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The "Fair and Equitable" Doctrine: Are Liquidation Rights a Realistic Standard During Corporate Reorganization?

John H. Frye, III*

In past years, much has been written concerning the concept that exchanges of corporate securities must, in certain circumstances, be "fair and equitable." Controversy has existed concerning the effect which must be given this requirement, particularly in view of the fact that such effect may vary depending upon the purpose of the corporate reorganization requiring the exchange of securities. Specifically, commentators have advanced views concerning the effect given the term "fair and equitable" under two federal statutes: the Bankruptcy Act¹ and the Public Utility Holding Company Act.²

As Professor Walter Blum pointed out in 1958,³ to conduct such an analysis at a time when the development of doctrine seems to have become a matter of historical interest may be considered a luxury.

The general state of the economy following the depression has been healthy, and consequently there has been little need to examine the "fair and equitable" standard since that time. The case law developed by the Supreme Court consists, with perhaps one or two exceptions, of reorganizations which came out of the 1930's and the enactment of the Public Utility Holding Company Act.

However, this happy state of economic affairs appears to have suffered at least a temporary reversal. Every week the financial news reports that

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companies are seeking the benefits of bankruptcy reorganization. The largest of these has been the Penn-Central Railroad. Consequently, the "fair and equitable" standard is likely to play a most important role in the future as the financial affairs of distressed companies are put in order.

The purpose of this article is to analyse the "fair and equitable" doctrine as developed by the Supreme Court in order to appreciate the issues presented by today's reorganizations, and to propose a course to be followed in those reorganizations.

By way of background, the Bankruptcy Act provides a means by which corporations which are insolvent in either the bankruptcy or equity sense may renovate their financial structures, receive a discharge from their debts, and continue business, while the Public Utility Holding Company Act was enacted to combat the evils which existed in the complex systems of public utilities which had grown up in the years prior to the Act's passage. These utility systems, after the Act's passage, were required to "simplify" themselves. Typically, this entailed merger, consolidation and/or liquidation of the corporations in the system.

Both acts require that the securities of the old corporation be called in and that cash and/or new securities of an equal worth be issued to replace them. Both acts require that the exchange set out by the plan of reorganization or simplification must be "fair and equitable." The source of the "fair and equitable" requirement may be found in the old equity receivership reorganization cases. Much of the meaning ascribed to these words had its origin in those cases.

The legacy of the receivership reorganization cases is manifested chiefly in the rule of absolute priority. This rule must be adhered to in reorganizations

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4. See generally 1 COLIER ON BANKRUPTCY ¶¶ 0.01-0.08 and 5 COLIER ON BANKRUPTCY ¶¶ 77.01-77.02 (14th ed. 1969).
7. See, e.g., Louisville Trust Co. v. Louisville, New Alb. & Chic. Ry., 174 U.S. 674 (1899). This case set down the rule that a secured creditor could not offer the shareholders of a corporation an interest in the proceeds of a foreclosure sale in order to secure a speedy sale without objections to the detriment of the unsecured creditors. In that case the sale was conducted under an agreement between the bondholders and shareholders in order to allow the corporation to escape liability to its unsecured creditors. See also Northern Pac. Ry. v. Boyd, 228 U.S. 482 (1913). In this case, Boyd was an unsecured creditor of the Northern Pacific Railroad Company, the predecessor of the Northern Pacific Railway Company. The assets of the railroad had been subjected to foreclosure and sold. The shareholders of the distressed Northern Pacific Rail had purchased the assets of the railroad at the foreclosure sale through the medium of the new Northern Pacific Railway. After applying the proceeds to the secured claims and expenses of sale, nothing was left for the unsecured creditors. The Supreme Court struck down the sale. The shareholders could not be allowed to participate in the reorganized corporation to the detriment of the unsecured creditors. "The invalidity of the
under both acts.\textsuperscript{8} Simply stated, the rule of absolute priority requires that each security holder, in the order of his priority, receive full compensation for the rights he surrenders.\textsuperscript{9}

In order to determine the effect given the words "fair and equitable" and the rule of absolute priority in reorganizations, one must consider three variables: first, the worth of the corporation; second, the worth of the claims (both debt and equity); and third, the number and character of the securities issued by the reorganized corporation which will be deemed adequate compensation for the individual claims against the old corporation. This article will deal with the second and third variables and mention the first only briefly.

\textit{Part I - The "Fair and Equitable" Test as Applied to Allocations of Securities Under the Reorganization Provisions of the Federal Bankruptcy Act}

\textbf{The Worth of the Corporation}

Mr. Justice Holmes once stated that "the commercial value of property consists in the expectation of income from it."\textsuperscript{10} This statement has furnished the premise to be followed in determining the worth of the corporation. Because the corporation will continue its business after reorganization, its worth must be determined on a going concern basis.\textsuperscript{11}

In \textit{Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad Co.}\textsuperscript{12} the value of the railroad was determined by relying mainly on the earnings experience of the railroad. Since the resulting dollar figure was less than the total debt of the railroad, the court concluded that the common stock had no value. The common shareholders were accordingly denied participation in the reorganization plan. In order to gain participation in the plan the common shareholders had to show that the value of the railroad was sufficient to cover the debt of the railroad and provide an excess which could be applied to the equity interests. A heavier weight-

\textsuperscript{9} 318 U.S. 523 (1943).
\textsuperscript{11} Consolidated Rock Co. v. Du Bois, 312 U.S. 510 (1941).
\textsuperscript{12} See cases cited note 8 supra.
Fair and Equitable Doctrine

ing of "cost of reproduction new and less depreciation"\textsuperscript{13} of the road's assets would have accomplished this purpose. The common shareholders argued, in fact, that a heavier weighting of those factors was constitutionally required. The Supreme Court rejected this contention and reasserted the proposition of Mr. Justice Holmes that the value of property inheres in the expectation of income from it.

Because the securities to be issued by the reorganized corporation ought to reflect the worth of the property which underlies them, the worth or dollar value which is assigned to them will theoretically represent the worth of the corporation determined on a going concern basis.\textsuperscript{14} Some writers have pointed out, however, that the valuation of the corporation often is not realistic, with the result that the securities issued by the reorganized corporation fail to live up to the values assigned to them.\textsuperscript{15}

The Worth of the Claims Against the Corporation

In order to take advantage of the reorganization provisions of the Bankruptcy Act a corporation must be insolvent in either the bankruptcy or equity sense, a situation in which it might be subjected to actual liquidation.\textsuperscript{16} When insolvency occurs, creditors with claims currently due are, at best, paid some time after their debts have matured, and doubt is cast upon the corporation's ability to pay its debts in the future. At the point of insolvency, only the method of valuing claims against the corporation according to their rights upon liquidation of the corporation would produce greater value for the senior claims than for those of shareholders. Any other method of valuation would lessen the value of the senior claims and benefit the holders of equity because they are entitled to receive whatever is left after the senior claims are compensated. Thus, the Supreme Court has concluded that in bank-

\textsuperscript{13} The relevant language of 11 U.S.C. § 205(e) (1964) provides "[t]he value [of the assets] shall be determined on a basis which will give due consideration to the earning power of the property. . . . In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts." \textit{But see FPC v. Hope Gas Co.,} 320 U.S. 591 (1944).

\textsuperscript{14} It has been held that valueless securities should not be issued to cover the possibility that earnings will increase sufficiently above anticipated earnings to give the securities value. Consolidated Rock Co. v. Du Bois, 312 U.S. 510 (1941).


ruptcy reorganizations any method of valuing claims other than according to their rights upon liquidation would tend to compensate the holders of equity in the corporation for the "nuisance value" of their claims incident to control of the corporation.\textsuperscript{17}

But if claims against the corporation must be valued as if the corporation were being liquidated, then compensation for the holders of equity would appear justified whenever they held "valuable rights" which they surrendered in reorganization. Such a "valuable right" might be the power to prevent the creditors of the corporation from enforcing their legal remedies for a period of time. If the holders of equity released such a power so that the corporation might be reorganized, they would benefit the corporation creditors to the extent that these creditors would receive new claims against the reorganized and (hopefully) profitable corporation in exchange for their old claims against the unprofitable corporation. The holders of equity would at the same time lose their right to attempt to put the old corporation on a paying basis without the dilution of their claims against it as a result of reorganization or liquidation. Thus the holders of equity would appear to have parted with a right which ought to be compensated in accord with the probability that it would have brought them benefit.\textsuperscript{18}

In \textit{Case v. Los Angeles Lumber Products Co.}\textsuperscript{19} Mr. Justice Douglas, speaking for the court, dealt with a right similar to the one discussed immediately above. The shareholders of the Lumber Company had, at a time prior to the reorganization, exacted an agreement from the bondholders which would allow the shareholders to continue in control without interference for a number of years. Subsequently, when the agreement had seven years to run, the shareholders consented to the revocation of the agreement in return for the bondholders' consent to a plan of reorganization which the shareholders had formulated. This reorganization plan was to be effected through proceedings in a state court or under chapter ten of the Bankruptcy Act, and the shareholders had the power to designate which proceeding would be employed. They chose chapter ten. The plan allowed the share-


\textsuperscript{18} The equity interest ought to be entitled to the benefits the right might have produced for them in terms of earnings sufficient to pay prior charges and leave some excess for the common stock. They ought not to receive compensation for the fact that they could have delayed the reorganization.

\textsuperscript{19} 308 U.S. 106 (1939).
holders to participate in the allocations of the securities to be issued by the reorganized corporation. The shareholders justified their participation by pointing to the right to control which they had relinquished in exchange for the bondholders' consent to the reorganization plan. Mr. Justice Douglas assumed that the shareholders had given up a valuable right on relinquishing their right to control for the prescribed period and that the bondholders had been under a disability to interfere with that control prior to the relinquishment. At the same time he refused to allow the shareholders to participate in the plan. Although he might have been able to base the decision on the ground that the shareholders' right to control was without value, Mr. Justice Douglas relied instead on the idea that, on invoking the jurisdiction of the Bankruptcy Court, the shareholders "necessarily waived or abandoned" their right to control of the corporation. Mr. Justice Douglas seemed to think that the allowance of compensation on the basis of the surrendered right to control would allow the parties to a reorganization to dictate to the court the terms of the reorganization. This had been the practice prior to the enactment of the reorganization provisions of the Bankruptcy Act and had furnished one of the chief reasons for enacting those provisions.

Mr. Justice Douglas was unquestionably correct in holding that the parties could not dictate to the court the terms of the reorganization plan. But once the agreement by which the parties had attempted to bind the court had been struck down, the question remained whether the shareholders had a right, acquired in the first agreement with the bondholders, for which compensation was due. To the extent that the Lumber Products case, supra, stands for the proposition that such compensation should not be awarded, it appears to benefit the creditors of the corporation at the expense of the shareholders.

While the value affixed to the claims against the corporation is to be determined as if the corporation were in liquidation, the method of determining the worth of the corporation discussed above brought out the fact that the securities to be issued by the reorganized corporation should represent the worth of the corporation determined on a going concern basis. Thus the

20. The financial situation of the corporation was such that the claims of the bondholders were about four times the highest worth that might be placed on the assets. Id. at 119.
21. Id. at 127.
22. See 1 COLLIER ON BANKRUPTCY ¶ 0.04 (14th ed. 1969).
23. Cf. Protective Committee v. Anderson, 390 U.S. 414 (1968); Blum, Some Marginal Notes on TMT Trailer Ferry Reorganization: The New Math?, 1968 SUP. CT. REV. 77. In TMT the Supreme Court may have tacitly recognized that the ability to delay a reorganization existing in junior security holders is not without value.
24. See note 14 supra, and accompanying text.
new securities, in most cases, will be worth less than the claims against the corporation. Because the absolute priority rule requires that each senior claim must receive full compensation before any distribution is made to the next junior claim, the difference between the worth of the new securities and the value affixed to the claims will represent the extent to which junior claims will be denied compensation.

The Allocation of New Securities Among the Participating Claims:
Claims of Successive Priority on the Same Assets

The financial posture of the corporation in reorganization resembles that which could precipitate actual liquidation, and actual liquidation would result in the payment of claims in cash. As a result, the rule of absolute priority in bankruptcy reorganization requires that the worth of the new securities equal the liquidation value of the participating claims to which they are allocated. The equivalence required by the rule of absolute priority is quantitative equivalence.

The term quantitative is used to refer solely to worth in the sense of the number of securities or the aggregate of the dollar figures affixed to them. It is used chiefly to distinguish this characteristic of a security from the incidents of the security contract, which include for example the priority of the security's claim on earnings and, in the event of liquidation, assets. The incidents of the security contract are characterized as being qualitative. Two securities with identical contracts are qualitative equivalents, while two securities with successive claims on earnings and assets are respectively qualitatively superior and qualitatively inferior.

Because the value of the securities issued by the reorganized corporation is, theoretically, the going concern value of the corporation, and because the claims are valued as if the corporation were in liquidation, quantitative equivalence of the new securities to the participating claims means that the going concern value of the corporation is supposedly the same as the value of the liquidation rights of the participating claims. The going concern

25. See notes 8 and 9 supra, and accompanying text.
28. Should those who formulate the plan of reorganization not place a dollar amount on the securities to be issued—a matter within their discretion—equivalence must still be effected in some quantitative measure. Group of Institutional Investors v. Chicago, Mil., St. P. & Pac. R.R., 318 U.S. 523, 564-65 (1943).
29. See note 14 supra, and accompanying text.
30. See note 17 supra, and accompanying text.
value of the corporation is determined by capitalizing estimated earnings at a rate appropriate to the economic setting in which the corporation is operating.\textsuperscript{81} This results in an estimation of the amount of capital needed to produce the estimated earnings. The claimant receives, therefore, securities evidencing a contribution of that portion of the capital of the corporation which is the quantitative equivalent of the liquidation value of his claim. However, because reorganization usually results in a reduction of fixed charges, the claimant will in all probability receive new securities which are qualitatively inferior to his claim.

The portion of capital represented by the securities received by the claimant ought to be interchangeable with the same portion of capital in a hypothetical corporation which is entirely identical to the claimant's corporation. But the portion of capital that the claimant receives in satisfaction of his claim will, in most cases, be qualitatively inferior to the claim. Therefore, in his exchange with the hypothetical corporation the claimant would be left, as he was on the exchange of new securities for old, with qualitatively inferior securities.

Thus, while the claimant may have received the quantitative equivalent of his claim in the reorganization, he will not have received securities which can be exchanged on the same basis as his claim could have been exchanged. The qualitative inferiority of the securities has resulted in a lessening of the worth of the claim. This occurs because capital attributable to the claim has remained the same while the protection afforded that capital has been reduced.

It will be noted that the qualitative incidents of the security contract protect the quantitative investment in the business enterprise. Qualitative incidents provide the investor with protection with respect to the earnings of the going concern and with respect to assets should the concern be liquidated. Qualitative rights, then, protect an investment in cash. It follows therefore that cash is qualitatively superior compensation when compared with securities.

Mr. Justice Douglas, speaking for the court in *Institutional Investors*\textsuperscript{32} held that if claims junior to those which have given up qualitative rights are allowed to participate in the reorganized corporation, compensation must be paid for the loss of those qualitative rights. The requirement that the claims be valued according to liquidation rights dictates that this compensation be given.\textsuperscript{33} Had liquidation taken place, the claimant would have been paid the

\textsuperscript{31} See notes 10, 11 and 12 supra, and accompanying text.

\textsuperscript{32} 318 U.S. 523 (1943).

\textsuperscript{33} There are two arguments against such compensation. First, the fact that the
full amount of his contractual claim in cash. Because cash is qualitatively superior compensation, it may be assumed that qualitative rights beneficial both in a going concern and on liquidation are compensated by payment in cash. If these qualitative rights are fully compensated on liquidation by a cash payment representing quantitative equality, and liquidation rights are the measure of the claim in reorganization, it follows that qualitative rights must be separately compensated in a transaction in which quantitative equivalence is effected in securities rather than cash.

Institutional Investors was remanded to the Interstate Commerce Commission (ICC), charged with the responsibility of approving plans of reorganization of railroads by Section 7734 of the Bankruptcy Act, so that the ICC might approve modifications in the plan which would award compensation to the senior claimants for the loss of qualitative rights. The ICC took the following steps. First, cash payments were made to the senior securities. These payments were equivalent to the interest earned by the old claims to the current date and constituted a greater amount than was due on the securities given in exchange for the claims. Second, a fund was created which would inure to the benefit of the old bondholders by being applied to the retirement of the securities given in exchange for the bonds. Payments into the fund were to equal 50 percent of the dividends paid to the new common stock.

In Denver & Rio Grande Western Railroad Reorganization the ICC was again faced with the task of providing the senior participating claims with compensation for the loss of qualitative rights. The Rio Grande Western qualitative rights to be compensated included those of benefit in a going concern, as well as rights beneficial on liquidation, presents some difficulty. The theory that the claims against the corporation are to be valued as if the corporation were in liquidation might be said to preclude compensation for qualitative rights beneficial only in a going concern. Thus it may be argued compensation for qualitative rights ought to be limited to only those rights which come into operation on liquidation. Second, the argument that those rights which come into operation on liquidation are "used up" in the reorganization and are therefore not entitled to compensation may be deserving of some weight. This argument stands on the premise that reorganization is a substitute for liquidation and that consequently, the fact that liquidation rights are given effect to preserve the claimant's priority in the allocation of new securities weighs against awarding compensation for these same rights. Such compensation would seem to amount to double payment. This double payment would be at the expense of the junior claims, because any payment made to the senior claims reduces the fund from which the juniors are to be paid.

first trust mortgage bonds were compensated with new mortgage bonds and inferior securities. The result of compensation in more than one class of security had reduced the quality of the first trusts' claim to earnings. In compensation for this reduction the first trusts received an increase in their rate of return, from four percent to 4.13 percent. They were further benefited by a substantial reduction in the amount of debt per mile of track which secured their claim and by lowering of the minimum amount of earnings which would be required in order to pay the interest to which they were entitled. Since the purpose of a reorganization plan is to reduce debt and fixed charges, these additional benefits accorded the first trusts were a consequence of the plan of reorganization rather than a deliberate attempt to compensate them for the loss of qualitative rights.

Another class of bonds in the Denver & Rio Grande reorganization, the Rio Grande Junctions, received 3.5 percent more compensation, in terms of their total claim, in senior securities than did the first trusts. Despite this difference, the ICC cited the same benefits that accrued to the first trusts as providing compensation for the Junctions.

In the same reorganization, the ICC stated: "Loss in earnings position and surrender of other rights, in our opinion, are offset by the possibility of increased return permitted by the 4.5 percent income bonds, five percent convertible preferred stock, unlimited dividends on common stock, and the other features of the plan. . . ." The ICC also declared: "It is our view that the various features of the new securities and of the plan as a whole adequately compensate the holders of the old refunding and improvement bonds for the rights surrendered . . . ."

These statements tend to reinforce the idea that the ICC does not look farther than the usual consequences of a reorganization plan in order to find compensation to accord the senior security holders who have given up qualitative rights. Thus it would seem that the requirement that senior claimants receive compensation for the loss of qualitative rights is given little effect outside of the benefits accruing to the old claim by virtue of its participation in a reorganized and, hopefully, profitable corporation. This conclusion is also supported by the treatment of first mortgage bonds in the recent reorganization proceedings concerning the New York, New Haven & Hartford Railroad. In its Fourth Supplemental Report, the ICC awarded the first mortgage bondholders new common stock in compensation for the principal amount of their bonds and warrants for the amount of accrued but unpaid interest. At the same time warrants were issued for the principal amount of the income bonds. It would seem that the first

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37. 254 I.C.C. at 361.
38. Id. at 362.
39. Id. at 365.
40. Id. at 366.
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ly the result of the fact that in the railroad reorganizations of the 1930's and 1940's, the ICC was faced with the problem of being unable to follow a realistic valuation of the roads in question.

Claims of the Same Priority on Different Assets

If the corporation being reorganized were in liquidation, the secured creditors would receive compensation first from the property that secured their claims. Should that property prove insufficient to satisfy their claims, they would be treated as unsecured creditors as to the deficiency. Under the theory that the same result ought to be obtained in reorganizations conducted in the financial situation that is a condition precedent to obtaining relief under the Bankruptcy Act, the Supreme Court has held that the allocations of new securities must be made with a view to the assets underlying the claims. This would seem to require that the allocations be made in senior securities to the extent that the claim could have been satisfied by a lien, and in junior securities to the extent that it could not have been satisfied by the lien.

In railroad reorganizations the ICC has developed a formula to insure that the allocations of the new securities are made in accord with the Supreme Court’s holding. The ICC computes the percentage of the total corporate income that is equal to the percentage of total corporate property underlying or securing the particular claims; it then issues the new senior securities to the claimants in accord with this percentage. Thus if the property underlying the claim furnished 35 percent of the total earnings of the corporation, the claimant would receive 35 percent of the new senior securities. If

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mortgage bondholders were thus deprived of compensation for the loss of qualitative rights while a junior class was accorded participation in the reorganized company. See Pennsylvania R.R.-Merger New York Central R.R., 334 I.C.C. 25, 98-101 (1970). This proceeding is also of interest because of the form the reorganization took. Rather than continue to operate its properties, the New Haven conveyed them to the Penn-Central in exchange for securities. Because the Trustees of the New Haven foresaw the need, in the future, to borrow against or to sell these assets in order to meet maturing debt claims of the reorganized New Haven, market value of the securities received from the Penn-Central became a factor in the consideration of the earning power of the New Haven. Id. at 93-94, 100. While this as well as the other facets of the reorganization will undoubtedly require further reflection when the proceedings are finally completed, it would appear that the consideration of sale or market value of the assets of the reorganized corporation, as opposed to earning power, constitutes a departure from the usual procedure of placing greatest emphasis on earning power. See notes 10-14 supra and accompanying text.


the claimant had only a second lien on the property which secured his claim, he would not be compensated in new senior securities unless the percentage of total earnings attributable to the property were sufficient, under the formula, to compensate first the claimant secured by the first lien.

It has been objected that the formula necessarily results in a distortion of the value of the properties underlying the claims which it purports to preserve because it applies the capitalization rate applied to total earnings to the earnings attributable to the individual properties. These latter earnings, it has been argued, ought to be capitalized at rates appropriate to the property which produced them in order to ensure that the value of the property underlying the claims will be preserved in the securities issued in exchange for the claim. In deference to administrative convenience the Supreme Court has refused to accept this argument. The argument undoubtedly poses a more precise way of preserving the value of the liens, but the already laborious process of formulating and approving plans of reorganization ought not to be further complicated unless a substantial benefit would result. The benefit that would result from the adoption of the method espoused by this argument is apparently not so great as to justify the administrative burden of such an adoption. In sum, the formula used by the ICC furnishes a convenient and reasonably accurate method of preserving the value of the property underlying the claims in the new securities given in compensation for the claim.

**Summary**

The rule of absolute priority in bankruptcy reorganization entails the matching of going concern values to liquidation claims on the theory that the use of going concern values is dictated by the fact that the corporation will be continued, and the use of the liquidation claims is dictated by the fact that any other method of measuring the claims against the enterprise would result in increased participation of junior claims at the expense of the senior claims. In the matching of going concern values to liquidation claims the rule of absolute priority requires that each claim receive compensation for the rights, both quantitative and qualitative, which it has surrendered. This compensation must be meted out in strict accord with the priority of the claims and must, insofar as possible, give effect to the liens which secured the claims.

As can be seen from the foregoing applications of the rule, the result is a

45. Id.
rigid, almost arbitrary approach to the problem of compensating claimants, even to the point of cutting off valuable rights which, under a literal following of the liquidation right standard, are deserving of compensation. This rigid approach has resulted in laxness in the area of valuation; and has in many instances resulted in severe overvaluation.

Where overvaluation occurs, it defeats the purpose of the liquidation rights standard by providing senior claimants with less than the qualitative and quantitative equivalent of their claims. This results because, as has been pointed out, the new securities to be issued in compensation for the claims are equal to the value of the enterprise determined on a going concern basis. If the value of the enterprise is overstated, the value of the new securities will similarly be overstated. Consequently, qualitative and quantitative equivalence is not effected. The senior claimants receive less than the amount of their liquidation claim, with the result that something more is left for the junior claimants than would have been the case had equivalence been effected for the seniors. The value of the enterprise is therefore spread over more of the claims, with the senior receiving less than their liquidation claim and the juniors more than their liquidation claim.

Despite the fact that the liquidation rights standard becomes little more than a fiction when overvaluation occurs, this standard should not be completely abandoned. When placed in a proper context, it can play a useful role in reorganization.

Part II - The "Fair and Equitable" Test as Applied to Allocations of Securities Under the Simplification Provisions of the Public Utility Holding Company Act

In 1935 Congress passed the Public Utility Holding Company Act. Congress' objective, in part, was to simplify existing holding company systems. This simplification typically entails the liquidation, merger, and/or consolidation of one or more corporations in the system. Whenever legal entities are changed or abolished by merger, liquidation or consolidation, the securities which were outstanding against the old legal entities must be called in and cancelled and new securities or cash issued in their place. The new securities and/or cash issued should be distributed in a rational manner among the old security holders so that each will receive the worth of the security given up.

The "fair and equitable" test, employed in the reorganization provisions of the Bankruptcy Act, was also enacted in the Public Utility Holding Com-

pany Act to furnish the standard by which distributions of new securities and/or cash should be judged in order to insure that each security holder will receive the worth of his claim and that no security holder will receive more than his due at the expense of another. 47

The Supreme Court has held that the rule of absolute priority stemming from *Northern Pacific Railway Co. v. Boyd* 48 is applicable in determinations under the "fair and equitable" test of the Holding Company Act as it is under the same test of the Bankruptcy Act. Thus under both Acts each claimant, starting with the most senior, must receive full compensation for the rights he surrenders before the claims junior to him may receive any compensation. 49

As was pointed out in Part I of this article, the rule of absolute priority is employed in determinations under the reorganization provisions of the Bankruptcy Act after an initial determination has been made as to the claims which are to participate in the reorganized corporation. Thus allocations made under the Bankruptcy Act will not effect the determination that a class of claims is to be denied participation. Under the Public Utility Holding Company Act, on the other hand, no initial determination of which claims are to be excluded is made. Rather, the claims receive compensation in order of their priority until the value of the enterprise is expended. 50 While this difference in the application of the rule of absolute priority probably does not often cause significantly different results, it is conceivable that where the claims to be accorded participation are determined prior to the determination of the compensation to be awarded each class of claims, a class of claims will be afforded participation which would not have received compensation under the Public Utility Holding Company Act. This appears to be most likely to occur when compensation is given for the surrender of qualitative rights in bankruptcy reorganizations, because the determination of the classes of claims to be allowed to participate, discussed in Part I, does not appear to take into account the fact that compensation must be given for the surrender of qualitative rights.

The major difference between the two Acts lies in the methods employed by each to evaluate the claims against the corporation. While under the Bankruptcy Act this evaluation is made according to the liquidation rights of the claims, under the Holding Company Act the "investment value" of the claims controls. The purpose of the "investment value" method of evaluating

48. 228 U.S. 482 (1913).
49. See notes 7 and 8 supra, and accompanying text.
claims is to preserve and carry to the new corporation the relative economic position of the claim in the old corporation. Thus, while corporations may be merged, liquidated, consolidated, and the like, the Act is not to effect, through these changes, any change in the economic position of the holders of securities in the corporation.\(^5^1\) In other words, the valuation is to be made as if there were no Act.\(^5^2\)

A preliminary determination must be made before a value may be assigned any specific security. Because valuation of securities is made as if there were no Holding Company Act, it follows that account must be taken of any events which likely would have occurred had not the Act intervened. One of the most significant events which must be considered is voluntary liquidation. If the Securities and Exchange Commission (SEC) finds that a

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\(^5^2\) SEC v. Central-Illinois Corp., 338 U.S. 96 (1949). This does not mean, however, that adjustments must be made for previous divestments compelled by the Act. If the previous divestments were "fair and equitable," the Supreme Court in the cited case, thought it would be useless to attempt to reconstruct the system as it had existed before the impact of the Act. The Court indicated that it would consider the opposite course to be an improper collateral attack on the previous determinations. *Id.* at 143.

However, should the security contract make express provision for the compensation to be paid the security in the event of a simplification under the Act, it seems probable that the provision would be upheld. In New England Power Ass'n, 22 S.E.C. 343 (1946), the Securities and Exchange Commission (SEC), charged with the responsibility of approving plans of simplification under Section 11e of the Holding Company Act, 15 U.S.C. § 79k(e) (1964), seemed to allow such a contractual provision to set the amount of compensation to be paid in cash to the holders of notes. These notes were to be retired prior to maturity under the plan. The notes provided for the payment of a one percent premium if retired prior to their maturity with the exception that no premium was to be paid if the retirement were compelled by a simplification under the Holding Company Act. The SEC approved the retirement of the notes without the payment of the premium. However, the SEC did not indicate that a different result would have followed absent the contractual provision. The allowance of compensation fixed by contract might be considered to be an exception to the rule that the Holding Company Act is not to cause a shifting of economic values, and its corollary, that the valuation of the enterprise and the claims against it must be made as if there were no Act. Certainly the allowance of compensation fixed by contract would constitute such an exception if the contract provisions were exacted by management with a view to benefiting their interest in the enterprise in the event of simplification. On the other hand, good faith provisions which prove to be reasonably accurate might be said to have the advantage of reducing the burden on the SEC, thereby increasing the speed with which plans are processed and approved. But the task of determining whether the provisions in question were made in good faith and are reasonably accurate would seem to entail no less work than the determination of the investment value of the security. Thus the advantage of administrative convenience would not appear to be substantial, and while the SEC may follow express contractual provisions providing for compensation in the event of simplification, it would seem that little advantage (in the form of speed of processing and approving plans) can be gained from doing so if the investment value doctrine is followed.
corporation would have been liquidated had not the Act intervened, the SEC measures the claims against it according to their liquidation rights.\textsuperscript{53} This procedure could easily be expanded to include not only a determination that liquidation would have been likely had not the Act intervened, but also a consideration whether voluntary corporate changes which have already occurred would actually have occurred absent the motivation to avoid the impact of the Act.

In \textit{Federal Light and Traction Co.},\textsuperscript{54} the SEC refused to be convinced that a series of divestments would have taken place absent the Act. Those in control of Federal had simplified the system which Federal controlled in order to avoid the impact of “fair and equitable” test of the Act. A similar approach could well be used in bankruptcy reorganization to evaluate charges that management has drained profits and other assets from the entity under reorganization so as to impair the financial health of the corporation and place the assets in other ventures. This approach would permit greater flexibility than traditional concepts of preference or fraudulent conveyance in evaluating such charges in complex reorganizations involving only one legal entity, such as the current Penn-Central reorganization case.\textsuperscript{55} In the \textit{Federal Light and Traction} case, the SEC found that Federal had simplified its utility system in order to avoid the impact of the Act. According to the SEC, this finding required that the system be “reconstructed” so that the investment value of the claims against Federal could be determined as if there were no Holding Company Act.\textsuperscript{56}

Finally, this approach takes into account the fact that it is not always possible to determine that liquidation would have (or could have) taken place. Under the Public Utility Holding Company Act, the SEC developed the practice of weighing the appropriate factors in order to reflect the probabilities. Thus if liquidation seemed probable, the SEC was likely to pay more attention to liquidation value rather than investment value.\textsuperscript{57}

\textsuperscript{54} 31 S.E.C. 619 (1950), \textit{aff'd sub nom.} Federal Liquidating Corp. v. SEC, 187 F.2d 804 (2d Cir. 1951).
\textsuperscript{57} This method may reflect in reality more a tendency to split the difference than to attempt to weigh various factors. In \textit{New England Power Ass'n}, 22 S.E.C. 343, 365-67 (1946), the SEC's treatment of the preferred shares of North Boston Lighting Properties (NOBO) seems to have been nothing more than a splitting of the difference. NOBO's preferred had a $50 par value, the right to $3 per share per year, and an investment value, not considering liquidation rights, of $75. On liquidation it was en-
Once the above preliminary matters are out of the way, the next step under the investment value theory is to determine the investment value of the claims against the corporation and their "equitable equivalents." The remainder of this article will be devoted to an analysis of the treatment of various aspects of the old security on its exchange.

**Assets and Earnings Coverage**

In *New England Power Association*, the SEC was faced with the problem of allocating cash and common shares of a new holding company, New England Electric System (NEES), among the public security holders of the parent holding company, New England Power Association (NEPA) and its subsidiaries, which were also holding companies (Massachusetts Power & Light Associates, North Boston Lighting Properties, Rhode Island Public Service Company and Massachusetts Utilities Associates, hereinafter referred to, respectively as MPL, NOBO, RIPS, and MUA).

The SEC stated:

Although, in our analysis of the various allocations proposed in the amended plan, data are presented with respect to the underlying assets applicable to the securities being surrendered and to be received, our conclusions with respect to the fairness of each allocation are based primarily upon an analysis of the earnings prospects of each presently outstanding security as compared with the prospective earnings allocated to the holders of such security if the amended plan is consummated.

The SEC further recognized that each allocation had to compensate the holder of the old security for the entire set of rights and limitations embodied in the old security.

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58. The proposition that each security holder is entitled to the "equitable equivalent" of the rights surrendered is widely quoted. It was first stated by Mr. Justice Douglas in Group of Institutional Investors v. Chicago, Mil., St. P. & Pac. R.R., 318 U.S. 523, 565 (1943).
59. 22 S.E.C. 343 (1946).
60. *Id.* at 361.
An analysis of the allocations made to two classes of preferred shareholders (RIPS preferred and MUA preferred) in the New England Power simplification reveals that the SEC, while it may have based its allocations primarily on earnings, also considered other factors worthy of receiving compensation. In the two instances under consideration the SEC found that the adjusted net assets underlying the new securities were less than the adjusted net assets underlying the securities surrendered. In both instances there were no dividend arrearages, and both classes had preferences as to assets on liquidation and to dividends. Both classes had the right to limited participation with the junior security holders after the preference as to dividends had been paid. In both instances the anticipated dividends attributable to the securities given in exchange exceeded the dividend preference of the shares given up. These two classes of security holders could expect to receive a greater portion of the earnings of the enterprise than they had previously received. The possible justifications for the excess of anticipated dividends over the old dividend preference are as follows:

1. the loss of right to participate with the junior securities after the payment of the dividend preference;
2. the loss of the following preferential, or qualitative rights: the right to receive a definite dividend each year prior to the payment of dividends to the junior holders; the right to be paid all such dividends that had not been paid in previous years prior to the payment of dividends to the junior securities; and the right to be paid the liquidation claim of the preferred shares prior to the distribution of assets to the junior securities on liquidation;
3. the loss of asset coverage;
4. the loss of the investment in a particular corporate entity.

Because the earnings of the old corporation had never been great enough to bring the right to participate with the junior securities in dividends into operation, it is reasonable to eliminate this justification for the excess of anticipated dividends over the old dividend preferences.

The second possible justification for the excess of anticipated dividends over the old dividend preferences (the loss of preferential, or qualitative, rights) may have furnished the basis for increasing the preferred shareholders' expectancy as to dividends.

The data presented do not provide a basis for drawing a reliable conclusion, but because cash is qualitatively superior compensation, the fact

61. The data presented by the SEC tend to indicate that the term "assets underlying the securities" is intended to mean the worth of the liquidation claim of the securities. In the case of the MUA preferred, both adjusted net and per books assets coverage were reduced.
62. For a discussion of cash as qualitatively superior compensation in bankruptcy reorganization, see Part I of this article. The SEC's treatment of cash as qualitatively
that both preferreds received partial cash payments tends to indicate that the excess of anticipated dividends over the old dividend preferences was not intended to compensate the shareholders for the loss of their preferential

superior compensation is borne out by the following analysis. In the first of the two instances (RIPS preferred) a comparison of the claim to earnings of the next junior stock reveals that, prior to simplification, the preferred received $50 for each $100 paid to the next junior stock. The plan approved by the SEC changed this ratio to $48.46 paid the preferred for each payment of $100 to the next junior class. The latter ratio is based on the estimate of dividends which the SEC felt the shareholders could reasonably anticipate. 22 S.E.C. at 375-77. The next junior class was expected to receive dividends between $4.31 and $4.87 annually—the median figure of $4.59 was used for the computation—and the preferred was expected to receive dividends between $2.15 and $2.30 annually—the median figure of $2.25 was used for the computation. Both the preferred and the next junior stock were entitled to receive dividends prior to the payment of dividends to classes junior to them. The preferred received a cash payment and new stock in satisfaction of its claim and the next junior stock received only new stock in satisfaction of its claim. Because classes of stock junior to both the preferred and the next junior class received compensation, it is reasonable to assume that both the preferred and the next junior class were equally entitled to compensation. This assumption follows from the fact that the rule of absolute priority requires that each senior class be fully compensated before any payments are made to junior classes. Because both classes were equally entitled to compensation for the loss of their preferential rights, and because a downward adjustment in the preferred's relative claim to dividends was made, it follows that the preferred received partial compensation which was qualitatively superior to that given the next junior class.

In American & Foreign Power Co., 32 S.E.C. 655 (1951), aff'd, 197 F.2d 307 (1st Cir. 1952), the SEC in order to properly compensate the holders of two classes of preferred shares with successive claims on earnings, approved a plan which increased the junior preferred's relative claim to earnings, an adjustment necessitated by the fact that the senior preferred had received partial compensation in more senior securities than had the junior preferred, thus giving the senior preferred compensation of a higher quality. The cash payment made to the RIPS preferred in the instance under consideration may reasonably be considered to call for the same type of adjustment that the unequal compensation in senior securities necessitated in the American & Foreign Power case, supra.

In the second instance under consideration (MUA preferred), the preferred shareholders received cash and new securities in compensation for the rights they surrendered. The next junior class to the preferred was the common. The common had received no dividend payments in past years, and in the event of liquidation, the common would probably have received very little if anything in the distribution of the assets of the corporation. Yet the common's earnings expectancy, which had been roughly $6.20 for each $100 payment to the preferred, was transformed into a dividend expectancy of approximately $23.98 for each $100 payment to the preferred.

The MUA preferred was entitled to a dividend of five percent of its expressed value per share of $50. The MUA common had earned $0.06 per share and it was estimated that it would earn $0.25. The median ($0.15) was used in the computation. The MUA preferred was exchanged for cash and new common stock which was considered to be equivalent to a return of $2.72 to $2.94 in dividends (the median—$2.83—was used in the computation). The common received new common stock which carried with it the expectation of dividends of $0.17 to $1.20 per share of old common (the median—$0.685—was used in the computation).

The common's relative claim to earnings was almost quadrupled. This points up the fact that cash is qualitatively superior compensation. But, although the common was entitled to whatever value was left in the corporation after the senior securities received compensation, it is difficult to imagine how the partial cash payment made to the preferred could justify the extremely favorable treatment accorded the common. Cf. SEC
rights. The shareholders having received partial qualitatively superior compensation, their claim in respect of the loss of qualitative rights would be eliminated or reduced.

The fourth possible justification, the loss of an investment in a particular corporate entity, would not appear to justify the increase in anticipated dividends over the old dividend preference because, to the extent that compensation consisted of new securities, the shareholders' investment was continued in the same enterprise, if not the same entity.

The remaining possible justification for the excess of anticipated dividends over the old dividend preference is the third, the loss of asset coverage. While the SEC's opinions do not make plain the rationale behind the term "asset coverage," the data that are presented tend to indicate that with respect to preferred stock and more senior securities the term is intended to indicate the value of the liquidation claim of the securities. With respect to common stock, the data tend to indicate that the term implies that the stock is backed by the excess of assets over the liquidation claims of the senior securities.

The RIPS preferred received an 11.25 percent increase in anticipated dividends and at the same time its adjusted net asset coverage was reduced by more than 16.06 percent. The MUA preferred received a 13.20 percent increase in anticipated dividends and at the same time its adjusted net asset coverage was reduced by 20.16 percent.

These figures should be compared with the ones for the New England Power Association [63] six percent and two dollar preferred, both of which had arrearages which the SEC sought to compensate through an increased claim to earnings. The six percent preferred's increase was 10.25 percent compared to a 6.55 percent decrease in adjusted net asset coverage. The two dollar preferred was awarded a 10.50 percent increase compared to a 5.08 percent decrease in adjusted net asset coverage. If the amount of the

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63. 22 S.E.C. 343, 384-86 (1946). The percentage increase in earnings was computed on the basis of the median of anticipated earnings for the two preferreds.
arrearage per share is subtracted from the adjusted net asset coverage of
the new security, the percentage decreases in asset coverage for the NEPA
preferreds are 27.41 percent for the six percent and 26.27 percent for the
two dollar. These figures are more nearly comparable with the figure of
20.16 percent for the MUA preferred. The percentage increases in antici-
ipated dividends are, as they stand, roughly comparable.

The above computations seem to justify the conclusion that the increase in
the claim to earnings of the RIPS and MUA preferreds was given as com-
ensation for the loss of asset coverage. The percentage increase in earnings
for RIPS, MUA, NEPA six percent and two dollar preferreds were all roughly
equivalent. While the decrease in assets coverage for the NEPA preferreds
was small, both preferreds had arrearages. The decrease in asset coverage
of the MUA preferred was large; it had no arrearage.

Thus it can be seen that while the investment standard of evaluating
securities takes into account factors which may not be considered under the
liquidation standard, by considering "asset coverage," it also considers the
liquidation standard itself.

It is interesting that the decrease in asset coverage in the instances under
consideration may be likened to a failure to provide each security holder with
the equivalent of his claim under the liquidation standard. This failure is
rectified by a provision for compensation of a different kind - an increase in
earnings. It is not necessary under the investment value theory, as it is un-
der the liquidation standard, to provide each claim for a specific amount with
compensation worth that amount, a practice which more often than not is
simply a fiction. Thus it is evident that a great deal more flexibility is pro-

64. This adjustment is appropriate when it is remembered that the SEC treats asset
coverage as the value of the liquidation claim. Since both preferreds were entitled to a
liquidation preference which included arrearages, the computation of the decrease in
asset coverage should include any arrearage.

65. The fact that these figures were not comparable to the 16.06 percent decrease in
asset coverage of the RIPS preferred would seem to be of no weight because the SEC
felt that, while the assets underlying the RIPS preferred probably exceeded its liquida-
tion preference, the value assigned those assets ought not to be stated at a higher figure
than the liquidation preference. Thus the percentage decrease for RIPS was relatively
small. It is interesting to note that if the NEPA and MUA percentage asset coverage
decreases are added to the percentage increases in claims to earnings, the following re-
results:

<table>
<thead>
<tr>
<th></th>
<th>NEPA 6%</th>
<th>NEPA $2</th>
<th>MUA Preferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in claim to earnings:</td>
<td>$10.25</td>
<td>$10.50</td>
<td>$13.20</td>
</tr>
<tr>
<td>Decrease in claim assets:</td>
<td>27.41*</td>
<td>26.27*</td>
<td>20.16</td>
</tr>
<tr>
<td>Total:</td>
<td>$37.66</td>
<td>$36.77</td>
<td>$33.36</td>
</tr>
</tbody>
</table>

* These percentages were computed after subtracting the amount of the arrearages
from the asset coverage of the new security. The MUA preferred had no arrearages.
vided under the investment value standard than the liquidation value standard.

Market Price

It seems to have been fairly well settled that the market price of a security is not by itself an item for which compensation must be given. The Supreme Court had occasion to decide this matter, and in so doing reversed a persuasive opinion written by Learned Hand. The problem before the court concerned what value if any should be assigned to outstanding warrants to purchase the common stock of the Niagara Hudson Company. The SEC found that if a capitalization rate of 30 were applied to estimated earnings, the value of the stock would be roughly equal to the option price. It found further that the option price was about 3.5 times recent highs for the common stock. It felt that a capitalization rate of 15 was the highest permissible estimate, and even at that rate earnings would have to more than double before the market price of the common would equal the option price. On this basis, despite the fact that the warrants had been traded and had never been without value on the exchange, the SEC found that the warrants had no value. Judge Hand reversed this determination. He felt that he could find no evidence, substantial or otherwise, to support the SEC's determination and he believed that it was the function of Congress, not of the SEC to legislate to the effect that the purely speculative value which the market assigned the warrants was not to be compensated. The Supreme Court, two Justices dissenting, reversed the Court of Appeals and reinstated the SEC's determination. The Court stated: "A purchaser . . . may be willing to pay a nominal price for a warrant which has no investment value, on the mere chance that it may be saleable in a rising market. . . . This, however, does not provide an adequate reason for allowing a value to the warrants, at the expense of the common stock, in a reorganization under this Act." The majority refused to hold that the SEC must, as a matter of law, award compensation for the speculative elements embodied in the market value of the warrants.

It would appear to be erroneous to reason from this that market value is not a proper element of investment value. The SEC has used the price-earn-

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67. 29 S.E.C. at 823.
68. 179 F.2d at 617-18.
69. Justices Frankfurter and Black agreed with Judge Hand.
70. 340 U.S. at 346.
ings ratio of comparable securities to arrive at an investment value for a given security.\textsuperscript{71} The Supreme Court approved this method against the contention of the common shareholders that it was erroneous to arrive at investment value through any method which did not involve a prediction as to future earnings. It should be noted that in this particular case, instead of new securities, the preferred shareholders were to receive cash. In this situation the SEC, with the court's approval, shifts its standard a bit. The objective becomes the satisfaction of the security holder's claim with sufficient cash to reinvest in a comparable security.\textsuperscript{72} The same objective obtains when the security holder receives partial compensation in cash, and the earnings which should be attributable to the cash payment are computed in the same way.

Thus it would seem that market value in a securities-for-securities exchange, although it may be entitled to consideration, is entitled to very little weight in arriving at investment value and is not a proper item for compensation unless supported by other elements of value. In a securities-for-cash exchange, market value, in the form of the average of the ratio of earnings to market price of similar securities, seems to be the major factor. The change of approach in a securities-for-cash exchange seems justified on the ground that, since the security holder will not continue his investment in the enterprise being reorganized, he ought to be compensated in such a way as to permit him to reinvest in a comparable security.

The use of the price-earnings ratio in a securities-for-cash exchange points up the major difference in the objectives of the liquidation and investment value standards. Under the investment standard, the object is to preserve the bargain that was made when the security was purchased, while under the liquidation standard the objective is to enforce the security contract regardless of the nature of the bargain or the possibility that the security contract could ever have been enforced outside of reorganization.


Here the SEC relied on the uncontroverted testimony of an expert to reach the conclusion that the preferred shareholders were entitled to the redemption price of their securities. The expert found the average yield for ten comparable securities and applied it, with a slight adjustment, to the preferred shares. This resulted in a figure in excess of the redemption price, but the latter was considered to be the upper limit of the amount of compensation. The SEC also employed other computations to check its result. Cf. Federal Liquidating Corp. 31 S.E.C. 619 (1950).

\textsuperscript{72} 338 U.S. at 144.
"Call" or Redemption Price

There seems to be little question that the recovery of a security holder is limited by the "call" or redemption price. The reasoning behind this limitation is that the junior security holders, generally in control of the corporation, could, apart from the dictates of the Act, retire the senior securities at this price and thereby preserve any added increment in value of the senior securities in the corporation. By preserving the excess of the investment value of the senior securities over their redemption price in the corporation, the common shareholders, because they are entitled to whatever is left in the corporation after the payment of all prior charges, have in effect enhanced the value of their interest in the corporation. Should the corporation lack sufficient cash to enable the common shareholders to redeem the senior securities, the above reasoning would still apply, because the favorable financial situation, which is a prerequisite to a high investment value for the senior securities, would seem to preclude the chance that the corporation would never be able to acquire, at some future time, sufficient funds to accomplish the redemption. The conclusion which follows is that the redemption price of senior securities is an element of value existing in the junior securities where the latter are in control of the corporation and the economic value underlying the senior securities exceeds their redemption price. Redemption price simply provides the controlling security holders with the power to limit the value of the senior securities and thereby preserve to themselves the worth of the enterprise above a certain figure.

Arrearages on Preferred Shares

Because the provisions of the usual preferred share contract are such that the preferred shareholders' right to receive dividends is limited to instances in which there are earnings and, even then, only to receive dividends before payments are made to the common shareholders, it is possible that even though the corporation has had earnings, no payments have been made to the preferred shareholders. Under usual preferred share contracts this situation gives rise to arrearages which constitute an obligation on the part of the corporation in the event of liquidation or redemption, but not otherwise. Because of the premise of the Act—that it shall not be construed so as to shift values from one security to another—the preferred's claim

74. See notes 51 and 52 supra and accompanying text.
is not matured. But, because to ignore the contractual right to receive payment of arrearages before the common shareholders receive dividends would deprive the preferred shareholders of a valuable right, some compensation must be given to the preferred shareholders for the arrearages. This compensation usually takes the form of greater dividends. In United Light & Power Co. the preferred shares were entitled to a liquidation preference of $98,700,000, $38,700,000 of which were dividend arrearages. A liberal estimate of earnings for the common shares to be issued to the preferred and common shareholders of United was $6,185,000. The old preferred shares were entitled to dividends of $3,600,000 per annum. Under the plan they were to receive 95 percent of the new common shares with estimated earnings of $5,875,750. The SEC did not estimate the dividends that would be paid on these shares.

In the New England Power reorganization both the NEPA and the MPL preferreds had arrearages. The NEPA six percent preferred was entitled to $113.50 per share on liquidation which included $13.50 in arrearages. It was entitled to a preference as to dividends of six dollars per annum. It received new common stock which the SEC expected would receive dividends between $6.21 and $7.02 per annum. The NEPA two dollar preferred was entitled to $37.83 on liquidation, which included $4.50 in arrearages. It was entitled to a preference as to dividends of two dollars per annum after payment of the first preferred claims. It received new common stock which the SEC expected would receive dividends between $2.07 and $2.34 per annum. The MPL preferred was entitled to a liquidation preference of $52.25 which included $2.25 in arrearages. It was entitled to a preference as to dividends of two dollars per annum. It received cash and new common stock which the SEC expected would amount to between $1.75 and $1.91 per annum.

If the median of the anticipated dividends (in the case of United Light & Power, anticipated earnings) on the new securities is capitalized at the rate of return applicable to the old preferred shares, the following figures result:

(1) United—$97,929,167, or about one percent less than the liquidation preference of the preferred;

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75. Generally, the preferred and common shareholders will receive common shares in a different corporation for their old shares. Therefore, both classes will be equally entitled to receive dividends from the new corporation while often only the preferred were paid dividends in the old. Thus to ignore the arrearages of the old preferred shares would constitute a shifting of value to the old common shareholders.


(2) NEPA six percent preferred—$110.25 per share, or about three percent less than the liquidation preference;
(3) NEPA two dollar preferred—$36.75 per share, or about two percent less than the liquidation preference;
(4) MPL preferred—$45.75 per share, or about 12 percent less than the liquidation preference.

It should be noted that if the anticipated dividends figure had been used for United Light & Power Co., as in the other cases, instead of anticipated earnings, the percentage difference from the liquidation preference would have been larger. The SEC in addition, considered the junior securities of MPL to be without value, which explains the fact that anticipated dividends capitalize at a considerably lower figure than the liquidation preference.

From the above it seems reasonable to draw the conclusion that the SEC takes the following as a rough index of fairness to preferred shares with arrearages:

\[ D = LP, \]

where:

- **D** is the anticipated dividends on the new security per old preferred share;
- **L** is the liquidation preference (including arrearages) of the old preferred;
- **P** is rate of return on the old preferred shares.

The method followed by the SEC seems to be in accord with the premise that the Act should not cause the economic values underlying the securities to shift. So long as the corporation continues as a going concern, the sole right of the preferred is to be paid the amount of the arrearages prior to any payments to junior securities. Assuming that both the preferred and the junior securities are compensated with the same new securities, the preferred will have given up this right. The common, on the other hand, having received the right to dividends immediately instead of at some time in the future, ought to receive a smaller amount of dividends presently than they would have received in the future. In other words, the common, having given up its expectancy of a sum in the future in return for a sum immediately, ought to receive a lesser amount immediately than they had an expectancy of receiving in the future. The expectancy should be discounted, and the rate of discount should, of course, depend on the certainty that the expectancy would have been realized.\(^7^8\)

Following the above method, that is, providing the preferred shareholders with dividends which roughly equal the return they could expect on their original investment plus the arrearages at the rate applicable to the original

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78. Two distinguished commentators found that the SEC had discounted the common stock's expectancy at the rate of 15.2 percent for 15 years in the United Power & Light case. See Blair-Smith & Helfenstein, supra note 51.
investment, and then discounting the expectancy of receiving dividends in the future which the common has given up (equal to the preferred’s return attributable to arrearages) to its present value and determining the common dividends based on this last value, would seem to best reconcile the interests of the parties to the transaction.

In substance, the above method seems to force the preferred shareholders to invest the amount of their arrearages in the enterprise. But that was exactly the position these shareholders were in prior to the proceedings under the Act. And any such forced reinvestment is always subject to being undone whenever the old preferred shareholders can find a market for their new securities. In sum, it is difficult to see how a preferred shareholder, in light of the usual incidents of his contract, could drive any better bargain than he is accorded by this method.

Compare the rigid method followed under the liquidation value standard. Under the liquidation value standard, the amount of the arrearage would be lumped with the amount of the claim and quantitatively equivalent securities issued to satisfy the claim. In the process, the contractual rate of return would probably be reduced in an effort to lower fixed charges, necessitating further compensation. In the final analysis, the valuation of the enterprise might mean that the new securities would fall far short of providing full compensatory treatment.

How much simpler and fairer it is to provide that the rate of return which had existed be preserved in the new securities in terms of anticipated dividends. The security holder is also less likely to find that his supposedly “full compensatory treatment” amounts to little more than a few high sounding words.

Conclusion

We have seen that under bankruptcy reorganization proceedings claims are matured and their dollar value controls the amount of compensation they are to receive as if liquidation were taking place. Within this standard, claims are awarded senior and junior securities, as dictated by their liens on the debtor’s property. The whole effort is to try to give a creditor what he would be entitled to upon liquidation.

It has been argued that such treatment is proper in view of the fact that both liquidation and reorganization are means of paying creditors.\footnote{79. See Blum, The "New Directions" for Priority Rights in Bankruptcy Reorganizations, 67 Harv. L. Rev. 1379 (1954).} Because the other alternative, moratorium, or a failure to pay, constitutes the only other approach, this argument finds no merit in the contention that the
continuance of the enterprise demands a different means of evaluation in reorganization than that employed in liquidation.

It has also been pointed out that actual liquidation for a publicly held corporation is virtually impossible.80 This may well be so. In any event, it appears highly unlikely that the liquidation of any corporation whose business holds any potential for profit or is necessary to the public would result in the liquidation of the enterprise as well as the legal entity. Viewed in this light, reorganization of the legal abode of a business is in effect a means of preserving a legal entity more than a means of preserving an enterprise.

Perhaps this factor is best illustrated by the Penn-Central reorganization now in progress. Chief among the issues to be determined legislatively in the course of that reorganization is whether Penn-Central (and other United States railroads) shall be privately operated for profit or operated by Government as a public service. The one immutable certainty is that the Penn-Central system itself will survive.

Under these circumstances, the wisdom of the argument in favor of resorting to the liquidation rights of security holders as the one and only means of determining the worth of their claims is questionable. It has been pointed out in previous discussions of the problem that the use of liquidation rights has often been accompanied by an overvaluation of the worth of the corporation in times of economic distress.81 When, as in the railroad reorganizations of the thirties, adherence to the liquidation standard is accompanied by an overvaluation of the enterprise, the liquidation standard itself becomes more fiction than reality.

In a situation in which the enterprise itself, as opposed to the legal entity, could be liquidated by selling its assets in such a way that these assets would cease to be an economic unit, the argument for the liquidation standard seems strongest. In that situation, it would not be “fair and equitable” to deprive a senior creditor of any of the contractual rights embodied in his security; consequently, liquidation rights should then provide a floor in the manner developed under the bankruptcy reorganization cases.

It must also be assumed that liquidation rights should represent the maximum amount of compensation due the senior creditors in the bankruptcy reorganization of any corporation, regardless of the feasibility of liquidation.

80. Id.
Any other rule would open the door possibly to awarding the seniors compensation which should go to equity interests.

Within this framework, the award of compensation to senior creditors based on their contractual liquidation rights, where actual liquidation of the enterprise is not feasible or possible, should be closely examined. The award of compensation based on liquidation rights in this situation amounts to nothing more nor less than an attempt to give senior creditors something which they could not have obtained except through reorganization. With liquidation denied them as a practical matter, the use of the liquidation standard to measure their claims becomes an effort to pull them up by their own bootstraps at the expense of the junior securities. Furthermore, the accompaniment of the liquidation standard by an overvaluation of the enterprise illustrates the inability of the senior creditors to drive the bargain to which, under the law, they are entitled.

It has been aptly pointed out that it is not possible for the seniors to protect themselves against such overvaluation. It is submitted that the seniors might actually increase their bargaining strength by a departure from the inflexible liquidation standard. By incorporating the investment standard with its increased flexibility and, under it, taking into account the possibility that the seniors could have forced liquidation, it would seem that the bargaining could be placed under greater control and the value of the enterprise stated on a more realistic basis. More effect might well be given to the contractual claims of the seniors.

All of this adds up to the conclusion that the award of realistic compensation for liquidation rights is not at present one of the reasonable expectations of the senior security holders. However, asking them to incorporate a provision in their security contracts calling for the use of the investment value standard as some writers have done is somewhat like asking a housewife voluntarily to pay more for her groceries in an effort to provide higher prices for farmers. Even if such a provision were incorporated, it is questionable whether it could be honored under the holding in Case v. Los Angeles Lumber Products.

Whether it is possible at this stage to work out effective changes in theory through the decisional processes of the courts is doubtful. In addition, jurisdictional problems could arise if previous corporate dealings are examined as suggested. It is as if it were five minutes to midnight, and the reorgani-

82. See Blum, supra note 79.
83. See Brudney, supra note 81.
84. 308 U.S. 106 (1939).
85. See note 55 supra and accompanying text.
ratings of greatest significance to the nation could be interminably delayed by the hammering out of doctrine by the courts. Consequently, it appears that what is called for is legislation which would provide for the incorporation of the investment value standard in bankruptcy reorganization while at the same time protecting senior creditors by requiring that appropriate attention be paid to the possibility and feasibility of actual liquidation.