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**CORPORATE REORGANIZATIONS IN THE LIGHT
OF THE REASSERTION OF THE DOCTRINE
OF THE BOYD CASE IN THE LOS
ANGELES COMPANY CASE**

By JAMES CAREY, 3D*

This article deals chiefly with the reorganization of corporations other than railroad, insurance, banking, municipal and building and loan associations, that is to say, corporations, the reorganization of which is governed by the provisions of Chapter X of the Bankruptcy Act of 1938, known as the Chandler Act,¹ enacted to supersede the provisions of Section 77B. However, the principles here discussed would seem to be in large part applicable to reorganizations of railroads under Section 77 of the Bankruptcy Act, as amended.² As a matter of fact it will be observed that the principles which are applicable to corporate reorganizations in general have been evolved to a considerable extent from cases involving the reorganization of railroads through Federal equity receiverships and foreclosure sales.

Prior to the enactment of Section 77B of the Bankruptcy Act, most corporate reorganizations were effected through the medium of equity receiverships and judicial sales. In a typical situation, title to the principal properties of the debtor would be held by a trust company as trustee under an indenture of mortgage securing an issue of bonds. The first step generally taken was to secure the appointment of a Federal equity receiver in response to the prayer in a creditor's bill, after which foreclosure proceedings would be instituted in the name of the trustee followed by a consolidation of the two causes. Such action would be taken pursuant to a general understanding reached between a bondholders' committee representing at least 80% of the outstanding bonds, and protective commit-

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¹ 52 Stat. at L. 883, Ch. 575.

² 48 Stat. at L. 912, Ch. 424 approved June 7, 1934.

tees representing the different classes of stock of the corporation. These committees, together with the management, which frequently held, or was identified with, a substantial percentage of the voting stock, would reach an amicable agreement with respect to the foreclosure, including the form of a consent decree which would include the up-set or minimum price at which the mortgaged properties could be sold. It was generally possible to procure the execution of the consent foreclosure decree by the District Judge in conventional form. The up-set price which was included in the decree was almost invariably arrived at by negotiations between the parties, and fixed at an amount which was calculated as carefully as possible to yield to the dissenting bondholders a price which would be somewhat less than the estimated market value of the securities which were allotted to assenting bondholders under the plan.³

One of the customary provisions of the decree would allow the bondholders or their representatives, the protective committee, to credit against the foreclosure sale price the dividend to which such bonds would become entitled after the sale, so that the amount of cash required to be available to the protective committee was only an amount sufficient to pay dissenters their proportionate part of the up-set price and to cover expenses connected with the sale. Thus real competitive bidding at such sales was almost unheard of. At the foreclosure sale the property would be purchased either by the protective committee or by a new company organized for that purpose, generally with a name similar to that of the old company in order to preserve, in so far as possible, good-will or going-concern value. New money was frequently raised from the old stockholders, to whom would be allotted a

³ The control of the reorganizers over the up-set price was not only based on the fact that representatives of a majority of the bonds had reached an agreement with representatives of a majority of the shares of stock, but also because the bondholders' committee could be counted on to be the only prospective bidder at the foreclosure sale, and if the up-set price was fixed at too high an amount by the court the committee could refuse to bid more than the amount of the price as fixed by the reorganizers.

participation in the securities of the New Company upon payment of an assessment. Since the general creditors, sometimes characterized as the holders of the floating debt, do not have possession of the debtor's properties and, generally speaking, are not interested in subscribing new capital for the reorganized enterprise, those responsible for the reorganization have not usually been under the necessity of reaching an agreement with this class of creditors in order to expedite the reorganization or to secure new money. Sometimes funds were allocated for the purchase of claims of general creditors at a discount and sometimes, as in the *Boyd* case which we shall discuss later, they were ignored on the theory that the bondholders were entitled to the mortgaged property and could make whatever arrangements they chose with respect to granting interests therein even to stockholders. Upon completion of the foreclosure sale securities of the New Company would be issued in exchange for securities in the Old Company to those entitled under the provisions of the plan. Generally, the same management, or at least a management which was satisfactory to the stockholders as well as the secured creditors would continue to operate the New Company.

With the enactment by Congress of Section 77B, in the exercise of its power to establish uniform bankruptcy laws, statutory reorganization procedure superseded the Federal equity receivership method of reorganization. Plans were originated and proposed either by the debtor or by creditors holding twenty-five per cent. of any affected class or, if the judge had not found the debtor insolvent, by stockholders holding ten per cent. of any affected class. Any such plan which had been accepted by two-thirds of each class of creditors, and by a majority of each class of stockholders, was eligible for confirmation provided the court found that it was "fair and equitable" and that it did not "discriminate unfairly in favor of any class of creditors or stockholders", and was "feasible". The acceptance by any class of creditors or stockholders which

either was not adversely affected by the Plan or did not have an equity in the debtor's property was not required.

Chapter X, with its revised procedure relating to corporate reorganizations, imposes the primary duty of formulating reorganization plans upon an independent trustee, appointed by the court, and provides for advisory reports prepared by the Securities and Exchange Commission. The securing of this report is obligatory if the debtor's assets exceed \$3,000,000; otherwise, such a report is optional. Chapter X further provides for a hearing on the trustee's plan and on any other plans which may be proposed by the debtor or by any creditor or stockholder, prior to the solicitation of acceptances which can be used in the reorganization proceedings. Before confirming the Plan under Chapter X, the judge is required to find that it is "fair, equitable and feasible". The language of this requirement is different from that of Section 77B dealing with the same question, but it is submitted that there is no difference in the legal intent and meaning of the provisions of the two Acts.

With this background in mind, we turn to a statement of the *Los Angeles Lumber Co.* case.⁴ This case involved the reorganization under Section 77B of the Los Angeles Lumber Products Company and its six subsidiaries, one of which was the Los Angeles Shipbuilding and Drydock Corporation, whose stock constituted practically the only valuable asset of the parent company. Since the parent was liable for the debts of the subsidiaries (except current obligations not affected by the plan), assets and liabilities will be given from a consolidated statement of the parent and the subsidiaries. The debtor was hopelessly insolvent in both the bankruptcy and the equity sense, and was so found by the District Judge. The value of the assets of the debtor as fixed by the court amounted to approximately \$830,000, whereas claims of bondholders (including

⁴ Case v. Los Angeles Lumber Products Co., 308 U. S. 106, 60 S. Ct. 1, 84 L. Ed. 110 (1939). See also the opinion of the Circuit Court of Appeals, *In re Los Angeles Lumber Products Co.*, 100 F. (2d) 963, (C. C. A. 9th, 1939), as well as the opinion of the District Court, 24 F. Supp. 501 (D. C. S. D. Cal., 1938).

principal and accrued interest) amounted to approximately \$3,800,000,⁵ i. e., value of assets was less than twenty-five per cent of the amount of the secured indebtedness. The debtor had outstanding an issue of Class A common stock, which appears from the opinion of the lower court to have been held by the management or by those identified with the management. It is to be noted that the shares of Class A stock had been issued in 1930, in connection with a voluntary reorganization⁶ in exchange for \$400,000 in cash which was raised among the then stockholders of the Company. A reorganization plan was formulated in 1937 to be made effective either by contract or pursuant to Section 77B, and over eighty per cent. of bondholders and stockholders of each class accepted the same.⁷ Nevertheless it was deemed advisable to effectuate the Plan under the provisions of Section 77B. The Plan was referred to a Special Master by the District Judge and was modified to provide for an authorized issue of a million shares of \$1 par value voting stock, of which 811,375 shares were non-cumulative participating preferred stock⁸ and 188,625 shares were common stock, allocated under the Plan as follows:

To bonds at rate 2500 shs. per	
\$1000 bond (77%).....	641,375 shs. of new pfd.
To new money.....	170,000 shs. of new pfd.
To Class A com. (23%).....	188,625 shs. of new com.
To Class B com.....	None

The aggregate par value of shares to be issued was \$830,000 which is equal to the going concern value of the debtor's

⁵ Total principal amount of bonds outstanding at date of 77B reorganization was \$2,565,500. The bonds were issued in 1924 to mature in 1944.

⁶ By amendment to the trust indenture in accordance with its terms, interest rate on the bonds was reduced from 7½% to 6% and made payable only if earned; old stock was wiped out by assessment; new stock divided into Class A and Class B with equal voting rights—Class B stock was allotted to bondholders to compensate for modification of indenture and release of stockholders' liability under California law in favor of contributors, to be outstanding after Plan became effective 57,788 shares of A stock, 5,112 shares of B stock.

⁷ Approximately 750,000 shares of new common was divided, roughly, 71% to bondholders, and 29% to Class A stockholders.

⁸ New preferred stock was entitled to 5% dividend if earned, then common to 5%, thereafter the two classes to share equally.

assets as found by the Court. Acceptances were obtained to the Plan as modified by the Special Master from over 90% of bondholders and stockholders of each class.⁹ Two bondholders holding only \$18,500 principal amount of bonds objected to the Plan at the hearing before the District Court,¹⁰ but the District Judge (Jenney, J.) confirmed the Plan¹¹ justifying the inclusion of stockholders (1) because relative priorities were maintained and (2) because the Court considered that certain compensatory advantages were derived by the new company as a result of having reached an agreement with stockholders of the old company, as follows:

(a) Continuity of present management was assured.

(b) If such an agreement had not been reached the Company might have been liquidated, in which event, in the opinion of the Court, the bondholders would have received substantially less than the appraised value of the assets.

(c) Old stockholders would have had the right to manage and control the debtor until the maturity of the bonds in 1944, if 77B proceedings had not been instituted, since the right to foreclose upon non-payment of interest had been waived by bondholders under the 1930 voluntary plan of reorganization. Furthermore, stockholders claimed that the institution of proceedings under 77B and the consummation of a re-

⁹ Most acceptances took the form of a failure on the part of those who had assented to the Plan, formulated before the institution of 77B proceedings, to withdraw from the Plan upon receipt of notice of amendment.

¹⁰ Judge Jenney relied on, and quoted at length from, the opinion of Judge Morris in *Downtown Inv. Ass'n. v. Boston Metropolitan Bldg.*, 81 F. (2d) 314 (C. C. A. 1st, 1936), and on *In re Baldwin Locomotive Works*, 21 F. Supp. 94 (D. Pa. 1937). In the former case, the District Court confirmed the Reorganization Plan dividing new common stock among first and second mortgage bondholders as well as common stockholders, although the Court frankly stated that no equity existed for stockholders. The Court took the position that to hold that the words "fair and equitable" as used in Section 77B did not permit certain adjustments between creditors and stockholders by agreement which would not have been sanctioned by the Court in equity receivership reorganizations would be to "nullify the provisions of the Act which was passed to facilitate corporate reorganizations." In the latter decision the Court took the general position that in the exercise of its power of approval it should defer to the business judgment of those whose property was at stake.

¹¹ These bondholders had not accepted the 1930 Plan, but were bound by its terms under the provisions of the Indenture.

organization was the equivalent of a foreclosure within the meaning of the agreement.

(d) By effecting an expeditious reorganization, after which the debtor's properties were unencumbered as a result of the exchange of bonds for preferred stock under the plan, the reorganized company was placed in a position to secure corporate surety bonds and made eligible to undertake construction work in connection with the Government's program which currently affected the territory in which the debtor operated. The Court stressed the fact that timely participation in this program might materially increase the prospective earnings of the company and add to its going concern value.

The Supreme Court held that the District Court erred in confirming the Plan, and that the Circuit Court of Appeals erred in affirming the lower court's decree, on the ground that the Plan was not fair and equitable as a matter of law.¹²

Mr. Justice Douglas states as follows the views of the Court as to the meaning of "fair and equitable" as used in Section 77B, views which are undoubtedly applicable to test the fairness of a Plan under Chapter X:

"The words 'fair and equitable' as used in Section 77B(f) are words of art which prior to the advent of Section 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations. . . .

"In equity reorganization law the term 'fair and equitable' included, inter alia, the rules of law enunciated by this Court in the familiar cases of *Chicago, R. I. & P. R. Co. v. Howard*, 7 Wall. 392, 19 L. Ed. 117 [generally referred to as the *Howard case*¹³]; *Louisville*

¹² By stipulation only questions of substantive law were raised on appeal on an abbreviated record.

¹³ The *Howard case* involved a reorganization through Federal equity receivership and the foreclosure of the railroad mortgages involved. In spite of insolvency of the debtor and the existence of a substantial floating debt stockholders participated in the securities of the New Company pursuant to an agreement between the bondholders and the stockholders.

The *Monon case* likewise involved a reorganization through equity receivership and foreclosure of the railroad mortgage involved. The rights of unsecured creditors were ignored. The Court in setting aside the foreclosure decree and holding the New Company liable for the debt of the complainant, states in substance that although it is perfectly permissible

Trust Co. v. Louisville, N. A. & C. R. Co., 174 U. S. 674, 43 L. Ed. 1130, 19 S. Ct. 827 [generally referred to as the Monon case]; Northern P. R. Co. v. Boyd, 228 U. S. 482, 57 L. Ed. 931, 33 S. Ct. 554 [generally referred to as the Boyd case]; Kansas City Terminal R. Co. v. Central Union Trust Co., 271 U. S. 445, 70 L. Ed. 1028, 46 S. Ct. 549 [this case will be sometimes referred to as the Kansas City R. Co. case]. These cases dealt with the precedence to be accorded creditors over stockholders in reorganization plans. In Louisville Trust Co. v. Louisville, N. A. & C. R. Co., 174 U. S. 674, 43 L. Ed. 1130, 19 S. Ct. 827, *supra*, this Court reaffirmed the 'familiar rule' that 'the stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors.' And it went on to say that 'any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation' (p. 684). This doctrine is the 'fixed principle' according to which Northern P. R. Co. v. Boyd, 228 U. S. 482, 57 L. Ed. 931, 33 S. Ct. 554, *supra*, decided that the character of reorganization plans was to be evaluated. And in the latter case this Court added, 'If the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event, it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever.' (p. 508.) On the reaffirmation of this 'fixed principle' of reorganization law in Kansas City Terminal R. Co. v. Central Union Trust Co., *supra*, it was said that 'to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation' (p. 455). In application of this rule of full or absolute priority this Court recognized certain practical considerations and made it clear that such rule did not 'require the impossible and make

for the bondholders of an insolvent company to give away an interest in the New Company which belongs to the bondholders, nevertheless for bondholders to secure waivers from stockholders of objections to foreclosure proceedings in order to expedite the same and then afterwards to transfer to stockholders an interest in the New Company "deserves the condemnation of any court".

it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock.' Northern P. R. Co. v. Boyd, supra (228 U. S. 508, 57 L. Ed. 943, 33 S. Ct. 554). And this practical aspect of the problem was further amplified in Kansas City Terminal R. Co. v. Central Union Trust Co., supra, by the statement that 'when necessary, they (creditors) may be protected through other arrangements which distinctly recognize their equitable right to be preferred to stockholders against the full value of all property belonging to the debtor corporation, and afford each of them fair opportunity, measured by the existing circumstances, to avail himself of this right' (pp. 454, 455). And it also recognized the necessity at times of permitting the inclusion of stockholders on payment of contributions, even though the debtor company was insolvent. As stated in Kansas City Terminal R. Co. v. Central Union Trust Co., supra (271 U. S. 455, 70 L. Ed. 1032, 46 S. Ct. 549): 'Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them. In such or similar cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights.' But even so, payment of cash by the stockholders for new stock did not itself save the plan from the rigors of the 'fixed principles' of the Boyd Case, for in that case the decree was struck down where provision was not made for the unsecured creditor and even though the stockholders paid cash for their new stock."

The decision of the Supreme Court in the *Los Angeles Lumber Company* case establishes certain principles, and directly and by implication raises a number of very interesting questions for discussion and speculation.

In the first place, it makes it clear that the so-called fixed principle of the *Boyd* case, as supplemented by the *Howard, Monon* and *Kansas City R. Co.* cases, (which will sometimes be referred to herein as the doctrine of the *Boyd* case) is to be applied to reorganizations to deter-

mine whether or not plans are "fair and equitable" within the meaning of the provisions of Section 77B, and it may be stated with assurance likewise within the meaning of the provisions of Chapter X of the Chandler Act.¹⁴ This re-focusing of the spotlight on the *Boyd* case which has been the subject of so much discussion and comment during the last twenty-five years, makes it pertinent to review this well known decision of the Supreme Court.

The *Boyd* case involved reorganization of the Northern Pacific Railway Company through Federal equity receivership and foreclosure of the mortgage securing its bonds. The Old Company at the time of reorganization had outstanding approximately \$157,000,000 of old bonds and receivers' certificates, and large issues of preferred and common stocks. The following is a condensed skeleton outline of the Plan in the *Boyd* case, as well as the capitalization of the New Company formed to acquire the assets of the Old Company in reorganization:

<i>Securities of the Old Company</i>	<i>Securities of the New Company under the Plan</i>
Bonds	\$190,000,000 new bonds
\$157,000,000	
Preferred	50% in new preferred and 50% in new common, upon pay- ment of an assessment of \$10 per share.
Common	100% of new common upon the payment of an assessment of \$15 a share.
<i>Capitalization of the New Company:</i>	
Bonds	\$190,000,000
Preferred Stock	75,000,000
Common Stock	80,000,000
Total	\$345,000,000

¹⁴ The Supreme Court in its opinion in the Los Angeles Co. case states (note 14) "... the standard of 'fair and equitable' as used in §77-B remained unaltered as one of the criteria necessary for the confirmation of a plan of reorganization."

Under the Plan, no provision was made for a large floating debt, but the debtor purchased unsecured claims totalling \$14,000,000. The total cash contributed by preferred and common stockholders in response to assessments amounted to \$11,000,000. A committee representing unsecured creditors conducted an unsuccessful attack on the foreclosure proceedings on the ground that such proceedings had been instituted pursuant to a conspiracy between bondholders and stockholders for the purpose of excluding the floating debt from participating in the securities of the New Company, and of turning over a valuable equity in the properties of the debtor to the stockholders. The District Court found:

- (a) That the Railroad was insolvent, and
- (b) That its assets were insufficient to meet its mortgage indebtedness, and
- (c) That its net income was insufficient to meet its fixed charges, and
- (d) That there was no equity for stockholders, and
- (e) That the Court was without power to impose a plan of reorganization.

The up-set price was fixed at \$61,500,000, that is to say, \$86,000,000 less than the secured debts. The properties were transferred to the New Company which issued the \$345,000,000 of securities to the security holders of the New Company, divided as shown above. Most of the old stockholders paid their assessments and became stockholders of the New Company. Ten years after the Plan was consummated, Boyd, the holder of an unsecured claim amounting to approximately \$71,000 which had been reduced to judgment against the Old Company, brought suit both against the Old Company and the New Company for the purpose of enforcing his claim against the property acquired by the New Company at foreclosure sale, claiming that the foreclosure sale was invalid on the ground that it was a step in a plan of reorganization agreed to between bondholders and stockholders to the exclusion of general creditors. The lower court entered a decree, the effect of

which was to give Boyd a lien on the property of the Old Company in the hands of the New Company, subject to mortgages which were executed pursuant to the provisions of the Reorganization Plan. The Supreme Court affirmed the decree.¹⁵

While many views have been expressed as to the grounds for the decision and the extent of its application, it is submitted that the soundest point of view, which is now widely accepted, is that the doctrine of the *Boyd* case is based upon the law of fraudulent conveyance.¹⁶ Under this doctrine if a creditor who is entitled to satisfy his claim out of specific property surrenders the property, or any part of it, such property becomes available for the satisfaction of claims of other creditors. In the *Boyd* case the bondholders were entitled to all of the assets. By agreement the stockholders received an interest in the property, although creditors received nothing. The Court took the position that the same legal consequences attached to the transfer of the assets to the stockholders which would have attached if the assets had been transferred directly to the debtor. This view is well expressed by Gerdes in his treatise on Corporate Reorganizations:¹⁷

"The *Boyd* case states the principle that any plan of reorganization which provides for the participation of stockholders without making provision for all unsecured creditors is an unfair plan, and that this is true whether or not any equity exists in the property of the old company above the secured indebtedness. The principle of the *Boyd* case is really one of fraudulent conveyance. For the purpose of doing justice the veil of the corporate entity is pierced and the stockholders were treated as if they were the corporation. As a result the conveyance of the property by the old corporation to a new one in which the old stockholders are given an interest, is treated in exactly the same manner as if the distribution to the old stockholders was a payment to the old corporation. Viewed in this

¹⁵ Dissenting, C. J. White, and J. J. Lurton, Holmes and Van Deventer.

¹⁶ Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganizations* (1933) 19 Va. L. Rev. 541, cited by Douglas, J., in Note 7 to his opinion in the Los Angeles Co. case. Gerdes, *General Principles of Plans of Corporate Reorganization* (1940) 89 U. of Pa. L. Rev. 39.

¹⁷ 2 GERDES, CORPORATE REORGANIZATIONS (1936) Sec. 1083.

light it appears that the mortgagor has sold the property to itself. Under such circumstances, the assets or securities given to the old stockholders should be and are reachable by the creditors of the old corporation. As the new corporation was a party to the 'fraudulent conveyance' chargeable with knowledge, the court permits the old creditors to proceed against the property of the new corporation to the extent of the value given to the old stockholders on the reorganization."

If we accept this view as to the basis of the decision in the *Boyd* case, it means that the doctrine is limited to cases in which stockholders of the New Company receive an interest although unsecured creditors or creditors of any other class are excluded. This conclusion is not consistent with the views expressed by Robert T. Swaine, of the New York City bar, in a lecture given before the Bar Association of the City of New York,¹⁸ when he interpreted the *Boyd* case as follows:

"The rule as I see it, and as I believe it will ultimately be developed by the courts, is that the relative priorities of the old securities, senior to the most junior securities which continue to have any interest in the property, must not be inequitably disturbed. Stockholders cannot be put ahead of creditors. Unsecured creditors cannot be put ahead of bondholders. Junior bondholders cannot be put ahead of senior bondholders; and, it is submitted common stockholders cannot unite with bondholders in the plan which will put them ahead of preferred stockholders."

Judge Jerome N. Frank, recent Chairman of the Securities and Exchange Commission, in an article written in 1933 strongly excepts to Mr. Swaine's views on the subject of the *Boyd* case:¹⁹

"In 1927 Mr. Swaine construed the rule of the *Boyd* case thus: First mortgage bondholders cannot through foreclosure perfect a reorganization which includes unsecured creditors but excludes secured mortgage bondholders—even if (a) the property of the old com-

¹⁸ SOME LEGAL PHASES OF CORPORATE FINANCING, ETC. (1927) 142.

¹⁹ Frank, *supra*, n. 16, 551.

pany is worth far less than the amount due on the old first mortgage bonds and (b) all old stockholders are excluded.

"When that precise question came before the Circuit Court of Appeals for the Eighth Circuit in 1928, in *New York Trust v. Continental & Commercial, etc., Bank*, 26 F. (2d) 872 (C. C. A. 8th, 1928), certiorari denied 278 U. S. 644, 73 L. Ed. 558 (1928) the Court adopted precisely the opposite view.

"The writer believes the Court's conclusion was sound and Mr. Swaine was not. Mr. Swaine's error it is submitted, was due to his failure to read the *Boyd* case as an adjunct to the *Howard* case."

So much for the fixed disagreement between Messrs. Frank and Swaine as to the fixed principle of the *Boyd* case, but even an adherent of Judge Frank's view, which has been adopted by implication by the Supreme Court, finds it difficult to determine this so-called fixed principle.

In a recent article²⁰ E. Merrick Dodd, Jr., of the faculty of the Harvard Law School, comments as follows on this point:

"... it is easy to quote phrases from the opinions in all of the four cases cited by Mr. Justice Douglas in which the creditors' rights to full priority over shareholders are proclaimed. The actual results of the cases are, however, not conclusive, the first three (*Howard*, *Monon* and *Boyd* cases) merely deciding that a reorganization which permits shareholders to retain an interest while eliminating unsecured creditors altogether is not saved from being a fraudulent conveyance by the fact that it has been carried out by means of a judicial sale, and the last (*Kansas City R. Co.* case) consisting merely of certain abstract propositions stated as answers to rather vague abstract questions asked by a circuit court of appeals. Thus, the Supreme Court was substantially unembarrassed by its previous holdings in determining what the words 'fair and equitable' actually mean as applied to a plan which has the assent of an overwhelming majority of all classes of securityholders."

²⁰ Dodd, *The Los Angeles Lumber Products Company Case and Its Implications* (1940) 53 Harv. L. Rev. 713, 719.

It is submitted that the decision in the *Los Angeles Company* case goes no further than to make it clear that the court cannot confirm a reorganization plan of an insolvent corporation which provides for participation by stockholders in absence of a new contribution by stockholders which is equivalent in value to the interests received under the reorganization plan. However, it is also submitted that by dicta and by reason of its stated approval of the "fixed principle" in the *Boyd* case, the Supreme Court has made it possible to assert certain general propositions which should be given careful consideration in connection with the preparation of reorganization plans under Chapter X:

(1) No plan can properly be affirmed by the Court which provides for a distribution to any subordinate class of creditors or stockholders unless all prior classes have been fully compensated.²¹

(2) The meaning of the words "fair and equitable" as is used in 77B, and we submit also as used in Chapter X, establishes the same test of fairness to be applied by the Court as had been established and applied in the equity receivership cases which have formulated the so-called doctrine in the *Boyd* case.

(3) Even although the debtor is found to be insolvent, stockholders may participate under the Reorganization Plan if they make new contributions which are substantially equivalent in value to the interests which they receive in the New Company.²²

(4) The overwhelming approval of each class of creditors and each class of stockholders involved in the reorganization does not relieve the Court from the necessity of determining whether or not the Plan is "fair and equitable", in fact, Mr. Justice Douglas makes it reasonably clear that these facts should not be taken into consideration in making this determination.

²¹ While it is commonly believed that this conclusion would follow from the provisions of Chapter X which requires that the Plan be "fair, equitable and feasible", if we accept the interpretation of the doctrine in the *Boyd* case reached by Gerdes and Frank and given above, this proposition has never been submitted to the Supreme Court and would represent an extension or modification of the doctrine in the *Boyd* case.

²² The language of the Supreme Court on this point is as follows: ". . . where the debtor is insolvent the stockholders' participation must be based on a contribution in money or in moneys worth, reasonably equivalent in view of all the circumstances to the participation of the stockholders."

(5) A fair and fully compensatory offer must be made to each class of creditors under the plan prior to recognition of any class of stockholders.²³

(6) The application of the so-called "rule of full or absolute priority" is approved by the Court.

(7) A valuation of the debtor's assets by the Court is required in all cases so as to determine whether or not one or more classes of stockholders or creditors should be eliminated under the Plan.

The holding of the Supreme Court in the *Los Angeles Company* case and the conclusions reached and asserted by Mr. Justice Douglas as stated above, pre-suppose the ability of the District Court to arrive at a fair valuation of the debtor's assets for the purposes of the Reorganization Plan. In considering this vital problem, namely, the valuation of the debtor's assets for purposes of the Plan, we find that no principles of valuation have been established in the equity receivership reorganizations where, as we have seen above, the up-set price was fixed in the consent foreclosure decree by an agreement between the parties at an amount which was related to the estimated market price of the securities of the New Company which were to be distributed under the Plan in exchange for securities of the Old Company. We have noted that, in the *Boyd* case, the properties there involved were purchased by the New Company for \$61,500,000 and immediately thereafter used as the basis for the capitalization of the New Company in a total amount of \$345,000,000, although it must be borne in mind that \$11,000,000 new capital was raised for the reorganized enterprise by assessments against the stockholders of the Old Company as a condition to the receipt of the participation which was allotted to them.

However, the authorities are in general agreement that the going-concern value of the assets of the debtor should

²³ The Court recognizes with approval a statement from the opinion in the *Kansas City R. Co.* case to the effect that the interest of the creditor can be taken care of "by the issuance, on equitable terms, of income bonds or preferred stock."

be used for purposes of reorganization.²⁴ It is submitted that the same basis of valuation would apply not only for purposes of determining whether or not stockholders or the holders of other junior securities are entitled to a participation under the Plan, but also in connection with the determination of whether or not the debtor is insolvent within the meaning of the definition of insolvency contained in Chapter I, Section 1(19) of the Bankruptcy Act,²⁵ which is applicable under Chapter X.

It is basically sound that the reorganized company should be valued as a "going concern" rather than at the value of its assets on liquidation, since liquidation is not contemplated. The value of the new enterprise is clearly dependent upon its capacity to earn. Such a valuation, however, resolves itself into a problem of determining anticipated profits taking into account a multiplicity of factors. This view is accepted by Gerdes, who in a recent article²⁶ enumerates certain factors deserving of consideration. After observing that no precise formula can be arrived at, he states as follows:

"... valuations based on capitalization of estimated profits should be modified by consideration of other factors. Additional elements which may enter into the determination of 'going concern' values are:

- (1) Original cost of fixed assets, less depreciation.
- (2) Replacement value of property.
- (3) Rate of obsolescence of assets due to technical development of industry.
- (4) Strength of financial set-up and ability to weather financial storms.
- (5) Stability and prospects of industry.
- (6) Efficiency and integrity of management."

²⁴ 2 BONBRIGHT, VALUATION OF PROPERTY (1937) 884-889. Consolidated Rock Products Co. v. Du Bois, 61 S. Ct. 675 (U. S. 1941).

²⁵ "A person shall be deemed insolvent within the provisions of this Act whenever the aggregate of his property exclusive of any property which he may have conveyed, transferred, concealed, removed or permitted to be concealed or removed with intent to default, hinder, or delay his creditors shall not at a fair valuation be sufficient in amount to pay his debts."

²⁶ Gerdes, *supra*, n. 16.

Judge Jerome N. Frank, writing before the enactment of either 77B or the Chandler Act, concluded that going-concern value should be used, but he fully appreciated the difficulties involved. His views are stated as follows:²⁷

“Doubtless the court will frequently find it difficult to determine with any degree of nicety whether there is any excess value. That problem will be peculiarly difficult in reorganizations which occur during a period such as the present where present earning power will often be found to be small or non-existent. Perhaps the court should take into account the average earnings over the preceding decade; and it is suggested that to avoid injustice to senior securityholders, a plan might frequently provide that distribution of the excess to junior securityholders should, in cases of doubt, take the form of stock purchase warrants or options to purchase stock exercisable over a period of five or ten years.”

It is submitted that Judge Frank does not emphasize sufficiently the importance of arriving at a forecast or estimate of prospective earnings taking into account all the new factors which are likely to affect the earning capacity of the reorganized company, among which are the following: (a) after a sound reorganization, the new company should have adequate working capital, and a sound financial set-up from the point of view of capital retirements. In many cases the low earning capacity of the old company and its financial difficulties can be traced, among other factors, to insufficient working capital coupled with maturity of fixed obligations. (b) The new company would be operated by new or revised management personnel.

Judge Frank does recognize that such valuations are at best an inexact science.^{27a}

“The word ‘value’ obviously has no precise meaning, as Professor Bonbright has brilliantly explained. But the substitution even of the vague concept ‘value’ for the fictitious judicial sale as a means of dealing

²⁷ Frank, *supra*, n. 16, 557.

^{27a} *Ibid.*

justly with the parties would mean a great advance from the present practice. It might serve as a red flag to the judge, by pointing out to him that he must investigate the plan in the light of divers considerations of fairness instead of mechanizing his decision by reference to the meaningless device of the price bid at the unreal sale."

Professor Bonbright, in an article to which Judge Frank refers,²⁸ states that the effort to discover a "single central principle underlying the action of judges, a principle of 'reasonable value' which might take its place along with the great, unifying principle of 'normal value' which was developed by classical economists" has been unsuccessful up to the present time, and continuing Mr. Bonbright says: "I strongly suspect most of us will soon abandon even the attempt to find the Holy Grail." Attempting to state the problem in a more realistic way, I turn again to the views of Bonbright in connection with the valuations to determine solvency, under 77B as follows:²⁹

"As to methods of valuation used as a test of solvency, the reported cases are yet too meager to warrant confident generalization. There is a distinct tendency, however, (a) to insist that the corporate properties shall be valued as a 'going concern' rather than at mere liquidation value, as long as liquidation is not contemplated, and (b) to measure value by the test of capitalized earnings, recent and prospective, rather than by historical costs, 'book values' of the assets, replacement costs ('physical value'), or market prices of outstanding securities. (A few courts have apparently been impressed by 'book values'.) But there can already be noted a marked difference in the extent to which courts will accept or reject the optimistic forecasts of future earnings that are almost invariably presented by stockholder interests."

There is a marked division between the attitudes of courts in considering the question of solvency in connection with reorganization plans. In some instances, a liberal attitude has been adopted as to the possibility of pros-

²⁸ Bonbright, *Problem of Judicial Valuation* (1927) 27 Col. L. R. 493.

²⁹ 2 BONBRIGHT, *VALUATION OF PROPERTY* (1937) 885.

pective earnings, whereas in others, prospective earnings have been severely discounted. In the case of *In Re Hopkins Lake Drive Realty Corporation*,³⁰ Judge Chesnut makes the following statement:

"I do not think it possible to read and understand the additions to the Bankruptcy Act without the conclusion that it was the intention of Congress that the question of solvency was at least to be very liberally construed in the interest of the debtor. It is not overwhelmingly clear that there is any equity in the property . . . In all events, the condition of the property is not such that it is hopeless to anticipate that some equity may be realized so, at the present time, it will not be determined that the debtor is insolvent."

See also dissenting opinions by Simmonds, J., in the recent cases of *Whitmore Plaza Corporation v. Smith*,³¹ and *Metropolitan Holding Co. v. Weadock*.³²

In the latter case the Court states its view as follows:³³

"The underlying philosophy of all the provisions of the Bankruptcy Act, including its agricultural adjustment provisions and the railroad and corporation reorganization sections, is that a distressed debtor should have an opportunity for rehabilitation, and that there is no inequity or constitutional infirmity in providing for such opportunity so long as creditors are protected in their priorities to the full face value of their security at the time of reorganization . . ."

Mr. Justice Douglas, as stated before, adopts what he terms as "full or absolute priority doctrine" of the *Boyd* case. This view was advocated by Judge Jerome Frank, following his appointment as Chairman of the Securities and Exchange Commission, before the Association of the Bar of the City of New York in an address which he delivered there on March 27, 1940. As indicated above, this doctrine calls for the complete elimination of any class of creditors or stockholders which does not have an equity in the

³⁰ C. C. H. Bankr., Par. 3276 (D. Md. 1934).

³¹ 113 F. (2d) 210 (C. C. A. 6th, 1940).

³² 113 F. (2d) 207 (C. C. A. 6th, 1940).

³³ *Ibid.*, 209.

debtor's property as determined by the Court's valuation; and no scaling down of debts or material alterations of the security holders' contract is permissible. This theory has been contrasted with what has been described as the relative priority theory.³⁴ The relative priority theory does not involve the scaling down of senior securities but rather the recognition of the full contract rights of the holders of senior securities, with modifications responsive to problems of reorganization such as the change, in whole or in part, from bonds bearing a fixed rate of interest to income bonds. However, having thus recognized the priority of the senior securities the plan may provide interests for junior securities on a prospective workout basis. In general, this is the theory towards which the judges are inclined who adopt a liberal attitude as to insolvency and give effect to an optimistic estimate of future earnings. This is illustrated by the attitude of Judge Chesnut in the *Hopkins Lake Drive Realty* case.³⁵ In such situations Judge Jerome Frank's suggestion³⁶ to the effect that options or stock purchase warrants might be granted to stockholders where the question of solvency is difficult of determination is worthy of serious consideration. This was the solution of the problem adopted by the court in the reorganization of Midwest Utilities Company.³⁷

³⁴ This distinction was first made in an article by Bonbright and Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization* (1928) 28 Col. L. Rev. 127. Under the relative priority theory, as stated in this article, interests in a reorganized company may be given to classes of creditors who have no equity on the basis of a strict present determination of values, provided the full relative preferences as to claims on earnings and on dissolution are preserved.

³⁵ See also, *In re Kelly-Springfield Tire Co.*, 13 F. Supp. 724, 729 (D. Md., 1935).

³⁶ Frank, *supra*, n. 16.

³⁷ In *In re Middle West Utilities Co.*, Com. Cl. H. Bankr. Ser., Par. 3671 (D. C. N. D. Ill., 1935) Judge Wilkerson refused to confirm the plan unless stockholders received options to buy common stock. In a ruling issued on November 6, 1935, he said:

"The stockholders, in my opinion, should be given some additional opportunity to share in the future prosperity of the new company, if it turns out to be prosperous. The appearances do not justify an outright allotment of additional shares of the new company to the stockholders. It appears equitable, however, that the stockholders should receive, in addition to the shares allotted them, warrants or contracts entitling them to purchase shares in the new company at set prices."

In conclusion, it is interesting to discuss and speculate briefly on the possible consequences which may result from the decision of the *Los Angeles Company* case.

The management, particularly if it owns or is identified with any substantial holdings of junior securities will be likely to pursue desperate measures to avoid a reorganization under Chapter X. An involuntary petition, to meet with success, requires proof of an act of bankruptcy. This means, in a vast majority of cases, only if the petitioning creditors can prove the insolvency of the debtor. The most likely ground for an act of bankruptcy requires not only the proof of insolvency but also the payment made to an existing creditor with intent to defer, which second requirement is by no means easy to meet if the debtor guards carefully against expenditures out of the ordinary course of business. As a second line of defense, the debtor is capable of, and undoubtedly will avail itself in many cases of, its right to conduct a protracted litigation on the question of insolvency. In other words, the necessity of securing the wholehearted cooperation of the debtor, and in most cases, of its stockholders, remains a serious practical problem even after the *Los Angeles Company* case, as it was in the case of equity receivership reorganizations in which it came to be recognized as a necessary step in the procedure.

There is probably no valid criticism that can be made of the unanimous decision of the Supreme Court in the *Los Angeles Company* case. The properties, as stated before, had been valued at less than 25% of the claims of secured creditors; and whether the Court took a pessimistic or optimistic view of the prospective earnings of the New Company, it is difficult to conclude that there was any excess value for stockholders other than the nuisance value arising from the right to obstruct and delay. True, considerable stress was laid upon the capacity of the management of The Los Angeles Construction Company and its financial standing in the community, and without a doubt, if the attitude of the Supreme Court had been

known in advance, the debtor would never have surrendered its right to defer foreclosure until 1944 by filing a petition under 77B. But there surely is a line beyond which courts should not go in permitting stockholders to trade and bargain themselves by obstructive tactics into a substantial interest in the securities of the New Company at the sacrifice of the contract rights of the holders of senior securities. Under the facts in the *Los Angeles* case, the decision of the Court is a sound one because the gross deficiency in value overrides all other relatively less important considerations.

However, the decision of the Court and its implications will tend to make it more difficult to deal with dissenting minorities and dissenting classes of junior security holders. If against their will they are forced to submit to reorganization proceedings under Chapter X, under circumstances in which they are likely to be wiped out entirely as a class by the so-called fixed doctrine of the *Boyd* case, or the doctrine of full and absolute priority, such classes of security holders will be likely to resist and attack the reorganization proceedings in every way which is open to them. The bondholders forbidden to follow the traditional method of making an agreement with stockholders or holders of other junior securities to expedite the reorganization proceedings will be likely to seek other methods of reaching such a compromise, and agreements are likely to be worked out to perfect voluntary reorganization outside of court. It is suggested that one basis for a compromise agreement between bondholders and stockholders is on the question of the going concern value of the assets of the debtor. There is a wide margin of error which is conceded by the former Chairman of the Securities and Exchange Commission himself in calculating such values, as, in fact, by implication, by Mr. Justice Douglas in his opinion recently handed down in the *Consolidated Rock Products Company* case.³⁸ It is entirely possible that judges inclined to be unsympathetic with the decision of the

³⁸ *Consolidated Rock Products Co. v. Du Bois*, *supra*, n. 24.

Supreme Court in the *Los Angeles Company* case, will give recognition to agreed values arrived at on a reasonable prospective basis between bondholders and stockholders and thus enable the stockholders to retain an interest under the plan without a violation of the doctrine of the *Los Angeles Company* case.