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Affecting Rights to Equity Interests under Chapter XI of the Bankruptcy Act - An Dedicated to Wilber G. Katz

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AFFECTING RIGHTS TO EQUITY INTERESTS UNDER CHAPTER XI OF THE BANKRUPTCY ACT†

AN ESSAY DEDICATED TO WILBER G. KATZ

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To what extent can rights to acquire equity interests in debtor corporations be affected by arrangements processed under chapter XI of the Bankruptcy Act?

At the heart of chapter XI is the command that an arrangement "shall include provisions modifying or altering the rights of unsecured creditors generally or of some class of them, upon any terms or for any consideration."[1] It is permissible for the arrangement to include "provisions for treatment of unsecured debts on a parity one with the other, or for the division of such debts into classes and the treatment thereof in different ways or upon different terms;"[2] and it is also permissible for the arrangement to include "provisions for the rejection of any executory contract."[3] To become effective an arrangement must clear two hurdles: It must be accepted "by a majority in number of all creditors or, if the creditors are divided into classes, by a majority in number of all creditors of each class affected by the arrangement, . . . which number shall represent a majority in amount of such claims generally or of each class of claims, as the case may be."[4] And it then must be confirmed by the court after a finding that the arrangement "is for the best interests of the creditors and is feasible."[5] Nothing in the chapter explicitly authorizes provisions affecting the rights of shareholders, nor the rights of persons entitled to become shareholders. This latter category covers rights to acquire shares through conversion of debt instruments, through exercise of options or warrants, and through operation of other types of contracts. It is the status of these rights under chapter XI which is our topic.

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1. Bankruptcy Act § 356, 11 U.S.C. § 756 (1970).
2. *Id.* § 357(1), 11 U.S.C. § 757(1) (1970).
3. *Id.* § 357(2), 11 U.S.C. § 757(2) (1970).
4. *Id.* § 362, 11 U.S.C. § 762(1) (1970).
5. *Id.* § 366(2), 11 U.S.C. § 766(2) (1970).

Considering that chapter XI has been in operation for more than three decades, and that some 20,000 proceedings have been processed under it, one might assume that most aspects of this limited subject have been already explored. But the fact is otherwise. The recent *Flora Mir Candy Corporation*[6] proceedings dramatically underscore the absence of commentary in this area of the law. At the same time, the particular controversy in *Flora Mir* serves as a good point of departure for analyzing the reach of chapter XI with regard to equity interests in a debtor corporation and contingent rights to acquire such equity interests.

The central problem in *Flora Mir* grew out of the circumstance that the financially troubled debtor corporation had outstanding an issue of subordinated convertible debentures. The debtor's plan of arrangement—filed before debenture holders had exercised their conversion option—provided that all unsecured creditors, including the debenture holders, would be given preferred stock in the debtor corporation on a dollar for dollar basis in full satisfaction of their claims.

During the negotiations over the proposed arrangement, the debtor moved to reject and disaffirm the convertible debentures as executory contracts—a move opposed by the debenture holders. The debtor contended that if the debenture holders were permitted to convert their debentures into common shares they would end up with a disproportionately large amount of the equity as compared to other creditors, all of whose claims were senior to the debentures.[7] It went on to argue that, in the face of this prospect, the arrangement would not be approved by the creditors and that such a failure would be burdensome to the corporation. In the words of the debtor: "Only by rejecting and disaffirming [the] convertible subordinated debentures in their entirety and directing the holders thereof to file claims in these proceedings and permitting them to participate under the proposed arrangement as indicated can the arrangement be made feasible."[8] With this it coupled the point that "the number of shares of stock which conversion of the debentures would compel be issued would limit and restrict the availability of such stock to the debtor for future financing and the obtaining of needed capital."[9] If the debentures were not disaffirmed, argued the debtor, the proposed plan would

6. *In re* Flora Mir Candy Corp., No. 69-B-316 (S.D.N.Y., filed Feb. 22, 1971), *aff'd* per curiam, 454 F.2d 1176 (2d Cir. 1971).

7. It should be noted that under the plan the creditors other than debenture holders would get preferred shares and the debenture holders would, upon conversion, get common shares. This pattern, which would preserve relative priorities, reveals that the real conflict is between the debenture holders and the common shareholders.

8. *In re* Flora Mir Candy Corp., No. 69-B-316, at 4 (S.D.N.Y., filed Feb. 22, 1971).

9. *Id.*

require both substantial modification and a new vote of the creditors, "thereby placing the entire arrangement in jeopardy and risking that the arrangement proceedings themselves will be aborted."[10] The ultimate thrust of the debtor's position thus was that "the efforts of the debtor to rehabilitate itself and pay off the [relatively large amount of] superior unsecured debt deserves priority over the debenture holders' claim for conversion."[11]

The debenture holders relied on several contentions to prevent extinguishment of their conversion rights. They argued that convertible debentures are equity securities, and cannot be affected by an arrangement under chapter XI. They argued that this position was buttressed by the fact that a convertible debenture is not itself a contract, and in any case is not an executory contract in any real sense inasmuch as "[n]o additional payment is made upon conversion" and the act of conversion is "purely ministerial."[12] In the alternative, the debenture holders argued that—even assuming the debentures to be executory contracts— disaffirmance would be an abuse of judicial discretion in view of the nature of the burden asserted to arise from carrying out the conversion provision. To properly disaffirm under chapter XI, they urged, the burden cannot consist of failure of a proposed arrangement but should be limited to a day-to-day burden on the work of the corporation.

The referee's order disaffirming the debentures as burdensome was appealed. Treating the matter as one of first impression, the bankruptcy court determined that the interests of the debenture holders could be reached by an arrangement under chapter XI because the convertible debentures "are evidences of debt and not of ownership;"[13] the debentures were executory contracts under applicable state law (and hence for purposes of the Bankruptcy Act) inasmuch as the option to convert "had not been executed up to the time that the motion for rejection was made before the referee;" and the referee's finding of burdensomeness was not clearly erroneous if the evidence (which was confused) established that conversion would prevent creditors from accepting the plan. The court accepted the referee's view that "there is no reason to suppose that an executory contract is not burdensome merely because it goes to success in confirmation [of an arrangement] rather than facilitating a small portion of the debtor's daily business operation."[14] The court of appeals affirmed in a per curiam decision without discussion.[15]

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10. *Id.* at 7.
11. *Id.*
12. Brief for Appellant at 11-12, *In re* Flora Mir Candy Corp., 454 F.2d 1176 (2d Cir. 1971).
13. *In re* Flora Mir Candy Corp., No. 69-B-316, at 11 (S.D.N.Y., filed Feb. 22, 1971).
14. *Id.* at 13.
15. *In re* Flora Mir Candy Corp., 454 F.2d 1176 (2d Cir. 1971).

Read broadly, *Flora Mir* asserts a doctrine of considerable importance in delineating the reaches of chapter XI. The essence of the *Flora Mir* doctrine is that rights to acquire an equity interest in the debtor corporation, being both contractual and executory in nature, can be extinguished by disaffirmance if it is found that leaving the rights intact will burden the debtor by making an otherwise satisfactory arrangement unacceptable to creditors. This broad proposition invites examination.

It seems most unlikely that the soundness or desirability of the *Flora Mir* doctrine can be tested by inquiring whether, under applicable law, convertible debt or other types of rights to acquire an equity interest are to be regarded as contracts or as securities or as some other conceptual relationship. For some purposes, convertible debentures have been classed as "debt obligations;"[16] for other purposes they have been treated as equity securities;[17] and for still others they have been dealt with as a combination of a debt obligation plus a right or privilege to acquire an interest in the equity.[18] The proper categorization must depend on the particular function or functions to be served by the designation. Viewing the categorization question in the abstract is an exercise in aridity. Likewise there is not much promise in inquiring whether a right or privilege to acquire an equity interest is or is not executory under applicable state law. Illumination is only to be had by inquiring whether, given the history and purposes of the legislation, such rights or privileges are extinguishable under chapter XI.

In pursuing this question it is tempting to be influenced, as the bankruptcy court appears to have been in *Flora Mir*, by the view that it is of paramount importance to facilitate arrangements which will be both approved by creditors and confirmed by the courts, so as to preserve businesses as operating entities. As a general guideline, however, this orientation is likely to be misleading. Chapter XI obviously was not designed to confer carte blanche authority to do whatever is necessary to arrive at arrangements acceptable to creditors. A more modest and discriminating approach to the subject at hand is apt to yield more defensible results.

A principle to begin with is that chapter XI does not authorize the modification of existing shareholder positions pursuant to arrangements.[19] The origins of this significant limitation are ob-

16. *See, e.g.*, Union Pacific R.R. v. United States, 401 F.2d 778 (Ct. Cl. 1968), *cert. denied*, 403 U.S. 931 (1971) (decided under the World War II Excess Profits Tax Act).

17. *See, e.g.*, Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p (1970).

18. *See* Hills, *Convertible Securities—Legal Aspects and Draftsmanship*, 19 CALIF. L. REV. 1 (1930).

19. Chapter XI contains the following language: "An arrangement with-

scure. There do not seem to be any statements in the legislative history of either chapter XI or its predecessors, section 74 and the old section 12 composition provision of the Bankruptcy Act,[20] which directly throw light on this matter. Nevertheless a few conjectures are warranted on the basis of the background against which chapter XI was developed.

There can be no doubt that the earlier composition section and the later arrangement chapter were designed primarily to deal with financially troubled individual businessmen and with closely held corporations. It was contemplated that the debtor would usually be in charge, would sound out the creditors, would devise a plan, and would try to persuade the creditors to accept it. In the case of corporations, this pattern does not envisage controversy among the shareholders; on the contrary, it would be realistic to assume that shareholders, who are seeking to keep the business going and to ward off creditors, would fully agree among themselves that the proposed plan is in their best interests. In the overwhelming majority of situations there will indeed be an identity of interests among shareholders.

This is not to imply that composition and arrangement plans have always left the interests of shareholders entirely unaffected. It has been fairly common for plans to transfer portions of the equity to creditors in order to satisfy a part of their claims or to compensate them for delay in payment or for the extension of new credit. As long as all existing shareholders are agreeable—in the sense of not making a formal objection—no question as to the reach of the law would be raised. There was, of course, no need for explicit authorization in the chapter XI legislation to en-

in the meaning of this chapter shall include provisions modifying or altering the rights of unsecured creditors generally or of some class of them, upon any terms or for any consideration." Bankruptcy Act § 356, 11 U.S.C. § 756 (1970). The term "consideration" is defined to include "stock." *Id.* § 306(2), 11 U.S.C. § 706(2) (1970). It would be improper to read these provisions as authorizing use of the chapter to compel shareholders to suffer a change or reduction in their equity interests. To harmonize these provisions with the structure and purpose of the chapter, they must be understood as having a much more limited reach. They make it clear that, as part of an arrangement, dissenting creditors can be forced to participate in a plan which calls for payment, entirely or partially, in stock which the shareholders make available or will cause the debtor to issue. This use obviously is not the same as coercing the participation of those shareholders who object to an arrangement which modifies their interests in the equity. The difference is explored later in the text.

20. Section 12 was originally enacted as part of the Bankruptcy Act of 1898, ch. 541, § 12, 30 Stat. 549 (1898). Section 12 was amended twice: ch. 412, § 5, 36 Stat. 839 (1910); ch. 406, § 5, 44 Stat. 663 (1926). It was then supplemented by ch. 204, § 74, 47 Stat. 1467 (1933). Finally, section 12 was incorporated into the Chandler Act as chapter XI. Ch. 575, 52 Stat. 840 (1938). Chapter X is now codified in 11 U.S.C. §§ 501-676 (1970).

able the shareholder group voluntarily to give up part of the equity to creditors.[21]

It is not difficult to envisage situations in which a minority of shareholders would dissent from a plan put forward by the majority, even though without the contested feature the plan might be unacceptable to creditors. Consider the following illustration: A proposed plan calls for extending and scaling down certain long term debts of the corporation and compensating the debt holders by turning over to them a substantial block of outstanding common shares held by the shareholders. The majority of shareholders are active in managing the corporation, while an inactive minority has been the primary suppliers of equity capital. Under these conditions the majority are willing to suffer a diminution in their equity position because their managerial position is not disturbed thereby; the minority, however, do not occupy a parallel position and could reasonably find the plan inimical to their best interests. The point to be underscored by this suppositious case is virtually indisputable. Even if it were admitted that a veto by the minority would doom the proposed arrangement and further that creditors would reject the plan unless the equity was redistributed, there would be no power under chapter XI for the court to coerce the minority shareholders into participating in the redistribution by giving up part of the shares which they hold. The majority shareholders in a chapter XI proceeding could volunteer to give up any portion of their shareholdings which they thought suitable, but the minority could refuse to give up any portion of its holdings and could not be coerced under chapter XI into so doing.

It is probable that the majority could cause the corporation to issue to creditors, in conjunction with a confirmed plan of arrangement, a portion of its authorized but unissued shares. Such a step would admittedly have the effect of diluting the participation of both the majority and the minority shareholders in equal proportions and would have the corollary effect of conscripting the unwilling minority into contributing a portion of its equity in order to make the arrangement acceptable to creditors. This obviously would affect the position of all stockholders in connection with the arrangement by virtue of the issuance of additional shares. The action, however, would not be quite the same as demanding a redistribution of outstanding shares, or altering

21. Chapter XI deals with corporations and proprietorships in the same way. The theory of relief it embodies—in fact the whole scheme of the chapter—was designed to deal both with proprietorships and corporations. This probably is an added explanation of why chapter XI does not envisage compelling a change in shareholder rights. It could be argued that inasmuch as rights to acquire an equity interest cannot arise in the case of a proprietorship, the chapter must not be an appropriate vehicle for affecting them in the case of corporations.

the terms of outstanding equity securities, or transmuting securities of one class into securities of another class. In any event, the issuance of additional authorized shares would be based on rights conferred by state corporation law and not by chapter XI.[22]

The importance of this point can be illustrated by postulating a capital structure with preferred stock and common stock outstanding. If the creditors demanded, as the price for their concurrence in the arrangement, that they be granted a specified percentage of the common equity, this adjustment might be accomplished by majority action under state law if authorized but unissued shares were available. If, however, the creditors asked in addition that common stock allocable to them be made more valuable by having the preferred stock deprived of its preferential position and having it changed into common stock, this could not be done under state law nor could the bankruptcy court coerce it under chapter XI.

Why, it might be asked, is this power of coercing shareholders denied in chapter XI when it is granted explicitly under chapter X?[23] While the legislative history is almost barren on this particular score, again the probable explanation can be inferred from the underlying nature of the two chapters. Proceedings in chapter X are surrounded by extensive safeguards and constraints not present in chapter XI, and the role and importance of the debtor in shaping and putting through the plan is much less prominent in chapter X.[24] Moreover, unusually complex and vexing problems of fairness among shareholders frequently arise when a plan compels a redistribution of the equity. It seems most likely, given the minimal safeguards and the dominant role of the debtor which characterize proceedings under chapter XI (as well as those under the predecessor composition section), that there was a reluctance to allow this vehicle of debtor relief to be used as a device for compelling adjustment of the rights of minority shareholders.

The question raised by *Flora Mir*, then, is whether these policy considerations have any bearing on the status, under chapter XI, not of existing equity interests but of rights to acquire such interests. The clearest case might be presented by warrants to obtain shares on payment of a stated price.[25] Suppose a situation in

22. *See* Posi-Seal International, Inc. v. Chipperfield, 457 F.2d 237 (2d Cir. 1972). The court confirmed an arrangement under chapter XI which contemplated distribution of part of the equity in the debtor corporation to persons who were not shareholders. Confirmation was expressly conditioned on success in obtaining authorization pursuant to the law of the state of incorporation.

23. Bankruptcy Act § 224, 11 U.S.C. § 624 (1970).

24. SEC v. United States Realty Co., 310 U.S. 434 (1940).

25. This situation is most graphically illustrated when the warrants are short term and fix an exercise price fairly close to the current market price for stock which had been sold by the corporation to the public in an ordinary public offering. The same principle holds good no matter how

which shareholders are divided into a managing majority and an inactive minority; suppose further that the minority also holds stock purchase warrants, enabling them at a fixed price to increase their portion of ownership, pursuant to a bargain negotiated in connection with putting equity capital into the corporation at a prior critical time. Lastly, assume that an arrangement proposed under chapter XI contemplates that the warrants be cancelled, the justification being that creditors will not approve the plan unless new equity capital can be raised and that such a capital infusion would not be feasible while the warrants are still outstanding. Warrant holders are unanimous in opposing this aspect of the plan.

It would seem that the policy against compelling changes in shareholder rights under chapter XI applies with equal force to the warrants in this situation. Although convertible debentures are sometimes described as debt and sometimes as equity securities, depending upon the purpose for which they are being considered, warrants are virtually always categorized as equity securities. For the purpose of evaluating the *Flora Mir* doctrine, there is no functional difference between coercing the minority into accepting a reduction in its present portion of the equity and coercing it into giving up its contractual right to increase that portion. In each situation, the adjustment involves a modification in actual or potential distribution of equity ownership—precisely the type of change which chapter XI was not designed to effectuate. The same can be said of a situation where the warrants are held not by existing shareholders but by purchasers from these shareholders.

Support for this view can be derived from noting what would be entailed in computing the claim for damages assertable if a warrant were permitted to be rejected as an executory contract.[26] In the typical case, disaffirmance of an executory contract gives rise to a claim, based on ordinary contract principles, for the out-of-pocket losses (but not loss of profits) attributable to aborting the contractual arrangement. What would be the comparable measure of damage if warrants were extinguished by rejection?

long the warrants remain in existence or even if they are perpetual warrants. The same principle should also hold good whatever exercise price is stipulated in the warrants for purchase of the stock deliverable upon exercise.

26. In passing it might be noted that under chapter XI one whose executory contract with the debtor is disaffirmed becomes a "creditor" of the debtor. Bankruptcy Act § 353, 11 U.S.C. § 753 (1970). Were warrants to acquire shares in the debtor corporation treated as executory contracts, upon disaffirmance the warrant holders would become "creditors." The awkwardness of such a result lends additional weight to the argument that options to acquire shares in the debtor corporation ought not to be regarded as executory contracts under chapter XI. Would it ever be defensible to transform a right to acquire an equity interest in the debtor into a claim which participates in the debtor's estate on the same basis as claims of creditors generally?

The only conceivable gauge would necessitate placing a value on the warrants;[27] that undertaking would require first making a valuation of the entire equity and then evaluating a right to purchase a portion of that equity. The very differences, already alluded to, between the procedural safeguards and roles of participants in chapter XI as compared with chapter X, strongly indicate why the former is not an appropriate vehicle for adjusting rights of shareholders or warrant holders. The structure for developing a plan of reorganization under chapter X facilitates arriving at a valuation for an enterprise as a whole and of equity interests within it; indeed, most proceedings under that chapter call for making such a valuation. In marked contrast, the format for chapter XI is not conducive to valuing either the enterprise or an equity component of its capital structure. The fact is that there is virtually no official record or any learned literature dealing with the valuation of equity interests under that chapter.

The thrust of this point can be reinforced by referring to the significant difference between the statutory thresholds for confirmation of plans under the two chapters. Chapter X requires that a plan be "fair and equitable."[28] The standard expressed in this term of art—which is well understood to incorporate the notion that priority of position must be fully recognized and that full compensation must be accorded for rights given up in a reorganization—generally can be complied with only if a value has been placed on the enterprise as a going concern.[29] In contrast, chapter XI requires simply that a plan be "for the best interests of the creditors."[30] Unlike the fair and equitable concept, this standard essentially calls for a determination that the creditors will be at least as well off as in an immediate liquidation of the enterprise. In making that judgment there is no need to value the enterprise itself or the equity component of its capital structure.

27. The Supreme Court, in Niagara Hudson Power Corp. v. Leventritt, 340 U.S. 336 (1951), held that perpetual warrants to acquire shares in a holding company could be eliminated in proceedings under the Public Utility Holding Company Act, 15 U.S.C. § 79 et seq. (1970). That conclusion should have no relevance for proceedings under chapter XI. The warrants were eliminated in *Niagara Hudson* because they were found to be without value for purposes of applying the "investment value" standard, which has been read into the Public Utility Holding Company Act criterion that a plan must be "fair and equitable." Proceedings under that act are, like those under chapter X and unlike those under chapter XI of the Bankruptcy Act, surrounded by strong procedural safeguards; and the standard for confirming a plan which coerces dissenters is not the loose chapter XI one of "for the best interests of the creditors." Further, the Public Utility Holding Company Act does not authorize rejection of executory contracts and hence there was no argument in *Niagara Hudson* to the effect that perpetual warrants are contracts of an executory nature.

28. Bankruptcy Act § 221(2), 11 U.S.C. § 621(2) (1970).

29. *See* Blum, *Full Priority and Full Compensation in Corporate Reorganizations: A Reappraisal*, 25 U. CHI. L. REV. 417 (1958).

30. Bankruptcy Act § 366(2), 11 U.S.C. § 766(2) (1970).

Reading backward from these observations, it is fair to conclude that equity valuations are not envisaged by chapter XI, that proceedings under it do not lend themselves to putting a valuation on the warrant component of the total equity, and that it would be inappropriate to use the chapter to transform warrants into claims for damages.[31]

If chapter XI could be used as a mechanism for the elimination of warrants, it could similarly be utilized as a means of sloughing off other kinds of calls upon equity, such as nontransferable options. For example, suppose a closely held corporation had outstanding a simple option entitling the holder to buy a specified number of shares, and that the exercise of the option would have significant effect upon the allocation of control within the enterprise. If chapter XI could be used to dispose of this kind of option, the door would be open to unscrupulous tactics. A corporation could file a petition under chapter XI and propose a plan of arrangement agreeable to creditors—perhaps because they are to be little affected by the modification and may even be paid off in short order. In conjunction with the plan the option to purchase stock from the corporation could be rejected as burdensome in that it impedes raising needed additional capital, thereby enabling the present controlling stockholders to perpetuate themselves in office and to avoid the impact of the option for delivery of shares to which the debtor had previously agreed. Adhering to the *Flora Mir* doctrine thus might provide a device for shareholders who wished to renege on the commitments of their corporations for the issuance of shares.

There is an important interplay between the disaffirmance of executory contracts and the classification of creditors. If warrants

31. Additional support for the position taken in the text might be grounded on the history of the "for the best interests of the creditors" standard which governs the confirmability of plans under chapter XI. As originally enacted the chapter XI standard was phrased in the same "fair and equitable" language as the standard contained in chapter X. Bankruptcy Act § 366, ch. 575, § 366, 52 Stat. 911 (1938), *as amended*, 11 U.S.C. § 766 (1970). It was early recognized, however, that the "absolute priority" and "full compensation" conceptions—which are at the heart of the chapter X standard—were out of keeping with the main function envisaged for chapter XI. The thrust of chapter XI is to allow proprietors or shareholders to retain their interest in financially troubled enterprises while creditors accede to a postponement or a reduction in payments to which they are entitled. Changing the language in the chapter XI standard, from "fair and equitable" to "best interests of the creditors" was explicitly intended to bring the statutory language into line with the function of the chapter. *See* General Stores Corp. v. Schlensky, 350 U.S. 462, 468, 471 (1956) (Frankfurter, J., dissenting).

One is hard put to imagine how the chapter XI standard could rationally be applied in the case of those who hold rights to acquire a portion of the equity of the debtor. In what sense, for example, would it be in the best interests of warrant holders to transform them into creditors and then force them into a composition with the debtor?

to purchase stock were treated as executory contracts, vulnerable to disaffirmance, the holders might be unable to protect their position through exercise of a class vote. In any claim for damages resulting from rejection they would be general creditors and would vote, if at all, only as participants in that pool. Their homogenized voting strength is not likely to be enough to generate effective bargaining power.

In the case of convertible debentures, *Flora Mir* imposes an even greater voting disadvantage on the holders. A debenture without any conversion rights would surely not be classed as an executory contract, and the holder could not only vote the full amount of his debenture as a claim but might, in all likelihood, successfully insist that the debenture owners be grouped as a separate class of creditors for voting purposes. The debenture holders would therefore have a strong position in negotiating with the debtor over the terms of any arrangement. One might have thought that the convertible debenture would be analyzed by a court which permitted tinkering with such a security under chapter XI as consisting of two items—the unequivocal promise to pay plus the right to convert; one might further have thought that these two items would be treated as separable, meaning that a disaffirmance of a right to convert would not have any effect upon the obligation to pay.[32] If this approach were taken, the right of the debenture holder as debt creditor would remain unchanged by the disaffirmance and that action would apply solely to the right to convert. In the event of disaffirmance the debenture holder should be in a separate creditor class so far as his position as owner of the debtor's promise to pay is concerned. In addition, he should have a claim as an undifferentiated general creditor for the damages resulting from the negation of the right to convert.

Flora Mir undercuts this potential voting strength of the debenture holder. By viewing the convertible debenture as a single contract, and by treating it as executory because of the existence of a conversion feature, the court virtually destroyed any claim of the debenture holders to be classified as a separate voting group and bolstered the argument for lumping them together with unsecured creditors generally. Strange indeed that an added right—convertibility—should detract from the protection accorded a debenture owner under chapter XI.

The choice between viewing a convertible debenture as a single item or as two separable items has other consequences where, as in *Flora Mir* itself, the debenture debt is subordinated to claims of general unsecured creditors. If the conversion feature were treated as a separate right, upon disaffirmance the debenture owners would remain holders of subordinated claims junior to the

32. *See, e.g.,* Augusta Trust Co. v. Augusta, Hallowell & Gardiner R.R., 134 Me. 314, 187 A. 1 (1936).

general creditors for the amount of their debentures and would become general creditors for the amount of damages resulting from the rejection of the executory contract to convert. In chapter X the consequences of being junior to general creditors might result in wholly or partially denying participation to the class under the plan of reorganization developed around a valuation of the enterprise, which is at the center of such a proceeding. Under chapter XI, where a class of creditors cannot be "valued out" of the enterprise, the junior status of the debenture holders would not have the same significance. Being a separate class would not jeopardize their right to participate in the enterprise but rather would give them leverage and protection during the negotiations.

Treating the subordinated convertible debenture as a single item, as did the court in *Flora Mir,* produces an extraordinary twist. Because of the convertibility feature, the court authorized the entire debenture (including the convertibility feature) to be disaffirmed and then moved the entire claim on the convertible debenture upward in the scale of priority—out of the position of being subordinate to general creditors and into the position of being on a parity with such creditors. In substance, the existence of a convertibility feature made the position of convertible debenture holders less secure than the position of nonconvertible debenture holders; the process of rejection had the effect of transmuting a subordinated creditor into a nonsubordinated creditor—seemingly for the strange purpose of submerging his voice in the vote upon the plan.

A convertible debenture is usually regarded in the financial community as practically equivalent to a package consisting of a debenture together with warrants to purchase stock. Under *Flora Mir,* however, if the investor accepts a convertible debenture he is vulnerable to disaffirmance of his entire contract and thus may be put into a general class of unsecured creditors. If, on the other hand, to achieve exactly the same financial objective the investor had specified a debenture together with stock warrants embodying the same amount and type of call upon shares, a chapter XI court would be powerless to subject him to a similar change in position. While the investor then would be the holder of two separate instruments instead of one, the documents could be so drafted that his economic rights would be practically identical in each situation.[33] In view of this equivalence it seems quite extraordinary that holders of a convertible debenture issue should be both deprived of their right to obtain stock in the corporation and

33. Although stock warrants normally call for payment of a certain sum of money in order to exercise them, they can be equated to a convertible debenture by providing that the holder of a stock warrant can make payment for the price specified upon exercise of the warrant through applying the debentures in payment of such price.

barred from enjoying the position of a separate class of creditors in the voting on a plan.

It should be observed, moreover, that valuing a disaffirmed convertible debenture presents the same difficulties as valuing an independent warrant. For valuation purposes, above all others, a convertible debenture realistically must be viewed as a combination of a debenture and an option to acquire shares. In the very ways that chapter XI is unsuitable for accomplishing the latter it is equally unsuitable for attempting the former. Any difference in the two processes is more likely to suggest that chapter XI is even less appropriate for dealing with the convertible debenture because the combination of elements conceivably could introduce an added complication, calling for a higher degree of expertise in arriving at a valuation.[34]

These reflections on the awkwardness of treating warrants and convertible debt securities as disaffirmable under chapter XI suggest that the scope of its executory contract clause be examined in greater depth. As noted earlier, the debenture holders in *Flora Mir* unsuccessfully argued that "only a day-to-day burden on the work of the corporation should be the basis for disaffirming executory contracts,"[35] while the debtor prevailed with the contention that disaffirmance was justified if necessary to avoid aborting the proposed arrangement. The court, it is submitted, reached this conclusion too quickly. The executory contracts clause in chapter XI (as well as in chapter X) was drawn from the comparable provision governing ordinary bankruptcies.[36] There can be little doubt

34. Some might argue that it is appropriate to reject a convertible feature in a debenture where the exercise price is so far above the current market price of the debtor's stock that it is unlikely that the right to convert will ever be exercised. However facile this solution to the problem might seem, one should recognize that it necessarily involves evaluating the worth of the right to convert; and, like the valuation of an independent warrant, worth is a function of the conversion price, the duration of the conversion feature, and the prospects that at some future time the fortunes of the corporation will be such that the conversion right will be exercised. This calls for a valuation process not different from that which is the central core of chapter X. The issue should not be allowed to be resolved by a short cut or without meaningful safeguards and controls of the kind which chapter X contains.

35. *In re* Flora Mir Candy Corp., No. 69-B-316, at 6 (S.D.N.Y., filed Feb. 22, 1971).

36. "The trustee shall assume or reject an executory contract, including an unexpired lease or real property, within sixty days after the adjudication . . . ." Bankruptcy Act § 70(b), 11 U.S.C. § 110(b) (1970).

By way of comparison, chapter XI provides: "An arrangement within the meaning of this chapter may include . . . (2) provisions for the rejection of any executory contract . . . ." Bankruptcy Act § 357, 11 U.S.C. § 757 (1970). On the other hand, chapter X provides: "A plan of reorganization under this chapter . . . (4) may provide for the rejection of any executory contract except contracts in the public authority . . . ." Bankruptcy Act § 216, 11 U.S.C. § 616 (1970).

as to the intended function of that provision. Authority is granted to reject executory contracts in ordinary bankruptcy to avoid burdening the debtor estate. In practical terms this means that, after an adjudication in bankruptcy, steps can be taken by the court to prevent completion of an executory contract, thereby protecting creditors of the debtor from the burden of the interest and forcing the other party to the contract to claim damages and thus to share the misfortune of the creditors in general. Disaffirmance, then, is a way of adjusting the distribution of the debtor's assets among those creditors who suffer by the financial failure—it is a mode of achieving a fair allocation of loss among all creditors. It was not designed as a means of otherwise promoting the welfare of the debtor.

In a chapter XI setting there is no reason to think that the power to disaffirm is intended to serve any different function. It is true that a disaffirmance, by readjusting rights as indicated, might facilitate arriving at an acceptable and feasible arrangement; it is also true that the arrangement itself might work to preserve the interest of the equity owners in the enterprise—an interest which likely would be lost in an immediate liquidation. This consequence of disaffirmance, however, should not be confused with the function of disaffirmance validated by the court in *Flora Mir*. Again consider the purpose of a request to reject warrants to acquire shares. Disaffirmance in this situation would not serve to improve the position of creditors by preventing a drain of assets through fulfilling a burdensome contract; instead it would merely serve to improve the position of shareholders at the expense of the warrant holders. A parallel condition would prevail where, as in *Flora Mir*, convertible debentures are held subject to disaffirmance. Such a function of the disaffirmance clause in chapter XI seems too far removed from that contemplated by the disaffirmance clause in ordinary bankruptcy to be sustainable, especially in view of the historical relationship between the two provisions.

Up to this juncture the discussion of rejecting rights to acquire equity interests has dealt with warrants to acquire shares and with debt securities convertible into shares. There are of course numerous other relationships involving rights to acquire shares on the happening of stated conditions.[37] Representative of these is the fairly common open ended acquisition agreement. One corpora-

37. The question of the rejectability of a contract calling for the issuance by the debtor of subordinated debentures convertible into common stock was presented in the case of *In re* Grayson-Robinson Stores, Inc., 227 F. Supp. 609 (S.D.N.Y. 1964). Unfortunately, from the point of view of aiding analysis of the problem of rejectability, the controversy was decided on the ground that the referee lacked jurisdiction to reject a contract subsequent to confirmation of an arrangement plan where the contract had inadvertently been omitted from the debtor's schedules.

tion obtains the assets or stock of another corporation in return for a certain number of its own shares and a promise to deliver a specified number of additional shares if earnings or income or some other measure of performance reaches a certain level. What is the status of this promise if the acquiring company seeks the protection of chapter XI before the condition for its delivery of additional stock has been satisfied? To sharpen the question, assume that a proposed plan of arrangement calls for compensating creditors in part with shares of the debtor, that all present shareholders consent to this plan, and that the plan will be unacceptable to creditors if the outstanding contingent right to acquire shares under the old purchase agreement remains in effect.

The argument under *Flora Mir* is that it would be illogical to confer a higher degree of invulnerability on a promise to deliver shares as contrasted to cash. Reduced to practical terms, the question is, why endow those having a conditional right to receive shares with greater power to prevent adoption of a proposed arrangement than is granted those who have a conditional right to receive money? In both instances, after all, the promisees obtained their conditional rights through selling a thing of value to a corporation, now operating under chapter XI.

The response calls for focusing more closely on the proper function of the right to disaffirm executory contracts. If the debtor's promise were a conditional one to deliver money, it would be proper to reject the contract under chapter XI in order to promote fairness among those seeking, as existing or future creditors, to share in the debtor's estate. Disaffirmance in this situation would further its historic and accepted function in bankruptcy. Moreover it would result in money damages, which is appropriate because the position of the party contracting with the debtor was that of a conditional claimant for money at all times. On the other hand, rejection would have totally different consequences and would be improper where the debtor's promise is to deliver, either conditionally or unconditionally, more shares of the debtor in the future. The beneficiaries of such a promise are not seeking to withdraw assets from the debtor's estate, either now or later; for that very reason they are not competing with the claims of others who are seeking to do so. Instead, they are looking forward to a redistribution of the equity interest in the corporation between themselves and the present shareholders. Chapter XI should not be turned by the courts into a forum for compelling a redistribution of equity interests.

With this reasoning as a guide, it should ordinarily be an easy task to distinguish between disaffirmable executory contracts and rights to equity interests which should not be subject to disaffirmance. One test of the distinction would be presented where a debtor corporation has agreed for adequate consideration to issue and deliver a debt instrument which is convertible into its shares. Those who seek to have the agreement enforced can point out that under it they are in a position to become shareholders on stated terms in two steps. Such a contract nonetheless ought to be disaffirmable in chapter XI under some circumstances. Before gaining the right to become shareholders, the promisees must first become owners of the debt obligation. In trying to move into that position these promisees ultimately are competing with other creditors and claimants who will be seeking satisfaction out of the assets of the debtor corporation. For this reason they should be treated as having executory contracts which could be disaffirmed if the terms of the promised debt instrument are of such character as to be burdensome. There is no way, in short, to preserve their expectations regarding an ultimate equity interest under a debt instrument which is in itself burdensome without giving them an advantage over creditors of the debtor enterprise. The mere addition of a right to acquire an ultimate equity interest would not, however, make a promise to deliver a debt instrument disaffirmable, if the terms of that debt instrument are not in themselves burdensome.

Another problem must be faced in working out the suggested distinction between disaffirmable executory contracts and nondisaffirmable rights to equity interests. Consider a promise by a corporation purchasing assets to deliver to the seller at a specified date in the future whatever quantity of its shares is required to equal, at the then market price, a stated total dollar value.[38] At first impression this fixed dollar program appears similar to a performance bonus, calling for delivery of a certain number of shares if a performance condition has been satisfied. On further analysis, however, a critical difference between the two situations emerges. In the performance bonus situation, the essence of the deal is that the selling party will gain from the performance achievement through obtaining additional shares in the purchasing corporation. Thus the seller stands the risk of nonachievement, and the payoff for success is to be in the form of greater future participation in the equity of the purchasing corporation—at the expense of others then already participating in that equity. The seller in this sense realistically has a contingent claim on the equity. In the contrasting fixed dollar situation, the size of the seller's claim against the purchasing corporation is first measured in dollars and then the amount fixed is to be satisfied in the form of an initial number of shares plus whatever number of additional shares are needed to reach the dollar total. The seller here is not

38. This situation is illustrated by the case of *In re* KDI Corp., Bankruptcy No. 61463 (S.D. Ohio, Mar. 9, 1972). The court decided that the arrangement should be categorized as an executory contract subject to disaffirmance, but the opinion did not reach the risk point suggested in the text.

taking a risk based on the value of the shares as of the time for completing payment of the purchase price.[39] Realistically the fixed dollar program amounts to an initial payment plus a promise by the purchasing company to pay a determinable sum of money to the seller at a future time, payable in shares of that company at the market price prevailing at the later date. Viewed in this way, the transaction should be treated simply as a promise to pay to the seller an additional sum determinable in the future. The seller in the fixed dollar program is either a creditor or a party to an executory contract which should be disaffirmable if burdensome. The seller in a performance bonus program is neither such a creditor nor a party to an executory contract, and his right should not be subject to disaffirmance.

A recapitulation with respect to *Flora Mir* is now in order. The doctrine of the case, which permits use of chapter XI to disaffirm rights to acquire an equity interest in the debtor corporation, is unsound. It is without historical justification; it is open to abuse; it distorts the function of the right of disaffirmance; and it permits the reallocation of equity interests under a procedure which is not designed to cope with the problem.

If it be thought wise that chapter XI should be available to coerce modification of rights to become shareholders, or even to coerce changes in the rights of those who are shareholders, an appropriate legislative solution can be sought.[40] At the very least such a solution, if enacted, should build into the revised chapter XI suitable and balanced procedural safeguards for the affected classes, together with a relevant standard of fairness to govern confirmation of such an arrangement.

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39. The key to this analysis is that the market price of the shares on completion date will not affect the total value to be received by the seller at that time. It is for this reason that the seller should not be treated under chapter XI as though he had a claim on the equity of the purchasing corporation; the mark of such a claim is that changes in the value of that equity would affect the total value to be received by the claimant. Another way of looking at this relationship is to observe that the deal in essence would not be altered if, on the completion date, payment of the set dollar amount was to be made in units of an asset other than shares of the purchasing company. As an illustration, assume that the contract called for payment to be made by delivery of Czarist bonds having a value equal to the stated sum. Such a deal for payment of what is essentially a fixed amount would clearly be an executory contract, vulnerable to disaffirmance under chapter XI. It is hard to see why the result should differ merely because the unit of payment is shares of the purchasing corporation rather than Czarist bonds.

40. The absence of such a coercive power under chapter XI today may occasionally make it difficult for dominant shareholders to work out an arrangement acceptable to creditors. A legislative solution could balance the desirability of facilitating arrangements and the desirability of safeguarding the interests of minority shareholders and those holding rights to obtain equity interests.