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CONFLICTING IDEALS FOR REORGANIZATION

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MOST of the recent literature dealing with reorganization and the reorganization amendments to the Bankruptcy Act has emphasized reorganization procedure, and properly so.[1] Abuses conceived to have existed in the past have been primarily procedural. The general tenor of reform objective has been to shift control over reorganization from investment bankers to the security holders themselves or to public authority.

In reorganizations the banker has managed the financial body politic much as machine organizations have managed municipal politics.[2] There has been more suavity and unction and much less scandal, but the essential sources of power and of weakness have been alike. Like Tammany, the wise bankers have adapted their government to the more

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1. Billig, *Corporate Reorganization: Equity vs. Bankruptcy* (1933) 17 MINN. L. REV. 237-269; Douglas, *Protective Committees in Railroad Reorganizations* (1934) 47 HARV. L. REV. 565; Friendly, *Some Comments on the Corporate Reorganization Act* (1934) 48 HARV. L. REV. 39; Kahn, *The New Corporate Reorganization Statute* (1935) 1 CORPORATE REORGANIZATIONS 254; Kaplan, *Corporate Reorganization Under Section 77B of the Bankruptcy Act* (1934) 33 MICH. L. REV. 77; Lisman, *Protective Committees For Security Holders* (1934) 13 HARV. BUS. REV. 19; Lowenthal, *The Railroad Reorganization Act* (1933) 47 HARV. L. REV. 18; Rodgers & Groom, *Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act* (1933) 33 COL. L. REV. 571; Sabel, *The Corporate Reorganizations Act* (1934) 19 MINN. L. REV. 34; Spaeth, *The Reorganization Amendments to the Bankruptcy Act* (1934) 8 TEMPLE L. Q. 447; Swaine, *Corporate Reorganizations—An Amendment to the Bankruptcy Act—A Symposium* (1933) 19 VA. L. REV. 317; Weiner, *Corporate Reorganization: Section 77B of the Bankruptcy Act* (1934) 34 COL. L. REV. 1173; Weinstein, *On the Meaning and Implications of "Affected" Under Section 77B* (1934) 1 CORPORATE REORGANIZATIONS 183.

For recent discussion of substantive limitations on the scope of reorganization plans see Douglas and Frank, *Landlords' Claims in Reorganization* (1933) 42 YALE L. J. 1003; Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganizations* (1933) 19 VA. L. REV. 541; Gerdes, *A Fair and Equitable Plan of Corporate Reorganization Under Section 77B of the Bankruptcy Act* (1934) 12 N. Y. U. L. Q. REV. 1; Payne, *Fair and Equitable Plans of Corporate Reorganization* (1934) 20 VA. L. REV. 37.

2. The analogy is more apt to city than to national government because in financial politics there are fairly well defined and respected spheres of influence. There is nothing akin to a two party system.

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permanent tendencies of human nature, rather than those moral abstractions that sometimes get written into law. They have managed to dispense patronage and warp the application of principles with a view to appeasing aggressive, articulate and influential constituents. The timid souls, the guileless and confiding masses, have been forgotten men.

Let us assume that recent procedural changes have inaugurated a "new deal"; that the bankers have been exposed as corrupt. In their efforts to get and retain power they may have overplayed their hands. Their concessions to expediency having been played up dramatically against the popular ideal of impartiality, a moral revulsion has resulted —if not among their immediate constituents in the financial community, at least among the wider public opinion which impinges upon governmental bodies, courts and legislatures. The upheaval which followed the exposure has put reform in the saddle. The reformer is expected to substitute an honest, i. e., a rational government of laws and not of men—for its corrupt predecessor.

Every reformer's problem is two-fold. He must keep alive the moral fervor for honesty, lest the forces which gave him power disintegrate into a general scramble for special privilege. He must also have a simple and understandable standard of what is righteous, upon which his followers are agreed.[3] Otherwise corrupt desire for self-aggrandizement will creep in under cover of alternative theories of what is right. Some of those who voted the reformers in will subsequently favor one theory and some another, according as their own self-interest will be affected.

It is not altogether clear how sweeping has been the reformer's victory in the recent changes in reorganization practice. Something equivalent to a new constitution has been established for that important segment of our economic affairs which is governed by the reorganization process. That constitution is to be found in the two latest decisions of the Supreme Court dealing with reorganization[4] and in Sections 77 and 77B of the

3. A perhaps apocryphal story quotes President Roosevelt as saying to one of his so-called "liberal" advisers, "One reason why the conservatives always have their way is that they don't want anything done and are all agreed upon it. You liberals all want something done but no two of you can agree what it is."

4. "Every important determination by the court in receivership proceedings calls for an informed, independent judgment." National Surety Co. v. Coriell, 289 U. S. 426, 436 (1933). "Moreover the court stood in a position different from that which it occupies in ordinary litigation, where issues are to be determined solely upon such evidence as the contending parties choose to introduce." First National Bank of Cincinnati v. Flershem, 290 U. S. 504, 525 (1934). There was no intrinsic novelty in the insistence that a receivership judge should be more than a yes-man for directing bankers. These decisions merely gave new emphasis and more specific direction to what had been said before. See Louisville Trust Co. v. Louisville and C. Ry., 174 U. S. 674, 688 (1899): ". . . a court assuming in foreclosure proceedings the charge of railroad property by a receiver can never rightfully become the mere silent registrar of agreements of mortgagee and mortgagor."

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Bankruptcy Act. It seems to require the judges of the lower federal courts to take more of a hand than heretofore in shaping the reorganization process.[5] They must give their approval to plans as fair and equitable. To many this would seem to imply that somewhere in the law books are to be found rational standards of fairness which will enable the reorganization judge to determine the fairness of the plan with reference to factors other than the loudness of the clamor and the vigorousness of the insistence upon special advantages of those interested in the various securities to be reorganized.

This article attempts to explore the precedents to which the reorganization judge must resort. The effort will be to ascertain whether they indicate any rational standards for appraising the fairness of a reorganization plan. The reform movement has drafted the reorganization judge out of his cloistered obscurity, out of his position of detachment from really vital economic issues, simply because of the general confidence in his integrity. It is only fair that someone should try to tell him what is expected of him. Is the answer to be found in the books of the law? If no rational substantive principle can be found, it may be that the objective of procedural reform has been misdirected.

Lower Court Practice Contrasted with Supreme Court Decisions as Evidence of Reorganization Law

Reorganization has supplanted liquidation as the normal consequence of the failure of large corporations. It is offered as an alternative to the sacrifice of going concern values which usually far exceed liquidation values. Yet creditors' and even preferred stockholders' rights are normally conceived of as rights and priorities in liquidation. This is both the abstract legal conception, and the natural implication of the financial documents and sales literature whether used to obtain mercantile credit or to sell securities with liens and preferential rights. The expectations of priority are created both with reference to what may be realized in the event of corporate failure and as sanctions to minimize the risks of failure. The promoters and managers identified with the junior stock are to be kept from rash solicitation or use of capital by the fear that whatever losses occur must first wipe out their own investment stake. In supplanting liquidation as the corporate day of judg-

5. For a review of the traditional hesitancy of receivership judges to take any part in shaping reorganization plans, see Sunderland, *Historical Background of the Corporate Bankruptcy Reorganization Act* (1934) 1 Corporate Reorganizations 4, 13. Both ideas of reform and the desires of the reorganization bar to improve the efficiency of their techniques seem to have found expression in the Act. Those actively engaged in reorganization work would not be so much interested in enhancing the reorganization judge's power to curb their own activities, as in using the assumption that the judge would pass upon the fairness of the plan as a justification for removing other restraints.

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ment, reorganization must offer equivalent opportunity for realization of these rights and expectations of priority—yet the attempt to insist on strict enforcement of priorities usually interferes with the conservation of going concern values. The incompatibility of these two desirable objectives gives rise to conflicting ethical attitudes and ideals—one punitive and the other practical. These ideals manifest respectively the basic human passions of vengeance and avarice. Each ideal has had its own typical champions.

The bankers, leading metropolitan lawyers, and judges whose task it is to get reorganization done have unreservedly and consistently championed the practical ideal. They emphasize the desirability of getting the company back on its feet as expeditiously and inexpensively as possible, and to this end suggest letting bygones be bygones, lest bickerings and recriminations convert partial into total loss.[6]

The Supreme Court has been the distinguished champion of the punitive ideal, but with much division among the justices and some vacillation in the extent of the concessions it has been willing to make to the practical point of view. Its position as a court of last but only occasional appeal prevents it from sharing in the contemporaneous shaping of reorganization plans. This has both relieved it from the immediate pressure of practical exigencies when announcing its views, and tended to prevent its views from being followed in practice when they seemed to stand in the way of what the practical reorganizers considered necessary to get reorganization done.

The two ideals have come to grips primarily over the treatment of stockholders. A convenient epitome of the Supreme Court's attitude is found in an oft-quoted exerpt from the *Monon* case:

> "Any arrangement . . . 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" (secured or unsecured) "comes within judicial denunciation."[7]

The reorganizations with which this article is concerned presuppose a

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6. The same clash of ideals arises over the administration of the property pending reorganization. From the punitive point of view it seems highly desirable to have a vigorous investigation to see if misconduct of the old management has caused the disaster. Where, however, the impact of changed business conditions upon the financial structure of the company is of itself sufficient explanation, those who usually dominate the reorganization machinery will endeavor to stifle inquiry. They wish to enlist the cooperation of those most familiar with the business; they fear that the cost of investigation will be out of proportion to possible recovery. There is also a certain feeling that business executives should not submit to trial as to their handling of complex situations except by a jury of their peers. For protest against the usual practice see Lowenthal, *supra* note 1, at 18, 24.

7. Louisville Trust Co. v. Louisville & C. Ry., 174 U. S. 674, 684 (1899), quoted in Northern Pacific Ry. Co. v. Boyd, 228 U. S. 482, 505 (1913); Kansas City Ry. Co. v. Central Union Trust Co., 271 U. S. 445, 454 (1926).

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shrinkage, at least in present realizable values, below the aggregate of creditors' claims. In such cases, strict enforcement of priorities would wipe out the stock. The incidental advantage according to the punitive point of view would be to teach a lesson to the promoters and managers identified with the stock interests,[8] and the bankers who, whether or not previously identified with the stock, seem to display a perverse desire to favor it in reorganization. The champions of the practical ideal recognize the pre-eminent strategic position of those identified with the stock, in view of their opportunity for sabotage and obstruction if not appeased and for positive co-operation if given sufficient inducement. They often favor liberal treatment of the stock.

The lack of sympathy between the Supreme Court and the leaders of the reorganization bar has been notorious. They have not been humble in accepting rebuke from the venerated Court. Convinced of the rectitude of their own practices, they have raged against the Court, delivered lectures to expose its folly,[9] and contrived subtly to refashion the patterns of reorganization so as to subvert the substance while seeming to comply with the letter of its admonitions. Thanks to the tolerance, if not actual sympathy of receivership judges, as well as to the concessions the Supreme Court itself has made to the practical point of view, they have by and large prevailed. The decisions of the Supreme Court may fall like thunderbolts from Almighty Jove. There is a blinding flash, perhaps some spectacular damage to a restricted area. Temporarily there is terror and repentance. But soon calm is resumed and with it confidence that, granted a proper observance of prescribed rituals

8. The Supreme Court opinions have imposed restrictions on the power of reorganizers to offer participation to any stockholders without suggesting distinctions according to whether their stock is preferred or common, voting or nonvoting, or whether the individual stockholders are "lambs" or "wolves." For the moment we are only concerned with the concept *stockholders,* as an ethical abstraction representing the villain of the corporate history. To show the power which this abstraction may exercise over the policy judgments that shape reorganization law, we must explore the way flesh and blood villains can use the power inherent in stock ownership to perpetrate villainy. Of course it does not follow that curbing stockholders' rights in reorganization will necessarily inflict the desired punishment on the flesh and blood villains. The question as to whether preferred stockholders are entitled to better treatment than common stockholders will be considered in a future article.

9. See especially JOLINE, RAILWAY REORGANIZATIONS (an address before the Maryland State Bar Association, July 26, 1900), and THE METHOD AND CONDUCT OF THE REORGANIZATION OF CORPORATIONS (lectures delivered before the Harvard Business School, April 4th and 6th, 1910). The general outline of Joline's lectures is followed and a similar attitude reflected in Cravath, *The Reorganization of Corporations* in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION (1917) 153. In bringing his predecessors' lectures down to date, Swaine substitutes for their bold frontal attack upon the Supreme Court's views a more subtle attempt to restate them as not really thwarting the practical conduct of a reorganization. *Reorganization of Corporations; Certain Developments of the Last Decade* in id. (ed. of 1930).

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and occasional adaptation of their form to the whims of an angry god, there is likely to be very little interference with the actual plans of those who walk the earth below.

A temptingly simple explanation of why the practical reorganizer has always scorned the ideals expressed by the Supreme Court, is that the practical reorganizer is a wicked manipulator, who by corruption of counsel, misleading suggestions and threats of forfeiture, obtains the support of the vast majority of all classes of security holders for some unfair plan, and thereby puts it over on a hand-picked receivership judge who is too dull to see through the semblance of unanimity or too weak to risk the responsibility of running the reorganization himself.[10] No doubt the subservience of receivership judges to practical considerations is due partly to the reorganizer's ability to maneuver the proceeding before the most acceptable of several possible judges, his opportunities for ex parte insinuation before hostile interests can become articulate, and his ability by pressure and use of patronage to dominate supposedly independent receivers, trustees and committee men. But it is easy to exaggerate the extent to which reorganization judges are actually deceived by the conventional reorganization fictions, and the degree to which they may differ in perspicacity from the Supreme Court justices who have been so impatient with these same fictions. It is much more plausible to attribute their different outlooks to the different roles played by lower court and appellate judges in reorganization.

Allowance must be made for the difference in the pressure of practical considerations while reorganization is still in progress and after it has been completed. With those whose investments are still in jeopardy, avarice proves a far more compelling motive than vengeance. Bondholders will acquiesce in a plan that seems unfairly preferential to stockholders if compromise on this basis seems to involve the greatest chance of minimizing their loss. They will surrender unlimited powers over their investments to banker-sponsored committees, despite feelings of grievance against the bankers. Very few are so stubborn and vindictive as to be willing to fight for principles without regard to cost. Usually there are some shrewd enough to see the bargaining power of a small minority obstructing the general desire to compromise. These may pretend that they are fighting to assert their rights against unfair demands of stockholders or corrupt manipulations of bankers, but their avarice is thinly disguised. Invocation of punitive ideals by knights errant of the bar, who purchase securities for their hold-up value, may also be

10. The best expression of this point of view is by Max Lowenthal in various articles and in his book THE INVESTOR PAYS (1933). The mixture of admiration and skepticism which the writer feels for Lowenthal's interpretation has been set forth in a review in (1933) 43 YALE L. J. 352. See also Douglas, *Protective Committees in Railroad Reorganizations* (1934) 47 HARV. L. REV. 565.

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set down to avarice. Those wishing to compromise feel toward these antagonists much as union laborers do toward "scabs." When stockholders use their strategic position to obstruct as a basis for getting better terms than they are theoretically entitled to, it is not considered blackmail. The term is reserved for the dissenters and knights errant. Thus those who champion the punitive ideal before the reorganization judge are made to appear far more loathsome than the stockholders against whom it is directed. Moreover, the stockholders of a large corporation include many unsophisticated investors, "widows and orphans" who have had nothing to do with the past promotion and management.[11] It seems cruel to wipe them out. Many of the actual promoters and those close to the management may have unloaded.

Inevitably the reorganization judge sympathizes with those who want to compromise. Day to day concern for the practical problems of running the business and impatience to get it off his hands tend to cool whatever punitive passions he may initially feel. He may even try to force the pace if haggling committees are slow in reaching agreement. He is predisposed to welcome any pressure of fiction or steamroller tactics which seems likely to accelerate the process. If a plan otherwise capable of enlisting the necessary formal support, happens to violate the principles laid down in Supreme Court decisions, he will wink at technical evasions and sophistries. If the distinguished counsel who advocate the plan think they can defend it on appeal or use the lower court's approval to effect a settlement with dissenters, that is their lookout.

After reorganization has been accomplished, it turns out that the punitive ideal has only been submerged, not extinguished. Practical considerations are now no longer compelling. Bondholders who have compromised remain dissatisfied and their grumblings cost them nothing. Accumulation of private grumbling may lead to public investigation. The typical reorganization plan preserves for bondholders as much as possible in fixed and preferential charges, and appeases the stockholders largely in securities whose value depends upon an upturn in earnings. If in fact the upturn comes, then bondholders regret not only the extent of the concession made to stockholders but also its form. Actual market

11. The last decade or so has seen a much wider extension than ever before of the classes of people who buy corporate securities. Some of this has resulted from the customer ownership campaigns among the public utilities. The original political objective of mobilizing a larger vested interest in defense of their rate structures has in some instances been supplanted by a desire to obtain capital by sale of securities for more than they would bring in the ordinary investment market. See Jules I. Bogen, *Investment Banking* (1932) 8 Encyc. Soc. Sciences 268, 272. For criticism of the practice of marketing holding company securities to operating company customers see, C. B. Kefanver, *Joyride in Associated Gas* (1933) 77 New Republic 66-68, 94-97; cf. Re N. Y. State Electric & Gas Corp. [1932E] P. U. R. 1; N. Y. State Electric & Gas Corp. v. Maltbie, 147 Misc. 560, 264 N. Y. Supp. 97 (Sup. Ct. 1933), rev'd, 241 App. Div. 780, 270 N. Y. Supp. 1010 (3d Dep't, 1934).

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quotations reveal that what was claimed to be an inconsequential concession is now in fact of great value. Those who have all along protested the iniquity of the settlement begin to sound more plausible. If they have not settled for the cash value of their power to obstruct they cannot now be characterized as blackmailers. There is glamour in the stubbornness of their lone and protracted struggle against the powerful in law and finance, contrasted with the supine acquiescence of all others in the "unfair" plan. Hindsight reveals the reorganization as a racket and they can say: "I told you so."

The lucky litigant who gets his objections before the Supreme Court years after the reorganization has been accomplished thus finds an ideal setting for the vindication of punitive ideals. Practical objection can be made only by appeal to the remote sanction of possible obstacles to future reorganizations. It must overcome the feeling that perhaps this is a wholesome consequence. If promoters and managers learn the limits of what they can get away with in reorganization, they may be more cautious, and caution on their part may prevent occasions for future reorganization.

If emphasis is shifted from reorganization to the whole process to which it is incident, there is much to be said for the Supreme Court's leanings toward strict enforcements of creditors' prior rights. The notorious dangers of complicated and pyramided financial structures are familiar. It is sufficient to summarize the conventional criticisms and defenses, and to show how the dangers are increased, and how important sanctions of self-interest, relied on to keep promotion and management within conservative bounds, fail or falter because stockholders so seldom bear their expected share of the burden of financial collapse.

Even a relatively simple capital structure may afford striking illustration of these dangers. Suppose that a corporation's capital has been contributed 70% by mortgage bondholders and general creditors, promised 6% interest, and the other 30% by stockholders who are running it; and suppose there is a potential choice between a relatively conservative managerial policy likely to net 7% on the total capital invested, and a more reckless one which if successful will net 10%.[12] The alternative re-

12. The choice between a conservative policy which promises moderate returns and a speculative one which may bring either large returns or disaster is common enough in business, although one would not expect to find situations where the relative chances of risk or gain could be reduced to actuarial calculations. The choice may be between expanding the plant to meet a possibly temporary increase in demand, and turning down orders; between keeping an ample reserve in cash or quick low-yield assets, and using the same funds for nonliquid high-yield investments; between making forward commitments for raw material in the hope of getting profits in case the past rising price trend continues, and hedging; between conservative and speculative investments for an investment company. Suppose the company is organized to finance installment sales; it may accept only Grade A risks which will limit it to a 7% return on capital employed or be less particular and

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sulting surpluses for the stock are 9 1/3% and 22 2/3%. In the language of the investment community the stock has "leverage." The more extreme the pyramiding, i.e., the ratio between the investment of the managerial group and that of others, the more striking is this leverage. Too much leverage for the controlling group is regarded by conservative critics as unsound. They regard the strain upon human frailty as too great since the less cautious the managers are, the more they stand to gain.

The typical promoter's answer is that leverage works both ways. The greater risks of those in the equity position are supposed to balance their greater chance of gain. Fear of increasing their own risks is supposed to be a sufficient deterrent to speculative management. This defense ignores the discrepancy between the presuppositions of finance and what has been the history of corporate reorganization. It assumes liquidation as the normal consequence of corporate failure, and that liquidation will occur just as soon as the shrinkage in gross assets has wiped out the theoretical margin for the equity group. This unreal assumption might make it possible to liken the speculative management group to a person engaged in an honest game of chance, who can play to win 200% profit only by running a 2 to 1 chance of losing his stake.

Let reorganization enter the picture and the analogy changes. The long-run tendency of stockholders to wring concessions from those theoretically ahead of them amounts to loading the dice in their favor. As an extreme illustration, suppose the common stock is all "water", i.e., return for promotional services. Suppose the reorganization plan scales down prior fixed charges and still allows the common stock to retain an interest. There has been only a nominal risk, a chance at a large share of whatever winnings there might have been; yet failure and sacrifice for everyone else may leave the holders of this water closer to actual dividends than before. To the extent that reorganization leads to such results the indirect influence on financial policy and management becomes appalling. When cold calculation reinforces the inevitable gambling spirit which it ought to temper, recklessness may become prudence.

However much punitive zeal for strict enforcement of stipulated priorities may be stimulated by desire to discourage pyramiding and speculative management, once a financial pyramid is an accomplished fact, and failure is impending, the danger to senior investors from the antagonistic self-interest of the management becomes a powerful inducement for practical compromises. The outlook of those who made and sponsored the senior investments will not be what it was when heaven lay round about the infancy of the corporation.

get 10%. In each case the expected return may make an allowance for bad risks equal to average experience for the recent normal, prosperous, or boom time years. The real difference in the probable consequences of the two alternative policies hinges on how soon there is likely to be a depression.

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In the beginning there may have been confidence that earnings would cover senior charges by an ample margin and leave a generous surplus for the common stock. Such hopes tend to divert attention from the difficulties of enforcing the priorities promised senior claimants and the possible impact of the financial set-up upon managerial policies. They also tend to make more experienced investors and sponsoring bankers, who may think of such risks, dismiss them as negligible.

But when actual earnings fall short of expectations the latent dangers of the stratified financial structure assume prominence. Declining quotations for the junior stock may make it easy for piratical speculative groups to buy up control. Even without this, there is likely to be difficulty enough with a stockholder management of only ordinary business morality. The more important bondholders and, above all, the sponsoring bankers begin to appraise the delays and uncertainty of the bondholders' legal remedies and to consider the danger of meanwhile continuing control in a management which can see no more hopeful way to any return on its own investment than by gambling against odds or using its strategic position to bludgeon concessions from those with prior claims. If the junior equity had no chance of improving its position by reorganization, its temptation would be to hang on as long as possible to the indirect perquisites of control and the forlorn hope either that desperate speculations will succeed or that general business revival will restore the particular company's prosperity.

It is a long and difficult process to dislodge a recalcitrant management. It has power to retard by months or even years those "events of default" which by the terms of the indenture condition rights to accelerate the maturity of long-term bonds. Matured claims may be disputed. Insolvency may be denied and evidence of it concealed. Meanwhile free assets may be pledged, perhaps in secret violation of covenants,[13] preferences may ripen into undisturbable liens, plant maintenance may be utterly inadequate, increasingly shoddy products and services may gradually destroy good will. Accumulation of unpaid wage claims may impair the morale of the operating staff and create claims with either legal or compelling moral priority.

When creditors finally succeed in getting a legal custodian appointed, they find the cupboard bare indeed. Then comes a battle as to whether the judicial administration shall be directed primarily to enforcement of creditors' rights or to conservation of alleged equities in the stock. Judicial sale may be delayed by invoking one of the most ancient traditions of equity—that of the chancellor protecting a poor debtor from

13. Cf. *First Report of Receivers for Middle West Utilities Co.*, (1933) 136 COMM. & FIN. CHRON. 4447. New York Times, March 5, 1935, at 29, col. 1 (report of suit in behalf of bondholders of Insull Utilities Investments Corporation).

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the rapacity of forfeiture-exacting creditors.[14] This picture, carried over from the economy of petty trade, is kept alive by the conventional reorganization patter about permitting stockholders to preserve their equity by paying an assessment. In the conditions of general business depression which accompany most reorganizations the stockholders gain strength from the universal clamor of debtors for relief against their creditors. Bondholders are made uncertain how far they may obtain the full measure of relief prescribed in an indenture.[15]

Even where the senior capital is represented by a single issue of bonds with a closed first mortgage, the stockholders may sometimes derive advantage from superior facilities for compact organization and from their wider affiliations in the financial world.[16] To the extent that they own bonds, or through indirect pressure can control some bondholders or those to whom bondholders might naturally look for leadership, they may cause division in bondholders' counsels. In ostensible solicitude for bondholders, specious objections may be made to a plan which just because of its favorable treatment of the bonds impinges on the ob-

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14. "Those who are subordinate to the first lien have opposed it [foreclosure] bitterly, since they earnestly believe their expectations to be of the nature of a vested interest, which should not be interfered with so long as they are willing to bear some sacrifices for the realization of those expectations. Almost endless and titanic litigations have been the result. Courts have leaned against the strict forfeiture of equities of redemption forever cutting off such contingent but vast pecuniary interests. An unwritten law of adjustment, depending neither upon statutory sanction nor upon direct acknowledgment in the opinions of courts, has come into existence, based on the recognition of what may be called an ethical patriotic sentiment—that it is a hardship to disappoint expectations resting upon the faith of the development of our common country. The absolute right of foreclosure, while admitted in theory, is made so difficult of accomplishment in practice that it amounts almost to a denial of a contract obligation of the railway mortgagors." Simon Sterne, *Railway Reorganization* (1890) 10 FORUM 37, 40.

15. The bondholders who sought foreclosure by intervention in an equity receivership were subject to uncertainty both as to when they could get a sale and whether the court would confirm a bid low enough to make reorganization possible. Sections 77 and 77B of the Bankruptcy Act substitute an uncertainty as to whether the court will find the plan to contain adequate provision for the realization of stockholders' equities, or find the corporation insolvent.

16. As where a powerful holding company initiates a plan for reorganization of a subsidiary. The holding company may also be a creditor. It may ostensibly participate in that capacity alone, but its dominance of the entire situation can not help affecting its participation as creditor. See Southern Pacific Co. v. Bogart, 250 U. S. 483 (1919); Mountain States Power Co. v. Jordan Lumber Co., 286 Fed. 217 (D. Mont. 1923), aff'd 293 Fed. 502 (C. C. A. 9th, 1923), cert. denied 264 U. S. 582 (1924). See a plan dated July 24, 1933 for reorganization of the Lexington Water Power Co. (1933) 136 COMM. & FIN CHRON. 4266; (1933) 137 id. at 865. The plan was later abandoned. See (1934) POOR'S PUBLIC UTILITIES 137. For other similar plans see Atlantic Gas & Electric Corp., (1933) 136 COMM. & FIN. CHRON. 156; Kansas State Telephone Co., id. at 327; Federal Public Service Co. plan (1933) 137 id. at 4012; Deep Rock Oil Corp. plan (1934) 139 id. at 1399.

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jectors' major interest in the stock. Objections may be emphasized by withholding or withdrawing deposit of the bonds controlled.[17]

Where the senior capital is represented by an elaborate hierarchy of claims, one group may be played off against another. While still in control of the corporate machinery, the junior stock may threaten long-term creditors with preferential treatment of short-term obligations, and short-term creditors with events that will accelerate maturity of the funded debt. Above all, holders of long-term junior bonds and preferred stockholders may be threatened with defaults on the senior mortgages. After a default, stockholders may co-operate with the senior mortgagees, obtaining for their co-operation a scaling down of junior claims ahead of theirs.

So wide are the possibilities of variation in corporate financial structures and in the minor incidents of reorganization that it is easy to lose sight of the basic problems. Analysis is much simplified if we confine ourselves to reorganization problems as they appear to whatever group

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17. Illustration of the possibilities, at least, is suggested by the various plans and campaign statements issued in connection with the struggle to reorganize the Fisk Rubber Company in 1932. The following account is offered as a matter of interpretation of this obviously biased controversial evidence. The writer has no direct information as to the actual conflict of ambitions, personalities or issues of business judgment.

The first plan was offered January 25, 1932 on behalf of committees who represented slightly less than 50% of the bondholders and who had failed to reach agreement with a stockholders' committee. The plan contained a subscription offer which was not underwritten, but the committee was prepared to proceed with the existing working capital in case no more should be made available. It offered bondholders and creditors no cash and no interest-bearing obligations, merely preferred and common stock. If subscriptions were not exercised this would be the entire stock, except for some common stock to be given, and some to be subject to option rights extended, to a new chief executive. Even if all the subscription privileges were exercised, the old creditors would hold a substantial majority of the stock. Subscription privileges to additional preferred and common stock were offered to each class of creditors and stockholders. Stockholders were offered nothing further. If we accept the proponents' judgment on various debatable questions of business policy (their opponents suggested no reason to doubt their good faith) the plan was as favorable to bondholders as it was unpalatable to stockholders.

Without waiting opportunity for legal obstruction, the stockholders' committee at once began a campaign to discourage bondholders' acceptance of the plan. One large bondholder joined this opposition. As such he appealed to his fellow bondholders, disclosing incidentally that he was also a stockholder, but not saying in which capacity he was most largely interested. While debate was raging, an independent bondholder-group sprang up, urging the maximum distribution of cash, and intervened in the receivership to insist upon an immediate payment on account. This apparently frightened the original bondholders' committee into a settlement with the stockholders and the large bondholder who had sided with them. The new plan involved a substantial cash payment to bondholders, the cash to be supplied by assessing the stockholders. The inducement to obtain this cash from stockholders meant far better terms for them than the earlier plan had proposed. There was also a modification of the proposals for change of management. See (1932) 134 COMM. & FIN. CHRON. 1033, 1202, 1381, 1769, 2157, 2348, 3987, 4164; (1932) 135 id. at 1662, 2344; (1933) 136 id. at 2618, 4096.

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of security holders has the major stake in getting reorganization accomplished. This is the group which is faced with the probability of some loss but which has substantial hopes of salvage. If it can avoid ultimate loss, it can do so by only a narrow margin. For convenience we shall hereafter refer to it as the marginal group. It may consist of the first mortgage bondholders or junior bondholders or unsecured creditors. Creditors senior to the marginal group are probably so amply secured that they have no need to bestir themselves about reorganization. But if prospects for the business should change during a prolonged period of reorganization negotiations, the marginal status may shift from one group to another.

Meeting interest requirements on the senior claims—or principal if they are matured—is simply one problem which confronts the marginal group. A second problem is dealing with dissenters and with those theoretically subordinate to the marginal group in the hierarchy of claims. The hypothesis that the marginal group is not adequately secured implies that creditors junior to them, and above all stockholders, have only remote expectancies of receiving anything in case the stipulated order of priorities should be observed. Delay pending an upturn in business may conceivably ripen this remote expectancy into something more substantial—but delay means further accumulation of prior charges and perhaps also added costs and loss of earning capacity. Usually the value of the junior claims is essentially a hold-up value. As a group their bargaining strength lies in their having little left to lose and some power to obstruct those who still have much to lose. Dissenting members of the marginal group, in proportion as their holdings are small compared with the majority's, have relatively less to lose, and in turn may force concessions from the majority if they have any power to obstruct.

Thus far attention has been focused principally upon the obstructive capacity of stockholders and the ethical objections to their using it to advance themselves beyond their theoretical position in the hierarchy of claims. Junior creditors and dissenters would have a relatively insignificant power to obstruct but for the fact that equitable weapons developed ostensibly to curb the stockholders have incidentally played into their hands. The same individualistic tradition which condemns stockholders for trying to evade the stipulated consequences of failure insists upon aiding only those creditors who are vigilant and aggressive in fighting for their rights. Bondholders who acquiesce in an unfair plan are held as rigorously to the new bargain as the stockholders should theoretically have been held to the old. Thus the "strikers"—whether entire groups of opposing creditors or dissenters—who alone are free to challenge the unfair benefit to stockholders, may take advantage of what has been yielded by the consenting bondholders. Where such a windfall to strikers is not expected, or where the stockholders are in

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a strong enough bargaining position to refuse to assume this risk, it may happen that the burden of any recovery by strikers will fall primarily upon the victimized assenting bondholders. The Supreme Court condemnation of devices to advance the stockholders over creditors has not relieved the unfortunate marginal group from the necessity of paying toll to stockholders as a condition to realizing effectively upon their security. It has sometimes forced them to pay an additional toll to dissenters and junior creditors as a condition to being permitted to appease the stockholders.

Whatever the legal obstacles to compromising with stockholders, the pressure to do so is overwhelming. The practical reorganizer sees only the absurdly wasteful alternative of waging a war of attrition for the eventual possession of a gutted and shell-torn corporation. The scattered character of the parties whose interests are to be compromised and the necessity of circumventing legal obstacles tend to drive the process of compromise underground. The extra-legal government of the financial community operates through pressures and loyalties, patronage and compulsions far too subtle to be set forth in terms of offer and acceptance.

The initial step of invoking judicial administration of the property by instigating a friendly receivership or filing a petition for reorganization in bankruptcy will come long before it is possible to commit bondholders to any promises. It may be taken, however, at the suggestion of the banker who has sponsored the bond issue, and to whom the bondholders will look for leadership in reorganization.[18] The ability to get reorganizations done is said to depend largely upon the prestige of the banker who assumes to direct. This prestige involves both a reputation for getting reorganization done and for dealing fairly with those who put themselves in the banker's power. Willingness of the management to surrender at a hint from the banker will usually imply that the management will be confident of receiving fair treatment for stockholders in the eventual reorganization plan. "Fair" treatment according to the business view implies some recognition of the value to the senior claimants of the obstructive powers surrendered—precisely what the Supreme Court would regard as unfair.

Sometimes the management itself takes the initiative in arranging for a judicial administration. This is particularly likely if there is no agres-

18. See Cravath, *supra* note 9, at 156-161. DEWING, FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934) 1104, 1119. Cravath assumes that the banker who issued the corporation's bonds will normally take the initiative in arranging for a friendly receivership. Dewing perhaps tacitly makes the same assumption, but begins his description of the practice with the decision of the debtor's directors to arrange a friendly receivership. For an account of the procedure followed in the St. Paul case, see LOWENTHAL, THE INVESTOR PAYS (1933) 131-145.

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sive or independent banking sponsorship for claims which the management hopes to scale down. The management may feel that whatever loss of bargaining power is incident to this nominal surrender of control is outweighed by other advantages. Receivership or bankruptcy serves to dramatize the crisis in corporate affairs and helps to prepare the minds of security holders for accepting some sacrifices. It may be desired to guard against attachment. The management's confidence of being able to come to terms with the bondholders usually makes it anxious to conserve quick assets so that more will be available to divide between bondholders and stockholders. Perhaps a friendly judicial administration is rushed to forestall an unfriendly one.

The extent to which there may have been co-operation rather than bickering as to the handling of the corporate affairs pending reorganization is only one of the many variables which tend to shape the ultimate compromise in the reorganization plan itself. There is a question as to the proportionate sharing of each group in the aggregate speculative value attributable to the property. This aggregate is usually reflected in market quotations. There is also a question as to the form of securities which shall embody this expectancy. It may be that the aggregate of market values can be enhanced by using securities which place the minimum emphasis upon deflations of past hopes consistent with avoiding too great a risk of subsequent insolvency.

The actual forms used will depend upon prevailing popularity with investors at large of particular types of securities, peculiar variations which may have appealed to persons dominant in the negotiation of the plan, the probability of challenge by strikers, together with current legal opinion as to what is least likely to be upset in the light of existing precedents. The controlling precedents are a handful of Supreme Court decisions. Attempt will be made to examine these decisions for their impact upon the actual reorganizations dealt with, and for their effect upon subsequent reorganization practice. Except for an early decision before the reorganization technique had been fully perfected it appears that the court has not been very effective in preventing arrangements "by which the subordinate rights and interests of the stockholders are . . . secured at the expense of . . . prior rights. . . ."[19] In fact the whole substantive law of reorganization is a memorial to the evasions of this simple prohibition.

The Howard Case

The Supreme Court decisions which condemn practical compromises with stockholders go back to *Chicago, Rock Island & Pacific Rail-*

19. Louisville Trust Co. v. Louisville & C. Ry., 174 U. S. 674, 684 (1899).

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road Co. v. Howard.[20] Here there was no assessment and it was clear that the only consideration for the stockholders' participation was non-exercise of power to obstruct creditors. Outsiders happened to be interested in the properties of a debt-burdened road, at a price below the aggregate face value of its mortgages. The mortgages amounted to $7,000,000 and the offer was $5,500,000 in new bonds to be secured by the same and certain additional properties. Stockholders' co-operation was enlisted by a promise of 16% of par. This made it necessary to scale the participation of the lowest ranking mortgage-bondholders to only 30%. The alternative was delay, possible loss of the outside bid and the risk of being wiped out by strict foreclosure of the senior mortgage. It was not proposed to offer anything to the holders of certain municipal bonds which had been issued in payment for stock and sold with the guarantee of the debtor road.

Committees of bond and stockholders having concluded the bargain, the problem remained to make it effective against dissenting junior bondholders who might want more than 30%, and against the holders of guarantees. As yet there was no conventional way of handling this problem. The machinery utilized was an uncontested foreclosure sale. The mortgagor joined in the conveyance and the trustees released their mortgages. The formal bid was only $2,200,000. Whether frightened by the low bid and the possible alternative of losing everything, or satisfied with the compromise payment of 30%, no junior bondholders ventured to litigate.[21] The legal challenge to the plan came from the ignored holders of guarantees. They managed to reduce their claims to judgment and as judgment creditors successfully levied equitable attachment upon the still undistributed fund for stockholders.

Both argument and opinion rested on narrow grounds. It was clear that prior to the arrangement there had been no surplus for unsecured creditors. Otherwise junior bondholders could not have been induced to accept so small a percentage of their claims. Therefore, argued the stockholders, unsecured creditors could not complain if bondholders permitted part of what was rightfully theirs to be used to appease stockholders. But the judgment creditors convinced the court that bondholders had agreed with the corporation as such, to settle and release their mortgages on a basis that did not exhaust the proceeds of sale. The surplus was, therefore, an unencumbered corporate asset. Of course it followed that creditors could reach it ahead of stockholders.

20. 7 Wall. 392 (U. S. 1868). For an interesting analysis of this case see Jerome Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganizations* (1933) 19 VA. L. REV. 541. Frank's analysis stresses the fact that old security holders were interested in the purchaser corporation, and thus emphasizes the similarity of the arrangement to the typical reorganization.

21. Some dissenting bondholders had originally instituted the foreclosure proceeding but they were bought off. With the control of their suit thus obtained it was continued in furtherance of the plan.

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In thus overriding the obvious intent of the parties to the arrangement the court avoided formulating any broad equitable principles. It did not have occasion to do so until the *Monon*[22] case thirty years later. The interval was a critical period in the development of reorganization practice. It was a time of rapid growth and frequent collapse of railroad systems. Leadership in reorganizations got centralized in a narrow group, accelerating the standardization of techniques. The reorganization bar did not have to reckon with any generalized denunciation of the inevitable concession to stockholders. The *Howard* case indicated the Supreme Court's feeling that it is inequitable to permit stockholders to capitalize their strategic position to obstruct, but the pressure of circumstances made reorganizers prefer not to take the hint. Then as now, in the complicated strategy of reorganization, guesses as to how the Supreme Court might react to a plan, in the unlikely event that some small group of objectors should get before it, counted for little. Much more important was the prestige and skillful use of techniques of persuasion by those who assumed to direct; their arrangements to dispense patronage and to finance elaborate campaigns of propaganda; their shrewdness in conforming to the prejudices and standards of fairness of the business community where these happened to be at variance with equitable standards set forth in law books. The *Howard* case did not block compromises with stockholders; it was merely an isolated reef to be avoided. Later cases indicated other reefs and shoals, but as each was carefully noted on the navigator's charts, it still remained possible for a skillful pilot with average luck to find a way through.

Legal ingenuity and varying business conditions usually make it possible to give to a scheme of reorganization some form which is not clearly invalidated by any of the existing precedents. It is possible to classify roughly under three heads the ways in which reorganizers have sought to escape the naive expression of the compromise with stockholders which the *Howard* case had proved to be vulnerable: I. Making the reorganization appear to involve only a voluntary exchange of new securities for old, and leaving seemingly undisturbed the existing rights of nonparticipants. II. Introducing complicated contingencies into the settlement as an obstacle to contestants' meeting the burden of proving that stockholders have been advanced at the expense of creditors' rights. III. Covering up the concession to stockholders in the terms of a sale to them of new securities. The first two will now be discussed in order; the third, postponed until a subsequent article.

I. Pseudo-Voluntary Reorganizations

In the early nineties an arrangement was made to turn over the newly

22. Louisville Trust Co. v. Louisville & C. Ry., 174 U. S. 674 (1899).

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built and disappointing Chattanooga, Rome & Columbus Railroad to a subsidiary of the Central Railroad and Banking Corporation of Georgia. First mortgage bondholders were to have their claims assumed, junior bondholders were to receive 15% of face value and stockholders 7½% of par in new bonds. Nothing was offered to general creditors. The settlement was strikingly similar to that involved in the *Howard* case, but whatever counsel arranged the plan was evidently too bold and too ingenious to regard the *Howard* case as an insuperable obstacle. Instead of transferring the properties by foreclosure sale, releasing the mortgage and thereby making room for an argument that the corporation as such was settling with secured creditors and leaving an attachable surplus for dissenters and junior creditors, the road was leased for a consideration that could not be attacked as inadequate, but which left no surplus, and the exchanged securities were kept alive. The new bonds were bonds of the lessee guaranteed by its parent the Central. In consideration of its guarantee the Central received the old junior bonds and stock. If the lease was challenged the assets would nevertheless remain subject to the mortgage, a dominant majority of the bonds would be held by the Central, and it could choose its own time for foreclosure.

The scheme seems to have enlisted enough exchanges by junior bondholders to make it worth while to go ahead, and it probably appeared invulnerable to such of them as were dissatisfied, as well as to most of the general creditors. Challenge came only from the stubborn holder of one small claim, who may have been emboldened by an alternative theory that local statutes gave his claim priority over the recorded mortgages. He insisted that there was a fraudulent conveyance and attached the property which had been turned over to the lessee. His attachment was sustained. The decision sustaining it was affirmed by a strong Circuit Court of Appeals consisting of Taft, Lurton and Severens.[23] Taft's opinion anticipates Brewer's sweeping language in the *Monon* case.[24]

> "Any device by which the assets of an insolvent corporation are to be parcelled out between shareholders, leaving creditors unpaid, is a fraud of which creditors affected may complain. . . . The shares were manifestly worthless. The price paid for them was really a part of the price paid for the corporate property. . . . For their assent to the sale they demanded and received a part of the consideration to be paid for the corporate property."[25]

23. Chattanooga, Rome and Columbus Rr. Co. v. Evans, 66 Fed. 809 (C. C. A. 6th, 1895). For further information see (1891) POOR'S MANUAL OF RAILROADS 91-97, 410-415. The Central owned all the stock of the Savannah & Western, which leased the Chattanooga. There had been no common directors as between the Chattanooga and the other roads. The Central had become a part of the Richmond and Danville system in 1888. See DAGGETT, RAILROAD REORGANIZATION (1924) 165.

24. Louisville Trust Co. v. Louisville & C. Ry., 174 U. S. 674 (1899).

25. Chattanooga, Rome & Columbus Rr. Co. v. Evans, 66 Fed. 809, 822 (C. C. A. 6th, 1895). The fact that this one creditor perfected an attachment upon the assets transferred

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One weakness of the arrangements involved in both the *Howard* case and the *Chattanooga* case was that the exchange of securities accompanied, and was obviously related to, the contemporaneous transfer of all the corporation's assets. It was only necessary to establish the doctrine that when an embarrassed corporation transfers all of its assets, benefit to the stockholders is, by disregard of the corporate fiction, equivalent to benefit to the debtor.[26] Such transactions would then clearly constitute fraudulent conveyances. This technical weakness might seem to be obviated by providing for an exchange of new securities for old, without explicitly contemplating any transfer of assets. The corporation as an accounting entity would have the same assets and liabilities as before. Nondepositing junior bondholders would hold the same proportionate interest in the same lien, and general creditors would be subordinate to the same lien as before. While the arrangement for unified control of the participating bonds and stock would leave nonparticipants in a position of hopeless insecurity, it might be difficult for them to persuade the courts to take cognizance of such an intangible method of coercion. The transferee as holder of a dominant majority of the old bonds and stock could choose its own time to precipitate a foreclosure sale at which it would be the only possible bidder.

This device was an incidental feature of the reorganization in 1899 which gave rise to the present Kansas City Southern Railway.[27] The plan contemplated unified operation of the properties of three companies called for short the "Gulf," the "Dock," and the "Belt." The Dock Company was at the southern terminus and the Belt at the northern terminus of the Gulf road. There was to be immediate foreclosure of the main

to the lessee did not mean that the elaborate subterfuge to avoid the *Howard* case had failed to serve its purpose for this reorganization. It is probable that all of the junior bondholders had long since accepted their 15% in new bonds, unaware of the opportunity of dissenters to obtain 100% in cash, and that general creditors' claims at large had been disposed of cheaply enough as a result of ignorance, inertia, nominal settlements and the statute of limitations.

26. See Gerdes, *A Fair and Equitable Plan of Corporate Reorganization Under Section 77B of the Bankruptcy Act* (1934) 12 N. Y. U. L. Q. Rev. 1, 16. The disregard of the corporate fiction is implicit in treating the stockholders collectively as the debtor; but neither the Supreme Court decisions nor the commentators upon them have bothered to articulate the problem in these terms. Assuming as a starting point that the corporate fiction will be disregarded makes the problem look too easy. Such an assumption permitted Frank to jibe the leaders of the reorganization bar for not seeing, as any country lawyer would, the inevitability of the Supreme Court decisions which have characterized their conventional practices as fraudulent. The country lawyer would have seen that stockholder's participation is equivalent to a farmer mortgagor's purchasing at the foreclosure of his own mortgage. See Frank, *supra* note 20, at 549. If Frank intended more than a playful nose-tweaking of some of his brethren, he fails to give them their due. Some country lawyers may have won their *Boyd* cases, but the reorganizers have won the campaigns.

27. Kansas City Southern Railway Co. v. Guardian Trust Co., 240 U. S. 166 (1916).

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line Gulf mortgage, transfer of its properties to the new company, and assessment of the Gulf stockholders as a condition to participation. With these conventional features we are not here concerned. In addition the plan contemplated exchange of securities of the new company for stocks and bonds of the Belt and Dock without immediate foreclosure of their mortgages, and without assessing their stockholders. The securities offered Dock bondholders were contemporaneously quoted at only about half the face amount of their bonds.[28] Nevertheless, there is no record of any challenge based on the participation awarded to the Dock stockholders.[29] The Belt bondholders had no reason to complain because they received new securities worth the full face value of their old bonds.[28] There was a prolonged litigation with the Guardian Trust Company, which ultimately established its status as a general creditor of the Belt

28. See quotations supplement to (June 2, 1900) 70 COMM. & FIN. CHRON. Contemporary market appraisal can only be approximated as there was not a wide market for the Dock and Belt securities, and the new Kansas City Southern securities were not traded in until some months after the plan was declared effective. There were however interim quotations for the old Gulf bonds and stock. These were tolerably stable and thus indicate the relevance of the later quotations for the new securities as indicating about what they seemed to be worth when the plan was announced. Taking 17½ for the new common (sale price April 19, 1900), 42 for the new preferred (low of 41 on April 6 and high 43 on April 3) and 60⅜ for the bonds (first sale May 18) the participation offered Dock Bondholders would be worth approximately $625 per $1000 face value of old bonds, whereas Dock stockholders would receive securities worth $130 per $1000 of par value. Belt bondholders received securities worth the full face value. Belt stockholders received securities worth $230 per $1000 par value.

29. Two competing groups had attempted to effect a reorganization, a Philadelphia group and a New York group. The Philadelphia group's plan was first announced and involved the reorganization of all three companies. The New York plan (Aug. 31, 1879) was urged as more favorable to Gulf security holders. It advocated reorganizing the Gulf first and then letting the reorganized company continue negotiations with the other groups or make other arrangements for terminal facilities. There were also competing theories as to the amount of fixed charges which the reorganized road could safely carry. The plan finally adopted was a compromise. It is a fair inference from the campaign documents that those active in the struggle were competing to control the reorganized system and perhaps there was also a minor issue as to the relative value of each of the three properties involved—but no sharp cleavage between Dock bondholders and Dock stockholders, because they were largely the same persons. The few who held Dock bonds and not Dock stock would be likely to accept the plan because it was recommended to them, and not suspect that those who recommended it had any ulterior motives at stake. See (1899) POOR'S MANUAL OF RAILROADS 555; (1900) id. at 658. For preliminary plans see (1899) 69 COMM. & FIN. CHRON. 384, 440, 491. E. H. Harriman was connected with the New York group. When the Philadelphia group came to terms with the New York group this incidentally involved the prospect of friendly rather than unfriendly relations with the Union Pacific, Chicago & Alton "and other important systems." Id. at 956. Dutch investors, bargaining collectively, held a majority of the Dock and Belt securities; also a substantial amount of Gulf securities. Id. at 1257. When the compromise plan was declared operative on Dec. 18, 1899, deposits claimed included $1,489,000 out of $1,545,000 Dock bonds and $1,575,000 out of $1,635,000 par of stock. Id. at 1346.

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and as such was held entitled to payment in full by the new company, which had meanwhile caused a foreclosure of the Belt mortgage and bid in the property in its capacity as bondholder. In behalf of the new company it was solemnly argued that the exchange of securities was a thing quite independent of the subsequent foreclosure sale, and therefore of no concern to nonparticipants; and that the new company acted strictly according to its rights in using its holdings of Belt bonds to acquire the Belt properties at the ultimate foreclosure sale.[30] Answering this argument Mr. Justice Holmes said,

"But the ownership of the Belt road by the new company was contemplated from the first and although no fraud on creditors was suggested or intended in the plan,[31] still the Court of Appeals was justified in regarding the whole proceeding as one from the start to the close and in throwing on the appellant the responsibility of so carrying it out as to avoid inequitable results."[32]

The *Kansas City Southern* case does not go far toward establishing a basis for equitable control over so-called voluntary reorganizations. It was something to have established the substantive principle that reorganizers and their corporate instrumentalities are to be fixed with responsibility for so carrying out their plans "as to avoid inequitable results" no matter how subtle the means employed; whether they employ the traditional immediate pressure of judicial sale or some remoter and more intangible pressure that comes from arranging for a weakened strategic position with reference to ultimate liquidation, at an unpredictable future date, of those who do not participate in the plan. But here, as elsewhere in dealing with complex corporate problems, the procedural imponderables may be far more important than substantive principles. Unfortunately the procedure which happened to result in eventual victory for the Guardian Trust Company would not be worth much to relieve the average small bondholder from pressure to acquiesce in a plan he believes inequitable. The Guardian Trust Company had a large claim not dealt with by the plan; it was not confronted with any choice between receiving something under the plan and waiting to assert its claim against the reorganized company; and there was no long delay by the new corporation in foreclosing the mortgage on the Belt company. By contrast, a dissatisfied bondholder may have a relatively small amount at stake, and will be obliged to forego accepting what is offered him under the plan if he insists that he is entitled to more. Besides the familiar

30. See Point XI, Brief of appellant and petitioner before Supreme Court, at 136-138.

31. The plan suggested some payment to creditors as among the objects for raising new money. One of the issues argued was as to whether this justified the trust company in assuming that its claim as general creditor would be taken care of, or whether it became estopped to claim in this capacity by depositing stocks and bonds in furtherance of the plan, and urging others to do so.

32. Kansas City Southern Railway Co. v. Guardian Trust Co., 240 U. S. 166, 177 (1916).

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obstacles which confront small bondholders in case they wish to challenge the fairness of a reorganization plan put through in connection with a foreclosure sale, there is the additional hardship of having to forego the advantage of liquidity for his investment and being subject to uncertainty while awaiting liquidition at some unknown future date before he can even begin his attack.

To remove these obstacles to redress he would have to be given opportunity to challenge the plan by injunction just as soon as he is subjected to any pressure to comply with it. Unfortunately the issues of fact as to the existence of pressure and as to the fairness of the plan can be made complex and confusing, and the slightest possibility that the plan will ultimately be found fair will make the remedy of injunction seem too drastic, and too subject to abuse by strikers, for the bona fide objector to have much chance of getting it. The judge asked to enjoin what the proponents maintain is a voluntary plan will probably prefer to wait and see how many bondholders will accept it before dealing with any claims of intangible pressure. Typical methods of complicating analysis as to the fairness of a plan are outlined in the latter part of this article. These are available whether the technique of obtaining acceptance is frankly involuntary or assumes the form of offering an opportunity for voluntary exchange. A more complete discussion of the peculiar difficulties of enforcing any limitations on the scope of pseudo-voluntary reorganization plans must be reserved for a future article.

II. Contingent Settlements with Stockholders

The Miracle of the Loaves and Fishes

The *Howard* case seemed to indicate that junior creditors (and by inference dissenters as well) have an interest in what inadequately secured mortgage bondholders may concede to stockholders out of that "which is rightfully theirs"—i. e., which bondholders are entitled to acquire for themselves at foreclosure sale.[33] One difficulty with the form of settlement involved in the *Howard* case was that it reduced all interests recognized in the plan to a common denominator, thus clearly revealing that the basis for settlement was relative bargaining power. Furthermore there was chosen for this common denominator a new security conservatively reflecting the actual present plight of the debtor corporation, and therefore below the aggregate of the existing mortgages. The admission that there was not enough to take care of creditors made it inequitable for stockholders to receive anything. Future reorganizers learned to avoid such admission. It became part of their task to "pass a miracle."

If the reorganizers can conjure up a capital structure for the new com-

33. See page 938, *supra*.

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pany, with a sufficient amount of new securities, subject to sufficient contingencies, they can offer full "recognition" of all creditors' claims against the old company in new securities nominally equivalent in face value and priority to the old ones, yet so circumscribed as to correspond in actual present speculative value to the relative bargaining power of each group of old security holders. There can then remain as many baskets full of equity as is necessary to appease the old stockholders.

It does not seem a material obstacle to obtain assent to a plan that the "adjustment" or income bonds or noncumulative preferred stocks which are so characteristic of reorganization, are quite unlike the bonds and stocks which would be used to raise new capital. In fact such elusive contingencies in the capital structure of the reorganized company actually make it easy to enlist support from enough bond and stockholders to enable the reorganizers to put pressure on the rest. A reorganization plan, like a party platform, must often promise all things to all men. Reorganizers find the line of least resistance in catering to prejudices and illusions. It may be that bondholders will be content with less substance if the name is suggestive of security. It may be that stockholders, whose insistence upon participation is based on arguments that the present low-rated earnings are only temporary, really believe it. If so, they may be appeased, with least irritation to bondholders, by securities whose value is contingent upon their predictions coming true.

All that is needed to make such nebulous securities as income bonds and noncumulative preferred stock a valid tender for paying off dissenting bondholders and junior creditors is the relatively easy legal trick of redefining creditors rights as in "equity" or in "substance" something quite different from what was promised them. Creditors promised payment at a certain date, or earlier in the event of default, or interest at a stipulated rate, will find in the Looking-Glass Land of reorganization "equity" that the "substance" of their right is only a contingent claim to occasional income at perhaps a lower rate. The incorporation of the unpredictable future into the terms of the settlement gives reorganizers a powerful advantage in defending their plan before judges predisposed to co-operate in bringing about reorganization, and against attack from contestants who have the formal burden of proving it inequitable. To find that the contestants have failed to meet the burden upon them, the chancellor has only to ignore as irrelevant the current market appraisals of the new securities, and to reject any other evidence as too speculative.

Arguments stressing the contingent character of the settlement, and the preservation of relative priorities, appear chiefly for their make-weight value in connection with other arguments. Their part in the cases dealing with assessment of stockholders will be considered later. They have been used to justify allowing stockholders participation without assessment, sometimes in illogical conjunction with the argument that,

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since there would have been no surplus if senior bondholders had their due, there was no "fraudulent" collusion of stockholders and bondholders to take away anything which the objecting general creditors might otherwise have received. The "no actual fraud" argument, which as we have seen failed in the *Howard* case, nevertheless continued long afterwards to serve the reorganizers in defending their plans before lower federal courts.

In the Toledo, Peoria and Warsaw reorganization in the late seventies, the stockholders of the old company received all of the common stock of the new. One of the general creditors, whom the plan offered merely second preferred income bonds, attempted to satisfy his claim out of the participation offered stockholders, but failed. District Judge Blodgett approved the plan as fair and distinguished the *Howard* case, saying:

> "The stockholders are placed behind the holders of these bonds, and the plan seems to fairly contemplate the protection of all classes of creditors of the old company in the equitable order of their priority. It was the evident purpose . . . to place these floating-debt holders in at least as good a relation to the new company as they bore to the old company."

It was also emphasized that but for the plan there would have been nothing for the objecting creditors.[34]

The relative priority theory was not used again as the basis for a judicial opinion until it reappeared in more complicated form after the *Boyd* case in connection with reorganizations which assess stockholders.[35] It was doubtless used meanwhile in informal arguments of counsel, in the negotiation of plans and in persuading security holders to accept them.

34. See Hancock v. Toledo, Peoria and Warsaw Rr. Co., 9 Fed. 738, 742 (N. D. Ill. 1882). The plan is summarized in (1877) 25 COMM. & FIN. CHRON. 115. See also (1880) 30 id. at 170, for further details as to the securities of the reorganized company. All participants of the plan whether bondholders, stockholders, or creditors were required to contribute ratably to expenses; but such contribution as this involved from the stockholders would necessarily be too small to be regarded as an assessment. The plan substituted a first mortgage on the system for divisional first mortgages carrying the same rate of interest. Some of the junior bondholders were forced to exchange their fixed interest securities for a contingent charge senior in rank to the income bonds offered to general creditors. The stock capitalization was cut down and simplified, old first preferred getting 50% in new common; old second preferred and old common, 25% in new common. Prior to the opinion in this case, the reorganized road had been leased to the Wabash. In connection with the lease Wabash common was offered at the rate of 1 share per $100 face value of Toledo, Peoria and Warsaw second preferred income bonds, and 1 share for 3 shares of the common stock of the reorganized system. The net effect of the plan and the lease was to enable some old stockholders to salvage one sixth as much, others one ninth as much per $100 par as was salvaged on each $100 of the old general creditors' claims. The Wabash common could not have been regarded as a very substantial salvage. It in turn had to be reorganized in 1884. See DEWING, FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934) 1144.

35. This will be developed in a future article.

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It is implicit in the typical financial structures of reorganized corporations, with their substitution of contingent for fixed-charge securities, followed by stock representing the old equity interests. Litigation in connection with the Southern Railway[36] and the Central of Georgia[37]

36. This reorganization involved the security holders of the holding company, and two of its main operating systems, the Richmond and Danville and the East Tennessee. The new corporation which resulted is the present Southern Railway. The holding company held almost all of the stock of the Richmond & Danville and a majority of stock in the East Tennessee. It also was a creditor and held various branch line bonds. No participation was offered with respect to any Richmond & Danville stock. The public holders of East Tennessee stock were offered participation on payment of an assessment. The holding company as such had no funds available to pay an assessment and the privileges incident to its holdings in East Tennessee stock were passed on to its common stockholders. The holding company's collateral trust bondholders were forced to accept drastic sacrifices by way of substituting contingent for fixed charges on the theory, it would seem, that there was no market for and only conjectural income possibilities from their security. Nevertheless the holding company preferred stockholders received new stock without assessment. This was afterwards defended before the Supreme Court against attack as in violation of the *Howard* case, by the assertion that they participated because they had an equity in the holding company's claim as creditor of the Richmond & Danville. It happened that the challenge came, not from the holding company bondholders, who would seem to have been in the best position to object, but from an unpaid supply creditor of the Richmond & Danville. The Supreme Court's decision in favor of the supply creditor was on the theory of an equitable right to priority over the mortgages. (Vague references to the size and complexity of the system were found to justify departure from the usual 6 months time limit). The court did not attempt to solve the elusive question as to whether in reality the plan involved a fraudulent disposition of the properties of the Richmond & Danville. Cf. Southern Railway Co. v. Carnegie Steel Co., 176 U. S. 257 (1900). See Point IV of Appellee's brief and supplemental brief of appellant. The case was argued in October 1898 and not decided until January 1900; meanwhile the *Monon* case had come before the court on April 24, 1899 and been decided May 26, 1899. Perhaps the court regarded the *Monon* case as a sufficiently illuminating exposition of reorganization principles, and preferred not to struggle with applying it to the complicated facts of the Southern Railway reorganization. For history of the Southern Railway system and its predecessors, see DAGGETT, RAILROAD REORGANIZATION (1924) c. V.

37. There was a separate receivership for the Central, and its reorganization followed the Southern Railway reorganization. Agitation as to possible suppression of competition, and possibly business considerations, made for doubts as to whether its combination with the rest of the Terminal system should continue. The plan set up three successive issues of income bonds. The first two went to some of the old bondholders. No formal offer of participation was extended to general creditors. The reorganization committee acquired such claims as could be purchased on terms satisfactory to it; the terms were not made public. In negotiation it could threaten to limit dissenters to their pro rata share of what the unmortgaged assets might bring at a sale dominated by the reorganization committee. The minority stockholders of the Central received third preference income bonds, and the Reorganization Committee for the Southern received in exchange for the old majority holdings of the Terminal company the entire common stock of the new company. (This was held by it until 1907 and then sold. It afterwards passed into the hands of E. H. Harriman and associates. See DAGGETT, op. cit. *supra* note 36, at 188). A dissenting general creditor succeeded in attacking the plan as fraudulent within the meaning of the *Howard* and *Chattanooga* cases. Central of Georgia Railway Co. v. Paul, 93 Fed. 878 (C. C. A. 5th, 1899). The claim was a small one. An alternative theory of priority was

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reorganizations which followed the collapse of the Richmond Terminal system in the nineties, reveals instances where bondholders accepted apparently without protest contingent-charge securities, despite the fact that stockholders retained an interest and paid no assessment. The challenges came only from general creditors denied participation, and in each instance by creditors having an unusual stimulus to litigate because of alternative theories which would give their claims priority over the old mortgages. It would not be surprising if there were many similar plans throughout the history of reorganization which did not get into the reports at all.

Following the stock market collapse of 1929, numerous reorganization plans were announced which dealt drastically with creditors claims and nevertheless allowed stockholders participation without assessment. Either because no new money was needed, or because the stockholders were unwilling or unable to pay them, it was not feasible to levy assessments. The extent of the participation offered stockholders would naturally depend upon their actual bargaining position in each instance. In some reorganizations they seem to have received a relatively insignificant sop; in others they retained most of their former equity in addition to having their chances of ultimate dividends improved by an absolute scaling down of the claims ahead of them. It is probable that in many instances the reorganizers counted on the ignorance and inertia of scattered bondholders, and upon extra-legal pressure to compel general acceptance of these plans. There was scarcely a gesture of buttressing them against legal attack from dissenters.[38]

Reorganization and the Concept of a Moratorium

The ancient concept of a moratorium stands in the background of

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partially responsible for inducing the challenge. The lone aggressive creditor got paid, but the plan itself was not upset. There was no record of challenge by any bondholders. There was, however, subsequent litigation which revealed to the bondholders the full extent to which they had been prejudiced by consenting to receive income bonds, while perpetuating a common stock control whose nebulous equity could only be made to amount to something by concealing earnings and using what should have been payable as interest to build up a basis for eventual dividends on the common. See Dewing, *The Position of Income Bonds as Illustrated by Those of the Central of Georgia Railway* (1911) 25 Q. JOURN. OF ECON. 396.

38. For example see the following among the plans appearing in the Commercial & Financial Chronicle between January 1, 1932 and July 1, 1934: Pacific Steamship Co., (1932) 134 COMM. & FIN. CHRON. 144; Mount Hope Bridge Co., id. at 1039; Continental Clay Products Corp., id. at 1378; Baxter Laundries Inc., id. at 3463; Pierce Butler & Pierce Mfg. Co., id. at 4170; Johnstown Traction Co., (1932) at 135 id. at 1490; Lukens Steel Co., id. at 3702; 4175 Witherbe Sherman Co., id. at 4175; Booth Fisheries Co. Del., (1933) 136 id. at 2977; Manville Jenckes Co., id. at 2984; Cairo Bridge & Terminal Co., id. at 3549; Globe Wernecke Co., (1934) 139 id. at 1403; two rival plans for Wayne Pump Co., id. at 1257, 1883. In some of these reorganizations participation was offered to preferred stockholders only.

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the arguments defending as fair and equitable the practice of preserving in modified form the old sequence of claims. The appeal of this venerable institution, especially in times of depression, may be strong enough to offset the Supreme Court's insistence upon the sanctity of creditors' rights. In case the decline in earnings which is responsible for the corporation's present inability to meet the claims of creditors should prove but temporary, there are obvious objections to allowing a forfeiture of the equity interest to enrich the senior creditors. Delay may reveal earnings adequate to satisfy the senior claims and leave a surplus. The delay incident to the equity receivership or bankruptcy procedure amounts to a moratorium of somewhat indefinite duration. Perhaps the Supreme Court precedents do not condemn a strict moratorium, if recognized as an emergency remedy and limited in scope.[39] It might therefore be inquired why it would not be advantageous to substitute a moratorium precisely defined in the reorganization plan and thus relieve the court of supervisory burdens.

The answer is that a mere moratorium would not serve the reorganizer's needs. For a reorganization plan to involve a moratorium and nothing more it may be necessary to fix a definite time limit to the period for preserving the junior equity. Unless the senior claim in default is paid off within this period it should be entitled to hold the property unfettered by any possibility of redemption. The senior claim and any arrears of interest must be paid off in full, in cash or new securities voluntarily accepted in lieu of cash, before any payment on account of principal or interest to the junior claimants. Then the next ranking claim must be paid and so on. Pending payment of the senior claim, its holders should be able to get partial satisfaction out of all income yielded by the property. Meanwhile there should be adequate representation of the creditor interests in the administration of the property.[40]

39. See Feller, *Moratorium* (1933) 10 ENCYC. SOC. SCIENCES 649, discussing the somewhat analogous problem of the constitutionality, under the contract and due process clauses, of state statutes providing moratoriums for individual debtors. There are of course instances where a mere extension of maturity as to principal is all the relief the corporate debtor requests, and where a majority of creditors will agree to this. See plan for Glen L. Martin Company of Baltimore reported as confirmed by the district judge Dec. 7, 1934, (1935) 1 CORPORATE REORGANIZATIONS 218. Where the plan "funds" several years' coupons into preferred stock, meanwhile leaving the debtor in complete control, and offers no assurance that the creditors' strategic position will be in any way improved at the end of such period, the modification of the creditors' rights may be as substantial as under any other form of reorganization; see Allegheny Corporation Plan, summarized in (1934) 138 COMM. & FIN. CHRON. 1911. See (1935) 140 id. at 1647 (refers to ruling of C. C. A. 4th, confirming plan as fair).

40. So far as voting control is concerned, it need not make any difference whether what the old stockholders get is called a stock, limited as to dividend participation until the old creditors' claims have been paid off, or called an option privilege to obtain stock by redeeming the equity from the prior claimants. By use of a voting trust, the reorgani-

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If the moratorium is worked out by giving income bonds or preferred stock, the entire income should be devoted to thus paying off each claim in order of priority. If the modern device of option warrants is used as the vehicle for the preservation of a junior equity the option must be on the entire equity interest in the reorganized company and the option price high enough so that if exercised by the entire group of option holders, it would furnish enough cash to retire the claims senior to it; and the proceeds should be so applied. A complex series of options could be used to extend pro rata to junior claimants successive rights of redemption comparable to the privileges accorded in some states to the mortgagor and junior lien holders upon foreclosure of an ordinary real estate mortgage.[41]

Such a moratorium type of plan is quite unlike the conventional reorganization patterns[42] and is subject to insuperable practical objections.

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zers may arrange any desired allocation of control. However, the conceptual difference may have an important procedural consequence bearing upon the chances of obtaining rigid adherence to whatever time limit is set for the duration of the moratorium. The option expires by its own terms, and the option holders would have an uphill fight to obtain protection for any alleged equity after the expiration date. If, however, creditors' interests are represented by income bonds, then foreclosure of the new income bonds may prove as difficult as it was to obtain strict enforcement of the conditions of the old securities. For a plan which ignored this difficulty see Chicago & West Towns Ry. Plan, dated Sept. 23, 1932, (1932) 135 COMM. & FIN. CHRON. 2652. For an attempt to cope with this difficulty see the Fashion Trades Building Plan, (1932) 134 COMM. & FIN. CHRON. 4667 (old bondholders received new 5% income bonds and 25% of the stock. The balance of the stock was placed in escrow and to be cancelled if less than 3% interest should be paid on the bonds.) Dierks Lumber Co. Plan, (1932) 135 id. at 3697.

The novelty of the stock warrant gives it an advantage over other complicated contingent devices for working out a settlement in such a way as to dull the realization by security-holders of the sacrifices imposed on them by a plan. It might be employed to snatch more from bondholders than they realize they are conceding. In cases where bondholders are dominating the plan, it is more likely to be used as a gentle way of easing the stockholders out of the picture.

41. Reference to the use of stock warrants in the plans announced during the last few years indicates no attempt to extend to junior equities a pro rata right of redemption. If exercised the proceeds are to be available for general corporate purposes; the proceeds will usually amount to much less than the aggregate of the old claims ahead of those to whom the warrants are offered; and exercise of the options will involve acquisition of only a minority interest in the new corporation. In part at least, the old bondholders or general creditors are abandoning their right to be paid ahead of the old stockholders and receiving in return a part of the equity interest in the new corporation. The junior interests in lieu of the right to all of the equity after certain claims are paid, are to receive a fraction of the surplus after a reduced amount of prior charges have been satisfied. For examples see the following plans in the Commercial and Financial Chronicle: Appalachian Gas Corp., Oct. 25, 1932, (1932) 135 COMM. & FIN. CHRON. 3519; Republic Gas Corp., id. at 3692; General Water Works & Electric Corp., id. at 2173; Allegheny Gas Corp., (1933) 136 id. at 657; American Service Co., (1934) 139 id. at 750. See also National Radiator Co. plan, *infra* page 955.

42. Cf. Plan of Dec. 15, 1932 for Ohio Terminal Co., (1932) 135 COMM. & FIN. CHRON. 4394. Old bondholders received new income bonds of which *one half* were to be retired before any payment on stock given to old preferred and common stockholders.

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The resultant financial structure of the reorganized company would embarrass future management and finance, and thus tend to impede that salvage of earning capacity which is the principal justification for reorganization. In this respect the plan would be regarded as unsatisfactory by all security holders. More immediately it would fail to distribute sacrifices in accordance with the relative bargaining power of those whose assents are necessary. The plan would founder on the stubborn fact of human greed.

Just what determines relative bargaining power is an elusive matter of speculation. One thing seems certain, however: de facto bargaining power can have very little relation to the de jure hierarchy of priorities. Suppose we are concerned with one class of mortgage bondholders, one of junior creditors and one class of stock, that there is about the same face value to each group, and that current earnings are less than the interest upon the bonds. It may be that the mortgage bondholders are so well organized and so stubborn, and so confident of being able to get prompt possession if forced to foreclose against the opposition of the junior claimants, that they would be able to compel all junior interests to agree to full preservation of their own right to prior payment of both principal and interest. But this assumption would imply a weak bargaining position for creditors junior to them. It would be most unlikely that the junior creditors would also be in a position to insist upon one hundred per cent preservation of their right to priority over stockholders. But for their equitable right to clog the settlement between bondholders and stockholders, they would usually be in a less advantageous position than stockholders to obstruct the bondholders and therefore in a weaker bargaining position. The only benefit to junior creditors as a class from the Supreme Court's requirement that their priority be preserved as a condition to appeasing stockholders, is to give them equality of bargaining power with the stock, plus whatever psychological advantage there may be in entering negotiations with a principle to fight for.

An oversimplified illustration may clarify the relationship between bargaining power and theoretical rights of priority. Suppose there is only a single junior creditor and a single stockholder. Each will realize that there is a limit to the amount which the mortgage bondholders will concede to obviate resistance to realization upon their security, that each is about equally likely to be wiped out if a stalemate develops and results ultimately in strict foreclosure, and that each has about the same chance of causing a stalemate. On what basis shall they divide the aggregate that may be snatched from the bondholders? If the creditor is moved by avarice alone, it would be to his advantage to take 10% and leave 90% to the stockholder, unless he could persuade the stockholder to offer something better. It would be equally to the stockholder's advantage to take 10% and leave 90% to the creditor, in case he felt

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that the creditor was so fanatically stubborn as to be willing to sacrifice everything rather than take less than 90%.

The process of settlement involves attempts upon each side to impress the other side with its own stubbornness, to the limit possible without provoking greater stubbornness upon the other side. The air is full of ethical principles for which each side is ready to die. It is also full of protestations of desire to be fair. Each side is maneuvering for the advantage of being the dog who is defending his own bone, not trying to snatch the other's away. Any strict insistence by the creditor upon his right to priority involves his taking the extreme position of wanting for himself one hundred percent of what is available for division. It is not, therefore, a principle which can be advanced as a basis of compromise. It can be matched with the ethical idea of avoiding forfeiture, upon which both junior creditor and stockholder are relying in their common struggle with the mortgage bondholders. A much more powerful and relevant ethical symbol to invoke is that of equality. But the idea of equality may be applied in a great variety of ways. The individual who happens to be the creditor and the individual who happens to be the stockholder may each take the same aggregate amount; or each may take the same percentage of some common denominator. Here in turn is further opportunity for competing theories. The common denominator may be the face value of the claim; the book value; the amount of capital contribution to the business which gave rise to the claim; what the particular holder paid for it; quotations and valuations put upon the claim by others at various possible times. Either claim may be scaled down with a view to squeezing out water or to prevent one holder from taking too much quick profit from a recent purchase, where the other is forced to take a loss with reference to original cost at some remoter period.[43] Thus in the course of negotiation the principle of respect for promised priorities is swallowed in a moral fog.

The lack of any one definite and controlling ethical principle enhances the significance of the other factors in the bargaining process: the known extrinsic pressures which make one party more likely to give

43. For the argumentative purpose of minimizing the extent to which a plan disregards creditors' rights of priority, comparison is frequently made between the face value of creditors' claims and par value of stock. If it happens that the creditor has actually contributed some value to the business, and that the stock represents nothing but promoters' expectations of earning capacity which did not materialize, the basis of comparison is absurd. If we consider the modern no par and nominal par stocks it breaks down altogether. In case of $1 par stock which actually represented much more both in actual investment and in quotations at about the time of the reorganization it may be that stockholders are in a strong enough bargaining position to insist upon much more per par value of their stock than creditors can get per face value of their claims. The argument also overlooks the basis upon which credit is usually solicited; namely, reference to the claims ahead of or on a par with that about to be created, rather than what claims may come after it.

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way than the other, and the personalities, whether timid or aggressive, of the negotiants. Matters of personality and pressure of collateral interests assume even larger importance when we turn from our simple illustration to the complex actualities of reorganization negotiations between committees representing large groups of security holders. Then is involved the personalities, interests and loyalties not only of the committee members but of the diverse constituents for whom each committee assumes to act. A committee's power is very largely affected by the degree of assurance with which it can count upon support from security holders. If its constituents must be cajoled with specious inducements, if it matters to them whether what they get is called a bond or a stock, or what is its nominal face value, or whether they or others put up new money, without regard to the consideration given for it, then the committee must sacrifice more substantial advantages to gain points of only illusory importance. With the multitude of immediate practical pressures tending to shape the plan, the tendency is to treat the legal requirement to respect priorities, as a minor technical detail—something for the lawyers to fix up—rather than a rigid mold to which the business aspects of the plan must conform.

Suppose however that the nonethical factors bearing upon the negotiations happen to be evenly balanced, and that the conflicting ethical principles, usually invoked by the contending groups, should give way to an authoritative judicial pronouncement as to what is equitable, and that this should point to a strict moratorium. There would still be powerful practical objections from the point of view of safety in future management and financing. Since the postponed claims of bondholders and other senior creditors would continue to threaten the extinction of the stockholders' equity, new capital, even for legitimate expansion, could not be obtained by sale of stock, but only by sale of bonds. This would mean piling up fixed charges as long as an upturn of the business cycle would make it possible to sell them; then would follow default on the new bonds, and reorganization, with the next depression. Moreover the remoteness of the chance that the old debts would be paid or refunded within the moratorium period would present in the most exaggerated possible form that conflict in interest as to managerial policies, present to some extent in even simple and conservative capital structures. A management which really protected the senior claimants would have to be so conservative that holders of the junior equities would not feel that they were receiving a proper chance of retrieving themselves. Whatever pressure they might exercise either by direct voting or by intangible influence upon voting trustees would prompt the management to put to speculative uses not only the working capital made available by the plan but whatever is obtainable from future borrowings.

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Even the limited and somewhat illusory preservation of the old priority hierarchies which has been typical of railroad reorganizations has been enough to develop these dangerous tendencies. This has been a frequent theme of those who have criticized the conduct of reorganizations.[44] The mild flavor of moratorium incident to the typical reorganization plan commends itself to the practical reorganizer because it helps to satisfy the many people who must be brought together. He is likely to agree with his critics that the resultant financial structure is anything but ideal. However, he will attribute its shortcomings to the perversity of the human emotions he must satisfy rather than to his own iniquity or shortsightedness. The reorganizer's self-interest in maintaining his own prestige gives him some motive to work for a sound financial structure. But this may be subordinated to his immediate need of obtaining maximum support for his plan. If he scorns to defer to the weaknesses and illusions of the security holders, his opponents may be counted on to make the appeal to prejudice. Nevertheless, there are some limits to the extent that security holders will desire, or reorganizers permit, the plan to be shaped by reference to past hopes rather than present prospects. Both would prefer to allow the old stockholders a reduced participation in a new stock interest that would carry some expectation of dividends, rather than to conform to the idea of a moratorium and give them the entire amount of an equity with so much ahead of it that there would be constant pressure for reckless management.[45]

Anticipatory Reorganization

Assuming that the law forbids compelling creditors of an insolvent corporation to accept a contingent obligation as a substitute for their right to exhaust all of the debtor's assets and that a moratorium is unworkable, what if insolvency itself is contingent at the time a plan is proposed? When ultimate insolvency is threatened but not certain,

44. See Max Lowenthal, *The Case of the Missouri Pacific* (Dec. 1934) HARPER'S MAGAZINE 86. For criticisms by the Interstate Commerce Commission, see Missouri-Kansas Texas Reorganization (Dissenting opinion of Commissioner Eastman), 76 I. C. C. 84, 108 (1922); Chicago Milwaukee & St. Paul Reorganization, 131 I. C. C. 673 (1928).

45. "Bondholders, debenture holders and prior preference stockholders have a real, although intangible, interest in seeing that the corporation has a preferred and common stock structure which is appropriate to the earnings, assets and financing requirements of the enterprise." Rodgers and Groom, *Reorganization of Railroad Corporations under Section 77 of the Bankruptcy Act* (1933) 33 COL. L. REV. 571, 578. Cf. note 37, *supra*, for an example of what may happen if this consideration is ignored. The voting trust which typically accompanies reorganizations is justified as a protection against giving control to stock which has so little present value. The protection is likely to be inadequate, however, either because of the short duration of the trust, or because there is too much pressure upon the voting trustees to pave the way to an eventual resumption of dividends upon the stock.

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reorganization may be proposed as a preventive rather than a cure. Such an anticipatory reorganization was attempted for the National Radiator Corporation in 1931.[46]

The corporation was still indubitably "solvent" in the sense of being able to meet all presently maturing obligations. It was in a very strong current asset position, but allegedly owing to the depression in the building industry, it was suffering large losses after interest and sinking fund obligations on its funded debt. The funded debt was represented by a single issue of debenture bonds, followed by preferred and common stock. The plan involved paying off short-term creditors, exchanging the old bonds for 50% in income bonds, 50% in preferred stock and common stock sufficient to give the bondholders as a class control of the reorganized company. Old preferred stockholders were to receive some common stock without assessment. Old common stockholders paid a nominal assessment for option warrants.

The plan was supported by a somewhat complicated hypothesis: that earnings were unlikely to improve before the present surplus of working capital had been paid out; that an ultimate revival of the building industry and consequent development of earning capacity for the business was probable; that if the revival came, the present amount of working capital would be needed to take advantage of it; that, therefore to postpone reorganization until the corporation was obliged to default would only mean the added burden of raising new money equivalent to what had meanwhile been paid out to bondholders, and no small burden it would be in case the then demoralization of the security markets should continue. Hence it was claimed to be in the bondholders' interest to substitute a generous claim on ultimate earnings for their smaller if more certain opportunity to realize upon the liquid assets.

Assuming anticipatory reorganizations are to be permitted at all, no one can question the fairness of stockholders receiving some participation. In fact it would seem a fraud upon stockholders for the management to engineer a gratuitous surrender to creditors so long as there is a speculative hope of being able to meet obligations as they mature and as a result of improved conditions, earn a surplus for stockholders. Nevertheless the value of the stockholders' equity is not measurable either absolutely or in terms of the new security which may be tendered them. In passing upon a particular plan it would be impossible to say how far the participation offered stockholders represents a return for surrendering control during the period that stockholders are entitled to retain it and how far it takes account of the fact that even if reorganization were postponed until actual insolvency, the stockholders

46. First Nat. Bank of Cincinnati v. Flershem, 290 U. S. 504 (1934). See Sargent and Zelkowich, *Reorganization of "Solvent" Corporations* (1934) 29 Ill. L. Rev. 137.

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would be in a position to demand something. Moreover, the anticipatory type of reorganization would lend itself admirably to giving value to promoters' watered stock by scaling down prior claims. Thus whether or not the National Radiator Corporation plan appeared likely to improve the caliber of the bondholders' investment, and whether or not it was fair as between its stockholders and bondholders, it was inherently vicious from the punitive point of view. The new technique pointed to an easy evasion of all the Supreme Court precedents. The proponents received full co-operation from the receivership judge, and approval of the result by the Circuit Court of Appeals, but their method was condemned by the Supreme Court.[46]

The attack was focused on the procedure rather than on the plan. Ninety-five per cent of the bonds having been deposited in support of the plan, a fight developed with dissenters over the right to use the coercive powers of this majority to compel unanimous acceptance. One group of dissenters succeeded in getting paid in full, despite their failure to rebut insinuations that their bonds were purchased at a discount for the purpose of attacking the plan.[47] The nature of the reorganization plan was such that the burden of the recovery by dissenters fell immediately upon the assenting bondholders although it incidentally lessened the value of the speculative equity retained by the old stockholders.

The corporation had failed to pay interest on its bonds whether or not their holders had assented to the plan. After a suit by unpaid dissenters to collect interest, a consent receivership was obtained, the trustee was induced to declare the maturity accelerated, to obtain judgment for the entire issue, and to intervene. Ultimately there was a sale, and the property was acquired by the reorganization committee. The distributive share for nondepositors was so low as to make it practically compulsory to come in, due, according to the Supreme Court opinion, "to the mistaken belief that it was the duty of the court to aid in effectuating the Plan of Reorganization."[48] In reversing the decision the Supreme Court held that such appellants as had objected to the lack of equity jurisdiction to appoint a receiver for a still "solvent" corporation were entitled to be paid in full.

47. Transcript of Record fol. 594-596. Intervening petitioner Amy Arzt was an office employee of counsel. Seventy-one bonds had been assigned to her "for the purpose of consolidating various claims of people interested in those bonds very recently." The assignor was a corporation called "Bondholders' Syndicate of America." Who the actual beneficial owners were, counsel could not state. Later request was made, "We believe that it is only proper to ask the Court to direct Mr. Palley to file in court here, when he has the necessary information, a statement as to who owns the bonds . . . and the dates when those bonds were acquired by the beneficial owners of them." There was no ruling made on this request (fol. 639).

48. First Nat. Bank of Cincinnati v. Flershem, 290 U. S. 504, 525 (1934).

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Reorganization in the Twilight Zone Between Equitable and Bankruptcy Insolvency

The new reorganization amendments to the Bankruptcy Act expressly continue the requirement of insolvency in the equity sense as a prerequisite to proceedings under them. But the extent to which manipulation may arrange a situation where default appears to be compulsory, and the rather perfunctory hearing provided as to the good faith of the petitioning debtor, suggest doubt as to how far the limitation will be observed in practice.[49] Moreover Sections 77 and 77B suggest a modified idea of anticipatory reorganization—reorganization of corporations which, though unable to meet their debts as they mature, are not shown to be insolvent according to the definition in Section 1 (15) of the Bankruptcy Act.[50] Unless the debtor is found to be thus insolvent there must be adequate protection for the realization by stockholders of the value of their equity in the property of the debtor dealt with by the plan.[51]

The inference from the text that bondholders who do not make their peace with the stockholders will have the burden of proving insolvency, the difficulties of proving insolvency as a prerequisite to obtaining an adjudication of bankruptcy upon an involuntary petition,[52] the inherent uncertainties of new legislation until authoritatively construed, the contemporary pressure for relief of the debtor classes, and the new economic philosophies with their emphasis on the desirability of wider distribution of purchasing power at the expense of vested rights, all contribute to giving stockholders a bargaining power even beyond what they enjoyed in the old equity reorganizations. Reorganizers are thus more than ever compelled to gain their support.

Moreover, it is not possible at the present time to win their support by an offering conditioned upon payment of an assessment—the one

49. The court is logically obliged to assume such insolvency for all the purposes of the proceeding including appraisal of the fairness of the plan. This prevents the surrender of control from being treated as a new consideration moving from those interested in the stock, making it fair to allow them some participation before creditors are satisfied. The business appraisal of what is fair is likely to involve the contrary assumption, that the management could have continued to meet maturing obligations for some time, and that its co-operation in timing the filing of its petition in conformity with the plans of those who wish to reorganize, makes it only fair that something should be done for stockholders.

50. § 1 (15) provides "a person shall be deemed insolvent . . . whenever the aggregate of his property, exclusive of any property which he may have conveyed . . . with intent to defraud . . . shall not, at a fair valuation, be sufficient in amount to pay his debts." Both § 77 (a) and § 77B (a) require the initiating petition to state that the debtor is "insolvent or unable to meet its debts as they mature."

51. § 77 (b) (4); § 77B (b) (4).

52. Bonbright and Pickett, *Valuation to Determine Solvency Under the Bankruptcy Act* (1929) 29 Col. L. Rev. 582. Wehle, *Railroad Reorganization Under Section 77 of the Bankruptcy Act* (1934) 44 Yale L. J. 197, 217.

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sure way, according to the equity precedents, of thwarting attack by dissenters.[53] The new procedure has accentuated the other factors prevalent since the depression which make assessments undesirable. The abolition of the requirement of offering dissenters a cash alternative, the elimination of ancillary receiverships and of the necessity of a sale and organization of a new corporation, together with the tendency to begin reorganization proceedings before cash and quick assets are exhausted, may dispense with any necessity for raising cash by the plan.[54] Even where cash is needed, the present unwillingness of stockholders to pay assessments, and the availability of the Reconstruction Finance Corporation, will frequently make it undesirable to obtain any new consideration as a justification for the participation offered to stockholders. The justification must be found in the assumption that insolvency has not been established and that therefore preservation of their equity is required.

The assumption of solvency, however, will make it difficult to accomplish the desired scaling down of creditors' claims. Both reorganization acts enjoin the preservation of the equity, if any, of junior creditors in language substantially identical with that applicable to stockholders.[55] While it is possible to bind an entire class of creditors to terms accepted by two-thirds in amount, this is only in case the plan is found to be "fair and equitable."[56] Objecting junior creditors may point to the assumption of solvency as indicating one hundred per cent equity for them, no matter how trivial the participation offered to stockholders. Dissenting bondholders may use the same argument in case anything is offered to junior creditors, and use it even more persuasively in case equities of both junior creditors and stockholders are recognized. They will insist that the standard of fairness under the amendments to the bankruptcy act, must be that hitherto laid down by the Supreme Court as applicable to equity reorganizations.

The finding of solvency in the bankruptcy sense, in lieu of the conventional assumption in equity reorganizations that the property is worth less than the amount of the mortgage in foreclosure, does not weaken the position of dissenters and junior creditors. It might perhaps be treated realistically as having no relation to facts, and merely a conclusion of law: just a complicated, legalistic way of saying that the court is willing to lend its aid to those who want to reorganize. If so, then there is an exact parallel to the situation assumed in the old equity reorganizations. If, however, the finding of solvency is treated as a

53. A future article will show the complete breakdown of the attempt made in the *Boyd* case to apply the principles of the *Howard* case to this type of reorganization.

54. See Weiner, *supra* note 1, at 1191.

55. § 77 (b) (5); § 77B (5).

56. § 77 (f) (1); § 77B (f) (1).

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finding of fact entitled to be respected by appellate courts, it still leaves the dissenters and objecting junior creditors in a strong position. If the principles of equity entitled them to insist upon one hundred per cent satisfaction in case stockholders received anything, even where the property was valued below the amount of the mortgage in default, can it be equitable that they should receive less satisfaction from a solvent corporation?

Of course the most perfect logical attack on a plan may be matched by equally perfect logic in its support, depending on the premises selected. Proponents of the plan may use over again all of the old arguments and fictions which have in the past served them so well before receivership judges. In addition, they may point to the impetus for the legislation in the economic emergency and the desirability of expediting the reorganization of the multitude of corporations now in financial difficulties, as requiring courts to approve plans that conform to common sense business standards of fairness rather than artificial legal ones. The choice of formal premises or of inarticulate assumptions throws us back to the struggle between practical and punitive ideals.

Today, as in the past, it is the practical ideal which is likely to dominate the reorganization judge. He is likely to feel as much pressure as heretofore to get reorganization done, and be as impatient as ever with those who insist for themselves upon terms which it is not practical to obtain for their entire class. Once a plan has received the statutory percentage of assents, the further requirement that it be found fair and equitable will appear to him as tautological. His approval of the plan will be a useful weapon to persuade dissatisfied but timorous bondholders to deposit, and will be of some help in settling with even the more predatory opposition. The opposition will be strengthened by the fact that they are invoking a clear-cut logical objection to the plan which does not involve appellate court inquiry into matters of fact. On the other hand, they must weigh the delays of appeal, the amount of capital which must meanwhile be tied up, the chance that the Circuit Court of Appeals may reflect the practical attitude of the reorganization judge, that the Supreme Court may deny certiorari or even depart from its historical insistence upon the preservation of the prior rights of creditors.

Where bondholders in a position of marginal security take a dominant part in shaping the reorganization plan, they may decide that there is less to be lost by allowing dissenters or a small number of junior creditors one hundred per cent recovery than by encountering the united opposition of the stockholders. Where the plan is engineered by stockholders who attempt to enlist the support of bondholders not independently represented, the stockholders may so arrange it that the consenting bondholders rather than the stockholders bear the impact of whatever

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toll must be paid to dissenters. This indicates a probability that a great many reorganizations will be successfully accomplished which secure the subordinate rights of stockholders at the expense of the prior rights of creditors before the Supreme Court shall have had occasion to pass upon their validity under the amendments to the Bankruptcy Act. For the purpose of accomplishing most of the pending reorganizations the important question is not what the Court will decide but what potential dissenters can now be made to think it will decide.

If the Court should hold that no reorganization plan is "fair and equitable" under the new legislation which amounts to a fraudulent conveyance within the equity precedents, then reorganizations subsequent to such a decision will have to be accomplished by finding some other excuse for the inevitable concession to stockholders. Perhaps by this time, it will be less inconvenient than now to resort to an assessment. It will be pointed out in a future article how this device, which has usually been necessary to raise cash, incidentally offered the royal road to evasion of the taboos against forcing creditors to compromise with stockholders. This will be offered as further proof that however vital it may be to a capitalistic society to uphold the sanctity of contracts, those who champion the punitive ideal for reorganization are engaged in a futile struggle. Once this fact is accepted, it leads to inquiry whether emphasis should not be shifted from control over reorganization to control over the financial processes which lead to it. Since every reorganization plan is itself a launching of a new financial structure to carry the expectations of investors, there should be less concern over the practical impossibility of reconciling the old inconsistent expectations, and more caution as to the adequacy of the foundation for the new hopes.

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