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REORGANIZATION OF CORPORATIONS: CERTAIN DEVELOPMENTS OF THE LAST DECADE*

The purpose of this discussion is not to summarize the legal machinery of a conventional reorganization, nor to attempt any general survey of the legal problems involved in reorganizations, but only to consider those few changes of procedure and new legal problems which have developed in this field since March, 1916, when Mr. Paul D. Cravath delivered his two lectures before the Association of the Bar of the City of New York, on *The Reorganization of Corporations.*[1]

I. Reorganization Through Judicial Proceedings

1. The Development of the Doctrine of the *Boyd* Case

Because of the large investments, the variety of different classes of securities and the widespread public interest usually involved in reorganizations of railroads, it has been in such cases that the law affecting corporate reorganizations, and particularly the law affecting reorganization through judicial proceedings, has been developed.

In March, 1916, there were in the hands of receivers, awaiting reorganization, over 80 railroad corporations owning about 42,000 miles of railroad, or about 16% of the total mileage of the country.[2] The reorganizations of many of these properties have since been concluded. Many additional railroads have passed into receivership, and at the end of the year 1925, 48 railroads with over 18,000 miles of road were being operated by receivers,[3] and the reorganizations of several of them were in process.

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* An Address delivered at the House of the Association of the Bar of the City of New York, March 10, 1927. The author acknowledges the assistance of Messrs. Donald C. Swatland and Alfred McCormack in the preparation and annotation of this article.

[1] Cravath, *Reorganization of Corporations,* Some Legal Phases of Corporate Financing, Reorganization and Regulation (1917) 153.

[2] See *ibid.,* 154.

[3] See Commerce Year Book 1925 (United States Department of Commerce, 1926) 524. Statistics of Railways in the United States for the Year Ended December 31, 1924 (Bureau of Statistics, Interstate Commerce Commission,

In practically all these reorganizations, one of the main problems confronting counsel has been that of the *Boyd* case,[4] and it has been in connection with the doctrine enunciated by the Supreme Court in that case, that an important development in the law affecting the reorganization of corporations has occurred during the last decade.

(a) *The Basis of the Doctrine*

The *Boyd* case decision was something of a shock to many lawyers. Mr. Justice Lurton, dissenting, spoke of the "alarming" consequences which might result from the decision.[5] Mr. Cravath, referring to Adrian H. Joline's characterization of the *Monon* case,[6] the precursor of the *Boyd* case, as a "perpetual spectre" in the path of reorganizers, asked whether that "spectre" had not "now become materialized into a veritable demon incarnate standing across the path of the reorganizers."[7]

But in retrospect, it may be questioned whether the decision should have occasioned any considerable surprise, and in practical experience the "demon incarnate" has become reasonably domesticated.

What was the decision in the *Boyd* case?

Boyd was, in legal effect, a creditor of the Northern Pacific *Railroad* Company. That Company had outstanding about $157,000,000 of bonds and about $155,000,000 of stock. Following default, the mortgages were foreclosed and the property sold to a reorganization committee for $61,000,000. Under the reorganization plan, bondholders received new bonds, and stockholders received new stock upon paying an assessment, in the case of the preferred stock, of $10, and in the case of the common stock, of $15, per share. No security other than the stock was issued in respect of the assessment. The plan made no provision for unsecured creditors such as Boyd.

Against the property when vested in the reorganized Northern Pacific *Railway* Company, Boyd sought to enforce his claim. The Supreme Court, by a bare majority, held that the transfer constituted fraud in law as against Boyd, and that his claim constituted a lien upon the property of the *Railroad* Company in the hands of the *Railway* Company, subject to the mortgages placed thereon in the reorganization.

Stated abstractly, the decision was that a plan of reorganization which admits stockholders of a debtor company to an interest in the

1926) xvi, gives figures for December 31st of each year from 1916 through 1924, which show an approximate annual average of 68 railroads and 17,000 miles.

[4] Northern Pacific Ry. v. Boyd, 228 U. S. 482, 33 Sup. Ct. 554 (1913).

[5] See 228 U. S. at 511, 33 Sup. Ct. at 562.

[6] Louisville Trust Co. v. Louisville &c. Ry., 174 U. S. 674, 19 Sup. Ct. 827 (1899).

[7] See Cravath, *op. cit.* at 197.

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 the stockholders.

The decision was but an application of the well-established equitable doctrine that a court of equity will not permit the exercise of a legal right in such a manner as to produce an inequitable result.[8] It had definitely been foreshadowed in the *Monon* case in 1899.

In that case the Supreme Court held, at the suit of a creditor who had intervened in foreclosure proceedings prior to decree, that a sale should not be confirmed to bondholders who had purchased pursuant to an arrangement with the stockholders that the property should be purchased by the bondholders, cutting off unsecured creditors, but giving the stockholders an interest in the purchase. After pointing out that the amounts involved in the foreclosure of railroad mortgages are usually so large that only the bondholders can be considered as probable purchasers, Mr. Justice Brewer said:

> " . . . no such proceedings can be rightfully carried to consummation which recognize and preserve any interest in the stockholders without also recognizing and preserving the interests, not merely of the mortgagee, but of every creditor of the corporation. In other words, if the bondholder wishes to foreclose and exclude inferior lienholders or general unsecured creditors and stockholders he may do so, but a foreclosure which attempts to preserve any interest or right of the mortgagor in the property after the sale must necessarily secure and preserve the prior rights of general creditors thereof. This is based upon 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 any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation."[9]

The *Boyd* case was the logical result of the legal theory thus expounded by Mr. Justice Brewer in the *Monon* case. But in the *Boyd* case the Court clearly recognized the frequent necessity for permitting stockholders to retain their interest in a reorganized company, and the validity of such arrangements if they include the preservation to all the creditors of interests in the reorganized enterprise which, all the circumstances considered, are fair and equitable.

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[8] See Swaine, *Reorganization—The Next Step: A Reply to Mr. James N. Rosenberg* (1922) 22 COLUMBIA LAW REV. 121.

[9] See 174 U. S. at 683-684, 19 Sup. Ct. at 830.

Mr. Justice Lamar, delivering the majority opinion, said:

> ". . . it is now settled that such reorganizations are not necessarily illegal, and, as proceedings to subject the property must usually be in a court where those who ask equity must do equity, such reorganizations may even have an effect more extensive than those made without judicial sale, and bind creditors who do not accept fair terms offered. The enormous value of corporate property often makes it impossible for one, or a score, or a hundred bond holders to purchase, and equally so for stockholders to protect their interests A combination is necessary to secure a bidder and to prevent a sacrifice. Coöperation being essential, there is no reason why the stockholders should not unite with the bondholders to buy in the property.
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> "That was done in the present case. And while the agreement contained no provision as to the payment of unsecured creditors, yet the Railway Company purchased unsecured claims aggregating $14,000,000. Whether they were acquired because of their value, to avoid litigation, or in recognition of the fact that such claims were superior to the rights of stockholders, does not appear, nor is it material. For, if purposely or unintentionally a single creditor was not paid, or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company. . . . Any device, whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor was invalid. Being bound for the debts, the purchase of their property, by their new company, for their benefit, put the stockholders in the position of a mortgagor buying at his own sale. . . ."[10]

The court definitely rejected the argument that the rights of the unsecured creditor depended upon whether the property in fact had a value in excess of the foreclosed mortgage, saying:

> "The invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property, for in cases like this, the question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether, on the day of sale the property was insufficient to pay prior encumbrances. . . ."[11]

The capitalization of the property with the issue of $155,000,000 of stock, against the payment of assessments thereon averaging less than $15 per $100 share, was adverted to as evidencing the existence of "a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever."

And to indicate clearly that the invalidity found to exist in the case before the court arose only out of the fact of the exclusion of Boyd from any interest in the property, the court further said:

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[10] See 228 U. S. at 503-504, 33 Sup. Ct. at 560.
[11] See 228 U. S. at 507, 33 Sup. Ct. at 561.

"This conclusion does not, as claimed, 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, on equitable terms, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it. If, however, no such tender was made and kept good he retains the right to subject the interest of the old stockholders in the property to the payment of his debt. If their interest is valueless, he gets nothing. If it be valuable, he merely subjects that which the law had originally and continuously made liable for the payment of corporate liabilities."[12]

The conception that the right of an unsecured creditor following a reorganization similar to that involved in the *Boyd* case, depends upon whether or not the property had an actual value in excess of the foreclosed mortgage debt, notwithstanding Mr. Justice Lamar's express statement to the contrary, found some support in the language of the Supreme Court in the *Kansas City Southern* case,[13] which was the first such case coming before it after the *Boyd* case. The Circuit Court of Appeals for the Eighth Circuit had held[14] that, since the value of the interest given to stockholders of the debtor under the reorganization plan in question was greater than the amount of the unsecured creditors' claims, and since no provision had been made for the complaining unsecured creditor, the reorganized company was liable for the full amount of complainant's claim, and had overruled the contention that "the Trust Company is entitled to no relief because the equitable interest of the creditors in the property of the Belt Company was of no value," saying:

". . . But the crucial issue here was not what the fair market value of the mortgaged property was, nor was it how much more the mortgaged property was worth than the amount of the mortgage. . . . that issue was: What was the equitable interest of the creditors in the mortgaged property of the Belt Company worth during the execution of the scheme and immediately after the foreclosure sale and the appropriation of it thereby by the Southern Company, the trustee for the creditors, to itself, for a trustee who violates his trust may not profit thereby? The creditors were entitled to the highest value their interest had during this time, either for the purpose of sale or for the purpose of preventing a foreclosure of the mortgage upon the Belt property, or for the purpose of compromising their claims or conditioning the foreclosure, or for the purpose of the present or future control of the property."[15]

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[12] See 228 U. S. at 508, 33 Sup. Ct. at 561-562.

[13] Kansas City Ry. v. Guardian Trust Co., 240 U. S. 166, 36 Sup. Ct. 334 (1916).

[14] Central Improvement Co. v. Cambria Steel Co., 210 Fed. 696 (C. C. A. 8th, 1913).

[15] See *ibid.* 706-707.

And again, quoting with approval from *Clements v. Moore:*[16]

> " 'A sale may be void for bad faith though the buyer pays the full value of the property bought. This is the consequence, where his purpose is to aid the seller in perpetrating a fraud upon his creditors, ...' "[17]

In affirming the decision of the Circuit Court of Appeals, the Supreme Court not only failed to clarify the doctrine of the *Boyd* case but added to the confusion by saying:

> ". . . it is essential to inquire whether the appellant [the New Company] received any such property, that is whether it got by the foreclosure more than enough to satisfy the mortgage, which was a paramount lien."[18]

But notwithstanding this language, the court looked, not to see what the actual value of the property was, but whether the stockholders of the Belt Company got a valuable interest, when the creditors were excluded.

Subsequent decisions[19] also make it clear that the real basis of the doctrine is the "fixed principle" enunciated by the *Boyd* case, and not the question whether the mortgaged property on some basis has a value greater than the amount of the foreclosed mortgage debt.

(b) *The Scope of the Doctrine*

As the *Boyd* case involved the claim of an unsecured creditor in a large railroad reorganization, and as the magnitude of railroad reorganizations had been referred to in that case, there was for a time among some the erroneous conception that the doctrine was limited to unsecured creditors and to railroad reorganizations. Since the doctrine is based on a general equitable principle not peculiar either to

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[16] 6 Wall. 299, 312 (1867).

[17] See 210 Fed. at 709.

[18] See 240 U. S. at 176, 36 Sup. Ct. at 336.

[19] Kansas City Ry. v. Cent. Union Tr. Co., 271 U. S. 445, 46 Sup. Ct. 549 (1926); Wabash Ry. v. Marshall, 224 Mich. 593, 195 N. W. 134 (1923). In the former case, the court said ". . . it now may be announced as settled doctrine, that where the value of corporate property to be sold under the foreclosure is so great as to render cooperation between bondholders and stockholders essential in order to secure a bidder and prevent undue sacrifice of their interests, they may enter into a fair and open arrangement to that end. But 'no such proceedings can be rightfully carried to consummation which recognize and preserve any interest in the stockholders without also recognizing and preserving the interests, not merely of the mortgagee, but of every creditor of the corporation. . . .' "

"This doctrine is the 'fixed principle' according to which Northern Pacific Railway Co. v. Boyd declares the character of reorganization agreements must be determined; and to it there should be rigid adherence." See 271 U. S. at 453-454, 46 Sup. Ct. at 551.

railroads or to the kind of claim[20] which happened to be before the court in the *Boyd* case, it is clear that it is not so limited, and it has not been so limited in its application by the courts. It has frequently been applied in cases involving industrial corporations.[21] While in every case in which the doctrine has been discussed, stockholders participated in the reorganization then before the court, and while the language of the decisions stresses the subordination of the interests of stockholders to those of creditors, I do not believe that the doctrine applies only to reorganizations in which stockholders are permitted to participate. The rule as I see it, and as I believe it will ultimately be developed by the courts, is that the relative priorities of the old securities, senior to the most junior securities which continue to have any interest in the property, must not be inequitably disturbed. Stockholders cannot be put ahead of creditors. Unsecured creditors cannot be put ahead of bondholders. Junior bondholders cannot be put ahead of senior bondholders; and, it is submitted, common stockholders cannot unite with bondholders in a plan which will put them ahead of preferred stockholders.

(c) *The Procedure to Determine the "Fairness" of a Plan*

Because of the broad scope of the doctrine of the *Boyd* case, and because of the tremendously serious consequences to the security holders in a reorganization consummated in violation of that doctrine, counsel for reorganizers have been extremely anxious to find machinery to determine in advance of its consummation whether or not a reorganization plan is "equitable." In their efforts they have met with most helpful cooperation and practical good sense on the part of the courts.

In March, 1916, the first large railroad reorganization following the *Boyd* case (that of St. Louis & San Francisco Railroad Company)

[20] See Pierce v. United States, 255 U. S. 398, 403, 41 Sup. Ct. 365, 367 (1921).

[21] Howard v. Maxwell Motor Co., 269 Fed. 292 (S. D. N. Y. 1920). In this case, Howard was the lessor of property under a lease under which the payment of rent had been guaranteed by a subsidiary of the insolvent company, whose assets were taken over by the new company. The new company was allowed by the decree of sale to elect, within a named period, whether to assume the guaranty. After it had taken over the assets of the old company, it elected not to assume the guaranty, and on the next rent day the lessee defaulted. The claim, therefore, arose after the distribution of assets to the creditors of the old company. The court held that the lessor was entitled to invoke the rule of the Boyd case and to subject the assets of the guarantor coming into the hands of the new company to the payment of his claim in full. See also Okmulgee Window Glass Co. v. Frink, 260 Fed. 159, 166 *et seq.* (C. C. A. 8th, 1919), a voluntary sale of all the corporate assets to a new company; and Safety Car Heating & Lighting Co. v. U. S. Light & Heat Co., 2 F.(2d) 384, 386 (W. D. N. Y. 1924). The rule was applied, although upon an erroneous theory, to a public utility in Mountain States Power Co. v. Jordon Lumber Co., 293 Fed. 502 (C. C. A. 9th, 1923), in which the provision that was made for unsecured creditors was held to be inadequate.

came on for final decree before Judge Sanborn.[22] There was inserted in the foreclosure decree[23] a provision that no sale should be confirmed to any corporation organized pursuant to a reorganization plan admitting stockholders of the old company to any interest, unless a fair and timely offer of cash, or a fair and timely offer of participation through stocks, bonds or otherwise, had been made to all creditors who had filed their claims and whose claims were subordinate to the junior mortgages. The court reserved exclusive jurisdiction to determine whether or not the plan contained such a fair offer.

It will be noticed that the provision in the Frisco decree referred substantially only to unsecured creditors,—evidence that the scope of the doctrine of the *Boyd* case was not fully appreciated.

In the Missouri Pacific reorganization, which immediately followed that of the Frisco, the machinery was somewhat improved. The reorganization plan was filed with the court in advance of the foreclosure decree, which, after reciting that fact, provided that the court would hear complaints as to the fairness of the offers to various named classes of creditors, including bondholders.[24] The court reserved jurisdiction to determine whether fair offers had been made, and to modify the terms of the foreclosure decree in case it should find that such offers had not been made.

The machinery thus initially worked out in the Frisco and Missouri Pacific reorganizations has been followed, and from time to time improved upon, in substantially all of the railroad reorganizations to date, and in many reorganizations of public utility and industrial properties. Its most recent and probably its most carefully worked out adaptation was in the final decree of foreclosure and sale, entered April 26, 1926, in the proceedings affecting the Chicago, Milwaukee and St. Paul Railway Company.[25] Under the provisions of that decree, any purchaser proposing to bid on behalf of a corporation to be organized pursuant to any plan of reorganization (not merely a plan in which stockholders should retain an interest in the property, as had been provided in the Frisco decree) was required to file, with the Special Master, the plan and a brief statement of the notice theretofore given of such plan to "persons

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[22] North American Co. v. St. Louis & S. F. R. R., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4174, final decree entered March 31, 1916 (not reported).

[23] See St. Louis-San Francisco Ry. v. McElvain, 253 Fed. 123, 126 (E. D. Mo. 1918).

[24] Guaranty Trust Co. v. Missouri Pacific Ry., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4540, final decree entered Dec. 21, 1916 (not reported).

[25] Guaranty Trust Co. v. Chicago, M. & St. P. Ry., U. S. D. C., N. D. Ill., E. Div., Cons. Cause Eq. No. 4931, final decree of foreclosure and sale entered Apr. 26, 1926 (not reported).

and corporations interested in the Railway Company and its property." Provision was made for hearing

> ". . . complaints as to the equity of the provisions of any plan or agreement so filed . . . affecting the respective priorities of all persons and corporations interested in the Railway Company and its property, from all bondholders or other creditors, secured or unsecured, or stockholders of the Railway Company, who before the date of such hearing, shall file, with leave of Court, their petitions herein for the purpose, specifying in reasonable detail the particulars in which such plan or agreement is alleged by them to be inequitable."[26]

Exclusive jurisdiction was reserved "to determine whether the provisions as to which complaints are so made are equitable." It was further provided that no sale to any one purchasing pursuant to a reorganization plan should be confirmed

> ". . . if this Court shall determine that the provisions of such plan and agreement, or any thereof, are inequitable or that said plan and agreement does not contain an equitable and timely offer of participation in the reorganization thereby proposed to all persons entitled thereto."[27]

Provision was made for giving, by extensive publication, notice of these provisions of the decree and of the filing of anv reorganization plan.

That such a judicial determination, in the course of a receivership proceeding, of the fairness of a reorganization plan, is binding upon creditors, even though they have not filed their claims in the proceedings, and that any effort by such creditors to pursue the reorganized company may be enjoined, has been held in a case[28] arising out of the Frisco reorganization, and also in a case[29] arising out of the Rock Island reorganization.[30]

The machinery for determining the fairness of the plan has usually been set up by the foreclosure decree, and that determination has usually not been made until sale of the property to a purchaser under the plan. In some instances, reorganizers have submitted their plan and procured a determination of its fairness in advance of the decree or of the

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[26] See *ibid.*, page 212 of the final decree.

[27] See *ibid.*, page 213 of the final decree.

[28] St. Louis-San Francisco Ry. v. Wall, U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4857, July 1, 1918 (not reported).

[29] Chicago, R I. & P. Ry. v. Lincoln Horse & M. Com'n Co., 284 Fed. 955 (C. C. A. 8th, 1922).

[30] In two other cases arising respectively out of the Frisco and Rock Island reorganizations, such determination was held binding upon creditors who had filed their claims. St. Louis-San Francisco Ry. v. McElvain, 253 Fed. 123 (E. D. Mo. 1918); Phipps v. Chicago, R. I. & P. Ry., 284 Fed. 945 (C. C. A. 8th, 1922).

sale.[31] Such procedure may be of material advantage to reorganizers, as it goes far toward eliminating the risk of competitive bidding by an opposition faction, and of course eliminates any possibility that the sale may be upset and a re-sale made necessary in the event that the plan should prove to be inequitable. There is, however, some question whether in advance of sale the question of the fairness of any particular plan may not be moot, and hence such a determination at that stage not binding.[32]

On the other hand, there is no doubt that a court of equity may, if a reorganization plan is brought before it, withhold the foreclosure decree if the reorganization plan is clearly inequitable, if the proponents of the plan are, as a practical matter, the only possible purchasers, and if the alleged inequitable plan will certainly be the plan under which the property will be reorganized. Such was the case alleged in *Guaranty Trust Co. v. Missouri Pac. Ry.*,[33] in which Judge Hook permitted certain division bondholders not represented by any trustee in the foreclosure proceedings, to intervene before decree and object to the provision for them in the reorganization plan.

It would seem to be established by the decisions to date, however, that the determination of the fairness of a plan should properly be had upon the application for confirmation of a sale pursuant to the plan,[34] and that there is no general right in security holders to compel such a

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[31] See Habirshaw Electric Cable Co. v. Habirshaw Electric Cable Co., 296 Fed. 875, 879 (C. C. A. 2d, 1924).

[32] See Guaranty Trust Co. v. Chicago, M. & St. P. Ry., 15 F.(2d) 434, 441 (N. D. Ill., 1926 and 1927).

[33] 238 Fed. 812 (E. D. Mo. 1916).

[34] This procedure was followed in the following railroad receiverships:

Guaranty Trust Co. v. Missouri Pacific Ry., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4540, order confirming sale entered March 6, 1917, and order finding plan fair and overruling objections made by creditors, entered March 7, 1917 (not reported).

Westinghouse Electric & Manufacturing Co. v. Brooklyn Rapid Transit Co., U. S. D. C., S. D. N. Y., Cons. Cause Eq. No. E 15-347, decree dated June 7, 1923, confirming sale and finding the offers to creditors fair (not reported). This decree recited that "no creditor of any class" had appeared at the hearing upon the fairness of the plan to make complaint as to such offers.

American Brake Shoe & Foundry Co. v. New York Rys., U. S. D. C., S. D. N. Y., Cons. Cause Eq. No. E 17-89, order confirming the sale and order approving plan of reorganization, entered July 10, 1924 (not reported).

Central Union Trust Co. v. Missouri, K. & T. Ry., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4564, order confirming sale entered February 9, 1923 (not reported).

North American Co. v. St. Louis & S. F. R. R., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4174, order confirming sale entered August 29, 1916, opinion by Sanborn, J. (not reported).

Railway Steel-Spring Co. v. Chicago & Eastern Illinois Ry., U. S. D. C., N. D. Ill., E. Div., Cons. Cause Eq. No. 57, orders entered May 3, 1921, confirming the sale and "finding offers to creditors to be fair and equitable and approving and confirming plan and agreement for reorganization" (not reported).

determination in anticipation of the foreclosure decree.[35] Certainly this is true where the objecting minority is proposing a plan of its own and asserting its intention, in case it cannot compel modification of the majority plan, to attempt to purchase the property at the judicial sale.

(d) *The Test of Fairness*

The fact that under the machinery which we have thus outlined, the court having administration of the property passes upon the fairness of the plan, does not mean that the court exercises a direct supervision over the reorganization.[36] The problem of the court is not whether the plan proposed is the best plan which could be drawn, or is the plan which the court would draw if left to its own devices, but whether there is anything in the plan so inequitable to any class of security holders that the court should withhold confirmation of the sale. As said by Judge Mayer in the *International Steam Pump* case:

> ". . . courts are not empowered to make contracts for parties in interest, nor can courts adjudge or decree the terms upon which a mortgagee may allow to

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Guaranty Trust Co. v. Chicago, M. & St. P. Ry., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4931, decree confirming sale and approving deed entered January 19, 1927 (not reported).

In each of these receiverships, the District Court, after the Master's Report of Sale, heard objections to the fairness and equitableness of the plan of reorganization, if there were any such objections, and entered orders finding the plan to be fair. In some of the cases these orders were inserted in the decrees confirming sale, and in others they were separate orders.

With a finding of the court that the offers made are equitable, the order of the court that the purchasers take the property free from any claims of creditors, etc., is binding upon the creditors. It has become the practice to insert in the order confirming sale an additional provision specifically enjoining creditors from enforcing their claims against the purchasers or against the property in the hands of the new company. See the orders made in the Missouri, Kansas & Texas case and in the St. Paul case.

[35] See Guaranty Trust Co. v. Chicago, M. & St. P. Ry., 15 F.(2d) 434, 440 (N. D. Ill. 1926). The expression of Judge Mayer that "the court, of course, must decide whether or not the plan is fair and equitable before it orders the sale which is the step precedent to effectuating the plan," in Habirshaw Electric Cable Co. v. Habirshaw Electric Cable Co., 296 Fed. 875, 879 (C. C. A. 2d, 1924), did not express the actual practice of Judge Mayer, for in several reorganizations before him, the fairness of the plan was not determined until after the entry of the decree of sale. For example, in the New York Railways case, Judge Mayer entered the final decree of foreclosure and sale on May 21, 1924; the property was sold on July 7, 1924, and the decree of confirmation of sale was entered July 10, 1924. On the same day, Judge Mayer entered an order overruling the objections to the plan of reorganization, finding that the offer to creditors and stockholders was "fair, timely and equitable," and approving and confirming the plan of reorganization. American Brake Shoe & Foundry Co. v. New York Rys., U. S. D. C., S. D. N. Y., Cons. Cause Eq. No. E 17-89. In the Brooklyn Rapid Transit case, Judge Mayer inserted a similar finding in the decree confirming sale, entered June 7, 1923. Westinghouse Electric & Manufacturing Co. v. Brooklyn Rapid Transit Co., U. S. D. C., S. D. N. Y., Cons. Cause Eq. No. E 15-347.

[36] The contrary impression has been somewhat furthered by the language of Judge Hook in Guaranty Trust Co. v. Missouri Pac. Ry., 238 Fed. 812, 815 (E. D. Mo., 1916).

junior lienors, or others, participation in his mortgaged property when failure to pay the debt due him brings that property under the hammer.

"It is rare that any reorganization is satisfactory to all concerned; for, in the nature of things, when there is not on hand enough to satisfy every obligation in full, some, and perhaps all, must suffer more or less; but, in the absence of fraud in the inception or a fraudulent scheme to which court proceedings are necessary incidents, the field in which the battle for respective adjustments must be fought out is beyond the court room, for the court can only ask whether, without the aid of fraud or unlawful means, the debt is really and justly due.

"It is clear, therefore, that the court cannot directly or indirectly rewrite this reorganization agreement and I should not state something so obvious, were it not for the fact that the argument, so urgently pressed, comes down to that."[37]

As already pointed out, the test of fairness 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. As stated by Judge Sanborn in a case growing out of the Frisco reorganization:

"There is no moral turpitude, nor is there any illegality in the making and performance of an agreement between the bondholders secured by mortgages, the stockholders, and the unsecured creditors of an insolvent mortgagor, that there shall be a foreclosure and sale of the mortgaged property to or for the benefit of a new corporation in which all the members of the three classes shall be permitted at the option of each of them to take the bonds or stock of the new corporation in substantial proportion to the respective ranks and equities of the classes."[38]

Mathematical exactness is not required and is not possible. Reasonable adjustments are encouraged.[39] Every reorganization plan of necessity represents a compromise. The court therefore is in a position to do no more than see that the respective priorities of the security holders are substantially maintained or that such adjustments thereof as may be made are not inequitable. It does not attempt to pass on questions of business judgment as to which the opinions of different groups of security holders may properly differ.

While, as has been stated, the relative position of security holders must not be *inequitably* disturbed *inter se,* practical considerations frequently require radical disturbances. Particularly is this true in re-

[37] See Guaranty Trust Co. v. International Steam Pump Co., 231 Fed. 594, 595 (C. C. A. 2d, 1916); Conley v. International Pump Co., 237 Fed. 286, 287 (S. D. N. Y. 1915).

[38] See St. Louis-San Francisco Ry. v. McElvain, 253 Fed. 123, 133 (E. D. Mo. 1918).

[39] See Kansas City Ry. v. Cent. Union Tr. Co. 271 U. S. 445, 455, 46 Sup. Ct. 549, 551 (1926).

organizations of railroads constituted of many originally independent lines with independent mortgages. A sound financial structure, which is of course the aim of every reorganization, may require unifying underlying divisional issues into securities upon the system as a whole; that is, it may be advantageous to give to security holders having an interest limited to a fraction of the property, a new security representing an interest in the system as an entirety. The courts have recognized the necessity and validity of such disturbances of existing rights, both as to the divisional bonds, and as to the system bonds whose security may thus be diluted.[40]

The factors which determine the proper basis for exchange of securities are primarily economic, not legal. Earning capacity, both present and prospective, and the strategic position of the various properties, must be considered. Main line securities obviously may require more liberal treatment than branch line securities. The necessity of simplification to procure an effective new mortgage for future financing often justifies liberal treatment of division securities.[41]

Objections to reorganization plans based upon provision for such exchanges have usually been supported with elaborate statistical material as to cost of construction, book values, etc.[42] The courts, however, have recognized that such considerations are not controlling. In the *Missouri Pacific* case,[43] Judge Hook, referring to objections by branch line bondholders, said:

> "But there are other considerations than those. The relation of a particular railroad to the system as a whole, its value to the system on that account, and the advisability of including or excluding it, in view of the necessities of the reorganization, enter into the problem. A court cannot well review such matters, but must leave them largely to the business judgment of those in

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[40] For a discussion, in some detail, of the methods used in recent railroad reorganizations to refund underlying divisional issues, see DEWING, FINANCIAL POLICY OF CORPORATIONS (1926) 1048 *et seq.*

[41] See Analysis of the Security for the Bonds Dealt with under the Missouri Pacific Plan of Readjustment, dated July 1, 1915, published by the reorganization committees in the Missouri Pacific receivership, which is referred to by Prof. Dewing as "a somewhat remarkable document in the annals of reorganization history, in that it laid before the public, in unequivocal form, the simple strategic motives which lead reorganization committees to deal with railroad bonds according to the security behind them and not according to their legal form." See DEWING, FINANCIAL POLICY OF CORPORATIONS (1926) 1056.

[42] See, *e.g.*, Petition containing Objections of Bondholders' Defense Committee to Confirmation of Sale and to Proposed Plan of Reorganization, filed Dec. 9, 1926; Brief for Bondholders' Defense Committee on Motion of Trustees to Fix the Time of Sale and Upset Price; and Affidavits and Exhibits Submitted by the Bondholders' Defense Committee on the Motion of the Trustees to Fix the Time of Sale and Upset Price, in Guaranty Trust Co. v. Chicago, M. & St. P. Ry., U. S. D. C., N. D. Ill., E. Div., Cons. Cause Eq. No. 4931.

[43] Guaranty Trust Co. v. Missouri Pacific Ry., 238 Fed. 812.

charge. It would, perhaps, be going too far to say a court should never interfere on a complaint of that kind; but clearly it should not do so unless in an exceptional instance of fraud or grossly inequitable discrimination. Generally the objection to a plan of reorganization should involve a definite principle, and not require a long complicated investigation of values, properties, etc."[44]

The most common basis of attack upon reorganization plans is, of course, the claim that stockholders are being too liberally treated. In substantially every railroad reorganization in which there has been any opposition at all, the argument has been made that so long as the creditors do not receive either cash in full or securities which are worth 100 per cent of their claims, stockholders cannot be permitted to retain any part of their equity in the property. While conceding that stockholders may be admitted to some interest in the new company, these objectors have urged that the fair value of this participation must not be in excess of the amount of the stockholders' assessment.[45] 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, as it did in the *Missouri Pacific* case,[46] 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 has been unlawfully diverted from the creditors for the benefit of the stockholders.[47] The *Boyd* case is cited to prove the con-

[44] See *ibid.*, 818.

[45] The Bondholders' Defense Committee in the St. Paul case, Jameson v. Guaranty Trust Company of New York, 20 F.(2d) 808 (C. C. A. 7th, 1927), *certiorari* denied by the Supreme Court, Nov. 28, 1927, contended that (Appellants' Brief, p. 33): " . . . it is proper to allot some of these securities to stockholders, but only on condition that the stockholders pay for the securities then allotted substantially what they are worth." The court overruled the contention, upon the line of reasoning set forth in the text. See 20 F.(2d) 808, at 812-813.

[46] Guaranty Trust Company of New York v. Missouri Pacific Railway Company, U. S. D. C., E. D. Mo., Cons. Cause Eq. No. 4540, hearing on complaint of McCaull-Dryer Tie Co., interveners, filed February 27, 1917.

[47] In the Frisco reorganization, unsecured creditors received 50% of the amount of their claims in preferred stock and 50% in common stock of the new company. Common stockholders were assessed $50 per share, and received new common stock and $50 principal amount of new bonds for each share of common stock of the old company held by them. The market value of these new securities prior to confirmation of sale was such that the participation of the unsecured creditors was worth $25, while that of the common stockholders was worth $7 (*i.e.*, $57 less $50 assessment). See North American Co. v. St. Louis & S. F. R. R., U. S. D. C., E. D. Mo., Cons. Cause Eq. No. 4174, transcript of evidence taken at hearing on petition for confirmation of sale, filed September 21, 1916 (not reported).

In the Rock Island reorganization, the market value of the stock which the old stockholders retained was $34, while their net assessment was $9 (total assessment of $40 less $31 representing the market value of $40 par value of new preferred stock received in respect of this assessment). Unsecured

sequent illegality of the reorganization.[48] This argument has never been successfully maintained, and, in fact, could not be maintained without making successful corporate reorganizations impossible. Bondholders do not, as a rule, enforce their strict right of foreclosure and buy in the property for their own sole benefit, because they are unwilling to put up the new money which is usually essential to the continued life of the enterprise. Stockholders constitute the best, and often the only, available source of new money, and their participation is essential. That participation,—and the underwriting of it, which may become necessary in order to assure a successful reorganization,—can be obtained only by a plan which gives the stockholders something of definite value, over and above what they pay for. If reorganizers did not make their plans in such a way as fairly to assure that, before the conclusion of the

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creditors received new securities which had a market value of somewhat less than 50% of the face amount of their claims. Thus the creditor's participation was worth less than $50 per $100 of claims, while that of the stockholder was worth $25. American Steel Foundries v. Chicago, R. I. & P. Ry., U. S. D. C., N. D. Ill., E. Div., Cons. Cause Eq. No. 445, petition of Abeles, filed May 29, 1927 (not reported).

In the M., K. & T. reorganization, figures submitted to the court showed that, based on the maximum market value of the new securities prior to confirmation of sale, the participations of creditors and stockholders were as follows: creditors . . . $29; preferred stockholders . . . $18; common stockholders . . . $17. The figures submitted to the court also showed that some of the new bonds issued to bondholders in the reorganization sold below $42 during the same period. Pages 380-381 of transcript of record on appeal in Kansas City Ry. v. Central Union Tr. Co., 271 U. S. 445, 46 Sup. Ct. 549 (1926).

[48] The capitalization of the new company, having stock of a great aggregate par value, and assertions of the property's value made in valuation or other proceedings, are also cited to show the substantial value of the stockholders' participation, and the consequent injustice to creditors. It is argued that the reorganizers should not be permitted to set one valuation upon the property in order to support a large capitalization or a high rate base, and another valuation in order to defeat the claims of creditors. The objector then points out that the market value of the security given him is considerably less than the principal of his claim.

This argument, of course, overlooks the fact that the basis of valuation which the objector applies to the common stockholder's security is quite different from that which he seeks to apply to his own, and that if the common stock is worth par, the securities given to the creditors, which are usually securities of a prior rank, are also worth at least par. See Guaranty Trust Co. v. Missouri Pacific Ry., 238 Fed. 812, 818 (E. D. Mo. 1916).

A similar argument was dealt with realistically in a recent case, and disposed of in the following somewhat picturesque language:

> "The sum of appellants' numerous contentions is, in the last analysis and when expressed in the vernacular, that appellees may not, as the devil is said to have said in the legendary incident, 'blow hot and cold.' Conceding, arguendo, that equity in some situations frowns faintly at least, on the inconsistency to be inferred from a too tempestuous exsufflation of calidity when immediately followed by a similar exsufflation of frigidity, yet the inequities which follow if any, even when the faults are laid at the right door, are to be measured by fairly well-settled rules and not 'by the length of the chancellor's foot.' Measured by such settled rules, we are constrained to conclude that the decree below was correct." See Temmer v Denver Tramway Co., 18 F.(2d) 226, 231 (C. C. A. 8th, 1927).

receivership, the new stock, upon a "when issued" basis, would sell substantially above the amount of the net assessment, the reorganization would not be successful. The answer to the argument that this constitutes an appropriation to the stockholders of a substantial equity in the property, which should be used to pay the creditors in full, is that this equity is largely attributable to the fact that the stockholders are willing to put more money into the property; and that if they were not willing to do this,—if the plan were not made reasonably attractive to them,—the "substantial equity" would disappear. In the words of Judge Sanborn in his opinion on confirmation of sale in the *Frisco* case:

> ". . . Now, it is said that . . . there was an equity of ninety-one millions of dollars left, and that that equity ought to be applied to the payment of creditors before the stockholders should receive anything. That is an estimate, but the court is clearly of the opinion that if the lien holders who foreclosed their mortgage upon this property had proceeded to a sale of the property under their rights, no one could have been found who would have paid enough to satisfy the bonded liens, and there would have been nothing left for either creditors or stockholders. It was, in the opinion of the court, only by virtue of this reorganization scheme, whereby these stockholders would take hold and assist to reorganize the company and to take these new securities, or a portion of them, that anything whatever could have been saved for the common creditors. They never could have bought this property, they never could have reorganized this company, they never could have purchased this property so as to give to themselves anything above the amount required to pay the bonded debt. So that this estimate of three hundred twenty-one millions and this equity of ninety or ninety-one millions, when it comes to an actual foreclosure of the mortgage and the handling of a big property like this, is more imaginary than real."[49]

The assessments imposed upon stockholders usually take the form of, or are equivalent to, the purchase by them, as a condition of their receiving stock in the new company, of securities having a rank equal or superior to those given to creditors or bondholders, but at a price above that of the market.[50] Objections have frequently been made that such provisions in reorganization plans displace the prior rights of creditors and give undue preference to stockholders. The courts have sus-

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[49] North American Co. v. St. Louis & S. F. R. R., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4174, August 29, 1916 (not reported).

[50] In the St. Paul case, for example, the stockholders received bonds which sold at about 80 after the publication of the plan on June 1, 1925. The common stockholder thus received, for an assessment of $32, $28 principal amount of bonds, having a market value of about $22.50, while the preferred stockholder received, for an assessment of $28, $24 principal amount of bonds having a value of a little over $19.

tained these provisions in all of the railroad reorganizations which have thus far been mentioned.[51]

In *Kansas City Terminal Railway v. Central Union Trust Co.*,[52] the Supreme Court held that a plan would be fair and binding upon unsecured creditors, which offered them securities of the same grade as those offered to the stockholders, the difference being only that a greater amount of such securities was offered to the creditors; and also held

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[51] Frisco: Unsecured creditors received 50% preferred stock and 50% common stock, while the stockholders were given bonds for the amount of their cash assessments. North American Co. v. St. Louis & S. F. R. R., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4174, order of confirmation of sale entered August 29, 1916; and see St. Louis-San Francisco Ry. v. McElvain, 253 Fed. 123, 126, 132 (E. D. Mo. 1918).

Missouri Pacific: The stockholders of the Old Company were assessed $50 per share and received for this, in addition to their new stock, $50 in bonds, while the holders of seven issues of bonds received 5% preferred stock, non-cumulative for three years. Unsecured creditors also received preferred stock. Guaranty Trust Co. v. Missouri Pacific Ry., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4540, order of confirmation of sale entered March 6, 1917; see Guaranty Trust Co. v. Missouri Pacific Ry., 238 Fed. 812, 813 (E. D. Mo. 1916); P. R. Walsh Tie & Timber Co. v. Missouri Pac. Ry., 280 Fed. 38, 43 (C. C. A. 8th, 1922), *certiorari* denied, 260 U. S. 743, 43 Sup. Ct. 164 (1922).

Missouri, Kansas & Texas: Some of the bondholders were given, in whole or in part, income bonds, non-cumulative preferred stock, or both. Unsecured creditors were given preferred and common stock, or, upon payment of an optional assessment, mortgage bonds and junior income bonds and common stock. Stockholders were given mortgage bonds and junior income bonds totalling the amount of their assessments. Central Union Trust Co. v. Missouri, K. & T. Ry., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4564, order of confirmation of sale entered February 9, 1923; see Kansas City Ry. v. Centr. Union Tr. Co., 271 U. S. 445, 450, 46 Sup. Ct. 549, 550 (1926).

Rock Island: The debenture holders received a 6% preferred stock, while new capital was raised by the sale to the common stockholders of a 7% preferred stock prior, to the extent of 1% in dividends, to the 6% stock. American Steel Foundries v. Chicago, R. I. & P. Ry., U. S. D. C., N. D. Ill., E. Div., Cons. Cause Eq. No. 445, final decree returning property to Company without a judicial sale, entered June 12, 1917; see Phipps v. Chicago, R. I. & P. Ry., 284 Fed. 945 (C. C. A. 8th, 1922). Attention may be called here to the erroneous statement in the Phipps case (at 946) to the effect that the 6% stock given to creditors had priority over the 7% stock issued to stockholders. This error, which was probably due to an ambiguous statement in the final decree, has been perpetuated in subsequent discussions of the case.

Chicago & Eastern Illinois: The holders of certain bonds, on which seven years' interest was due, received preferred stock, non-cumulative for three years, equal in par value to the principal amount of their bonds, while the stockholders were assessed $30 per share and received new bonds for the amount of their cash assessments. Railway Steel Spring Co. v. Chicago & Eastern Ill. Ry., U. S. D. C., N. D. Ill., E. Div., Cons. Cause Eq. No. 57, order finding offers to creditors to be fair and equitable, and approving and confirming plan and agreement for reorganization, entered May 3, 1921.

St. Paul: The plan and agreement of reorganization, dated June 1, 1925, as modified November 19, 1925, provides that the foreclosing bondholders will receive 20% of prior lien mortgage bonds bearing fixed interest and 80% junior income bonds. The stockholders are to receive prior lien bonds in respect of their assessments, as set forth in the preceding footnote. Guaranty Trust Co. v. Chicago, M. & St. P. Ry., U. S. D. C., N. D. Ill., E. Div., Cons. Cause Eq. No. 4931, order confirming sale entered January 19, 1927. Jameson v. Guaranty Trust Co., 20 F.(2d) 808 (C. C. A. 7th, 1927) *certiorari* denied by the Supreme Court, Nov. 28, 1927.

[52] 271 U. S. 445, 46 Sup. Ct. 549 (1926).

that an alternative offer to such creditors would be fair and binding which consisted only of the same grade and amount of securities as those offered to the stockholders, the only difference being that the right of the stockholders to participate was conditioned upon their paying an assessment greater than that asked of the creditors; provided that in each case the court was of the opinion that the offer tendered to the creditors all that could reasonably be expected under the existing circumstances.

Mr. Justice McReynolds, in his opinion in that case, said:

> " . . . But, as that opinion [the *Boyd* case] states, this does not require the impossible and make it necessary always to pay unsecured creditors in cash before stockholders may retain any interest whatever in the reorganized company. By way of illustration it further pointed out, that such creditors can be protected 'by the issuance, on equitable terms, of income bonds or preferred stock.' And we now add that, when necessary, they 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.
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> "Unsecured creditors of insolvent corporations are entitled to the benefit of the values which remain after lienholders are satisfied, whether this is present or prospective, for dividends or only for purposes of control. But reasonable adjustments should be encouraged. Practically, it is impossible to sell the property of a great railroad for cash; and, generally, the interests of all parties, including the public, are best served by coöperation between bondholders and stockholders. If creditors decline a fair offer based upon the principles above stated, they are left to protect themselves. After such refusal they cannot attack the reorganization in a court of equity."[53]

In almost every railroad reorganization the major financial problems of the reorganizers are

(1) To reduce fixed charges to an amount safely within the earnings of the property;

(2) To fund early maturities into long-time obligations or stock; and

(3) Immediately to raise funds for working capital and necessary capital expenditures and to provide some security capable of being used to finance future capital requirements.

So long as the relative positions of the old securities are not inequitably disturbed *inter se,* radical scaling down or readjustment of the rights of security holders for the accomplishment of these ends will be sustained.[54] Indeed, the courts recognize the principle well stated

[53] See 271 U. S. at 454, 46 Sup. Ct. at 551.

[54] See chapter on "The Reduction in Fixed Charges in Contemporary Railroad Reorganization," DEWING, FINANCIAL POLICY OF CORPORATIONS (1926) 1042 *et seq.*

in the words of Professor Dewing that "a reorganization to be well done must be thoroughly done."[55]

It is quite customary to convert fixed charge obligations into obligations the charges upon which are contingent upon earnings[56] or, indeed, into preferred stock.[57] So, too, it may be provided that interest thus made contingent shall for a time be non-cumulative,[58] and that part of the earnings of the property may be applied to necessary capital expenditures in advance of meeting such contingent charges.[59] Such provisions are often necessary to the maintenance of the property's credit. They contemplate merely a possibly reduced return to creditors during a period when, of course, the stock receives no income. Such provisions are not rendered inequitable to creditors, merely because the stockholders are benefited by the improved credit of the property which results from such use of income which might otherwise go to the creditors, or because at some distant date the income thus capitalized may earn dividends for the stockholders or go to them upon a theoretical but wholly unlikely distribution in liquidation.[60]

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[55] See *ibid.* 991.

[56] See POTTER, INCOME BONDS (published by the Harvard Graduate School of Business Administration, 1926), a study of income bonds outstanding in June, 1925, lists 54 railway income bonds, of which 51 were issued at the time of reorganization.

[57] Preferred stock, non-cumulative for three years, was issued to the holders of some of the issues of bonds in the Missouri Pacific, M., K. & T., and C. & E. I. reorganizations.

[58] *E.g.*, the Frisco Income Mortgage Bonds, the M.—K.—T. Adjustment Mortgage Bonds, the International-Great Northern Adjustment Mortgage Bonds, and the new St. Paul Adjustment Mortgage Bonds.

[59] Interest upon the Denver and Rio Grande Western Railroad Company's General Mortgage Sinking Fund Gold Bonds, dated February 1, 1924, does not become a fixed charge until 1929, and is payable only out of net income, as defined in the mortgage. The mortgage further provides (Art. Six, Sec. 4):

> "The payment of the interest accruing on the General Mortgage Bonds for the period from February 1, 1924, to February 1, 1929, shall not be mandatory even if the same shall have been earned by the Railroad Company; but if earned and available, whether prior to February 1, 1929, or thereafter, the interest on the bonds accruing during such five year period (including accumulations, if any,) shall be paid to the extent that in the reasonable discretion of the Board of Directors of the Railroad Company such payment is not inconsistent with due regard for the protection of the property of the Railroad Company and the maintenance of efficient service thereon."

The M.—K.—T. Adjustment Mortgage Bonds were income bonds, non-cumulative for three years, during which period the directors were required to apply only half the available net income to the payment of interest, and might use the rest for capital expenditures.

[60] In the St. Paul case, the objectors argued that the concessions made by bondholders constituted "contributions" in the same sense as the stockholders' assessments. Thus the bondholders were said to be contributing $60,000,000, by subordinating their lien to that of the new bonds issued to stockholders in respect of their assessment. They were further alleged to be contributing large sums by reason of the contingent nature of the interest on the adjustment bonds which they were to receive, and the non-cumulative feature of such bonds, and because the company had the right, under the mortgage, to divert to

While, of course, the fact that a majority of a given class of security holders have joined in the plan does not conclusively establish the fairness of the plan as to that class, it is always persuasive evidence of fairness.[61]

The suggestion has been made that those assuming the reorganization of a large property have a fiduciary relationship to all the security holders, which imposes a duty to admit all of each class, for which the reorganizers purport to act, to participation in the plan upon equal terms. If there is such a rule, the courts nevertheless recognize that practical necessities frequently compel special dealings with some of the security holders, which may not be accorded to the others of the same class.[62] As was said by Judge Seaman in the *Investment Registry* case:

> " . . . I believe it to be well recognized that reorganizations on the part of bondholders are needful and legitimate means for the purpose of purchasing the mortgaged property at foreclosure sales; that no bondholder can be brought into such reorganization without his consent; that bonds may be purchased of a non-assenting bondholder for the purpose (express or implied) of foreclosing his objections or attempts to interfere with the reorganization plans; that equality in prices so paid is not, generally speaking, an essential requirement in such transaction; . . . ."[63]

In his unreported opinion on confirmation of the Frisco sale, Judge Sanborn said:

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capital expenditures, from payment of interest on the bonds, two-thirds of the first $7,500,000 of available net income. To these arguments the Circuit Court of Appeals, in Jameson v. Guaranty Trust Co., 20 F.(2d) 808, 812 (C. C. A. 7th, 1927) made the following common sense answer:

> "While it is true the Refunding bondholders make concessions to the extent of possibly all the interest accruing for five years until 1930, and after 1930 the possible deferring of part of their interest in favor of permanent improvements (the unpaid interest after 1930 to accumulate), as well as inferiority as to certain new bond issues, this is not a contribution in the same sense as new money paid into the company by those under no lawful obligation to supply it. If the Railway's assets were such as reasonably to assure prompt, full payment of the Refunding bonds and interest, concessions by the bondholders would be more nearly equivalent to cash contribution by them. But where, as here, the strong probability is that foreclosure sale in the ordinary way, without some fair plan for reorganization of the property, would realize these bondholders but small proportion of their full claims, concessions therein for the purpose of reorganization, in the hope that ultimately most of the debt will be realized, cannot be regarded as the equivalent of cash contributions."

[61] See Jameson v. Guaranty Trust Co., 20 F.(2d) 808, 815 (C. C. A. 7th, 1927); P. R. Walsh Tie & Timber Co. v. Missouri Pac. Ry. Co., 280 Fed. 38, 44 (C. C. A. 8th, 1922); Simon v. New Orleans, T. & M. R. R., 242 Fed. 62, 64 (C. C. A. 5th, 1917); Fearon v. Bankers' Trust Co., 238 Fed. 83, 85 (C. C. A. 3d, 1916).

[62] See Investment Registry v. Chicago & M. E. R. R., 212 Fed. 594, 612 (C. C. A. 7th, 1913).

[63] See *ibid.* 612.

" . . . It is said that larger payments have been made to some creditors than to others. It is difficult to perceive how that fact can determine the question whether or not this is a fair and timely offer. There is no objection that the court can perceive to a reorganization committee, or anyone else, purchasing claims against an insolvent railroad company, for any price it sees fit to give, and paying some percentage to one creditor and a larger or less percentage to another, and it seems to the court that the fact that the banks have been paid a larger percentage than some others, and that small creditors under a hundred dollars have been paid a larger percentage than others, does not determine the question whether or not these protestants have received a fair and timely offer in settlement of their claims."[64]

It has also been suggested that the reorganizers must keep open the offers to each class of creditors and stockholders (even those who are opposing the reorganization), until the reorganization has been completed and approved by the highest courts.[65] Clearly offers of participation in a reorganization must be kept open for a reasonable time, if the vice found to exist in the *Boyd* case is to be avoided.[66] But it would seem, on principles of common fairness, to be equally certain that an offer of participation need not be kept open indefinitely. As the Circuit Court of Appeals said in the *St. Paul* case:

"It is hardly possible that each and every security holder can be reached or will act, and it is apparent that at some stage a time should be fixed beyond which holders of securities may not exercise their option to deposit and to take under the Plan . . ."[67]

Receiverships are always expensive luxuries, and once a plan of reorganization has been agreed upon by a majority of the security holders, its prompt consummation is imperatively desirable, in order to obtain, at the earliest possible moment, the cessation of the drain of the receivership, the savings presumably provided by the plan, and the elimination of uncertainty in the personnel of the organization. Minority factions usually avail themselves of this value to the majority of early consummation, to seek delay and, by their opposition, to create

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[64] North American Co. v. St. Louis & S. F. R. R., U. S. D. C., E. D. Mo., E. Div., Cons. Cause Eq. No. 4174, order confirming sale entered August 29, 1916 (not reported).

[65] See brief for appellants in Jameson v. Guaranty Trust Co., C. C. A. 7th, Oct. T. 1926, No. 3897, page 98.

[66] See Bound v. So. Carolina R. R., 78 Fed. 49, 56 (C. C. A. 4th, 1897), in which the court said:

"If notice of the fullest kind possible is given to all bondholders, and all are invited to come into the association upon the same terms, and the privilege is not withdrawn until there is a really valid reason for doing so, there can be no just complaint by those whose inaction has left them outside that they do not share in the benefits of those who are inside the association, and have taken the risks for its success or failure."

[67] See Jameson v. Guaranty Trust Co., 20 F.(2d) 808, 814 (C. C. A. 7th, 1927). *Cf.* Carpenter v. Catlin, 44 Barb. 75 (N. Y. 1865); Shaw v. Railroad Company, 100 U. S. 605 (1879) *(semble).*

for their bonds or claims a maneuvering value which will secure them better terms than are given to others of their class, or gain advantages for their class at the expense of other classes of participants. It would, therefore, seem not unfair that claimants who take such a position should, if their objections are ultimately proved without merit, be wholly excluded from participation in the reorganization which they have attacked, and be left to take their distributive share in the proceeds of sale of the corporate property. Certainly it would seem that, inasmuch as the delay which such a minority induces, in real and substantial effect, imposes a financial penalty upon the majority, the payment of a money penalty may properly be imposed as a condition of any offer of participation which may be made to the minority after it has been defeated. This has been the universal practice in the past.[68]

In considering the objections of minority security holders, the courts consider the circumstances under which the objectors obtained

[68] The validity of the practice has, so far as I know, never been directly passed upon by the courts. In the St. Paul proceedings, minority bondholders have unsuccessfully contended that statements in the advertisements of the reorganization plan that deposits would be received after a certain date only upon the payment of such money penalties as might be imposed, rendered the Plan unfair, or at least prevented the court from considering the support of the majority as evidence of the fairness of the plan. The same minority applied for an injunction which would in effect keep open their opportunity to deposit under the Plan until after final determination of their appeal from the order confirming sale and approving the Plan. This application was denied by both the District Court and the Circuit Court of Appeals. Guaranty Trust Co. v. Chicago, M. & St. P. Ry., U. S. D. C., N. D. Ill., E. Div., Cons. Cause Eq. No. 4931, order denying petition entered April 8, 1927; Jameson v. Guaranty Trust Co., C. C. A. 7th, Oct. T. 1926, No. 3897, order denying petition entered April 26, 1927 (not reported).

The following cases were cited to support the application for an injunction: Shaw v. Railroad Company, 100 U. S. 605 (1879), in which an application to the trial court to extend the time within which bondholders might become parties to the Plan, until the arguments of dissenters in favor of modification should be heard, resulted in an order extending the time sixty days; but in which the propriety of such order was not litigated; Lamb v. Sambas Rubber, &c Co., L. R. [1908] 1 Ch. 845; Jones v. Pacaya Rubber &c Co., L. R. [1911] 1 K. B. 455, in each of which a subscriber to stock who had brought a bill to cancel his subscription on the ground of fraud, was granted an injunction against the corporation to restrain it from forfeiting his subscription for failure to pay an additional call, pending the determination of his suit.

The objectors also cited Sunter v. Sunter, 204 Mass. 448, 90 N. E. 561 (1910), and Fenton v. Farmers' & Merchants' Nat. Bank, 27 Tex. Civ. App. 231, 65 S. W. 199 (1901), for the somewhat dubious analogy of a suit for specific performance where the plaintiff is granted relief on condition that he make tender within a certain time of the amount found due, and the plaintiff appeals in order to reduce such amount, and in which it is held that a supersedeas of the decree extends the time for making the tender until a corresponding period after the determination of the appeal.

Subsequently, after hearing the appeal of the objectors from the order confirming sale, the Circuit Court of Appeals modified the order of the District Court "to make provision for approval by the District Court of any limit of time thereafter to be fixed by the Reorganization Managers for terminating the option to deposit Refunding Bonds and take new bonds." See Jameson v. Guaranty Trust Co., 20 F.(2d) 808, 814 (C. C. A. 7th, 1927) *certiorari* denied by the Supreme Court, Nov. 28, 1927.

their securities. While one who has bought securities after receivership or after the promulgation of the plan is entitled to an offer of the same right of participation as others of his class, his opinions as to what may or may not be fair are not entitled to the same weight as the conflicting opinions of those who purchased their securities as an investment long before financial difficulties arose.[69]

In the *Denver & Rio Grande* case,[70] the court said:

> ". . . a court of equity . . . will not lend its aid to a scheme by a minority bondholder of holding up a fair reorganization, solely as a means for obtaining greater value or more favorable terms for his bonds than are to be given by the plan to the great majority of the bondholders. Especially is this true if it should appear that the minority bondholder has bought his bonds pending the reorganization and for the purpose of speculating thereon."[71]

(e) *The Effect of the Doctrine upon Upset Prices*

It would seem that if a security holder cannot be cut off until the court has found that he has had a fair offer of participation, the question of upset or purchase price at the judicial sale would cease to be of any practical importance. Indeed, if the doctrine of the *Rock Island* cases,[72] the soundness of which we will in a moment consider, is to be adopted,—that a court of equity may impose a reorganization upon all security holders by injunction without judicial sale,—then of course there can be no question of upset or purchase price. However, the courts generally have not accepted any such doctrine, and notwithstanding their careful consideration of the fairness of reorganization plans, they continue to require an upset or purchase price which is not grossly inadequate.

The fixing of an upset price, that is, the naming, in advance of the sale, of a minimum price below which the court will not consider bids, is entirely discretionary.[73] The court may, if it determines, postpone the question of price until there has been an actual bid which comes up for confirmation.[74] From the standpoint of the reorganizers the advantage of asking for an upset price is that to a certain extent it brings out the opposition and develops the views of the court so that, to

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[69] See Palmer v. Bankers' Trust Co., 12 F.(2d) 747, 754 (C. C. A. 8th, 1926); Guaranty Trust Co. v. Chicago, M. & St. P. Ry., 15 F.(2d) 434, 443 (N. D. Ill. 1926); Jameson v. Guaranty Trust Co., 20 F.(2d) 808, 815 (C. C. A. 7th, 1927).

[70] Palmer v. Bankers' Trust Co. 12 F.(2d) 747 (C. C. A. 8th, 1926).

[71] See *ibid.* 754.

[72] Phipps v. Chicago, R. I. & P. Ry., 284 Fed. 945 (C. C. A. 8th, 1922); Chicago, R. I. & P. Ry. v. Lincoln Horse & M. Com'n Co., 284 Fed. 955 (C. C. A. 8th, 1922).

[73] See Palmer v. Bankers' Trust Co., 12 F.(2d) 747, 754 (C. C. A. 8th, 1926); *Ex parte* Equitable Trust Co., 231 Fed. 571, 593 (C. C. A. 9th, 1916).

[74] See Provident Life & Trust Co. v. Camden & T. Ry., 177 Fed. 854, 863 (C. C. A. 3d, 1910).

use the language adopted by the court in the *St. Paul* case, "it reduces the chances that the confirmation of the sale will have to be withheld because of inadequacy of the bid."[75]

Minority factions always seek high upset prices and resist confirmation of sales on the ground of inadequacy of the purchase price. They almost always support their claims with elaborate statistics as to book values, reproduction costs, valuations in rate cases, etc., forgetting that what the court is selling is usually not the going concern which will emerge from reorganization, but the entirely broken down machine. It is submitted that the value of the property for forced sale purposes is certainly not greater than the market value of the securities which are being foreclosed, for even that value includes an element based upon the hope of reorganization. If this be the true value, no court should set aside for inadequacy of price a sale which will yield as much as two-thirds of that value. While there has been no uniformity in the decisions, the average is approximately this figure, although the courts have not always arrived at the result by the line of reasoning here taken.[76]

(f) *Reorganization by Injunction without Judicial Sale*

Our discussion thus far has dealt entirely with reorganization accomplished by judicial sale. Some have found in the *Boyd* case support for the theory, for which I can find no shadow of such support, that a court of equity may, without judicial sale, impose upon all security holders and creditors a reorganization plan found by the court to be equitable, and enjoin them forever from attacking it.[77] Square support for the doctrine is found in two cases arising out of the Rock Island receivership.[78] Judge Carpenter, sitting in the northern district of Illinois, found that a plan for the reorganization of the Chicago, Rock Island and Pacific was fair to creditors and stockholders, and turned the property back to the company without sale, enjoining all creditors from pursuing their claims against the company.[79] There had been deposited under the plan more than 95% of the debt and 99% of

[75] See Guaranty Trust Co. v. Chicago, M. & St. P. Ry., 15 F.(2d) 434, 442 (N. D. Ill. 1926).

[76] See Weiner, *Conflicting Functions of the Upset Price* (1927) 27 COLUMBIA LAW REV. 132, 140 *et seq.*

[77] See Rosenberg, *Reorganization—The Next Step* (1922) 22 COLUMBIA LAW REV. 14 *et seq.*

[78] Phipps v. Chicago, R. I. & P. Ry., 284 Fed. 945 (C. C. A. 8th, 1922); Chicago, R. I. & P. Ry. v. Lincoln Horse & M. Com'n Co., 284 Fed. 955 (C. C. A. 8th, 1922).

[79] American Steel Foundries v. Chicago, R. I. & P. Ry., U. S. D. C., N. D. Ill., E. Div., Cons. Cause Eq. No. 445, final decree entered June 12, 1917 (not reported). The Rock Island receivership was brought about by creditors' bills, and was not accompanied by a mortgage foreclosure. No secured creditors were involved, and the reorganization did not disturb any existing liens.

the stock. No appeal was taken from the decree, but nonassenting creditors attempted to attach property of the company in other jurisdictions. The company sought to enjoin them, on the ground that such attachments were in violation of Judge Carpenter's decree in the receivership proceedings. The Circuit Court of Appeals for the Eighth Circuit sustained such injunctions. Judge Sanborn, in his opinion, said that the reorganization constituted a method of administering the trust estate which was within the power of the court; and that the terms of the reorganization were binding upon creditors, both those who had filed their claims but refused to accept the terms of the plan,[80] and those whose claims had not been filed.[81] He said, quite properly, that it was not lack of judicial sale which was the vice in the *Boyd* case, pointing out that the fact of a judicial sale did not prevent that reorganization from being held invalid as to the excluded creditor. It is submitted, however, that it does not at all follow, as he assumed, that a court of equity has the power to require creditors to take securities under a reorganization plan, particularly stock, with no cash alternative. If such a power exists, it exists independently of any assent by the creditors, and for reasons elaborated in a previous article in this Review,[82] I believe that the assertion of any such jurisdiction by the courts is not only without foundation in legal principles, but is unwise.

The decision in the *Rock Island* cases may perhaps be defended on two grounds: first, that the proper remedy for the creditors was by appeal from the decree, and, second, that as the stock offered to them had an immediately realizable cash value on the New York Stock Exchange, considerably in excess of any amount which they could have realized from the sale of the railroad property, and as 95% of the creditors had assented to the transaction, the balance of convenience required that the aggrieved creditor should realize his cash by the sale of the securities allotted to him, and not by judicial sale of the property itself,—a method which would have been so damaging to the other creditors. Support for this latter ground is found in an analogous line of cases, involving the sale of all the assets of a solvent corporation. When it is proposed to transfer the property of one corporation to another, in exchange for stock of the transferee, to be distributed to the shareholders of the transferor, any stockholder may, in the absence of authority in the certificate of incorporation or statutes under which the transferor corporation exists, enjoin such a transaction

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[80] Phipps v. Chicago, R. I. & P. Ry., 284 Fed. 945 (C. C. A. 8th, 1922).

[81] Chicago, R. I. & P. Ry. v. Lincoln Horse & M. Com'n Co., 284 Fed. 955 (C. C. A. 8th, 1922).

[82] Swaine, *Reorganization—The Next Step: A Reply to Mr. James N. Rosenberg* (1922) 22 COLUMBIA LAW REV. 121.

in limine.[83] If, however, the transaction is consummated with the substantially unanimous assent of the stockholders, the courts will not set it aside at the suit of the complaining stockholder if he is given a chance to obtain in cash the fair value of his interest,—as is the case if the new stock has an established market value and may readily be sold for the full value of the old stock.[84]

That the doctrine of Judge Sanborn's opinion in the *Rock Island* cases will support a decree effecting a radical change in the rights of both creditors and stockholders of the insolvent corporation, has been asserted[85] on the ground that in an equity receivership the court assumes plenary jurisdiction over the corporation and all its affairs.[86] This, however, is not the fact, for federal courts of equity, certainly under creditors' bills, do not take the insolvent corporation under their general visitorial control, but are merely custodians of that part of its property which is within their territorial jurisdiction.[87]

This theory of defense for the *Rock Island* case was definitely rejected by Judge Sibley in the *American Sumatra Tobacco* case,[88] where he said, speaking of the *Rock Island* case:

> "This is a stretching of equity power beyond anything previously known, and quite beyond the intimations in the Boyd Case. . . . To deprive a creditor of his usual remedies and force him into membership in the corporation which he only credited seems to me to be of very dubious correctness, however convenient and cheap it may be to reorganizers, and however justly disappointing to recalcitrant minorities, who may be trying to force the majority to buy them out to get rid of them."[89]

A decree something like that in the *Rock Island* case was entered in connection with the reorganization of the Pittsburgh Railways, where the property was turned back to the company under a plan of voluntary readjustment, and creditors were enjoined from prosecuting their claims for ten months.[90] The procedure has not, however, been generally adopted, and I do not believe that counsel experienced in such matters have sufficient confidence in its soundness to advise their clients to accept securities issued in a reorganization based upon it.

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[83] See 3 COOK, CORPORATIONS (8th ed. 1923) § 670.

[84] See Geddes v. Anaconda Mining Co., 254 U. S. 590, 598, 41 Sup. Ct., 209, 212 (1921).

[85] See Rosenberg, *Phipps v. Chicago, Rock Island & Pacific Ry. Co.* (1924) 24 COLUMBIA LAW REV. 266, 271.

[86] See Graselli Chemical Co. v. Aetna Explosives Co., 252 Fed. 456 (C. C. A. 2d, 1918).

[87] See Manhattan Rubber Mfg. Co. v. Lucey Mfg. Co., 5 F.(2d) 39, 43 (C. C. A. 2d, 1925).

[88] Harding v. Amer. Sumatra Tobacco Co., 14 F.(2d) 168 (N. D. Ga. 1926).

[89] See *ibid.* 169.

[90] Amer. Brake Shoe & F. Co. v. Pittsburgh Rys., 296 Fed. 204 (W. D. Pa. 1918).

The *Rock Island* case must, of course, be distinguished from a reorganization without judicial sale under provisions of a mortgage, which by its terms,[91] or under the statute[92] under which it was created, permits a majority of the bondholders to cause the mortgaged property to be purchased for their benefit and reorganized as the majority may determine, and the securities of the new company to be distributed among the bondholders. Such provisions, while valid,[93] are not frequently found.

The *Rock Island* case must also be distinguished from those in which security holders are prevented from attacking a reorganization by reason of the fact that the mortgages or trust agreements under which the securities are issued contain provisions, incorporated by reference in the securities, expressly prohibiting suits to enforce the obligation, except by action of a named percentage of the security holders. Where the majority of securities issued under such an agreement, which join in the plan, is so large as to make impossible the obtaining by any minority of the percentage necessary to sue, the desired reorganization or readjustment can in practical effect be imposed upon the minority.[94] It should be noted, however, that to accomplish this result, the provisions of the agreement must not merely require a percentage of security holders to bring about enforcement of the lien.[95] They must be sufficiently broad to defeat any right of the individual holder to sue on the obligation. Such broad provisions are extremely rare, and it is a serious question whether they do not destroy the negotiability of the obligations affected by them.[96]

(g) *The Measure of Recovery by an Aggrieved Security Holder*

We have seen that under the rule of the *Boyd* case the creditors' cause of action is not dependent upon the total value of the property,

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[91] Sage v. Central R. R., 99 U. S. 334, 337 (1878).

[92] Gates v. Boston & N. Y. Air Line R. R., 53 Conn. 333, 5 Atl. 695 (1885); *cf.* (1908) 8 Edw. VII c. 69, §§ 120, 191.

[93] See Sage v. Central R. R., 99 U. S. 334, 341 (1878); Gates v. Boston & N. Y. Air Line R. R., 53 Conn. 333, 345-347, 5 Atl. 695, 701-702 (1885). In case of provisions of this sort, as in case of the provisions referred to in the succeeding paragraph of the text, there would seem to be some question as to the negotiability of the bonds.

[94] Crosthwaite v. Moline Plow Co., 298 Fed. 466 (S. D. N. Y. 1924); Allan v. Moline Plow Co., 14 F.(2d) 912 (C. C. A. 8th, 1926).

[95] See notes on the rights and remedies of the bondholder under corporate bonds and indentures (1927) 27 COLUMBIA LAW REV. 443, 448; *ibid.* 579, 582.

[96] *Cf.* Allison v. Hollenbeak, 138 Iowa 479, 114 N. W. 1059 (1908); King Cattle Co. v. Joseph, 158 Minn. 481, 198 N. W. 798, 199 N. W. 437 (1924); Hibbs v. Brown, 112 App. Div. 214, 98 N. Y. Supp. 353 (1st Dept. 1906), *aff'd* 190 N. Y. 167, 82 N. E. 1108 (1907); Higgins v. Hocking Valley Ry. 188 App. Div. 684, 177 N. Y. Supp. 444 (1st Dept. 1919); Enoch v. Brandon, 128 Misc. 695. 220 N. Y. Supp. 294, (Sup. Ct. 1927).

but arises from a "fixed principle" irrespective of that value. But where the right is found to exist, a question of value arises in determining the measure of recovery.[97] This question is not as to the value of the entire property[98] but is as to the value of the participation in the new company which has been given to interests junior to those entitled to complain,[99] for the gist of the complaint is that a share in the property has been appropriated to parties having an interest junior to that of the complainant.[100] If the aggregate value of the interest given to the stockholders is not sufficient to pay off the creditors who have been left out, then the right of the complaining creditor must be cut down to his proportion of that aggregate. Most of the decided cases have not involved such evaluations, because the equity preserved for the stockholders has usually been sufficient (or has not been shown to be insufficient) to pay such creditors in full. It would seem that if this were not the case, the money value of the complainant's right should be measured by determining the aggregate value of the interest given to stockholders as a class, valuing that interest on the basis of the reorganized going concern at the time of reorganization, and pro-rating that value among the unsecured creditors as a class.[101] Nice problems of valuation may be imagined, in cases where some period of time has elapsed between the inception of the reorganized company and the date of the creditor's suit.

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[97] See Mayer, J., in Howard v. Maxwell Motor Co., 269 Fed. 292, 305 (S. D. N. Y. 1920), quoting in part from the Boyd case:

> "Plaintiffs, therefore, retained the right to subject the interest of the old stockholders in the property to the payment of their claim. If their interest is valueless, he gets nothing. If it be valuable, he merely subjects that which the law had originally and continuously made liable for the payment of corporate liabilities."

[98] See Central Improvement Co. v. Cambria Steel Co., 210 Fed. 696, 706 (C. C. A. 8th, 1913).

[99] Northern Pac. Ry. v. Boyd, 228 U. S. 482, 33 Sup. Ct. 561; Okmulgee Window Glass Co. v. Frink, 260 Fed. 159 (C. C. A. 8th, 1918).

[100] For a review of the authorities dealing with the extent of this liability, see Okmulgee Window Glass Co. v. Frink, 260 Fed. 159, 166 *et seq.* (C. C. A. 8th, 1919).

[101] *Cf.* Southern Pacific Co. v. Bogert, 250 U. S. 483, 39 Sup. Ct. 533 (1919).

It is regrettable that the one case which involved the problem of evaluating the interest given to the stockholders was decided upon a misconception of the Boyd decision. This is the case of Mountain States Power Co. v. Jordan Lumber Co., 286 Fed. 217 (D. C. Mont. 1923), *aff'd* 293 Fed. 502 (C. C. A. 9th, 1923), *certiorari* denied 264 U. S. 582, 44 Sup. Ct. 302 (1924).

In that case, the reorganization plan gave the bondholders of the old company, except the holders of bonds of a small issue which was not disturbed, new bonds, preferred stock and common stock. The balance of the common stock of the new company—23,400 shares—was set aside for the benefit of unsecured creditors. It was provided, however, that this stock should first be offered to the stockholders of the old company, up to 70% of their holdings in the case of preferred stock and 20% in the case of common stock, at $15 per share. No other rights were given to the old stockholders, and of this 23,400 shares, only 1,532 shares were taken up at that price. Practically speaking, therefore, the plan gave nothing to the stock of the old company.

2. Effect of the Federal Transportation Act of 1920

Besides the marked development of the law arising out of the *Boyd* case, the last decade has in another respect witnessed a material change in the procedure for railroad reorganizations. In his lecture in 1916, Mr. Cravath pointed out[102] the embarrassments which arose from the necessity of submitting to public service commissions in the many states in which the railroad had property, the various steps required for consummating the plan. Apart from the question of expense and delay, there was always danger of conflicting determinations by different state commissions. This whole difficulty has been substantially obviated by the enactment of the Federal Transportation Act of 1920,[103] and the practical exercise of jurisdiction by the Interstate Commerce Commission thereunder. The Commission has substantially asserted jurisdiction over every acquisition of control over railroad

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The plaintiff had a claim against the old company for damage from fire caused by negligence, but the claim had been rejected by the receiver. Plaintiff got a judgment against the old company and proceeded to levy execution against the new company, which brought suit to enjoin this course and to quiet title. The court entered a decree adjudging the plaintiff's claim to be a lien upon the property in the hands of the new company and ordered the property sold to satisfy this lien.

The Circuit Court of Appeals cut down the recovery to 66% of the claim—a result which was commendable so far as it went. But while it purported to follow the Boyd case, its reasoning was flatly opposed to the theory of that decision. The district court had found that the property "at the time of reorganization" was of a value not less than $6,200,000. A computation from the figures given in the two opinions will serve to demonstrate that this was grossly excessive. The appellate court, however, felt bound to accept the finding of the lower court upon this point. It took the sum of the undisturbed bonds and the foreclosure judgment, which totalled $5,834,272, subtracted this from the valuation found, and treated the difference—approximately $350,000—as "the interest of the old stockholders in the property," which, under the Boyd case, the creditor had the right to subject to the payment of his debt. As the unsecured claims amounted to about $525,000, the plaintiff was permitted to recover 66% of its claim. Since the old stockholders got nothing by virtue of the reorganization, no interest junior to the plaintiff had received anything. The other unsecured creditors had received a portion of common stock and at the trial the plaintiff was offered a participation in this interest. Any larger participation would have been at the expense of creditors whose claims *ranked ahead of the plaintiff's*. To allow the plaintiff to get more than its proportionate share of this residuary interest which remained for unsecured creditors, was to permit it to impeach the entire foreclosure proceedings by collateral attack. It was, in effect, a holding either that the forced sale value of the property was in excess of the $5,800,000 mortgage debt, which seems clearly wrong on the facts, or that the foreclosing bondholders are under a duty, in reorganizations, to provide for interests junior to their own. In either event the decision is thoroughly unsound, and it is unfortunate that the Supreme Court did not regard the case as sufficiently important to warrant a review by *certiorari*.

[102] See CRAVATH, *op. cit. supra* note 3 at 187.

[103] Act of Feb. 28, 1920, 41 STAT. 456. The parts of the Transportation Act with which we are here concerned are the provisions of Title IV (41 Stat. 474 *et seq.)*, containing amendments to the Interstate Commerce Act. For the sake of brevity, the references will be cited to the Interstate Commerce Act, with the section numbers as they appear in that Act as amended.

properties,[104] and over every issue of securities by an interstate railroad.[105] The Act under which this jurisdiction is asserted provides, in effect, that authority granted by the Interstate Commerce Commission in the premises shall empower the carrier to do the things authorized, irrespective of any provision of state statutes.[106] While there may be a question whether the Transportation Act gives to state corporations corporate powers otherwise non-existent,[107] to the extent that regulatory jurisdiction is conferred upon the Interstate Commerce Commission, jurisdiction over the same matters by state commissions is excluded.[108]

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[104] The sections under which this jurisdiction has been asserted are § 1 (18) and § 5 (2). These sections are discussed in the third sub-division of this article which will appear in a subsequent issue of this Review.

[105] The securities provision, Interstate Commerce Act, § 20a, recites that it shall be "unlawful for any carrier to issue any share of capital stock or any bond or other evidence of interest in or indebtedness of the carrier," or to assume any obligation or liability as lessor, lessee, guarantor, etc., "in respect of the securities of any other person," "even though permitted by the authority creating the carrier corporation unless and until, and only to the extent that," the Commission "by order authorizes such issue or assumption." The findings which the Commission must make, before it grants the authorization, are set forth, and provision is made for applications, notice and hearing. The Commission is given power "to grant or deny the application as made, or to grant it in part or deny it in part, or to grant it with such modifications and upon such terms and conditions as the Commission may deem necessary or appropriate in the premises." The broad terms of this section have been applied literally by the Commission. To cite two rather striking examples, in Bonds of Union Pacific R. R., 65 I. C. C. 735 (1921), the Commission held that the exchange of bonds payable in dollars for bonds payable in sterling, under the same mortgage, upon payment of a small sum of money, where by their terms the sterling bonds, issued in 1908, were so exchangeable, constituted an issue of securities within the meaning of § 20a; and in Stock Issue of Atchison, Topeka & Santa Fe Ry., 65 I. C. C. 76 (1920), the Commission assumed jurisdiction to authorize the Santa Fe to continue to exchange its convertible bonds for stock, under the terms of an indenture which provided that the failure of the Company to make such exchange would be a ground for accelerating the maturity of the bonds.

[106] Section 1 (20) provides that after the Commission has issued a certificate of public convenience and necessity under § 1 (18), the carrier may "without securing approval other than such certificate . . . proceed with the construction, operation, or abandonment covered thereby."

Section 5 (8), with respect to the acquisition of control by one carrier of another, and with respect to consolidation, provides that the carriers affected by any orders made under the preceding paragraphs of the section, are relieved from the operation of the antitrust laws and "of all other restraints or prohibitions by law, State or Federal, in so far as may be necessary to enable them to do anything authorized or required by any order made under and pursuant to the foregoing provisions of this section."

Section 20a (7) provides that the Commission's jurisdiction shall be exclusive and plenary, and that "a carrier may issue securities and assume obligations or liabilities in accordance with the provisions of this section without securing approval other than as specified herein."

[107] *Cf.* Sinking Fund Cases, 99 U. S. 700 (1878).

[108] Railroad Comm. v. Southern Pacific Co., 264 U. S. 331, 44 Sup. Ct. 376 (1924); Napier v. Atlantic Coast Line R. R., 272 U. S. 605, 47 Sup. Ct. 207 (1926); Staten Island Rapid Transit Ry. v. Public Service Com'n, 16 F.(2d) 313 (S. D. N. Y. 1926); see Dayton-Goose Creek Ry. v. United States, 263 U. S. 456, 478, 44 Sup. Ct. 169, 172 (1924); *cf.* Alabama Ry. v. Vicksburg Ry., 271 U. S. 245, 46 Sup. Ct. 535 (1926).

Accordingly, although the language of the Transportation Act is not as clear as it might be, and although for a time after its passage counsel dealing with security issues were hesitant about dispensing with action by state commissions,[109] the general practice has grown to be that a reorganization of an interstate railroad may be consummated through authorization by the Interstate Commerce Commission of the various steps over which it has asserted jurisdiction,[110] without action by state commissions.[111]

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[109] Where the state statute made the issue of securities void if authority had not been obtained from the state commission, it would have been impossible, while the extent of the Interstate Commerce Commission's jurisdiction was in doubt, to sell the securities without getting such authority. Accordingly, in several instances, after application had been made to the state commissions and had been granted, and the securities had been issued, suit was brought by the Company to recover the fees paid in connection with the application, upon the ground that the application had been made and fees paid under duress. In Minneapolis, St. P. & S. S. M. Ry. v. Railroad Comm., 183 Wis. 47, 197 N. W. 352 (1924), and Chicago & E. I. Ry. v. Miller, 309 Ill. 257, 140 N. E. 823 (1923), the carrier was allowed to recover, on the ground that the state statute had been superseded by the Transportation Act, 1920.

[110] The Commission has assumed jurisdiction, in passing upon railroad reorganizations, of a three-fold kind: (1) under § 1 (18), to issue a certificate that public convenience and necessity require the acquisition and operation by the new company of the railroad of the old company, (2) under § 5 (2), to authorize the new company to take over control, by lease or by purchase of capital stock or otherwise, of properties so controlled by the old company, and (3) under § 20a to authorize the issue of the securities called for by the reorganization. Missouri-Kansas-Texas Reorganization, 76 I. C. C. 84 (1922); Missouri-Kansas-Texas R. R. of Texas Reorganization, 76 I. C. C. 651 (1923); International-Great Northern Reorganization, 72 I. C. C. 722 (1922).

[111] The New York Central issued bonds, having secured the Interstate Commerce Commission's approval, but without making application to the state commission for authority to make the issue. For such failure it was fined $100. The Appellate Division reversed the conviction and the Court of Appeals affirmed such reversal. People v. N. Y. Central R. R., 199 App. Div. 949, 191 N. Y. Supp. 944 (3d Dept. 1921), *aff'd* 233 N. Y. 679, 135 N. E. 967. No opinion was written in either court, but the case was argued upon the issue whether or not the jurisdiction given to the Interstate Commerce Commission had superseded the requirement of the state law. See Dayton-Goose Creek Ry. v. United States, 263 U. S. 456, 478, 44 Sup. Ct. 169, 172 (1924); Colorado v. United States, 271 U. S. 153, 165, 46 Sup. Ct. 452, 455 (1926).