6-1-1959

A critical analysis of the development of the procedure of industrial corporate reorganization as modified by the reorganization acts, 1934-1938

Suren Nath Sadana
Atlanta University

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A CRITICAL ANALYSIS OF THE DEVELOPMENT OF THE PROCEDURE
OF INDUSTRIAL CORPORATE REORGANIZATION AS
MODIFIED BY THE REORGANIZATION ACTS,
1934-1938

A THESIS
SUBMITTED TO THE FACULTY OF ATLANTA UNIVERSITY
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR
THE DEGREE OF MASTER OF ARTS

BY
SUREN NATH SADANA

SCHOOL OF BUSINESS ADMINISTRATION

ATLANTA, GEORGIA
JUNE 1939
Without fear of disagreement, one can say that the United States is a country of corporations par excellence. Some of the contemporary literature and classroom discussions about the growth of the importance of business corporations in this country has immensely impressed the writer of this study. Almost half a century ago, John P. Davis in his classic history of corporations stated: "The most important and conspicuous feature of the development of society in Europe and America on its formal or institutional side during the past has been the growth of corporations."\(^1\)

It has been further stressed that the business corporation has become so important in present-day life that it is difficult to conceive of our economic system surviving without it; and, as a way of organizing and conducting business, the corporation has been one of the building blocks of a free enterprise society.\(^2\)

Suggestive of their importance in the national economy is the estimate that out of a national income of \$361.1 billion in the third quarter of 1958 (seasonally adjusted at annual rates), income originating in corporate business was \$134.5 billion, whereas income originating outside corporate business amounted to \$166.6 billion.\(^3\) Therefore, an endeavor to investigate the development of an important aspect of corporate activity, which


this study proposes to undertake, needs no apology.

Broadly speaking, corporation finance can be defined as the activity concerned with the raising and administering of the funds by the corporation. For both large and small business, financial management is mainly concerned with the problems of planning and financing the recurring long- and short-term needs of the enterprise. Many intermittent but equally important and complex problems arise in the structure of a corporation which demand special attention. Corporations suffering from financial maladies sometimes die, but if they are considered to be large and more important in their public interest, they are likely to be recapitalized or reorganized than liquidated.

The recent years have brought into increasing prominence certain aspects of the corporation business. Most important perhaps, have been the legal background and the actual practice of corporate reorganization. Following the epidemic of business failures of the nineteen thirties, many corporations, large as well as small, were reorganized. Legal technicalities were set aside. Precedents were ignored. A new procedure of corporate reorganization was recognized, and in the actual practice of corporate reorganization, the social significance of corporation was accorded greater importance than individual legal rights.1

Owing to the delicacy of the situation and the judgement required, "corporate reorganization is the most intricate phase of the whole field of finance."2 How is a corporation reorganized? The late Adrian H. Joline—and no lawyer of his day had a more varied contact with corporate reorganization—said in one of his Harvard lectures delivered in 1910, "that after an experience running over a period of thirty years, he found it about as difficult to tell how to reorganize a corporation as it would


be for a poet to tell how to write poetry.\textsuperscript{1} One may amuse with
Thurman Arnold when he satirizes the ritual of corporate reorganization as:

\ldots a combination of a municipal election, an historical pageant, an
anti-vice crusade, a graduate school seminar, a judicial proceeding,
and a series of horse trades, all rolled into one, thoroughly
buttered with learning and frosted with distinguished names.\textsuperscript{2}

In view of the problems involved in the reorganization of the corpo-
rations, and the new developments in the theory and practice of corporate
reorganization, the writer has undertaken this study for the purpose of
analyzing and ascertaining whether or not the reorganization techniques
as modified by the Reorganization Acts in the thirties have gone far
enough to obviate the abuses and shortcomings which are supposed to have
been existing under the earlier reorganization procedure. Moreover, the
writer is desirous of discovering what steps are significant and which
may be useful hereafter in applying and formulating a reorganization
procedure to a financially distressed corporation. The writer wishes to
emphasize the fact that he does not advocate an absolute reorganization
procedure which could be formulated universally. The writer feels,
however, that some general methods have been developed that are very
helpful guide-posts in the preparation and formulation of a specific plan
of reorganization in an environment strongly colored by government
regulation. It may be mentioned that, for the purpose of this study,
the writer shall mainly direct his investigation concerning large

\textsuperscript{1} P. D. Cravath, Some Legal Phases of Corporate Financing, Reorganization

\textsuperscript{2} Quoted in: Bosland, \textit{op. cit.}, p. 211.
corporations for their greater complexity and larger public significance that justify particular attention to their financial problems.

The writer wishes to express his sincere most thanks to Mr. Morgan Maxwell for his admirable patience, and for his constructive criticism during the preparation of this study.

The writer wishes to acknowledge the greatfulness of Dr. Samuel Z. Westerfield, Jr., and Mr. John G. Gloster, for supplying the writer with necessary impetus which made possible the undertaking of this study. The writer wishes to express thanks to Mr. Jesse E. Blayton for his very useful advice on some of the legal questions encountered in this study. To Dr. Akhllesh Dubey, the writer is thankful for his helpful suggestions.

The writer deeply appreciates the cooperation of Mr. Richard N. Hubert of the Emory University Law Library for his help in locating some of the most important material needed for this study.

The writer wishes to express his deep gratitude to Dr. Horace B. Bond whose qualities of perseverance and encouragement helped to further guide the writer in the preparation of this study.

Thanks are also due to Mesdames Jessie B. Ebanks, Dorothy S. Benset, and Carrie C. Ashmore, for their helpful suggestions during the type-writing of the text of this study.
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CHAPTER I

INTRODUCTION

Problem.—This study will strive to analyze, as critically and as carefully as possible, the significance and the extent to which the new reorganization procedure as modified by the Reorganization Acts, 1934-1935, has obviated the abuses and shortcomings which are supposed to have been existing under the Equity Reorganization procedure, 1868-1934.

Scope.—This study is first concerned with a brief but comprehensive survey of how the corporate reorganization was developed through the administration of equity receivership to cases of financially distressed railroads requiring rehabilitation. The underlying theories as well as the formal procedure of reorganization have been developed through a long series of precedents almost entirely within the field of the reorganization of railroads. These precedents and methods have been adapted to other types of corporations in financial difficulties.¹ This study shall observe the important aspects of railroad reorganization which have a bearing on the development of reorganization procedure as applied to industrial corporations. Primarily, this study is directed to examine as critically as possible the defects and shortcomings of the equity reorganization procedure, and, to the analysis of the revised reorganization procedure as defined by the reorganization acts of 1934 and 1935. During the course of investigations in this study, more stress will be placed on the important developments. Minor details and other less significant but relevant material will be

¹Dewing, op. cit., p. 1237.
Significance.— The passage of reorganization acts after 1933 dealt a drastic change in the process of corporate reorganization in the United States. The information provided in this study attempts to familiarize the reader as carefully as possible how and what changes were brought about, as, the amendments to the Federal Bankruptcy Act mark a recognition of investor and public interest, as well as an effort to streamline the process of reorganization. Without doubt, much was needed in the way of improved technique for the overhauling of distressed companies, and it would appear that the intent of the legislation marks a step forward....

Besides, it should provide useful information for further investigations in this subject and the corporate activity in general.

Definitions.— Failure: Business corporations operate within a legal system which insists that obligations to pay money between persons must be respected. In the business world, failure has the very definite meaning that some person or persons have instituted legal proceedings against the enterprise in order to secure payment of their claims. In a discussion of corporate reorganization it seems advisable to employ this more clear cut concept of business failure, rather than the economic concept, because it corresponds more closely with popular understanding and legal usage. In this study, the term failure shall mean that the enterprise, here a corporation, has come to a point where it is unable to meet the cash claims upon it.

Liquidation: Failure may lead either to liquidation or reorganization of the corporation; and because it can not meet its obligations as they mature, it has no choice in the matter and must accept whatever consequences the law

provides. By liquidation of a corporation is meant that the particular working relationship in which the assets now stand to one another is destroyed, and that they are sold off item by item for cash. The sums so yielded, after deducting any costs incurred in the process, are then paid over to the claim holders in their legally established priorities.

Reorganization: In the financial sense, it is not easy to define "reorganization." "The term, like most of the terms which have found their way into financial literature out of the vernacular of the market place, has no precise meaning." Speaking broadly, the term "reorganization" as applied to corporations means the re-arrangement of the financial structure of an incorporated enterprise, rendered necessary by insolvency or by the inability of the corporation to secure funds for its operations because of obstacles resulting from its financial structure. "Reorganization is a process involving a recasting of the capital structure which the corporation is compelled to undergo either because insolvency has been evidenced by a default on an obligation or because such default is imminent." This study shall be describing corporate reorganization to cases where the adjustment and reconstruction of the capital account is forced upon the proprietors because of actual or impending default on obligations to pay cash, and not initiated by them voluntarily. The term "reorganization" as it is applied in income-tax law to a voluntary tax-free recapitalization will not be considered in this study.

Large Corporations: The largeness of the corporations has been measured

---

1 Dewing, op. cit., p. 1223.

in terms of their capitalization and public significance, and whose activities have a contributing influence over the whole industry of which they are a part. Hence, for the purpose of this study, a large corporation is one the securities of which are in the hands of the public when large numbers of persons in widely scattered areas purchase stock and bonds in the corporation through stock and bonds salesmen and dealers, and when the stock and bonds of such a corporation are traded and dealt-in in large volume.

Security holders: In this study, the term security holders would refer to both the debt security holders as well as the equity security holders.

Procedure.—The beginning chapters of this study are concerned with a discussion of the historical background and the controlling factors of the process of corporate reorganization. Chapter IV will critically examine the system of equity reorganization. The central issues involved in the main body of the text will be developed in Chapters V, VI and VII, and the economic content of corporate reorganization will be examined in Chapter VII. During the course of investigations, emphasis will be placed on the contemporary literature, opinions of the men of profession and academicians, and the government participation. The conclusions of this study will be drawn through a critical analysis of the old and new reorganization procedures. The evaluation of the new, revised system of corporate reorganization will be achieved through the writer's personal judgement and other authors' critical reviews. In the scheme of presenting material in this study, the writer would follow the technique of leading from "general" to the "particular."

Sources of Information.—So far as the writer has been able to ascertain,
no other work exactly like this has been published, except for related materials which have been appeared as parts of various books, Law Reviews and Journals, United States Reports, the reports of the Securities and Exchange Commission and other Government Publications. The material of this study is a result of the interpretation and compilation of these references. Following are the main sources of information: (1) Text books on corporation finance for general guidance throughout this study; the most important ones are: A. S. Dewing's Financial Policy of Corporations; N. S. Buchanan's The Economics of Corporate Enterprise; Modern Corporation Finance by W. H. Husband and J. C. Dockery; Corporate Financial Policy by N. G. Guthmann and R. E. Dougall; and Hastin g Lyon's Corporations and Their Financing; (2) Periodicals: A good part of the main body of this thesis has been derived from various law journals and reviews, such as, the Harvard Law Reviews, 1920-1934; the Columbia Law Reviews, 1915-1948; the Virginia Law Reviews, 1929-1941; and the Yale Law Journals, 1925-1939; (3) Government Publications: Various reports and releases issued by the Securities and Exchange Commission, and other statistical data issued by government departments and agencies are relied on as an authoritative source of facts; (4) Miscellaneous sources: Certain specific information has obtained through personal correspondence and interviews with persons who are connected, directly or indirectly, with the activities concerning corporate reorganization, and this has served as a general guide to both public and private opinions.
CHAPTER II

HISTORICAL BACKGROUND

Evolution of Reorganization Procedure.—Most highly developed social, legal, or economic procedure has its origins in historical incidents, many of them apparently unimportant at the time of their occurrence yet very important in terms of historical evolution. This is true of corporate reorganization. The procedures and practices followed at the present time in effecting the reorganization of a large business corporation have developed through a series of precedents. It is a subject which has as its formal elements in the changing provisions of the federal bankruptcy statute, the statutes of the states, and a mass of conflicting legal precedents. The technicalities of reorganization procedure have been, in the past, molded by the makeshifts of temporary expedients; and the historically important precedents have been established more by accident than by forethought. These practices have arisen through immediate necessities; they have come into existence at times when any action, illegal or legal, impetuous or reflective, was better than no action at all. Subsequently, these expedients have been crystallized into legal pronouncements and statutes. The underlying theories as well as the formal procedures have been developed almost entirely within the field of the reorganization of railroads, where a series of established precedents have guided the methods of procedure, and these methods have been adapted to other types of corporations in financial difficulties.¹

¹Dawing, op. cit., pp. 1230-1237.
1934 and 1938, it was generally possible to effect an arrangement of a financially distressed company in one of three major ways: (1) through voluntary arrangement entered into between the debtor and creditor; (2) through the formal bankruptcy procedure usually entailing liquidation of the assets of the company for the benefit of the creditors; (3) through an equity receivership obtained on a creditor's bill. A brief review of these methods is as follows:

(1) In the eighteenth and the early nineteenth centuries, business was often carried on by individual traders and craftsmen, or by small business units or partnership, and the operation and effect of such business were primarily a local community affair. Under these circumstances, when the company is small and the creditors are few in number, it is rather common and practicable for the debtor and creditor parties to work out some kind of debt compromise towards a settlement. Voluntary agreements of this nature may provide for the scaling down of the debts or an extension of the period for the payments of the debts. Instances of this kind indicate that the creditors are, in effect, accepting a smaller certain loss in preference to greater possible loss in liquidation.

Modern business of the corporation type is complex; it has numerous claim holders and security holders, and if business encounters serious financial difficulties, a system of voluntary arrangement between the parties concerned seems unappealing and inapplicable.

(2) The debtor-creditor relationship is contractual. At common-law, each debt contract was regarded as an individual agreement standing by itself. Each creditor could pursue his own remedy without regard to other creditors, first come first served, and employ liens and attachments to
obtain redress ahead of the others on the principle that "the law favors the diligent creditors." In the same light, the most noteworthy provision of England's first bankruptcy law required creditors to share pro rata in the sale and distribution of a debtor's property. The bankrupt remained a criminal by legal definition, and could not be discharged from its debts until they were paid. Generally, in England, the practice of imprisoning the debtor remained in vogue throughout eighteenth century and past the middle of the nineteenth.¹

The English thought and practice somewhat dominated the treatment of the bankrupt in early colonial America. It was primarily the creditor who was protected. Nonetheless, the beginning of a trend towards leniency for the hapless debtor was apparent in the New World as early as the second half of the eighteenth century. At the time of the Constitutional Convention, debt was the largest single cause of imprisonment.

All thirteen colonies had different laws for the debtor, creditor, and the government, with varying provisions for releases and exemptions. If a law passed by New Hampshire in 1785 had been rigorously prosecuted, two-thirds of the state's population would have been imprisoned for debt. Roger Sherman, speaking in the Convention, declared that it must never be in America, as in England, that men could be put to death for debt....²

In the United States, the abuses and inconveniences of multiple state bankruptcy laws were apparent. Although extremely conscious of the objection of the separate states to a powerful central government, the Convention approved the constitutional provision that "Congress shall have power to establish...uniform laws on the subject of bankruptcies throughout the United States."³


²Ibid., pp. 619-620.

³U. S. Constitution, Art. 1, Section 8, Part 1.
This clause became the basis for federal regulation of bankruptcy; however, it was not until 1898 that Congress had enacted a permanent bankruptcy statute. "With the enactment of Bankruptcy Act of 1898, Congress asserted its constitutional authority over bankruptcies and the state laws elapsed."\(^1\)

But, "the Act of 1898 was based on the theory that only the creditors were interested in the bankrupt's estate, that their selfish interest, concertedly pursued, would assure fair treatment for all."\(^2\)

For many years after 1898, the bankruptcy proceedings usually contemplated exclusively the liquidation of debtor for the benefit of the creditor through a foreclosure sale, rather than reorganization and continued operation.\(^3\) There was little comprehensive statutory enactment applicable to the reorganization of companies that had failed. However, the bankruptcy legislation of 1898 did provide some facilities for the rehabilitation of companies in distress by a composition whereby the unsecured creditors simply voted to scale down the debtor's obligation. This agreement was subject to court approval in order to assure fair and equitable treatment of all parties who were affected by the adjustment. By this means, resumption of business by distressed companies was facilitated; but reorganization in the modern sense of the term, was not possible. The simple composition of debts which was permitted under the Bankruptcy Act 1898 provided a convenient remedy for small companies with unsecured debts, but it was entirely inadequate to meet the needs of large scale enterprises.\(^4\)

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\(^{3}\) Bogen, *op. cit.*, p. 930.

(3) The Bankruptcy Act of 1898, which remained substantially the same until 1933, did not include any provision for the reorganization of a corporation. Perhaps it is worthwhile to note that under the Bankruptcy Act, corporations, except railroads and utilities, were permitted to purge themselves of their debts by turning their properties to their creditors, which usually led to the liquidation of business. In the bankruptcy proceedings, the frequent application of the theory that to the diligent creditor belonged the spoils did not permit much leeway for the debtor, especially the "honest and unfortunate one," who needed time and creditor cooperation to seek salvation from temporary financial difficulties.¹

While corporations grew in number and importance there was no corresponding simplification of the procedure either liquidating them or reorganizing them when they had failed. The consequence was that the courts had to bend old forms and devices to new uses. Out of this necessity evolved the procedure of reorganizing corporations under the protective cloak of courts of equity. Under this procedure, a system was developed in the federal courts for reorganization rather than liquidating of a concern that had failed in the sense that it could not meet its obligations as they mature, but that gave promise of future profit and stability under a reorganized management. This system was known as equity receivership,² and it was a legal attempt to correct the economic waste which

²"In the course of the growth of that system of justice which was administered by the High Court of Chancery in England in the exercise of its extraordinary jurisdiction, commonly called Equity, a system adopted in this country, and substantially, if not in form, in all our States, and covering three broad heads of jurisdiction,–equitable title, equitable rights, and equitable remedies,—we find under the last title, the preventive remedy of appointment of receivers ..." D. H. Chamberlain, "New Fashioned Receiverships," Harvard Law Review, X (October, 1896), p. 139.
usually resulted from the cold-blooded action of the creditors in satisfying their claims without giving a second chance to their debtor. Briefly, the equity receivership sought continued operation of the business under the supervision of a receiver appointed by the court, and terminating in a judicial sale whereby part or all of the old security holders—often the bond-holders—became purchasers under a new arrangement or plan evolved for the continuance of the business in the form of the new company. Because of public interest, property should be intact as a functioning unit and for that end the device of a receiver in equity was found. As one writer has described it,

"... using old equitable forms which were designed to convert the properties of an insolvent debtor into cash for distribution among its creditors, they (courts) evolved a proceeding which achieved the opposite results of preserving the properties intact and of readjusting the debts of the insolvent debtor."²

Of these three methods, the rehabilitation of a business through equity receivership, particularly as administered in the federal courts, was more feasible and came to be most frequently employed. "It was the only resort in the case of railroads, which were debarred from the benefit of bankruptcy proceedings."³

A discussion of the administration of reorganisation through equity receivership now follows:

**Growth of Equity Reorganisation.** — Railroad reorganisation has been essentially an indigenous problem. "American financiers have had no

---

¹The office of the receiver is primarily to husband the assets of the corporation (awaiting a plan of reorganization) for the benefit of all persons having an actual interest whether they are parties to the suit or not. Vide: Charles Thomas Payne, "The General Administration of Equity Receivership," Yale Law Journal, XXXI (May, 1922), p. 665.


historical precedents to guide them."\(^1\) When the railroad expansion era began in the last century, railroads were contracted more rapidly than industrial conditions could be adopted to these changes, and failure became frequent. Railroads operated under heavy bonded indebtedness secured by mortgage\(^2\) on their property. A default on the part of railroad to meet cash claim on its bonds usually led to the foreclosure of mortgage. Since public policy demanded and still demands, that the operation of railroads as public highways be continued for the benefit of the public, regardless of the best interest of the creditors and stockholders. Hence, the railroad could not be liquidated. It was only in rare instances that a railroad was sold at foreclosure for the benefit of creditors. Some basis of settlement was usually found, and pending adjustment the property subject to default was placed in the control of a receiver, by the proper court of equity. It was the task of the receiver to operate the property and conserve its assets until the various interested parties worked out a plan of reorganization. The plan of reorganization became effective on court's approval of the fairness of the plan and usually required a judicial sale for the purpose of transferring the property from the old to the newly organized company. In regard to the system of equity receivership, Justice Waite said:

\[\ldots\] it rarely happens in the United States that foreclosures of railway mortgages are anything else than the machinery by which arrangements between the creditors and other parties in interest are carried into effect, and a reorganization of the affairs of the corporation under a new name brought about \ldots.\]  

\(^1\) Dewing, op. cit., p. 1239.  
\(^2\) A mortgage is a security for debt and failure to pay the debt in whole or part when it is due is necessarily a breach.  
The following statistics indicate the railroad receiverships in the United States, 1883-1997.

**TABLE 1**

<table>
<thead>
<tr>
<th>Year</th>
<th>Receiverships Established</th>
<th>Miles Owned in Receiverships</th>
<th>Total Railroad Mileage in United States</th>
<th>Percentage Put in Receiverships</th>
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<td>3,205</td>
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<tr>
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<td>24</td>
<td>3,759</td>
<td>161,353</td>
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<tr>
<td>1890</td>
<td>26</td>
<td>2,860</td>
<td>166,706</td>
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<td>1891</td>
<td>29</td>
<td>2,017</td>
<td>170,795</td>
<td>1.18</td>
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<tr>
<td>1892</td>
<td>40</td>
<td>4,213</td>
<td>175,201</td>
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<tr>
<td>1893</td>
<td>132</td>
<td>27,570</td>
<td>177,753</td>
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<tr>
<td>1894</td>
<td>50</td>
<td>4,139</td>
<td>179,279</td>
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<tr>
<td>1895</td>
<td>32</td>
<td>3,227</td>
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<tr>
<td>1896</td>
<td>39</td>
<td>3,715</td>
<td>182,680</td>
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<tr>
<td>1897</td>
<td>21</td>
<td>1,536</td>
<td>181,664</td>
<td>.83</td>
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</tbody>
</table>


Note: One caution must be observed in interpreting this data. The great falling off in the number of receivership in the years immediately following those in which the maximum is reached, does not necessarily indicate any improvement in railroad conditions. For instance, the number in 1894 was only fifty as compared with one hundred and thirty two the preceding year; but at the beginning of 1895 nearly all the roads for which receivers had been appointed in 1893 were still in hands of receivers. Consequently, the fact that any considerable number at all was added in 1894-1895, showed a continuance of very serious conditions. Henry H. Swaine, *ibid.*, pp. 63-69.

Naturally and inevitably, with the rise and growth of the corporate form of business organizations, receiverships were extended to all types of large corporate failures including industrials. Towards this end, the initial impetus was furnished by changing business structure of the country.
and economic and social expediency. 1

*Equity Reorganization.*— Prior to the early thirties, the process of reorganization through equity receivership was basically the same for all the major fields of business corporations. The administration of reorganization through equity receivership usually involved the following four steps:

1. Appointment of receiver(s) to operate the corporation and, at the same time, allow the proper machinery of reorganization to get under way.

2. Organization of protective committees to represent and protect the interests of security holders; and the device of deposit agreement.

3. Appointment of reorganization committee to formulate and execute the reorganization plan.

4. Approval by the proper courts, and, usually, a foreclosure sale to make the plan effective.

A brief review of each step is as follows:

Appointment of the Receiver: Failure of a corporation gives rise to loss of confidence and numerous possible conflicts of interest among the various creditors, stockholders, and the management. In this situation, it is highly important to place the corporation in the hands of a competent and non-partisan party. Under the equity reorganization system, such independent administration was provided by the appointment of a receiver.

1Following the lead of the railroads in the last part of the nineteenth century and the early years of the twentieth, one aspect of economic life after another has come under corporate sway ... "A rapidly increasing proportion of industry is carried on under this form of business organization ... it is coming more and more to be the industrial unit with which American economic, social and political life must deal." Adolf A. Berle, and Gardiner Means, *Modern Corporation and Private Enterprise* (New York, 1933), pp. 10ff.
by the proper court. As soon as the receiver was appointed and qualified, he assumed control over the affairs of the failed business. The receiver was responsible only to the court that appointed him. Stockholders as well as the directors were rendered powerless for the period of the receivership. Creditors and others had to postpone action against the corporation, except with the approval of the court. The receiver was endowed with special authority permitting various priorities and privileges which were intended to aid in the rehabilitation of operations. For instance, he could relegate the claims of the old creditors of the corporation to a junior position, facilitating thereby the purchase of new materials and supplies more favorably. It may be pointed out that the receiver's job was chiefly one of placing the run-down and strained corporation on an efficient basis, and of conserving the property of the corporation for the various claimants while a plan of reorganization was being worked out by the representatives of the interested parties.

Protective Committees: It may be observed that a person with a thousand dollar bond, a creditor to the extent of a few hundred dollars, a stockholder owning a few shares, can not afford the cost, in time or money outlay, of complete vigilance in asserting his rights and ascertaining his proper relationship to all others interested in the corporate fund. He is, however, one of a large number of people with interests

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1 Federal Courts were favored when the corporation was engaged in inter-state commerce... One of the reason for bringing the original proceedings in the Federal Courts is that they form a coordinated system. Federal Courts have had much greater experience in such litigation... their rules and procedure are comparatively settled and are substantially the same in all districts and circuits; their relation with one another are more intimate with one another than those of State Courts, and they accept more easily than State Courts the difficult position arising over the appointment of ancillary receivers." James Byrne, Some Legal Phases of Corporate Financing, Reorganization and Regulation (New York, 1927), p. 30.
identically corresponding in kind, though differing in amount. He falls into a class. If all in the same class can find some mechanism through which they can act as a group, that is, effect a resolution of their individual wills into a force exerted as though that of a single will, they reduce the cost to each; and their united action increases the effective power that can bring to bear. In order to realize this, protective committees are formed to represent and to protect the rights and interests of groups of creditors and stockholders. The protective committees are a device to mobilize the holders of interests in the corporation.¹

Under the system of equity reorganization, the protective committees by means of formal agreements with creditor and investor interests, had virtually the rights of true security holders. The organization of these committees was largely the result of self-interest, and any group of investors was free to act. Since the committees were not officially appointed by the corporation or by reason of legal requirement, some stimulus was necessary to secure prompt action. These self-constituted committees were formed, generally by leading representatives of the various classes of security holders who had considerable interests at stake, or by the bankers who had previously underwritten the defaulted securities. The committees, through the mails and advertisement sought the deposit with them of the classes of securities that they assumed to represent. The deposit was made under the terms of an agreement, called the deposit agreement, clothing the committees with almost unlimited powers. With the aid of counsel and accountants, one of the main tasks of the committees was to study the affairs of the insolvent corporation—its assets, liabilities,

past earning, fixed charges, causes for insolvency and prospect for future success. The committees actively participated in the preparation of a plan of reorganization for the failed corporation.

Reorganization Committee: Since each party at interest was represented by a separate committee, it was to be expected that their programs and recommendations will be in conflict with each other. As a consequence, the work of reorganization was expedited by the creation of a reorganization committee. By this process the difference of opinion and interest on the part of holders of the various security issues were ironed out before the formulation of the reorganization plan. The reorganization committee was usually composed of bankers and members or nominees of the contending committees. If the reorganization committee in consultation with other protective committees concluded that the business was worth saving, they negotiated with one another so as to the terms of a reorganization plan. These negotiations involved many questions such as the extent and priority of liens of secured creditors; requisite amount of new capital, who was to furnish it and on what terms; how far the security holders were to scale down their holdings and be called on to furnish new capital; the amount of and character of new securities to be issued to the old security holders and new investors (if any); the fees and commissions of the committees, depositaries, counsel, bankers and the like. At last, when the reorganization committee had sunk differences among its members, a plan of reorganization was prepared, a formidable document was printed. Those security holders who had deposited their claims with their respective committees were asked to approve the plan, or,

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... to state the matter more accurately, (they) were informed that, pursuant to the agreement under which they had made deposit, they will be deemed to have assented to the plan unless they withdrew their securities from their committees and paid their share of their committee's expense.¹

Making the Reorganization Plan Effective: The final step under the equity reorganization procedure was to make the plan of reorganization effective. This called for court approval of the fairness of the plan and usually required a foreclosure sale for the purpose of transferring the property from the old to the newly reorganized corporation. The receiver offered the property for sale. There was rarely any competition at the sale, and the reorganization committee bought in the assets. It paid actual money only to the extent of furnishing the cash distributive share, as fixed by the court, to the security holders who did not assent to the plan of reorganization.

... Thus, as, in a simple real estate foreclosure, a mortgagee may bid in the mortgage property, crediting upon his bond the amount of his bid and paying no actual money except for the fees of the referee and the expenses of the sale; so, in case of a purchase by a reorganization committee, the committee delivers to the receiver the securities of the assenting security holders, paying in actual money only for the non-assenters and for the administrative expense.²

The corporation reorganized thusly, continued its business anew, under a slightly different name.

The next chapter deals with the factors and fundamental motives involved in the reorganization of a corporation.

¹Ibid., p. 525.

²Ibid.
FACTORS AND FUNDAMENTAL MOTIVES IN REORGANIZATION

Plan of Reorganization. — The "plan" of reorganization contains the financial details of the company's reorganization; a statement of the powers of the committees; the rights of participants in the reorganized company; and the machinery for carrying the plan into execution. In practice each company may and probably will face different underlying causes which lead the company to reorganization, and base its reorganization plan on individual necessity. Then, too, there may be considerable differences existing in the bargaining power of varying classes of claimants and security holders in individual concerns. The point common among all reorganizations is that sacrifices must be made by all creditors and investors, but the nature of these sacrifices must differ according to the nature of the enterprise and the seriousness of the failure. Also, the character of the action taken in a plan of reorganization in response to the crisis would depend upon, inter alia, the width of holdings of the company's securities and the amount and kinds of securities already issued. In any sizeable reorganization, usually many persons seek an opportunity, whether for the sake of their interest, or merely due to jealousies or vanity, or to prove their genuine or nuisance value. In brief, "a quiet reorganization, put through without attracting unfavorable comment to the company, has usually been impracticable."1

Fundamental Problem in Reorganization.--Reorganization of a corporation is primarily an economic issue. The acts and statutes supply only the outward form of reorganization procedure. The fundamental substance of every reorganization, whatever the nature or size of the business in which the distressed corporation is engaged, is the determination of the questions: (1) whether to liquidate or reorganize the failed corporation and if the latter, then, (2) how may be the burden of the liabilities, and incidentally fixed charges, if any, be reduced; or in other words, more basically, how to eliminate the conditions which drove the corporation into financial troubles. The fundamental motive of a reorganization plan is determined by the gravity of economic and business state of affairs, whereas, the sacrificial changes and other modifications in the important rights of the security holders, nevertheless important, are only incidental.

Economic Setting.--Whenever a business finds itself in some grave financial distress, it is obviously essential to resolve the condition in order to protect the interests of all parties concerned. Also involved is the economic welfare of the community where the company is located or even of larger areas. A business failure brings to a halt the normal self-sustaining activities of a going concern and generally disrupts the flow of the economic processes. The failure of a corporation is a misfortune to its stockholders, creditors, employees, and even the customers.

The financial difficulties usually preclude free and voluntary functioning by management; the creditors naturally assume or inherit the responsibility for action. Suppose, that each one of these creditors undertakes to enforce his claim against the company, which he has a right to do, it is understandable that the property would be completely disintegrated in the contest of creditors. Each set of creditors could make off with a piece of
the "corpus," and the value of the property, after it had been torn to pieces by the creditors would have little relation to its value as a going concern.

Small business that has failed may be liquidated without serious consequence to any except those directly responsible for the misfortune. Often times, in the case of a small business enterprise, creditors find it possible to obtain unanimous agreement on a solution, or else, "small concerns frequently reach the end of their financial rope, cease operations, and let the creditors fight over the business carcass."

Large corporations are different. Their importance to the community is great, and the interests behind them are varied and powerful. If they fail, legal complexities and personal disagreements among the parties concerned often make it impossible to proceed on a voluntary basis. Large number of claim holders make it impracticable to reach a debt compromise and settlement with the owners.

Liquidation is seldom applicable to large corporations mainly because of the desire to avoid the resulting economic dislocation, and liquidation of the assets would under the very best conditions may involve waste and sacrifice. The most valuable things in an established business are frequently its trade marks, its good-will, its trade connections and above all its organization. These are intangibles; they would be destroyed if the business were disintegrated and its assets given over to other hands and other uses. Not infrequently, the salable property of a corporation would not bring an amount sufficient to reimburse the first mortgage bond

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1 Bosland, op. cit., p. 209.

2 The question of liquidation will be further analyzed in Chapter VII of this work.
holders or even the merchandise creditors. Under ordinary circumstances, therefore, when the business operates in an industry where normal profits may be expected, it would be better in the interest of both— the creditors and stockholders—to arrange some readjustment of liabilities, so that the business may be continued as an organized unit even though creditors and stockholders make a sacrifice. Hence, even if it appears that the business may be dismembered and parts sold for an amount sufficient to meet the creditors' claims, the stockholders themselves may deem it expedient to invest new money to pay at least a part of these claims immediately and thus save the business and its organization from complete disintegration.

In this way a new or reorganized business, free from immediate embarrassment, starts with essentially the same property as the old. The financial structure is changed, but the business itself, with a revitalized management remains, so far as possible, the same.1 This continuation of business is made possible through a deliberate and comprehensive plan of rehabilitation—not only to provide for the settlement of claims among various claimants but also to place the enterprise on a sound financial basis for the future, for

... the essence of reorganization is the preservation of the corporation as a going concern, not only because some concerns like public utilities, and railroads cannot suspend service without government consent, but also because the best way to salvage the maximum of value for those who have interests in the corporation is to preserve its worth as a going concern. Piecemeal liquidation shrinks the realizable value of specialized assets to small proportions, to mere scrap value...2

Of course it must not be thought that reorganization is a sort of cure-all.

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"It is more accurately described as redistribution of claims so that the fundamental curative process of profitable operations inherent in the business and its management can be realized."\(^1\) Without prospects of profitable operation, reorganization can be of little avail, and liquidation is the proper prescription for the distressed corporation.\(^2\)

**Legal Setting.**—It has been indicated that a corporation's reorganization is a form of financial readjustment adopted in the presence of real or threatened failure, in order that the business of the corporation may be continued under more favorable conditions. Reorganization always involves a conspicuous re-arrangement of capital liabilities, ordinarily accompanied by a reduction in fixed charges, and the addition of new capital. The formulation of such re-arrangement is affected by psychological bias and prejudices of numerous dissatisfied human beings whose interests are in fundamental conflict. Hence, in order to accomplish the general adoption of a plan of reorganization, before the property and good-will of the corporation to be reorganized have dissipated, pressure usually has to be brought to bear upon the various classes of claim holders. Recourse to law therefore becomes inevitable. The balance between the economic and statutory legal elements of a reorganization was well expressed in a quotation taken from a legal opinion:

\(^1\) *Ibid.*

\(^2\) Numerous business enterprises without justification for their existence, apparently keep going to avoid funeral expenses. Some pass through successive reorganizations processes before finally giving up the ghost. A certain railroad was, for a period, a sort of presidential railroad: it had a failure every four year. But hope springs eternal and encourages the use of headache tablets when major operations are necessary. Efforts at reorganization of corporations that should be dissolved merely postpone the fatal day." *Henry E. Hoagland, Corporation Finance* (New York, 1953), p. 719.
Reorganization of distressed corporations is primarily and principally a business (economic) problem. Reorganization is occasioned by the situation that the business cannot go as it is,... readjustment is necessary. Such readjustment involves suspension or alteration of some or all existing legal interests in the business and property and may involve extinguishment of some interests. It is only because of such changes in legal rights that the matter of reorganization comes in the courts. When it does come into a court a reorganization must proceed in accordance with the machinery and methods thus existing.\(^1\)

But it must be stated that the reorganization of a corporation is not just simply a law suit in the ordinary sense of a procedure designed to settle issues between individual litigants; it is a complex exercise of legal methods, corporate finance and business management. "The traditional concept of a court as a forum for settlement of sharply defined issues presented by parties litigant, is inapplicable to reorganization proceedings which are largely administrative in nature."\(^2\) In the same light Justice Brandeis remarked: "the court in a reorganization case stands in a position different from that which it occupies in ordinary litigation where issues are to be determined solely upon such evidence as the contending parties choose to introduce."\(^3\)

**Motives Governing Reorganization.**—Human Motives: Dr. Dewing emphatically points out that the "interplay of human motives, ambitions, antagonisms, jealousies, and friendships underlie every financial episode of importance."\(^4\) A corporate reorganization is no exception.

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Whereas T. Prince, a writer on the reorganization of the Rock Island and Pacific (Railroad) said:

... Financial philosophies of all philosophers are least amenable to matters of human emotion or sentiment. Like economic laws they are ruthless and immutable. In the sound reorganization of a railroad system, certain general principles are to be born in mind and adherence to them can safely disregard all matters of personal motive or ulterior objects.1

Dr. Dewing refutes this idea, and further clarifies, that financial philosophies are amenable to human emotions because they are based on human nature—at most a complex association of emotions, sentiments, passions, instincts, and some reasoning. Then, too, "sound" reorganization must regard personal motives; they become "unsound" the moment they are ignored.2

On this issue, the present writer's personal disposition is more or less in line with what Dewing feels that "corporations, outwardly most impersonal of the elements in industrial organization, are in reality intensely human,"3 and, a corporation is reorganized by men not puppets, its officers, its security holders, the attorneys and the judges are not merely thinking machines, but ordinary men, governed by emotions and passions subject to human weaknesses.4 This view has been further substantiated by another author who said:

... Reorganization is not merely a process for readjusting debts and stock and of solving legal problems, but also a battle for proxies, prestige, power and profits in which the ins fight to preserve their position while the outs, whether 'chislers' or bold financial entrepreneurs strive to oust the old groups or at least to win a place with them...5

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2Dewing, (1953), op. cit., p. 1235.
4Dewing, (1953), op. cit., pp. 1234-1235.
Therefore, a reorganization procedure must take into account the friction incident to the conflict of personalities, and must strive to allay them as far as possible.

Economic Motives: The second set of motives governing reorganization process is economic. Every reorganization procedure must recognize the fundamental economic obligation that in order for an enterprise to be successful and to be of service to public, it must be enabled to pay its operating expenses including reasonable wages to its employees, an adequate upkeep of its physical facilities, and in addition a reasonable rate of return on the invested capital according to the prevailing business and economic conditions. This is fundamental, and the reorganization aims must take into account this simple economic imperative.

Legal and Judicial Motives: The third set of motives governing reorganization procedure is legal and judicial. The legal profession and the statutes have worked out certain more or less clearly defined lines of orderly pattern for corporate reorganization. The reorganization technique and practice has been immensely influenced by the legal profession, for

...the quality of reorganization practices has in large measure been dependent upon the lawyer,... he has done more than decide the form for and method of reorganization; he has been in a position to determine the character and quality of administration of estates undergoing reorganization; he has played an indispensable role in the formulation of certain policies;... and upon him in large part has depended the honesty, efficiency, and thoroughness of reorganization plans.¹

Lawyers are prone to exaggerate their own importance and the significance of their legal machinery in determining the form and the details of reorganization procedure, forgetful that a reorganization is primarily

¹Douglas, op. cit., p. 379.
an adjustment of human motives and economic conditions, circumscribed rather than determined by the law.

The present well-defined, and, on the whole, socially expedient procedure as revised by the reorganization acts of the thirties, has been built from the interplay of these three underlying motives.¹

The next chapter is concerned with a critical investigation of the system of equity reorganization.

CHAPTER IV

ANALYSIS OF THE EQUITY REORGANIZATION SYSTEM

A Critical Investigation into Equity Reorganization Practices.—Before
the passage of reorganization acts in the thirties, the equity reorganiza-
tion was the popular method of effecting reorganization of corporations.
In order to appreciate fully the revised system of corporate reorganization
as detailed by the reorganization acts, it is essential to investigate
thoroughly, and as carefully and critically as possible, the practices and
techniques surrounding the procedure of equity reorganization.

As mentioned in Chapter II of this work, receivership was one of the
main mechanisms whereby creditors and all other parties were stayed and
the assets of distressed corporation were preserved and protected for the
benefit of all investors pending reorganization. But not infrequently,
this device was used in such a way as to cause its function to be perverted
to serve the interests of reorganizers as distinguished from the interests
of investors. It is hoped that the material contained in the following
pages will bear testimony to this charge made against the system of
equity reorganization.

"Consent" Receivers.—Under the equity reorganization system, the
initiative for the appointment of receivers was customarily taken by the
management of the corporation as there was always a danger that unfriendly
creditors might throw the company into bankruptcy or liquidation.
Hence, prior action on the part of management was likely to prevent hostile
parties from seizing control of the receivership proceedings. Usually, the
management-banker group, known as the "inside group," made arrangements with a friendly unsecured creditor whose claims exceeded $3,000, and who was the resident of a different state,\(^1\) to ask a federal district court for a receiver. Control over receivership proceedings was essential to the inside group.

If there was no fraud involved, the court usually appointed a receiver, sometimes an official of the old management, and also sometimes a judge as a co-receiver. The late Adrian H. Joline observed:

> Apparently well established principles of law, based on social and economic expediency, enable every company in difficulties, which can find a non-resident creditor, willing to act, to place it-self in the possession of a federal court receiver when ever it plases.\(^2\)

It seems reasonable to assume that the control over receivership proceedings may give the inside group opportunity to obtain the appointment of friendly receivers and receivership counsel. Such opportunity may be possible from the ability to select a court, before which the proceedings will be brought— whose judge will be sympathetic with and more responsive to its suggestions of candidates for these offices. Or it may be the result of inclination of courts to give special weight to the suggestions of the petitioning creditor. In either case, the power to institute proceedings is important, particularly where there is a risk that unfriendly proceedings will be started. Therefore, receivers and their counsel were normally drawn from the panels of friends and associates of the inside

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\(^1\)The use of a creditor who was a citizen of a state other than the state of the company's incorporation provided the necessary diversity of citizenship for federal jurisdiction.

group. Such receivers are known as "consent" receivers, as they were sympathetic with those in power, namely the inside group, and under these circumstances, it was quite possible that the control of receivership administration and of reorganization would be highly influenced by the men who controlled the business prior to its formal acknowledgement of insolvency. By means of such control, the old management could get immunity from suits of mismanagement or other wrong doings in the company's past, and it also helped them putting at their disposal the resources and personnel of the company in receivership— a powerful aid, for example, in influencing security holders and creditors to support the reorganization aims of old management. These aims usually include:

... The retention of this (management) group's control of the property when reorganized and opportunity to the old management and its friends of such remunerations as are involved in managing the property while in receivership, in floating whatever securities may be issued by the receivership estate ... in retaining their old jobs, and in securing special professional jobs arising out of receivership, such as the making of accounting and engineering studies.¹

The testimony of James F. Gates, Jr., before the Securities and Exchange Commission, is illustrative of this procedure of "consent" receivership:

Answer: My memory is that I telephoned my partner, Dwight Dickerson, when I was at Wilmington, and stated that receivers had been appointed, or would be appointed shortly by the judge, and that I felt that it was important to ascertain from the records of the company whether or not there were three unsecured creditors who would be willing through independent counsel to file involuntary bankruptcy proceedings so that


²A member of the firm of Cutting, Moore and Sidley, counsel for the Federal Public Service Corporation which went into federal receivership in 1932 and later came under the investigation of the Securities and Exchange Commission. Vide: p. 31, footnote 1.
we could be assured that bankruptcy proceedings were in the hands of honest people not seeking for their own gain to milk this desperate situation. As a matter of fact, while I was in Wilmington, I met Josiah Marvel, Jr., who is the son of the former President of the American Bar Association, and who is a brother-in-law of a close friend and classmate of mine, and asked him if he would be available to represent unsecured creditors for the purpose of filing such a petition and he said he would.1

The inside group pursued its own interest, and disregarded the safety and interest of investors. "Many complaints have been made against consent receivership on the ground that it is a subterfuge—a method by which the corporation may obtain an indefinite moratorium against creditor's claims."2 Security holders may still lose more if men controlling the property pending reorganization desire, or are friendly to others who desire, control of the company when reorganized. Nor are they likely to obtain best possible results, if the management is handed over to the same men under whose guidance the company arrived at difficulties. Therefore, under "consent" receivership, security holders would be compelled to bear loss, not of their own making, and that men who were mostly responsible for the loss, generally escaped liability. Hence it was injurious to the interest of investors.


Note: Pursuant to Section 211 of the Securities Exchange Act of 1934, the Congress directed the Securities and Exchange Commission to make an investigation and study the problems of corporate reorganizations and to report the results of its study, together with its recommendations. Consequently, the Commission prepared a voluminous report consisting in part of oral and documentary evidence relating to substantial number of reorganizations which the Commission's representatives studied in detail and in part of statistical data obtained as a result of questionnaires. The Commission's investigation was conducted by Commissioner, later Chairman, William O. Douglas who was assisted by S. C. Clark, Jr., Abe Fortas, S. H. Levy, Martin Riger, and several other notable persons.

2 Guthmann and Dougall, op. cit., p. 633.
Protective Committees.—As it was pointed out in Chapter II, from the viewpoint of investors, the functions which the protective committees performed were very important ones. In fact, however, it was frequently the case that the committees performed these functions poorly and inadequately. At times this was due to incompetence; at other times to design.

The following discussion under sub-heads attempts an investigation into the practices and strategies which were usually followed by the protective committees.

List of Security Holders: Although, as it was indicated, any one interested was free to organize a protective committee, but this depended upon the ability to organize the security holders and to obtain their support. The inside group was at an advantage, as against any outside group, in this matter because of its (inside group's) access to the names and addresses of the security holders. Being first in the field, it could in all probability be able to acquire substantial support from security holders before any opposition group could move into action. Without names and addresses of the security holders the efforts of the minority groups to obtain support were delayed, made expensive, and perhaps rendered futile. They were forced to resort to such indirect and slow methods as general advertisement and publicity intended to induce security holders to communicate with them. "Thus it was that possession of, or access to, lists which was key to the dominant and strategic positions of the protective committees."  

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2The "independent" and other groups which were not affiliated with the inside group are referred to as the out-side groups.

3Ibid., p. 405.
The following testimony taken from the hearings conducted by the Securities and Exchange Commission (heretofore mentioned as SEC) reveals that committees representing management interests were at a decided advantage over outside or minority groups:

Answer: ... may I suggest there that the method of advertising for the bond holders' names is highly expensive and unsatisfactory. I do not think any bond holders' committee can obtain the best results or best protect the interests of the bond holders unless it is able to obtain such list of names...

Question: Wouldn't you, from your experience in this field, Mr. Coyle, know that the so called independent committee was pretty much at the mercy of the person who had possession of the bond holders' list?
Answer: Yes, sir. Its work is seriously handicapped unless it obtains that list.

Question: Do you consider that your committee was seriously hampered by its failure to obtain lists?
Answer: I should certainly say so, because without it they can not cope with the rival interests that have access to the lists, or means of creating a list.1

"As the law and practice and practice developed, possession of, or access to, these lists was almost exclusively in the hands of the banker and management groups."2

Deposit of Securities: After the lists of security holders was prepared, the next step was the solicitation of the security deposit with the sponsoring committee so that full proxy powers may be established in favor of the committee. It was indicated before that deposit agreements usually endowed the committee with virtually all the rights of the original owner. It is for this reason that campaigns with much of the pressure of Community Chest drives took place. Once a security holder deposited his security,

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1 Ibid., pp. 410-411, in regard to the Independent Bondholders Committee for the Republic of Cuba Bonds; and the Independent Krouger and Toll Debenture holders committee.

2 Ibid., p. 411.
withdrawal of the security was not so easily achieved. In many cases, drastic penalties served as a barrier to withdrawal; in other instances, withdrawal was actually a legal impossibility.¹

In the reorganization of Cuba Cane Corporation, 1929-1930, which came under the investigatory authority of the SEC, the paramount argument used to solicit assent of the security holders was sought in support of a voluntary plan in order to avoid receivership. However, the depositing security holders were not permitted to withdraw their securities when the receivership instituted. This refusal stands in great contrast to the spirit of the appeal for committee support.² The following circulars sent out by the committee managers were typical:

Prompt and practically unanimous assent to the Plan is essential to avoid receivership. Unless the Plan can be promptly carried out receivership is inevitable. The Plan will not be carried out unless practically all security holders become bound by the provisions thereof. Inertia means receivership. Bond holders who prefer the Plan to a long and expensive receivership must DEPOSIT NOW. If, however, receivership is to be avoided, security holders, must, with substantial unanimity, promptly assent to the Plan. If receivership is to be averted, you act promptly, you are strongly urged in your own interest to execute immediately the enclosed Proxy, Agreement and Consent....³

Generally, it was not feasible to impede the formulation of deposit agreements. Such deposit agreements, the reorganization bars argued, were matters of private contract, over which the courts had no power. The courts,

¹Husband and Dockeray, op. cit., p. 654.
²See report on the Study and Investigation, etc., p. 313.
³Ibid., pp. 315-319.
while extending their powers over committees, chiefly perhaps by refusing
to permit a judicial sale unless in pursuance of a plan approved by the
court, did not go so far as to override deposit agreements.\(^1\)

Position of Investors: For the most part, the state of mind of an
average investor asked to deposit his security with a protective committee
was bewildered. He could be a good "yes man" and cooperate with his com-mit-
tee or he could do nothing. These were almost the only alternatives open to
him. Refusal to deposit may place him in the position of being outcast with-
out any one to champion his cause or to act in behalf of his rights. On the
other hand, endorsement of a particular protective committee had many of the
earmarks of signing a blank check. With such conflicting situations and lack
of ready means of selecting the committee that would merit his support,
expediency, anxiety, and other pressures\(^2\) brought upon the security holder
compelled him to sign up with his protective committee.

Committee Representation: Naturally, it is of vital interest to the
security holder to expect committee representation, and undoubtedly it is the
key to developing investor's confidence and committee strength. It would
seem that, ideally, bona-fide representatives of the security holders should
be on the committee. However, under equity reorganization system, there were
obstacles in putting it into practice. This may be illustrated in the
following testimony given in the hearings held by the S.E.C:

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\(^1\) Rosenberg, "Reorganization, Yesterday, To-Day and Tomorrow," *op. cit.*,
p. 134.

\(^2\) Such pressures included: "Threats and Discrimination.—Attention was
called to potential losses which would be caused by failure to deposit ...  
Services Rendered.—Emphasis was magnified upon activities in behalf of
depositors which were not available to non-depositors, such as filing
proof of claims, protection of investors' rights ...  
Time Limit for Depositor.—... Security holders were impressed with the
urgency of deposit; if they were to participate in the benefits made avail-
able by committee action." (Friede: Ruskind and Decker, *op. cit.*, pp. 651-
659.)
Question: ... Do you feel that the actual owners of a security should be the members of a committee wherever possible?
Answer: I think it very important that as large a representation of actual owners should actually serve on the committee as can be found willing to give the time and attention to it. However, it is not always true that those actual owners have the technical knowledge or financial experience to enable them to function successfully in working out a reorganization plan without legal and banking assistance.

Question: In other words, protective committees are for the purpose of protecting actual owners, and as such they should wherever possible be formed by or composed of actual owners of the securities. Would you subscribe to that?
Answer: Yes, I would subscribe to it, with the possible qualification that the issuing house ought to accept their share of the responsibility for the working out of the situation.

Question: That is, the issuing house should be available for consultation and should give whatever assistance is necessary?
Answer: And accept the actual responsibility of membership on the committee if the stockholders want them to.
Question: But only where the stockholders want them to?
Answer: Absolutely...

From the foregoing testimony it is clear that members of the committees, generally, were not the owners of the securities. Replies from committees representing 1,229 issues received by the SEC, in response to the questionnaire sent by the SEC reveal more pointedly the composition of committees' personnel. In 295 issues, or 22.9 per cent, did not include in their membership either a person holding the securities personally, or a person directly representing or affiliated with a security holder as, for instance, an officer or employee of an institutional security holder. Of the remaining 939 issues, the representation of security holders consisted of less than a majority in 353 cases, or 36.7 per cent. If only persons directly owning the securities are counted, committees for 732, or 60.9 per cent, did not include a single security holder among their members.1

1 SEC, Report on the Study and Investigation, etc., op. cit., p. 373.
Testimony of Edward Hopkins, Jr., a partner of Drexel and Company and J. P. Morgan and Company.

2 Ibid., p. 374
In some instances the absence of security holders' representation may be attributed to the fact that the ownership of the securities is so widely dispersed that a competent committee of security holders could not be assembled, especially this difficulty may be encountered in forming the committee for the common stock holders. The relative infrequency with which security holders or their representatives found on committees was in large measure due to the practice of the inside group to preempt the positions for their friends. The following statistics, based on questionnaires sent by the SEC to protective committees, indicate the pre-eminence of the inside group or its affiliates on the membership of protective committees.

Of 872 committees replying to the pertinent items in the questionnaire, 673, or 77.3 per cent, included one or more members directly connected with the inside group; in 349, 51.5 per cent of these 673 committees, a majority of the members were so connected.¹

Under such circumstances it would not be unusual to find that such committees would evince anything but friendly cooperation with the inside group in furtherance of its program. Furthermore, the mere fact of selection of committee members by the inside group is itself both a symptom and a cause of loyalty. It indicates that there may be a close relationship between the chosen committee members and those who have appointed them. Indeed, that close relationship may carry with it by subtle implication the understanding that the appointees will do nothing hostile or unacceptable to the inside group. Above all, the SEC observed that "the findings and figures set out indicating the representation of the inside group on the

¹Ibid.
committees doubtless understate the condition which has existed.\(^1\)

Cost of Depositories: As indicated in Chapter II, protective committees commonly asked for the physical deposits of securities under a deposit agreement. Certificates of deposit receipts were issued in exchange for securities. An agency was selected to receive and take the custody of the deposited securities and which issued the certificates of deposit or deposit receipts. This agency was depository. This agency also performed many technical and miscellaneous duties. The services rendered by a depository appeared as a prominent expense item in a reorganization.

In well over the majority of cases examined by the SEC, the depositoryships were occupied by the affiliates and friends of the inside groups.\(^2\) In connection with the reorganization of the Cuba Sugar Cane Corporation in 1929 and 1930, these depository agencies received $111,125, which was 14 per cent of the total reorganization expenses, $1,071,052.\(^3\) One of the members of reorganization committee testified before the SEC as to the unreasonableness of this charge as follows:

**Question:** Do you think that $111,000 is —

**Answer:** (Interposing) Is a very large sum of money?

**Question:** Do you think that $111,000 is a large sum of money to pay for such services?

**Answer:** I have, ever since I have been down there, been trying to persuade the trust companies that they should work for less than they thought the service justified, but I have never been successful in doing so. When you look at the expense they are put to and the enormous amount of mechanical labor that is involved, it is very hard to handle it on a given job, and the total charge is large. However, the number of pieces handled is large also. I have been,

\(^1\) Ibid.

\(^2\) Ibid., p. 165.

\(^3\) Ibid., p. 171.
as I have stated, for a number of years, trying to persuade the institutions to give a cheaper price.\footnote{Ibid.}

Compensation of Committee-Members: In many instances committees' fees constituted substantial incentive for the organization of protective committees. In some cases there were larger stakes which submerged the significance of committees' fees. A scrutiny of 676 deposit agreements of committees filing questionnaire replies with the SEC disclosed that 632 contained provisions for the payment of compensation to committee members. Moreover, it may be added, that with rare exceptions, committees were the sole judges of the amount and reasonableness of their compensation.\footnote{Ibid., pp. 190-191} Table 2, page 140, based on questionnaire replies filed with the SEC, lists fees of committees acting for bonds, debentures and other non-equity securities and indicates the relation of such fees to the face amount of deposited securities.

Remuneration of Attorneys.—During its investigations into the reorganization practices, the SEC observed:

Corporate reorganization has long been regarded as one of the most lucrative fields of legal endeavor ... large fees for attorneys are a customary incident to the rehabilitation of corporations in financial difficulties. In aggregate, counsel fees frequently constitute the largest single item on the list of reorganization fees.\footnote{Ibid., p. 211.}

In two cases upon which the SEC held hearings, the fees for legal counsel exceeded all of the other items combined. In the Paramount-Publix corporation, attorneys' fees amounted to approximately $370,000;\footnote{Ibid.} in the reorganization of Joe and Company, Inc., they were about $131,000.\footnote{Ibid.}
### Table 2

**Summary of Committee Members' Fees in Completed Reorganizations**

<table>
<thead>
<tr>
<th>Type of Issuer</th>
<th>Number of Committees</th>
<th>Face Amount of Securities Deposited (000 Omitted)</th>
<th>Fees Paid to Committee Members (000 Omitted)</th>
<th>Percentage of Fees of Deposited Amount</th>
<th>Range of Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrials</td>
<td>46</td>
<td>$103,605</td>
<td>$625</td>
<td>0.60</td>
<td>$4,000-$60,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>39</td>
<td>103,534</td>
<td>609</td>
<td>0.59</td>
<td>$7,500-$50,000</td>
</tr>
<tr>
<td>Railroads</td>
<td>5</td>
<td>17,036</td>
<td>60</td>
<td>0.35</td>
<td>$2,750-$35,000</td>
</tr>
<tr>
<td>Real Estate</td>
<td>6</td>
<td>18,232</td>
<td>36</td>
<td>0.47</td>
<td>$3,070-$51,036</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>1</td>
<td>2,157</td>
<td>41</td>
<td>1.35</td>
<td>$4,770-$10,500</td>
</tr>
</tbody>
</table>

Total 100 $214,395 $1,121 0.58 $4,000-$50,000

*Derived from: SEC, Report on the Study and Investigation, etc., op. cit., p. 199.*

**Note:** The number of committees, taken as a whole, seem sufficiently large to justify the conclusion that the general average of charges is representative. *Ibid.,* p. 200.
It is not to be wondered, therefore, that among the richest stakes in reorganization, eagerly sought legal positions were among the most valuable items of reorganization patronage. In criticizing the legal profession, the SEC remarked:

... And there are stakes in addition to direct compensation. Counsel for the company will be desirous of continuing as counsel for the reorganized company. The value of their professional reputation may give them an interest in protecting the management against the assertion of claims based on fraud or mismanagement. The observations are apt with respect to counsel for bankers.... Counsel of the dominating inside group will frequently be found in the position which will probably wield the greatest influence and accordingly carry the largest rewards.

... In its avarice for reorganization fees the legal profession by and large has forsaken the tradition of officers of the court and has become highly entrepreneurial in nature....

... Yet, though there are, of course, exceptions, the profession by and large has not evidenced a desire to promote reorganization expeditiously, economically, and solely in the interests of investors. On the contrary, it has evidenced ability and ingenuity in furthering the interests of those who utilize the reorganization processes to serve selfish-ends.

In considering these charges made by the SEC, it must be mentioned that the practice of charging high fees in these cases was also sought to be justified on the grounds that the matters involved were intricate and involved, required utmost precision, were painstaking and arduous, and the compensation for the work should therefore be commensurate not only with the time expended and skill required, but also with the property values involved. However,

... the idea prevailed that attorneys were entitled to greater compensation when employed in a receivership or bankruptcy case than when serving private interests...

In reality, receivers and attorneys are officers of the court. As public servants their compensation should never be as large as the compensation of those engaged in private employment. There seems to have grown up a feeling that it is entirely proper to pay lawyers and others ... more than right otherwise be paid because they are dealing with a very ill patient.

1 Ibid., pp. 211-212.

In the reorganization of the Paramount-Publix Corporation, Judge Wilkerson, in defending the position of attorneys in reorganization cases called attention to the fact that attorneys, unlike public officers, did not receive the full amount of their allowances, because, he argued, there were numerous fixed and incidental expenses which took from them (attorneys) one-third to one-half of their gross-receipts; therefore, allowance for services should be made accordingly.\(^1\)

From the available evidence, the present writer wishes to point out that the fees charged by the attorneys were often high and drew considerable public attention. In an article captioned "No Joke To The Creditors," in the New York Post of June 13, 1935, it was observed:

... the way in which companies in receivership or bankruptcy are drained by lawyers, auditors, trustees, has become a joke in business circles ... But it's no joke to the creditors. Certainly creditors and stockholders of National Department Stores, Inc., will fail to see the humor in the $1,644,000 expense account submitted to the Federal District Court at Wilmington by lawyers, auditors, and trustees who have been 'arranging' the affairs of that bankrupt corporation. If National Department Stores were not bankrupt before, the fees would be enough to put it into bankruptcy now!\(^2\)

However, it must also be emphasized that in analyzing the compensation for various services rendered by the lawyers, probably the chief criterion is the amount and fairness of such remuneration. But, the significant role of the lawyers in reorganization is very difficult to over-emphasize, and the determination of what constitutes fair and reasonable compensation is a very vexing problem. Finally, in its investigations, the SEC maintained the view that

\(^1\) SEC, Report on the Study and Investigation, etc., op. cit., p. 214.

... whatever may have been the cause the end result has been that more conservative and modest professional standards have been discarded... the vice is that the bar has been charging all that the traffic will bear.

About the question of fair and reasonable compensation, Husband and Dockery have tried to rationalize the proposition by stating that:

... it is not easy to lay down a final dictum in settlement of the question (of compensation). Lay interests are not likely to appreciate the quid pro quo for advisory service; its intangibility makes it difficult to visualize the concrete benefits which may be derived. On the other hand, the very courts which determine the fairness of fees are themselves, in a sense, segment of the profession upon which judgement is being passed.

Table 3, page [41], based on questionnaire replies filed with the SEC, lists fees of the committee counsel for completed reorganization cases and indicates the relation of such fees to the face amount of deposited securities.

Compensation of Receiver.—Usually, under the equity reorganization, the most lucrative position of all was that of the receiver. He was the executive officer with virtually plenipotentiary power with regard to the normal operation of the business. Therefore, it is not surprising to find salaries that were typical of the executive grade being paid. In the reorganization of Cuba Cane Sugar Corporation in 1929 and 1930, more than $55,000 were awarded in receivers' fees for a period of four months.

Too frequently, appointment of receiver was made synonymous with an opportunity for profit rather than for service, as

1SEC, Report on the Study and Investigation, etc., op. cit., p. 215.
### Table 3

**Summary of Committee Counsel Fees in Completed Reorganizations**

<table>
<thead>
<tr>
<th>Type of Issuer</th>
<th>Number of Committees</th>
<th>Face Amount of Securities Deposited (000)</th>
<th>Fees Paid Committee Counsel (000)</th>
<th>Percentage of Fees of Amount Deposited</th>
<th>Range of Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrials</td>
<td>43</td>
<td>91,159</td>
<td>61</td>
<td>0.61</td>
<td>$150-$125,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>35</td>
<td>94,814</td>
<td>102</td>
<td>.66</td>
<td>$750-$50,000</td>
</tr>
<tr>
<td>Railroads</td>
<td>5</td>
<td>17,056</td>
<td>32</td>
<td>.22</td>
<td>$200-$31,812</td>
</tr>
<tr>
<td>Real Estate</td>
<td>3</td>
<td>14,814</td>
<td>46</td>
<td>1.62</td>
<td>$275-$20,250</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>4</td>
<td>2,564</td>
<td>4</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>90</td>
<td><strong>$220,000</strong></td>
<td><strong>$1,551</strong></td>
<td>.70</td>
<td><strong>$150-$125,000</strong></td>
</tr>
</tbody>
</table>

*Derived from: SEC, Report on the Study and Investigation, etc., op. cit., p. 222. Note: The table above indicates only the committees representing non-equity securities. It may be emphasized that the counsel fees indicated relate to committees that had completed their task when the questionnaire reply was filed. All committees reporting both as to amounts of securities deposited and final payments of counsel fees were included, regardless of the importance of the committee or the size of counsel fees paid in individual case. This information was compiled in December, 1934. Vide: Ibid., pp. 222-223.*
... the dispensation of this patronage has been eagerly sought either in repayment for favor previously rendered or in expectation of favors to be received. In this connection the rewards of the office are not always to be found in compensation alone.... Some may employ this office to distribute valuable patronage in order to cement business contacts, and,... when it comes to shielding or protecting the liability to the corporation for mismanagement or other tortuous acts, the stakes may seem even more attractive and the combat to acquire them may become more intense.  

Activities of Insiders.—The necessity for a reorganization, particularly if preceded or accompanied by a default, will often create a resentment in the minds of the security holders against the management and the bankers. The management may have been faith-less and incompetent. The bankers, too, may have been poor managers in the sale of securities or in their financial advice to the company. Although, circumstances wholly beyond the control may have caused their difficulty. But in either case, they will be under pressure to take steps to "save face" and preserve their status in the situation.  

Under the system of equity reorganization, favorable conditions helped to make it easier for the inside groups to retain their lost prestige, or at least its further impairment was prevented. Although for their own interests, the insiders, outwardly, were able to champion the security holders' cause by prompt and vigorous action, and at the same time they were able to discourage all tendencies towards investigation into what transpired prior to the reorganization. This was one of the most important stakes which the management and the bankers frequently had in common.  

Considering, that the old management would seek to perpetuate its control in the new company, and likewise the bankers would be financially interested in having the old management reinstated so the friendly and profitable banking connection could be resumed, there would be no likelihood  

¹Ibid., pp. 190-191.
of dissensions between these two most important elements of the inside group. In the first place a company's bankers are often represented on its directorate, and to a certain extent, therefore, the management and banking interests will be identical. Secondly, the mutual advantages to be desired from management-banker harmony during reorganization would provide a powerful incentive for compromising any differences which may exist.

It is true that those who are familiar with the details of the company's affairs, with the progress of negotiations in the formulation of a plan will frequently have advance knowledge of matters which will necessarily affect the market value of the securities of the victim company. They may buy securities in the light of impending bullish developments or sell against proposed bearish announcements. Indeed, the inside group it-self may create these developments or control the public announcements so as best to synchronize its own purchases.

It is illuminating to know how the insiders could gain from the security holders' confusion when a company was in a state of reorganization. Announcement of failure necessarily throws the market for the securities of the victim company into a state of confusion which reflects the fear and anxiety of investors, rather than the values involved. Under these conditions, often, the public demand for the securities disappears. At this juncture under the equity reorganization practice, the insiders came up to "make a market" which means that they or their affiliates declared themselves willing to accept offerings. Naturally, the price paid in this position would be one at which the insiders anticipated a profit by waiting through the uncertain period of reorganization. At times, the insiders may be generous if the securities were desired for the purpose of control rather than for financial gains. In either event, the security holder was virtually at the mercy of
the dominating inside group.

From the observations made earlier in this chapter, it is clear that the inside group and its affiliates in the protective committees were much too much in a better position to know the facts and other pertinent information about the corporation undergoing reorganization. And the advantage of buying securities from the helpless investors at almost discarded price sometimes, is also readily apparent.

But, from another view point, it may be contended, that failure on the part of inside group to act would mean, in many instances, no market at all.

Through an analogy, a terse observation may be followed that:

Their (inside group's) willingness to purchase the securities might be likened to the service rendered by personal finance companies, which admittedly render a much needed service, but at a relatively high cost to the borrower. Hence the alternatives are posed: no market at all, or a market that permits investors to sell at sacrifice prices.\(^1\)

However, it is considered well to point out that under such conditions as described above, the investor is caught in a web of take-it-or-leave-it proposition about which he had no foreknowledge.

In many instances, under the equity reorganization, the secret designs of the inside groups were not conducive to the creation of a cooperative response from the investors. Probably, the insiders were not looking for such cooperation, for they were in a unique position to learn the facts about the company, and their motives may be to accumulate holdings liquidated by distressed investors. "Such profit making opportunities through trading in the securities of a company in reorganization are well known."\(^2\)

The SEC's findings give evidence of one striking example where a

\(^1\) Husband and Dockery, op. cit., p. 660.

\(^2\) Ibid., p. 661.
financial group—an affiliate of the insiders—interested in the securities of a company passing through reorganization realized profit by trading in the various securities as reported below:

TABLE 4
PROFITS OF PHOENIX SECURITIES CORPORATION BY TRADING IN THE SECURITIES OF THE CELTIX COMPANY

<table>
<thead>
<tr>
<th>Securities</th>
<th>Profit ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>25,136.45</td>
</tr>
<tr>
<td>Debentures</td>
<td>341,877.30</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>69,239.60</td>
</tr>
<tr>
<td>Common stock issued under reorganization plan, with a value computed at over-the-counter price of $12 per share</td>
<td>92,153.72</td>
</tr>
<tr>
<td>Total Trading Profit</td>
<td>717,631.45</td>
</tr>
</tbody>
</table>

*Derived from: S.B. report on the Study and Investigation, etc., op. cit., p. 133.*

Promotion of Banker Interest.—Corporation reorganization constitutes one occasion on which banking interests have exercised a high degree of control. The precise role of investment bankers in a reorganization is a controversial subject. However, it may be asked: Is the position occupied by bankers one of functional agent or controlling interest? Is their appointment the result of free choice by investors or are they selected by management? Or is their participation self-instituted?

Under the system of equity reorganization, it must be emphasized that the bankers' permeating influence, or their domination in a reorganization, was not a matter of surprise. There was no legal preventive measure in the way of bankers in order to restrain their participation in a reorganization. Therefore, bankers could easily participate in the "reorganization-business"
of a corporation.

On the eve receivership, bankers, who had sold securities to customers, easily cited their moral obligation to protect the interest of those customers. Then, they were likely to possess complete lists of bondholders which gave them the "inside track" in soliciting deposits and proxies under the deposit agreement. Frequently, bankers participated with the management of a corporation in the preliminary talks about reorganization. Sometimes, the bankers actually precipitated the very need of reorganization by refusing to under-write the refunding of maturing obligations.

In the eyes of most investors, banking houses seemed to possess a reputation for understanding the baffling intricacies of finance and other complexities of various types of issues. In the absence of any public agencies to which investors could turn, it was therefore not surprising to find investors entrusting the protection of their rights to bankers who seemed to be experts and who had a legitimate reason for being interested in the investors' welfare and who usually were also to be first in the field to offer their services.

The bankers served in various capacities in reorganizations, such as receivers, manager of reorganization proceedings, secretary of protective committee, and the like. The bankers' participation per se was not necessarily subject to condemnation; however, investigations indicate that in many cases bankers insured in a reorganization some measure of continued control in the corporation concerned. This took the form of various devices in reorganization plan, such as: voting trusts, banker representation on board of directors, designation of principal executive officers, and restriction on the voting power of certain classes of new stock issues.  

Presumably, the bankers did want to do the best they could for the security holders, but this "moral support" was commonly interwoven with their anxiety for protection so that confidence of their customers may not be impaired. At the same time bankers also looked forward thinking of their personal advancement and of possible future financing with accompanying profits through information about the property which may enable them to trade in the securities to advantage and possibly committee fees.¹

Often, bankers' activities appeared to be a carry-over from earlier services rendered as selling agents and financial advisers of the debtor corporation. It may be observed, that in the acid test of their performance of various high sounding alleged purposes, such as, moral responsibility to the security holders, the bankers preferred reorganizing a company to liquidating it, because they could make money out of the former.

About reorganizations, the bankers' viewpoint has been: "If the job has to be done again later so much the better."²

... the wise bankers have adopted their government to the more permanent tendencies of human nature, rather than those moral abstractions that sometimes get written into law. They have managed to dispense patronage and warp the application of principles with a view to appeasing aggressive, articulate and influential constituents. The timid souls, the guileless and confiding masses, have been forgotten men....³

Bankers, it may be argued, tended to keep particular corporate enterprise intact in situations where liquidation of sources and their recombination in other ventures may have been fundamentally more economical.

¹Ibid.


"The entrepreneurship of bankers in reorganizations has frequently been inconsistent functionally with entrepreneurship of competitive economic system."  

The SEC concluded that at times the insiders may have any substantial financial interest in the enterprise but they may be interested in the maintenance of control. The moral obligations of the bankers and duty to the stockholders of the management were frequently rationalizations for activity— not factual basis for representing security holders.

Example of Management-Banker Activity.—The typical part played by management-banker interests is well illustrated in the reorganization of Paramount-Publix Corporation. In the reorganization of this company, a minority group raised opposition because of alleged past mismanagement and the continuance in power of the same persons. The nature of the alleged mismanagement was set forth in a memorandum submitted during the course of hearings held by the SEC.  

When approaching the problem of reorganization of the Paramount-Publix Corporation it must be borne in mind that the persons now negotiating the reorganization were not selected by the security holders, but by the bankers and management under whose domination and guidance the said corporation deteriorated from leader in its field to a bankrupt. These, briefly, are some of the outstanding acts of mismanagement:

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1 O'Leary, op. cit.


3 Ibid.

4 Ibid.
1. Excessive salaries and bonuses were paid to a favored group of officials;
2. Several millions were improperly distributed to common stockholders out of capital;
3. The company wrongfully disbursed over ten million dollars in repurchasing its own stock out of capital, and in violation of law;
4. Almost all the current assets of the Company were wrongfully hypothecated as additional collateral to the banking creditors; in violation of the Trust Indenture under which the debenture holders were secured;
5. Large sums were wasted in the purchase of real estate and other properties at unjustifiably high prices; and
6. Payrolls were padded with unnecessary employees and favorites of executives.¹

When interrogated as to the reasons for opposing the plan of reorganization of those in control, Mr. Fortington, leader of the minority interest, testified that the only important objections to the proposed plan were the management and the principle of banker domination of the company. The hearings testified as follows:

Question: ..., the thing that was standing between you and the plan when first announced, was some question as to the management?
Answer: Unquestionably.

Question: Were there any other features of the plan or circumstances surrounding the plan that were bothering you, besides, the management?
Answer: There were, but relatively unimportant.

Question: Relatively unimportant?
Answer: Relatively unimportant.

Question: The big thing, the major thing, was management?
Answer: Absolutely.

Question: There was more of an element of control over the company than anything else that you were concerned with?
Answer: Not control. I think control is perhaps an expression which is too strong a word.

Question: Participation in control?
Answer: Proper representation proportionate to the stake in the enterprise.

Question: You were more concerned with that when you were talking about banker domination than with anything else?
Answer: Yes.²

²Ibid., p. 13.
Outside Groups.—The SEC observed that, by and large, "reorganizations are, with rare exceptions, controlled by the management and the bankers."[1] However, occasionally, an outside group, not affiliated with the insiders might succeed, at least partially, in wresting control from the insiders. In all types of reorganizations, "independent" committees led by individuals or lawyers work in opposition to the dominate interests. Under equity reorganization, the insiders sometimes sought to "buy off" a bona-fide opposition group which was seeking not merely its own profit, but benefit to the class of security holders which it represented. At times the assistance of detectives was obtained in order to check the quality of the opposition. Or to test the integrity of the opposition, certain "feelers" were sometimes put out! Sometimes if an outside group threatened to bring suit based upon allegations of fraud or mismanagement, or if it threatened to launch adverse publicity; such pressure could be possibly lifted if the insiders made a financial payment satisfactory to these "strikers."

Whatever the conditions, usually the outside groups had to engage in a formidable struggle with the inside groups if it were a matter of control over the reorganization proceedings. In obtaining support of security holders, or domination of the new company, stakes were high, but the odds against the outside groups were great. In view of these facts, the SEC concluded that "the equity reorganization was designed with the view towards, and has resulted in, protecting the position of vested interest."[2]

Judicial Sale.—One of the most prominent feature and the last step in the process of equity reorganization was the buying of the property of the

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[1] Ibid., p. 671.

[2] Ibid.
company under reorganization by the reorganization committee. As indicated in Chapter II, the receiver offered the assets of the company for sale pursuant to a court order which permitted the reorganizers to use deposited securities in lieu of cash as medium for purchase. Obviously, the larger the amount of deposited securities with the reorganizers the easier it would be to bid at the sale. Hence, it was important that the reorganizers must try to obtain consents to the plan of reorganization from as large number of security holders as possible. Those who did not want to join in the reorganization were called dissenters, and the reorganizers had to pay money to them according to their share of what the property brought at sale. Naturally, a cheaper price paid at the sale would mean less cash requirement needed to pay of dissenters.

A low price at the sale may be wholly unfair to the dissenters, on the other hand a high price would result in more cash to each dissenter not proposing to be in the plan, and this would tempt to increase the number of dissenters and the consequent inability to meet the cash requirements. Therefore, the court fixed what is known as an "upset-price," or a minimum bid (which the master of sale was allowed to accept). This was fixed at a figure not too low so as to completely "freeze out" the dissenters, not so high as to make the dissenters' position so attractive that increase in their number may result beyond the capacities of the reorganizers to raise cash, and this may fail the whole reorganization plan.

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1*Example of Judicial-sale*: Suppose reorganization committee holds in its hands 60 per cent or more of creditors' claims. If the total claims are $100 million, the committee holds $60 millions of those claims. Committee can bid, say $30 million, in which case it will have to raise $30 millions, that is, 20 per cent of $30 millions, with which to pay off the dissenters. Any one else bidding at the sale must put up more than $30 millions in order to out-bid the committee.
Theoretically, it was the duty of the court to see that the sale was fair; however, "traditionally a low bid except in extreme cases did not indicate fraud."\(^1\) In regard to the test of the fairness of a plan of reorganization, the problem of the court, under the system of equity reorganization, was not whether the plan proposed was the best plan which could be drawn, but whether there was anything in the plan too inequitable to any class of security holders that the court should withhold the confirmation of the judicial sale of the company's property under reorganization.\(^2\)

The reorganizers knew that the court's confirmation would be forthcoming, at that late date, the time and expense put into the finished plan, together with the large number of security holders, would weigh the scales heavily in favor of the plan. Here also, the inside group controlled directly or indirectly, the whole affair of judicial sale to suit its aims. It was observed that

... the cash a dissenter receives is invariably less than the market value of the securities which he would receive if he assented to the plan, and everybody knows that the judge in the receivership suit usually fixes the upset-price on the advice of his receivers, and that they in turn, almost always cooperate with the reorganizers and therefore advise the court to fix the upset-price at the figure desired by the reorganizers ... and the reorganizer refuse to bid the bid the upset-price at a high price. To use street language, the reorganization committee holds the aces...\(^3\)

Although the theory behind upset-price was to offer protection to the minority, that is, the dissenters, but in fact, the protection of minority


security holders through the upset-price in most cases was utterly futile. "The upset-price ceased to be a protection for the minority security holders, if it ever was one, and became one of the most useful tools of the majority, that is, reorganization committee, for forcing recalcitrants into line."¹ In other words, in the actual working of the equity reorganization, the right of the security holders to refuse reorganization securities and demand cash instead was seldom worth exercising. They were made to realize that they would lose by taking cash and, that even though they disliked the reorganization, participation in it was more valuable than the modicum of cash they had the right to accept instead.

It must be mentioned that one serious drawback of the judicial sale was that even if a reorganization plan was an honest and advantageous one, dissenters could not be compelled to join the plan. The inevitable result of such a jurisprudence in which no apparatus existed to enforce a fair plan on minorities was, as one author put it, "on the one hand to encourage majority oppression over silent dissenters and, on the other, to invite extortions by clever, selfish and nuisance-value minorities."²

The necessity of paying cash to dissenters, how so ever small it may be, was a hindrance to the reorganizers, for

... it implied that reorganization could be carried through successfully only when a large percentage of claim holders agreed to the plan.... one could not tell how much cash had to be raised for dissenters until the percentage of agreement and upset-price were known. On the other hand, no very definite plan could be proposed and gain general acceptance so long as amount of cash to be raised was indeterminate.... and if more cash was needed than anticipated,


²Rosenberg, "Reorganization, Yesterday, To-Day and Tomorrow," op. cit., p. 135.
the investment banker might refuse to under-write the cash requirement which would upset the whole plan,... the net result of such a dilemma was not a happy one. 1

Another serious shortcoming in the system of equity reorganization was that the judicial sale was in genuine danger of attack years after it had been accomplished. The Boyd case, 2 which caused most excitement for many years in the reorganization law of the United States, pointed out, inter alia, the dangers and inadequacies of sale in equity reorganization.

Not only for the purpose of illustrating this point just mentioned, but to this study as such, the implications of the Boyd case are of tremendous significance, and they will be alluded many times during the course of investigations. Hence, it is considered essential to review the highlights of the Boyd case as follows:

The Northern Pacific Railway Company was reorganized in 1893. The reorganization was primarily a bondholders' reorganization based upon the foreclosure (judicial) sale of their mortgage. The plan of reorganization gave to the old preferred stock 50 per cent in new common stock on paying an assessment of $10 per share, and to the old common stock 100 per cent in new common stock on paying an assessment of $15 per share. The aggregate assessment was $111 millions. The capitalization of the new company was to be $130 millions in bonds, $75 million in preferred stock and $30 million in common stock, a total of $245 million, and the capitalization was based upon the assumption or one might say fiction, that property had the value of $345 million. No provision was made in the plan for the unsecured debt, which was considerable. The property was bought at judicial sale by the bondholders' committee for $61.5 million, which was $66 million less than the secured debt (presumably $127 million); it was then transferred to a new corporation which issued the $34.5 million securities as contemplated under the plan, and the old stockholders, most of whom paid the assessment, became the owners of the bulk of the stock of the new company.

About twenty years after the consummation of this reorganization, the

1 Norman Sharpe Buchanan, The Economics of Corporate Enterprise (New York, 1940), p. 115.

2 North Pacific Railway Company v. Boyd, 228 U.S. 482 (1913)
new company, North Pacific Railway Company, having in the meanwhile become highly prosperous, Boyd, an unsecured creditor brought a suit against the Company. He claimed the judicial sale was invalid on the theory that the assets of the old company were more than sufficient to pay off the bondholders' claims, and therefore, the unsecured creditors had an equity not recognized in the reorganization and that stockholders by being allowed to participate had retained interest which belonged to the unsecured creditors. The court sustained this contention and recovery was made. The majority of the court maintained that while the bondholders might have lawfully bought in the property to the exclusion of both the unsecured creditors and stockholders, the moment they provided for participation in the new company, by the stockholders, even at the price of paying a heavy assessment, the obligation arose to make provision for the unsecured debt which would recognize its priority to the interest of the stockholders.

On the other hand, for reasons of practical necessity, it was considered essential to allow stockholders to participate in order to gain from them the payment of an assessment. Bondholders preferred to allow stockholders' participation, partly to avoid dissatisfaction, litigation and delay which might result from their exclusion, and partly to assure new capital by inducing them to retain their interest in the property. Consequently, the stockholders willingly furnished new capital on more favorable terms than could be had from strangers.¹

The implications of the Boyd case are that if stockholders are allowed participation in the interest of the reorganized company, the unsecured creditors, or for that matter all classes of claimants over and above the stockholders, would have to be allowed participation as well.

It has been argued that the reorganizers could and did utilize the theory of the Boyd case to bring all classes of security holders into line:

Bondholders must give up something to unsecured creditors as the price of stockholders' admission; unsecured creditors could not complain because if stockholders were left out, they would receive nothing; stockholders were told that if they demanded too much they would upset the whole plan.²

With the foregoing analysis into the practices and techniques involved in the equity reorganization process, it becomes clear that dominating

¹Vide ibid., pp. 432-515; Gravith, op. cit., pp. 152-163.

forces and extraneous motives confused the rehabilitation process. The interests of investors require that reorganization be expeditious, economical, and fair and honest. But self serving objectives incompatible with the needs and requirements of investors too often caused perversion of the functions of reorganization. The techniques of reorganization were shaped to conform with the aims of the reorganizers. Briefly, reorganization occurred not just to put the company on a sound financial basis, but it was also applied as a means of perpetuating control and as a source of remuneration. The emoluments of control were the stakes of reorganization. Reference to these emoluments is made merely to emphasize the existence of strong motivation for the management to retain its position of dominance and control over the enterprise when it emerges from reorganization.

There was no independent supervision of the reorganization proceedings as a form of insurance against the reorganization machinery being bent towards the pursuit of private ends not in accord with the purposes of reorganization.

The rehabilitation procedure was burdensome on the debtor's estate, as it was costly and often time consuming. The generally liberal compensation paid to receivers, legal counsel, committee members and the like increased reorganization costs. Payment to dissenters was a serious problem. Not infrequently, receiverships lasted many years. The data presented in Table 3, page 60, lends support to this conclusion.

The fundamental economic motives of reorganization as formulated in Chapter II of this work remained clouded under equity reorganization. Under the "consent" receivership, courts usually accepted creditors' allegations and corporation's reply. Inquiry as to the need for reorganization was
TABLE 5

AVERAGE RECEIVERSHIP DURATION FOR SELECTED GROUPS OF CORPORATIONS,
1919-1923*

<table>
<thead>
<tr>
<th>Type of Corporation</th>
<th>Number of Cases</th>
<th>Average Period of Receivership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steam Railroad</td>
<td>20</td>
<td>2.9 years</td>
</tr>
<tr>
<td>Iron and Steel Producers</td>
<td>10</td>
<td>3.5 years</td>
</tr>
<tr>
<td>Oil Producers and Refiners</td>
<td>15</td>
<td>2.9 years</td>
</tr>
<tr>
<td>Pulp and Paper Manufacturing</td>
<td>10</td>
<td>3.3 years</td>
</tr>
<tr>
<td>Meat Packing and Food Products</td>
<td>7</td>
<td>1.3 years</td>
</tr>
</tbody>
</table>


discouraged, and investigation into corporation's past management was prevented. The domination of the vested interests usually did not facilitate court's examination of the basic economic issue, that is, whether the assets of the failed corporation were worth more in reorganization or in liquidation, because on that basis depended whether to grant or deny the appointment of receiver. "Doubtless, one of the most serious criticism of corporate reorganization in equity is that the basic question of asset valuation was not squarely posed at all."¹

The terms of reorganization plans were by and large manoeuvred by the inside groups to suit their personal aims. The courts' hollow part was to appoint receivers, and enjoin creditors and stockholders in order to hold the property free from attack. Lastly, courts were not concerned with the fairness of the plan of reorganization ultimately prepared and carried

¹Buchanan, op. cit., p. 405.
through. These were the abuses and defects of the equity reorganization procedure.¹

The next chapter is concerned with an analysis of the development of reorganization acts during the thirties.

¹Some more defects of the equity reorganization system will be uncovered in Chapters V, VI and VII of this study.
CHAPTER V

DEVELOPMENT OF STATUTORY REORGANIZATION

The Great Depression and Statutory Reorganization.—Following the World War I, tremendous development and expansion took place in the industrial, railroad, and even in the municipal field. The huge floatation of Liberty Bonds by the Government during the war served to acquaint American investors with the machinery of financing through bond issues in a manner and to an extent never dreamed before. This situation was utilized by large corporations and banking interests of the country to promote an extensive sale of both debt and equity securities of industrial, railroad, utility, and real estate companies, to a scale unknown before.

It has been estimated that, in the period from 1919 to 1933 inclusive, a total of not less than fifty seven billion dollars worth of securities were sold to American Public. This does not include Government, State, County or Municipal bonds, nor does it include the more than six billion of bonds of foreign governments or states which were sold in this country during this period.... Necessarily, a vast amount of this new capital went into the expansion of great industrial enterprises....

In the fall of 1929, it became quite evident that the capital structures of a great many of corporations could not be supported and sustained by a continuance of boom conditions.... It was, of course, apparent from the moment when all values began to topple that cruel and grievous losses would have to be taken by the security holders.1

The repercussion of the great economic depression of the nineteen thirties inevitably dealt a considerable readjustment of the capital structures of many corporate debtors. The appalling extent of economic distress and financial panic which was prevalent in the early thirties may be somewhat indicated from the following data compiled in Table 6, page 63.

### TABLE 6

**TOTAL ANNUAL BONDS DEFAULTS, 1929-1933**

(000 omitted)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Industrial</th>
<th>Railroad</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Issues</td>
<td>Principal Amount</td>
<td>Number of Issues</td>
</tr>
<tr>
<td>1929</td>
<td>115</td>
<td>$160,787</td>
<td>43</td>
</tr>
<tr>
<td>1930</td>
<td>251</td>
<td>228,534</td>
<td>67</td>
</tr>
<tr>
<td>1931</td>
<td>1,075</td>
<td>2,047,433</td>
<td>216</td>
</tr>
<tr>
<td>1932</td>
<td>1,069</td>
<td>2,699,972</td>
<td>237</td>
</tr>
<tr>
<td>1933</td>
<td>862</td>
<td>2,182,571</td>
<td>233</td>
</tr>
</tbody>
</table>

### Public Utility | Real Estate | Foreign

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Industrial</th>
<th>Railroad</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Issues</td>
<td>Principal Amount</td>
<td>Number of Issues</td>
</tr>
<tr>
<td>1929</td>
<td>25</td>
<td>$51,081</td>
<td>45</td>
</tr>
<tr>
<td>1930</td>
<td>56</td>
<td>98,344</td>
<td>125</td>
</tr>
<tr>
<td>1931</td>
<td>96</td>
<td>201,722</td>
<td>705</td>
</tr>
<tr>
<td>1932</td>
<td>132</td>
<td>523,136</td>
<td>518</td>
</tr>
<tr>
<td>1933</td>
<td>109</td>
<td>369,333</td>
<td>312</td>
</tr>
</tbody>
</table>

---


During the depression the number of corporation insolvency cases increased considerably, although not in the bankruptcy sense of the term. They were left without statutory methods to obtain relief from maturing obligations. The result was winding up of their business with a sacrifice of assets.¹

¹ Vide: Appendix A for the total number of bankruptcy cases filed during 1900 through 1959.
Under the ordinary bankruptcy procedure, relief was possible only through liquidation of the assets of the debtor. The chief defect of the bankruptcy form of relief was that bankruptcy, as it had developed in this country, was by and large a mechanism for liquidation and not for the rehabilitation of a distressed business. Moreover, perhaps bankruptcy was synonymous with "failure," it was commonly felt that there was a stigma attached to bankruptcy—that bankruptcy was dishonorable. Under these circumstances, corporate officials avoided placing their corporations in bankruptcy when that was at all possible. Hence, the distressed corporations could not benefit by this method.

Reference was made in Chapter II to the composition in bankruptcy as a method of relief for the debtor corporation whereby all unsecured creditors could force on the minority, even over their objections, a compromise with the debtor accepted by the majority and sanctioned by the court. Composition could not be effective to deal with the problems of large corporations. Because, firstly, composition was a petty affair involving only thousands of dollars. Secondly, it was difficult to achieve complete readjustment under composition because secured claims were left unaffected. Thirdly, it was necessary to deposit money to pay all those debts which had priority, and which in many cases was a severe requirement. Lastly, under composition agreement, new securities in the form of bonds and stocks were not used. Hence, composition as a method of debtor relief was ineffective for the rehabilitation of the large corporations.

The only method of rehabilitation available to the large corporation was to resort to equity reorganization. However, when the depression came upon the country, the weaknesses of this system were laid bare. The agitation
against this system was heightened. Firstly, difficulty arose to secure
cash for the dissenters. Naturally, under the depressed economic conditions,
the number of dissenters tended to increase which aggravated the chances of
a successful reorganization. New money could be secured from the public
only after scaling down the old indebtedness. Secondly, the human element
entered into this system; many investors openly began to denounce the
abuses and extravagances which usually accompanied equity reorganizations.
Thirdly, a culmination of dissatisfactions and uncertainties, which categori-
rized this system, plus economic urgency, created a demand for more specific
statutory methods for debtor relief. "The old problem of an adequate forum
for reorganization, the treatment of dissenters and formalism of the judi-
cial sale, and the supervision of an economically sound and fair plan of
reorganization came in for new treatment."\(^1\)

The equity reorganization might perhaps have overcome significant
difficulties if the courts could assert power to enforce a plan upon minori-
ties, or to wipe out a mortgage bond and force its owners to accept in
place thereof an inferior security, or to cancel a note issue, and the
like. However,

... prudent bankers feared such a course would destroy the investment
market by casting doubts on what was once naively considered the
sacredness of mortgage obligations... So the ritual of the judicial
sale was deified, and the courts hesitated to enforce plans on minori-
ties or take jurisdiction over committees whose authority was
derived by contract...\(^2\)

As described in the previous chapters, ordinarily, equity reorganization
terminated in a judicial sale of the debtor's assets, and the power of the

\(^1\) Levi and Maleo, op. cit., p. 236.

\(^2\) Rosenberg, "Reorganization, Yesterday, To-Day and Tomorrow,"
op. cit., p. 355.
courts over the reorganizations was only an indirect one. However, instances have been found where resourceful and vigorous judges come to exert a considerable pressure in the shaping of a proper reorganization; although, in exceptionally rare instances did they dominate the decisions of the reorganizers. The power of the judges rested in such cases more upon their personality and a capacity for negotiation than upon any legal basis. In two instances for example, judicial sale was not effected. The plans of reorganization were assented overwhelmingly by both creditors and stockholders, and the property was turned back to the corporation without judicial sale. Dissenters were enjoined from suing on their claims and, instead, had to accept the securities the plans provided for them. Moreover, 

... gradually, the courts perceived that what was in form the sale of a business was actually its retention, not its winding up but its continuance... With the realization that what was legally a sale, was, in truth a method whereby the property was retained by the debtor with debts scaled down as to interest or principal or both, with stockholders' equities cut....2

During the depression it became increasingly difficult to raise money for dissenters. The need of a new procedure was felt whereby a plan of reorganization, having assented by a required number of majority security holders and adjudged fair and equitable by the court, could be enforced on dissenters. It was realized that a measure of this kind could appreciably cut down the burden of a debtor corporation undergoing reorganization, and help revive its business.

The result of widespread increase of corporate debt during the period

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2Rosenberg, "Reorganization, Yesterday, To-Day and Tomorrow," op. cit., p. 133.
of expansion, 1923-1929, and the shrinkage of property values which followed in the economic depression created an acute situation. The state laws were inadequate to cope with this situation, because of the contract clause limitation they could not constitutionally cause dissenters to be bound; jurisdiction ended at state boundaries, and the state courts were not sufficiently versed in reorganization techniques. Only by further exercise of the bankruptcy power of Congress could adequate relief be afforded the distressed corporate debtors and their creditors. It was believed, that a reorganization scheme based upon the unanimous consent of the majority security holders could help remedy many financially distressed corporations undergoing reorganization. Since it was not customary for the equity courts to enforce a plan of reorganization on the dissenting security holders, a very significant question arose: Could Congress enact an amendment to the existing Bankruptcy Statute requiring all security holders to accept what their majorities were content to take and thus deprive the minority of their share of security?

About the composition in bankruptcy, the judicial history indicated that courts usually assented a readjustment plan when a large number of creditors agreed to the plan. The Bankruptcy Act of 1898 had for many years provided that to be confirmed, (1) a composition must receive the approval of a majority in number and amount of the creditors, and (2) in addition, the court must find that the composition was in the best interest of the creditors. Experience also indicated that, in fact, courts never


2 Moore and Oglebay, op. cit., p. 55.
withheld approval of a composition, which received the requisite number of creditors' assents unless the composition was so unfair as to be virtually outrageous. On this basis, it was argued that by simply enlarging the scope of bankruptcy statute, "Congress had the power to put into effect a workable piece of legislation for the rehabilitation of large corporations."  

It was also pointed out that England successfully safeguarded her industrial life by a simple reorganization law which was enacted by the Parliament as early as 1870, and that had remained substantially the same ever since. According to this law when three-fourths of the amount of respective classes of creditors, bondholders, and stockholders approved a plan of reorganization it bound the minority provided the plan as a whole was found fair by a disinterested tribunal. It was argued that the good sense and economic justice of such a legislation would accord the rock-bottom safety of American industrial democracy despite the vast complexity of American corporate structure.  

... We need not unduly concern ourselves with legalistic fears on score, since it is plain that good law supports good economics and empowers Congress to write an amendment to the present bankruptcy statute patterned on a half century of British experience....

In his message for the debtor-relief program, President Herbert Hoover recommended that

... the bankruptcy act should be amended to provide remedial process in voluntary proceedings under which debtors unable to pay their debts in due course, may have the protection of the court without being adjudged bankrupt ... for the purpose of reorganization. The act should be

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2 Ibid., pp. 336-337.

3 Ibid., p. 337.
amended to require the examination ... and full disclosure of the cause of (debtor's) failure and its conduct in connection therewith for the consideration of the court....

Accordingly, amendments for a new procedure of corporate reorganization were proposed by the Attorney-General in his report to 72nd Congress, in which he said that the proposed amendments were meant

... to provide a simple process, under the administration of the bankruptcy court, for the reorganization of corporations, ... Such a process in bankruptcy will have great advantage over the cumbersome equity reorganization procedure. The proposed amendments not only afford a simple, prompt, and effective process of reorganization, but they are carefully drawn to adequately preserve the rights of lien holders and other creditors.

Since Section 3, Article 1 of the Constitution provides that "Congress shall have the power to establish ... uniform laws on the subject of Bankruptcies," the question arose whether a law providing a method for the reorganizing of insolvent corporations a law "on the subject of bankruptcies.

The proposed bill to amend the Bankruptcy Act, which was drafted by the Solicitor-General and which contained reorganization provisions was said to render the law unconstitutional. Regarding the constitutionality or unconstitutionality of the principal features of the reorganization bill, it may be examined that

the first principle of the reorganization statute called that the law should apply to corporations unable to meet their debts as they mature although the corporation may not be insolvent in the bankruptcy sense of the term, which is when liabilities exceed assets.... The criticism of such measure asserted that a law 'on the subject of bankruptcies' could not deal with a corporation which was merely temporarily unable to meet its debts in the course of business ...

The second principle of the reorganization statute was that the reorganization plan, when accepted by a given proportion of the different classes of security holders and subsequently confirmed by the court as to its fairness and equitability should become


binding upon stockholders as well as the creditors. This meant that dissenters which are usually a minority, would be legally compelled to accept the plan. It was argued that a law which binds dissenters is not a law on the subject matter of bankruptcies.¹

In order to appreciate the assertions whether or not Congress had power to bring in the proposed amendments under the Bankruptcy Act, it is important to examine what "the subject matter of bankruptcies" properly is? The courts gave broadest possible interpretation to the bankruptcy clause and in effect adopted the view of Justice Story, that

... A satisfactory description of a bankruptcy law is, that it is a law for the benefit of creditors and their debtors, when the latter are unable or unwilling to pay their debts, ... and a law on the subject of bankruptcies, in the sense of the constitution, is a law making provisions for cases of persons failing to pay their debts ... ²

From this interpretation, it is clear that a corporation unable to meet its debts as they mature, may be quite properly the subject of bankruptcy law even though it is not insolvent in the bankruptcy sense.

Furthermore, it has been found that even under 1898 Bankruptcy Act 'a debtor may voluntarily go into bankruptcy while actually solvent ... and the basis of bankruptcy jurisdiction does not now and never has rested upon the peculiar definition of insolvency contained in the Bankruptcy Act.'³

Hence, it is noteworthy, that a reorganization statute was in substance a bankruptcy law, and making reorganization plans binding upon creditors and stockholders where a certain proportion of each class of security holders consented, was in entire harmony as to the nature of bankruptcy law.

²Ibid., p. 344.
³Ibid., p. 347, "this interpretation and other similar definitions laid down by courts in regard to what constitutes a law on 'the subject matter of bankruptcies,' were approved by the Supreme Court...." Vide: Ibid. Quoted in: Commentaries on the Constitution, Chapter XVI, Section 131.
The pending bill provided for reorganization without either adjudging or calling the debtor corporation a "bankrupt." The critics asserted that the law for that reason would not be one "on the subject matter of bankruptcies." However, the courts had repeatedly declared:

... questions of terminology and form have nothing to do whether or not the law is one on the subject of bankruptcies ... and the Congress had power to adopt new forms of procedure for the relief of insolvent debtor, without branding them as bankrupt.°

It may be mentioned that there was a fundamental similarity between composition in bankruptcy and the proposed reorganization procedure as methods of relief for a distressed debtor. It was indicated in Chapter III that reorganization usually involves decrease in the liability of the failed corporation, and modification of the interests of the security holders. It may be observed, that in reorganization, theoretically, creditors deal with the corporation, but in actuality the creditors deal with its stockholders. Hence, the interposition of a fictitious entity does not alter the real nature of transaction, which is between the creditors and the stockholders.

The analogy of a composition between an individual debtor and his creditors is close enough. In a composition procedure under the Bankruptcy Act, creditors' claims could be satisfied out of the debtor's assets. The debtor, in order to retain his assets and continue his business, raised money from other sources, negotiated with the creditors, and reached an agreement which was made binding by court order.

Similarly, in a corporate reorganization, creditors acting through their respective committees, seek satisfaction out of the assets of the debtor corporation by expressing their desire through a plan of

Tbid., p. 350.
reorganization. The stockholders, however, like the individual debtor, wish these assets to be preserved in order that business may continue, and (they) may undertake to raise the needed cash, negotiate with the creditors and agree on a plan of reorganization.

The two cases are in substance alike and if Congress could constitutionally legislate with respect to one, it could constitutionally legislate with respect to the other. Both relate to "the subject matter of bankruptcies."

The composition agreement, in addition to being equitable, required the assent of minority creditors. Similarly, the new bill provided that the court shall confirm the plan only if satisfied that it was equitable and had the assents of the requisite number of security holders.

... Hence, Congress could enact such a law, where the law itself, having for its object the settlement of claims and the continuation of a debtor's business in the interest of the debtor and creditors alike, was clearly a law on "the subject matter of bankruptcies."

The case of *Canadian Southern Pacific Railway Company v. Gebhard* supported these conclusions eminently well. Briefly, in the reorganization of Canadian Southern Pacific Railway Company in 1883, a plan was proposed and assented to by the great majority of bondholders and stockholders. The Canadian Parliament in the meanwhile passed a special legislation making the reorganization plan binding on all creditors and stockholders. Certain bondholders in the United States asserted that the scheme of reorganization could not be made binding upon them. The Supreme Court of the United States held that it was binding upon them, for

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2 109 U.S. 527 (1883)
... the confirmation and legislation of scheme of reorganization under such circumstances is no more than is done in bankruptcy when a "composition" agreement with the bankrupt debtor, if assented to by the required majority of creditors, is made binding on the non-assenting minority. Bankruptcy Laws, whatever may be the form they assume, are of that character.

From the foregoing analyses, it may be concluded that the reorganization bill was in line with bankruptcy legislation and tradition and did not destroy the character of the law as law "on the subject matter of bankruptcies."

Here, a question may be asked: Why no legislation was effected in the preceding three decades 1930-1900 to provide a forum for corporate reorganization? The inefficiency and waste involved in the equity reorganization process should have continued through three decades of the present century is well-nigh unbelievable. In the words of an author, partly this has been because no one was willing to take the trouble to bring about sensible legislation; partly because doubts have been expressed as to the constitutionality of such a law as an invasion of property rights.

Congress by transfiguring the humble "composition" into the splendor of "reorganization," could long ago have brought all corporate reorganization within its domain as a British Statute did so far back as 1370. That this did not happen here was no accident... Such was the worship of these once sacred cows, the mortgage and the trust indenture, such the prestige of bankers, underwriters, committees and counsel who managed reorganization; such was their condescension towards the bankruptcy proceeding as a refuge for corner grocers and pants manufacturers, that proposals for legislation whereby the bankruptcy court might be elevated to a reorganization forum with power to wipe out mortgage bonds, carve away common stockholders' equities without owners' consent, and assume control over committees, were for years disregarded... Not until economic collapse brought us to the reorganization statutes of the thirties were such principles made into law.

It was against this background that the 74th Congress amended the National Bankruptcy Act of 1898, and the Corporate Reorganization Bill, known as Section 77B of the Bankruptcy Act, passed at the last session of Congress, became law on June 7, 1934.¹

**Corporate Reorganization Through 77B.**—The amendments to the Bankruptcy Act, constituting Section 77B, contained such important changes for the reorganization of corporations as the following:

**Power to Compel Compliance with Plan of Reorganization:** The court was given power to make binding on all parties a plan of reorganization which it considered to be fair and equitable and if it had the approval of two-thirds of the security holders and a majority of the stockholders. The stockholders' approval was not required if the corporation was insolvent in the bankruptcy sense.

**Discontinuance of Ancillary Receivers:** Equity reorganizations frequently required the appointment of ancillary receivers wherever the property of the debtor corporation extended beyond one federal district. This arrangement was expensive and unhealthy for the economic life of the debtor. Section 77B ended the need for such ancillary receivers.

**Increased Supervisory Powers of the Court:** Although the supervisory powers of the court were increased, still, no power was given to the court or the trustee to work out a plan of reorganization; but the court's authority to scrutinize deposit agreements, and some other phases of reorganization practice was supposed to have been enhanced under 77B.

**Appointment of the Trustee:** Section 77B allowed the debtor to file a petition stating its insolvency, in either the bankruptcy or equity sense,

and wishing to propose an arrangement with its creditors. The court could permit the debtor to serve himself as a trustee. At least in theory, therefore, the practice of "consent" receivership was obviated.

Submission of Plans of Reorganization: As a means of encouraging widespread interest in the plan of reorganization, the debtor was free to submit such a plan without prior consent, and twenty-five per cent of the secured creditors were likewise in a position to act.

Effectiveness of 77B Reorganizations.1 The amendments mentioned above were intended to improve the reorganization procedure not only to expedite relief for the debtor, but also encourage active participation by investors, and allow a practice of fairness in the corporate reorganization proceedings.

It was emphasized in the preceding chapter that the need of cash for dissenters complicated and stalemated the rehabilitation in equity reorganization. Section 77B abolished the formalism of judicial sale by making provision to enforce a reorganization plan on all dissenters. This was an important step towards rapid and economical reorganization because the total cash requirement to carry through a plan of reorganization was reduced. Also, the problem of securing a large percentage agreement to the plan was practically solved.

Under the equity reorganization system, the appointment of ancillary receivers made impossible the effective operation of the business as a going concern. "There could not be unanimous cooperation between the various courts appointing receivers, or between the various receivers having once appointed."2

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1Section 77B applied to industrials and utilities; Section 77, which was passed in 1933, relates to railroads, but its essential features are similar to 77B.

With the enactment of 77B, the cumbersome and wasteful ancillary receiverships were abolished, because the trustee appointed under this statute acquired legal title to the debtor's assets in all parts of the country. The effectiveness of business operations was thus improved.

Under equity reorganization, it was almost impossible to give new capital contributors rights in assets and earnings more than those retained by the first claimants in the failed corporation. The court, usually, had no power to displace liens already in existence. Mostly, the only source of new money was through "assessment" of junior security holders, and only infrequently through the sale of new securities. The receiver was seriously hampered in his efforts to raise funds for the operation of the business, unless the receivers' certificates could be made prior liens, they were often unmarketable.

Under 77B, provision was made whereby it became comparatively easier to give the new contributors exclusively first claims because pre-existing liens and contracts could be modified. Hence, 77B solved to a great extent the capital raising problem in a reorganization by making more accessible the sources through which funds could be raised.\(^1\)

Section 77B did take into consideration to some extent the relative values of the debtor under reorganization as against under liquidation. It contemplated, that having shown that the corporation needed relief, the petition must then show that there was reasonable prospect of a feasible reorganization being carried through. However, 77B did not contain any specific provision to this effect. Professor T. K. Finletter is of the opinion that unless it could be shown that reorganization was probable

\(^1\) Buchanan, op. cit., pp. 423-424.
under 778, the courts could refuse to assume jurisdiction, and

... a petitioner therefore, who was unable to satisfy the court that properties of the debtor were worth reorganizing and there was reasonable probability that a plan could be put into effect, had not demonstrated his good faith. Evidence which will show the fundamental worth of the business must however be presented or otherwise the court can not know whether liquidation was the proper remedy....

Hence, it may be inferred that courts did touch the important economic question such as the relative values of the debtor under liquidation and reorganization. However, from the available evidence, it appears that the courts did not go far enough to determine the validity of the need for reorganization. In the opinion of late... Herrick Dodd, Jr.,

... with respect to wasteful continuation of enterprise which ought to be wound up, the amendment was unlikely to cure and may even accentuate the existing evils. In their eagerness to make the procedure easy where reorganization was desirable, the draftsmen apparently failed to impose a properly check on real or simulated attempts at reorganization when it was undesirable or unpracticable.... There was requirement that the petition should allege facts showing the need for relief;... and allege facts that there was a reasonable chance that reorganization was practicable. But cases which have thus far arisen under 778 do not however indicate any judicial tendency so to construe it, the mere requirement that such facts be alleged would not be a serious deterrent to unfeasible reorganization unless creditors were sufficiently alert to controvert these facts and insist on liquidation... or unless the judge had the legal power, the practical means and the inclination to make an independent investigation...  

Furthermore, District Judge Murray Hubert, Southern District of New York, voiced the judicial view in regard to 778 reorganizations in the following manner:

... many debtors were not coming within the letter and spirit of the Section (77b) apply for relief under it in the belief that by so doing

1Finletter, op. cit., p. 63.

they avoid the stigma of bankruptcy... too many petitions are filed under this Section should be filed under the provisions of the Bankruptcy Act prior to these amendments.¹

The data indicating the total number of industrial and commercial reorganization cases filed under 77B is provided in Table 7, page 79.

To answer the question more specifically as to how far the courts pursued the principle that "a petition must show reason for reorganization," it may be observed that the judicial tendency was not strict so as to compel examination of the alleged evidence. However, the mere fact that such a requirement did exist was significant. In some cases, courts did consider the wisdom of reorganization against liquidation in considering the petition addressed to them. Hence, it is reasonable to conclude that 77B was an improvement over the equity reorganization in that there was a greater likelihood that the court would consider the valuation of the debtor corporation—the relation between liquidation and reorganization in granting or denying petitions. But, it must be emphasized that the question of valuing the debtor corporation was still not "fully" brought into the proceedings, because 77B did not expressly require petitioners to submit positive evidence that reorganization was the proper solution to the debtor's difficulties. "Notwithstanding there was the absence of statutory requirement of this kind."²

Under 77B, in the negotiations which led to the plan of reorganization, court and its trustees had no official part. Courts usually left it to the parties to work out their own salvation. Judicial approval was required after and not before the plan was submitted to the parties in interest.

¹Quoted in: Carl D. Friebolin, "Section 77B—Sword or Shield?" Journal of the National Association of Referees in Bankruptcy, X (April, 1936), p. 57.
²Buchanan, op. cit., p. 420.
### TABLE 7

SECTION 77B APPLICATIONS BY INDUSTRY GROUPS
INDUSTRIAL AND COMMERCIAL CASES

<table>
<thead>
<tr>
<th>Period</th>
<th>Total Number</th>
<th>Manufacturing</th>
<th>Wholesale Trade</th>
<th>Retail Trade</th>
<th>Commercial Service and Construction</th>
</tr>
</thead>
<tbody>
<tr>
<td>June - December</td>
<td>1934</td>
<td>465</td>
<td>100</td>
<td>214</td>
<td>52</td>
</tr>
<tr>
<td>January - June</td>
<td>1935</td>
<td>464</td>
<td>100</td>
<td>235</td>
<td>51</td>
</tr>
<tr>
<td>July - December</td>
<td>1935</td>
<td>350</td>
<td>100</td>
<td>166</td>
<td>48</td>
</tr>
<tr>
<td>January - June</td>
<td>1936</td>
<td>296</td>
<td>100</td>
<td>114</td>
<td>47</td>
</tr>
<tr>
<td>July - December</td>
<td>1936</td>
<td>173</td>
<td>100</td>
<td>89</td>
<td>51</td>
</tr>
<tr>
<td>January - June</td>
<td>1937</td>
<td>225</td>
<td>100</td>
<td>123</td>
<td>55</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>1,973</strong></td>
<td><strong>998</strong></td>
<td><strong>259</strong></td>
<td><strong>230</strong></td>
<td><strong>286</strong></td>
</tr>
</tbody>
</table>

This usually led to the courts' taking a passive rather than an active role in the whole question of fairness of reorganization plans. Obviously, 77B recognized the principle of the majority rule, because a plan could be passed by the courts if it had been accepted by the requisite percentage of the security holders. Hence, it may appear that this was a step towards "democratization" in the reorganization practice. However, it would be well to consider, that an ill-informed and possibly frightened majority may in turn be led by a powerful and organized minority.

To a considerable extent, committees and the inside groups similar to those employed in equity reorganization continued under 77B to propose and influence reorganization plans and to secure assents thereto. Although the court was required to consider the fairness of the plan on its own account, yet the courts usually gave assent to the plans by the mere fact that the requisite percentage of creditors and stockholders had already approved the plan. Under 77B, as in equity reorganization,"from the courts' point of view, acceptance was presumptive evidence that the plan was fair."¹ It is readily apparent, that with the continuance of committees and inside groups such a conclusion would be incorrect. The following views expressed by the members of the Editorial Board, Yale Law Journal, clarifies the issue under consideration:

... the 77B courts are seldom in a position to form an intelligent judgement on a reorganization plan for they are infrequently equipped with the necessary grasp of the financial conditions, potential assets, and business prospects of the enterprise and the past conduct.... The statute has not provided an independent fact finding agency,... and friendly trustees are frequently appointed and the judge has been altogether dependent upon the statements of the interested parties.

Although the courts authorized the debtor or the trustees to prepare

¹Buchanan, op. cit., p. 425.
security holders' lists for inspection by any creditor or stockholder,... but court's lack of broader jurisdiction over lists left practically unimpaired the advantages possessed by insiders, and this was particularly inadequate to stimulate the presentation of plans by 'independents.'

Although 77B attempted to protect the investors' interest by subjecting protective committees to judicial supervision ... the vital functions of preparing plans and enlightening security holders to their content remained within the control of protective committees. Courts usually did not inspect committee personnel,... equity reorganization type management-banker chosen committees were still functioning,... the abuses under the committee system and deposit agreement were largely untouched. Committees still endeavored to gather up the security holders' votes in advance and reorganization was pretty much still carried by the inside dominating interests.

From these observations, it may be concluded that in "making the democracy" work, neither care was taken that the majority of security holders were properly informed, not were previous conditions repaired to promote their bona-fide representation. In brief, vested interests still ran the show for themselves in regard to the reorganization proceedings and the formulation of the plans.

Evaluation of Section 77B.—The repercussion of the economic dislocation of the early thirties did not impinge solely upon industrial enterprises; it also affected and seriously upset the financial stability of the entire nation. With prices of finished products collapsing and a formerly active market rapidly vanishing, earnings dropped down heavily, and numerous enterprises became insolvent. In meeting this situation for the rehabilitation of insolvent corporations, the equity reorganization procedure proved completely inadequate and its dangers and shortcomings were further exposed.

Experience had shown that drastic liquidation destroyed economic balance by dumping on an already crowded market bankrupt stocks at

sacrifice prices, and there was hope that prompt and liberal treatment of
developer corporations would eliminate this problem. Relief was expected to
increase the volume of business and diminish the amount of unemployment.
Recognizing the need for debtor relief, Congress passed enabling legis-
lation in the form of amendments to the Bankruptcy Act as the best means
for serving the social and economic needs of the country.

Section 77B did away with the myth of judicial sale and compelled
dissenters to accept new securities in lieu of the old cash alternative.
Ancillary receiverships were abolished. The debtor himself could be
appointed as trustee during reorganization. Section 77B reduced
the reorganization costs. These measures helped debtor rehabilitation.
"Thus, undoubtedly, the most pressing problem of corporate reorganization
during the depression, the problem which had kept reorganizers from moving,
was met and solved."

Possibly, Section 77B was least satisfactory in handling the problem
of fairness and the technique of independent review in the reorganization
proceedings. In regard to the protection of investors, the deficiencies
of the Statute were aggravated by its provision granting management to
remain in control of the corporate affairs during reorganization of the
corporation. No safeguards were provided to insure that the vital
function of formulating and negotiating the terms of plans of reorganiza-
tion will be adequately scrutinized and controlled by the court.
Individual security holders failed to receive adequate information
concerning plans of reorganization upon which to base proposals of their
own or upon which to determine whether to accept the proposals of others.

1 Edward H. Levi, "Corporate Reorganization and a Ministry of Justice,"
Investor participation in the proposal of plans was difficult. In considering the plans, the court was supplied with no expert and impartial assistance which in theory the law required. The public significance of large corporations was not fully realized with respect to corporate reorganization. In respect to "fair" and "equitable" plans of reorganization, the Act 77B was ambiguous and prescribed no criterion to be applied by the court in making this determination.¹

It is believed that 77B merely recognized and codified the procedure which had grown up for the appointment of receivers by courts of equity. The defects of equity reorganization had long been subject of comment. Section 77B was rushed through. Probably it received less careful attention than it might have received in less strenuous times. It is a fair guess that nothing would have been done to correct the weaknesses of the equity reorganization system had there not been a serious economic depression. Thus it was remarked:

... under fairly normal business conditions, equity reorganization procedure even though severely criticised might have developed a generally acceptable system of corporate reorganization for the United States.... But the great depression 1929 fell upon the country and the ensuing economic upheaval served to accentuate the cracks and strains in the somewhat jerry-built structure (of equity reorganization system) ...²


²Moore and Oglebay, op. cit., p. 49.
Another writer, in summing up the significance of Section 77B, said:

... the 77B, in a manner speaking, is the old equity receivership pressed upon a bankruptcy mold, with additions. It was intended
... to take care of a new need; to accomplish something which would
not be done in bankruptcy as the law stood, nor by an equity
receivership.1

Whatever the criticism levelled at Section 77B, the present writer
believes, and few deny, its superiority over the equity reorganization,
which was the only vehicle of corporate reorganization before the
enactment of 77B.

CHAPTER X OF THE CHANDLER ACT

Public Interest.— From the foregoing investigations it seems clear
that Section 77B obviated some of the pressing drawbacks of equity
reorganization procedure. However, the paramount abuses associated with
the domination of the insiders were not cured.

By the third decade of the present century, corporate activity in this
country had become very widely spread. The stocks and bonds of large
industrial corporations were owned by a multitude of small investors.
It was realized that a great number of these publicly owned or indebted
industrial corporations were undergoing reorganization (vide: Table 7,
page 79) and in consequence the great mass of people were directly
affected by what was done in these reorganizations, either by loss of
income from their investments, or by virtue of loss of employment.
As a result of the failure of Section 77B to adequately safeguard the
public interest involved in reorganizations, it was felt that the exist-
ing reorganization statute required amendment—not only to safeguard
public interest, but also to facilitate honest reorganization. Experience

1Friebolin, op. cit., p. 79.
pointed that abuses in reorganizations had been widespread and persistent, and they called for vigorous and aggressive action. The inadequacy of 77B provided sufficient raison d'être that mild and temporizing remedies would not afford investors the protection they need. William O. Douglas, Commissioner of the SEC, urged that additional machinery to aid and assist the courts was desirable and necessary, and therefore a fundamental revision and complete overhaul of the Statute (77B) was desirable. It was also suggested that present government supervision over fraudulent practices in the issuance and sale of securities should be extended to prevent similar practices in corporate reorganization. Strict and permanent supervision over reorganizations was recommended.

Enactment of Chapter X—A Complete Reorganization Statute.— The remedial legislation, introduced by Walter Chandler (a representative from Tennessee), was contained in H. R. Bill 8046, and was introduced in the 75th Congress, 1st session, July 1937. This Bill, popularly known as the Chandler Bill, was concerned with an extensive revision of the Bankruptcy legislation of this country as well as with the statutes concerning corporate reorganization. It was the result of many years of study by the

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3. The original Chandler Bill, H. R. 6439, was introduced in the House in the 75th Cong., 1st sess., June 1, 2, 3, 4, 5, 8, and 9. Hearings were held on the Bill before the Committee on Judiciary of the House after which the Bill was amended, reintroduced, and reported as H. R. 8046. Hearings were held on this Bill before a subcommittee of the Committee on
House Judiciary Subcommittee, by the National Bankruptcy Conference—which is an unofficial body and was made up of various groups interested in perfecting the Bankruptcy Act. Such groups were: The American Bar Association, National Association of Credit Men, American Bankers' Association, United States Chamber of Commerce, and the American Institute of Accountants. A complete spread of expert opinion was obtained from the courts and administrative officers, accountants, and economists. In developing the reorganization statutes of this bill, these groups were joined by the SEC in perfecting Section 77B for the corporate reorganization.¹

Congressman Chandler, who shared the views of Commissioner Douglas, stated that "77B could not be patched up, it must be completely rewritten."² After extensive hearings on the Chandler Bill and a careful inquiry of the provisions, the resulting legislation, known as the Chapter X of the Chandler Act³ was meant to reflect fully an understanding of the needs of practical situations as well as a recognition of public interest and the interest of investors.


³"Chapter X is an integral part of the whole Bankruptcy Act, as amended in 1938. Although the Chapter is a remedial provision, designed for the relief of corporate debtors by means of rehabilitation instead of liquidation, it is notwithstanding a proceeding in bankruptcy limited in its purpose, embodying a Congressional exercise of the bankruptcy power conferred by the Constitution, and administered under the jurisdiction of the regularly constituted courts of bankruptcy." Moore and Oglebay, op. cit., p. 225.
It must be stressed that Chapter X, which became effective in September 1933, was substantially a contribution of the SEC. As investigated in the preceding chapter, the SEC studied the reorganization practices as exemplified in the important cases, and sought to show how investors' interest was jeopardized and disregarded under the equity reorganization system. The SEC strongly recommended the investors' interest could be protected only if the reorganization proceedings were taken out of the hands of those who are closely affiliated with the corporation before its failure. The SEC insisted that "full disclosure" throughout the whole proceedings would be wholesome. The SEC took the position that reorganization of a failed corporation was not simply a matter of private concern; it had a public significance; therefore, a public officer should play an active role in the reorganization proceedings and an expert public body should be allowed to comment upon reorganization plans before they are adopted.1

The SEC's recommendations gave meaning to the evolutionary trend in the reorganization practices. Ideas similar to the ones as expressed by the SEC in its recommendations were crystallizing as far back as 1916 when an observation was made by Judge Charles M. Hough in the following manner:

... there is a good deal to be said in favor of a new scheme of law which would in some way confer upon an impartial and disinterested tribunal the entire supervision of corporate reorganization ... but no such system of legal procedure now exists and the proposals to accomplish such results were ineffectual....2

The abuses, exhaustively reported by the SEC, so impinged themselves upon the consciousness of those familiar with the activities of reorganization that with a few exception there was no violent opposition to the

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reforms recommended by the SEC. "... Critics generally recognized the existence of evils but, as in the past hoped for purification by incantation rather than by legislation."^1

The Principles of Chapter X Reorganization.—It was against this background that Chapter X of the revised Bankruptcy Act was born. Presently, corporate reorganization among large industrials, and utilities, is effected by a comprehensive procedure as prescribed in the Chapter X. The main procedure for the reorganization of large corporations consists of the following steps:

(1) Filing of the petition for reorganization
(2) Appointment of disinterested trustee(s)
(3) The SEC's "advisory" participation in reorganization proceedings
(4) The determination of a "fair" and "feasible" plan
(5) The acceptance, and the confirmation of the plan

A brief discussion of these points is as follows:


2"Certain reports and writings preceding the enactment of Chapter X were characterized as partaking of the qualities of Shakespeare, Sherlock Holmes and Billy Sunday!" Moore and Oglebay, op. cit., p. 83.

3Railroads have different mechanism for their reorganization than the one provided for industrials and public utilities. The former are reorganized under Section 77 of the Bankruptcy Act, as amended in 1938. As a result of the changes in the laws, there is now a difference in the reorganization procedure of railroads and that prescribed for industrials and utilities. There is no peculiarity of financial arrangement which warrants this distinction. It is more likely the result of areas of regulation and historical development than one of industry characteristics; in that the line of cleavage reflects primarily the respective authorities of the Interstate Commerce Commission and the Securities and Exchange Commission. Vide: Husband and Dockeray, op. cit., pp. 667, 692, 693.
(1) A voluntary petition for reorganization may be filed by a corporation stating that the corporation is insolvent or unable to pay its debts as they mature, and set forth the facts relating to the nature of the business of the corporation, liabilities, capital stock, the need for relief, and express the desire that a plan be effected (Section 130). On the other hand, an involuntary petition for reorganization may be filed by an indenture trustee or three or more creditors having claims amounting in the aggregate to $5,000 or more. When the creditors or indenture trustee file the petition, there is need to show that the corporation was adjudged bankrupt (either in the traditionally bankruptcy or the equity sense of the term) and that adequate relief can not be obtained under Chapter XI of the revised Bankruptcy Act.¹

Following the filing of the petition, adequate opportunity is provided, prior to the first date set for the hearings, to file answers by any interested party including creditors and stockholders of the failed corporation. This right to answer individually and effectively did not exist under the former system.

The judge approves the petition for reorganization only if he is satisfied that it has been filed in good faith. Chapter X undertakes to aid the judge on this point by specifying that a petition is not filed in good faith if: (1) the express purpose of filing the petition is the acquisition of claims; (2) there is knowledge that a plan of reorganization can not reasonably be effected; and (3) there is probability that the best interests of the claim holders would be better served by prior proceedings.²

¹Chapter XI of the Bankruptcy Act deals with corporations with only unsecured debt. Such corporations are generally small and therefore the dealings under Chapter XI are outside the scope of this study.

²Husband and Dockeray, op. cit., p. 675.
(2) Assuming the approval of the petition, the judge is required to appoint a disinterested trustee.\(^1\) Wherever the indebtedness of the debtor corporation is $250,000, or greater, the trustee becomes the agent of the court and is responsible to it. The court may direct the trustee to investigate and examine all the relevant facts with reference to the condition of the debtor. This usually includes an analysis of the financial state of affairs, the desirability of continuing the business, and examination for the purpose of uncovering acts of fraud, mismanagement, or other irregularities, and the like. (Section 167)

Under the revised system of corporate reorganization, the trustee assumes the responsibility for reorganization; the law gives him the sole authority to formulate, present, file and initiate reorganization.\(^2\) His role is that of executive management during the period of reorganization. All interested parties are invited to submit plans; the trustee gives due consideration to all plans, who then, in turn, formulates a plan and submits it to the court. It must be emphasized that under the former system, no one was specifically charged with the task of reorganization; and it was usually assumed voluntarily by inside interests. After the trustee has submitted a plan to the court, the latter sets a hearing on the plan and also on any

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\(^1\) The following are the criteria of a disinterested trustee: No creditor, stockholder, director, or attorney of the debtor may be appointed as the independent trustee. Underwriters, and the directors, officers, employees and attorneys of the debtor corporation are barred; and anyone, by reason of any other direct or indirect relationship to, connection or interest in, the debtor or any of its underwriters or having an interest materially adverse to the interest of any class of creditors, stockholders, is prohibited from serving. (Section 152)

\(^2\) Husband and Dockeray, op. cit., pp. 677-678.
objections, amendments, or substitute plans which may be proposed by the
developer or by any creditor or stockholder.

(3) As intended guardian of the rights of investors, Chapter X places
considerable responsibility on the SEC.

The court must ask the advice of the SEC in all cases where the debts
of the company in reorganization exceed $3,000,000; where the amount
is less, reference to the SEC by the court is optional.... Also, at
the time when the approved plan of reorganization is sent to the
interested parties, either the report of the SEC or a summary that
it prepares must be sent to all the creditors and stockholders who
are affected by the plan. 1

It is a usual practice that the SEC may recommend the form of reports and
summaries which the trustee prepares on the operations of the business.
The importance of the SEC's participation results from a need to obtain the
benefits of expert opinion in determining the adequacy of reorganization
plans which are submitted to it. By way of its facilities, the SEC is
clearly in a position to provide advice to the court through research and
financial analysis. It is quite likely that reference to the SEC would
give assurance of the independence and objectivity to corporate rehabili-
tation. The "advisory" capacity of the SEC intended to be of benefit to
both the court and the security holders.

(4) The ultimate objective of a reorganization under Chapter X is the
formulation, acceptance, and consummation of a "fair," "equitable" and
"feasible" plan of reorganization. 2 In other words, the criteria by which
the acceptability of plans of reorganizations are determined are by (1) the
fairness of the plans, and, (2) the feasibility of the plans.

1 Ibid., p. 678.

2 SEC, Sixth Annual Report for the Fiscal Year Ended June 30, 1940,
p. 64.
The feasibility of plans necessarily suggests the practicability of the plans which means whether or not the plan obviates the causes of past trouble and permits the recovery of sound operations in the future. Among other things, this calls for the appraisal of the quality of management and an examination of the physical (plan and equipment) and financial condition of the corporation. Actually, feasibility amounts to saying that a business that fails should avoid failing in the future. Sometimes the question of feasibility can be determined at the outset of reorganization proceedings; at other times the determination of feasibility may be reached only after careful analysis of the situation. Financially and economically speaking, the question of feasibility usually depends upon whether the underlying business structure is sound or not, and any weakness of feasibility may be remedied by changing the capital structure.

Probably the most difficult question about the plans of reorganizations is the determination as to what constitutes a "fair" plan. However, in the words of the SEC, to be fair, such plans must provide fully compensatory treatment for claims in the order of their legal and contractual priority, either in cash or securities or both, and ... the participation granted to junior claims must be based either upon the existence of an equity for them in the enterprise after the satisfaction of prior claims or upon a fresh contribution in money or money's worth necessary to the reorganization of the debtor.1

Essentially, fairness involves the manner in which the rights and priorities of the old security holders are treated, and the question of participation by the junior interests in relation to the existence of an equity or of a new contribution on their part.2

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1Ibid., p. 65.

2The problems raised by a determination of these conditions, and the theories of "relative Priorities" and "Absolute Priorities" will be fully developed and critically examined in Chapter VII of this study.
It may be observed that of these two tests of a plan of reorganization, the question of feasibility is relatively easier to determine by an objective examination of past operating performance and probable future earning capacity and the competitive position of the corporation within the industry. On the other hand, the question of fairness usually involves an approach to the problems created by conflicting interests.

(5) The court initially approves the plan after it is satisfied that the plan is fair and feasible, and is in keeping with the public interest. Then the plan is submitted to the creditors and stockholders, accompanied by the report of the SEC and the opinion of the court. Acceptance by the parties requires approval by two thirds of the amount of claims of creditors and if the debtor is not insolvent, approval by a majority of the stock.

If the debtor is insolvent, the consent of the stockholder is not required. If the plan is accepted by the requisite amount of the security holders, the minority creditors and stockholders are bound by the plan.

After the "majority-acceptance," the judge holds a final hearing to consider any objections which may be made against the final confirmation. Ultimately,

the court renders a confirmation if satisfied that the plan is fair and equitable and that it has been made in good faith in keeping with the provisions of the act. With this conclusion, the plan becomes binding upon all parties concerned; and a final decree is entered 'discharging the debtor from all its debts and liabilities, closing the estate,' and making miscellaneous clearances.\(^1\)

The next chapter is concerned with a critical review of the reorganization proceedings as they have developed under Chapter X.

\(^1\) Husband and Dockeray, op. cit., p. 687.
CHAPTER VI
APPRAISAL OF CHAPTER X REORGANIZATION PROCEEDINGS

Independent Review.—Chapter X of the amended Bankruptcy Act, 1938, results from the determination of its fathers to bring about a shift of power in the process of reorganization. As indicated in the preceding chapter, Section 77B did introduce some important innovations in the reorganization procedure by enhancing the powers of the court, but the chief objections of the equity reorganization were carried over to the 77B reorganization procedure. The framers of the revised law became convinced that reorganizations continued to be dominated by self-seeking insiders whereby the true owners of the property were being betrayed. While the modified system has introduced drastic changes, the fundamental approach to the problem of reorganization has been preserved under the revised law. One of the major principles in the reform program was based on the belief that a qualified administrative agency was indispensable for the protection of interest holders and for the fairness and soundness of reorganization plans. The SEC's extensive investigations into the history of reorganization proceedings made it clear that reorganization was not exclusively a problem of law, that judges, trained to consider legal questions, were being called upon to decide business and financial problems, and the courts were being overwhelmed by non-legal, administrative problems.

Reorganizations involve problems of corporation finance and management, therefore, an inquiry into the causes of the financial collapse of the corporation is of paramount concern. A determination must be made how
rehabilitation can best be accomplished upon a basis economically sound. Formerly, the question of the economic soundness of plans of reorganization did not receive much consideration at the hands of the inside groups which generally dominated the reorganization proceedings. Chapter X recognizes that the formulation of a sound plan of reorganization is the single most important aspect in reorganization proceedings. Hence, it imposes positive duties upon the "disinterested" or "independent" trustee in connection with drafting of the plan, and it makes him the focal point of the reorganization proceedings. Not only does the trustee hold and conserve the property of the failed corporation—in accordance with the traditional duty of the receiver—but he cooperates with all interested parties concerning the progress of a plan of reorganization.

A reorganization should offer an opportunity for security holders not only to get an accounting for what the management did, but also to replace it where it has not measured up. This calls for an analysis of the failed corporation, and the assembling and study of the facts so discovered. The availability of such information would make it possible for the court and investors to decide intelligently whether the old management should be restored to power and whether assets were being wasted or overlooked. Under the former system, an inquiry into the past affairs of the failed corporation was often not feasible.

The revised system specifically empowers the trustee to make a searching inquiry into the all relevant affairs of the failed corporation. The trustee can also bring legal action against the former management for the benefit of claim holders against the debtor corporation. The revised procedure encourages maximum individual participation on the part of the security holders; the holder of one share of stock may propose a plan or suggest anything
which he considers important in the formulation of the plan, and the same is true of the holder of a claim for $1 (Section 169). The response of security holders to voice their views in regard to a plan would depend upon the clarity with which trustee in his report has explained the problems of reorganization and the manner and the extent to which he has indicated an approach to their solution.

It must be mentioned that a trustee, by virtue of his qualification of knowing nothing about the business may be somewhat at a loss to meet the problems involved. It is true that the trustee must be not only competent and legally responsible for the debtor corporation, but also qualified to perform the other important duties of advising and reporting on plans of reorganization. In this matter, cooperation between the trustee and the former management is essential (1) in ascertaining the causes of failure and in remedying difficulties, and (2) in securing the services of any one connected with the enterprise, so that the operation of the business may not suffer for lack of comprehensive knowledge on the part of the trustee.

The flexibility of the Statute is demonstrated here, as the trustee is empowered to retain the services of any of the officers of the debtor (Section 191), and an officer, director, or employee of the debtor may be appointed as a co-trustee for the purpose of aiding in the operation of the business (Section 156). Hence, in some cases this may be desirable, by virtue of peculiar knowledge or abilities indispensable to the operation of the corporation possessed by such officers, directors, or employees. Thus, "the management of the embarrassed business may be entrusted to two trustees—one qualified by not knowing anything about the business but charged with the duty of investigating and prosecuting a management of
which the second trustee was a part."

Probably the only justifiable reason for requiring the appointment of an independent trustee is that the management is either incompetent or dishonest; on the other hand, corporations often meet with disaster because of a variety of reasons beyond the control of management. Moreover, it is quite possible that the management may tend to be secretive and uncooperative instead of open and helpful. Such obstruction may delay reorganization process resulting in the loss of business, which in the final analysis would mean a loss to the creditors and stockholders.

It must be emphasized that experience has shown that some independent agency is essential to deter the tendency of inside groups from dominating reorganization proceedings. If a disinterested trustee is not appointed, the problem of investigation looms larger. In the absence of the disinterested trustee, it seems, the judge has no one to look for advice except persons representing the corporation, and it is quite difficult—in spite of great caution—in accepting advice from the management quarter for fear that those who might be appointed as trustee(s) be only "ostensibly and not actually independent of the management." Broadly speaking, the important question is not whether it would be advantageous to the investors in the particular enterprise if the management is left in control (during reorganization). It is whether the interest of the whole body of American investors are not best served and safeguarded by a rule which would compel those corporation officers and directors who are inclined to ignore their fiduciary obligations to face the certainty that if reorganization becomes imperative of their managerial delinquencies will inevitably result.... In the long run the policy of requiring such an investigation (by the trustee) has proved sounder than one which enables the management to bring financially embarrassed corporations into court with relatively little personal risk. 2

1Dewing, (1953), op. cit., p. 1296.

Hence, the appointment of a disinterested trustee seems advisable. As the practice has developed since the passage of the new law, not only does the trustee conduct his own investigations into the affairs of the debtor, in most cases, he is closely assisted by the SEC in many ways.

After SEC's preliminary investigation of the debtor corporation is complete, the assembled information and statistics are carefully considered and a comprehensive initial analysis of the legal and financial problems involved is prepared and distributed to the members of the legal and financial staff. This analysis forms the basis of SEC activities in the proceedings.... The SEC and the trustee work hand in hand with respect to investigation ... mutual cooperation and periodic consultation.1

By and large, the method of appointing an independent trustee has proved fairer to all parties concerned. Some evidence of this appears in the records of House Hearings on the Chandler Bill. In a letter supporting the appointment of disinterested trustee, a federal referee stated that in 77B proceedings twice as many plans had been adopted in cases wherein trustee had been appointed as in those wherein debtor had been allowed to remain in possession, and that the plans adopted in trustee reorganizations seemed fairer and more meritorious.2

The SEC has continued to scrutinize the qualifications of the trustee in light of the standards prescribed by the Statute. Since the trustee has to analyze financial and managerial problems, his thoroughness and skill are essential for the performance of this task. In spite of the strict qualifications, cases have occurred under the revised procedure where the conduct and objectionable affiliations of the trustees with the old management called for the removal from the position.3


The trustee, with the assistance of the SEC, undertakes an independent review of the whole situation concerning the failed corporation. Now, there is ordered separation between those directing the reorganization and the old management. The chief purpose of this separation is to preserve the independence of rehabilitation, and one writer has observed that "the most important single change ... in the process of corporate reorganization under the Bankruptcy Act is to divorce the whole procedure from the management of the corporation."¹

The twenty years' experience with the trustees of Chapter X reorganizations has been well expressed in the following manner:

An ideal Chapter X trustee should be possessed of great wisdom, boundless energy, extraordinary executive ability, and an unusual faculty for reconciling adverse interests. He should have at least thirty years legal experience, twenty years business experience, ten years as a CPA, five years with the FBI, and ten years as industrial engineer, with a good background as an efficiency expert. ... If it should be doubtful that one man can be possessed of so many good qualities, ... still it must be admitted that Chapter X has served our economy well, and that many communities, industries, jobs and homes have been saved thereby. And those who have served as trustees must have had a great many of those qualities, else Chapter X could not have worked nearly so well.²

Protective Committees.—In equity reorganization, the kind of representation that security holders got through their committees determined the kind of plan they had to take. That is why the reforms of reorganizations had to begin with the reform of the committees.³

Under the revised system, the committees have been deprived of


unrestricted control of the emoluments of reorganization and they have been subjected to stricter supervision. However, the significance of the role of protective committees under the revised procedure is just as essential as it was under the proceedings prior to the passage of reorganization acts, when the committees independently negotiated among themselves and worked out a plan of reorganization. Under the equity reorganization system, often, the committees were formed for the express purpose of gaining an interest in the forthcoming reorganization business, or in order to exact high compensation for their services.

It is important to note that under the revised system the wholesome position of the trustee, and the active participation by the SEC, have helped to limit the significance of the protective committees to their original purpose—which is to "protect" the interest of security holders. The protective committees have been given official status under the new law. An authorized committee seeks to mobilize and organize the interests of investors so that it may have standing before the court as well as in bargaining with the other committees and in negotiations before the SEC. Now that the protective committees are aware that a reorganization plan will go directly to the security holders themselves for their approval, the committees realize that their real worth in attracting security holders lies in their (committees') abilities to perform astute bargaining with all other parties concerned. Consequently, the members of the committees desire to justify the value of their efforts to a group of security holders by the obvious merit of what they can accomplish. Also, care is exercised in the authorization of committees to represent stockholders and bond issues.
widely held by public investors.¹

As before, the committees make use of the deposit agreement to enlist
the support of security holders. It may be well to recall that under equity
reorganization a deposit agreement endowed virtually ownership powers to the
committees; whereas now, the terms of the deposit agreement have come under
a careful and explicit supervision of the court having jurisdiction over the
entire reorganization.²

The SEC has prescribed rules regulating the solicitation and the proxy
statement which is submitted to the security holders by the committees.
The SEC has endeavored to enforce the observance of requirements concerning
the full disclosure of the deposit agreement, the names of the persons who
instigated the committee, the information concerning their appointment,
affiliations, securities transactions, and the securities represented by
the committees and the like. Consequently, the committees have displayed
higher standard of conduct in their negotiations in regard to plans of
reorganization. Furthermore, the SEC has constantly alerted committees to
insist upon the honesty of their relationship to the debtor corporation
and to investors. "Protective committees stand in a fiduciary relation-
ship to the depositors whom they ostensibly represent."³ The SEC is con-
cerned with the qualifications of indenture trustee, attorneys, and other
representatives of security holders, and it has always sought to dis-
qualify committees whose members were in conflicting positions during the
proceedings.

¹Dewing, (1953), op. cit., p. 1274.

²Vide: Sections 212 and 176, Chapter X for an explanation on the
restriction of the use of deposit agreements and unauthorized solicitation.

³SEC, Report on the Study and Investigation, etc., op. cit., Part II,
p. 2.
In the Automatic Washer Company reorganization, the SEC moved to disqualify a committee attempting to represent stockholders, because the committee members were almost wholly from insiders of the debtor who had been charged by the trustee with mismanagement. In the same reorganization case, the SEC also observed:

... Trading in the debtor’s bonds by a committee member was a basis for disqualification ...

Normally an old director could not organize a bondholders’ committee, because members of this committee will not effectively be able to review the conduct of the previous management.2

Often, the SEC scrutinizes the material mailed out the security holders by other security holders or representatives who contemplate to form a committee and where such material appears to be misleading the SEC undertakes to obtain curative and preventive relief.3

It was emphasized in Chapter IV that under equity reorganization the control of security holders by the inside group was facilitated by the latter’s access to the lists of the security holders’ names and addresses. Hence, other independent groups wishing to organize protective committees were seriously handicapped because their access to such lists was not easy. It is said that among the important protective provisions adopted in the interest of public security holders as part of the Chapter X reorganization legislation are those which facilitate free communication among security holders who desire to organize in order to take action in their own interest and to exchange ideas. "To prevent the abuses of equity

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2 Ibid., p. 138.

3 Ibid., In re Star Dust Company, Inc., No. 955, September, 1957.
reorganization, Chapter X requires that the trustee file lists of security holders with the court and make available to all bona-fide security holders.\(^1\) Hence, it is now feasible for security holders to participate in the reorganization to the extent that at least there is no more any procedural barrier.

The experience of twenty years of Chapter X reorganizations indicates a forward step in the evolution of reorganization practices in this country. The despotic influence of those who in the past were the dominating factors in a reorganization has been broken down. The new procedure has induced other potential representatives of security holders, such as institutional investors, to undertake the work of representation. Such groups, under equity reorganization, were deterred by the great odds or by unwillingness to offend more powerful groups represented or controlled by the insiders.

Fear was expressed\(^2\) that with the new legislation investment bankers might lose their sense of moral obligation and so creditors and stockholders would be lost to the services which the bankers are often best qualified to render. Under the revised system, the bankers still play an important role in the formation of protective committees and have a voice in the negotiation process. The traditional sponsors of the committees—the management-banker groups—have not been eliminated. Yet, in their role in effectuating a reorganization, the trustee is expected to supply the motive power and to determine the direction of proceedings. Consequently, the management-banker groups are able to participate on substantially equal terms with all other parties. Stimulus is not lacking; many


\(^2\)Vide: Dodd, "The SEC's Reform Program for Bankruptcy Reorganization," op. cit., p. 252.
management-banker sponsored committees are motivated by a sincere sense of responsibility to investors or by a desire to retain their good-will. Under the independent review of the debtor corporation by the trustee and the SEC, the common investor—who was usually left at the mercy of the inside groups—enjoys a new status under the revised system.

The SEC, Compensation and Fees.—Chapter X provides judicial supervision over the compensating and granting of fees and allowances to various committee members, counsel, attorneys, under-writers and the like. Compensation or allowance is granted only if the contribution has been worthwhile and/or constructive. Hence, those elements who wish to impose their nuisance value, or who used to make money under the former system of reorganization, have been diminished by the inability of all to be compensated. The SEC in its advisory capacity endeavors to protect the estate from exhorbitant and inequitable charges for fees and expenses while at the same time providing a fair treatment to applicants which will adequately compensate them for their services rendered. This does not mean that the difficulties in regard to granting allowance are no longer encountered, for every reorganization presents a difficult problem in this matter.

There is no definite measure of setting up an amount of compensation. Each applicant's case is examined individually. However, usually the court allows compensation on the basis of (1) what was produced? and, (2) how much work was involved? If the court determines that little constructive has been achieved, no matter how much work was involved, the court may be conservative in granting allowance; if the reverse is true, the court may grant a higher compensation. At any rate, the applicants' original demands are usually higher than what they subsequently get.1

On the question of compensation, the SEC's advisory reports have played

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1Interview with J. Ellis Monday, (Referee in Bankruptcy, Federal Court, Atlanta, Georgia, April 8, 1959).
a significant part. They have guided the courts judiciously in many instances. Sometimes specific recommendations are also made by the SEC. For example, in the reorganization of Child's Company, claimants had requested aggregating $1,400,000, the SEC recommended approximately $750,000, and the court awarded a total of approximately $950,000.

In another case, the court followed the SEC's recommendation and denied application for compensation to a potential under-writer of an unsuccessful plan of reorganization, (as his interest was solely to obtain the profits from underwriting a plan of reorganization), there was no basis for a finding that any of the services rendered contributed to a plan approved by the judge. As for general allowances (in regard to the same case), the SEC recommended approximately $1,818,000. The court found that the reorganized company could afford $250,000 greater than recommended by the SEC. In making the awards, the court substantially increased the allowances recommended to certain applicants, reduced somewhat certain of the recommendations and left the balance unchanged. In commenting upon the role of the SEC in the allowance proceeding and in the proceeding generally, the court stated:

Though I have been forced to differ from the recommendations of the SEC in many of the instances, I wish to pay tribute to the careful and helpful analysis that the SEC made of the claims. Indeed, I take this opportunity to express my gratitude for the active and intimate participation of the SEC and its counsel in the reorganization proceedings. If any proof were needed of the wisdom of Congress in reorganization proceedings, it has been furnished in this case. I would have felt helpless without the aid given, unstintingly by counsel for the SEC.


3Quoted in ibid.
The SEC has opposed the granting of fees to applicants in various cases where as fiduciaries they occupied conflicting positions. For instance, in regard to the case of Berner v. Equitable Office Building Corporation, the SEC objected to any allowance to an attorney for stockholders on the grounds that he had disclosed private information regarding the proceedings to his brother-in-law on the basis of which his brother-in-law had purchased stock of the debtor corporation. The SEC also pointed out that the attorney had proposed a plan of reorganization under which his mother-in-law would participate in and profit from the financing of a new common stock issue. Finally, the Court of Appeals indicated that "the attorney had a personal interest as distinguished from a financial interest ... and it was within the discretion of the court as to how much the fee earned by the attorney should be reduced because of this breach."2

It is noteworthy that reasonable compensation and expenses are allowed to all parties, except the SEC with respect to services in the administration of the estate, or in connection with a plan approved by the judge, whether or not the plan is accepted by the creditors and stockholders or is finally confirmed (Section 212). This may have a tendency to increase the reorganization expenses; however, it seems advisable that the value of the constructive ideas—whether they are in support of or in opposition to favored plans, and whether advanced by groups or individuals—should be well recognized and duly paid. Hence,

... despite the increased expense which results from compensating the representatives of minority as well as majority groups, it may be observed that the right of objections to a plan sponsored by a


2Ibid.
majority before the court may be so great, that a statutory require-
ment awarding more liberal compensation to those who attack majority
plan and successfully induce modification or abandonment of them
is clearly in the public interest.¹

The SEC's Advisory Participation. At the time when Chapter X was being
enacted, one chief criticism against the proposed reorganization system was
directed to the participation of the SEC in reorganization proceedings.
Critics held, that the SEC, in its participation, would be formal,
doctrinaire and theoretical.

Chapter X for the first time injects Securities and Exchange Commission
into the proceedings of the judicial branch of the Government, basing
its new powers upon the bankruptcy clause in the Constitution. The
part which the Securities and Exchange Commission plays in these pro-
ceedings is certainly a new concept in our legal system....
In administrative functions Government bureaus have usurped powers
unknown to sound democratic government. The proper course is to
devitalize some of these bureaus, rather than to bestow upon them
greater powers and increased authority.... The study of plans by
the Securities and Exchange Commission will inevitably delay the
confirmation of a plan which will result in prolonged litigation
and consequent diminution of assets of the debtor corporation.²

Within two years of operations under Chapter X, the fears thus expres-
ased were not materialized. The SEC's experience with the reorganization of
corporations goes back to 1935 when the Public Utility Holding Company Act
was passed. Hence, the SEC had already had some experience before under-
taking Chapter X reorganizations from 1938.³

With the help of its specialized staff, the SEC is able to familiarize
it-self with the debtor's affairs soon after the appointment of the trustee.
With the cooperation of the trustee, the SEC's orientation of the various

¹Dodd, "The SEC's Reform Program for Bankruptcy Reorganization," op. cit.,
pp. 242-243.


³Panuch, op. cit., p. 22.
problems involved is simplified. The SEC usually renders its advisory report on the plan at a later stage in the proceedings. Hence, there is no fear of any party in interest coming under the "influence" of the SEC to the extent that such a party may voice its personal views with complete independence. The SEC does not spend much time on the administrative aspects of its functions; red tapeism is minimum. Thus in 1942 the SEC said:

... Four years of experience by the SEC have permitted greater concentration of the SEC's energies upon substantive matters. There now exists a substantial number of precedents on nearly all important procedural and interpretative questions.\(^1\)

The SEC's status is no better than any other party in the interest, and like any other litigant, it is subject to the control of the court. The reports of the SEC are only "advisory" and courts can and have disregarded them in several cases. In many cases the arguments and opinions expressed by the SEC in hearings upon proposed plans probably obviate the need for formal advisory reports. As a general method,

the SEC has sought to participate actively principally in those proceedings in which a substantial public interest is involved. However, this is not the only criterion, and in some cases involving only limited public interest, the SEC has participated because an unfair plan was or about to be proposed, the security holders were not adequately represented, the proceedings violated some provisions of Chapter X, other facts indicated that the SEC could perform a useful service, or the judge requested the SEC to participate.\(^2\)

Hence, the overall "advisory influence" of the SEC permeates through almost every Chapter X reorganization whether the SEC actively participates or not. "Because of its Nation-wide activity and its experience in Chapter X cases the SEC is able to respond to requests for help in the interpretation and application of Chapter X when it does not participate as a party."\(^3\)

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\(^1\) SEC, Eight Annual Report for the Fiscal Year ended June 30, 1942, p. 27.


\(^3\) SEC, Sixteenth Annual Report for the Fiscal Year ended June 30, 1950, p. 115.
Some indication of the SEC's active participation in reorganization proceedings is provided in the varied data complied in Table 8, page 110.

**Democratization of Reorganization.**—The central theme of the reorganization proceedings under the revised system is to safeguard the interest of the investors and to bring rehabilitation into the open thus affording participation by interested parties.

... The new system would not only afford a shield but a sword for bona-fide investors and their representatives. It makes great progress ... and it is believed that its adoption would provide for the first time in the reorganization history of this country the fundamental safeguards which are sorely needed.1

It has been investigated that under the former system the individual action by the security holders to protect themselves was in many cases out of question. They either lacked funds, or the skill, the acumen or the initiative to take matters into their own hands. Under the revised system, not only the court and the SEC seek to protect the interest of the security holders by imposing a high standard of conduct on the protective committees, attorneys, counsel, but the individual investor is free to file his answers, suggestions, and objections during the course of proceedings. The trustee, through the aid and advice of the SEC, is required to assemble all the salient facts about the debtor corporation. The information so collected is made available to the committees and the security holders as a routine matter. The courts are no longer too much at the mercy of the competence, vigilance, and integrity (or lack of them) of those who happen to be active in the proceedings. The shift in power from the inside group to the independent trustee is fundamental in the revised system which was re-constituted in the interest of investors. Now, during the

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<th>Total Liabilities Involved (000 Omitted)</th>
<th>Average Assets per Proceeding (000 Omitted)</th>
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*Data derived from the Annual Reports of the Securities and Exchange Commission for the Fiscal Years Ended June 30, 1939-1958.*
These proceedings in which the SEC took active part include the principal corporations as well as their subsidiaries.

Figures are approximate.


Estimates.
proceedings, investors are not kept in dark; they know "what the score is" in regard to the conditions surrounding the failed corporation, so that they may act accordingly.

Under the present system, it is not the practice to advance a definitive plan of reorganization in haste; whereas, under the former system it could be possible through manipulation by the inside group. Since the enactment of Chapter X, more or less, an orderly system has developed whereby considerable time elapses in the preliminary investigations and adjustment in which the main role is played by the trustee.

... A reorganization plan is published only after hearings have been held on the various proposals of all bona-fide interests. During the discussions since the hearing, the contents of the plan together with the recommendations of all the committees, the SEC, are published at all events. So far as possible it has become the practice to shorten the period of public hearings by means of reaching a preliminary agreement on the part of all the influential interests to support the tentative plan when it has been approved by the court. Hence, a plan is offered for acceptance to the security holders only after mature consideration by all the parties concerned....

Under the equity reorganization system, the plan had the requisite assentors before it was passed by the judge. Whereas now the judge approves first and the security holders afterwards, which is likely to remove any pressure judges formerly felt to approve a plan because the interested parties were seemingly satisfied.

Under the revised system, before the plan is submitted to the security holders for adoption, an expert yet independent body may offer comment and suggestions on the specific arrangements proposed. Hence, the likelihood of an intelligent vote for or against the plan individual security holders is clearly enhanced. Under this technique, the plan is one which has been developed under effective safeguards. When the security holders receive

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Dewing, (1953), op. cit., 1291-1292.
it they know that the judge has approved the plan and they also know the SEC's opinion of it.

However, it must be observed that the technicalities of reorganization procedure are usually confusing to the lay investor. The investor simply waits expectedly— at times, patiently; at other times impatiently. It is difficult to believe that the individual security holder has come forward to much greater extent, or even then, it is doubtful if anything more could be accomplished if he did. Usually a security holder is not interested in independent action unless his interest is considerable to impel him to take some action. Moreover, the legislation did not contemplate on holding "town-meetings" of the investors in a reorganization.

The significance of Chapter X in protecting investors during reorganization proceedings is to be construed in its democratic philosophy, its unrestricted articulation of different views, by which it keeps various parties adequately informed, and its means for materializing these goals.

In contrast, under the equity and the 77B reorganization systems, there was no effective mechanism to inhibit the ability of inside groups who capitalized on both courts' and investors' lack of information, and a common investor faced a well calculated coercion and frustration from the strategically situated groups.

Finally, to make the "democracy" work, Chapter X endorses the two-thirds principle of the "majority rule" for materializing the acceptance of a plan, if the judge believes that the plan is fair and feasible and is in keeping with the Statute and the trend of judicial opinion. Generally, as in a democracy, the investors may defeat the "plan" by

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1 The fact that a court has tentatively approved the plan does not affect the right of any interested party to object the confirmation of a plan (Chapter X Article VII).
inducing a sufficient numbers of voters (investors) to disapprove the plan so the "two-thirds and majority requirement" will not be met.

The next chapter is concerned first with the economics of corporate reorganization, and then with the analysis of the "fair" and "feasible" plans of reorganization.
CHAPTER VII

DEVELOPMENT OF "FAIR" AND "FEASIBLE" REORGANIZATION PLANS

Reorganization— A Mixture of Financial, Managerial and Economic Problems.— The earlier investigations and the discussion of the reorganization proceedings up to the preceding chapter of this study easily provoke an impression that probably the legal arrangement and the techniques involved are the ultimate objectives in a reorganization. However, these are only means to an end. One author, commenting on the economics of corporate reorganization, very pertinently remarked:

It is a commonplace that the reorganization of failed corporation is an economic process that is carried out in a legal forum. Economic considerations are fundamental and well-nigh controlling, the economists' discussions of reorganization have a tendency to become so involved in the details of legal procedure that the economic issues do not stand out clearly and distinctly.¹

It must be emphasized that the ultimate purpose of reorganization is to restore a failed corporation to a sound condition. This inevitably involves all the problems of corporate finance and management, such as an inquiry into the causes of the financial embarrassment of the corporation, and into its worth if reorganization instead of liquidation is determined upon, and how this can be best accomplished on a basis not only fair but economically sound. An attempt to solve these questions will further necessitate an inquiry into broader economic issues such as competitive conditions in the industry, its trend of demand, and its pricing policies, as well as an inquiry into more immediate questions such as the quality of

¹ Buchanan, op. cit., p. 365.
the debtor's management. In the final analysis, there will have to be
inquiry into earnings in the past and the estimation of future earnings,
and chiefly the latter will determine the soundness of the capitalization
and financial structure of the company undergoing reorganization. From
the economic point of view, these are the most important aspects of
reorganization. However, since they are not legal problems, they attracted
considerably less attention in the evolution of the reorganization practices.
The primary reasons for the neglect of these economic questions in the former
reorganization practices will become apparent in the subsequent analysis
contained in the following pages of this study.

In the reorganization of a corporation, it is only after these broader
economic issues are decided that attention could properly be given to
questions concerning the extent of participation which is to be allowed
the old security holders, and the problem of a fair and equitable plan
as understood in corporate reorganization. 1

The Economics of Corporate Reorganization.— When an enterprise fails,
one of the most important question is to decide whether to prescribe
winding up of the enterprise, by selling its assets, or whether it would
be advisable to invest new money into the failed enterprise with a view to
putting it back as a going concern. In other words, it is always necessary
to decide on liquidation or reorganization of the failed corporation.
Before recommending one or the other, it is desirable to make an estimation
of the value of the assets of the failed corporation in "liquidation" as
against their value in "reorganization." From strictly economic point of

1 "The term 'fair' and 'equitable' became a term of art used to indicate
that the plan of reorganization fulfilled the necessary standards of fair-
ness." SEC, Report on the Study and Investigation, etc., op. cit.,
view, if the value of the assets of the failed corporation "as they now stand" is more in liquidation than their value in reorganization, liquidation is the preferred course.

For the sake of elucidation and clarity, let the maximum value obtainable from liquidation be designated by the symbol L. This value of L is net after liquidation expenses. In determining the value in reorganization of the assets of the failed corporation it must be emphasized that the figure sought is the value in reorganization of the assets "as they now stand"; it is this amount which is to be represented by the symbol R and which must be compared with their (assets) liquidation value L. The value of R is also net after reorganization expenses.

It has been before indicated that new money must be somehow raised in order to carry out successfully a plan of reorganization. Suppose under given conditions, there is a certain optimum amount which it will pay to invest in reorganizing the failed corporation. Let this amount be represented by the symbol I. It may now be assumed that if the optimum amount of capital (I) is invested, the reorganized corporation as a whole will have a value on the basis of its prospective earning power. Let this "prospective" value be designated by the symbol V. It follows, that the value of the assets "as they now stand" (R) plus the commitment of new investment (I) is equal to the total value of the reorganized corporation (V). In other words, the value of R is derivative of V — which is the value of the corporation as reorganized only if new capital investment (I) is committed to it. The relationship of the symbols described above may be presented in the following manner:
$L = \text{Value of the assets 'in liquidation'}$

$R = \text{Value of the assets 'in reorganization'}$

$I = \text{Amount of 'new investment'}$

$R + I = V = \text{Value of the 'reorganized' corporation}$

Hence, $V - I = R = \text{Value in reorganization of the assets as they now stand}$

What opportunities exist for the profitable investment of new capital (I) in reorganization process will be conditioned by the factual situation surrounding each instance of failure. Sometimes further investment may be a waste of resources. At other times, it may that the marginal efficiency of capital investment (I) will be distinctly above the going rate of interest and under such circumstances, the corporation could be reorganized successfully. At any rate, in this analysis, reorganization is called for only on the belief that the value of $R$ is greater than the value of $L$. Else liquidation is the preferable treatment.

It must be warned at the outset that even though it is believed that the value of $R$ is greater than the value of $L$, this is based on anticipated returns on capital investment (I) rather than upon definite certainty. Furthermore, since the value of $R$ must be based upon estimates, it is not possible to demonstrate the absolute correctness of any single computation. Views will vary as to the value of $R$.

It is considered important to point out that the significance of the value of $R$ as against the value of $L$ and vice versa transcends the purely private interests of the various parties in the failed corporation. Upon purely economic grounds, if the value of $L$ is greater than $R$, the enterprise ought to be liquidated, or else the claim holders of the enterprise will suffer directly, and indirectly it will bear an "uneconomic" repercussion on the general public. Because, if capital resources and
other agents of production are retained in or directed to one use where, fundamentally, their productivity in another would be greater, this results in genuine, if statistically unmeasurable, reduction community's real wealth. However, on the other hand, it must be conceded that reorganization of large corporations which have failed is not primarily decided strictly on the basis of their economic justification. Usually large corporations have a public significance in that they provide goods and services to a considerable number of people, they may have a large number of employees, creditors, stockholders and the like. Liquidation is seldom applicable to large corporations mainly because of the desire to avoid the resulting economic dislocation. Furthermore, as indicated in Chapter III (vide: pages 21-22), the most valuable things in an established business are frequently its trade mark, its good-will, its trade connections, and above all its organization. These are intangibles; they would be destroyed if the business were disintegrated and its assets sold for their scrap value.

From the foregoing description it should not be concluded that the failed corporation should be reorganized per se. At times the nature of the assets of an enterprise may be such that they could be re-installed at a different place under different management without loss of their productive properties and with no considerable loss to the various parties in interest. Under these conditions liquidation is desirable. Hence, when a corporation fails, at least theoretically, the question of reorganization or liquidation has a considerable significance.

Besides the problem of finding the value of the assets in reorganization (R) of the failed corporation, there is another vexing problem of readjusting claims against the assets of the debtor corporation. Failure of a corporation is in it-self an index that the total face value of
security holders' claims against the assets is greater than the value of the assets (R) "as they now stand." Hence, all claims can not be paid in full. The total face amount of all claims, represented by the creditors' debt-securities and the stockholders' equity-securities, may be represented by the symbol T. In other words, to use the language of symbols as used here, if reorganization is contemplated, although the value of R is greater than the value of L, it (R) is less than the face value of the total claims (T) against the failed corporation. Usually, the total claims (T) consist of creditors' claims (let they be represented by the symbol C), and the stockholders' claims (let they be represented by the symbol S). Hence,

\[ T = (C + S) \]

as \( R \) is less than \( T \)
or \( (C + S) \) is greater than \( R \), therefore total claims (T) can not be paid in full from the value of the assets (R) when the corporation is contemplating reorganization.

The conflict among creditors and stockholders of a failed corporation may confuse the issue involved in the valuation of R and L. The basic reasons of this conflict arise from: (1) the natural tendency on the part of stockholders to insist that they "still" have an equity in the failed corporation (which means some portion of the value of R) which the creditors refuse to recognize, and (2) the inadequacy of a precise and universally acceptable method for determining the value of the assets (R) in reorganization.

The Heart of Reorganization—Valuation of the Assets.— Some basis must be found in order to resolve this conflict between the senior security holders and the junior security holders. If it were possible to accurately
find the value of the assets (R), and if all the parties in interest agree to the figure arrived at by such valuation, the conflict may be allayed. This may be illustrated by a hypothetical case: Suppose at the time of its failure, a corporation has $250,000 bonds outstanding, $250,000 debentures outstanding, and $500,000 common stock outstanding. In other words, the total claims (T) against the corporation are equal to $1,000,000. Assume further that it is decided to reorganize the corporation (because R is greater than L), and new capital (I) is committed to it. Suppose on the basis of prospective earnings the value of R is determined at $750,000. It is clear that T = $1,000,000 is greater than R = $750,000; hence some means must be employed to equate these two values, because the total amount available for distribution among the security holders (C + S) is no greater than R = $750,000. In other words, T will have to be reduced to R so that T = R. Since bondholders claims rank ahead of stockholders claims, logically therefore, in this case, the bondholders would be given new claims against the assets of the reorganized corporation to match with the face value of their old securities which is $500,000; and the stockholders equity will be reduced and they would receive new common stock with a par value of $250,000 so that the old claims (T = $1,000,000) may be reduced by $250,000 to equate the value of R = $750,000 = T (new claims) = $750,000. Thus, the corporation will emerge with a reorganized capitalization with the total face value of all new claims ($750,000) equal to the sum value of the corporation represented by the value of R ($750,000).

The paramount significance of this example is indicated in the determination of the value of assets (R) which in turn is dependent on the prospective earnings. It is only when a particular value is associated
with R that the question of reducing the claims of security holders becomes clear. In other words, the extent of participation by various classes of security holders can not be determined without finding the value of R. The valuation of the assets (R) is the most important and difficult problem in corporate reorganization.

The core of the problem of corporate reorganization is estimating future earnings. This perplexing problem can not be solved in any exact manner, for it involves certain unknown variables. Some of the unknowns are these: Will there be war or peace? Will there be severe or moderate inflation? Will the labor supply be adequate? What will be the nature of competition in the future?...

From the example given above, it is readily apparent that the junior security holders of the debtor corporation will argue for a higher estimate of future earnings, so that the value of R may be raised, and therefore under this assumption they may suffer very little or no loss. In contrast, a low estimate of future earnings will result in assigning a low value to R which would mean possible loss to the junior security holders. Whereas on the other hand, a very high estimate of future earnings would result in the issuance of watered stock and unsound financial structure, which, in effect, would mean that the senior security holders will suffer at the expense of junior security holders. Hence, future earning and valuation of the corporation are pivotal in reorganization.

The Nature of "Fair and Feasible" Plans under the Former System.—

Chapter X contains more concerning reorganization procedure than had ever been set down in the written law. Nevertheless, the chief mandate in the Statute was the old one, that reorganizations shall be 'fair,' 'equitable,' and 'feasible.' Therefore, the effectiveness of Chapter X depends upon how these old, old, words are interpreted....


2Taylor, op. cit., p. 647.
In order to appraise the fairness and feasibility of reorganization plans as they have developed under the revised system of corporate reorganization, it is essential to look into the criteria of fairness and feasibility of reorganization plans under the equity reorganization system. This involves an analysis of the evolution and culmination of the legal and economic theories as they have developed from the era of equity reorganization, 1860-1934, to the present modern reorganization system as ushered by the reorganization acts during the thirties.

In considering the salient features of equity reorganization with respect to fairness and feasibility of the reorganization plans, it must be emphasized that the reorganization plans were, for the most part, the products of reorganizers. They were frequently presented to the courts after a long period of negotiations in obtaining the necessary consents from the security holders. The courts did not attempt to force upon reorganizers the plans of courts' own devising; or rather, as investigated in the earlier chapters of this study, courts were then extremely reluctant to withhold approval of a plan or require its modification unless there were glaring instances of unfairness. By and large, the "insiders" held control of reorganizations in order to perpetuate their control in the reorganized corporation, or to participate in the emoluments of reorganization, or both. Naturally, then, the reorganizers weighted unduly the relevant considerations in favor of reorganization, because they reaped gains. The reorganizers tended to make irrelevant the underlying economic issue: the question of the valuation of assets (\( R \)) upon which depends the fairness and the economic and financial soundness of the reorganization plans.
No doubt the question of valuing assets in reorganization is a dif-
ficult one; it was rendered more so under equity reorganization. Because
of the absence of effective control over the system, the basis of valuation
was uncertain and the rules indistinct. Too often, the valuation was
determined by various so called "practical" considerations of little
relevance and merit. To suit their own designs, sometimes the reorganizers
did not want real valuation disclosed; at other times they had ample opportu-
nity to marshal data purporting to bolster high values. Moreover, even when
the reorganizers evaluated the assets of the failed corporation, the purpose
was usually to determine whether there was any equity left for the stock-
holders and not to test the extent or manner in which various classes were
allowed participation in the reorganization plans. Consequently, the
strict rights and priorities of the claim holders were disregarded for the
sake of expediency and other considerations most important to the
reorganizers. The resultant fairness and validity of such plans was based
on the theory that the majority may be trusted to protect its own interest
and thereby necessarily afford the same protection to the minority.

The concept of fairness under equity reorganization can probably be
best told by studying the mechanism of "upset-price" and "judicial-sale."
Theoretically, the upset price was set to "protect" the dissenting cre-
ditors. Whereas, as indicated in Chapter IV (vide: pages 54-56), in
actuality, it was tantamount to freezing out the interest of dissenters
because the upset price was typically fixed at a low figure. The courts
were not in a position to intelligently decide upon the fairness of the
upset price, because they did not possess facts. It was impracticable for
the judge to make an independent investigation; the safeguards were in many
cases more apparent than real; the judicial rules dealing with the fairness
of plans did no more than define the outer limits of tolerance.  

From the foregoing, it is understandable that as a result of the "non-interference" from the side of courts, the reorganizers enjoyed considerable liberty in formulating plans and in granting participation to the various classes of claim holders. It is here that the question of fairness and feasibility may be said to have arisen under equity reorganization with which reorganizers were concerned according to their standards. In the language of symbols as used here, the reorganizers were faced with the problem: What procedure should be employed so that the total claims (T) of the various classes of claim holders be reduced to just equate the fair value of the assets (R). In other words, how to apportion new securities among the old security holders. The manner in which this problem was approached and solved would necessarily explain the standard of fairness of equity reorganization plans.

It might appear that since all claim holders against the assets are not on an equal footing, and by law and agreement creditors' claims rank ahead of stockholders' claims, it would seem that after the evaluation of the assets (the figure arrived may be fictitious), it would be logical, in reducing total old claims (T) to the fair value of the assets (R) in reorganization, to grant new claims to the old creditors as far as possible to match fully with their old claims according to their legally

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2 If they were, then each claim could be merely reduced by the proportion $\frac{T - R}{T}$, hence, if $T = 2,000$, and $R = 1,500$, the claims of each class could be reduced by one fourth of their face value so that the total new claims would be equal to the value of $R = 1,500$. 
established rights and priorities; and to eliminate stockholders' claims if they are found to have no equity left in the assets of the corporation.

This scheme just outlined for the distribution of new claims to the creditors according to their legal and contractual priorities has come to be known as the theory of "Absolute Priorities." When a corporation has failed, it may be that the creditors' claims, principal and interest, are much higher than the value of the assets (R) in reorganization; and in this case, an application of the absolute theory will wipe out completely the interests of the junior security holders who will then not participate in the reorganization plan.

It must be emphasized that under the system of equity reorganization, the stockholders were invariably included in the plans and given participation in spite of the fact that they did not have an equity at the fair value (R) of the assets. Many reasons have been advanced for this (participation of stockholders): Usually, the value of the assets was set at a high figure; the courts feared that their finding of insolvency will seriously delay the consummation of reorganization, and were therefore reluctant to make such a finding. Hence, on the slightest sign of stockholders' having an equity, the justification of their participation was not questioned, and usually the courts acquiesced with the decision of the majority dissenters. Probably the most important reason was that the reorganizers preferred to afford stockholders' participation to secure new capital.

1Precisely it means, that in reducing T to R, commence with stockholders' claims in reverse order of their legal priorities and eliminate claims until T is reduced to R. If all the stockholders' claims are wiped out and T were still greater than R, then it would be necessary to follow the same procedure with the junior creditors' claims in order of their legal priorities until ultimately the diminished T = R. This scheme of scaling down claims made necessary because T is greater than R has come to be known as the theory of "Absolute Priorities."
by inducing them to retain their interest in the property. Consequently, the stockholders willingly furnished new capital on more favorable terms than could be obtained from strangers. Finally, the insiders wished to retain the confidence of old stockholders to perpetuate their own control. In view of these observations, it may be concluded that the stockholders were allowed participation for reasons of "practical necessity."1

It is very important to examine what would be the repercussion of such participation by stockholders on the rights and priorities of all classes of participants in the reorganization plan.

It has been stressed before that acquisition of new capital is indispensable in all reorganization. It has also been concluded earlier in this chapter that it is the input of new capital (I) which gives any meaning to the value of R, that is, the value of assets in reorganization. If the new investment is not forthcoming, the total amount available for distribution among all claim holders against the failed corporation is I, that is, the liquidation value of the enterprise, which by definition is less than R. New investors will be skeptical about investing in an enterprise that has once failed, and therefore may insist that they be given claims and priorities against the assets and earnings higher than the ones already in existence. Under equity reorganization, usually this was not possible. The receiver was not empowered to displace existing liens against the property. Hence, the only alternative open to reorganizers was

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to appeal to existing claim holders to provide the necessary investment (I). The stockholders were often found to be the best source for new capital for reasons just described above. Hence, they were asked to pay an "assessment" which, in effect, was the necessary investment = I. It is natural, that stockholders, if willing to advance the necessary new capital (I), would like to get new claims (securities) in the reorganized company which will have a greater value in the market than the amount of their "assessment" = I; for else they would apply their investment in an alternative enterprise of established earning power. Hence, stockholders were afforded new claims (let they be represented by the symbols $S_n$) against the reorganized corporation of an amount greater than their assessment = I. Let this amount be known as $x$. In following through, it means

$$I + x = S_n$$
$$\text{or } S_n - I = x$$

This indicates that the creditors would obtain from reorganization a value less than the value of the assets ($R$) in the reorganization. How less would depend upon the extent of stockholders' participation in the claims of the reorganized company. Briefly, creditors will suffer more if the value of $x$ is high, and vice versa. The following example should clearly illustrate the relationships just described:

Suppose a corporation has failed, and the value of $L = $8 million, and the value of $R = $15 million. It is estimated that the cash requirements of the plan of reorganization are $11 million = I$. The corporation has $10 million first bonds outstanding, and $5 million second bonds outstanding, and the common stock outstanding is $5 million. It is apparent that the stockholders do not have

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1 Hypothetical Case
an equity. If the first and second bondholders do not wish to reorganize the corporation, the value of the property is $8 million = L, which is insufficient to pay off even the first bonds. On the other hand, in order to recognize the value of $15 million, new investment I = $1 million must be committed. As per this example, the stockholders would agree to advance the necessary investment = I = $1 million on the condition that they must be given new securities with face value above $1 million.

The corporation is reorganized with a new capitalization, wherein old first bondholders get new bonds of $9 million, and the second bondholders get new bonds of $4 million. The common stockholders who paid an assessment (I) of $1 million receive new common stock with a par value of $2 million.

In this example the value of $ = $1 million because the old stockholders received a value ($2 million) which is greater than their investment of $1 million by $1 million. On the other hand, first and second bondholders obtained a value which is less than $15 million by $(2 million + 4 million - $15 million) = $2 million, but their relative rights and priorities over the earnings and assets of the reorganized corporation remained unchanged.

The above scheme of arrangement among the security holders was typical of equity reorganizations. It is important to point out that the scheme of distributing new claims as outlined above did not involve a denial of priority rights to the creditors. On the whole successive classes of securities were reconstructed in the reorganized corporation in the same order and with approximately the same relative claims on earnings.

This revision of the nature of priorities was based on the theory commonly known as the theory of "Relative Priorities," as against the theory of "Absolute Priorities" under which the same principle must be applied in the distribution of claims that is presumed to be applied in the event of cash sale and liquidation. The application of the relative theory—which was in vogue during equity reorganization—has been aptly described by John Gerdes in the following manner:

Interest in the reorganized company may be given to classes of creditors and stockholders who have no equity based on going concern values, 'provided that the old relative preference of all classes of creditors and stockholders as to claims on earnings and on dissolution are preserved.' This theory is known
as the 'Relative Priorities' theory.\(^1\)

Mr. Gerdes goes on to distinguish between the theories of "Relative Priorities" and "Absolute Priorities" and says:

This (the theory of 'Relative Priorities') is misleading, it does not adequately describe the theory. Both the relative and absolute theories call for a recognition of the relative priorities of the old classes of claims and interest in determining the value of their equities in the assets of the debtor. The absolute theory, however, limits participation under the plan to the values so found, while relative theory permits participation by classes who no longer have any equity.\(^2\)

The equity reorganizations usually followed the relative theory. However, the present writer wishes to express that this theory obviously grew out of "practice." The reorganizers, under those conditions, found themselves obliged to allow junior security holders to participate even though they did not have an equity, and this became commonplace in reorganizations and changed the nature of claim holders' participating rights and priorities—not fundamentally, but in their absolute applicability. This militated against the orthodox "creditors' principal first" rule which was rendered unsuitable to meet the exigencies of reorganizations.

According to one view, the test of fairness in reorganization plans is whether each class of security holders which retains any interest in the property retains approximately its relative position with respect to the other security holders. Mathematical exactness is not required; reasonable adjustments should be encouraged; every reorganization plan is of necessity represents a compromise. Such views were expressed by Robert T. Swaine,\(^3\) the chief exponent of the "Relative Priorities" theory.

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\(^1\) Gerdes, "General Principles of Plans of Corporate Reorganizations," op. cit., p. 56

\(^2\) Ibid.

Mr. Swaine emphasized that the applicability of this theory was pre-
eminently suited to reorganizations for they are primarily economic,
ot legal problems.\footnote{Ibid.}

Hence, the criterion of "fairness" under equity reorganization was that
fairness is achieved in reorganization plans provided the parties in inter-
est are left undisturbed in order of their priority of claims on earnings.
In other words, those having first claims on earnings before failure will
be given first claim on earnings in the reorganized corporation; similarly
with the second claims and so on down the line. In practical application,
this would usually mean that no group of claimants would be wiped out
entirely in a plan of reorganization, although the participation of some
classes or class of junior claimants may be of little or no value at all,
because the earnings of the reorganized corporation may not be enough to
yield them anything.

On the basis of the theory of "Absolute Priorities" it might be argued
that the equity in reorganization of an insolvent corporation ought to be
applied to the payment of the claims of senior security holders before
junior security holders should receive any thing. However, it may be
observed that in the example mentioned above (\textit{vide: pages 126-129}), if the
first bondholders proceed to liquidate their claims, there will be nothing
left for the second bondholders and the stockholders. Only a reorganiza-
tion scheme, whereby the old stockholders assist to reorganize the corpo-
ration, makes it possible for all classes of security holders to retain an
interest in the reorganized corporation.

But, Mr. Swaine warned the reorganizers against excessive participation
of the junior security holders:
While conceding that stockholders may be admitted to some interest in the new company, but the fair value of this participation, must not be in excess of the amount of stockholders' assessment....

Current stock exchange quotations are introduced in evidence to show how the new securities are selling on a 'when issued' basis, and when it appears, and as it did in the Missouri Pacific case,\(^1\) that junior bondholders and unsecured creditors are to receive preferred stock which is selling at 53, while common stockholders, upon payment of a net assessment of $17 per share, are to get stock selling at 30, it is argued that the difference—here $13 per share of common stock—represents 'a substantial equity' in the property which had been unlawfully diverted from the creditors for the benefit of the stockholders....\(^2\)

However, Mr. Swaine himself condemned this argument and maintained that...

... on this argument (that the property had been diverted from the creditors for the benefit of the stockholders) successful corporation reorganization is impossible; how to get new money? Who to assess but stockholders ... and have their participation essential, and if they were not made to participate—'this substantial equity' would disappear.\(^3\)

In 1913, the reorganizers experienced their first rebuff at the hands of the Boyd case\(^4\) which created a tremendous stir in the reorganization law and practice of this country for a very long period. What was this Boyd case? To recapitulate very briefly, Boyd, owner of a judgement for an unsecured claim brought a suit against the reorganized Northern Pacific Railway Company, on the grounds that the reorganization plan had made no provision for the unsecured creditors while it had permitted the old stockholders to retain an interest in the new company by the exchange of old shares for new shares. Boyd's contention was sustained and recovery made. The prevailing opinion of the Supreme Court held: "Any device,


\(^3\) Ibid.

\(^4\) Northern Pacific Railway Company v. Boyd, op. cit.
whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditors was invalid...."1 Was it a pronouncement of the absolute theory of creditors' rights? Probably so. However, it was not acknowledged so at that time. The Boyd case doctrine concerned the reorganizers to the extent that "whether or not some creditor was defrauded of his rights by a reorganization plan which gave to the stockholder that which should have been given to the creditor." 2 In practice, it meant that if nothing remained to give to stockholders, the junior creditors' non-participation could be justified. Hence, according to the Boyd case doctrine, it was required of reorganizers that some recognition must be given to all classes senior to the stock (lowest in hierarchy) if the latter were included in the plan. The interpretation of the Boyd case doctrine was not construed to mean that full recognition in the form of new securities must be apportioned to all senior classes, as necessarily this would mean that the assets of the average insolvent corporation would in all probability be exhausted in satisfying the rights of first or at the most second mortgagees. Mr. Swaine, after careful examination of the Boyd case concluded that

... its only significance is that equity courts have insisted upon a little more enlightened conception of fairness. They have received a little more consideration with reference to fairness in all later reorganization plans than was customary earlier. Stated abstractedly, the decision was that a plan of reorganization

1 Ibid., p. 508.

2 Dewing, (1953), op. cit., p. 1302; Also vide: Railway Company v. Howard, 7 Wall. 392 (1868), and Louisville Trust Company v. Louisville, New Albany and Chicago Railroad, 174 U.S. 674 (1899) known as the Monon case. These two cases are considered to be the forerunners of the Boyd case tradition. Vide: SEC, Report on the Study and Investigation, etc., op. cit., Part VIII, pp. 58ff; Dewing, (1953), op. cit.
which admits stockholders of a company to an interest in the
reorganized company, even upon the payment of cash, is constructively
fraudulent as against creditors if it does not make to them a fair
offer of an interest in the reorganized company and that in such a
case creditors may follow the property of their debtor into the hands
of the reorganized company, at least to the value of the interest
therein retained by stockholders....

Another writer believes that in essence, the Boyd case doctrine merely
announced a principle of fraudulent conveyance and did not directly deal
with the fairness of a plan of reorganization, and he further substantiates
this view on the basis of an opinion voiced by the Supreme Court:

If a creditor declines a 'fair offer' he is left to protect him-self
as any other creditor of a judgement debtor, and having refused to
come into a just reorganization, could not thereafter be heard in
a court of equity....

However, the court did not define what constituted a "fair offer." Hence,
the application of the Boyd case doctrine was made flexible in most of the
cases is indicated in Kansas City Terminal Railway Company v. Central
Union Trust Company case when the Supreme Court said on the question of
fairness and indicated clearly as follows:

... at least in theory, the Court would insist on fullest possible
priority for creditors over stockholders; however, 'additional funds
will be essential to the success of the undertaking, and it may be
impossible to obtain them unless stockholders are permitted to
contribute and retain an interest sufficient to move them....
No offer is fair which does not recognize the prior rights of
creditors. The fairness of plan, in the final analysis, depends
on the extent to which the position of the parties interested in
the old corporation must be preserved in the new company.

1 Swaine, "Reorganization of Corporation: Certain Developments of the
2 John A. Gilchrist, "Fair and Equitable Plan of Reorganization: A Clearer
3 271 U. S. 445 (1926)
4 Ibid., p. 446.
From the foregoing, it appears that the Supreme Court itself was conscious of the situation that a strict adherence to the theory of "Absolute Priorities" was not possible for reasons of practical necessity and expediency.¹

On the basis of the foregoing analysis of the impact of Boyd case on equity reorganizations, the present writer wishes to point out, that for the most part, there were no reliable rules in regard to the requirements of a fair plan of reorganization. Probably the only "directive" which the reorganizers regarded was that if stockholders were given participation all classes senior to them must also be allowed participation. Actually, the Boyd case "directive" began to be used by the reorganizers as a weapon to bring all claimants in line. (Vide: page 56) Because the reorganizers "used" the issue of stockholders' participation to exact concessions all the way up and down the classes of security holders. Hence, participation to all classes of security holders was generally allowed on a basis conforming with the application of the theory of "Relative Priorities" as described earlier in this chapter. The SEC carefully winds up the question of fairness under equity reorganization in the following manner:

The cases reveal little or no determination of value on which any informed conclusion could be based as to sufficiency of the offers, first to the senior creditor classes, and then to junior classes,... Instead, the cases reveal that the reorganization plans roughly followed the relative priority doctrine under which 'the successive classes of security holders are reconstructed in the new enterprise in the same order and with approximately same relative claims on income...!'¹

... the tendencies in equity reorganization were away from the orthodox mortgage and contract law, and there is no unifying thread that can be seen concerned with the fairness of the plans, ... all that is clear from the studies made of cases in which the courts passed on the fairness of plans in equity reorganizations, is that there existed an enormous area of play in which reorganizers were able to exercise their own discretion in fixing the terms of reorganization plans.

Under Section 771 reorganizations, 1934-1935, the Statute necessitated a finding by the judge, before confirmation, that the plan of reorganization be fair and feasible. However, as examined in Chapter V (vide: pages 82-83), the words were not defined in the Statute. It was to be expected that their meaning would be derived from the background of equity reorganization practice. Hence, the question of fairness and feasibility remained in status quo until the enactment of Chapter X in 1938.

It may be observed that application of the theory of "Relative Priorities" during equity reorganization was chiefly justified on the grounds that it facilitated the acquisition of new capital and hence reorganization. But, in view of the strict legal and contractual rights and priorities of the senior security holders, the application of the relative theory often eliminated a portion of their total claims and benefited stockholders inspite of the latter's paying an assessment. Hence, at times, the senior security holders did suffer considerable losses.

With the passage of Section 77B in 1934 the reorganizers no longer had to depend on the stockholders for new money because the problem of paying off dissenters was solved. Secondly, the Statute made it possible for the reorganizers to raise new money from other sources (vide: page 76).

1SEC, Report on the Study and Investigation, etc., ibid., pp. 56-57.

2Because whenever stockholders' extent of participation was considerably higher, the value of \( x \) became high resulting in more loss to the creditors. Vide: pages 128-129.
Hence, the chief justification for the participation of stockholders (if there was no equity) was rendered worthless. However, the domination of "insiders" over the formulation of reorganization plans was not mitigated under 77B, and the courts were still away from the facts about the debtor corporation. Consequently, the plans of reorganization continued to be developed in the same fashion as before with stockholders participating in them as under equity reorganization. It was argued that in the interest of fair plans of reorganization proper valuation of the debtor corporation should be the determining factor for the participation of security holders. In other words, those who are found to have no equity left in the estate should not be allowed to retain an interest in the debtor corporation. Thus,

... the importance of having an expert impartial agency exercise its judgement on the issues of valuation is significant. The great number of variables involved in predicting future earnings might otherwise provide an avenue for the submission of exaggerated figures by the parties in the hope that the inexpert judges will adopt an attitude of compromise.\(^1\)

Before the enactment of Chapter X, John Gerdes warned the law makers by saying that

... the most important object of any reorganization vehicle is the effectuation of a fair plan of reorganization. Reorganization legislation may assure a sound and honest, economic and speedy administration of the debtor estate, it may be perfect in draftsmanship, but all advantages are of little avail, if it does not contain adequate restrictions against the perpetration of an 'unfair' plan of reorganization.\(^2\)

Hence, the need of investigating the debtor corporation's affair by the independent trustee, and the valuable assistance made available to him through the agency of the SEC in sifting facts, is quite apparent.

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\(^1\) "Distribution of Securities in Corporate Reorganization," Yale Law Journal, LI (November, 1941), pp. 93-94.

Moreover, the economic uncertainty of the depression period created a need to accelerate the search of uniform procedure and fixed concepts in the rehabilitation of debtor corporations. A new emphasis in corporate reorganization centered on the creation of enterprises soundly financed in light of the available economic data.

The Criterion of "Fairness and Feasibility" under the Revised System. — Since the passage of Chapter X in 1938, the principle of a "fair" and "feasible" plan of reorganization has received comprehensive treatment. The means of determining the fairness and feasibility of plans are provided under the revised system. The courts, who are supposed to be "unfamiliar" with the economic and financial questions regarding the failed corporation, are no longer at the mercy of "insiders." The trustee and the SEC render expert information which is utilized by the courts and which helps in determining the criterion of a fair and feasible plan of reorganization.

It has been argued that prior to the passage of Chapter X, the general principle of the reorganization plans was guided by the theory of "Relative Priorities." For all practical purposes, the ability to determine the provisions of reorganization plans resided in the inside group. The plans were ordinarily passed as fair and feasible in the absence of strict judicial supervision.

This complacent attitude of the reorganizers was rudely shocked by the Los Angeles Lumber Products reorganization case in the autumn of 1939.

A fundamental pronouncement by the United States Supreme Court, scored in substance, a new landmark in the history and law of corporate reorganization. It was a decision in regard to the fairness of a reorganization plan for a ship building company on the Pacific Coast. Briefly, the debtor corporation had total appraised value of assets at $330,000 at failure. The liabilities amounted to approximately $1,500,000. When the reorganization was instituted in 1938, bondholders of the company held claims against the company in the amount of approximately $3,800,000. The debtor corporation had outstanding 57,788 shares of Class A stock, and 5,112 shares of Class B stock. A plan of reorganization was proposed whereby the bondholders were to receive 64,1,375 shares of new preferred stock, and the Class A stockholders were to receive 186,625 shares of new common stock. The plan was assented to by approximately 92 per cent of the face amount of the bonds; and 99.75 per cent of the Class A stock. The petitioner, who owned $13,500 face amount of the bonds, objected to the plan not being fair and equitable to the bondholders. The District Court confirmed the plan approved by the security holders, and Circuit Court of Appeals affirmed it on the grounds that the relative priorities were preserved by virtue of the preference accorded in the distribution of the new securities.

But, the Supreme Court reversed the Circuit Court of Appeals, and held that the debtor was insolvent, the proposed inclusion of stock A in the reorganized corporation made the plan unfair and inequitable as a matter of law. It was unanimous decision, written by Justice Douglas, a former chairman of the SEC. Douglas denounced the "Relative Priorities" theory. The Boyd case doctrine and other cases of the same tradition were quoted with renewed vigor to assert the inequitability and inappropriateness of

1 Vide Appendix B for Supreme Court Decision on Los Angeles Lumber Products Company case.
the theory of "Relative Priorities" which was a part of the equity reorganization system. As already analyzed earlier in this chapter, the Boyd case doctrine, in effect, "permitted" the functioning of the relative theory as a matter of course. Whereas the same doctrine in the Los Angeles case decision was given a somewhat new interpretation and was reevaluated in order to assert strict compliance with the theory of "Absolute Priorities" of creditor rights.

The present writer wishes to emphasize that under equity reorganization, the courts did not conform to any uniform interpretations in deciding the fairness of plans. "... No unifying thread can be seen in the decisions of the lower federal courts concerned with the fairness of plans."¹ speaking about the development of legal precedents under equity reorganization, a writer observed that

... further confusion of thought in this field of law has been created by the practice of the courts in great reorganization cases, after deciding the question squarely before them, of indulging in unnecessary discourses which is open to as many interpretations as a syllabline utterance. The proponents of varying and opposing theories culled from identical opinions different statements.²

Under equity reorganization, the underlying meaning of the Boyd case doctrine, that is, "full" protection of creditors, was evaded, and for which ample justification was available on the basis of expediency.

... the significance of the Boyd case decision was not fully realized, either by lawyers interested in the practical problems of reorganization or federal judges who are concerned with weighing the fairness—in the absence of fraud—of reorganization plans approved by substantially all the creditors and stockholders of a corporation seeking to extricate it itself from receivership. The fundamental significance (of the Boyd case decision) was not realized at that time.³

¹Sec. Report on the Study and Investigation, etc., op. cit., Part VIII, p. 57.
²Gilchrist, op. cit., p. 593.
On the basis of foregoing observations, it is not surprising that the
"familiar doctrine" of the Boyd case received a "fresh" treatment and
renewed interpretation at the hands of Supreme Court in the Los Angeles case.
This decision of the Court has borne paramount significance in the
reorganization of corporations under the revised system. From this decision
has emanated the "definite and unequivocal acceptance of the absolute theory
of creditors' rights,"¹ and by the same token a denunciation of the theory
of "Relative Priorities." In the view of Supreme Court, there were enough
precedents established in the past to warrant a conclusion that those
"familiar doctrines" actually enunciated the theory of "Absolute Priorities."
This, in brief, may be the "legal" justification of the absolute theory which
is to be followed in the reorganization plans.

It must be stressed again that the controlling factors in the
reorganization practice are the economic issues involved. Everything else
is incidental. For instance, it may be mentioned again, even at the risk
of repetition, that in equity reorganization, when the stockholders were
found to have no equity in the debtor corporation, the courts probably
might not have tolerated stockholders' inclusion in the reorganization plans.
However, as analyzed earlier, the old stockholders were generally allowed to
participate (even though they did not have an equity) for the "economic"
success of the undertaking which was referred as: "for reasons of practical
necessity." Secondly, there was the problem of valuation—essentially an
economic issue. Since the reorganizers usually desired the participation
of stockholders, hence they (reorganizers) evaded the issue of evaluating
the assets of the debtor corporation and did not hesitate to bolster up the

¹Ibid., p. 1306
assets' value in order to make sure the participation of stockholders.

No doubt, in many cases, this led to the weakening of the capital structure; but that was not the consideration of reorganizers, and there was no effective mechanism to test the feasibility of reorganization plans. Thus it was remarked that

... during equity reorganizations ... evaluation is frequently avoided and top-heavy capitalization retained. Thereafter, the unsuspecting public again takes the newly issued but still watered securities and when a depression again occurs, there is another reorganization proceeding or foreclosure. All this is with consequent loss to the many security holders, but not without profit to bankers and the reorganizers.

With the enactment of Chapter X, the predominant position of the "insiders" has been superseded by the court-appointed trustee. Now the courts have the means to get the facts about the debtor corporation. Hence, seemingly, there is no longer any justification or motivation to include stockholders or for that matter all junior classes of security holders who are found to have no equity in the debtor corporation. It is for these reasons that the security holders may not participate in a plan in the absence of an equity. In the opinion of the present writer, this may be, in brief, the "economic" justification for upholding the theory of "Absolute Priorities" as affirmed by the Supreme Court in the Los Angeles case. Reviewing the Los Angeles case, Merrick Dodd remarked so pertinently that

... the new procedure has weakened the control of those interests which formerly tended to dominate reorganizations and by so doing has modified some of the old motivating factors for making concessions to stockholders and other junior interests.

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The Los Angeles case's decision laid down a standard of fairness to which all reorganization plans must conform. The reorganization plan of corporation, the debts of which exceed the assets, must allocate all the new securities only to those classes of security holders who have an equity. Fair and equitable means full value to creditors before anything is distributed to any of the stockholders. "The stockholders in order to be taken into the reorganization must contribute property; their contribution must be substantially more than the surrender of hypothetical rights which have, at most, nuisance value." In other words, stockholders' new investment will be purely voluntary; and any preservation of their interest will be the result of new funds rather than past equity.

Another important principle which emerged from the Los Angeles case is that although the statutory percentage—two thirds or more—assent to a plan, the court is not bound by the consent of the creditors and stockholders. In the Los Angeles case, more than two thirds of each participating class of security holders gave their assents to the plan (vide page 139). Since the Supreme Court found the plan unfair as a matter of law it was not therefore approved. Hence, the number or proportion of creditors and stockholders that approve a plan of reorganization has nothing to do with the fundamental fairness of the plan. The former is not a substitute for the latter. The court is not merely a ministerial register of the vote of several classes of security holders. All those interested in estate are entitled to the court's protection. Accordingly, the fact that the vast majority of the security holders have approved the plan is not the test of whether the plan is a fair and equitable one.2

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1 Dewing, (1953), op. cit., p. 1307.

2 SEC, report on the Study and Investigation, etc., op. cit., Part VIII, p. 150.
It is significant to note that the application of absolute theory makes it even more essential to find the value of the assets of the debtor corporation, because only then it would be possible to know the existence (or non-existence) of equity for the lowest class(es) of security holders in the hierarchy. What is the standard for the valuation of the debtor's assets under the revised system? It was indicated at the beginning of this chapter that the question of valuation is the most perplexing proposition in the whole reorganization process. However, the SEC has stressed that

... the difficulty of valuation is not a pertinent argument against attempting valuation; the choice is between having or not having objective standards for determining the fairness of reorganization plans.¹

It was two years after the Los Angeles case that the criterion for the valuation of the debtor's assets was provided. In the reorganization of Consolidated Rock Products Company in 1941,² from the available records of the company, the judge could not draw conclusions concerning the value of the property. The Supreme Court said:

... absent the requisite valuation data, the court was in no position to exercise the informed independent judgment. Consequently, on this record no determination of the fairness of any plan of reorganization could be made. It is apparent that the determination of that value (of the assets of the debtor) must be made so that criteria will be available to determine an appropriate allocation of new securities between bondholders and stockholders in case there is any equity remaining after the bondholders have been made whole.³

The Supreme Court, in the person of Justice Douglas, specifically laid down the criterion for appraising the value of the assets of the debtor:

¹Ibid., p. 56.

²Consolidated Rock Products Company v. Du Bois, 312 U. S. 510 (1941)

³Ibid., pp. 520-521.
Since we are dealing with the issue of solvency arising in connection with reorganization plans involving productive properties. It is plain that valuating for other purposes are not relevant to or helpful in a determination of that issue, except as they may indirectly bear on earning capacity.... 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.¹

Hence, under the revised system the fundamental basis of valuation is the determination of prospective earning capacity of the debtor corporation. It must be emphasized at the outset that by merely defining the criterion for the valuation of assets does not solve the problems inherent in valuation.

The most generally significant basis for the valuation of the assets is to apply the "capitalization of earnings" method. Briefly, this method rests on two factors: (1) Prospective earnings, and (2) A suitable rate of capitalization. Prospective earnings depend upon record of past earnings as reflected under "truly" normal and usual conditions surrounding the corporation. This figure of the past earnings is used as indicative of the average future earnings which is then capitalized at a "suitable" rate of interest (called the rate of capitalization) commensurate with the risk involved in the enterprise.²

The determination of prospective earnings, and hence valuation, is not only important for the fairness of a reorganization plan, but it is equally or even more important for the feasibility of the plan. A knowledge of

¹Ibid., p. 526

²Thus, if the estimate of annual earnings is $1,000,000, and the rate of capitalization is 10 per cent, a valuation of $10,000,000 results.²

²The "capitalization of earnings" method for the valuation of the debtor's assets has the approval of both— The Supreme Court and the SEC.
prospective earnings helps in shaping the capital structure of the reorganized corporation. No aspect of reorganization plan merits greater consideration than its economic soundness. Sound capitalization and financial structure are the ultimate determinants of effective reorganization. The plan will be considered feasible only if the corporation should emerge from the reorganization process with a capital structure consistent with the value of the property.

Under the revised system, plans must satisfy the objective of feasibility as distinguished from the objectives of fairness and equitability. In order to be feasible, the plan must have a workable capital structure; this calls for a total capitalization to be set at a reasonable figure. The various types of securities issued should contain provisions which are compatible with the future earning prospects of the corporation. The criterion of feasibility of reorganization plans was given by the Supreme Court in the Consolidated Rock Products case in the following manner:

Whether or not the earnings may reasonably be expected to meet the interest and dividends of the new securities is a sine qua non to a determination of the integrity and practicability of the new capital structure.1

What the Supreme Court said in this case is the basic requirement of sound capitalization. The SEC has made both general and specific remarks in regard to the feasibility of plans:

The security holders' representatives frequently regard the fairness of the plan as their principal concern. For the full protection of their interests, it is also required that the plan be feasible so that it will not hamper future operations or compell another reorganization.2

With regard to "asset-protection" of the reorganized company, the SEC believes in a conservative relation between assets on the one hand, and


the issues of debt-obligations and preferred stock on the other:

The combined funded and preferred stock issues should not exceed the value of fixed assets, and that funded debt not exceed fifty per cent of the total capital structure....

Furthermore, the SEC advocates that

the ratio of fixed charges to total capitalization must not be too great in an industry faced with the prospects of relatively unstable earnings ... in such cases sometimes one stock plan is advisable.... The holders of common stock will benefit more from an early retirement of bond issues than from dividend payment if provision for sinking-fund is made.

Appraisal of "Fairness" and "Feasibility" under the Revised System.—

Under the equity reorganization system, the plans of reorganization were supposed to require the valuation of debtor's assets; also, the legal pronouncements intended these plans to be fair and feasible. But, as examined under that system, no specific criterion was established to determine these objectives, and the inside group appeared to represent the most substantial interests in the reorganization which made difficult for the court to disagree or to lay finger on the weaknesses of its conclusions. Hence, the underlying objectives of reorganization were subordinated to more powerful incentives offered by those reorganizations.

Under the revised system of corporate reorganization, as noted above, criterion has been provided for (1) the fairness and (2) feasibility of the plans, and (3) the valuation of the debtor corporation. Probably the best way to appraise the revised system would be to determine the extent to which the said criterion is effectively applied in working out the plans of reorganization.


2 Ibid.
It is apparent that the question of valuation penetrates directly into the objectives of a fair and feasible plan of reorganization; the former controls the character and nature of the latter. For instance, briefly, a high valuation may result in a capitalization which the assets fail to hold and so the plan will be "unfeasible." On the other hand, if a very conservative valuation is made, the junior interests, who may be on the "margin" in relation to the probability of their having an equity, will be wiped out completely and the plan will become "unfair." Hence, the inseparability and the conflicting nature of the concepts of fairness and feasibility must be borne in mind during the course of following survey.

As noted earlier, the Los Angeles case laid the rule of absolute theory in determining the fairness of the reorganization plans. The application of the same rule was affirmed by the Supreme Court in the Consolidate Rock Products case;¹ however, at the same time, some reservations to the universal application of absolute theory appear to have been made in the said case. It was realized that a literal application of the absolute theory would imply that a judge has no legal right to adjust or compromise the claims of any security holder, and this may render the plans unfeasible. Hence, the application of absolute theory was slightly modified to permit some adjustments at the informed discretion of the court. But, in any case, junior security holders without an equity could not participate, and creditors were entitled to have full value of the property. However, if the face value of the new claims given the creditors corresponded with the face value of their old claims, it was considered that the absolute rule would still be preserved.¹ In many instances, this may mean

¹Dewing, (1953), op. cit., pp. 1319-1321.
acceptance by a bondholder of security of a diminished "quality" as compared to the quality of his old security, and this would constitute bondholder's loss of "status." Generally, a "status" is lost when (1) an old security bearing a fixed and absolute interest is changed to a contingent charge security (such as income bonds or preferred stock), or (2) the lien or sinking fund is weakened, or (3) the interest or dividend rate is lowered, or (4) the maturity date is extended or postponed. The court said that the loss of status must be "compensated" in order to achieve "fairness."

It may be stated that in practical situations the compensatory "clause" is easily an elusive phase of the absolute theory. For instance, a senior claim (principal + interest) is a demonstrable claim, but a claim for loss of status—contingent claim, for example,—is a claim for a sum which is not subject to precise determination and can not be readily estimated.

"Indeed it is not clear by what standard the courts and the SEC determine proper 'compensation' for loss of status."  

An actual case involving loss of status by the senior security holders is noteworthy. In the reorganization plan of Utilities and Light Corporation, the property was valued at $14,000,000. At the time of failure, debentures claim was $36,000,000. The plan of reorganization provided thusly: Every debenture holder of $1,000 received $400 in new debenture, $300 in preferred stock, fifty shares of $1 par value common stock, and

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2Ibid., p. 915.

for every $6 of accrued and unpaid interest an additional one share of common stock. Old preferred stockholders participated to some extent, receiving five shares of common stock for each preferred share. Obviously, the plan's fairness depended upon the asset value of the common stock. If each share of common stock was worth only its $4 par value, this gave old debenture holders only ($400 + $500 + $200) = $200 for every $1,000 of principal, and only $4 for every $6 of interest and nothing for loss of "status." If the stock was worth $6 a share, the debenture holder would receive securities in exact value of their claims for principal and interest ($400 + $300 + $300 + $6) = $1,006, but still not compensated for loss of "status." Question: What value the stock needed to provide adequate compensation? It was not ascertainable. The court said that $6 a share was the actual value of the common stock and it approved the plan by "failing" to compensate for "status" lost, and to that extent the "court" violated the absolute rule. 1

A strict application of the absolute theory, together with the difficulties inherent in the valuation of the debtor corporation, may, consequently result in inequitable treatment of the junior security holders. It must be emphasized that the underlying conditions surrounding the typical industrial corporation are varied and complicated. The problems in valuing railroads and utilities are relatively less difficult; the rise and fall in their earnings are ordinarily gradual, especially compared with the abrupt and sudden changes in earnings of industrials. Hence, the practical application of the earnings power criterion of valuation presents usually great difficulty with industrial

1 Ibid., pp. 916-920.
reorganizations than with reorganization of any form of utility.\footnote{Dewing, (1953), op. cit., p. 1120.}

The inequitable result of "wrong" evaluation and strict adherence to the absolute rule is probably best illustrated by the Los Angeles Products Company case which laid the basis for the absolute rule in the revised system (vide: pages 138-139). In that case, the final reorganization plan gave bondholders 340 shares of common stock for each $1,000 claim. The stockholders received nothing. Shortly after reorganization, defense orders rolled in, and earnings improved, and in 1941 the new stock earned fifty three cents a share and sold for as high as $1 a share. At such a price the market value of 340 shares became worth $1,360. The company earned $16 per share in 1943, and at the end of 1944 the new net worth represented by the common stock totalled $4,700,000.\footnote{Suthmann and Dougall, op.cit. pp. 669-670.} (The company's assets were appraised at $330,000 during the reorganization of the company in 1939) About the outcome of this case a comment was provoked in the following manner:

Note: The difference in the rate of capitalization at which the estimated earnings are capitalized can create startling differences in the valuation of the corporation. Thus, if one appraiser uses an 8 per cent rate of capitalization and other 10 per cent, the former will arrive at a figure one fourth greater than the latter if the same income estimates are used. For example, an average annual earnings of $5,000,000, capitalized at 8 per cent give a valuation of $6,250,000; at 10 per cent, a valuation of $5,000,000. The significance of this illustration becomes greater with the application of absolute theory. With lower valuation of $3,000,000 the junior security holders will lose equity by ($6,250,000 - $3,000,000) $3,250,000.
..., by a strange anomaly, the company that provided the case in which the absolute priority theory was established by the Supreme Court also provides a dramatic argument against the principle. Room for errors in valuation exist in both the estimate of probable earnings and in the rate of capitalization. The loss inflicted upon junior securities wiped out by too low a valuation works an irrevocable damage.¹

Unfortunately, it is not possible to determine with reasonable accuracy the value of a business enterprise which is unable to pay debts as they mature. Particularly in such a case the value of the enterprise is largely a matter of speculating as to its earning power.

The fact is that the test of value which is and will continue to be applied in determining solvency is a different test from which the market applies in appraising the securities of an enterprise with an unsuccessful past and an uncertain future.²

It may be observed that the SEC's estimates of the value of claims against the debtors, and the estimates of earning power of the debtors, have generally been low. A comparison of actual performance with SEC estimates of valuation of claims, and estimates of earning power is indicated in the following eight cases examined from the data exhibited in Tables 9 and 10 (vide: pages 153-154). As a general rule, a low estimate of earning power will be favorable to creditors by decreasing the valuation, and this under-estimation of valuation may bear inequities to stockholders and other junior security holders such as appear to have occurred as indicated by Table 10, page 154. In almost every case examined it is apparent that the SEC estimates are conservatively low.

¹Ibid.

TABLE 9

RELATIVES OF MARKET VALUE OF TOTAL SECURITIES OUTSTANDING\(^a\) TO SEC ESTIMATES OF VALUATION FOR SELECTED CORPORATIONS REORGANIZED UNDER CHAPTER X, 1941-1946*

<table>
<thead>
<tr>
<th>Corporations</th>
<th>SEC Estimates (000 Omitted)</th>
<th>1941</th>
<th>1942</th>
<th>1943</th>
<th>1944</th>
<th>1945</th>
<th>1946</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. National Radiator Corporation</td>
<td>$ 6,000</td>
<td></td>
<td>19</td>
<td>31</td>
<td>37</td>
<td>60</td>
<td>75</td>
</tr>
<tr>
<td>2. Griese-Pfleger Tanning Company</td>
<td>1,675</td>
<td>40</td>
<td>53</td>
<td>52</td>
<td>87</td>
<td>103</td>
<td>127</td>
</tr>
<tr>
<td>3. Flour Mills of America, Inc.</td>
<td>2,160</td>
<td></td>
<td></td>
<td>60</td>
<td>108</td>
<td>140</td>
<td>188</td>
</tr>
<tr>
<td>4. Deep Rock Oil Corporation</td>
<td>7,150</td>
<td></td>
<td></td>
<td></td>
<td>192</td>
<td>222</td>
<td>261</td>
</tr>
<tr>
<td>5. Minnesota and Ontario Paper Company</td>
<td>25,195</td>
<td>48</td>
<td>50</td>
<td>66</td>
<td>87</td>
<td>106</td>
<td>122</td>
</tr>
<tr>
<td>7. McKesson and Robins, Inc.</td>
<td>76,900</td>
<td>27</td>
<td>28</td>
<td>42</td>
<td>55</td>
<td>72</td>
<td>106</td>
</tr>
<tr>
<td>8. Philadelphia and Heading Coal and Iron Company</td>
<td>20,100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>108</td>
</tr>
</tbody>
</table>


Fixed obligations valued at lower of market or par value.

Note: In these eight cases, the SEC participated and issued advisory reports on the valuation of claims recognized by the courts. These reorganizations consummated were examined on the basis of financial returns and market prices of securities received under the reorganization plan. Ibid.
**TABLE 10**

RELATIVES OF NET OPERATING INCOME FROM ACTUAL OPERATIONS TO SEC'S ESTIMATES FOR SELECTED CORPORATIONS REORGANIZED UNDER CHAPTER X, 1941-1946*

<table>
<thead>
<tr>
<th>Corporations</th>
<th>SEC Estimates (000 Omitted)</th>
<th>Relatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. National Radiator Corporation</td>
<td>$268</td>
<td>111 230 417 404 385 83</td>
</tr>
<tr>
<td>2. Griess-Pfleger Tanning Company</td>
<td>150</td>
<td>236 210 208 265 219 501</td>
</tr>
<tr>
<td>3. Flour Mills of America, Inc.</td>
<td>250</td>
<td>— 81 183 355 305 322</td>
</tr>
<tr>
<td>4. Deep Rock Oil Corporation</td>
<td>539</td>
<td>— 445 386 358 411 464</td>
</tr>
<tr>
<td>5. Minnesota and Ontario Paper Company</td>
<td>1,529</td>
<td>221 245 178 150 161 290</td>
</tr>
<tr>
<td>6. Higbee Company</td>
<td>592</td>
<td>— 70 155 159 160 407</td>
</tr>
<tr>
<td>7. McKesson and Robbins, Inc.</td>
<td>4,000</td>
<td>— 266 414 508 460 510</td>
</tr>
<tr>
<td>8. Philadelphia and Reading Coal and Iron Company</td>
<td>1,962</td>
<td>— 184 250 295 131 410</td>
</tr>
</tbody>
</table>

Some writers argue that a strict application of the theory of "Absolute Priorities" gives excessive weight to the valuation of the enterprise during reorganization, and this disregards completely the possibility of future valuation of the enterprise as superseding the earlier estimate of valuation.\textsuperscript{1}

From Table 9, page 153, it is clear that the value of securities issued to the security holders under a plan and the valuation of the enterprise in "in market" may be at variance.

Actually, the value of the securities will also to a large extent depend upon the kind of securities created in the plan. For instance, an all common stock plan is likely to give a lower market value to the enterprise than when a "judicious" combination of bonds and stocks. The underlying implication is that the portion of earnings used to pay dividends is likely to be capitalized in the form of market value at a higher rate than the part of earnings used to pay bond interest. A simplified example should make it clear: Suppose a corporation's prospective earnings (before interest and taxes) are $100,000. The plan of reorganization provides 4 per cent $500,000 bonds, and 8 per cent $500,000 common stock. The interest and dividend charges in this case will be $60,000 and the net income ($100,000 - $60,000) = $40,000. On the other hand, with an all common stock plan, the dividend charges will be $80,000, and in this case the net income will be $20,000. Although an all common stock plan will reduce the net earnings, yet it is probable that such plan will enhance the feasibility of a reorganization plan.

It is quite likely that in the interest of feasibility, the courts and the SEC may be conservative and hence advocate all common stock plans.

\textsuperscript{1}Guthmann, "Absolute Priority in Reorganization," \textit{Columbia Law Review}, XLIV (September, 1945), pp 747-748.
Especially it may be true in case of competitive industrials where the prospective income is relatively unstable. At any rate, an all common stock plan is likely to lower the valuation estimate because of the reduced earnings as a result of such plan. Consequently, this may preclude the participation of junior security holders.

In the same line of observation, it may be said that a drastic reorganization which converts bonds into stock is likely to be injurious to all security holders. The taxes are payable upon the balance after interest but before dividends. At a 50 per cent tax rate, a corporation with net earnings of $1,000,000, before interest and income tax would be able to support 4 per cent $12,500,000 bonds, but would only have $500,000 for dividends if no bonds are issued. If the going rate of return on stock is 7 per cent, it would hold an all stock capitalization of approximately $7,143,000.

The points mentioned in the above paragraphs become more meaningful by a review of the pertinent aspects of an actual case. In April 1944, the Indiana Limestone Corporation filed a petition for reorganization in consideration of the impending default in interest on its bond issue. After approval of the petition, an independent trustee was appointed. In November 1944, the trustee filed a plan of reorganization, which was referred to the SEC for the letter's advisory report on the plan. The trustee reported the Company’s Balance Sheet as indicated in Table 11, page, 157.

The trustee's plan was based on a valuation of the debtor corporation at $4,000,000. All new securities were to be received by the holders of Income (bond) 6's on the basis of $400 in new bonds and twenty shares of stock for each $1,000, and accrued interest. The stockholders were to

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1Albert Ward (Trustee), "Plan of Reorganization," Indiana Limestone Corporation, No. 9413, in the District Court of the United States for the Southern Dist. of Indiana, March 2, 1945, pp. 17-18.
### TABLE II

**INDIANA LIMESTONE CORPORATION — DEBTOR**

**BALANCE SHEET, AS OF NOVEMBER 30, 1944**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash assets $49,000</td>
<td>Current liabilities $617,000</td>
</tr>
<tr>
<td>Other assets 920,000</td>
<td>Income 6's $6,490,000</td>
</tr>
<tr>
<td>Net fixed assets 6,527,000</td>
<td>Common stock and Surplus (deficit) 2,389,000</td>
</tr>
<tr>
<td><strong>$8,696,000</strong></td>
<td><strong>$8,696,000</strong></td>
</tr>
</tbody>
</table>


receive nothing. The SEC in its advisory report suggested that

... in view of the cyclical nature of the building lime-stone industry and the boom and depression character of the industry, and appropriate rate of capitalization lies between 15 per cent and 12 per cent. Applying these rates the trustee's evaluation of $4,000,000, for the enterprise represents a capitalization of earnings ranging between $600,000 and $300,000 per year. Nothing in the history of the debtor demonstrates any likelihood that its normal average future earnings will approximate any such amount. The financial history of the company in fact, points to the contrary (as indicated in Table 12 page 156). 1

In view of this observation, the SEC concluded that although the plan was fair in the sense that the stockholders were eliminated, but it was financially unsound and therefore not feasible. It appeared to the SEC that by experience and prospects the issuance of debt securities to be issued to the bondholders would render the company insolvent at the outset. Since the plan also provided a sinking fund not exceeding $25,000 per year, the SEC said:

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### TABLE 12

GROSS SALES AND EARNINGS BEFORE DEPRECIATION, DEPLETION, 
INTEREST ON FUNDED INDEBTEDNESS, AND FEDERAL TAXES 

INDIANA LIMESTONE COMPANY—PREDECESSOR

<table>
<thead>
<tr>
<th>Year Ended November 30</th>
<th>Gross Sales in Dollars</th>
<th>Profit or (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1927</td>
<td>$12,131,573</td>
<td>$2,676,475</td>
</tr>
<tr>
<td>1928</td>
<td>11,985,200</td>
<td>2,598,973</td>
</tr>
<tr>
<td>1929</td>
<td>10,917,258</td>
<td>1,780,006</td>
</tr>
<tr>
<td>1930</td>
<td>10,351,643</td>
<td>1,737,244</td>
</tr>
<tr>
<td>1931</td>
<td>1,618,402</td>
<td>(743,117)</td>
</tr>
<tr>
<td>1932</td>
<td>3,200,794</td>
<td>177,570</td>
</tr>
</tbody>
</table>

INDIANA LIMESTONE COMPANY—DEBTOR

<table>
<thead>
<tr>
<th>Year Ended November 30</th>
<th>Gross Sales in Dollars</th>
<th>Profit or (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1933</td>
<td>$2,880,129</td>
<td>$166,616</td>
</tr>
<tr>
<td>1934</td>
<td>1,355,207</td>
<td>(314,164)</td>
</tr>
<tr>
<td>1935</td>
<td>738,925</td>
<td>(362,666)</td>
</tr>
<tr>
<td>1936</td>
<td>1,337,056</td>
<td>(286,819)</td>
</tr>
<tr>
<td>1937</td>
<td>1,097,615</td>
<td>(95,501)</td>
</tr>
<tr>
<td>1938</td>
<td>648,142</td>
<td>(265,642)</td>
</tr>
<tr>
<td>1939</td>
<td>1,193,800</td>
<td>(51,519)</td>
</tr>
<tr>
<td>1940</td>
<td>785,497</td>
<td>(95,501)</td>
</tr>
<tr>
<td>1941</td>
<td>331,411</td>
<td>(191,930)</td>
</tr>
<tr>
<td>1942</td>
<td>693,305</td>
<td>(101,970)</td>
</tr>
<tr>
<td>1943</td>
<td>309,896</td>
<td>(26,165)</td>
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</tbody>
</table>


... a further element of risk lies in the fact that, at the rate of $28,000 per year, only an insignificant amount of the bonds would be retired before their maturity date unless it is expected that outstanding bonds will be reacquired at a substantial discount.... This in it-self impels towards the conclusion that the debt is
excessive and the plan is not feasible...

Furthermore, the SEC, in discrediting the tax advantages of the bond issue indicated that even if tax savings can be predicted, that element should not outweigh the necessity for a sound capital structure within the limits of feasibility.

Hence, the SEC urged the adoption of a plan involving all common stock structure for the debtor company. About the final outcome of the plan of reorganization, Mr. Herbert E. Wilson, General Counsel, Indiana Limestone Company, Incorporated, has this to say:

... The SEC was leaning to an all common stock company with no outstanding bonds. I represented about $5,000,000 of the outstanding bonds and we were insisting that the reorganization give us new bonds and common stock in exchange for our old bonds. This is what the court finally approved.

Mr. Wilson goes on to point out that

... the new bonds,... are income bonds, but they do permit the company to deduct the interest from its profits for tax purposes. Since the reorganization in 1945 the company has retired about one-half of these bonds and purchased them at approximately 80 per cent of their face value.

In the case referred above, the wisdom of hindsight must suggest that the trustee's plan was feasible. How far it was fair, it is difficult to conclude. The old stock-holders were not permitted to participate in the plan because they were found to have no equity according to the valuation

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3Letter to the present writer, Dated February 25, 1959.

4Ibid.
of the company during reorganization. However, the earnings on the common stock reached $1.31 per share in 1949. In 1953 bond price range was 64 - 72 1/2; the common stock range was 3 7/8 - 5.¹

The case above tells on the whole the difficulty of forecasting profits and so the imperfection in valuation and hence the inherent weakness of the "Absolute Priorities" theory.

Probably the greatest criticism of the absolute theory is in its disregard of the concept of reorganization. After the failure of a corporation, if it is decided to liquidate the assets and apply the liquidation value L to satisfy the claim holders according to their strict legal rights and priorities, it seems eminently suitable to insist that theory of "Absolute Priorities" may be the general principle in the distribution of claims.² In liquidation, the business ceases and the assets are sold for cash. The creditors are paid in full as far as possible before any surplus becomes available for junior claim holders. In other words, to use the language of symbols as used in this study,³ the problem of reducing total claims T to the claims in liquidation L is relatively a minor one, because the value of L is easier to determine as against the value of R.

But, reorganization presents a different situation; it tends to preserve going concern values. It may be contended that the absolute theory fails to give weight to the essential difference between liquidation and reorganization. However, the SEC, in supporting the absolute

¹ Guthmann and Dougall, op. cit., p. 678.
² For a description on the value of L, vide: "The Economics of Corporate Reorganization," pp. 116-120 of this study.
³ For elaboration vide: pp. 116-129 of this study.
theory for reorganizations, said:

Bankruptcy reorganization is the modern alternative to forced liquidation by creditors of a corporate enterprise which cannot meet its final obligations. It is an outgrowth of equity reorganization which, utilizing the liquidation device, preserved the enterprise and its going concern value for the benefit of security holders.1

Another author also supports the creditors' absolute position in reorganization by saying that...

... both liquidation and reorganization are methods of enforcing creditors' rights. To speak of reorganization as a substitute for liquidation is not to deny this proposition but rather to affirm 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. Hence, 'this relationship of creditors' rights under liquidation or reorganization suggests the modes of enforcement call for similar evaluation... 2

In considering these arguments, firstly, it must be borne in mind that equity reorganization grew out of the necessity of preserving railroads instead of liquidating them. It was hardly a mode of liquidation. Its basic philosophy was the preservation of going concern values for the benefit of security holders. Equity reorganization did not utilize the liquidation device as argued by the SEC; the judicial sale was not a liquidation device, it was rather a legal assurance of reorganization by binding dissenters and adjusting claims against the reorganized property.3

Secondly, although both—reorganization and liquidation—are methods of enforcing creditors' rights, yet the very fact of reorganizing an enterprise (because the value of R is greater than the value of L)

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presents totally a new situation not conceived in liquidation. Their cases are different. In one T (total claims) is reduced to R (the value of assets in reorganization), in the other T is reduced to L (the value of assets in liquidation). Hence, it seems anomalous to prescribe the same formula for enforcing claims for two different situations— one preserving values, the other destroying them. Hence, "this" relationship of creditors' rights under liquidation or reorganization does not call for similar evaluation.

Finally, the theory of "Absolute Priorities" (of creditors' rights) is narrow in the sense that it does not give any consideration to the chance factor which is mainly responsible for the imperfection of business evaluation. It does not leave any room for the by play of equitable factors, and

... it closes the door on the 'pragmatic-approach'— therein lies its weakness. A rule of law which fails to recognize the uniqueness of each case and the sense of justice who administers it, though universally reiterated, is bound to be honored in the breach rather than observance.

Whatever the merits or demerits of the absolute rule in granting participation to the old security holders in a reorganization, there can be no doubt that this principle has become firmly established. And it has been reiterated by the Supreme Court a number of times since the Los Angeles Lumber Products Company case.

The next and last chapter is concerned, first, with a brief summary of the development of reorganization procedure in the United States; second, with a conclusion to this study.

1 "Absolute Priority Under Chapter X— A Rule of Law or a Familiar Quotation," op. cit., p. 321.

CHAPTER VIII

SUMMARY AND CONCLUSIONS

Summary.—In the United States, the practice of corporate reorganization originated with the railroad expansion in the last century. The railroads usually operated under heavy bonded-indebtedness; often they became involved in financial difficulties serious enough to entail judicial proceedings. In the interest of public, it was considered undesirable, much as it would be considered to-day, to liquidate the railroads in straight bankruptcy. Instead, they were customarily reorganized as going concerns through the mechanism of equity receivership. The resort to equity receivership, for the purpose of judicial reorganization, was due to the force of precedent. It grew from an adaptation of traditional creditors' equitable remedies to the exigencies of corporate financial readjustment. As utility and industrial corporations expanded, it became inevitable that their "going concern" values likewise would be preserved or salvaged in periods of financial stress by the use of some instrumentality similar to that which had been proven in the case of financially embarrassed railroads. Hence, the mechanism of equity receivership also came to be applied to utilities and industrials in serious financial troubles.

The reorganization of corporations through equity receivership had a tendency to entrench delinquency in power, and to stifle inquiry into mismanagement and other abuses. This resulted in grievous losses to the investors. The demand became insistence for a practice more open, more
responsible, and more efficiently and closely regulated under the supervision of a court of bankruptcy. The great depression of the thirties laid bare the inconveniences and the shortcomings of the equity reorganization system. This led to the enactment of reorganization acts in 1934 and in 1936 as amendments in the bankruptcy legislation of this country. "Where the origins lie, the Reorganization Acts are Bankruptcy Statutes primarily for constitutional reasons.... Broadly speaking, the Reorganization Acts are Bankruptcy Statutes only in name." 

The reorganization acts have revised and streamlined the procedure in which corporations are now reorganized. However, they have not broken with the tradition. They have combined the experience of equity reorganization and the bankruptcy composition tradition for a complete arrangement of corporation reorganization.

The revised system has brought reorganization proceedings into the open and has attempted to provide bona-fide representation of the security holders. Two outstanding features of the revised system are: (1) The disinterested trustee, who is the central figure in the whole reorganization proceedings, and who is appointed and authorized by the court to operate the business and formulate the plan of reorganization for the debtor corporation. (2) In cases where the debtor corporation has liabilities of $3,000,000 or more, the reorganization plans must be referred to the SEC for the latter's advisory opinions. However, the SEC may also initiate to participate in its advisory capacity in any reorganization case upon the approval of the court. Similarly, the court may ask the SEC to supervise any reorganization. The SEC attempts to safeguard

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the interest of investors through its enlightened vigilance, and it dis-
courages the diverting of reorganization proceedings toward personal ends.
Through its nation-wide activities and continuous experience in reorganiza-
tions the SEC has tried to encourage uniform and appropriate application of
the principles and policies of the revised system as laid down by the
reorganization acts.

Conclusions.—Whether equity reorganization or the revised reorganiza-
tion system is under consideration, so far as the substance is concerned,
the results are identical. The technical, legal form of procedure may be
different— as a result of the changing economic conditions— but the
fundamental motive is the same: the regeneration of the corporation with
a financial structure such that there is a realistic probability that it
will remain solvent. Under the revised system, no doubt, the approach to
the problems involved in corporate reorganization has been distinctly
ameliorated. The central economic issues have been given due recognition.
The courts under the revised system can insist, if they wish, upon
definite evidence that the failed corporation ought to be reorganized in
the interest of all parties rather than liquidated (Section 116). Any
interested party (including stockholders if they have an equity) is
allowed to file an answer to the petition controverting the facts there
alleged (Section 137). Under equity reorganization, there were no such
provisions. Now there is a probability that the court will, in the
language of symbols used in this study, consider the relationship
between $R$ (the value of assets in reorganization) and $L$ (the value of
assets in liquidation). A number of times, the SEC has urged successfully

\[^1\] For the description of symbols, *vide* pp. 116–129 of this study.
the sale of the assets of the debtor where it considered advisable to do so. Hence, under the revised system, the economic necessity of reorganization as against liquidation, and vice versa, is given consideration—an issue of scarce significance under equity reorganization.

The interest of the investors demand that the reorganization be fair, economical, expeditious and feasible. Probably it was none of these under equity reorganization. In the revised system, in addition to these aims, a reorganization should also conform with the objective of public policy. Such generalization is likely to mislead unless it is taken for what it is intended to be—a statement of an ideal capable of partial fulfillment.

"Any reorganization at its best is likely to result in only an approximation of these objectives ... concessions, settlements, compromises, practical adjustments will be the rule rather than the exception...." These objectives may have conflicting ends. Probably experience has indicated preference for fair and feasible plan of reorganization as against expeditious or even economical. These objectives, of course, can not be mutually exclusive. For instance, an investigation of the conduct of the enterprise involves expenses; whether the expense is a good investment should depend upon the probability that the resultant information will shed enough light on the problems of administration, the fairness and feasibility of reorganization plans, and the protection of investors to which they are entitled. Every reorganization calls for some sacrifice on the part of security holders. However, security holders would not like to make any sacrifices unless they are fully acquainted with the necessity

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1See, Sixteenth Annual Report For the Fiscal Year ended June 30, 1950, p. 118.

and given an opportunity to express their opinions. Hence, a number of public hearings are usually desirable in reorganization proceedings. It is likely that more time will be required to effect a reorganization in this way. So, it is not surprising, if reorganizations move slow under the revised system. On the feasibility side, if sufficiently better plans should emerge, as seems to be the case under the revised system, the added cost will be more than worth while.

One might venture to conclude that the most outstanding innovation of the revised system is its greatly increased emphasis upon the fairness problem in corporate reorganization and its attempt to provide suitable machinery for achieving that end. In the recent years, no other phase of reorganization practice has drawn more attention than the question of fairness. Fairness of reorganization plans was the most ill-defined phase of equity reorganization. The revised system makes a forward step in this direction by defining the criterion of a "fair" plan. In corporate reorganization, "fairness" is measured by the manner and extent to which the security holders of the debtor corporation are granted participation in the reorganized corporation for the adjustments of their claims. Under the system of equity reorganization, application of the "relative Priorities" theory was a generally acceptable method of distributing claims to the old security holders against the reorganized corporation. According to this theory, the old security holders preserved their relative priorities as to their claims on the earnings of the reorganized corporation. Under this scheme, usually the senior security holders were given new securities with a face value less than the matured value of their claims. On the other hand, even though the stockholders did not have an equity, for practical reasons, they were allowed to participate in the distribution of new claims
to an extent that would induce them to invest new money for the purpose of reorganizing the corporation. No one knows for sure whether this was a fair method of adjusting claims. However, it is true, that without this type of arrangement reorganizations were rendered impracticable.

Times changed, methods changed, rules also changed. Under the revised system, the Los Angeles Lumber Products Company case set the criterion of a "fair" plan of reorganization (vide: pages 138-140). This criterion was the so called re-assertion of the "Absolute Priorities" theory preached by the classic Boyd case and the other cases of the same tradition. It is very difficult to determine whether, in fact, the Boyd case doctrine proffered the absolute theory or the relative theory for the adjustment of claims among the security holders. However, the equity reorganizers used the Boyd case doctrine to construct reorganization plans conforming with the theory of "Relative Priorities."

By and large, to-day, surely for the reorganization of industrials, the absolute theory prevails. What is this absolute theory? Simply, it means that stockholders, or for that matter security holders, who do not have an equity in the debtor shall not retain an interest in the reorganized corporation. Briefly, it amounts to saying that creditors' rights will be enforced in reorganization as they are enforced in liquidation. Experience has indicated clearly certain undesirable results which may follow from a strict application of the absolute theory in corporate reorganization. The economic basis of this theory is found in the valuation of the enterprise by capitalizing the prospective earnings of the reorganized corporation—a fortuitous matter indeed! The absolute theory considers valuation as an end in itself. This is the greatest

\[^{1}\text{Vide: Appendix B,}\]
mistake of the absolute theory. Once a valuation figure is established
the junior security holders, usually the stockholders, who are adjudged to
have no equity in the debtor corporation are completely severed from
preserving any interest in the reorganized corporation. The absolute
theory fails to give any credence to the "intangible" equity of the
stockholders which is "retained" in the corporation contemplating
reorganization.

Recommendations.—Usually in reorganization the valuation of the
corporation is set reasonably low. Probably there is a good reason for
this, for else the objective of feasibility of plans may be defeated and
the corporation may have to undergo a second reorganization later—cutting
off more stockholders. However, the reorganization plans based on the
absolute theory tend to squeeze out the stockholders. This has a tendency
to result in bitter opposition and probable litigation and consequent
delay. Such delay inevitably increases the cost of reorganization, which
in the final analysis would be borne by all security holders. However,
this attitude on the part of stockholders does not suggest that they should
be given consideration for their delaying tactics. But, it appears that
due to opposition of disgruntled stockholders, the "marginal cost" of
carrying a reorganization through would be greater than the "marginal cost"
involved in a more considerate policy towards the stockholders.

By taking a practical approach and in line with the objective of fair-
ness, caution must be exercised lest permanent injustice results from
drastic treatment of stockholders. "Errors that completely shut out this
class of investor can not be rectified; errors of generosity, however,
can be largely remedied by ... financial devices incorporated in the
carefully constructed reorganization plans."¹ It may be suggested that
a compensatory device may be used to satisfy the stockholders who are
treated harshly under the plan. In drafting the reorganization plan, it
is recommended that it is proper to grant stockholders contingent securities
and watch the developments rather than to wipe them out entirely. In case
the earnings remain low, their contingent claims will then be worthless,
but not if the reverse is true. This objective can be achieved through
the device of stock-purchase warrants that will permit purchase of common
stock by the old stockholders at a profit should the corporation's future
enhances the market value of the stock. Prior claims will remain un-
affected by this device, whereas old stockholders may "repossess" some
equity.

The SEC is against the use of stock-purchase warrants. Its use is not
so radical as it appears to the SEC. This device has already been adopted
in large measure in railroad reorganization which is under the eye of the
Interstate Commerce Commission. The SEC questions the wisdom of issuing
securities "without value." According to the Securities Act of 1933,
"Securities must be evidences of either debt or ownership" (Section 2(1)),
and warrants are not obligations. Warrants must be considered a type of
ownership and therefore stock. Section 216 (2) of Chapter X prohibits
use of non-voting stock, accordingly the SEC argues, the issue of warrants
is questionable, "since warrants are in effect a junior equity security
with voting power, there is a question of their issuance conflicting with
the Congressional policy expressed in this Section."²

²SEC, Corporate Reorganization Release No. 67, September 30, 1946,
p. 34, In re Childs Company Reorganization.
In considering these arguments of the SJC it may be stated that warrants are only "potentially" an equity security, and have no actual existence on corporate books of account until exercised. It may be further pointed out that if warrants are "without value" and hence should not be used, the SJC implicitly attaches to the valuation of a reorganized corporation a definiteness which it has admittedly does not exist.¹

The SJC's second argument is that warrants would be exercised usually when the corporation did not need funds. Perhaps it is true. However, it may be observed that the exercise of warrants would attract funds that could be used to retire senior issues faster than otherwise would be possible. Above all, it would still permit the original equity holders of the pre-reorganized corporation to regain some of their equity holdings. Finally, objections to the use of warrants may also be met by limiting their life to, say, a decade at the most, and by restricting their transferability.²

It appears that despite the shortcomings of the "Absolute Priorities" theory, if the above-mentioned recommendations are followed, any possible gross inequities resulting to the old stockholders of the debtor can be avoided. Mention must be made that the "Relative Priorities" theory does not provide a workable solution to the question of fairness, as this theory is imprecise and unjustifiable. On the other hand, a literal interpretation of the absolute theory is not advisable. Failed corporations can not be reorganized from the straight-jacket of one rule.

¹"We do not attribute to our conclusions on our earnings and valuation the quality of mathematical certitude." SJC, Corporate Release No. 67, November 13, 1946, p. 2.

The uniqueness of each corporate failure should be realized. Mathematical exactness is not required and is not possible, reasonable adjustments should be encouraged. The industrial corporations are competitive in nature and have little in common among themselves as to their financial structures and causes of failures unlike the railroads or utilities.

"In industrial reorganization plans ... each reorganization presents new problems that have to be solved in original manner, ..."¹

Implication.—Broadly speaking, in the reorganization of corporations, a strict application of the rule of "Absolute Priorities" may point to an undesirable end. Knowing the treatment of the equity security holders as it is under this rule, the investors may be impelled to invest only in enterprises of proven earning power or only in properly protected equities. There are chances that this trend could help to create a far greater monopoly than exists to-day, and then the society would be the loser. The consequences could provide a remedial program which would only mean further extension of government activities. In the long run this would weaken the basis on which a private enterprise system exists.

Public Policy.—Probably the very question of the amelioration of reorganization practices is an extension of the more fundamental problem that lies in the nature of corporate activity. It grows out of the doctrine of Justice Stone that

"a man can not serve two masters!.... No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle. The separation of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of

great number of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper functions. Yet those who serve as trustees, but relieved ... from the obligations to protect those whose interests they proposed to represent, corporate officers and directors who award to themselves huge bonuses from corporate funds without the assent or even knowledge of their stockholders, reorganization committees created to serve interests of others than whose securities they control... The loss and suffering inflicted on individuals, the harm done to a social order founded upon business, and dependent upon its integrity, are incalculable.¹

It would be naive to suppose that the separation of ownership and control which is characteristic of the large corporate enterprises to-day can be overcome for a special occasion such as reorganization. In order to mitigate the control of "insiders," the interest of public demands government participation in the financial sphere of the corporate activity.

For the preservation of free competition, the development of federal action in the monopoly and trust movement and other similar considerations can be traced from the Anti-Trust Act of 1890, Clayton Act of 1914, and down to the Banking and Public Utilities Acts of 1935. Without much fear of disagreement, many provisions of the Reorganization Acts of the thirties may be regarded as an extension of this legislation.²

Finally, it should be observed in closing that the revised system of corporate reorganization is a step forward; yet, it is too early for a categorical judgement on its merits or demerits. The reorganization practice is still replete with many fascinating and challenging problems. The search for a better approach to these problems can not be abandoned.


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Canadian Southern Pacific Railway Co. v. Gebhard, 109 U. S. 527 (1883).


Miscellaneous Material


"Plan of Reorganization," Indiana Limestone Corporation, District Court of the United States, Southern District of Indiana, March 2, 1945.


1 Cases adjudged in the Supreme Court.

2 Adjudged in the district Court.
APPENDIX A

TOTAL FILINGS OF ALL TYPES OF BANKRUPTCY CASES BY FISCAL YEARS ENDING JUNE 30 OF EACH YEAR FROM 1900 THROUGH DECEMBER 31, 1958*

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Fiscal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900</td>
<td>62,815</td>
</tr>
<tr>
<td>1901</td>
<td>65,333</td>
</tr>
<tr>
<td>1902</td>
<td>70,009</td>
</tr>
<tr>
<td>1903</td>
<td>62,256</td>
</tr>
<tr>
<td>1904</td>
<td>58,688</td>
</tr>
<tr>
<td>1905</td>
<td>69,153</td>
</tr>
<tr>
<td>1906</td>
<td>60,624</td>
</tr>
<tr>
<td>1907</td>
<td>57,445</td>
</tr>
<tr>
<td>1908</td>
<td>57,306</td>
</tr>
<tr>
<td>1909</td>
<td>50,997</td>
</tr>
<tr>
<td>1910</td>
<td>52,577</td>
</tr>
<tr>
<td>1911</td>
<td>56,332</td>
</tr>
<tr>
<td>1912</td>
<td>52,109</td>
</tr>
<tr>
<td>1913</td>
<td>34,711</td>
</tr>
<tr>
<td>1914</td>
<td>19,533</td>
</tr>
<tr>
<td>1915</td>
<td>12,662</td>
</tr>
<tr>
<td>1916</td>
<td>10,196</td>
</tr>
<tr>
<td>1917</td>
<td>13,170</td>
</tr>
<tr>
<td>1918</td>
<td>13,510</td>
</tr>
<tr>
<td>1919</td>
<td>28,621</td>
</tr>
<tr>
<td>1920</td>
<td>32,392</td>
</tr>
<tr>
<td>1921</td>
<td>35,195</td>
</tr>
<tr>
<td>1922</td>
<td>34,673</td>
</tr>
<tr>
<td>1923</td>
<td>40,087</td>
</tr>
<tr>
<td>1924</td>
<td>53,136</td>
</tr>
<tr>
<td>1925</td>
<td>59,464</td>
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<tr>
<td>1926</td>
<td>63,086</td>
</tr>
<tr>
<td>1927</td>
<td>72,761</td>
</tr>
<tr>
<td>1928</td>
<td>91,668</td>
</tr>
<tr>
<td>1929</td>
<td>13,744</td>
</tr>
</tbody>
</table>


aFirst six months
APPENDIX B

THE SUPREME COURT DECISION ON THE LOS ANGELES LUMBER PRODUCTS COMPANY CASE*

"In equity reorganization law the term 'fair and equitable' included, inter alia, the rules of law enunciated by this Court in the familiar cases of Railroad Co. v. Howard, 7 Wall. 392; Louisville Trust Co. v. Louisville, New Albany & Chicago Railway Co., 174 U. S. 674; Northern Pacific Railway Co. v. Boyd, 228 U. S. 452; Kansas City Terminal Railway Co. v. Central Union Trust Co., 271 U. S. 445. These cases dealt with the precedence to be accorded creditors over stockholders in reorganization plans. In Louisville Trust Co. v. Louisville, New Albany & Chicago Railway Co., supra, this Court reaffirmed the 'familiar rule' that 'the stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors.' And it went on to say that 'any arrangement of the parties by which the subordinate rights and interests of stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation' (p. 674). This doctrine is the fixed principle according to which Northern Pacific Railway Co. v. Boyd, supra, decided that the character of reorganization plans was to be evaluated.... On the reaffirmation of this 'fixed principle' of reorganization law in Kansas City Terminal Railway Co. v. Central Union Trust Co., supra, it was said that 'to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation' (p. 455). In application of this rule of full or absolute priority this Court recognized certain practical considerations and made it clear that such rule did not require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, in equitable terms, of income bonds or preferred stock.' Northern Pacific Railway Co. v. Boyd, supra, p. 508. And this practical aspect of the problem was further amplified in Kansas City Terminal Railway Co. v. Central Union Trust Co., supra, by the statement that when necessary, they (creditors) may be protected through other arrangements which distinctly recognize their equitable right to be preferred to stockholders against the full value of all property belonging to the debtor corporation, and afford each of them fair opportunity, measured by the existing circumstances, to avail himself of this right (pp. 454-455). And it also recognized the necessity at times of

permitting the inclusion of stockholders on payment of contributions, even though the debtor company was insolvent. As stated in Kansas City Terminal Railway Co. v. Central Union Trust Co., supra, p. 491:

"Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them. In such or similar cases the Chancellor may exercise an informed discretion concerning the practical adjustment of the several rights." But even so, payment of cash by the stockholders for new stock did not itself save the plan from the rigors of the 'fixed principle' of the Boyd case, for in that case the decree was struck down where provision was not made for the unsecured creditors and even though the stockholders did pay cash for their new stock. Sales pursuant to such plans were void, even though there was no fraud in the decree.

"As this Court there stated, p. 502: 'There is no difference in principle if the contract of reorganization, instead of being effectuated by private sale, is consummated by a master's deed under a consent decree.' Throughout the history of equity reorganizations ... the doctrine of Northern Pacific Railway Co. v. Boyd, supra, p. 504, and related cases, was commonly included in the phrase 'fair and equitable' or its equivalent. ... we find the words 'fair and equitable' ... used to include the 'fixed principle' of the Boyd case, its antecedents and its successors. Hence we conclude that that doctrine is firmly embedded....

We come then to the legal question of whether the plan here in issue is fair and equitable within the meaning of that phrase.... We do not believe it was for the following reasons. Here the court made a finding that the debtor is insolvent not only in the equity sense but also in the bankruptcy sense. Admittedly there are assets not in excess of $500,000, while the claims of the bondholders for principal and interest are approximately $3,500,000. Hence even if all of the assets were turned over to the bondholders they would realize less than 25 per cent on their claims. Yet in spite of this fact they will be required under the plan to surrender to the stockholders 23 per cent of the value of the enterprise.

Thus, the relative priorities of the bondholders and the old Class A stockholders are maintained by virtue of the priorities accorded the preferred stock which the bondholders are to receive. But this is not compliance with the principle expressed in Kansas City Terminal Railway Co. v. Central Union Trust Co., supra, that 'to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation,' for there are not sufficient assets to pay the bondholders the amount of their claims, nor does this plan recognize the equitable right of the bondholders 'to be preferred to stockholders against the full value of all property belonging to the debtor corporation,' within the meaning of the rule announced in that case, since the full value of that property is not first applied to claims of the bondholders before the stockholders are allowed to participate. Rather it is partially diverted for the benefit of the stockholders even though the bondholders
would obtain less than 25 per cent payment if they received it all. Under that theory all classes of security holders could be perpetuated in the new company even though the assets were insufficient to pay— in new bonds or stock— the amount owing senior creditors. Such a result is not tenable."