a cash settlement.

52. The fact that a 100% offer is followed by liquidation does not necessarily indicate dilatory action. The lack of ready cash may force debtors to seek long term extensions of their debts. Thus Colbert, Inc., Bankr. Docket No. 76296 (S. D. N. Y. 1940), offered to issue 33 monthly notes of 3%, but the demand of creditors for a cash settlement forced liquidation.

53. Bankr. Docket No. 19997 (D. Conn. 1940).

54. Federated Purchaser, Inc., Bankr. Docket No. 76339 (S. D. N. Y. 1940).

55. Humpty Dumpty Auto Stores, Inc., Bankr. Docket No. 75447 (S. D. N. Y. 1940); Abe Horowitz, Bankr. Docket No. 76541 (S. D. N. Y. 1940). The broad statutory definition of a "plan" enabled two Connecticut debtors to file under Chapter XI to complete a private sale. George McGrath, Bankr. Docket No. 19389 (D. Conn. 1939); Harry J. Anfenger, Bankr. Docket No. 19232 (D. Conn. 1939). *Cf.* Matter of Western Steel & Equipment Corp., 45 Am. B. R. (N.S.) 361 (D. Ore. 1940) (refusal to allow use of Chapter XI for the completion of a private liquidation for the benefit of creditors).

cases for which appraisal information was available, court appraisals were ordered in 40 cases, while in 15 instances there was no appraisal and the debtor's schedules were relied upon. Despite the incompleteness of the data and the varying standards of valuation, the discrepancies between the value scheduled by the debtor and the appraiser's estimate seem to indicate the need for mandatory appraisals.[56] Of the 40 cases, the appraised valuation was lower than the debtor's figure in 35 instances—by 50% in 19 cases—and higher in five cases. Occasionally, especially when fraud is suspected, creditors' committees secure additional reports by skilled accountants. In one Connecticut case the court utilized such a report to set aside the referee's confirmation of an arrangement.[57]

Receivers and Indemnity Bonds. Of great advantage to debtors is the provision allowing them to continue operation of the business and maintain the concern's goodwill during the pendency of the arrangement. To avoid dissipation of the assets, however, the statute provides for the appointment of a receiver or the filing of an indemnity bond upon a showing of necessity.[58] Of the 87 cases in Connecticut, debtors continued in possession in 56 instances, two indemnity bonds were ordered, 25 receivers were appointed and 18 liquidation trustees supervised the estate after the debtor in possession had been adjudicated bankrupt. In six cases the debtor petitioned for the appointment of a receiver to prevent creditor attachment. In five instances trustees were named to supervise the performance of the arrangement, while in all other cases which achieved confirmation a distributor was named to handle payment. In New York, 127 debtors continued in possession, 19 receivers were appointed, and 37 liquidation trustees functioned after the adjudication of the debtor in possession.[59] To protect creditors, indemnity bonds were required in 14 cases; failure to comply with the order resulted in seven adjudications and one dismissal. Referees and creditors generally regard the indemnity provision as unworkable since few distressed debtors can post cash or its equivalent for indemnity, or comply with the stringent requirements of insurance companies writing such bonds. As an alternative, creditors agree to forego indemnity if debtors will agree to strict supervision by the creditors' committee, which usually involves approval of sales and purchases, countersignature of checks and limitation of operating expense. But mere parallelism in effect has not resulted in reliance

56. Immediate mandatory appraisals would allow this information to be included in the first court notice to creditors. The cost of an appraisal is not large and it offers a basis for evaluating the fairness of the debtor's plan.

57. H. Krieger, Bankr. Docket No. 20774 (D. Conn. 1941).

58. Sections 332 and 326. But in Ulen & Co., Bankr. Docket No. 75734 (S. D. N. Y. 1940), the debtor was left in possession over creditor protest although the liquid assets of the corporation were being depleted at the rate of $50,000 a month.

59. The New York Credit Men's Association was trustee in three cases and the Credit Agency of America was trustee in a fourth case.

upon the use of receivers as a substitute for the defective indemnity device. Appointment of receivers should be reserved, as the cases studied indicate it has been, for cases where fraud, the debtor's large size, or special circumstances make unwise the expediency gained by leaving the debtor in possession.

Creditors' Committees and Compensation. Although the functioning of creditors' committees is an important creditor safeguard, the device has been insufficiently used.[60] Furthermore, courts constantly guard against the depletion of the debtor's estate by the expenses of over-zealous committees and the fees of their attorneys. As a result, an overly stringent attitude has been adopted toward the reimbursement of unofficial committees. In *Lane v. Haytian Corporation of America*[61] the Circuit Court of Appeals for the Second Circuit, despite an express provision in the arrangement for the expenses of three unofficial committees, limited the reimbursements to the official committee's expenses incurred while passing upon the fairness of the plan. The difficulty in such a position is that official committees cannot be elected prior to the first court meeting and, if speedy procedure is to be achieved, creditor action must start upon the filing of the petition. Formerly, under the *Fisher Dress*[62] decision, compensation to unofficial committees was allowable if provided for in the arrangement. Thus in six cases studied, plans were specifically amended to include the expenses of an unofficial committee. In one case two unofficial committees were granted $11,569 in allowances without any such provision in the plan.[63] More typical, on the other hand, was the treatment of the compensation problem in *Alpine Meat Market.*[64] There two days after the filing of the petition, an unofficial committee was elected at an informal meeting of 90% of the general creditors. On the basis of a private accountant's report, this committee prepared the debtor's amended plan, which was accepted at the first official creditors' meeting and later confirmed. At the first official meeting, the unofficial committee was made official. The court, however, held that since neither plan contained a provision for administration expense, reimbursement was not possible.[65] The total committee expense allowed was a $50 payment to the attorney for services rendered to the official committee.

60. The cases examined revealed the election of 64 official creditors' committees, 17 in Connecticut and 47 in New York. Managers of local credit bureaus state by a large majority that the device of creditors' committees is not sufficiently used. See *Surveys on Functioning of Chandler Act* (1940) A3 CORP. REORG. 216.

61. 117 F. (2d) 216 (C. C. A. 2d, 1941). See *In re* Aloof, C. C. H. Bankr. Serv. (3d ed.) ¶ 53,185 (S. D. N. Y. 1941).

62. *In re* Fisher Dress Corp., 33 F. Supp. 157 (S. D. N. Y. 1939).

63. Burland Printing Co., Bankr. Docket No. 75625 (S. D. N. Y. 1940).

64. Bankr. Docket No. 76090 (S. D. N. Y. 1940).

65. Reimbursement was denied under the authority of *In re* Max Fishman, Inc., 27 F. Supp. 33 (S. D. N. Y. 1939).

Denial of compensation for the early activity of unofficial committees may increase the opportunities for debtor domination of the proceedings. If such committees do not operate, many small debtors will be able to muster the assent of unorganized creditors prior to the first official court meeting, and the debtor's plan will get perfunctory approval without adequate consideration of his financial situation.[66] To insure protection of creditors' interests, credit associations often schedule an immediate informal meeting of interested merchandise creditors.[67] At these meetings are elected unofficial committees which often represent a majority of claims and are thus able to approve or defeat any plan proposed by the debtor. The result is that the debtor is forced to cooperate and submit to the strict supervision of the committee.[68] If allowances are stringently curtailed, bankruptcy experts fear that secret fee agreements between the debtor and creditors' attorneys will increase. Debtor's attorneys may also waive court compensation in reliance upon the debtor's secret promise of larger payment.[69] Since the machinery of Chapter XI is heavily weighted in favor of the debtor, it seems that

66. In Dimock & Fink, Bankr. Docket No. 19543 (D. Conn. 1939), the debtor secured the requisite number of creditor acceptances prior to the first court meeting. After investigation at the first meeting revealed the existence of "dummy" directors and large withdrawals by silent partners, an official creditors' committee was elected, whose subsequent letter to creditors recommending the revocation of previous acceptances caused the immediate withdrawal of sufficient votes to break the debtor's majority.

67. The New York Credit Men's Association estimates that it participates in 30 to 50 Chapter XI cases each year. The importance of informal meetings sponsored by credit agencies is illustrated by the *McKesson & Robbins* case under Chapter X. Bankr. Docket No. 72697 (S. D. N. Y. 1940). The unofficial meeting of creditors, called by the New York Credit Men's Association immediately after the filing of the petition, was attended by 100 representatives of suppliers and creditors whose combined claims amounted to over $1,000,000. This meeting formed the nucleus of the Merchandise Creditors' Committee, which subsequently obtained proxies from creditors holding claims totaling $4,000,000. Communication to the YALE LAW JOURNAL from New York Credit Men's Association, Oct. 29, 1941.

68. Since unofficial committees usually represent the principal creditors and suppliers, debtors heed their demands in order to insure a continuity of merchandise for their business and also to secure approval of the proposed arrangement. Certain wholesalers are particularly well organized. "In cases where textile manufacturers, commission houses, paint manufacturers or shoe jobbers are creditors, the informal proceedings run along smoothly and the committees so formed in these trades usually hold the substantial block of claims and are in a position to approve or defeat any plan proposed." Communication to the YALE LAW JOURNAL from New York Credit Men's Association, Oct 29, 1941.

In Chase Superior, Inc., Bankr. Docket No. 75974 (S. D. N. Y. 1940), the court disqualified attorneys holding creditor proxies from serving on creditors' committees. Upon appeal this restrictive holding was reversed. Arrow Dairy Co. v. Chase Superior, Inc., 116 F. (2d) 573 (C. C. A. 2d, 1941).

69. Waiver of court payment is not in itself indicative of secret fees. To reduce the amount of funds necessary to deposit for confirmation of the arrangement, many debtors secure waivers of payment from both creditors and attorneys alike. For example, in Leona Frocks, Inc., Bankr. Docket No. 75612 (S. D. N. Y. 1940), the attorney for the debtor and the secretary of the creditors' committee waived court reimbursement.

early creditor activity should be encouraged as the most effective method of limiting debtor control and of achieving speedy confirmation of his plan. Serious consideration should be given the provision in the amending bill allowing reasonable reimbursement of unofficial committees representing at least 20% of the total amount of claims and functioning prior to the first official meeting of creditors.[70]

Even where official committees have incurred expense, the courts occasionally refuse to grant compensation when the debtor's plan is not confirmed and liquidation is ordered. In one case reimbursement was denied to the creditors' committee[71] and in another case to the debtor's attorney[72] for services rendered while attempting to effect an arrangement. In two liquidation cases, however, courts allowed priority payment of operating expenses incurred pending the arrangement.[73] In one instance of liquidation after confirmation, the court allowed priority payment of current debts by reading such an implied provision into the arrangement.[74] Future possibility of such an inequitable distinction between treatment of the expenses incurred in a successful, and those incurred in an unsuccessful, arrangement seems to be effectively foreclosed by the proposed amending bill.[75]

Protection Against Fraud. The controlling position of the debtor often makes impossible the detection of fraudulent transfers and withdrawals. In the cases studied, creditors charged debtor fraud in nine instances. The types

70. If reimbursed for their services, unofficial committees should be subject to some control in the interests of other creditors. To avoid plunder of the debtor's estate by competing unofficial committees, it is suggested that the amendment require at least 35% representation as a condition precedent to reimbursement. This would help to democratize unofficial creditor activity and probably would not impose too great a hardship since the large amount of merchandise claims are usually held by a small number of suppliers and wholesalers.

71. Bouton Cheese Corporation, Bankr. Docket No. 75385 (S. D. N. Y. 1940).

72. Bornbaum Bros., Bankr. Docket No. 76145 (S. D. N. Y. 1940). The court relied upon *In re* Kinnane's Estate, 242 Fed. 769 (C. C. A. 6th, 1917). This authority is hardly applicable to a Chapter XI proceeding as it involved work of an attorney who proposed a composition settlement after adjudication in involuntary bankruptcy.

73. Pisacano's Clam Bar, Bankr. Docket No. 76155 (S. D. N. Y. 1940); Sheridan Square Pharmacy, Bankr. Docket No. 75554 (S. D. N. Y. 1940).

74. Irving Electrical Supply Co., Bankr. Docket No. 73517 (S. D. N. Y. 1939); 46 Am. B. R. (N.S.) 105 (1941). The proposed amending bill specifies that "debts incurred by the debtor after the confirmation of an arrangement, whether or not the court has retained jurisdiction pursuant to the provisions of section 357(7) of this Act, shall not be entitled to priority over the debts affected by the arrangement, unless otherwise provided in such arrangement." See *In re* Gelardin, Inc., 41 F. Supp. 17 (E. D. N. Y. 1941).

75. The bill specifically provides that, if the Chapter XI petition is dismissed or the debtor is adjudicated bankrupt, the court may "fix and allow reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred in the proceeding prior to such dismissal or adjudication, by persons who would be entitled thereto, as provided in this chapter, if the arrangement had been confirmed, and shall make provision for the payment thereof."

of illegal action alleged included the transfer of assets by a subsidiary to the parent company,[76] heavy withdrawals by owners just before the Chapter XI petition was filed,[77] falsification of records,[78] preference of creditors,[79] and a secret plan to buy back the assets after liquidation.[80] Only two debtors, however, were denied discharge on grounds of fraud.[81] While it is difficult to calculate the extent of undetected abuse, encouragement of active creditor investigation or more frequent appointment of receivers would assure protection to creditors.

Speed and Economy. The principal objectives of the Chapter XI procedure — speed and economy — appear to have been achieved. In the 52 Connecticut cases confirmed, an average of 64.4 days elapsed from the date the petition was filed to the date of confirmation of the arrangement. In the 88 New York cases confirmed, the average was 93.3 days. Complete data on cost were not obtainable, but examination of 30 New York arrangements confirmed indicates that the average cost was 5% of the amount distributed to creditors if this amount was over $25,000. Where the amount distributed was less than $25,000, cost averaged 8%. The major cost factors in a Chapter XI proceeding are attorneys' fees, which vary with the size of the estate and the number of issues in controversy. The fees of receivers, trustees and referees are fixed by statute and are usually nominal.[82] Occasionally, controversial claims swell cost to as high as 50% of the amount distributed to unsecured creditors. In *Hodges, Inc.*,[83] the large amount of litigation involved forced the court to grant allowances of $1,024 to the debtor's attorney and $2,000 to the receiver-trustee for work connected with a $120,973 estate, although unsecured creditors received only $5,263, or

76. Kitchen Cabinet Co., Bankr. Docket No. 20644 (D. Conn. 1941); Felton & Sons, Bankr. Docket No. 75637 (S. D. N. Y. 1940).

77. Dimock & Fink, Bankr. Docket No. 19543 (D. Conn. 1939); Bouton Cheese Corp., Bankr. Docket No. 75385 (S. D. N. Y. 1940); Fite Rite Footwear, Bankr. Docket No. 19687 (D. Conn. 1940); Manhattan Yacht Cruises, Bankr. Docket No. 76538 (S. D. N. Y. 1940); Spitz Window Shade Co., Bankr. Docket No. 75424 (S. D. N. Y. 1940).

78. Fite Rite Footwear, Inc., Bankr. Docket No. 19687 (D. Conn. 1940). In Central Grille, Bankr. Docket No. 18927 (D. Conn. 1938), the perjury of one of the partners caused the referee to certify the transcript of the hearings to the United States Attorney.

79. Bouton Cheese Corp., Bankr. Docket No. 75385 (S. D. N. Y. 1940).

80. Central Grille, Bankr. Docket No. 18927 (D. Conn. 1938). In Kagan's Dairy, Bankr. Docket No. 20970 (D. Conn. 1941), the debtor lacked funds to carry out the proposed arrangement and was adjudicated bankrupt. Under court supervision a private sale of the assets for $2,000 to the debtor's wife secured a discharge for the debtor of $18,782 worth of liabilities.

81. Ralph Sutton, Bankr. Docket No. 76104 (S. D. N. Y. 1940); Bornbaum Bros., Bankr. Docket No. 76145 (S. D. N. Y. 1940).

82. Sections 40 and 48.

83. Bankr. Docket No. 20137 (D. Conn. 1937).

10% of their claims, under the arrangement. In the same case, however, the referee's fee amounted only to $275 and the distributor received only $100.

CONTROL OF RESULTS: THE ARRANGEMENT AND COURT SUPERVISION

Data on Arrangements. Open as it is to all small enterprises regardless of the extremity of their insolvency, Chapter XI is much used as the last resort of sanguine or obstinate debtors seeking to stave off liquidation. Therefore, the large number of resulting adjudications is not so much indicative of rigorous creditor demands as of the dire straits of the debtors. In New York 44 out of 146 debtors were adjudicated bankrupt while the arrangements of 88 petitioners were confirmed. In addition, two debtors were denied discharges by reason of fraud, one case was transferred to Chapter X, two were dismissed by the court, one was withdrawn by the debtor and eight cases were still pending at the time of investigation. Similarly in Connecticut there were 52 confirmations, 23 adjudications, one transfer to Chapter X, one debtor withdrawal and ten cases pending.

The commonest cause of adjudication was the debtor's inability to raise sufficient funds either to make the required deposit for priority or preferred claims, or to finance the first payment to general creditors under the proposed plan. In New York 25 liquidations were ordered because the debtor did not have the necessary funds to secure confirmation of an accepted plan, and seven debtors were adjudicated for failing to post indemnity bonds as directed. Of the remainder, seven plans failed to get creditors' acceptance, one debtor was unable to consummate the arrangement after confirmation and in four instances the reason for adjudication was undetermined. In no case did the court reject the proposed arrangement. The 23 Connecticut adjudications included five creditor rejections, nine instances of lack of funds and one debtor default after confirmation. The court in one case set aside the referee's order of confirmation as not "for the best interests of creditors"[84] and in another case affirmed the referee's refusal to confirm the arrangement.[85]

The threat of liquidation is a powerful lever for creditors to employ in negotiating changes in the debtor's settlement. As a practical matter, therefore, the need for provisions allowing creditors to offer amendments to the debtor's plan is slight. Of the 88 New York cases confirmed, 31 original plans were accepted while amendments were made in 57 cases. Two amendments were necessary in six instances, two cases required three amendments and in one instance the debtor's fourth amendment was confirmed. The purpose of 41 of the amendments was to shorten the time of payment, while the amount was lowered in 21 cases and raised in 19 cases. The loss of time

84. H. Krieger, Bankr. Docket No. 20774 (D. Conn. 1941). See *infra* p. 274.

85. Dimock & Fink, Bankr. Docket No. 19543 (D. Conn. 1939). See *infra* note 102.

resulting from such amendments averaged 4.2 weeks. In Connecticut amendments were necessary in 20 of the 52 cases confirmed. The revised plans provided for shorter payment periods in ten cases and a lower amount in 12 instances. An average of 7.9 weeks was lost by amendment, but upon omission of one case in which a confirmed arrangement was reopened a year later to allow an amendment, the average dropped to 5.7 weeks.

An analysis of final plans shows that 34 of the New York arrangements called for an immediate cash payment, while 53 debtors gained their discharge by deferred partial payments. Since the court's supervision rarely extends beyond the first payment, creditors sometimes receive additional paper acknowledgment of the deferred liability. For example, installment notes were issued in 12 instances, two debtors issued corporate debentures, two others issued certificates of indebtedness and two plans provided for the issuance of notes secured by chattel mortgages. The nature of the Connecticut plans was similar.[86] Notes, however, were issued in only one case. The bulk of the New York payments, specifically 57, ranged from 5% to 30%, yet ten debtors paid 100%. In Connecticut only four 100% payments were found and the majority of settlements were less than 30%.

By express statutory authorization, debtors are able to segregate general claims into classes for the purposes of settlement.[87] Thus the traditional mandate of priority, allowing classification only upon a juristic economic basis, has been modified in the interests of expediency. Draftsmen of Chapter XI emphasized the importance of treating merchandise and bank creditors upon different bases.[88] In the cases studied, however, the commonest practice was to classify merchandise creditors in terms of amount in order to simplify administration and reduce expense. Of the eight New York cases in which merchandise creditors were divided into those holding large and those holding small claims, four plans paid both classes 100% but extended the payment of the large claims over a longer period. Two plans paid small claims 100% in cash while the larger claims received a smaller percentage amount in installments. In one case small claimants received 33% while the claims of $100 or more were paid 50% in installments. This latter treatment seems more justifiable as it balanced a larger amount by an installment payment. Six Connecticut cases, in which payment by classification occurred, presented other variations. In one case common stock was given noteholders while merchandise creditors were paid in cash. Another arrangement paid 100% to bank creditors but only 30% to merchandise creditors.

86. Cash was paid in 16 cases and 34 debtors paid by installments. In terms of amount there were 38 payments of less than 30%—13 payments of less than 10%, 11 of from 11% to 20% and 14 of from 21% to 30%. See *infra* Table IX.

87. Section 351. See Comment (1940) 49 YALE L. J. 881; (1941) 50 YALE L. J. 892, 896-98.

88. *Analysis of H. R. 12889*, 74th Cong., 2d Sess. (1936) 42.

The fairness of such divergent treatment is highly questionable. While useful in securing the required creditor assent, arbitrary division of claims into classes must bear a reasonable relation to administrative expediency to be justifiable under a "fair and equitable" plan.[89]

Although a large proportion of the arrangements studied provided for a percentage cash settlement with general creditors, the formation of a new corporation and the issuance of all or part of its stock to creditors occurred in a few instances. Of the Connecticut cases, it was utilized in four arrangements when cash payment was not feasible. *Metropolitan Body Corporation,*[90] a manufacturing concern whose liabilities amounted to $323,703, issued prior preferred stock to five persons holding $90,000 worth of unsecured notes. In the arrangement of the *Woodbridge Hills Country Club*[91] merchandise creditors were given the option of receiving 10% in cash or 50% of their claims in preferred stock of the new corporation. Six New York plans provided for the issuance of stock to creditors. In *Adams & Sandburg*[92] the device was utilized to compensate merchandise creditors of a partnership operating 14 retail millinery shops. A new corporation was formed to operate nine of the retail outlets and the two debtors received all the common stock. Class A preferred stock was issued to contributors of new capital, while unsecured creditors received redeemable, non-cumulative, Class B preferred stock. The convenience of thus forming a new corporation emphasizes the inadvisability of the *May Oil Burner* decision[93] which would prohibit alteration of stock interests.[94]

The "Fair and Equitable" Plan. The opportunities and standards for judicial control of Chapter XI arrangements spring mainly from the statutory mandate that upon confirmation courts must be "satisfied" that the arrangement is both "for the best interests of creditors" and "fair and equitable and

89. See Comment (1940) 49 YALE L. J. 881, 888; 8 COLLIER ON BANKRUPTCY (14th ed. 1941) 1184.

90. Bankr. Docket No. 19636 (D. Conn. 1939).

91. Bankr. Docket No. 19214 (D. Conn. 1939).

92. Bankr. Docket No. 76329 (S. D. N. Y. 1940).

93. See *supra* p. 259.

94. The data indicated that one current tax problem is delaying the confirmation of arrangements. A Circuit Court of Appeals has held that amounts owing by employers for federal unemployment taxes shall not be granted bankruptcy priority on the ground that they are debts and not taxes, since the employer functions merely as the collector of the sum from employees. *In re* Independent Auto Forwarding Corp., 118 F. (2d) 537 (C. C. A. 2d, 1941). Reversal seems probable as the "collector" rationale has been rejected recently by the Supreme Court in regard to the similar problem of state sales taxes. City of New York v. Feiring, 313 U. S. 283 (1941). But revenue officials demand that pending Chapter XI cases be held open and the amount of the tax be placed in escrow until the appeal is decided. This position prevents substantial payment of creditors when the amount of the tax is large. *Cf.* Norwalk Hardware Co., Bankr. Docket No. 19933 (D. Conn. 1940).

feasible."[95] The Supreme Court has held that the latter provision requires an independent appraisal of the plan by the court regardless of creditor acceptance.[96] Yet the New York and Connecticut cases suggest that bankruptcy courts are more concerned with the practical problems of creditor assent than with the somewhat shadowy judicial rules of fairness. Actual discussion of plans in terms of these standards occurred in only three instances, when the issue was raised by objecting creditors. In fact at least one plan was confirmed which would seem to violate the "fair and equitable" principle. In *Bergram Mechanical Engineering Corporation*[97] the assets of the debtor were sold to another corporation for $45,000, $30,000 in cash and $15,000 in the common stock of the purchaser. The cash consideration allowed a 41% payment to general creditors, but the stock received was distributed pro rata among the old stockholders.

This apparent lack of judicial concern with the standard of a "fair and equitable" plan does not mean that "fair" plans were not in fact usually achieved. For had the issue been raised in the cases studied, the identity of management and ownership would have allowed the majority of debtors to claim that the contribution of their continued management to the going concern value of the enterprise was sufficient under the *Realty* decision to allow partial payment of creditors without modification of the interests of ownership.[98] The exact force of this going concern doctrine is not clear. The cases studied, for example, revealed numerous instances of small family or private corporations in which the managers shared stock ownership with relatives or friends. It might be argued that since the *Realty* decision discusses the issue in terms of "alteration of the management's interests," the *Boyd* case would force the elimination of such passive stock interests. The practical result of such a literal application of the doctrine would be unfortunate, however, for creditors would be unwillingly loaded with slivers of ownership in a large number of small retail outlets.

In addition to the traditional "fair and equitable" principle of equity reorganization the draftsmen included in Chapter XI the "for the best interests of creditors" test of former Section 12. Under this standard of fairness, courts had determined the probable dividend obtainable by liquidation and had evaluated the debtor's settlement in terms of liquidation value.[99] Coupled as it is in Chapter XI with the "fair and equitable" standard, this former

95. Section 366(2) and (3).

96. Case v. Los Angeles Lumber Prod. Co., 308 U. S. 106, 115 (1939), (1940) 49 YALE L. J. 1099; National Surety Co. v. Coriell, 289 U. S. 426, 436 (1933).

97. Bankr. Docket No. 19986 (D. Conn. 1940).

98. SEC v. United States Realty & Impr. Co., 310 U. S. 434, 454 (1940).

99. Fleischmann & Devine, Inc. v. Wolfsen Dry Goods Co., 299 Fed. 15, 18 (C. C. A. 5th, 1924); Adler v. Jones, 109 Fed. 967 (C. C. A. 6th, 1901); 8 COLLIER ON BANKRUPTCY (14th ed. 1941) 1167; Comment (1938) 51 HARV. L. REV. 1403, 1413.

meaning of "for the best interests of creditors" has received scant attention.[100] In a Connecticut case the court ruled that large creditor acceptance "is not decisive of the 'best interests of creditors' " and that it was not intended under Chapter XI "to allow the debtor to pay less than the property is worth."[101] The court found that the arrangement in question allowed the discharge of $20,500 of liabilities by the payment of $6,000, despite an accountant's report which valued the assets at $36,500. Although the court was unequivocal in its rejection of the liquidation value test, the presence of a private purchase offer of $8,500 may have been controlling.[102]

Heavy creditor acceptance under former Section 12 was regarded as prima facie evidence of the fairness of the plan, and to avoid the expense and delay of full administration courts generally approved plans offering an amount approximately equivalent to liquidation value.[103] Under Chapter XI creditor acceptance is an irrelevant factor in determining the "fair and equitable" nature of the plan.[104] As a matter of general practice, however, courts are disinclined to disturb the referee's confirmation of a plan which received substantial creditor assent.[105] It is recognized that substantial business reasons may cause creditor acceptance of an arrangement which offers less than the assets are worth or perhaps even less than liquidation value. Many wholesalers and manufacturers are reluctant to lose retail outlets and prefer to receive token payment of the specific claim in reliance upon future business under more stringent credit terms. Intangible factors of friendship and good will may also be present. In *Kitchen Cabinet Company*[106] the fact that 48% of the unsecured claims were held by "friendly" creditors forced the court to name a receiver to supervise the arrangement. In two cases studied the interest of community officials in avoiding unemployment problems affected

100. For the relevance of liquidation value in evaluating a "fair and equitable" plan, see Case v. Los Angeles Lumber Prod. Co., 308 U. S. 106, 123 (1939), (1940) 49 YALE L. J. 1099.

101. H. Krieger, Bankr. Docket No. 20774 (D. Conn. 1941).

102. The only other consideration of the principle occurred in Dimock & Fink, Bankr. Docket No. 19543 (D. Conn. 1939) in which the court affirmed the referee's ruling that the plan was not "for the best interests of creditors." Actually the meaning of the test was not discussed as the issue was whether the miscount of votes cast at the first meeting required the referee to confirm regardless of subsequent creditor withdrawals which broke the debtor's majority.

103. *In re* Spiller, 230 Fed. 490, 492 (D. Mass. 1916). Under this standard the debtor retained the difference between liquidation and going concern value. Moreover, since the determination of liquidation value allowed for costs of administration, the debtor was able to settle many times for an amount less than the gross receipts of liquidation.

104. Case v. Los Angeles Lumber Prod. Co., 308 U. S. 106, 114 (1939); *In re* May Oil Burner Corporation, 38 F. Supp. 516 (D. Md. 1941) (unanimous creditor assent but plan set aside upon objection of stockholder).

105. See *In re* Romec Pump Co., 31 F. Supp. 389 (N. D. Ohio 1939).

106. Bankr. Docket No. 20644 (D. Conn. 1941).

the tenor of the proceeding.[107] It is the task of the court to prevent any of these factors from dominating the proceeding at the expense of minority creditors.

Proposed Elimination of "Fair and Equitable" Test. The most striking alteration proposed by the draftsmen of the amending bill is the deletion of the "fair and equitable" standard as a condition precedent to confirmation. The tentative bill expressly provides that "it shall not be a bar to the approval or confirmation of an arrangement that property of the debtor or the interests of stockholders will thereby be preserved even though the arrangement does not provide for payment in full of the claims of creditors." Although this provision was undoubtedly inspired by the apathy of merchandise creditors toward the receipt of ownership equities, the change proposed seems both inequitable and unnecessary. While the effect of the "fair and equitable" requirement in Chapter XI is limited by practical considerations of feasibility and judicial reluctance to disturb accepted plans, the presence of such a conceptual standard is valuable as a stimulus to more careful protection of creditors. Such an amendment, when coupled with the proposed statutory division between Chapter X and Chapter XI, will nominally make divergent principles of priority controlling and allow differing treatment of unsecured creditors on the basis of a mechanical, rule-of-thumb determination of jurisdiction. The economic difference between corporations having ninety and one hundred stockholders is not so great as to justify such disparate standards of reorganizations. The inequity of allowing large, closely held or subsidiary corporations, which might qualify under the proposed test of Chapter XI jurisdiction, to escape from the Chapter X requirements of a "fair and equitable and feasible" plan seems clear.

Even if the proposed jurisdictional rule is supplemented by discretionary denial of jurisdiction, the suggested elimination of the "fair and equitable" standard in Chapter XI would be unwise. It would remove the impact of the "fair and equitable" doctrine upon participation of stockholders in the rehabilitated enterprise when creditors receive only partial payment.[108] In addition, all the potential elements of creditor protection inherent in the entire concept of "strict priority" would be dissipated by such an amendment. Judicial interpretation of the remaining test of "for the best interests

107. Fite Rite Footwear, Bankr. Docket No. 19687 (D. Conn. 1940) (necessity that factory be sold to an operating purchaser in order to avoid local unemployment problem); Metropolitan Body Corp., Bankr. Docket No. 19636 (D. Conn. 1939) (necessity of settling existing strike of debtor's employees before confirmation of the arrangement). *Cf. In re* Romec Pump Co., 31 F. Supp. 389, 392 (N. D. Ohio 1939).

108. The "fair and equitable" standard is aimed at securing full priority of senior claims over junior interests in three typical relationships—among different classes of creditors, between creditors and stockholders, and among different classes of stock. See Comment (1941) 51 YALE L. J. 85, 87.

of creditors"[109] might possibly revert to its traditional meaning under former Section 12, stressing liquidation value and creditor acceptance as prima facie evidence of fairness. Such a test would not offer sufficient protection to minority, non-assenting creditors. As an additional touchstone of judicial control, the requirement of "feasibility" is retained in the amending bill. In most cases, however, the fact that the debtor is able to raise the funds necessary for confirmation readily attests the "feasibility" of the plan. But since confirmation should envisage rehabilitation of the debtor for re-entry into competitive activity, retention of the "feasibility" criterion is important for the isolated instances of its use.

If the use of Chapter XI were limited strictly to very small corporate and non-corporate debtors in which management and ownership were substantially identical and in whose rehabilitation there was little public interest, then departure from the full priority doctrine might be justified on practical grounds. In that case, however, it would be unnecessary to eliminate the "fair and equitable" standard because the *Realty* decision specifically allows the preservation of the interests of management if they are vital to going concern value.[110] Furthermore, even if there were practical justification for the statutory change, its constitutionality would be questionable. Recent decisions[111] indicate that the principle of strict priority is so entrenched that the present Supreme Court might well hold that lacking unanimous creditor acceptance, confirmation of an arrangement which violated "a fixed principle" of equity reorganization would constitute taking of creditors' property without due process of law.[112]

Conclusion

Notwithstanding the heavy criticism it has received, bankruptcy experts agree that Chapter XI has proved exceptionally workable and adaptable to the needs of small distressed enterprises. But inherent in the very flexibility of the machinery, allowing speed and economy of operation, are factors which make difficult the achievement of the fundamental goal of Chapter XI — the

109. As a sole standard of fairness, the amending bill allows confirmation if the plan "is for the best interests of the creditors and is feasible."

110. SEC v. United States Realty & Impr. Co., 310 U. S. 434, 454 (1940).

111. Especially Case v. Los Angeles Lumber Prod. Co., 308 U. S. 106 (1939); SEC v. United States Realty & Impr. Co., 310 U. S. 434 (1940); Consolidated Rock Prod. Co. v. DuBois, 312 U. S. 510 (1941).

112. Critics have long speculated about the constitutional implications of the "fair and equitable" principle of full priority. See Rostow and Cutler, *supra* note 4 at 1357; Dodd, *Reorganization Through Bankruptcy: A Remedy For What?* (1935) 48 Harv. L. Rev. 1100, 1132; Spaeth and Winks, *The Boyd Case and Section 77* (1938) 32 Ill. L. Rev. 769, 782. The argument is based upon dicta in Continental Illinois Nat. Bank & Trust Co. v. Chicago, R. I. & P. Ry., 294 U. S. 648, 671 (1935); Louisville Bank v. Radford, 295 U. S. 555, 589 (1935); Wright v. Vinton Branch of the Mountain Trust Bank, 300 U. S. 440, 470 (1937).

securing of a fair and equal bargain between the debtor and the creditor. Speed and economy prompted the provisions requiring the debtor to file a plan with the original petition, allowing debtors to remain in possession and to solicit creditor assents before the petition is filed, and delaying court consideration of the plan until after creditor acceptance. To balance the controlling position of the debtor, a fair arrangement requires active creditor participation and judicial supervision. But a Chapter XI arrangement is many times not the product of judicial machinery but rather of private negotiation without the benefits of even subsequent judicial inquiry. The cases examined revealed many instances in which the first court meeting of creditors was not a forum of investigation but rather an opportunity for the presentation by the debtor of written acceptances gathered from disorganized creditors. The participation of the court was limited in these instances to the confirmation of an essentially private plan. In other cases credit associations sponsored unofficial committees, which were able by the marshalling of claims to dominate the proceedings. Often creditor acceptance was a matter of bargaining between the debtor and the attorney holding the majority of claims, and the first official meeting of creditors, usually held two or three weeks after the filing of the petition, was too late a date to begin the official proceedings.

Postulating the bargaining system of Chapter XI as desirable, serious efforts should be made to enlarge the supervision of the court so as to include part of the negotiation which is now conducted privately. Creditor acceptances solicited prior to the filing of the petition should not be valid. Early creditors' meetings, corresponding to those now called by credit associations, should be officially scheduled or at least officially supervised. It is equally important that the position of creditors be strengthened. Mandatory court appraisals and provisions allowing the reimbursement of unofficial committees seem to be minimum needs. More active supervision of the debtor's assets by creditors' committees may provide a substitute for the unworkable indemnity provision.

The three years of operation of Chapter XI have revealed vital weaknesses which require statutory solution. The amending bill proposed by the original draftsmen of the statute makes several useful procedural changes,[113] but it

113. Certain of these procedural changes have been indicated, *supra* notes 74 and 75. Two other proposed amendments are important. At present under § 361 the debtor must deposit the funds required by the arrangement with the motion for confirmation. Because such a requirement ties up funds during the court's deliberation or during an appeal, the amending bill delays such deposit until after the formal approval of the plan. Section 366(4) now prevents confirmation of an arrangement if "the debtor has been guilty of any of the acts or failed to perform any of the duties which would be a bar to the discharge of a bankrupt." The amending bill modifies this rule by providing that when the debtor is a corporation the court shall consider the circumstances involved and confirm the plan if it is "for the best interests of creditors" to do so, provided that the interests of the officers responsible for such conduct are not preserved.

seems an inadequate solution of the major problems of Chapter XI. The arbitrary jurisdictional marker between Chapter X and Chapter XI that the bill proposes should be supplemented by a provision allowing discretionary refusal of jurisdiction. Moreover, any amendment should expressly permit the adjustment of stockholders' interests not only when such adjustment is necessary to achieve a fair plan but also when it is useful as a technique of debtor rehabilitation. While the strict system of judicial administration provided in Chapter X is not necessary in Chapter XI, it should be realized that the weakness of court supervision of the Chapter XI arrangement, as well as the informality of its procedure, has been responsible in large part for the abuses of the past. In sweeping away the standard of a "fair and equitable" plan, the proposed statutory amendment deprives the courts of a valuable potential weapon of judicial control. Although its leverage effect in normal Chapter XI practice is largely academic, the standard is vital in marginal cases to prevent collusive or "friendly" groups from foisting an unfair plan upon disorganized creditors. The argument that the "fair and equitable" principle in Chapter XI obstructs the rehabilitation of small enterprises is entitled to little support, since the doctrine provides for the continued participation of manager-stockholders whose services are vital to going concern value. In fact the arrangements studied suggest that the doctrine has been underused rather than overused as an astringent of "strict priority". Statutory revision should not undercut judicial control but rather should develop additional techniques of creditor protection and court supervision without undue sacrifice of speed and economy of operation.

APPENDIX

TABLE I: TYPE OF CHAPTER XI PETITIONS FILED.

	*New York**	*Connecticut†*
Original Petitions under Section 322	141	80
Precipitated by creditor attachment	5	6
Precipitated by pending creditor suits	17	
Preceded by assignments for benefit of creditors	2	
Property in hands of state court receiver	1	
Debtors previously reorganized under 77B	2	
Debtors with prior discharges in bankruptcy	1	
Petitions under Section 321	10	7
Filed in pending voluntary bankruptcies	2	5
Filed in pending involuntary bankruptcies	8	2
Involuntary petitions followed assignments for benefit of creditors 2		
Transferred from Chapter X	1	
Total	152	87

* New York data based upon examination of the 152 cases instituted under Chapter XI in the Southern District of New York during the period, January 1 to June 30, 1940.

† Connecticut data represent the cases instituted under Chapter XI in the District of Connecticut from October 1, 1938, to September 30, 1941.

TABLE II: DISPOSITION OF CASES

	New York	*Connecticut*
Arrangements confirmed	88	52
Adjudicated bankrupt and liquidated	44	23
Transferred to Chapter X	1	1
Denial of discharge for fraud	2	0
Petition withdrawn by debtor	1	1
Dismissal of petition by court	2	0
Arrangement pending	8	10
No information	6	0
Total	152	87

TABLE III: CAUSES OF BANKRUPTCY ADJUDICATION

	New York	*Connecticut*
Creditor rejection of debtor's plan	7	5
Inability to raise cash to carry forth arrangement	25	9
Failure to post indemnity as ordered	7	0
Inability to consummate arrangement after confirmation	1	1
Rejection of plan by court after creditor approval	0	1
Reason undetermined	4	7
Total	44	23

TABLE IV: TYPES OF BUSINESS

	New York	*Connecticut*
Retail Outlets		
grocery store	20	15
clothing store	19	11
restaurant	16	3
drug store	11	6
tavern or grill	8	2
furniture store	7	7
printers	4	2
hardware store	0	6
gas station	1	4
luggage shop	0	2
miscellaneous	5	6
Total	91	64
Summary		
Retail Outlets	91	64
Wholesale and Service.	27	13
Manufacture	28	10
No Information	6	0
	152	87

	New York	*Connecticut*
Wholesale or Service		
food supply	7	0
auto dealer	5	0
contractor	3	3
trucking	1	3
dairy	2	1
dentist	0	1
golf club	0	1
miscellaneous	9	4
Total	27	13
Manufacture		
clothing	7	1
furniture	5	2
food	4	0
shoe	1	2
miscellaneous	11	5
Total	28	10

TABLE V: FORMS OF BUSINESS ENTERPRISE

	New York	*Connecticut*
Individual	31	40
Partnership	11	6
Family Corporation	38	30
Private Corporation	64	10
Wholly-Owned Subsidiary	2	1
No Information	6	0
	152	87

TABLE VI: SIZE OF ASSETS AND LIABILITIES SCHEDULED.

Assets	*New York*	*Connecticut*	*Liabilities*	*New York*	*Connecticut*
0-$5000	50	37	0-$5000	14	20
$5001-$10,000	21	18	$5001-$10,000	28	13
$10,001-$20,000	32	12	$10,001-$20,000	31	22
$20,001-$30,000	10	8	$20,001-$30,000	30	9
$30,001-$100,000	23	11	$30,001-$100,000	32	20
$100,001-$250,000	6	0	$100,001-$250,000	8	2
$250,001-$1,000,000	1	1	$250,001-$1,000,000	2	1
Over $1,000,000	3	0	Over $1,000,000	1	0
No information	6	0	No information	6	0
Total	152	87	Total	152	87

TABLE VII: SCHEDULED SECURED AND UNSECURED CLAIMS AS A PERCENTAGE OF TOTAL SCHEDULED LIABILITIES.

Secured Claims	*New York*	*Connecticut*	*Unsecured Claims*	*New York*	*Connecticut*
no secured claims	29	16	less than 25%	0	0
less than 10%	34	30	26% to 50%	21	12
11% to 20%	35	25	51% to 75%	36	13
21% to 30%	22	4	76% to 90%	43	34
31% to 50%	14	5	over 90%	46	28
over 50%	12	7	no information	6	0
no information	6	0		152	87
	152	87			

TABLE VIII: NUMBER AND TYPE OF AMENDMENTS TO PLANS IN CASES CONFIRMED.

	New York	*Connecticut*
No Amendment	31	32
1 Amendment	48	18
2 Amendments	6	1
3 Amendments	2	1
4 Amendments	1	0
	88	52

TABLE VIII—(Continued)

Amount amended upward	19	6
Amount amended downward	21	12
No change in amount	17	2
Time of payment extended	5	4
Time of payment shortened	41	10
No change in time of payment	11	6

TABLE IX: TYPE AND AMOUNT OF PAYMENT PROVIDED IN ARRANGEMENTS CONFIRMED.

Amount paid as a percentage of total claim.	*New York*	*Connecticut*
0% to 10%	6	13
11% to 20%	30	11
21% to 30%	21	14
31% to 40%	8	5
41% to 70%	12	5
71% to 99%	1	0
100%	10	4
	88	52
Type of Payment		
Absolute cash	34	16
Cash in installments	53	34
Stock issued to merchandise creditors	1	2
Stock issued to unsecured note-holders although merchandise creditors received cash payment	5	2
	93	54