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BANKRUPTCY - CORPORATE REORGANIZATION - ABSOLUTE PRIORITY RULE

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BANKRUPTCY — CORPORATE REORGANIZATION — ABSOLUTE PRIORITY RULE — A plan for reorganization under section 77B of the Bankruptcy Act[1] involved a debtor holding company and two subsidiaries. Each subsidiary had a bonded indebtedness which, including unpaid accrued interest, was in excess of the value of assets that were subject to its trust indenture. These bonds were also guaranteed by the debtor parent corporation, pursuant to a unified manage-

[1] 48 Stat. L. 912 (1934), 11 U. S. C. (1934), § 207.

ment agreement which in fact had resulted in a commingling of assets of all three corporations. The submitted reorganization plan provided that the bondholders of the two subsidiaries should receive income bonds and preferred stock in the new corporation, and that the preferred shareholders of the old parent corporation should receive common stock of the new corporation without further payment. A bondholder of one of the subsidiaries objected to an approval of the plan on the theory that it discriminated against his interest. *Held*, the plan of reorganization was not "fair and equitable" [2] under the act because a full and absolute priority was not accorded the bondholders over the assets of their respective subsidiaries, as well as over those of the parent company, and because the old preferred shareholders should be denied participation for want of a showing that their participation was based on a contribution of money or of money's worth. Furthermore, there was no adequate determination of what assets were subject to and available for the payment of the respective claims of two classes of bondholders and of stockholders, and therefore no determination of the fairness of any plan of reorganization could be made. Finally, the "absolute priority" rule applies to solvent as well as to insolvent corporations, and protects interest as well as principal of bonds. *Consolidated Rock Products Corp. v. Du Bois*, (U. S. 1941) 61 S. Ct. 675.

The position of the United States Supreme Court on the question of what constitutes a "fair and equitable" plan for reorganization of corporations under old section 77B and Chapter X of the present Bankruptcy Act has not been made convincingly clear until this decision.[3] In the principal case, Justice Douglas, speaking for the Court, reiterated a former position in *Case v. Los Angeles Lumber Products Corp.*[4] and dispelled all doubts expressed about the Supreme Court's adoption of a strict "absolute priority" doctrine for participation in bankruptcy reorganizations.[5] In the principal case, the preferred stockholders were given participation in the new corporation without any clear account of what assets were separately owned by the parent corporation and its

[2] "After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible." 48 Stat. L. 919 (1934), 11 U. S. C. (1934), § 207 (f). Substituted for this section was Chapter X of the Chandler Act, without substantial change. 52 Stat. L. 897 (1938), 11 U. S. C. (Supp. 1939), § 621.

[3] In Case v. Los Angeles Lumber Products Corp., 308 U. S. 106, 60 S. Ct. 1 (1939), commented upon in 38 MICH. L. REV. 695 (1940), the Supreme Court held that rights and interests of creditors were not satisfied even though the "relative priorities" of creditors and stockholders were maintained. The "absolute priority" rule, however, was not clearly and expressly adopted. To this effect, see 25 IOWA L. REV. 793 at 799-780 (1940). The decision that started the controversy was that of Northern Pacific Ry. v. Boyd, 228 U. S. 482, 33 S. Ct. 554 (1913), which has been understood to have enunciated the "relative priority" test. Swaine, "Reorganization of Corporations," 27 COL. L. REV. 901 at 912 (1927).

[4] 308 U. S. 106, 60 S. Ct. 1 (1939).

[5] Conflicting theories of fairness of plan have been the subject of much discussion among legal theorists. See Bonbright and Bergerman, "Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization," 28 COL. L. REV. 127 (1928); Swaine, "Reorganization of Corporations," 27 COL. L. REV. 901

subsidiaries, without a determination of exactly what assets were subject to the trust indentures of the subsidiaries, and without an adequate valuation of the assets accounted for. This procedure fell directly within the sphere of condemnation of the Court in the *Los Angeles Lumber Products* case in that (1) the bankruptcy court must exercise that "informed, independent judgment" [6] which an appraisal of the fairness of a plan of reorganization entails, and (2) the full and absolute priority rule precludes participation by the equity interests in any of these assets until the bondholders have been made whole.[7] The "absolute priority" rule means that a stockholder's interest in corporate property is subordinate, first, to the rights of secured creditors, and, second, to the rights of unsecured creditors; that creditors are entitled to be paid from the property before the stockholders can retain it for any purpose whatever; and that such right of the creditors over stockholders extends to all property of the debtor and to the full value thereof.[8] On the other hand, "relative priority" has meant participation on the basis of something less than absolute priority, the exact extent of the encroachment upon contract rights depending in each case upon the balance struck by the court between its willingness to accept compromises reached by various groups and its desire to protect the interests of dissenting minorities.[9] The "relative priority" theorists claim that the "absolute priority" plan is too impractical and inflexible, and that it ignores the fundamental purpose of section 77B and Chapter X of the Chandler Act—to provide a speedier and more effective method of reorganization.[10] Furthermore, it is argued that

(1927); 2 GERDES, CORPORATE REORGANIZATIONS, §§ 1083-1085 (1936); Dodd, "The Los Angeles Lumber Products Company Case and its Implications," 53 HARV. L. REV. 713 (1940); Fennell, "Some Reflections on the Los Angeles Lumber Company Case," 29 GEO. L. J. 36 (1940).

[6] Principal case, 61 S. Ct. at 682; National Surety Co. v. Coriell, 289 U. S. 426 at 436, 53 S. Ct. 678 (1933); Case v. Los Angeles Lumber Products Corp., 308 U. S. 106, 60 S. Ct. 1 (1939); First National Bank v. Flershem, 290 U. S. 504, 54 S. Ct. 298 (1934).

[7] Case v. Los Angeles Lumber Products Corp., 308 U. S. 106, 60 S. Ct. 1 (1939); 7 UNIV. CHI. L. REV. 549 at 550 (1940).

[8] Case v. Los Angeles Lumber Products Corp., 308 U. S. 106 at 116, 120, 60 S. Ct. 1 (1939). A holding company, as well as others in dominating or controlling positions, has fiduciary duties to security holders of its system which will be strongly enforced. Taylor v. Standard Gas & Electric Co., 306 U. S. 307, 59 S. Ct. 543 (1939); Pepper v. Litton, 308 U. S. 295, 60 S. Ct. 238 (1940). Where a holding company directly intervenes in the management of its subsidiaries so as to treat them as mere departments of its own enterprise, it is responsible for the obligations of those subsidiaries incurred or arising during its management. Davis v. Alexander, 269 U. S. 114, 46 S. Ct. 34 (1925); Foard Co. v. Maryland, (C. C. A. 4th, 1914) 219 F. 827; Stark Electric Co. v. McGinty Contracting Co., (C. C. A. 6th, 1917) 238 F. 657; Kingston Dry Dock Co. v. Lake Champlain Transp. Co., (C. C. A. 2d, 1929) 31 F. (2d) 265.

[9] Bonbright and Bergerman, "Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization," 28 COL. L. REV. 127 (1928); Kansas City Terminal Ry. v. Central Union Trust Co., 271 U. S. 445, 46 S. Ct. 549 (1926); Jameson v. Guaranty Trust Co., (C. C. A. 7th, 1927) 20 F. (2d) 807, cert. den. 275 U. S. 569, 48 S. Ct. 141 (1927).

[10] 25 IOWA L. REV. 793 at 798 (1940).

absolute priority cannot be followed when the plan contemplates new cash coming in from the junior equities, for they will not be moved to put in new money unless they receive some participation at the expense of some of the senior equities.[11] The "absolute priority" proponents, however, assert that such a rule exerts a desirable check or restraint on corporate reorganizations, and that it will tend toward more security in investment inasmuch as it protects the contract rights of investors.[12] Furthermore, as the Court points out, "The absolute priority rule does not mean that bondholders cannot be given inferior grades of securities, or even securities of the same grade as are received by junior interests. Requirements of feasibility of reorganization plans frequently necessitate it in the interests of simpler and more conservative capital structures." [13] Also, the absolute priority rule eliminates the factor which has plagued and prolonged many reorganization proceedings, namely, the necessity of dealing with non-entitled classes because of their nuisance value.[14] As for the minor points of discussion in the principal case, the authorities amply support the Court in its finding that accrued interest on bonds is entitled to the same priority as the principal.[15] Also, regarding the applicability of the same rule of priority to solvent debtors as to those that are insolvent, there would appear to be no doubt or disagreement amongst the courts.[16] A corporation may come within the terms of section 77B although it is not insolvent but is unable to meet its debts as they mature,[17] and the statute requires a plan to be "fair and equitable" [18] regardless of the condition of the corporation, whether it be solvent or insolvent.

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[11] 38 MICH. L. REV. 695 at 700 (1940); Swaine, "Reorganization of Corporations," 27 COL. L. REV. 901 (1927).

[12] 25 Iowa L. REV. 793 at 798 (1940).

[13] Principal case, 61 S. Ct. at 686, citing Kansas City Terminal Ry. v. Central Union Trust Co., 271 U. S. 445, 46 S. Ct. 549 (1926). See FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 440 (1939).

[14] Fennell, "Some Reflections on the Los Angeles Lumber Company Case," 29 GEO. L. J. 36 at 49-50 (1940); FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 452-453 (1939). With absolute priority the established rule, evaluation becomes of paramount importance. Indications are that the court must require a valuation before considering a plan, involving expense and delay, rather than the court permitting the valuation to be reached by bargaining among the various classes. See 7 UNIV. CHI. L. REV. 549 (1940); FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION 556 (1939).

[15] Bonbright and Bergerman, "Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization," 28 COL. L. REV. 127 (1928); American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U. S. 261, 34 S. Ct. 502 (1914); Ticonic National Bank v. Sprague, 303 U. S. 406, 58 S. Ct. 612 (1937).

[16] In re 620 Church St. Bldg. Corp., 299 U. S. 24, 57 S. Ct. 88 (1936), noted in 35 MICH. L. REV. 999 (1937); A 3 CORP. REORG. & AM. BKCY. REV. 268 at 270 (1940). Cases in the lower courts where the debtors have been considered solvent have been predicated on that principle. In re Utilities Power & Light Co., (D. C. Ill. 1939) 29 F. Supp. 763; In re National Food Products Corp., (D. C. Md. 1938) 23 F. Supp. 979.

[17] 48 Stat. L. 912 (1934), 11 U. S. C. (1934), § 207 (a).

[18] Quoted note 2, supra.