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ABSOLUTE v. RELATIVE PRIORITY IN REORGANIZATION: A RECONSIDERATION

DAVID G. TYNDALL

Introduction

In the long and stormy discussions which have marked the history[1] of the theory and practice of corporate reorganization, two different conceptions of the basic postulates on which a reorganization plan should be hased, have emerged. These have come to be known as the "relative priority doctrine" and the "absolute priority doctrine". In this paper it will be my purpose to show:

(1) that the generally accepted version of the relative priority doctrine should be completely rejected, except in the special circumstances to be described below;

(2) that if a narrow interpretation is placed on the absolute priority doctrine it would be impractical and would seriously impede the development of sound reorganization procedures; and

(3) that a broad interpretation of the absolute priority doctrine will provide the basis for the development of reorganization plans which meet the requirements of both justice and expediency.

The Relative Priority Doctrine

One of the proponents of the relative priority doctrine, Mr. H. G. Guthmann,[2] argues as follows:

> ". . . A reorganization is an attempt to capture the greater values which it is hoped that the business will have as a going concern over what it would be worth in liquidation. Where a liquidated business has a definite sum to distribute, the value of a going concern is uncertain and a matter of expert estimate. It is the element of uncertainty in future earning power that gives a market value to stocks even when the size of prior claims to income are [sic] so great as to leave no appreciable hope of dividends in the reasonably foreseeable future. The future may

[1]For an extended discussion of this history, see: BUCHANAN, ECONOMICS OF CORPORATE ENTERPRISE, Part III (1940); DEWING, FINANCIAL POLICY OF CORPORATIONS, Part V (4th ed. 1941); SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, Part VIII, §§ 1-4 (1940); Dean, *A Review of the Law of Corporate Reorganizations,* 26 CORNELL L. Q. 537 (1941).

[2]Guthmann, *Absolute Priority in Reorganization,* 45 COL. L. REV. 739 (1945); GUTHMANN AND DOUGALL, CORPORATE FINANCIAL POLICY, Ch. 28 (2d ed. 1948).

always develop an unforeseen profitability. If reorganization is to preserve the security holders' respective interests in the going concern, the logical sharing in the new securities would be a division on the basis of the relative value of the old claims against the corporation. Thus, a preferred stock or an income bond of a corporation that requires reorganization is rarely worth full par value plus accumulated dividends or interest arrears; a common stock, while likely to be of low value, often falls short of being worthless. The shares of such issues in the (let us say) common stock of the reorganized corporation on the basis of relative value would give a preponderant portion to the prior issue but would not wipe out completely the old common. The valuation of such interests is a difficult matter, as is the valuation of business as a whole; but it is a necessary step if the reorganization process is to be a means of preserving relative position instead of transferring property rights from junior to senior securities in reorganization."[3]

This argument should be rejected on two grounds; one positive, the other negative. In the first place the argument rests on the invalid assumption that, because methods of valuation of going concerns are necessarily subject to uncertainty, it is not reasonable (apparently under any circumstances whatsoever where the process is one of reorganization and not liquidation) to eliminate any groups of security holders which happen to feel that they have any interest in the going concern. Since hope springs eternal in the human breast, presumably the groups would never be eliminated. But this argument involves a fundamental misconception regarding the nature of the valuation process. Perhaps an example from another sphere will help to illuminate the problem: assume that you are attempting to evaluate the opportunity of throwing dice on the condition that if you throw a seven you get $100, if you throw a twelve you get $5000, for any other throw you get nothing. Clearly your evaluation of that opportunity will depend not only on the fairly good chance of throwing a seven, but also on the much smaller chance of turning up two sixes. If the latter possibility is ruled out, your evaluation of the opportunity will drop. Similarly with the evaluation of a going concern or of any claims against a going concern. The value is determined not only by the fairly good chance of making "average" returns, but also by the smaller possibilities that profits may be very large, or, on the other hand, may be negative. In the case of the going concern, the neat mathematical probabilities which inhere in the dice situation are not present. As has been pointed out many times in the history of economic thought, there is an immeasurable uncertainty regarding the future of a business

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[3]GUTHMANN AND DOUGALL, CORPORATE FINANCIAL POLICY 610 (2d ed. 1948).

enterprise. But this fact does not rule out the possibility of considering the relative probabilities of various patterns of future earnings and making an estimate of value for reorganization purposes which will, in the light of then current knowledge, be at least in the correct order of magnitude. The impossibility of making valuations which are accurate to the cent is no basis on which to found a general principle which would in fact *create* interests for groups which have clearly and in all equity lost all previous claims against the concern because of the priority of other claims which far exceed in amount any reasonable valuation of the concern in question.[4]

There will still be borderline cases; in these the courts and regulatory bodies will have to make a decision one way or the other—a decision which is certain to be slightly unfair to one group or the other in the vast majority of such cases. But the injustice is slight and unavoidable, and in other than borderline cases the problem will not arise. Nor will the fact that the passage of time may prove the estimates to have been overly optimistic or overly pessimistic have any bearing on the situation. Valuation must be carried out at a given point in time. The value will almost inevitably change as events unfold themselves. But if the valuation is carried out as carefully as possible, that is all that can be expected; if that valuation is inadequate to meet the prior claims, the junior claims are shown thereby to have no further equitable interest in the concern.

This brings us to our second point—the fact that acceptance of the relative priority doctrine in its current version involves a nullification in large part of the contractual rights which the bondholder is supposed to receive in return for the limitation on his share in profits. It would turn bonds into prior preferred stocks with questionable rights on liquidation.

There may be some point in arguing that corporations would be better off in the long run (in many if not all instances) if they issued no obligations involving fixed charges. But to argue, as Guthmann does, that having issued such obligations, the holders of same have no equitable right to enforce such claims, apparently on the grounds that the stockholder or other junior claimants do not like it, seems a little strange. If the stockholders wish to have the privilege of trading on the equity, surely they should be forced to accept the risks which accompany such a policy. It is true that reorganization is

[4]The opinion of the Supreme Court in Ecker v. Western Pacific R. Corp., 318 U. S. 448, 476, 63 Sup. Ct. 692, 713 (1942), is comparable. For a sound justification of the use of prospective earning power as the prime determinant of value for reorganization purposes, see the Court's opinion in Group of Investors v. Milwaukee R. Co., 318 U. S. 523, 540, 63 Sup. Ct. 727, 738 (1942).

an attempt to maximize the value of the assets of the concern by keeping it on, or returning it to, a going-concern basis; but it may well be that the going-concern value after reorganization is inadequate to meet the fixed contractual claims of the senior claimants; if such is the case, it is difficult to see how any justification can be found for giving any interest to the junior claimants. The senior claimants did not contract for a proportionate share in the assets—they contracted for a given absolute share, and there seems to be no reason why that should not be their right in law and equity.

Guthman seems to have particularly in mind instances of reorganization which are instigated by management, not because default has already occurred or is imminent, but because the capital structure is deemed to be unsound in some way or other. The implication is that they are attempting to improve the efficiency of the concern but that such desirable action will be avoided because it would involve the danger that stockholders would be unfairly wiped out in the process. This line of reasoning may be based on the assumption that the courts or regulatory bodies will be biased towards low valuations, but I see no reason why there is not an equal chance that the bias will be in the opposite direction. To my knowledge the history of reorganizations does not indicate any particular bias on the part of the courts toward undervaluation. Mr. Justice Douglas' dicta in the *Los Angeles Lumber* case may indicate some personal tendency on his part in this direction, especially with respect to intangibles, but I do not think that one can generalize too far on this basis.

On the other hand, Guthmann may be basing his analysis on a basic distinction between voluntary and involuntary reorganization, a distinction which takes on considerable significance in the light of the facts of the *Los Angeles* case. The essence of this argument would be that there is a need for distinguishing between a voluntary reorganization—perhaps one could call it a "formal composition"—and involuntary reorganization. That is, where the stockholders or other junior claimants can show that there is no danger of bankruptcy in the foreseeable future in the sense of inability to meet maturing obligations, that they have certain rights to control and to share in uncertain future profits—rights which therefore are valuable—, but that a reorganization is desirable and is in the best interests of all concerned, there should be some procedure, quite separate and distinct from formal bankruptcy proceedings, which would take account of these facts, would not wipe out the junior claimants even though the value of the assets were found to be less than the prior claims, and would provide machinery for preventing

obstructionist tactics by small minority groups.[5]

A simplified example may help to bring out the point. Assume a corporation whose assets have:

1 chance	in	10	of	being	worth	$1	million
2 chances	in	10	"	"	"	10	"
4 "	"	10	"	"	"	15	"
2 "	"	10	"	"	"	20	"
1 chance	"	10	"	"	"	29	" ;

and that a reasonable valuation of the assets would be $15 million. Assume further that the corporation has bonds outstanding of $15,100,000; that it is currently earning its interest by a slight margin;[6] and that it has a fairly large cash account so that it could meet interest payments for several years despite a subsequent decline in earnings. In this situation the stockholders, looking to the distant future when the bonds will mature, wish to effect a reorganization which will put the corporation on a sounder financial basis.

It seems indisputable that in such a situation the stockholders' claims would have real value despite the current excess of liabilities over the real value of the assets, for though the chances are 7 in 10 that they will be worth nothing, there are 2 chances in 10 that they will be worth $4,900,000, and 1 chance in 10 that they will be worth $13,900,000. Moreover there are current earnings available for dividends. Similarly the real value of the bonds will be less than the face value, for though there are 7 chances in 10 that they will get the face value, there are 3 chances in ten that they will not.

Thus we reach the astonishing and apparently paradoxical conclusion that if the corporation can continue to pay interest on its bonds, the bondholders' claims will be worth less than $15 million. If the corporation cannot meet

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[5]It is most unfortunate that the SEC and the Court took the *Los Angeles* case and attempted to create a general pattern for reorganization proceedings from the distorted material which it provided. The sharp increase in value of the assets which took place between the time when the proceedings were started and Nov., 1939, and, what is more important for our argument above, the existence of the agreement not to foreclose prior to 1944 which had been drawn up in the early 1930's, provide effective ammunition for those who oppose the general principle on which the decision was based. For while it *may be* that the rights accorded to the stockholders by the plan which had been accepted by the lower courts was too generous, there seems to be no basis in equity for excluding them completely. Mr. Justice Douglas asserted that the right to delay foreclosure had been lost as a result of the instigation of bankruptcy proceedings, but this argument is questionable to say the least. I am indebted to Professor Arthur John Keeffe for a helpful discussion of this point.

[6]This of course is quite conceivable, for the rate at which the earnings are capitalized will normally exceed the interest rate on the bonds.

its interest payments, the bondholders can force the corporation into bankruptcy and will under their contract be entitled to receive the full face value of their claims.

Paradoxical or not, this is the result of the facts of the situation, and it would seem to follow that a "formal composition" would be fair and equitable which granted the bondholders new securities worth considerably less than $15,100,000 and granted to the stockholders securities of real value. This does not mean acceptance of the relative priority doctrine when the reorganization is involuntary—the fact that proceedings are instigated by the debtor does not prove that the reorganization is voluntary; to be voluntary the possibility of bankruptcy must be remote—; nor does it mean that a majority or even a significant minority of the bondholders should be forced to accept a plan of this sort; but it does point to the necessity for formal machinery which would force obstructionist minorities—so-called "strikers"—to accept a plan which is equitable and is in the best interests of the consuming public.[7] For this type of case a modified relative priority doctrine may have some application, but unfortunately the supporters of the doctrine have attempted to apply it to all types of reorganization.

The proponents of the relative priority doctrine have buttressed their positive arguments for the doctrine by attempts to show that implementation of the absolute priority doctrine would be unwise on two important counts. First they suggest that it would constitute a "special hazard to the stockholders of a borrowing corporation"[8] which would increase the costs of or even make impossible the equity financing which is needed in order to maintain a sound financial structure for American industry. If stockholders have been investing on the assumption that reorganization, if and when necessary, would be carried out in accord with the relative doctrine, then certainly the emphatic decision to enforce senior claimants' contractual rights will mean an increase in the costs of equity financing. But I do not see why it should make it impossible, and there is surely no objection to a rise in the returns on equity, if it is necessary to cover the risks involved.[9]

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[7]This is simply a logical extension of the attitude already adopted by the SEC toward reorganizations under the PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, 49 STAT. 803 (1935), 15 U. S. C. § 79 (1940). See FEDERAL WATER SERVICE CORPORATION, SEC HOLDING COMPANY ACT RELEASE No. 2365, March 24, 1941. See also the interesting discussion by Dean, *A Review of the Law of Corporate Reorganizations*, 26 CORNELL L. Q. 537, 564-574 (1941).

[8]GUTHMANN AND DOUGALL, CORPORATE FINANCIAL POLICY 611 (2d ed. 1948).

[9]For a different view see Dean, *A Review of the Law of Corporate Reorganizations*, 26 CORNELL L. Q. 537, 563-564 (1941). However, his argument is based on a narrow interpretation of the absolute doctrine, for he assumes that under the rule no special

Second, they argue that implementation of the absolute doctrine would make impossible the acquisition of new cash or the retention of able management on the best possible terms. Before considering these points in detail we must define carefully what is meant by the "absolute priority doctrine".

The Absolute Priority Doctrine

It must be emphasized at the start of an analysis of the absolute doctrine that it means many things to many persons. However it does seem possible to specify two main types of interpretation and to classify the various interpretations as variants of one of these two main types. All interpreters would agree on the fundamental tenet that, "The stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors".[10] The central difference of opinion revolves around the question of the determination of the thing to which these creditors' rights apply. Specifically the point is: do the creditors have a legal and equitable right to the *full* going-concern value of the reorganized corporation, even though the cooperation of other groups is necessary to achieve that result; or is their absolute right limited to that part of the value of the reorganized concern which they have contributed? If the latter view is accepted, how are the contributions of the respective groups to be evaluated?

Most of the criticism of the absolute doctrine has assumed that it was the former narrow view of the doctrine that was adopted and set forth by the Supreme Court in the long series of cases which came before that body. If this were so the criticism would indeed be well merited, and it is a fact that the language of the Court does leave considerable room for disagreement as to what the learned judges did mean. It seems reasonably clear to the writer, particularly in the light of many of the dicta which accompanied these decisions, that, at least in most cases, the Court was feeling its way toward the broader interpretation, though at times, *e.g.*, the *Boyd* case, it may have seemed closer to the narrow one. Let us assume that the critics were right in their interpretation of the Court's decisions and consider the validity of their criticism.

As we have suggested above, there are two conditions under which the absolute doctrine was said to be unwise or impractical:

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treatment could be given to junior claimants, whereas the *Western Pacific* case offers a recent example of the many instances in which the Supreme Court has recognised the justice of granting special rights to junior claimants who contribute new cash. Ecker v. Western Pacific R. Corp., 318 U. S. 448, 486, 487, 63 Sup. Ct. 692, 713 (1942).

[10] Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co., 174 U. S. 674, 684, 19 Sup. Ct. 827, 830 (1898).

(1) when a considerable amount of new cash or other property was needed to effect a successful reorganization;

(2) when it was desirable to retain a management which owned considerable amounts of junior claims.

Swaine has explained the first point very well.

> ". . . While conceding that stockholders may be admitted to some interest in the new company [it has been] urged that the fair value of this participation must not be in excess of the amount of the stockholders' assessments. . . . When it appears, as it did in the *Missouri Pacific* case, that junior bondholders and unsecured creditors are to receive preferred stock which is selling at 53, while common stockholders, upon payment of a net assessment of $17 per share, are to get stock selling at $30, it is argued that the difference—here $13 per share of common stock—represents "a substantial equity" in the property which has been unlawfully diverted from the creditors for the benefit of the stockholders. This argument has never been successfully maintained, and, in fact, could not be maintained without making successful corporate reorganizations impossible. Bondholders do not, as a rule, enforce their strict right of foreclosure and buy in the property for their sole benefit, because they are unwilling to put up the new money which is usually essential to the continued life of the enterprise. Stockholders constitute the best, and often the only, available source of new money, and their participation is essential. That participation can be obtained only by a plan which gives the stockholders something of definite value over and above what they pay for. . . . The answer to the argument that this constitutes an appropriation to the stockholders of a substantial equity in the property, which should be used to pay the creditors in full, is that this equity is largely attributable to the fact that the stockholders are willing to put more money into the property; and that if they were not willing to do this,—if the plan were not made reasonably attractive to them,—the 'substantial equity' would disappear."[11]

A simplified example may bring out the point more clearly. If the liquidation value of the assets of a corporation are $10,000, whereas their value on a going-concern basis, *if* $2,000 working capital is supplied, would be $15,000, to whom belongs the $3,000 difference? Without the $2,000 working capital, it would not exist; but, similarly, the $2,000 working capital alone is worth but $2,000. It is apparent that we have here one of those cases where on economic grounds there is no basis for logical imputation. *If* the capital market were perfect, the difference would go to the owners of the assets, but the capital market, and particularly the market for equities

[11]Swaine, *Corporate Reorganizations: Certain Developments of the Last Decade*, 27 Col. L. Rev. 901, 914-916 (1927).

or for debt of bankrupt corporations, is far from perfect. If the corporation is to be reorganized, some part, perhaps the major part, of the difference will, as a matter of practical necessity, have to be offered to the suppliers of new cash. If less has to be offered to holders of old junior securities than would have to be offered to induce the general public to purchase—whether or not this will be so will depend on the circumstances of the case—the senior creditors are to that extent better off to make the offer to the junior security holders.

It has been argued that this line of reasoning is invalid because:

> ". . . The managers of the reorganization must be assured, and not merely hopeful, that the new money will be forthcoming, and where the stock is scattered a bank underwriting of the offer must be obtained. With such a banking commitment the offer to stockholders ceases to be a method of getting money from them and becomes a method of giving them a valuable right. Under these circumstances the motive is the desire to see the former owners retain part of their original investment."[12]

Whether or not the motive suggested was the prime one influencing the actions of the reorganization managers I am obviously in no position to know, but certainly the existence of such a motive does not necessarily follow from the procedure of underwriting. It may well have been that the underwriters, who usually desire to dispose of the issues as rapidly as possible, might have agreed to a higher price if the issue were to be offered by rights than they would if it were to be sold to the general public.

The offer to junior security holders of the right to purchase stock in the reorganized corporation at a figure below its "real value" does not *preserve* their interest. Their original interest has been eliminated; they have acquired new interests by their contribution of cash, and the importance of liquidity is such that they are able to claim a greater proportion of the total assets than their dollar contribution bears to the dollar value of the rehabilitated assets. An equal if not greater proportion would have to be offered if the offer were made to outsiders. Thus so long as the price is not unreasonably lower than that which is necessary to induce them to purchase, the offer of rights to former junior security holders is both just and practical.

Bonbright and Bergermann, while conceding that such action might be justified as a practical expedient, assert that the "junior security holders

[12]FINLETTER, PRINCIPLES OF CORPORATE REORGANIZATION IN BANKRUPTCY 413-414 (1937), quoted in SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 53-54 (1940).

should be allowed to participate, not as a matter of legal right, nor even as a matter of business fairness, but rather as a matter of expediency in financing the reorganization."[13] I cannot accept this point of view. There seems no reason why the creditors should have a right, either in law or equity, to the full going-concern value of the assets after they have been rehabilitated by the contribution of new cash. They *have* an absolute right to the going-concern value before the contribution of new cash—to the broken down corporate machine—but in some instances this will be little more than the liquidation value.[14] If the corporation is to be rehabilitated, they have an equitable right to some part of the increase in the value of the assets. Their share in that increase can often be made greater if the junior claimants (rather than the general public) are permitted to share in that increase. Instead of lessening the claims of the senior claimants, the policy of offering to those who have previously had an interest in the corporation will add to those claims. The rights of the stockholders are not secured at the expense of the senior and prior rights of the creditors.

Turning now to the other point of criticism, it is claimed that the absolute priority doctrine is impractical in situations where "the bulk of the stock in the corporation to be reorganized is owned by the management interests and the continued presence of that group in the saddle is essential to creating the going concern value which makes creditors prefer reorganization to liquidation."[15] It is argued that in many instances the only practical, or at least by far the best, way of retaining these management interests is by offering them a stock interest, but that this is not possible under the absolute priority doctrine. If the narrow interpretation of the absolute doctrine were made, this criticism would be valid. But on the broader interpretation of the doctrine, the giving of stock or purchase-warrants to management interests is permissible if it is deemed more advantageous to retain able management by this method than by means of high salaries, for the action does not necessarily divert assets from senior creditors. The courts will need to give very careful scrutiny to plans involving this sort of procedure to prevent the emergence of fraud, but there is nothing about them which is fraudulent

[13]Bonbright and Bergermann, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COL. L. REV. 127, 132 (1928).

[14]This is not to say that where additional cash is not required in order to reorganize successfully the bankrupt corporation, the creditors are entitled only to the liquidation value. A sharp distinction must be drawn between cases where cash is and where it is not needed in order to achieve successful reorganization. *See* Case v. Los Angeles Lumber Products Co., 308 U. S. 106, 113, 123, 124, 60 Sup. Ct. 1, 6, 11 (1939).

[15]GUTHMANN AND DOUGALL, CORPORATE FINANCIAL POLICY 610 (2d ed. 1948).

per se, or which is inconsonant with the broad interpretation of the absolute priority doctrine. That part of the value of the assets of the reorganized corporation which arises from the agreement of the management to work for nominal salaries does not in any sense belong to the creditors. Indeed it may be best to look at the participation granted to owner-management interests as a promise of compensation for services to be rendered in the future—compensation which is essentially unconnected with past security ownership and which is essentially similar to that which might be granted to the investment bankers for their services in underwriting the issues of the reorganized corporation.[16]

In brief then, the narrow interpretation of the absolute doctrine is open to severe criticism when cash is needed and can be obtained on more reasonable terms from junior security holders than from the general public, or where high salaries are an inopportune way of retaining the services of an owner-management group; however a broad interpretation of the doctrine —an interpretation which in no way resembles the relative priority doctrine— is not subject to these criticisms and meets the requirements of justice and expediency.

It is of some interest that the relative approach as it was originally set forth by Swaine is very similar to the broad approach which has been set forth in this article and bears little resemblance to the modern version of the relative doctrine. In summing up his argument in the article from which I have quoted above, Swaine said:

> "... The rule as I see it, and as I believe it will ultimately be developed by the courts, is that the relative priorities of the old securities, *senior to the most junior securities which continue to have any interest in the property,* must not be *inequitably* disturbed."[17] [Italics supplied.]

Note the obvious implication that no provision is to be made for securities which have no interest in the property because prior claims have exhausted the value thereof.

This is vastly different from the interpretation of the theory offered by most writers in the field. The "distortion" was introduced at a very early

[16] I am indebted for this suggestion to Mr. Lawrence Wilsey.

[17] Swaine, *Corporate Reorganizations: Certain Developments of the Last Decade,* 27 COL. L. REV. 901, 907 (1927). This paper was in its present form when two articles by Swaine in the HARVARD LAW REVIEW (1942-1943) came to my attention. They completely confirm my interpretation of Swaine's original position, and are in almost complete accord with, though they differ considerably in scope and emphasis from, the analysis of this paper. See Swaine, *A Decade of Railroad Reorganization under Section 77 of the Federal Bankruptcy Act,* 56 HARV. L. REV. 1037 and 1193 (1942-1943).

date, apparently by Bonbright and Bergermann, and has persisted ever since. According to Bonbright and Bergermann, the relative priority doctrine as enunciated by Swaine held that "all that the first mortgage bondholders are entitled to is an exchange of their old securities for new securities, (a) with an approximately equal income claim (in the form of fixed or contingent charges) and (b) with priority over any new securities issued in exchange for the old junior securities."[18] Sometimes one is led to believe that subsequent writers failed to read Swaine and relied on Bonbright's erroneous interpretation. But whether or not this be true, it is clear that Swaine did not support a doctrine which "attempts merely to preserve relative interests" and on the basis of which "even where the common stock appears valueless some participation has been accorded."[19] Nor would I agree with Buchanan that, "The relative rule [as laid down by Swaine] would insist that fairness is achieved in reorganization plans provided the parties in interest are left undisturbed in the order of priority of claims on income. . . . Strictly applied this would mean that *no* group of claimants would ever be wiped out entirely. . . ."[20]

What Swaine was trying to say was that, having decided that a certain number of classes of claimants have in fact an equity in the assets of the corporation, there is no injustice involved, *per se,* in altering the contracts of any of the classes so long as the relative priority of their claims is undisturbed and each is given a claim to his fair share of the total net assets. This point was clearly recognised in the *Consolidated Rock Products* case where it was said, "The substitution of a simple, conservative capital structure for a highly complicated one may be a primary requirement of any reorganization plan. There is no necessity to construct the new capital structure on the framework of the old."[21]

In addition Swaine wished to make the point (which I have stressed above) that in order to increase the value of the assets it may be necessary under certain circumstances—if new cash can best be obtained from former junior security holders or if owner-management should be retained—to share that increase with those who make it possible; but that this is completely independent, conceptually, of the problem of adjusting the contractual rights of

[18]Bonbright and Bergermann, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization,* 28 COL. L. REV. 127, 130-132 (1928).
[19]GUTHMANN AND DOUGALL, CORPORATE FINANCIAL POLICY, 684-685 (1st ed. 1940).
[20]BUCHANAN, ECONOMICS OF CORPORATE ENTERPRISE 381-382 (1940).
[21]Consolidated Rock Products Co. v. DuBois, 312 U. S. 510, 531, 61 Sup. Ct. 675, 687 (1940).

the various claimants in order that a sound financial structure be created for the reorganized corporation.

The unfortunate consequence of the general acceptance of the "current version" of the relative priority doctrine is that it is conceived as the only logical alternative to the narrow version of the absolute docrine. Thus, because the absolute doctrine in its narrow version (which would not permit the subscribers of new capital, *if they happened to be former junior security holders,* to obtain a share in the reorganized corporation greater than the proportion which their cash contribution bears to the value of the reorganized corporation), is obviously impractical in certain circumstances, while the relative priority doctrine in its "current version" would arbitrarily nullify the contractual rights of the creditors the attitude most commonly adopted is that justice must be tempered with expediency[22]—that complete justice is impossible. I have tried to show that a broad interpretation of the absolute priority doctrine—an interpretation which is strikingly similar to Swaine's original version of the relative priority doctrine—meets the criteria both of justice and expediency.

It may be instructive to consider the application of this broad interpretation to an actual case of reorganization, for example, the Brown Co. reorganization which, according to Dewing, "shows how difficult it is to apply an absolute rule of justice to the exigencies of actual reorganization."[23]

This plan gave ⅜ of a share of new common stock to holders of the original common, and 12½ shares of new common for each $100 of old preferred, while giving the old bondholders $600 of 5% "cumulative bonds" and $650 par value of new 6% convertible preferred for each $1252.80 of principal and accumulated interest. This was done even though "the common stock had no value on the basis either of past earnings or of assets."[24] Could this plan be considered just? In this instance the problem is not complicated by the desire to obtain new cash. The answer to the question depends on the value of the assets of the reorganized corporation on a going-concern basis, *i.e.,* on expected *future* earnings, and on the extent to which that value is due to the retention of the owner-management group (which in this instance owned virtually all the outstanding common stock).

The past earnings which Dewing considered were indeed dismal, but they

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[22]See e.g., Buchanan's treatment. BUCHANAN, ECONOMICS OF CORPORATE ENTERPRISE, Chapters XIII and XIV (1940).

[23]This case is considered at some length in DEWING, FINANCIAL POLICY OF CORPORATIONS 1486-1499 (4th ed. 1940).

[24]*Id.* at 1496.

were the result of a catastrophic cyclical depression in which the pulp and paper industry generally was very severely hit. The increase in the price of pulp in October, 1939, the reduction of foreign competition resulting from the war and the general revival of business in late 1938 and 1939, all presaged a brighter future for Brown Co. If the estimates of value indicated the existence of an equity for the common of the order of magnitude of that which they were in fact given, then, even apart from the value of the management factor, the plan was just. The mere fact that the rights of the bondholders were *changed* does not necessarily indicate any sacrifice on their part. If they have a claim *worth* $25,000,000[25] against assets worth $30,000,000, they make no sacrifice if, after the reorganization, they still have prior enforceable claims *worth* $25,000,000. In most cases the form of the claims cannot remain unchanged if the corporation is to be rehabilitated.

Moreover, in this case, the value of the assets may have been due, in part at least, to the retention of management, so that this factor too would have justified the granting of some share in the reorganized concern to the management interests.

In short, contrary to Dewing's claim, there is nothing inconsistent in the S.E.C.'s attitude as reflected in its brief in the *Los Angeles Lumber* case on the one hand, and its implicit approval of the Brown Co. reorganization on the other. The broad interpretation of the absolute priority doctrine (and it is this broad interpretation which the S. E. C. appears to have adopted) offers room for the working out of reorganization plans which are both equitable and practical. In view of Dewing's comments on this case it should perhaps be repeated that the fairness of a plan cannot be judged on the basis of hindsight; windfall profits or losses which occur after a plan has been confirmed cannot be used as evidence to prove that a plan was not fair when it was confirmed.

An interesting point arises here. It would seem that the going-concern value of a corporation depends to a considerable extent on the nature of its capital structure. Thus, if a corporation has a capital structure composed 50% of bonds and 50% of equity, its assets would clearly be of less value

[25]In view of the attitude displayed by some of the courts and regulatory bodies, and even by certain professional writers in the field of corporation finance, it is perhaps necessary to emphasize that a bond with a *face value* of $1000 may be *worth* much more or much less than $1000 depending on the relation between the market rate of interest for securities involving similar risk factors and the rate of interest on the bond itself, and on the maturity of the bond, not to mention a variety of other factors which may be of importance in certain special circumstances. On this point see the interesting comments in Gerdes, *General Principles of Plans of Reorganization,* 89 U. OF PA. L. REV. 39, 47, 48 (1940).

than identical physical assets owned by a corporation with a capital structure composed entirely of equity, were it not for the reduction in taxes which bond interest permits. This fact follows from the absence of any future possibility of bankruptcy proceedings or other embarrassment arising out of the fixed charges.[26] In the absence of the tax complication then, the greater the reduction in fixed charges that is achieved, the greater would be the value available for satisfying the claims of the junior claimants, so that, in fairness to the latter, complete elimination of fixed charges would be called for. On the other hand, certain investors, both individual and institutional, are unwilling or unable to hold large quantities of junior securities, so that any attempt completely to remove fixed charges might produce a heavy selling of the junior securities and a consequent reduction in their market price which would injure both the former bondholders and the former stockholders. Certainly fixed charges should be reduced to a level which, in the light of the best available estimates of future circumstances, can be safely borne by the company; so much is necessary in order to save the company from the expense of future reorganization. Whether or not the adjustment of fixed charges should be pushed farther, will depend on the relative importance of the loss in tax savings and the danger of adversely affecting the market price of the new equity securities on the one hand, and the increased flexibility and safety which would result from the elimination of fixed charges on the other.

A further point which bears consideration is the justice of the growing practice of granting warrants to the common stockholders for whom no equity in the corporation's assets exists on the basis of a reasonable valuation. This practice is usually justified on the grounds that since the valuation is uncertain and there may be some equity for the stockholders if certain favorable occurrences take place, they should be given a right to participate in case the favorable occurrences should in fact take place. This function is served, it is said, by giving them warrants. If the conservative valuation should turn out to be correct, they would have no claim; but if the most optimistic hopes were realized, they would be able to claim their fair participation.[27] This

[26]The opposite conclusion is reached by GUTHMANN AND DOUGALL, CORPORATE FINANCIAL POLICY 607, 608 (2d ed. 1948), but this is clearly the result of their quite arbitrary choice of capitalization factors. The general consensus that a financial structure composed entirely of equity is sounder than a mixed structure is so overwhelming that it is very surprising that they would depart from it on the basis of such weak—indeed, of quite indefensible—argument.

[27]In Ecker v. Western Pacific R. Corp., 318 U. S. 448, 476, 63 Sup. Ct. 692, 713 (1942), the Court said, "After all reasonable value had been exhausted by senior se-

argument involves the fundamental error of the relative priority approach, namely, it overlooks the fact that value is the resultant of weighing the probability of the occurrence of both favorable and unfavorable developments. If the possibility of gain from some favorable development were in large part eliminated, the value of the claims would be to that extent eliminated. Certainly the market often gives a value to warrants which is independent of the *most probable* expectation regarding future earnings. If such valuable warrants are given to the junior security holders when the value of the assets is insufficient fully to compensate the senior security holders, it is an unwarranted diversion of value, for the issue of warrants will not supply cash when it is needed—at the time of reorganization—but only if and when the corporation is successfully rehabilitated and highly prosperous and probably is in no need of cash.

This is not to say that warrants to purchase stock over some future period should never be issued during a process of reorganization. There may be instances, though they are probably rare, where they may be appropriate, *e.g.*, the owner-management situation, but in general they seem to fill no real function and their issue has frequently been defended by reasoning which rests on a misconception of the valuation process.

Conclusion

In summary, it would seem desirable that the courts and regulatory bodies adopt the broad interpretation of the absolute priority doctrine. Specifically:

1. If the problem of raising cash from junior security holders or of retaining the services of an owner-management group is not present, the only problem is that of valuation of the assets on a going-concern basis. If the valuation indicates any equity for the junior security holders, they should be accorded their residual share, and the fact that certain rights of the senior security holders must be *changed* is of no consequence so long as they receive property or claims equal in *real value* to their former claims—in the words of the Supreme Court in the *Milwaukee* case—so long as they receive "the equitable equivalent of the rights surrendered."[28]

curities, warrants might have been authorized for otherwise unsatisfied claims." But on the other hand, in the *Milwaukee* case we are told that "Only 'meticulous regard for earning capacity' (Consolidated Rock Products Co. v. DuBois, 312 U. S. 510, 525, 61 Sup. Ct. 675 (1940) can afford the old security holders protection against a dilution of their priorities. . . ." Group of Investors v. Milwaukee R. Co., 318 U. S. 523, 541, 63 Sup. Ct. 727, 738 (1942). It is to be hoped that the Court has now recognized that the first statement is untenable if the second is accepted at its face value, but its opinion in the *Milwaukee* case does not justify great optimism on this score.

[28]Group of Investors v. Milwaukee R. Co., 318 U. S. 523, 566, 63 Sup. Ct. 727, 749 (1942).

2. If cash must be raised, and if it can be raised more "cheaply" from junior security holders than from any other source, the fact that said security holders are granted a share in the going-concern value which is greater than the proportion which their cash contribution bears to the going-concern value, should not be construed as diverting value from the senior security holders, but rather as increasing the absolute size of the share of the senior security holders. Similar "rights" should be granted to all security holders.

3. If in the case of owner-managed corporations, the retention of management will increase the going-concern value, the fact that part of the increase must be given to the management in the form of common stock or warrants should not be construed as diverting value from senior security holders, the only qualification being that laid down in the *Los Angeles Lumber* case, namely, that convincing evidence of the value of continued owner-management must be presented, and that the participation granted be not excessive. The fact that rights are granted to one class of junior security holders does not, in this case, necessitate the granting of similar rights to other such groups.

The recommendations outlined above appear to meet the canons of justice and expediency for "involuntary" reorganization. They would obviate the practical difficulties inhering in the attempt to apply the narrow version of the absolute doctrine,[29] and would avoid the serious errors of the relative approach when it is applied to "involuntary" reorganizations. The only possible objection to this broad absolute priority approach would seem to be the difficulty of some of the valuation problems which are involved; but as the S. E. C. has said, "The difficulty of valuation is not a pertinent argument against attempting valuation; the choice is between having or not having objective standards for determining the fairness of reorganization plans—an issue which the Supreme Court has now resolved beyond further question."[30]

Finally, a new reorganization procedure should be established which would leave the door open for "formal compositions" and would provide a means for preventing the obstructionist tactics of minority groups who might try to enforce the absolute rule even though its application would mean serious injustice to junior claimants.

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[29]On this point see BUCHANAN, ECONOMICS OF CORPORATE ENTERPRISE 383-389 (1940).

[30]SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 156 (1940).