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THE "NEW DIRECTIONS" FOR PRIORITY RIGHTS IN BANKRUPTCY REORGANIZATIONS

Walter J. Blum *

TAKING advantage of a temporary calm in the field of corporate reorganization principles and practices, De Forest Billyou in his recent article in this *Review*, "Priority Rights of Security Holders in Bankruptcy Reorganization: New Directions,"¹ takes stock of where our priority doctrines stand today. His main observation is arresting and provocative. He labels "unsound" the familiar distinction between the priority rights of security holders in bankruptcy reorganization and in reorganization under Section 11 of the Public Utility Holding Company Act² and argues that on a proper reading of the Supreme Court precedents investment value as a priority theory is "not limited in application to Section 11 proceedings, but is equally applicable in bankruptcy reorganization."³ He further argues that bankruptcy reorganizations would be fairer to junior security holders and quicker if they were governed by the investment value theory. In brief, Billyou would change accepted reorganization doctrines by no longer treating liquidation preferences as matured in bankruptcy reorganization.

While it is uncertain how much effect legal theory has in hammering out reorganization plans, there can be no doubt that theory tends to limit the area within which the negotiation of reorganization settlements takes place. And in view of the central position occupied by priority theory in reorganizations, the need for subjecting the "new directions" to close scrutiny becomes strong enough to require comment. Even though another rash of bankruptcy reorganizations accompanying a future de-

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¹ 67 HARV. L. REV. 553 (1954).

² *Id.* at 585. 49 STAT. 820 (1935), 15 U.S.C. § 79k (1946).

³ Billyou, *supra* note 1, at 584.

flation probably would in time work changes in priority doctrines, the new very likely would build upon the old. Thus it is still worthwhile to reassess the old, especially at a moment of tranquility in reorganization law.

Billyou lays the foundation for his analysis of priority doctrines by emphasizing that priority, when associated with reorganizations, has two equally important aspects. "One aspect is the concern of priority with the identification, the construction, and the evaluation of a security contract."⁴ The function of priority here is to determine what features of the old security contracts are to be accorded significance in the reorganization. The second aspect, which comes into play only after all issues under the first have been settled, "is concerned with the form or the amount of participation or compensation that is to be awarded in recognition of those features of the particular security contract that are to be accorded significance."⁵ There is a close interrelationship between these aspects of priority in 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."⁶

From the vantage point of this distinction Billyou reviews the main reorganization precedents, observing that the distinction has not always been recognized or preserved. In his survey he points up the emergence of two competing theories. One, "relative" priority, "would preserve for creditors a claim on the income of the reorganized company equal to the old income claim as well as retaining in the new capital structure rights on dissolution equal to the old claim for principal."⁷ The other, "absolute" priority, "would require that old creditors receive, in the order of their legal priorities and before junior security holders might participate, new securities whose fair cash market value would roughly equal their dollar claims."⁸ These are the classical meanings of the terms "absolute priority" and "relative priority" that have figured so prominently in the law and language of reorganization. While they could be understood to refer in part to both aspects of priority, they have often been thought to pertain

⁴ *Id.* at 566.

⁵ *Ibid.*

⁶ *Id.* at 566-67.

⁷ *Id.* at 559.

⁸ *Ibid.*

primarily if not exclusively to the second aspect — the form or amount of compensation.

The development of this aspect of priority in statutory reorganizations is easily extracted from Billyou's presentation. In industrial bankruptcy reorganizations the SEC has consistently advocated that the statutory standard of a fair and equitable plan calls for application of the absolute priority theory, and this view has been accepted by the Supreme Court in the few industrial reorganization cases in which it has expressed itself on the question. In railroad bankruptcy reorganizations the ICC and the Supreme Court both have talked in terms of adhering to absolute priority, but the approved plans contain allocations that give senior security holders substantially less compensation than called for by absolute priority in the classical sense. In Section 11 public utility reorganizations this second aspect of priority has not been discussed "because the SEC in Section 11 cases has never authorized the retirement of debt securities for payment in 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."⁹

The development of the first aspect of priority — the evaluation of the contract — is somewhat more difficult to trace from Billyou's treatment of the precedents. In the *Los Angeles Lumber* case¹⁰ the Supreme Court condemned a composition-type settlement in an industrial reorganization under the fairness requirement and called for adherence to the rule of "absolute priority." It is not clear whether Billyou thinks that the opinion overlooked the first aspect of priority entirely or that the Court was aware of it but did not discuss the basis for the result reached in the case.¹¹ He does, however, criticize the SEC for its later intimation that the determination of rights to be accorded significance in a reorganization precedes application of the "absolute priority rule" announced in the *Los Angeles Lumber* case, and therefore could not be controlled by it.¹² Not until the SEC turned to Section 11 reorganizations did it recognize that this first issue was

⁹ *Id.* at 580.

¹⁰ *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

¹¹ It is possible to read Billyou as implying that the Court completely overlooked the first aspect of priority inasmuch as it did not expressly concern itself with the fact that the security in question was a bond that was not due and was secured by a mortgage that could not be foreclosed. Billyou, *supra* note 1, at 579.

¹² *Id.* at 579 n.84.

an aspect of priority, and then it took the lead in convincing the Supreme Court that no particular feature of a contract, such as a liquidating preference, should be decisive, but instead that the contract should be appraised in the light of all its investment features to arrive at its "investment value." But for some reason, which Billyou seems at a loss to explain, the SEC sought to reinforce this position by inviting a comparison: "Contrast cases dealing with matured (or provable as if matured) debt claims in bankruptcy reorganizations, where the only right to be dealt with and accorded full priority is the right to receive the face amount of the debt claim."¹³ And once the investment value doctrine had been sanctioned for Section 11 reorganizations by the Supreme Court in the *Otis* case,¹⁴ the SEC, along with most courts, went right on assuming that it had no bearing on priorities in bankruptcy reorganizations. It is this attitude of the SEC which Billyou characterizes as a "willingness to disregard history" as well as a "willingness to disregard substantial evidence that the Supreme Court recognizes its Section 11 precedents to be part of the same body of doctrine as its bankruptcy reorganization precedents."¹⁵

These are the conclusions which call for examination.

Billyou distinguishes bankruptcy reorganization (and its ancestor, equity receivership reorganization) from straight bankruptcy proceedings on the ground that the former aims to preserve values for investors by maintaining the distressed organization as a going concern instead of allowing it to be liquidated to satisfy claims of creditors. In this he is historically correct. The basis of his contention that the SEC has disregarded history is its assertion, in support of its position that in bankruptcy reorganization creditors' rights are to be dealt with as if in liquidation, that "bankruptcy reorganization is a substitute for liquidation" ¹⁶ But this assertion does not imply that in any particular case there is a valid choice between reorganization and liquidation. In the case of most large enterprises in financial distress, liquidation is clearly not a practical alternative, and for publicly held corporations in general there probably never was a time when liquidation could be so considered. The

¹³ American Power & Light Co., 21 S.E.C. 191, 197 n.13 (1945).

¹⁴ *Otis & Co. v. SEC*, 323 U.S. 624 (1945).

¹⁵ Billyou, *supra* note 1, at 583.

¹⁶ *Id.* at 581.

real choice is between doing something affirmative to enforce the creditors' rights and holding them off entirely — between enforcement and moratorium. Both liquidation and reorganization are methods of enforcing those rights. To speak of reorganization as a substitute for liquidation is not to deny this proposition but rather to affirm it by indicating that enforcement of creditors' rights is to take place through reorganization, which preserves values, instead of through liquidation, which tends to destroy them. Surely there is nothing in *this* relationship which suggests that in reorganization creditors' claims should be evaluated differently than in liquidation. On the contrary, it strongly suggests that the two modes of enforcement call for similar evaluations.

The disregard of Supreme Court decisions which Billyou imputes to the SEC is on equally tenuous ground. Paradoxically he seeks to derive the strongest support for his conclusion from a sentence in the *Otis* opinion — the very opinion that gave the investment value doctrine its status in Section 11 reorganizations: "Creditors' contracts also have been declared subject to equitable adjustment in corporate reorganizations so long as they receive 'full compensatory treatment' whether the reorganization is in bankruptcy . . . or in compliance with regulatory statutes."¹⁷ Alongside this statement he places an excerpt from the Court's earlier opinion in the bankruptcy reorganization of the Milwaukee Road in which it is said: "It is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered. That requires a comparison of the new securities allotted to him with the old securities which he exchanges to determine whether the new are the equitable equivalent of the old."¹⁸ On first impression these statements and other similar ones appear to mean that the Court considers the investment value theory as applying equally to all reorganizations. A more critical reading of them in their context and historical setting, however, is likely to result in a wholly different interpretation.

The phrase quoted from the *Otis* opinion concerning full compensatory treatment for creditors, and the language in the *Milwaukee* opinion calling for security holders to receive in the order

¹⁷ 323 U.S. at 634 n.14.

¹⁸ *Group of Institutional Investors v. Chicago, M., St. P. & Pac. R.R.*, 318 U.S. 523, 565-66 (1943).

of their priorities the equitable equivalent of the rights surrendered, have a common ancestor. Both can easily be traced back to the Supreme Court opinion in the *Consolidated Rock* case — an industrial bankruptcy reorganization.¹⁹ There, in talking about the need for full compensatory treatment of creditors and the propriety of offering new securities of a value equal to the creditors' claims, the Court clearly was addressing itself not to the first aspect of priority — evaluating the features of security contracts to be given significance in the reorganization — but to the second. The Court was concerned with the form or the amount of compensation to senior security holders, a point which Billyou himself explicitly makes,²⁰ and its language was intended to convey the thought that the amount of compensation did not have to be stated in dollar terms or be in the form of securities superior to those given junior claimants. On this subject the Court climaxed its discussion by saying: "Practical adjustments, rather than a rigid formula, are necessary. The method of effecting full compensation for senior claimants will vary from case to case. . . . [W]hether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on the facts and requirements of each case. So long as the new securities offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the court."²¹

There is no need to speculate whether in using this language the Court intended to concern itself at all with the first aspect of priority. The Court dealt with that subject in another part of the opinion, and made it plain that the statutory standard of fairness in industrial bankruptcy reorganizations required treating claims of creditors as if matured. "The instant plan runs afoul of [the absolute priority] principle," it concluded, because "no provision

¹⁹ *Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510 (1941). The same is true of similar language quoted by Billyou from the *Engineers* case, *SEC v. Central-Illinois Securities Corp.*, 338 U.S. 96, 143 (1949), and from the *Niagara Hudson* case, *Niagara Hudson Power Corp. v. Leventritt*, 340 U.S. 336, 347-48 (1951), as additional authority for his assertion that the Supreme Court considers the investment value theory as applying to all reorganizations. Billyou, *supra* note 1, at 584.

²⁰ *Id.* at 568.

²¹ 312 U.S. at 529-30.

is made for the accrued interest on the bonds. This interest is entitled to the same priority as the principal."²² To dispel any doubts as to the sense in which the term "priority" is here used, the Court cited as authority two cases holding that in receiverships, as in bankruptcies, "a secured creditor . . . may enforce his lien against his security, where it is sufficient to cover both principal and interest, until his claim for both is satisfied."²³ Thus, reading the language common to the *Milwaukee* and *Otis* opinions in the light of its forerunner in the *Consolidated Rock* case, there is no ground for believing the Court was introducing the investment value theory into bankruptcy reorganization. What the Court was saying is that the different kinds of reorganization are alike in that the standard of fairness as to the form and amount of compensation to holders of senior securities is the same in all reorganizations. For a plan to be fair, seniors must get the equivalent of those features of their security contracts which are entitled to be accorded significance in the reorganization.

Whether or not Billyou is correct in his interpretation of reorganization history and Supreme Court precedents, there is still the question whether on the merits of the issue the claims of senior security holders should be treated as matured in a bankruptcy reorganization. On this question Billyou offers arguments on what he terms the theoretical and the practical levels for not regarding the claims as matured. Once again his presentation invites rejoinder to the main arguments in behalf of his position.

On the theoretical level he underscores the fact that to treat liquidation preferences as matured can result "in some security holders receiving a participation in the reorganized enterprise which they could not receive in any proceeding other than actual liquidation."²⁴ His argument against permitting this is stated forcefully: "To arrive at such results in proceedings whose very purpose is to enable an enterprise to continue in order to preserve legitimate security interests is hardly an effectuation of the promises made to corporate security holders and on which their investments were presumably made."²⁵ This statement truly

²² *Id.* at 527.

²³ *Ticonic Nat. Bank v. Sprague*, 303 U.S. 406, 413 (1938). The other case cited was *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 266-67 (1914).

²⁴ Billyou, *supra* note 1, at 586.

²⁵ *Ibid.*

goes to the heart of the matter. The central issue of fairness in a bankruptcy reorganization concerns the degree to which the spirit, if not the letter, of security contracts can be ignored or overridden by a majority — but not all — of the security holders involved.

Because reorganization, as a substitute for liquidation, was shaped to preserve values for investors, it does not follow that reorganization was designed to preserve values for junior claimants at the expense of senior claimants. Billyou seems to say that in ascertaining the amount of value to which seniors have a right, the liquidation preferences in their security contracts should not be controlling since these do not accord with the legitimate expectations of the various groups as to their respective interests in a continuing enterprise.²⁶ This is the basis of his theoretical argument for applying the investment value theory in bankruptcy reorganization. But since he does not purport to have conducted his own survey of investors, and since there is no organized body of knowledge about investor expectations, his premise may be questioned. As to large institutional investors, who might be expected to rely on the frequently repeated views of the courts and the SEC, any expectation would probably coincide with the accepted understanding of the existing state of the law. As to other investors, who are not likely to be familiar with reorganization law, it is reasonable to suppose that those who invest in common shares expect to bear the risk of loss in case of a financial debacle, and that those who invest in senior securities expect to have the protection of the equity cushion when the going gets rough.²⁷ When all is said and done, it appears likely that uppermost in the minds of most investors who purchase comparatively low-yielding senior securities is protection against disaster. The distinction between debt and equity may be becoming blurred, but to the extent that it retains vitality it seems to be associated with the notion of ultimate risk.

This, of course, is not to argue that private senior security holders have precise expectations concerning their default rights. Rather it is to emphasize that rights on default very likely figured heavily in their choice of senior instead of junior securities. In

²⁶ *Ibid.*

²⁷ This argument applies to all types of senior securities, including preferred shares. Its force perhaps is less in the case of preferred shares than debentures or bonds, but the direction of its thrust is the same.

the case of bonds an important default right is priority as to accrued interest as well as principal; in the case of cumulative preferred shares an important catastrophe right is preference for dividend arrears as well as for the stated liquidation preference. To refuse to treat such crisis rights as matured in a reorganization which is a substitute for liquidation is to make substantial inroads on the bundle of rights for which the senior investors bargained. When disaster occurs, and the bargained-for protection is sought, is it fair to respond that the distress features are only a part of the contract and that the contract should be viewed as a whole?

On the practical level, Billyou's main argument for applying the investment value theory to the second aspect of priority is at once the most interesting and the most baffling portion of his article. He notes that in the bankruptcy reorganization of certain railroads, "[i]n no meaningful sense did the new securities issued under those . . . plans represent 'full payment' of the claims they purported to satisfy."²⁸ He then states that on balance, "[t]he effect of the emphasis of bankruptcy priority theory on the amount of the debt claim has been largely nullified by the character of the securities issued in recognition of such a claim."²⁹ These reflections may seem somewhat unrelated to the investment value standard, but Billyou makes clear the connection he has in mind. "The emphasis of the investment value theory on *all* of the investment features of the security contract would result in some attention being given to such features of the security contract as the earning coverage of the old bonds and the underlying security, as well as the financial weakness of the enterprise."³⁰

The desire of Billyou to have attention focused on the factors he enumerates, at the time of determining the form or amount of compensation to be given the various classes of participating security holders, merits enthusiastic endorsement. But this is not a function of the investment value theory. That theory is significant only in its application to the first aspect of priority—the identification and evaluation of the features in security contracts to be accorded significance in a reorganization. As to the other aspect, there is nothing in the nature of the investment value

²⁸ Billyou, *supra* note 1, at 589.

²⁹ *Id.* at 590.

³⁰ *Ibid.*

theory which calls for following a process divergent from that which the SEC and Supreme Court are generally thought to have prescribed for bankruptcy reorganization. This is well-demonstrated by the lineage of the "full compensatory treatment" and "equitable equivalent" language of the Court, which, as shown before, can be traced from *Consolidated Rock*, through *Milwaukee*, to the *Otis* and *Engineers* cases. In the light of this history, it is practical and sound to view the investment value theory as relating solely to the first aspect of priority.

Billyou's position, moreover, greatly underplays the actual facts of the situation. The undercompensation of senior security holders in railroad bankruptcy reorganizations, as contrasted with the adequate compensation of seniors in Section 11 reorganizations, is not to be explained by any failure to consider all the features of the investment contracts involved. The ICC and no doubt the Supreme Court were fully aware that unless the fortunes of railroads improved tremendously, many senior security holders would be getting considerably less than genuinely full compensatory treatment while juniors were being allowed to participate in the reorganized companies. No additional amount of contract analysis could or would have changed this. The railroad industry had been overcapitalized, it had been overcontrolled by the Government, it had almost never earned a favorable return on capital invested in it, and it had suffered a severe and long depression.³¹ Under the circumstances it is somewhat surprising that the ICC was able to cut off in reorganization as many classes of security holders as it succeeded in doing; it simply was not in the cards to make a deeper incision. The atmosphere surrounding the Section 11 public utility reorganizations was incomparably different. The utility industry had fared far better than most other industries during the great depression, the operating companies were returning satisfactory profits on invested capital, and the market

³¹ BELLEMORE, INVESTMENTS—PRINCIPLES PRACTICES AND ANALYSIS 633-34 (1953):

For the period from 1926 to 1945 inclusive the railroads earned an average of 3.54% of their investment compared with 6.30% earned by electric utility companies in the same period. Since 1930 it has been virtually impossible for railroads to sell additional stock. From 1938 to date 99% of all new issues sold have been in the form of bonds and 1% in stocks. If the railroad industry can only earn a maximum of less than 6% in its best years and does much worse than that in its poor years the industry can expect little more than casual interest from investors if it attempts to market new issues of equity securities for investment purposes.

for their securities by and large was not in the doldrums.³² Under the circumstances the SEC in its public utility work could afford to talk about present values; the ICC was practically forced to dodge direct discussion of present values and instead indulge in a kind of double talk which tended to obscure the embarrassing dilemma with which it was faced.

The importance of the distinction between present values — that is, market values — and presumed future values — that is, reorganization values — is not confined to the railroad end of bankruptcy reorganizations. At least in time of widespread economic depression, the reorganization of distressed companies could go forward only if enterprise valuations departed from valuations of the market place. It is true that immediately after the Supreme Court in the *Consolidated Rock* case ordained that seniors were entitled to full compensation, several distinguished reorganization lawyers said in print that seniors should be given "new securities with a *market value* equal to the full amount of their respective claims."³³ In retrospect it is hard to explain these extreme statements inasmuch as those who were actively participating in reorganization settlements must have known that in depressed times such strict foreclosure of junior interests was unacceptable and unworkable. Perhaps the best explanation is that the *Consolidated Rock* decision occurred after there had been a fair degree of general economic recovery. Be that as it may, what calls for comment here is the fact that Billyou lumps together these extreme "market value" statements and the parallel but significantly different position taken by the SEC. It was the SEC's view that "senior securityholders are entitled to receive more than mere paper securities of a face amount equal to their claims.

³² *Id.* at 582:

The utility industry as a whole has proved to be one of the most stable segments of American industry. During the severe depression of the early 1930's, drastic losses were suffered by many holding companies largely as the result of past financial manipulation. In direct contrast, the operating companies displayed notable stability. This stability was again brought to the attention of investors in the recession year, 1938. Phenomenal growth has taken place since 1940.

Consequently, the securities of the industry have become the most widely accepted quality stable investments of all private capital securities. The wide acceptance has been especially marked among institutional investors, investors acting in a fiduciary capacity, and other investors who follow conservative policies either through necessity or wish. There are, of course, poor and medium quality securities in the group, but it would be extremely difficult if not impossible to point to any other group of private securities that have achieved the investment stature or acceptance that has been accorded those in the electric power industry. They are considered the best of defensive securities and many show growth.

³³ Dean, *A Review of the Law of Corporate Reorganizations*, 26 CORNELL L.Q. 537, 559 n.63 (1941) (emphasis original). See Billyou, *supra* note 1, at 565-66.

. . . In other words, the new securities should be intrinsically sound, so that there is a *reasonable prospect that they will have values* equal to their face amounts, or in the case of stocks, equal to the values put upon them for reorganization purposes.”³⁴ This statement holds the key to the real difference between the form or amount of compensation for claims — the second aspect of priority — in bankruptcy reorganizations under depression conditions and in Section 11 public utility reorganizations. In the latter it was reasonable and practical to insist that senior security holders in healthy utility companies be given full compensation in terms of present market values of securities. In the former such a course was usually out of the question.

An exception very conveniently illustrates this point. Billyou comments: “In some instances new securities distributed to security holders pursuant to SEC-approved Chapter X plans have had cash market values equal to their par values; witness the securities issued pursuant to the plan approved in *Central States Elec. Corp. v. Austrian*”³⁵ However the *Central States* reorganization³⁶ was atypical. The plan of reorganization was drawn during generally prosperous times and, of equal significance, the corporation was a holding company owning securities whose immediate market values could be ascertained with comparative ease. Under these circumstances it would have been awkward, to say the least, for the SEC to contend that the value of the holding company exceeded the present market values of its quickly marketable assets. It may be palatable during a depres-

³⁴ Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U.L.Q. Rev. 317, 340 (1941) (emphasis supplied). It is true that at the time the statement in question was published Frank had left the SEC and had been appointed a federal judge. However, the article apparently was written while he was Chairman of the SEC and at the beginning of the article it is noted that “[s]ince the writing of this article Mr. Frank has been appointed to the Circuit Court of Appeals, Second Circuit.” The precise timing here, however, is not important. It is clear from the article itself that Frank was expounding the views of the Commission, whether or not he was technically in a position officially to speak for it. The remark of Samuel Clark quoted in note 31 of Billyou’s article is not necessarily at variance with Frank’s statement. Clark said: “[T]he law requires that a plan provide recognition for claims in the order of their priority; that such recognition must approximate full payment in the order of priorities, either in cash or in securities of the reorganized company” He did not go on to consider whether full payment in securities of the reorganized company required valuing those securities at “market value” or the value which the securities could reasonably be expected to attain.

³⁵ Billyou, *supra* note 1, at 589 n.110.

³⁶ *Central States Elec. Corp. v. Austrian*, 183 F.2d 879 (4th Cir. 1950).