The Investment Value Standard Under the Railway Modification Act

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THE "investment value" standard of fairness or justness developed by the Securities and Exchange Commission in corporate readjustments under the Public Utility Holding Company Act apparently is being taken over by the Interstate Commerce Commission for use in some corporate readjustments under the Railroad Modification Act. In the recent Lehigh Valley proceedings under the latter act the ICC cited the Supreme Court opinion in Otis & Co. v. SEC, which sanctioned use of the investment value standard under the Holding Company Act, and then remarked:

... the court's decision contemplated valuation of the properties, for the purpose of determining the values of the rights of each class of securities, on the basis of a going concern business and not as though a liquidation were taking place, a situation similar in that respect to the problem in the proceeding before us. Thus, in our opinion, the standards which we must apply in this proceeding to insure each class receiving just compensation for the rights surrendered may differ from those in a proceeding contemplating a liquidation of the carrier's property.

The use of something like the investment value standard in the railroad readjustment cases may be justified by the language and history of the Modification Act. With that matter this Comment is not concerned. However, the quoted portion of the ICC's opinion might carry, as an overtone, the suggestion that the similarity between situations in which readjustments take place under the Holding Company Act and situations arising under the Modification Act supports using the same investment value standard in both types of proceedings. It is that proposition which is to be examined in this Comment.

A recent article by Hand and Cummings, tracing the development of standards of fairness or justness in various kinds of readjustment procedures, provides a good background for this endeavor. Attention is directed primarily to two standards. One is the "strict priority" or "absolute priority" standard, initiated in

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5. See note 2 supra.
7. Throughout this Comment, the terms "fairness," "justness," "fair," and "just" are used in a non-technical sense. They are not to be construed as terms of art.
connection with equity receivership reorganizations, developed further under Section 77B of the Bankruptcy Act, and currently applied in reorganizations under Chapter X (and to some extent under Section 77) of that Act. The crux of this standard is that reorganization is to be treated as a substitute for liquidation, that all claims of creditors and preferred shareholders are to be treated as matured as though liquidation were taking place, and that each class of security holders must receive full compensation for his old rights before the holders of securities lower in the liquidation hierarchy may participate in the reorganized entity. Its emphasis thus is on valuing securities with liquidation rights in the foreground. The other standard is that of "investment value" or "present value" of securities. This was developed with respect to readjustments under the Holding Company Act. The heart of this standard is that the rights of the various classes of security holders are to be valued "on the basis of a going business and not as though a liquidation were taking place." From this it follows that liquidation preferences are "only one factor in valuation rather than determinative of amounts payable."

Although the investment value standard was initially advanced as being only an application of absolute priority in a special situation, the difference between the two sets of guides for allocating securities in a readjustment is easily delineated. The valuation placed on an enterprise for purposes of a capital readjustment may fall short of the aggregate liquidation preferences of its senior securities. Even so, its junior securities may have present value if the company's anticipated earnings exceed the amount required to service its senior securities while they are outstanding. This value rests on the right of the company to continue using the capital obtained through issuance of the senior securities. That right, and the value of junior securities arising from it, end if liquidation preferences are treated as matured; for then the position of junior security-holders is to be reassessed as though the capital raised through the senior issues were to be "repaid" in accordance with such preferences.

10. Ibid.
12. "A concrete, if greatly oversimplified, illustrative situation may be of assistance in showing the differences in results under a standard of present value of securities and a strict priority criterion. In receivership or bankruptcy under the strict priority approach, the holder of a first mortgage bond has the right to be paid his $1,000 of principal before anything can be given to the holders of second mortgage bonds. This means that unless the value of the debtor's assets is more than enough to pay the senior lien bonds there is really no value in any junior security. But in a readjustment, while liquidation rights affect present value, they
There is a sound reason, apart from statutory language and history, for adopting the investment value standard in readjustments under the Holding Company Act. Professor Dodd has stated that reason in examining the position of the preferred shareholders of United Light & Power Company, the holding company whose readjustment gave rise to the Otis case and thus was the vehicle for judicial sanction of the investment value standard. He points out that if it were not for the enactment of the Public Utility Holding Company Act, preferred shareholders would not have had any matured claim on the assets or the choice, under the Act, of a method for simplification. In effect, the Securities and Exchange Commission gives literal import to the liquidation aspects of a contract made by the preferred shareholders who had acquired such shares without anticipation of such possibility of a Congressional policy of simplification.

Does this or a comparable reason support using the investment value standard in readjustments under the Modification Act? An intermediate inquiry may provide a useful stepping-stone. Reorganization under the Bankruptcy Act generally is "the reconstruction of an enterprise that is to continue and not the disposition of a defunct venture." Why, then, is it not sound to apply the investment value standard to Chapter X reorganizations? (This is not entirely a fanciful question. A commentator has recently remarked, "Whether the investment value method will carry over into bankruptcy reorganizations cannot now be determined with any finality . . .") Professor Dodd gives a sufficient answer to this question. He states that though reorganization of insolvent corporations does not ordinarily involve liquidation of the business, the reason for maturation of creditors priorities are independent of any actions based on statutory provisions for reorganization.

are not decisive. The first mortgage bondholder has no claim for principal amount; his right is to receive interest until maturity, at which time he will be entitled to repayment of principal. The present worth of his security is the value of this long-term right against the particular obligator. Under this approach, the first mortgage bonds may have a value of $750 each and the second mortgage bonds $250. To apply the present value method of treatment to this situation would mean that the new or altered securities to be held after the readjustment should continue to be in this three-to-one ratio of value. Strict priority is meaningless here because there is no hierarchy of priority to be observed; as to present value all securities are on the same plane and differ only in their relative worth." Hand and Cummings, Consensual Securities Modification, 63 Harv. L. Rev. 957, 975 at n. 65 (1950).

14. See note 12 supra.
15. See note 8 supra.
but, in fact, mature because of the company's financial weakness. The bankruptcy act, in permitting reorganization instead of requiring liquidation, does not depart from the theory that creditors are entitled to "payment" at a particular time or upon the occurrence of a default. Thus, "instead of requiring liquidation, the law permits reorganization as a substitute. Reorganization prevents creditors from getting the cash for which they bargained but the absolute priority doctrine comes to their rescue by giving them the nearest practicable equivalent." ¹⁷

In other words, the very reason for using the investment value standard in Holding Company Act situations constitutes a cogent reason for not using it in bankruptcy reorganizations. Readjustment to comply with the dictates of the Holding Company Act should not be an occasion for senior investors to get the benefits of their rights relating to default and liquidation, inasmuch as such rights were acquired by senior investors in order to protect their investments in the event the corporation in which they invested did not prosper. To ignore or minimize the value of these rights when a distressed corporation seeks reorganization in place of liquidation is to deprive senior investors of the protection (or its equivalent) which they particularly sought in acquiring their securities. It is conceivable that Congress in the future might decide to replace the strict priority standard with another one in bankruptcy reorganizations. But whatever may be the policy behind such a change, it cannot be justified by the fallacious explanation that default and liquidation rights incorporated in senior securities are without significance when distressed enterprises are reorganized instead of liquidated.

This intermediate analysis establishes a basis for considering whether the reason for using the investment value standard under the Holding Company Act also justifies employing it under the Modification Act. Railroads which are not in distress and do not anticipate being in distress may wish to proceed under the Modification Act to reform outmoded indentures and similar instruments. But the Act certainly was not designed primarily to cope with cases of that nature. Its legislative history and structure reveal clearly that the dominant motif was readjustment of railroad securities in anticipation of financial distress. Specifically, the proponents of the legislation desired a medium by which a railroad anticipating difficulties in meeting fixed interest charges could have these reduced or made contingent on earnings, and a railroad anticipating difficulties in retiring or refinancing a maturing bond issue could have the maturity

¹⁷. See note 13 supra.
Railroads faced with such difficulties are not apt to be roads which are prospering. They are much more likely to be roads whose earnings are falling short of expectations since it is the failure to achieve expectations which compels readjustment. In these circumstances it seems unreasonable to ignore or greatly minimize the value of default and liquidations rights. The need for modification of securities is itself a pretty good indication that more than passing attention should be paid to the protective features in securities.

This is not to argue that it is unsound to treat liquidation and default rights as being not matured in proceedings under the Modification Act. Rather this is to point out, first, that the situation giving rise to such a readjustment is likely to be essentially different from that involved in a Holding Company Act readjustment; and, second, that the difference has a direct bearing on what constitutes a fair or just standard for allocating securities in the readjustments. It may be fair to practically ignore liquidation and default rights in the Holding Company Act cases, but no comparable reason exists for doing so when a weak or weakening railroad seeks to readjust its capital structure. To measure the investment value of securities in such a road without emphasizing the value of default and liquidation rights is to dilute the contracts of preferred shareholders and bondholders in order to preserve the equity of the common shareholders. A reductio ad absurdum statement of this relationship might be useful: If the value of default and liquidation rights is to be minimized in determining present values of securities, then as the affairs of the railroad further deteriorate, the value of senior securities relative to common shares will further decrease.

There remains for consideration the almost wholly terminological question whether existing notions of the investment value standard preclude giving great weight to the value of liquidation and default rights in ascertaining present values of securities. The usual statements of the standard do not contain such a limitation: "priorities as to both earnings and assets are, of course, to be considered in ascertaining investment value." Moreover, the Hand and Cummings article, mentioned previously, notes that "In some proceedings under [the Modification Act], . . . which specifically contemplates employment of [the Act] by railroads in bankruptcy or receivership on the effective date of the Act, the [ICC] might wish to give greater than usual weight to factors such as potential
Thus it seems that, despite the differences between the atmosphere in which Holding Company Act cases take place and that in which Modification Act cases are likely to take place, the thrust of the investment value standard can be applied to both without disturbing accepted terminology. But it is well to remember that any standard of fairness or justness in allocating securities in a readjustment is nothing more than a set of guides to control negotiations of the parties and the discretion of officials. If the analysis set forth in this Comment is sound, it seems especially important to remember this fact in connection with using the investment value standard in railroad readjustments under the Modification Act.

20. Id. at 973.