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William Polatsek

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Recommended Citation
William Polatsek, Wreck of the Old 77, 34 Cornell L. Rev. 532 (1949)
Available at: http://scholarship.law.cornell.edu/clr/vol34/iss4/3
THE WRECK OF THE OLD 77

A Requiem Review of Equity Interests In
Railroad Reorganizations Under The Bankruptcy Act

WILLIAM POLATSEK

I

"Courts of Equity have a tradition of aiding the helpless, such as Infants, Idiots, and Drunkards. The average security holder in a corporate reorganization is of like kind." —Jerome Frank

A railroad wreck is almost inevitably a most melancholy thing. "Almost" is used advisedly, for one of the most colossal wrecks of recent years promises to have a reasonably happy ending. In this wreck, no lives were lost and no injuries were sustained, although the conditions that caused the wreck were responsible for the loss of untold millions of dollars. The victim is Section 77 of the Bankruptcy Act, derailed for all practical purposes by the Railroad Adjustment Act of 1948. As a result of this happy catastrophe, that forlorn and forgotten man in railroad reorganizations, the average holder of railroad equities, now appears to have a reasonable prospect of survival. It is the purpose of this discussion to examine the past condition of this newly nascent equity holder, rather than to analyze his defender and champion, the new Act, in the hope that a better appreciation of the equity position may be reached in applying the new legislation.

The financial reorganization of a great railroad system as practiced heretofore presents both economic and legal problems of monumental complexity. Previous treatment of financially ailing roads fell into two classifications—the equity receivership cure, and the Section 77 proceeding of the Federal Bankruptcy Act. Both left a great deal to be desired. Inasmuch as most contemporary reorganizations have been effected under the latter law, this article will be limited to the analysis of the status of the share and shareholder from the vantage point of Section 77. For the sake of convenience, the legal and administrative aspects of the problem will be discussed first, and the economic considerations will be covered subsequently, insofar as the two may be separable.

Section 77 in the Courts

As with any statute, the final interpretation of the Bankruptcy Act rests with the courts. Whatever uncertainty existed in the past with respect to the status of the equity—and for a time many questions remained unanswered—it has been firmly resolved by relatively recent decisions. The controversies over the scope of the Commission's jurisdiction, what constitutes the proper basis for the capitalization of the new company, and the merits of the relative priority theory versus the absolute priority theory are now settled.

Basis of Controlling Decisions

For the purposes of the railroad stockholder, three cardinal principles (among others of lesser import) have emerged from the Supreme Court:

1. The absolute priority rule is now firmly settled.

2. The capitalization of the new company shall be determined primarily by the consideration of the road's probable prospective earnings.

3. The ICC has sweeping discretion to determine all matters pertaining to the financial structures of bankrupt railroads in Section 77 proceedings. The Commission's findings are binding on the courts, ex-

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3 Relative priority is a theory of income position rather than a theory of priority of principal. Voluminous comment is available, but perhaps the best general discussion is Bonbright and Bergeman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization, 28 Col. L. Rev. 127 (1928). The insistence on strict priority among classes of bondholders inter se, and all of them over stockholders, which usually interferes with the conservation of going-concern values, and the problem of getting the company back on its feet as a going concern, are two ideals which come to grips over the treatment of stockholders. For an analysis of this see Foster, Conflicting Ideals for Reorganization, 44 Yale L. J. 923 (1935); Guthmann, Absolute Priority in Reorganization: Some Defects in a Supreme Court Doctrine, 45 Col. L. Rev. 739 (1945). Guthmann asserts that the absolute priority rule works a serious injustice to stockholders and junior claimants generally, and makes a plea for reasonable treatment of risk-takers.


cept for review on matters of law alone, or for clearly unreasonable exercise of discretion.  

Other significant conclusions of the courts are that the statute demands that operation of the roads be continued for the benefit of the public, regardless of the interests of creditors and stockholders; that a basic requirement of any reorganization is to give the new company a reasonable prospect for survival; that such a reorganization contemplates the scaling down of claims and that security holders may take a substantial loss, the procedure not being one designed to recoup losses; that the statute was intended to remedy the evils of the old equity receiverships; that Section 77 is not a composition statute in the sense that business must be preserved to existing stockholders; and that elimination of valueless interests of shareholders and creditors by the ICC is in accordance with the Act.  

This last rule raises the immediate contention that the holding, in effect, is that an administrative body may determine a value, on the basis of which private property rights could be wiped out without any effective review by the courts. I do not apprehend that this contention is untrue; nor do I feel it is one which is radically new or startling.

"A statute will not be held to violate the due process clause merely because it modifies or even destroys rights of private property, and this is true as to contracts, including corporate securities."

With regard to the three major policies previously enumerated:  

(1) The doctrine of absolute priority was first laid down before the Section 77 cases, in the Boyd case, but over the years there tended to be a drift away from that principle. The Los Angeles Lumber Com-

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8 Rio Grande cases, note 5 supra.  


13 Hand and Cummings, The Railroad Modification Law, 48 Col. L. Rev. 689, 709 (1948). A collection of U. S. Supreme Court cases, some of vintage quality and upholding the assertion quoted above, is to be found in footnotes 60 and 61 of the article.  


15 Probably due to a dictum in the Boyd case permitting shareholder participation
pany case resuscitated it, and now the absolute priority principle must be applied whether the road is solvent or insolvent. Neither the courts nor the ICC is permitted to give the stockholders anything if the debtor's assets are less than the aggregate of its debts. The holders of senior securities must be compensated in full before any value will be recognized for holders of interests of lesser dignity. This means full equitable compensation, and not necessarily full dollar compensation for the face value of the securities held.

(2) In formulating a reorganization plan, earning capacity is the essential criterion. This rule has been repeatedly insisted upon, and the financial structure of the new company is very largely determined by capitalizing the probable prospective earnings. It usually results in a considerably smaller capitalization. With very few exceptions, the most notable one being the Erie, the new structures have been too small to accommodate the claims of prior interests and leave anything for the old equity. Consideration is given, however, to other factors, including original cost and reproduction cost new, according to the published reports of the Commission. In practice these "other factors" are generally given lip service and as a practical matter they are relatively unimportant in determining the new capitalization. This under certain conditions. Frank, Some Realistic Reflections on Some Aspects of Corporate Reorganization, 19 Va. L. Rev. 541 et seq. (1933); see Spaeth and Winks, The Boyd Case and Sec. 77, 32 Ill. L. Rev. 769 (1938). Many courts took a realistic view of the reorganization problem and by sheer necessity to accomplish a result thought practical and agreeable with the rehabilitation object of the statute, have confirmed plans that have not followed strictly the rule of the Boyd case. . . ." Swanstrom, Stockholder's Participation in Reorganization, 28 Geo. L. J. 336, 338 (1939). Also it seems "Probable that one of the strongest reasons for disregard of the Boyd and Kansas City Terminal cases lies in the double edged nature of provisions concerning voting rights of the shareholder and creditor." Note, Fairness of Reorganization Plans: The Bondholder Pays, 31 Ill. L. Rev. 505, 517 (1936).


But cf. the United Light and Power case: Otis & Co. v. SEC, 323 U. S. 624 (1945). This involved a solvent utility other than a railroad. The rule is modified by this decision. Here, the SEC held that where on a basis of book value there was no equity available for the common but where earnings exceeded the preferred dividend requirements, and future earnings pointed to further improvements, the possibility that eventually there might be dividends available for the common entitled it to participation in the new company. This principle has not yet been applied to railroads, but might conceivably be in the future. For two good analyses, see Sonnenschein, An Analysis of the United Light and Power Case, A6 Corp. Reorg. & Am. Bankr. Rev. 35 (1945); Note, The Absolute Priority Rule and the United Light and Power Case, 31 Va. L. Rev. 928 (1945).

See note 4 supra.

avoids the expensive and inconclusive engineering valuations of properties necessary when new capitalization is based solely on original cost or reproduction cost. It mirrors the economically classic theory of investment; if someone must lose, historically the shareholder trades security for the risks of greater profit. Put simply, if the earnings of the new company are going to be only $1,000 per year, it is difficult to justify a capitalization of $10,000,000 merely on the ground that it would cost the latter sum to reproduce the plant new.

(3) The ICC has, for all practical purposes, carte blanche in determining policy and details of the new capital structure, who shall participate in it, and to what extent. Thus the Commission exclusively determines the amount and character of the capitalization, the distribution and allocation of new securities (and may override state laws in this respect), all questions pertaining to the valuation of the properties, whether or not the plan is within the public interest, the ratio of debt to stock, the amount of fixed and contingent interest, and matters pertaining to the issue of warrants to old shareholders. The courts are limited to correcting the ICC's errors of law, setting aside findings of fact not supported by the evidence, and revising conclusions which violate constitutional rights. They must exercise an independent judgment but their powers are negative. They can veto a plan which does not follow legal standards. They can improve it only by suggestion.

22 The valuation of the New York Telephone Company took ten years to complete. Seven different parties submitted valuations, all different. The valuations of two competent independent corporate appraisers differed by $100,000,000. P. T. Homan, in a course on public control of business, Cornell University (1947).

23 This, of course, is not per se a desirable practice or an economically realistic one. Thompson, Respective Rights of Preferred and Common Stockholders in Surplus Profits, 19 Mich. L. Rev. 463 (1921).


The Commission has very wide authority. Accordingly, the shareholders must turn to it to discover how their rights are determined. A detailed analysis of 36 railroads in Section 77 reorganizations, shows the ICC has seven major aims:

1. The restoration of the road's credit is a paramount objective. The Commission must parcel out sacrifices and preside as mortician at the interment of the old financial structure. To avoid a repetition of these requiems, the reorganized company must be made financially viable insofar as possible, and this cannot be accomplished until the road can establish a decent credit standing.

2. Simplification of the capital structures will be effected. Undue diversity of security issues will not be tolerated. Complex financial structures have been the demon incarnate of railroad reorganizations, plaguing the ICC and the courts, especially in allocating new securities. The new capitalizations eliminate the haphazard patchwork of innumerable security classes.

3. Of the security classes that will be permitted, a rough balance tends to be 25% fixed debt, 25% contingent or income debt, 25% preferred stock, and 25% common stock. Variations in this proportion reflect the peculiar circumstances of individual roads.

4. The millstone of heavy bond finance will be substantially lessened. In the 36 reorganizations analyzed, fixed charges which were

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Footnotes:
33 The reason for this is due to the historical development of the railroads. Big systems, such as the Pennsylvania and the Baltimore and Ohio, represent the absorption of scores of small lines by one means or another. Securities were assumed, exchanged, and otherwise shuffled about. See Barriger, The Development of Railway Corporate Structures, 7 LAW & CONTEMP. PROBS. 367 (1940). Pennsylvania has 151 companies in its system, and the B. & O. has 122.

34 For the principles and mechanics of security distribution, see Friendly and Tondel, The Relative Treatment of Securities in Railroad Reorganizations Under Section 77, 7 LAW & CONTEMP. PROBS. 420 (1940); Note, Distribution of Securities in Corporate Reorganization, 51 YALE L. J. 85 (1941).

35 "A well balanced financial structure requires that a substantial part of the new capitalization be represented by capital stock, and not be represented in too great proportion by bonds, whether the interest be fixed or contingent, since control of the management of the property should be in the hands of persons holding a substantial part of the entire interest in the property." St. Louis-Southwestern Ry. Reorganization, 252 I.C.C. 325, 335 (1942), approved, 53 F. Supp. 914 (E. D. Mo. 1944), cert. denied, 330 U. S. 836 (1947), rehearing denied, 331 U. S. 870 (1947).

36 For the terms and conditions of the stock and bond issues, and the "rather distinct patterns" they follow, see Stevens, Railway Financing, 1890-1940, NATIONAL RESOURCES PLANNING BOARD, TRANSPORTATION AND NATIONAL POLICY, pt. I, § V (1942).

37 This pattern is undergoing a certain erosion, because the tax disadvantages attaching to preferred stock are tending to diminish its importance. Stevens, 9 J. of Bus. of the Univ. of Chi. 211 (1936).

38 The limitation-of-charges philosophy of the Commission is concisely expressed by Commissioner Mahaffle in his dissent in the Chicago, Great Western case: "We must find that the probable earnings of the property, in the light of its earnings experience and all other relevant facts, will provide adequate coverage for its fixed charges." 228 I.C.C. 385, 630 (1938). On fixed charges generally, see Moore, Railroad Fixed Charges in Bankruptcy Proceedings, 47 J. Pol. Econ. 100 (1939).
comfortably earned with at least a 25% margin during the average depression years were approved in almost every case. Contingent charges such as debentures were usually limited to the difference between the fixed charges and the maximum earnings estimated for the prospective normal year.\(^8\)

(5) Provision is made in most plans for gradual retirement of debt, the most frequently used device being the sinking fund. This is of special interest to shareholders for it removes the preferred and common shares from participation in the earnings of the new company by the amount of the fund.\(^9\) Retirement ultimately benefits the shareholder, as the value of the equity increases with the reduction in bonded obligations. Roads have commonly met maturities by refunding them. At least one writer has pointed out the fallacy of the view that regards payment of debt by the incurring of another, \textit{i.e.}, refunding, as somehow providing a way out of debt difficulties.\(^40\)

(6) The Commission apparently favors a plan which provides for a reserve account to cover extraordinary expenses, an “Improvement and Betterment Fund.” By the time the railroad has reached insolvency, the condition of the physical plant has not infrequently reached the stage where efficient operation is impossible and is downright unsafe. The company will go the limit to meet its maturities and interest payments, using money that would normally go into maintenance. This is known as “deferred maintenance”—the genteel way of saying that the property is allowed to fall apart.\(^41\)

The objectives of such a fund are twofold: first, an attempt to prevent future deterioration of the plant by providing a source out of which future maintenance expenditures may be made regularly, instead of deferring them; and second, a specific method for financing new capital improvements by some means other than issue of further debt under an open-end mortgage—a step away from acquisitions by conditional sale on “terms.”

\(^8\) The prime consideration of the Commission is that fixed charges shall be adequately covered out of earnings, as indicated in the Act. See \textit{Friendly, Amendment of the Railroad Reorganization Act}, 36 Co. L. Rev. 27 (1936). Stevens lists six specific methods by which the expansion of fixed interest debt in approved plans may be restricted. 15 J. of Business of the Univ. of Chi. 205 (1942).

\(^9\) For a discussion of these sinking funds at length, see Warner, \textit{Railroad Reorganization Practices and Policy}, 20 Savings Bank J. No. 10, p. 7 (1939). An accounting problem is raised: the fund comes out of earnings, but is not available for distribution of dividends. Thus, in one sense it is income, and in another sense, an expense.

\(^40\) \textit{Moore, The Reorganization of Railroad Corporations} 101 (1941).

\(^41\) “Our maintenance of way is now down to the point where we are taking chances.” Letter of the President of the Frisco, quoted in \textit{Hearings before Committee on Interstate Commerce on S. Res. 71, 74th Cong., 1st Sess.} 96 (1935), on the fact that the Frisco experienced as many as 25 rail breaks per day.
(7) Total capital structure will be limited to an amount not in excess of the value of the property which has been determined by the ICC.

Within these seven general aims, what are the determinants of the new capitalization that lead the Commission to permit or deny participation of the old shareholders' equity in the reorganized company?  

1. Earnings

The ICC is concerned with earnings not only because they are a salient determinant in the capitalization permissible, but also because they influence the nature and types of new securities offered. The Commission has commented on this latter aspect in almost every reorganization plan and its conclusions may be broadly summarized as follows:

(a) The earnings will support a fixed debt amount only to the extent that service on the debt can be assured in the worst years.

(b) The earnings will support a contingent debt to the extent that income bondholders may expect a return in average normal years.

(c) The preferred stock should pay in “good” years with a considerable degree of certainty.

(d) The common should pay in periods of high earnings.

What earnings are considered? The “earnings factor” in the new capitalization generally refers to capitalization of the income available for all the outstanding securities in a future normal year. This estimated figure is reached by a consideration of past and present earnings within the context of the carrier’s general economic position. Warner notes that the difficulties in adequately gauging future earnings are innumerable, and that at best the capitalization labors under the burden of human fallibility. The Commission would be first to admit it.

The proper base period to be used is a very sensitive matter, and

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42 For ICC statement on criteria governing new capitalization, see Missouri Pacific Reorganization, 257 I.C.C. 479, 522-23 (1944). Cf. Swaine, A Decade of Railroad Reorganization Under Section 77 of the Federal Bankruptcy Act, 56 Harv. L. Rev. 1193 (1943). This article is an excellent general survey. For historical development, see Bonbright, RAILROAD CAPITALIZATION (1920).

43 See text at p. 533.; Anderson, U. S. Supreme Court Rule of Valuation as Applied to Corporate Reorganization, 27 Marq. L. Rev. 111 (1943). The new capitalization, which should reflect the value for reorganization purposes, is composed of two factors: the reasonable prospective earnings, and the rate of capitalization.

44 Usually by at least a 25% margin. See text at p. 537.


46 Id. at 441.

the Commission has insisted that the base period be of sufficient scope to reflect operations in both good and adverse times. Present earnings are considered only as they fit into the long-run picture. The Commission then tentatively proceeds to estimate future earnings after considering an extensive study of the future traffic potential the road may expect, the territory the line serves and whether or not it is developing, any possible operating economies the road may obtain by modernizing, the extent of the competition, and the future of properties producing "other income," i.e., income from non-operating holdings.

The question of precisely what revenues should be included in the earnings figure to be capitalized is troublesome. To cite a single illustration: joint facility rentals are not included. They reflect property that is used but not owned. Such matters involve controversies over accounting procedure outside the scope of this paper.

2. Rate of Capitalization

I have scoured the finance dockets of the ICC in vain for a statement of policy on this. A study of 36 railroad reorganizations reveals that the rate of capitalization has averaged about 43.4%. The usual range is from 4% to 5%. The utilities, by way of contrast, are allowed about an 8% return, which they have no trouble earning. The railroads are fortunate if they earn 43.4%.

While earnings are of major importance, they do not constitute the sole criterion in setting up the new structure. The criticism that no consistent relation of capitalization to earnings exists perhaps overlooks the fact that the earnings test is not by itself conclusive.

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49 Frequently emphasized. E.g., the Missouri Pacific Reorganization, 257 I.C.C. 479, 523 (1944).
50 See dissent in Chicago, G. W. R. R. Reorganization, 228 I.C.C. 585, 630 (1938) and the Missouri Pacific Reorganization, 257 I.C.C. 479 (1944). In the Ecker case, war-swollen earnings were excluded from the long run earnings picture and disregarded in the consideration of the road's probable earning capacity.
51 E.g., income from lessee railroads, from real estate holdings such as New York Central's property on Park Avenue in New York City, and from investments.
52 The mathematical average obtained by totalling the capitalization rates (where stated) in 36 reorganizations under § 77 and dividing by the number of cases. No rates were found under 3% and none in excess of 5%.
53 See Chicago Great Western Reorganization, 228 I.C.C. 585, 612 et seq. (1938): "But other factors should be given appropriate consideration."
54 For an analysis, see an excellent Note, Valuation and Capitalization of Railroads in Reorganizations, 54 HARV. L. REV. 655 (1941).
3. Valuation of the Property

The value of the road for rate-making purposes is always a thorny problem. Perhaps the most frequently voiced complaint against the ICC is that in reorganization cases it has consistently refused to evolve any general principles of valuation since the enactment of Section 77, and that it has not proclaimed any definite formulae that might be universally applied. It follows a policy wherein "lines are pricked out by gradual approach and contact of decisions on opposing sides."

Much of the confusion concerning valuation results from a failure to distinguish between "value" for reorganization purposes and "value" for rate-making purposes. The contention that the two are the same was expressly disapproved by the Commission in the Rock Island...
case.\textsuperscript{50} The Commission has stated the value for reorganization purposes

\begin{quote}
"... as the actual worth of the properties to their owners, and basically it is dependent upon the present and prospective earning power of the properties considering ... the amount of business available, ... the competition, ... and the condition of the facilities which make up the physical properties."
\end{quote}

The rate-making value is defined as being that amount

\begin{quote}
"... upon which the owners of the property are entitled, under the Constitution, to an opportunity to earn a reasonable return, an opportunity of which they cannot be deprived by public regulation if confiscation is to be avoided."
\end{quote}

That the rate-making value ordinarily will differ from "value" in its strict economic meaning is noted:

\begin{quote}
"... for example, it may not be possible to earn a reasonable return upon 'value for rate-making purposes' even if public regulation allows the carrier a free hand in the making of its rates and charges. On the other hand it may be higher, if the carrier ... can earn more than a reasonable return upon 'value for rate-making purposes. ...'\textsuperscript{59a}
\end{quote}

The ICC has not stated how much weight it gives the value for rate-making purposes in determining the value for reorganization purposes. In the Special Master’s report in the \textit{Erie} case,\textsuperscript{60} it is noted that

\begin{quote}
"The Commission, however, is not required under the statute to make any formal or precise findings of fact, nor is it required to adopt any precise formula which accords specific weights to the different factors which may be considered in determining a proper capitalization. Hence a complete statement of the grounds of its determination is not essential. U. S. v. B. & R. R. (1935) 293 U. S. 454, 464. In the absence of a showing to the contrary, it may not be assumed that the Commission failed to give appropriate consideration to all of the relevant facts."
\end{quote}

Also in the \textit{Erie} case, note that

\begin{quote}
"The Commission, in its reports, does not expressly adopt or reject any of the evidence on the subject of valuation and, save for ... earnings ..., the grounds of its determination are not set forth."
\end{quote}

\textsuperscript{59} 247 I.C.C. 533 (1941).
\textsuperscript{59a} Chicago, G. W. R. R., 247 I.C.C. 193, 196 (1941).
\textsuperscript{60} \textit{Erie} Reorganization, ICC Finance Docket 11915 (Submission of Plan of Reorganization) p. 104 (1941).
Assuming earnings to be the primary test, the irrelevance of rate-making value in reorganizations is illustrated by the following example:

<table>
<thead>
<tr>
<th>Earnings per year</th>
<th>Earnings capitalized @ 5% Valuation for Rate-making Purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Road A $400,000.</td>
<td>$8,000,000</td>
</tr>
<tr>
<td>Road B $225,000.</td>
<td>$4,500,000</td>
</tr>
</tbody>
</table>

While both roads have identical rate-making values, reflecting physical plants equivalent cost-wise, Road B because of light traffic density and adverse operating conditions due to terrain, can earn only 56% as much as road A. Clearly, B cannot support a capitalization of eight million without facing another insolvency.

Yet under Section 77 (e), the rate-making value must be considered by the Commission. It gives it lip service, but I know of only five cases where the ICC capitalization of a reorganized road under Section 77 equals or exceeds the value for rate-making purposes. The Rio Grande valuation for rate-making is about $178 million; post-reorganization capitalization totals $152.4 million. In the Monon case, rate-making value is about $38 million; new capitalization, $34 million. The primary reason why many carriers are forced into bankruptcy is simply that they have not been able to earn a reasonable rate of return on their rate-making value, not because of Commission fiat, but because of competition or a dearth of traffic due to the vicissitudes of the business cycle.

The elements determining rate-making value are:

(a) original cost of the properties; (b) reproduction cost new; (c) present value of land; (d) extent to which the properties have depreciated; (e) cost of additions and betterments.

4. Other Factors

While Section 77 provides for consideration of the reproduction cost, original cost, and actual investment, the Supreme Court in the Milwaukee case held these items were subordinate to earnings, but did not elaborate as to how much weight should be given these other costs. It said this was a matter for the Commission. The Commission has not indicated the relative weights it gives to these costs as against

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61 See text at p. 539.
62 The Akron, Canton & Youngstown has a capitalization 10% over the ICC valuation for rate making; the Chicago & Eastern Illinois, a 20% overage; the Missouri Pacific, 15%; the St. Louis Southwestern, 21%; and the Spokane International, 1%.
63 247 I.C.C. 533 (1941).
64 Subsection (e).
65 318 U. S. 523, 540 (1943).
earnings. In a study of the 36 roads, in some instances the "other" costs have been found to be entirely beyond what prudence would have dictated, as in the Missouri Pacific case; but generally the "other" costs have set the upper limit of new capitalization where it appears that this factor was roughly equivalent to the capitalized earnings. The precise relation of earnings to "other" costs can not be reduced to a formula. The weight accorded "other" costs seems to be best regarded as limiting the maximum capitalization. (This policy with regard to the importance of original and reproduction costs is in marked contrast to those prevalent in the electric and gas utility fields.)

Two other general features are considered by the Commission, although the ICC does not specifically state that it considers them. The first is one of those imponderables that cannot be reduced to precise terms, and that is the nature and character of the management of the road. This bears on the profitability of railroad operations and affects future earnings. The administrative abuses of railroad management, particularly in the field of finance, have caused much regulatory legislation. The effect of management on the road's earnings is perhaps best illustrated by Lowenthal's acid castigation of the equity receivership of the Milwaukee in 1928.

The Commission has stated that one of the four important and indispensable factors in railroad organization is management, and that it calls for a high degree of specialization. The implication is that those who operate banks or insurance companies with a high degree of success are not necessarily those who can do the same thing with a railroad.

The Commission's attitude toward management has been endorsed by at least one court in very strong language indeed. In the Rio Grande case, District Judge Symes said:

"The new management of the property should be made up of Western men familiar with the problems of the customers living in the territory served by the railroad. Its control as in the past should not be centered in a group of financial institutions in New

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68 LOWENTHAL, THE INVESTOR PAYS (1933). This book is a "behind the scenes" exposé of the Milwaukee reorganization of 1928 under the old equity receivership procedure. This infamous case played a highly prominent part in fanning the demand for a reorganization method not subject to such flagrant abuse as the equity proceeding, and resulted eventually in the enactment of § 77.
69 Fort Worth and Denver City Ry. Co. Lease, 247 I. C. C. 127 (1941).
York City, the officers of which have never willingly ventured west of the Hudson River, and who set foot for the first time on their property when invited on an inspection trip by the Trustees.\(^7\) (Italics added).

The matter concerns the equity, because at least in theory the equity is the management; and the Commission's feelings on the subject must bear at least indirectly on their attitude toward the equity's participation in reorganization.

Consideration may also be given to taxes;\(^7\) to the effect of permissible rates, such as favorable or unfavorable rate differentials;\(^7\) the effect of rising costs, principally wages;\(^7\) the character of the physical facilities of the road,\(^7\) present and contemplated; and "any other relevant facts," for example, the effect of new routes available and the relation thereof to costs and earnings of the carrier.\(^7\)

From all this data, the Commission must fit together the new capitalization; a structure that will be "in the public interest" and that will be "fair and equitable," as well as adjust the rights of the security holders so as to fit the old holders into the new company within the statutory requirements.

The status of the railroad share interest in reorganizations can be appreciated only when viewed in the proper perspective, and this requires consideration not only of the judicial and administrative aspects which have been briefly outlined up to this point, but the share interest in the light of the general economic setting of the industry,\(^7\) and in the light of the internal relation of the share with the bondholders.

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\(^7\) All plans treat taxes due and unpaid as a prior claim. Taxes are a fixed charge, and as such the tax load is of necessity a part of the consideration of fixed charges in every plan, from the point of view of whether the road's earnings will support a structure having a given amount of bonded debt in excess of other fixed charges such as interest, rents, etc.

\(^7\) Rutland R. R. Reorganization, ICC Finance Docket 14635 (Submission of Plan of Reorganization) p. 20, (mimeographed; not yet published). Parenthetically it may be noted that the constitutionality of the rate differential between the North and South has been opened to serious question in Georgia v. Pennsylvania R. R., 324 U. S. 439 (1944).

\(^7\) Rutland case, note 72 supra.

\(^7\) Chicago, Indianapolis & Louisville Ry. Co. Reorganization, ICC Finance Docket 10294 (Submission of Plan of Reorganization) p. 94, citing cases. Almost all cases consider deferred maintenance.

\(^7\) E.g., the development of the Dotsero cut-off and the Moffat Tunnel in the Rio Grande case, 328 U. S. 495 (1946). This issue is a major consideration in merger and consolidation cases. See Nickel Plate Unification, 105 I. C. C. 425 (1926).

\(^7\) Corporate reorganization is in the first instance a problem of readjusting legal promises to conform to economic substance, and legal changes are dominated by economic factors. The strict priority rule is not necessarily sound economically. Field, Valuation for Purposes of Corporate Reorganization, 16 ROCKY MT. LAW REV. 13 (1943).
Let us now examine some of these economic matters that bear so directly on the problem.

II

Equity and the Bondholders

The relationship of the equity to the secured creditors in a reorganization bears some inspection, both internally, as private rights are compromised, and externally, as the ICC and the courts apply external regulation to the relative claims and rights. The problems divide themselves into: (a) the issue of management and control of the properties; (b) the shareholder as a source of capital; (c) the problem of the creditor who becomes a shareholder by exercising an option on a convertible bond, or by the ICC's allocating the junior lienor equities in the new company, where the absolute priority rule precludes him from an interest of greater dignity.

(a) It can scarcely be denied that control of the management of the road is an asset, although not of a type that can be reduced to a tangible value with ease. Under the absolute priority rule, this asset should be offered to senior claimants before it is tendered to the stockholders, yet it has been noted that this procedure was not followed in many major receiverships, such as the old equity receivership of the Milwaukee and more recent cases where the controlling interest in the debtor was another railroad. Where the ICC has found the equity to be of no value, the result has been, in theory, to unseat the old controlling interests. But there is nothing to prevent bondholders from leaving control of the road in the hands of the pre-reorganization management. Undoubtedly a substantial proportion of the tremendous pressure directed towards the salvage of the equity in reorganization emanated from sources which were in a position to exercise control, rather than from those who have had an altruistic concern for the small shareholder.

A major factor, therefore, has been the tenacity with which management in the saddle resists ouster. Among the evils of the old equity procedure that Section 77 was designed to prevent was the elimination of obstructive litigation on the part of junior interests. The “cram-down” provisions were partially directed toward this end. However, the obstructive powers of the stockholders could not be automatically

77 The views of the Commission on stock control are noted specifically in Nickel Plate Unification, 105 I. C. C. 425, 444 (1926). For a general discussion see Frederick, Herring, and Hynes, Regulation of Railroad Finance, c. 2, The Acquisition of Control of Carriers (1930).


eliminated, and it is quite likely that in many of the plans, concessions are made to the equity in exchange for forbearance in opposing the plan.\(^8\) These concessions do not necessarily appear as such at the time the plan is submitted.\(^8\)

(b) As a source of capital in providing new money, the stockholder has been largely replaced by the Reconstruction Finance Corporation. When the old stockholders constituted the only source of funds, their participation, although a clear violation of the absolute priority rule, was dictated by expediency and condoned by the courts.\(^8\) Under Section 77 proceedings, however, dissenting creditors need not necessarily be bought off with cash;\(^8\) also the road is freed of meeting its fixed charges in cash while in reorganization. However, in times of depression such as the 30's, which are the times when railroads fail, a real question exists as to the possibility of securing funds from the equity. That they \textit{would} pay an assessment is tenuous; and whether or not they \textit{could} pay is a matter of conjecture. The argument that the equity should participate because it constitutes the only source of new money rests on a dubious rationale.

(c) The creditor who becomes a co-owner presents a problem concerning strictly legal rights. It also has certain social implications. The chief method by which the creditor becomes a shareholder is by receiving stock in the new company as compensation for a bond held in the old. It applies generally to holders of junior issues secured by divisional mortgages, who, in the determination of the Commission, are too low in the priority scale to receive a portion of the secured issues of the reorganized company. The Supreme Court, quoting with approval the Commission's statement that "it is of great importance that a completely unified system be created through the reorganization and that the capital structure be not complicated by numerous mortgages,"\(^8\) has found no constitutional bar to the conversion of debt into stock by this

\(^8\)"Reasons for making concessions to stockholders are many and various . . . " (citing many others). Dodd, \textit{The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganization}, 38 Col. L. Rev. 223 (1938).

\(^8\) It has been noted that "In a great railroad, if a man's directors are already in possession, 10\% is practical control. . . . Experience has demonstrated that you cannot dislodge them, even where gross mismanagement is proven." \textit{Hearings before House Judiciary Committee on the Clayton Act}, 63d Cong., 1st Sess. Vol. 1 p. 820 (1914), as cited in \textit{Regulation of Stock Ownership in Railroads}, H. R. Rep. No. 2789, 71st Cong., 3d. Sess. I, 44 (1931).

\(^8\) Kansas City Term. Ry. v. Central Union Trust Co., 271 U. S. 445 (1925); see Spaeth and Winks, \textit{The Boyd Case and Section 77}, 32 Ill. L. Rev. 769 (1938).

\(^8\) See note 79 supra.

method. Thus, the pages of guarantees and the fine legal exposition of the security contained in a 250 page indenture is inevitably, in a reorganization, compromised by the pressure of economic realities, and the lender of money, who in the first instance bargained only for the purposes of obtaining an investment return, finds himself as owner of the properties. Carried through several reorganizations, as in the case of the Western Pacific, bondholders once firmly entrenched can be ushered right out to the street by the process of reducing their claims in this manner—from bonds to lower grade bonds to stock to "no value in the equity."

The alternative, however, is a perpetuation of a structure that almost certainly will lead to another bankruptcy. Refusing to sanction complex new structures requires occasional variations from the absolute priority doctrine to fulfill its spirit. A further factor that must be considered in the debt-into-stock conversion is the possibility that control of the road will shift to the hands of competitive roads or into financial circles; a circumstance not favored by either the ICC or the courts.

The other method by which debt is transformed into equity is at the holder's option. The issuance of convertibles in reorganizations is surely aimed at the goal of an increasing dependence on stock as

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85 Allocation of convertibles and other inferior issues to satisfy first priority claims is not necessarily a violation of the absolute priority rule. On this point, known as qualitative preference, as distinguished from quantitative preference, see Erie R. R. Co. Reorganization, I.C.C. Finance Docket 11915 (Submission of Plan of Reorganization) p. 105 (1941), listing a collection of cases in the courts which approve the concept. In other words, different classes of old security holders may be offered different amounts of the same class of new securities without violating the absolute priority rule. See Consolidated Rock Products Co. v. DuBois, 312 U. S. 510, 528 (1941).

86 "The refunding and improvement mortgage is a lien on all the properties covered by the Erie First Consolidated mortgage, the Erie general mortgage, the Erie & Jersey first mortgage, and the Genesee River first mortgage subject to the liens of those mortgages and to all mortgages underlying those mortgages." Erie R. R. Co. Reorganization, I. C. C. Finance Docket 11915 (Submission of Plan of Reorganization) p. 31 (1941). A Philadelphia lawyer would despair of tracing the security underlying each issue.

87 See the institutional investor, discussed in the text at p. 551.

88 The recurrent reorganizations of the Milwaukee, the Rio Grande, and the Georgia & Florida, are good examples of the result of perpetuating a structure having fixed charges that cannot be supported by earnings.


90 "But the fact is that public authorities do recognize in the bonded debt a financial claim against the public superior to that of the stockholders, regardless of the fact that the latter has made an equal contribution to the common cause—indeed is often a former bondholder who has been converted into a stockholder against his will." Movitzon et al., The American Transportation Problem 294-95 (1933). The Commission, in the Nickel Plate Unification case, 105 I. C. C. 425 (1926), indicated disfavor of any plan in which those who control the road do not have a substantial beneficial ownership. For specific disapproval of voting trusts see Chicago, Milwaukee & St. Paul Reorganization, 131 I. C. C. 673, 697 (1928).
a means of finance, and a move away from the rigidities of the fixed interest bearing, definitely maturing bond. A possible objection from existing shareholders that the exercise of the option by bond holders dilutes the relative share of ownership can be answered by a reminder that any diminution of the debt increases by that amount the interest of the stockholders in the company. In voluntary adjustments, where the cumbersome legal "remedies" of equity procedure or Section 77 are not invoked, it is management—the equity—that promulgates the plan, so it is unlikely that the plans will alter the stock interests. The new Railroad Adjustment Act has now specifically sanctioned this procedure.

A common justification for issuing securities with the conversion feature is that this right aids in marketing the bond. However, an income debenture that failed to earn its charges would hardly be an attractive investment from the point of obtaining dividends, and, conversely, if the interest was covered and the income maintained, the conversion feature would offer little incentive, unless the equity was receiving fat dividends—a prospect, which, in the capital structure theory of the Commission is not likely. I know of no case where the equity's control has been materially altered by voluntary conversion of bonds into voting stock. Most convertible issues have various restrictions with respect to the voting rights of the securities after conversion.

Equity and the Investor

The railroad share has alternated as whipping boy and as court favorite in the investor's fancy. From the wild gyrations of rail equities in the great building periods preceding and following the war between the states, and the even wilder gyrations characteristic of the days when the rail barons were forming the great systems of today, rail stocks have lost practically all of their gaudy speculative appeal as the industry has matured and as security regulation has increased. Railroad

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91 For a discussion of the investment characteristics of railroad convertibles, see GRAHAM & DODD, SECURITY ANALYSIS 284-329 (2d ed. 1940).
92 See text at p. 564.
93 Elaboration of this point is found in Will, The Voluntary Adjustment of Railroad Obligations, 7 LAW & CONTEMP. PROB. 519, 526-27. (1940).
94 See text at page 539.
95 For an excellent general reference for the investor in reorganization securities, see PALMER, INVESTMENT SALVAGE IN RAILROAD REORGANIZATIONS, (1938).
96 The classic example was the fight between Hill and Harriman for control of the Northern Pacific. At one time the common stock touched $1000 per share. In earlier days, the manipulations of Erie and New York Central stock caused tremendous price variations on the Exchange. Numerous other accounts are available of these dramatic struggles.
stocks have had investor appeal through the years because of their high degree of leverage, due to the disproportionately small amount of shares to the amount of bonds and senior securities inherent in most of the rail capital structures. Thus, in periods of high business activity, earnings flow rapidly to the equities, conversely, in depression the leverage factor operates in reverse and income available to shareholders vanishes rapidly.

From the investor's point of view, railroad reorganization has in the long run been beneficial to railroad equities, but this result has been reached by a cure that many will assert is more painful than the malady—millions of dollars of stock found to have no value, millions of dollars of hard-earned funds wiped out in the bankruptcies. The only justification for this can be seen in merely stating the alternative—perpetuation of top heavy capitalizations, and the years when the shareholders would reap only a harvest of barren regrets. With the drastic reduction of fixed charges that come prior to dividends, the common and preferred shares of reorganized companies have a proportionately greater opportunity of participating in the distribution of available funds, a result that is surely in the interests of the shareholders, the roads themselves, and the public. It is the rather ruthless method whereby this result is achieved that has been the target of bitter opposition. Yet the ICC expresses concern over small investors.

With the long term trend of personal income taxes moving in the direction of higher and higher limits, profits from stock holdings have lost some of their attractiveness. So called "double taxation" of dividends operates in such a way that I doubt if the rate of return on shares represents much more in the form of "take home" income than the yield on a high grade bond. The investor is confronted with a conflict of public policies which is in no way resolved—the demand and need on one hand for heavy taxation of corporate profits and increasing demands on individual taxpayers; and the Commission policy—approved by the courts—of increased rail financing by the use of the share. Interest on bonds may be deductible, while dividends on stock are taxed, not once, but twice.

97 "Investors, particularly in bankrupt properties, should bear in mind that good credit is essential to railroad success. They have more to hope from a reorganized property which can face the future with good credit prospects than from one which gives greater paper recognition to their claims at the cost of a sound financial structure." Eastman, Transportation Problems and Suggestions toward a Constructive Solution, 17 Acad. Pol. Sci. Proc. 239 (1938).

98 This view was strongly endorsed, in effect, in Consolidated Rock Products Co. v. DuBois, 312 U. S. 510 (1941).

99 "There is a market for railroad securities among small investors today. Nothing should be done to destroy this market or the machinery of distribution by which it is reached." In re Competitive Bidding in Sale of Securities, 257 I. C. C. 129, 147 (1944).
The leverage factor mentioned previously works to the disadvantage of the non-expert investor for a high per-share return can conceal the unsatisfactory basic condition in the industry. This is important for rail shares are very widely held indeed. The small investor, who in the final analysis knows little or nothing about the economies and financing of railroads, finds himself owner of a worthless bit of paper, when the equity is deemed valueless in a reorganization. This produces a sort of mass "I've been swindled" attitude that eventually takes the form of pressure for legislation to alleviate their plight. And yet it is the equity, at least in theory, that manages the road and is responsible for contracting the very debts that eliminate their interest, through excessive bond financing. Regardless of the illogic of their claim, their attitude cannot be dismissed, for when the roads wish to finance with stock, the market for rail shares will be ultimately in the hands of the little fellow.

The institutional investor deserves special mention because of the peculiar income requirements necessary to institutional enterprise. Statutes prohibit insurance companies and banks from investing in equities at all, or require equity standards that the rail shares cannot possibly meet. Their investments demand first of all security, and secondly, an orderly income due to the requirements of the long term contracts of the insurance companies themselves. From this, Moore concludes that by seeking to obtain greater stability than exists in speculative business investment, the institutional investors have furnished a ready market for fixed income securities that railroad managements could not afford to ignore.

The institutional group are faced with serious complications if they hold contingent interest bonds or stocks in lieu of original fixed interest obligations, after the reorganization. They presumably do not purchase bonds for the purpose of acquiring railroads as they are not in the railroad business.

The railroads themselves have indulged in practices that would put them in the category of institutional investors by purchasing their

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100 See text at p. 564.
101 On purely logical grounds, these claims should be dismissed under the absolute priority rule. But the "... conception of fairness in reorganization plans as a matter susceptible of determination according to clear cut rules about legal priorities is an unrealistic one." Note, 39 Col. L. Rev. 1030, 1031 n. 4 (1939).
102 MOORE, THE REORGANIZATION OF RAILROAD CORPORATIONS 76 (1941).
103 "Securities dependent upon income for their return, or securities of like character, cannot be held and they must be disposed of." Testimony of F. N. Oliver, counsel, National Association of Mutual Savings Banks, Hearings before Committee on H. R. 6249, 74th Cong., 1st Sess. 108 (1935). Cf. Garbutt, Vicissitudes of Railroad Credit, 83 TRUSTS & ESTATES 243 (1946), (relation of railroad credit to trustee's investments).
own shares in the market during reorganization. This practice was carried to such an extent that even the President felt called upon to castigate it. Railroad's buying in their own bonds present certain special problems, not the least of which is the improvement of the stockholder's relative position at the expense of the secured creditors, when the bonds are bought in the market at a price far below par.

Economic Aspects of the Capital Structure

Within recent years the rationale of regulation has undergone a shift; first from a fear of overcharges to support an excessive capitalization; then to a fear for the maintenance of adequate transportation; and currently to concern over the part played by the financial structure as it affects the general economic plight of the roads. As system after system has been drawn into the bankruptcy vortex, the evils of fixed charges have become recognized as being the chief causative agent. This realization leads in the direction of complete financing by means of equity issues, producing a structure with no bonded indebtedness. Except in cases where the road has only the poorest prospects of earnings, the elimination of all fixed debt in the capital structure is a practice of debateable merit. With judicious utilization of bonds, the equity may earn a return above the service on debt through the use of capital furnished by bondholders.

While it is perfectly apparent that the soundness of the capital structure of a railroad cannot be appraised effectively solely by inspection of the ratios of stock to bonds or the ratio of these securities

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104 Testimony of M. J. Cleary, President, North Western Mutual Life Insurance Co., Hearings before Committee on H. R. 6249, 74th Cong., 1st Sess. 88 (1935). Lowenthal's exposé of the part played in the Milwaukee reorganization of 1928 by the National City Bank of New York, however, casts considerable doubt on the piety of such assertions by the institutional investors.

105 93 CONG. REC. 543 (1947). For analysis of this practice in the utility field, see Note, Participation in Reorganizations under the Public Utility Holding Company Act of 1935 of Preferred Stock Purchased by Controlling Interests During Reorganization Period, 10 GEO. WASH. L. REV. 979 (1942). Here, controlling shareholders acting as reorganization managers are held to a fiduciary duty, and the SEC may deny fees as a deterrent to breach of such duty—an admirable schema. Cf. SEC v. Cheney Corp., 317 U. S. 80 (1943).

106 See Swaine, The Purchase by Railroads of Their Own Obligations, 7 LAW & CONTEMP. PROB. 532 (1940).

107 Note, Distribution of Securities in Corporate Reorganization, 51 YALE L. J. 85 (1941).


109 E.g., Chicago Great Western R. R. Reorganization, 228 I. C. C. 585, 630 (1938). Commissioner Mahaffie, dissenting in part, states flatly that "The carrier is in trouble because of its fixed charges." Id. at 630. For the effect of this on service, see text at p. 538

110 The Commission's plan for the Rutland is a case in point.

111 GRAHAM & DODD, SECURITY ANALYSIS 99 (2d ed. 1940).

112 See LOCKLIN, THE ECONOMICS OF TRANSPORTATION 611 (1938), for merits and disadvantages of the stock-bond ratio as a measure of debt burden. GRAHAM & DODD, SECURITY ANALYSIS 547-52 (2d ed. 1940), gives optimum ratios from the investment point of view.
to total capitalization, these ratios are nevertheless of material aid in comparing the railroad capitalization with established standards of the theoretical optimum structures investment analysts have determined to be sound. For example, Graham and Dodd state that railroad debt should not exceed that amount upon which fixed interest charges cannot be earned at least twice. Concurrently, the minimum ratio of stock value to bonded debt (stock-value ratio) is shown as $1.00 of stock to $1.50 of bonds.\(^\text{113}\) It is interesting to note how these tested investment standards compare with the 36 reorganized roads studied by the writer.\(^\text{114}\) The fixed charges times interest earned figures before reorganization for the best years of rail earnings prior to the war averaged 1.70, whereas Graham and Dodd indicate a figure of 2 to be the safe minimum. The Monon, with a coverage of 2.02 and the Wabash, with a coverage of 2.12, are the only two roads that subsequently faced bankruptcy that had their fixed charges covered at least twice. The theoretical minimum coverage suggested by Graham and Dodd is highly accurate when applied to the statistical facts of railroad earnings. The bankrupt roads failed to earn the minimum safe coverage by an average margin of about 15\%.

In contrast to the "ideal" ratio of $1.00 of stock to $1.50 of bonds, the average of the 36 roads prior to reorganization was $1.00 of stock to $1.81 of bonds, or 20\% in excess of the minimum safe standard.\(^\text{115}\)

It is strikingly apparent that had the equity been more rationally represented in the structures of the reorganized roads such widespread disparities from the safe "standard" would not have existed and such reorganization would have been unnecessary.

Thus far we have been concerned with the railroad share and reorganization from what may be termed the "internal" aspects; an outline of the applicable law, the capitalization and its effect, the relationships between the equity and other investors and security holders. Behind all this lies the larger problem of railroad economics. When all is said and done, the holder of railroad equities, whether the road is solvent or in reorganization, will have his lot determined not by legislative fiat operating through commissions, not by adjusting his

\(^{113}\) Graham & Dodd, Security Analysis (2d ed. 1940).

\(^{114}\) See table at the end of this article.

\(^{115}\) It should be noted that Graham and Dodd use the market value of the stock in determining their ratio, and the table states the par value, hence the comparison is not exactly parallel. However, use of the par or stated value in setting up the ratio is more conservative. The market values of the reorganization shares were drastically lower than their face value. Had the market value been used in the comparison, the ratio would indicate a radically greater divergence from the minimum standard, possibly as high as 100\% excess of bonds to the stock, instead of the 20\% indicated by the more conservative use of face value.
status with respect to his fellow security holders, and not by decisions of the Supreme Court. It will be determined by the economic condition of the roads themselves as a part of the national transportation system. Accordingly, certain key postulates are apparent:

1. The equity holder in a road emerging from reorganization should face the fact that a real possibility exists that the railroads will never again have the potential earning capacity they once enjoyed. The complex of reasons that has resulted in this situation is relatively unimportant except insofar as the equity can profit from hindsight and, through management, attempt to prevent a reoccurrence of the conditions that have caused the industry to suffer its economic decline. The roads may be able to regain their relative competitive position through skilled generalship, but the factor over which the equity exercises only negligible control is the rising floor of costs, chiefly material and wages, and the stable ceiling of rates, which the shipping public wants, understandably, kept down. With the opportunity for profit margins thus narrowed, the impact of a rigid debt structure can have fatal results, even if traffic does not decline. Aside from liberalizing capital structures, this issue can be partially met by increased rationalization of existing plant.

2. Rationalization of the existing plant does not imply Socialism or nationalization of the railroads, but it does imply economic integration of existing facilities to eliminate wasteful duplications and to avoid intra-railroad competition of the internecine type. Services which inherently can best be performed by competing forms of transport should be abandoned by the road and efforts made to attract new traffic from existing sources. The financial success of the German system before the advent of the Nazis shows that rationalization has a direct bearing on the return to both senior and junior security holders. The rationalization of the British lines resulted in the public of England having the most completely integrated transportation systems in the world.


117 "And this competition . . . consists largely of taking tonnage from each other, and then taking it back." Sturgis, Transportation Development in the United States, 17 ACAD. POL. SCI. PROCS. 215, 222 (1938). Cf. NATIONAL RESOURCES PLANNING BOARD, TRANSPORTATION AND NATIONAL POLICY 15 (1942). Duplication of terminal facilities is a frequent example of the former, and the use of exorbitant rentals for trackage rights illustrates the latter.

118 Hutchins, in class lectures in economic and business history, Cornell University (1947). Prof. Hutchins asserts that had Britain's transportation system been as poorly integrated as ours, it could never have done the job demanded by the war, under conditions of great shortages and extreme congestion, and might well have resulted in a supply collapse that could have caused her defeat.
(3) Both the stockholders and creditors of our railroads must recognize that our national transportation policy, which is slowly emerging from the planning stage to the action stage, will result eventually in a degree of rearrangement of traffic and services adversely affecting incomes of some individual roads in the interests of an over-all increase in the efficiency of our transport system as a whole. The National Resources Planning Board made an analytical survey of our transport system, and in its report the Board indicated its concern over the problem:

"This multiplication of overlapping services in fields of doubtful economy must, in the aggregate, account for a considerable inflation of transportation cost above that which would result from a more economic division of traffic.... The roads as a whole have not gone far enough in investigating new devices and improving purchasing, marketing, and operating methods. There is clear need for development of a stronger cooperative spirit in the railroad industry which will seek the solution of outstanding problems on an industry basis, rather than from the restricted point of view of individual carriers. It is certain that the traditional policies of railroad finance do not fit the needs of the present." (Italics added).  

It would be gratuitous to cite the numerous instances in which the ICC has made it clear that precisely these matters are of major importance in the thinking and approach of the Commission, and particularly in the cases of reorganization of marginal roads.  

The American system of transportation is governed on the economic theory of regulated competition, in contrast to the control of public service utilities, which is based on the theory of regulated monopoly. An obvious incongruity in the transportation theory is the fact that the railroads are placed at an economic disadvantage through the policy of public subsidizing of competing forms of transport. All forms should be put on the same basis, preferably the user basis. The roads, as taxpayers, contribute to competing agencies that then use the money to take business away from the roads—a fact that the railroad in-

119 NATIONAL RESOURCES PLANNING BOARD, TRANSPORTATION AND NATIONAL POLICY 7-8 (1942).
120 E.g., Associated Rys. Acquisition, 228 I. C. C. 378 (1938).
121 OWEN, NATIONAL RESOURCES PLANNING BOARD, TRANSPORTATION AND NATIONAL POLICY 277 (1942). In the same publication, R. L. Dewey comments on subsidies to competing forms of transportation in his article, Government Ownership and Operation of Railroads: "If, in fact rail earnings and credit are jeopardized by transport subsidies, it may be true that the only feasible alternative to an impaired rail position is nationalization." Id. at 279.
122 "An economic division of traffic between different forms of transport cannot be brought about if a part of the costs of some transportation agencies is borne by the taxpayer." LOCKLIN, THE ECONOMICS OF TRANSPORTATION 852 (1938).
industry never tires of pointing out. This puts the investor in the absurd
position of a man who is buying an ownership equity in a business and
by so doing indirectly contributes funds to agencies actively operating
to reduce his investment's earning power. Similarly, the creditor lends
money that is partially used to undermine the value of the loan's col-
lateral security. Further, the relative impact of taxation on rail-
roads as compared with other carriers has been terrific.

Of particular significance to the shareholder of a bankrupt road is the
fact that taxes accrued and unpaid constitute, obviously, an obligation
which must be met before the residuum (if any) can be allotted
to the equity. Taxes are, therefore, a factor in determining whether
or not a value exists in the equity for purposes of participation.

**Railway Credit**

These considerations lead to a major economic problem of the rail-
roads, and of railroads in reorganization in particular: the maintenance
of railway credit. The cost of long term money to the industry is a
good indication of what the money market thinks the value of the earn-
ing power of the roads will be in the years ahead. What will this cost
be? It is governed by two factors: the earnings prospects of the indus-
try, and the policy of the Government that interest rates shall
remain low. From a study of the problem one economist has concluded
that if government interest rates remain around 2%, new railroad
bonds should average around 4%. He predicts that foreseeable net
earnings will be sufficient to attract private capital unconditionally to
finance equipment by equipment trust certificates; a probability that
only the stronger carriers can sell bonds; and that low profits will
preclude any substantial proportion of finance by sale of equities.

These conclusions raise serious implications in connection with the

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123 A sad paradox indeed. Yet, for air transport, at least, military necessity dictates
a strong air transport system based ultimately on the commercial lines, and in order to
maintain the commercial system, some form of subsidy appears essential.
124 See Stevens, *op. cit. supra* note 35 at 175-83 for detailed discussion; Moulton et.
125 E.g., New York, N. H. & H. R. R. Reorganization, 257 I. C. C. 9, 27 (1944); Min-
126 In 1940, the Central of New Jersey earned only 69% of the New Jersey taxes
assessed on its properties. In other words, if all of its earnings had been applied to taxes
alone, the road would still have been shy 31% of meeting its tax bill, let alone meeting
annual interest charges. Under such conditions, bankruptcy for the Central was a guaranteed
certainty.
127 See text at p. 537.
129 Ibid.: "Net profits of most companies are not likely to be large enough to tempt
any but the most speculative investors." Yet stock issues should be the chief reliance of
railroads for new capital, according to Moulton et. al., *The American Transportation
Problem* 294 (1933).
source of railroad credit. A possible straw in the wind was the inability of the solvent Delaware & Hudson to float a $50 million issue in 1945 at competitive bidding. Only one bid was received for issues of four other roads, including two carriers only recently reorganized. The ICC was moved to say, "This experience suggests that the present available underwriting capital in this country is hardly sufficient to afford effective competition on a very large issue." This certainly alludes to the possibility of obtaining funds from outside private means. The only other source is the Government. While the Government has aided the roads before, there is a decided division of opinion as to the advisability of such a policy today, and it is not at all clear how this matter will be resolved when the roads are confronted with it on a large scale. While speaking of public attitudes, it should be noted that the Commission is well aware of the sensitivity of railroad credit to public reaction on issues pertaining to financial matters of the roads.

The great imponderable with respect to rail credit is, of course, that much depends on what the investing public thinks about the credit risk of the roads, rather than what the risk actually is in terms of Dun and Bradstreet. As long as the public buys rail issues readily, rail credit is good. And, of course, the roads do not perform in an economic vacuum, but reflect the general business level, and the rails' credit is related to business credit in industry.

One specific method of strengthening rail credit is in making railroad capital structures more flexible. The Commission has been very careful in Section 77 reorganizations to insist upon this, as shown by the more balanced structures that have emerged, the increasing use of income bonds and other contingent charges. Moulton's study concludes that new capital for the roads should be acquired chiefly by the issue of stock. Stevens advocates the use of participating bonds.

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130 57 ICC ANN. REP. 27 (1943).
131 For ICC policy on competitive bidding, see In re Competitive Bidding in Sale of Securities, 257 I. C. C. 129 (1944), and 58 ICC ANN. REP. 15 (1944).
133 E.g., at a recent hearing on a bill to amend § 77 the following ensued:
Q. "Are there any specific roads, or any specific maturities that make it imperative that this bill be passed at once, Mr. Mahaffie?"
A. Commissioner Mahaffie: "I think you will have some testimony from individual railroads that feel the need of the bill. I would hesitate, if you will permit me, to attempt to name the roads in need of relief at this time, or that may need it later. I would hesitate to do that because of the possible effect on their credit."
134 Moulton et al., THE AMERICAN TRANSPORTATION PROBLEM 294 (1933).
135 Stevens, Railway Financing, 1890-1940, 194-95, NATIONAL RESOURCES PLANNING
provisions, convertible features, and limitations on accrual of interest that cumulative issues are entitled to, are all methods pointed in the direction of liberalizing the structure and improving credit. New legislation is directed in part towards the same end, without resorting to the cumbersome bankruptcy reorganizations under Section 77.138

The Public Interest

The courts and the ICC consider every phase of a reorganization from the primary approach of the public interest. The connotations of that term are as familiar as a precise definition is impossible.137 By and large what is in the public interest in railroad reorganizations is in practice what the ICC says it is. The basic consideration is, of course, the maintenance of a swift, efficient, dependable transportation service to the greatest number of people at the lowest cost consistent with the achievement of this goal.

Two points remain to be clarified: first, if heavy bond finance is not in the public interest, why have the roads persisted in this type of financing; and secondly, does the elimination of the equity in so many reorganizations support the conclusion that the ICC is partial to the surrender of railroad properties to creditors at the expense of investing ownership? Locklin states five reasons for the large proportion of borrowed capital to invested capital.138

(1) The advantageous marketing conditions which exist for sale of bonds to the institutional investor. Stocks are not legal investments for institutional groups in most jurisdictions.

(2) Borrowing necessary capital is profitable: an addition may earn 12% on the additional capital needed to finance it, and if this capital can be obtained for 4%, the equity is that much ahead.

(3) Legal obstacles prohibiting the issuance of stock below par force the roads into bond issues.

(4) Bonds, especially collateral trust bonds, facilitate the acquisition of control of other carriers. The proceeds can be used to purchase the stock of the road to be acquired.

(5) It is easier to retain control of other roads. When new capital for the subsidiaries is needed, bonds provide it and the controlling

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136 See text at p. 564.
137 Moore, The Reorganization of Railroad Corporations 156 (1941): Indeed, “A philosopher might very humbly shirk the responsibility of determining what is the public interest.”
138 Locklin, The Economics of Transportation 610 (1938).
company need not put up money to purchase voting shares as it would in financing by a stock issue.

To these factors, Moore would add:

(6) "Complacent acceptance" of bond finance has been due to the ideology of the quasi-guaranteed fair return, based on the fiction that rail capital was essentially immutable—the ideal investment for widows and orphans.

(7) This fiction encourages trading on the equity, because of the great gains possible through the leverage provided by a small proportion of stock.

(8) Finally, Moore ascribes "the most pernicious combination of circumstances which encourage bond financing of railroads is that . . . it does not dilute control over the property, and (in effect) does not disturb control when the bonds are defaulted upon." The same management stays on.

Whatever the reasons are for such top-heavy financing methods, it is perfectly apparent from the study of 36 reorganizations that the Commission is well aware of the dangers inherent in this practice, and that new capital structures will not be permitted if they are heavily "bonded."

A fair question arises: The Commission has the exclusive power to regulate the sale and issuance of securities by railroads. And it has had the power for twenty-eight years, charged with the responsibility of seeing that the issuance of securities will be in the public interest. Now, if the Commission feels that the debt-ridden rigidity of railroad structures was a proximate cause of so many bankruptcies, how is it that the Commission itself has authorized, in the public interest, the issuance of so many securities of a character that causes the rigidity? True, much of this debt represented refunding operations at more favorable rates of interest, and of debt piled up prior to Commission jurisdiction over rail issues. But this is not entirely convincing; nor does it explain permitting the Wabash to issue $17 million worth of 40 year income bonds unbacked by a sinking fund—a radical departure from announced policy; or the approval of issuance of $11 million of fixed interest bonds to furnish new money in the Rock Island reorganization. The complacency of the Commission in permitting fixed debt to be issued may have been partially responsi-

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140 Id. at 164. The most striking example is the Milwaukee equity reorganization of 1928.
ble for subsequent financial stringencies of the roads, but the roads themselves initiate proposals to market securities—and the type of security they wish to market. ICC approval does not mean the Commission is guaranteeing the bonds and is substituting its business judgment for that of management. Nonetheless, the Commission ought to justify its actions. Would it not be “in the public interest” to do so? The accusation has been that the Commission is pervaded by a “debtor philosophy.” But the charge that the ICC exhibits certain partiality to bondholders at shareholders’ expense, from the treatment accorded the equity in past reorganizations is, I believe, without merit. At various times the Commission has said:

“We are of the opinion that the best interests of the public and the security holders will be served by an early return (of the properties) to private management.”

“It should be borne in mind, I think, that the system of private ownership and operation of railroads will not in the long run work successfully, unless the stockholders, who are responsible for the managements, have a real interest in the properties and are able to derive a reasonable profit therefrom. . . . I believe that we should either go in for public ownership and operation or play the game of private ownership and operation according to the rules.”

Numerous other instances might be cited. While the Commission has not hesitated to declare the equity valueless, it is evident that it does so with reluctance.

The overriding public interest is the maintenance of service. The effects of excessive debt finance are most apparent in service. In the desperate effort to meet the charges and maturities as they occur, expenses for operation are cut to the bone. Deferred maintenance piles up, service is curtailed, and every penny over the actual costs of operating is poured into the fixed charge payments. This starts a vicious cycle; service deteriorates to the point where shippers become disgusted, traffic falls off, and service is then further curtailed. The evil day is only postponed, and when it comes the property is sometimes little

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145 See note 31 supra. However, the impartiality and fairness of the Commission is universally conceded. It is probably the only major administrative agency that has escaped accusations of partisanship, fraud, or collusion.
148 E.g., Chicago, Milwaukee & St. Paul Reorganization, 131 I. C. C. 673, 697 (1928); Nickel Plate Unification, 105 I. C. C. 425, 444 (1926).
149 Noted long before the advent of § 77. See Bonbright, Railroad Capitalization 38-43 (1920); Dagget, Railroad Reorganizations (1908).
more than junk. President Barriger of the Monon, figures that $50 million will be needed to remake the properties into a first-class system. The significance of this figure is that the Commission's Bureau of Valuation reported the entire cost of reproduction new of the properties to be about $47½ million.

The effects of excessive bond finance can be summed up as follows:

1. the physical deterioration of the properties reaches alarming proportions, necessitating huge rehabilitation expenditures;
2. reorganization is only postponed; interest arrearages and principal defaults continue to mount;
3. the value of shareholder's equity is reduced to zero;
4. service to the public reaches rock bottom. Whatever else is said about reorganizations and the Commission, financial structures fostering these conditions will not be approved regardless of the size of injury or financial loss to any particular group, and quite properly so.

The losses to every group—creditors, investors, shareholders, the public—reach a scale so appalling that Stevens has computed the investor loss in 25 reorganizations in the period 1938-40 alone at over $3.5 billion, and total market value losses in the period 1929-38 at over $20 billion. Surely if the public interest demands anything, it is that such situations not occur in the future.

**Utility Recapitalizations**

The suggestion has been made that the ICC should be more definitive in its consideration of reorganizations, and that it would be helpful to counsel in particular and the public generally to have some idea of its policies. Reference is made to the SEC and its announced prac-

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160 The Monon, the Minneapolis and St. Louis, and the Frisco are fine examples. See Moore, _The Reorganization of Railroad Corporations_ 70 (1941).
162 Monon reorganization, p. 94.
163 In connection with the elimination of fixed interest bonds, it is well worth noting the words of the district court judge in commenting on the plan: "This problem directly involves the question as to whether the plan is compatible with the public interest. . . . All fixed interest charges which now aggregate $1½ million are eliminated. If the property should again be in need of judicial reorganization it will not be because of its inability to earn interest charges created or preserved by this plan." Igoe, _In the Matter of C. I. & L. R., I.C.C. Finance Docket 10294_ (1941).
164 Stevens, _op cit. supra_ note 35 at 171-72.
165 Especially vigorous criticism has come from the reorganization bar. One authority feels that the ICC should follow the custom of the SEC and "chart" principles that counsel might rely on. See Swaine, _Present Status of Railroad Reorganizations and Legislation Affecting Them_, 18 N. Y. U. L. Q. Rev. 161 (1941). Part of the difficulty he charges to § 77 in that it does not adequately distinguish between questions affecting the public interest, such as aggregate capitalization and questions affecting private rights of security holders. The former fall within the administrative jurisdiction, and the latter within the judicial realm.
tice of furnishing reliable guideposts, particularly in cases involving recapitalizations under Section 11 of the Public Utility Holding Company Act. There can be no doubt that these criticisms have merit, but I would object to the comparison of SEC and ICC practice in this respect:

First, a true basis of comparison between railroad reorganizations and utility recapitalizations under the PUHCA is difficult if not impossible. No common denominator can be found between Section 11 and Section 77. Fundamental differences exist in the purposes of the two acts. In the one case, legislative fiat has decreed that the profits of a healthy enterprise be divided, and the enterprise operated henceforth as a group of smaller units; in the other, the idea is to salvage the skeleton of an enterprise which has been driven to the wall, insolvent and bankrupt. The former is a banquet, and the latter a breadline.

Secondly, compared with railroad reorganizations, there are few utility failures. Most railroads that fail are operating companies; the big utility failures have been holding companies, such as the Insull empire. The utility business has been extremely profitable, from the income of operating companies. They have been riding a rising market since their inception, and the trend is continuing. The railroads are in no such position, nor is their future as secure. The utility problem is to limit income to the rate of fair return—a stage the railroads passed long ago. The problem of the railroads today is to earn the return they are legally entitled to, not to figure out some method of keeping income down to the legal rate.

Finally, in the railroad industry the earning capacity of individual

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156 Although the SEC is not bound by settled judicial precedents in evolving standards of fairness and equity, SEC v. Chenery Corp., 317 U. S. 80 (1943), it has adhered firmly to the absolute priority rule from the first, up to the United Light and Power case, Oils & Con. SEC, 323 U. S. 624 (1945). See SEC report in the matter of Penn Timber Co., No. B-23063 (1939), and an article by Swaine discussing generally SEC philosophy, Democratization of Corporate Reorganizations, 38 Col. L. Rev. 256 (1938). Rebutting Swaine, see Weiner, The Securities and Exchange Commission and Corporate Reorganization, id. at 280.

157 PUHCA was passed by Congress to provide protection for investors in public utilities and their subsidiaries. Creditors' rights were not the primary issue, as in § 77 reorganizations. See Note, Recapitalizations Under Section 11 (g) of The Public Utility Holding Company Act, 49 Yale L. J. 65 (1939). Cf. Dodd, Investor Protection by Administrative Agency: The United States Securities and Exchange Commission, 5 Mod. L. Rev. 174 (1942).

158 The strategic position of the common stock in a solvent company cannot be ignored. Note, Recapitalizations Under Section 11 (e) of The Public Utility Holding Company Act, 49 Yale L. J. 1297 (1940). This is surely another matter in railroad bankruptcies. In voluntary reorganizations, preferred shareholders were given assurance that some feasible method would be devised to protect their interest. 49 Stat. 814, 815 and 822 (1935), 15 U. S. C. §§ 79 f (a), 79 g and 79 k (e) (1946). See Note, Rights of Cumulative Preferred Shareholders under PUHCA, 52 Harv. L. Rev. 1331 (1939), indicating SEC preference for common over preferred. However, once issuance of preferred is condoned, its rights will be protected. ICC exhibits no particular partiality in this respect.
roads shows enormous variations. At one end of the scale is the Pennsylvania, which, up to 1946, had showed a profit in every year of its century-old history. At the other end have been roads like the Erie, the Rutland, and the Minneapolis & St. Louis, which have been in more or less perpetual financial embarrassment. But rare indeed is the utility that has failed to earn 5% consistently. In the light of this, the SEC would certainly be on much safer ground if it were to generalize and formulate “rules” with respect to capitalization and participation than the ICC in the case of the railroads.

No really practical and useful purpose is achieved by comparing the treatment of utility and rail shareholders. SEC policies will not affect ICC treatment of rail equities.

The Role of Management

Management cannot be solely responsible for reorganizations. Beating management for past indiscretions and poor leadership may be an interesting pastime, but hardly constructive. On the other hand, the lack of foresight and mossbacked complacency of management that grew, perhaps naturally, out of the monopoly enjoyed by rail transport in past years, can lead only to further financial trouble. Commissioner Eastman once declared that “success will go to those who can create new traffic by giving continually better service at lower prices.” Yet, for example, when buses dig into passenger traffic, many managements still respond by taking off more trains on the particular line, increasing running time, and substituting older and older equipment. This will guarantee further traffic going by highway.

Certainly the public relations end of the business cannot possibly continue along past lines. President Barriger of the Monon put it succinctly: “For too many years, the railroads have been merchandising their troubles rather than their services.”

159 At the depth of the depression in 1933, Pennsy net income after charges was $17 million. Pennsylvania Railroad 87th Annual Report (1933).

160 For a discussion of SEC policy toward the equity, see an excellent article by Dodd, The Relative Rights of Preferred and Common Shareholders in Recapitalization Plans Under The Holding Company Act, 57 Harv. L. Rev. 295 (1944), analyzing a number of utility cases.


162 Quoted in Railway Progress, May, 1947, p. 13.
action is summed up by the remark of one man interviewed by a reporter of the New York Herald Tribune and asked to comment on the recent increase of rail fares, "We won't get anything for it. The services will be the same. The airplanes give you real service for your money."

What does this mean? It means that railroad equity holders might better elect an aggressive management which can provide good service, and tap the traffic potential, instead of scrambling with the bondholders for a place at reorganizations. Archaic railroad management and railroad reorganization have too often been consecutive chapters in the same book.

**New Legislation**

For a considerable period of time it had been evident that Section 77 would be revised. It proved to be a fabulously costly and time-consuming procedure, due largely to the administrative mechanics of the section, resulting in the "ICC-court shuttle." Moreover, roads in this form of reorganization did not pay interest or principal on the debt; it accrued. As a result of war-swollen earnings, several major carriers found themselves with huge cash accumulations on hand—enough to pay the entire accrued interest, and, in the case of the New Haven, the Chicago & North Western, the Rock Island and the Cotton Belt, certain maturities as well. The utterly absurd result was reached of a road technically bankrupt in law but fully solvent in the economic sense. Meanwhile, the reorganization plans had declared the equity of no value, and it did not participate in the distribution of new securities. Stockholders and junior lienors foamed at the mouth. The upshot was the introduction of the Railroad Adjustment Bill in 1947, support for which was apparently universal. This bill is comprehensively analyzed elsewhere, and for the purpose of this discussion it will suffice to outline its major purpose only.

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164 Lisman, *Railroad Reorganization and Section 77*, 16 HARV. BUS. REV. 24, 40 (1937).
165 While in bankruptcy, the Chicago and North Western was paying 6½% on its obligations and could not refund because of its entanglement in § 77, although it was economically solvent. Concurrently, the Union Pacific was borrowing in the market at 2½%, although it was no more solvent than the North Western.
166 "Obviously, the primary purpose of debt readjustment is to so rearrange the debt burden that new common may have a tangible equity value." Brooks, *Railroad Reorganizations Under Section 77*, 135 BANKER'S MAG. 503 (1937). This purpose is frustrated when the shareholders' interest is declared valueless in the face of conditions where the road is economically solvent although still in § 77.
167 The Commission was aware of this, but apparently turned a deaf ear. See 57 ICC ANN. REP. 74 (1943).
168 Suddenly the Commission favored legislation of this type. 59 ICC ANN. REP. 23, 24 (1945), 60 ICC ANN. REP. 26 (1946).
The Act has two principal features: first, it provides that carriers may alter the terms of their securities with the consent of 75% of each class of security holder; secondly, it permits roads now in Section 77 proceedings to avail themselves of this new law. It expressly directs that consideration shall be given to all past earnings (and other earnings) since the date of approval of the plan. Apparently there will be no future repetition of overflowing coffers and technical bankruptcy.

Briefly, it is a composition statute. It permits a railroad that can see financial difficulties ahead to alter and adjust its financial structure by dealing on a business basis with the holders of the road's obligations. Creditors are often quite ready to do this. They dislike the "cancerous morbidities" of receiverships or the elaborate, expensive, and time-consuming procedures of Section 77, and the accompanying moratorium on interest and principal payments. Rather elaborate safeguards are provided for the protection of persons affected, but dissident minorities cannot use their position to hold up the majority by nuisance suits, the inevitable evil in the old equity receiverships and, by incessant court appeals, as in the Section 77 procedure.

This is good legislation. Section 77 has failed dismally in one of its most important objectives, i.e., speedy reorganization, and has proved to be unwieldy in practice in numerous other respects. This Act benefits the equity, for in composition negotiations it is certain that the equity, which initiates the adjustment offer, will not permit itself to be eliminated. If the debt structure is in real need of drastic overhaul and agreement cannot be reached with the creditors, Section 77 is still available. Such situations are likely to be few and far between, however, in the light of the way junior creditors have fared in plans under Section 77.

Provisions of the Act

Finally, on April 9, 1948, the second session of the 80th Congress passed the bill as a new section of the Interstate Commerce Act, providing for a more simple, less expensive, and expeditious method of effectuating modification of the financial structure of railroad corporations, and patterned on the so-called Chandler and McLaughlin Acts (extending Chapter XV of the Bankruptcy Act).

Basically, its principal use will be to avoid the lengthy, cumbersome, and expensive procedures of Section 77. It affords a means of bringing up to date pertinent facts which affect changes in financial structures of those railroads in Section 77 or in equity proceedings at the time of pass-
age of the bill. It is essentially a composition statute, enabling the roads to deal with creditors on business basis. The new law will permit roads to:

(1) Alter or modify, with the consent of the ICC, any provision of any class or classes of its securities, and to alter or modify any mortgage provisions underlying the securities, excepting only equipment trust obligations. In practice, the carrier will apply to the Commission for alteration. The ICC may require the applicant to secure assurances of assent to the modification by holders of a percentage of the principal amount or number of shares outstanding of the securities involved. A public hearing is held, and all persons having an interest must be notified. Before the ICC can give its approval, it must specifically find four things: that the plan is within the scope of the new law; that it will be in the public interest; that it will be in the best interests of the carrier, of each class of its stockholders, and the holders of each class of bonds affected; and/or, that it will not be adverse to the interests of any creditor not affected by the modification. The Commission cannot consent to the plan unless at least 75% of each class of security holder has approved it, whereupon it becomes binding on dissenters.

(2) Roads in Section 77 or equity receivership may avail themselves of the provisions of the new law providing the property has not already been sold, or the Section 77 plan finally consummated, and providing that they comply with the carefully safeguarded procedural steps involved. These carriers must first apply to the court of proper jurisdiction for authority to avail themselves of the new law, and must show that at least 25% of its outstanding securities are involved. The district court has final authority to grant or deny the application; if it approves, the reorganization proceedings are suspended until the ICC advises the court that a voluntary plan has been approved or denied. The court retains custody of the property, however, and the voluntary plan must also be approved by the court after notice of the ICC's consent. If both court and Commission OK the plan, the bankruptcy proceeding will be terminated and the property returned to the debtor.

(3) The Act further provides that in any cases henceforth where a carrier enters a Section 77 proceeding, anyone having an interest may, if the plan has not already been confirmed (or where an appeal is pending on the confirmation order), petition either the court or the ICC to have the ICC report to the court any changes, facts, or developments which may have taken place since the plan was approved. The court may then return the plan to the Commission in its discretion. If so, the Commis-
sion, after hearing, may modify or refuse to modify the plan. In the event of refusal, the court may uphold the ICC if it finds that the conclusions of the ICC are supported by the evidence. If, in the opinion of the court, they are not, the plan goes back to the Commission and further consideration by that body, after which it is re-certified back to the court. Thus the court has a wary eye on the proceedings at each step.

That part of the law permitting voluntary adjustment is satisfactory, I believe. On the other hand, those provisions of the Act providing for carriers now in Section 77 and those subsequently entering Section 77 (as in (3) above) have in them certain of the same pitfalls that are found in the application and practice of Section 77 itself. I refer to the matter of court approval of each step, the certifying and re-certifying. The Senate report stated that the committee did not “intend that the plan shall become a football between the Commission and the courts; it believes that while courts will give due weight to the facts as ascertained by the Commission, the Commission will also respect the judgment of the courts, particularly in view of the fact that in these cases the court has custody of the property and is intimately familiar with the pertinent facts.”

This declaration has a wonderful sound to it, but the preaching and the practice are frequently two different matters. The fact remains that in a sense there is the same divided jurisdiction as obtained in Section 77. Concededly, the provisions of the new act are far superior to the old procedure of Section 77 in this respect, for the opportunity for the disgruntled to appeal incessantly no longer exists. Moreover, the composition process itself tends to accelerate procedure rather than lengthen it as an involuntary bankruptcy inevitably does. The court has what might be termed a veto power over a Commission plan in these instances, enabling it only to refer the plan back to the ICC but precluding it from substituting its judgment on the merits for that of the Commission. Nonetheless, should the court and the ICC happen to have differing opinions as to what constituted sufficiency of evidence to sustain the Commission’s findings, there would be no limitation on the number of times the plan might go back and forth.

The real significance of this legislation lies in the composition provision itself. The provisions relating to roads now in Section 77 will shortly become inapplicable once those carriers get back on their feet. The provision for transferring from future Section 77 proceedings to the voluntary method will not, in all probability, have much usage since, assuming the voluntary reorganization procedure is used as it is in-

tended to be used, future Section 77 proceedings ought to be few and far between.

This law will currently affect about fifteen carriers, mostly small ones, now in reorganization under Section 77, where the plans have not yet been confirmed, and about six small roads undergoing equity proceedings, providing any of these carriers avail themselves of the new provisions. In the future, the new section will affect any carrier whose financial structure appears to be shaky. It seems certain that all concerned would prefer a “renegotiation” of securities to the bitter struggle through Section 77. In any event, the absurd situation of financially solvent but technically bankrupt properties will be definitely out of the picture. Further, the shareholders will be able to face financial difficulties without the fear of losing their shirts. Any plan instigated at the behest of the equity will include participation by the equity, and, even if the carrier is now under Section 77, the provision for transfer to the voluntary proceeding, plus the requirement that a Commission take changed conditions into consideration, augurs well for a more reasonable treatment of the share interest.

One problem remains to be answered: what of the road with a top-heavy capitalization that cannot make ends meet as a result? Is there any means whereby the financial structure can be pruned down to a manageable size? Yes, there is, but it must be remembered that any road in this condition is inevitably going to be faced with painful surgery—Section 77 again. By refusing to assent to a voluntary plan, the Commission can, in effect, force the carrier into the old method. In this manner the water can be squeezed out, if indeed this is the situation, for the court would uphold the Commission’s refusal if there was evidence in support of the finding.

This, then, is the law that wrecked Section 77. The average small investor in railroad securities emerges from the wreckage, a gleam of survival in his eye. True to form, he is bloody, but unbowed.
<table>
<thead>
<tr>
<th></th>
<th>Dollar figures in Thousands</th>
<th>Rio Grande Before</th>
<th>Rio Grande After</th>
<th>Monon Before</th>
<th>Monon After</th>
<th>Erie Before</th>
<th>Erie After</th>
<th>36 Railroads Before</th>
<th>36 Railroads After</th>
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<tbody>
<tr>
<td>Fixed Interest Debt (Including Rentals, Sinking Funds, and Bonds)</td>
<td>137,395</td>
<td>$55,600</td>
<td>31,089</td>
<td>4,179</td>
<td>314,606</td>
<td>170,615</td>
<td>4,925,582</td>
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<td>Contingent Interest Debt</td>
<td>29,116</td>
<td>16,528</td>
<td>13,487</td>
<td>52,889</td>
<td>214,868</td>
<td>141,415</td>
<td>2,731,978</td>
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<td>Capital Stock</td>
<td>46,857</td>
<td>67,699</td>
<td>15,488</td>
<td>529,474</td>
<td>364,919</td>
<td>7,870,654²</td>
<td>6,003,843</td>
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<tr>
<td>Total</td>
<td>193,061</td>
<td>152,413</td>
<td>46,577</td>
<td>529,474</td>
<td>364,919</td>
<td>7,870,654²</td>
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<td>% Fixed Debt to Total Capitalization</td>
<td>70.8</td>
<td>36.5</td>
<td>66.6</td>
<td>12.2</td>
<td>59.5</td>
<td>46.7</td>
<td>62.6</td>
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<td>% Capital Stock to Total Capitalization</td>
<td>24.4</td>
<td>44.4</td>
<td>33.9</td>
<td>39.4</td>
<td>40.7</td>
<td>38.8</td>
<td>34.7</td>
<td>44.8</td>
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<tr>
<td>Ratio of Stock to Debt Fixed and Contingent</td>
<td>1 to 2.94</td>
<td>1 to 0.82</td>
<td>1 to 2.0</td>
<td>1 to 0.31</td>
<td>1 to 1.46</td>
<td>1 to 1.20</td>
<td>1 to 1.81</td>
<td>1 to 0.76</td>
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<tr>
<td>Increase, Capital Stock to Total Capitalization</td>
<td>20.1</td>
<td>5.5</td>
<td>-1.9</td>
<td>10.0</td>
<td>60.0</td>
<td>87.0</td>
<td>46.0</td>
<td>59.0</td>
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<tr>
<td>% Reduction, Fixed Debt</td>
<td>60.0</td>
<td>87.0</td>
<td>46.0</td>
<td>-1.9</td>
<td>10.0</td>
<td>60.0</td>
<td>87.0</td>
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<tr>
<td>% Reduction, Total Capitalization</td>
<td>21.0</td>
<td>27.0</td>
<td>31.0</td>
<td>24.0</td>
<td>60.0</td>
<td>87.0</td>
<td>46.0</td>
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<tr>
<td>1940 Gross</td>
<td>28,582</td>
<td>9,495</td>
<td>86,607</td>
<td>1,302,333</td>
<td></td>
<td></td>
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<td>Ratio of Fixed Debt to 1940 Gross</td>
<td>4.81 to 1</td>
<td>1.95 to 1</td>
<td>3.27 to 1</td>
<td>0.44 to 1</td>
<td>3.63 to 1</td>
<td>1.97 to 1</td>
<td>3.78 to 1</td>
<td>1.56 to 1</td>
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</tr>
<tr>
<td>Ratio of New Fixed and Contingent Debt to 1940 Gross</td>
<td>2.96 to 1</td>
<td>2.18 to 1</td>
<td>2.58 to 1</td>
<td>2.54 to 1</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Fixed Charges</td>
<td>5,938</td>
<td>1,631</td>
<td>1,476</td>
<td>166</td>
<td>13,861</td>
<td>7,002</td>
<td>223,799</td>
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<td>Contingent Charges</td>
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<td>1,171</td>
<td>89</td>
<td>49</td>
<td>4,569</td>
<td>49</td>
<td>105,960</td>
<td>64</td>
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<tr>
<td>% Reduction, Fixed Charges</td>
<td>73.0</td>
<td>89.0</td>
<td>89.0</td>
<td>89.0</td>
<td>73.0</td>
<td>89.0</td>
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<tr>
<td>Fixed Charges, Times Earned 1924-1929 (Best years)</td>
<td>1.10</td>
<td>Note A</td>
<td>2.02</td>
<td>Note A</td>
<td>1.58</td>
<td>2.70</td>
<td>1.70</td>
<td>1.78</td>
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<tr>
<td>Fixed Charges, Times Earned 1932-1941 (Depression years)</td>
<td>1.78</td>
<td>Note A</td>
<td>2.90</td>
<td>Note A</td>
<td>2.13</td>
<td>1.83</td>
<td>Note A</td>
<td>Note A</td>
<td></td>
</tr>
</tbody>
</table>

1 Includes about 9 million of guaranteed obligations other than fixed or contingent debt.
2 Includes about 213 million of guaranteed obligations other than fixed or contingent debt.
A. Almost all of these roads, including the Rio Grande and the Monon, entered Sec. 77 and remained therein throughout this period, hence no times interest earned figure is available which reflects operation by the reorganized company.
B. Figures in this chart were compiled from data published in Standard and Poor; Moody's; ICC Statistics of Railroads of United States; and from the brokerage firms of Merrill Lynch, Pierce, Fenner & Beane, and Buckley Bros.