RECENT CASES

Bankruptcy—Corporate Reorganization—Priorities—[Federal].—In 1930 the Los Angeles Lumber Company effected a readjustment outside of court, wiping out the old stock, but giving a new Class A common stock to old stockholders for a $400,000 cash contribution. A new Class B common was given to bondholders in lieu of unpaid interest on the mortgage debt. The interest rate on the mortgage bonds was reduced and made payable only if earned. No provisions were included by which bondholders might gain control if interest requirements were not covered by earnings. In 1937 the assets were appraised at twenty-five per cent of the bonded indebtedness.[1] Shipbuilding contracts were an immediate prospect, but it was said to be impossible to obtain necessary performance guarantees unless the indebtedness of the company were substantially scaled down. The corporation filed a voluntary petition for reorganization in bankruptcy under Section 77B. The plan submitted was assented to by 92.81% of the bondholders, 99.75% of Class A stockholders, and 90% of Class B stockholders. It provided for participation by Class A stockholders, without any contribution, by receipt of all of the common stock of the new company, having a par value equal to twenty-three per cent of the present appraised value of the company. No provision was made in the plan for the Class B stockholders. The bondholders were to be given 5% non-cumulative participating[2] preferred stock having a par value equal to the remaining seventy-seven per cent of the appraised value of the company. A further amount of the preferred stock was to be sold to the public to secure needed working capital. A dissenting minority of the bondholders contested the fairness of the plan. The district court[3] confirmed the plan and the decision was sustained by the Circuit Court of Appeals.[4] On certiorari to the Supreme Court, *held*, a plan which permits participation of stockholders where the assets of the debtor company are insufficient to satisfy prior interests in full is unfair under Section 77B(f)[5] of the Bankruptcy Act. Judgment reversed. *Case et al. v. Los Angeles Lumber Co.*[6]

[1] It is impossible to determine from the reports of the case whether the appraisal was made pursuant to a court order and later became a court finding, or was made at the request of the guaranty company, or by stipulation of the parties. At any rate the appraisal was accepted by the trial court and no dispute about valuation arose. See In re Los Angeles Lumber Co., 24 F. Supp. 501, 505 (1938); In re Los Angeles Lumber Co., 100 F. (2d) 963, 964 (1939).

[2] The preferred stock was to be entitled to a 5% non-cumulative dividend, after which the common stock was entitled to a similar dividend. Thereafter all shares of both classes were to participate equally in dividends. On liquidation, the preferred stock was to receive a preference to the amount of its par value, then the common was to receive a similar preference. Thereafter, all shares of both classes were to participate equally.

[3] In re Los Angeles Lumber Products Co., 24 F. Supp. 501 (1938).

[4] In re Los Angeles Lumber Products Co., 100 F. (2d) 963 (C.C.A. 9th 1939).

[5] 48 Stat. 912 (1934). "After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible. . . ."

[6] 60 S. Ct. 1 (1939).

The problem in corporate reorganization of proper distribution of securities representing interests in the new company among the holders of various claims and equities in the old company is generally presented as involving the choice between the doctrines of absolute and relative priority.[7] Absolute priority requires that each senior interest in the old company be satisfied in full before any inferior interest is accorded any participation.[8] Relative priority has meant participation on the basis of something less than absolute priority, the exact extent of encroachment upon contract rights depending in each case upon the balance struck by the court between its willingness to accept compromises reached by the various groups, and its desire to protect the interests of dissenting minorities.[9] Despite the large number of reorganizations which have taken place since the development of the equity receivership, the Supreme Court has on but few occasions passed directly on the rules of priority. In those cases,[10] there were strong expressions favoring absolute priority; nevertheless, the distinctive fact situations actually litigated combined with the recurrent presence of qualifying language led to uncertainty with respect to permissible deviations from strict priority. Thus in *Kansas City Terminal R. Co. v. Kansas City Trust Co.*,[11] the Court, while speaking in terms of absolute priority, added the qualification that the trial judge

[7] Frank, Some Realistic Reflections on Some Aspects of Corporate Reorganization, 19 Va. L. Rev. 541 (1932); Swaine, Reorganization of Corporations: Certain Developments of the Last Decade, 27 Col. L. Rev. 901 (1927); Spaeth and Winks, The Boyd Case and Section 77, 32 Ill. L. Rev. 769 (1938); Bonbright and Bergerman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization, 28 Col. L. Rev. 127 (1928); Friendly, Some Comments on the Corporate Reorganization Act, 48 Harv. L. Rev. 391 (1934); Buscheck, A Formula for the Judicial Reorganization of Public Service Corporations, 32 Col. L. Rev. 964 (1932); Foster, Conflicting Ideals for Reorganization, 44 Yale L.J. 923 (1935); see generally, Levi and Moore, Bankruptcy and Reorganization: A Survey of Changes, 5 Univ. Chi. L. Rev. 1, 219, 398 (1938).

[8] This is the so-called "fixed principle" of Northern Pacific R. Co. v. Boyd, 228 U.S. 482 (1912) which is held by the instant case to be enacted in Section 77B(f). The Boyd case has been analyzed by Frank, op. cit. supra note 7, as based on the doctrine of fraudulent conveyance; namely, that retention of an interest by the debtors (stockholders) when all prior claims have not been satisfied, renders the plan a fraudulent conveyance. See 2 Gerdes, Corporate Reorganization § 1083 et seq. (1936). Under this interpretation, a plan which wiped out the stockholders but which accorded participation to junior creditors although no equity exists for them would not necessarily be unfair because the essence of a fraudulent conveyance is retention of some interest by the debtor. On the other hand, if emphasis is placed on the broad language of the Boyd case, any plan which excluded or insufficiently satisfied prior interests while permitting participation of inferior interests, whether stockholders or creditors, would be unfair. See Jameson v. Guaranty Trust Co., 20 F. (2d) 807, 813 (C.C.A. 7th 1927), cert. den. 275 U.S. 569 (1927). The instant case is susceptible of either interpretation. Except where otherwise mentioned, this note will be confined to the treatment of stockholder participation.

[9] Bonbright and Bergerman, op. cit. supra note 7.

[10] Railroad Co. v. Howard, 7 Wall. (U.S.) 392 (1868); Louisville Trust Co. v. Louisville, N. A. & C. R. Co., 174 U.S. 674 (1898); Northern Pacific R. Co. v. Boyd, 228 U.S. 482 (1912). (The plans involved in these cases permitted stockholder participation while making no provision for an intermediate class of creditors.) Kansas City Terminal R. Co. v. Kansas City Trust Co., 271 U.S. 445 (1925). (The Court here considered the question of how much participation must be accorded each class.)

[11] 271 U.S. 445 (1925).

"may exercise an informed discretion concerning the practical adjustment of the several rights" as the circumstances of each case may require.[12] The doubt thus occasioned was perhaps an important factor in the widespread approval in lower courts of plans recognizing "relative priority" notions.[13]

The enactment of Section 77B of the Bankruptcy Act,[14] with a caption stating its purpose as relief of debtors,[15] and coming at a time when debtor relief legislation was prevalent in other fields[16] was thought by some to require stockholder participation in every plan on a relative priority basis. This inference was corrected by the unanimous Supreme Court decision in *In re 620 Church St. Building Corp.*,[17] in which the Court held that stockholders had no right to participation when an evaluation of assets showed no residual equity after creditors were satisfied, and that a plan which did not include them was "fair and equitable," as those terms are used in the statute. Additional support for this conclusion might have been found in the express statement in the act that where the judge shall find no equity for a class, the assent of that class is not necessary to the plan.[18] That a plan which did provide for stockholder participation when no equity remained would be necessarily unfair was established in the principal case.

In the earlier Supreme Court decisions the objections to the plan came from an entire class. Where the objection comes from a minority within a single class there arises the problem of the value of democratic notions of majority rule in corporate reorganization.[19] Prior to the enactment of Section 77B non-assenting senior creditors had the opportunity to receive in cash their portion of the proceeds of the foreclosure sale. In fixing "upset prices," the courts often attempted to give some protection to the minority but the dissenter's cash distribution was always less than the probable value of the securities received by the assenters.[20] While it is true that, at the behest of minority bondholders, most courts inquired into the fairness of the plan as well as the adequacy of the bid, the fact that a large majority of bondholders had agreed to the plan was usually considered as evidencing the plan's fairness.[21] Consequently,

[12] Ibid., at 455.

[13] Following the decision of the Supreme Court in the Kansas City case, the Circuit Court permitted relative priority participation. Kansas City Terminal R. Co. v. Central Union Trust Co., 28 F. (2d) 177, 184 (C.C.A. 8th 1928), cert. den. 278 U.S. 655 (1928); see Jameson v. Guaranty Trust Co., 20 F. (2d) 807 (C.C.A. 7th 1927), cert. den. 275 U.S. 569 (1927). See cases collected in Buscheck, op. cit. supra note 7, at 977, et seq.

[14] 48 Stat. 911 (1934).

[15] Section 77B refers to the corporation as the "debtor." But cf. the language of Brewer, J., in Louisville Trust Co. v. Louisville, etc. R. Co., 174 U.S. 674, 683 (1898), where the Court refers to the stockholder as the mortgagor. See also 35 Col. L. Rev. 549 (1935).

[16] See e.g. the first Frazier-Lemke Act, 48 Stat. 1289 (1934); the second Frazier-Lemke Act, 49 Stat. 943 (1935), 11 U.S.C.A. § 203(s) (1935); see Home Bldg. &. Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934), passing on the constitutionality of Minnesota mortgage moratorium legislation.

[17] 299 U.S. 24 (1936). [18] §77B(e), 48 Stat. 918 (1934).

[19] Two ideas are here involved: (1) that majority rule is intrinsically a fair one, and (2) that the self-interest of the majority is sufficient safeguard to protect the class.

[20] See Levi and Moore, op. cit. supra note 7.

[21] Katz, The Protection of Minority Bondholders in Foreclosures and Receiverships, 3 Univ. Chi. L. Rev. 517 (1936).

the problem of standards of fairness to a minority group did not receive a great deal of attention by the courts. Section 77B provided for the binding of minorities to a plan assented to by a two-thirds majority of each class.[22] With the alternative of cash payment thus removed, an independent inquiry into the fairness of the plan became even more desirable. Inasmuch as the statute provided for court approval only after the requisite assents had been obtained,[23] there was some tendency to continue the old practice of approving the plan as fair if agreed to by the required majorities.[24] In the instant case, however, Mr. Justice Douglas said, ". . . . Congress has required both that the required percentages of each class of security holders approve the plan and that the plan be found to be 'fair and equitable.' The former is not a substitute for the latter."[25] Adapting the strong language of the *Boyd*[26] and *Kansas City Terminal*[27] opinions (there applied to the unfair treatment of an entire class under the plan) to the protection of dissentient minorities,[28] the Court establishes absolute priority as the criterion of a fair and equitable plan.

Although absolute priority does not permit retention of an interest by junior security holders as long as those senior to them have not been fully compensated, it does not prohibit purchase of an interest in the new company in return for valuable consideration contributed.[29] Both lower courts[30] in the instant case found that stockholders had given ample consideration to warrant their participation. The Supreme Court, in reversing this finding, held that money or money's worth is the only asset justifying stockholder inclusion. The Court refused to recognize as consideration for an interest given to stockholders, the contribution of business reputation and experience, maintenance of continuity in management, or the foregoing of tactical advantage and potential litigation. This refusal was based on the knowledge that recognition of such intangible assets would facilitate evasion of absolute priority, and on the unwillingness to recognize coercive tactics as consideration. Upon the basis of a tangible contribution, the stockholders may be accorded participation "reasonably commensurate"[31] to the value given. Moreover, the interest given in return for a cash

[22] § 77B(e), 48 Stat. 918 (1934).

[23] This objection to 77B has now been remedied by Chapter X of the Chandler Act, 52 Stat. 840 (1938), 11 U.S.C.A. c. 10 (VII) 1939). The court now evaluates the plan from the "fair and equitable" standpoint before it is submitted to the security holders for approval. See Levi, Corporate Reorganization and a Ministry of Justice, 23 Minn. L. Rev. 3 (1938) where it is suggested that the fact that the plan is proposed by a disinterested trustee may itself lead the court to be hesitant about upsetting a plan submitted for approval.

[24] In re A. C. Hotel Co., 93 F. (2d) 674 (C.C.A. 7th 1937); cf. Downtown Investment Co. v. Boston Metropolitan Build. Inc., 81 F. (2d) 314 (C.C.A. 1st 1936). See Dodd, The Securities and Exchange Commission's Program for Bankruptcy Reorganizations, 38 Col. L. Rev. 223, 235 (1938).

[25] 60 S. Ct. 1, 6 (1939).

[26] 228 U.S. 482 (1912).

[27] 271 U.S. 445 (1925).

[28] See note 8 supra.

[29] See Bonbright and Bergerman, op. cit. supra note 7, at 149; Jameson v. Guaranty Trust Co., 20 F. (2d) 808, 811 (C.C.A. 7th 1927), cert. den. 275 U.S. 569 (1927).

[30] In re Los Angeles Lumber Products Co., 24 F. Supp. 501 (1938); In re Los Angeles Lumber Products Co., 100 F. (2d) 963 (C.C.A. 9th 1939).

[31] 60 S. Ct. 1, 6 (1939). Because of the inherent difficulty of evaluating the securities given in return for contribution (see e.g. Jameson v. Guaranty Trust Co., 20 F. (2d) 807 (C.C.A.

contribution may be allowed priority over all other interests inasmuch as the cash is of benefit to all.[32]

The Court, while thus ruling out intangible consideration and coercive tactics as a basis for stockholder participation, yet indicates that certain types of claims may be compromised in the interests of "administering the proceedings in an economical and practical manner."[33] In this category the Court lists ambiguities arising out of a conflict of wording in two indentures, close interpretations of after-acquired property clauses in mortgages, and problems of preference in stock certificates and divisional mortgages. Settlement of such claims is deemed a normal part of the reorganization process. It is noteworthy that nowhere in the opinion does the Court mention the possibility of compromise on the close question of the value of the corporate assets. While the facts of the instant case present an extreme discrepancy between indebtedness and assets, frequently the disparity will be less and a bona fide dispute as to valuation may arise. Neither Section 77B nor Chapter X[34] expressly requires that an appraisal be made at any time.

With absolute priority the established rule, however, evaluation becomes of paramount importance. Two of the possible approaches to the problem of when an appraisal shall be made may be suggested. First, the court may require an appraisal in every case before considering the plan.[35] While this procedure recommends itself because it establishes a definite rule, delay will be incurred and the expense involved must come out of the assets of the company. An alternative solution allows the court to permit the valuation to be reached by bargaining among the various classes. Majorities of the classes should be permitted to decide whether it is worth while to use the assets of the company for a valuation, by being permitted to bind minorities to an agreement with respect to the extent of participation by junior security holders. In the absence of patent misvaluation, collusion, or coercion, retention of some interest by junior security holders might well be permitted under the heading of settlement of doubtful claims. Vigilant judicial scrutiny of the compromise should be able to avoid easy evasions of absolute priority. Proof of misvaluation, collusion, or coercion should be required of a dissentient minority before an appraisal will be required at

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7th 1927)), participating on this basis may provide a method of evading absolute priority. The language in the instant case, which limits participation to an interest "reasonably commensurate" with the contribution, is more restrictive than the permissive language used by the Court in Kansas City Terminal R. Co. v. Kansas City Trust Co., 271 U.S. 445, 455 (1925), that stockholders may be "permitted to contribute and retain an interest sufficiently valuable to move them."

[32] See Bonbright and Bergerman, op. cit. supra note 7; Jameson v. Guaranty Trust Co., 20 F. (2d) 808, 811 (C.C.A. 7th 1927), cert. den. 275 U.S. 569 (1927). It would seem that there is no objection to giving old stockholders an opportunity to invest new money in the renovated company ahead of the general public.

[33] 60 S. Ct. 1, 14 (1939).

[34] 52 Stat. 883 (1938), 11 U.S.C.A. c. 10 (1939).

[35] In re Philadelphia & Reading Coal Co., 105 F. (2d) 353 (1939). In view of the uncertainty which attends valuation, there arises the problem of determining what effect is to be given the appraisal in a close case, where the value found is just below the point where a junior interest would receive some participation. One writer suggests that in such a case some compromise should be permitted. Buchanan, The Economics of Corporate Enterprise 383 (1939.)

their request; otherwise, the minority could impose its opinion upon the majority as to whether an appraisal was worth the cost.[36]

The propriety of permitting participation by junior interests on a contingent basis where no present equity exists for them, was not raised in the principal case. It is a possible position that absolute priority prevents participation even on a contingent basis, on the theory that junior interests have been wiped out and any future prosperity and increment are results of and accrue to the interests which as yet remain. On the other hand it is arguable that bondholders have contracted only for a return of principal and interest; consequently, contingent participation would only prevent strict foreclosure of the interests of junior equities at a time of depressed values, and would not violate the doctrine of absolute priority.[37] Of course, any future participation would have to depend wholly upon the renovated company's prospering to a point where securities of the new company held by those who possessed senior interests in the old company, reached a value sufficient to satisfy claims of their holders against the old company.[38] Methods of according participation might take the form, for example, of an option to purchase stock at a stated figure, or of an arrangement by which an interest, held in trust for former holders of junior equities, passes to the former senior security holders, unless within a stated period the earnings reach a specific amount.[39] One of the difficulties with such solutions would be to determine at what figure the option to purchase should be set, or to determine the sum earnings should reach before the trust interest becomes unconditional in the former holders

[36] A conceivable solution would permit a minority to call for an appraisal whenever dissatisfied with the compromise. Should their dissatisfaction be found groundless, the cost of the appraisal should be borne by them. If, however, their suspicions were well founded, the cost would come out of the assets of the company.

[37] The Court in the instant case quotes a dictum in Northern Pacific A. Co. v. Boyd, 228 U.S. 482, 508 (1912), which seems to look both ways: "If the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was *present or prospective*, for dividends or only for purposes of control. In either event, it was a right of property out of which the creditors were entitled to be paid *before the stockholders could retain it* for any purpose whatever." (Italics added.)

[38] In In re 620 Church St. Bldg. Corp., 299 U.S. 24 (1936) counsel contended that Section 77B was analogous to farmer-debtor legislation. The stockholders claimed a present interest which, in view of the insolvency of the company, could only be had at the expense of the bondholders. The refusal of the court to recognize the analogy was in line with its decision in Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935) wherein the first Frazier-Lemke act, 48 Stat. 1289 (1934) was declared invalid because the mortgagee's rights were inadequately protected under the statute. The allowance of contingent interests to stockholders, however, may be reconciled with the decision of the Court in Wright v. Vinton Branch of Mountain Trust Bank of Roanoke, 300 U.S. 440 (1937), holding valid the second Frazier-Lemke act of 1935, 49 Stat. 943 (1935), 11 U.S.C.A. § 203(s) (1935). This act was construed as purely moratory, the mortgagee having the right to be paid off in full after the stated period of continuance. The benefit of any rise in the value of the property during the interim was to accrue to the mortgagor. A contingent interest to stockholders would secure just this benefit to stockholders while protecting the interests of creditors in their accrued claims.

[39] See Moore, The Economics of Railroad Financial Reorganization 174 ff. (unpublished thesis, University of Chicago, 1938).

of junior equities.[40] Assuming this obstacle to have been overcome, it would seem that there should be no need of re-establishing the old hierarchy of priorities, i.e., again putting those who were formerly stockholders subordinate to those who were formerly bondholders, since the *Kansas City Terminal* case[41] held that absolute priority may be satisfied by quantitative differences in the same grade of security. The main objection to contingent participation is a practical one. Instead of emerging from reorganization with a simplified capital structure, the company is burdened by outstanding interests of an indefinite and unascertainable nature which may very well limit its ability to raise needed funds.

Absolute priority has long been advocated on principle as the standard by which the fairness of a plan should be measured. The Securities and Exchange Commission, under its power to criticize prospective plans under Chapter X[42] and in its administration of the Public Utilities Holding Company Act[43] has strongly urged its adoption.[44] The Interstate Commerce Commission has likewise indicated a preference for absolute priority.[45] The advantage of so definite a standard in simplifying the work of courts and commissions in investigating plans, is apparent. Adoption of this standard will facilitate one of the primary objects of reorganization: cleaning up the capital structure of the company in order to put it in a position to undertake successfully further equity or credit financing. Assuming the need for two types of investment, the rule of absolute priority should lessen any tendency to blur the line between "safe" and speculator investments. Furthermore, rigorous enforcement of absolute priority will remove that additional unfair advantage which relative priority gives to those who trade on the equity by compelling equity holders to bear the full burden of losses in return for their opportunity to secure greater profits.[46]

Criminal Procedure—Right of Prosecution to Writ of Error—Special Pleas in Bar— [Illinois].—The defendant, a criminal court judge, was indicted for conspiracy to

[40] If the contingent interests are of a nature which can be dealt with in the open market, conceivably, the market would determine the point at which their contingency is terminated by giving them value. But see the opinion of the SEC in In the Matter of Detroit Int'l Bridge Co., Reorg. Act Rel. 9 (1939), where it is suggested that transferability of such contingent interests be limited to protect ill-advised investors against their doubtful value.

[41] 271 U.S. 445 (1925). In answer to questions certified, the Court stated that priority might, where circumstances fairly required it, be satisfied by giving prior interests a greater amount of the same grade securities given junior interests.

[42] §§ 172, 173, 52 Stat. 890 (1938), 11 U.S.C.A. c. 10 (1939).

[43] 49 Stat. 803 (1935), 15 U.S.C.A. § 79 (Supp. 1937).

[44] Under Chapter X: In the Matter of Griess-Pfleger Tanning Co., Reorg. Act Rel. 13 (1939); In the Matter of Detroit Bridge Co., Reorg. Act Rel. 9 (1939); In the Matter of National Radiator Corp., Reorg. Act Rel. 10 (1939). Under the Public Utility Holding Company Act: Genesee Valley Gas Co., Hold. Co. Act Rel. 981 (1938); Utilities Power & Light Corp., Hold. Co. Act Rel. 1655 (1939). See Meck and Cary, Regulation of Finance and Management under the Public Utility Holding Company Act of 1935, 52 Harv. L. Rev. 216 (1938).

[45] See, e.g., the letter of Commissioner Eastman, printed in H.R. Hearings on H.R. 3704 and H.R. 5704, 76th Cong., 1st Sess. at 82 ff. (1939).

[46] See Buchanan, op. cit. supra note 35 at 378 ff.; Moore, Railroad Fixed Charges in Bankruptcy Proceedings, 47 J. Pol. Econ. 101, 123 (1939).