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# FINDINGS OF "VALUE" IN RAILROAD REORGANIZATIONS

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SECTION 77 of the Bankruptcy Act has not generally proved an expeditious medium for railroad reorganizations. Nevertheless, by November, 1941, a number of cases involving some of the larger systems had reached advanced stages, and it was not commonly supposed that the Supreme Court's opinion in *Consolidated Rock Products Co. v. Du Bois*,[1] which had been handed down on March 3, 1941, had established any new procedural requirements which had not been fully understood and respected by the Interstate Commerce Commission. However, startling developments were destined to take place.

On November 28, 1941, the Circuit Court of Appeals for the Ninth Circuit reversed on procedural grounds the decision of the District Court approving the plan of reorganization of *The Western Pacific Railroad Company*.[2] On December 4 the Circuit Court of Appeals for the Seventh Circuit similarly disposed of appeals from an order approving the plan for the *Chicago, Milwaukee, St. Paul and Pacific Railroad Company*.[3] On December 8 District Judge Hincks disapproved the plan which had been approved by the Interstate Commerce Commission for *The New York, New Haven and Hartford Railroad Company*.[4] On December 9 District Judge Igoe issued an order in *The Chicago, Rock Island and Pacific Railway Company*[5] case, re-

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1. 312 U. S. 510 (1941), Comments 51 YALE L. J. 85, 51 YALE L. J. 907.

2. *In re* Western Pac. R. R., 124 F. (2d) 136 (C. C. A. 9th, 1941). Petitions for writs of certiorari were granted by the United States Supreme Court on April 27, 1942.

3. *In re* Chicago, M. St. P. & P. R. R., 124 F. (2d) 754 (C. C. A. 7th, 1941). Certiorari was granted by the Supreme Court on June 8, 1942.

4. In the Matter of The New York, New Haven and Hartford R. R., Debtor. No. 16,562 (Conn.), Printed Court Record, 8923-9031, C. C. H. Bankr. Serv. ¶ 53,518 (1941).

5. In the Matter of The Chicago, Rock Island and Pacific Ry., Debtor. No. 53,209 (N. D. Ill.), Printed Court Record, 3547–48. Under date of April 6, 1942, the Interstate Commerce Commission issued a Supplemental Report which included detailed schedules setting forth each step in the mathematical process on which most of the Commission's

voking the previous directions for the filing of briefs on the plan theretofore approved by the Commission and requiring counsel to submit suggestions as to further procedure. In another major case, that of the *Missouri Pacific Railroad Company*,[6] an appeal is pending from a District Court order approving a plan of reorganization and, if the rules laid down in the *Western Pacific* opinion should be followed, a reversal would seem to be required. In the *Chicago & North Western Railway Company*[7] case, decided after the *Milwaukee* opinion was handed down, the Circuit Court of Appeals for the Seventh Circuit affirmed orders approving and confirming a plan, but its decision, if not reversed by the Supreme Court, would constitute a precedent only in exceptional instances, as it was based on the results of the submission of the plan for acceptance or rejection.

Further delays in these cases, all of which have been pending for at least six years, are now inevitable. Section 77 of the Bankruptcy Act provides that, if a plan be disapproved, the Court "may either dismiss the proceedings, or . . . refer the proceedings back to the Commission for further action."[8] If the latter course be followed, the Commission is required to proceed to a reconsideration of the proceedings under the provisions of subsection (d) of Section 77.[9] There must be new hearings, on notice, and a new report and order from the Commission — whether this means that there must be a complete reconsideration of the case, in the light of changes in conditions, remains to be determined.

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proposed allocation of the new securities is based. On April 17, 1942, the Court directed the filing of briefs. Presumably the adequacy of the findings made by the Commission will be an issue to be determined by the Court.

6. *In re* Missouri Pac. R. R., 39 F. Supp. 436 (E. D. Mo. 1941). By order dated October 9, 1941, the Commission submitted the approved plan for acceptance or rejection to fifteen classes of creditors and a class of stockholders of a subsidiary. The statutory percentage of ten of the sixteen classes voted to accept the plan.

7. *In re* Chicago & North Western Ry., 126 F. (2d) 351 (C. C. A. 7th, 1942). The Circuit Court considered the Commission's findings insufficient. It held, however, that the bondholders had waived the "requirement that the I. C. C. fix value of the property covered by each mortgage". The holding was based on the record of the votes to accept the plan. The necessary implications are that (a) the District Court's order approving the plan was erroneous when entered, because at that time there had obviously been no such waiver, and (b) the order approving the plan would have been reversed if the submission had not been effected while the appeal from the order approving the plan was pending and the appeal from the orders confirming the plan had not been heard at the same time. It is hardly to be expected that a similar situation will exist in many cases.

An application for a writ of certiorari has been filed in the Supreme Court.

8. Section 77(e) of THE NATIONAL BANKRUPTCY ACT, 49 STAT. 918 (1936), 11 U. S. C. § 205(e) (1940).

9. Section 77(d) of THE NATIONAL BANKRUPTCY ACT, 49 STAT. 917 (1935), 11 U. S. C. § 205(d) (1940).

In the *Western Pacific* case the Circuit Court of Appeals disapproved the plan solely because of a supposed inadequacy in the findings of "value" made by the Commission.[10] That appears to be also true of the *Milwaukee* case, although the opinion is not so clear.[11] Only in the *New Haven,* of the six cases referred to above, has a Court thus far indicated a disagreement with the Commission on the provisions of a plan. The *Western Pacific* opinion has the merit of being clear and specific, and thus sharply defines the problem of findings of "value".

The most serious aspects of that problem stem from the Circuit Court of Appeals' interpretation of the opinion in *Consolidated Rock Products Company v. Du Bois.*[12] In that case Justice Douglas said that, in order for the court "to exercise the 'informed, independent judgment' (*National Surety Co. v. Coriell*, 289 U. S. 426, 436) which appraisal of the fairness of a plan of reorganization entails," certain "valuation data" were required, including, apparently, findings as to "the extent of the deficiency" on the secured claims and "the amount of unmortgaged assets and their value."[13] The corporate and security structure involved in the *Consolidated Rock Products* case was comparatively simple and the findings apparently required by the Supreme Court would presumably not be numerous.

In the *Western Pacific* case, however, the Circuit Court of Appeals construed the *Consolidated Rock Products* opinion as calling for sixteen findings of "value", to be certified by the Commission to the Court.[14]

10. *In re* Western Pac. R. R., 124 F. (2d) 136, 139-40 (C. C. A. 9th, 1941).
11. *In re* Chicago, M. St. P. & P. R. R., 124 F. (2d) 754, 766 (C. C. A. 7th, 1942).
12. See note 1 *supra.*
13. 312 U. S. 510, 520 (1941).
14. 124 F. (2d) 136, 139 (C. C. A. 9th, 1941). This part of the opinion reads:

"Subsection e of Sec. 77 provides: 'If it shall be necessary to determine the value of any property for any purpose under this section, the (Interstate Commerce) Commission shall determine such value and certify the same to the court in its report on the plan.' In this case, as has been seen, it was necessary to determine the value of (1) the debtor's entire property, (2) each of the claims of Reconstruction Finance Corporation, (3) the claim of Railroad Credit Corporation, (4) the claim of A. C. James Company, (5) the claims of the holders of first mortgage bonds now outstanding, (6) the $10,000,000 of new first mortgage bonds, (7) the $21,219,075 of income bonds, (8) the 318,502.97 shares of new preferred stock, (9) the 319,441 shares of new common stock, (10) the property subject to the first mortgage now outstanding, (11) the $18,999,500 of refunding bonds pledged to secure the claims of Reconstruction Finance Corporation, Railroad Credit Corporation and A. C. James Company, (12) the other collateral pledged to secure each of said claims, (13) the property subject to the refunding mortgage only, (14) the property subject both to the refunding mortgage and to the first mortgage now outstanding, (15) the property which would be subject to the new first mortgage and (16) the property which would be subject to the income mortgage. It thus became the duty of the Commission to determine these values and certify them to the court. That duty was not performed."

It appears likely that several of the sixteen findings said to be necessary would cover the aggregate values of several items and that the total number of findings would be much larger. In the *Milwaukee* case the Circuit Court of Appeals did not specify what findings of "value" should be made, leaving the parties and the Commission to work out the problem as best they could.

In the writer's judgment the *Western Pacific* and *Milwaukee* opinions impose procedural requirements which make the reorganization process under Section 77 useless except in the simplest kind of case,[15] and even lack a sound theoretical basis. Whatever doubt there may be as to the propriety of comment on cases which are still sub judice, especially comment by one who has some interest in the outcome of the cases,[16] must give way if there be any chance of assisting in the solution of a problem which involves the national interest because of the importance of enabling railroad executives to devote their time to transportation service without the continued harrassment of reorganization proceedings.

## The Scope of Any Requirement of Findings of Value

The supposed requirement of findings of "value" in dollars is not imposed by any statute, and, if it exists, applies alike to Section 77, Section 77B, Chapter X and equity cases. *Consolidated Rock Products Company v. Du Bois,* on which the *Western Pacific* ruling is based, was a Section 77B proceeding and that part of Justice Douglas's opinion which refers to findings is not based on any provision of the statute.[17] The *Western Pacific* case, arising under Section 77, was based squarely on the *Consolidated Rock Products* opinion. While a reference was made in that opinion to subsection (e) of Section 77, it was only to establish that, if findings of "value" were to be made, the Commission should make them.[18]

15. That is believed to be true notwithstanding the consummation of a number of plans under Section 77. That Section was not construed to require such detailed findings of "value" prior to the opinion of the Circuit Court of Appeals in the *Western Pacific* case.

16. The writer's firm is counsel for a protective committee which supported the *Missouri Pacific* plan, for a trustee of a mortgage which considers the plan approved by the Commission in the *St. Louis Southwestern* case acceptable, and for a protective committee which is opposing the *Rock Island* plan. In each instance the writer's firm is representing the holders of underlying bonds, and the *Consolidated Rock Products* opinion is favorable to such holders in so far as it establishes the "absolute priority" rule.

17. 312 U. S. 510, 520-27 (1941).

18. The sentence of § 77 which was quoted commences with the words "If it shall be necessary to determine the value of any property for any purpose under this section." No such "if" clause should be construed as imposing a requirement that sixteen findings of "value" be made as was done in the *Western Pacific* case. 124 F. (2d) 136, 138-40 (C. C. A. 9th, 1941). See Supplemental Report of the Interstate Commerce Commission

Section 77 does require findings by the Commission and the Court that a plan is "fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders."[19] There are differences in the wording of the requirements of Section 77B and Chapter X, but the substance seems to be the same.[20] Indeed, it is not too much to say that the only real requirement expressed in any of the three statutes is that a plan be found to be "fair and equitable", because, if a plan is "fair and equitable", it will necessarily meet any of the other statutory requirements which pertain to the treatment of creditors and stockholders.

Section 77 also authorizes a finding that the "equity of [a] class of stockholders" or the "interests of [a] class of creditors" have "no value" as a basis for not submitting the plan to such a class,[21] and any such finding can doubtless serve the same function in a Section 77B[22] or Chapter X proceeding.[23] However, there is a marked difference between a requirement that there be a finding that a plan is "fair and equitable" (coupled with one or more additional findings that the equity of a particular class of stockholders or the interests of a particular class of creditors has "no value" if such class or classes are to be excluded from participation in the plan) and a requirement that numerous findings of dollar "value" be made. Frequently it requires hardly more than a glance at a balance sheet and a few income accounts to establish that the equity of a class of stockholders is worthless; it is quite a different matter to say that a part or all of the property of a large railroad corporation is worth a specified number of dollars.

It has been suggested, even by some who do not agree with the *Western Pacific* decision, that there must always be a finding of the dollar "value" of all of the assets of a debtor, but that it is not necessary, because it is impossible, to make findings of the dollar "value" of the parts of the property of the debtor in which particular classes

in St. Louis Southwestern Railway Company Reorganization, Finance Docket No. 11040, decided March 9, 1942, p. 68.

19. Sections 77(d) and (e) of THE NATIONAL BANKRUPTCY ACT, 49 STAT. 917-18 (1935), 11 U. S. C. § 205(d) and (e) (1940).

20. 48 STAT. 919 (1934), 11 U. S. C. § 207 f (1940); 52 STAT. 897 (1938), 11 U. S. C. § 621 (1940).

21. See note 8 *supra*.

22. In the Matter of 620 Church Street Building Corp., 299 U. S. 24 (1936); *In re* National Food Products Corporation, 23 F. Supp. 979 (D. Md. 1938); *In re* Utilities Power & Light Corporation, 29 F. Supp. 763 (N. D. Ill. 1939).

23. Chapter X, Sections 179 and 216, of THE NATIONAL BANKRUPTCY ACT, 52 STAT. 892, 895-97 (1938), 11 U. S. C. §§ 579, 616 (1940).

of security holders are interested, or of the value of their claims, or of the value of the new securities. Another suggestion is that findings of the latter type are necessary in a comparatively simple case, like *Consolidated Rock Products Co. v. Du Bois,* but that they cannot be required in a complicated railroad reorganization case because they cannot be made.

The question, however, is not what findings may be made by the Interstate Commerce Commission or a Court in its discretion, as an aid to the review of its determinations, but what findings must be made. If there must always be a finding of the dollar "value" of the total assets of a debtor in order to determine the relative treatment of the creditors (taken as a whole) and the stockholders, it is difficult not to conclude that there must always be a similar finding with respect to the dollar "value" of a part of the debtor's property, if there are senior and junior liens on that part, in order to determine the relative treatment of the two liens. A junior lienholder stands in the shoes of a stockholder vis-a-vis the senior lienholder, and whenever there is a senior and a junior interest in a particular piece of property the situation is fundamentally like that where property is owned by a separate debtor corporation and bonds and stock are outstanding against it.

A rule which made the necessity for dollar findings of "value" depend on the difficulties of the particular case would serve little purpose except to lengthen briefs. In any doubtful situation such findings would usually be held to be unnecessary and in any situation which was not doubtful it would not make any difference whether the findings were made or not. Professor Dodd has pointed out that doubt and difficulties can exist even as to the value "in dollars and cents" of an entire enterprise and that a judge is not likely to "commit himself" to a finding unless he is required to.[24]

As a practical matter the choice seems to be between (1) a requirement of an ultimate finding that a plan is "fair and equitable", supplemented by additional findings in the language of the statute with respect to the claims and interests of particular classes of creditors and stockholders if they are to be excluded from participation in the plan, and (2) a requirement of such ultimate findings, supported by as many preliminary findings of dollar "value" as may be necessary in order to make the ultimate findings a matter of simple arithmetic.

## THE PRACTICAL PROBLEM

In the *Consolidated Rock Products* case there were two bond issues, and preferred stock and common stock, making four classes of securities

24. Dodd, *The Los Angeles Lumber Products Company Case and Its Implications* (1940) 53 HARV. L. REV. 713, 730.

in all. Each of the two bond issues was apparently secured only by a direct first lien on certain properties (there were no over-lapping liens, pledges of leaseholds or securities, or other familiar complications of a railroad reorganization), and the two properties which secured the mortgages, plus the unmortgaged assets, or three items (or groups of items) were all that had to be "valued".

In the *Missouri Pacific* case, the plan approved by the Commission and the Court was submitted to sixteen classes of security-holders, and one of the sixteen classes includes five different bond issues.[25] A condensed summary of the security for one class of bonds requires almost an entire page in Moody's Manual of Investments,[26] which lists (1) first lien mileage, (2) second lien mileage, (3) third lien mileage, (4) fourth lien mileage, (5) trackage rights, (6) equipment, and (7) securities and other property. It is safe to say that compliance with the requirements apparently laid down in the *Western Pacific* opinion would require well over a hundred findings of "value".

Nearly four years elapsed in the *Missouri Pacific* case between the closing of the record before the Commission and the Court's approval of the plan.[27] Even if the plan should be approved on appeal, there is no reasonable chance that it can be consummated within five years after the record was closed before the Commission or within less than ten years after the proceedings were commenced. How much longer would have been required if the Commission had had to make a hundred or more additional findings of "value"? Assuming that it could have made so many findings of "value" and that they could have been supported by the evidence, what possibility is there that, with radical changes affecting the earnings of the system taking place over comparatively short periods, all or any large number of its findings of "value" would have continued to be supported by the evidence at the time of the hearing in court on the plan?[28]

25. Order of Interstate Commerce Commission, dated October 9, 1941, in Missouri Pacific Railroad Company Reorganization, Finance Docket No. 9918.

26. MOODY'S MANUAL OF INVESTMENTS, AMERICAN AND FOREIGN, RAILROAD SECURITIES (1941) 1376-77.

27. The record before the Commission was closed on September 30, 1937; the District Court approved the plan on June 20, 1941.

28. Section 77 does not specify whether the Court hearing shall be on the record before the Commission or whether new evidence may be received. In the *New Haven* case Judge Hincks ruled (Printed Court Record, 8421-22):

> "In my view, Section 77 contemplates that normally in passing upon a plan reported by the Commission the Court shall base its conclusions upon substantially the same record of fact as that made before the Commission. True, Section 77 has sufficient flexibility to permit the Court to receive evidence to show the entry of new factors of sufficient importance and permanence to indicate the necessity of some material modification of a plan which

Moreover, a mere indication of the number and variety of the readily determined legal interests in the different parts of a railroad system does not convey a true impression of the difficulties which are presented if, as the *Consolidated Rock Products* opinion may be thought to imply, it is necessary to decide all controversies affecting liens or other interests in the different parts of the system before making findings of value. It is impossible to do more than to suggest the number and type of questions which exist — and frequently lie more or less dormant — in a railroad reorganization proceeding. Perhaps one example will suffice to illustrate what it would mean if all questions of liens were required to be determined before a plan of reorganization could be approved.

In the *Erie Railroad Company*[29] case the Commission fixed a total capitalization of $332,692,250, of which $138,289,887 represented fixed-interest debt and $52,987,392 income bonds. A Protective Committee for the Convertible Bonds objected to the treatment of that issue.[30] The mortgage securing the issue was a lien, direct or collateral, subject to prior mortgages, on most of the Erie System. In addition, it was a collateral first lien on several properties, of which the Penhorn Creek Railroad Company was one. The title to and claims against the Penhorn Creek's properties were a matter of dispute and the story was a complicated one.[31] There were no findings as to the ownership of or claims

when reported by the Commission was designed to accomplish a permanent reorganization."

In several cases, notably the *Missouri Pacific, Rock Island, North Western* and *Erie*, new evidence has been received before the Court. The gravest question could be raised, to say the least, if the Court refused to permit the introduction of evidence showing changes in conditions between the closing of the record before the Commission and the commencement of the hearing in Court. If that period is measured in years, there are bound to be such changes.

29. Erie Railroad Company Reorganization, 239 I. C. C. 653 (1940); 240 I. C. C. 469 (1940); *In re* Erie R. R., 37 F. Supp. 237 (N. D. Ohio 1940).

30. *In re* Erie R. R., 37 F. Supp. 237, 251 (N. D. Ohio 1940).

31. In the brief of the principal creditor group, the facts were summarized as follows:

"The interest of the Convertible Bonds in the Penhorn Creek is evidenced by the pledge of all of the stock of the Penhorn Creek (Ex. 31a, p. 21), which is of a par value of $6,000 (Ex. 206, p. 26).

"The principal property of the Penhorn Creek is stated in the Debtor's Plan to be 'a four-track cut through Bergen Hill' extending 'from Jersey City to a connection with the lines of the Paterson and Hudson River near Croxton, New Jersey', but the Plan also states that 'title to the land' is 'in large part in The Long Dock Company' (D. P. 6).

"The map which was introduced in evidence (Ex. 260a), the additional documentary data (Ex. 260b), and the testimony (Tr. 795-800), disclose that 'the so-called main stem part of the Penhorn Creek Railroad' is 'located entirely on property the fee of which is owned by other companies, except parcels 7 and 8 shown on the map' (Tr. 795-796). The assessed valuation of the main stem in 1938 was $2,414,285 (Tr. 796) and the assessed valuation of the properties actually owned by the Penhorn Creek was only $490,458 (Ex. 260b).

against the properties, to say nothing of their "value", although more than a million dollars of "value" may have been involved.[32] If *Consolidated Rock Products Co. v. Du Bois* had been decided before the

"The valuation figures in Exhibit 128 set forth an Interstate Commerce Commission valuation, before depreciation, of $1,110,295 as of September 30, 1938, and represent the valuation of properties constructed on 'lands owned by Penhorn Creek Railroad Company and improvements thereon' (Tr. 796). Presumably this is also true in respect of the small item of depreciation as of June 30, 1918, shown on Exhibit 280, which is so insignificant as not to require mention.

"As already noted, Penhorn Creek Railroad Company has only $9,000 of Capital Stock, which is pledged under the General Mortgage securing the Convertible Bonds. As of December 31, 1937, the Penhorn Creek owed the Erie $4,907,736.75 (Ex. 206, p. 26). Prior to the first hearings before the Commission it had been suggested that no value whatever could be attributed to the stock of Penhorn Creek Railroad Company in determining the proper treatment of the Convertible Bonds, on the ground that the properties owned by the Penhorn Creek were not worth more than the amount owed by the latter to the Erie, and that the claim for that amount was unpledged. Mr. Sturgis testified that such a contention could not fairly be sustained (Tr. 202-204). Even assuming that we are incorrect in our opinion that the claim for advances is probably pledged under the General Mortgage, like the claim for advances against the Susquehanna (*supra* pp. 263-264), it seems reasonably clear that no court of equity would hold the Penhorn Creek liable for that part of the advances which represented the cost of improvements on lands of other corporations, and that the Erie would be accountable for the use which it had made of the Penhorn Creek property and would be required to set off the amount for which it was accountable against so much of the advances as represented a proper charge against the Penhorn Creek (Tr. 202-203).

"The circumstance that such a large proportion of the properties which are carried in the name of the Penhorn Creek are in fact on lands owned by other corporations can, however, hardly be disregarded in determining what weight should be given to the stock of the Penhorn Creek in treating with the Convertible Bonds. In this connection, of course, it would be improper to reject the possibility that the Trustee of the General Mortgage, which secures the Convertible Bonds, might secure an adjudication that the Mortgage is an equitable lien, at least to the extent of the cost of the improvements, on the lands on which the improvements remain. But it is obviously impossible to forecast the outcome of any such legal proceedings, and it is equally clear that there would be no justification for postponing the reorganization until they could be commenced and carried through the courts.

"Another factor which requires consideration is that the principal function of those properties which are generally regarded as Penhorn Creek properties is in connection with passenger business, which is admittedly unprofitable (Tr. 204, 798-799).

"The Group was clearly correct in concluding that 'some not inconsequential weight should be given to the lien of the Convertible Bonds on the stock of the Penhorn Creek Railroad Company' (Tr. 203), and also in deciding that it would be folly to try to decide that a specific dollar amount of new First Consolidated Mortgage Bonds or General Mortgage Bonds should be distributed in respect of that property."

32. *Ibid.*

Court approved the *Erie* plan, and if it had been held that there must always "be a determination of what assets are subject to the payment of the respective claims", and that there must be findings of "value",[33] the *Erie* plan could not have been approved. Yet the treatment of the Penhorn Creek Railroad Company was not a serious issue;[34] the serious issues raised by the Committee were so fully answered by the Special Master[35] that the Committee filed no exception to his report; and, of the Convertible Bonds voted on the plan, the holders of 99.86% in amount voted to accept it.

Procedural requirements which may not be insuperable in a simple Section 77B or Chapter X case may be fatal in a railroad reorganization proceeding. The structure of a debtor in the former may differ from that of a railroad system as much as a pre-fabricated one-room house differs from a Gothic cathedral.

## Problems of a Reorganization Process Based on Findings of Value

The opinion of the Circuit Court of Appeals in the *Western Pacific* case necessarily implies that it is feasible to determine with reasonable accuracy the dollar "value" of railroad property, of "old" securities which are to be discharged under a plan of reorganization, and of new securities which are to be created under a plan. If that be true, the Court hardly needs to do more, in determining whether a plan of reorganization is "fair and equitable", than ascertain whether the evidence supports the findings and whether as a matter of simple arithmetic the findings support the conclusion that the plan is "fair and equitable". On the same hypothesis, the "absolute priority" rule can be applied with mathematical precision and "full compensation" can always be determined exactly. Moreover, all other standards or methods of determining whether a plan is "fair and equitable" become useless. If determinations of "value" can be what they purport to be, and it is possible to demonstrate with mathematical precision the fairness of an exchange of old securities for new, it is unnecessary to analyze the "bundles of rights"[36] which are to be exchanged except for the purpose of determining their "value".

*Some Dangers of Findings of "Value":* A suggestion of the dangers of reliance on findings of "value" may be gleaned from a recent report of the Commission in which the Commission evidently undertook to go as far as possible in complying with the requirements laid down in

33. 312 U. S. 510, 520 (1941).
34. *In re* Erie R. R., 37 F. Supp. 237, 248 (N. D. Ohio 1940).
35. *Id.* at 248-52.
36. Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510, 528 (1941).

the *Western Pacific* opinion.[37] The Commission found that the property of the debtor had a value of $75,000,000; that "the sum of the undisturbed and new securities, representing as they do the sum of the interests of all those who will have an interest in the properties of the reorganized company, are of the same $75,000,000 value"; and that "the new securities may be equitably exchanged for the existing claims on the basis of $1 par value of any of the new securities for $1 of value of the existing claims." If these findings meant what they said, they would mean that it would be "fair and equitable" to scramble the priorities of the old securities in distributing the new. For example, such findings would seem to permit the Commission to allot new common stock for old divisional first mortgage bonds which are a first lien on property having earnings and at the same time to allot new fixed interest bonds for old divisional mortgage bonds which are a second lien on property having the same amount of earnings. Such findings imply that each of the new securities has a dollar "value" equal to its face or par amount, and, if that be true, no holder of an old security can complain or should care whether he receives new fixed interest bonds or common stock.

Of course, in the case cited the Commission did not undertake to reverse or disregard priorities in reliance on findings of dollar "value" and there is little danger that it will ever do so, because it is too experienced to give such findings the significance which could be attributed to them logically and mathematically. However, findings of such a character tend to confuse the issues and to make a true analysis by the Court of any sound objections to a plan more difficult to obtain. On the other hand, a sound plan may be weakened before the Court, because an objector's challenge, which should be directed at the plan itself, can be directed at the findings, and if they are demonstrated to be erroneous the plan may be disapproved even though it is entirely "fair and equitable".

*The Fictitious Character of "Findings of Value":* There is little danger that the Commission will ever reverse or ignore existing priorities in reliance on findings of dollar "value", since it must recognize that a finding of the dollar "value" of railroad properties, of the old securities, or of the new securities, is necessarily fictitious. In the case of any proposed exchange of old securities for new securities the ultimate determination to be made is whether the exchange is "fair and equitable". The exchange is not one of property for dollars, but of one "bundle of rights" for another "bundle of rights". A finding of the dollar "value" of securities or property implies that there is a proved

37. Supplemental Report in St. Louis Southwestern Railway Company Reorganization, Finance Docket 11040, decided March 9, 1942, 57-58.

equality between the securities or property and a specified number of dollars. Such a finding is fictitious to the extent that the things valued cannot be converted into the specified number of dollars or that the conversion must be delayed before the specified number of dollars can be received.

The fundamental difficulty in determining the "exchange value" of a public utility was succinctly stated by Justice Brandeis:[38]

> "It is impossible to find an exchange value for a utility, since utilities, unlike merchandise or land, are not commonly bought and sold in the market. Nor can the present value of the utility be determined by capitalizing its net earnings, since the earnings are determined, in large measure, by the rate which the company will be permitted to charge; and, thus, the vicious circle would be encountered."

There are, however, other difficulties in capitalizing earnings in order to determine the "value" of a railroad property in a reorganization.

To capitalize past earnings it is necessary to decide what period of earnings to take and what rate of capitalization to use. There is no scientific way of determining either of the figures which are to be multiplied, and the leeway for judgment in the selection of each figure is inevitably considerable. Even if each figure which is used in the multiplication seems not unreasonable when considered by itself, the result of multiplying the two may be absurd. In any case the result will be far from an exact determination, being produced by the multiplication of two figures neither of which has any scientific sanction.

Furthermore, a capitalization of past earnings disregards the consequences of a reorganization. One of the most important consequences of the usual reorganization is a substantial decrease in the interest charges, which increases the income taxes payable from the same amount of revenues. In addition, a reorganization may result in a change of the tax basis.[39]

38. See State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri, 262 U. S. 276, 292 (1923) (dissenting opinion).

39. See Helvering v. Southwest Consolidated Corporation, 86 L. Ed. 512 (1942). It is the position of the Bureau of Internal Revenue that, if the properties of a debtor are transferred to a new corporation, the tax basis of the new corporation will ordinarily be the face amount of its debt plus the fair market value of its stock. Some conception of the drastic consequences, if such be the effect of the formation of the new corporation, will be obtained from a memorandum entitled "Federal Tax Problem of Railroads in Reorganization", dated August 27, 1941, submitted by the Association of American Railroads and Railroad Security Owners Association, Incorporated.

The Commissioner's office has intimated that, if a new corporation is not formed, the debtor may realize income through the discharge of the indebtedness in the reorganization by the delivery of stock having a "fair market value" less than the amount of the debt discharged by the issuance of such stock, on the theory that the transaction is con-

In the *Consolidated* case Justice Douglas did not refer to a capitalization of past earnings, but to a "capitalization of prospective earnings".[40] Such a mathematical calculation is not open to all of the objections which may be made to a capitalization of past earnings, but any estimate of "prospective earnings" can be no more than an intelligent guess and there is the same opportunity for a difference of opinion with respect to the rate of capitalization if prospective earnings are used as there is if past earnings are used.

Furthermore, it will be found on analysis that a "capitalization of prospective earnings" cannot lead to anything approaching an exact determination of the "value" of the new securities, if there are several classes, as is the case in most reorganized railroad companies. It is impossible even to estimate the "earnings" after income and excess profits taxes, which are all that will be available to pay dividends on the preferred and common stock, without first determining what new securities will be issued and what the new charges will be.

There is a further objection to the customary procedure, which is to make a computation based on the "prospective earnings" and a rate of capitalization which is selected without regard to the rate or rates of interest actually borne by the new obligations. The different kinds of interest-bearing securities and the interest rates which they bear obviously make a considerable difference in determining how much new preferred stock and common stock can be issued under a reorganization plan and what the dividend provisions of the preferred stock should be. For example, as of December 31, 1941, the reorganized Erie Railroad Company had a funded debt of $201,398,925, with average interest charges, fixed and contingent, of 4.067%. If the average interest charges had been 5%, a funded debt of $163,817,886 would have produced the same annual charges. As the amount of the interest charges is a principal factor in determining the permissible amount and the appropriate provisions of the stock, it is futile to use an arithmetical process which disregards the charges actually determined upon.

It may be thought that these criticisms can be met by setting up a more complicated process based upon a capitalization of earnings at one rate in determining the proper amount of the new debt, a capi-

trolled by the principles laid down in United States v. Kirby Lumber Company, 284 U. S. 1 (1931). If that position be correct, the reorganized carrier will ordinarily be compelled to consent to a change of basis under Section 22(b)(9) of the INTERNAL REVENUE CODE in order to avoid a heavy income tax liability.

Amendments of the applicable statutes may be made this year. However, the proposed amendments would not eliminate the inevitable increase in income taxes which results from a reduction in interest charges through a reorganization.

40. 312 U. S. 510, 525 (1941).

talization of the balance of the earnings (remaining after deducting the new fixed charges from the "prospective earnings") at another rate to fix the amount of the new preferred stock, and a capitalization of the balance then remaining (after the deduction of preferred dividends) in computing the proper amount of the new common stock. Or it may be suggested that the different interest and dividend rates of the new securities can be taken into consideration in determining what rate of capitalization to use.[41] However, it will be found on analysis that, if a "capitalization of prospective earnings" is to reflect the amounts of, and interest or dividend rates borne by, the various issues of new securities — and such a capitalization would hardly be helpful unless it did — it is necessary first to decide what amounts of new securities of each class shall be issued and what their respective interest and dividend rates shall be before making the capitalization. In other words, the answers to the problems must be found before making the mathematical computation which is supposed to assist in determining what the answers shall be.

Space does not permit a discussion of every possible method of attempting to determine the "exchange value" of railroad property or the effect, if any, to be given to the original cost, the cost of reproduction, or "prudent investment", but perhaps enough has been said to indicate the inevitably fictitious character of a finding that a railroad property which cannot be sold at a fair price has a "value" equal to a specified number of dollars.

Nor can there be a satisfactory determination of the dollar "value" of the old securities, except in rare instances. Usually most of the securities of a large railroad system in reorganization are listed on the New York Stock Exchange, and the usual method of determining the "value" of a listed security is by recourse to market quotations. There is, however, substantially unanimous agreement on the proposition that it would not be "fair and equitable" to base the treatment of the old securities in a plan of reorganization primarily on market quotations.[42] Among other things, the existence of the reorganization proceeding it-

41. In Minneapolis, St. Paul & Sault Ste. Marie Reorganization, Finance Docket No. 11897, decided March 17, 1942, the Commission recognized that, since a substantial proportion of the securities of the reorganized company would bear interest at a rate less than 5%, it was not proper to use a 5% rate in making an over-all "capitalization of earnings" (41-42). The Commission therefore used a 4¼% rate. It is clear that the process thus followed, on the supposition that it is necessary to make a single over-all "capitalization of earnings", is not at all exact, although it is sound, in determining what new securities may be issued, to consider what interest rates and dividend rates they will have to bear.

42. See St. Louis Southwestern Railway Company Reorganization, Finance Docket 11040, decided March 9, 1942, 58-59, cited *supra* note 37.

self creates an abnormal market condition; developments in the proceeding, which do not affect the true value of the rights which the securities represent, drive quotations up or down; and the fluctuations in the quotations are far more severe and rapid than any possible changes in the true worth of the securities themselves.

It is equally impossible to determine with any satisfactory precision the dollar "value" of the new securities, except in rare instances. Ordinarily there is not even a "when issued" market at the time a plan of reorganization is approved by the Commission. In any instance where there is room for a difference of opinion — and a finding serves no useful function unless there be room for such a difference — an opinion as to the "value" of a new security which will not even come into existence for a year or more is rarely more than a rash assertion as to the relationship of dollars at some indefinite future time to things not yet in being.

The particular kind of a fiction which is involved in a finding that a thing which is not convertible into dollars is equal to, or has a "value" of, a specified number of dollars, is not always shocking, because the law is frequently compelled to indulge in fictions of that kind. Pain and suffering are measured in dollars in a personal injury case because the law's only remedy is to award dollars. It is necessary to place a value on railroad property for tax purposes, because taxes are customarily measured in percentages of assessed values.[43] Congress thought it appropriate to try to place dollar values on railroad properties for rate making purposes[44] and, whether or not the effort has proved to have been soundly conceived, the practical basis of a valuation for rate making purposes is evident, since rates are collected in dollars. The Interstate Commerce Commission has comprehensive rules regulating the accounts of carriers,[45] and it may be asserted that a carrier's books of account set forth values of a certain kind, but books of account have to be kept in dollars and no one is misled into supposing that book value is the same thing as "exchange value". Values for tax purposes, values for rate making purposes, and book values are all more or less fictitious, depending upon the extent to which any implied equality between the things to be valued and a specified number of dollars is not supported by the actual facts, because the things valued cannot be converted into the specified numbers of dollars. The justification for the use of the fictions is practical.

No such justification exists for findings of dollar "values" in a railroad reorganization. A plan of reorganization involves exchanges of

43. *Cf.* Nashville, C. & St. L. Ry. v. Browning, 310 U. S. 362 (1940).

44. 41 STAT. 488 (1920), amended 48 STAT. 220 (1933) and 54 STAT. 912 (1940), 49 U. S. C. § 15(a) (1940).

45. 41 STAT. 494 (1920), 49 U. S. C. § 20(a) (1934), amended 49 STAT. 543 (1935), 49 U. S. C. § 20(a) (1940).

securities, and the bundles of rights to be exchanged can and should be analyzed and compared in order to determine whether the exchanges are "fair and equitable".[46] An effort to place a dollar "value" on each of the bundles of rights to be exchanged tends to obscure the process which is really required.

Discussion of the *Western Pacific* opinion sometimes rests on the implied assumption that it may be a "liberal" extension of the doctrines of *Case v. Los Angeles Lumber Products Co.* and *Consolidated Rock Products Co. v. Du Bois.* The writer believes, on the contrary, that it is reactionary in every real sense. In equity the practice has always been to have a sale or sales on foreclosure. But "a railway is a unit; it can not be divided up and disposed of piecemeal like a stock of goods."[47] A foreclosure sale of a railroad property is, therefore, a legal formality except in rare instances.[48] A finding of the dollar "value" of a railroad property is a formality of essentially the same kind. Section 77 was undoubtedly intended to eliminate, wherever possible, the need for foreclosure sales, which are fictional because the fairness of a plan is never determined on the basis of the upset prices on foreclosure. The imposition now of a requirement that findings of dollar "value" be made would merely substitute new fictions, not unlike the old.

It may be observed that many of the foregoing comments, if sound, apply to the reorganization of any large industrial or real estate corporation whose properties cannot be sold at a fair price. Indeed, a determination of "value" in a Section 77B or Chapter X case sometimes makes strange reading,[49] and the Securities and Exchange Commission has apparently recognized, at least in some instances, that it is imprudent to undertake to place a precise "value" on the assets of a debtor, and has reported minimum and maximum figures to the Courts, allowing a considerable spread between the two.[50] However, an analysis of the practicability of requiring findings of "value" in non-railroad cases lies outside the scope of this article.

46. *Cf.* Comment (1942) 51 YALE L. J. 967, 985.

47. Continental Illinois National Bank & Trust Company v. Chicago, Rock Island & Pacific Ry., 294 U. S. 648, 671 (1935).

48. See Canada Southern Ry. v. Gebhard, 109 U. S. 527, 539 (1883).

49. In *In re* Warren Bros. Co., 39 F. Supp. 381, 385-86 (D. Mass. 1941), the Court held in effect that $8,702,900 of Cuban bonds, valued by a Master at $4,829,265 on the basis of several factors, "should be valued at the amount of the debt in the absence of a clear present showing either that the bonds are in default or that they are inadequately secured and will not be paid." The rule enunciated by the Court is like one followed in determining the values at which bonds may be carried on the books of insurance companies and savings banks, but quite different considerations govern accounting rules which are applicable generally to large and diversified amounts of institutional investments and a determination which materially affects the relative treatment of those interested in an estate which consists largely of a single holding.

50. *In re* Porto Rican American Tobacco Co., 112 F. (2d) 655, 656 (C. C. A. 2d, 1940); *In re* Plankinton Bldg. Co., 40 F. Supp. 517 (E. D. Wis. 1941).

*The "Value" of a Part of a Railroad System:* Assuming that it would be feasible to make a realistic finding of the "value" of a railroad system as a whole, how is the "value" of a part of the system to be determined, and what effect is to be given to the determination after it has been made?

The Commission's most recent expression of opinion on this subject reads as follows:[51]

> "The properties comprise one operating unit; a complete separation of values would necessarily have to be based on extensive assumptions of unprovable validity; and any attempt at such a separation would in the end serve no purpose except to present an apparent certainty in the formulation of the plan which does not exist in fact. The Act calls for valuations only where necessary; and in our view further valuations are not necessary here."

It is sometimes supposed, however, that a "segregation study", a "severance study", or a "contributive traffic study", or a combination of such studies, can lead to a relatively exact determination of the "value" of a part of a railroad system.[52]

A "segregation study" involves an allocation of the revenues and expenses of the system to its different parts and may be indispensable if there is to be a determination of the net earnings or deficits of the various leased lines or mortgage divisions for the purposes of an accounting.[53] However, the results of a "segregation study", taken by themselves, are not usually regarded as determining the "value" of a part of a system. A "severance study" purports to disclose what the severance of a part of a system would mean to the system and to that part. A "contributive traffic study" purports to disclose what one or more parts of a system contribute in traffic to the system as a whole or to other parts.

A "segregation study" calls for the use of a formula which is unavoidably long and replete with technical railroad accounting terms.[54] Both a "severance study" and a "contributive traffic study" call for an expert. It is not unusual to find one or more such studies, supplemented by additional computations which purport to involve a scientific use of

51. St. Louis Southwestern Railway Company Reorganization, Finance Docket 11040, decided March 9, 1942, 67-68, cited *supra* note 37.

52. The nature of a "segregation study" and a "severance study" are explained in Meck and Masten, *Railroad Leases and Reorganization* (1940) 49 YALE L. J. 626, 640-47; also in the District Court's opinion in *In re* Chicago & North Western Ry., 35 F. Supp. 230, 239-40 (N. D. Ill. 1940). The opinion in the latter case also describes a study of "contributive income" value.

53. *Cf.* Palmer v. Palmer, 104 F. (2d) 161 (C. C. A. 2d, 1939), *cert. denied*, 308 U. S. 590 (1939).

54. *Cf.* New York, New Haven and Hartford R. R. Reorganization, 224 I. C. C. 723 (1938).

the studies themselves, offered as the bases for apparently exact determinations. However, an esoteric terminology and an accumulation of intricate tables of computations cannot obscure the fact that in the nature of things it would be impossible to determine, with anything approaching precision, the "value" of a part of a railroad system which is operated as a unit, even if it were feasible to determine the "value" of the whole. In essence a "segregation study" is not different from an effort to determine how much an executive contributes to the earnings of a corporation, or a partner to the earnings of a law firm. A "severance study" is like an effort to determine what it would mean to the corporation and to the executive if he were to leave or, similarly, what would be the result of the resignation of the partner. No doubt impressive reports can be prepared on such subjects, but no one would suppose that they could lead to exact determinations except in rare instances.

Assuming, however, that it were possible to place a dollar "value" on each of the parts of a railroad system, what use would be made of the valuations? One part might have a stable, but comparatively small, earning power and another part a more uncertain, but potentially larger, earning capacity, so that it might be determined that the "value" of the two was the same. Would that determination afford a basis for the distribution of the same kind of new securities in respect of each part? If the answer is affirmative, the result is obviously anomalous. If the answer is negative, it means that each class of new securities must have an equal dollar "value" and be exchangeable on a dollar for dollar basis for any of the old securities. The practical impossibility of so basing a plan of reorganization on findings of the dollar "value" of the new securities has already been commented on.

*The Date of the Findings:* The *Western Pacific* case apparently held that the findings should be made "as of the effective date of the plan."[55] The Circuit Court's decision was handed down on November 28, 1941. The "effective date" of the plan was January 1, 1939, almost three years earlier.[56] Even if findings had been made which purported to establish, as a matter of simple arithmetic, that as of January 1, 1939, the exchanges provided for in the plan were of exact equivalents in "value", would the holders of the old securities have been bound by such findings if the plan had been approved on November 28, 1941, submitted for acceptance or rejection in 1942, and then presented for confirmation? Under such circumstances would findings of dollar "value" which were three years old carry any weight? Indeed, should such findings of "value"

55. 124 F. (2d) 136, 139 (C. C. A. 9th, 1941).
56. *Id.* at 137, n. 4.

carry any weight in influencing the Court to approve the plan so long after they were made?

The real meaning of the words "effective date" in a plan of reorganization is a matter of sufficient importance to merit extended discussion in any general consideration of railroad reorganizations,[57] but no adequate discussion is possible here. It suffices to say that a plan of reorganization does not become effective as of its "effective date", unless it has previously been confirmed; that the words "effective date" will not be found in Section 77; and that the whole theory of Section 77 is that the security holders are entitled to an exchange that is reasonably fair at the time when they are asked to accept or reject it.[58]

If the findings are not to be made as of the "effective date", what date should be selected? In one Chapter X case a District Court directed a valuation of a debtor's property in advance of the preparation of the plan of reorganization; although apparently only one item of property was involved, "some eight months were consumed by some members of the staff" of the Securities and Exchange Commission in a study, and the Court hearing took nine days.[59] Assuming that a true "value" was found, what reason is there to suppose that it will be the true "value" when the plan is approved and submitted for acceptance or rejection? What authority is there in the statute for taking a date prior to the promulgation of the plan for a determination of "value"?

If neither the "effective date" nor a date prior to the promulgation of the plan be proper, what date shall be taken? Under Section 77 all findings by the Commission must be made simultaneously. If findings are to be made of the "value" of both the old and the new securities and of properties, as the *Western Pacific* opinion directs, all must be made at one time. Presumably it is expected that the various findings will support the proposed exchanges under the plan — that equivalence can be determined by simple arithmetic. However, if there is a general change in values, resulting from improved business conditions, a wage increase, new taxes, or any one of the many factors which can affect the value of railroad property or securities, the findings become dated and the plan is no longer supported by them when it is presented to the Court. It is not at all necessary for that result to follow inevitably if the only requirement is that a plan be "fair and equitable"; a plan of reorganization can usually be so constructed that, if changed conditions increase

57. The Chicago, Rock Island and Pacific Ry. Reorganization, 247 I. C. C. 533, 572-73 (1941).

58. Under subsection (e) of Section 77 the judge may confirm the plan even though it has not been accepted by the creditors and stockholders, if he is satisfied and finds, among other things, that "such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it."

59. *In re* Plankinton Bldg. Co., 40 F. Supp. 517, 518 (E. D. Wis. 1941).

or reduce the value of a class of the old securities, they will have a reasonably equivalent effect on the new securities that are to be exchanged for them. Changes in conditions, which must always be expected, will not defeat such a plan, unless findings of dollar "value" are required.

The question as to the proper date to select for any findings of "value" draws attention to another problem. On any date, unless it be practically at the commencement of the reorganization proceeding, the security of a mortgage is likely to include income of the mortgaged property which has not been disbursed as interest and which will be, as often as not, a very considerable amount. In order to determine what it is, however, it would usually be necessary to have a formula approved and to have a formal accounting. Such accountings have been the exception, rather than the rule, in railroad reorganizations; those which have been attempted have produced serious controversies and delays; and a procedural requirement which would necessitate a formal accounting with respect to the accumulated income subject to the different mortgages would be fatal.

## The Reorganization Process

The reorganization process must be creative, and the development of a satisfactory plan of reorganization resembles the construction of a building more than it does an ordinary suit or other legal proceeding. Perfect findings cannot transform a bad reorganization plan into a good one and, if a plan of reorganization is "compatible with the public interest" and "fair and equitable", the absence of findings implying a "certainty" that no plan can possess does not afford a sound basis for an attack on it.

The requirement that the plan conform to the "public interest" effectively controls the kind of compensation which the architect of a plan may provide for the holders of the old securities. The requirements of the "public interest" are necessarily somewhat elastic but, after studying the Commission's decisions, a capable and experienced architect can usually estimate, within reasonable limits, what the Commission will determine them to be. If the Commission will not approve more than $50,000,000 of new fixed interest bonds, and if four classes of security holders present plausible demands for an aggregate of $75,000,000, the architect of the plan is faced with the difficult task of determining how the $50,000,000 should be apportioned among the four classes. In making such a determination, a finding of the "value" of the interests of the different classes can only be a handicap, and a finding of the dollar "value" of the new securities can only be an invitation to error. The holders of each of the four classes of the old securities will rightly

demand their respective fair shares of the new fixed interest bonds, and, if they be allotted junior securities instead, a finding that the latter have the same dollar "value" as the fixed interest bonds will not solace them.

It will be evident that it is quite impossible to treat the development of the new capital structure and the allocation of the new securities as if they were separate tasks. Simultaneous consideration must be given to the public interest and the interests of the investors, just as the architect of a building must give simultaneous consideration to governmental restrictions and the probable demands of prospective tenants.

*The Development of the Capital Structure:* A supposition that there should be a determination of the "value" of all the property of a debtor reflects the conception that the first step in developing the new capital structure is to determine the total amount of the new securities. However, the realistic method of determining whether a particular capital structure is in the "public interest" is to try to foresee how it will function in all reasonably foreseeable contingencies, *i.e.*, to endeavor to determine whether the earnings will service the new securities, and whether the sinking fund and other requirements will improve the structure over the years without unduly restricting the operations of the company or involving either too great a sacrifice by the security holders or too great a risk of serious complications in periods of poor earnings.

The sound procedure in developing a plan is, therefore, to commence at the bottom, so to speak, with the new senior securities, and to build up — testing any proposed feature of the structure at all times to see whether it is both "compatible with the public interest" and permits "fair and equitable" exchanges — and to determine the number of shares of the new common stock at the end of the process. The determination of the "total capitalization" is thus the last, rather than the first, step.

*Methods of Allocation:* In the past the distribution of new securities under a plan of reorganization has not usually been governed by any rigid mathematical formula or by many fixed rules, because no one has been able to devise a perfect formula and the decided cases do not lay down many fixed rules.[60] However, sound distributions have usually conformed not merely to such fixed rules as have been established but also to a number of other principles, many of which are taken more or less for granted. Most of these principles are based upon an implicit realization that market values cannot be used except for limited purposes; that it is impossible to determine exact "value" except in rare instances; that reasonably fair equivalents should be provided in any

60. Note the general language in the Kansas City Terminal Ry. v. Central Union Trust Co., 271 U. S. 445, 455 (1926), quoted with approval by Justice Douglas in Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510, 528-29 (1941).

distribution; and that priorities should be respected to the extent that is consistent with the development of a sound capital structure for the reorganized company.

There is no recorded case in which a mathematical formula for the allocation of securities in a plan of reorganization of a railroad was used prior to the enactment of Section 77. On the other hand, the Supreme Court ruled that the ascertainment of value for rate-making purposes was not "a matter of formulas", but that "there must be a reasonable judgment having its basis in a proper consideration of all relevant facts."[61] Similarly, the Court said that the "ascertainment of the value of a railway system" for tax purposes "is not a matter of arithmetical calculation and is not governed by any fixed and definite rule", and that, whether the problem be to ascertain the value of an entire system or only of a part, "the determination is to be made in the exercise of a reasonable judgment based on facts so pertinent and significant as to be of controlling weight."[62]

At least until recently it was more or less accepted that evidence of the acceptability of a plan of reorganization was about as satisfactory evidence of the fairness of a plan as could be obtained. There are many cases under former Section 12 of the Bankruptcy Act, relating to compositions, in which courts have indicated that they would be largely guided by the judgment of the creditors.[63] The general principle which is involved is no different in railroad reorganizations, and evidence of the acceptability of a railroad reorganization plan has been given substantial weight in the past.[64] It should, of course, be emphasized that evidence of the acceptability of a plan can be material only on issues involving matters of opinion or judgment; *Case v. Los Angeles Lumber Products Co.* establishes that the acceptability of a plan is wholly immaterial if the plan clearly violates a rule of law.[65]

Section 77 was unquestionably intended, among other things, to increase the Commission's control over a plan of reorganization and to confirm the duty of the Court not to permit a plan of reorganization to be effected unless it is judicially found to be "fair and equitable". The new statute had other objectives, such as a more direct control over

61. The Minnesota Rate Cases, 230 U. S. 352, 434 (1913).

62. Rowley v. Chicago & North Western Ry., 293 U. S. 102, 109-10 (1934).

63. See Adler v. Jones, 109 Fed. 967, 968-69 (C. C. A. 6th, 1901); *In re* H. J. Arrington Co., 113 Fed. 498, 500-01 (E. D. Va. 1902); *In re* Waynesboro Drug Co., 157 Fed. 101, 102 (S. D. Ga. 1907); *In re* Spiller, 230 Fed. 490, 491 (D. Mass. 1916); *In re* Griffith Stillings Press, 244 Fed. 315 (D. Mass. 1917).

64. See Guaranty Trust Co. v. Missouri Pacific Ry., 238 Fed. 812 (E. D. Mo. 1916); St. Louis-San Francisco Ry. v. McElvain, 253 Fed. 123 (E. D. Mo. 1918); P. R. Walsh Tie & Timber Co. v. Missouri Pacific Ry., 280 Fed. 38 (C. C. A. 8th, 1922); Jameson v. Guaranty Trust Co., 20 F. (2d) 808, 815 (C. C. A. 7th, 1927).

65. 308 U. S. 106, 115 (1939).

the expenses of reorganization, and it and related statutes were doubtless designed to prevent any domination of a reorganization which was inconsistent with the public interest. Nothing in Section 77, however, indicates that it was intended to revolutionize the reorganization process.

As a result of the combination of circumstances, however, Section 77 proceedings did bring about a marked change. Plans of reorganization were filed for tactical purposes and were supported by lengthy testimony and voluminous exhibits.[66] Ordinarily two or more plans were filed in a single case and the relative merits and demerits of particular features of each of the plans, questions of law respecting liens and other matters, data bearing on opinions as to "earning power", and a vast number of other subjects were discussed in numerous and extensive briefs. Coincidentally, a disposition developed to minimize, at least as a matter of record, the importance of the judgment of the interested parties with regard to the fairness of a reorganization plan and to rely more and more on mathematical formulae. The methods used have sometimes been referred to as "scientific".[67]

If, as can hardly be disputed, the ultimate decision whether a proposed exchange of securities is "fair and equitable" must depend upon the basic facts, it can be made only after considering all relevant factors. The question whether it is helpful to reach that decision with the aid of a mathematical formula, or to use a mathematical formula to test the soundness of a tentative decision, is a practical one. Many who have

66. In the *Missouri Pacific* reorganization, Finance Docket No. 9918, the hearings lasted 32 days, there were 4,931 pages of testimony and 828 exhibits, and the Abstract of Evidence was 1,397 pages long. A very large proportion of the testimony, the exhibits, and Abstract of Evidence related to the Debtor's original plan, to which the plan finally approved by the Commission bears only the remotest resemblance.

67. Friendly and Tondel, *The Relative Treatment of Securities in Railroad Reorganizations Under Section 77* (1940) 7 LAW AND CONTEMP. PROB. 420, 431-33. The writers mention the *New Haven* and the *Chicago & North Western* cases as examples of an "approach to adherence to a 'scientific' method of distribution, at least so far as concerned the allotment of fixed-interest bonds". They mention "another method of allocation, followed notably in the *Erie* and *Missouri Pacific* reorganizations and to some extent in the *Milwaukee* proceeding" which they say "might be termed the method of comparison." The true distinction would appear to be not between a "scientific" method and a "method of comparison", but between a method which is based largely on mathematical formulae of one kind or another and purports to be "scientific", and one which does not purport to be so based and is frankly "unscientific" in the sense that it does not purport to provide precise determinations. In any case the distribution must be based on a "comparison", because it must be "fair and equitable" and there must be a comparative analysis of the claims which are to be surrendered in order to determine what distribution of the new securities is "fair and equitable". The "scientific" method purports to make the comparative analysis with mathematical precision. In the *Erie* and *Missouri Pacific* reorganizations, however, the allocation was based on the application of judgment to all of the facts rather than in reliance upon "scientific" yardsticks.

had considerable experience in railroad reorganizations appear to be convinced that mathematical formulae may be distinctly helpful. The writer's conviction is that in most instances the use of a mathematical formula will "serve no purpose except to present an apparent certainty in the formulation of the plan which does not exist in fact" and to make it more difficult to obtain an intelligent and realistic analysis of the factors on which the ultimate judgment should be based. That conviction is based on the belief that there is no substitute for a fair, thorough, and intelligent analysis of all the factors which require consideration and the application of an informed judgment to such factors.[68]

68. In the *Erie* case, cited *supra* note 29, the plan approved by the Commission, and subsequently carried out, was the result of negotiations, and the principal sponsors of the allocation between the different bond issues made no pretense that it could be supported with scientific precision. They devoted themselves to establishing that they had tried to ascertain all of the relevant facts and to apply an intelligent judgment to all of those facts, without the use of any mathematical formula. Their authority for doing so was Rowley v. Chicago & North Western Ry., 293 U. S. 102, 109 (1934). The principal witness who testified in favor of the plan filed on behalf of the creditors, which was adopted without any substantial change affecting the treatment of the creditors *inter sese*, testified as follows (Tr. of Record, Interstate Commerce Commission, 171):

> "Since it is obviously out of the question to use the formula figures as a yardstick without adjustment, the question comes up whether you could use them as a yardstick with adjustments. What adjustments should you make? When you come to decide that, you really have to take into account every factor which you would have to consider in determining the relative value of the various mortgaged and leased lines. Some of those factors are known and capable of definite proof; others require judgment or, if one cares to be frank, informed guesswork. We think that any plan must be based to a considerable extent on judgment or intelligent guesswork. We think that all of the plans which the Commission has approved in other cases have necessarily involved judgment or intelligent guesswork in matters affecting the capital structure, which is the most important thing from the point of view of the public interest, and we do not think that the Commission is under any illusion that the exercise of judgment can be avoided in determining a fair allocation."

In actual practice, a railroad company which undertakes to build a new line or to buy an existing line, or an experienced investor which is seeking to buy a divisional railroad bond, will not base a decision on any formula. The individuals who are charged with the responsibility of making the decision will try to learn what they can, and to guess what they cannot learn, and they will make a final decision based on judgment.

A distinction must be made between a so-called "segregation formula" for the allocation of revenues and expenses, authorized by clause 10 of subsection c of Section 77, and a mathematical formula for the allocation of the securities which may or may not be based wholly or partly on the so-called "segregation formula". It is not suggested that a "segregation study", a "severance study", or a "contributive traffic study"—all of them, or one or more of them—may not be desirable as an aid to a final judgment. Indeed, there can be no doubt that in certain instances a "segregation study" or a "severance study", or two such studies taken together, will afford a conclusive answer to a

Mathematical formulae and tables of computations which purport to reach precise determinations exercise a real fascination, because the mind naturally seeks certainty and "figures are a language implying certitude."[69] By contrast, "honest and sensible" judgments may appear unsatisfactory even though they are the best that can be made and none the less sound because, to quote Justice Holmes, they "express an intuition of experience which outruns analysis and sums up many unnamed and tangled impressions; impressions which may lie beneath consciousness without losing their worth."[70] In any event, whether the use of a mathematical formula is likely to be helpful or harmful, there is no valid reason why the use of such a formula should be mandatory.

In this connection it is important to note that the only requirement of Section 77 pertaining to the contents of the Commission's report is as follows: "In such report the Commission shall state fully the reasons for its conclusions." The statute does not contain the slightest intimation that the use of a mathematical formula is mandatory, and, if anything, indicates that it was not expected that mathematical formulae would be used. On the other hand, since the statute does require the Commission to "state fully the reasons for its conclusions", it clearly contemplates that the Commission shall present a reasoned analysis of the factors on which its conclusions are based.

Although Justice Douglas's opinion in the *Consolidated Rock Products* case was construed by the Circuit Court of Appeals in the *Western Pacific* case to require numerous findings of dollar "value", and it has been suggested that Justice Douglas intended at least to require the Commission to use mathematical formulae and to explain their use,[71] there is much in the *Consolidated Rock Products* opinion to indicate that Justice Douglas did not visualize either such findings of "value" as the Court in the *Western Pacific* case supposed or the use of mathematical formulae. He spoke of "practical adjustments, rather than a rigid formula", and of compensation for a loss of seniority by "an increased participation in assets, in earnings or in control, or in any combination thereof."[72] If he had pictured the rigid procedure which

particular question. However, most final decisions should be based on judgment applied to all of the ascertainable, relevant facts; and technical studies can be helpful only if used by a person who understands them fully. They rarely lead to exact determinations, and a mathematical formula for an allocation of securities, involving the use of one or more technical studies, may present an illusion of precision and make it more difficult to obtain a fair and intelligent analysis of the factors which should control the allocation.

69. See Mr. Justice Brandeis, dissenting in State of Missouri ex rel Southwestern Bell Telephone Co. v. Public Service Commission of Missouri, 262 U. S. 276, 289 (1923).

70. Chicago, Burlington & Quincy Ry. v. Babcock, 204 U. S. 585, 598 (1907).

71. *Cf.* Comment (1942) 51 YALE L. J. 967, 981.

72. Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510, 529 (1941).

the Circuit Court of Appeals has required in the *Western Pacific* case, he could have announced, as that Court did, just what findings of "value" were necessary and his discussion of compensations, which implies a fair exchange of one "bundle of rights" for another, with no determination of the "value" of either, would have been unnecessary. Furthermore, while the word "formula" has many meanings, the reference to "practical adjustments, rather than a rigid formula" certainly does not indicate that the use of a mathematical formula is mandatory.

*"Absolute Priority" and "Full Compensation":* Recognition that it is impossible to make a large number of findings of "value" in a railroad reorganization case inevitably suggests questions as to the meaning of the "absolute priority rule".[73] The word "absolute" is like a dollar figure — it implies "certitude". The "relative priority" rule is commonly supposed to represent the alternative. However, neither the "absolute priority" rule nor the "relative priority" rule had been so clearly defined before the Supreme Court's recent opinions that it is possible to know exactly what was meant by the adoption of the "absolute priority" rule.[74]

It is suggested that the Supreme Court's rejection of the "relative priority" rule means that a plan of reorganization is not "fair and equitable" simply because the order of priority of the old securities is the basis for the order of priority of the new securities. Thus the holder of a 4% fixed-interest bond may not ordinarily be required to exchange it for a 4% non-cumulative income bond, if it appears that over a period of years he will probably receive less, and the holder of a junior security will receive more, out of the property on which they both have liens, than would be the case if the exchange were not made. "Full compensatory provision" must be made for "the entire bundle of rights which the creditors surrender."[75]

On the other hand, it is suggested that the "absolute priority rule" cannot be "absolute" in the sense that its application must be based on findings of dollar values, "a language implying certitude". It is "absolute", however, in the sense that a holder of a junior interest may not receive new securities unless the holders of the senior interest have been "made whole"[76] by a distribution of new securities which constitutes "full compensatory provision" for "the entire bundle of rights which the creditors surrender." In the nature of things it is usually impossible to know whether a particular distribution of new securities will make a creditor exactly "whole", especially in view of the unavoidable lapse

73. See 312 U. S. 510, 528.

74. Bonbright and Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization* (1928) 28 COL. L. REV. 127.

75. Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510, 528 (1941).

76. *Id.* at 527-28.

of time between the approval of the plan by the Commission and the establishment of a normal market for the new securities.

It is difficult, if not impossible, to state briefly what should be considered "full compensatory provision" in the many different kinds of situations which arise. If a claim be fully secured by railroad property or collateral which could be liquidated at an amount sufficient to pay off the claim the creditor would seem to be entitled to cash in the amount of its claim or to new securities which are reasonably certain to be salable promptly for such an amount of cash. If the security for a senior claim consists of railroad property which, as a practical matter, cannot be sold, and it is proposed that provision be made in the plan for junior creditors or stockholders so that "full compensatory provision" must be given, probably the most satisfactory test, although by no means a perfect one, of a proposed distribution of new securities in satisfaction of the senior claim is to try to estimate what the recipients of the new securities would be likely to receive as income over a number of years and what additional risks, whether of failing to receive income or of having the payment thereof delayed, are represented by the new securities when compared with the old. Neither proof of the quoted values of the old securities nor suppositions as to the future market quotations of the new securities are of help for the reasons already indicated; the expectations with respect to future income form the best theoretical measure of the value of the new securities and, if not disappointed, should eventually determine their normal market value, if there be such a thing. Such a test of "full compensatory provision" necessarily lacks precision, because the reorganizer must deal in uncertainties throughout, but it is realistic.

The requirement of "full compensatory provision" does not apply unless the plan undertakes to provide something for junior creditors or stockholders in respect of property in which senior creditors are interested. Junior creditors and stockholders are entitled to anything left over after "full compensatory provision" for their seniors. In one sense at least they cannot receive "full compensatory provision" for what they surrender, because the reorganization will have the effect of allotting to the Government, as income taxes, a substantially larger share of the revenues than would have been allotted to it if there had been no reorganization, and, if the "absolute priority" rule be followed, the tax consequences of the reorganization will fall first on the holders of the most junior securities.

These general comments suggest that the impossibility, in ordinary circumstances, of determining exactly what constitutes "full compensatory provision" may enable junior creditors and stockholders who are tactically in a strong position to exact more favorable treatment than they are entitled to receive. This is no doubt true, and it would be more

satisfactory if it were possible to achieve the ideal of according to the senior interests "full compensatory provision" expeditiously and exactly. However, as in so many other instances, a practical solution of the problem which approaches, even if it does not attain, the ideal may serve both public and private interests far more effectively than an interminable and expensive search for an unattainable ideal. The Commission or a Court should find that "full compensatory provision" has been accorded if an analysis of all the relevant factors leads reasonably to that conclusion; otherwise they should find to the contrary. Findings of "value" will be of no help in making the determination. A sincere and intelligent effort to achieve the objective is far more important than findings which may create the illusion that the process is an exact one.

### The Weight to be Given by the Court to the Commission's Findings

One of the most interesting features of the *Western Pacific* and *Milwaukee* opinions is the divergence of the two Circuit Courts of Appeals with respect to the weight to be given to the Commission's findings.

In the *Western Pacific* case the Circuit Court of Appeals said:[77]

> "In determining whether a plan of reorganization satisfies the requirements of subsection e, the court is not concluded by any determination made by the Commission, but may, and must, exercise its own independent judgment; and this is true whether such determination relates to value or to some other subject."

The Court apparently expected to have the Commission make a large number of findings and then to have the District Court make the same number of findings, based on "its own independent judgment". Presumably a plan would be approved only if the Commission and the Court independently reached the same conclusions in making sixteen findings of "value" in that case, or a much larger number in some of the other pending cases.

On the other hand, the Circuit Court of Appeals in the *Milwaukee* case said:[78]

> "While question-arousing arguments have been advanced for and against the plan, which invite lengthy discussion by us, the outstanding, unchallenged fact is that the conclusions of the I. C. C., approved by the District Court, are entitled to great weight, and we are hardly justified in substituting our judgment for that of those tribunals, save where clearly satisfied that their judgment is erroneous, or is based upon incorrect assumptions, or where an incorrect rule or principle is applied."

77. 124 F. (2d) 136, 140 (C. C. A. 9th, 1941).
78. 124 F. (2d) 754, 762 (C. C. A. 7th, 1941).

The suggestion in the *Western Pacific* opinion that, after a determination has been made by the Commission, the Court "must exercise its own independent judgment" seems extraordinary if it means that the Court should disregard the Commission's findings. The use of such an expression in the *Western Pacific* opinion is probably attributable to Justice Douglas's quotation in the *Consolidated Rock Products* case[79] of Justice Brandeis's admonition in *National Surety Co. v. Coriell.*[80] The gist of that admonition, however, was simply that a court is a judicial body which should reach its conclusions after considering a proper record and should not base its decisions on unsupported and unverified statements of the parties or their counsel. It would be extraordinary indeed if a Court were not to give weight to conclusions reached by the Commission, an administrative authority which functions quasi-judicially and has a jurisdiction "brigaded" with that of the Courts in the administration of Section 77 proceedings.[81]

The question whether the nature of the findings which are made by the Commission determines the weight to be given to them by the Courts has been the subject of a recent able discussion, in which the opinion has been expressed that "the argument distinguishing between 'public' and 'private' functions of the Commission is patently inadequate", because the distribution of the new securities depends upon the capital structure.[82] It is no doubt true that all findings, like all provisions of a plan of reorganization, are more or less related and that there can rarely be sharp distinctions between them. However, for over twenty years it has been the function of the Commission to control the issuance of securities by railroad corporations.[83] Under Section 77 the Commission has exclusive jurisdiction to determine whether a plan of reorganization is "compatible with the public interest."[84] If the Commission holds that it is incompatible with the public interest to provide for more than a certain amount of total charges or of total capitalization, the Commission's determinations will probably be considered virtually conclusive, unless it be demonstrated that they bear no reasonable relation to the evidence of record, either because the Commission has made palpable errors of fact or because it has indulged in arbitrary action.[85]

79. 312 U. S. 510, 520 (1941).

80. 289 U. S. 426, 436 (1933).

81. Palmer v. Massachusetts, 308 U. S. 79, 87 (1939). See also Warren v. Palmer, 310 U. S. 132 (1940).

82. Comment (1942) 51 YALE L. J. 967, 975.

83. Section 20a of the INTERSTATE COMMERCE ACT, 41 STAT. 494 (1920), 49 U. S. C. § 20a (1940). See Pittsburgh & W. V. Ry. v. Interstate Commerce Commission, 293 Fed. 1001, 1004-05 (App. D. C. 1923).

84. Section 77d of THE NATIONAL BANKRUPTCY ACT, 49 STAT. 917 (1935), 11 U. S. C. § 205(d) (1940).

85. In *In re* Louisiana and North West Railroad Company, C. C. H. Bankr. Serv. (3d ed.) ¶ 51,360 (S. D. N. Y. July 30, 1938) Judge Goddard disapproved of the Com-

With respect to questions which involve primarily the allocation of the new securities, it is suggested that the weight which the Courts should give to the Commission's findings depends on the reasonable presumption as to the respective qualifications of the Commission and the Court to make the particular findings. If the fairness of a proposed distribution of new securities in satisfaction of the claims of a particular class of creditors involves only an appraisal of factors about which the Commission is presumed to have expert knowledge, a Court will be reasonably certain to accept the Commission's view in the absence of a showing that the Commission was demonstrably wrong. On the other hand, if the Commission makes a ruling on a question of law or on some other matter on which there is no reason for a Court to defer to the Commission's judgment, a Court should form a truly "independent judgment".

Of course, it is frequently not easy to classify any particular question as falling exclusively into either of the two categories just mentioned, and the most difficult questions which arise are those which involve both matters as to which the Commission is presumably expert and those as to which it is not. It is needless to add that the natural inclination of the Courts to approve plans which represent years of effort and have been approved by an authority having coordinate jurisdiction is bound to be an enormously important factor in determining what the Courts will do.

## THE HISTORICAL DEVELOPMENT OF THE REQUIREMENT OF FINDINGS OF "VALUE"

It may be suggested that, whether or not the views expressed above are sound, and whether or not the decisions in the *Western Pacific* and *Milwaukee* cases were required by Justice Douglas's *Consolidated Rock Products* opinion, those decisions are consistent with the trend of the cases involving judicial review of plans of reorganization. Such a suggestion involves a failure to distinguish between the development of judicial responsibility for plans of reorganization and the development of procedures by which that responsibility is to be discharged. There has been a definite trend toward the imposition of greater responsibility on the Courts for the fairness of plans of reorganization, but there has been no tendency to straitjacket the procedure by which a Court may discharge that responsibility.

The process of the reorganization of railroads in equity evolved over a period of many years.[86] For a long period it was asserted that the

mission's refusal to approve income bonds instead of preferred stock, and the Commission modified the reorganization plan which it had originally approved [230 I. C. C. 171 (1938)].

86. The essential features have been (a) the Court's assumption of jurisdiction, usually though not always, on the filing of a bill of equity by an unsecured creditor,

Court was not concerned with the fairness of the plan of reorganization, that the plan was a matter of voluntary contract between the security-holders and the Reorganization Managers, and that the Court's function was to administer the receivership estate and to effect the foreclosure sale.[87] Such an assertion reflected an extremely technical point of view, because it has long been recognized that ordinarily foreclosure sales in railroad reorganizations are merely steps by which plans of reorganization are carried out.[88] It is not surprising, therefore, that such an unrealistic view did not prevail, but it was apparently not until 1916 that a court undertook to pass upon the fairness of a plan of reorganization.[89]

*Northern Pacific Railroad Company v. Boyd*[90] was an important factor in the development of judicial review of plans of reorganization, as it led the reorganization bar to seek court approval of the fairness of plans, and the gradual extension of that review was not dependent wholly upon the initiative of the courts. Between 1916 and the enactment of Sections 77 and 77B in 1933 it became the regular practice to ask for a judicial finding that a plan of reorganization was "fair and equitable".[91] During that period, however, there appears to have been no thought that it was necessary to have detailed findings of "value" stated in dollars. Such an idea was expressly rejected in at least one

(b) the filing of bills to foreclose mortgages, (c) the consolidation of the causes, (d) the promulgation of a plan by reorganization managers, (e) deposits of securities under the plan, (f) a foreclosure sale or sales at not less than a fair upset price or prices, (g) the transfer of the property of the railroad company to a new corporation, (h) the distribution of the securities of the new company as provided in the plan, and (i) cash payments to the non-assenters, the amounts payable being determined by the upset prices fixed by the court. See Byrne, *The Foreclosure of Railroad Mortgages in the United States Courts* and Cravath, *The Reorganization of Corporations; Bondholders' and Stockholders' Protective Committees; Reorganization Committees; and the Voluntary Recapitalization of Corporations*, both in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION (1917) 77-152, 153-234.

87. See Rosenberg, *A New Scheme of Reorganization* (1917) 17 COL. L. REV. 523, 527-28; Merchants' Loan & Trust Co. v. Chicago Railways Company, 158 Fed. 923 (C. C. A. 7th, 1907).

88. Canada Southern Railway Company v. Gebhard, 109 U. S. 527, 539 (1883).

89. See Guaranty Trust Co. of New York v. Missouri Pacific Ry., 238 Fed. 812 (E. D. Mo. 1916); Grasselli Chemical Co. v. Aetna Explosives Co., Inc., 252 Fed. 456 (C. C. A. 2d, 1918); see also Rosenberg, *supra* note 87, and Rosenberg, *The Aetna Explosives Case—A Milestone in Reorganization* (1920) 20 COL. L. REV. 733.

In Bonbright and Bergerman, *supra* note 74, it is suggested that Judge Lurton in Toledo, etc., R. R. v. Continental Tr. Co., 95 Fed. 497 (C. C. A. 6th, 1899) passed on the fairness of a plan of reorganization in the exercise of the powers of a court of equity, but the opinion in that case appears to deal with questions arising under state statutes.

90. 228 U. S. 482 (1913).

91. See Swaine, *Reorganization—The Next Step: A Reply to Mr. James N. Rosenberg* (1922) 22 COL. L. REV. 121; Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade* (1927) 27 COL. L. REV. 901.

instance.[92] The leading Supreme Court opinion of that period contained no suggestion that there was any such procedural requirement.[93] Nor was such a thought even remotely suggested in the opinion of the Circuit Court of Appeals in the most important railroad reorganization of the era.[94]

In *National Surety Company v. Coriell*,[95] decided in 1933, the Supreme Court did lay down certain principles. The District Court had undertaken to approve a plan of reorganization in reliance on "only informal, inadequate and conflicting *ex parte* assertions unsupported by testimony".[96] In other words, there was no competent evidence whatever to support a finding that the plan was "fair and equitable". The Supreme Court reversed the District Court and Justice Brandeis indicated the kind and scope of the evidence which he said "might have influenced the court in deciding whether the plan should be approved".[97] However, he made no suggestion that findings of "value" in dollars are required.

In cases in equity the courts did, of course, fix upset prices, but the determination of an upset price did not fulfill the function of a determination of "value" in the sense in which the word "value" is used in the *Western Pacific* opinion. Upset prices were always fixed in amounts sufficiently small to make sure that the cash distributable to non-assenters would be less than the probable market value of the new securities which they would be entitled to receive under the plan.[98] The Supreme Court has recently indicated that there are limits on the extremes to which courts of equity may go in fixing upset prices in order to put through plans of reorganization.[99] There can be no doubt, however, that, if upset prices in equity were fixed in amounts aggregating the capitalization of the new company, there would be no reorganizations in equity. Among other things, the "when issued" market value of new securities at the time when the deposit of old securities is being solicited is usually considerably less than the market value of the new securities after the new company is actually operating and is almost invariably less than the par value of the new securities.[100]

92. Guaranty Trust Co. of New York v. Missouri Pacific Ry., 238 Fed. 812, 818 (E. D. Mo. 1916).

93. Kansas City Terminal Railway Co. v. Central Union Trust Co. of New York, 271 U. S. 445 (1926).

94. Jameson v. Guaranty Trust Co. of New York, 20 F. (2d) 808 (C. C. A. 7th, 1927), *cert. denied*, 275 U. S. 569 (1927).

95. 289 U. S. 426 (1933).

96. *Id.* at 435.

97. *Id.* at 435-36.

98. Weiner, *Conflicting Functions of the Upset Price in a Corporate Reorganization* (1927) 27 COL. L. REV. 132; Bonbright and Bergerman, *supra* note 74, at 127-28.

99. First National Bank of Cincinnati v. Flershem, 290 U. S. 504 (1934).

100. See note 98 *supra*. On August 25, 1941, the District Court for the Eastern District of Missouri, Eastern Division, approved a plan of reorganization for Wabash Rail-

The enactment of Section 77 and Section 77B, and later of Chapter X, introduced new problems, but, as already noted, the *Consolidated Rock Products* decision, which the *Western Pacific* opinion purports to follow, was not based on any provisions of Section 77B, the applicable statute. Justice Douglas in the *Consolidated Rock Products* case cited *National Surety Company v. Coriell.*

It is an extraordinary jump from the proposition established by Justice Brandeis's opinion in *National Surety Company v. Coriell,* that the ultimate finding that a plan is "fair and equitable" must be supported by competent evidence and based on an "informed, independent judgment", to the proposition, asserted in the *Western Pacific* case, that the ultimate finding must be supported by detailed findings of "value" in dollars.

## CONCLUSION

The Securities and Exchange Commission, when Justice Douglas was a member, issued a report prepared under his direction, which, after outlining certain criteria of the reorganization process, made the following general comment:[101]

> "Concessions, settlements, compromises, practical adjustments will be the rule rather than the exception, even though these objectives are the criteria which govern the reorganization process. The outcome is that although the interests of investors are dominant throughout, practical considerations control and the investor is forced to compromise. This may be conceded to be the end result of any reorganization system, no matter how well conceived, no matter how faithfully administered."

Practical experience in reorganization cases teaches how profoundly true this observation is. It is, or should be, especially true when applied to reorganizations of the larger railroad systems.

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way Company, providing for a new capitalization of $330,759,265, of which $192,638,498 will be the debt [Chase National Bank of City of New York v. Wabash Ry., 40 F. Supp. 859 (1941)]. On October 2, 1941, the Court fixed upset prices aggregating $62,061,900 [Final Decree of Foreclosure and Sale]. Whether or not these figures are exactly comparable, it is evident that there is an enormous difference between the new capitalization and the upset prices, and that the latter were not regarded as "findings of value" of the kind referred to in the *Western Pacific* opinion. It is reasonable to assume that, if the experienced counsel in the *Wabash* case had thought it possible to have upset prices equal to the "value" of the parcels for reorganization purposes (*i.e.,* the allocation of the new securities) they would have done so, and that they concluded that, if they did, too many bondholders would demand cash.

101. REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES PURSUANT TO SECTION 211 OF THE SECURITIES EXCHANGE ACT OF 1934, PART I, p. 4.

Prior to the enactment of Section 77 a principal feature of the reorganization process was the negotiation of a plan of reorganization between the representatives of the security holders. Thus the most satisfactory railroad reorganizations in history, such as those of the Atchison, the Northern Pacific, and the Union Pacific, were developed before the turn of the present century.[102] During the period between about 1912 and the enactment of Section 77 railroad reorganizations were the subject of considerable criticism.[103] To what extent this criticism was justified is hardly material in determining whether "concessions, settlements, compromises, practical adjustments" should be "the rule rather than the exception", unless the conclusion be reached that the abuses were so serious and so irremediable that a complete revolution in the reorganization process was necessary.

The writer believes that the true solution was to continue to encourage the negotiation of plans of reorganization, but to provide an effective protection of the interests of the public and the smaller investors by supervision of the negotiations and, when required, by actual initiation and control of them by a representative of the Commission.

Anyone familiar with the number and variety of the factors which must be considered in developing a satisfactory plan appreciates that it is almost impossible to know what "concessions, settlements, compromises, practical adjustments" should be made without an opportunity for a free, informal exchange of ideas. This does not mean an abandonment of "open covenants, openly arrived at". It does mean, however, that the Commission, and especially the Commission's examiners, who have had to work out the details of plans of reorganization, have been faced with an almost superhuman task in attempting to extract satisfactory plans of reorganization from enormous records, in instances where the principal features of plans have not been agreed upon by the principal parties in interest and found by the Commission to be "compatible with the public interest". Anyone who has had the task of drawing a plan of reorganization in a large and complicated railroad case realizes how indispensable it is to have the help of many minds; how infinite are the number, and how unlimited is the variety, of the points that have to be considered; how much can be accomplished by conferences, revisions of drafts, and an informal procedure; and how difficult it must be for one of the Commissioner's examiners to closet himself with proposed plans, testimony, exhibits and briefs, and to emerge from the melee with a really satisfactory plan. The circumstance that the Commission acts as a quasi-judicial body in Section 77 proceedings

102. See DAGGETT, RAILROAD REORGANIZATION (1924) 192-210.

103. *Cf.* dissenting opinion of Mr. Justice Stone in United States v. Chicago, Milwaukee, St. Paul and Pacific R. R., 282 U. S. 311, 331-44 (1931); Chicago, Milwaukee, St. Paul and Pacific Railroad Company Investigation, 131 I. C. C. 615 (1928).

and is unwilling to participate in informal conferences with regard to plans of reorganization, because of the absence of any statutory authority therefor, is unfortunate; but the Commission is hardly subject to criticism on that account, even though many share the opinion that public conferences might accomplish far more in a shorter time than the study of the extensive briefs which have become customary in Section 77 proceedings.

The present attitude of the Supreme Court towards compromises is not entirely clear. In *Case v. Los Angeles Lumber Co.*, Justice Douglas said:[104]

> "There frequently will be situations involving conflicting claims to specific assets which may, in the discretion of the court, be more wisely settled by compromise rather than by litigation."

and added:

> "Settlement of such conflicting claims to the *res* in the possession of the court is a normal part of the process of reorganization."

Presumably *Consolidated Rock Products Co. v. Du Bois* was not intended to indicate otherwise, but only to hold that where there are no "honest doubts",[105] "there must be a determination of what assets are subject to the payment of the respective claims".[106] If so, there is nothing disturbing about that part of the *Consolidated Rock Products* opinion.

However, neither of the two opinions suggests that it is permissible to compromise a difference of opinion as to the "value" of a property. If the absence of specific mention of a compromise as to "value" were to be taken to mean there can be no "concessions, settlements, compromises, practical adjustments" with respect to differences of opinion as to "value", the situation would be anomalous and disturbing. Ordinarily the determination of conflicting claims is a judicial function, but *Case v. Los Angeles Lumber Co.* emphasizes that the settlement of such claims "is a normal part of the process of reorganization". A fortiori, "concessions, settlements, compromises, practical adjustments" with respect to questions of "value" may properly be regarded as "a normal part of the process of reorganization", especially in the case of a railroad reorganization, because it is impossible to determine the "value" of railroad property on any scientific basis.

The question arises, moreover, whether, if there are "honest doubts" as to which security holders have the first claim on certain assets, and also "honest doubts" as to the value of the assets which are involved in the controversy, it is necessary to have a separate compromise of the

104. 308 U. S. 106, 130 (1939).
105. *Ibid.*
106. 312 U. S. 510, 520 (1941).

dispute as to liens, translated into a separate finding, and another compromise of the differences of opinion about "value", also translated into a separate finding. Ordinarily a single compromise may cover several related points in dispute and there appears to be no sound reason why that should not be true in a railroad reorganization.

In the writer's view anything which tends to discourage proper "concessions, settlements, compromises, practical adjustments", or which fails to encourage the negotiation of plans of reorganization, is to be deplored. The record to date of the progress in the reorganization proceedings involving the larger railroad systems has been distressing. It is obviously futile to blame that record on the difficulty of the problems. It is equally futile to attempt to apportion the blame for what has not been done, and the credit for what has been achieved, among those who have participated in reorganization proceedings, whether as parties, counsel, or in an official capacity.

The practical approach to the problem is to try to make the procedure under Section 77 more efficient than it has proved thus far. The difficulty about the development of practical suggestions along this line is that the requirements laid down in the *Western Pacific* opinion are so strict, so unrealistic, and so unsound that, in the writer's opinion, it is futile to consider any constructive suggestions with regard to the serious defects which exist in the procedure under Section 77 until there has been an unqualified rejection of any scholastic procedural requirement with respect to findings of "value".

This does not mean that plans of reorganization which are not "fair and equitable" should be approved. It does mean, however, that both the Commission and the Courts can determine whether a plan is "fair and equitable" more satisfactorily by analyzing what the plan does, and by comparing the "bundles of rights" which are involved in the proposed exchange, than they can by making fictitious determinations of "value" in dollars.