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BANKRUPTCY-STATUS OF CLAIMS IN BANKRUPTCY PROCEEDING FOLLOWING DEFAULT IN CHAPTER XI ARRANGEMENT

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COMMENTS

BANKRUPTCY—STATUS OF CLAIMS IN BANKRUPTCY PROCEEDING FOLLOWING DEFAULT IN CHAPTER XI ARRANGEMENT—A significant question arising under the Bankruptcy Act of 1938 which has not been satisfactorily dealt with by the statute is the relative status, in a bankruptcy proceeding precipitated by the debtor's default under the terms of a chapter XI arrangement, of claims of creditors participating in the arrangement and of those who became creditors after confirmation. Specifically, the problem is whether the old creditors, those who

participated in the arrangement, can prove to the amount of their original claims, or merely to the extent of their claims as scaled down by the terms of the arrangement; and whether the new creditors, those extending credit after confirmation of the arrangement, can participate in the bankruptcy proceeding, and if so, whether their claims should be accorded priority over those of the old creditors. A satisfactory solution must be premised upon the policy underlying chapter XI arrangements, debtor rehabilitation. To foster rehabilitation, the status accorded old and new claims should provide an incentive to old creditors to participate in the arrangement, and, at the same time, furnish an inducement to new creditors to extend credit after confirmation. The statute contains no express solution to these problems. The few courts considering the matter have reached divergent and unsatisfactory results. It has been recognized that the answer lies in legislative action, for a proposed amendment is currently pending before Congress. Facing the possibility of a business recession, an examination of the problem and its background and evaluation of the proposed legislation are particularly timely and desirable.

A. COMMON LAW AND STATUTORY DEVELOPMENTS PRIOR TO 1938

1. *Revival of Claims Participating in Compositions or Extensions after Default by Debtor*

a. Common Law. Arrangements under chapter XI and compositions under previous bankruptcy statutes had their inception in the common law composition. It was well recognized at common law that a debtor could contract with willing creditors for a discharge of his debts upon part payment or promise of part payment of the amounts owed them. Commercial expediency demanded that this type of agreement be enforceable despite the difficulties courts encountered in finding consideration in the orthodox sense.[1] This is demonstrated by the statement generally found in the cases that a composition is an exception to the general rules governing consideration.[2] The composition may be characterized as a third party beneficiary contract between the creditors for the benefit of the debtor, as a promise by the creditors not to sue the debtor on their claims,[3] as a release of such

[1] At common law part payment or promise of part payment of a liquidated debt was not sufficient consideration to discharge the whole debt. Foakes v. Beer, 9 App. Cas. (H.L.) 605 (1884).

[2] 15 C.J.S., Compositions with Creditors §5; 26 COL. L. REV. 77 (1926).

[3] The legal difficulties arising from this characterization are indicated in Slater v. Jones, L.R. 8 Ex. 186 (1873).

claims,[4] or, most logically, as being in the nature of an accord and satisfaction.[5]

If the creditors have accepted a promise of part payment rather than part payment itself, the composition being wholly executed, the original claims are discharged upon making the agreement.[6] A problem arises only if the agreement is executory. If the debtor defaults on his promises under the composition, and such agreement is described as being in the nature of an accord and satisfaction, it is clear that the creditors may recover on their original claims, for an accord without a satisfaction is no defense to a suit on the contract sought to be discharged.[7] Should the agreement be characterized otherwise, the same result can often follow on the theory that default is a substantial failure of consideration giving the creditors an option to rescind, which, if exercised, would place them in their original positions.[8] The cases uniformly hold, often without mention of the theory of decision, that default by the debtor under an executory agreement revives the original claims of the creditors.[9]

b. The Bankruptcy Act of 1867, as amended in 1874. The common law composition was inadequate in many respects as to both the debtor and his creditors. Participating creditors were not protected against the possibility of dissenting creditors levying individual processes against the debtor's estate during the period when their own original claims were barred by the agreement. From the debtor's perspective, it failed as a rehabilitation device, inasmuch as nonassenting creditors could not be forced to participate and give a discharge. The first Congressional attempt to remedy these shortcomings

[4] Bowen v. Holly, 38 Vt. 574 (1866).

[5] In re Clarence A. Nachman Co., (C.C.A. 2d, 1925) 6 F. (2d) 427. Regardless of the particular characterization chosen, conventional consideration can be found either in the mutual promises of the creditors to forego a portion of their claims, or in the debtor's surrendering or promise to surrender his privilege of preferring one of his creditors over the others. 1 CONTRACTS RESTATEMENT §84, comment d (1932); 1 WILLISTON, CONTRACTS, rev. ed., §126 (1936).

[6] In re Plaza Music Co., (D.C. N.Y. 1934) 10 F. Supp. 310; Mullin v. Martin, 23 Mo. App. 537 (1886). There was a rebuttable presumption at common law that the composition was a bilateral agreement. In re Carton Co., (D.C. N.Y. 1906) 148 F. 63.

[7] In re Clarence A. Nachman Co., (C.C.A. 2d, 1925) 6 F. (2d) 427; Allen v. Harris, 1 Ld. Raym. 122 (1696).

[8] The creditors may elect to enforce the composition agreement and sue for damages on the new cause of action. Brown v. Farnham, 55 Minn. 27, 56 N.W. 352 (1893); Bailey v. Boyd, 75 Ind. 125 (1881). Mullin v. Martin, 23 Mo. App. 537 (1886), expressly denies rescission, since the notes themselves had been taken as consideration.

[9] Home Ben. Assn. v. Gayle, (Tex. App. 1941) 147 S.W. (2d) 280; Braude v. Vehon, 201 Ill. App. 486 (1916); In re Carton Co., (D.C. N.Y. 1906) 148 F. 63; Flack v. Garland, 8 Md. 188 (1855).

was the 1874 amendment to the Bankruptcy Act of 1867.[10] This enactment provided that the acceptance of a composition agreement by a majority in number and three-fourths in value of a debtor's creditors, upon approval by the court, had the legal effect of an acceptance by all.[11] In this manner, the non-assenting creditors were compelled to accept the payments provided by the terms of the composition when this condition precedent was fulfilled, or they were barred from any satisfaction of their claims. Under this act composition became a judicial procedure subject to the supervision and direction of the bankruptcy court, and the express statutory authorization relieved the courts of the necessity of inquiring into the matter of consideration with all of its attendant difficulties. However, since Congress did not indicate a contrary intent, it was generally agreed that this statutory scheme did not change the existing view that the debtor was discharged only after the composition was fully executed.[12]

3. *The Bankruptcy Act of 1898.* The composition provisions of the Act of 1898[13] reflected the decided change in Congressional attitude toward bankruptcy legislation, which began to emphasize the rehabilitation of the harassed but honest debtor.[14] The principal contribution of the new act was the discharge provision, section 14 (c). After the requisite number of acceptances by creditors, the act provided for a confirmation of the composition by the court,[15] and stated that this confirmation would "discharge the bankrupt from his debts, other than those agreed to be paid by the terms of the com-

[10] 18 Stat. L. 178-186 (1874). The amendment was adopted, almost verbatim, from the English Bankruptcy Act of 1869 (32 & 33 Vict. c. 71).

[11] 18 Stat. L. 182, §17 (1874).

[12] It was generally held that, on default, creditors could sue on their original claims even in a state court. Harrison v. Gamble, 69 Mich. 96, 36 N.W. 682 (1888); Whittemore v. Stephens, 48 Mich. 573, 12 N.W. 858 (1882); Pupke v. Churchill, 91 Mo. 81, 3 S.W. 829 (1887); *contra*: Defford v. Hewlett, 49 Md. 51 (1878); In re Bayly, (C.C. La. 1879) 2 Fed. Cas. 1085, held that the creditors' only remedy was enforcement of the composition, or resumption of bankruptcy. The English Bankruptcy Act of 1869 (32 & 33 Vict. c. 71) §126, was also interpreted to allow revival. Edwards v. Coombe, L.R. 7 C.P. 519 (1872); In re Hatton, L.R. 7 Ch. 723 (1872); Newell v. Van Praagh, 43 L.J.C.P. (n.s.) 94 (1874).

Most courts held that the amendment of 1874 did not change the view that if the promise itself were accepted as satisfaction, action on the old claim was forever barred, but a few departed from this and stressed that section 17 stated that payment should be made in "money." Thus they held that notes (i.e., promises) did not suffice, even though the parties might have intended to accept them in full satisfaction. Ransom v. Geer, (C.C. N.Y. 1882) 12 F. 607; In re Hurst, (C.C. Mich. 1876) 12 Fed. Cas. 1020; Defford & Ely v. Hewlett, 49 Md. 51 (1878); *contra*: In re Kinnane Co., (D.C. Ohio 1915) 221 F. 762. For criticism, see Pupke v. Churchill, 91 Mo. 81, 3 S.W. 829 (1887).

[13] 30 Stat. L. 549, §12 (1898).

[14] In re Mirkus, (C.C.A. 2d, 1923) 289 F. 732.

[15] 30 Stat. L. 549, §12 (1898).

position and those not affected by a discharge."[16] Though it seems clear from the statutory language that the order of the court confirming the composition would discharge the original debts and leave the creditors, in the event of default, with substituted causes of action based on the obligations "agreed to be paid by the terms of the composition,"[17] the early cases were by no means in harmony.

Some courts continued to apply the common law doctrine, reasoning that since unwilling creditors were forced to accept the composition, it would be inequitable to derogate from their prior privilege either to sue in a state court in an assumpsit action for the amount of their original claims or to prove this amount in a subsequent bankruptcy proceeding.[18] This question was eventually settled by the holdings in *Jacobs v. Fensterstock*[19] and *In re Mirkus*,[20] which ruled that confirmation of the composition was an absolute discharge and that default under the terms of the agreement did not detract from the efficacy of this order as a discharge. Consequently, upon default, only the composed amount of the claim could be recovered in a suit brought in a state court, or proved in a subsequent bankruptcy proceeding.[21] This latter view is the necessary interpretation to effectuate the policy of debtor rehabilitation. To give the debtor a fresh start in business he must be able to deal with new creditors on the basis that he has been relieved of his old debts and left merely with the burden of paying his obligations under the composition.

The wave of business failures attending the depression of the 1930's caused Congress to enact further debtor rehabilitation measures.[22] Section 74 afforded relief, through compositions or extensions of time for payment of debts, to non-corporate debtors who were not insolvent but who needed simply a moratorium.[23] Although confirmation of the agreement was not expressly given the effect of a discharge, it seems clear that section 14 (c) applied equally to plans under section 74 as it did to compositions under section 12 of the act of 1898.[24] The

[16] 30 Stat. L. 550, §14c (1898).

[17] Ibid.

[18] Page v. Carton, 64 Misc. 645, 120 N.Y.S. 277 (1909); Am. Woolen Co. v. Friedman, 97 Misc. 593, 163 N.Y.S. 162 (1916); Beck v. Witteman Bros., 185 App. Div. 643, 173 N.Y.S 488 (1918); cf. Wood v. Vanderveer, 55 App. Div. 579, 67 N.Y.S. 371 (1900); 31 A.L.R. 439 (1924).

[19] 236 N.Y. 39, 139 N.E. 772 (1923).

[20] (C.C.A. 2d, 1923) 289 F. 732, 33 YALE L.J. 105 (1923).

[21] See notes 19, 20, supra; also In re Kornbluth, (C.C.A. 2d, 1933) 65 F. (2d) 400.

[22] 47 Stat. L. 1467, §§73-77 (1933); 48 Stat. L. 912, §§77A, 77B (1934).

[23] 99 A.L.R. 1325 (1935); 33 COL. L. REV. 704 (1933).

[24] COLLIER, BANKRUPTCY, 13th ed., 239 (Supp. 1938).

terms of an extension agreement were held by one court to be sufficiently effective, even after default, to allow recovery only on the obligations due under the extension.[25] Presumably, the same result would have been reached upon default under the terms of a composition, with the effect that distribution in a subsequent bankruptcy proceeding would be made on the basis of the composed rather than the original amount of the debts.

Section 77B, applicable to reorganization of corporate debtors, provided that upon final confirmation of the plan of reorganization by the bankruptcy court, the debtor was thereby discharged of his old debts and obligations.[26] The same effect should have been given to this discharge provision as was accorded section 14 (c) in its application to compositions and extensions of individual debtors, although this question does not seem to have been litigated. Thus, upon failure of a confirmed plan of reorganization, the creditors affected would, in a subsequent liquidation or bankruptcy proceeding, have only those rights conferred by the terms of the plan.

2. *Status of Claims Arising Subsequent to Confirmation after Default by Debtor*

Whether claims arising after confirmation should be accorded priority over composed claims in a subsequent bankruptcy proceeding arguably should be made to hinge upon whether the composed creditors can prove to the amount of their original claims. If this were permitted, it would be an obvious injustice to compel the new creditors to share in the estate on a pro rata basis, as they have probably extended credit on the assumption that the debtor's sole liabilities are those represented by the composition. An examination of the reported cases prior to 1938 fails to disclose any consideration of these factors or determination of the status of new claims. Conceivably, one explanation is that prior to 1938 any bankruptcy following default was an independent proceeding, for there was nothing in earlier legislation

[25] Hartsfield Co. v. Stinson, 51 Ga. App. 155, 179 S.E. 819 (1935). Under an extension agreement there is no discharge of any part of the original claims. Thus, the problem of revival does not directly arise. But the analogous question, whether default allows a creditor immediately to sue for the entire debt, was presented in the Hartsfield case, and answered in the negative. The statutory language expressly provided for disposition of the case where there was a default under an extension. By implication it probably covered composition also. Kinnane, "Some Aspects of Section Seventy-Four of the Bankruptcy Act," 9 NOTRE DAME LAW. 291 (1934).

[26] 48 Stat. L. 912, §77B (1934).

providing for retention of jurisdiction by the court and allowing it to dismiss the composition and institute bankruptcy in the same proceeding.[27] Thus both old and new claims, being in existence at the time of commencing of a bankruptcy, were provable in that proceeding and shared pro rata. This is the equitable result where, as the later trend of authority indicated, default did not revive the composed claims.[28]

B. CHAPTER XI ARRANGEMENTS UNDER THE CHANDLER ACT OF 1938[29]

The relative rights of old and new creditors in a bankruptcy proceeding precipitated by default of a debtor upon the terms of an arrangement under chapter XI is dependent upon whether the court has retained jurisdiction after confirmation of the arrangement.[30] Only if jurisdiction has been retained does the statute expressly dictate the disposition to be made of the case upon default.[31] Apparently, if jurisdiction is not retained, a subsequent bankruptcy will be an independent proceeding.

From the time of filing the chapter XI petition until issuance of the order of confirmation, the court has complete jurisdiction over the debtor and his estate. The operation of the business during this period is a court operation, with a trustee, receiver, or the debtor himself in possession,[32] and for the purposes of preserving the estate during the formulation of a plan, the claims of those extending credit during this period are given priority under section 64 (a) (1). Unless otherwise stipulated in the plan of arrangement and in the confirma-

[27] Section 74, which was added in 1933, did provide for liquidation, and perhaps bankruptcy, if the debtor defaulted in the performance of the plan. 47 Stat. L. 1467 (1933). See Kinnane, "Some Aspects of Section Seventy-Four of the Bankruptcy Act," 9 NOTRE DAME LAW. 291 (1934). No cases have been found, however, dealing with the application of section 74 to the problem of interim debts, treated in this comment.

[28] At least, this result was reached upon failure of a plan of corporate reorganization under section 77B. Clinton Trust Co. v. Elliott Leather Co., (C.C.A. 2d, 1942) 132 F. (2d) 299; In re Michel, Maksic, & Feldman, (D.C. N.Y. 1942) 48 F. Supp. 23.

[29] 52 Stat. L. 905-916 (1938).

[30] The similarities of §§482, 483 and 666, 667 to §§377, 378 indicate the same problems here discussed can arise under chapters XII and XIII. The problems can also arise under chapter X §236. There are no cases which have considered these questions. But see Clinton Trust Co. v. Elliott Leather Co., (C.C.A. 2d, 1942) 132 F. (2d) 299.

[31] 52 Stat. L. 913, §377 (1938).

[32] 52 Stat. L. 908. §332; id. 909, §§342, 343 (1938).

tion order,[33] the court's jurisdiction for these purposes ceases upon confirmation, at which time title to the assets revests in the debtor.[34]

If jurisdiction is expressly retained, the question may arise as to whether it was retained merely for the purposes of section 377, providing for disposition of the case upon default, or to enable the court to retain the same control over the operation of the debtor's business as it had before confirmation. There is considerable variance in the few reported decisions concerning the language necessary to effect a retention of the latter type.[35] If this jurisdiction is desired, it should be clearly expressed in the order of confirmation, for rehabilitation contemplates that the debtor be permitted to resume operation of his business as quickly as possible, without judicial interference.[36]

1. Where Jurisdiction Has Been Retained after Confirmation of an Arrangement

a. Status of old debts in bankruptcy proceeding following default in the arrangement. Section 371, essentially the same as section 14 (c) of the act of 1898, states that "The confirmation of an arrangement shall discharge a debtor from all his unsecured debts and liabilities provided for by the arrangement. . . ." As indicated previously, section 14 (c) of the act of 1898 was finally interpreted to mean that confirmation of a composition had the same effect as a discharge in an ordinary bankruptcy proceeding, and was unaffected by the debtor's subsequent default under the composition. Although chapter XI revised the composition procedure of the act of 1898, neither the terminology nor the policy pertaining to the effect of a confirmation was substantially altered. Therefore, unless other provisions of the Chandler Act demand a contrary result, the old debts should not be revived upon default in a chapter XI arrangement.

[33] In re Independent Macaroni Co., (D.C. N.Y. 1942) 46 F. Supp. 813, 51 A.B.R. (n.s.) 50. Contra: In re Ohio Bldrs. & Milling, Inc., (C.C.A. 6th, 1942) 128 F. (2d) 165. Even though the plan contains no express provision for retention of jurisdiction, the court retains a residuum of jurisdiction for certain purposes, none of which is pertinent to the issue at hand. See 52 Stat. L. 912, 913, §§367(2), 367(3), 369, 370, 372, 386 (1938). See also id. 844 §2a (21).

[34] 52 Stat. L. 882, §70 (i) (1938).

[35] Vogel v. Mohawk Electric Sales, (C.C.A. 2d, 1942) 126 F. (2d) 759; In re Irving Elec. Sup. Co., (D.C. N.Y. 1941) 41 F. Supp. 16, 48 A.B.R. (n.s.) 812; In re Irving Elec. Sup. Co., (D.C. N.Y. 1941) 46 A.B.R. (n.s.) 105; In re Plymack, (D.C. Cal. 1941) 48 A.B.R. (n.s.) 818; In re Gelardin, Inc., (D.C. N.Y. 1941) 41 F. Supp. 17.

[36] Seedman v. Friedman, (C.C.A. 2d, 1942) 132 F. (2d) 290; In re Gelardin, Inc., (D.C. N.Y. 1941) 41 F. Supp. 17.

In the only case where this question has been considered, *Vogel v. Mohawk Electric Sales Co.*,[37] the court reached the opposite conclusion. Although the issue was not directly presented for decision, Judge Learned Hand asserted that upon default "the 'arrangement proceeding' must be 'dismissed' and that of course revives the old debts."[38] No authority is cited in support of this view, but it is reconcilable with the idea expressed by the court that a dismissal of the proceeding under section 377 (1) is tantamount to a setting aside of the confirmation for fraud under section 386 (1). The confirmation order, being an integral part of the arrangement proceeding, is nullified upon dismissal of the proceeding and no longer stands as a discharge. Prior to 1938, the sole basis upon which a composition, once confirmed, could be vitiated by the court was fraud in its procurement.[39] Since the Chandler Act provided an additional basis, default where jurisdiction is retained, the court argued that these are but two methods of attaining the same end, that is, nullification of the arrangement proceeding, and thus the old debts should be revived in both instances. Under this view, a debtor could assert his original claim in an independent proceeding in a state court.

An intermediate approach, proposed in a leading textbook, is that confirmation is a discharge of the debt as a claim against the debtor, but does not destroy the debt as a claim in the proceeding.[40] Thus, upon default by the debtor, the old creditors could prove to the extent of their original claims in a subsequent bankruptcy, but could not recover this amount in an independent action in a state court. Absent new creditors, there is no serious objection to either result regarding revival.[41] Possible inequities arise upon determination of the relative position of the old and new claims, however, and Judge Hand's reasoning as to revival has an undesirable effect upon the status of new claims.

b. Status of new debts in bankruptcy proceeding following default in arrangement. A strict interpretation of the statutory language reveals that those creditors who extend credit after confirmation do not participate in the subsequent bankruptcy proceeding. Section 355 provides that upon entry of an order pursuant to section 377 (1) or

[37] (C.C.A. 2d, 1942) 126 F. (2d) 759, 55 HARV. L. REV. 1207 (1942).

[38] Id. at 761.

[39] In re Klein, Inc., (C.C.A. 2d, 1927) 22 F. (2d) 906.

[40] 8 COLLIER, BANKRUPTCY, 14th ed., 1407 (1941). This theory has never been judicially considered.

[41] Conceivably, difficulties might arise in the rare instance where the assets available for distribution in the bankruptcy exceed the amount of the participating arranged claims. If the theory of non-revival is pursued, what disposition should be made of such excess?

(2) directing that bankruptcy be proceeded with "only such claims as are provable under section 63 of this act shall be allowed. . . ." Claims, to be provable under section 63, must be in existence at the time of the filing of the bankruptcy petition, where a chapter XI petition is filed pending bankruptcy,[42] or at the time of the filing of the chapter XI petition where it is an original petition.[43] In either situation, the claims of new creditors arise too late to be eligible to participate in the bankruptcy proceeding.[44] However, the new creditors may proceed against the property acquired by the debtor after confirmation, for the trustee in the subsequent bankruptcy gets title to only that property which comprised the debtor's estate at the time of confirmation.[45]

This result is so inequitable that the courts have been astute to find means of avoiding it. Several courts have treated the new claims as expenses of administration, according them priority under section 64 (a) (1).[46] This approach presupposes retention of such jurisdiction as to give the court supervisory powers over the operation of the debtor's business after confirmation. The courts have been overly indulgent in inferring a retention of this type of jurisdiction. Thus, an order of confirmation retaining jurisdiction "over the debtor and his property until consummation of his plan" has been construed as vesting this degree of control and supervision in the court.[47] As previously indicated, continued judicial tutelage of the business usually has an unfavorable effect upon the speedy rehabilitation of the debtor.

A second method, adopted in *Vogel v. Mohawk Electric Sales Co.*,[48] attributes priority status to the new claims under section 64 (b). This section provides that "Debts contracted . . . after confirmation of an arrangement, shall in the event of a . . . setting aside of the confirmation, have priority and be paid in full in advance of the payment of the debts which were provable in the . . . arrangement pro-

[42] 52 Stat. L. 913, §378 (1) (1938).

[43] 52 Stat. L. 913, §378 (2) (1938).

[44] 8 COLLIER, BANKRUPTCY, 14th ed., 1409 at 1410 (1941); contra: In re Ohio Bldrs. & Milling, Inc., (D.C. Ohio 1941) 50 A.B.R. (n.s.) 830.

[45] 52 Stat. L. 879, §70 (a) (1938).

[46] In re Irving Elec. Sup. Co., (D.C. N.Y. 1941) 41 F. Supp. 16, 48 A.B.R. (n.s.) 812; In re Irving Elec. Sup. Co., (D.C. N.Y. 1941) 46 A.B.R. (n.s.) 105; In re Plymack, (D.C. Cal. 1941) 48 A.B.R. (n.s.) 818; contra: In re Gelardin, Inc., (D.C. N.Y. 1941) 41 F. Supp. 17.

[47] In re Plymack, (D.C. Cal. 1941) 48 A.B.R. (n.s.) 818. See also other cases cited in note 46, supra.

[48] (C.C.A. 2d, 1942) 126 F. (2d) 759. See also In re Ascher, (D.C. N.Y. 1949) C.C.H. BANKR. LAW REP. ¶56,407.

ceeding. . . ." Since a "dismissal" of the arrangement proceedings under section 377 (1) was held equivalent to a "setting aside," section 64 (b) became operative, giving the new claims priority.[49] Without citation of authority or explanation, the court asserted that the claims of new creditors were provable in a subsequent bankruptcy. If this were correct, new claims could share pro rata with those arranged. Having decided that default revived the original debts, however, the court felt it necessary to accord priority to the new claims, for the debtor would not be able to obtain new credit unless the new creditors were assured that some favorable position would be given their claims.

The court rejected the argument that new creditors might be less likely to anticipate failure of the arrangement because of fraud in its procurement than because of default in performance; it therefore felt that Congress did not intend to give more protection to the creditor in the former instance than in the latter. Although new creditors are injured to the same extent regardless of the reason for the failure of the arrangement, their anticipations may be less justified where failure is attributable to default. New creditors should realize that the probability of success in performance of the arrangement may have changed materially since the court's determination that the plan was feasible. Subsequent events, however, could have no effect upon the accuracy of the court's original finding that the plan was not procured by fraud. Moreover, new creditors have more adequate facilities for determining the current financial condition of the debtor than they have for discovering antecedent fraud. Thus, restitution in the form of priority is more justified where the creditor relies on the apparent absence of fraud than where he relies upon the judicial opinion that the plan is likely to succeed.

Any determination of the relative rights of old and new creditors must be made with recognition that the fundamental policy of chapter XI is the rehabilitation of the honest but unfortunate debtor.[50] In one respect, the reasoning of the *Vogel* case furthers rehabilitation, for it aids the debtor in securing new credit by giving priority status to claims arising after confirmation. However, unless the old creditors agree to the arrangement, the debtor will have no occasion for seeking new credit. To implement rehabilitation it is necessary to grant a more favorable position to the claims of old creditors than that allowed by

[49] In a similar case, In re Ohio Bldrs. & Milling, Inc., (D.C. Ohio 1941) 50 A.B.R. (n.s.) 830, the court expressly refused to equate "dismissal" to "setting aside," and thus denied priority to the new claims under section 64 b.

[50] In re Western Steel & Equip. Corp. (D.C. Ore. 1940) 45 A.B.R. (n.s.) 361.

the *Vogel* case, in order to encourage their participation in an arrangement, and discourage their predisposition toward liquidation in a straight bankruptcy proceeding.[51] This result can be achieved by permitting equal participation in the bankruptcy proceeding of the new claims with the old, as scaled down. This scheme effects the proper balance between providing an incentive to old creditors to approve the plan, and to new creditors to extend credit after confirmation.

2. *Where Jurisdiction Has Not Been Retained after Confirmation of an Arrangement*

Where jurisdiction has not been retained to allow dismissal of the arrangement proceeding pursuant to section 377, a bankruptcy proceeding following the default is an independent action. This action leaves the arrangement proceeding undisturbed and renders inapplicable the argument advanced in the *Vogel* case in favor of reviving the old claims. The confirmation order remains effective as a discharge and the old claims are provable only to their arranged amounts. No difficulty arises as to provability of new claims, since they are in existence at the time of filing the independent bankruptcy petition. Obviously, the view that "dismissal" is synonymous with "setting aside" for the purpose of granting priority under section 64 (b) has no application, and the new claims share on a parity with the old, as arranged.

Section 377 makes possible the institution of bankruptcy against the debtor in the arrangement proceeding, in order to allow creditors to force the debtor into bankruptcy after default without the commission of an act of bankruptcy. The operation of this provision is made dependent upon retention of jurisdiction by the court, solely to comply with the doctrine that judicial orders are enforceable only where the court has jurisdiction over the parties or their property. Therefore, this retention of jurisdiction should not be made the basis for a distinction in the treatment accorded the relative status of the two classes of creditors. As between them, the same result should follow regardless of the means by which the subsequent bankruptcy proceeding is commenced.

[51] In re Ohio Bldrs. & Milling, Inc., (D.C. Ohio 1941) 50 A.B.R. (n.s.) 830.

C. CONCLUSION

The desirable result, pro rata sharing of the new claims with the old, as arranged, can apparently be attained only through an express statement to this effect in a statutory amendment. This amendment should also provide that the effective date for determining the provability of claims and the vesting of the trustee's title in the subsequent bankruptcy is the date of entry of the order under section 377 directing that bankruptcy be proceeded with. This renders the new claims provable and makes available for distribution to the creditors all assets acquired by the debtor before entry of the order. Legislation providing for the changes here suggested has been proposed and is currently before Congress for consideration.[52] Its passage is essential to resolve the confused state of judicial opinion and to rectify the inequalities of the present statute.

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[52] H.R. 5693, 80th Cong., 2d sess. (1948). The present English statute also seems to provide the solution suggested in this comment. Bankruptcy Act, 1914 (4 & 5 Geo. 5, c. 59) §§ 16(16), 33(7). No cases under this act, or under prior English statutes, seem to have presented the Vogel type fact situation. It is not clear how this proposed amendment would affect the type of case discussed in note 41, supra.