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SOME REALISTIC REFLECTIONS ON SOME ASPECTS OF CORPORATE REORGANIZATION

"A proposition so plain that only the intelligent will dispute it."[1]

"We must not shut our eyes to any facts of common knowledge * * *. All judicial proceedings must be adjusted to facts as they are."[2]

I

CASES involving large sums of money often have a curious effect on the reasoning processes of lawyers. The following is illustrative:

Farmer Smooth is in financial difficulties. His bank holds a $10,000 mortgage on his farm, which is worth about $10,000, and the bank has begun to foreclose. At the same time he owes $15,000 to miscellaneous creditors, and he has $10,000 in cash and no other assets. He develops what he thinks is a bright idea. He allows the foreclosure to proceed to a final decree and sale. At the foreclosure sale he buys in the farm, using his $10,000 cash. He is now discharged of the mortgage debt and sits back confident that, his farm having been sold and purchased at the foreclosure sale, he stands in the shoes of his mortgagee and holds the farm free from the claims of all his creditors. Of course, he does no such thing. He cannot thus pull himself up by his bootstraps. A mortgagor by buying in at a mortgage foreclosure sale cannot cut off the rights of his unsecured creditors to proceed against the property purchased at the sale. The courts denounce such a transaction as a "fraudulent conveyance" and allow Farmer Smooth's credi-

[1] In the Matter of Jones Hardwood Co., 10 F. T. C. D. 320 at 328.

[2] Louisville Trust Co. v. Louisville, *etc.*, Ry. Co., 174 U. S. 674 at 683 (1899).

tors to levy on the farm. But there need be no actual fraud. Even if the farmer erroneously believed that he owed nothing but the mortgage debt and had, in good faith, forgotten the fact that he owed his neighbor Jones $1,000, the result would be the same: Jones could levy on the farm notwithstanding the foreclosure.

Now that is a well-established idea in our jurisprudence. And the fact that large amounts of money are involved would not seem to alter the application of that simple idea. Nor should the fact that the debtor happens to be a corporation instead of an individual farmer. But lawyers are likely to overlook first principles where large numbers of dollars are involved. Perhaps that explains the fact that capable corporate lawyers forgot all about the farmer-mortgage cases and attempted in 1866, in the case of a large railroad corporation, to do precisely what the courts had repeatedly said could not be done by a farmer. What they did was condemned by the United States Supreme Court three years later in 1869 in the case of *Railroad Company* v. *Howard*.[3]

The court then decided that a transfer of the assets of a corporation, by agreement between its mortgage bondholders and its stockholders, which left unsecured corporate creditors unpaid while the old stockholders were given an interest in a new corporation which acquired the old corporate assets, was a so-called fraudulent conveyance which could not be sterilized by washing it through solemn foreclosure proceedings and a judicial sale. The rights of the unsecured creditors could not thus be cut off. The court held that the true facts of a corporate reorganization receivership involving such a transaction could not be effectively concealed. The court proceedings and the judicial sale were considered, in effect, merely extra shells under which to hide the pea, but the hand of the reorganization prestidigitator was not quicker than the court's eye. (No offense is intended of course. The so-called fraud in those cases was not actual but "constructive"—that is, not fraud at all.[4] And the word "pres-

[3] 7 Wall. 392 (1868).

[4] *Cf.* Northern Pacific v. Boyd, 228 U. S. 482 at 502-3 (1913), 177 Fed. 804 at 816 (1910). As to "constructive" fraud as an "as if" or fiction, see FRANK, LAW AND THE MODERN MIND (1930) 38-41.

tige" is derived, so the philologists tell us, from the same root as "prestidigitator.") The decree of sale in such a case was a consent decree, and a consent decree, the courts have said, is really nothing more than a judicially recorded agreement of the parties;[5] judicially recording a fraudulent conveyance cannot, of course, purge it of its sins.

The *Howard* case was decided in 1869. But in 1896 experienced and able counsel completed the reorganization of the Northern Pacific Railroad, using almost precisely the same methods which the courts had condemned in the farmer-mortgage cases and which the Supreme Court had denounced twenty-seven years previous in the *Howard* case.[6] And yet when in 1899 the Supreme Court in the *Monon* case[7] reiterated the views expressed in the *Howard* case, the members of the reorganization bar looked upon it "with terror" and as a perpetual spectre in their path."[8] And when in 1913 the Northern Pacific reorganization of 1896 came before the Supreme Court in *Northern Pacific Railway* v. *Boyd,* 228 U. S. 482, and the court once more announced the obvious doctrine of the now 44-year old *Howard* case, that decision created, we are told, "uncertainty and confusion" in the minds of the reorganizers, who regarded it as a "veritable demon incarnate."[9]

Just as a reading in 1896 of the *Howard* case might have changed the manner of reorganizing the Northern Pacific and might in 1910 and 1916 have saved Messrs. Joline and Cravath the demoniac or ghost-fears provoked by the *Monon* and *Boyd*

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[5] Gay v. Parpart, 106 U. S. 679 (1882); Hodgson v. Vroom, 266 Fed. 267 (C. C. A. 2d, 1920); American Radium Co. v. Hipp, etc., Co., 279 Fed. 601 (D. S. D. N. Y. 1921).

[6] As appears from the argument of the counsel in Northern Pacific v. Boyd, *supra* note 4 at 495, this forbidden method of reorganization denounced in the Howard case was used extensively between 1892 and 1900. It was used, for instance, in the reorganization of the Monon in 1894, as shown in Louisville Trust Co. v. Louisville, *etc.,* Ry. Co., 174 U. S. 674 (1899).

[7] Louisville Trust Co. v. Louisville, *etc.,* Ry. Co., *supra* note 6; see also Central of Georgia Ry. Co. v. Paul, 93 Fed. 878 (C. C. A. 5th, 1899), decided in 1899 by the Circuit Court of Appeals for the Fifth Circuit, in which Judge Pardee quoted the Howard case and followed it.

[8] Speech of Mr. Joline in 1910 quoted in Cravath, *Reorganization of Corporations,* (1917) SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, 197.

[9] Cravath, *loc. cit. supra* note 8.

cases, so it would seem that a reading of the *Howard* case today may dispel some of the alleged but ghost-like perplexities of the *Boyd* case and its progeny. Seen in the perspective of the *Howard* case, the *Boyd* case decision [10] is simple, almost elementary. It is the application of an idea "so plain that only the intelligent will dispute it," to borrow the language used by Commissioner Humphrey in another context.[11]

II.

1. In the *Howard* case [12] the Mississippi & Missouri Railroad Company had outstanding mortgage bonds the amount owing on which, together with interest, amounted to $7,000,000, conceded to be "a sum greatly beyond what the road was worth." Interest was in arrears and the company was insolvent. The mortgages securing the bonds were accordingly foreclosed and at the foreclosure sale the property was bid in for $2,200,000—or $4,800,000 less than the amount due on the mortgage bonds. The bidder at the judicial sale was a new railroad company (organized by a committee representing the bondholders) which apparently purchased the property by bidding the mortgage bonds. This new company was then consolidated with the C. & R. I. R. Co. under the name of the C. R. I. & P. R. R. Co.; the consideration moving to it in the consolidation was $5,500,000 of bonds of the new consolidated C. R. I. & P. Company. By previous arrangement between the old bondholders of the old Mississippi Company and the old stockholders of that company $552,000 of these new C. R. I. & P. bonds were deliverable to the old stockholders. Just as these new bonds were about to be distributed to the old stockholders, unsecured creditors of the old Mississippi Company (who had meanwhile obtained judgment against the Mississippi Company) filed a bill in the same court in which the foreclosure proceedings were pending, asking that their claims be satisfied out of the $552,000 of new C. R. I. & P. bonds thus about to be delivered to the old stockholders. The United States Supreme Court affirmed a decree granting this relief.

[10] The dictum will be discussed below.
[11] In the Matter of Jones Hardwood Co., *supra* note 1 at 328.
[12] *Supra* note 3.

In the course of the proceedings brought by the unsecured creditors, no attack was made on the propriety or legality of the foreclosure proceedings. It was conceded that *the property was worth less than the old mortgage debt* and had been bought in for less than the mortgage debt and that the aggregate of new bonds (including those deliverable to the stockholders) were less in amount than the aggregate amount due on the old mortgage bonds. But it was shown that, prior to the institution of the foreclosure proceedings, a contract had been made between the old Mississippi Company and the old C. & R. I. R. R. Co. (in pursuance of resolutions passed by a meeting of bondholders and stockholders of the old Mississippi Company) by which the parties had agreed to a plan calling for the foreclosure, the transfer of the property, the delivery of the new bonds and the allocation of the $552,000 of those new bonds to the old stockholders.

On behalf of the stockholders it was argued that there was no impropriety in these arrangements. The foreclosure decree, it was said, completely cut off the rights of the unsecured creditors. Since the old Mississippi Company's property was worth markedly less than the face amount of the old mortgage bonds and was bought on the foreclosure sale for less than that amount, and as the old company was insolvent, the property (and therefore the proceeds thereof in the form of the new bonds) belonged, it was argued, to the old bondholders free and clear of any possible claims of the unsecured creditors, for there was no equity remaining in the old property to which the claims of the creditors could attach. Consequently, it was said, the new bonds were the exclusive property of the old bondholders and they had a right to do with these new bonds as they pleased, and if they chose to give some of them away to the old stockholders, that was no concern of the unsecured creditors and gave them no rights. On behalf of the unsecured creditors it was contended that regardless of any question of values, the fact that the old stockholders were receiving something as a result of this entire arrangement made the transaction, to the extent of the $552,000 of bonds, a fraudulent conveyance which the creditors had a right to ignore. The Supreme Court flatly rejected the argument on behalf of the stockholders. The basis of its decision in favor of

the creditors was that the transfer of the new bonds to the old stockholders was a "voluntary" or "constructively" fraudulent conveyance. The court said that the corporation could not distribute its assets to stockholders until its debts were paid and that any such transfer was a "voluntary transfer" which could not stand on an attack by creditors. The court looked through the form to the true substance of the transaction and held that, since the old stockholders were to receive the new bonds as stockholders of the old company, these bonds, in contemplation of law, came to them through the old company. It was a simple case of an insolvent corporation distributing assets to stockholders when corporate debtors remained unpaid.

Even if the old stockholders had given nothing to the old bondholders for the new bonds and even if the transfer of those bonds had been a pure gratuity on the part of the old bondholders, the result would have been the same. If a corporation, which has no assets but owes $500,000 to its creditors, receives a gift of $100,000 from its former president (or from his maiden aunt), the gift will be valid. But if the corporation distributes that $100,000 among its stockholders, leaving its debts unpaid, the distribution is invalid or voidable at the suit of its creditors. The distribution, not the gift, is at fault; it constitutes a voidable "voluntary" or "constructively" fraudulent conveyance regardless of the form that distribution takes. As Glenn puts it

> "the creditor is wronged when any alienation or other dealing in the debtor's property prevents the realization of the debt. The touchstone is not a thing of form." [13]

2. The ingenuity of those seeking to bring about such legally condemnable transfers is inexhaustible. Parties have often used judicial proceedings, of one kind or another, to that end. An interesting instance is that found in *Johnson* v. *Waters,*[14] where the court cut through a judicial sale, ordered and confirmed by a probate court, and allowed a creditor of a decedent to levy on property which had come into hands of the heirs via the judicial sale. In *Johnson* v. *Waters,* there was actual fraud. In the

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[13] Glenn, The Law of Fraudulent Conveyances (1931) 263.
[14] 111 U. S. 640 (1884).

Howard case the court applied the same notion to a "constructively" fraudulent judicial proceeding.[15]

3. The *Boyd* case decision was merely an application of the *Howard* case to slightly more complicated facts.[16] There a foreclosure decree and sale were used in the same way as in the *Howard* case. As in that case so in the *Boyd* case no provision was made for unsecured creditors. For present purposes the differences between the two cases were that in the *Boyd* case (1) the old stockholders received shares of new stock in the new company (not bonds) and (2) paid some cash for those new shares. But the old stockholders received the right or privilege to purchase these new shares of stock[17] by virtue of their being stockholders of the old company.[18]

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[15] See GLENN, *op. cit. supra* note 13 at 286-7, 294-301.

[16] The facts of the Boyd case are so well known that for purposes of economy, they will not here be set forth at length. For like purposes of economy the Monon case (Louisville Trust Co. v. Louisville, *etc.*, Ry. Co., *supra* note 6 will not here be discussed.

[17] Of course, a "right" to purchase stock has value. Such "rights" are often bought and sold.

[18] In the Boyd case, as in the Howard case, it was argued that the old company received or retained nothing, that all its assets had been cut off by the foreclosure decree and sale; the opinion of the district court (170 Fed. 779 at 781 (D. E. D. Wash. 1909)) reports this argument thus:

"This is the theory of counsel for defendants: The bondholders and other lien creditors were necessarily compelled to protect themselves by bidding in the property. Sufficient sums of money for the purchase of like properties are rarely, if ever, available. The fact that shareholders were allowed to subscribe for stock was an independent transaction, and *they should be treated, if I have apprehended counsel aright, as individuals who incidentally happened to hold stock of the railroad company.* In view of the conditions, it is said that the Railroad Company stands now upon the insolvency of the Railroad Company, the liens which it acquired, the foreclosure of those liens, and the necessity for placing the property upon some working basis." (Italics the author's.)

The district court succinctly commented on this argument:

"But this is the shadow: However the transaction be obscured by legal phraseology, or the form be changed, the substance is that the conflicting interests desired to maintain the integrity of the property as a general railroad system. The difficulties in the way of this consummation arose out of the different rank of the liens, combined with the demands of stockholders * * *. And it was for this reason that the stockholders of the Railroad Company as such received a substantial benefit directly attributable to their ownership of stock * * *. *It is not to be supposed that they were treat-*

The district court in the *Boyd* case expressed surprise that anyone could doubt that the *Howard* case settled the matter.[19] The Circuit Court of Appeals expressed a like attitude.[20] The United States Supreme Court likewise rested its decision on the principle declared in the *Howard* case, and decided in favor of Boyd, the unsecured creditor. "Any device," said the court, "whether by private contract or judicial sale under a consent decree, whereby stockholders were preferred before the creditors was invalid." The plan *"put the stockholders in the position of a mortgagor buying at his own sale.* As against creditors it" (the sale) "was a mere form. The old stockholders were still owners of the same railroad encumbered by the same debts. The circumlocution did not better their title as against Boyd as a non-assenting creditor. They had changed the name but not the relation." It was like the case of a "defendant who buys his own property at a tax sale. There is no difference in principle if the contract of reorganization, instead of being effectuated by private sale, is consummated by a master's deed under a consent decree. As against him" (the non-assenting creditor) "the sale is void in equity regardless of the motive with which it is made." The "creditor's legal right against the shareholders' interest" cannot "depend upon the motive with which they act and the method by which they carry out the scheme."

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ing the transaction upon a charitable basis, but rather that they regarded it as of substantial advantage to themselves to surrender their stock and pay the ten and fifteen dollars per share assessed as a condition to becoming stockholders in the new company. But whether the stock secured was valuable or not (although it proved to be immensely so, and the then existing revenues made it apparent that it would be), *they did retain an interest. Its value does not enter into the consideration of the question; it is the retention of that interest which invalidates the transaction.* The purpose throughout the proceedings, so often displayed, coupled with the manner in which it was finally consummated, lead irresistibly to the conclusion that *that which was designated as a reorganization was meant to be a reorganization in fact, and not a foreclosure sale in the strict sense of the term * * **. The foreclosure sale was made as a means of reorganizing, and the complainant's contention as to its purpose and effect in this regard is well sustained." (Italics the author's.)

[19] *Supra* note 18 at 806. The court also cited and quoted from Johnson v. Waters, *supra* note 14, as did the Circuit Court of Appeals; see 177 Fed. at 820.

[20] See 177 Fed. at 818.

4. There was one element of possible novelty in the decision [21] in the *Boyd* case. In the *Howard* case the attacking creditor sued just prior to the distribution to the stockholders and the court seized the assets which were about to be distributed to them. Boyd sued ten years after the distribution to the stockholders.[22] Instead of requiring Boyd to sue the distributee — stockholders or their privies, the court recognized that such relief, if realistically considered, would be virtually useless, and therefore allowed Boyd to sue the new company and to have judgment against it, such judgment to be a lien subject to the mortgage lien of the new bonds given to the old bondholders.[23] Whatever possible doubt there might once have been about the propriety of this realistic procedure, it is now orthodox.[24]

5. The *Boyd* case is one of many in which a client has won because he went to the "wrong" lawyer. Probably any competent country attorney, especially after reading the *Howard* case,

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[21] The novelty in the dictum will be noted below.

[22] The court found, on the facts, that he was not guilty of laches.

[23] The court in the Boyd case, *supra* note 4 at 502, cited with approval earlier cases which had arrived at a similar result, *viz.:* San Francisco & N. P. R. R. v. Bee, 48 Cal. 398 (1875); and Grennell v. Detroit Gas Co., 112 Mich. 70, 70 N. W. 413 (1897). Similar cases theretofore decided were McIver v. Young Hardware Co., 144 N. C. 478, 57 S. E. 169 (1907); Luedecke v. Des Moines Cabinet Co., 140 Ia. 223, 118 N. W. 456 (1908); and Hibernia Insurance Co. v. St. Louis & New Orleans Transportation Co., 13 Fed. 516 (D. E. D. 1882).

For other prior and subsequent cases of similar character, see 15 FLETCHER, CYCLOPEDIA CORPORATIONS (Permanent Edition), §§ 7127 and 7128.

[24] Kansas City Ry. Co. v. Guardian Trust Co., 240 U. S. 166 (1916); *cf.* Okmulgee Window Glass Co. v. Frink, 260 Fed. 159 (C. C. A. 8th, 1919); *cf.* Shapiro v. Wilgus, 287 U. S. 348 (1932).

However, questions may perhaps still be raised where (1) creditors also are given stock in the new company or (2) rights of innocent third persons have intervened. Suppose, for instance, that the old bondholders received for their bonds new common stock and that some common stock was also given to the old stockholders. To allow the attacking creditors (the Boyds) to have a judgment such as Boyd was allowed would be unfair to the bondholders. Perhaps the court would give the Boyds a judgment which would be a lien on such of the common stock as had been given to the old stockholders. But would that require all the old stockholders to be made parties to the suit? And what would be the effect of the UNIFORM STOCK TRANSFER ACT? If the suit were not begun for several years, there would doubtless be *bona fide* purchasers of much of the stock originally given to the old stockholders. What effect would that have?

would have seen that Boyd was likely to be victorious. But if Boyd had asked a member of the corporate-reorganization bar to bring suit on his behalf, doubtless he would have been politely laughed out of the office. The well-educated reorganization lawyer would have told him that "everybody knows" that such a reorganization program as that employed in the *Boyd* case was the stereotyped method used in reorganizing many railroads between 1892 and 1900, that such a method was practically unavoidable, and had never been and never would be condemned by the courts.[25] But the well educated reorganization lawyers knew too much. They were too much dominated by their wishes. Those wishes had blinded them to the obvious. The less well informed lawyer would have said that what was done by the reorganizers of the Northern Pacific looked to him just like the case of an individual farmer-mortgagor who bought in his own property at a foreclosure sale and then claimed that he held the property free of the claims of his unsecured creditors. That was just what the Supreme Court said. And the country lawyer would have relied on the *Howard* case. So did the Supreme Court. (There is an apocryphal story that, if Einstein had been better informed, he would have known that long before he began to work on his relativity theory it had been rejected by the best minds; if that story is not true it ought to be.)

The writer believes that much current misunderstanding of the *Boyd* case—and hence of the development of the judicial attitude towards several phases of corporate reorganizations — arises from the failure to study the *Boyd* case in the clear light of the *Howard* case.

In particular Mr. Swaine (like his senior partner, Mr. Cravath) seems to have given insufficient attention to the *Howard* case. Accordingly, although Mr. Swaine is today one of the leaders of the corporate reorganization bar, the writer (putting himself in the class of the simple-minded country lawyer who has carefully read the *Howard* case) ventures to disbelieve in some of the ghosts[26] which Mr. Swaine purports to see arising from the *Boyd* case.

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[25] See argument of counsel for defendant in the Boyd case, *supra* note 4 at 494-5.

[26] To Mr. Swaine they are not fiendish but friendly ghosts.

III

1. In 1927 Mr. Swaine construed the rule of the *Boyd* case thus: First mortgage bondholders cannot through foreclosure perfect a reorganization which includes unsecured creditors but excludes second mortgage bondholders—even if (a) the property of the old company is worth far less than the amount due on the old first mortgage bonds and (b) all old stockholders are excluded.[27]

When that precise question came before the Circuit Court of Appeals for the Eighth Circuit in 1928, in *New York Trust Co.* v. *Continental & Commercial, etc., Bank,*[28] the court adopted precisely the opposite view.

The writer believes that the court's conclusion was sound and Mr. Swaine's was not. Mr. Swaine's error, it is submitted, was due to his failure to read the *Boyd* case as an adjunct to the *Howard* case.

True, the *Boyd* case opinion did say, as Mr. Swaine contends [29] that the value of the property of the old company was irrelevant. But, in so saying, it was exactly following the *Howard* case; and, as appears from the *Howard* case, what the court meant was that where, after foreclosure, stockholders receive something and unsecured creditors remain unpaid, in such circumstances it is irrelevant that the property of the old company was worth less than its mortgage debt. In the *Howard* case, as noted above, the assets of the old railroad were admittedly of less value than the mortgage debt of $7,000,000. Consequently, on a fair appraisal basis or any other basis, the bondholders were entitled to all the property and all its proceeds. Even if the property had been sold for its full fair value, it would have brought less than $7,000,000 and nothing would have been left for the unsecured creditors. And if the old bondholders had kept for themselves all the new bonds exchanged for that property, on no possible basis could the unsecured creditors have complained. The vice in the transaction was not that the old bondholders gave away something to which

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[27] Swaine, *Reorganization of Corporations* (1930), SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, 142.

[28] 26 Fed. (2d) 872 (C. C. A. 8th, 1928) *c. d.*, 278 U. S. 644.

[29] Swaine, *loc. cit.* 139-141.

the creditors were entitled as against the old bondholders. There was nothing wrong about the conduct of the bondholders in giving up some of the new bonds for those new bonds were the proceeds of property to which they were entitled. Had they transferred them to someone who was in no way a debtor of the unsecured creditors, all would have been well. The vice—and the only vice—was in the attempted retention of those new bonds by the debtor of the unsecured creditors—the body of the old stockholders. That and that alone made the transaction a "constructively" fraudulent conveyance. And that made the value of the property of the old company an irrelevant factor.

And so in the *Boyd* case. The court said that the actual value of the old company's assets mattered not at all; perhaps that value was more than the old mortgage debt, but that was of no consequence. The "fixed principle" that was violated was the doctrine of the *Howard* case—the doctrine of the "law of fraudulent conveyances;" something was given to the old stockholders while unsecured creditors remained unpaid.[30]

But suppose that in the *Howard* case the $552,000 new bonds had been given by the old bondholders to the unsecured creditors, and suppose that old second mortgages and the old stockholders had received nothing. Remember that the first mortgage debt greatly exceeded the value of the assets. What is there in the *Howard, Monon, Boyd* or other Supreme Court cases that even begins to intimate that the second mortgagees could effectively complain? Surely such a transfer would not be a constructively fraudulent conveyance. The old first mortgagees had a perfect right to those $552,000 of new bonds and therefore a right to give them away or sell them. These bonds came, we are supposing, into the hands of the unsecured creditors. But what duty did those creditors owe to the second mortgagees? These creditors were neither the debtor of the second mortgagees nor privies of that debtor. In the *Howard* case there was nothing wrong about the old bondholders giving up the new bonds to the stockholders; the wrong was in the retention of those bonds by the stockholders. But where the transfer is to creditors, there is nothing wrong about the retention.[31]

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[30] See GLENN, *op. cit. supra* note 13 at 300-301.

[31] The transfer to the unsecured creditors cannot be assailed as preference.

2. The writer believes that the result should (and probably would be) otherwise, if the value of the old assets greatly exceeded the first mortgage debt. Suppose the following: A railroad (or industrial) has a first mortgage of $75,000,000, a second mortgage of $25,000,000, and unsecured debts of $10,000,000. Suppose that the actual worth of its property is $90,000,000—that is, $15,000,000 in excess of the first mortgage. Suppose, now, that a reorganization were attempted which included only the first mortgagees and the unsecured creditors.

Now in that case the second mortgagees had had a lien on the $15,000,000 excess over the first mortgage. They would have just cause for complaint if this excess—their "property"—went to others. Had there been such excess value for the second mortgage bondholders in the *New York Trust* case, the writer believes the court should (and probably would) have decided in favor of the second mortgagees. But that result would not rest on Mr. Swaine's alleged doctrine.[32]

The writer also believes that, if the excess value ran up to an amount greater than the first and second mortgage debt, then the unsecured creditors should have a right to object if they were excluded—even if the stockholders did not participate. And, further, if the excess value clearly exceeded all the debts, the writer believes the stockholders should be entitled to participate in this excess.

Why? Not because of any doctrine of fraudulent conveyances but because of current notions of fairness, decency and morals. If a doctrinal name must be given, call it due process—for due process perhaps means merely current notions of fairness, decency and morals; see Mr. Justice Holmes' opinion in *Noble State Bank* v. *Haskell.*[33]

For aside from the fact that, in the absence of statute, there is no such thing as an unlawful preference, here no property of the debtor is distributed among his creditors unevenly or without adequate marshalling. The first mortgagees are transferring some of their property, not the debtor's. For here we are assuming that the first mortgage debt greatly exceeds the value of the debtor's assets.

[32] For Mr. Swaine contended that the value of the assets was without significance and that the only question was whether the order of priorities was preserved or disturbed.

[33] 219 U. S. 104 at 111 (1911).

It is not contended that any such doctrine should ordinarily be applicable to the case of a corporation with a comparatively small debt structure. In that kind of case the rough and ready traditional way to fix values and determining rights is by a judicial sale, if the sale is fairly conducted. To be sure, such sales often bring an unduly low price, but in "normal" times, if no one bids sufficient to pay off the first mortgagee (or the second and so on) the juniors who are excluded have had rough justice.[34]

But where the case involves corporations with a huge debt structure, it is rank injustice to utilize a judicial sale as a means of determining rights in the property. The sale in such a case is a farce.

Why? Because while theoretically the judicial sale is an open sale at public auction, actually there is only one possible purchaser—the reorganization committee. At the so-called sale, no one can bid against them. They hold in their hands 80% or more of the claims of creditors. If the total claims are $100,000,000 and they hold 80% or $80,000,000 of those claims, they can bid $30,000,000 and yet put up only $6,000,000 in cash, *i. e.*, 20% of the $30,000,000 which they bid. But anyone else bidding at the sale must put up more than $30,000,000 in cash in order to outbid the committee.[35]

$30,000,000 does not grow on bushes. It is almost impossible to obtain—especially as it is usually impossible to induce any banking group to compete with those in charge of the reorganization. The Supreme Court recognized this fact when it said that "practically it is impossible to sell the property of a great railroad for cash." And in the *Monon* case it said that

[34] It may well be that in such a catastrophic period as the present the courts should hold that virtually no judicial sales involving more than a small amount of money are at all a fair test of value. Steps in that general direction have already been taken by some courts. See Suring State Bank v. Giese, decided by the Wisconsin Supreme Court Feb. 17, 1933, reported in the New York Law Journal for March 7, 1933; see cases discussed in (1933) 19 VA. L. REV. 420, and *cf.* cases on a cognate point collected in 18 A. L. R. 564; 10 A. L. R. 179; and 3 A. L. R. 610.

[35] Even if the outsider held all the $20,000,000 of non-assenting claims (and he never does), he would have to put up more than $24,000,000 in cash to outbid the reorganizers.

"all judicial proceedings must be adjusted to facts as they are," that "We may not shut our eyes to any facts of common knowledge," and observed that "the railroad mortgages, or trust deeds, are ordinarily so large in amount that on foreclosure thereof only the mortgagees, or their representatives, can be considered as probable purchasers. While exceptional cases may occur, yet this is the rule, as shown by the actual facts of foreclosure proceedings, as well as one which might be expected from the value of the property and the amount of the mortgage." And of course the same is true of any large industrial.

Which means—what? That the judicial sale in all such cases (even where the stockholders do not participate, even where no one but mortgage bondholders participate) is a mockery and a sham. And it is such, quite apart from any doctrine of fraudulent conveyance. It is a piece of mummery not because of any legal doctrine but because of the actual facts of the situation, because the amount bid at the sale is precisely what—and no more than—the reorganization committee wants to bid.[36] In truth no judicial sale takes place. A sale at which there can be only one bidder is a sale in name only.

Where an act of God or the intentional acts of parties have "chilled the bidding," the courts have often set sales aside as unfair and unjust because such sales are not sales in fact. In the kind of case here under discussion there is no technical chilling. No one is at fault. But bidding is chilled as fully as if a pestilence or an earthquake or false rumors or fraud kept prospective buyers from attending the sale. If there must be a name for a doctrine on which to base the fair result in these cases of large corporations, call it "the rule relating to unintentional (or 'constructive') chilling of the bidding."

Now if there is no sale in fact but only in form, then if there is excess value over and above the first mortgage, the party to whom that excess value belonged[37] prior to the sham judicial sale but who has not been allowed to participate in the reorgan-

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[36] And that amount, as we shall note below, is carefully computed so that Mr. Dissenter will receive a sum less than the market value of the new securities allocable to him if he assents.

[37] Or who had a claim against it.

ized company, has been deprived of his property without compensation.[38] (There is the doctrinal due-process avenue to a just conclusion, the shades of the barons at Runnymede and the Founding Fathers being thus properly invoked.)

This position, be it noted again, cannot be supported by the doctrine of the *Boyd* case. For the *Boyd* case doctrine is merely a part of the "law of fraudulent conveyances" and turns entirely on the fact that stockholders participate while creditors remain unpaid. Wherefore, the doctrine of the *Boyd* case would be just as applicable to a case involving a small corporation with a small debt structure.[39]

4. But how determine whether excess values exist and in what amount? Obviously, by valuing the property. That is an horrendous task, to be sure. But the courts have not hesitated to tackle that task in other contexts. What the criteria of values should be in such cases the writer will not in this brief

[38] So far as the writer knows, no case has yet arisen in which this question has come before the Supreme Court. He is not asserting that his views express what the "law" now is, but only what he thinks it ought to be and what he believes the courts should and perhaps will declare it to be.

The argument that to dispense with the sale is to deprive the mortgagees of contract rights may be met with a statement of the court in the Monon case (*supra* note 6 at 683): "We may not rightfully say that the contract of mortgage created certain rights, and that when those rights are established, they must be sustained in the courts, and no inquiry can be had beyond these technical rights." To be sure, there is language in the same opinion (at p. 688) which intimates that, regardless of the value of the property, railroad bondholders have a right to foreclose and then deal with the property or its proceeds as they please, provided only, they do not become parties to a fraudulent conveyance. But that language is obviously dictum as the court was not addressing itself to the problem discussed in the text.

[39] Here is where the writer diverges from what he understands to be the views of Mr. Rosenberg. He agrees with Mr. Rosenberg's admirable comments on the sham character of the judicial sale in cases involving railroads and other large industrials. (See ROSENBERG, CORPORATE REORGANIZATION AND THE FEDERAL COURTS, pp. viii, 5-7, 10, 95.) But Mr. Rosenberg seems to state that the Boyd case turned on the fact that the judicial sale in that case was of a large railroad as a consequence of which the sale was artificial and unreal. (See ROSENBERG, *loc. cit.* viii, 97.) The writer believes that such was not at all the pivotal factor in the Boyd case, and that the Boyd case would have been decided in favor of Boyd even if the old company's mortgage debt had been only $25,000 and even if, therefore, the judicial sale had been a real sale at which persons other than the reorganization committee might have made a successful bid.

sketch venture to suggest.[40] The word "value" obviously has no precise meaning, as Professor Bonbright has brilliantly explained.[41] But the substitution even of the vague concept "value" for the fictitious judicial sale as a means of dealing justly with the parties would mean a great advance from the present practice. It might serve as a red flag to the judge, by pointing out to him that he must investigate the plan in the light of divers considerations of fairness instead of mechanizing his decision by reference to the meaningless device of the price bid at the unreal sale.

And how can the excess be apportioned? Plainly through the distribution of new securities in accordance with a just ranking, approved by the court, of the several interests in the old assets and with due regard to the future welfare of the new company.

Doubtless the court will frequently find it difficult to determine with any degree of nicety whether there is any excess value. That problem will be peculiarly difficult in reorganizations which occur during a period such as the present where present earning power will often be found to be small or nonexistent. Perhaps the court should take into account the average earnings over the preceding decade; and it is suggested that to avoid injustice to senior security holders, the plan might frequently provide that distribution of the excess to junior security holders should, in cases of doubt, take the form of stock purchase warrants or options to purchase stock exercisable over a period of five or ten years.[42]

5. If the foregoing views are correct, then it might seem that, while stockholders should be allowed participation where

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[40] See Temmer v. Denver Tramway Co., 18 Fed. (2d) 226, 228-9 (C. C. A. 8th, 1927); New York Trust Co. v. Continental Trust & Savings Bank, 26 Fed. (2d) 872, 874 (C. C. A. 8th, 1928); Mountain States Power Co. v. Jordan, 293 Fed. 502 (C. C. A. 9th, 1923).

[41] *The Problem of Judicial Valuation,* (1927) 27 COLUM. L. REV. 493.

[42] This problem is tied up to a much more extensive problem, which can only be indicated briefly in this paper, *viz.* In the interest of all classes of claimants and security holders, should not financing in the future (if we ever recover from the present depression) take the form of contingent charges? The fixed charge in a period of general distress is likely to be almost as harmful to the holder of the fixed charge as to the debtor.

the assets exceed the aggregate debts, they may never participate where the debts exceed the assets.

Of course, that is not true. Under exceptional circumstances the stockholder may participate though the value of the assets does not cover the debts. This exception derives from the famous dictum (or advisory opinion) in the *Boyd* case. That it is an exception and the nature of the exception Mr. Swaine seems to overlook. It is therefore desirable to observe just how that dictum happened to be uttered.

In arguing the *Boyd* case in the Supreme Court, counsel for the new railroad put up to the court an unreal antithesis. If (they said in effect) you follow the Howard doctrine and require that in all cases unsecured creditors be paid in full in cash as a condition of participation by stockholders, then you will seriously impede reorganizations of large corporations; for experience has shown that a large portion of new funds required for reorganization can often be procured only from the old stockholders, and they cannot be induced to supply such new funds if they are not given some interest in the new company in exchange for their old stock. Now, it was argued, if all the unsecured creditors have to be paid in full in cash, it will be impossible to raise sufficient cash. Consequently, you must allow us to do what we did to creditors such as Boyd or make railroad and other like reorganizations impossible.[43]

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[43] Counsel for defendant in the Boyd case said (*supra* note 4 at 494-5): "Only by the plan adopted, or by one substantially similar, could this hopelessly insolvent property have been placed upon a sound financial basis. The reorganization of insolvent railroad properties would be an impossibility if honest, reasonable plans such as this were to be condemned, and in fact this court never has condemned them. * * * Treating the question broadly, it is to be remembered that between 1892 and 1900, a large number of the railroad companies of the United States, by their necessities, were forced to submit to foreclosure. They have been succeeded by a system of vigorous, solvent, prosperous and useful corporations. The change, obviously to the public advantage, was the result of reorganizations so-called, of which almost all were based upon plans similar to that involved in the present case. The principle of such plans was that financial necessities of the physical properties could be met only by sufficient and prompt provision of additional cash capital for the new corporation; and that for *prompt and sufficient cash provision the most available source was and would be those who already were acquainted with the physical property and would have faith in its future possibilities.* Manifestly these were and must continue to be, those who had been

The court, in its dictum, rejected this unreal antithesis. It told the bar how the practical situation might be met. It "made law" by realistically ignoring doctrinal difficulties and by taking into account economic actualities. Because of those realities, it said, in cases of large railroad corporations it would not

> "require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, 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."

And in the later case of *Kansas City Terminal Co.* v. *Central Union Trust Co.*,[44] the court clarified this language, saying:

> "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 cooperation between bondholders and stockholders * * *. Generally, *additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them, unless stockholders are permitted to contribute and retain an interest sufficiently available to move them. In such or similar cases* the Chancellor may exercise an informed discretion concerning the *practical adjustment of the several* rights." [45]

And the court went on to say that the new securities offered the creditors under such circumstances need not be "superior in value or grade to any which stockholders may obtain."

It is essential to note that this language creates an exception to the doctrine of the *Howard* case. The court said that what would otherwise be an invalid transfer to stockholders may be permitted to stand—and regardless of the worth of the corpo-

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interested in the old company, either as bondholders or stockholders and not necessarily or probably those who were its general creditors." (Italics the author's.)

[44] 271 U. S. 445 (1926).

[45] Italics the author's.

rate assets—(a) if "additional funds are essential," *and* (b) if it will be "impossible to obtain them unless stockholders are permitted to retain an interest sufficiently valuable to move them" to supply these essential funds.

Mr. Swaine, if the writer correctly understands him,[46] believes that stockholders may be allowed to participate, provided only that they contribute funds and that some adequate offer is made to unsecured creditors and other senior interests; and that this is true (1) even if there is no excess value over the debts, and (2) even if the essential new moneys could be raised without going to the stockholders.

The writer submits that there is no warrant in the authorities or otherwise for such a belief. If the property of the old company cannot on any conceivable basis be shown to be worth more than its debts, there is no excuse for allowing (and the *Howard* doctrine prohibits) participation by stockholders where essential new funds can be as advantageously procured without recourse to the stockholders. To hold otherwise would be to eviscerate the "law of fraudulent conveyances."

To avoid misunderstanding it may be well to repeat that the writer believes that the courts should allow stockholder participation without any assessment where the value of the assets exceeds all the debts.[47] No case has as yet so held. This is merely what the writer thinks the "law" ought to be and perhaps will be said to be.

IV.

1. Suppose an unsecured creditor of the old company brings suit against a new company arising from a reorganization of a large railroad company or a large industrial. Suppose that the old stockholders have participated in the reorganization, but suppose also that it can be and is proved that a fair offer has been made to unsecured creditors. Then, clearly, under the dictum in the *Boyd* case, that fact would constitute a defense. Indeed, that would seem to be the only defense on the merits against such an attack.

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[46] It may be that the writer at this point misunderstands Mr. Swaine.

[47] As indicated above, this is a matter not easily determined, and in order to avoid unfairness, where there is any possible doubt as to excess value, the stockholder's interest might well be represented by stock warrants.

And that defense would be good regardless of whether or not the reorganization had been effected through judicial proceedings. Accordingly, it might be argued that reorganizers in such circumstances, having made a fair offer to stockholders, should dispense with judicial proceedings. But, for divers reasons,[48] reorganizers usually prefer not to reorganize without court proceedings.[49]

2. But how can the reorganizers procure an effective adjudication in the receivership proceedings as to the fairness of the offer to the unsecured creditors, an adjudication which will prevent the Howards and the Boyds from subsequent attacks on the reorganization? Judge Sanborn in 1916, in the Frisco reorganization receivership, invented a device which seemed to yield such a result. He inserted in the decree of sale, entered in the receivership proceedings, a provision that, before confirming the sale, he would determine whether the plan contained a fair offer to the unsecured creditors. And, since then, it has become standard practice in reorganization-receiverships to have (1) a sale and also (2) a hearing on the plan, in some form or other.[50]

But, since, when stockholders participate, the judicial sale is nugatory as against unsecured creditors, why not abandon the sale and have only a hearing on the plan? Where a foreclosure is involved, that suggestion is logically unanswerable—so far as the unsecured creditors are concerned.

But, it is said, that does not meet the case of the mortgage bondholders who do not assent to the plan: They are entitled to have a foreclosure sale for cash so that they may receive a money decree (and the money pursuant thereto) for their distributive share of the cash proceeds of the sale. To deprive them of that, it has been suggested, would be unconstitutional [51] or immoral.[52]

[48] See Swaine, *Reorganization of Corporations* (1930), SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, 182-3.

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

[50] The question of the notice given to creditors of such a hearing is discussed below.

[51] See Cutcheon, *An Examination of Devices Employed to Obviate the Embarrassments to Reorganizations Created by the Boyd Case* (1930) SOME LE-

[52] As noted above, that is perhaps what lack of due process means according to Noble State Bank v. Haskell, *supra* note 33.

Or take the case where no mortgage is being foreclosed and only unsecured creditors are involved. Each such creditor is said to have a constitutional right to a share of the cash proceeds of the sale. It is argued that to offer him merely securities in the new company is to deprive him of inalienable rights. Wherefore, when Judge Carpenter in the Rock Island receivership in 1917 did dispense with the sale and, after examining the plan, ordered that creditors should receive only the new securities offered thereunder and be enjoined from all further proceedings against the debtor company, his conduct was severely criticized —as were the so-called Rock Island decisions of Judge Sanborn in the Circuit Court of Appeals for the Eighth Circuit [53] approving that conduct.

It must be conceded that the *decisions* of the United States Supreme Court in the *Howard, Monon, Boyd* and related cases, do not in and of themselves justify the *Rock Island* decree. It is true that the Supreme Court in those cases held that the judicial sale was not of any efficacy. But there the court decided merely that the sale was not of any use as a defense against an unsecured creditor when the sale had been employed as a means of accomplishing a fraudulent conveyance to the disadvantage of the creditor. Those cases did not decide that for any and all other purposes the judicial sale would be without purpose or effect. The justification of the *Rock Island* decree must rest upon considerations other than those referred to by Judge Sanborn.[54]

3. The support of the *Rock Island* decree can rest upon the

GAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, 70 *et seq.;* Harding v. American Sumatra Tobacco Co., 14 Fed. (2d) 168 (D. N. D. Ga. 1926); Coriell v. Morris White, 54 Fed. (2d) 255 (C. C. A. 2nd, 1931); Swaine, *op. cit. supra* note 48 at 171; *cf.* Swaine in Rosenberg, *supra,* 111.

[53] Phipps v. Chicago, etc., R. R., 284 Fed. 945 (C. C. A. 8th, 1922); Chicago, etc., R. R. v. Lincoln Horse & Mule Commission Co., 284 Fed. 955 (C. C. A. 8th, 1922).

[54] The writer agrees with Mr. Rosenberg's vigorous approval of that decree but he disagrees with Mr. Rosenberg to the extent that the latter concurs in the arguments of Judge Sanborn. See Rosenberg, *loc. cit.* pp. 124-134.

As to the question of whether the creditors in the Rock Island cases were parties to the proceedings so as to be bound by the decree, see the second instalment of this paper which will appear in the May issue.

fact heretofore discussed: the utter practical uselessness and meaninglessness of a judicial sale in connection with any reorganization of a corporation with a huge debt structure. That practical uselessness and meaninglessness in such cases is a fact. And it is a fact which the courts should recognize and to which they should attach consequences even in cases where stockholders have not participated and quite apart from any aspect of the doctrine of fraudulent conveyances.

For, in cases of huge railroad and industrials, the sale does the non-assenting creditor no practical good. He will not get one cent more because of the sale than he otherwise would. True, the court, when decreeing the sale, usually fixes an upset price. True, the non-assenting bondholder or creditor often receives some cash as a result of the sale. But—and here is the controlling fact—in such cases, for reasons already noted, the cash he receives is invariably less than the market value of the new securities which he would receive if he assented to the plan.

That is no accident. For the lawyers and bankers in charge of the reorganization carefully arrange matters in advance so that the non-assenter is bound to get, as his distributive share of the price realized at the judicial sale, less than the market value of the new securities offered to him under the plan. To be sure, the upset price is fixed by the court. But "we must not shut our eyes to facts of common knowledge" and "judicial proceedings must be adjusted to facts as they are," as the Supreme Court observed in the *Monon* case.[55] And everyone knows that the judge in the receivership suit usually fixes the upset price on the advice of his receivers (or their counsel) and that they, in turn, almost always cooperate with the reorganizers and therefore advise the court to fix the upset price at the figure desired by the reorganizers. *The upset price, then, is, in most cases, actually fixed not by the court but by the reorganizers;* it is actually determined not in the court room but in the lawyer's office.

And even if the court fixed the upset price above that thus suggested, what good would that do? The reorganizers would refuse to bid a figure as high as the upset price. Sooner or later the court would have to sell the property for the amount which

[55] Louisville Trust Co. v. Louisville, *etc.*, Ry., *supra* note 6 at 682-3.

the reorganizers decided to bid. To use street language, the reorganization committee holds the aces.

Wherefore, realistically viewed, the judicial sale is no protection to the creditor (in any case where the assets are vast and the debt structure huge) and in no manner actually meets due process requirements.[56] Since, as the Supreme Court has observed, the sale, although nominally for cash is not actually for cash, and since the only bidder at the sale is the reorganization committee, the price which the property brings at the sale can by no stretch of the imagination be deemed an adequate measure of value[57] nor a sensible way of determining the proportionate amount of cash to which the non-assenting creditor is entitled.[58] The courts use the elaborate mechanism of a judicial sale to determine what amount of cash shall be offered to a creditor who does not want to accept securities under the plan. As that

[56] All that is said here is equally applicable to the mortgage bond-holder who does not assent to the plan.

[57] Swaine, *loc. cit. supra* note 48.

[58] In reorganizations of large railroads and great industrials, the new securities offered to the creditor are the equivalent of cash if those securities have a ready market value. The Supreme Court doubtless had this in mind in its dictum in the Boyd case and its opinion in the Kansas City Terminal case. Seven years after the Boyd case was decided, the Supreme Court in Geddes v. Anaconda Copper Mining Co., 254 U. S. 590 (1921), realistically stated that when securities have "an established market value" they "should be treated as the equivalent of money * * *. It would be a reproach to the law to invalidate a sale otherwise valid because not made for money, when it is made for stock which a stockholder receiving it may at once, in the New York or other general market, convert into an adequate cash consideration * * *."

It may be (although on this point the writer has considerable doubt) that a judicial sale should not be dispensed with except in those cases where the new securities have a ready market value on some general market. On that basis the decision in Corriel v. Morris White, *supra* note 51, would perhaps be incorrect. That decision may perhaps also be deemed unwise because the assets and debt structure were not, perhaps, of such magnitude as to make a judicial sale meaningless; the Circuit Court of Appeals did not order a judicial sale but merely required that the non-assenting creditor should be given his percentage of a sum estimated, months after the decree approving the plan, to be what the property would have brought at a judicial sale. Moreover, there the attack by the creditor was not made collaterally but on appeal from the order approving the plan, and it may be that the plan was unfair. That case has recently been argued on certiorari before the United States Supreme Court and the decision is likely to create an important precedent.

amount will always be less than the market price of those securities, it is silly and wasteful to employ such expensive and time-consuming mummery for so simple a result.[59]

4. Worse, *the preservation of the hocus-pocus of sale, as it is now employed, is often positively injurious to the creditors.* For its preservation means that the judicial proceedings are conducted as if the sale were their primary end and purpose. As a result the reorganization plan takes on the appearance in the court room of a relatively unimportant and subsidiary item, a sort of post-script or foot-note.

It is brought to the attention of the court at the last minute. The judge has been devoting his attention to the details of the receivership, the numerous administrative problems, the determination of liens, the terms of the order of sale, the upset price, the notice to be given of the sale, the description of the property, the confirmation of the sale. The plan is lugged in at the last moment. Ordinarily, the judge has not carefully studied it. Usually he has not asked his receivers about its details, he has not ascertained the reasons for its divers provisions and how they were negotiated and arrived at.

It can be said with a high degree of accuracy that many judges do not thoroughly understand the plans which they approve. How can they, as those affairs are now conducted? Accordingly, the judge will be loath to upset a plan. He knows that months of labor have gone into its preparation and that it will take

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[59] In GLENN, *op. cit. supra* note 13 at 303, it is indicated that International Insurance Co. v. Sherman, 262 U. S. 346 (1923), is a holding to the effect that a judicial sale cannot be dispensed with in connection with a reorganization. An examination of the case shows that the court in no manner dealt with that question. The Supreme Court merely decided that the approval by a court in a receivership of a plan of reorganization was not binding on the non-assenting creditors because they had never in any manner been made parties to the proceeding. The court did not consider what would have been the effect of dispensing with a judicial sale if the creditors had in some manner been made parties to the receivership proceedings. The case of In re Alamac Operating Corp., 42 Fed. (2d) 120 (C. C. A. 2d, 1930), referred to by Glenn, pp. 301-2, is likewise not in point on this question for the reason that the non-assenting creditor was not a party to the receivership proceedings in which the plan was approved without a judicial sale; moreover, the decree did not even purport to bind non-assenting creditors.

weeks for him understandingly to study it. And how can a dissenting creditor, at the hearing on the plan, know enough to present adequate objection? It is extremely unlikely that his objections will be well founded, even though the plan be faulty. For he will not have the detailed information necessary to discover those faults.

But suppose that the proceedings, from their inception, were called "Reorganization Proceedings." [60] Or suppose the judge constantly thought of them as such. Suppose he instructed his receivers to participate in and assist in the preparation of a plan, to call in the divers interests in the property, learn their views and rights and seek to protect them, and to report periodically to the court on the progress of such efforts. Suppose pertinent data bearing on the plan were made part of the court's files and therefore open to all parties. *Suppose, in brief, the plan was made the core of the receivership proceedings.* Then the creditors would be far more likely to receive real protection.

All this is not meant as criticism of judges who have administered receivership estates. Or of receivers or their counsel or reorganization committees or their counsel. They are often—as the writer has learned from much experience—hard-working, God-fearing, conscientious, painstaking men. The conventional over-emphasis on the judicial sale is not due in any considerable measure (if at all) to a desire to injure anyone. It is a manifestation of "cultural lag," or a mental stickiness which makes lawyers act as if the judicial sale of a $50,000,000 railroad were actually like a judicial sale on foreclosure of a mortgage on a $10,000 house. Its complete explanation would involve a study of rites and rituals; it is a fit subject for the psychologist and the anthropologist. It is in part like the vestigial buttons on the cuff of one's coat, or the practice of making stone buildings look as if they were made of wood [61] or steel-skeletoned buildings appear to be elongated stone-buildings. For judicial analogies one would turn to the old fine and recovery [62] or the fictitious action

[60] *Cf.* 170 Fed. at 801.

[61] It has been remarked, says the social geographer, Febvre, that in Spain the Saracens, who were skilful workers in stone, carved it in the same way as their ancestors used to carve wood in Africa.

[62] See the argument of counsel for the creditors in the Howard case; see *supra* note 3 at 402.

of ejectment against which Bentham loudly and (finally) effectively railed.

The drift or slide of national and world events economically at this writing may lead to a state of affairs where the only interest in the entire subject matter of this paper will soon be in the light it throws, via anthropology and psychology, on the judicial process.[63] *For the judicial process presents problems which are bound to arise in any state of society.*[64]

If no statute is enacted in the near future to clear up the situation, it might be well for a time, to retain the judicial sale—but subordinate it, reverse the present practice and make the sale a mere appendage to the plan. Later on, when the sale is generally recognized as only a vestigial organ, it can be eliminated. Whether it can be eliminated without a statute is a matter of guessing what a majority of nine Supreme Court justices will say at some future date. The writer now timidly guesses that, if the matter were realistically presented, they would sustain the practice of removing such a vermiform appendix without the necessity of new legislation.

5. Perhaps, considering the inertia of the Bar, it would be well to enact legislation[65] dispensing with the judicial sale in cases where the court finds that, by virtue of the mere size of the debt structure and as a result of no impropriety whatsoever, there is or is bound to be such a "masterful situation"[66] that a sale would be meaningless.

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[63] The present paper is merely a sketch of a more elaborate paper (now in process in connection with some work the writer is conducting at Yale Law School) dealing with reorganization problems; there the writer will consider more at length several of the questions here discussed and will attempt to set forth some of the motives behind the zealous efforts to preserve the judicial sale in corporate reorganizations.

[64] See Frank, *Mr. Justice Holmes and Non-Euclidean Legal Thinking,* (1932) 18 Corn. L. Q. 568 at 598-599.

[65] Such legislation should perhaps be mandatory in its character. The Delaware statutes for some time have permitted corporations to insert in their charters provisions, more or less following the English statute, permitting reorganizations without a sale. Many corporations have availed themselves of this privilege and some of them have been reorganized, but the writer knows of no case to date in which use has been made of this statutory mode of reorganization.

[66] See Investment Registry v. Chicago, Milwaukee Electric R. R., 212 Fed. 594 at 609 (C. C. A. 7th, 1913).

But no new legislation and no departure from any existing precedent would be necessary to establish the practice in reorganization receiverships of having the courts require that the receivers and all other parties should, from the commencement of the proceedings, look upon the suit as designed basically to effect a reorganization. In that event, even if the judicial sale were retained, it would be treated as a necessary but meaningless mumbo-jumbo—a mere set of elaborate useless motions, words and gesticulations. The consequence would be that the attitude of the judges and the parties would be reoriented and the courts would openly, avowedly and conscientiously devote themselves to the promulgation of a reorganization plan which would be fair to all persons concerned.[67]

Time was when courts refused so much as to consider a reorganization plan.[68] However, some of the deans of the reorganization bar, such as Messrs. Cutcheon and Swaine,[69] protested not long ago that the courts should not concern themselves with the formulation of the plan but should content themselves with merely passing upon it when presented to them. Courts, says Cutcheon, should not make contracts for the parties. But that hoary slogan is what Thurman Arnold would call a piece of argumentative technique, to be employed whenever one wants to oppose the exercise of judicial power, wise or unwise. Of course, it is not true that courts do not make contracts for parties. Almost all the rules about concurrent and dependent conditions in contracts mean merely that the courts are determining not what the parties to the contract intended but what the court thinks is fair under the circumstances. The history of equity and quasi-contracts is full of instances where the courts have, for equitable reasons, remade contracts for parties.

The bulk of the security holders are inevitably uninformed and usually concur in a plan presented to them by the reorganizers because of lack of information and lack of any practical alternatives. If the courts accept the supine role which Messrs. Swaine

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[67] *Cf.* Berle and Means, The Modern Corporation and Private Property (1933) especially pp. 279-280.

[68] But that day has fortunately passed.

[69] Cutcheon, *op. cit. supra* note 51 at 70-71; Swaine, *op. cit. supra* note 48 at 148 *et seq.*

and Cutcheon would assign to them, they will do nothing more than to consider a reorganization plan after it has thus been accepted, and they will therefore be of little help to those security holders. For a judge is reluctant to overturn a completed plan because he feels that it represents months of effort which may be wasted if he disapproves.[70] The judge in that event may often be unconsciously swayed so to find the facts as to sustain the plan.[71]

But the situation would be quite different if the judge looked upon it as his function from the beginning of the receivership to participate actively as the supervisor in the formulation of a reorganization plan. An equity court surely has this power. The United States Supreme Court has shown admirable awareness of the realities of corporate reorganizations in the cases which have come before it. There is every reason why that court should approve and foster active supervision by the lower courts of reorganizations so as to protect the average security holder who is otherwise helpless. Courts of equity have a tradition of aiding the helpless, such as infants, idiots and drunkards. The average security holder in a corporate reorganization is of like kind.[72]

6. An important step in the right direction was taken by Judge Mack in the Miller receivership. The receivership involved a company which had sold numerous real estate mortgage bond issues on properties throughout the country. Judge Mack directed his receiver to assist in the organization of committees of bondholders for these several properties and see to it that provisions were inserted in the several deposit agreements (under which bonds were deposited with these committees) to the effect that

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[70] Swaine states the very considerations which should lead to a conclusion which he rejects; he says (*op. cit. supra* note 48 at 163): "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."

[71] As to the discretion inherent in judicial fact finding, see Frank, *What Courts Do in Fact* (1932) 26 ILL. L. REV. 645, 761.

[72] See, generally, BERLE AND MEANS, *loc. cit. supra* note 67, and dissenting opinion of Commissioner Eastman in Chicago, Milwaukee and St. Paul Reorganization, 131 I. C. C. 673.

the committees could make no major decisions except after a hearing on notice before Judge Mack or some other Federal judge acting as arbitrator. That splendid forward-looking conduct points the way to constructive reorganization jurisprudence.*

Jerome Frank.

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(To be concluded)

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*The final instalment of this paper, to appear next month, will discuss, *inter alia,* some phases of the recently enacted Federal railroad reorganization statute.