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FULL PRIORITY AND FULL COMPENSATION IN CORPORATE REORGANIZATIONS

A REAPPRAISAL

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TO WRITE at this time about priorities and compensation in corporate reorganizations under the Bankruptcy Act doubtless seems something of a luxury. The whole development of doctrine might be regarded as rapidly becoming part of the past and of historical interest only. But from another view the topic appears to have vitality because corporate reshufflings are not likely to cease, and those which are less than completely voluntary always potentially can raise the central question whether a proposed plan is fair and equitable. There are, moreover, gaps and inconsistencies in our doctrine which may prove to hold more than academic interest.¹

I

Fundamentally our standard of fairness in bankruptcy reorganization is the antithesis of composition. In its most general sense it calls for giving senior security holders the equivalent of full measure of what they are entitled to by contract—whatever ambiguities may lurk in that notion—before junior security holders get anything. Composition, to the contrary, would allow seniors to take less than they are legally entitled to, even though not all of them agreed to the reduction. This antithesis between composition and what we label as “full priority” and “full compensation” does not imply that the former would necessarily be unworkable in corporate reorganizations. We long have permitted an assenting majority of trade creditors or non-public creditors to bind a dissenting minority to a composition under the Bankruptcy

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¹ This article is concerned with doctrine, not with covert departures in its application. As to the latter, see Absolute Priority under Chapter X—A Rule of Law or a Familiar Quotation? 52 Col. L. Rev. 900 (1952).

Act, provided the arrangement "is for the best interest of the creditors."² Quite possibly a rapid reorganization facilitated by composition-type compromises would in many situations turn out better for all concerned than a slow reorganization governed by principles of full priority and full compensation. Nevertheless the Supreme Court decisively outlawed composition as being incompatible with the statutory requirement of fairness.³ The Court obviously was moved by our experiences with reorganization through equity receiverships. Studies of these proceedings had revealed that bondholders often are not in a position to understand or protect their own interests where a compromise is being arranged, that their interests might not coincide with those of their representatives, and that a dissenter would have great difficulty in demonstrating that any particular compromise was not in the best interest of his class. In these essentials the position of the average bondholder is markedly unlike that of the average trade creditor. Businessmen usually are better equipped than the mass of individual investors to size up the merits and implications of a proposed compromise, and their interests generally will parallel those of other trade creditors who undertake composition negotiations with their common debtor. Where these interests do diverge, the quick liquidation value of the business often can afford protection against a bad bargain by providing a ready guide for testing whether a plan of composition is in the best interest of all the creditors.⁴ In most reorganizations, on the contrary, this yardstick is hardly useful since the very reason for reorganization lies in the existence of substantial going-concern value which would be destroyed by quick liquidation of the enterprise.

² 52 Stat. 911 (1938), as amended, 11 U.S.C.A. 776 (1946). Earlier compositions "for the best interest of the creditors" were available under old Section 12 of the Bankruptcy Act, 30 Stat. 550 (1898), as amended, 36 Stat. 839 (1910).

³ This is the main thrust of *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). In barring compositions the Court did not intend "to intimate that compromise of claims is not allowable. . . . There frequently will be situations involving claims to specific assets which may, in the discretion of the court, be more wisely settled by compromise rather than by litigation. Thus, ambiguities in the wording of two indentures may make plausible the claim of one class of creditors to an exclusive or prior right to certain assets as against the other class in spite of the fact that the latter's claim flows from a first mortgage. Close questions of interpretation of after-acquired property clauses in mortgages, preferences in stock certificates, divisional mortgages and the like will give rise to honest doubts as to which security holders have first claim to certain assets. Settlement of such conflicting claims to the *res* in the possession of the court is a normal part of the process of reorganization." *Id.*, at 130.

Composition among creditors in a reorganization may be all right for those who are not members of the investing public. "We see no reason why the eleven business corporations and individuals, including such companies as General Motors Corporation, Socony-Vacuum Oil Co., Inc., and Baltimore & Ohio Railroad Company, who hold the parent company's notes, may not accept, voluntarily, parity treatment among themselves [even though some are entitled to priority]." *In re Keeshin Freight Lines, Inc.*, 29 S.E.C. 724, 745 (1949).

⁴ E.g., *Fleischmann and Devine v. Saul Wolfson Dry Goods Co.*, 299 Fed. 15 (C.A. 5th, 1924).

The rejection of composition suggests that we are able to measure both what claimants are entitled to in reorganization and what they receive under a plan. Otherwise it often would be impossible to detect whether a plan reflected a compromise in the nature of a composition. In groping for standards of measurement, our touchstone seems to have been the thought that reorganization was a substitute for liquidation—that contractual rights are to be enforced through a reshuffling of interests in the company instead of by means of selling the corporate assets and distributing the proceeds. From this it might appear to follow that creditors should come out of reorganization in about the same position as in an involuntary liquidation, except that going-concern values would have been preserved for them in the process. Thus early in the development of reorganization doctrine it was argued that

. . . creditors are entitled not merely to priority but payment. Since they cannot be paid in cash, they should be paid, so far as the resources of the company permit, in securities having the value of cash.⁵

But however strong its logic, this view was not destined to prevail. It directly collided with the hard fact that reorganization proceedings usually take considerable time, during which market conditions very likely will change. To adjust reorganization plans continuously to market gyrations obviously would be impractical and would invite maneuvering to complete or delay the plan when the market was favorable or unfavorable to a particular class of claimants.⁶ Moreover there is a persistent debtor-relief strain which can be found running through our insolvency laws. The use of market values in compensating creditors necessarily would operate against the interests of equity holders who for this purpose are usually assimilated to debtors. This effect would be especially pronounced in reorganizations occurring during depressed times when the level of the whole securities market is apt to be low. There likewise is evidence that securities of a corporation coming out of reorganization frequently are depressed because the enterprise has been undergoing reorganization. The new securities may be regarded by investors as unseasoned, or a new management may be rated as untested, or the plan itself may be viewed with skepticism. Topping these considerations, but possibly of most importance, is the understandable reluctance of valuation experts to be bound by the judgments of an impersonal yardstick over which they have no control.

⁵ Friendly, *Some Comments on the Corporate Reorganization Act*, 48 Harv. L. Rev. 39, 77 (1934).

⁶ Even without such an inducement there might well be enormous pressures to delay a reorganization until the financial outlook improves and thus make room for greater participation by junior interests. See *Knight v. Wertheim & Co.*, 158 F.2d 838 (C.A. 2d, 1946); and compare the long history of the Missouri Pacific reorganization. Two related aspects of fairness are not dealt with in this paper: (1) the time at which a reorganization is to be treated as so complete that the plan cannot be modified or disturbed; (2) the manner in which earnings during reorganization are to be handled in arriving at a fair plan.

This is illustrated by ICC opinions in railroad reorganizations under Section 77 of the Bankruptcy Act. The most senior bonds of almost all the major railroads usually are classed as bearing about the same risks, so that their market prices are determined largely by their relative maturity dates and interest rates, and hence it is possible within short periods to predict with a considerable degree of accuracy the price at which a new issue will sell. There frequently is, furthermore, a highly developed market for "when, as and if issued" trading in these securities. Nevertheless in this situation the ICC has steadfastly refused to rely on the immediate market, but instead has sought for what it calls the "intrinsic worth" of the bonds. In its own words:

Even if it could be established that the new bonds would not sell at par when the reorganization is consummated, this would not disprove our conclusion as to the intrinsic worth of the bonds, since there is an obvious distinction between such value of a particular security and the price which may be obtainable for it on the stock market at any given time, the latter being influenced by extrinsic factors having no relation to intrinsic worth.⁷

The Commission is even less inclined to look to existing market conditions in dealing with riskier types of issues, where comparison with securities of other companies involves making more arguable and chancy assumptions. In the case of a proposed income bond junior to a fixed-interest obligation, for example, the ICC remarked that experience

serves to show the more speculative character of the income bonds and the wider range of their price fluctuation as a result of actual or rumored economic trends as well as changes in prevailing interest rates. The futility of attempting to determine the coupon rates of such bonds from conditions existing at any one time [in order to have a bond soon selling at par] is even more obvious than in the case of the fixed-interest bonds. It is equally clear that speculative aspects, such as probable future earnings, should be accorded consideration.⁸

With market values by-passed, the injunction against composition might have been policed through requiring specific findings as to the intrinsic values of new securities. An aggrieved security holder would then have been in a position to demonstrate either that the assumed intrinsic values were improperly computed or that, even accepting them, he was being inadequately compensated. Again, however, we pulled away from building such an objecti-

⁷ Wisconsin Central Ry. Co. Reorg., 282 I.C.C. 567, 572 (1952). Subsequently in another reorganization the ICC commented: "While these decisions [in the Florida East Coast Ry. Co. Reorganization] show our refusal to consider market value of securities as the sole basis for appraising the compensation of creditors, it is clear from the remainder of the last decision that we considered such values along with other factors. . . . Thus it appears that we may not ignore the market conditions which may be expected to exist within a reasonable period after the issue of the securities." Missouri Pacific R. Co. Reorg., 290 I.C.C. 477, 553-54 (1954).

⁸ *Id.*, at 562.

fied measurement into our standard of fairness. Faced with the problem of fitting old divisional lien claimants into a streamlined non-divisional capital structure for a railroad, the Supreme Court stated the reason for not compelling use of specific dollar values:

A requirement that dollar values be placed on what each security holder surrenders and on what he receives would create an illusion of certainty where none exists and would place an impractical burden on the whole reorganization process.⁹

Perhaps implicit in this is another explanation for avoiding dollar values. While compelling the use of dollar terms might aid a senior claimant in protecting his rights, by the same token it might retard the reorganization process by facilitating comparisons with market values that could prove to be embarrassing.

These developments of doctrine produced a troublesome combination. Compositions were outlawed; yet full compensation could be measured in non-dollar terms which left room for give and take. Practical accommodations are permissible; but gross trading away of rights is prohibited. Under these circumstances, it is patent that resolution of the underlying tension could, by and large, take only the form of general hortatory language. And of this we have had an abundance. "It is sufficient that each security holder in the order of his priority receive from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered."¹⁰ "Creditors may be given inferior grades of securities," but then "their 'superior rights' must be recognized."¹¹ If senior security holders "are given only a face amount of . . . their claims," they will not be made whole unless they "receive, in addition, compensation for the senior rights which they are to surrender."¹²

It soon becomes apparent, however, that although securities need not be valued dollarwise, these canons must refer to something more than the formal qualities of the old and new paper. Take, for example, a reorganization in which the plan calls simply for extending a bond issue whose claim far exceeds the value of the enterprise under any acceptable method of appraisal. The proposal manifestly falls short of completely compensating the bondholders since they are entitled to the whole of the enterprise in the absence of any new contribution of monetary value by the old shareholders. In almost every case the value of the enterprise generally is relevant in evaluating compensation. An informed judgment about the securities, in other words, cannot be divorced from an appraisal of the firm itself.

But though the test for full compensation transcends mere formal compari-

⁹ *Group of Institutional Investors v. Chicago, M., St. P. & P. R. Co.*, 318 U.S. 523, 565 (1943).

¹⁰ *Ibid.*

¹¹ *Consolidated Rock Products Co. v. DuBois*, 312 U.S. 510, 528 (1941).

¹² *Id.*, at 529.

son of paper, there turns out to be an important ambiguity in our precepts. A senior claimant is to be compensated in full, but for what? His priority is to be recognized in full, but priority as to what? A bondholder, for purposes of illustration, may have first claim to both principal and unpaid interest¹³ upon liquidation; before liquidation he may have first claim to a certain amount of interest each year, and his claim may be entitled to certain prescribed protections. When confronted with the task of compensating him in a reorganization, are we to be concerned only with his liquidation rights or, on the contrary, are we to consider the other features of his security which had a bearing on its quality as an investment? This turns out to be a stubborn problem.

A quick, and perhaps accurate, answer is that inasmuch as bankruptcy reorganization is a substitute for liquidation, only liquidation rights are relevant. But this might seem too pat. If security holders are to receive equitable equivalence, "[o]bviously, a 7% non-cumulative preferred share with a \$100 liquidation claim is worth more than 5% preferred with equivalent features."¹⁴ The question thus is whether it is possible to avoid looking at investment features if we wish to achieve full compensation.

¹³ It is well settled that interest which had accrued but was unpaid prior to commencement of reorganization proceedings is entitled to the same treatment as the claim to principal if such would have been the case in an involuntary liquidation. The discussion in the text, however, omits the problem of interest accruing after proceedings have begun. Our solution in bankruptcy reorganization follows the rules developed for ordinary bankruptcies: The general rule is that interest does not run, but there are exceptions to the extent (1) the debtor is solvent, or (2) the security for a claim is adequate to cover interest as well as principal, or (3) the security for a claim produces income during the proceedings. While the general rule is appropriate for ordinary bankruptcy, it is harder to justify in reorganization. In ordinary bankruptcy the business usually ceases as a continuing operation about the time proceedings are initiated, and thereafter the risks to which creditors are exposed are the largely unique ones of winding up the enterprise. The no-interest rule thus is a concomitant of liquifying and distributing the debtor's estate. In reorganization, however, the business usually continues in operation, so that creditors remain subject to the normal types of business risks. These are capable of altering the affairs of the enterprise and consequently having a bearing on the reorganization plan itself. Therefore it might be fairer to reward different groups of creditors for these risks in accordance with their separate contracts, which envisage normal business risks, rather than equate the groups through ignoring interest altogether once the proceedings have begun.

The force of this point is perhaps greatest where secured and unsecured creditors have claims against unencumbered assets of an enterprise in reorganization. To preserve the going concern, the pledged and unpledged assets continue to be operated as a unit for the common benefit, and the same variety of changes takes place as occur in a business functioning free from judicial stewardship. In this process, "[t]he tangible assets subject to the lien of secured creditors tend, in the typical case, to be used up in the operation of the business, and as they depreciate the proceeds of operations become liquid assets free of the lien. . . . On the other hand, additions to and betterments of the pledged assets may be made out of free assets. After these changes have occurred, the properties are valued for reorganization purposes on the basis of conditions then existing." SEC Memo: Accrual of Interest During Reorganization Proceedings, SEC Corp. Reorg. Rel. No. 33, at 8 (1940), supplementing *In re Minnesota & Ontario Paper Co.*, 7 S.E.C. 456 (1940).

¹⁴ Allocation of Securities in Corporate Reorganizations: Claims Measurement Through Investment Value Analysis, 61 Yale L. J. 656, 684 (1952).

Consider, in this connection, a bond bearing a rate of interest low in the light of current enterprise and market conditions. If the bond has matured naturally, there surely is no justification for treating the holder as having in reorganization a claim less than the principal sum. Such a result would amount to compelling him to extend his bad bargain without any compensation. But is a different conclusion in order where the bond has matured solely because of a default or the inauguration of reorganization proceedings? The argument for perpetuating the bondholder's inferior investment position in this situation is that the enterprise in fact continues as a consequence of reorganization. The process in effect is analogized to a moratorium: preserving the investor's status would be like a mere extension of his old security. It can be granted that moratory relief in respect to a distressed corporate debtor might be regarded as equitable. Bankruptcy reorganization, however, is not predicated on that principle, and in the usual case the creditor will not be permitted, for reasons of feasibility, to retain his former rights. It is thus a long jump from enforcing creditors' rights through reorganization to employing a moratory image of fairness in judging reorganization plans. A bond which has a relatively low interest rate has this inferior aspect either because interest rates generally have increased since its issuance or because the risk represented by it is rated as greater than at its inception. To the extent the inferiority is related to a deterioration in the credit of the enterprise, the case for giving effect to default rights in reorganization is clear cut. It was precisely such inferior conditions, if anything, which were uppermost in the minds of investors who purchased securities calling for preferred payment in full in case of default. As to weakness in the bond due to a rise in the pure rate of interest, no comparable point is involved. The strength of the bondholder's case must rest on the principle that reorganization is a substitute for liquidation, and in a liquidation the creditor is free to reinvest the proceeds at the current rate of interest.¹⁵

¹⁵ The argument for perpetuating that part of the bondholder's inferior position not attributable to the financial condition of the enterprise is most forceably stated as follows: "Let us assume . . . a default on a senior mortgage bond bearing an unusually low coupon rate of interest. . . . In this case, even if the bonds had not defaulted, and even, indeed, if the railroad had remained in at least as good a credit condition as at the time when the bonds were issued, still these bonds would have been selling at a heavy discount because of the discrepancy between the coupon rate and current market rate of interest. Under such circumstances, it may be argued with much force that a strict enforcement of the doctrine of priority of principal, whereby the 3½% bondholders would be entitled to recover on the basis of the full face value of their bonds, would constitute a real injustice to junior security holders. For the result would be to allow the bondholders to profit by the misfortunes of the railway, in that they would be better off than if the company had remained solvent and healthy. To be sure, it may be argued that the bondholders, by virtue of the acceleration clause in the mortgage, have a strict common-law right to realize on the face value of the debt. But principles of equity have long prevailed to prevent a mortgagee from enforcing his common-law rights in such a way as to profit at the expense of the mortgagor. And it would be an obvious and proper extension of this old equity principle for a court to hold that the mere technical acceleration of maturity of a bond should not permit a bondholder to recover more than his bond could

The reported cases hardly discuss the problem of evaluating the claim for which an inferior quality security is entitled to be compensated in full. The explanation probably stems in large part from our avoiding use of dollar values or relying heavily on intrinsic values not precisely defined. Suppose it is decided to give a new bond "intrinsically worth" \$1000 in exchange for each old \$1000 bond. How would one determine the appropriate interest rate for the new issue? Current market rates may, as we have seen, be ignored, if desired, since they can always be dismissed as transitory conditions. Alternative guides for the choice prove to be either illusory or indeterminate. Under these circumstances might not the interest rate on the old security be as logical (and certainly as convenient) a standard as any other that comes to mind? The suggestion is that when the terms of the old securities, other than liquidation preferences, are taken into account, they may be utilized not in measuring the claims assertable, but as a prop in ascertaining the amount of compensation which passes as being "full." Thus while the investment quality of old inferior securities enters into some of the cases, an investment value doctrine of priorities may not have been at work.¹⁶

This general view is confirmed in two situations in which the underlying problem does produce explicit discussion. Where an old security is of superior investment quality, attention to rights other than those in liquidation might call for awarding new paper that reflected the premium which the old could command. In virtually all cases, as illustrated by this language of the ICC, the demand for such a premium has been refused:

have been worth if the company had maintained its good credit." Bonbright and Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 Col. L. Rev. 127, 156-57 (1928). It should be noted that the foregoing argument is limited to changes in the "pure" rate of interest—that is, changes in interest rates which are entirely independent of changes in the credit risk of the debtor. The fact that the average interest rate for senior railroad bonds in the aggregate has increased does not conclusively demonstrate that the "pure" rate of interest likewise has risen; the change may be a reflection that the market views such bonds on the average as bearing a higher degree of risk than formerly.

¹⁶ It should be emphasized that the discussion in the cases does not develop this suggestion, but usually is limited to more general language about full compensatory treatment. After the Supreme Court decision in the Milwaukee case, the ICC spoke in terms of the full compensation issue involving "a consideration of the numerous features of the old and new securities, and a financial analysis of many factors." *Chicago, R.I. & P. Ry. Co. Reorg.*, 257 I.C.C. 307, 311 (1944). These ICC reports show that the Commission was comparing the features of the new with the features of the old—and in this sense was taking investment features into account. But the surrounding discussions indicate that this process was undertaken in order to demonstrate the existence of full compensation without using dollar values, rather than as a development and application of an investment value doctrine along the lines of that generated by the SEC under the Public Utilities Holding Company Act.

It is possible that the ICC was developing an investment value standard without being aware of its course. Or the reports might be read as indicating that the ICC has taken the hard-to-defend position that claims are matured by reorganization but nevertheless the investment features of the old claims determine the compensation to which the claimants are entitled.

In many situations these various formulations of a standard would produce about the same result. But, as indicated later in the text, they frequently will call for significantly different allocations of securities in reorganizations.

The [most senior] groups . . . use the term "equitable equivalent" as though it meant something more than satisfaction in full; as though creditors now are entitled to the present value of all the rights attached to their old securities, regardless of the fact that the sum of such values may now exceed the amount necessary to pay in full the principal and interest on [their] claim. . . . If the bondholders were being paid in cash, their claim would be satisfied in full upon payment of principal and interest. But since they receive new securities for the principal of their claim [the accrued interest being paid in cash], the new securities must be the equitable equivalent of the cash.¹⁷

If an advantageous rate of interest on a bond is not to be preserved in reorganization, it would be doubly unfair to require continuation of an unfavorable rate. The basic problem similarly comes into the open where participation in the reorganized entity is accorded preferred shares with cumulative dividends in arrears. The liquidation claim versus investment quality issue is squarely presented since, unlike the case of an inferior bond, the magnitude of the claim cannot be stated until the question has been resolved. Again the reported cases are unanimous in treating the arrearage according to its liquidation priority.¹⁸ Answering the contention that "since the accumulated and unpaid preferred-stock dividends do not represent a claim which has become due and payable, they should be discounted in determining the allotment of new securities to them," the ICC explained that:

the doctrine [of full priority] which governs in such proceedings [as this] is violated by any arrangement whereby the senior interests are deprived of distinct recognition of their right to preference against the full value of all property of the debtors and fair opportunity, measured by existing circumstances, to avail of such right.¹⁹

¹⁷ *Missouri Pacific R. Co. Reorg.*, 290 I.C.C. 477, 560-61 (1954). Similarly, the SEC has rejected the contention that preferred shareholders "are entitled to the investment value of their securities, which they claim is greater than the liquidation preference, primarily because of the non-callable feature of this preferred stock bearing a 7% dividend." *In re Childs Company*, 24 S.E.C. 128 (1946).

A comparable position was taken by the SEC in the case of debt securities having superior investment qualities. "In the reorganization of McKesson & Robbins, the plan gave holders of the 5½% Convertible Sinking Fund Debentures 40% of their claim in cash, 40% in new 4%, fifteen-year, non-sinking fund debentures, and 20% in preferred stock. The SEC recognized the need for compensation for loss of status, but, nevertheless, approved the plan with the explanation that [under existing conditions] the new securities were readily marketable at a price in excess of their par value." *Absolute Priority under Chapter X—A Rule of Law or a Familiar Quotation?* 52 Col. L. Rev. 900, 919-20 (1952). For further details see note 42 *infra*. See also *Survey of Chapter X in Operation*, 18 N.Y.U.L.Q. Rev. 399 (1941).

¹⁸ This treatment might seem anomalous in that, while the preferred shareholders themselves could not put the company into reorganization for non-payment of dividends, they are given the full benefit of their preferred liquidation position once reorganization has been commenced by others. The result, however, is parallel to that reached in a liquidation brought about by default on a debt, where the priority position of a preferred arrearage is accepted as of course.

¹⁹ *Missouri Pacific R. Co. Reorg.*, 290 I.C.C. 477, 595 (1954). See also *Central States Electric Corp. v. Austrian*, 183 F.2d 879, 885 (C.A. 4th, 1950); *In re Portland Electric Power Co.*, 162 F.2d 618 (C.A. 9th, 1947); *In re Missouri Pacific R. Co.*, 120 F. Supp. 392 (E.D. Mo., 1955).

The suggestion has been made that in bankruptcy reorganization "investment value analysis supplements rather than supplants face amounts [that is, liquidation claims] as a measure of bondholder claims."²⁰ This compromise position cannot stand in the face of the foregoing analysis. If a claim is regarded as matured for purposes of arriving at its dollar magnitude, there is no basis for viewing it as a continuing investment for purposes of evaluating it. A matured claim, in short, has no investment features which affect its value.

One now might understandably be puzzled as to why a considerable degree of controversy developed over this whole issue of doctrine.²¹ Of course protagonists in reorganizations can be expected to raise any respectable contention which serves their interests, but more substance is involved here. First there is the point that reorganization is the very opposite of liquidation in the sense that the enterprise is continued rather than dismantled. From this it might be inferred that rights in reorganization should be evaluated as though the various classes of securities reflected continuing interests in an ongoing business, rather than as though liquidation were occurring.²² The flaw in the reasoning is that while reorganization replaces liquidation, it does so as a means of enforcing senior contractual rights and not of over-riding or defeating them. A second factor is the method employed by the ICC in evaluating the claims of divisional lienors where underlying assets were being commingled into a new system mortgage. In dealing with such claimants, who did not stand to each other in a simple senior-junior relationship, the Commission's procedure was to make a comparative evaluation of the securities in terms of their investment qualities.²³ Liquidation rights alone could not provide a solution be-

²⁰ Allocation of Securities in Corporate Reorganizations: Claims Measurement Through Investment Value Analysis, 61 Yale L. J. 656, 683 (1952).

²¹ See generally Billyou, Priority Rights of Security Holders in Bankruptcy Reorganization, 67 Harv. L. Rev. 553 (1954); Blum, The "New Directions" for Priority Rights in Bankruptcy Reorganizations, 67 Harv. L. Rev. 1367 (1954); Billyou, "New Directions": A Further Comment, 67 Harv. L. Rev. 1379 (1954).

²² "... the public interest demands the continued operation of railroads and public utilities, thus barring their liquidation. And other large companies eschew liquidation because their values as going concerns exceed their liquidation value. In no meaningful sense, therefore, are bankruptcy reorganizations a substitute for liquidation." The Full Compensation Doctrine in Corporate Reorganizations: A Schizophrenic Standard, 63 Yale L. J. 812, 842 (1954).

Compare the view of the SEC: "... equity and bankruptcy reorganizations are in substance liquidations on a going concern basis. The enterprise is preserved and recapitalized and security holders receive a distribution of new securities representing interests in the reorganized company instead of a distribution of the proceeds of an actual liquidation. But there is no reason for departure from the contractual rights applicable to liquidation situations." In re Green River Steel Corp., SEC Corp. Reorg. Rel. No. 105, n. 21 (mimeo, Jan. 24, 1957).

²³ A representative illustration of the application of this method is found in the Denver and Rio Grande reorganization. In trying to show the equitable equivalence of old and new securities in terms which compared their income and principal positions, without placing dollar values on the proposed new issues, the ICC commented: "The consolidated-mortgage 4-percent bonds . . . now participate, through payment of interest, in earnings between the levels of \$2,863,922 and \$3,522,922. The securities allotted to them under the plan, i.e.,

cause the securities had different liquidation rights in different assets, and the value of the assets depended largely on earnings, which in turn were affected by the level at which the railroad system, of which the division was a part, operated. In this setting the relative worth of the underlying assets, and hence of the bonds, could not be divorced from those features which are germane to an investment value analysis. It was, in fact, in response to the ICC's procedure in a divisional lien situation that the Supreme Court promulgated the previously noted guide that, "[i]t is sufficient that each security holder in the order of his priority receive from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered."²⁴ The last phrase, in drawing attention to "the rights surrendered," added new doubts about priorities.²⁵ By itself the passage is neutral on this score since the rights surrendered could refer to the old contract either as a continuing investment or as a matured claim. In context, however, the meaning which the Court attached to it is clear and is shown by an earlier passage in the opinion dealing with the same divisional lien problem:

[I]t is necessary to fit each into the hierarchy of the new capital structure in such a way that each will return in relation to the other the same position it formerly had in respect of assets and of earnings at various levels. If this is done, each has obtained new securities which are the equitable equivalent of its previous rights, and the full priority rule . . . as applied to the rights of creditors *inter se* is satisfied.²⁶

20 percent in new income bonds, 73 percent in new preferred stock, and 7 percent in common stock, would receive interest and dividends out of earnings after the level of \$3,142,846 is reached. Loss in earnings position and surrender of other rights, in our opinion, are offset by the possibility of increased return permitted by the 4½ percent income bonds, 5-percent convertible preferred stock, unlimited dividends on common stock, and the other features of the plan." *Denver & R.G.W.R.Co. Reorg.*, 254 I.C.C. 349, 364-65 (1943). It should be added that the consolidated mortgage bonds constituted a first lien on certain properties and a second lien on others.

Note the problem which is presented where divisional mortgage bonds are compared through such an analysis, and a wholly junior mortgage bond is also allowed to participate. Although the divisional bonds may be of differing quality, each would be entitled to full compensation vis-à-vis the junior issue, assuming there are no unmortgaged assets against which both senior and junior issues could claim.

In some situations the ICC has used an investment feature analysis to demonstrate that as between a wholly senior class and a wholly junior class, the senior received new securities which compensated them in full. See *Wisconsin Central Ry. Co. Reorg.*, 267 I.C.C. 423, 498-501 (1947). See note 16 supra.

²⁴ See note 10 supra.

²⁵ "The statement in the Milwaukee case to the effect that it 'is sufficient that each security holder in the order of his priority receives . . . the equitable equivalent of the rights . . . surrendered' . . . has spurred counsel and courts to the very type of inquiry required by the investment value theory. Because of such use of that statement in the Milwaukee opinion there is substantial reason to feel that as to debt securities and with respect to [the evaluation of claims assertable] the 'investment value' theory has already seen some application in bankruptcy reorganization." Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization*, 67 Harv. L. Rev. 553, 588-89 (1954).

²⁶ *Group of Institutional Investors v. Chicago, M., St. P. & P. R. Co.*, 318 U.S. 523, 563 (1943).

It is equally clear that the problem here being addressed is different from measuring claims of a wholly senior and a wholly junior class, and the solutions likewise might be expected to differ.

A third and likely the most persistent source of doubt about priorities in bankruptcy reorganization arose from doctrines generated in corporate readjustments under the Public Utility Holding Company Act. Confronted with situations under the Act where a holding company with preferred shares in arrears on dividends was being liquidated, and where preferred shares with dividend rates favorable to the owners were being retired as part of a corporate liquidation, the Supreme Court approved the SEC's view that involuntary liquidation priorities were not controlling since these liquidations were other than the types envisaged by the default provisions of the security contracts.²⁷ They were not liquidations caused by financial shortcomings of the debtor companies, but rather were alternative routes to accomplishing a capital readjustment compelled by paramount national policy. Senior security holders, the Court concluded, should therefore be compensated for the "investment value" of their contracts in the continuing enterprises, not for their rights in case of default. The evaluation accordingly should take into account that absent a readjustment, payment of an arrearage would occur in the future, and a superior quality investment would command a premium. Logic would seem to require that the evaluation also reflect that an inferior quality investment would sell at a discount absent a readjustment. But for reasons neither explained nor obvious, the SEC seems to regard the principal amount of an indebtedness as a floor, at least where the debt-holders are being paid off in cash in the reshuffling.²⁸

The Supreme Court's approval of the investment value standard in public policy readjustments, however, did not carry the implication that it was also proper in bankruptcy reorganization. The Court drew a sharp distinction between the two procedures, and then added a precautionary note presumably with the intention of confining the differing standards of fairness within their respective spheres: "No possibility," it observed, "exists that simplification of structure is employed here to evade or nullify creditors' rights in reorganization or to take the place of traditional reorganization."²⁹ The need for maintaining this compartmentalization becomes even more apparent when the

²⁷ SEC v. Central-Illinois Securities Corp., 338 U.S. 96 (1949); *Otis & Co. v. SEC*, 323 U.S. 624 (1945).

²⁸ "The SEC has not in any Section 11 case authorized retirement of debt for payment of cash in an amount less than, or by the allocation of securities having a market value less than, the face amount and accrued interest of the security being retired." Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization*, 67 Harv. L. Rev. 553, 577 (1954). While the Commission has said that "there may be reasons why the face amount of a debt claim is the minimum amount which it can be accorded" (*American Power & Light Co.*, 21 S.E.C. 191, 201 [1954]), apparently it has never explained what these reasons might be.

²⁹ *Otis & Co. v. SEC*, 323 U.S. 624, 634 (1945).

operation of the investment value principle in public policy readjustments is examined. Investment value of securities there takes account of the condition and potential of the enterprise itself insofar as projected earnings have a bearing upon the quality of the securities. So, for example, where old securities were being retired for cash in a readjustment, the Supreme Court endorsed the SEC's view that the appropriate question to be resolved is, "How much money would it cost the preferred stockholders to replace their securities with comparable ones?"³⁰ To carry over this investment value test into bankruptcy reorganization would produce results which are wholly perverse:³¹ the worse the fortunes of the enterprise, the lower the investment quality of its securities; and if this latter be the measure of compensation, then the more the creditor or preferred shareholder is in need of the protection of his default rights, the less he would be entitled to in the reorganization.³²

It is not to be concluded, however, that the investment value standard of measuring claims has in fact been rejected in bankruptcy reorganizations for all purposes. Though premium values in excess of liquidation claims are not recognized, and arrearages on preferred shares are not discounted, this does not conclusively establish that inferior quality securities will be evaluated as though in liquidation. Despite the arguments advanced to the contrary, the position that fairness requires only that the paper awarded in reorganization be equal in quality to that given up seems to have considerable appeal. And official pronouncements which can be construed to support that view of fairness are not lacking.

II

We now turn from concentrating on the measurement of claims assertable in bankruptcy reorganization to focusing attention on compensating such claims in full.³³ At this juncture a reminder is in order. In the absence of

³⁰ SEC v. Central-Illinois Securities Corp., 338 U.S. 96, 144 (1949).

³¹ This conception of investment value is to be distinguished from the thought that bondholders whose claims have been technically matured should not benefit in bankruptcy reorganization from the fact that the market rate of interest is higher currently than at the time the bonds were issued. See note 15 *supra*.

³² A comparable anomaly would exist if the investment value doctrine developed under the Public Utility Holding Company Act were stressed in readjustments under Section 20b of the Interstate Commerce Act. See Blum, *The Investment Value Standard under the Railroad Modification Act*, 45 Ill. L. Rev. 357 (1950).

³³ If a proceeding concluded with a sale of all assets for cash and a distribution of the proceeds, presumably there would be no occasion for this aspect of fairness to arise. The distribution of cash would in theory be dictated by the doctrines already considered—that is, by the evaluation of the claims. But few bankruptcy reorganization proceedings wind up in cash sales, and of course the main thought behind our reorganization statute is that in a financially embarrassed company the owners of its outstanding securities usually will have to continue their association within the enterprise.

Occasionally it has been intimated that the full compensation problem could be by-passed if the old capital structure and the distribution of rights in it were left intact, so that reorgani-

dollar values on both sides of the balance, it usually will not be possible to separate the sides completely for examination. Consider, for example, a case in which an old bond with very weak investment features receives new poor-quality securities which are said to be its equitable equivalent. One may not be able to learn whether the result came about because the old claim was erroneously measured on an investment value basis and then was adequately compensated, or because the old claim was evaluated properly on a liquidation status basis and then was inadequately compensated.³⁴ This difficulty is left in the background during most of the remaining discussion.

It was emphasized earlier that in bankruptcy reorganization we generally have shied away from weighing compensation in market values, and sometimes even in any kind of dollar values. Our most prevalent denominator has been "intrinsic" values, or "long-run" values, or "investment" values—all of which probably are quite alike in vagueness and content. It was also pointed out that while compensation in a reorganization consists of corporate paper, the value of this paper is tied in with the potentialities—the intrinsic value—of the business. The nearer a security approaches being the ultimate equity in the enterprise, the closer the connection between its value and that of the firm. But while we thus cannot escape appraising the business in reaching an informed judgment about the worth of its securities, there is the question of what further steps, if any, are called for.

In the case of a bond issue whose interest and principal payments are almost certain to be well covered even if the worst predictions regarding the firm materialize, the intrinsic value of the paper is largely independent of the fortunes of the enterprise. It will instead turn mainly on the interest rate of the bond in the light of the maturity date and retirement features (unless one crudely uses the term "intrinsic value" to refer only to the probability that interest and principal payments will be met on time). We have already observed the difficulty encountered in setting an interest rate where the securities market is not accepted as the guide, and have noted the convenience of using the rate on the old issue for lack of any more persuasive standard. What is to be added now is that this rate-of-return aspect is potentially involved in arriving at the intrinsic value of all securities with a fixed or limited return, and might affect even common shares to the extent that the market treats earnings and dividends per share differentially. However, while this is analytically sound, in practice the point is frequently ignored when dealing with

zation amounted to merely a moratorium. The point to be sure is largely academic inasmuch as the suggested arrangement probably would seldom adequately relieve the financial distress which invited the reorganization proceedings, or result in a "feasible" capital structure. But still it is instructive to note that in many situations the arrangement would conflict with the doctrine that institution of reorganization proceedings matures default rights.

³⁴ "It should be obvious that variations in the standards as to the form or amount of participation and compensation can modify the effect of any standards established for identifying and evaluating the security contract." Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization*, 67 *Harv. L. Rev.* 553, 566-67 (1954).

junior grade securities. Their values will be so closely tied to the affairs of the enterprise that any additional speculation about other factors affecting the intrinsic value of the securities might be viewed as mere frosting.³⁵

Little need be said here about the process of appraising the potential of an enterprise for reorganization purposes. According to the Supreme Court: "The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable.³⁶ We can always obtain expert guesses as to future earning power which take account of assets in hand, past experiences, costs, trends, straws in the wind, developments in technology and marketing and changes in the economy generally. We further can get expert opinion on the risks of suffering a diminution in the value of the capital committed to the enterprise and the risks of failing to attain various levels of projected earnings. Likewise we can learn the views of experts on how these risks compare with others for which we have data and with rates of return in the market, both current and in the past. But when everything has been considered we then have to decide whether, in trying to be fair to the various classes of security holders, we are willing to rest on our present "best estimate" of the most probable intrinsic value of the enterprise from our vantage point of today; or whether we are prepared only to adopt a highly optimistic valuation on the almost certain prospect that in the future the enterprise will have widely differing values depending on its earning capacity and on capitalization rates prevailing in years to come. This is an important decision: the two courses lead in divergent directions as far as full compensation is concerned, and their merits perhaps differ.³⁷

Basing a plan of reorganization on a present "best estimate" valuation, the approach generally championed by the SEC under Chapter X of the Bankruptcy Act,³⁸ has the obvious advantage of simplicity. Not that it is easy to

³⁵ More attention probably would be paid to such factors as expected dividends if there were greater concern with the near-term market values of the securities. Thus many of the SEC reports on readjustments under the Public Utility Holding Company Act consider these features.

³⁶ *Consolidated Rock Products Co. v. DuBois*, 312 U.S. 510, 526 (1941).

³⁷ The succeeding discussion in the text perhaps overstates the two approaches, in order to highlight the difference between them.

³⁸ "It is well settled that capitalization of the reasonably expected earnings of an enterprise, at a rate which properly takes into account the nature of the enterprise and the risks involved therein, is the basic and generally appropriate method of valuation for reorganization purposes. . . ." *In re Third Avenue Transit Corp.*, SEC Corp. Reorg. Rel. No. 99, at 38 (mimeo, May 8, 1956). While a plan is to be built around a single best estimate of value, the SEC, in its advisory reports, has recognized that there may be a "considerable range of reasonable estimates" (*In re Ulen & Co.*, 9 S.E.C. 576, 592 [1941]) within which the single figure may fall. The upper limit of the range is sometimes referred to by the Commission as "the maximum value which may reasonably be placed upon the assets of the debtor." *In re Sayre & Fisher Brick Co.*, 10 S.E.C. 64, 73 (1941). This concept resembles the notion of a "maximum permissible capitalization" employed by the ICC (see p. 439 *infra*) but the difference between them should be clear from the text.

arrive at the valuation, for that process can almost never be simple. The point rather is that the concept of a best estimate as of the present time is a familiar one and the end result is therefore more readily understandable. This is true even considering that, since valuation calls for prediction as to the future, in virtually every case there will be a considerable range of plausible valuations. All the "best estimate" approach requires is that from this range there be selected a single valuation that represents a judgment which takes account of forecasts of probable earnings and of risks associated with the business, which are realistic in the light of what we now know. This process need not obscure the fact that the end result necessarily rests on multiple assumptions concerning earnings and capitalization rates to take account of risk. There may be a point in isolating each of these judgments to facilitate subjecting it to adequate scrutiny; but such a procedure in no way is incompatible with finally arriving at a single "best estimate" valuation.³⁹ Indeed one merit of the approach lies in recognizing that since many related judgments are involved, the ultimate result should be a proper combination of all of them.

The approach, moreover, has several other advantages. Using "best estimate" as the target probably tends to hold down wilder guesses as to value. If appraisals are badly out of line this is likely to be more apparent where we have such a target than where the wildness can be buried in a complex series of value projections or in a round-about formulation of potential value predicated on a high degree of optimism. Further, the approach is more in keeping with the thought that reorganization is a substitute for liquidation, since liquidation of the going concern would produce a total immediate value based on present conditions. By reinforcing the liquidation analogy, it possibly might encourage more rigorous adherence to the principle that liquidation rights control priorities in arriving at a fair plan. The approach also probably tends to produce less complex capital structures for reorganized concerns inasmuch as the structure will be geared directly to the immediate best estimate figure rather than be allowed to fit loosely into a more free-wheeling view of valuation.

³⁹ "It may be suggested that the apparent absurdity and unfairness encountered in the foregoing examples results from the use of a flat . . . percent capitalization [rate] which on its face fails to recognize that different segments of earnings are subject to varying degrees of risk that they will not be realized. This suggests the propriety of capitalizing each segment of earnings at a rate which will fairly reflect the risk attached to its realization. . . .

"In opposition to use of the varying rate it may be urged that it . . . requires not only the determination of earnings segments but also the fixing of a different rate for each segment. . . . Finally it may be urged . . . that the flat rate should be a composite of the varying rates, and that there is, therefore, no need for departure from the conventional flat rate method. This would seem, theoretically at least, to be so. There would seem to be less chance of serious error, however, in taking several small jumps, guided in each by reference to what appears to be a fitting financial structure and subject more or less to market check in fixing segment risk, than in taking one relatively unguided big jump. Hence, at the very least, employment of the varying rate would appear to be a useful means of discovering what the composite rate ought to be." Gardner, *The SEC and Valuation under Chapter X*, 91 U. of Pa. L. Rev. 440, 462-64 (1943).

It is not to be implied, however, that once the "best estimate" valuation has been set, the old security holders will be indifferent about what mix of new securities is to compose this total. Even if the mixture is not treated as a factor affecting the over-all valuation, as indeed it sometimes appears to be, at least three sources of pressure will be at work to maximize the amount of debt obligations. One is that interest is deductible in computing federal corporate income tax, while dividend distributions on shares are not.⁴⁰ A second is that in times of optimism about the future of an enterprise, the totality of securities in a relatively highly leveraged capitalization will have a greater aggregate market value than the totality of securities in a low leveraged capitalization.⁴¹ Insofar as companies usually emerge from reorganization under a cloud, their ratings by investors might be expected to improve as the firms lose the taint of judicial supervision and their securities gain seasoning. Therefore, it is often argued that high leverage in a reorganization plan is likely to be favored by the market. A third factor is our doctrine that full compensation requires giving something additional to senior security holders if they are called upon to exchange their securities for an equal amount of inferior ones in a reorganization.⁴² The added something frequently can only be a slice of the equity in the reorganized concern.⁴³ In order to maximize their share of the equity, particularly given the usual conditions where high leverage seems favorable, the juniors will tend to favor awarding the seniors new securities qualitatively as good as their old, to the fullest extent

⁴⁰ This is not a place for considering how the corporate income tax does or should affect the valuation of an enterprise or its securities. But it should be noted that since interest is deductible in calculating taxable income, the composition of the capital structure might have a bearing on the over-all valuation or total capitalization of the enterprise. The ICC occasionally has paid considerable attention to the tax situation in fixing the maximum permissible capitalization. See *Missouri Pacific R. Co. Reorg.*, 290 I.C.C. 477, 563-88 (1954). The usual view of the SEC has been, "We do not believe that speculation as to the nature and extent of the tax statutes which may be enacted in the immediate future or over the life of the reorganized debtor is suitable or appropriate." In *re Indiana Limestone Corp.*, 18 S.E.C. 178, 198 (1945).

⁴¹ *Graham and Dodd, Security Analysis* c. 37 (3d ed., 1951).

⁴² Since creditors are entitled to no more than payment in full, it follows that "if it can be shown that the new bonds have a high investment rating and command a current market price at least equivalent to the principal amount of the bonds, full compensation of the bondholders' principal claim will have been attained and the consideration of additional compensatory treatment in this respect would be unnecessary." In *re Boston Metropolitan Buildings, Inc.*, 31 S.E.C. 854, 878 (1950). "If, however, at the time when confirmation of the plan is proposed, market conditions should be such that creditors could not thus realize the full value of their claims, it would then become necessary to consider what changes in the treatment accorded to creditors would be required in order to give them full compensation for their claims, in the light of the sacrifices imposed upon them by the plan." In *re McKesson & Robbins*, 8 S.E.C. 853, 878 (1941). See note 17 *supra*.

⁴³ This is particularly so in view of the Supreme Court's declaration that "we cannot say that the inclusion in the new securities . . . of features normally common to them are adequate compensation for the lost seniority." *Group of Institutional Investors v. Chicago, M., St.P. & P.R. Co.*, 318 U.S. 523, 571 (1943).

permitted by our requirement that a reorganization plan be feasible. While juniors thus seek the advantage of doing business largely on the investment of others, the seniors themselves might well prefer receiving new debt securities equal in quality to their old issue. Especially is this likely to be the case where the seniors distrust the over-all valuation of the company or are skeptical about its projected future, and therefore desire maximum protection for their investment above all else.

An important question, in this connection, is whether common stock is inferior to a debt security. More specifically, should we regard a dollar of the equity in the new capital structure, based on a "best estimate" valuation, as equal to a dollar of senior debt in the old structure? At first impression one likely would conclude that a bond of a company is superior to its stock. This is the accepted view in bankruptcy reorganization,⁴⁴ shared in by the SEC which has defended it by pointing out that "in addition to their loss of priority with respect to income, [the debt-holders who are to receive common shares] would be giving up priority for . . . their present claim in event of liquidation."⁴⁵ But if the enterprise has been valued realistically, in the light of existing conditions, is not a bondholder being compensated in full if for every dollar of his claim he receives a dollar of the equity? While he loses his priority as to income and his preferred position on liquidation, he gains the right to share generally in the prosperity of the company and to exercise a voice in its ultimate control. This thought has been expressed by the SEC in a readjustment under the Public Utility Holding Company Act:

For example, if a \$1,000 3% bond which is conceded to have a long-term value of \$1,000 is to be exchanged for shares of common stock which have a long-term value of \$20 per share, it would seem that the proper number of shares to be given in exchange would be 50 shares. . . . Thus, . . . comparative valuations are obtained in terms of a common denominator. The element of *quality* is thus taken into consideration. . . .⁴⁶

⁴⁴ "A 'step up' in allocations, where they are to be made in stock rather than cash, is a conventional device for equalizing distributions where senior security holders are to surrender their priority." *In re Inland Gas Corp.*, 211 F.2d 381, 385 (C.A. 6th, 1954).

⁴⁵ *In re Deep Rock Oil Corp.*, 7 S.E.C. 174, 193 (1940).

⁴⁶ *In re American & Foreign Power Co.*, 27 S.E.C. 1, 51, n. 57 (1947). Immediately before the passage quoted in the text, the SEC had analyzed the problem in these terms: "We agree that recognition must be given to the differences in quality of income which occur under the plan. The difficulty in reorganizations which involve exchanges of senior securities for junior securities and the converse is to find a standard by which the gain or loss in quality may be measured. In general, there are two methods. One involves a comparison of the availability of earnings and the degree of certainty that they might be paid to the security holders; the other involves a capitalization of the segments of applicable earnings at appropriate rates from which a comparison of the long-term values of the securities are made. It is obvious, however, that in applying the first method alone, beyond determining that there should be a substantial difference between the more certain claim of a debt security and the less certain claim of a junior security, the final determination of the amount of the appropriate

It is instructive to consider whether these two positions voiced by the SEC are necessarily inconsistent. First to be noted is that the particular holding company readjustment in which the Commission so spoke was one in which a parent corporation owning senior securities of the debtor wished to retain its control by taking new common shares for its senior claims. The old seniors, in brief, were not being forced to take a lower ranking security. While this fact is unusual, the Commission did not treat it as relevant to the analysis and conclusion. A second consideration is that in public policy readjustments it is more probable than in bankruptcy reorganization that the new shares will in fact sell at their assumed values within a relatively short time if general market conditions remain unchanged. The assessment of the intrinsic value of the equity in public policy readjustments is likely to be more nearly in line with existing market conditions, since the companies, by and large, are not in acute distress. In bankruptcy reorganizations the estimate of intrinsic value of the enterprise and therefore of the equity is more likely to be generous compared with prevailing conditions for reasons already mentioned. Most such reorganizations take place in depressed times, when the whole market is generally thought to be abnormally low. Many of them tend to embody at least a tinge of debtor relief. And not a few companies coming out of bankruptcy reorganization are likely to invite skepticism from an investment standpoint, especially regarding their equity securities, until seasoning has taken place.

This is a plausible explanation of why stock might be regarded as inferior to a bond in a bankruptcy reorganization but not in a public policy readjustment. There is doubt, however, whether even the SEC would be content to rest on it. The matter apparently has never been discussed publicly by the Commission in a bankruptcy reorganization situation; and in most instances where it has recommended that there should be a step-up in the quantity of stock allocated to bondholders, its analysis can be interpreted as questioning the valuation placed on the new shares.⁴⁷ But in at least one instance the

differential is a matter of the broadest judgment and subject to the greatest controversy. For this reason, we believe that the second method, though not mathematically conclusive, supplies a more objective basis for a comparison; for there the common denominator is the value of each security expressed in dollars. . . ." Ibid.

⁴⁷ For example, where a plan in a Chapter X case allocated "an increase in common stock equal to 20% of the balance of these claims which is not to be paid in cash or new bonds," the SEC approved it on this reasoning: "The increase of 20% in the amount of new common stock which will be allocated to the secured creditors over the balance of their claim has been considered in the light of the fact that these creditors are being asked to forego a senior-secured claim . . . which would be entitled to fixed interest. If we assume an interest rate of 4½% per year (a rate which we have found to be fair with respect to that portion of the same claim which is to be paid off in first mortgage bonds) these creditors would receive first mortgage bonds to be retired 10 years hence and carrying interest at an amount beginning at approximately \$40,000 per year, and declining thereafter as bonds are retired. Instead, for reasons of feasibility, they are being asked to accept . . . shares of common

Commission seemed flatly to say that in a bankruptcy reorganization stock is always inferior to bonds (unless the stock will sell immediately at its assigned value):

For the balance of the claims of . . . creditors . . . the plan allocates new capital stock equal in par to this amount plus 10% for additional compensation to accord them full compensatory treatment. *Apart from the valuation placed upon the stock*, the increase seems warranted by reason of the necessity . . . to compensate its creditors for "their entire bundle of rights" including relinquishment of a creditor status for that of a stockholder position.⁴⁸

If this statement is to be taken literally, it presents a position which seems to be directly challenged by the Commission's analysis of equivalence in the public policy readjustment previously considered.

In any event, there is nothing about the "best estimate" valuation approach that demands allocation of new securities which likely will sell on the market at their projected values soon after distribution. All that can be said is that under a realistic enterprise valuation, if reorganization expectations are realized, and if rates of return for limited income securities are in line with pre-

stock which on the basis of the adjusted estimate of cash income would receive an average of about \$70,000 per year for the first ten years and about \$50,000 per year thereafter if all available cash income were paid out in dividends. In addition such stock would have a claim in liquidation on the remaining salvage value, net current assets, and other elements of value discussed above." In re Inland Gas, 29 S.E.C. 377, 413-14 (1949). This analysis can be understood as implying that the stated value of the common shares for reorganization purposes was too high. If the equity had been valued lower, resulting in the old bondholders receiving a larger fraction of it to satisfy their claim quantitatively, would there then have been any need for giving them a "step-up" in allocating the common shares?

The point here is also illustrated by the SEC's analysis in the readjustment of the Community Gas and Power Company under the Public Utility Holding Company Act. Under the plan debenture holders were to receive common stock. In passing upon whether the allocation provided full compensation, the Commission observed: "It may be noted that such earnings of \$880,000 and such potential dividends of \$704,000 if multiplied 14.0 and 17.5 times, respectively (capitalized at 7.1 percent and 5.7 percent, respectively), would produce figures equivalent to the face amount of the debentures (including accrued conditional interest); application of multipliers of approximately 14.3 times and 17.8 times, respectively (capitalized at 7.0 percent and 5.6 percent, respectively), would produce figures equivalent to the call price of the debentures." In re Community Gas & Power Co., 22 S.E.C. 115, 141, n. 46 (1946).

Compare In re Central States Electric Corp., 30 S.E.C. 680, 719 (1949), in which, under the plan, "debenture holders will receive in payment of their claim, redeemable shares of the new reorganized [open ended investment] company having an underlying asset value . . . equivalent to the principal amount of the debentures plus accrued and unpaid interest." Here the SEC observed that "the kind and amount of common stock allocated to the debentures must be considered to determine whether full compensatory treatment is accorded to them." Ibid. In the context of the particular situation, in which the debtor was a holding company with a fairly liquid portfolio, the Commission thought it fair to give the debenture holders a step-up in share allocation because the new shares were not redeemable immediately and thus "on the effective date of the plan, the debenture holder is not assured of receiving the precise equivalent of his claim in cash before junior security holders receive anything." Id., at 720.

⁴⁸ In re Inland Gas Co., 33 S.E.C. 688, 723 (1952). (Emphasis added.)

vailing norms, the new securities will have good prospects of reaching their projected or "intrinsic" values in the not-too-distant future.

But if they have such prospects there is the distinct possibility that the new securities may reach even higher ground; and should this occur, in the light of hindsight it might be thought the senior classes have been over-compensated at the expense of juniors.⁴⁹ It is that outlook, especially when coupled with sympathy toward debtors and junior interests during depressed times or perhaps even in depressed industries, which underlies the alternative approach of predicated full compensation on the possibility that highly optimistic forecasts for the future might prove to be correct. It is apparent, however, that since the odds are against realization of these very optimistic horizons—that being what is meant by optimism here—the new securities are most unlikely to attain their projected values under foreseeable conditions. To pretend otherwise all the way along the line in allocating the new securities, so that the same paper is given to different ranking classes, would patently penalize the seniors in order to confer value on the juniors. The principle of full compensation could not be expected to tolerate such flagrant violation. What the alternative approach thus requires is some way of at least ostensibly protecting the position of seniors while enabling juniors to share in the good fortune if and as the more optimistic estimates are in fact reached.

An apparent solution is a hierarchy of new securities that would take on value in descending order as the earnings or prospects of the enterprise improved. A full dress hierarchy, to use an extreme example, might consist of bonds, income debentures, preferred shares, common shares, junior common shares and finally warrants to purchase common shares at various prices. The key thought behind this arrangement is that the "relative priority" positions of the old claimants might be preserved by somehow building them into the distribution of the new securities.⁵⁰ Then if only the most probable estimates were realized, the top class of new securities, allocated to the old senior claimants, would have a good prospect of selling at its projected value while the other new classes would sell at discounts increasing in size in descending order of the hierarchy. As conditions for the enterprise improved, these discounts would tend to close, at some point disappearing altogether, and in this manner full compensation in dollar terms would be received by successive strata of claimants. In more general terms, to use the words of the ICC:

⁴⁹ If this rise occurs before the reorganization has been effectuated, so that it appears during the proceedings that the senior claimants will be getting new securities having cash values greater than their claims, it is likely the courts will find that the plan is or has become unfair because the seniors are being over-compensated. See the use which the Supreme Court made of "when, as and if issued" prices of proposed reorganization securities in *Insurance Group Committee v. Denver & Rio Grande Western R. Co.*, 329 U.S. 607 (1947).

⁵⁰ This statement does not imply that old claims must be valued on an investment value basis. See discussion in text at note 16.

If the new securities, as allocated under the plan . . . , offer full protection for the relative priority of the rights of the old security holders over the holders of securities junior to theirs to receive payment of the principal and interest represented by their claims, and if the investment advantages of the old securities be offset by those of the new, the [fairness] requirements of the [bankruptcy reorganization] statute have been met.⁵¹

This expansible value approach, which has the merit of facilitating agreement by junior interests to reorganization plans,⁵² might have some drawbacks in addition to fostering complexity in corporate structures. To put full and continuous control of the enterprise in the hands of the new common shares possibly is unreasonable where the main expectation is that ordinarily they will represent little or no earning power. If such a weak security is to have residual control of the corporation, it might be thought necessary to build in protection for the more senior securities against the declaration of unconscionable or imprudent dividends or the elongation of leverage. In comparable circumstances the ICC has generally insisted upon providing both sinking funds to retire debts and improvement and betterment funds to build up the equity, and restricting dividends when earnings fail to reach a specified plane.⁵³ There is, also, the troublesome point that the concept of a hierarchical capitalization predicated on high optimism is capable of considerable expansion, creating an illusion that it is always possible to give even the most junior class of old securities a place at the bottom of the rain-check ladder.⁵⁴ Following such a course, however, would be tantamount to reorganizing a company without placing a value on it, a procedure wholly incompatible with the basic

⁵¹ Chicago, M., St.P. & P.R. Co. Reorg., 254 I.C.C. 707, 729 (1943).

⁵² See Guthmann, *Absolute Priority in Reorganization: Some Defects in Supreme Court Doctrine*, 45 Col. L. Rev. 739 (1945).

⁵³ See Swaine, *A Decade of Railroad Reorganization under Section 77 of the Federal Bankruptcy Act*, 56 Harv. L. Rev. 1193 (1943).

⁵⁴ "If it were permissible to include junior creditors for whom no value existed, on the theory that they would receive nothing until senior creditors were first paid off in the future, there would be no reason why worthless stock interests should not be preserved on the same basis. Thus, on such approach, no class of creditors or stockholders whose claims are presently worthless would have to be eliminated upon reorganization." *In re Penn Timber Co.*, 9 S.E.C. 1063, 1075, n. 22 (1941).

An extreme application of the "expansible valuation" approach was urged on the ICC by junior interests in the Wisconsin Central Ry. Co. reorganization. The proposed plan called for "the issuance, largely on account of matured and unpaid bond interest, as well as in minor degree for unsecured claims, of . . . non-interest-bearing scrip, with no maturity and no lien, to be redeemed, if future earnings permit, within a period of 15 years after consummation of the plan. Any scrip not retired within that period would become void . . . [and] in the event of failure to redeem that scrip at the end of the 15-year period the new capital stock inseparably attached thereto . . . would then belong to the scrip holder." *Wisconsin Central Ry. Co. Reorg.*, 282 I.C.C. 393, 503 (1952). The ICC rejected the proposal because it failed to compensate bondholders fully and because "it is contrary to the fundamental principles applicable in bankruptcy proceedings that determination of the rights of bondholders be so long postponed after consummation of the plan." *Id.*, at 505.

premise that reorganization is an alternative to liquidation for enforcing creditor rights. Awareness of this has almost always resulted in the ICC placing a limit on any expansible valuation, usually taking a form embodying the notion of a "maximum permissible capitalization"⁵⁵ (which, be it noted, the Supreme Court regards as a valuation).⁵⁶ But as compared with the idea of a "best estimate" valuation, such a concept is likely to be highly amorphous. It thus is not surprising that, to justify the cut-off point in setting the maximum permissible capitalization, the Commission has fallen back on such thoughts as

there was "no evidence whatever" to indicate that a recovery of earning power of the peak periods was "reasonably probable," but that it was a "remote possibility only, which may not be utilized to support a finding" that the stock has "an equity."⁵⁷

Even when the "expansible valuation" approach is worked to theoretical perfection, it has a built-in bias as contrasted with the "best estimate" approach. It tends to keep in the reorganized company a junior class (or classes) which would have been eliminated. The equity interests allocated to that marginal junior class would otherwise have gone to more senior classes. These old seniors in effect are being required to take the risk that the estimated most probable earnings will not be attained or that the capitalization of earnings rate is too low, since prior to reaching the valuation produced by this combination there, in effect, is no adequate capital cushion beneath them. At the same time, however, they are deprived of some of the gain to be had from coming up to the more optimistic estimates, since part of the equity has been allocated to the marginal old junior class. In this sense the "expansible valuation" or "maximum permissible capitalization" approach embodies an element of heads we win, tails you lose.

This difference inherent in the two approaches perhaps stands out most clearly in connection with the issuance of long-term warrants to junior interests in a reorganization. The "expansible valuation" approach could congenially embrace the arrangement as a means of both protecting old senior claimants if the future should be less-than-rosy, and giving the juniors a slice of any future prosperity.⁵⁸ The "best estimate" approach would find the arrangement incompatible. Where, for instance, it was proposed that old common shareholders be given fifteen per cent of the new equity plus warrants to acquire additional common stocks, the SEC in disapproving of the plan, commented:

⁵⁵ This phrase is not used as a term of art, but as a way of expressing the thought that the total capitalization should not exceed a certain stated figure. See note 38 *supra*.

⁵⁶ *Group of Institutional Investors v. Chicago, M., St.P. & P.R. Co.*, 318 U.S. 523, 536-39 (1943).

⁵⁷ *Id.*, at 538.

⁵⁸ This is not to say that the ICC has championed the use of long-term warrants; it generally has disapproved of them.

If the common stockholders are entitled to more than 15% of the equity, a present participation in the proper amount should be accorded to them at this time rather than mere rights to acquire a stock interest in the company at some future date. . . .⁵⁹

It would be incorrect to say that the ICC has explicitly adopted a limited "expansible valuation" approach in bankruptcy reorganizations under its jurisdiction. Indeed, it would be going too far to conclude that the Commission has articulated any one approach to achieving full compensation. Sometimes there seem to be signs that it has proceeded mainly in a case-by-case manner, making cross references only where convenient or when challenged. In the final analysis, however, there is little doubt that generally in bankruptcy reorganizations it has worked out plans on the basis of (1) using highly optimistic valuations, (2) arranging a hierarchy of securities having little or no water at the top and a great deal at the bottom, and (3) awarding these securities so as to maintain what it regards as the relative priorities of the claimants participating in the reorganization.

With these observations we turn again to priorities and consider the suggestion that the ICC has silently adopted an investment value notion in evaluating claims assertable in bankruptcy reorganizations. In the last of the great railroad reorganizations, involving the *Missouri Pacific* system, the Commission seemed to be drawing a distinction that could have a bearing on the point at hand.

From the facts herein and heretofore stated . . . with respect to the liens of the first-grade securities of the three principal debtors [comprising the system] and the earning power of the properties subject thereto, we believe it is clear that the holders of such claims should receive new securities having a reasonable prospect of selling at or near par in the reasonably near future. The junior interests [and these included unsecured debentures, preferred shares and common stock] must necessarily be considered as satisfied if they receive the equitable equivalent of all rights surrendered.⁶⁰

This apparent distinction between the top-most senior issues and all others is mirrored in the Commission's separate analysis of the adequacy of compensation under the plan for each particular class of claimants. When dealing with the most senior bonds, it considered at length the market values which were likely to prevail for the new bonds to be received in exchange, and concluded that under the plan the seniors would obtain "for their total claim, a par amount of new securities having a reasonable prospect of selling for the amount of the claims for which they are exchanged."⁶¹ In sharp contrast, when dealing with the new income debenture allocated, in satisfaction of most of their claim, to the old five and one-half per cent fixed interest de-

⁵⁹ *In re Childs Co.*, 24 S.E.C. 85, 131 (1946); see *In re Central States Electric Corp.*, 30 S.E.C. 680, 728-30 (1949).

⁶⁰ *Missouri Pacific R. Co. Reorg.*, 290 I.C.C. 477, 545 (1954).

⁶¹ *Id.*, at 555.

bentures, the ICC was content to say merely that, "we believe that a 5-percent interest rate on such debentures would be necessary to insure full compensation to the claims [of those] who would receive these securities,"⁶² and that, "the treatment provided . . . [for these creditors] constitutes the economic equivalent of the rights surrendered and will satisfy their claim in full"⁶³—although everyone certainly understood that for the road it would be a sunny day indeed if the new income debentures ever sold at three-quarters of their par value in the decades immediately ahead.

We have already observed why it is difficult to square the Commission's action in awarding intermediate claimants or even senior claimants "cheap" paper, while permitting junior classes to participate, with an investment value theory of priorities. A more plausible explanation can now be seen to lie in the approach to valuing an enterprise and its securities.⁶⁴ The poor quality of the paper awarded, and the improbability of these new securities reaching their assigned values within a reasonable time,⁶⁵ seems to turn not on an investment evaluation of the claims assertable, but rather on a willingness to capitalize optimistically estimated railroad earnings at rates more suited to government bonds.⁶⁶

⁶² *Id.*, at 567.

⁶³ *Id.*, at 593.

⁶⁴ Another suggested explanation of the results in the Missouri Pacific reorganization is that the different ranking claimants were given new paper which had a market value somewhere near the market values that had prevailed for their old securities. This view probably mixes cause and effect: the new tended to equal the old because of expectations regarding what would be allocated under the plan to be adopted. An attempt to award new paper on the basis of the market values of the old thus would always be circular.

Anyhow, it would be highly unfair to discount a claim because the security had been weak on the market. See discussion in text at note 15 *supra*. Nor is the position any more tenable if it can be shown that most of the holders of the weak security bought at a discounted price. Such a principle would penalize former owners by depressing the value of what they had to sell.

⁶⁵ The issue being considered arises where some of the "cheap" paper is allocated to a wholly senior class while a wholly junior class is allowed to participate. If all the cheap paper were allocated to the marginal participating class, the only question would be whether awarding a lot of cheap paper to that class is or is not preferable to giving it a smaller quantity of better grade paper. See *In re Philadelphia & Western Ry. Co.*, 13 S.E.C. 330 (1943). In itself this question does not pose an issue of fairness.

⁶⁶ For present purposes nothing turns on whether the ICC uses highly optimistic estimates of earnings, or uses highly liberal (i.e., low) rates in capitalizing estimated earnings, or does both. Note, however, that a conservative estimate of earnings logically calls for a more liberal capitalization rate than does an optimistic estimate of earnings under the same circumstances. See *Field, Valuation for the Purpose of Corporate Reorganization*, 16 *Rocky Mt. L. Rev.* 13 (1943).

As to the ICC's estimation of earnings, it has been said that: "It has been [the Commission's] practice, broadly speaking . . . to make an estimate of prospective earnings divided roughly into four categories: [The fourth is those] of which there is no probability of uninterrupted realization but which will probably be realized from time to time and, if optimistic hopes are fulfilled, may ultimately be maintained. Against these additional earnings, together with the potential increment to the ultimate equity arising from the operation of any capital fund or sinking fund, the Commission has permitted the issue of common stock, which it has

This view may be sharpened by restating the contrast between the SEC and ICC approaches to full compensation. Both agencies apparently would agree that under the doctrine of "equitable equivalence" those in a higher ranking class are "entitled to securities having an investment value equal to their total claims"⁶⁷ before juniors receive anything. Further, the ICC apparently would concur in the SEC's understanding that "investment value," as used in this context, is synonymous with "intrinsic value," as distinguished from "immediate spot market value."⁶⁸ But the two commissions, nevertheless, would reach substantially different results in compensating security holders because they would be wide apart in valuing the enterprise, and it is on this judgment that the findings as to the intrinsic or investment values of the new securities must ultimately rest.

These surmises also may throw light on the question whether in a reorganization cash-in-hand is superior to a bond. Suppose, for example, that a plan provides that bondholders are to receive for each \$100 of their claim a \$75 debenture inferior to their old bond and \$25 cash. Are we to conclude that they might be fully compensated because, although as to 75 per cent of their claim they receive an inferior security, as to the remaining 25 per cent they get something superior? Full priority and full compensation doctrine would seem to call for a negative answer. The cash serves to reduce pro tanto the bondholder's assertable claim and the balance of it would seem to be entitled to full compensation as ordinarily computed, since otherwise the bondholder would not be made whole. The SEC, using the "best estimate" approach, apparently holds this view generally.⁶⁹ Numerous ICC reports, in contrast, seem to treat cash as a superior item.⁷⁰ Might not this latter result likewise be a consequence of the "expansible valuation" approach? Under it, after all, cash undoubtedly is superior to less than top grade bonds; and this manner of thinking about cash would seem particularly appropriate where the competing rights of divisional mortgage claimants are being weighed in the balance.

usually allotted at a price requiring a six percent dividend to make whole the income rights of the most senior existing securities to which it is allotted." Swaine, *A Decade of Railroad Reorganization under Section 77 of the Federal Bankruptcy Act*, 56 Harv. L. Rev. 1193, 1198-99 (1943).

As to the ICC's choice of rates in capitalizing projected earnings, "[i]n fourteen cases in which definite estimates of future average annual earnings are referred to in the Commission reports, the Commission has approved capitalizations which capitalize such prospective annual earnings at rates varying from 2.9 percent in the case of the Milwaukee to five percent in the Akron, Canton and Youngstown and Chicago and Eastern Illinois cases." *Id.*, at 1200.

⁶⁷ *In re Green River Steel Corp.*, SEC Corp. Reorg. Rel. No. 105, 21 (mimeo, January 24, 1957).

⁶⁸ *Ibid.*

⁶⁹ See, for example, *In re McKesson & Robbins*, 8 S.E.C. 853 (1941).

⁷⁰ See, for example, *Chicago, M., St.P. & P.R. Co. Reorg.*, 254 I.C.C. 707 (1943); *The Full Compensation Doctrine in Corporate Reorganizations: A Schizophrenic Standard*, 63 Yale L. J. 812, 817 (1954).

It is beyond immediate goals to explain why the ICC has preferred to follow something resembling a limited "expansible capitalization" approach.⁷¹ When the country was coming out of the deep depression two decades ago, the attitude of the Commission was sometimes rationalized in terms of the statistics showing that the depression in the railroad industry was particularly severe. Whatever the truth of this thrust, we now know it to be insufficient. In the last round of the *Missouri Pacific* reorganization—which took place in 1954 after a period of high prosperity for the country as a whole, for the railroad industry, and for the Missouri Pacific system—the ICC projected "average earnings" considerably above recently achieved levels and then in effect used a rate of about 5.1 per cent in capitalizing the whole of the estimate.⁷² Suffice it to say that at the time prime grade railroad bonds of long maturities were yielding between 4 and 4.7 per cent.⁷³

⁷¹ A somewhat different perspective of the ICC's approach to valuation and full compensation is provided in the reorganization of the Florida East Coast Railway by the peculiar circumstance that one interested group proposed an internal reorganization along the usual pattern, while a second interested group favored a merger with the Atlantic Coast Line under which cash and securities issued or assumed by the Coast Line would be received by those participating in the reorganization. The Commission found that, considering "the value of the debtor's assets and its past, present, and probable future earnings . . . the permissible capitalization of the reorganized debtor should not exceed approximately \$46,000,000 exclusive of equipment obligations outstanding on consummation date." *Florida East Coast Ry. Co. Reorg.*, 282 S.E.C. 81, 115 (1951). In response to arguments, the Commission undertook to compare the probable market values of securities (and cash) which would be issued in an internal reorganization and the securities (and cash) which would be issued or assumed by Atlantic Coast Line in a merger. It placed the latter total market value at \$35,142,186, the face value of the securities and cash being \$42,342,186. As to the total market value figure for an internal reorganization, it was of the opinion that the computation should be based on a hypothetical permissible capital structure in which "the first mortgage bonds would be worth par, . . . the second-mortgage income bonds would be worth \$65 and the common stock at five times earnings, about \$20 per share," which produced a total market value of \$27,295,000 (including cash). *Id.*, at 158. Thus the merger plan would result in receipt of \$7,847,186 more in estimated market value than an internal reorganization. But having established this relationship, the Commission found fault with the merger plan because "we do not believe . . . the issue to the creditors of the debtor of \$42,342,186 of cash and principal or stated amount of Coast Line securities compensates them fully for surrendering property valued at \$46,000,000 [i.e., the maximum permissible capitalization]." *Id.*, at 159. It then concluded that if the creditors "are to receive a full return on the value surrendered under all conditions, there should be a reasonable relationship between the value of the property and the amount, as distinguished from the present value, of securities received therefor"—which in this case would be "approximately \$46,000,000." *Ibid.*

⁷² Calculated as follows: The ICC estimated "annual average earnings . . . available for charges and Federal income tax," adjusted to reflect various factors, at \$57.5 million for the Missouri Pacific system. (*Missouri Pacific R. Co. Reorg.*, 290 I.C.C. 477, 534-35 [1954]). (Actual earnings before taxes had been running around \$45 million dollars on the average for the previous five years.) Interest charges under the proposed capitalization, deductible in computing income taxes, would at the maximum amount to \$26,655,857, leaving \$30,844,143 of the estimated average earnings subject to tax (*Id.*, at 587). Under the 52% tax then prevailing, there would be an approximate total of \$41,640,000 earnings after taxes (ignoring ac-

[Footnote 72 continued on p. 444]

⁷³ See *Missouri Pacific R. Co. Reorg.*, 290 I.C.C. 477, 548 (1954).

Having observed the workings and the advantages and drawbacks of the two approaches to full compensation, we are not likely to reach agreement on which is preferable. To those who favor simplicity in corporate capital structures and in the analysis of reorganization plans, and who are concerned that values placed on reorganization securities have a fair chance of materializing, the "best estimate" valuation approach will appear superior. To those who are primarily concerned with the plight of junior interests in financially distressed companies, and who are highly skeptical about the whole process of valuation by appraisal, an "expansible valuation" or "maximum permissible capitalization" approach will seem best. We can be sure that these competing judgments—which differ in how full is full compensation—are not likely to be reconciled. And we can be equally sure that in the reorganization of distressed firms, despite rules calling for full priority and full compensation, it always will be possible to find language that does lip service to doctrine but which results in giving senior claimants less than would be prescribed by a strict application of the rules.⁷⁴

[Footnote 72 continued from p. 443]

celerated depreciation). The maximum capitalization permitted by the Commission was \$809,167,553. Thus the estimated earnings, after tax, were in effect capitalized at about 5.1%.

The suggestion has been made that this rate of capitalization was too high: "Today, Class I railroads bear approximately the same risks; therefore their composite interest rate approximates the proper one for the Missouri Pacific. This rate is reflected in the relation of their profits to book capital, since this is the rate at which necessary capital will be attracted. If profits were higher, more capital would flow in, raising book values and reducing profit rates. Conversely, if profits were lower, disinvestment would raise the profit rate. Thus, the 4+ % which railroads have earned on book capital since 1940 should be the average return, or capitalization rate, for reorganizations." *The Full Compensation Doctrine in Corporate Reorganizations: A Schizophrenic Standard*, 63 *Yale L. J.* 812, 824 (1954). Under this view, the poorer the showing of railroads generally, the lower should be the rate at which projected earnings are capitalized in reorganization, and thus the larger should be the total capitalization of roads emerging from reorganization.

⁷⁴ See Blum, *The Law and Language of Corporate Reorganization*, 17 *U. of Chi. L. Rev.* 565 (1950).