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NOTES

JUDICIAL POWER TO VARY A CHAPTER XI ARRANGEMENT AFTER CONFIRMATION*

Chapter XI of the Bankruptcy Act affords the small, closely-held business enterprise an opportunity for adjusting its unsecured debts in a speedy, economical proceeding. Where a debtor can avail himself of an arrangement under Chapter XI, he salvages the going-concern value of his business and avoids the stigma of bankruptcy. Such a non-liquidation settlement also preserves for business creditors a continuing outlet for their products.

Theoretically, a creditor should receive as much from a Chapter XI arrangement as he does from a bankruptcy liquidation. But the expeditious

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2. Statistics compiled on the basis of Chapter XI proceedings initiated in the District of Connecticut and the Southern District of New York in a representative six-month period indicate that the vast majority of arrangements involve small retail merchants and private corporations with assets of less than $100,000. About 75% of those analyzed involved less than $30,000. Comment, 51 YALE L.J. 253, 280 (1941).

In SEC v. United States Realty & Improvement Co., 310 U.S. 434 (1940), 40 Col. L. Rev. 1245, the Supreme Court held that if the debtor is a large corporation whose stock is publicly held and the reorganization plan scales down unsecured debt without diminishing or affecting stockholder interests, the corporation must file under Chapter X, even though it may literally come within the provisions of Chapter XI. For a discussion of the relationship of Chapters X and XI, see Rostow & Cutler, Competing Systems of Corporate Reorganization, 48 YALE L.J. 1334 (1939).

3. Section 306(1) provides that: "'Arrangement' shall mean any plan of a debtor for the settlement, satisfaction, or extension of the time of payment of his unsecured debts, upon any terms."


Results of a YALE LAW JOURNAL survey indicated that on the average less than three months elapsed between the filing of Chapter XI petition and confirmation. The cost of administration ran from an average of 5% on estates above $25,000 to 8% for smaller estates. Comment, 51 YALE L.J. 253, 269 (1941).

5. Creditors usually prefer to forego full payment of their present claim in reliance on future dealings with the debtor under more stringent credit terms. See Comment, 51 YALE L.J. 253, 274 (1941).

6. The Bankruptcy Act entitles creditors to all of the debtor's property which is accessible to them. Accordingly, §366 specifies "the best interests of creditors" as one of the conditions precedent to judicial confirmation of an arrangement. This test has been interpreted as preventing the debtor from paying less than the property is worth. See
and economical administration provided for by Chapter XI is obtained only at the expense of creditor safeguards. The debtor is ordinarily retained in possession, and is invested with the powers of a trustee. He enjoys a strong bargaining position and controls every phase of the proceeding. He alone may propose a plan and offer modifications. Short of actual fraud, no restrictions are placed on his representations in soliciting acceptances.

Levin, Weintraub & Singer, Third Year of Arrangements under the Bankruptcy Act, 18 N.Y.U.L.Q. Rev. 375, 386 (1941); 8 COLLIER ON BANKRUPTCY 1167 (14th ed. 1941).

Even on liquidation, the going-concern value of a business which the debtor retains under Chapter XI, is not an asset available to creditors. The personality, skill, experience, and good will of a debtor command a market price only where he covenants not to compete with his purchaser. As such a covenant cannot be imposed by a bankruptcy court, creditors lose nothing by permitting the debtor to retain such intangible property. Rostow & Cutler, Competing Systems of Corporate Reorganization, 48 YALE L.J. 1334, 1358 (1939).

A Chapter XI arrangement may provide a greater recovery for creditors since the estate is spared the expense of a trustee and his attorney whenever the debtor is retained in possession. See note 7 infra. Cf. Comment, 51 YALE L.J. 253, 269 (1941), which lists attorneys' fees as the largest single item of administration cost.

7. Section 342 provides that "where no receiver or trustee is appointed, the debtor shall continue in possession of his property and shall have all the title and exercise all the powers of a trustee appointed under this Act, subject, however, at all times to the control of the court and to such limitations, restrictions, terms, and conditions as the court may from time to time prescribe."

The debtor is retained in possession in the great majority of cases. Comment, 51 YALE L.J. 253, 264 (1941). His powers are the same as those of any other trustee in bankruptcy. In re Martin Custom Made Tires Corp, 108 F.2d 172 (2d Cir. 1939) (setting aside of unrecorded conditional sales contract); In re Rand Mining Co., 71 F. Supp. 724 (S.D. Cal. 1947) (invalidation of judicial lien); In re Janoff & Rosseth, CCH BANKRUPTCY LAW REP. (3d ed.) ¶ 54,429 (S.D.N.Y. 1943) (turnover order); 8 COLLIER ON BANKRUPTCY ¶ 6.32 (14th ed. 1941).

8. Chapter XI proceedings are initiated by voluntary petitions. Sections 321, 322.

In practice the debtor usually has the power to segregate claims into arbitrary classes for the purpose of settlement. He can thus coerce creditors into acquiescence by promising or threatening to place them into one class rather than another. While the division is subject to judicial scrutiny under the "fair and equitable" test (§ 366(3)), when the plan comes up for confirmation, courts have frequently approved divisions which bore little relation to administrative expediency. See Comments, 49 YALE L.J. 881 (1940), 51 YALE L.J. 253, 271, 272 (1941).

The court may only confirm an arrangement if it was offered "in good faith," if it is "for the best interests of creditors," and if it is "fair, equitable, and feasible." Section 366. But the efficacy of judicial scrutiny is weakened by the fact that the court does not pass on the fairness of the plan until after acceptance by the requisite majority of creditors. At that point, the court is faced with a fait accompli, and will frequently be inclined to give presumptive weight to the creditor approval which the debtor can ordinarily secure with the help of such devices as noted above. Cf. In re Polk's Model Hobbies, Inc., CCH BANKRUPTCY LAW REP. (3d ed.) ¶ 56,454 (S.D.N.Y. 1949); In re Romec Pump Co., 31 F. Supp. 389 (N.D. Ohio 1939). This occurs in spite of the fact that the Supreme Court has declared that creditor acceptance is irrelevant when determining the "fair and equitable" nature of the plan. Cf. Case v. Los Angeles Lumber Prod. Co., 308 U.S. 106, 114 (1939).

9. Section 363.
from poorly informed and frequently disorganized creditors.\textsuperscript{10} The latter are confronted with the narrow alternative of assenting or objecting to the arrangement. And their decision is influenced by awareness of the asset-depleting effect of protracted administration.

As the case of \textit{Whiteford Plastics Co. v. The Chase National Bank of New York} \textsuperscript{11} illustrates, this emphasis on speed frequently results in the adoption of a plan which does not reflect the best interests of creditors. In this case, a vendor of machinery whose claim was secured by a conditional sales contract assigned his security and the underlying debt to the Chase National Bank. Chase neglected to record the contract until after the vendee-debtor had proposed a Chapter XI arrangement and was appointed trustee by a Bankruptcy Court. Failure to record the conditional sales contract rendered the security void as against lien creditors under New York law.\textsuperscript{12} But believing Chase’s lien to be valid, the debtor at first made no attempt to use his power under Section 70c\textsuperscript{13} nor did he include the value of the machinery in his proposed arrangement which called for payment of about ten cents on the dollar. The arrangement was accepted by the requisite majority in number and amount of the unsecured creditors. Sometime after creditor acceptance, however, the debtor petitioned the court to invalidate the lien.\textsuperscript{14} While the petition was pending, the court confirmed the arrangement as originally formulated and subsequently denied the debtor’s petition.\textsuperscript{15}

\begin{itemize}
\item \textsuperscript{10} The Act specifies that at the first meeting of creditors, the court “shall receive and determine the written acceptances of creditors on the proposed arrangement.” Section 336. This clearly contemplates that the plan, which must accompany the initial petition (§323) shall have been considered by creditors prior to their first meeting. But an official creditors’ committee which can exert effective supervision is ordinarily not appointed until the first creditors’ meeting. Section 338. Unofficial creditors’ committees, functioning prior to the first meeting, are hampered by the decision in \textit{Lane v. Haytian Corporation of America}, 117 F.2d 216 (2d Cir. 1941), which denied compensation for expenses incurred by creditors prior to the appointment of the official committee. See Montgomery, \textit{The Chandler Act Again: Two Criticisms}, 25 VA. L. REV. 881, 884 (1939).
\item \textsuperscript{11} 179 F.2d 582 (2d Cir. 1950).
\item \textsuperscript{12} N.Y. PERS. PROP. LAW §§ 64, 65.
\item \textsuperscript{13} “The trustee, as to all property in the possession . . . of the bankrupt at the date of bankruptcy, shall be deemed vested as of the date of bankruptcy with all the rights, remedies, and powers of a creditor then holding a lien thereon . . . .”
\item \textsuperscript{14} The reason why the debtor instituted suit at this time is not clear. Chase maintained that the debtor, relying on judicial reluctance to increase the creditors’ share after confirmation, intended to invalidate the bank’s security purely for his own benefit. Brief for Appellee, p. 2, \textit{Whiteford Plastics Co. v. The Chase National Bank of New York}, 179 F.2d 582 (2d Cir. 1950). That position was accepted by the referee and the district judge. Transcript of Record, pp. 15, 21, \textit{Whiteford Plastics Co. v. The Chase National Bank of New York}, \textit{supra}.
\end{itemize}

The suit would have been allowed if the debtor at any time prior to confirmation had proposed an amendment to the plan (§ 363) which would have permitted the court to retain jurisdiction after confirmation (§ 368) for the purpose of ordering an additional disburse-
The Court of Appeals for the Second Circuit affirmed the denial in a 2–1 decision. The court reasoned that as between vendor and vendee the conditional sales contract was valid. The security could only be voided for the benefit of general creditors. But any recovery on the petition would inure not to them but to the debtor since the creditors’ share in the estate was limited by the plan which they had approved and which the court had confirmed. And even if the creditors were not estopped by their failure to object and their rights were not abated by confirmation, the majority felt that a Bankruptcy Court was powerless to decree the additional distribution of a post-confirmation dividend to creditors.

A consideration of the background and function of Chapter XI leads to the conclusion that the court was mistaken both in limiting creditors to the benefits of their bargain, and in disclaiming the power to distribute among them whatever funds the debtor’s suit might bring into the estate.

If a Chapter XI arrangement were akin to a common law composition, there might be some validity in the court’s position that the creditors were estopped by their acceptance of the plan. However, several points in the mechanics of Chapter XI emphasize the inappropriateness of contract doctrine. In contrast to a composition there is a provision for the coercion of minority creditors. Furthermore, acceptance of a chapter XI arrangement does not of itself fix a creditor’s rights. The plan does not become effective unless accepted by a majority in number and amount of the creditors and

16. The historic derivation of Chapter XI from the common law composition agreement is responsible for the injection of contract tenets into this area of the law. Compositions, being voluntary debt-adjusting settlements between a debtor and two or more creditors, are of course governed by principles of contract. In re Clarence A. Nachman Co., 6 F.2d 427, 430 (2d Cir. 1925). Compositions were brought into the bankruptcy law by the amendment of 1874 to the Act of 1867. 18 Stat. 182 (1874). They were taken over into the Act of 1898 as §§ 12 and 13, 30 Stat. 549, 550 (1898). For the early history of compositions in bankruptcy, see Moore’s Bankruptcy Manual, 636–8 (1939); Hanna, Contemporary Utility of General Assignments, 35 Va. L. Rev. 539, 551–4 (1949). The wholly voluntary initiation of proceedings, the retention of the terms “compositions” and “extensions,” and perhaps the drag of inertia induced most courts dealing with §12 proceedings to retain the composition analogy. See Myers v. International Trust Co., 273 U.S. 380, 383 (1927); In re Realty Associates Securities Corp., 69 F.2d 41, 43 (2d Cir. 1934); In re Lane, 125 Fed. 772 (D. Mass. 1902). But cf. In re Hammo, 12 F. Supp. 228 (N.D. Cal. 1935).

Chapter XI superseded §§ 12 and 13 in 1938. The word “arrangement” was substituted for the old terms “composition” and “extension.” The contract analogy, never apt even under §12, is still less so under Chapter XI which grafted some additional provisions for creditor safeguards and judicial supervision onto the statute. See Moore’s Bankruptcy Manual 639, 645–8 (1939). But see In re Vulcan & Reiter Co., 80 F. Supp. 286 (S.D.N.Y. 1948), criticized in Note, 62 Harv. L. Rev. 1062 (1949).

17. Section 362(1).
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subsequently confirmed by the court. Confirmation is not automatic but is predicated on a judicial finding that the plan is fair, equitable, feasible and in the best interests of creditors. And until confirmation, an acceptance is revocable.

Nor was the debtor's petition barred by an inherent lack of power to modify the plan after confirmation. The court felt that it was limited by Section 386 of the Bankruptcy Act which specified fraud as the only ground for setting aside the confirmation of an arrangement. This provision contemplates full reinstatement of the proceedings and, where the fraud is the debtor's, liquidation in bankruptcy. Because of the attendant expense and delay, this section is restricted to instances of culpable defection by parties in interest.

Although no fraud was alleged in this case, the court still had the power, without technically “setting aside” the confirmation, to grant such incidental

18. Sections 362 and 367.
19. Section 366. See note 8 supra.
20. 8 COLLIER ON BANKRUPTCY 499-501 (14th ed. 1941). But see In re Conway, 39 F. Supp. 172 (D.N.J. 1941) (creditors must present a “valid ground” on which to base a right of rescission). Courts have uniformly refused to allow an individual creditor to rescind his acceptance of a common law composition for anything short of an actual mistake in the factum. Dambmann v. Schulting, 75 N.Y. 55 (1878); Johnson v. Parker, 34 Wis. 596 (1874).
21. The introductory clause of §386 specifies three conditions precedent to setting aside the confirmation: (1) the petition to set aside must be filed within six months of confirmation, (2) fraud must have been practiced in the procuring of the arrangement, and (3) knowledge of such fraud must have come to the petitioners since confirmation.
22. Section 386(1). Where the fraud is not attributable to the debtor, relief is available only under sub-sections (2) and (3) of §386. Under clause (2), the confirmation is set aside, and the court hears applications for leave to propose modifications of the arrangement “for the purpose of correcting the fraud.” That subsection envisions the eventual confirmation of the modified plan. Under clause (3), the court reinstates the proceeding and modifies the arrangement without technically setting aside the confirmation. Such alteration may not, however, prejudice third parties who have acquired rights subsequent to and in reliance on confirmation. 8 COLLIER ON BANKRUPTCY ¶11.01-4 (14th ed. 1941). While the proceedings under subsection (3) are the least complex contemplated by §386, they still effect a detrimental change in the position of the debtor and/or the creditors taking under the assignment. Cf. Levenson v. B. & M. Furniture Co., 120 F.2d 1009 (2d Cir. 1941).
23. When confirmation is set aside, the proceedings start substantially from the beginning. Section 64a(3) gives priority to the reasonable costs of a creditor in obtaining the setting aside of confirmation and §64b gives priority to post-confirmation debts if the confirmation is set aside. 8 COLLIER ON BANKRUPTCY 1481, 1482 (14th ed. 1941). The trustee may recover sums paid out to creditors under the prior arrangement. In re Lilyknit Silk Underwear Co., 73 F.2d 52 (2d Cir. 1934).
24. While one treatise insists that the confirmation may be vacated on grounds other than fraud if justice requires it, 8 COLLIER ON BANKRUPTCY 1465, 1465 (14th ed. 1941), the cases have rigorously insisted on the requirement of fraud. In re Isidor Klein, 22 F.2d 906, 908 (2d Cir. 1927) (decided under former §13); In re Siff, 295 Fed. 761 (S.D.N.Y. 1923) (decided under former §13). See In re Mirkus, 289 Fed. 732, 734 (2d Cir. 1923).
relief as is within the ordinary cognizance of a court of equity.25 As indicated by Judge Clark in his dissent, the Bankruptcy Court had the power to invalidate the lien on the property here involved, to relegate the bank to its pro-rata share of the debtor's estate, and to decree that the remainder of the recovered fund be distributed ratably among the unsecured creditors.25 A Bankruptcy Court may reopen estates for cause shown and, a fortiori, may amend and supplement its decrees where, as here, the estate had not been finally closed at the time of the debtor's petition.27 It sits continuously; it is not limited by the rule which deprives other courts of equity of the power to alter their decrees after expiration of the term at which the orders were entered.28

Even though a Bankruptcy Court has the power to consider a tardy petition, it should not make use of it in every case. Indiscriminate dispensation of post-confirmation relief may neutralize the advantage of speedy settlement which a Chapter XI arrangement offers. Thus the court should consider whether the petition will give rise to a vexatious suit which will burden the estate with heavy costs or unreasonably delay final disposition.29 The petition should also be denied if it would prejudice the rights of third parties who have relied on the plan.30 However, in the absence of counter-


26. Judicial post-confirmation orders have covered a broad range of subjects. Commercial Wholesalers, Inc. v. Investors' Commercial Corp., 172 F.2d 800 (9th Cir. 1949) (modification of final decree closing the estate); Grand Union Equipment Co. v. Lipner, 167 F.2d 958 (2d Cir. 1948) (court modified injunction to enable creditor to recover judgment against debtor as preliminary step to taking recourse against debtor's insurer); Mullican v. Texas Land and Mortgage Co., 117 F.2d 576 (5th Cir. 1941), reharing denied, 118 F.2d 560 (reexamination of usurious claim; court construed referee's failure to dismiss the case as a retention of jurisdiction); In re H. H. Buggie & Co., 18 U.S.L. Week 2372 (N.D. Ohio, Jan. 19, 1950) (creditor failed to file claim till after confirmation but was permitted to share pro-rata as debtor had scheduled creditor's claim).

27. "The case is dismissed" upon confirmation (§367(4)) but the "estate is not closed" until a decree to that effect is entered "upon the consummation of an arrangement. . . ." Section 372. Until the estate is closed, the case remains open for the exercise of all jurisdiction proper in bankruptcy proceedings. In re Rubin's Department Store, 75 F.2d 731, 732, 733 (7th Cir. 1935).

In the present case, no decree closing the estate had been entered at the time the debtor's petition came up for hearing. Communication to the YALE LAW JOURNAL from Counsel for the debtor-appellant, dated February 20, 1950, in the Yale Law Library. But even if the estate had been formally closed, it could have been reopened "for cause shown." Section 2a(8). That clause of §2a(8) is applicable to Chapter XI proceedings. 8 COLLIER ON BANKRUPTCY 1280 n.9 (14th ed. 1941).


30. See Mohawk Realty Corp. v. Wise Shoe Stores, 111 F.2d 237 (2d Cir. 1940).