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CORPORATE REORGANIZATION IN EQUITY

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REORGANIZATIONS based on the foreclosure of mortgages or the enforcement of other rights by creditors and involving the organization of a new corporation to acquire the property commenced to developed in the courts of equity in the latter part of the nineteenth century. After 1878, until the Panic of 1893 caused the enactment of the Bankruptcy Act of 1898, there was no composition section nor in fact any Bankruptcy Act. The procedure was worked out in the Federal Equity Courts primarily in connection with railroads. There was no other suitable method.

The conventional process of reorganization in equity involves a receivership proceeding to prevent creditors from enforcing their claims against the property, a foreclosure and sale to free the property from the old debts, the purchase of the assets by the creditors or a part of them and the transfer of these assets to a new corporation organized for that purpose by the bondholders or stockholders or both.

A creditor's bill in equity is used also because the business of the corporation can be continued during the reorganization and the creditors restrained from dismembering and harassing it. If there are assets in more than one state, ancillary receiverships and foreclosures should be commenced and suits by creditors enjoined. It is important that the creditor's bill should be filed first so that the corporation may be put under the protection of the equity court and a friendly receiver appointed before hostile creditors commence objectionable tactics.

Historically, the purpose of a creditor's suit was liquidation for the equal benefit of all. It was in theory a collective execution. At first it could be brought only by a judgment creditor with execution unsatisfied, but as this requirement delayed the proceedings, the theory of consent receivership was developed. Under this doctrine, a simple contract creditor could bring the suit and the corporation could by consent waive the defense that the remedy at law was adequate.[1] It then became the custom for a debtor to have a friendly creditor who possessed a claim over $3,000 and diversity of citizenship to bring such a suit. Often the bill was prepared by counsel for the debtor and thus a receiver was obtained within a very short time. But the creditor's bill and the other equitable forms, as they developed, became a proceeding which achieved the result of preserving the properties in-

[1] In re Application of Konrad (Metropolitan Railroad Cases), 208 U.S. 90, 28 Sup. Ct. 219. 52 L.Ed. 403 (1908).

tact, of readjusting the debts of the insolvent debtor and of protecting the property from the inevitable waste and loss of value—which would have resulted from a multiplicity of suits by creditors and under the historical purpose of a creditor's bill. To prevent such forced liquidation by the creditors, the debtor usually anticipated the defaults and all the necessary papers for the proceedings were prepared beforehand. Counsel for the corporation often was instrumental in organizing committees for the various classes of creditors and stockholders. It is advantageous to have as members of the Protective Committees men who are experienced in financial matters and understand the problems of the debtor and whose integrity commands the support of the various creditors. This is a realistic approach, for if nothing is done, self-appointed Protective Committees would be formed with the results left to chance.

Regardless of the origin of the Protective Committee, a depositing agreement must be prepared. There are many different types of such agreements. Their purpose is to control the rights of the depositing security holders and to give to the committee sufficient power to act effectively in the reorganization. Such agreements generally give a maximum of power to the committee and place it practically in the position of owners of the securities. Under carefully drawn agreements, the committee has power to purchase the property, if a bondholders committee, and to negotiate and adopt a plan of reorganization, either proposed by itself or by someone else. It is not unusual for the Protective Committee to have power to adopt a plan in its discretion without submitting it to the depositors. Such agreements must reserve some control to the security holders or the committee will be unable to secure deposits thereunder.

While the various committees are being formed, the foreclosure suits are commenced. By bringing the creditor's suit first, the foreclosure proceedings are drawn into the creditor's suit and the intervention by other creditors controlled. The equity receiver is often appointed receiver in the foreclosure proceedings. If the corporation is seeking the reorganization, the foreclosure generally goes uncontested by it. It is usual to have the decree of foreclosure entered before the adoption of any plan, as dissenters are always disposed to obstruct the foreclosure at this point in order to secure more favorable treatment in the plan. After the decree is entered, the proposed plan of reorganization appears, although it has been prepared previously. While the receiver is operating the corporation and the period of redemption is running, the negotiation of the plan between the various conflicting interest goes on until the dominant forces in the reorganization have substantially agreed. Seldom is any plan acceptable to all;

seldom is the plan strictly logical or legally perfect. It is usually the result of concessions on all sides and emerges as a hybrid compromise with high hopes and some doubts on the part of its co-authors that it will enable the distressed corporation or its successor to live another few years. In the case of railroads, the plan is usually prepared by a banking or underwriting house acting through reorganization managers.

The formal plan and agreement to reorganize is then prepared. The purpose of the plan is to give the financial details of the reorganization, and generally contains a detailed statement of the outstanding indebtedness, the amount of cash that is required, a description of the new securities and a statement of the distribution of the new securities among the various classes of existing securities. If considerable cash is required, provision is made for underwriting and the necessary data of the terms and conditions. The capital structure of the new corporation is generally set forth in full. There is a statement of the method and the term of participation in the plan by the various security holders and what they must do in order to participate. Most plans also contain a provision for modifying either the plan or the agreement so that any adjustments that are necessary may be made without resubmitting the plan.

The whole theory of the plan is generally based on the theory of foreclosure. The property is to be purchased by the committee or committees in their name or through agents and, under the agreement to reorganize, to be transferred to a new corporation, which is to issue the new stock and whose financial set-up presumably is free from the defects of the old company. The various Protective Committees would then become owners of the new securities, subject, of course, to the obligation to distribute them to their depositors. The cash requirements of the plan to provide for new capital, the expenses of reorganization, and the non-assenting creditors are generally obtained from the old stockholders. This is especially true if the Bondholders' Committee is in control of the reorganization. This additional investment is called an assessment and it is a condition precedent to participation in the reorganization by the junior security holders. For this money they usually receive some form of security, usually stock in the new company. The plans generally provide for preserving part of the equity, if any, of the old stockholders as an inducement for them to pay the assessment.

Cash for the non-assenting lien creditors of the plan is necessary since they have the right to participate in the sale of the mortgaged property. If the purchase is to be made by bondholders, there must be some form of valuing the property to ascertain the value of the rights of the non-assenting bondholders and whether there is any surplus equity for general creditors or stockholders. The foreclosure sale accomplishes this as it does in any other mortgage foreclosure. Since there is no possibility of any real competitive cash bidding for a large corporation, the court customarily fixes an upset price, which is the minimum at which the property can be purchased. Much delay and litigation is involved in establishing an upset price. Practically it must be high enough so as not to be unfair to non-assenting bondholders and yet not so high that the distributive share of the non-assenters will impose a too serious burden upon the reorganization.

In the early cases it was usual to establish the upset price on the theory of liquidation and consistent with the theory of a foreclosure, and thus force or induce the creditors to assent to the plan, wherein their rights or at least those of the junior security holders were recognized on some theory of going value of the assets.

Up to 1913 when the *Boyd* case[2] was decided, the plan of reorganization and the agreement to reorganization were not regarded by lawyers as being an essential part of the legal proceedings. They were rather an outside force that determined the course of the receivership and the foreclosure proceedings, but were not judicially embraced within them. The court took little notice of the plan and regarded the foreclosure sale as settling the rights of the parties, the petitioner taking free from the claims of the old corporations, stockholders or creditors. The *Boyd* case, however, recognized the real function of the foreclosure sale as only a step in the reorganization proceedings, rather than as an adjudication of rights. In the dictum of the *Boyd* case, the court enunciated the principle that equitable relief would not be afforded to a creditor who had rejected a "fair offer" under the plan and had refused to come into a "just reorganization." It then became the practice of hearing objections to the proposed plan before the confirmation of the sale. If the plan was unfair to any class of creditors, the sale was not confirmed; but if the court approved the fairness of the plan, it confirmed the sale and enjoined later suits by creditors to reach the transferred property.

The *Boyd* case is perhaps the most important and most discussed case on corporate reorganization in equity. Most of the objections of creditors to a plan have been based on its decision or dicta. This case of the *Northern Pacific Railroad Co.* v. *Boyd,* arose out of the Northern Pacific reorganization of the 1890's. The plan under which the properties were sold refunded the secured indebtedness and gave participation to stockholders who contributed a cash assessment. It made no provision for unsecured creditors. The reorganization was primarily a bondholders reorganization based upon a foreclosure of

[2] Northern Pacific Railroad Co. v. Boyd, 228 U.S. 482, 33 Sup. Ct. 554, 57 L.Ed. 931 (1912).

the mortgage. The outstanding bonds and receiver's certificates amounted to $157,000,000. The property was sold at the foreclosure sale and confirmed for $61,500,000, and a new company was capitalized for a total of $345,000,000, consisting of $190,000,000 in bonds, $75,000,000 in preferred stock and $80,000,000 in common stock. The preferred stockholders were given 50% in new common stock on the payment of $10.00 per share. The common stockholders received 100% new common stock upon a payment of $15.00 per share assessment. The total assessment aggregated $11,000,000. The unsecured creditor's committee was unsuccessful in defeating the foreclosure action on the ground of conspiracy between the bondholders and stockholders to squeeze them out. The Circuit Court held that the assets were insufficient to pay the mortgage debt and there was therefore no equity in the property for the unsecured creditors.[3]

About ten years later, while the new company was prospering, Boyd, the owner of a judgment for an unsecured claim against the old company, sued both the old and the new company seeking to subject the property of the new company acquired through the foreclosure to payment of his debt. Boyd claimed the foreclosure sale was invalid because it was made pursuant to the plan of reorganization between the bondholders and the stockholders, which made no provision for the payment of unsecured creditors, although the stockholders retained their interest by receiving shares in the new company. The United States Supreme Court in a five to four decision sustained Boyd and granted him a lien on the property of the old company in the hands of the new corporation, subject to the mortgage placed thereon at the time of reorganization.

The theory of the majority of the court was that while the bondholders might have purchased the property covered by the mortgage and kept it for themselves to the exclusion of the unsecured creditors and stockholders, they could not provide for participation in the new company by the stockholders even at the expense of paying an assessment without making a fair and equitable provision for the unsecured debts, which would recognize their priority to the interest of the stockholders. The court said on page 504:

> "The property was a trust fund charged primarily with the payment of corporate liabilities. Any device whether by private contract or judicial sale under consent decree, whereby stockholders are preferred before creditors, was invalid."

And on page 507:

> "The invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the prop-

[3]Paton v. Northern Pacific Railroad Co., 85 Fed. 838 (E.D. Wis. 1896).

erty, for in cases like this, the question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether on the day of sale the property was insufficient to pay prior encumbrances."

And continuing on page 508:

> "This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholder 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."

Taking the Boyd case, together with the subsequent cases of the *Kansas City Terminal Railway Co.* v. *Central Union Trust Co.*[4] and *Kansas City Southern Railroad Co.* v. *Guardian Trust Co.*,[5] the following principles are established:

1. The question whether the creditor has received what he is entitled to as compared with the stockholder is decided by inquiring whether the plan gives him an advantage over the stockholders such as reasonably corresponds with the advantage to which he originally was entitled, regardless of the sale price in the foreclosure. This advantage extends even to prospective value accruing from the plan.
2. A complaining creditor is not barred by decree, sale, confirmation or conveyance which results from a plan and agreement to which he is not a party, even though the plan was affirmed, nor is he barred by orders requiring creditors to file claims.
3. A very great delay in asserting the creditor's claim against the reorganized company does not under the circumstances of the Boyd case amount to laches.

These principles apply in favor of a security holder of any claims who by a like process has been refused an equitable advantage over a junior security holder. This seems to follow from *Southern Pacific Railroad Co.* v. *Bogert*[6] *and Guaranty Trust Co.* v. *Missouri Pacific Railroad Co.*[7]

The Boyd case condemns plans other than those which result in a freeze-out. Mere participation in a plan is not sufficient. While it is not necessary to pay cash to the junior security holders or unsecured

[4] 271 U.S. 445, 46 Sup. Ct. 549, 70 L.Ed. 1025 (1925).
[5] 240 U.S. 166, 36 Sup. Ct. 334, 60 L.Ed. 579 (1915).
[6] 250 U.S. 483, 39 Sup. Ct. 533, 63 L.Ed. 1099 (1918).
[7] 238 Fed. 812 (E.D. Mo. 1916).

creditors, their priorities of income and liquidation position must be recognized in the new set-up.

However, there is a recognized exception in the Boyd case, which justifies the stockholders' participation in a plan of reorganization to the extent to which they have contributed new money to the company. This is justified by the need of the corporation for cash to pay the receivership costs, to pay dissenting creditors and to provide working capital for the reorganized corporation. Consistently with the Boyd case, this amount of fresh capital may be represented by securities in the new corporation which could not be subject to the demands of the creditors, but the exception goes farther. When a corporation is embarrassed, new money is not readily available from an outside source without an offer of adequate security. Since ordinarily a reorganization looks to scaling down the mortgage debt, the required funds can be best secured from the stockholders who may be induced to contribute fresh money in order to salvage their old investment. As a practical matter, stockholders will not invest new money on junior securities representing merely the amount of their contribution, and they must therefore be given participation in excess of that amount. Such added participation may be defended on the ground that only through the receipt of the new money is liquidation avoided and the excess of the going value over the forced-sale-value of the assets preserved for the creditors.

Generally bondholders do not want to run the property and are incapable of doing so. The creditors to secure the cooperation of the management are usually willing to sacrifice part of their investment to induce the old stockholders and management to continue in the enterprise, but in order to give this added participation to the stockholders the security holders of prior rank must be given participation on terms more favorable than those to the stockholders. Whether the principles of the Boyd case or the principles underlying compositions are applicable to proceedings under Chapter X of the Bankruptcy Act is a controversial question which is outside of the scope of this paper. A good article, however, on the problem is found in 51 *Harvard Law Review* 1408.

In one important case, *Phipps* v. *Chicago Rock Island & Pacific Railway*,[8] a reorganization in equity was accomplished by decree without sale. In the Rock Island case the question raised was whether the equity court had the power to compel non-assenting unsecured creditors to accept stock or securities for their claims instead of cash and thus avoid a judicial sale. The court held that it had such power and went to the extent of returning the property in receivership to the old

[8] 284 Fed. 945 (C.C.A. 8th, 1922).

corporation and imposing upon the dissenting minority of unsecured creditors a plan of reorganization approved by the court without a cash alternative to which the creditors would have been entitled had the property been sold. If the principle of this case is correct, it might well be extended to secured creditors. However, doubt has been expressed on the soundness of the decision. The case was appealed to the United States Supreme Court, but was not passed upon because the appeal was dismissed upon stipulation. In passing, it is to be noted, however, that the principle of the case was codified in the reorganization sections of the Bankruptcy Act.[9]

It can be seen from this brief recital that the equity method had many disadvantages. At times it became an expensive necessity. It was somewhat cumbersome where ancillary suits were necessary. The looseness of the method allowed abuses both by the debtor and by recalcitrant security holders. It was especially defective in that there was no efficient and expeditious way of binding dissenting minorities to a fair plan. Hold-ups, confusion, delay and uncertainty were present. There was no effective way to investigate and prosecute the management for misfeasance and mismanagement. In many cases there was no inclination on the part of the receiver to do so.

There was a distinct need not only for reform but also for advancement of the technique of reorganization. The advancement came not in granting more power or regulating the procedure in the courts of equity but, for constitutional reasons, as amendments to the Bankruptcy Act, and like most other important amendments it took a panic and a depression to bring it about.

[9] 11U.S.C.A. §§ 529, 616, 621 (Supp. 1938) (Chandler Act, Ch. X, §§ 179, 216, 221).