Fair and Equitable Plan of Reorganization A Clearer Concept

John A. Gilchrist

Follow this and additional works at: http://scholarship.law.cornell.edu/clr

Part of the Law Commons

Recommended Citation
John A. Gilchrist, Fair and Equitable Plan of Reorganization A Clearer Concept, 26 Cornell L. Rev. 592 (1941)
Available at: http://scholarship.law.cornell.edu/clr/vol26/iss4/8

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.
II.

"FAIR AND EQUITABLE" PLAN OF REORGANIZATION: A CLEARER CONCEPT

John A. Gilchrist

Before a judge can confirm a plan of corporate reorganization under the applicable provisions of the federal Bankruptcy Act he must be satisfied that it is "fair and equitable." What constitutes a "fair and equitable" plan within the meaning of that statute is a source of perplexity to those who draft plans of reorganization. Indeed, the same difficulty arose in reorganizations effected through the earlier instrument of equity receivership from the requirement of equity courts that a plan be "fair and equitable" to all parties in the proceedings.

The lower federal courts have reached varying conclusions as to what constitutes a fair and equitable plan, for not until recently had the Supreme Court provided sufficiently clear guidance. Showing a new willingness to review reorganization plans, the Court, in its recent opinion on the Consolidated Rock plan and earlier on the Los Angeles Lumber plan, established new guideposts in an inadequately charted field and, at the same time, overruled many precedents established by lower federal courts.

Many reorganization lawyers had believed that reorganization was essentially different from liquidation, as far as concerned the right of the various parties to participate. But the Supreme Court has now ruled, in effect, that reorganization is in essence a liquidation on a going concern basis.

The significance of these decisions is clearly recognized only after a thorough understanding of the development and state of the law as it existed when the Los Angeles Lumber plan was presented to the Supreme Court for its consideration. A brief review of earlier cases is essential also to determine which of them no longer constitutes authority for future reorganization plans.

Although it has been said that the fairness of the treatment accorded the various parties interested in an insolvent estate depends upon "the circumstances and necessities of the particular situation," nevertheless a court must consider the "particular situation" in the light of some legal principles. Even

---

2At first, equity courts did not consider it their function to pass upon the fairness of a plan; subsequently, they assumed this duty as an incident of their equity power. See infra note 6.
3Consolidated Rock Products Co. v. duBois, 85 L. ed. 603, 61 Sup. Ct. 675 (1941).
5Kansas City Terminal Ry. Co. v. Central Union Trust Co., 28 F. (2d) 177, 184 (C. C. A. 8th 1928).
though the fairness of every plan depends in a large measure upon questions of business judgment, the inquiry into “fairness” of a plan is not divorced from principles of law. Consequently, prior to the Los Angeles decision certain principles had been evolved in reorganizations in equity and under Section 77B of the Bankruptcy Act.

I. DECISIONS IN EQUITY RECEIVERSHIPS

Consistent and complete principles which would afford a convenient measure of the fairness of reorganization plans have not been developed by the decisions arising out of reorganizations effected in equity receiverships.

This is not surprising since the traditional practice in equity reorganizations was to buy off objectors. Again, equity courts have not always considered it their function to examine into the fairness of a plan although they always scrutinized the fairness of the foreclosure sale. Even after equity courts regularly assumed the power and the duty of inquiring into the fairness of a proposed plan, they would exercise this power only when called upon to do so by the objection of an interested party, and even then they would examine the contemplated arrangement only in the particular pointed out by the objection. Thus, no complete, searching inquiry into the fairness of a plan as a whole was ever made. And legal principles are not developed where issues have not been litigated and resolved by judicial decision.

Further, confusion of thought in this field of law has been created by the practice of the courts in the great reorganization cases, after deciding the question squarely before them, of indulging in unnecessary discourse which is open to as many interpretations as a sibylline utterance. Thus, proponents of varying and opposing theories culled from identical opinions different statements and dicta upon which they have relied to substantiate their respective theories with respect to “fair” plans.

6The Circuit Court of Appeals for the Second Circuit in Graselli Chemical Co. v. Actua Explosives Co., 252 Fed. 456 (C. C. A. 2d 1918), was apparently the first court to hold that the determination of the fairness of a plan was within its equity power. However, Circuit Judge Hook’s opinion in Guaranty Trust Co. v. Missouri Pacific Railroad Co., 238 Fed. 812 (E. D. Mo. 1916), also contains, at p. 815, statements which are authority for the decision in the Graselli case.

7In contrast, Chap. X, Section 221(2) which is based on Section 77B (f) (1), requires that a judge be satisfied as to the fairness of the plan even where no objection has been made. Courts, however, have referred to the absence of objections or to the small amount of the objecting claims, as evidence of the fairness of the plan.

8Compare, for instance, the various and contrasting theories espoused in Rosenberg, Reorganization—The Next Step (1922) 22 Col. L. Rev. 14; Swaine, Reorganization—The Next Step: A Reply to Mr. James N. Rosenberg (1922) 22 Col. L. Rev. 121; Weiner, Conflicting Functions of the Upset Price in a Corporate Reorganization (1927) 27 Col. L. Rev. 132; Bonbright and Bergerman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization (1928) 28 Col. L. Rev. 127; Frank,
A. The Boyd case

The vexatious problem, relating to the preservation of the priorities of the various creditors and stockholders, issues from the "fixed" principle laid down by the Supreme Court in the famous Boyd case, according to which the validity of every reorganization agreement is to be determined.

There a creditor who had been excluded from participation in a reorganization was held entitled to satisfy his claim from the property of the reorganized company by an application of the "trust fund" and fraudulent conveyance doctrines and the analogy of a mortgagor buying in his property upon foreclosure. The Court declared that a creditor for whom no provision was made "could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company." This statement would afford basis for an "absolute priority" theory for preserving the creditors' position ahead of stockholders—that creditors' claims be paid in full before junior interests participate. This view has regard for the contractual rights of creditors as distinguished from their property rights in the debtor's estate.

Yet a different approach—a "relative income priority" doctrine which requires merely that creditors receive new securities in income rank ahead of

---

Some Realistic Reflections on Some Aspects of Corporate Reorganizations, (1933) 19 Va. L. Rev. 541, 698.

These various theories are discussed under Point III, infra.

9 Northern Pacific Railway Company v. Boyd, 228 U. S. 482, 33 Sup. Ct. 554 (1913). To review briefly the facts before the Court in that case: One Spaulding recovered a judgment against the Coeur D'Alene Railroad and Navigation Company. Boyd, claiming this judgment belonged to him, instituted suit in 1898 to establish his title thereto. By participating in a diversion of the funds of the Coeur D'Alene, the Northern Pacific Railroad Company made itself responsible for the debts of the Coeur D'Alene, including the judgment of Spaulding. In 1899 the mortgages on the property of the Railroad were foreclosed and said property was sold to the newly organized Northern Pacific Railway Company.

The plan of reorganization provided, inter alia, that each holder of $100 of old preferred stock, upon paying $10 per share, was to receive $50 of new preferred and $10 of new common stock, and that each holder of $100 of old common stock was to receive one share of new common upon paying $15 per share. No provision was made for the payment of unsecured claims, but the Railway Company purchased $14,000,000 of unsecured debts. While the reorganization was taking place, Boyd was actively litigating his claim to the Spaulding judgment and thus was held not guilty of laches when he instituted the present suit against the Railroad and Railway Companies in 1906.

The Supreme Court, per Mr. Justice Lamar, held that the property of the Railway Company was subject to the lien of Boyd's judgment.

10 For a discussion of the "trust fund" doctrine in connection with the Boyd case, see Notes (1924) 9 Cornell L. Q. 192, 193 and (1935) 10 Ind. L. J. 377, 378.


stockholders, and in face amount equal to their old claims—may be predicated on an important dictum in this opinion:

"This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it."\(^\text{13}\)

Not until its decision in the Kansas City Terminal Railway case\(^\text{14}\)—thirteen years later—did the Supreme Court amplify the proposition announced in this dictum.

Although the Boyd decision caused great surprise and anguish to many reorganization counsel, being regarded as a "veritable demon incarnate,"\(^\text{15}\) it was presaged by earlier decisions of the Supreme Court in the Howard\(^\text{16}\) and Monon\(^\text{17}\) cases.

The decision of the Boyd case, however, did not directly involve the question of the fairness of a reorganization plan. The evil which that decision condemned arose from the fact that Boyd was completely "frozen out" of the reorganiza-

---

\(^{13}\) Northern Pacific Ry. v. Boyd, 228 U. S. 482 at 508 (1913).

\(^{14}\) Kansas City Terminal Railway Company v. Central Union Trust Company of New York, 271 U. S. 445, 46 Sup. Ct. 549 (1926). This case will be discussed later.

\(^{15}\) Paul D. Cravath, Reorganization of Corporations, in Some Legal Phases of Corporate Financing, Reorganization and Regulation (1917) 197.

\(^{16}\) Railroad Company v. Howard, 7 Wall. 392, 19 L. ed. 117 (1868).


In the Howard case the Railroad Company had become insolvent, no equity remaining over the secured debt. (This strengthens the conclusion that the existence of an equity is immaterial under Boyd doctrine.) The stockholders subsequently sold their railroad under a plan of sale, which contemplated that sixteen per cent of the consideration would go to old stockholders and the remainder to old bondholders. After the sale the unsecured creditors contended that they were entitled to realize upon their claims from the amount intended to be distributed to old stockholders.

Upholding this contention of the unsecured creditors, the Court declared: "Equity regards the property of a corporation as held in trust for the payment of the debts of the corporation, and recognizes the right of creditors to pursue it into whosoever possession it may be transferred, unless it has passed into the hands of a bona fide purchaser; and the rule is well settled that stockholders are not entitled to any share of the capital stock nor to any dividend of the profits until all the debts of the corporation are paid." Ry. Co. v. Howard, 7 Wall. 392, at 409-410 (1868).

This case is fully considered by Frank, Some Realistic Reflections on Some Aspects of Corporate Reorganizations (1933) 19 Va. L. Rev. 541 at 544-547.

In the Louisville Trust (Monon) receivership, unsecured creditors intervened, alleging that the proceedings were instituted to delay and defraud creditors and were entered into pursuant to an agreement between stockholders and bondholders whereby securities were to be issued to these latter parties without any payment to unsecured creditors. The Supreme Court reversed the decree of the lower court which had affirmed the foreclosure sale.
tion. As far as the fairness of a plan is involved, the Boyd case is important to the extent that it defines the relation of creditors to stockholders; its application to controversies between other classes of interests is a disputed question. Some writers declare that the Boyd case announced a principle of "fairness" applicable as between all classes of interests. Others contend that the Boyd doctrine is inapplicable as between various classes of creditors since the forbidden act of a former owner conveying his property to defraud his creditors has not occurred. For the same reason the application of the rule to controversies between various classes of stockholders is opposed.

18 This doctrine should apply equally to secured as well as unsecured creditors. To this effect see Rosenberg, Phipps v. Chicago, Rock Island & Pacific Ry. Co. (1924) 24 Col. L. Rev. 266, 271.

19 This was the result reached in New York Trust Co. et al. v. Continental & Commercial Trust & Sav. Bank et al., 26 F. (2d) 872 (C. C. A. 8th 1928), where first mortgage bondholders made payments to unsecured creditors, to the exclusion of the second mortgage bondholders, in connection with the reorganization of a street railroad. No equity existed over the first lien. However, the Louisville Trust case was referred to in an inquiry into the fairness of a plan as between bondholders and unsecured creditors in Guaranty Trust Co. of New York v. Missouri Pac. Ry. Co., 238 Fed. 812, 819 (E. D. Mo. 1916).

In a case arising under § 77B, In re Day & Meyer, Murray & Young, 93 F. (2d) 657 (C. C. A. 2d 1938), the Court held a plan unfair as between bondholders and general creditors on the authority of the Boyd case, and in In re Peyton Realty Co., 18 Fed. Supp. 822 (E. D. Pa. 1936), the Court "assumed, without deciding" that the Boyd case applied as between various classes of secured creditors. In In re 620 Church St. Corp., 299 U. S. 24, 57 Sup. Ct. 88 (1936), the Supreme Court, without citing its Boyd decision, held that securities should not be distributed to junior lienors who had no equity.

There is irreconcilable conflict on this point among the text writers. Arguing against the applicability of the doctrine in this situation are: Frank, supra note 8, at 551. Opposed are: Swaine, supra note 8, at 907; Gerdes, A Fair and Equitable Plan of Corporate Reorganizations under Section 77B of the Bankruptcy Act (1934) 12 N. Y. U. L. Q. Rev. 1, 23; Note (1936) 31 Ill. L. Rev. 505, 509. See generally, Friendly, The Corporate Reorganization Act (1934) 48 Harv. L. Rev. 39, 79.

20 But in Eagleson v. Pacific Timber Co., 270 Fed. 1008 (D. Del. 1920), although the court did not cite the Boyd case, it held a plan unfair which was "not equally favorable to stockholders of the same class" and further "denied to the holders of the preferred stock entitled to priority in payment over the common stock upon dissolution or liquidation of the company, rights which it conferred upon the holders of the common stock." (p. 1010.) See Swaine, supra note 8, at 123 and Note (1936) 31 Ill. L. Rev. 499, 511.

In this connection, in so far as a plan affects the various classes of stock interest, inter se, it is profitable to consider the problems raised by Keller v. Wilson, 190 Atl. 115 (Del. 1936), and related cases, which prohibit the elimination, by recapitalization and consolidation of a preferred stockholder's right to accrued dividends. See Note (1941) 54 Harv. L. Rev. 488.

As Bonbright and Bergean, supra note 8, at 143 point out, in the large railroad reorganizations preferred and common stockholders were usually treated alike. Only in the St. Paul reorganization did they receive different grades of stock. Under the Great Western plan they received securities of the same rank but in different amounts.

The position, opposing the application of the doctrine in this connection, seems sustained in several cases arising under § 77B: In re Parker-Young Co., 15 F. Supp. 965 (D. N. H. 1936); In re Pressed Steel Car Co. of New Jersey, 16 Fed. Supp. 325 (W. D. Pa. 1936); In re Louisiana Oil Refining Corporation, 20 F. Supp. 590 (W. D. La. 1937). In all these cases, there was an equity for the preferred but not for the common stockholders, yet provision was made for the common stockholders. The Boyd case was not discussed. But compare the treatment of preferred and common stockholders in In re Consolidation Coal
If new securities are distributed to old stockholders solely in consideration of new funds advanced by them and not on account of their old stock interest, creditors can not successfully object.  

B. Cases Subsequent to Boyd Decision

After merely reiterating the "fixed principle" of the Boyd decision in the Kansas City Southern Railway case, the Supreme Court handed down another landmark decision in Kansas City Terminal Railway case.

From the District Court's decree approving a plan for reorganizing the Missouri, Kansas & Texas Railway Company, an appeal was taken to the Circuit Court of Appeals for the Eighth Circuit, which certified three ques-

Co., 11 F. Supp. 594 (D. Md. 1935), and in In re Utilities Power & Light Corporation, 29 F. Supp. 763 (E. D. Ill. 1939), and in In re National Food Products Corporation, 23 F. Supp. 979 (D. Md. 1938), where no equity remained for the common stock.


22 Kansas City Southern Railway v. Guardian Trust Company, 240 U. S. 166, 36 Sup. Ct. 334 (1916): There an unsecured creditor of the Kansas City Suburban Belt Railroad Company sought to charge the defendant Railway Company for the Belt Company's debt on the ground that the reorganization scheme, adopted upon the foreclosure sale of a mortgage of the Belt Company's property, did not adequately provide for unsecured creditors while making considerable provision for stockholders of the Belt Company. That reorganization plan, which gave nothing to unsecured creditors, provided that for every share of stock in the Belt Company each stockholder was to receive one-quarter of a share of new preferred and three-quarters of new common. For this reason the Court was of the opinion that there was a valuable equity remaining in the Belt Company's property, although the price received at the foreclosure sale did not exceed the amount of the mortgage lien. The Court, therefore, followed the reasoning of the Louisville Trust case and held that the complaining creditor could charge the new company for the amount of its debt.


24 The plan evolved in that proceeding provided (1) that holders of bonds of the various issues were to receive new lien bonds, new adjustment bonds, new preferred and new common stock, (2) preferred stockholders were to receive $14 in prior lien bonds, $6 in adjustment bonds and one share of new common stock upon payment of $20 for each $100 share of old stock, (3) common stockholders were to receive $17.50 in 6% prior lien mortgage bonds, $7.50 in adjustment bonds and one share of new common stock upon payment of $25 for each $100 share of old stock and (4) unsecured creditors were to be given the choice of two plans (a) one-third of a share of new preferred and two-thirds of a share of new common stock for each $100 of their claims or (b) $14 in prior lien mortgage bonds, $6 in adjustment bonds and one share of common upon payment of $18 for each $100 of their claims.

Reference to the assets and liabilities of the Railway is nowhere to be found in the cases arising in this proceeding. The provisions for unsecured creditors were held "fair, just, equitable and timely" by District Judge Sanborn, who approved the plan and declared: "... the offer to the unsecured creditors in this case, in comparison with the offer to the stockholders, is much more favorable to the former than were the offers made to the unsecured creditors in the cases cited [The Frisco and Rock Island reorganizations]." Central Union Trust Co. of New York v. Missouri, K. & T. Ry., 28 F. (2d) 176, 177 (E. D. Mo. 1923).
tions with respect to the fairness of the plan which, in substance, offered to creditors securities of the same grade as, but in greater amount than, those offered to stockholders. Answering these questions, the Court stated that the Boyd doctrine could be satisfied by a fair “offer of different amounts of the same grade of securities to both creditors and stockholders.” The several rights of creditors and stockholders were held subject to a “practical adjustment” to the extent necessary to move stockholders to contribute “additional funds ... essential to the success of the undertaking.” But except for this one qualification, a “rigid adherence” to the “fixed principle” of the Boyd case was held requisite to a fair offer.

The Court, however, did not clearly define the nature of that fixed principle. Some of the Court’s language can be interpreted to support the “absolute priority” theory, yet other language in the opinion supports a different view—that of “relative value priority” under which priority is maintained by the value of the securities issued, which must be equivalent to the recipient’s property interest in, rather than his claim against, the insolvent estate.

These questions were:

“I. Is a plan of reorganization of a railway company sufficient as to unsecured creditors and binding upon them which does not give precedence to the entire claim of the creditor over any part or interest of a stockholder in the old company?

II. Is such a plan fair and binding upon such creditors even though they be offered securities of the same grade as the stockholders, the difference being only in the greater amount offered the creditors, provided the court shall be of the opinion that the offer tenders to such creditors all that could reasonably be expected under all of the existing circumstances?

III. Is such offer as to such creditors fair and binding if it consists only of the same grade of securities as offered the stockholders, the difference being that the right of the stockholders to participate is conditioned upon the payment of an assessment or the payment of a relatively greater assessment than that asked of such creditors, provided the court shall be of the opinion that the offer tenders to such creditor all that could reasonably be expected under all of the existing circumstances?” 271 U. S. at 452, 453.

The Court, per Mr. Justice McReynolds, answered the first question in the negative and the last two in the affirmative.

Examination of the briefs submitted to the Supreme Court in this controversy reveals that one of the principal points in issue was whether preservation of a creditor’s priority over stockholder interest could be effected by the respective value (market price) of the securities offered to these parties, as well as by the character or rank of the securities.

In answering the second and third certified questions, the Supreme Court adopted the view urged by counsel for the Trust Company, that priority could be preserved by the value of the new securities.

Its questions being answered, the Circuit Court of Appeals then considered the fairness of the plan and concluded that “there is no doubt as to the fairness of this offer to the unsecured creditor.” 28 F. (2d) 177 (C. C. A. 8th 1928) at 188.

For criticism of this plan see Buscheck, A Formula for the Judicial Reorganization of Public Service Corporations (1932) 32 Col. L. Rev. 964, 977-981.

The Court’s reliance on its decision in the Howard case, might indicate that a creditor is entitled to priority to the full amount of its claim. This is the conclusion reached by Buscheck, supra note 26, at 977, and Bonbright and Bergerman, supra note 8, at 152.

As above stated, to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation.

The primary right of unsecured creditors to the assets of an insolvent corporation remaining after lienholders are satisfied, must be adequately protected; and to each
As can be seen, the foregoing decisions provided only the vaguest outline for the "fair and equitable" treatment of parties to a reorganization. It is not surprising, therefore, that plans in equity receiverships were predicated on widely divergent theories as to fairness.29

II. DECISIONS IN PROCEEDINGS UNDER SECTION 77B

Difficult as it is to reconcile the plans produced in equity reorganizations, that task seems relatively simple when one undertakes to rationalize all decisions relating to plans of reorganization formulated in proceedings under Section 77B.

This latter problem is complicated by the fact that the application of the Boyd principle to such plans was not settled until the Los Angeles decision. There the Supreme Court resolved the conflict which had existed among the lower federal courts on this point by holding that the doctrine of the Boyd case "is firmly imbedded in Section 77B."30

one of them there must be given such opportunity as the circumstances permit to secure the full enjoyment of this preference.

"... Whenever assessments are demanded, they must be adjusted with the purpose of according to the creditor his full right of priority against the corporate assets, so far as possible in the existing circumstances." 271 U. S. at 455-456.

This theory will be considered under Point III, infra.

29 An analysis of the Boyd doctrine as applied in these cases will be summarized in Point III, infra.

Analyses of plans of reorganization in equity proceedings are found in Payne, Fair and Equitable Plans of Corporate Reorganization (1933) 20 Va. L. Rev. 37, Buscheck, loc. cit. supra note 26, and Bonbright and Berghman, loc. cit. supra note 8. A summary of the treatment accorded general creditors and stockholders in the major railroad reorganizations is set forth in a footnote in Swaine, supra note 19, at 917.


30308 U. S. 106, 119, 60 Sup. Ct. 1 (1939). While the Supreme Court, in In re 620 Church St. Corp., 299 U. S. 24, 57 Sup. Ct. 88 (1936) did not expressly refer to the possible application of the Boyd doctrine to reorganizations under Section 77B, it can be said that its decision therein is not inconsistent with cases which held that doctrine applicable to proceedings under that section. There, the Court held that the Circuit Court of Appeals for the Seventh Circuit had not abused its discretion in declining an appeal of a junior lienor from an order of the lower court which had found inter alia: "that there is no equity over and above the $445,500 of the first mortgage bonds; that the debtor is insolvent; that the claims of the junior lienors, the holders of the second and third mortgages, are of no value and hence that no securities or cash should be distributed under the plan in respect to their claims; that stockholders are not entitled to participate in
Prior to this decision of the Supreme Court, two points of view had been developed by the lower federal courts. The Circuit Court of Appeals for the First Circuit originated one view—that Section 77B was based on a "composition" theory—with a dictum in Downtown Inv. Ass'n v. Boston Metropolitan Bldgs., Inc.\(^\text{31}\) that the principles of "fair and equitable" plans as developed in equity receiverships were inapplicable to proceedings under Section 77B. Some district courts followed this dictum.\(^\text{32}\) An opposing view was sponsored by the majority of courts, notably the Circuit Courts of Appeals for the Second and Eighth Circuits.\(^\text{33}\)

Albeit a rule had not been developed from the Boyd case by which fairness of reorganization plans could be easily measured, nevertheless when this doctrine, difficult as it is to apply, is completely disregarded, the confusion in the cases is greatly increased for then the only "test" to be applied is whether the plan in question appeals to a judge as fair in light of all the circumstances of the particular case.

Until its decision in the Los Angeles case the Supreme Court did not clarify the law as developed by its decisions in equity reorganizations,\(^\text{34}\) although in the Deep Rock litigation\(^\text{35}\) the Court uttered a dictum which lends some support to a "relative income priority" theory. There the Court reversed a plan of reorganization on the ground that the District Court had abused its discre-

---

\(^{31}\)F. (2d) 314 (C. A. 1st 1936).


\(^{33}\)For a discussion of corporate reorganizations and the composition principle, see Note (1938) 51 Harv. L. Rev. 1408; Fennell, Some Reflections on the Los Angeles Lumber Company Case (1940) 29 Geo. L. J. 36.


\(^{35}\)No court has clearly decided the question of the applicability of the Boyd doctrine to proceedings under Section 77. However, indications that this principle is applicable in such proceedings are found in In re New York, N. H. & N. R. Co., 16 F. Supp. 504, 509 (D. Conn. 1936), and in In re Chicago & N. W. Ry. Co., 18 F. Supp. 932, 936 (N. D. Ill. 1936). But see In Matter of The Denver and Rio Grande Western Railroad Company (D. Colo. 1938; Vol. 4, Part IV, of the printed record) where the court stated that "a reorganization contemplated by this section [77] is not indistinguishable in principle from a composition with creditors." p. 3985.

Decisions on this problem arising under Section 77B would seem to have some force even with respect to Section 77, if the view is taken that "so far as concerns" purpose and aim "the analogy between Section 77 and Section 77B... is absolute and thorough-going." Central States Life Ins. Co. v. Koplar Co., 80 F. (2d) 754, 759 (C. C. A. 8th 1938).

\(^{32}\)Its decision in In re 620 Church St. Corp. did not squarely consider the application of the Boyd doctrine to Section 77B.

tion in approving the compromise of a claim of a parent against its subsidiary corporation, the debtor, and in approving a plan of reorganization based upon that compromise. In passing, the Court declared:

“If a reorganization is effected the amount at which Standard’s [the parent’s] claim is allowed is not important if it is to be represented by stock in the new company, provided the stock to be awarded it is subordinated to that awarded preferred stockholders. No plan ought to be approved which does not accord the preferred stockholders a right of participation in the equity in the Company’s assets prior to that of Standard, and at least equal voice with Standard in the management. Anything less would be to remand them to precisely the status which has inflicted serious detriment on them in the past.”

At this point it may be noted that Section 77B, to some extent at least, modified the application of the Boyd principle. This diversion from the Boyd case resulted from subdivision (b) which limited a landlord’s claim for breach of lease to a maximum of three years’ rent. A lessor, asserting a claim for wrongful termination of a lease in the reorganization of United Cigar Stores Company, contended that his claim should be ranked on a parity with other provable debts to the extent of three years’ rent and, as to the balance, be subordinated to other provable debts but awarded priority over the claims or interests of the debtor’s stockholders. The Supreme Court overruled this argument on the ground that Section 77B (b) “limited” a lessor’s claims for all purposes of participation. This deviation from the basic Boyd principle must be interpreted, in the light of the Los Angeles case, as limited solely to treatment of landlord’s claims rather than as an authority for the complete inapplicability of the Boyd case to reorganizations under the Bankruptcy Act.

36 306 U. S. at 324 (1939).
37 Specifically, Subdivision (b) provided:
“.... The claim of a landlord for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall be treated as a claim ranking on a parity with debts which would be provable under section 63 (a) of this Act, but shall be limited to an amount not to exceed the rent, without acceleration, reserved by said lease for the three years next succeeding the date of surrender of the premises to the landlord or the date of re-entry of the landlord, whichever first occurs, whether before or after the filing of the petition, plus unpaid rent accrued up to such date of surrender or re-entry: ...”

This provision, except for some minor clarifying and conforming changes in language, has been carried into Section 202 of Chapter X.

39 Yet compare this decision with Howard v. Maxwell Motor Co., 269 Fed. 292 (S. D. N. Y. 1920), where the plan made no provision for the contingent claim of an unsecured creditor to whom one of the insolvent companies had executed a guaranty of a lease. See Douglas and Frank, Landlords’ Claims in Reorganizations (1933) 42 Yale L. J. 1003, 1009, 1028; Levi and Moore, Bankruptcy and Reorganization: A Survey of Changes, (1938) 5 U. of Chi. L. Rev. 219, 249; Note (1937) 37 Col. L. Rev. 489.
III. ANALYSIS OF THE Boyd PRINCIPLE AS INTERPRETED AND APPLIED IN THE CASES BEFORE THE Los Angeles CASE

As has been seen, the Boyd case requires, irrespective of the existence of an equity for an unsecured creditor that if the latter is excluded from participation, he may assert his claim against the interest retained in the property by old stockholders who are compelled to hold their share in trust for the satisfaction of his claim.

In essence, the Boyd case merely announced a doctrine of fraudulent conveyance and did not directly deal with the fairness of a plan of reorganization, as pointed out earlier. The statement of the Court, however, that if a creditor declines "a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it," has enabled courts in subsequent decisions to hold the Boyd rule applicable to a determination of the fairness of a plan. The Supreme Court did not define a "fair offer" in the Boyd case, but later, in the Kansas City Terminal Railway case, it declared that "no offer is fair which does not recognize the prior rights of creditors."

The fairness of a plan, in the final analysis, depends on the extent to which the position of the parties interested in the old company must be preserved in the new. With respect to the nature or extent of the priority which must be preserved, judicial decisions reach different results. Various theories have been evolved by those who seek to explain these divergent decisions.

Upon foreclosure of an ordinary mortgage on real property there is no doubt that a holder of the first mortgage has a right to insist upon payment in full to the amount of the principal of his claim plus unpaid interest thereon. Because of the peculiar nature of mortgages on railroad property, the rights of the senior lienholders have been to some extent impinged upon. Thus, although the Court pronounced the rule applicable, irrespective of an equity for creditors, nevertheless it seemed to think that an equity existed in spite of the low upset price. In the Howard case, however, no equity existed; see supra note 17.

Thus, the creditor may vindicate his claim against the property of the reorganized company which represents the stockholders' interest, as in the Boyd case, or against the securities to be distributed to the stockholders, as in the Howard case, or actually distributed to stockholders, as indicated in Central Improvement Co. v. Cambria Steel Co., 210 Fed. 696 (C. C. A 8th 1913). This latter case, at pages 705-706, points out the choice of remedies open to the unsecured creditor.

See Gerdes, supra note 19, at 15-18, 22, for a discussion of the Boyd principle as one of fraudulent conveyance. Contra: Note (1936) 31 ILL. L. Rev. 505, 509.

These theories have been essentially developed to explain the treatment accorded various classes by plans formulated in railroad reorganizations; as will be indicated later, the necessity of obtaining new funds requires certain changes in old priorities.

Compare the earlier decision of the United States Supreme Court in Kneeland v. American Loan Co., 136 U. S. 89, 97, 10 SUT. P. 950 (1890), with Merchants' Loan & Trust Co. v. Chicago Rys. Co., 158 Fed. 923, 927 (C. C. A. 7th 1907), as illustrative of the earlier
under judge-made rules, rights of senior lienholders were first subordinated to the claims of holders of receiver's certificates and to certain so-called "six months" claims. Later, plans were held fair although they provided for the subordination of the lien of the first mortgage bondholders to the lien securing bonds distributed to those who furnished new money to the enterprise. The foregoing, however, constitute exceptions to the fundamental rule of real estate mortgage law which requires that senior lienholders be paid the full amount of their principal and interest before junior interests can appropriate a share of the proceeds realized upon foreclosure sale. This rule would be applied to reorganizations by a theory of "absolute priority" under which first mortgage bondholders would be entitled to receive securities, equivalent in value to the full amount of their principal and interest, before securities could properly be distributed to junior interests. This test would be applied to the claims of all classes in order of their priority. In determining the amount of the debtor's assets available to the various parties, even under this theory, "going concern," rather than "liquidation," values are employed.

The Boyd case held that a creditor, who had been "frozen out," was entitled to retain priority over stockholders to the full face amount of his claim.

view which upheld the sanctity of mortgage liens even in the case of railroad reorganizations. Yet a distinction was made between the ordinary mortgage on real property and mortgages on railroad property as early as Shaw v. Railroad Co., 100 U. S. 605, 25 L. ed. 757 (1879).


Kansas City Terminal Railway Co. v. Central Union Trust Co., 271 U. S. at 445, 455, 46 Sup. Ct. 549 (1926); Jameson v. Guaranty Trust Co. of New York, 20 F. (2d) 808, 811 (C. C. A. 7th 1927). This practice has been generally restricted to railroads and is justified on the ground that the public interest requires a continuation of the road, hence that new money must be forthcoming, and that a lien senior to the old first lien, must be given to induce the contribution of new money.

But, in In re Prima Co., 88 F. (2d) 785 (C. C. A. 7th 1937), where the debtor was a manufacturer and distributor of beer, trustee's certificates, with a lien prior to an existing mortgage on the debtor's property, were held authorized under § 77B (c) (3) [carried without substantial change into Chapter X, § 116 (2)]. See Note (1938) 51 Harv. L. Rev. 923.

In this respect Boyd must have fared better than other unsecured creditors whose claims had been purchased by the new company, undoubtedly at a figure much less than their face amount. This was also true in the Kansas City Southern case (see lower court's decision in 210 Fed. 696, 723).

It should be observed that the right of recovery of an unsecured creditor who has been "frozen out" is not limited by the equity over secured debt but by the amount, or value, of the interest given to stockholders. Central Improvement Co. v. Cambria Steel, 210 Fed. at 706 (C. C. A. 8th 1913). That case held that such creditors could recover to the extent of the "highest value" that the stockholders' interest had during and subsequent to the execution of the plan.

Where other general creditors are also denied participation, recovery from the interest retained by stockholders should be prorated among all of them. Compare the relief accorded the complaining unsecured creditor for whom a plan made insufficient provision
This result would seem to support an "absolute priority" view as between general creditors and stockholders. Yet the dictum of the Court that a creditor's interest "can be preserved by the issuance, on equitable terms, of income bonds or preferred stock" would seem to give approval to a "relative income priority" theory, which will be later discussed. Most writers are of the opinion that the "absolute priority" theory is also supported by the Supreme Court's opinion in the Kansas City Terminal Railway case.51

The propriety of the "absolute priority" rule can be sustained if a reorganization is considered as constituting, in essence and irrespective of the procedure employed, a method whereby assets of the debtor are transferred, by way of sale, to a new company in exchange for the latter's securities. Under such a view, these securities are paid to the debtor company which must distribute (in reality, liquidate) the proceeds of the sale to the parties interested in the old company. Fundamental is the rule that before assets (which may be in the form of securities issued by the new company) of the old company can be liquidated, provision must be made for full payment of the claims of creditors. It would follow that stockholders are not entitled to receive any securities until creditors are made whole by the present value of the securities received. Consistent with such an approach is the statement of the Supreme Court in the Howard case that the suit there brought by a creditor who had been "frozen out" was "not one against stockholders to compel them to pay a corporate debt out of their own estate, but it is a suit against the corporation and certain other parties holding or claiming assets which belong to the principal respondent, to prevent that fund from being distributed among the stockholders of the corporation before the debts due to the complainants are paid."52 This ap-

and who was, consequently, treated as if he had been "frozen out" of the Mountain States Power Company reorganization, Mountain States Power Co. v. A. L. Jordan Lumber Co., 293 Fed. 502 (C. C. A. 9th 1923). There the court ascertained the amount of the equity remaining after lien indebtedness (rather than the amount of the interest given to old stockholders), calculated the complainant's pro rata share of that amount and permitted him to recover to that extent. This case conflicts with the result of the Boyd decision, but is distinguishable on its facts; here there were other unsecured creditors who were unprovided for (who were entitled to equal consideration); in the other case, Boyd was apparently the only general creditor who had not been paid. In so far as the general creditors' right of recovery was held limited by the amount of the equity over lien indebtedness, the case is subject to criticism; see Note (1924) 8 MIK. L. Rev. 604, 606. In Phipps v. Chicago, R. I. & P. Ry. Co., 284 Fed. 945 (C. C. A. 8th 1922), the court refused to let an objecting general creditor recover the amount of his claim in cash on the ground that he would thereby get more than others of his class (p. 953). See Swaine, supra note 8, at 927-928.

51 Reaching this conclusion in Buscheck, loc. cit. supra note 26, and Bonbright and Bergman, supra note 8, at 152.

Frank, loc. cit. supra note 8 argues for full priority for creditors just as in foreclosures of ordinary real estate mortgages. A similar position is taken in Note (1936) 31 ILL. L. Rev. 505, 513. See supra note 26.

proach, that a reorganization is, in effect, merely a liquidation, with payment by securities, if carried to its logical conclusion, prevents a reorganization from including parties who would not participate on a liquidation.

The lower federal courts, however, accorded the Supreme Court's requirement of "full priority" only a lip service. Inquiry into the realities of the situation reveals that in only one large railroad reorganization did first mortgage bondholders receive securities worth, at the time of distribution, the full amount of their claims. In this connection it should be observed that the Supreme Court, in the Kansas City Terminal Railway case, qualified a creditor's right to full payment to the extent that senior liens would have to be subordinated to a lien given to secure new money.

"Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them. In such or similar cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights." It would seem that this exception should be strictly construed, with only such "adjustment" of the "several rights" as is absolutely necessary to the inducement of new funds from old stockholders. The lower federal courts, however, have not inquired deeply into the liberality of such "inducement." To the extent that the modification of the rights of prior interests is absolutely necessary to the inducement of new funds, it would seem that there has been no violation of the doctrine of "absolute priority"; but further modification

---

53 Bonbright and Bergerman, supra note 8, at 134. Indeed, they point out that in only three instances were first mortgage bondholders ultimately made whole by the market value of their securities.

54 271 U. S. at 455 (1926).

55 See Note (1936) 31 ILL. L. Rev. 505, 513; Friendly, supra note 19, at 76.

56 See Bonbright and Bergerman, supra note 8, at 980, where they point out that under the Missouri, Kansas and Texas Railway plan the stockholders were given a prospective premium of $68 for every $20 or $25 par of bonds purchased.

57 In this connection it is interesting to note that the Boyd doctrine operates to modify the rights of the senior lienholders. Displacement of senior liens is proper to induce the contribution of new capital by stockholders. But, when stockholders participate, the Boyd rule requires that unsecured creditors also be included; any securities, however, given to these creditors must come as a result of further concessions from the senior liensors. See Bonbright and Bergerman, supra note 8, at 155.

It has been urged that new money should be sought from sources other than stockholders wherever possible (Frank, supra note 8, at 557-560) and it has been further urged that the old stockholders are entitled to participate only by redeeming the property from prior interests and upon their failure to do so new money should be obtained from those interested in the property according to the seniority of their respective interests (Buscheck, supra note 26, at 989).

As will be seen, the Los Angeles decision has limited, in the case of insolvency, stockholder participation in the new company strictly to the amount of their contribution.
must be rationalized on another, and different, theory which has been supplied by the lower federal courts as will be hereinafter shown.\footnote{58} At any rate, since the modification of existing rights is made proper, under the “absolute priority” theory, only by the contribution of new money, if no new money is contributed by stockholders, they should, according to that theory, be completely excluded.\footnote{59}

This rule of “absolute priority” was early disregarded in railroad reorganizations by some lower federal courts which proceeded on a “relative income priority” theory which requires only that the various classes of creditors and stockholders be given securities with an income rank and claim equal to that which they had in the old company.\footnote{60}

\footnote{58}Bonbright and Berghman, supra note 8, at 133.

\footnote{59}Warrants, however, have been issued to the stockholders in this situation. See In re Middle West Utilities Co., (N. D. Ill. 1936, reported in C. C. H. ¶ 3671) and In re Reading Hotel Corporation, 10 F. Supp. 470, 471 (E. D. Pa. 1935), where the court declared, by way of dictum: “Although, if the corporation is insolvent, a stockholder should not ordinarily participate in the assets of the reorganized company without a new contribution, it may be that considerations of fairness would require stockholders to be given preferential rights (as against outsiders) to come into the new enterprise upon terms.”

See also the provision for common stockholders, for whom there was no equity, in In re Consolidation Coal Co., 11 F. Supp. 594 (D. Md. 1935).

Stockholders have been permitted to participate, however, for a variety of reasons, as is indicated by Foster, Conflicting Ideals of Reorganization (1935) 44 YALE L. J. 923, 936; Note (1935) 35 COL. L. REV. 549, 563 and Dodd, Reorganization Through Bankruptcy (1935) 48 HARV. L. REV. 1100, 1123. Chief among such reasons is the desire to settle stockholders’ contentions for their nuisance value and to preserve the good will of this group. See In re Utilities Power & Light Corporation, 29 F. Supp. 763, 770 (E. D. Ill. 1939).

In some instances courts have justified a violation of the Boyd doctrine on the ground of de minimis: P. R. Walsh Tie & Timber Co. v. Missouri Pac. Ry. Co., 280 Fed. 38 (C. C. A. 8th 1922); and see Brock & Winkle Terra Cotta Co., 81 F. (2d) 949 (C. C. A. 8th 1936); and the expense of obtaining the consents of stockholders to less favorable treatment: In re Anchor Post Fence Co., 14 F. Supp. 801 (Md. 1936).


\footnote{60}Hancock v. Toledo, Peoria & Warsaw R. Co., 9 Fed. 738, 742 (N. D. Ill. 1882) (where the court held that a plan was not fraudulent which “seems to fairly contemplate the protection of all classes of creditors of the old company in the equitable order of their priority.”) This decision, while antedating the Boyd case, seems to have begun a new line of thought which federal courts have followed even after the Boyd decision.

This approach received impetus from a statement by Judge Hook in Guaranty Trust Co. of New York v. Missouri Pac. Ry. Co., 238 Fed. 812 (E. D. Mo. 1916), that the relation between stockholders and general creditors would not be disturbed even if the former received new common stock without paying an assessment. This is the intimation in Western Union Telegraph Co. v. United States & Mexican Trust Co., 221 Fed. 545, 549 (C. C. A. 8th 1915). Again in St. Louis-San Francisco Ry. Co. v. McElvain, 253 Fed. 123, 133 (E. D. Mo. 1918), Judge Sanborn declared: “There is no moral turpitude, nor is there any illegality in the making and performance of an agreement between the bondholders secured by mortgages, the stockholders, and the unsecured creditors of an insolvent mortgagor, that there shall be a foreclosure and sale of the mortgaged property to or for the benefit of a new corporation in which all the members of the three classes [bond-
Opponents of the “relative income theory” argue that creditors are entitled to payment, not merely to priority; that realistically, senior classes are not “paid” by a “relative income priority” treatment, because, if their legal rights were strictly preserved, they would be entitled, until fully paid, to whatever value is possessed by the subordinate securities given to junior classes; and that the subordinate securities given to those classes who have no equity in the insolvent estate, usually have some market value.\(^6\)

With rare exception,\(^2\) the lower federal courts have disregarded this possible argument when those who have no equity in the insolvent estate receive only securities completely subordinated to senior interests.\(^3\)

A third theory must be evolved, in cases where an equity remains neither unsecured creditors nor stockholders, to justify the issuance to these parties of securities of the same grade but different amounts, for under the “absolute priority” view neither class could participate, and under the “relative income priority” theory priority is maintained by the issuance of securities of differ-

holders, unsecured creditors and stockholders] shall be permitted at the option of each of them to take the bonds or stock of the new corporation in substantial proportion to the respective ranks and equities of the classes."  


This doctrine of “relative income priority” was advocated by Swaine, supra note 8, at 912, 918. See also Friendly, supra note 19, at 76 and Note (1935) 35 Col. L. Rev. 549, 552.

Apparently no consideration is given to the fact that stockholders may receive some dividends before the old unsecured creditors are fully paid. See Note (1938) 31 Harv. L. Rev. 1408, 1411.

61See Foster, supra note 59, at 945; Dodd, supra note 59, at 1133; Friendly, supra note 19, at 77; Gerdes, supra note 19, at 25; and Note (1935) 35 Col. L. Rev. 549, 552, 556.

Tables set forth in Bonbright and Bergerman, supra note 8, at 134-140, showing the market values of the old interests of bondholders and stockholders in the large railroad reorganizations and the market values of their new interests, demonstrate that in only one of the large railroad reorganizations have bondholders been paid in full, through the value of the new securities, at the time of the sale, and in only three of such reorganizations have the bondholders ultimately been made whole. In all of these reorganizations the securities given to old stockholders have had at least a slight, and in most cases a substantial market value.

That stock warrants may have a present value is pointed out in GRAHAM & DODD, Security Analysis (1934) 550-551, where it is stated: “The warrants will have no ‘exercisable value’ at the time of issuance; but they would have a real value nevertheless, and they would command a market price. For the right to benefit from any increase in the price of the stock is well worth owning and is therefore worth paying for. . . . whatever value attaches to the warrants must have been subtracted from the common stock.”


62See Wayne United Gas Co. v. Owens-Illinois Glass Co., 91 F. (2d) 827 (C. C. A. 4th 1937) (where the court stressed the fact that bondholders, who were the real owners of the insolvent estate, were not given the voting control), and In re Reading Hotel Corporation, 10 F. Supp. 470 (E. D. Pa. 1935).

ent rank. This distribution must be sustained by what may be denominated a “relative value priority” view; priority is preserved by the relative value of securities, which value must also represent the value of the recipient’s interest in the insolvent estate. This approach preserves the property rights of creditors in the insolvent estate, whereas the “absolute priority” theory preserves their contractual rights as well. Although not clearly articulated, this theory finds some basis in the Kansas City Terminal Railway and other cases.64

There is merit to this “relative value priority” approach, for it would seem that a plan is fair which affords a creditor the same realization of his claims which would be possible in other ways. In equity reorganizations there was no way of compelling a creditor to assent to a plan nor to compel him to accept anything but cash in exchange for his claim.65 Therefore, if a creditor did not assent to the plan, it would seem that he would be entitled merely

64See supra, note 28. The Court stated several times in its opinion that the right of unsecured creditors against the “full value of all property of the debtor” should be preserved. The value of the creditor’s interest would, therefore, seem to be an important factor. The Court did not pass upon the fairness of a particular plan as applied to the facts of that proceeding, for when questions of law are certified to the Supreme Court, it passes solely on the questions presented in the certificate. See Robertson and Kirkham, Jurisdiction of the Supreme Court of the United States, §§ 135, 146.

The answers to the second and third certified questions (see supra, note 25) are not necessarily inconsistent with the view that a creditor is entitled to priority, to the full amount of his claim, over stockholders; for instance, where securities of the same rank are offered to both unsecured creditors and stockholders, if the “bundle” of securities allotted to an unsecured creditor equals in value the amount of his claim, then the strict view of the Boyd case is followed. In most cases, however, it must be conceded that it is difficult to accord an unsecured creditor priority to the full amount of his claim in the manner indicated in the second and third certified questions.

If the Supreme Court had passed upon the fairness of the plan in question, then there would be the highest authority for the view that a creditor is not entitled to an “absolute priority” to the full amount of his claim over stockholders, since it is clear that the value of the securities allotted under the plan to an unsecured creditor did not equal the amount of the creditor’s claim. This test has been referred to in a case arising under Section 77B. In In re Dutch Woodcraft Shops, 14 F. Supp. 467, 470 (W. D. Mich. 1935) the court stated that: “It has been said that a plan of reorganization must meet two requirements—it should give to each creditor and stockholder the value of his interest in the debtor’s assets and it should fully recognize the priority of claims.” (Italics added.) No authority, however, was cited for this statement.

See Note (1935) 35 Col. L. Rev. 549, 552, where it is stated that the measure of the value of the securities to be allotted to a particular creditor is the worth of the old claim before reorganization. This is another way of stating that the value of the new securities issued to a particular creditor must approximate the value of his interest in the estate.

See also Gerdes, supra note 19, at 14, 23, where he indicates that the value of a creditor’s claim has an important bearing on a determination of the fairness of payment of such creditor. This would probably be a good test under Chapter X in light of the provisions of Section 216(7), (8), where the minimum rights of a non-assenting class of stockholders and creditors is made the “value” of their equity or claims in the debtor’s estate. Of course, while a requisite number of a class may consent to a plan which gives them less than the value of their interests or claims, the plan must still be fair to the dissenting minorities.

65Coriell v. Morris White, Inc., 54 F. (2d) 255 (C. C. A. 2d 1931). But see the Phipps case, supra note 50. A discussion of this point is found in Payne, supra note 29, at 47, and Note (1923) 36 Harv. L. Rev. 1007, 1010.
to receive his share of the price received at a judicial sale at not less than a fair upset price.  

The "relative value" method was easily applied where there was an equity neither for general creditors nor stockholders; the slightly greater value, accruing from a slightly greater amount of securities, received by such creditors preserved their priority over stockholders.  

Where some equity remains for general creditors but none for stockholders, under the "relative value" approach it would seem necessary to ascertain the value of the former's interest and then to ascertain whether the value of the securities allotted to them approximates that value before securities can be distributed to junior interests. However, very little discussion by the courts of the value of the interests of the various classes of creditors and stockholders in the insolvent estate is to be found in these situations.

---

66 In view of the decision in First National Bank of Cincinnati v. Flershem, 290 U. S. 504, 54 Sup. Ct. 298 (1934), it is probable that the Supreme Court would now hold that the upset price (for the purpose at least of determining non-assenting creditors’ rights to cash) must approximate the fair value of the property sold.

67 This was the approach taken by the Circuit Court of Appeals in the Kansas City Terminal Railway case after its certified questions were answered by the Supreme Court.

It might be argued that if no equity remains over secured indebtedness, the general creditor’s priority over stockholders has vanished since there cannot be, in reality, a priority in "nothing"; hence, it would follow that the general creditor was at most entitled to share only on an equal basis with the stockholders. See Note (1936) 49 Harv. L. Rev. 1007, 1009. This probably would be his minimum right for, if bondholders seek to include stockholders in a reorganization, they must also include creditors on the same basis on a theory that "he who seeks equity must do equity"; the bondholder requires the aid of the equity court to consummate the foreclosure sale and the plan of reorganization.

However, there is force to the contrary argument that, because of the prior relation of the parties, unsecured creditors should be given some priority, however slight, over stockholders. Certainly the Boyd doctrine cannot be reduced below this point. Of course, under the Los Angeles decision, where there is no equity for general creditors and stockholders, no securities can be issued to either the unsecured creditors or the stockholders.

68 A thorough appraisal would seem to have been essential to an intelligent determination of the fairness of a plan (1) where a class of creditors or stockholders was excluded from participation, (2) where the interests of a class in the insolvent estate were preserved by value or amount, rather than rank, of new securities, or (3) where the consents of a dissenting class were dispensed with under subsection (b) (4) and (5) of Section 77B (now Chapter X, Section 216(7) and (8)).

The Supreme Court, in National Surety Co. v. Coriell, 289 U. S. 426, 53 Sup. Ct. 678 (1933), condemned a plan formulated in an equity receivership, which the lower court had approved without the aid of an inventory. And again, in First Nat. Bank v. Flershem, supra note 66, the Court denounced the failure of the district court to make an appraisal by "independent experts" in fixing an upset price and confirming the sale of the debtor’s property. Few courts, however, carefully considered the necessity of an appraisal under Section 77B. An appraisal was held necessary in Jamieson v. Watters, 91 F. (2d) 61 (C. C. A. 4th 1937), not only for the exclusion of stockholders under a plan but also for a determination of fairness of such plan as between bondholders and unsecured creditors. An appraisal was held requisite to the inclusion of stockholders in In re Dutch Woodcraft Shops, 14 F. Supp. 467 (W. D. Mich. 1935).

Yet in In re Pressed Steel Car Co. of N. J., 16 F. Supp. 320 (W. D. Pa. 1936), no appraisal was made although part of the securities given to preferred stockholders were of the same grade as those given to common stockholders. And in In re Georgian Hotel Corporation, 82 F. (2d) 917 (C. C. A. 7th 1936), part of the securities issued to first mortgage
Similarly, where an equity remains for both general creditors and stockholders, the “relative value” method is identical with the “full priority” rule since an equity for stockholders would assume that the value of the creditors’ property interest equals their contract rights; under both views the value of the securities issued to such creditors should be equivalent to the full face amount of their claims. Yet, even in cases which present this situation, rarely has a thoroughgoing appraisal been made.\(^6\)

It should be observed, in passing, that “absolute priority” may be preserved either by the issuance, to creditors and stockholders, of securities of different rank or of securities of the same grade but in different amounts. The first method imposes on the new enterprise the same stratified capitalization that obtained in the old and results in the creation of “hybrid” securities. For this reason, it is not always a satisfactory solution in reorganizations which seek to eliminate a topheavy capitalization.\(^7\)

Not all of the foregoing theories have been evolved by courts but by those who seek to explain the decisions of the lower federal tribunals, which, although consistently citing the *Boyd* and *Kansas City Terminal Railway* opinions as authority for the result reached in the case, apparently entertain different views on the types of priority required by those opinions.

### IV. Recent Decisions of the Supreme Court

By indicating in the *Los Angeles* case that the test of absolute priority is the sole measure of fairness, the Supreme Court resolved much of the confusion created by the foregoing cases and clarified the concept of “fair and equitable” treatment.\(^8\)

---


\(^8\)This decision, as already stated, is also important as resolving a conflict which had previously existed among the lower federal courts by holding the *Boyd* doctrine applicable to reorganizations under Section 77B. See *supra* notes 32 and 33.

In this connection the Court stated: “The words ‘fair and equitable’ as used in § 77B(f) are words of art which prior to the advent of § 77B had acquired a fixed meaning through
In that case the debtor was a holding company with assets amounting to $830,000 which consisted principally of the property of a subsidiary. It had outstanding a bond issue in the principal amount of $3,800,000, interest upon which had been delinquent for several years. Also outstanding were 57,000 shares of Class A and 5,000 shares Class B no par stock. The debtor was insolvent in the equity and in the bankruptcy sense.

The Supreme Court held that the plan which provided for the issuance of Class A stock to old bondholders and a Class B stock to old Class A stockholders,\(^2\) was, as a matter of law, not fair and equitable despite the approval of the plan by an overwhelming majority of the bondholders and stockholders,

judicial interpretations in the field of equity receivership reorganizations. * * *

"... Thus throughout the cases in this earlier chapter of reorganization law, we find the words 'equitable and fair,' 'fair and equitable,' 'fairly and equitably treated,' 'adequate and equitable,' 'just, fair and equitable' and like phrases used to include the 'fixed principle' of the Boyd case, its antecedents and its successors. Hence we conclude, as have other courts, that that doctrine is firmly imbedded in § 77B." 308 U. S. at 115, 118-119.

It should be noted that Section 77B (1) (1) empowered a judge to confirm a plan, if satisfied, \textit{inter alia}: "that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders"; whereas Chapter X, Art. XI, Section 221 (2) merely requires the judge to be satisfied that the plan is "fair and equitable."

This change, effected by the Chandler Act, does not alter, in substance, the requirement of Section 77B. See Securities and Exchange Commission v. United States Realty & Improvement Co., 310 U. S. 434, 452, 60 Sup. Ct. 1044 (1940); and S.E. & R. No. 1916, 75th Cong., 3d Sess. (1936) 35.

It has been held that the phrase "fair and equitable" has a "different meaning as used in the Public Utility Holding Company Act, Section 11 (e). In Matter of Federal Water Service Corporation, S. E. C. Holding Company Act Release No. 2635. This opinion is interesting as indicating the view of the Commission that "equity and bankruptcy reorganizations are in substance liquidations on a going-concern basis." (p. 15.) The Commission further declared:

"... The enterprise is preserved and recapitalized [by such reorganization] and security holders receive a distribution of new securities representing interests in the reorganized company, instead of distribution of the proceeds of an actual liquidation. But there is no reason for departure from the contractual rights applicable to liquidation situations." \textit{Ibid.}

Since under Chapter X the Commission is charged with the duty of advising the District Court of the fairness of a proposed plan for reorganizing corporations whose assets exceed $3,000,000, and is entitled to appear as a party, the Commission's own idea of "fairness" is very important. (Also, by filing \textit{amicus} briefs in the \textit{Los Angeles} and \textit{Consolidated Rock} appeals, the Commission was very persuasive on this problem before the Supreme Court.) The views taken by the Commission on some plans are set forth in notes in (1939) 39 Col. L. Rev. 1030; (1940) 2 La. L. Rev. 693.

\(^2\)More specifically, the plan contemplated the transfer of assets of the aforementioned subsidiary, free and clear of liens, to a new corporation. The capital structure of the new company was to consist of 1,000,000 shares of $1 common stock, divided into Class A and Class B shares, all shares having equal voting rights. The Class A stock was to have a preference upon liquidation, to the amount of its par value and a preference to the extent of a 5% annual dividend if earned. The holders of Class B stock were entitled to dividends at the rate of 5% on the par value of their shares only after a 5% dividend has been paid on the Class A shares.

Bondholders were to receive 641,000 shares of Class A stock, to be divided \textit{pro rata} among them on the basis of 250 shares for each $1,000 bond. The balance of this Class A stock, amounting to 170,000 shares, was to be sold to furnish additional working capital. The Class B stock, amounting to 168,600 shares, was to be issued to the holders of the old Class A stock.
by the District Court, and the Circuit Court of Appeals for the Ninth Cir-
cuit.

The relative priority theory, upon which the plan (unfair under any theory) 
was based, was expressly condemned in the following language:

"True, the relative priorities of the bondholders and the old Class A 
stockholders are maintained by virtue of the priorities accorded the pre-
ferrred stock which the bondholders are to receive. But this is not compli-
ance with the principle expressed in Kansas City Terminal Ry. Co. v. Cen-
tral Union Trust Co., supra, that 'to the extent of their debts creditors are 
entitled to priority over stockholders against all the property of an in-
solvent corporation,' for there are not sufficient assets to pay the bond-
holders the amount of their claims. Nor does this plan recognize the 
'equitable right' of the bondholders 'to be preferred to stockholders 
against the full value of all property belonging to the debtor corporation,' 
within the meaning of the rule announced in that case, since the full value 
of that property is not first applied to claims of the bondholders before the 
stockholders are allowed to participate. Rather it is partially diverted for 
the benefit of the stockholders even though the bondholders would obtain 
less than 25% payment if they received it all. Under that theory all classes 
of security holders could be perpetuated in the new company even though 
the assets were insufficient to pay—in new bonds or stock—the amount 
owing senior creditors. Such a result is not tenable."\textsuperscript{73}

The Court declared that stockholders of an insolvent corporation might 
under certain circumstances participate in the plan but that such participation 
"must be based on a contribution in money or in money's worth, reasonably 
equivalent in view of all the circumstances to the participation of the stock-
holder."\textsuperscript{74}

The District Court had held that participation by these stockholders would 
be beneficial to the bondholders because the former had "financial standing and 
influence in the community" and could provide a "continuity of management"; 
that the bondholders were not entitled to foreclose until 1944 under an agree-
ment entered into prior to reorganization; and that the stockholders had con-
tributed $400,000 to the capital of the company. The Supreme Court, however, 
held this "consideration" was not reasonably equivalent to the stockholders' 
participation. This ruling sounds the death knell to the liberality which had 
characterized the treatment of junior interests under many plans.\textsuperscript{75}

\textsuperscript{73}308 U. S. at 119-121.
\textsuperscript{74}308 U. S. at 122. It should be observed that a contribution must be "necessary" before 
stockholders can participate in this manner. See In re Associated Owners, Inc., 32 F. 
Supp. 828, 829 (D. Wis. 1940).

It has been urged that new money should be sought from other sources than stock-
holders wherever possible. Frank, supra note 8, at 560. But the cases do not support 
this position.
\textsuperscript{75}See supra note 54.
After reaffirming by dictum in the United States Realty litigation the view it took in the Los Angeles case, the Court recently stated that the doctrine of absolute priority was applicable to a reorganization of a solvent corporation, Consolidated Rock Products Company.

That proceeding involved not only the debtor but also its two wholly owned subsidiaries, Union Rock Company and Consumers Rock and Gravel Company, Inc. It appeared that both Union and Consumers had outstanding, in the hands of the public, mortgage bonds. Consolidated had outstanding preferred and common stock.

In 1929 Consolidated had acquired control of the properties of its subsidiaries and commingled them under an operating agreement. The District Court, therefore, did not find specific values for the separate properties nor, indeed, for all of the properties as a unit. The average of the valuations given by witnesses were $2,202,733 for Union as against a mortgage indebtedness of $2,280,555; $1,151,033 for Consumers as against a mortgage indebtedness of $1,358,715.

Consolidated was indebted to Union and Consumers for about $5,000,000.


The issues involved in that litigation were (1) should a petition by a corporation for an arrangement of its unsecured debts under Chapter XI be dismissed because the relief obtained under that Chapter was inadequate, and (2) whether the Securities and Exchange Commission was entitled to raise and litigate that question by intervention and appeal.

In discussing the first issue the Court referred to "fair and equitable" plans and reaffirmed the position it took in the Los Angeles case:

"'Fair and equitable,' taken from § 77B and made the condition of confirmation under both Chapter X and Chapter XI are 'words of art' having a well understood meaning in reorganizations in equitable receiverships and under § 77B which is incorporated in the structure of both Chapters X and XI. See Case v. Los Angeles Lumber Products Co., 308 U. S. 106, 115, et seq. The phrase signifies that the plan or arrangement must conform to the rule of Northern Pacific Ry. Co. v. Boyd, 228 U. S. 482, which established the principle which we recently applied in the Los Angeles case, that in any plan of corporate reorganization unsecured creditors are entitled to priority over stockholders to the full extent of their debts and that any scaling down of the claims of creditors without some fair compensating advantage to them which is prior to the rights of stockholders is inadmissible. . . .

"In cases where subordinate creditors or the stockholders are the managers of its business, the preservation of going-concern value through their continued management of the business may compensate for reduction of the claims of the prior creditors without alteration of the management's interests, which would otherwise be required by the Boyd case. See Case v. Los Angeles Lumber Products Co., supra, 121, 122." 310 U. S. at 452, 454.


78More specifically, Union had outstanding in the hands of the public $1,877,000 of 6% bonds secured by a lien on its property, with accrued and unpaid interest thereon of $403,555, and Consumers had outstanding in the hands of the public $1,137,000 of 6% bonds, secured by a lien on its property, with accrued and unpaid interest thereon of $221,715. Consolidated had outstanding 283,947 shares of no par value preferred stock and 397,455 shares of no par common stock.
The District Court made no finding with respect to the validity or amount of that claim but concluded that the agreement under which the debt was created was not made for the benefit of the bondholders.

The proposed plan provided for the formation of a new corporation under which would be transferred all of the assets of Consolidated, Union, Consumers, and Reliance Rock Co., a wholly owned subsidiary of Union. Briefly, Union and Consumers bondholders were to receive income bonds of the new company, secured by mortgage on all of its property, for one-half of the principal amount of their claims, for the remainder an equal amount of new preferred stock. No securities were to be issued for their claim to accrued interest which was to be extinguished. Such bondholders were also to receive warrants for the purchase of new common stock. Preferred stockholders of Consolidated were to receive new common and common stockholders of Consolidated were to receive warrants for the purchase of new common. The new preferred stockholders were to elect four, and the new common stockholders the remainder, of the nine directors of the new company.

The District Court confirmed the plan, but the Circuit Court of Appeals for the Ninth Circuit reversed. Petitions for certiorari were granted by the Supreme Court "because of the importance in the administration of the reorganization provisions of the Act of certain principles enunciated by the Circuit Court of Appeals."

Affirming the decision of the Circuit Court of Appeals the Supreme Court, per Mr. Justice Douglas, declared that without "the requisite valuation data" it could not pass upon the fairness of the plan of reorganization and that a valuation based upon capitalization of prospective earnings was essential. The Union and Consumers bondholders were to receive 5% cumulative income bonds of the new company and $50 par value 5% preferred stock. Each share of new preferred stock was to have a warrant for the purchase of two shares of new $2 par value common stock at prices ranging from $2 per share within six months of issuance, to $6 per share during the fifth year after issuance.

Preferred stockholders of Consolidated were to receive one share of new common stock for each share of old preferred stock. Common stockholders of Consolidated were to receive for each five shares of old common, a warrant to purchase one share of new common for $1 within three months of issuance.

On designated delinquencies in payment of interest on the new bonds, the old bondholders were to be entitled to elect six of the nine directors.

The status of the Union and Consumers bondholders emphasizes its necessity and importance. According to the District Court the mortgaged assets are insufficient to pay the mortgage debt. There is no finding, however, as to the extent of the deficiency or the amount of unmortgaged assets and their value. It is plain that the bondholders would have, as against Consolidated and its stockholders, prior recourse against any unmortgaged assets of Union and Consumers." 61 Sup. Ct. at 682.

Further, the Court stated that it was necessary to determine what assets were subject to the payment of the Union and Consumers bonds in order to pass upon the fairness of the plan with respect to the bondholders inter se.

With respect to this method of valuation, the Court stated:
The Court, nevertheless, considering some of the other problems presented by this litigation, stated that the absolute priority rule of the Boyd case was applicable to the reorganization of solvent corporations, and further held that the plan in the instant case violated that principle since bondholders did not receive full compensatory treatment thereunder. The preservation of the priority of bondholders by receipt of "inferior grades of securities, or even securities of the same grade as are received by junior interests" (a method approved earlier in the Kansas City Terminal Railway case) was sanctioned, but the Court emphasized that "while creditors may be given inferior grades of securities, their 'superior rights' must be recognized."

With these decisions the Supreme Court has established a clear rule that a plan is not fair which permits participation by parties who do not have an equity in the debtor's property, even though they are given securities completely subordinated to senior interests, unless they make a contribution in money or in money's worth. Thus, reorganization is now regarded as essentially a liquidation, except that going-concern, rather than liquidation, values are used.

"Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a sine qua non to a determination of the integrity and practicability of the new capital structure. It is also essential for satisfaction of the absolute priority rule of Case v. Los Angeles Lumber Products Co., supra. Unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result." 61 Sup. Ct. at 685.

This principle had previously been applied in the reorganization of solvent corporations. See In re Utilities Power & Light Corporation, 29 F. Supp. 763 (E. D. Ill. 1939); Sophian v. Congress Realty Co., 98 F. (2d) 499 (C. C. A. 8th 1938); and In re National Food Products Corporation, 23 F. Supp. 979 (D. Md. 1938).

The Court gave as its reasons:

"In the first place, no provision is made for the accrued interest on the bonds. This interest is entitled to the same priority as the principal. See American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U. S. 261, 266-267; Ticonic National Bank v. Sprague, 303 U. S. 406. In the second place, and apart from the cancellation of interest, the plan does not satisfy the fixed principle of the Boyd case even on the assumption that the enterprise as a whole is solvent in the bankruptcy sense. The bondholders for the principal amount of their 6% bonds receive an equal face amount of new 5% income bonds and preferred stock, while the preferred stockholders receive new common stock. True, the relative priorities are maintained. But the bondholders have not been made whole. They have received an inferior grade of securities, inferior in the sense that the interest rate has been reduced, a contingent return has been substituted for a fixed one, the maturities have been in part extended and in part eliminated by the substitution of preferred stock, and their former strategic position has been weakened. Those lost rights are of value. Full compensatory provision must be made for the entire bundle of rights which the creditors surrender." 61 Sup. Ct. at 685-686.

It is to be expected that the phrase "money's worth" will not be interpreted to include the nebulous type of "consideration" which has been used to justify the perpetuation of equity interests in some reorganizations. See supra note 59.

The approach to be taken in the formulation of a reorganization plan is, first, to value the debtor's assets, then to ascertain the parties entitled to share therein and, finally, to determine a fair allocation of new securities among such parties. The second step is now governed by a clear legal principle by which parties participate in order of their full contractual rights and under which lower courts must revise their former practice and require a valuation of the debtor's estate.  

The most difficult problems will arise from the third step.  

The first step in this process, however, is not simple for the measurement of assets available to creditors is essentially different in liquidation and reorganization. In liquidation, a debtor's assets are distributed on the basis of actual realization by sale of such assets; in reorganization, such assets are distributed on the basis of an appraised value. Little discussion is necessary to demonstrate the difficulty of precisely appraising a debtor's assets especially under the "going-concern" value test suggested by the Supreme Court. The "going-concern" value of a company means the capitalization of estimated prospective or actual earnings at a rate of return commensurate with the risks involved in the normal pursuit of the corporation's business. The absence of a definite formula to determine the rate on which capitalization should be based and the existence of numerous and indefinite elements render impossible any precise figure for the going-concern value of a debtor.  

It would seem highly inequitable, therefore, to exclude, on the basis of such an appraisal, parties from a reorganization when it is a close question whether they have an interest in the debtor's property. Where a party obviously has no equity, an application of an absolute priority rule, based upon an appraisal, is eminently fair, but in a situation where there is considerable doubt as to the existence or non-existence of his equity, it would seem more consonant with equitable principles to give him some securities completely subordinated to those given to prior interests. Further, this treatment would eliminate
the lengthy and costly litigation which may be required in a controversy on valuation and facilitate reorganization where a close question is raised on this point.

In this situation the technique afforded by the "relative income priority" theory would have permitted the inclusion of the junior group. Although that theory has been condemned, it is still possible to permit such class to participate. When it is found that a valuation, based upon a capitalization of prospective earnings, just excludes a group from participation, the rate of capitalization of earnings could be raised, thereby increasing the value of the debtor's assets to permit the inclusion of this group. Again, in this situation, since no precise figure can be reached with respect to going-concern value, a court would undoubtedly be inclined to accept a figure which would afford a basis for the participation of this junior class. Although bound to apply a strict priority rule, a court may nevertheless administer the rule in accordance with equitable considerations.

More difficult problems arise with respect to the allocation of new securities among the parties entitled to participate in the reorganization.

Under the Consolidated Rock opinion "full compensatory treatment" must be accorded to creditors where stockholders are included in a plan. What constitutes "full compensation" must necessarily depend on a business, rather than a legal, judgment, for the Court declared that: "Practical adjustments, rather than a rigid formula, are necessary"; and further that: "So long as the new securities offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the court."  

"Value," however, is not defined in the opinion for the purpose of testing the fairness of an allocation of securities. It might be argued that the foregoing language requires that creditors be paid by new securities of a present realizable or market value equal to their claims. This argument should fail since the foregoing language should be read in connection with the preceding reference by the Court to the position it took in the Boyd case that "creditors are entitled to have the full value of the property... first appropriated to payment of their claims." Thus, the emphasis is on the value of the debtor's property rather than the market value of securities mathematically, the exact treatment which must be accorded to common stock in such a situation, but the Court is satisfied that the treatment provided by the debtor's plan is fair to both classes, and this view is confirmed by the acceptance of the plan by both classes in substantially equal percentages." See also In re Utilities Power & Light Corporation, 29 F. Supp. 763, 769 (E. D. Ill. 1939); In re Chain Inv. Co., 102 F. (2d) 323, 324-325 (C. C. A. 7th 1939).
representing that property. And further, any arrangement whereby all creditors’ claims are paid in full would not seem to constitute a plan of reorganization within the meaning of Chapter X, Section 216(1), which provides that such plan: “Shall include in respect to creditors generally or some class of them, secured or unsecured, ... provisions altering or modifying their rights, either through the issuance of new securities of any character or otherwise.”

Since the market value of the new securities which are distributed to a creditor is not the measure of his “full compensatory” treatment, what sort of “value” did the Court mean? “Value” in this connection must refer to the worth of such securities as a means of ultimately reimbursing their holder for his former claim. This value of securities, which represents an informed business judgment reached after a study of the capitalization and condition of the issuing company, is essentially different from their market value which

9See 2 Gerdes, Corporate Reorganizations (1936) § 1037 and cases therein cited.

The argument was made by debentureholders in In re Radio-Keith-Orpheum Corporation, 106 F. (2d) 22 (C. C. A. 2d 1939), that the lien of their debentures could not be disturbed except on payment of cash or “its immediately realizable equivalent.” Dismissing this objection, the Court stated: “The argument loses sight of the fact that the debentures, while a lien on property with a going value in excess of the debt, are not now a lien on cash or its immediately realizable equivalent for the full amount of the debt.” 106 F. (2d) at 25.

The position taken by the Securities and Exchange Commission in its recent report on a proposed plan for the reorganization of McKesson & Robbins, Inc. (S.E.C. Corp. Reorg. Release No. 41, March 29, 1941) does not impose the requirement that the market value of new securities must equal a creditor’s claim. Under that plan, holders of old 5½% debentures were to be given accrued interest and 40% of the principal amount of their claims in cash, 40% of the principal amount in new 4% debentures, and 20% in new 5½% preferred stock. The Commission approved this treatment of creditors who were required to sacrifice their creditor status to the extent of 20% of the principal of their claims, to extend the maturity of 40% thereof and to accept a reduction in rate of return in exchange for cash and new securities in a face amount only equal to the amount of their claims. However, since the plan provided for an underwriting of the new debentures and preferred stock that would net at least the aggregate face amount of these securities, the Commission declared that “no question of fairness as to them [holders of old debentures] would arise” since, if “such an underwriting is obtained for the securities otherwise allocable to creditors, their claims for both principal and interest will be paid in cash in full.”

And, further, even in the absence of such an underwriting, said the Commission, the plan would be fair since testimony was received at the hearings on the plan that securities of the kind offered to the old debentureholders would have sold at par under then current market conditions; thus “the package of securities and cash allocable to creditors would have an aggregate realizable value equal to the full amount of their claims for principal and interest.”

The Commission merely said, in effect, that if the realizable value of the new securities given to creditors equals the amount of their claim, they have received the full compensatory treatment required by the Consolidated Rock opinion; but this does not constitute a ruling that creditors must receive securities, the realizable value of which equals their claims, before they have received such compensatory treatment.

9The approach is illustrated in Matter of Porto Rican American Tobacco Co., S.E.C. Corp. Reorg. Release No. 27. There certain assets of the debtor were to be liquidated and others sold to another company in consideration of the latter’s 4% 10 year notes. Holders

98
is affected by numerous factors totally unrelated to the issuer's present or prospective financial condition. To illustrate, if a reorganized or new corporation has a going-concern value of $1,000,000, one of its bonds of a total issue of $10,000 has greater value than one bond of a total issue of $800,000.

Under the rule of the Consolidated Rock case "full compensatory" provision must be made for "the entire bundle of rights which the creditors surrender." Thus, where a creditor is forced to accept a reduced or contingent claim to interest, extend the maturity of his claim, or surrender a secured obligation for an unsecured claim or for stock, he must be compensated for these relinquished rights. And he is not fully compensated, said the Court, merely by receipt of "inferior securities" in face amount equal to his claim. Without purporting to fix a "rigid formula" for testing the adequacy of such compensation the Court declared:

"But whether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on the facts and requirements of each case. So long as the new securities offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the court." 97

In short, "value," in the sense discussed earlier, is the test of "full compensation," not the face amount of the new securities. Something "extra," to be determined differently in each case, must be given to creditors who yield any of their rights to compensate for the new risk involved in the ultimate satisfaction of their claims. 98 Of course, in the rare case where the immediate realizable value of the new securities equals the face amount of their claims, creditors are fully compensated although the new obligations carry less interest than the old; 99 such creditors can sell these securities and presently satisfy their claims.

of the debtor's 6% bonds were to receive common stock in the liquidating company and also a portion of the notes of the purchaser of the other assets of the debtor. To determine the fairness of this treatment the Commission inquired into the value of the notes and, after fully considering the financial record and capitalization of the purchaser, concluded that "it is not unreasonable to regard the notes as compensation approximating their face amount." (p. 11.)

9761 Sup. Ct. 686-687.
This principle of "full compensation" in the allocation of securities to the interested parties prohibits the approach taken in many reorganization plans. For example, whether bondholders could be compelled to accept unsecured obligations or stock has been a subject of controversy. But where creditors were required to relinquish their lien for new securities, such securities did not exceed the face amount of their claims; no additional securities were given to these creditors to reimburse them for the loss of their security.

It has been argued in some cases that creditors of an insolvent debtor have the right merely to be paid the amount of their claim and that the fact that a claim is secured, rather than unsecured, entitles the claimant to no greater right; that upon foreclosure of a mortgage, a secured creditor is not entitled to realize more than the principal and interest of his debt and cannot receive any more of the proceeds merely because he had a "special" type of claim. The Supreme Court, however, took the more realistic view in its Consolidated Rock opinion that, since a creditor is not being presently paid by receipt of new securities, such creditor should be compensated for the risk involved in accepting an unsecured or inferior obligation of a new corporation and for the postponement of the satisfaction of his claim.

To summarize, by its recent decisions the Supreme Court has provided reorganizers and the lower federal courts with a clear rule for measuring the fairness of reorganization plans by which the sanctity of the contractual rights of creditors is preserved and the perpetuation of equity interests in hopelessly insolvent corporations is prohibited.

In future reorganization proceedings the principal issues will relate to (1) the valuation of the debtor's assets in cases where there is a close question whether a certain class of interests has an equity in such assets, and (2) the allocation of new securities among the parties entitled to participate. Since the Court has declared that no "rigid formula" is necessary but rather "practical adjustments," it would seem that a fair exercise of the "informed discretion" of a lower court on such matters will be upheld.


See, for example, In re Radio-Keith-Orpheum Corporation, 106 F. (2d) 22 (C. C. A. 2d 1939); National Food Products Corporation, 23 F. Supp. 979 (D. Md. 1938); and cases cited supra note 100. See Dodd, The Los Angeles Company Case (1940) 53 HARV. L. REV. 713, 741.