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## CORPORATIONS - REORGANIZATION- FAIR AND EQUITABLE PLAN

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CORPORATIONS — REORGANIZATION — FAIR AND EQUITABLE PLAN — Both section 77B of the federal Bankruptcy Act<sup>1</sup> and chapter X of the Chandler Act<sup>2</sup> provide that the judge shall find the plan of reorganization to be “fair and equitable” before he approves it. This and similar expressions had acquired a well-recognized content in equity reorganization before the statutes were enacted. Congress probably intended to enact the *Boyd* case<sup>3</sup> rule. Several lower court deci-

<sup>1</sup> 48 Stat. L. 919 (1934), § 77B (f), 11 U. S. C. (1934), § 207 (f): “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. . . .”

<sup>2</sup> 52 Stat. L. 897 (1938), 11 U. S. C. (Supp. 1938), § 621: “The judge shall confirm a plan if satisfied that . . . (2) the plan is fair and equitable, and feasible. . . .”

<sup>3</sup> *Northern Pacific Ry. v. Boyd*, 228 U. S. 482, 33 S. Ct. 554 (1913).

sions<sup>4</sup> have expressed doubt as to just what the phrase "fair and equitable" means under the federal Bankruptcy Act. To find the meaning of the phrase "fair and equitable," it is necessary to look back to the *Boyd* case and determine what the phrase meant in equity reorganization. This the Supreme Court did in the recent decision of *Case v. Los Angeles Lumber Products Co.*<sup>5</sup>

### I.

As to what is a "fair and equitable" plan under the principle of the *Boyd* case, there has been considerable difference of opinion.<sup>6</sup> Two different theories have evolved. One is the absolute priority theory and the other is the relative priority theory. Under the absolute priority theory, the senior equities are entitled to securities in the reorganized corporation which would equal in value the amount of their claims against the old corporation before junior equities are entitled to receive securities.<sup>7</sup> Thus in every case where the value of the underlying properties is so far depleted as to be less than the claims of the senior equities, the senior equities get all the securities in the reorganized corporation and the junior equities are excluded from the plan unless they contribute a new consideration. The underlying idea behind the absolute priority theory is one of fraudulent conveyance. If the

<sup>4</sup> See 34 MICH. L. REV. 992 (1936) for a collection of cases in which the lower federal courts struggled with the meaning of "fair and equitable."

<sup>5</sup> 308 U. S. 106, 60 S. Ct. 1 (1939), discussed *infra* at note 9.

<sup>6</sup> There have been many articles treating the *Boyd* case in legal periodicals: Swaine, "Reorganization of Corporations: Certain Developments of the Last Decade," 27 COL. L. REV. 901 (1927); Frank, "Some Realistic Reflections on Some Aspects of Corporate Reorganization," 19 VA. L. REV. 541, 698 (1933); Bonbright and Bergerman, "Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization," 28 COL. L. REV. 127 (1928); Spaeth and Winks, "The *Boyd* Case and Section 77," 32 ILL. L. REV. 769 (1928); Friendly, "Some Comments on the Corporate Reorganization Act," 48 HARV. L. REV. 39 (1934); Dodd, "Reorganization Through Bankruptcy: A Remedy for What?" 48 HARV. L. REV. 1100 (1935); Douglas and Frank, "Landlords' Claims in Reorganizations," 42 YALE L. J. 1003 (1933); Foster, "Conflicting Ideals for Reorganization," 44 YALE L. J. 923 (1935); Cutcheon, "An Examination of Devices Employed to Obviate the Embarrassments to Reorganization Created by the *Boyd* Case," 8 LECTURES ON LEGAL TOPICS 35 (1931) [SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION]. Also the following treatises: FINLETTER, PRINCIPLES OF CORPORATE REORGANIZATION IN BANKRUPTCY, c. 6 (1937); 2 GERDES, CORPORATE REORGANIZATIONS, § 1084 (1936).

<sup>7</sup> It will be convenient for the reader to think of the term "senior equities" as a symbol for unsecured creditors and the term "junior equities" as a symbol for stockholders in the following discussion. This conforms to the situation in the *Boyd* case. However, the terms "senior" and "junior equities" can just as well symbolize the relationship between preferred and common stockholders or any similar classification of senior and junior securities.

junior equities get any securities in the reorganized corporation before the claims of the senior equities of the old corporation are satisfied in full, then the junior equities are inequitably participating ahead of the senior equities no matter how worthless the securities which junior equities receive may prove to be. Under this theory, the junior security holders should not receive a "chance" to gain in the new corporation, for this "chance" belongs to the senior claims until they are satisfied in full.

On the other hand, the relative priority theory is much more lenient to the junior equities in that they can participate under the plan so long as the senior equities maintain their old position as to principal and income in the new corporate structure. Thus, the old bondholders can be given the same principal amount of new income bonds or any other type of security which maintains their old claim to principal and income with priority over the junior equities. In this way the old preferred and common stockholders are entitled to junior securities in the new corporation, on the theory that if the corporation is successful the bondholders will get all they are entitled to anyway as long as they maintain their prior claim to income. If the new corporation is unsuccessful the bondholders lose nothing, for they still retain their prior position in liquidation.

## 2.

The relative merits of the two theories have been the subject of much learned discussion.<sup>8</sup> However, there has never been any degree of certainty in the legal profession as to which of the two theories a court will follow when presented with a given set of facts. There have been several recent decisions which perhaps will shed some light on the attitude of the federal courts.

In *Case v. Los Angeles Lumber Products Co.*<sup>9</sup> the assets of the old corporation were so far depleted that it was insolvent in both the equity and bankruptcy sense. The claims of the first mortgage bondholders were \$3,807,071.88, while the assets of the corporation were estimated to be only \$830,000. Under the plan which the district court approved as "fair and equitable," the bondholders got preferred stock in the new corporation while the old stockholders got all the common. As a total result, the stockholders came out with twenty-three per cent of the assets and voting power in the new corporation without making any contribution of new money. The district court and the circuit court of appeals justified the inclusion of the stockholders (1) because the

<sup>8</sup> See citations in note 6, especially Bonbright and Bergerman, "Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization," 28 COL. L. REV. 127 (1928). Also Brief for the United States, Amicus Curiae, in *Case v. Los Angeles Lumber Products Co.*, p. 13 (1939).

<sup>9</sup> 308 U. S. 106, 60 S. Ct. 1 (1939). Since this was written, comments have appeared in 26 VA. L. REV. 504 (1940); and 34 ILL. L. REV. 589 (1940).

relative priorities of bondholders over stockholders were maintained by the issue of preferred and common stock in the new corporation with the preferred having a prior claim to assets and income; (2) because the stockholders had certain rights which they gave up in consideration for their participation in the new corporation. The Supreme Court held that the assents of over ninety per cent of all classes of security holders to the plan did not make the plan "fair and equitable." Since the corporation was clearly insolvent, the stockholders had no right to participate until the bondholders were paid in full unless the stockholders gave new consideration. However, the old stockholders contributed no new consideration and no consideration whatever except that of "nuisance value," which should not be considered in reorganization proceedings.

In the case of *In Re Utilities Power & Light Corp.*<sup>10</sup> the district court approved a plan which shut out three classes of stock even though the corporation was solvent in the equity sense. Its assets had a value, as found by a special master and the Securities and Exchange Commission, of \$44,000,000. It had a bonded indebtedness of \$36,710,500, with \$17,817,367 seven per cent preferred stock, \$1,602,127 Class A, \$1,128,386 Class B, and \$2,166,084 common stock. The plan provided for participation of the seven per cent preferred, but since the remaining three classes of stock clearly had no equity they were not included in the plan. Judge Holly seemed to express the absolute priority theory in saying "unless the property of the debtor exceeded in value the amount of the claims of creditors and preferred stockholders (using the term claims in a broader sense than debts simply), the stockholders had no interest to protect or preserve."<sup>11</sup>

## 3.

The legal profession still cannot predict which theory the Supreme Court will adopt if a case were squarely presented which would compel a choice between the two theories. Some of the language in the opinion

<sup>10</sup> (D. C. Ill. 1939) 29 F. Supp. 763.

<sup>11</sup> *Ibid.*, 29 F. Supp. at 770. See also *In Re Wilton Realty Corp.*, (D. C. Mich. 1938) 30 F. Supp. 486, for an application of the absolute priority theory in which the bondholders were to pay all the expenses of the reorganization of an apartment house corporation as well as taking a reduction in their claims. The stockholders, who only put in \$10,000 cash originally while the bondholders put in \$105,000, were to retain their stock in the reorganized corporation. The court held that the stockholders had no equity in the assets of the old corporation and were not entitled to participate in the plan without putting in new money. The same principle was applied in *In Re 620 Church St. Bldg. Corp.*, 299 U. S. 24, 57 S. Ct. 88 (1936), where there were three classes of mortgage bonds in an apartment house corporation. There was no equity in the property above the first mortgage, so the court held that the consent of the junior lienors and stockholders was not required to a plan which entirely excluded them. This case is noted in 35 MICH. L. REV. 999 (1937).

in *Case v. Los Angeles Lumber Products Co.*, written by Justice Douglas, would seem to indicate that the Court favors the absolute priority theory.<sup>12</sup> However, the opinion recognizes that the junior equities can always be included in the plan if they put in new money.<sup>13</sup> Under the plan they may receive sufficient new securities to move them to put up new money. This can only mean that they are usually going to receive new securities which are of a greater value than the money they put in. The result is that the senior equities have to induce the junior equities to put in new money by giving up some of their prior participation rights to the junior equities. To this extent the Court would be compelled to depart from the absolute priority theory in order to allow the corporation to get new money from the junior equities, which are generally recognized as the most fertile source of cash. However, the Court indicates that there is a limit to the amount of participation which can be given to the junior equities. If they receive more than a "fair equivalent" for their money, then they have to that extent participated ahead of senior equities contrary to the principle of the *Boyd* case. As to what the Court means by a "fair equivalent," it is difficult to say at this time. Certainly the Court does not mean dollar for dollar. Probably it means that junior equities will be allowed to participate only to an extent which will reasonably move them to put in the new money, thus giving the senior equities the best bargain possible under all the circumstances. If they are allowed to participate over this amount, then they have received a participation over senior equities in violation of the principle of the *Boyd* case. While the formula of "fair equivalent" is elusive and uncertain, the problem is susceptible of no sharp incisive definition. From the nature of the interrelations of the various claims in their order of priority and the uncertain values of the assets of the embarrassed corporation, no such clear-cut definition is desirable. Each plan should be able to withstand a searching judicial inquiry into the treatment of the various equities.

It is submitted that the crux of the matter is whether the plan contemplates new money from the junior equities. If it does not, the absolute priority theory should be strictly followed. If it is not fol-

<sup>12</sup> 308 U. S. 106 at 117: "In application of this rule of full or absolute priority. . . ." Then on pages 119-120 the justice expresses his disapproval of the relative priority theory: "True, the relative priorities of the bondholders and the old Class A stockholders are maintained by virtue of the priorities accorded the preferred stock which the bondholders are to receive. But this is not compliance with the principle expressed in. . . ."

<sup>13</sup> 308 U. S. 106 at 121: "It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. . . . Where that necessity exists and old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made."

lowed, the junior equities in every case receive a participation ahead of the senior equities even though they receive only junior securities of an extremely speculative nature. It is necessary to recognize the fact that the absolute priority theory cannot be followed when the plan contemplates new cash coming 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. This is fair, since the senior equities are benefited by the new money without which the corporation would be unable to reorganize. Furthermore, this new money enhances the value of the senior equities so there is no loss by giving up an amount of their participation rights reasonably necessary to induce the junior equities to contribute new money. This deviation from the absolute priority theory can be justified on the grounds of practical necessity. When the senior equities give up more than this "bargain value," the absolute priority rule should again be applied.

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