

THE UNIVERSITY OF CHICAGO LAW REVIEW

VOLUME 17

SUMMER 1950

NUMBER 4

THE LAW AND LANGUAGE OF CORPORATE REORGANIZATION

WALTER J. BLUM*

I

CORPORATE REORGANIZATION under the National Bankruptcy Act is a process of dealing with the rights of those having financial commitments in distressed corporations. It is primarily concerned with the rights of investors—shareholders and bondholders and other lenders. It also acts upon the rights of merchandise and similar creditors and occasionally even treats some of these tradesmen as involuntary or disguised investors. But, in the main, security contracts that embody the rights of investors are the basic raw material of reorganization. The process itself has been largely fashioned to conform to the principal characteristics of these contracts. It is hardly understandable when approached from any other direction.

Corporate security contracts in our society have several attributes which are reflected in the reorganization process. In all of them the rights of holders and the corresponding obligations of corporations are expressed in dollar quantities. No provision is made for these magnitudes to vary with fluctuations in the value of the dollar itself. This fact is especially significant in that most security contracts with creditors impose unconditional obligations on the corporation to make interest and maturity payments in dollars without reference to the company's ability to perform. Failure to pay at the time specified ordinarily results in a default regardless of surrounding circumstances or the purchasing power of the dollar. Usually the contracts spell out in detail the rights to which corporate creditors will be entitled if a default occurs.

* Associate Professor of Law, University of Chicago Law School.

The pattern of these rights invariably rests on the pretension that creditors will obtain payment through the old common-law routine of selling the company's assets at auction and applying the proceeds in satisfaction of the debts.

But, despite the traditional default provisions which continue to appear in security contracts, the rights of creditors and others on default are not settled in the specified fashion. The development away from enforcement by the typical judgment and execution procedure, and the invention of the equity receivership as a substitute, is a familiar story not needing another restatement. It is sufficient to note that two main principles emerged from the development, and that they constitute the framework for our existing system of reorganization. One is that the assets of a distressed business are not to be disposed of until there has been a reasonable opportunity to determine what disposition will be most advantageous. This principle is so clearly sound that elaboration is unnecessary. The other is that the market value of a distressed business or its assets is not to govern the rights of those financially interested in the company. More particularly the creditors are not to foreclose and force a sale or valuation of assets at prevailing market prices. Instead junior interests are to be protected from forced sales and the impact of unfavorable market conditions. It is the fulfillment of this principle which has produced the primary substantive content of our reorganization system.

Abandonment or avoidance of the market in reorganizations has been explained in a number of ways. The most general explanation is that ordinarily no pertinent market exists. Large distressed corporations cannot be sold intact,¹ and selling them piecemeal changes the commodity by destroying whatever value arises because a concern is a going thing and not a random collection of assets.² These assertions are said to be especially realistic in times of widespread economic depression,

¹ "Of course, numerous . . . reasons may make for a decision to reorganize rather than liquidate. . . . [A] corporation may be so large that its sale would bring forth not merely inadequate bids, but no bids at all. It is commonplace that a railroad cannot be sold like a suburban acre." SEC, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part VIII, at 7 (1940).

² The contention that piecemeal sale of a business destroys its going concern value often contains an ambiguity. Generally it is a sound point to make against permitting unplanned dismantling of a company brought about as a result of individual actions by creditors to enforce their rights upon default. But it has a different thrust, and lacks soundness, once a procedure has been established for holding the assets of the business together until a comprehensive decision as to its future can be made. See *First National Bank v. Flershem*, 290 U.S. 304 (1933). Moreover, a business can be sold "piecemeal" by flotation of securities to the public without providing any impact on the organizational value of the concern.

and such slumps have usually coincided with large waves of defaults by particular companies. Our railroads, which periodically have been in financial difficulties, are most frequently used to illustrate the explanation. A troubled road, it is said, cannot be sold for more than a token sum because it is too big to sell in one piece and too integrated to break up into smaller units. The proof of its unsalability consists of pointing out why it would be difficult to find a purchaser. From this muster a pair of observations or assertions emerge: Rarely does any one person or private group have the wealth to finance acquisition of a railroad, while a public sale through flotation of new securities is impractical inasmuch as individual investors are said to be averse to buying into a distressed road. Sometimes this display is qualified by noting that certain "syndicates" or "speculators" conceivably could be interested in purchasing. But then they are dismissed from consideration presumably as not constituting a legitimate or proper market for such a sale.

It is obvious that a distressed enterprise or its assets can be sold at *some* price. That is impliedly acknowledged when potential offerors are labelled speculators. It is equally plain that the public would finance a purchase if the terms were advantageous as compared to alternative investment possibilities. But the effective sale price might be very low as judged by those who already have a jeopardized financial commitment in the company. This judgment is at the bottom of another explanation for by-passing the market: Even if there is a market for distressed corporations it is too thin to be meaningful and in times of economic slump it is too chaotic to be fair. According to this approach the market prices are low not because the distressed companies are of relatively little worth; they are low because not enough investors are interested in buying into troubled businesses and even the interested ones have unreasonable doubts about such enterprises.³ A variety of observations are gathered to show why those who make the market seldom give a distressed company a break. It is said that potential investors are unduly disturbed about the effects of temporary financial difficulty and of insolvency proceedings on the future of a troubled business. They have doubts whether the firm can hold (or regain) its customers, make satisfactory arrangements with suppliers, or obtain suitable management. They are apt to lack confidence in the old directing group and at the same time question the seasoning of any prospective new one. These

³ This summarization of the position omits all reference to monetary panic and conditions associated with it. The contentions which are rested on the ramifications of monetary panic can be made about the market for almost everything.

and similar conjectures could be elaborated at length. Their common denomination is clear. Investors are likely to be less optimistic about a business in trouble than about a prospering company.

Another explanation for shelving the market in reorganizations builds upon the previous one. Senior investors⁴ whose claims are in default ordinarily will not be satisfied, it is said, with the prices obtainable through a sale of the business to outsiders in a thin market. Instead they will usually prefer to bid in their claims and thereby take over the distressed enterprise.⁵ In practice few defaulting large corporations have been sold to outsiders for new money; they have been reorganized by invalidating some or all of the rights of junior investors and distributing equivalent rights to the old senior claimants. Under such an arrangement the market price of the company or its property is said to have little significance because no real sale is involved or contemplated. The contention usually has been clothed in more flavorful terms. Bidding for the debtor or its assets is likened to "chilled" bidding because seniors can bid with their unvalued claims, while cash is required of all others. With cash purchasers deterred and with senior creditors bidding claims of undetermined worth, a double conclusion is drawn: a market price is neither ascertainable nor significant.

This reasoning was widely circulated and accepted but its weakness is not to go unnoticed. The bid chilling analogy can be made about all kinds of defaulted debts; in fact it has been applied almost without discrimination to debts ranging from huge corporate obligations to tiny home mortgages. Closely examined the underlying argument is never more than a commonplace. When the market price of property is substantially below the amount of defaulted claims running against it, the lien creditors often prefer taking over the property to receiving the market price in cash. To ascribe a scarcity of cash bidders to the ability of creditors to bid in their claims is to miss the important relationship. Bidding is cooled off only in the sense that the market forces—the potential cash purchasers—value the property considerably below the face

⁴ The terms "senior investors" and "junior investors" (or "seniors" and "juniors") are employed without precise definition. The contexts should make the intended references sufficiently clear. The fact that in a particular case the juniors are creditors rather than shareholders, or vice versa, is generally of no importance for the analysis.

⁵ "[T]he creditors could themselves purchase the property at the sale. If the sale was to have value for them, it had to do more than attract purchasers at any price. It had to attract purchasers willing to pay enough for the assets to make the creditor willing to let the property go. . . . In times of financial depression such sales could be expected to bring out buyers with only low or nominal bids. . . ." SEC, *op. cit.* supra note 1, at 6-7.

amount of the creditors' claims. More cash bidders would appear if creditors refrained from bidding with claims. This, however, is only a roundabout way of saying that cash purchasers would be attracted if creditors were willing to accept the market price for the property with which they are secured.

The explanations advanced for ignoring market values of distressed companies are useful in understanding our reorganization system, but their soundness was not the decisive factor in molding that system.⁶ The prevailing pressure was to relieve junior corporate investors from those senior contracts which had turned out disastrously for them. This pressure was only a single facet of the broader drive to relax strict enforcement of all bargains which sympathetic bystanders felt were harsh. That drive in turn was but one manifestation of the wider movement away from reliance on the market place to arbitrate economic rewards and penalties. Sympathy for losers apparently combined with mistrust and misunderstanding of the market mechanism to furnish special rescue for many endangered equities. Seasoning the combination was the recurrently popular notion that economic slumps are temporary and therefore the settlement of rights at depressed prices which exist during them is unfair to junior interests. This ingredient became more potent as the government was increasingly expected to take positive measures to reverse economic declines. Most of those who favored such action also favored channelling its benefits to harassed debtors or juniors rather than to creditors or seniors whom they apparently regarded as less deserving.

The pressure to undo security contracts was met by a counterforce. Direct resistance was offered by many senior groups seeking to secure the advantages of their bargains. In addition lawmakers and courts generally recognized that in a credit economy financial pacts cannot be disturbed too much without seriously impairing the entire credit structure. Constitutional limitations moreover seemed to coincide with the demands for honoring security contracts. The impact of the various competing forces called for a political compromise. The result was an almost self-contained system of corporate reorganization.

⁶The text summarizes the major explanations for not permitting the market to govern rights in reorganizations and points out their weaknesses. It does not consider the question whether the market mechanism would or could be made to work well in the reorganization environment. The reason for this apparent one-sidedness is that understanding the dissatisfaction with valuation by the market is important in understanding the reorganization system which we have developed. A discussion of the potentialities of the market is not a requisite to analyzing that system.

The essential parts of the system perhaps might easily have been foreseen. Since market value was ruled out, a substitute standard of measurement had to be devised. For psychological and constitutional reasons the new gauge would be named to convey the impression that it measures "value." Probably the first appropriate name that comes to mind is "reorganization value." The quantity represented by this label is that which is to be apportioned among possible claimants. But the allocation must not seem arbitrary and accordingly canons of fairness for a plan of distribution are needed. These ought to stress upholding contractual priorities among classes of security contracts in order to emphasize that contracts are being enforced and not ignored. Obviously it would be embarrassing if the rehabilitated company soon ran into distress again. To prevent that from happening reorganization plans must be workable; the synonym "feasible" suggests itself as a label for this idea because it pairs better with "fair" and sounds less mundane. The entire reorganization process should appear to remain democratic in a democratic society. Accordingly those having a financial stake in the distressed company ought to vote on the important questions that arise during the proceedings. However, there may be some irreconcilable differences between investor groups having conflicting interests. To avoid everlasting stalemates someone must have power to resolve the issues by cramming a plan down the pockets of one side or the other. This is a task naturally cut out for a judge. Finally the whole process should seem to be predicated on principles and not on arbitrary actions. Inasmuch as the principles must be created, it is advisable to have a group of experts on hand. These conveniently can be collectively called an "administrative agency."

The compromise between enforcing and relaxing security contracts of course did become embodied in such a reorganization system. It now may be looked upon, for analytical convenience, as having three key doctrinal aspects: reorganization value; the fair and feasible plan; and the cram-down power. To analyze corporate reorganizations under the National Bankruptcy Act we have to consider the content given each of these concepts by the courts and the administrative agencies.⁷ Their

⁷ The analysis in this article primarily concerns reorganizations under Chapter X of the Bankruptcy Act, 52 Stat. 883 (1938), as amended, 11 U.S.C.A. § 501 et seq. (1946); and its predecessor, Section 77B, 48 Stat. 912 (1934). A large part equally concerns reorganizations under Section 77 of the Act, 47 Stat. 1474 (1933), as amended, 11 U.S.C.A. § 205 (1946). The Securities and Exchange Commission is the administrative agency under Chapter X; the Interstate Commerce Commission is the agency under Section 77.

products currently comprise the basic law and language of corporate reorganization.⁸

II

Reorganization value is the substitute for market value in reorganization. Perhaps market value was never actually permitted to govern rights in corporate reorganizations. It is unimportant whether the reorganization process was or was not identifiable as such by the time market value was replaced in this area (if in fact it ever even gained a foothold). But there is no doubt that reorganization value now occupies the role comparable to that which market value otherwise would have performed.⁹ Basically it purports to determine what classes of claimants are entitled to be satisfied in whole or part out of the assets of the distressed company. This it does by seeming to measure what classes are

⁸ There is a fourth very important aspect of the reorganization system. But it is not on the same plane as the others. In a sense it is not a component of reorganization theory but is the machinery of reorganization. It consists of all the procedural steps and techniques which affect the relative effective strength that the different classes are able to exert. A representative list of these elements should indicate the range of factors comprehended by this aspect of the system: (1) control over initiation of the proceedings; (2) management of the company during the proceedings; (3) availability of lists of security holders; (4) access to the records and books of the business; (5) power and function of committees; (6) authority to draw up plans; (7) control over statements furnished security holders; (8) circumstances surrounding submission of plans to security holders; (9) nature and extent of judicial inquiry during the proceedings. Many of the changes introduced by Section 77B and Chapter X were designed to redress the distortions of comparative strength that had developed under equity receivership reorganizations. The statutory changes sought to eliminate artificial advantages gained from procedural phases of the reorganization process. The new procedure was thought to be more democratic in that the relative strength of the groups was expected to reflect more accurately the attitudes of their proper constituents, and it was hoped that the attitudes themselves would reflect intelligent deliberation based on adequate information and competent advice.

Much of the criticism of Chapter XV of the Bankruptcy Act (no longer in effect) was directed at its procedural contours, which tended to place great leverage in the hands of the management, and thus of junior interests, of railroad companies. A comparison of the structures of Chapter X and Chapter XV highlights such criticism. See Will, *The Voluntary Adjustment of Railroad Obligations*, 7 *Law & Contemp. Prob.* 519 (1940).

⁹ To analyze reorganization value by contrasting it to market value, as is done in this article, may not be conventional. Moreover this approach has the drawback of tending to emphasize valuations and to direct attention away from the processes of determining the rights of the parties. These disadvantages might have been avoided by casting the analysis in terms of contrasting the "foreclosure principle" with the "adjustment principle." This alternative would not have altered the analysis substantively; the foreclosure process determines rights on the basis of market values while the adjustment process does so on the basis of values fixed by experts—now called reorganization values. However, on balance the alternative seemed less attractive than the approach adopted. The market value—reorganization value distinction appears to be more flexible and to provide a less cramping frame of reference. The idea of market value is fairly crisp while the notion of foreclosure has acquired a cluster of overtones that might be distracting. Finally, the use of an unconventional orientation may assist in gaining further insights about corporate reorganization.

to participate in the reorganized entity and what ones are to be left out. Reorganization value might be used in two other connections in the reorganization process. It might be referred to in determining whether a proposed allocation of interests among participants in the reorganized company is fair and equitable. It also might be consulted in deciding whether the business should be sold—either as a going concern or as scrap—or reorganized. These various functions which reorganization value can be made to perform will become more clearly delineated as the full scheme of reorganization doctrine is unfolded.

The difference between market value and reorganization value is a touchstone for analyzing the reorganization system. Market value is a real value in that it not only is expressible in dollar terms but is realizable in dollars. Property can always be exchanged for cash at market price because that price is made by those who are ready and willing to back up their own estimates of value with money. For the same reason market value can always be ascertained objectively by noting the highest bid. In marked contrast, reorganization value has the opposite characteristics. It is a fictional value which cannot command real money dollar for dollar. It is set by the estimates of persons who are not standing back of them with a willingness to invest their own funds. Accordingly it can never be objectively ascertained or verified but always remains in the realm of opinion or belief.¹⁰

Nevertheless the need for making reorganization values appear objective and realistic had to be met. A related need also invited attention. Almost everyone was agreed in the abstract that there could be better or worse valuations for reorganization purposes. Canons therefore were required to guide setting reorganization values at the better rather than the worse levels. The twin goals of gaining an objective appearance and adopting proper canons could be satisfied at once through borrowing techniques developed in the market place. Intelligent and prudent investors are known to analyze and make judgments about various separable and describable factors in reaching an appraisal of a company or its securities. By imitating these steps in finding reorganization value this comparatively new concept might acquire stature by seeming associated closely with market value. In time the two "values," arrived at by similar techniques, might tend to become merged in popular thought.

¹⁰ This comparison between reorganization value and market value suggests that the problem of finding a proper reorganization value is like that of finding a proper rate to be charged by a public utility for its services.

The imitation of investor practices resulted in crystallizing the calculation of reorganization value into an approved procedure that formally involves making three guesses.¹¹ The first is an estimate of the annual income which the business hereafter most probably will earn.¹² This guess is to be reduced to a yearly average after consideration has been given to foreseeable highs and lows for the business. The crystal gazing of course must be bottomed on facts, and therefore it is to be a projection of the company's past and present, rather than mere fancy about its future. The facts however are likely to be slippery and plastic. Past earnings of the business may suggest something about its future, but there cannot reasonably be a presumption that the historical pattern will continue substantially unchanged. Current earnings are perhaps even better indicators, but if the enterprise is experiencing hard times a low level of earnings can invariably be explained away easily. In a changing world there will almost always be adjustments which can or should be made to past or current earnings to reflect the direction of change. Doubtless some predictions as to future earnings may seem more prudent than others; the range of reasonable predictions, however, appears usually to be extremely wide.

The second guess pertains to the probable life of the business as a going concern after reorganization. Often this matter is not in issue because the parties agree that the foreseeable operational life is sufficiently long to justify valuing the entity as a perpetuity.¹³ But where there

¹¹ Of course the valuation technique described in the text is not the only one that is used in bankruptcy reorganizations. There are situations in which valuation by the capitalization of projected earnings is not suitable. However, it is fairly realistic to view the method discussed in the text as the standard operating procedure which has general official sanction. Other approaches to valuation by and large do not have a comparable status in reorganizations; it almost seems as though they must be specially justified in particular cases before being acceptable for such limited service.

The techniques followed by the SEC in Chapter X cases and by the ICC in Section 77 cases are not identical. The SEC estimates future earnings, chooses a capitalization rate, and then (after considering the prospective life of the enterprise) mechanically applies one to the other to compute reorganization value. The ICC estimates future earnings but usually does not explicitly consider a capitalization rate or compute a specific reorganization value. Instead it calculates how large a capitalization can be supported by the estimated earnings. This is an indirect method of arriving at a rate for capitalizing the estimated earnings. The difference between the two techniques has no significant bearing upon this analysis.

¹² For a discussion of estimating prospective earnings see 1 Bonbright, *Valuation of Property*, c. xii (1937).

¹³ One difference in the problems confronting the SEC under Chapter X and the ICC under Section 77 should be noted. In railroad reorganizations the ICC can generally assume that the roads will have perpetual life. The SEC often cannot take for granted that the life span of a distressed industrial corporation will be of long duration. See Field, *Valuation for the Purpose*

is a question whether the business will be able to continue operations for an extensive period, a fairly specific prediction about its duration is needed to compute its reorganization value or, more accurately, its delayed liquidation value. Making this estimate might be largely a technical undertaking where the limiting feature for continuation of the business is exhaustion of an asset not being replaced, such as a mineral deposit or a determinate franchise. It is otherwise where the limit is suggested by doubts about the firm's ability to finance replacement of necessary equipment which is or might soon become obsolete. A guess about continuation of the business under these circumstances necessarily involves assumptions as to replacement costs, the rate of technical change in the industry, the replacement program of competitive firms, and other factors of a similar nature. On these matters agreement among the technicians is neither likely nor very persuasive.

The third guess, which generally is most consequential, consists of picking a proper rate at which to capitalize the projected earnings.¹⁴ This endeavor presents a double puzzler. On the one hand *the* rate cannot be obtained from a review of the capitalization rates for the distressed enterprise itself which are implicit in the ratio between its earnings and the evaluation of the company (or its securities) by investors.¹⁵ Its current rate (that is, its earnings-valuation ratio) is fixed

of Corporate Reorganization, 16 Rocky Mt. L. Rev. 13 (1943); Field, Strict-Priority-of-Liens-Policy of Federal Agencies, 9 Am. L. School Rev. 1518 (1942).

Regarding the difference between valuing a business as a perpetuity and as an entity with a specified limited life, see Atlas Pipeline Corp., 9 S.E.C. 416 (1941); cf. the majority and minority opinions in *Palmer v. Conn. Ry. & Lighting Co.*, 311 U.S. 544 (1941).

¹⁴ The following references discuss the problems of selecting an appropriate capitalization rate: Valuation by the SEC in Reorganizations, 55 Harv. L. Rev. 125 (1941); Gardner, The SEC and Valuation under Chapter X, 91 U. of Pa. L. Rev. 440 (1943); 1 Dewing, The Financial Policy of Corporations, Bk. 2, cc. 1, 2 (4th ed. 1941).

Simplification plans under the Public Utility Holding Company Act frequently entail a valuation process similar to that employed in reorganizations under the Bankruptcy Act. The simplification cases, however, seem to present easier targets for making guesses as to future earnings and proper capitalization rates. The income of gas and electric utilities over the years has been, and is likely to continue to be, more stable than that of industrial concerns and railroads. Utility operations are characterized by a greater degree of similarity than is found among industrial concerns, and hence comparability between firms might more readily be found. Moreover, the company undergoing simplification is usually not financially distressed in the same sense as enterprises involved in insolvency proceedings. For this reason the market capitalization rates for the subject company may be thought to be more significant in choosing a proper capitalization rate. See, for example, *American & Foreign Power Co.*, SEC Holding Co. Act Release No. 7815 (1947).

¹⁵ In a reorganization the term "capitalization rate" is an orderly one for referring to the relationship between earnings (estimated) and valuation. This is so because the reorganizers are attempting to reach a valuation; if they start with predicted earnings the earnings must be capitalized at a rate to obtain the valuation. But the term is not such an orderly one for

by the current market and that institution has been cast aside as a standard for measuring values in reorganizations. For the same reason its rates (or ratios) in the near past cannot be meaningful because the imminent or actual distress of the business almost certainly then affected its capitalization. Its rates in a more rosy past are likely to be only of historical interest because times and the corporation probably have changed. On the other hand the spread of capitalization rates (again meaning earnings-valuation ratios) for similar or competing businesses during these various time periods seems to afford equally little data upon which to base selection of *the* rate. Most businesses do not have twins. Similar or competing firms may range from highly successful concerns to others undergoing the reorganization treatment. An average rate of all such firms is meaningless for the purpose in view, while individual comparisons are somewhat circular because the very factor which is being sought—*the* rate—is likely to be influential in deciding what firms are comparable. Once the yardstick companies have been designated there again arises the question whether it is their past or present rates which are significant. Inasmuch as rates determined by the market fluctuate frequently, the capitalization rate which prevailed at any one time—that is, a spot rate—appears to be useful only as a component in a large series of spot rates which go to make up the average rate for some fairly extensive interval. At best the guessers can fall back only on average long-run capitalization rates for each of the corporations which they feel is more or less comparable to the one being rehabilitated.

This cursory review of the guesses which go into reorganization value indicates that all three have similar characteristics. Being guesses they of course cannot possess certainty. But each appears closely dependent upon factors that can be reduced to at least near certainty. Furthermore each can be “explained” and expressed in precise mathematical terms. As a result each seems open to reasonably accurate prediction by competent experts. In fact, however, these appearances are highly deceptive. All three objects of the guesses (with the exception of estimating the life of depleting or depreciating assets in some cases) conceivably may be affected by innumerable circumstances, including the

referring to the market relationship between earnings and valuation. Both these factors are given; and therefore the term “earnings-valuation ratio” or “times-earnings ratio” is more descriptive. To avoid shifting terms unnecessarily, however, the text uses “capitalization rate” to designate generally the relationship between valuation and earnings, whether actual or projected.

guesses themselves. Expert guessers, with divergent backgrounds, surely will differ in appraising the implications of possibly relevant factors. It is manifestly impossible to lay down in advance rules that determine the proper weight to be assigned the various circumstances in particular cases. Only broad and general pronouncements can be beamed at the guessers. These directives are the official guides for making the guesses and thereby arriving at reorganization value. Our short description of the guesses is tantamount to a rough summary and paraphrase of those guides.

Accompanying the three-part estimate there is a one-part necessary assumption in calculating reorganization value which the authorized guides do not mention. It deals with the future state of our economy and in the cases it is usually implied rather than expressed. Because reorganization value concerns future conditions, something must be assumed as to the future general level of economic activity and the future real worth of the monetary unit. This poses a problem: the objective and scientific appearance of the valuation process must be preserved notwithstanding the fact that there are no experts in the game of peering into our over-all economic future. The solution evidently is to wrap up the critical assumption in vagueness and bury it. In most reorganization cases it probably is assumed that the economic future will be much like the economic past—without being too careful about designating how much or what part of the past. If the past which the calculator deems relevant strikes him as too gloomy or too bright an atmosphere for the future, he is likely to make adjustments through altering the projected earnings or capitalization rate for the particular firm.¹⁶ In this way a guess as to the general economic future is translated into specific estimates about the distressed enterprise undergoing reorganization. The shift, in effect, keeps the crucial guess in the province reserved for (or by) experts and thereby maintains the illusion that reorganization value is being determined on a sound foundation.

¹⁶ In the sense that the future earnings of a firm cannot be estimated as though it is to be operated in a vacuum, the assumption about general economic conditions is not separate from the guess as to earnings. However, there is a conceptual difference between the general economic outlook and that for the particular company. To illustrate: it is possible to make a series of guesses as to the company's future, each being tied to a different assumption about general conditions. In any event it is possible to state separately the assumption about the general future. See, for example, the argument made in the *Denver & Rio Grande Western* reorganization that a "permanent elevation of the National income" involved "for the indefinite future a greatly increased demand for railway transportation." *Insurance Group Committee v. Denver & R. G. W. R. Co.*, 329 U.S. 607, 610 (1947).

A troublesome but central question doubtless has been intruding. The guiding formula for finding reorganization value is a copy of that used by careful and informed investors. Presumably the copywork was accurate. Why then should anyone duplicate the valuation work which is independently and simultaneously being undertaken anyway by numerous investors with sharp pencils? Surely the risk-free imitators are not *that* much more proficient than their risk-bearing models. The correct answer is not so simple and it lies nearer the core of the reorganization process. A clue might be furnished by the frequent assertion that reorganization value is unlike market value in that the latter is a spot or immediate value while the former is a long-run average value. This is the premise for a basic tenet of reorganization doctrine: Market value, especially in depressed times, is to have little weight since rights in a distressed company are to be adjusted in the light of an average or long-range value which takes account of both possible future highs and possible future lows.¹⁷ Valuation for reorganization thus is supposed to aim at reaching the long-range average of future market valuations of the enterprise. So the answer to the troublesome question might seem to be that experts on reorganization value are not aiming at the same target as professional investors who make the market.

But such an answer is built on an error. Investors who make the spot prices are themselves attempting to predict the future long-run or average values of particular companies. Their judgments as to present values are derived from their predictions as to comparative future values of alternative investment opportunities. This may be a more helpful clue to finding the correct answer to the question. Investors focus on predicting the future of a company in order to compare a present investment in it with other possible immediate investments. Current market prices are obviously of utmost importance to them in calculating the relative attractiveness of opportunities. In contrast, appraisers of reorganization value usually seem not much concerned with the present range of market prices. They apparently make their guesses

¹⁷ "It has been [the] practice [of the Interstate Commerce Commission] broadly speaking . . . to make an estimate of prospective earnings divided roughly into four categories: (1) Those reasonably certain to continue without serious interruption. . . . (2) Those of which there is a substantial probability but whose regular annual continuance cannot be counted upon in a period of general business depression. . . . (3) Those of which there is a reasonable probability but which . . . may be frequently interrupted. . . . (4) Those of which there is no probability of uninterrupted realization but which will probably be realized from time to time, and if optimistic hopes are fulfilled, may ultimately be maintained." Swaine, *A Decade of Railroad Reorganization under Section 77 of the Federal Bankruptcy Act*, 56 Harv. L. Rev. 1037, at 1198-99 (1943).

as to future values without attempting to relate them definitely to the existing structure of market values. Instead the appraisers generally act as though the predicted future values are the present values. The essence of reorganization value can now be restated in other terms: Reorganization value is what some appraisers believe the current market value of the distressed company ought to be if the present were like the future they foresee. It is thus a liberalization of market price corresponding with some expert opinions about the inherent value of the enterprise.¹⁸

Though reorganization value is in a world apart from market value the two realms are never completely isolated from each other. Securities of the reorganized company will be independently priced by the market regardless of how they were valued for purposes of the reorganization. In the period immediately following reorganization, and for some indefinite time thereafter, it is to be expected that in the aggregate the new securities will sell below the values assigned them in the reorganization. That is, the total of market prices will fall substantially short of the total of their par or stated or face values. These *nominal*¹⁹

¹⁸ This may seem to be an overstatement but it is a statement of a point which needs emphasis. It is at the root of the inflation of reorganization value to exceed market value. It explains why, in the large majority of reorganizations, the new securities do not have market values equal to their nominal values (as defined in note 19 *infra*).

It may be objected that the SEC, in reorganizations under Chapter X, endeavors to reach a "realistic" reorganization value which takes account of existing economic and market conditions. There are numerous indications that the Commission has been more hard-headed than other experts and appraisers who have figured in the cases. See, for example, Field, *Valuation for the Purpose of Corporate Reorganization*, 16 *Rocky Mt. L. Rev.* 13, 23 (1943): "[T]he SEC used two approaches which simultaneously and cumulatively reduced the valuation for reorganization purposes. That is, (1) it made very conservative estimates of future earnings, and (2) it applied a relatively high interest rate in capitalizing the scaled down earnings." Compare *Valuation by the SEC in Reorganizations*, 55 *Harv. L. Rev.* 125, 132 (1941): "In summary . . . it may be said, that, in the light of past and current earnings records, its determination of prospective earnings appears to have been unduly optimistic." But being hard-headed in figuring out reorganization value is not equivalent to seeking to ascertain what price the market would place on the distressed business. In this connection see the statement regarding SEC policy in note 24 *infra*.

A reminder might be useful at this juncture. The present analysis is not intended to demonstrate or suggest that market prices and values would or could work satisfactorily in governing rights in corporate reorganizations. In any event the attempt to use market values for that purpose would raise a large number of problems which either are not mentioned or are passed over lightly in this piece. Market values and prices are utilized here to analyze the reorganization value concept. See note 6 *supra*.

¹⁹ The phrase "nominal amount" or "nominal value" may be an unfortunate choice but no other short one seems to convey the meaning intended. The phrase is employed to designate the computational amount assigned to a claim or interest regardless of its actual dollar value. It refers to the following: (1) the face amount of bonds or other creditor claims, including interest in default; (2) the par value of preferred shares, plus arrearages; (3) the artificial value assigned to common shares in working out the allocation of securities in a reorganization.

values at the outset will be discounted because of the very factors which produced the "low" prices that led to discarding market value of the business as the standard for determining the rights of the parties upon default. In time the security prices should, on the whole, approximate nominal values if the guesses and assumption behind the calculation of reorganization value turn out to be fairly close to reality. The new securities, in other words, should approach becoming wholly sound to the extent the figure chosen for reorganization value happens to be a sound estimate.

The need for a warning makes advisable a short digression. While the market prices of the securities of a reorganized company are a link between reorganization value and market value of the business, the market prices of the company's securities prior to reorganization cannot act as a comparable link. If reorganization value were set with an eye toward market quotations on the pre-reorganization securities the valuation process would become circular. Market quotations would affect reorganization value; that usually would affect the terms of the reorganization plan; that in turn usually would affect the treatment of the old securities in the reorganization and therefore affect market quotations on the old securities. Only after the reorganization plan has become definite and firm can the link between market value and reorganization value be formed. The link, moreover, will always have an inherent shortcoming. The market value of a business as a unit is generally not identical with the aggregate market prices of the securities issued by it. But this discrepancy does not seriously impair the reach of our analysis. It is enough that the two figures ordinarily tend to move in the same direction and on the average are not likely to be widely apart over a long time span.²⁰

These collateral observations concerning reorganization value should not obscure the main point about the concept. Not only is it different from valuation by the market, but it can be understood fully only when contrasted with market value. A sharp reminder of the contrast is supplied by the case of a distressed holding company which owns nothing but relatively small blocks of publicly traded securities of enterprises not undergoing reorganization.²¹ The market value of the company's

²⁰ The uses and shortcomings of the stock-and-bond method of appraising a company are considered in 1 Bonbright, *Valuation of Property* 244-49 (1937). The position taken in this article is not inconsistent with the observations of Bonbright.

²¹ The problem of valuing holding company assets, both those in small and those in substantial lots, is considered by the SEC in its advisory report on plans to reorganize the Central

assets can be ascertained immediately and accurately by referring to present quotations, and the market value of the company itself obviously is the sum of those values. To assign a higher amount as reorganization value is to assume that the company's officers will manage its assets more profitably than investors believe these or similar assets will or can be managed. The evident brashness of that assumption is a deterrent to departing from market values in such a situation. In the more usual reorganization the market values of the debtor's assets, treated either individually or as a going business, are not so easily or surely or definitely determinable. To use a reorganization value greater than the best gauged market value is not as jarring in these circumstances. But doing so nevertheless assumes that the debtor's officers will perform better, or that general economic conditions will be better, than is believed likely by those who make the market.

III

Apart from the over-all valuation issue, questions of fairness about a reorganization plan arise principally because there is an uncertain ratio between reorganization value and market value, and so between a dollar of reorganization currency and a real dollar. If reorganizations were predicated on real dollars, presumably cash or its equivalent in securities would be allocated to claimants in the amounts and order of their contractual priorities. With claims being satisfied in this manner the fair allocation could be worked out mechanically. However no objectively gauged allocation is possible when the medium of distribution is reorganization currency of unknown dollar value. Such currency must consist of new securities in the distressed company; but a unit of one possible kind of new security (e.g., a \$100 bond) is not equivalent to the same denomination of another possible variety of new se-

States Electric Corporation, an investment company, under Chapter X. Experts brought in by junior interests contended "that the then current market prices were an undervaluation of the public utility securities held by the Debtor . . . ; that there were favorable factors in the case of these public utilities which were not fully appreciated by the investing public, or if appreciated, were accorded too great a discount in relation to the risks involved." The SEC's comment upon this approach was that "conjecture as to future market prices is not a sound basis upon which to measure the rights of creditors and stockholders. Under the circumstances it is difficult to see how the Court can speculate that market prices of these securities will rise in the future." *Central States Electric Corp., SEC Corp. Reorg. Release No. 82, at 89 (1949)*.

A different attitude was displayed by the court in the reorganization of Warren Brothers Company, which owned a large number of bonds issued by the Cuban Republic. In deciding that the bonds should be valued at par rather than at market price (about half of par) the court said that "it would be unfair to the common stockholders to value the debtor's assets on the assumption that Cuba will not meet its obligations." *In re Warren Brothers Co., 39 F. Supp. 381, 385 (Mass., 1941)*.

curity (e.g., a \$100 par value preferred share). Unless contractual priorities are to be dismissed entirely someone has to decide whether in his opinion a proposed allocation of reorganization currency is fair to the classes of claimants. Such a subjective judgment cannot be avoided; at best an effort can be made to hedge it about by formulating additional official guides for making an allocation. These, along with the guides for determining reorganization value, become the standard for a fair and equitable plan. For convenience of analysis we are treating the two sets of guides separately. Under reorganization doctrine they are interrelated, and to be fair and equitable a plan must comply with both.

The prevailing allocation guides collectively are designated the absolute priority standard. They purport to call for strict enforcement of security contracts as qualified by the premises contained in the reorganization value concept. In theory the contractual priorities affecting the rights of creditors and shareholders are to be recognized in full. Senior claimants are supposed to be completely compensated, which includes being given equitable compensation for loss of any valuable rights, before junior claimants are permitted to receive anything of value. Compensation to the seniors may be incorporated in the new securities or take some other form. In any case the new bundle of rights and claims allocated to them are supposed to be the equitable equivalent of their old packet.²² The worth of the new securities is not to be tested by reference to market quotations because that yardstick is patently inconsistent with predicating the plan on reorganization

²² The main precepts of our absolute priority standard are contained in the following decisions of the United States Supreme Court: *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939); *Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510 (1941); *Group of Institutional Investors v. Milwaukee R. Co.*, 318 U.S. 523 (1943); *RFC v. Denver & R.G.W.R. Co.*, 328 U.S. 495 (1946).

The priority which is referred to by the phrase "absolute priority" comprehends all kinds of prior rights and claims. Particular emphasis, especially in Chapter X proceedings and to a lesser extent in Section 77 proceedings, is placed on the priority of rights in case of default or liquidation. The priorities of creditors and preferred shareholders on liquidation are treated as matured for purposes of the reorganization proceedings. The reason underlying this approach is that reorganization is viewed as a substitute for enforcement of rights through liquidation. "Reorganization prevents creditors from getting the cash for which they bargained, but the absolute priority doctrine comes to their rescue by giving them the nearest practical equivalent." *Dissolution Preferences and Public Utility Holding Company Act Simplifications—The Otis Case*, 58 *Harv. L. Rev.*, 604, 608 (1945). But in determining whether seniors are completely compensated in a reorganization, the absolute priority doctrine seems to require that attention be paid to all their prior rights, including claims on income and rights to control the management of the enterprise.

A fuller understanding of the absolute priority standard might be gained by contrasting it with the "investment value" standard developed under the Public Utility Holding Company Act. See note 49 *infra*.

values.²³ Instead their worth presumably is to be gauged by assuming that the corporation's market value has come up to its reorganization value or soon will do so.²⁴ The stage for formulating a fair plan thus

²³ It would be possible, for example, to decide what the capitalization of a company is to be after reorganization and issue of enough of the new securities to senior creditors to give them a package having a market value equal to the nominal amount of their claims. An article written shortly after the enactment of Section 77B seems to endorse this approach. "[C]reditors are entitled not merely to priority but to payment. Since they cannot be paid in cash, they should be paid, so far as the resources of the company permit, in securities having the value of cash. Although the corporate assets may have an appraised value in excess of the amount of the debts, the total market value of securities issued against these assets may be far less than that amount." Friendly, *Some Comments on the Corporate Reorganization Act*, 48 *Harv. L. Rev.* 39, 77 (1934). Such an approach, which in effect would replace appraised reorganization value with market value, is far different from that now used (which is described in note 24 *infra*).

The difference between full compensation under a fair plan of reorganization and full payment of claims in cash or its equivalent is pointed up in an interesting and unusual fashion in *Guaranty Trust Co. of New York v. Chase National Bank*, 194 *N.Y. Misc.* 628, 86 *N.Y.S.2d* 505 (1949). In the reorganization of the Denver & Rio Grande Western Railroad the senior bondholders were compensated in full by new securities in the reorganized company. The old senior bonds had been secured by certain accommodation collateral that had not been within the jurisdiction of the reorganization court because it was not an asset of the debtor company. After completion of the reorganization proceedings the disposition of this collateral was put in issue. The old junior bondholders, who participated in the reorganization as the marginal class, which was compensated only in part, claimed the value of the released collateral on the ground that the old senior bondholders were already made whole in the reorganization. But the court awarded the value of the collateral to the old seniors, reasoning that "the pledge [of the collateral] was made under a contract which guaranteed full payment of the [senior] bonds . . . *actually* and not merely fictionally and constructively." *Ibid.*, at 632-33 and 510.

²⁴ On this matter the position of the SEC under Chapter X has been stated to be: "[S]enior security holders are entitled to receive more than mere paper securities of a face value amount equal to their claims; . . . the securities they receive should be such as to give them really compensatory treatment for their claims. In other words, the new securities should be intrinsically sound, so that there is a reasonable prospect that they will have values equal to their face amounts, or in the case of stocks, equal to the values put upon them for reorganization purposes." Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 *N. Y. U. L. Q. Rev.* 317, 340 (1941).

Compare the foregoing statement with the following description of the principle imputed to the ICC in reorganizations under Section 77 prior to the decisions of the Supreme Court in the reorganizations of the Chicago, Milwaukee, St. Paul and Pacific Railroad and the Western Pacific Railroad:

"However—and this is a vitally important corollary—100% satisfaction is deemed to be given by 100% satisfaction in paper. Priorities are considered satisfied if the full amount of the claim is recognized in securities of the appropriate dollar amount. No attempt has been made to insist that the securities issuable to a senior class must have a prospective market value of 100 cents on the dollar before a junior class may participate. Indeed, in those few instances where senior interests have asked for more than 100% in new securities to compensate for sacrifices entailed in receiving partial compensation in income bonds or stock, such treatment has been denied.

"The Commission has even gone further. It has not insisted upon allocations which would reasonably assure that the securities issuable to senior interests should attain a market value of 100 cents on the dollar before any income of the reorganized company could be paid to junior interests." Friendly & Tondel, *The Relative Treatment of Securities in Railroad Reorganizations under Section 77*, 7 *Law & Contemp. Prob.* 420, 423-24 (1940).

has a complex backdrop. The seniors are supposed to be compensated in full, but only in terms of reorganization currency which generally is not immediately convertible into dollars except at large discounts. The juniors are supposedly entitled to the excess, if any, of reorganization value over and above the amount needed to satisfy claims of the seniors. Interaction between these two guides is at the core of our absolute priority standard.

The main source of friction in this interaction is not difficult to locate. Reorganization value by hypothesis should equal the new capitalization of the rehabilitated enterprise. The new capitalization by definition equals the aggregate of nominal values assigned to the new securities (i.e., the amount of reorganization currency). Therefore the total nominal value of the new securities should equal reorganization value. The new securities are to be allocated among the participating classes of creditors and stockholders. Superficially it might seem that the juniors should receive the difference between the total nominal amount of senior claims and the reorganization value. But this formula assumes that the seniors receive new paper thought to be equivalent in quality, as well as in nominal quantity, to their old holdings. In most situations that arrangement would undermine the rehabilitation operation by preserving fixed charges that are heavy in relation to estimated earnings. The statutory requirement that a plan be feasible as well as fair usually necessitates a more or less drastic scaling down of such obligations and this ordinarily can be accomplished only by reducing the quality of paper allocated to the seniors. Compensation for the deterioration usually can be provided only by giving the seniors a sum of reorganization currency greater than the aggregate nominal amount of their old claims. When this is done the balance of reorganization currency left for the juniors is concomitantly decreased.

These mathematics of reorganization explain why junior classes frequently insist that a large proportion of reorganization paper be debt obligations. They also indicate why juniors often seek to introduce unique features into the paper earmarked for seniors in the hope that such features will be counted as compensation for other rights given up by the seniors.²⁵ It is at these points that the conflict among the spar-

²⁵ "Counsel and securityholders wrestling with the implications of [the Supreme Court's opinion in *Group of Institutional Investors v. Milwaukee R. Co.*, 318 U.S. 523 (1943)] in pending cases are trying, by a 'flash of genius,' to find some new 'qualitative' type of compensation which is not 'normally common.' It has been suggested that an abnormally high sinking or purchase fund, payable out of earnings as a condition precedent to the payment of dividends upon the new common stock allotted to old junior creditors and to be applied

ring classes of security holders runs into what is considered to be an overriding public interest that the rehabilitation of distressed companies be soundly executed. The standard of feasibility for a plan is supposed to protect this public interest and in doing so seems to place additional limitations on the area within which a fair plan may be worked out. The feasibility guides are still in the course of growth.²⁶ As a minimum they include a prohibition against saddling the reorganized business with excessive fixed charges of any kind. In addition they probably include a restriction on trimming new securities with rococo qualities which tend to be misleading and make intelligent judgments by investors more difficult. One might speculate whether our standard of fairness could not itself be stretched to impose comparable limitations so that there would be no need for a separate requirement of feasibility. There surely seems to be an element of unfairness in awarding seniors new securities which are unsound. But such doubts about fairness are likely to be associated with a distrust of the valuation for reorganization purposes. It would be awkward to accept a certain value as fair and then label an allocation of securities unfair on the ground that they are unsound though within the permissible capitalization. The feasibility requirement at least seems to avoid what might appear to be double-talk about fairness.²⁷

The feasibility guides probably are not as effective in channelling official discretion, and thus in shrinking the permitted latitude for negotiation²⁸ among the claimants, as might be inferred from a separate

to the purchase or retirement of the inferior grades of securities allotted the old senior creditors, might suffice." Swaine, *A Decade of Railroad Reorganization under Section 77 of the Federal Bankruptcy Act*, 56 *Harv. L. Rev.* 1037, 1193, at 1212 (1943).

²⁶ See *Philadelphia and Western Ry. Co.*, 13 S.E.C. 330 (1943); cf. *In the matter of Philadelphia and Western Ry. Co.*, 51 F. Supp. 129 (Pa., 1943). The concept of a feasible plan should be compared with the standards of a sound corporate capital structure developed under the Public Utility Holding Company Act. See in particular *Consumers Power Co.*, 6 S.E.C. 444 (1939); *El Paso Electric Co.*, 8 S.E.C. 366, 383 (1940).

²⁷ Whether or not the fairness notion could be made to do the work of the feasibility notion, the idea of feasibility can be separated out from allocation problems for purposes of analyzing a plan. And there is no doubt that analysis is facilitated by such a separation.

The relationship between the "fairness" of a valuation for reorganization purposes and the "fairness" of an allocation of securities under that valuation is more readily observed in ("horizontal") plans in which the same class of new security is divided between junior and senior participants. But the relationship is also present in some ("vertical") plans in which senior participants are given a higher ranking security than that given to junior participants. See the discussion in part V of the text.

²⁸ The term "negotiation" is used in this article as having a very broad meaning. It comprehends every kind of legitimate activity by which security holders or their representatives try to convince the court or administrative agency or trustee that a distressed business should be handled in a particular fashion or that a reorganization plan should embody one arrangement

study of them. Their impact seems attenuated by the opportunity of the parties to deal simultaneously with both reorganization value and the composition of the new capital structure. It is to be expected that courts and administrative agencies have not advertised how the interdependency of these two matters has affected the outcome of particular cases. To do so might cast suspicion on the objective appearance of the subjective judgments involved in calculating reorganization value and in determining whether senior classes have been compensated completely for loss of rights. But in the give and take of negotiation two controversial matters so closely related are almost inevitably linked together. A good case for testing this observation is presented when the likely range of reorganization value runs from a low which eliminates the juniors entirely to a high which allows them a relatively small participation.²⁹ The bargaining position of the seniors is apt to be very strong and that of the juniors correspondingly weak. It is a pretty safe bet that the juniors must either accept an arrangement which gives the seniors the protection demanded or run the risk of having the court hold that their stake in the company is so speculative as to make it undesirable and unfair to grant them participation.³⁰

rather than others. It also includes dealings among different classes of security holders and their representatives to reach agreement concerning any phases of a plan. From this description of the term it should be plain that negotiation is involved even where the actual plan is drawn up by the ICC under Section 77. No distinction is drawn in the text between direct negotiation among classes of security holders or their representatives, and the more indirect form which centers on persuading the authorities in charge of the reorganization. "Negotiation" is intended to include both.

For a statement of the need for and the importance of vicarious negotiation in reorganizations, see Foster, Review of Lowenthal, *The Investor Pays*, 43 *Yale L. J.* 352, 357 (1934).

²⁹ Two cases which arose under Section 77B of the Bankruptcy Act are highly useful in connection with this portion of the analysis. The first is *In re Hopkins Lake Drive Realty Corp.*, C.C.H. Bkcy. L. Serv. ¶3276 (D.C. Md., 1934), in which the senior claims (adjusted) totalled approximately \$905,000 and valuations of the assets ranged from about \$800,000 to \$1,000,000. After noting that \$900,000 "is possibly the best figure," the court rejected both the plan proposed by the seniors and that offered by the junior interest. As to the latter the court remarked: "In solving the question of insolvency in favor of the debtor [i.e., the junior interest] I do not think I am at liberty to enforce on the bondholders against their will the sacrifice of any part of their claim, either principal or interest. Equity and fairness require the debtor corporation to discharge all of its original obligations which were incurred in good faith." Concerning the plan of the seniors the court said: "The plan . . . is not fair because it does not take into consideration any equity in the debtor."

The second case is *In re Murel Holding Corp.*, 75 F. 2d 941, 942 (C.A. 2d, 1935), in which senior claims totalled about \$500,000 and the "properties were assessed at \$540,000." The precise issue raised in the case cannot arise under Chapter X, but both the broader problem posed by the facts, and the discussion in the opinion, are of current interest.

³⁰ "After having determined the total capitalization the ICC must provide fair and equitable compensation for all senior creditors upon the 'strict priority' theory. In a situation where this distribution leaves only enough to partially compensate a junior group, the threat that this junior group would reject the plan could [in the absence of an effective cram-down power]

The effectiveness of the allocation and feasibility guides in controlling the discretion of officials might be further affected by whether our standards are construed to sanction only one or more than one acceptable plan in any particular case. It has usually been thought that in most situations a number of fair plans can be formulated within the confines of feasibility. Moreover there has been a reluctance to rank possible plans according to degrees of fairness probably because the notion of fairness would tend to become unmanageable.³¹ But a strong argument can be made that the theory of reorganization dictates that there can be only a single fair allocation for any particular situation.³² In large measure the reorganization process was designed to preserve for juniors the greatest possible amount of value consistent with both full compensation for seniors and adequate protection of the public interest as reflected in the canons of feasibility. To accomplish this objective, the fair allocation must be that arrangement which gives juniors maximum participation within such limits. It must therefore be the plan which compensates seniors qualitatively to the fullest extent practicable in order to minimize the need for compensating them quantitatively and thereby increasing their nominal interests in the company. There is as yet no clear indication that this view of the fair plan has gained official sanction. But its approach to fairness doubtless explains in part why courts are sympathetic to plans which emphasize qualitative compensation to seniors.

completely stall the reorganization. To prevent such an impasse the ICC might reasonably be tempted to adjust the valuation in such a way as to eliminate completely marginal classes which otherwise would be admitted to partial participation." Confirmation of Plan under Section 77 over Vote of Dissenting Class of Creditors, 14 Univ. Chi. L. Rev. 84, 91 (1946).

³¹ Remarks by courts indicate that degrees of fairness among plans might be recognized. An example is the statement in *In re Lower Broadway Properties, Inc.*, 58 F. Supp. 615, 618 (N.Y., 1945), that Chapter X "does not require of the court to find the fairest plan conceivable but only that the plan proposed be fair." The SEC sometimes gives the impression of rating the fairness or unfairness of plans or particular provisions in them by its use of such adjectives as "grossly unfair," "obviously inequitable," or merely "unfair." See, for instance, *Central States Electric Corp.*, SEC Corp. Reorg. Release No. 82 (1949).

³² This position seems to be taken in Swaine, *A Decade of Railroad Reorganization under Section 77 of the Federal Bankruptcy Act*, 56 Harv. L. Rev. 1193, 1209 (1943). "Equitable compensation must be made for rights which senior creditors are thus compelled to surrender. So far as permitted by feasibility and the public interest, such compensation should be made 'qualitatively,' i.e., be incorporated in the new securities themselves. Insofar as feasibility and the public interest prevent the relative priorities being made whole 'qualitatively,' they must be made whole, and equitable compensation for surrendered rights must be made, 'quantitatively'—i.e., by giving to the old senior creditors new securities of the same classes as those given old junior claims but upon terms sufficiently more favorable than those given the junior claims." Another article which might be read as suggesting this position is Guthmann, *Absolute Priority in Reorganization*, 45 Col. L. Rev. 739 (1945).

This approach to fairness also highlights the role that feasibility guides can be made to play. The single fair plan idea means, in effect, that *the* plan should push to the limits of feasibility whenever necessary to protect the juniors. To the extent the idea influences those who draft and pass upon plans, the feasibility issue becomes the active center of controversy between participating classes. A two-directional relationship between fairness and feasibility is brought into focus. As a plan is thought to exceed the limits of feasibility it tends to seem unfair to seniors. As a plan is thought to fall short of the limits of feasibility it tends to seem unfair to juniors. In this sense it might be said that in reorganization doctrine fairness and feasibility are merely two different impressions of the same panorama.

Having completed an excursion into absolute priority a reminder and a question are in order. The absolute priority standard consists of guides for distributing reorganization currency among classes participating in a reorganization. Would adoption of another set of allocation guides, appropriately named, make any appreciable difference in the reorganization process? A change of guides would not lessen the need for making subjective judgments about the fairness of proposed allocations. Pressure and negotiation accordingly would continue to shape reorganization plans. Any change wrought by the new guides would simply be a shift in the permissible range for negotiation resulting from a changed effectiveness of the guides in confining official discretion about the fairness of plans. The absolute priority guides are said to be more effective than alternatives which have been suggested.³³ This view is plausible insofar as the existing guides can be articulated in a form that sounds very narrow and precise. A more decisive answer to the question does not seem possible. Even if the guides were changed no method would be available for measuring the relative effectiveness of the old and new in limiting official discretion. In any event, increased solicitude about guiding allocations might be counteracted by relaxed application of the guides for setting reorganization values.

³³ In arguing in favor of the absolute priority doctrine in reorganizations, as contrasted with some form of "relative priorities" doctrine, the government (including the SEC and ICC) has stated: "Finally, we direct the attention of the Court to the stimulus which uncertainty as to relative rights gives to obstructionist tactics. If the basis for the treatment of contract rights is unsettled, reorganization ceases to be an orderly process of allocating assets in accordance with priorities. Instead it becomes a process of haggling, in which endurance challenges legal position." *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), brief for the United States as amicus curiae at 22.

IV

Financial distress of an industrial enterprise always focuses attention on what should be done with the business. Should it be continued in operation, sold as a going concern, scrapped, or disposed of in some other way? Even without the intervention of our reorganization system this question often is attended by many complications. There may be differences of opinion among those who have invested in the company. Fights for control are apt to develop. Sometimes the group in the saddle may have no equity in the entity under existing market values, and therefore it struggles to keep the company going. Not infrequently efforts are made to end a conflict by a compromise that transfers rights in the business from junior to senior interests. A need for additional capital to keep the company in operation may color the situation and influence the bargaining positions of the parties. These are only a few of the more common complications which might affect the disposition of a distressed business.³⁴

None of the complications disappears when our reorganization system is introduced into the affairs of a company in trouble. On the contrary the goal of a fair plan based on reorganization value adds a new dimension of complexities in deciding whether the business is to be sold or reorganized and, if the company is to be reorganized, in deciding what plan of reorganization is to be adopted.³⁵ To protect their own interests the creditors and shareholders who continue to have a financial stake in the company will want to make these determinations.

³⁴ The discussion in this portion of the article is limited to industrial corporations which can be reorganized under Chapter X and does not cover railroad reorganizations under Section 77. The sale-versus-reorganization issue is unlikely to arise in connection with railroads, and if it were to be present it would be complicated by the public utility aspect of the operation of a railroad.

³⁵ There is no clear line of demarcation between a sale and a reorganization. Where someone who has had no interest in the distressed business acquires it by putting up new money which is distributed to those who have an interest in the business, the transaction is obviously a sale. Where no new money enters the arrangement and the interests in the company are reallocated among the old investors, the transaction is obviously a reorganization. Between these two clear-cut cases there are many variations and it might be difficult to classify realistically a few transactions which could be posited. But nothing is likely to turn on classification in the close cases. The terms "sale" and "reorganization" are useful primarily in connection with an analysis such as the one undertaken in this article, and precise definition of these terms is unnecessary for that purpose. It should be noted, however, that an arrangement which fundamentally is a sale can take the form of a reorganization. An example of this relationship is presented where an outsider first buys up the claims of juniors and then proposes a reorganization plan under which he, as holder of the junior securities, will pay off the senior obligations in full. In this situation the arrangement could be indifferently embodied in either a sale plan or a reorganization plan.

Decision by majority vote is to be expected in a democratic society; it preserves the voluntary appearance of the process and may act to check abuse of authority by officials. But not all questions can be left to the vote of competing classes of claimants. They obviously cannot decide which of their numbers are and are not to have a vote when there is a disagreement on that very issue. Nor can participating classes be depended upon to resolve their differences as to disposition of the business without going beyond the boundaries of feasibility. The authority given the majority of a class to bind its minority members makes it all the more necessary for some disinterested outsider to arbitrate these clashes of interests. Under our statutory scheme the disinterested party is either the reorganization judge or a combination of the judge and an administrative agency.

The determination of which classes of creditors and shareholders shall have a voice in formulating the program of rehabilitation is treated under reorganization doctrine as a function of reorganization value. All classes whose claims, taken in the order of their priority and at their nominal amounts, fit within the reorganization value are considered as having a stake in the business. Accordingly these groups are allowed to participate through appropriate representation in drawing up the program and to vote upon it. The classes that are wholly eliminated by reorganization value are given more limited rights. To protect their interests they must be able to take part in hearings concerned with fixing that value, and have the right of appeal to correct irregularities or errors in the valuation process. Once reorganization value has been properly established the groups eliminated by it should have no further standing in the rehabilitation proceedings. Two exceptions might be in order. Eliminated classes perhaps should be allowed to demonstrate either that a change in conditions prior to completion of the proceedings makes it reasonable to increase reorganization value enough to accommodate them or that the business should be sold instead of reorganized because an advance in market prices enables them to share in the sale proceeds. We will return later to these possible exceptions.

More difficult is the problem of settling differences between classes of participants as to disposition of the business or as to reorganization plans. In many situations a number of plans can meet the fairness and feasibility standards as presently construed. Where one such plan is championed by senior security holders and another by juniors the reorgani-

zation might be stymied unless one of the groups could be forced to yield. Similarly there might be an impasse where one group favors a given plan and the other class opposes it without coming forward with an alternative fair and feasible plan. It was suggested earlier that the dilemma could be avoided by reducing reorganization value just enough to eliminate the marginal junior class from the enterprise. But this maneuver is questionable and in any event it seems to be manageable only when a slight shift in reorganization value will turn the trick and there is adequate evidence in the record to justify the lower value. In most cases a more direct and flexible approach is needed. That need is filled by the explicit or implicit power of the reorganization court to cram down a fair and feasible plan upon a dissenting class of claimants.³⁶ It is this power which is at the root of judicial control over the ultimate disposition of a company undergoing reorganization.

In theory it appears that the cram-down could be used against either a senior or a junior class. In practice it is unlikely to be employed against seniors. A judge understandably is apt to feel that the seniors are making a greater sacrifice or have more at stake than the juniors and therefore their plan is entitled to greater weight than that endorsed by the juniors. But courts not infrequently have threatened to use the cram-down power in order to spur seniors into proposing a plan or into adopting a more conciliatory attitude.³⁷ Moreover, it is not difficult to envisage a situation in which a court might actually cram down on uncooperative seniors a plan sponsored by juniors. A case in point is presented when seniors want to sell the business at the current market price while the juniors propose a plan of reorganization.

Such a case furnishes a helpful setting for further analyzing the internal relationship of the three principal aspects of reorganization doc-

³⁶ The term "cram down" is sometimes employed in a more limited manner than it is here. Throughout this article it refers to the power of a reorganization court to force any dissenting class into an arrangement which it refuses to accept voluntarily. The more limited usage confines the reference to the court's power to force a *senior* class into such an arrangement. See Bankruptcy—Corporate Reorganization under Chapter X—Compelling Assent and Barring Bad Faith Creditors, 25 N. Y. U. L. Q. Rev. 115 (1950).

The cram-down clause in subparagraph (e) of Section 77 is discussed at length in RFC v. Denver & R.G.W.R. Co., 328 U.S. 495 (1946). As to the power to cram down a plan on seniors under Section 179 of Chapter X, see Country Life Apartments, Inc. v. Buckley, 145 F. 2d 935 (C.A. 2d, 1944).

³⁷ One form of prodding is the threat to "put the debtor on the block" by transforming the reorganization proceeding into an ordinary bankruptcy proceeding. In the case of a large corporation which is thought to have going concern value the threatened course of action is practically without meaning. Nevertheless the threat has frequently been made in both equity receivership reorganizations and statutory reorganizations.

trine: reorganization value; the fair and feasible plan; and control over disposition of the business (with particular emphasis on how the control is shared by the participants and the court). Where reorganization value cuts out all but one class of security holders, a disagreement among that class whether to sell or reorganize is like a family fight in which a minimum of judicial intervention is needed. The court clearly should make certain the sale market has been thoroughly canvassed so that the highest bid accurately reflects the market. In addition it has the duty to ascertain whether the votes are cast in good faith and to disqualify any that are prompted by interests that conflict with those arising from investment in the distressed business. With these exceptions it seems reasonable to rest the decision with the investors. There might be occasions when the judge and his advisors believe that a sale is preferable to a reorganization, or vice versa, or that the highest bid so far received is too low, though the market has been well sampled. It may be tempting for the court to impose its judgment by refusing to approve one of the alternative plans or by preventing the investors from voting to sell where the top bid seems unsatisfactory. Such moves could be defended as necessary to protect investors—particularly where there are many small investors—from their own folly in choosing a course which seems imprudent. That sort of protection, nevertheless, is incompatible with our belief in economic democracy. The court certainly should feel free to express its views and provide investors with the opinions of experts. But in dealing with an industrial company no consideration appears paramount to permitting those who have capital already committed to decide whether to liquidate or reorganize.³⁸

³⁸ If there were an even split in the class over whether the business should be sold or reorganized the court might have to settle the issue. It might be argued that the court should favor reorganization because the investors who wish to sell can in effect do so by selling their securities on the market. However, there may be a difference between the price for individual sales of securities and the pro rata share of the price which could be obtained for the entire business. See 1 Bonbright, *Valuation of Property* 244-49 (1937).

Not infrequently it is remarked that there is a public interest in having distressed industrial enterprises reorganized rather than sold. This assertion is difficult to handle unless its reference and assumptions are made explicit. It seems unlikely that it refers to sale of a business as a going concern inasmuch as the public has little interest in whether the company is run by its old owners or by a new group which purchases the enterprise. If there were any public interest here, it probably would be on the side of removing the management which has been associated with the distress. More likely the assertion means that there is a public interest in having a business continued in operation rather than sold for scrap. The assumption here apparently is that no matter how inefficient or economically unnecessary the enterprise may be, the public is benefited if the assets are maintained as a going concern. The error in this proposition is so evident that an exposition of it is unnecessary. Possibly the remark is intended to have a more limited sweep. It may mean only that the public has an interest in preventing a hasty and ill-informed decision whether to maintain or scrap the enterprise. If so, there is no

Where the controversy over sale or reorganization is not within a single class but is between two classes, both of whose claims are or may be accommodated within the reorganization value, the essence of the problem under reorganization doctrine is different. Presumably the seniors favor immediate liquidation at the prevailing market price while the juniors insist upon either reorganization at a higher reorganization value or a sale at not less than that value. Such a dispute between classes best exposes the basic antagonism between the enforcement and renegotiation pressures surrounding our corporate rehabilitation system. The dispute neatly frames the question whether seniors can deprive juniors of their "rights" under a fair plan built on reorganization value by bringing about a sale at a lesser amount. It is a question which goes to the nucleus of our reorganization system. Obviously it is one which must be answered by the court and not by the contending parties.

The available procedure most suitable for resolving this question is to have the court set as an upset price an amount below which it will not approve a sale.³⁹ There is a statutory requirement that the upset price be "fair." No criteria of fairness are specified in the act but the meaning of a "fair" upset price evidently is closely allied to the meaning of a "fair" plan. On first impression it may seem that in reorganization theory a fair upset price must always be reorganization value.⁴⁰ If it is higher it is too harsh on the seniors; if it is lower it appears to deprive juniors of the full measure of value which reorganization is designed to give them. But this analysis is based on the erroneous assumption that, in a reorganization, juniors are entitled to an amount of reorganization currency measured by the excess of reorganization value over

need to consider the point in this analysis of reorganization. Under Chapter X the decision whether to scrap or operate is accorded a proper place in the proceedings. See Cary, *Liquidation of Corporations in Bankruptcy Reorganization*, 60 *Harv. L. Rev.* 173 (1947). For a discussion of the importance of the reorganization-versus-liquidation (as scrap) issue see Buchanan, *The Economics of Corporate Enterprise*, c. xiv (1940). Note particularly the shortcomings in the procedure provided by the equity receivership reorganization for deciding this issue.

³⁹ Section 216(7) of Chapter X, 52 Stat. 896 (1938), 11 U.S.C.A. § 616(7) (1946); cf. Section 77(b)(5), 48 Stat. 912 (1934).

⁴⁰ In the *Keeshin Freight Lines* reorganization the SEC appeared to equate a fair upset price with reorganization value (which it termed "going concern value"). In analyzing a plan to liquidate the company at not less than a certain upset price, the SEC commented: "But unless liquidation value is greater than going concern value, it is manifest that its use deprives creditors and shareholders of the full measure of value which is rightfully theirs." *Keeshin Freight Lines, Inc., SEC Corp. Reorg. Release No. 78* (1949). The Commission then went on to determine what it believed was a fair reorganization value, making no distinction between a fair value for reorganization purposes and for upset price purposes. The absence of such a distinction probably was not merely an oversight, in view of the fact that the Commission was simultaneously rendering advisory reports on both a plan of sale and a plan of reorganization.

the total nominal claims of seniors. The fallacy of ignoring the quality of the paper allocated to the seniors has already been pointed out in connection with the mathematics of reorganization. The share of reorganization value to which the juniors can lay claim under a fair plan is the residue after seniors have been given the equitable equivalent of their old rights. To equate fair upset price with reorganization value is to confuse real money with reorganization currency. Only in the former and not in the latter does three dollars total value less two dollars of senior claims necessarily leave a one dollar residue of value for juniors.

These sets of relationships might suggest appropriate guides in fixing an upset price. In the extreme they seem to indicate that a fair upset price could not be ascertained without considering the real value of reorganization currency the juniors would receive under a fair plan which the court would be willing to cram down on them. They seem to imply that the upset sum should provide the juniors with that amount of real value in real dollars. When it is so viewed the upset price is nothing other than one application of the cram-down apparatus. This extreme characterization of the upset price probably is not to be found in official discussions of the device; but courts doubtless have been more or less aware of, and influenced by, the considerations which suggest that characterization.⁴¹ In fixing an upset price more than one court has remarked that under it juniors are as well treated as they could expect to be under a fair reorganization plan.

The sale-versus-reorganization issue⁴² also offers an opportunity for

⁴¹ In some cases the recognition that fair upset price properly should be lower than reorganization value might be reflected in a disguised manner. For example, if a court believes that a distressed company will be sold rather than reorganized, it might approve of a lower going concern value than if it believes the concern will be reorganized. In doing so the court might feel that it is dealing with an upset price and not a value for reorganization purposes. There is a danger in making such a hidden adjustment. If efforts to sell fail, and reorganization becomes the only practical alternative, the court might find that the approved valuation cannot conveniently be adjusted upwards. It is interesting to compare the advisory report of the SEC and the memorandum opinion of the court in the Keeshin Freight Lines reorganization. The SEC found a reorganization value of approximately \$2,100,000. The court, after agreeing with the reorganization trustee that "a plan providing for a cash sale at or near the enterprise value is the most advantageous to the creditors," reduced the reorganization value to \$1,700,000. *In re Keeshin Freight Lines, Inc.*, 86 F. Supp. 439 (Ill., 1949).

⁴² An excellent case study of the reorganization-versus-sale question is furnished by the Atlas Pipeline Corporation proceeding under Chapter X. The practical alternatives in the case were to reorganize or to liquidate at scrap value. The advisory report of the SEC analyzes the issue clearly and comprehensively. *Atlas Pipeline Corp.*, 9 S.E.C. 416 (1941). The opinion of the reorganization court, which comments on the advisory report, reveals some of the practical factors which are at work in determining what disposition should be made of a distressed company. *In re Atlas Pipeline Corp.*, 39 F. Supp. 846 (La., 1941).

exploring further the relationship between reorganization value and market value. Because reorganization value is a fixed estimate of long-term average value it is not unusual to find, in our economically unstable economy, that as the future of the enterprise unrolls, its market value at times is below reorganization value and at times above it. Reorganization doctrine acknowledges the possibility of market value climbing above reorganization value. Nevertheless, such an occurrence may be troublesome. If it takes place not long after a reorganization has been finally consummated those who were eliminated from participation may feel especially aggrieved and press for legislation to reopen the proceedings. Reorganization theory perhaps should not be concerned with these reactions. But it can hardly avoid being concerned when a substantial advance in market value occurs after reorganization value has been fixed but before the proceedings have been terminated. Two possible developments need to be distinguished.

The first consists of a marked enhancement in market value, but not to exceed reorganization value. Any such increase probably can be attributed to a change in a factor which was considered relevant in computing the reorganization value. Consequently, the change might lead to a demand that reorganization value be reviewed and increased.⁴³ For example, if earnings of the business rise above those projected as an average in calculating reorganization value, the marginal participating class or an excluded class may argue that a new valuation is in order. Such an argument alone is not persuasive under reorganization doctrine. In estimating average earnings it must have been contemplated that there would be fat as well as lean years. Unless a change in conditions is reasonably likely to work a long-run and significant improvement in the affairs of the company, an immediate upturn in earnings ought to be ignored because already taken into account.

The second possible development is an advance in market values of sufficient magnitude that the securities allocated (or to be allocated) to the seniors sell above their nominal values. A marginal participating or excluded junior class might attempt to utilize such an upturn in one of two ways. It might try to reopen the valuation question by pointing out that the market prices, which represent independent appraisals of the company's future by investors, reveal the inadequacy of the reor-

⁴³ The reorganization of the Denver & Rio Grande Western Railroad under Section 77 probably best illustrates this situation. See *RFC v. Denver & R.G.W.R. Co.*, 328 U.S. 495 (1946); *Insurance Group Committee v. Denver & R.G.W.R. Co.*, 329 U.S. 607 (1947).

ganization value.⁴⁴ Or the class might try to end the reorganization proceeding by paying off the seniors in full with new money raised by the sale of new securities or otherwise.⁴⁵ Courts are disposed to be sympathetic to these efforts though the possibility of succeeding may encourage junior classes to stall reorganizations in hopes of catching a rising market. Permitting changes of the kind described prevents seniors from obtaining what might be regarded as windfalls and appears in harmony with the design of reorganization to prevent unnecessary forfeitures by junior classes. But one limitation on the liberty extended juniors seems desirable: at some point the reorganization process should be treated as at an end, and all rights created under it should be deemed irrevocably vested.⁴⁶

In looking into the relationship between market value and reorganization value we have noted how it might be thought to bear on deciding whether a distressed business is to be sold or reorganized. To an extent largely unknown, courts may consider the relationship in exercising their ultimate control over disposition of the business where participating classes are in disagreement. It has been suggested by others, however, that courts are motivated by a simpler line of reasoning: Reorganization value is someone's guess as to what the value of the business will be during "good times." The court adopts it to prevent the juniors from being squeezed out at a lesser valuation. Thus reorganization value is always a kind of upset price; it is an upset price used when reorganization rather than sale is to be the solution of the distress. When courts believe we are at a low stage in the "business cycle" they will approve of reorganization values and upset prices which are substantially above prevailing market price levels. When they believe we are at a fairly high stage in the cycle, courts will refuse to endorse such differentials. Under this explanation the critical factor in the reorgani-

⁴⁴ The United States Supreme Court in the second *Denver & Rio Grande Western Railroad* case implied that such an event might be grounds for reopening a plan prior to completion of the reorganization proceedings. See particularly footnote 6 and the related portion of the text of the majority opinion. *Insurance Group Committee v. Denver & R.G.W.R. Co.*, 329 U.S. 607, 617 (1947).

⁴⁵ See *Knight v. Wertheim & Co.*, 158 F. 2d 838 (C.A. 2d, 1946).

⁴⁶ A detailed discussion of this general problem is contained in Miller, *Status of Economic Interests in Proceedings Under Chapter X After Confirmation of the Reorganization Plan*, 24 N.Y.U.L.Q. Rev. 707 (1949). The problem is pointed up by the efforts of juniors to keep open the reorganization of the Chicago, Milwaukee, St. Paul and Pacific Railroad under Section 77 in order to take advantage of proposed legislation which was being considered in Congress. In re *Chicago, M. St. P. & P. R. Co.*, 155 F. 2d 489 (C.A. 7th, 1946). See also In re *Chicago, Rock Island & Pacific Ry. Co.*, 162 F. 2d 606 (C.A. 7th, 1947).

zation process is the optimism or pessimism of the judge regarding the economic future. He will permit a sale at market value if he believes that conditions are not likely to improve markedly, but bar a sale, through fixing a comparatively high upset price, if he feels that prosperity is not gone forever.

This simple explanation no doubt contains a significant element of realism. Judges surely are influenced by their intuition concerning the economic future just as all the expert guessers are so affected. But to offer this as an adequate analysis of reorganization value and the upset price is to assume that the whole procedure of reorganization is a sham. If someone's intuition accounts for reorganization value it may as easily account for all the other aspects of the process. There are people who think or say that legal actions always are merely ceremonies to act out or glorify decisions already made. Corporate reorganizations are especially singled out by them as illustrations of the point—apparently because of the grandiose magnitudes involved.⁴⁷ No one however has yet shown that the ordinary corporate reorganization is any more or less stagecraft than the mine-run tort action. To attempt demonstration here that the reorganization process has a genuine foundation would be foolhardy. Those who at this date are convinced that a typical tort action is a sham are not likely to accept a different interpretation of a reorganization. All others can appreciate a significant distinction. Reorganizations might be based on fictitious values and subjective judgments; but those who operate the process and accept its doctrines do not think they are playing a game or acting under false pretenses.

V

Completion of the analysis of liquidation compared with reorganization enables us to return to the subject of fair and equitable plans, and discuss another phase of it. Using reorganization value is a way of inflating the putative value of a company beyond its market value. This *extra* value is allocated among participants by means of a plan which must be fair and feasible. The cram-down and upset-price apparatus guard against maneuvers which might frustrate the inflation. The end result fulfills the basic objective of reorganization: Junior interests receive something of value, out of the extra value, which would have been denied them under a market-place regime. The value conferred on juniors must be withdrawn or withheld from seniors but the intricacies

⁴⁷ Compare Arnold, *The Folklore of Capitalism*, c. 10 (1937).

of reorganization tend to obscure the route by which the transfer is effectuated. We are now in a position to trace the course by which extra value is redistributed through fair reorganization plans. For convenience we shall postulate that there are the practical alternatives of selling distressed businesses at prevailing market prices or reorganizing them. The reality of this proposition has already been discussed. To expedite the analysis we shall also assume that sales at market prices would afford no return to those juniors who could participate in reorganizations predicated on reorganization values.

Several varieties of reorganization plans usually can be formulated in any particular case, but for our proximate purpose all plans may be viewed as falling into two polar patterns. One consists of differentiating between the junior class and the senior class by allocating to the juniors only new securities which are subordinate to those allocated to the seniors. This arrangement may be termed a "vertical" plan. The other entails dividing a single issue of new securities between the juniors and seniors. This may be called a "horizontal" plan.

In a horizontal plan it is evident that the extra value conferred upon the juniors is initially taken from the seniors. Presumably the aggregate market prices of the securities in the new single issue approximates the market value of the enterprise. A part of this enterprise market value, the whole of which by our postulate would have belonged to the seniors if the business had been sold, is immediately transferred from the seniors to the juniors when they are given some of the new securities. But under reorganization doctrine this transfer is supposed only to be a temporary loan. When the company attains its full reorganization value, through a sufficient increase in its market value, the doctrine assumes the seniors will have been repaid completely by the increase in value of their new securities. In a vertical plan it may not be evident that any excess over market value conferred on the juniors is taken or even merely initially "borrowed" from the seniors. It is sometimes suggested that the model vertical plan is one so constructed that at the outset only the new senior securities have value while the new junior securities are practically worthless.⁴⁸ Thereunder extra value

⁴⁸ Describing the securities as "practically worthless" confuses analysis. If the securities are wholly worthless at present, that means investors do not believe they have value now or will have value in the foreseeable future; and if they are wholly worthless, it is senseless to allocate mere pieces of paper to the juniors. If the securities have some worth at present, then part of the total value of the enterprise is being given to the juniors, and the present value of the securities reflects the judgment of investors as to their value in the future. A present low value might indicate investors believe (among other possibilities) that the securities have a

would seem not to be taken from the seniors, but to come into existence only if and as the market value of the company increased. An illustration is furnished by a plan to issue common shares to the seniors and to allot the juniors warrants to purchase such shares. If the warrants are initially almost worthless they would acquire value as the market value of the entity improved. As a corollary it might seem that exercise of the warrants would not deprive the seniors of any value which had been allotted to them.

But these analyses of vertical and horizontal plans are incomplete. They ignore the risk of a further decline in the market value of the business. If a sale at market value were permitted in place of a reorganization the seniors would actually receive a certain sum of money. The purchaser would then bear the risk of a decline in value and stand to gain the full benefit of an increase in value. By being forced into a reorganization to protect the reorganization value "belonging to" the juniors, the seniors are required to accept a position inferior to that which a purchaser would voluntarily acquire at market price. The seniors are compelled to bear the entire risk of decline but are given only a fractional share of any improvement. This is equally true of vertical and horizontal reorganization plans, though in the latter the risk of deterioration may deceptively appear to be divided between the juniors and seniors. To the juniors the decline would be merely a reduction in the value initially transferred to them from the seniors when reorganization value was substituted for market value in the enforcement of rights. To the seniors the decline would be a further real loss in their investment as measured by market values.

VI

There remains for consideration the ultimate question about our reorganization system: Is a fair plan a just plan? One approach to this problem has already been explored in part. It consists of explaining why the market apparatus is inadequate in reorganizations and then arguing that a fair plan based on reorganization value simulates the results an adequate market would reach. The assumptions and weaknesses of this treatment of the question have been indicated. Three other approaches, which do not necessarily assume anything about the adequacy of the market, invite attention.

chance, but only a slight one, of having a great value in the future. If that chance materializes it cannot be said the increase in value was not taken into account by investors in initially appraising the securities.

The first seeks to defend the justness of a fair plan in terms of the reasonable expectations of the parties to security contracts. In our society, it has been argued, senior claimants are predominantly interested in receiving the income for which they have contracted. All the protective devices contained in the contracts, including rights on default, are merely ancillary to the receipt of income from the investments. Reorganization by means of a fair plan is only another method of making that income available to the seniors. It therefore does no more than carry out the primary intentions of the parties and satisfy their reasonable expectations.⁴⁹ Strict enforcement of default provisions at market prices causes perverse results. It would distort the contractual scheme by placing rights on default ahead of the right to receive income. Moreover, a fair-plan reorganization upon default has for all practical purposes replaced other means of "enforcing" the claims of seniors. In making their investments the seniors accordingly should have understood that the rules for reorganization automatically became terms of the contracts.

The rhetoric of this argument may be appealing, but the logic is not without a flaw. In part there seems to be confusion of cause and effect. The right to income appears to be of paramount importance to investors partly because our system of corporate rehabilitation has stressed that right above all others. Similarly, reorganization under a fair plan is to be expected upon default because that is the treatment we have prescribed. To the extent such circularity is present this approach has the weakness of justifying a fair plan reorganization by the fact that it, rather than some other procedure, has been authorized by law.

The second approach attempts to support the justness of fair plan reorganizations by pointing to the widespread endorsement of that sys-

⁴⁹ The emphasis on the income factor in reorganizations may have been further stimulated by the approach of the SEC in simplification plans under the Public Utility Holding Company Act. See *Otis & Co. v. SEC*, 323 U.S. 624 (1945).

The similarity between the guides for compensating seniors under a Chapter X reorganization and under a PUHCA simplification calls for further comment. Both sets of guides are viewed as being part of the absolute priority doctrine. This means that under both sets contractual priorities are to be recognized and higher ranking claimants are to be equitably compensated before lower ranking claimants are awarded anything. The basic difference between the two is that a reorganization is treated as a substitute for liquidation, and therefore as an occasion for the maturing of default rights, while a simplification is treated as not maturing such rights. Consequently, in a simplification seniors are entitled to the equitable equivalent of the value of their securities as constituted immediately before simplification or, stated in another manner, the investment value of such securities; while in a reorganization seniors are not only entitled to the value of their securities immediately preceding reorganization, but to the equitable equivalent of their entire position, including that part of it which arises from the maturing of their rights on default.

tem by investors. Many senior security holders, especially institutional ones, seem to approve strongly of reorganization under a fair plan. In fact they frequently offer to renegotiate their security contracts before the debtor company reaches a financial crisis so as to help it ward off insolvency proceedings.⁵⁰ Sometimes they are willing to extend maturity dates or accept other adjustments without demanding full equitable compensation. Once an insolvency action has commenced these investors often try to speed up the process in order to restore regular income payments by the distressed business. From such observations it has been contended that a fair plan is a just plan because the seniors themselves prefer it.

This contention may have merit but it comes close to asserting too much. When told that seniors favor voluntary adjustment or the rapid development of a fair plan, we must ask what alternatives are available to them. They may prefer voluntary adjustment to statutory reorganization; or they may prefer a quick reorganization to a slow one. But these preferences are not strong indications of how they would react to strict enforcement of security contracts at market values if that alternative were proffered. Furthermore, the contention readily lends itself to regarding all seniors as having the same attitude as the archetype institutional investor. It is obvious that a uniform attitude is improbable in most cases. The wide variety of investors who purchase senior securities surely do not have an identical hierarchy of interests. To ignore the differences is to flirt with the dangerous assumption that what a majority considers good is good for all members of its class. In the renegotiation of security contracts it has long been recognized that an uninformed majority of a class may need protection from an aggressive minority. But of equal importance is the point that every minority may need protection from the majority of its class. Otherwise

⁵⁰ The attitude of the archetype institutional investor might be reflected in the provisions of the Railroad Modification Law of 1948, 62 Stat. 162 (1948), 49 U.S.C.A. 73 (Supp. 1950). Under the law a specified majority of a class can bind the minority to a renegotiation of their security contracts though the debtor has not defaulted and no insolvency proceeding is imminent. The ICC must approve the plan but this feature does not alter the underlying authorization for renegotiation by majority rule prior to default. See Hand & Cummings, *The Railroad Modification Law of 1948*, 48 Col. L. Rev. 689 (1948). It has been suggested that institutional investors did not oppose the legislation because plans under it are likely to affect junior bondholders rather than senior bondholders, and the institutional investors are primarily interested in the senior issues. But see *In re Baltimore & Ohio R. Co.*, 63 F. Supp. 542 (Md., 1945), for the views of institutional bondholders as to the readjustment of certain Baltimore & Ohio Railroad junior bonds under Chapter XV of the Bankruptcy Act. It has also been suggested that institutional investors might have been willing to support the Railroad Modification Law in order to avoid passage of legislation less favorable to them.

we could simply dispense with our present notions of fairness and be content to accept almost any plan to which the majority of each participating class would agree.

The third approach attempts to establish the justness of a fair plan by linking reorganizations to our economic instability. In an economically stable society built on private property foundations the compulsory renegotiation of security contracts would likely be regarded as both inexpedient and unjust. But in a highly unstable economy such as ours the instability may be the most significant factor in forming public policy as to enforcement or renegotiation of contracts. To some extent the instability probably affects the expectations of the contracting parties. But regardless of their actual or presumed expectations the society may wish to alter their deals to adjust for violent economic fluctuations which it permitted. To attenuate ramifications of a great downswing, for example, the society may refuse to enforce strictly certain types of contracts. The attitudes which result in such a move can at best be only vaguely articulated. It can be said that the society will hesitate to enforce strictly those contracts which turn out to be unduly harsh for large numbers of persons. Or it can be said that if a bargain proves to be too good there will be reluctance to enforce it literally and thereby confer a windfall upon a fortunate but not necessarily deserving party. In the case of security contracts this general feeling may be reinforced by another circumstance. The instability of the economy is itself aggravated by the efforts or willingness of seniors to minimize their risks by concentrating all risks on the juniors.⁵¹ Knowing the economy is unstable, the seniors may be asking too much of the juniors when they contract for them to accept not only the risk of loss from operations of their businesses, but also risk of loss through a deterioration in general economic conditions to which the contracts contribute.⁵²

⁵¹ Reorganization proceedings are commenced in times of high economic activity as well as in depressed times, although the former group of cases is relatively small in number. It might be expected that in nondepression proceedings there perhaps will be greater emphasis on liquidation or sale rather than reorganization and greater caution in finding a reorganization value substantially in excess of market value. Where financial distress of an enterprise is not paralleled by general economic distress, the usual arguments about the market as a poor governor of values seem out of place. Consider, for example, the current Chapter X proceeding to reorganize the Tucker Corporation, which became insolvent at a time when the automotive industry and the country generally were enjoying a very high level of economic activity. In the matter of Tucker Corp., Docket No. 48-B-530 (N.D. Ill., 1950). It is not unlikely that courts are influenced by the economic environment surrounding financial distress even if their reported opinions do not discuss the matter.

⁵² "What is less clearly apprehended is the aggravated instability of the whole economy, and the obstacle to deliberate monetary stabilization, which corporate debt structures pro-

In our society it may not be manifestly just to allow or compel renegotiation of security contracts but it may be more unjust to enforce such contracts strictly and thereby let widely fluctuating market values govern the rights of the parties. Renegotiation through reorganization under a fair plan based on reorganization value may be the least unsatisfactory adjustment to economic instability. This perhaps is the most persuasive justification for our system of corporate reorganization. But the effects and accomplishments of the system should not be overstated. At most the system results in what is thought by many to be a more equitable way of adjusting rights among those who have a financial interest in distressed companies. Beyond this its demonstrable reach is almost negligible. Its bearing on the instability of the economy has been the subject of inconclusive argument. Some have urged that the system might act as a brake on serious downward movements through warding off wholesale liquidations of corporate securities by investors in anticipation of foreclosures at depressed market prices. With equal if not greater force others have reasoned that such foreclosures aid recovery from depressions by eliminating old debts and thereby providing a basis for new investment in the financially distressed enterprises.⁵³ In any event the net effect of the reorganization system on economic instability is unlikely to be significant and the system cannot reasonably be rated as an important instrument for maintaining stability. Likewise the system has an indeterminate, but certainly a very slight, effect on the composition of the capital structures of enterprises. By protecting junior interests in time of distress it might

duce in their aggregate. It should be obvious what desperate and frantic struggles for corporate liquidity mean in total where the economy has slipped into general recession which, debt structures apart, might prove innocuous and short-lived. They may well mean the difference between a mild recession and a precipitous, catastrophic deflation." Memorandum prepared by Henry C. Simons, quoted in Groves, *Postwar Taxation and Economic Progress* 33-34 (1946). For a broader consideration of the effect of debt on the economy see Fisher, *Booms and Depressions* (1932).

⁵³ "Bankruptcy, business failures and foreclosures in depressions of the past may not have been 'just' but they probably did contribute to recovery. When the old owner was wiped out and the creditor became the owner, the debt was wiped out and there was a basis for new savings to flow into investment in the form of debt. . . . Bankruptcy as a corrective for overindebtedness of the economy is tending to decline. . . . [P]ublic opinion appears to have been becoming progressively less sympathetic with, or tolerant toward, foreclosure. . . . Thus, the incubus of debt remains largely intact, and there is a reduced basis for new savings flowing into investment. Bankruptcies and foreclosures in the heyday of the free enterprise system wiped out not equities but debt, and were an important contribution to turn from depression to prosperity, and to affording a basis for financing the prosperity." Jones, *Investment Prospects*, 2 *J. Finance* 15, 24 (1947). To the extent the reorganization system replaces foreclosure at market value with adjustment at reorganization value it apparently contributes to this trend.

make equities somewhat more attractive to investors in general. But this very protection might encourage corporate directors, elected by junior interests, to indulge in heavier debt financing than they would sanction absent the protection. In no other respect can the reorganization system be made to appear as an aid to implementing sound monetary and fiscal policy designed to promote economic stability and well-being.⁵⁴ In the end its most significant aspect for society as a whole may be a negative one: The junior interests who are relieved by it from the judgments of the market are rescued without the direct disbursement of public funds for their benefit.

⁵⁴ One minor qualification may be in order. It has been said that, as part of the broad program for building up confidence in the securities market by government supervision and related actions, the reorganization system contributes to establishing conditions for increased useful investment. This statement is open to at least three challenges. Is increased investment necessarily useful? Does so-called investor confidence result in more or less investment? Does the reorganization system have any appreciable effect on the decision of a person to invest or not?