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

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Discussions of the rights of secured creditors under the Bankruptcy Act are conspicuous by their absence. 1 Ironically, the Act speaks the least about those creditors receiving the most. 2 In bankruptcy liquidation cases under Chapters I-VII of the Bankruptcy Act, secured claims are entitled to the highest priority, being paid in preference to all other claims and administrative expenses when the security for such claims is liquidated. 3 Since most bankrupt estates are heavily encumbered by mortgages and liens, nearly all of the assets of the estates, after being liquidated, are paid toward secured claims. Accordingly, after the payment of secured debts, administrative expenses and then priority claims, there is usually little or nothing left to pay dividends to unsecured creditors.

While there is a paucity of discussion about secured creditors in liquidation proceedings, similar discussions of the rights and remedies of secured creditors in arrangements under Chapter XI of the Bankruptcy Act are virtually nonexistent. ⁴ Once again, secured creditors are integral par-

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1. A "secured creditor" is defined by § 1(28) of the Bankruptcy Act as a creditor whose payment is secured by the property of the bankrupt whether the creditor himself or a person secondarily liable has the security.

2. In straight bankruptcy liquidations under Chapters I-VII of the Act, secured creditors are only discussed in §§ 1(28), 56(b), 57(e), (h), (i) and 59(e).


4. There is no specific definition or mention of secured creditors under Chapter XI. Creditors are defined under section 306(1) which states that for purposes of Chapter XI, an "arrangement shall mean any plan of the debtor for the settlement, satisfaction, or extension of time of payment of any of his unsecured debts, upon any terms." This definition has led some naive practitioners to observe that Chapter XI cannot affect any of the rights of secured creditors. However, section 311 of Chapter XI provides the court with exclusive jurisdiction of the property of the debtor, wherever located, and section 314 gives the court the power to enjoin the enforcement of any liens by secured creditors. Moreover, under the new bankruptcy rules, secured creditors are automatically enjoined in the commencement or
ties in these bankruptcy proceedings. The treatment of secured claims outside the plan of arrangement will be a critical consideration in the formulation of the Chapter XI plan itself. Furthermore, the debtor's retention and use of secured creditors' collateral will frequently generate the funds for the payment of unsecured debts. Therefore, the success of a Chapter XI proceeding is usually premised upon retention of secured creditors' collateral and payment of their claims outside of the arrangement plan.\(^5\)

Because of the general lack of knowledge surrounding the rights of secured creditors under Chapter XI, this writer has previously presented an overview of the subject.\(^6\) The prior article simply highlighted some of the basic issues regarding secured claims and gave suggestions for resolutions of these issues. To more knowledgeable bankruptcy practitioners, this prior article was rather simplistic, and it failed to discuss some of the more difficult problems regarding secured creditors. Accordingly, this article should be considered a continuation of the prior article, containing an analysis of one of the more difficult problem areas found in arrangement proceedings: the rights of partially secured creditors. To explain more fully a resolution of this subject, it is necessary to review, in detail, the substantive rights of secured creditors under the Bankruptcy Act.

**Substantive Rights: The Fifth Amendment v. Congressional Bankruptcy Power**

Valid secured claims have always enjoyed a favored position in ordinary bankruptcy proceedings. Basically, the bankruptcy trustee acquires title to the bankrupt's property subject to all valid liens.\(^7\) Therefore, unless the Act provides to the contrary, all valid liens constitute a prior


7. See generally 4A W. COLLIER, *Bankruptcy §§* 70.04, 70.70 (1977) [hereinafter cited as *COLLIER*].
charge on the bankrupt's assets and must be paid before administrative expenses or other debts to the extent of the value of the security. In addition, even though the personal liability which the lien secures may be discharged, the lien on the bankrupt's property is preserved and may be enforced after bankruptcy, notwithstanding the discharge granted in the proceeding.8

The rule of law that a valid lien is preserved in bankruptcy has been created by the negative implication that liens cannot be curtailed, unless the Act specifically provides otherwise.9 Some courts have considered statutory expressions of these rights unnecessary, under the assumption that valid liens are protected under inherent principles of our substantive law and the fifth amendment of the Constitution.10 In any event, it is now firmly established that a secured creditor holding a valid lien is constitutionally entitled to the liquidation value of his collateral upon the filing of the bankruptcy proceeding, and his lien represents a surcharge on the collateral which must be satisfied in preference to all other claims when it is liquidated.11

With certain exceptions, the rights of secured creditors are basically the same in arrangement proceedings as in liquidation proceedings. The present Bankruptcy Act was enacted in 1898 and has maintained its basic form with few amendments and modifications. Compositions under the Bankruptcy Act of 1898 were provided under Sections 12 and 74, which were repealed in 1938 with the enactment of the Chandler Act, which created the present Chapter XI. Sections 12 and 74 were oriented towards compositions of unsecured debts, thereby serving as models for Chapters

8. 1 id. at § 17.29.
10. Securities Mortgage Co. v. Powers, 278 U.S. 149 (1928); Oppenheimer v. Oldham, 178 F.2d 86 (5th Cir. 1949); In re Schafer's Bakeries, 155 F. Supp. 902 (E.D. Mich. 1957); 4A COLLIER, supra note 7, at § 70.70.
XI and XIII, both of which may also deal only with unsecured debts.\textsuperscript{12}

In compositions under Sections 12 and 74, secured creditors fared no better than in ordinary bankruptcy proceedings, receiving merely the value of their security and a dividend on any unsecured portions of their claims.\textsuperscript{13} It was absolutely clear under both sections of the Act that the substantive rights of secured creditors could not be "affected," and it was also established that regardless of Congressional authority to impair contractual obligations of repayment under its constitutional authority to enact bankruptcy legislation, the contractual impairments which Congress authorized were only permissible when they were consonant with the fifth amendment prohibition against taking property without due process of law.\textsuperscript{14} In conclusion, compositions under Sections 12 and 74 permitted the bankruptcy court to modify the contractual rights of secured creditors,\textsuperscript{15} but their substantive rights could not be "affected," diminished, or curtailed.\textsuperscript{16}

The case law under Sections 12 and 74, which set out these rules of law, evolved from a series of Supreme Court cases under other sections of the Bankruptcy Act which set forth the general constitutional principles as to the fifth amendment restrictions on the Congressional power to impinge upon creditors' substantive rights through bankruptcy legislation.\textsuperscript{17} These principles are equally applicable to all bankruptcy proceedings and are succinctly stated as follows:

\textsuperscript{12} Section 306(1) states that the Chapter XI plan may deal only with unsecured debts and section 646 states that Chapter XIII plans may deal with unsecured debts and secured debts, but section 652(1) states that the Chapter XIII plan can be confirmed only after it has been accepted in writing by the secured creditors whose claims are dealt with by the plan.

Therefore, neither the Chapter XI, nor the Chapter XIII plan may deal with nonconsenting secured creditors, but a plan providing for the modification of the consenting secured creditor's rights may be confirmed. Armstrong v. Alliance Trust Co., 112 F.2d 114 (5th Cir. 1940).

\textsuperscript{13} In re Everick Art Corp., 39 F.2d 756 (2d Cir. 1930); 9 Collier, \textit{supra} note 7, § 7.05.

\textsuperscript{14} In re Rubins, 74 F.2d 432 (7th Cir. 1934); In re Everick Art Corp., 39 F.2d 765 (2d Cir. 1930); In re Philibosian, 19 F. Supp. 787 (N.D. Ga. 1937); 9 Collier, \textit{supra} note 7, § 7.05; Poulos, \textit{The Secured Creditor in Wage Earner Proceedings: Dream v. Reality}, 44 Ref. J. 68 (1970).

\textsuperscript{15} In re Philibosian, 19 F. Supp. 787 (N.D. Ga. 1937). The impairment of contracts is the very essence of the bankruptcy system. Hanover v. Moyes, 186 U.S. 181 (1902); In re Prima, 88 F.2d 785 (7th Cir. 1937).


\textsuperscript{17} See the authorities cited in note 11, \textit{supra}.
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(1) The rights of the secured creditor are based upon his collateral and its value at the date of bankruptcy.\textsuperscript{18}

(2) The secured creditor has no "contractual" substantive rights; rather, Congress has plenary power to negate contracts and the impairment of contracts is the very essence of our bankruptcy system.\textsuperscript{19}

(3) The fifth amendment requires protection of the secured creditor's right to the liquidation value of his collateral at the date of bankruptcy, but the bankruptcy court has the power and discretion to delay the realization of this value and impair the contractual obligation concerning repayment, if the creditor can be furnished adequate protection during the realization process.\textsuperscript{20}

These constitutional principles have not been vitiated; rather, they have been applied in almost every bankruptcy rehabilitation proceeding.\textsuperscript{21} Moreover, when Sections 12 and 74 of the Bankruptcy Act were repealed with the adoption of the Chandler Act, these rules of law were applied to the new debtor relief statutes, which are presently Chapters X, XI, XII and XIII of the Act.\textsuperscript{22}

\textsuperscript{18} Id.

\textsuperscript{19} See the authorities cited in note 15, supra. See also Continental Bank v. Rock Island R.R., 294 U.S. 648 (1935). It has been noted that "the secured creditor has a distinct property interest entitled to constitutional protection throughout the proceeding, but that the property interest is limited to the value of the collateral and should be distinguished from the secured creditor's procedural remedies which can be impaired or even abrogated." Use of Collateral, supra note 11, at 1491.

Further, the "remedial and substantive contractual rights of the secured creditor can be modified extensively, so long as the modifications do not constitute a deprivation of specific property [the value of the collateral of the secured creditor] in violation of the due process of law guaranteed by the Fifth Amendment." Poulos, supra note 14, at 72.

\textsuperscript{20} As stated in In re Philibosian, 19 F. Supp. 787 (N.D. Ga. 1937): "Under the bankruptcy power Congress has authority to impair the obligation of contracts, but may do so, as declared in the Radford Case only when property is not, contrary to the Fifth Amendment, taken without due process of law. . . . To delay realization of the security, especially when the security is ample and the secured creditor will receive his debt in full, or at least the full present value of the security, with compensation for delay, and there are good reasons for the delay, all judged by a Court, is not unprecedented, nor unreasonable, and is within the bankruptcy power; just as it has always been within equitable power, though verging on the impairment of the obligation of the security contract." See generally Countryman, Real Estate Liens and Business Rehabilitation Cases, 50 AM BK. L.J. 303 (1976) [hereinafter cited as Real Estate Liens]. See also the authorities cited in note 15, supra.

\textsuperscript{21} See the authorities cited in note 11, supra.

\textsuperscript{22} Id.
SECTION 57H: THE BANKRUPTCY RULE OF DISTRIBUTION

From the above, one can readily see that judicial principles guarantee secured creditors constitutional protection to the extent of the value of their collateral. The Bankruptcy Act provides the framework for realization of this value through liquidation of the collateral and for payment of dividends on the amount of debt exceeding its value. The scheme of the Bankruptcy Act is, then, that secured claims will be satisfied by the collateral which secures their payment. If there is equity in the collateral for the benefit of unsecured creditors, the trustee will liquidate it and pay the secured claims from the proceeds in preference to all other debts. If there is no equity in the collateral, the trustee will presumably abandon the property to the secured creditors, so that they may liquidate their security and satisfy their debts. Also, if the secured creditors have no equity in their collateral, Section 57h and Bankruptcy Rule 306 allow them the right to prove their claims as unsecured to the extent that their debts exceed the value of the underlying collateral.

It must be remembered that the inadequately secured creditor can participate in the general distribution of the estate as an unsecured creditor only for the unpaid portion of his claim which remains after deducting the value of his security. This is known as the Bankruptcy Rule of Distribution and is said to be an outgrowth of the command that there should be a fair and equitable distribution of the bankrupt's assets. Under the Equity Rule of Distribution, the creditor is permitted to participate in the general distribution for the entirety of his debt and to apply the security against this debt only after crediting the dividends paid.

Section 57h is a codification of the Bankruptcy Rule of Distribution and appears to envision the secured creditor's liquidation of his collateral prior to filing for any deficiency as an unsecured creditor. The Act itself

23. Pasky, supra note 3, at 58 states: "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."


25. 3 COLLIER, supra note 7, at § 57.20.

26. Id.
appears to require the conversion of the security into money in accordance with the terms of the security agreement or according to agreement, arbitration, compromise or liquidation between the creditor and the trustee within the discretion of the court. Bankruptcy Rule 306(d) clarifies the actual mechanics of valuing securities, stating that the court, within its discretion, may utilize any mode for determining their value. It has been the experience of this writer that most courts use some appraisal method, rather than liquidation method, with which to arrive at the value of the security and any deficiency on the claim. Naturally, this method is the most expeditious and aids in the general liquidation of the estate and settlement of unsecured claims by the trustee.

In ordinary bankruptcy proceedings, most commentators suggest that secured creditors have generally three courses of action available in collecting their debts, all of which are premised on the assumption that there will be a liquidation of the creditors' collateral. In comparison, where the proceeding is one whose purpose is rehabilitation under Chapter XI, one may not assume liquidation of secured creditors' collateral, since the normal purpose of the proceeding is to maintain the "going concern" value of the debtor's property. The debtor is usually allowed to retain the collateral if it is necessary for the arrangement plan and for the repayment of unsecured debts. However, the secured creditor may agree with the debtor as to the repayment of the secured portion of his claim or may file a complaint for the purpose of having the court dissolve or modify the stay order under Bankruptcy Rule 11-44 so as to provide for repayment of the secured portion of the creditor's claim. Also, in Chapter XI situations the secured creditor clearly may apply to the court to value his collateral through appraisal, set the amount of any deficiency of his debt in comparison to his collateral, participate as an unsecured creditor in the proceeding to the extent of any deficiency, and receive distributions of the plan of arrangement to the extent of any deficiency.

27. 12 id. at § 306.07; 14 id. at § 11-303-09.
28. First, a secured creditor may disregard the bankruptcy proceeding entirely and decline to file a proof of claim, relying solely on 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. See Anderson, supra note 4, at 6.
29. In re Pure Penn Petroleum, 188 F.2d 851 (2d Cir. 1951).
30. See generally Anderson, supra note 4; see also the authorities cited in note 5, supra.
31. See generally Anderson, supra note 4.
32. R.I.D.C. Indus. Dev. Fund v. Snyder, 539 F.2d 487 (5th Cir. 1976); Law
In conclusion, the courts have developed several rules regarding rights of secured creditors to realize the value of their claims against the underlying collateral under Chapter XI, when read in context with Section 57h of the Act. First, no provisions of Chapter XI allow any substantial alteration of secured creditors' right to the liquidation value of their collateral. To the extent creditors are secured under Section 57h, they must receive the appraised value of their security. Second, if secured creditors appraise their security under Section 57h and show that there is a deficiency in the amount of their debts as against their collateral, they may participate in the arrangement proceeding as unsecured creditors for this deficiency. The plan of arrangement may, then, deal with the unsecured portion of their debts. Third, secured creditors' contractual rights may not be altered by the arrangement plan, but these rights may be extensively modified and impaired by the injunctive power of the court. Creditors are not materially and adversely affected by delays in the repayment of the secured portion of their claims, if they can be reasonably assured of realizing the liquidation value of their collateral through compromise with the debtor or through judicial modification of the automatic injunction which issues under Bankruptcy Rule 11-44. Finally, secured creditors must be allowed to realize their collateral within a reasonable length of time, since it is probable that an extensive delay in the realization process would be an unreasonable modification of their substantive rights.

**Secured Creditors: Contractual Rights**

Whether a creditor is secured is determined by state law, and the status of being secured is generally conferred upon the creditor by state statutes or contractual security agreements. It has been this writer's

Research Serv., Inc. v. Crook, 524 F.2d 301 (2d Cir. 1975); United States v. National Furniture Co., 348 F.2d 390 (8th Cir. 1965); In re Everick Art Corp., 39 F.2d 765 (2d Cir. 1930); 9 Collier, supra note 7, at § 801.

33. See the authorities cited in note 32, supra. See also Anderson, supra note 4.

34. See the authorities cited in note 11, supra.

35. See the authorities cited in note 33, supra.

36. See generally Anderson, supra note 4.

37. See Anderson, supra note 4, at 22-24. This final rule is stated with one caveat. This writer has found no cases which indicate that the bankruptcy court is restricted in its power to enjoin foreclosures after confirmation of the arrangement plan, but prior to consummation of the plan. Therefore, under Bankruptcy Rule 11-44b, it would appear that the court has unlimited power and discretion to delay the realization process of the secured debt, during the debtor's completion of a confirmed plan, so long as the secured creditor is given reasonable assurance that he will receive ultimately the liquidation value of his collateral.

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experience that most questions regarding secured creditors' substantive rights arise in regard to those creditors who are secured by contracts with the debtor. Usually, these creditors nurture the curious notion that they are given extensive property rights by the terms of their contract, whereas their security agreements only guarantee them the narrow substantive right to preferential payment of the value of the collateral described in their agreement when it is liquidated. In making this assumption, the creditors fail to distinguish between their substantive property rights, which are protected by the fifth amendment, and their contractual rights and remedies, which have no constitutional protection and which may be impaired or even abrogated.

Nevertheless, creditors holding security agreements argue that if they are paid less than the full contractual monthly payment, the impairment of the contractual repayment term abridges a substantive right. However, the preponderance of decisional law and commentary on this issue indicates that the terms of security agreements are not sacrosanct. The argument favoring this point of view is premised upon the fact that all parties to a contract are necessarily aware of the existence of, and subject to, the power of Congress to legislate on the subject of bankruptcies. Therefore, contracting parties are chargeable with the knowledge that their rights and remedies are affected by existing bankruptcy laws and all future

39. In In re Philibosian, 19 F. Supp. 787 (N.D. Ga. 1937), the court stated at 789: "An unsecured note is property, whose value rests wholly on the debtor's obligation to pay it and in the right to seize his property to satisfy a judgment on the note. The holder may be deprived of this property by a process of bankruptcy resulting in the bankrupt's discharge without any payment, and due process of the law is not lacking. A secured creditor has exactly the same property with the additional right to have the specified security exclusively applied to his debt. This last right is dignified with the name 'vested right,' but the Federal Constitution knows no such term and the Fifth Amendment speaks of 'property' of all kinds. It is not clear to me that to deprive a secured creditor of his security through a bankruptcy deprives him of property anymore than to deprive the unsecured creditor of his debt does; or that the process of bankruptcy is any less a due process of law in one case than in the other. The true reason why a bankruptcy may not nullify a security is not the Fifth Amendment but the fact that it never has. It lies in the limitations inherent in the bankruptcy power." See also the authorities cited in notes 15 & 19, supra.

40. See note 39, supra. See also Countryman, supra note 20, at 335-36; Use of Collateral, supra note 11, at 1491.

bankruptcy legislation, in case the debtor becomes insolvent. Consequently, all contracts are made with the knowledge that they are subject to existing bankruptcy laws and any applicable future amendments.

Notwithstanding the presumption of knowledge of potential contractual impairments, there is a general prohibition against "affecting" secured creditors by the Chapter XI arrangement plan. As a general rule, then, most plans should not include terminology which appears to alter or deal with the contractual provisions of secured claims without the prior consent of the claimholders. However, this rule leaves unanswered the question of whether the injunction against foreclosure by these creditors "affects" them, if the injunction does not require the debtor to fulfill all contractual terms of the security agreement. For example, upon the filing of arrangement proceedings, most contractual obligations are in default regarding some or all of the terms of the contract. Most frequently, the defaults concern repayment of the secured debt. Where arrearages exist, the creditors will argue that their debts must be brought current in payment, or their debt will necessarily be affected by the arrangement proceeding. This argument must fail, ultimately, because the obligation to pay arrearages on secured obligations depends exclusively upon contractual rights, which are subject to modification upon the filing of bankruptcy. The only right which must be maintained by the court is reasonable assurance of realization of the value of creditors' collateral, and so long as this value can be paid within the original term of the secured obligation, it will be difficult for the creditors to argue that an "affectation" of their debts is material or adverse. If they can be furnished this assurance, they will receive all of the constitutional protection to which they are entitled, and they have no right to more. Therefore, the bankruptcy court has the power to maintain a stay order against foreclosure without "affecting" secured creditors regardless of contractual defaults, if their collateral is necessary for consummation of the arrangement plan and if they can be given reasonable protection for the value of their collateral.

In comparison to the secured creditors' right to preferential payment from specific items of property, unsecured creditors have an interest in the non-exempt equity in all of the debtor's property. Therefore, both secured

42. See note 41, supra. Continental Bank v. Rock Island Ry., 294 U.S. 648 (1935); In re Prima, 88 F.2d 785 (7th Cir. 1937).
43. See generally Anderson, supra note 4, at 10.
44. Id.
45. See, e.g., Partially Secured Creditors, supra note 41; Poulos, supra note 14.
46. See Poulos, supra note 14, at 72.
47. See the authorities cited in note 11, supra.
48. See generally Anderson, supra note 4.
and unsecured creditors have an interest in the debtor's estate which must be given equal protection. \(^{49}\) Since the obligation to pay arrearages depends solely on contractual rights, it has been argued that there should be no overriding reason why unsecured creditors holding identical contractual rights should not also be paid arrearages. \(^{50}\)

To carry this argument in favor of fulfillment of all contractual terms to its logical end would lead to absurd results. The requirement of curing contractual defaults and payment of arrearages would logically require compliance with all major contractual terms, including acceleration clauses calling for payment of the entire balance of contractual debts upon default. \(^{51}\) Immediate payment of all contractual debts is virtually impossible in bankruptcy proceedings, and to allow payment of secured claims upon the basis of contractual clauses, rather than the debtor's realistic financial means, would probably undermine payments of unsecured claims through the arrangement plan. To the extent that secured creditors receive undue payment on their claims, unsecured creditors may be deprived of their substantive rights. \(^{52}\) Even more conservative commentators acknowledge that it is debatable whether secured creditors' contractual rights in specific property are greater than the unsecured creditors' general rights and interest in the debtor's unencumbered assets and equity. \(^{53}\) In any event, the issue of whether secured creditors are affected by the injunction issued under Rule 11-44 addresses itself to the debtor's ability to furnish protection for the value of the creditors' collateral and not his ability to fulfill some or all of the terms of the contractual agreement. \(^{54}\)

**Partially Secured Creditors**

Generally, the Bankruptcy Act envisions only secured claims and unsecured claims. \(^{55}\) However, there are numerous occasions where se-

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49. See the authorities cited in note 39, *supra*.
50. *See* Poulos, *supra* note 14, at 79. This writer suggests that the reason that unsecured creditors are not given identical contractual rights under Chapters XI and XIII is that the plan of arrangement is the only means for altering unsecured debts and because the alteration of this unsecured debt is normally completed in a payment manner as dictated by the plan the debtor files, rather than by any contracts between the debtor and creditors.
51. See Poulos, *Leading Case Commentary*, 46 AM. BK. L.J. 165 (1973) [hereinafter cited as *Leading Case Commentary*].
52. *Id.* at 169.
53. *Use of Collateral, supra* note 11, at 1484; see also note 39, *supra*.
54. *Leading Case Commentary, supra* note 51, at 168.
55. Unsecured claims may be given a priority status under section 64 of the Bankruptcy Act.
cured obligations exceed in amount the value of the collateral securing them. These claims are commonly known as partially secured claims: partially secured and partially unsecured. 56 In most Chapter XI proceedings both the debtor and partially secured creditors are perplexed as to the rights of the creditors regarding the secured and unsecured portions of their debts, the manner in which both portions should be paid, and the general problems which are likely to arise from these claims.

For example, let us assume the following hypothetical situation. A farmer files for a Chapter XI arrangement. His principal asset is a farm valued by a court-appointed appraiser at $1,200,000. The farmer proposes to cultivate the land, produce crops, sell the crops, and use the proceeds to fund the Chapter XI plan, which provides for a composition (25%) of numerous unsecured debts (totalling $1,000,000) and an extension in payment of the reduced debt over a term of three years. The property is encumbered by a first mortgage securing a debt in the amount of $700,000, by a second mortgage securing a debt in the amount of $900,000, and by a third mortgage securing a debt in the amount of $210,000. As additional complications, let us assume that the first and second mortgage notes are endorsed by individuals other than the debtor, and the second mortgage holder holds another item of collateral belonging to the debtor and valued at $100,000 to further secure payment of the mortgage note. The following issues are immediately raised:

(1) Which mortgage holders are fully secured, partially secured or unsecured?
(2) Which mortgage holders can receive payments through the arrangement plan?
(3) Assuming that the debtor is only paying current installments of the first mortgage note, what are the rights of the second and third mortgage holders to payment as secured creditors?
(4) Which mortgage holders are entitled to receive interest on their debts?
(5) Does the debtor have the right to pay the second mortgage note in full and in accordance with its terms? If so, what would be

56. Chapters XI and XIII are silent regarding secured claims generally, and there is no mention of partially secured claims. However, Chapters X and XII specifically provide for partially secured claims under sections 197 and 453. Notwithstanding the fact that Chapter XI does not specifically speak regarding partially secured creditors, all major treatises recognize that a "secured creditor is a holder of an unsecured debt for any sum as may be owing over and above the value of the security." 9 COLLIERT, supra note 7, at § 705; C. NADLER, THE LAW OF BANKRUPTCY § 184 at 151 (1977); H. REMINGTON, BANKRUPTCY § 3643 (1977).
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The rights of this creditor to vote regarding the arrangement plan?

A resolution of the first issue is relatively simple, since an appraisal of the value of the security has been made and presented to the court. Creditors are secured only to the extent that their debts are collateralized by equity in the property. Clearly, the first mortgage holder is fully secured. After deducting the amount of the first mortgage from the value of the property, there remains equity in the collateral of $500,000; therefore, the second mortgage holder is inadequately secured. The total value of the second mortgagee's equity is $600,000 ($500,000 farm equity, plus $100,000 other collateral) as against a debt of $900,000. Thus, this creditor holds a secured claim for $600,000 and an unsecured claim for $300,000. Finally, the third mortgagee's claim is totally unsecured, since there is no equity in his collateral after deducting the amount of the superior mortgages.

As to the second issue, the first mortgagee cannot participate in the arrangement proceeding as an unsecured creditor; however, the inadequately secured second and third mortgage holders can file applications with the court to value their security and fully participate in the proceedings as unsecured creditors for the unsecured portions of their claims. Of the unsecured debts totalling $1,000,000, the second mortgagee holds a claim of $300,000 and the third mortgagee holds a claim for $210,000. Therefore, these partially secured creditors constitute a majority in amount (but not number) of the unsecured debts, and there is an initial possibility that they will not vote in favor of any arrangement proposed by the debtor, thereby precluding confirmation of any plan and forcing a dismissal of the arrangement proceeding or forcing the debtor into a straight bankruptcy proceeding.

Regarding the third issue, the debtor has kept current in his payments to the first mortgagee before and during the proceeding, but is in default in payments to both junior mortgagees because the income from the farm is only sufficient to fund the arrangement plan and keep the first mortgage current. In order to gain payments on their debts, the mortgage holders must file complaints with the court to dissolve or modify the injunction against their foreclosing. At the trial on the complaint, the judge must

57. See Partially Secured Creditors, supra note 41; Restraint and Reimbursement, supra note 11.
58. See the authorities cited in note 32, supra.
59. Section 362(1) requires that a plan be accepted in writing by a majority in number and amount of all creditors before there can be a confirmation of the plan.
60. See generally Anderson, supra note 4.
balance the interests of all parties. The unsecured creditors and the first mortgagee desire that the debtor retain his farm and pay their debts under the arrangement plan and first mortgage, respectively. Naturally, the debtor has the same desire, since he wants to consummate his arrangement plan and keep his farm. In comparison, the second and third mortgage holders have similar desires, but the income produced from the farm is insufficient to pay their debts, too. Accordingly, they will request adequate protection for their substantive rights. In protecting these rights, the judge must define and fix the value of their substantive interest, determine what modifications vel non of the injunction against foreclosure will protect this interest, and then decide whether the valuation and modification process can be achieved without a material and adverse alteration of their interest.

In defining and valuing the creditors' interests in the debtor's farm, the judge will find ample case law holding that these creditors may voluntarily value their security through appraisal and participate in the arrangement proceeding as unsecured creditors for their deficiency; however, the judge will find that there are no Chapter XI cases stating whether the debtor may force secured creditors involuntarily to value their security and accept payment of only the secured portions, as appraised, outside of the arrangement plan. For example, let us assume that the second and third mortgage holders choose to boycott the arrangement proceedings by not filing proofs of claim or applications to value their security. Obviously, they will not be entitled to vote on the plan or receive dividends. However, they may decide to follow this course of action under the assumptions that the debtor cannot force a valuation of their collateral and that the court cannot force them to accept less than the full amount of their secured indebtedness. If this course of action is taken, the debtor will place a provision in his plan providing retention of jurisdiction over such disputes, gain confirmation of his plan, refuse to make any payments on

61. The four factors in determining whether the judge will grant relief on the complaint are: (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. See generally Anderson, supra note 4, at 11-25.

62. See the authorities cited in note 32, supra.

63. The plan of arrangement may provide for retention of jurisdiction by the
their obligations, and thereby force them to seek relief by filing a complaint to dissolve or modify the Rule 11-44 injunction. Filing such a complaint will necessarily raise the questions of what definition and value should be attributed to their security, whether it is being impaired, and whether any impairments of contractual rights "affect" them.

Though the judge will find few cases under Chapter XI that have considered these exact questions in this procedural context, these questions are presently the cause of much litigation and commentary under Chapter XIII, which is directly analogous to Chapter XI regarding secured debts. Neither chapter allows an alteration of secured debts through the arrangement plan without the consent of the creditor affected, and it is clear that they should be read in pari materia regarding similar issues. Under Chapter XIII, where an inadequately secured creditor is denied recourse to his collateral and is resisting, rather than seeking, the "right" to participate as an unsecured creditor, the decisions are split as to whether the creditor can be stayed from foreclosing when he receives payments court under section 357(7). However, after confirmation of the arrangement plan, the jurisdiction of the bankruptcy court continues under Bankruptcy Rule 11-44 "until the case is closed, dismissed, or converted to bankruptcy or the property subject to the lien is, with the approval of the court, abandoned or transferred." Therefore, until consummation of the plan, the automatic injunction against foreclosure continues until the completion of the arrangement plan, which necessarily allows the court jurisdiction to determine all disputes regarding the secured debt and the realization of it. But cf. In re Lieb Bros., Inc., 198 F. Supp. 229 (D. N.J. 1961).

64. For a complete discussion of this problem under Chapter XIII, see Leading Case Commentary, supra note 51; Lee, Leading Case Commentary, 46 Am. Bk. L.J. 73 (1972); Partially Secured Creditors, supra note 41.

65. Hallenbeck v. Penn Mut. Life Ins. Co., 323 F.2d 566, 571-72: "[Although] the provisions of Chapter XI are expressly declared to apply exclusively to proceedings thereunder, we are of the opinion that decisions pertinent to proceedings under Chapter XI (applicable only to unsecured creditors) may be helpful in construction of Chapter XIII provisions respecting the jurisdiction and injunctive power of the bankruptcy court.

It is well settled that statutes which relate to the same persons or things, or have a common purpose may be regarded as in 'pari materia'. Furthermore, similar statutory provisions in pari materia should receive similar and harmonious construction. [Citations omitted]. In view of the similar language, the simultaneous enactment of these debtors' statutes by the same legislative body and the similar purposes to be served thereby, we hold that the statutes comprising Chapters X, XI, XII, and XIII of the Bankruptcy Act are in pari materia and that the construction so uniformly given to §§ 311 and 314 of Chapter XI should be equally applicable to §§ 611 and 614 of Chapter XIII of the Act. Additionally, the legislative history of Chapters XI and XIII reveal that § 311 of Chapter XI and § 611 of Chapter XIII were derived from the same source, and that § 314 of Chapter XI and § 614 of Chapter XIII were derived from the same source."
which prevent impairment of his collateral, even though they are less than the payments specified in his security agreement.66

Notwithstanding the split in decisions, the bulk of commentary recognizes and clearly favors the concept that the Bankruptcy Act envisions partially secured creditors and that payment of the secured portions of their rights as secured creditors should be limited solely to the value of their collateral.67 More importantly, the Chapter XIII Rules were written under the assumption that the substantive law under Chapter XIII did not allow a creditor holding valueless collateral to be treated and paid differently than unsecured creditors merely because "he now holds a now otherwise useless security agreement and has achieved a now otherwise useless perfection of a security interest in nothing."68 The commentators favoring this position argue that where the value of a secured creditor's collateral is worth less than the amount of his debt, he should not be elevated to the status of a fully secured creditor and paid as such because of the simple fact that he holds a security agreement. This would obviously ignore the true value of his collateral. Further, it would be inequitable to creditors who hold unsecured contracts, but who receive no such preferential treatment. Finally, the preferential payment would deplete the total equity in the debtor's estate, because the payments from unencumbered funds on the secured debt would cause a depletion in the overall value of the debtor's assets without a corresponding increase in the equity of the collateral securing the debt. Therefore, there would be a prejudicial diminution of the unsecured creditors' interest in the debtor's unencumbered assets. This logic is equally applicable under Chapter XI or Chapter XIII.

Ironically, the Chapter XIII cases and commentary favoring the concept of partially secured creditors rely on two cases which were decided under Chapter XI and which allow partially secured creditors to prove voluntarily the unsecured excess of their claims for purposes of participating in the Chapter XI plan.69 Logically, if the creditor has the right to value his collateral and receive dividends as an unsecured creditor,

67. See the authorities cited in note 64, supra.
68. Partially Secured Creditors, supra note 41, at 276.
the debtor and other creditors should be able to force this result if the partially secured creditor chooses not to exercise this right. Valuation should not be the unilateral decision of the secured creditor in Chapter XI proceedings. The creditor's right of valuation is generally premised on Section 57h of the Act, which allows valuation of security in liquidation proceedings, and this section is applicable to arrangement proceedings, thereby allowing valuation of security in Chapter XI proceedings.70 Where the security must be retained, and not liquidated, and where it is necessary for the consummation of a Chapter XI plan, the debtor and unsecured creditors have an equal, if not overriding, interest in this security and its value. Thus, the court has the power to determine the validity, amount and value of all secured claims,71 and all interested parties should be able to invoke this power and limit secured claims to their proper value.72

Also, Collier appears to favor this approach in Chapter XI cases, stating that a "secured creditor is the holder of an unsecured debt for such sum as may be owing over and above the value of the security" and that the "arrangement may deal with that unsecured debt, whether the arrangement is by way of settlement, satisfaction, or extension."73 If the arrangement can deal with the unsecured portion of a secured claim, there is the necessary implication that failure to exercise the proof of the unsecured portion prior to confirmation will extinguish that portion. The creditor should not be allowed to boycott the proceeding in an attempt to collect the unenforceable unsecured portion of his claim after confirmation, as though he were fully secured.

Applying these principles to the facts of our situation, the judge should not allow any payments to the third mortgage holder, regardless of the validity of his mortgage, since there is no equity in the farm for this creditor. Clearly, if the property were liquidated, he would receive nothing; a fortiori, where the debtor has to retain the property in order to consummate the arrangement plan, he should not be forced to pay more than the appraised value to the mortgage holders to keep the collateral. If the third mortgagee valued his collateral and proved his deficiency, his debt should be compromised along with all other unsecured debts in the plan. If he boycotted the proceeding, his debt should be extinguished,74

70. Section 57(h) of the Act has been restated in Bankruptcy Rule 306(d), which is made applicable to Chapter XI arrangements by Bankruptcy Rule 11-33(e).
71. Pasadena Inv. Co. v. Weaver, 376 F.2d 175 (9th Cir. 1967); In re Premier Sales Co., 277 F. Supp. 802 (D. Utah 1967).
72. See notes 64 & 71, supra.
73. 9 COLLIER, supra note 7, at § 7.05.
74. Confirmation of the arrangement plan acts as the equivalent of a bankrupt-
and he should not be allowed any dissolutions or modifications of the Rule 11-44 injunction so as to receive payments. By his boycott, he has waived any substantive rights in the debtor's general assets, and by his lack of equity in the farm, he has no substantive property rights in this specific collateral.75 Thus, he is entitled to no protection and should be denied any relief under the complaint. The court should rule that his debt is unenforceable and order his mortgage cancelled. This ruling will not "affect" his debt, since no alteration was produced by the plan; rather, the third mortgage holder himself altered whatever substantive rights he had by boycotting the arrangement proceeding when he was inadequately secured.76

The rights of the second mortgage holder are similar, but the protection which the court must provide his debt is very different. The unsecured portion of his debt ($300,000) should be unenforceable, under the reasoning regarding the third mortgage holder, but he is secured on the other portion of his claim ($600,000) and entitled to protection on this portion. Certainly, the court will not dissolve the injunction, if at all possible, even though there is no equity in the farm; under our facts, the debtor has gained confirmation of his plan, the farm is necessary for consummation, and the revenues appear sufficient to fund the plan. The Chapter XI court's power initially to restrain lien enforcement is as broad as that of a Chapter X or XII court, and the automatic stay rules make no distinction among the chapters.77 After confirmation, the court has the power, and even more discretion, to find just cause to continue the restraint against foreclosure.78

cy discharge under Chapters I-VII of the Act, thereby extinguishing any personal liability of the debtor on the secured debt. Bankruptcy Rule 11-43. Therefore, if the debtor has not valued his collateral under Bankruptcy Rules 11-33(e) and 306(e), so that he may share in the arrangement plan as an unsecured creditor, the unsecured portion of his debt will be extinguished, and the payment of the secured portion of his debt will be limited solely to value of the collateral upon which he has a lien. See the text and note 8, supra.

75. One commentator has pointed out that "where the security is valueless the secured creditor can hardly be said to be materially and adversely affected by a modification of his rights with respect thereto." Restraint and Reimbursement, supra note 11, at 43. See also Partially Secured Creditors, supra note 41: Poulos, supra note 11, at 43.

76. See note 75, supra.

77. Real Estate Liens, supra note 20, at 315. See also In re Freed & Co., 534 F.2d 1235 (6th Cir. 1976) (court held that the bankruptcy court has jurisdiction in the Chapter XI proceeding to enjoin a foreclosure proceeding which was pending in a state court more than four months prior to the filing of the Chapter XI proceeding in order to protect the equity in mortgaged property available to general creditors).

78. Bankruptcy Rule 11-44(b); see generally Anderson, supra note 4, at 20-25.
The rights of all of the unsecured creditors are contingent upon maintenance of the stay. Therefore, the court will attempt to balance the interests of all parties, and if the debtor can assure the maintenance of an equity of $500,000 in the farm during consummation of the plan, the court will probably deny dissolution of the stay. Also, any modifications of the stay will be oriented toward maintaining this equity until consummation of the arrangement plan.\textsuperscript{79}

A resolution of the fourth issue is also unclear, since there are, to the writer's knowledge, no Chapter XI cases regarding the rights of partially secured creditors to receive interest and since analogous Chapter XIII cases are in conflict. One traditional bankruptcy rule is that interest on obligations does not accrue after the date of bankruptcy, except for those obligations whose underlying collateral is adequate to cover both principal and interest.\textsuperscript{80} One may argue, then, that a secured creditor whose security does not exceed the principal debt is entitled to no post-petition interest on any part of his claim.\textsuperscript{81} Therefore, under this argument, a partially secured creditor would never receive any interest on his claim, since his collateral is worth less than the amount that he is owed.

On the other hand, one may assert that Chapter XI does not envision partially secured creditors. Thus, one could argue that if a secured creditor holds a contract requiring interest payments, their payment would be mandatory, regardless of the value of the underlying security, or the debt would be altered.\textsuperscript{82} Of course, this argument is not persuasive, because it fixes the creditor's substantive rights according to his contract, rather than according to his collateral.\textsuperscript{83}

A more persuasive argument for payment of post-petition interest is premised on a distinction between liquidation and rehabilitation pro-

\textsuperscript{79} Factors favoring continuance of the stay order under Bankruptcy Rule 11-44(b) are as follows: (1) The debtor is paying current installments on the first mortgage and thereby reducing the principal balance owed, which creates equity in the property; (2) The farm is not as subject to depreciation as movable property, but rather, it will probably appreciate in value over the future, thereby building equity; and (3) The plan will only continue for three years, with the debtor presumably making arrangements to satisfy the second mortgage at the end of this period by sale, refinancing, or some other means.


\textsuperscript{81} Compare Partially Secured Creditors, supra note 41, at 279 and Poulos, supra note 14, at 73 with Use of Collateral, supra note 11.

\textsuperscript{82} In re Moralez, 400 F. Supp. 1352 (N.D. Cal. 1975).

\textsuperscript{83} But cf. In re Wall, 403 F. Supp. 357 (E.D. Ark.) (limited the value of the secured claim, but required interest payments on this portion).
ceedings. The rule prohibiting post-petition interest arises from liquidation cases where the debtor’s assets constitute a dead fund which is simply liquidated and divided among the creditors. The assets are normally unproductive during the liquidation and distribution process, and the burden of the delays in the process are borne equally by all creditors by not allowing interest to any. If interest were allowed to some, the delay would change the distribution of the fund without increasing its size. Therefore, some creditors would be favored over others, and this discrimination is only mandated in favor of those secured creditors holding collateral having enough equity to provide enough funds with which to pay both the interest and the principal amount of the debt.

One may argue that this rule has developed in the context of straight bankruptcy and has no application to rehabilitation proceedings because of the basic differences between the two processes. Thus, any justification for this rule based upon the fact that the filing of bankruptcy “fixes the moment when the affairs of the bankrupt are supposed to be wound up” would be inapplicable in arrangement proceedings where the plan proposes to continue the affairs of the debtor and use the debtor’s assets, rather than to end the business and liquidate the assets. In addition, application of this rule would not be warranted under the presumption that there will be the “administrative inconvenience of continuous recomputation of interest” because arrangement proceedings do not contemplate the bankruptcy requirements that there be periodic distributions as assets are converted to cash.

In arrangement proceedings, the debtor often proposes to continue his business and use the secured creditors’ collateral to generate profits to fund the plan. Through the proceeding, the court may become the liquidating agent for secured creditors and provide a free collection service. But the liquidation process may take several years, which causes delays in payment far in excess of the delays inherent in the straight bankruptcy liquidation process. At the same time, the debtor may be generating profits from use of the property. Arguably, interest may be seen as simply fair compensation to secured creditors for the productive use of their collateral, rather than a penalty for the debtor’s delay in payment.

87. Partially Secured Creditors, supra note 41, at 279.
The writer suggests the following approach. If the repayment period is lengthy, an inadequately secured creditor will suffer from the delay because he will not have the immediate use of the value of his collateral and inflation will reduce the buying power of the actual proceeds which he ultimately receives. Therefore, compensation may be proper for delay in repayment of the creditor, but it should be oriented towards this inflationary loss rather than to the interest specified in the security contract. Interest actually represents the creditor's profit or yield from the lending of money and is usually set out in the loan instrument. Once again, the creditor's rights should be fixed by the value of his collateral at the date of bankruptcy, rather than the profit contemplated under the terms of his agreement. Thus, if the repayment period of a partially secured debt is extended, if the underlying collateral is retained by the debtor and used to generate profits, and if the profits are ample to fund the plan and make all other necessary payments, the court should consider whether the inadequately secured creditor should receive payments on the secured portion of his claim to offset the devaluation of his property rights due to inflation.

In applying these principles to the hypothetical facts given, it would appear that the first mortgagee should receive all of the interest specified in his mortgage, because there is ample equity in the farm to satisfy both principal and interest payments. By the same token, the third mortgagee should receive no principal or interest payments, because there is no equity in the farm to cover his debt. Finally, the second mortgagee may be entitled to receive compensation for the delays inherent in the arrangement proceeding if the court feels that the facts of the case warrant such; but any compensation should be oriented towards the rate of inflation and any other economic factors which diminish the actual realization value of his collateral, and not towards any interest figure which represents a profit to the creditor.

In resolving the fifth issue of our hypothetical situation, the debtor may desire to favor the partially secured creditor through the arrangement plan. For example, the second mortgage note is endorsed by individuals who may be closely connected to the debtor through business or family relationships. Even though the personal liability of the debtor is extinguished upon confirmation of the arrangement plan, this will probably not

88. The writer cautions that this situation will be a rare occurrence, and that if this situation prevails, compensatory payment for devaluation of the property rights of secured creditors due to inflation should be set according to the inflationary rate that the economy is presently experiencing. Certainly, the compensation should have no connexity with the interest rate on the secured debt.
cancel the liability of the endorsers. Therefore, if the arrangement plan does not provide for full payment of all unsecured debts, the unsecured portion of the second mortgagee's claim will ultimately have an outstanding balance for which the endorsers may be contingently liable. To avoid the problem, the debtor may file an arrangement plan which sets out payment in full of any unsecured portion of the second mortgage as though the mortgagee were fully secured and which further provides a composition (25%) and extension (over 3 years) of all other unsecured debts. Arguably, this plan would not materially and adversely affect the second mortgagee since he would be treated favorably under this plan.

The second reason that the debtor may desire to favor the second mortgagee is to aid in confirmation of the plan. For example, a dispute will probably arise as to whether and to what extent this creditor is partially secured, which may lead to animosity toward the debtor and his plan. The second mortgagee may decide not to vote for any plan which does not pay him in full, regardless of the fairness to other creditors or the


90. Section 357(1) allows the debtor to file an arrangement plan which divides unsecured debts into classes and treats each class in a different and upon different terms. Therefore, the debtor may voluntarily divide one or more creditors into a separate class which receives preferential treatment (e.g., full payment). See generally Comment, Classification of Claims in Debtor Proceedings, 49 YALE L.J. 881 (1940).

91. Under these facts, the secured creditor will be in the horns of a dilemma. If he applies to value his security, is recognized as an unsecured creditor, votes for the plan of arrangement, and receives dividends, he will face the argument by the endorsers that he has contractually waived his rights against them. See the authorities cited in note 89, supra.

If the secured creditor does not apply to value his security and receive dividends, and if the plan of arrangement does provide for dividends to unsecured creditors, and if there is a portion of his claim which is not fully secured, the endorsers will argue that their rights have been jeopardized because the secured creditor did not take the fullest steps to realize complete compensation on his claim. Therefore, if the debtor resists the full payment of the secured debt and attempts only to pay the secured portion, as appraised by the court, the mortgage holder may find a portion of his debt relegated to the status of unsecured. This unsecured portion will be enforceable and uncollectible through the arrangement proceeding. Therefore, by not applying to value his security and participating in the arrangement as an unsecured creditor, the secured creditor will have failed to receive payments from the arrangement plan. Obviously, the failure of the secured creditor to avail himself of these dividends through the arrangement plan will be detrimental to the endorsers and furnish a defense for them. But cf. Bankruptcy Rules 11-33(d) and 304.
debtor. If he values his security, the second mortgagee holds 30% of all unsecured debts, and if there is a lack of voting by other creditors or if some other creditors also reject the proposed plan, the second mortgagee may effectively block any plans proposed by the debtor. To prevent this creditor from gaining a "whip hand" in the proceeding, the debtor may once again choose to file a plan favoring the second mortgagee by paying him in full. Regardless of the reasons, this writer suggests that the debtor can and may file an arrangement plan paying the second mortgagee in full, and if this is done, this creditor will not be allowed to vote because his debt will not be materially and adversely affected by such a favorable plan.

CONCLUSION

Since partially secured creditors are often involved in Chapter XI proceedings, a full understanding of their rights and remedies is essential to the attorneys for both the debtor and the partially secured creditor so that they can resolve their disputes. Only this understanding will allow the partially secured creditor to protect his constitutional rights and allow the debtor and the other interested parties to limit him to those rights so that he will not receive preferential treatment that is not sanctioned by law. An understanding of these rights of partially secured creditors is keyed to valuation of underlying collateral; as long as this principle is consistently recognized, a resolution of the rights and remedies of partially secured creditors will be facilitated.

92. See the text and note 59, supra.
93. See the text and note 90, supra.