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Secured Creditors: Their Rights and Remedies Under Chapter XI of the Bankruptcy Act

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SECURED CREDITORS: THEIR RIGHTS AND REMEDIES UNDER CHAPTER XI OF THE BANKRUPTCY ACT

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Chapter XI of the Bankruptcy Act abounds with pitfalls for the practitioner relying on superficial readings of the Act and treatises regarding secured creditors' rights under Chapter XI.[1] For example, several treatises contain statements such as, "No provision of the Act permits a plan proposed under Chapter XI to deal with the rights of secured creditors . . . ."[2] Proceeding blindly under this beguiling language could prove disastrous. In-depth research would indicate that although the plan of arrangement under Chapter XI may not modify or affect the status of secured creditors, there is no language in Chapter XI indicating that the proceeding itself does not affect the rights and remedies of secured creditors. Further research would reveal that the Chapter XI proceeding does affect the rights of secured creditors, although the plan of arrangement may not do so. This article will explore the status of secured creditors under Chapter XI of the Bankruptcy Act and illustrate how the proceedings themselves have a direct bearing on their rights and remedies.

CHAPTER XI: COMPARATIVE PROCEDURAL AND MECHANICAL ASPECTS

Advantages and Disadvantages of Chapter XI Option

Chapter XI is a swift and effective means by which either an individual or corporate debtor may effect a composition or extension of his obligations with his unsecured creditors. The purpose of the proceeding is to allow the debtor to effect an

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1. 11 U.S.C. §§ 701-99 (1964) contains the provisions for arrangement proceedings under Chapter XI of the Bankruptcy Act. Chapters I-VII of the Bankruptcy Act are found at 11 U.S.C. §§ 1-112 (1964). References to the Bankruptcy Act hereinafter will be to the Act and will omit citations to Title 11 of the United States Code. A "secured creditor" is defined at § 1(28) of the Act.

2. 9 W. COLLIER, BANKRUPTCY § 8.01 at 168 (1975) [hereinafter cited as COLLIER]. *See also* C. NADLER, THE LAW OF BANKRUPTCY § 875 at 723 (1972) [hereinafter cited as NADLER]; 9 H. REMINGTON, BANKRUPTCY §§ 3643-44 at 301-02 (1955).

arrangement with his unsecured creditors and thereby rehabilitate his finances.[3] The procedure offers an alternative to an arrangement with creditors via an out-of-court settlement in which the debtor obtains the consent of his creditors to a composition or extension of the obligations due them. Composition or extension is frequently difficult, especially when the debtor cannot gain unanimous consent of all creditors.

By comparison to the other procedures, a Chapter XI proceeding offers several advantages to the debtor. An obvious advantage is that only a majority of creditors in number and amount need consent to the arrangement.[4] Further, upon filing of the petition, creditors are automatically enjoined from instituting or continuing legal action against the debtor, and federal and state taxing authorities are also enjoined from seizing the debtor's assets.[5] In addition, burdensome executory contracts may be rejected or terminated, and the debtor may normally continue operating his business under the court's supervision without harassment from creditors.[6]

On the other hand, a Chapter XI proceeding harbors certain disadvantages. The debtor is somewhat restricted in the operation of his business because of the court's supervision, and faces the possibility of having a receiver appointed to operate the business if the court feels that such action is appropriate. In addition, an interested party may petition to convert the proceedings to a reorganization under Chapter X of the Bankruptcy Act,[7] which would create new dangers and pitfalls. Finally, the costs of Chapter XI proceedings are usually higher than an out-of-court settlement, and it generally takes longer to have a plan of arrangement confirmed, as opposed to arriving at a composition of creditors outside of the court.[8]

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3. *See generally* 9 COLLIER at § 8.01.

4. Bankruptcy Act § 362(1) (1964).

5. Bankruptcy Act §§ 311, 314 (1964); Bankruptcy Rule 11-44 (1974). Bankruptcy Rules are published by West Publishing Co.: UNITED STATES CODE ANNOTATED, BANKRUPTCY RULES & OFFICIAL BANKRUPTCY FORMS (1974) under chapters 1, 7, 11 & 13 of the Bankruptcy Act.

6. A debtor who operates his business is known as a "debtor-in-possession." A debtor-in-possession is a debtor for whom no receiver or trustee has been appointed in an arrangement proceeding, and whose powers are the same as a bankruptcy trustee. Bankruptcy Act § 342 (1964).

7. Bankruptcy Act § 328 (1964).

8. For a more detailed discussion of the comparative advantages and

Mechanics of the Chapter XI Procedure

The Chapter XI proceeding is instituted by filing a petition.[9] Upon filing the petition, or in due course, the debtor must file schedules of assets and liabilities, a statement of affairs, a statement of executory contracts, and other pleadings required by local court rules or the new bankruptcy rules.[10] Between twenty and forty days after the filing of the petition, the court fixes a first meeting of creditors.[11]

After the filing of the petition and generally before the first meeting of creditors, the court may fix a hearing to determine whether the debtor should file an indemnity bond.[12] Pending the first meeting, the debtor usually continues in possession of his property and business, operating under the *aegis* of the court.[13] At the first creditors' meeting, a creditors' committee and a stand-by trustee are elected or appointed.[14] The creditors' committee looks into the debtor's affairs and negotiates with the debtor concerning the terms of the proposed plan. The committee usually advises the other creditors and the court of its recommendations and reports.[15]

A plan of arrangement may be filed with the petition, or thereafter, but not later than the time fixed by the court.[16] After it is filed, the debtor attempts to gain acceptance of the plan by a majority of the creditors in number and amount.[17] The debtor normally negotiates with the creditors' committee and solicits acceptances from the creditors. When the plan is accepted and the debtor obtains a sufficient deposit,[18] the court may confirm the arrangement plan, if it feels that the plan is feasible and in the best interests of the creditors.[19]

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disadvantages of an out-of-court settlement and the Chapter XI arrangement, see Leibowitz, *Rehabilitating Your Financially Embarrassed Client by Common Law Settlement or a Chapter XI Arrangement*, 45 N.Y.S. B.J. 387 (1973).

9. Bankruptcy Rule 11-3 (1974).
10. Bankruptcy Rule 11-11 (1974).
11. Bankruptcy Rule 11-25 (1974).
12. Bankruptcy Rule 11-20 (1974).
13. Bankruptcy Rule 11-18(b) (1974).
14. Bankruptcy Rule 11-27 (1974).
15. Bankruptcy Rule 11-29 (1974).
16. Bankruptcy Rule 11-36 (1974).
17. Bankruptcy Act § 362(1) (1964).
18. The deposit is "the money necessary to pay all priority debts and costs of administration." Bankruptcy Rule 11-38(a) (1974).
19. Bankruptcy Act § 366 (1964); Bankruptcy Rule 11-38 (1974). Bank-

Confirmation of the plan acts as the equivalent of a bankruptcy discharge under Chapters I-VII of the Act.[20]

Chapter XI of the Bankruptcy Act does not mention secured creditors, their rights, or their remedies in the outlined procedure. One may legitimately ask how the proceeding affects secured debts, since the acceptances, solicitations, and procedure involve only unsecured creditors. First, the secured creditor will generally be affected as he would in a normal bankruptcy proceeding, since secured creditors are frequently affected by "straight" bankruptcies (liquidations), and Chapter XI proceedings have aspects found in straight bankruptcies. However, there are other, more esoteric points of law which burden his rights and remedies under Chapter XI, as will be explained later.

SECURED CREDITORS AND CHAPTERS I-VII OF THE BANKRUPTCY ACT

Basically, the Bankruptcy Act is oriented toward unsecured creditors. Administration of the assets of the bankrupt's estate is for the purpose of ultimately realizing dividends, if possible, for unsecured creditors. Accordingly, the bankruptcy trustee acts for the benefit of unsecured creditors, under the assumption that the secured creditor's collateral will amply protect and provide for him if his security interest is valid.[21] It should make little difference to the fully

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ruptcy Act § 366(3) & (4) also requires that the debtor not be guilty of any acts or have failed to perform any duties which would be a bar to the discharge of a bankrupt and that the plan and its acceptance be in good faith and have not been made or procured by any means, promises, or acts forbidden by the Act. Bankruptcy Rule 11-38 eliminated the requirement that the debtor file a formal application for confirmation.

20. Bankruptcy Rule 11-43 (1974).

21. *See, e.g.*, Pasky, *Some Procedural Aspects of Administering Encumbered Properties and the Treatment of Secured Creditors and Ordinary Bankruptcy*, 44 REF. J. 54 (1970) [hereinafter cited as Pasky] where the author, a Bankruptcy Judge, states at 58:

> It requires no citation of authority to support the proposition that the prime purpose of any administration is to produce funds for the benefit of unsecured creditors. It is equally well established that the trustee is not a liquidating agent of secured creditors and they should employ their own liquidating agent to dispose of their collateral. Thus, if investigation reveals that the property is fully encumbered the trustee ordinarily should eliminate the encumbered properties at once if they are valueless or unprofitable to be administered and should concentrate only on properties which are a potential benefit to the general estate.

secured creditor what bankruptcy proceeding the debtor chooses, other than with respect to certain delays inherent in the liquidation, reorganization, or arrangement system. Absent fraud or the most egregious insolvency, the fully secured creditor will emerge from any proceeding reasonably whole, unless substantive provisions of the Bankruptcy Act avoid his security interest. The secured creditor is protected substantively and procedurally by both the United States Constitution and statutory provisions of the Bankruptcy Act.

The bankruptcy power of Congress granted by article I, section 8, clause 4, is limited by the provisions of the fifth amendment. Inherent in a secured creditor's property rights under the fifth amendment are five specific crucial rights, set forth in the landmark Supreme Court case of *Louisville Stock Bank v. Radford:*[22]

(1) The right to retain the lien until the indebtedness is paid;
(2) The right to realize upon the security at the public sale;
(3) The right to determine when such sale shall be held, subject only to the discretion of the court;
(4) The right to protect its interest in the property by bidding at such sale; and
(5) The right to control the property during the period of default, subject only to the discretion of the court, and to have the rents and profits collected by a receiver for satisfaction of the debt.[23]

The *Radford* case makes it clear that any bankruptcy statute would be constitutionally infirm to the extent that it significantly limited the aforementioned rights, but *Radford* and later decisions have not clearly articulated an explicit constitutional standard by which the limitations of those rights may be judged unjustifiable and unconstitutional.[24]

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22. 295 U.S. 555 (1935).

23. *Id.* at 594-95.

24. Two cases following *Radford, Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273 (1940), and *Wright v. Mountain Trust Bank*, 300 U.S. 440 (1937), stated that the five property rights enumerated in *Radford* may be modified by the Bankruptcy Court through regulating the means of enforcing the security interest of the creditor; however, the court could not destroy the creditor's substantive rights and must insure that the creditor receive ultimately the liquidation value of his collateral as of the date of bankruptcy.

Reading these cases in context simply establishes one clear rule of law: the secured creditor must realize either the full amount of his debt or at least the full value of his security at the filing of bankruptcy with compensation for delay. There are fifth amendment limitations, then, on the bankruptcy power, and those limitations come into play when secured creditors' rights are involved.

Implicit in the Bankruptcy Act are certain statutory rights granted to the secured creditor, according to the course of action which he desires to pursue in the bankruptcy proceeding. A secured creditor has a choice of three lines of conduct. First, he may disregard the bankruptcy proceeding entirely and decline to file a proof of claim, relying solely upon his security, if that security is proper and solely within his possession. Second, he may surrender or waive his security entirely and prove his entire claim as an unsecured one. Finally, he may avail himself of his security and share in the general assets as an unsecured creditor to the extent of his unsecured balance.[25] It appears inherent within the scheme of the Bankruptcy Act that the fully secured creditor must look primarily to his collateral for payment of his debt rather than to the bankruptcy proceeding and the administration of assets of the estate upon which he has no security interest.

In addition, the bankruptcy scheme limits the secured creditor's rights in the bankruptcy proceedings to the extent that he is fully secured. For example, § 56 of the Act and Bankruptcy Rule 207(c) restrict the secured creditor's right to vote at creditors' meetings unless the amount of his debt exceeds the value of his security. Even then, the secured creditor can participate and vote in such meetings only to the extent of his deficiency. Section 57 and Rule 306(d) also restrict distribution of dividends to the secured creditor to the amount of his deficiency. Moreover, Rule 306(d) clearly states that the bankruptcy court shall determine the value of the creditor's security and shall allow the creditor's proof of

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However, these three cases, when read in context, may allow the Bankruptcy Court to regulate or modify the five property rights under *Radford.*

For an expanded and more detailed discussion of the fifth amendment limitations on the bankruptcy power, see Rosenberg, *Beyond Yale Express: Corporate Reorganization and the Secured Creditor's Rights of Reclamation,* 123 U. PA. L. REV. 509 (1975) [hereinafter cited as Rosenberg].

25. NADLER § 564-69 at 435-38.

claim, if filed, only to the extent that the creditor's debt exceeds his security.

In ordinary bankruptcy proceedings, the secured creditor may disregard the bankruptcy proceedings entirely and proceed through appropriate remedies under state or federal law, provided his security interest is valid and his collateral is solely within his possession.[26] If the collateral is within the *custodia legis* of the bankruptcy court, he must proceed through adversary proceedings within the scope of Rule 701 to obtain appropriate relief, such as obtaining relief from the stay provided by Rule 601 or recovering (reclaiming) money or property within the custody of the court. Expedited relief from the automatic stay against lien enforcement provided under Rule 601 may be obtained upon an ex parte basis, if the secured creditor can comply with the provisions of section (d) of the Rule. In addition, courts in some jurisdictions allow abandonment of property, often referred to as a "disclaimer," upon the application of secured creditors. However, abandonment of property lies within the discretion of the trustee and should be more properly granted upon application filed by the trustee, after due consideration of whether the asset in question should be administered.[27]

SECURED CREDITORS AND CHAPTER XI OF THE BANKRUPTCY ACT

The rights and remedies of secured creditors normally involve four aspects of the Chapter XI process: (1) affirmative attacks on the security interest, (2) the plan of arrangement itself, (3) the initial restraint upon secured creditors provided by Bankruptcy Rule 11-44(a), and (4) continuing restraint of secured creditors under Bankruptcy Rule 11-44(b).[28]

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26. *Id.*

27. For a more detailed and expanded discussion of procedural aspects regarding, and the treatment of, secured creditors in ordinary bankruptcies, see Pasky. *See also* Diamont, *Bankruptcy and the Secured Creditor*, 45 L.A.B. BULL. 416 (1970).

28. The secured creditor may also be affected by the use or consumption of his collateral by the receiver or debtor-in-possession. *See In re* Presidential Homes, Inc., 1 Bk. Ct. Dec. 983 (D.N.J. 1975). Such alterations may be protected, however, by compromise order, as suggested at the text accompanying note 80, *infra.*

Affirmative Attacks on the Security Interest

Although the provisions of Chapter XI are oriented towards affecting the rights of unsecured creditors, the secured creditor may find himself seriously affected by the proceedings if the debtor-in-possession or receiver files a complaint under Rule 11-61 to determine the validity, priority or extent of the secured creditor's lien or interest in his collateral. Where the validity of the creditor's secured interest is questioned and is material to the proposed arrangement, the bankruptcy judge is under an inherent duty to encourage such a complaint and may be in error if he confirms a plan of arrangement in which a questionable security interest is not challenged.[29] Moreover, the debtor-in-possession or receiver is probably under an affirmative duty to file such a complaint.[30]

Bankruptcy Rule 11-18 states a presumption that the debtor will be continued in possession of his property in the absence of a bankruptcy trustee, and § 342 of the Act provides that the debtor-in-possession has all the title and powers of a trustee elected or appointed under the Act. Accordingly, the debtor-in-possession or the receiver has the same fiduciary duties as the bankruptcy trustee, and must properly fulfill these duties by using the powers provided him to strike down any invalid security interest, if avoiding it would result in benefit to the general creditors under the plan. Arguably, if the debtor-in-possession does not fulfill these duties and utilize his property powers, his failure may be grounds for the appointment of a receiver under Rule 11-18. Furthermore, subsection 3 of § 366 provides that if the debtor has been guilty of any acts or failed to perform any duties which would be a bar to the discharge of a bankrupt, the court cannot confirm an arrangement plan. The use of this broad language indicates that the same standards of conduct and duties applicable to a trustee in a straight bankruptcy would also be

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The citation given for *In re Jenifer Mall Court* comes from a new bankruptcy reporter published by the Corporate Reorganization Reporter, which is located in Washington, D.C.

29. *In re* Premier Sales Co., 277 F. Supp. 802 (D. Utah 1967). *See also* Ashe, *Chapter XI Arrangements—Confirmation Requisites and Minority Creditor's Rights*, 70 COM. L.J. 92 (1965); Yacos, *Secured Creditors and Chapter XI of the Bankruptcy Act*, 44 REF. J. 29 (1970).

30. *See* authorities cited in note 29, *supra*.

applicable to the debtor-in-possession or receiver. Accordingly, the debtor-in-possession or receiver would appear to be under a duty to expose and avoid any preferences or concealments of assets.[31]

Because of these duties imposed on the debtor-in-possession or receiver, he is under a duty to bring appropriate action challenging the validity, priority, or extent of a lien or security interest of secured creditors involved in the proceedings. The failure of the debtor-in-possession to take such affirmative action might warrant an application for the appointment of a receiver under Rule 11-18 or impose an affirmative duty on the bankruptcy judge to satisfy himself that an arrangement plan is in the "best interests of the creditors" before he confirms it, regardless of lack of objections.[32]

Section 366 of the Bankruptcy Act provides that the court shall confirm an arrangement if, *inter alia*, the arrangement plan is in the "best interests of the creditors." The term "best interests of the creditors" has been interpreted as requiring a comparison between what could be obtained under the arrangement plan and what could be obtained in a straight liquidation under the Bankruptcy Act.[33] Unless more can be obtained under the arrangement plan, the judge must refuse to confirm the plan.[34] It would be virtually impossible to determine the extent of a probable dividend for general creditors in a straight liquidation proceeding without determining what assets are encumbered by valid encumbrances. Obviously, if a secured creditor's encumbrance on the debtor's assets is invalidated, unsecured creditors would probably receive a larger dividend if the debtor's assets were liquidated pursuant to Chapters I-VII of the Bankruptcy Act. Hence, secured creditors must be especially cognizant of their rights in order to successfully defend affirmative attacks upon their security interest by the debtor-in-possession or receiver.

The Plan of Arrangement

Only the rights of unsecured creditors may be arranged; and the arrangement must not change the status of any

31. *Id.*
32. *Id.*
33. *Id. See also* 9 COLLIER § 9.17 at 281.
34. *Id.*

classes of security holders.[35] If the plan contemplates a judicial alteration of secured creditors' rights, the plan will be held invalid.[36] These principles do not prohibit a secured creditor from consenting to come under the plan of arrangement, and a plan providing for the modification of a consenting secured creditor's rights may be confirmed.[37] In addition, if a secured creditor becomes inextricably involved in Chapter XI proceedings and negotiations, he may be estopped from objecting to the alteration of his rights as they are affected by the arrangement proceeding.[38]

Notwithstanding these principles, the rights of a secured creditor may be altered through the arrangement proceeding, if the plan does not provide for the alteration and if the alteration is in accordance with alterations allowed in a straight bankruptcy liquidation. In other words, the proceeding, not the plan, may furnish the means for alteration, especially when the debtor's property has no connection with the operation of the debtor's business but is the cause for his financial difficulties.[39] For example, the debtor may be a corporation which manufactures machinery. In addition, the debtor may engage in real estate development, having invested in real estate which is heavily encumbered by mortgages and liens and which is the cause of his financial woes. Assuming that the development of the real estate is financially infeasible and the businesses are not interdependent, the debtor-in-possession could sell the real property if equity could be realized from a sale. Also, if the real property had no equity and was burdensome to the estate, the debtor-in-possession could abandon it and require the creditors not fully secured but holding liens and mortgages on the property to apply for a valuation of security in accordance with Bankruptcy Rules 11-33(e) and 306. The sale of the property might produce equity for the estate and thereby allow the debtor to increase the consideration to be distributed to the unsecured creditors. Alternatively, if the property is abandoned, the real

35. *In re* Camp Packing Co., 146 F. Supp. 935 (N.D.N.Y. 1956); 9 COLLIER § 8.01(3). *Cf.* Chaffee County Fluorspar Corp. v. Athan, 169 F.2d 448 (10th Cir. 1948); *In re* Tracy, 194 F. Supp. 293 (N.D. Cal. 1961).

36. *See* authorities cited in note 35, *supra.*

37. Armstrong v. Alliance Trust Co., 112 F.2d 114 (5th Cir. 1940).

38. Farmers Bros. Co. v. Huddle Enterprises, Inc., 366 F.2d 143 (9th Cir. 1966).

39. Compare the alteration alluded to in note 27, *supra.*

estate would reduce, by its fair market value, the amount of the secured creditors' claims against the debtor's estate through valuation in accordance with Bankruptcy Rules 11-33(e) and 306. The abandonment would also rid the debtor of the cause of his financial problems, so that he could file a feasible plan of arrangement centered around the manufacturing business.

Either of these illustrated "alterations" of the secured creditors' rights would be in accordance with the powers granted to a trustee in bankruptcy and a debtor-in-possession or receiver under § 342 of the Act.[40] Furthermore, such action would suit the realities of the situation when the rehabilitation of the debtor is centered around the more successful aspect of his business rather than around a tangential aspect which is causing his financial difficulty. Finally, such action would not impinge the rights established by the fifth amendment respecting the rights of secured creditors, since a sale of their property would allow them to be paid in full and since abandonment of their property would not alter any of their rights as set out in the *Radford* case.[41]

Initial Restraint under Bankruptcy Rule 11-44(a)

The filing of a petition under Chapter XI operates as an automatic stay on the commencement or continuation of any proceeding against the debtor, including enforcement of any encumbrance against the debtor's property.[42] The authority for the stay was previously provided through § 314 and is now provided under the recently enacted Rule 11-44. "Initial restraint" can best be appreciated by focusing, in turn, on the automatic nature of the restraint, the liens restrained, the jurisdiction of the court to restrain, the remedies by which relief from the restraint can be made available to the secured creditor and the factors which the court will take into consideration in deciding whether to grant the relief to the secured creditor.

Before enactment of the new Chapter XI Rules, the filing of a Chapter XI petition did not automatically enjoin proceedings against the debtor. Under § 314 of the Bankruptcy Act, the requirement of notice to the enjoined creditor and a

40. *Id. See also In re* O.K. Motels, 1 Collier Bankruptcy Cases 416 (M.D. Fla. 1974); *In re* Tracy, 194 F. Supp. 293 (N.D. Cal. 1961).

41. *See* text at note 23, *supra.*

42. Bankruptcy Rule 11-44 (1974).

hearing prior to the stay order seemed implicit in § 314.[43] Any confusion surrounding whether a stay could be granted under § 314 without appropriate notice and hearing was clearly resolved when the bankruptcy rules for Chapter XI were enacted. Rule 11-44 clearly states that the stay order is not simply ex parte; it is automatic upon the filing of the petition. The rule supplements and reinforces the policy of §§ 11(a), 311, and 314 of the Act.[44] Section 11(a), which provides for mandatory stay of all actions founded on dischargeable claims which are pending against the debtor when the petition is filed, is applicable to Chapter XI proceedings through § 302 of the Act. Section 311 grants the court in which the petition is filed exclusive jurisdiction over the debtor and his property, wherever located. Section 314 authorizes the stay of pending actions and of enforcement of other actions against the debtor regardless of whether they are founded on dischargeable claims. Moreover, § 314 authorizes the stay of any act or proceeding to enforce any lien on property in which the debtor has a sufficient ownership interest.

The term "lien" as used in Rule 11-44 is intended to be interpreted in its broadest sense to cover consensual liens or security interests in personal or real property, liens obtained by judicial proceedings, statutory liens, or any other charge against property of the debtor which secures an obligation.[45] Since secured creditors are automatically enjoined from proceeding outside of the bankruptcy court to realize upon their security or collateral, the filing of a Chapter XI petition automatically affects the rights and remedies of secured creditors by restraining enforcement of their security interest.

The most frequent pitfall which practitioners encounter in representing secured creditors in Chapter XI situations is the assumption that the court does not have jurisdiction to enjoin them from enforcing their liens or security interest, especially when the secured creditor has the sole possession of his collateral or where state court proceedings have been instituted previous to the filing of the Chapter XI petition. When a straight bankruptcy petition is filed, the secured creditor is not enjoined under § 11(a) or any other section of the Bankruptcy Act from enforcing his security interest, since in

43. *Cf. In re* Haines Lumber Co., 144 F. Supp. 108 (E.D. Pa. 1956).
44. *See* Bankruptcy Rule 11-44, Notes of the Advisory Committee (1974).
45. *Id.* 8 COLLIER § 3.22 at 251.

straight bankruptcy the jurisdiction of the bankruptcy court is premised on possession rather than ownership of the property.[46] Under § 311, the Chapter XI court has exclusive jurisdiction over the property owned by the debtor, or in which the debtor has a sufficient ownership interest, regardless of the possession of the property. In essence, the jurisdiction of the court is greatly expanded in order to effectuate the broad policy behind Chapter XI: rehabilitation of the debtor's finances.[47]

While in straight bankruptcy situations the state or federal court first acquiring jurisdiction over the *res* is permitted to continue with the adjudication of the rights of the parties,[48] in the Chapter XI situation the federal court retains exclusive jurisdiction irrespective of pending state court proceedings. Since the purpose of the arrangement proceeding is the rehabilitation of the debtor and not the liquidation of his property, no breach of comity between state and federal court occurs in Chapter XI proceedings. Federal law is paramount and supersedes both state law and comity to fulfill the overriding function of the federal bankruptcy court.[49] The bankruptcy court in Chapter XI proceedings must be empowered to review the foreclosure proceeding to determine whether it is compatible with the rehabilitation of the debtor's finances. Obviously, when the collateral in question is necessary for the continuation of the debtor's business and when the arrangement plan must be centered around the debtor's business, foreclosures upon collateral must be restrained in order to determine whether there is a reasonable possibility that the debtor can effect an arrangement with his unsecured creditors. In these cases, the bankruptcy court must protect the interest of the unsecured creditors, for to allow the secured creditor in such instances to continue foreclosure would undermine the unsecured cred-

46. 8 COLLIER § 3.02.

47. *In re* Haines Lumber Co., 144 F. Supp. 108 (E.D. Pa. 1965); *In re* Atlantic Steel Prod. Corp., 31 F. Supp. 408 (E.D.N.Y. 1939); 8 COLLIER § 3.22 at 251.

48. 8 COLLIER § 3.22 at 258. In straight bankruptcy situations, a foreclosure in state court will provide the same function regarding disposition of the collateral as would be provided by the federal bankruptcy court: liquidation of the property. Hence, as a matter of comity and to avoid unseemly conflicts, the second court defers to the court first acquiring control over the property.

49. *In re* Haines Lumber Co., 144 F. Supp. 108 (E.D. Pa. 1965); *In re* Atlantic Steel Prod. Corp., 31 F. Supp. 408 (E.D.N.Y. 1939); 8 COLLIER § 3.22 at 251.

itors' prospects for obtaining payment.[50] The bankruptcy court must have jurisdiction to protect the rights and interests of all parties: the debtor, the unsecured creditors, and the secured creditors.

Because the bankruptcy court has jurisdiction under Chapter XI, when the debtor has sufficient ownership interest in the collateral, the filing of the petition under Chapter XI automatically enjoins the secured creditor from enforcing his security interest.[51] The secured creditor is therefore affected by the Chapter XI proceeding to the extent that he is delayed in enforcing his security interest. However, the bankruptcy rules provide appropriate remedies for the secured creditor to gain relief from this initial injunction.

The primary means of relief is to initiate an adversary proceeding by filing a complaint pursuant to subsection (d) of Rule 11-44. Subsection (d) provides that the bankruptcy court shall set the trial on the complaint on the earliest possible date and that the complaint shall take precedence over all matters, except older matters of the same character. In effect, the creditor's posture is as though he were asking for an expedited abandonment of the property by the debtor-in-possession or receiver, as soon after the filing of the petition as possible, so that the secured creditor may enforce his security interest immediately.

Subsection (e) of Rule 11-44 also provides a means by which a secured creditor subject to the stay order may obtain relief in appropriate situations. Relief from the stay may be granted ex parte under subsection (e) if the secured creditor files an affidavit or verified complaint showing that immediate and irreparable injury, loss, or damage will result to him before a hearing can be had on the matter and if the secured creditor's attorney certifies in writing to the court his efforts, if any, to notify the debtor or receiver and the reasons supporting his claim that the notices normally required should not be given. The granting of ex parte relief lies within the broad discretion of the court.[52]

Once the secured creditor obtains ex parte relief from the stay order, he must give written or oral notice of it as soon as possible to the trustee, receiver, debtor-in-possession, or the

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50. *See* authorities cited in note 49, *supra.*
51. Bankruptcy Rule 11-44 (1974).
52. *Id.*

debtor. In any event, he must mail "forthwith" to the appropriate party a copy of the order granting relief.[53] In order to satisfy any due process requirements of notice and hearing to any parties affected, parties adversely affected by the ex parte order may appear and request reinstatement of the stay order under Rule 11-44, on giving two days notice, or on shorter notice if the court prescribes, to the party who obtained relief from the stay. The court shall then proceed to hear and determine the reinstatement motion as expeditiously "as the ends of justice require."[54]

If a secured creditor invokes an adversary proceeding by the filing of an appropriate complaint under Bankruptcy Rules 11-44(d) and 11-61(5), the bankruptcy court will generally look toward four factors in determining whether to grant relief:

(1) Whether there is equity in the property in question which is subject to the security interest;
(2) Whether the security in question is in jeopardy because of the delays necessarily caused by the restraining order under Rule 11-44;
(3) Whether the possibility of an arrangement between the debtor and his unsecured creditors is realistic and feasible; and
(4) Whether the property subject to the creditor's security interest is essential to the operation of the debtor's business and whether the debtor would be unable to consummate the arrangement without the property.[55]

Predictably, the bankruptcy court will especially scrutinize whether there is equity in the property subject to the security interest, taking into consideration all liens encumbering the property. If there is equity in the property which may be ultimately realized for the benefit of unsecured creditors, the court will probably deny relief to the secured creditor on this basis alone without giving any consideration to the other three factors.[56] Naturally, the property would be

53. Bankruptcy Rule 11-44(e) (1974).

54. *Id.* For an expanded discussion of subsections (d) and (e) see Bankruptcy Rule 11-44, Notes of Advisory Committee (1974).

55. *In re* O.K. Motels, 1 Collier Bankruptcy Cases 416 (M.D. Fla. 1974).

56. *In re* Atlantic Steel Prod. Corp., 31 F. Supp. 408 (E.D.N.Y. 1939). *Cf. In*

of benefit to the debtor's estate, regardless of whether an arrangement is consummated. If no arrangement is consummated and if there is a subsequent adjudication of the debtor as a bankrupt, the property would be valuable to the estate from a liquidation standpoint, yielding a surplus over and above any encumbrances. Accordingly, relief should be denied to the secured creditor solely because there is equity in the encumbered asset in order to protect the equity in the property and preserve it for the benefit of the unsecured creditors.[57]

Frequently, determination of whether there is equity in the property subject to the security interest is not easy, as when there are conflicting appraisals of the fair market value of the property or when there is a dispute as to the amount or the validity of the encumbrances on the property. In these cases the court, in reviewing the secured creditor's complaint, will consider the second factor: whether the delays caused by the restraining order will jeopardize the secured creditor's status. In resolving this question, the court will usually examine the plaintiff's position as a lien holder and balance the plaintiff's position against the value of the property.[58] For example, the property in question may have a value of $50,000.00. If the plaintiff holds the first mortgage on the property, securing a $20,000.00 debt, there would be a difference of $30,000.00 between the amount of the plaintiff's debt and the value of the collateral. Unless the property in question would depreciate rapidly or is highly perishable, the plaintiff would have a difficult time proving that his security

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re Tracy, 194 F. Supp. 293 (N.D. Cal. 1961). *But see In re* Empire Steel Co., 228 F. Supp. 316 (D. Utah 1964).

57. This conclusion is stated with one *caveat*. The writer assumes that the property will be a marketable commodity with prospective purchasers ready, willing and able to buy the collateral. Property with equity should not be administered in Chapter XI proceedings, or even in ordinary bankruptcies, unless there is a reasonable prospect that the property can be sold and the equity realized by the debtor.

At this point in time, the court's initial consideration of whether to dissolve the stay order, the court will be more hesitant to dissolve the stay and may only modify it by ordering periodic payments to the creditor. If periodic payments or other protection cannot be provided by the debtor and if there is no market for the collateral, strong consideration should be given to dissolving the stay order, regardless of equity, unless the third and fourth factors militate against this.

58. *In re* Atchafalaya Workover Contractors, Inc., 1 Bk. Ct. Dec. 499 (W.D. La. 1975); *In re* Jenifer Mall Court, 1 Bk. Ct. Dec. 179 (D.D.C. 1974).

was in jeopardy, because there is ostensibly $30,000.00 of equity in the property which may be used to pay the plaintiff upon liquidation of the collateral.

If, however, another creditor in the foregoing example held a second mortgage securing a $25,000.00 debt, and the debt was evidenced by a promissory note bearing a high interest rate, there would be ostensibly an equity of only $5,000.00 in the property over and above the first two mortgages. The second mortgage holder would argue that the second mortgage secured both the principal and interest on his note. As the interest on his note accrued, the equity in the property would decrease. When the interest on the second mortgage holder's note increased to $5,000.00, there would no longer be equity in the collateral. The court should deny the second mortgage holder's request for relief from the stay order only until such time as the interest on his note accrues to the amount of $5,000.00, subject to a determination based upon the third and fourth factors. The second mortgage holder will be jeopardized by the delays necessarily caused under the restraining order when his interest becomes delinquent in the amount of $5,000.00. At this point, the court should dissolve the stay order, absent other mitigating circumstances.[59]

If the court is unable to base its decision on the first and second factors, it will turn to the third and fourth, seeking to fulfill the rehabilitative purpose of the arrangement proceeding and to consummate a plan of arrangement under which all creditors will have the greatest possibility of being paid in full. Hence, the court will center its inquiry next on the third factor, the possibility of consummating a realistic and feasible plan of arrangement.[60]

At hearings on any complaints under Rule 11-44(d), the court will require evidence from the debtor as to the feasibility of the arrangement.[61] At these hearings, the court must balance the interests of the unsecured creditors and the

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59. *In re* O.K. Motels, 1 Collier Bankruptcy Cases 416 (M.D. Cal. 1974); *In re* Jenifer Mall Court, 1 Bk. Ct. Dec. 179 (D.D.C. 1974).

60. *In re* Atlantic Steel Prod. Corp., 31 F. Supp. 408 (E.D.N.Y. 1939); NADLER at § 871. See also *Continental Illinois Nat. Bank & Trust Co. v. Chicago, R.I. & P. Ry.*, 294 U.S. 648 (1935), which involved a railroad reorganization proceeding, but which states the principles of law governing the accompanying text.

61. *See* authorities cited in note 60, *supra.*

debtor against the interests of the secured creditor. The balancing process will include some practical considerations which militate against the debtor's consummating an arrangement and in favor of the secured creditor. For example, not every insolvent debtor can realistically effect an arrangement with his unsecured creditors which is in their best interests. Also, petitions for an arrangement under Chapter XI are sometimes filed as a dilatory tactic, simply to delay the debtor's inevitable liquidation. On the other hand, some considerations favor the debtor. For example, unlike reorganizations under Chapter X of the Bankruptcy Act, where the public has a great interest, arrangement proceedings under Chapter XI are usually a matter solely within the discretion of the debtor and his unsecured creditors, with the public and other parties having only a minimal interest. Although the purpose of the bankruptcy court is not to place crutches under financial cripples, the debtor and his unsecured creditors should be able to reach a mutually agreeable plan if an arrangement is realistically possible. Presumptively, an arrangement will benefit the unsecured creditors more than a liquidation proceeding (straight bankruptcy) because of the greater flexibility the debtor-in-possession or receiver has in operating or liquidating a going concern. Also, hearings on the complaints under Rule 11-44(d) frequently arise prior to the first meeting of creditors and before the debtor has had time to negotiate with his unsecured creditors. In this case, feasibility of the arrangement between the debtor and his unsecured creditors should be presumed, and the secured creditor will bear a difficult burden in overcoming the initial presumption. Naturally, the presumption will dissipate as time passes unless the debtor makes progress in achieving consummation of an acceptable plan.

After first presuming consummation, the court must turn to the fourth factor: whether the property subject to the plaintiff's security interest is essential to the operation of the debtor's business and the consummation of the arrangement. Certainly, if the property is necessary for the operation of the debtor's business and the consummation of the arrangement plan, the court will be reluctant to allow the secured creditor to foreclose on the property, thereby defeating any arrangement between the debtor and his unsecured creditors.[62]

62. *Id.*

Normally, the judge will make the initial determination before the debtor has had sufficient opportunity to file an arrangement plan, negotiate with his unsecured creditors concerning it, and testify regarding the plan at the first meeting of creditors. Even so, the court should usually be able to determine whether the property subject to the plaintiff's security interest is essential to the operation of the debtor's business and the consummation of the arrangement plan.

Assuming that the third and fourth factors are determined in the debtor's favor, after adverse determination of the first and second factors, the court must strike a balance between protecting the constitutional rights of the secured creditor and protecting the interest of the debtor and unsecured creditors in achieving a successful arrangement. The court usually strikes this balance through a compromise judgment and order, modifying the stay under Rule 11-44 by imposing such conditions on the use of the property by the debtor-in-possession or receiver as will adequately protect the secured party. For example, the judge may make a finding as to the value of the secured creditor's interest in the property as of the date the Chapter XI petition is filed, and the extent to which the property may be subject to depreciation or damage. If the property has no equity, but appears essential to the operation of the debtor's business and the consummation of the arrangement plan, the court frequently issues an order requiring the debtor to periodically pay to the secured creditor amounts commensurate with the depreciation or damage which the collateral may suffer from its use by the receiver or debtor-in-possession during the arrangement proceeding.[63] In addition, the court usually reserves to the secured creditor the right to petition for periodic review of the situation, including, for example, determination of whether the payments required are actually being made, whether the property is depreciating at a more expedited rate than projected, or whether the property is being damaged to a greater extent than projected.[64]

The compromise modification of the stay order is usually oriented to the fair market value of the property and its rate

63. *See, e.g., In re* Atchafalaya Workover Contractors, Inc., 1 Bk. Ct. Dec. 499 (W.D. La. 1975); *In re* Atlantic Steel Prod. Corp., 31 F. Supp. 408 (E.D.N.Y. 1939).

64. *Id.*

of depreciation and damage. Since a previous determination has been made by the court as to whether the secured creditor's debt exceeds the fair market value of the property, the amounts required to be paid by the debtor should also be oriented towards the fair market value of the property, taking into consideration the property depreciation or damage rather than the contractual terms of the security agreement, if one exists. The amount of payments should not be the same as required in any security interest but should be determined by the value of the property or the realities of the situation.[65]

If, after examining all of the factors, the court strikes the balance strongly in favor of the debtor, it will not dissolve the stay order but instead will continue it and may modify its terms to protect all parties.[66] Continuation of the stay order is subject to further negotiations, the possibility of consummation of the arrangement plan, and the realities of the situation. Thus, the court should weigh carefully the four factors governing the initial restraint in determining whether to continue the stay order under Rule 11-44(b), and it should alter the weight accorded these factors as the proceeding progresses.

Continuing Restraint under Bankruptcy Rule 11-44(b)

The Chapter XI court has broad power to restrain secured creditors at the outset of the proceeding with regard to enforcing their liens.[67] At the inception of the proceeding, the bankruptcy judge will have only a limited opportunity to review the fair market value of the property in question, the interconnexity of the property with the debtor's business, the necessity of the property for confirmation of an arrangement plan, and whether it is feasible and realistic for the debtor to effect a plan of arrangement. As the proceedings progress,

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65. *See In re* Philibosian, 19 F. Supp. 787 (N.D. Ga. 1937). *See also* Lee, *Leading Case Commentary*, 46 AM. BK. L.J. 73 (1972); Poulos, *Leading Case Commentary*, 46 AM. BK. L.J. 165 (1972); Poulos, *The Secured Creditor in Wage Earner Proceedings: Dream Versus Reality*, 44 REF. J. 68 (1970) (similar propositions under Chapter XIII proceedings).

66. *See, e.g., In re* Atchafalaya Workover Contractors, Inc., 1 Bk. Ct. Dec. 499 (W.D. La. 1975); *In re* Atlantic Steel Prod. Corp., 31 F. Supp. 408 (E.D.N.Y. 1939).

67. *In re* Haines Lumber Co., 144 F. Supp. 108 (E.D. Pa. 1965); *In re* Tracy, 194 F. Supp. 293 (N.D. Cal. 1961); *In re* Laufer, 230 F.2d 866 (2d Cir. 1956).

these factors usually become clearer. For example, the proceedings will come under review before the judge at the first meeting of creditors and at adjourned meetings of creditors. Also, the debtor-in-possession or receiver will be required to furnish periodic (usually monthly) reports as to the business, its operations, and its finances. Furthermore, a creditors' committee will be elected or appointed at the first meeting of creditors, and the committee will usually investigate the affairs of the debtor and make recommendations to the court.

Prior to the enactment of the Bankruptcy Rules for Chapter XI, especially Rule 11-44, Section 314 of the Bankruptcy Act provided the power of the court to initially restrain creditors and to continue restraint, even until "final decree."[68] Exercise of this power lay within the broad discretion of the court, usually the referee, and its decision to exercise the power was usually upheld unless abused.[69] To determine whether the court had abused its discretion in continuing the injunction, the jurisprudence created the principle that the continuing stay required affirmative showing of just cause by the debtor.[70] The just cause standard was, and still is, a nebulous one. Accordingly, there are no clear, judicially manageable standards by which to decide what constitutes just cause for continuing restraint. The cases state that the court should balance the interest of the debtor in preserving the status quo of his finances pending negotiation of a plan against the interest of the secured creditor to be free from unreasonable delay in enforcing his security interests.[71]

In balancing these interests, a distinction should exist between the considerations developed under § 314 governing the granting of the initial restraint and those considerations governing continuation of the restraint against secured creditors. The term "initial restraint," as used here, contemplates the stay order maintained against the debtor's creditors at the inception of the proceedings and until such time as the

68. *Cf. In re* Lieb Bros., Inc., 198 F. Supp. 229, 232 (D.N.J. 1961).

69. *In re* Laufer, 230 F.2d 866 (2d Cir. 1956).

70. *In re* Zeckendorf, 326 F. Supp. 182 (S.D.N.Y. 1971); *In re* Laufer, 230 F.2d 866 (2d Cir. 1956). Section 314 speaks in terms of "for cause shown."

71. *In re* Jenifer Mall Court, 1 Bk. Ct. Dec. 179 (D.D.C. 1974); *In re* Empire Steel Co., 228 F. Supp. 316 (D. Utah 1964); *In re* Atlantic Steel Prod. Corp., 31 F. Supp. 408 (E.D.N.Y. 1939).

debtor has had a reasonable opportunity to negotiate a plan of arrangement with his unsecured creditors. This contemplates, at a minimum, such time as would allow a first meeting of creditors, election or appointment of the creditors' committee, initial negotiations with the committee, filing a plan of arrangement after these initial negotiations, and receipt by the court of the recommendations of the creditors' committee regarding the plan of arrangement, its feasibility, and whether it is in the best interests of the creditors. In addition, the court will often adjourn the first meeting of creditors to allow the creditors' committee to perform its functions and negotiate with the debtor, and then it will reset the meeting of creditors to review the entire proceeding. Generally, all of these activities will take several months.

After the debtor has had adequate time to negotiate with his creditors and to file a plan of arrangement, and the creditors' committee has had enough time to perform its functions and report to the court, a hearing will be scheduled for more careful determinations by the court as to the possibility of the debtor consummating an arrangement. Unless there are complicating circumstances, a determination should be possible and appropriate by the first or second adjourned meeting of creditors. The court will then have had ample opportunity to carefully scrutinize whether the debtor is making affirmative progress in achieving an acceptable plan of arrangement with his unsecured creditors. After full examination of the proceeding, any further restraint is "continued" rather than "initial."

After the proceeding has passed the initial stages, the debtor's burden of showing just cause for continued restraint is greatly increased. The courts have developed no clear formulas or standards under § 314 for judging just cause after the initial stages other than the "balancing of interests" test, which is summarized in *In Re Empire Steel Company:*[72]

> It is emphasized that in Chapter XI proceedings only the rights of unsecured creditors of the debtor may be arranged and this without alteration of the status of any other classes of security holders. . . . [I]f there is no possibility of submitting a plan except upon the happening of some future contingency, the basis for any protracted stay simply does not exist. Otherwise, secured creditors

72. 228 F. Supp. 316 (D. Utah 1964).

> could be indefinitely delayed, for almost every debtor hopes that something may happen in the future to relieve his plight and permit him to avoid foreclosure. Chapter XI would become simply authority for general moratoria against secured creditors rather than a means to permit appropriate submission, progressing, and consideration of plans of adjustment. The "status" of secured creditors then unavoidably would be affected, for status depends not only upon assurance of eventual payment, but the right to payment or enforcement in point of time bearing some relationship to the conditions of the security instruments.[73]

In *Empire Steel Company*, a Chapter XI petition was filed and an immediate stay order issued. The court never fixed a date for filing the plan of arrangement, and the record was silent as to the possibility of formulating a feasible plan. Fourteen months later, the court refused to vacate the stay order on the ground that the collateral had adequate value to protect the secured creditor. The appellate court found this sole ground insufficient, and the case was remanded for further findings consistent with the balancing of interests test.[74]

Sufficiency of value in the collateral to assure eventual payment of the secured creditor is too narrow a criterion for determining whether continued restraint of the secured creditor should be allowed under the balancing of interests test.[75] Other criteria which courts have considered include, for example, indications of a purpose or pattern by the debtor to frustrate the particular secured creditor, especially where foreclosure proceedings by that creditor are pending,[76] the length of time for which the secured creditor has been enjoined,[77] and the progress made on effecting a plan of arrangement.[78] While secured creditors are under continued re-

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73. *Id.* at 319.

74. *Id.*

75. *Id. See also In re* Tracy, 194 F. Supp. 293 (N.D. Cal. 1961).

76. Chaffee County Fluorspar Corp. v. Athan, 169 F.2d 448 (10th Cir. 1948). *See also In re* Norden, 369 F.2d 396 (7th Cir. 1966).

77. Chaffee County Fluorspar Corp. v. Athan, 169 F.2d 448 (10th Cir. 1948); *In re* O.K. Motels, 1 Collier Bankruptcy Cases 416 (M.D. Fla. 1974); *In re* Zeckendorf, 326 F. Supp. 182 (S.D.N.Y. 1971); *In re* Empire Steel Co., 228 F. Supp. 316 (D. Utah 1964).

78. *See* authorities cited in note 77, *supra.*

straint from enforcing their lien rights, their most meritorious argument is that arrangement proceedings cannot effect a general moratorium on payments of secured debts and that an indefinite delay regarding enforcement of their rights is unconstitutional when the plan of arrangement is based upon future contingencies and is a mere will-o'-the-wisp.[79] For example, the secured creditor can appropriately maintain that continued deprivation of his right to repossess or foreclose is contrary to the constitutional rights set out in *Radford.* If there is no equity in his collateral and if maintenance of his economic condition can not be assured, he may cogently argue that he is being deprived of property rights contrary to the fifth amendment. Furthermore, he may argue that the delay itself is an infringement on his constitutional rights, if he has been given the contractual right to foreclose upon the debtor's default.[80]

The debtor's most cogent rejoinder is that the arrangement court may regulate the means of enforcing the creditor's security interest and may reasonably delay the secured creditor in realizing his debt.[81] To buttress this argument, the debtor may offer compromises in addition to periodic payments to the creditor equivalent to the economic depreciation of his collateral. For example, he may offer other security of equivalent value, but less subject to depreciation or damage, in place of the creditor's collateral; or, if there is no equity or only marginal equity in the collateral, he may offer to the creditor additional security equivalent to the anticipated decrease in the value of the creditor's collateral; or he may offer, with approval of the court, to give a priority to the secured creditor in case of liquidation, if the property of the debtor's estate will clearly yield sufficient proceeds upon liquidation to pay the secured creditor in full.[82] In essence, the debtor may prevent sabotage of a viable arrangement plan through a multiplicity of compromise solutions.

Apparently, the inability to adequately define just cause

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79. Louisville Stock Bank v. Radford, 295 U.S. 555 (1935). For a similar argument regarding Chapter X reorganizations, see Rosenberg at 530.

80. *Id.*

81. Wright v. Union Central Life Ins. Co., 304 U.S. 502 (1938); *In re* Atchafalaya Workover Contractors, Inc., 1 Bk. Ct. Dec. 499 (W.D. La. 1975); *In re* Atlantic Steel Prod. Corp., 31 F. Supp. 408 (E.D.N.Y. 1939).

82. *See* proposed Bankruptcy Act of 1973 § 7-203(a) & (b) and accompanying Commission suggestions. *See also* Rosenberg at 532-36.

for continued restraint is due to the numerous and various criteria used to determine whether the interests of all parties have been balanced and a variety of factual circumstances which have caused the debtor's financial problems. Determinations of whether restraint should be continued should be based especially on jeopardy to the collateral and feasibility and probability of consummating the arrangement. Of these two factors, the latter is paramount. The purpose of an arrangement proceeding is to allow the debtor to rehabilitate his finances through a mutually acceptable plan with his unsecured creditors. If a plan of arrangement cannot be feasibly consummated, the delays inherent in the proceeding do injustice not only to secured creditors, but also to unsecured creditors. Furthermore, the debtor's purpose in filing a Chapter XI petition is to preserve any good will or going concern value of his business or property. If there is none, any attempt to rehabilitate is a futile gesture, and only serves to overburden the already crowded dockets of bankruptcy courts. In these circumstances, all parties at interest and judicial economy are best served by liquidation proceedings and straight bankruptcy. Continued restraint should be keyed to the debtor's affirmative action in achieving confirmation of an arrangement that is both feasible and in the best interests of his creditors.[83]

PRACTICAL CONSIDERATIONS: FROM BOTH THE VIEWPOINT OF THE DEBTOR AND THE SECURED CREDITOR

From the debtor's standpoint, the key to achieving consummation of the successful arrangement plan lies in the dual negotiations which must be carried on. Negotiations as to the unsecured creditors generally transpire under supervision of the court. For example, a plan of arrangement as to the unsecured creditors must be filed in the court. Negotiations as to the terms of the arrangement generally occur between the attorney for the debtor and the creditors' committee. Solicitations of acceptance in negotiations occur outside of the courtroom; however, the report and the recommendations of the creditors' committee as to these negotiations, the debtor's finances and problems, and the possibility of achieving an arrangement plan are reported to the court in hearings at adjourned meetings of creditors. The

83. *In re* O.K. Motels, 1 Collier Bankruptcy Cases 416 (M.D. Cal. 1974).

attorney for the debtor is faced first with a set of negotiations with the unsecured creditors, the results of which are reported to the court and are usually embodied in the actual plan of arrangement.

As to the secured creditors, the attorney for the debtor generally conducts a second, separate set of negotiations outside the supervision of the court and apart from the plan of arrangement. In most cases, much of the debtor's property is encumbered with liens, and part of this property is essential to the debtor's finances and necessary for the confirmation of the arrangement. If the encumbered property is essential to the debtor's finances and the arrangement plan, the debtor's attorney generally negotiates with the secured creditors having security interests in the property in an attempt to compromise out of court as to the protection of the secured creditors' rights through periodic payments or other compromise solutions. If an out-of-court compromise is achieved, the debtor and creditor may submit a consent stipulation which would modify the stay order under Rule 11-44. If a compromise cannot be reached out of court, the secured creditor usually files a complaint with the court under Rule 11-44(d) for dissolution or modification of the stay order.

If encumbered property of the debtor is not essential to the arrangement proceeding, the debtor-in-possession or receiver usually petitions for abandonment of the property under Rule 11-55. If abandonment is the appropriate course of action, the debtor generally attempts to gain a stipulation from the secured creditor that the creditor will accept the return of the property in full satisfaction of the indebtedness and that he will not file a proof of claim as an unsecured or partially secured creditor. If he cannot gain this stipulation from the creditor upon abandonment of the property, the debtor must resort to protection against the secured creditor's filing a proof of claim through the utilization of collateral valuation under Rules 11-33(e) and 306(d), which provide that the secured creditor may file a proof of claim only to the extent he is not fully secured and that the valuation of the security interest held by him in the collateral shall be determined by the court.

From the secured creditor's standpoint, the most important aspect of the arrangement proceeding is the validity, priority, or extent of his lien or security interest in his collateral. When his security interest is not in question, his

second most important consideration is the delay he suffers in being paid or in realizing upon his collateral.[84] Frequently, upon the filing of a Chapter XI petition, the secured creditor and his attorney will either take no action or will vigorously attempt to regain possession of the collateral without regard to the feasibility or possibility of the debtor's consummating his plan. The attorney for the secured creditor should first investigate the cause of the debtor's financial difficulties, the merits of any arrangement plan filed, the probabilities of consummation of the plan, and the effect of the consummation upon the creditor. Investigation is available through an examination of the debtor under Rule 205, made applicable in Chapter XI proceedings through Rule 11-26. No course of action should be recommended to the secured creditor by his attorney until after these facts have been ascertained.

After investigation, the attorney for the secured creditor may conclude that the arrangement proceeding is not only compatible with his client's interest, but also favorable to him. If this is not the case, the attorney for the creditor should take immediate action under subsections (e) and (d) of Rule 11-44 to dissolve or modify the restraint. By taking this action, the secured creditor can most expeditiously bring a resolution as to the rights of his client. In any event, the attorney for the creditor should examine the facts surrounding the arrangement proceeding and take an appropriate course of action as rapidly as possible.

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84. *See also* the possible dangers alluded to in note 27, *supra*.