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Arrangements and Wage Earner Plans: Proceedings Under Chapters XI and XIII

*Sydney Krause**

In this article, Mr. Krause considers the practical problems confronting the attorney who conducts proccedings under chapters 11 and 13 of the Bankruptcy Act. The article is a revision of remarks made by Mr. Krause at the Institute on Debtor-Creditor Relations held at the Vanderbilt University School of Law on November 11, 1961. While a number of changes have been made in the remarks, the author has retained insofar as possible the original flavor of the address.

Ladies and gentlemen, I too will start by telling you how great a pleasure it is to be here and to talk with an audience that is interested in the subject which has been very close to my heart for many, many years. I do not suppose any of us knows how we ever happen to center our attention on particular aspects of the law. There are very few of us, I think, who when we leave law school know just what particular phase of the law is going to engage the major part of our attention once we have entered private practice. I include myself among the unknowing. But at a rather early stage in my professional career I happened to associate myself with a firm that did a good deal of bankruptcy work, and so for many years now I have devoted myself to this field; I find it a fascinating one and I wonder whether I can interest some of you in giving more than passing interest to what I consider to be a field which could be a very fruitful and rewarding one if you would pay more attention to it. There is entirely too much of a tendency in private practice today to specialization in this whole field of creditors' rights, bankruptcy and even more particularly the subject to which I am going to address myself in a moment, a very special phase of the bankruptcy law known as arrangements. There is a tendency to refer these things to other practicing lawyers who are specialists in handling these problems. I suppose when you get to very, very complex situations, there may be some good sense in that approach. But by and large there is nothing too, too peculiar about the whole field of bankruptcy, nor particularly about the field of chapter XI, arrangements.

I. Historical Background

The arrangement section goes back in its history to an earlier section of the Bankruptcy Act adopted in 1898. Section 12 of that act dealt

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with "compositions." I do not know how many of you in this room practiced law when the only means of effecting a settlement in a bankruptcy proceeding was through a composition. This unhappy situation lasted for many years until finally in the early thirties a real effort was made to enlarge the scope of the section because its inadequacies had become quite apparent. At that time two sections were grafted on to the Bankruptcy Act, sections 74 and 77b. Unfortunately those two sections also proved to be inadequate, for reasons we need not discuss here.

In the late thirties the National Bankruptcy Conference undertook the job of seeing whether a comprehensive body of legislative law could not be grafted on to the Bankruptcy Act which would make settlement or composition a much more effective instrument than the then-existing legislation permitted. And as a result of some four or five years of work, in 1938 the Chandler Act was finally passed. I would rather think that many of you in this room know Walter Chandler; he is a dear gentleman and I am very, very fond of him. I am happy to say that I know him and am so glad that he has given his name to this act which has been so effective since 1938, in elevating to the status of an art the practice of reorganization in bankruptcy proceedings.

II. Chapters X and XI Compared

By the Chandler Act chapters X, XI, XII and XIII were added to the Bankruptcy Act and proceedings under these sections are frequently referred to as the "chapter proceedings." Chapter X is a very special proceeding, a rather involved one, so special that I shall say no more about it other than to point out in passing some rather unusual differences between chapter X and chapter XI. There are special cases which belong only in chapter X. If a corporate debtor, for example, were to file under chapter XI in a situation where there were many publicly held securities—either securities that were listed on a recognized stock exchange or securities that were traded over some over-the-counter market—the court might of its own motion (or certainly the Securities and Exchange Commission might step in and call this to the attention of the court) determine that this is a proceeding that would be more suited for reorganization in a chapter X proceeding. And under those circumstances there is a section in chapter XI which would permit the proceeding to be converted from a chapter XI arrangement into a chapter X reorganization.[1] Concomitantly there is a similar section in chapter X; if a company did not need the type of reorganization which chapter X affords, then again the court would of its own motion or on motion of an interested party convert the proceeding into a chapter XI proceeding by transferring it into what is known as an

1. Bankruptcy Act § 328, 66 Stat. 432 (1952), 11 U.S.C. § 728 (1958).

"arrangement proceedings."[2]

For practical purposes, the first significant difference between the two is that the chapter X proceeding is usually administered by a judge while the chapter XI proceeding is administered as an ordinary bankruptcy proceeding in the respect that as soon as it is filed it is referred by the clerk of the court to the referee sitting in the particular district where the proceeding is initiated. I should hasten to add that in many jurisdictions even in chapter X cases, the judge who theoretically is to administer the proceeding may frequently refer certain aspects of the case to the referee in bankruptcy sitting in that district; he may even refer them to a practicing lawyer as a special master who will hear and report to the judge. The judge will then confirm the report after hearing parties who were interested in the matter when it was heard before the special master.

However, to revert to chapter XI, that chapter, in essence, permits you to do in court what John Mulder[3] told you might frequently be a good idea out of court. He told you some of the advantages of out-of-court settlements and mentioned, very briefly, some of the advantages of being in court, and by "in court" he was referring particularly to chapter XI.

I should like to excite your interest by mentioning some problems that would confound you if you tried to effect a settlement out of court and yet would be relatively simple of solution under chapter XI. For example, suppose there were many law suits that had been commenced and that, notwithstanding the convincing nature of the argument which you as the attorney for the debtor would give these various litigants, you could not prevent them from going ahead with their suits. There is no conventional means that I know of under state law (I speak now of the law of New York, assuming that it is not unusual), other than perhaps putting in an answer that would not survive a motion for summary judgment, that would prevent the entry of judgment within a reasonably short time. You therefore face the problem of impending judgment. Or let us assume the debtor needs working capital. The problem involves more than having the creditors get together and organize a committee to sit down and discuss how much of a settlement should be offered. You are faced with the problem of actually operating a going business while all of these things are taking place. Creditors would naturally and necessarily be reluctant to put more money into a venture of that kind. To be sure there are various devices for trying to arrange for advances of money even while the company's negotiations looking to out-of-court settlements are pending. Take, for example, the device of opening special bank accounts into which the new money goes. We try all sorts of security devices to insure that the new

2. Bankruptcy Act § 147, 52 Stat. 888 (1938), 11 U.S.C. § 547 (1958).

3. John Mulder, Director of the Joint Committee on Continuing Legal Education of the American Law Institute and the American Bar Association, preceded Mr. Krause on the Institute program.

money, necessary while the settlement is being worked out, will not eventually end up on a parity with a lot of old money and recover only a dividend instead of full payment. This certainly would not recommend itself to a potential financier. Problem number two is, therefore, what do you do about new money?

Let us pass now to problem number three. Suppose there are a number of secured claims pressing to foreclose their particular interests, whether they be chattel mortgages, factors' liens, or assignments of accounts receivable. I do not mean to suggest that in a chapter XI proceeding you would be able to restrain these people from enforcing their rights indefinitely. But certainly in a well administered arrangement proceeding you could obtain the assistance of the referee, who is in the court for purposes of an arrangement proceeding, to see to it that even secured creditors should forebear a while longer.[4] There you have another advantage of filing a chapter XI proceeding.

I should have mentioned earlier when I pointed out the fact that you frequently need working capital and cannot get it in out-of-court proceedings, that chapter XI expressly permits the debtor or a receiver or trustee to borrow money on what are known as "certificates."[5] These certificates are given the status of administration expenses so that they are senior to the old debt and no elaborate security device is needed to accomplish that end.

I should like to advert briefly to the kind of business that can avail itself of chapter XI. Unlike chapter X, which by its very title excludes any business entity except a corporation from its benefit, chapter XI is available to all sorts of business entities. There are particular exclusions under chapter XI, such as municipal corporations, building and loan associations, and municipal, railroad, insurance or housing corporations.[6] Generally speaking most ordinary business entities that are engaged in manufacturing and servicing operations of one kind or another now file under chapter XI.[7] Chapter XI is available for use by any type of business entity, including a sole proprietorship, a partnership or a corporation.

III. Procedure Under Chapter XI

How does one institute a chapter XI proceeding? Suppose you represent a debtor and three creditors have petitioned your client into an involuntary

4. See Bankruptcy Act § 314, 52 Stat. 907 (1938), 11 U.S.C. § 714 (1958).

5. Bankruptcy Act § 344, 52 Stat. 909 (1938), 11 U.S.C. § 744 (1958).

6. Section 4 defines who may become a bankrupt. Only persons who may become bankrupt can avail themselves of the remedies afforded by chapter XI. See Bankruptcy Act § 306(3), 52 Stat. 906 (1938), 11 U.S.C. § 706(3) (1958).

7. Corporations, as distinguished from individuals, which own and operate real estate may also file under chapter XI. Individuals who own real estate are covered by a specific chapter designated XII. This new chapter was designed to cover a particular type of situation that arose frequently in the area of Chicago, Illinois. In recent years, chapter XII has fallen into disuse.

bankruptcy. Let us assume further that in the pending involuntary proceeding there has been no adjudication in bankruptcy as yet; in other words the court has not had a hearing to determine whether the particular case belongs in bankruptcy. Is chapter XI available? The answer is yes, it is available and the law very distinctly states that in a pending bankruptcy proceeding you may file a chapter XI proceeding. To go one step further, let us suppose that the involuntary petition has already led to an adjudication in bankruptcy. Is chapter XI still available to the debtor? Well, there again the answer is yes. Even in a proceeding in which the debtor has been adjudicated a bankrupt, a chapter XI proceeding may be filed. As a matter of fact, I have participated in proceedings in which the proceeding has been going along in what we call a straight bankruptcy proceeding for many months until some particular circumstance would turn up as a result of which it would appear that it would be to the advantage of the creditors as well as the bankrupt that a settlement under chapter XI be worked out. Even at that late date, it is not too late to file a chapter XI proceeding and to attempt to work out a plan under the mechanics afforded by chapter XI. Thus you may, in a pending bankruptcy, at practically any stage of the proceeding prior to the final wind-up of the bankruptcy proceeding, file a chapter XI.

You may also initiate a chapter XI proceeding where there is no pending bankruptcy. In other words, you can start a chapter XI as a matter of first impression. The papers are a little different, but in the last analysis there is no essential difference between a chapter XI which is initiated in a pending bankruptcy proceeding[8] and a chapter XI which is initiated as an original proceeding.[9] The papers which are required for use in a chapter XI proceeding are fairly well set forth in the act; I doubt that it would be fruitful for me to advert to them at great length. Briefly stated, you file a petition stating that you want to try to work out an arrangement proceeding. There was a time prior to 1958 when you had to file a plan along with the arrangement petition, but this is no longer true. All you have to state now is that you intend to work out an arrangement proceeding. With the petition you must file either the schedules in bankruptcy and some related papers, called the statement of affairs and statement of executory contracts, or—if time is short and if you are trying desperately to head off some judgment creditor who is about to obtain a judgment and levy execution on the debtor's property and time simply does not permit you to get up an elaborate set of schedules in bankruptcy and the other papers that I mentioned—there is now a provision in chapter XI that you may get an order of the court extending your time to file.[10] In other words the

8. Bankruptcy Act § 320, 52 Stat. 907 (1938), 11 U.S.C. § 720 (1958).
9. Bankruptcy Act § 321, 52 Stat. 907 (1938), 11 U.S.C. § 721 (1958).
10. Bankruptcy Act § 324, ch. 575, 52 Stat. 907 (1938), as amended, 11 U.S.C. § 724 (1958).

Congress has seen fit to encourage prompt filings here so that an estate will not be dissipated even before the proceeding can be launched. When the proceeding is filed, unfortunately, it can go two routes, and I use the word "unfortunately" advisedly, for the practice throughout the country has not been uniform. In certain parts of the country the district judges who have, in the first instance, supervision and control over arrangement proceedings, have been of the opinion that it would not be wise to allow a debtor who files under chapter X to continue to operate the business as "debtor-in-possession." There is express sanction for this in the act, but such sanction is permissive rather than mandatory. In other jurisdictions it is accepted practice to continue the debtor as debtor-in-possession, absent special circumstances. If you will think for a moment you will realize what a tremendous advantage operation by a debtor-in-possession can be, although there are disadvantages as well which we will discuss in a moment. Under the debtor-in-possession arrangement you continue in management and operation of the business the very people who have been responsible for running it before. They know the customers, they know the inventory, they know the suppliers, they know all this without any interruption at all for the sort of familiarizing that the receiver would have to do if he came into a strange business. On the other hand you can easily visualize the objections to such an arrangement. You are entrusting the management of such a business to the very people who are responsible for its financial failure.

The court has to weigh, in a sense, whether the advantages of continuing the operation of a business by a debtor-in-possession outweigh the advantages of putting in a receiver or continuing a trustee. The decision will have to be made and once it is made, if it is to allow the debtor-in-possession to continue, you will need an order of the court. It's rather a comprehensive order; any good form book in bankruptcy will furnish you with orders under which a debtor-in-possession is authorized to continue to operate a business. I am a little bit ahead of my story, because I started out by telling you that there is a difference as to the practice and I neglected to say that there are some districts in the country where they have an invariable practice that a receiver will be appointed in every chapter, regardless of whether it is called for specially or not. In two states that are as close to each other as New York and New Jersey, completely different practices have grown up. In New York, it is the rare exception in which the debtor-in-possession is not continued to operate the business when a chapter XI proceeding is filed. Right across the Hudson River in New Jersey just the opposite practice prevails, and it is indeed an exceptional case in which there will not be a receiver appointed (who will retain counsel) to operate the business while the arrangement proceeding is going forward.

In those cases where the debtor-in-possession is continued, the Congress has seen fit to include in chapter XI some preliminary safeguards. Notwithstanding the fact that the debtor-in-possession is going to run the business, the creditors will have a voice in making the decision or in helping to make the decision as to whether the business will be run without the posting of any indemnity so far as future losses in the operation are concerned. There is an express section in chapter XI which says that within a very short time after the institution of the proceedings there will be a preliminary meeting (in some jurisdictions on notice to the ten largest creditors) to determine whether or not the debtor-in-possession is to continue without posting an indemnity bond or whether such a bond will be required.[11] Within a very short time after that hearing, there will usually go out to creditors a notice by the referee's office calling a first meeting of creditors. At that first meeting of creditors there are several things that will take place. In the first place there will be the election of what we call a tentative trustee.[12] This does not mean that the person who is elected at that meeting will take over. It means only that there will be somebody in being to serve as trustee if the arrangement proceeding collapses and the matter goes into what we call a liquidating bankruptcy.[13] The Congress decided that it would be well to have such a person in being at an early stage of the proceeding so that there would be no hiatus in the event of collapse, so you elect a tentative trustee. And you do that just as you would elect a trustee at the first meeting of creditors in an ordinary bankruptcy proceeding. In other words, that trustee is elected by a majority in number and amount of filed claims. At that same meeting, just as would happen in an ordinary bankruptcy proceeding, you elect a committee of creditors.[14] The committee of creditors is a much more important instrument in a chapter XI proceeding than it is in a liquidating bankruptcy proceeding because the coming into being of that committee of creditors is frequently what converts the proceeding from a sort of a one-sided show into an adversary proceeding. This is particularly true where there has been no pre-reorganization activity on the part of creditors. In our district and in many districts where I have observed proceedings, it is rather unusual for a chapter XI proceeding to be filed without some preliminary meeting of creditors being held at which a so-called informal creditors committee is selected. We use the term "informal committee of creditors" to distinguish that body from the official creditors committee for which there is express sanction in chapter XI. The creditors com-

11. Bankruptcy Act §§ 326-27, 52 Stat. 907 (1938), 11 U.S.C. §§ 726-27 (1958).

12. Bankruptcy Act § 338, ch. 575, 52 Stat. 909 (1938), as amended, 11 U.S.C. § 738 (1958).

13. Bankruptcy Act § 378(2), 52 Stat. 913 (1938), 11 U.S.C. § 778(2) (1958).

14. Bankruptcy Act § 338, ch. 575, 52 Stat. 912 (1938), as amended, 11 U.S.C. § 738(2) (1958).

mittee is important for a number of reasons. For one thing, its voice will be given great heed by the court, and that, as I say, is the referee in most cases. If such a committee comes in with recommendations and suggestions as to how the business should be run, even during the pendency of the chapter XI, the referee, knowing their interest in the case, will place a great deal of store by their suggestions. In other words, if the creditors committee should come in with a recommendation that during the pendency of the arrangement proceeding there ought to be somebody countersigning checks such as an accountant or the chairman of a creditors committee, the referee might very well amend the order under which the debtor-in-possession is operating the business to provide for such countersignature. It may be that the referee will insist that the creditors committee frequently have a voice in the selection of an accountant who shall continue during the pendency of the chapter XI. These are all the result of interplay in what has now been converted into an adversary proceeding, once the official creditors committee has been elected at the first meeting of creditors.

Usually at that first meeting of creditors there will be before the court a plan of arrangement. In many cases, however, this is not so, because as I mentioned a while ago since the 1958 amendment, it is no longer necessary to file the plan along with the chapter XI petition. The debtor frequently will get successive orders extending his time for filing a plan so that you might very well come up to the first meeting of creditors with no plan before the court. Then depending upon how important it is for such a plan to be filed at an early date, the referee will further extend the time to do so if he thinks it desirable, and in the best interests of the entire situation. Eventually there comes a time when the plan must be filed, and as a matter of fact the failure to file a plan within such time as the court shall direct is a ground for adjudicating the debtor in the arrangement proceeding a bankrupt.[15]

Let us assume that within the time fixed by the court the plan is filed by the debtor's attorney. As a matter of law such a plan can be filed without any prior negotiation with creditors, but as a practical matter it would be inadvisable to do so. You will need the creditors committee eventually to make a favorable recommendation concerning the proposed plan to the creditor body at large, because, as I shall mention in just a moment, to put through this plan, you will have to obtain the written consent of the creditors in the arrangement proceeding. If you have neglected to include in the plan safegnards which the creditors committee or creditor's representatives want or if you have made an offer which is inadequate in the eyes of the creditors committee you will probably have to amend the plan. There

15. Bankruptcy Act § 376, ch. 575, 52 Stat. 912 (1938), as amended, 11 U.S.C. § 738 (1958).

fore, the sensible way and the practical way to do this is to negotiate before the plan is formally prepared assuming, of course, that the plan was not filed along with the original petition. It should be noted that one of the reasons that prompted the Congress to amend the act so as to eliminate the requirement as to the filing of the plan along with the petition instituting the proceeding is that the plan that was customarily filed was unrealistic. In the ordinary case there had not been sufficient time, or perhaps no opportunity, for prior negotiations between the creditors and the debtor. The plan that accompanied the arrangement was usually pro forma. This unrealistic plan had to be sent out to creditors because under the law the referee had to send out whatever plan was filed.[16] Thereafter it became necessary to start all over again after the creditors committee came into being to negotiate and to formulate the plan that was really intended for consideration by the creditors.

I revert to the point where the plan, as a result of negotiations between the creditors' attorneys and the debtor, has finally been agreed on.

While all of this is pending (when I say all of this, I mean the hearing on the indemnity, the first meeting at which the debtor will have to appear and be examined, the filing of the plan, the negotiations between the creditors committee and the debtor) claims are being filed in the referee's office. Here you have a somewhat unique situation. I imagine that most of you are familiar with the fact that in an ordinary bankruptcy proceeding, and I speak of that in contradistinction to a chapter XI proceeding, there is a terminal date for filing proofs of claim. Without going into the many exceptions, the general rule is familiarly referred to as the six-month rule, which means six months from the first date set for the first meeting of creditors. In chapter XI that is not the rule. Until the initial meeting is closed, and we have had proceedings where the initial meeting remained open as long as two years, any creditor may file a claim. In other words, the claim may be filed so long as the initial meeting of creditors in the arrangement proceeding has not as yet been closed.

I have frequently been asked what is the effect of not filing a proof of claim in an arrangement proceeding. I pause for a moment to remind you that the effect of not filing a proof of claim in an ordinary bankruptcy proceeding in most cases is fatal. In other words, if there be assets and if there be a dividend and you have failed to file a claim on behalf of your client, your client will not share in the estate and will not receive the dividend. But assuming that in chapter XI proceeding you do not file a claim, the same result does not follow. Chapter XI provides that when distribution is made under a plan, not only the creditors who have filed proofs of claim will participate, but also those who have been scheduled by the bankrupt.[17] When I say schedules, I use that as a word of art because

16. Bankruptcy Act § 335(1), 52 Stat. 909 (1938), 11 U.S.C. § 735(1) (1958).
17. Bankruptcy Act § 367(3)(b), ch. 575, 52 Stat. 912 (1938), as amended, 11

there is a section in the Bankruptcy Act which describes exactly what the schedules are and there are General Orders promulgated by the Supreme Court of the United States which also disclose exactly what form those schedules should take. So the bankrupt files the schedules in the bankruptcy proceeding. Now assume you represent a creditor with a $5,000 claim and you examine the schedules and you find that his name and his address are all proper and he is scheduled there for $5,000. Should you file a claim? This is an important decision to make. In the ordinary case it is not necessary to file a claim to receive the same consideration paid to creditors under the arrangement. But, if you want to have a voice in whether or not the plan which is going to be presented by the debtor shall be accepted or rejected, you have to file a proof of claim. This is something which is not known generally. In other words, the rule to remember is that under chapter XI the plan will be accepted when and if a majority in number and amount of each class of creditors assents to the plan. This has to be read, in the light of other sections of the act, to mean that only the creditors who have filed proofs of claim in the proceeding may be counted in determining this majority. I would like to illustrate just to make this abundantly clear. Let us assume that we were dealing with a debtor with $100,000 of scheduled claims, you might think offhand that you will need approximately $50,001 of assents in order that a plan presented by such a debtor in such an arrangement proceeding could be accepted. Well that is not so, because you have to measure the dollar acceptances only by the proved claims. Therefore, if only $50,000 of the $100,000 in scheduled claims have filed proofs of claim, you will need $25,001 of assents for the plan to become effective. In order that the plan be approved, you need not only a majority in the amount of the filed claims but a majority in number. Here again, the emphasis is on the word "filed." In other words, if there were 100 creditors scheduled, you do not need 51 if only 50 creditors filed. You need 26 in order to get the majority in number. There are certain other procedural matters and substantive matters which also have to be made clear before the plan will be confirmed, but on the matter of consents alone, the adequacy of consents is not measured in relation to the scheduled claims but to the filed proofs of claim.

I would like to add a final word on the subject of when and whether to file a proof of claim. If you want to have an effective voice in the consideration of the plan, then you have to file a claim.

You may be wondering under what circumstances would it be inadvisable to file a claim. There has been a rather extended line of cases in recent years beginning with *Columbia Foundry v. Lochner*,[18] which say

U.S.C. § 767(3)(b) (1958). The debtor will have had to file schedules in a chapter XI proceeding. See Bankruptcy Act § 324, ch. 575, 52 Stat. 907 (1938), as amended, 11 U.S.C. § 724 (1958).

18. 179 F.2d 630 (4th Cir. 1950).

that when a creditor files a proof of claim in a bankruptcy proceeding, he thereby subjects himself to the summary jurisdiction of the bankruptcy court to determine any disputes which might not ordinarily be cognizable in the bankruptcy proceeding. Therefore, you have to consider the merits and the facts and circumstances of the claim that you represent, in order to determine whether or not there may be any reason why you should not file a claim. For example, suppose in a proceeding held in Nashville you represent the claim of a creditor in California. In the ordinary case, if there were some claim against that California creditor that the debtor wanted to assert he might have to go out to California to start the suit, and he might think twice before he would incur the expense and go to the trouble of starting a suit in California. However, the moment a Nashville attorney files a claim for this creditor in the bankruptcy proceeding, he automatically subjects that creditor to the jurisdiction of the bankruptcy court for the determination of any disputes which would not otherwise be justiciable by the bankruptcy court.

At this very point it is well to point out one other circumstance in arrangements that is frequently overlooked. The Bankruptcy Act says that in a plan you can classify creditors. You can classify them in a variety of ways. You can classify them in relation to the genesis of the claims; you can classify them as to the amount of claim. For example, John Mulder mentioned that in out-of-court settlements you would frequently limit the number of claims you have to deal with by paying some cash amount to the smaller claims and then paying a deferred dividend to larger claims. The idea is that in cases where you are going to pay in installments it would be rather pointless to have to send out so many communications with checks of piddling amounts. The one caveat here that all of you should bear in mind is this: (a) the classification has to have some reasonable relationship to a business purpose or to a valid purpose, and (b) the court will have to approve the classification. You can not say that you are going to pay a certain amount to all of your creditors who have blond hair and another amount to other colors. There has to be some rational basis for it. Furthermore, I would like to point out a situation where so many people who are not familiar with chapter XI fall down completely. As I said, you can classify into smaller claims and larger claims and you can offer the smaller claims 100 cents on the dollar and the larger claims a deferred dividend. However, classification makes it necessary to comply with the provisions of the arrangement statute that require a majority in number and amount of the filed claims of *each* class. Now, in many cases, you have to give this a great deal of attention before you propose the plan, because you may be cutting your own throat. Suppose, as a matter of fact it will be important to have a majority in number of creditors. If you classify all the $50.00 creditors into a separate class and the larger creditors into another, you automatically deprive yourself of the right to

use consents of the $50.00 creditors in determining whether a majority in number of consents has been obtained. This is so because their consents count only in the special class of creditors of $50.00 or less. By making this separate class, you may deprive yourself of the affirmative vote of these small creditors to your prejudice.

In other words, again, to illustrate in order to make the point, suppose you have 55 creditors and 50 of them were $50.00 or less and the others were up in the many thousands of dollars. If you provided in your plan to classify these creditors as between those with claims of $50.00 or less and those with claims in excess of $50.00 you would put the 50 claims in one class and you will need a majority in number and amount of those and you would put the 5 claims in another class, and you will need a majority in number and amount of those. Which means that 3 creditors in that larger class by refusing to consent to your plan can make the entire plan inoperative.

To get along with my story, when the plan is proposed and the consents are in, there still remain certain functions to be performed by the referee. He has to determine that the debtor has not committed any acts that would be a bar to a discharge. Furthermore, in order to make the plan operative, there has to be a deposit made by the creditor and the deposit means the amount of cash which is going to have to be distributed to creditors and for administration expenses on consummation of the plan. Since under chapter XI you cannot compromise the claims of priority creditors, this means that in the ordinary case, as part of the consideration which you will have to deposit, you will have to post all of the money which is necessary to pay tax and wage claims in order that the plan can be made effective. Do not let that frighten you unduly, because in our district and in adjacent districts and in many other districts in which I have had arrangements that I have either been interested in or handled, the Director of Internal Revenue will be cooperative. Although, as a matter of law, he could insist that you deposit the entire amount of the federal tax claim, prior to confirmation, he will frequently agree to what we call a "deferred payment program" so that the entire amount of unpaid taxes need not be deposited on confirmation.

We are now at the point where you have your cash consideration deposited, held your hearing to show that the plan meets the specifications in the act, and you have obtained the requisite consents. You are now in a position to move for confirmation. You make such a motion before the referee on notice. The referee sends out the notice. In point of fact, what happens in most cases is that the referee will have sent out the notice of confirmation at the same time he sent out the plan, expecting that in due course he will be at the point where this notice of confirmation will have to be acted upon. If he finds that all the prerequisites have been complied

with, he will sign the order of confirmation. The effect of the order will be that for all practical purposes you have a complete discharge of all of the debts just as if a discharge order had been made in an ordinary bankruptcy proceeding.[19] The business is returned to the debtor if the plan provides for such a return or can pass to another entity such as a new corporate entity, if the plan so provides.

One of the problems that comes up frequently in chapter XI proceedings is the matter of obtaining credit for the reorganized debtor after the arrangement has been confirmed. This becomes important because the Bankruptcy Act distinctly provides that in the event that the debtor defaults after an arrangement has been confirmed, the creditors who extend credit after the confirmation, together with any amount due to the old creditors under the arrangement will all share on a parity.[20] This will normally act as an effective deterrent to the granting of new credit so that it would be wise to consider, when you work out your plan, whether it would not be well to include a provision subordinating the claims of creditors in the arrangement proceeding to the claims of newly created creditors.

This is a matter of give and take. It may be more important to you that your creditors' claims have parity with newly created debt than it is to insure the continued operation of the business. Obviously, if a reorganized debtor cannot get credit, he will not be in the position to continue the business. But these are the gives and the takes of a proceeding and the things that have to be considered.

There frequently arises in the negotiations of a plan in chapter XI, the question as to whether or not there ought to be included in the plan what we call a "reservation of jurisdiction" clause. Until just about a year or two ago, I, as the attorney for a debtor, would have fought very vigorously to exclude such a provision from a plan of arrangement. Just instinctively, I did not want to have the same court that went through with the arrangement proceeding have the right to step right in and take my client's business back into the bankruptcy court. I wanted to be in the position where, if perchance there should have been a default, I would be able to negotiate anew with my creditors to see whether I could not stay out of court a second time. That consideration has been effectively eliminated by an amendment to the Bankruptcy Act which now states that in an arrangement where jurisdiction of the court has been reserved, if the debtor fails to live up to the provisions of the plan, he can go back to the court and propose an amended plan, and if a majority in number and amount will approve such an amendment of the plan, either by a further extension of time or by a reduction in the amount of dollars to be paid,[21] it can be

19. Bankruptcy Act § 371, ch. 575, 52 Stat. 912 (1938), as amended, 11 U.S.C. § 771 (1958).
20. Bankruptcy Act § 381(2), 66 Stat. 434 (1952), 11 U.S.C. § 781(2) (1958).
21. Bankruptcy Act § 387, 72 Stat. 822, 11 U.S.C. § 787 (1958).

effective, *but only if there has been the saving clause inserted in the arrangement that jurisdiction is reserved.* So I recommend to all of you that you reconsider the question as to whether you want to take the position that I did once upon a time in trying to exclude a "reservation of jurisdiction" clause. I now consider it to be an eminently desirable provision to include in every plan.

There is a good deal more to be said on the subject of arrangements which time allotted to me would not permit, but I hope that I have said enough to excite your interest and to convince you that this is an extremely effective medium for rehabilitation of debtors.

IV. PROCEEDINGS UNDER CHAPTER XIII

In my remaining time, I would like to speak briefly on chapter XIII, which is known as the chapter dealing with Wage Earner Plans. We do not have many chapter XIII proceedings in my section of the country. I do believe that there are certain sections where they are more numerous. Chicago is beginning to have some of them, and I understand that you have a great many here. Chapter XIII is in a sense a replica of chapter XI with a few important exceptions. Since I have said so much already on the subject of chapter XI, it might be more expeditious to point out the distinction between chapter XI and chapter XIII. Chapter XIII is reserved exclusively for wage earners. There was a time until a few years ago when the definition of a wage earner was built right into chapter XIII and a person who earned more than $5,000 could not take advantage of the section. There has been an amendment to chapter XIII now so that there is no such limitation, and you may take advantage of chapter XIII irrespective of the amount earned by the debtor so long as his principal income is derived from wages (Section 606(8)). The sailent distinctions between chapter XIII and chapter XI are as follows: In the first place, you can provide in a chapter XIII provision for sequestering a certain part of your wage earner client's future income, which will be paid to a trustee and will be distributed to the creditors by that trustee over the period of the wage earner plan on some basis that will be set forth in the same type of a plan that I mentioned in discussing chapter XI. The proceeding is initiated in the same way a chapter XI proceeding is. In other words, you may file a wage earner's plan in a pending bankruptcy proceeding. If any of you questions the propriety of a wage earner being in a bankruptcy proceeding in the first place, the answer is that there is a different definition of a wage earner in Section 1(32) from that which appears in Section 606(8). It is only the former who cannot be adjudged an involuntary bankrupt.[22] In other words, a wage earner who earns in excess of $1,500 per

22. Bankruptcy Act § 4(b), ch. 541, 30 Stat. 547 (1898), as amended, 11 U.S.C. § 22(b) (1958).

year can be petitioned into involuntary bankruptcy.

If such a wage earner finds himself in bankruptcy and would feel that he would prefer to put through a wage earner's plan, he may under the act, file such a wage earner's plan in the pending involuntary bankruptcy proceeding.[23] Moreover, just as in chapter XI, he can voluntarily file a chapter XIII petition.[24] There are a number of provisions in chapter XIII which were not as carefully planned as they might have been. It is my considered opinion that chapter XIII is really in need of an overhauling, because it seems that Congress by the time it got through with chapters X, XI and XII did not give adequate attention to chapter XIII and this appears from a great many omissions in chapter XIII. For example, there is no specific statement as to the terminal date for filing claims in the chapter XIII proceeding, and people who have worked on this section extensively in the areas where it is used a great deal more often than it is used in New York say that the practice certainly is a jungle, so far as uniformity is concerned. Certain of the referees have ruled that you can file a claim in a chapter XIII proceeding at anytime during the six month period which means that if you were to confirm a chapter XIII proceeding within three months from the date fixed for the calling of the first meeting, creditors could continue to file claims thereafter. The chapter is not as clear as it should be, and I would suggest that if you represent a creditor in a chapter XIII proceeding you file a claim as soon as the matter comes to your notice.

There are two or three other very significant differences between chapter XI and chapter XIII. In the first place, if you put through a plan in chapter XIII and the proceeding runs on for three years, at the end of that time the referee, if convinced that the debtor has made an honest effort to carry out the plan, may cancel all further payments so that it may very well be that, irrespective of the terms that go into the plan itself, at the end of the three-year period, the debtor will be completely discharged from any further payments.[25] Additionally, there is a specific provision in chapter XIII that the plan must include a provision giving the referee power to consider the question as to whether or not there should be higher payments or lower payments made by the debtor.[26] In other words, let us assume that the wage earner has proposed that he intended periodically to pay 15% or 20% of his wages to the trustee who will accumulate this money and pay it out. Let us assume further that there comes a time when either he gets a windfall and his salary is increased very appreciably or when he loses his job or has to take a cut in salary. In such a situation

23. Bankruptcy Act § 621, 52 Stat. 931 (1938), 11 U.S.C. § 1021 (1958).
24. Bankruptcy Act § 622, 52 Stat. 931 (1938), 11 U.S.C. § 1022 (1958).
25. Bankruptcy Act § 661, ch. 575, 52 Stat. 936 (1938), as amended, 11 U.S.C. § 1061 (1958).
26. Bankruptcy Act § 646(5), 52 Stat. 934 (1938), 11 U.S.C. § 1046(5) (1958).

the referee can either increase or reduce the stipulated payments, as the case may be. Moreover, the referee has jurisdiction to direct the employer to pay this money, the percentage of the wages, directly to the trustee.

I should like to comment briefly on the matter of the trustee in chapter XIII proceedings. This is really a misnomer, and I think that the Congress was unwise in calling the distributing agent under a wage earner's plan a trustee, because he is not a trustee in the sense in which the Bankruptcy Act generally uses the word trustee. This man who is called a trustee under chapter XIII performs a very limited function. He simply collects the money which is provided for in the plan and makes distribution.[27]

I call to your attention the fact that there are provisions in chapter XIII with respect to secured creditors. However, they are not particularly effective. There is a provision in chapter XI that you may under certain circumstances on notice enjoin the foreclosure by a creditor on his lien.[28] There is a similar provision in chapter XIII.[29] Chapter XIII goes a good deal further and provides that a wage earner can settle "severally" with his secured creditors.[30] What this means, in effect, is that if a secured creditor is willing to make a settlement, the debtor can make a settlement with him, the difference being that you can put the text of such a settlement right into the plan if you get a secured creditor who is willing to go along with it. In other words, you may provide in the plan itself that the company who sold the wage earner a radio or a television set or the refrigerator has agreed to take stipulated payments and allow the wage earner to continue to own and use the particular appliance. Moreover, you can also put into the wage earner plan the priority in terms of payment to be given secured creditors.[31] In other words, you can provide that unsecured creditors will have to wait until the appliance creditors are paid off. But keep in mind that all of this has to be done with the consent and blessing of each secured creditor. This is not a pooling of secured creditors. If a man has bought appliances which come to approximately $1,000, he cannot, by getting the consent of $501 of these appliance vendors and a majority in number of the appliance vendors make it obligatory on their part to go along with the plan. He needs the consent *severally* of each of these.

One final item. There is a provision in chapter XIII that the court shall require proof from each creditor that his claim is free from usury. It is difficult to understand why this burden was placed on the referee only in chapter XIII proceedings. If such a showing is important, it would seem

27. Bankruptcy Act § 633(4), ch. 575, 52 Stat. 932 (1938), as amended, 11 U.S.C. § 1033(4) (1958).
28. Bankruptcy Act § 314, 52 Stat. 907 (1938), 11 U.S.C. § 714 (1958).
29. Bankruptcy Act § 614, 52 Stat. 931 (1938), 11 U.S.C. § 1014 (1958).
30. Bankruptcy Act § 646(2), 52 Stat. 934 (1938), 11 U.S.C. § 1046(2) (1958).
31. Bankruptcy Act § 646(3), 52 Stat. 934 (1938), 11 U.S.C. § 1046(3) (1958).

to be equally important in other chapter proceedings. There is serious consideration being given right now to the elimination of that section from the act. Apparently, the reason behind this was that so many of the creditors in these chapter XIII proceedings loaned money at usurious rates. This is a sort of an *in terrorem* section to scare them, but it does not usually accomplish that purpose. If you fail in having a chapter XIII plan confirmed, the proceeding goes forward as in an ordinary bankruptcy proceeding.

The advantages of chapter XIII are conspicuous in certain respects. They give a man who has to take advantage of one or another section of the Bankruptcy Act the feeling that he has done something constructive in an effort to clear himself of his valid obligations. From conversations that I have had with people in jurisdictions where there are a great many chapter XIII proceedings filed I understand that often they come about as a result of the employment policy of many companies who will not continue to employ a person who, because of insolvency, goes into bankruptcy. These companies make it a rule that if an employee gets into financial difficulty, he will have to make an honest effort to use his future salary to compose with his creditors, and that means taking advantage of chapter XIII as distinguished from chapters I to VII of the Bankruptcy Act.

I am certain that all of you have in mind that a financially distressed person, a wage earner if you please, can voluntarily go into bankruptcy if he has done nothing which would be a bar to his discharge. In such a proceeding he can get an immediate discharge without paying anything to his creditors. However, chapter XIII is a device to induce certain debtors, who feel that this would not be the right and fair thing to do, into making some token payment on account of their just debt.

In a sense, chapter XIII is a compromise between those interests who deplore the discharge provisions of the Bankruptcy Act and who are working continuously to erode them and those who believe that the discharge provisions need further liberalization. However, lacking compulsory provisions that make mandatory recourse by wage earners to chapter XIII, it falls short of an effective compromise. It is to be hoped that the resurvey of chapter XIII, about to be undertaken by the National Bankruptcy Conference, will eventuate in legislation that will make it a more effective medium.