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The Absolute Priority Doctrine in Corporate Reorganizations

Walter J. Blum and Stanley A. Kaplan†

The absolute or strict priority doctrine in corporate reorganizations under the Bankruptcy Act¹ has never been comfortable for practitioners or theorists to live with.² Almost as soon as the courts articulated this standard of fairness, it was subjected to attack. Over the years, dissatisfaction has grown and proposals for modification have accumulated. The recent Commission on the Bankruptcy Laws had little difficulty in locating uneasiness over the doctrine and in turning up suggested modifications.³ Even the specific changes recommended by the Com-

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¹ Bankruptcy Act, ch. 541, § 1 *et seq.*, 30 Stat. 544 (1898), as amended 11 U.S.C. §§ 1 *et seq.* (1970) [hereinafter referred to in the text and notes as Bankruptcy Act].

² No attempt is made in this article to restate the case for the absolute priority doctrine. That case has been amply developed in court decisions, see *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939); *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510 (1941); *Group of Institutional Investors v. Chicago, Mil., St. P. & Pac. R.R.*, 318 U.S. 523 (1943), and in the literature, see Blum, *Full Priority and Full Compensation in Corporate Reorganizations: A Reappraisal*, 25 U. CHI. L. REV. 417 (1958); Frye, *The "Fair and Equitable Doctrine": Are Liquidation Rights a Realistic Standard During Corporate Reorganization?*, 20 CATHOLIC U.L. REV. 394 (1971); Gardner, *The SEC and Valuation Under Chapter X*, 91 U. PA. L. REV. 440 (1943); Note, *Strict Priority in Bankruptcy Reorganizations*, 49 YALE L.J. 1099 (1940).

³ The Commission on the Bankruptcy Laws of the United States was established by the Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468 (reproduced in textual note preceding 11 U.S.C. § 1 (1970)), and it filed reports with Congress on July 31, 1973 (Part I) and on August 6, 1973 (Part II).

This article does not deal with any aspects of the commission's report except the recommendations relating to the absolute priority doctrine. The judgments expressed

mission were not entirely novel. Despite the fact that discussion of the doctrine has been ongoing, the framing of the issues in controversy has generally been troublesome.

The difficulty in putting the issues is largely traceable to two factors. One is that the development of the doctrine, which originated in equity receivership reorganizations, was influenced by the peculiar architecture of the Bankruptcy Act. Absolute priority was decreed by courts to be the proper doctrine for adjusting rights of shareholders and creditors under section 77⁴ and Chapter X⁵ (as well as old sections 74⁶ and 77B⁷). There was little specific consideration of situations involving corporate financial distress to which the doctrine was best suited. Absolute priority came to run with classification of the proceedings: in principle, the doctrine was applied to all Chapter X cases, but not to Chapter XI⁸ cases. Because selection of the governing standard of fairness depended upon a decision on the appropriate procedural framework for dealing with the enterprise in distress, argument over the choice between Chapter X or Chapter XI was, among other things, an argument over the standard of adjusting rights. In this setting there was little inducement to articulate principles for determining with precision the proper scope for the absolute priority doctrine, apart from those fixed by the general reach of Chapter X and section 77.

The other major difficulty in firming up the issues concerns the nature of the doctrine itself. In a sense, the absolute priority doctrine does prescribe a general rule: before a class of investors can participate in a reorganization, all more senior classes must be compensated in full for their claims, measured on the basis of their priorities upon involuntary liquidation, unless the junior class contributes to the reorganized enterprise something that is reasonably compensatory and is measurable. Reorganizers have always understood, however, that this general formu-

in this article apply whether or not one accepts the commission's proposal to combine Chapters X and XI into a unified framework or its proposal to eliminate the reorganization functions of the Securities and Exchange Commission (SEC) and turn them over to a new bankruptcy agency. No views are expressed in this article concerning the proposed agency or the elimination of the SEC's reorganization functions.

⁴ 11 U.S.C. § 205 (1970) [hereinafter referred to in the text and notes as section 77].

⁵ 11 U.S.C. §§ 501-676 (1970) [hereinafter referred to in the text and notes as Chapter X].

⁶ Act of July 1, 1898, ch. 541, § 74, as added by Act of March 3, 1933, ch. 204, § 1, 47 Stat. 1467, transferred and incorporated as parts of Chapters 10, 11, 12, 13, and 14 by Act of June 22, 1938, ch. 575, § 1, 52 Stat. 840.

⁷ Act of July 1, 1898, ch. 541, § 77B, as added by Act of June 7, 1934, ch. 424, § 1, 48 Stat. 912, transferred and incorporated as parts of Chapters 10, 11, 12, 13, and 14 by Act of June 22, 1938, ch. 575, § 1, 52 Stat. 840.

⁸ 11 U.S.C. §§ 701-749 (1970) [hereinafter referred to in the text and notes as Chapter XI].

lation does not dictate a specific pattern of adjusting rights among classes of investors. Reorganization plans are the result of a process in which representatives of the investors "negotiate" (indirectly and sometimes directly) with each other, with the reorganization trustee, sometimes with the Securities and Exchange Commission (SEC), or occasionally even with the reorganization judge. The function of the absolute priority doctrine has in essence been to set guidelines for carrying on these negotiations, largely by validating or invalidating certain lines of argument and by fixing boundary marks upon the areas within which negotiation is allowable. For example: it is permissible to argue that a given junior class has a right to participate in the reorganized company because a proper valuation of the enterprise leaves an equity for that class; it is impermissible to argue that a junior class should be allowed to participate merely in order to forestall the efforts of that class to prolong the proceedings. The absolute priority doctrine can be characterized as a way of structuring negotiations so that they are sufficiently disciplined to be held within permissible areas and to permit judicial review.⁹

This perspective on the doctrine helps to explain why so many questions of fairness remain unresolved. It may also explain why any proposal to relax the hold of the absolute priority doctrine might be seen as an attack on the doctrine itself. Since the doctrine is really a loose mold for controlling negotiations, it is understandably taken in some quarters as a symbol of the position that any plan of adjusting rights must be so structured that it is governable by courts. Any inroad on the doctrine is then thought of as permitting a type of leeway in plans of reorganization that can defy governance. History supports this concern. The courts first read the doctrine into the statute in order to prevent recurrence of ineffectual reorganization adjustments under which inordinate prices were paid to avert threatened delays, nuisance claims, and occasional "sweetheart" allocations to juniors.¹⁰ The fear is

⁹ See Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565 (1950); Brudney, *Standards of Fairness and the Limits of Preferred Stock Modifications*, 26 RUTGERS L. REV. 445 (1973). The importance of such a structure and frame of reference is indicated by the nonstructured and seemingly almost nonreviewable results in comparable nonbankruptcy recapitalizations, in which allocations between classes of shareholders appear to be made and even approved by the courts without any articulated rationale (unless the implicit standard is "whatever the traffic will bear"). See, e.g., *Honigman v. Green Giant Co.*, 309 F.2d 667 (8th Cir. 1962); *Goldman v. Postal Tel. Inc.*, 52 F. Supp. 763 (D. Del. 1943). For a reprint of a portion of a valuation report by investment bankers, taken from the record on appeal in the *Green Giant* case, see W. BLUM & S. KAPLAN, *MATERIALS ON REORGANIZATION, RECAPITALIZATION AND INSOLVENCY* 28-31 (1969) [hereinafter cited as BLUM & KAPLAN].

¹⁰ See Brief for the SEC as Amicus Curiae, *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939), reprinted in BLUM & KAPLAN, *supra* note 9, at 390-91:

that a back track from the absoluteness of strict priority will make it easier for reorganization courts to approve deals under an illusory "rule" that permits unjustifiable allocation of securities while precluding effective complaint by an objecting member of a senior class.

I

By way of background to a discussion of the attacks on the doctrine it is well to recall that reorganizations under Chapter X (and under its predecessor section 77B, as well as earlier equity receiverships and foreclosure proceedings) involve some of the law's most difficult problems of analysis, adjustment of rights, and litigation. In the case of a large industrial enterprise, a not atypical plan of reorganization might have to deal with the competing claims of: general trade creditors; institutional lenders; factors who had advanced money against accounts receivable; mortgage bond holders (sometimes with paramount liens against different properties that may be essential to each other and sometimes with several liens of graded priorities against the same property); unsecured debenture holders (whose claims may be subordinate to other kinds of unsecured debt); and various preferred and common shareholders.

The early railroad reorganizations, predating the landmark case of *Northern Pacific Railway Co. v. Boyd*,¹¹ might have tolerated resolution of the problems in either of two ways. The first approach involved a general scaling down of various competing claims of creditors and equity investors through relative reduction of their claims. The second approach involved allocating all or substantially all of the value of the enterprise to the top level or levels of creditors and also allowing a share to any class of equity investors that might be in a position to provide a special future benefit or might be able to obstruct or delay consummation of the reorganization. The first procedure was commonly followed in railroad and industrial reorganizations.¹² The second pro-

Yet fixed charges, top-heavy debts, and complicated structures have persisted in corporate reorganizations. This has frequently been due to a failure properly to apply the absolute priority rule. Instead of eliminating valueless claims, a participation has been allotted to all existing securities holders. . . . Frequently companies have emerged from reorganization with more burdensome debt charges and more complicated capital structures than they had at the beginning of the proceedings. The usual result is an early return to the reorganization fold.

Economic disadvantages also flow from the issuance of valueless securities in reorganization, securities which reflect neither existing value nor the payment of a fresh contribution by junior interests. It is patently undesirable to place upon the market securities which represent little more than the paper upon which they are written. Such valueless securities create the risk of fraud upon future purchasers, and are peculiarly susceptible to use as media for market manipulations. . . .

¹¹ 228 U.S. 482 (1913).

¹² The weight which pressed for approval of the plan and confirmation of the sale would be overbearing. Inevitably this machinery of reviewing plans could not

cedure was typical of the real estate mortgage foreclosure reorganizations of the late 1920s and early 1930s. In those proceedings, first mortgage bond holders, having bought the property at a foreclosure sale for less than the total principal amount of the outstanding first mortgage bonds, would allocate a portion of the new corporation (customarily 10 percent) to the equity in order to obviate possible redemption in states where a right of redemption still existed.¹³

The *Boyd* case was generally understood to require that a class of juniors could not participate in the reorganized corporation (absent a contribution of new value) if a more senior class of claimants lacked proper participation. In 1939 the Supreme Court held in *Case v. Los Angeles Lumber Products Co.*¹⁴ that the *Boyd* doctrine was mandatory in section 77B proceedings (the predecessor of Chapter X). That decision necessarily implied that: (1) the value of the debtor's property and business first had to be ascertained; (2) the classes of claimants had to be arranged in proper order of priority, so that participation in the reorganized enterprise could be distributed to claimants in descending order of priority; and (3) all claimants below the level of available reorganization value would be excluded from participation in the reorganized enterprise.

II

The leading basis for attack upon the strict priority doctrine is that its premise of a valid and reliable valuation is specious or inflexible or illusory. In order to distribute the value of an enterprise among the various claimants, it is first necessary to fix the precise dollar value as

afford full protection to investors, and it served a purpose chiefly insofar as it "reasonably domesticated" the *Boyd* case in the interests of reorganizers. . . .

. . . . [T]he inescapable conclusion [is] that within the vaguely defined bounds of fairness, the courts permitted reorganizers in federal equity receiverships, mostly concerned with the larger industrial and railroad reorganizations, to move almost unchecked in deciding the apportionment of securities in the reorganized enterprise. Generally, if the order of priorities was roughly preserved, and recognized by at least marginal differences in amounts allocated, the courts were not further concerned with the details of the plan.

SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES pt. VIII, at 51, 58 (1940) [hereinafter cited as 1940 REPORT].

¹³ It should be noted that much of the doctrine concerning absolute priority was developed in railroad reorganizations, though its most recent development has come from Chapter X cases. The justification for applying the absolute priority doctrine to railroad reorganizations is equally applicable to other reorganizations in bankruptcy.

It should be remarked that, in the railroad reorganization field, the distinction between Chapters X and XI is loosely analogous to the division of functions between sections 77 and 20A.

¹⁴ 308 U.S. 106 (1939).

of a given time. The usual valuation process involves making a projection of earnings (based upon past performance, foreseeable capital needs, and estimated revenues and costs) and then capitalizing earnings at an appropriate rate. Capitalization establishes the relationship between projected earnings and total present value. That value can be viewed as being 100 percent, and a level earnings stream can then be taken as a percentage of that total. For example, if the annual earnings of the business are deemed to constitute 20 percent of its worth, the earnings would be said to be capitalized at a 20 percent rate or on a five times earnings basis.

The relationship between total present value and estimated earnings is necessarily a matter of judgment. Some guidance may be found in comparisons with rules of thumb frequently used in the valuation of businesses and in the price-earnings ratios of securities traded in the public market. These determinations entail many uncertainties, assumptions, and conjectures. Any choice of capitalization rate necessarily involves many judgments concerning hazards, business stability, and future developments. It is difficult to adduce convincing "proof" to justify applying, say, a 5 percent rather than a 6 percent capitalization rate—or vice versa. Nevertheless, a 5 percent capitalization rate could result in a total value that would include a particular class of creditors as participants in the reorganization plan, whereas a 6 percent rate would result in a lower value that could exclude those creditors.

The valuation procedure always produces a dollars and cents figure. Although that figure looks mathematically exact, it actually reflects in a single number a whole series of highly conjectural and even speculative judgments concerning long-range business expectations and hazards as well as future social and general economic conditions. To exclude a class of creditors or investors from participation in a reorganization plan based upon so illusory a figure is criticized as capricious. The process is said to deceive by treating "soft" information as if it were "hard" and by cloaking predictions in the guise of mathematical certainty, under circumstances where consequences are drastic and final.

Dependency of the valuation process upon the future outlook as of a particular moment adds to this dissatisfaction. The resultant value figure is inextricably related to the then accepted set of expectations and assumptions. If the situation improves shortly after the reorganization proceedings have been terminated (so that the risk factor used in determining valuation may appear to have been too high and the valuation too low), the elimination of certain investors from participation in the plan might be regarded as having been unwarranted and unduly harsh. Valuation is also considered somewhat arbitrary: values are al-

ways in flux because relevant conditions are always changing. A particular valuation figure, obtained at a given instant on the basis of the special circumstances of that moment, may well not be the same figure that would be obtained by the same process at a later date when circumstances have changed. Pushed to an extreme, the position suggests that no valuation should ever take place because any valuation is always subject to attack as evanescent—the valuation figure would always be different if it had been made either earlier or later. Thus, criticism of valuation on the basis of changing conditions can prove too much, undermining the entire concept.

The imprecision of the valuation process has also led to the argument that valuation is so malleable that the entire process is perverse—that, in actuality, it is the reverse of what it seems to be. On this view, valuation is not an objective process by which projected earnings are capitalized to reach an ultimate figure under a procedure that has admitted infirmities. Instead, these critics assert, the trustees or the courts first determine the classes of claimants that should participate in the reorganization plan—on the basis of rough judgment or visceral reactions or other unexpressed or even unexpressable criteria—and then select the projection of earnings or the capitalization ratio necessary to reach a valuation figure that will include the preselected groups. The valuation process is not viewed as unduly harsh or rigid, but rather as so flexible that it is subject to abuse.

A second major criticism of the strict priority rule is that it frequently eliminates common stockholders from participation in the reorganized enterprise and thereby excludes the class of investments usually owned by management. Since stock ownership provides not only status and voting position but also a vehicle for possible capital gains, management personnel may be unwilling to remain with the reorganized firm as employees if the common stock interest is wiped out in the reorganization. This is alleged to have an adverse effect upon operation of the reorganized enterprise, at least where management has something in the way of unique characteristics, specialized know-how, or other particular abilities important to the enterprise. Although one might respond that suitable management is always available at an appropriate price, critics would argue that existing management might embody exceptional talent that the enterprise would be fortunate to retain. Many enterprises fall into financial difficulties for reasons over which management has no control, such as adverse economic conditions, sudden shortages of essential raw materials, or assorted acts of fate.¹⁵

¹⁵ In some instances management possesses unique know-how or controls sources of raw

Forcing out management by eliminating the common stock may then not be in the best interests of the enterprise.

A third but related criticism is that the strict priority doctrine unnecessarily fetters the court and the parties. Reorganization planners, it is said, should have greater freedom in negotiating an imaginative adjustment of various interests and should not be limited to determining participations pursuant to the strict priority doctrine. This broad criticism subsumes, but goes beyond, the point that management is often excluded through elimination of the common stock interest. It builds on the fact that reorganization proceedings are so extremely complex that they almost always present special circumstances or unusual attributes relevant to participation decisions. The conclusion from this point of view is that the governing rules should permit adjustment and settlement on the basis of individual circumstances rather than following the single, inexorable strict priority track.

A fourth criticism is that the strict priority doctrine introduces unreasonable delay in the reorganization process by extending litigation over its proper application. The valuation process involves so much speculation that it almost always provides grounds for attack by those adversely affected by the result. These attacks, it is claimed, lead to a proliferation of appeals and to even longer delays. The longer the final disposition of the reorganization proceedings is postponed, the more likely it is that circumstances affecting the enterprise may change; the premises upon which the original valuation was based may no longer apply, and revaluation in light of changed circumstances may be sought or granted. The long and complicated valuation process may then take place again, followed in turn by a replay of the appeals process and its consequent delay. A well recognized strategy has been developed around the possibility of favorable shifts in the underlying circumstances affecting valuation. The scenario is to protract the litigation by any means so that a basis for an upward revaluation may somehow develop somewhere along the way.

The extension of litigation increases the cost of reorganization. Apart from the expenses of appeal, the mere retention of an enterprise in the reorganization court imposes business restraints and disabilities that are exceedingly costly and burdensome to the enterprise. In extreme situations the costs of delay and unnecessary legal proceedings could force a

materials or indispensable customer good will that would vanish if certain management personalities were to withdraw from the business following elimination of their equity interest. A more likely effect is merely to deprive the reorganized company of whatever benefits flow from continuity in management.

beleaguered corporation out of reorganization into straight bankruptcy. It is therefore argued that if the strict priority doctrine were not mandatory, or if some flexibility were built into it, the parties might more readily agree upon a plan of reorganization and avert extended litigation over valuation.

A fifth criticism of the strict priority doctrine—a somewhat oblique one—derives from the present division of reorganization procedures between Chapter X, in which the strict priority doctrine is mandatory, and Chapter XI, to which it does not apply. Management will ordinarily try to come under Chapter XI in order to avoid appointment of an independent trustee, avert application of the strict priority doctrine, and seek a composition-type readjustment with a scaling down of all or part of the outstanding unsecured debt. Senior creditors, shareholders outside the management group, or the SEC may seek to have the proceedings transferred from Chapter XI to Chapter X, upon the principle that proper allocation of proceedings between the two chapters depends upon the nature of the enterprise, its difficulties, and the character of its creditors and shareholders. The issue of which chapter applies to the particular enterprise may cause extended litigation, although the real issue between the parties is whether the strict priority doctrine eventually should apply. The fundamental question concerning the applicability of the strict priority doctrine will be masked and never openly and directly at issue.

A sixth attack upon the strict priority doctrine comes from those who assert that a reorganization should impose proportional sacrifices upon investors by making priorities relative rather than absolute. This position rests upon the notion that it is fairest for investors' participation in the reorganized enterprise to be based on the values of their respective securities immediately prior to the debacle. The suggestion substitutes an order of priority based upon market or going concern values for an order based upon contract provisions governing involuntary liquidations. This proposal has great appeal for junior creditors and shareholders. It was adopted in readjustments under the Public Utility Holding Company Act,¹⁶ but has never won acceptance in bankruptcy reorganizations.

In connection with its criticism of the strict priority doctrine, both the report of the Bankruptcy Commission¹⁷ and a recent article by one

¹⁶ 49 Stat. 820 (1935), 15 U.S.C. § 79K (1970).

¹⁷ REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. pt. I, at 259 (1973) [hereinafter cited as REPORT OF THE BANKRUPTCY COMM'N].

of its consultants¹⁸ regard the fundamental issue in a reorganization proceeding as the determination of who shall receive the difference between the enterprise's liquidation value and its higher reorganization value. Under the strict priority doctrine the total valuation of the enterprise goes to the claimants in order of their involuntary liquidation priorities. The Bankruptcy Commission and its consultant apparently agree that the liquidation value of the enterprise should be distributed to claimants in order of strict priority, but they submit that the difference between liquidation value and any higher reorganization value could be more properly handled in a different manner. They do not specify why this particular "upper" layer of total valuation should be treated differently from the liquidation component of total valuation, nor do they indicate who has a better claim upon the "excess." But they leave the impression that, being of a different character, the "upper" layer should be available to some extent to junior interests even when seniors have not been fully compensated according to prevailing doctrines.

One might ask why liquidation value should be discussed at all in a specialized proceeding in which liquidation is not contemplated. The underlying purpose of the reorganization sections of the Bankruptcy Act is to provide a procedure and a milieu in which to work out a plan of reorganization that permits continued operation of the company to avert liquidation. At the present time, liquidation value is seldom ascertained in a reorganization proceeding. By introducing the liquidation value concept as a separable item in the reorganization process¹⁹ and pursuing the analysis by asking how this segment of incremental value should be allocated, the central question of fairness is begged: a dubious assumption is treated as if it were an unassailable axiom. The assumption that the courts should not apportion the entire reorganization value among the interested parties in order of contractual priority implicitly attacks the core of the present concept of fairness in a reorganization. If the assumption of the Bankruptcy Commission on this point is accepted, a significant change in reorganization doctrine will occur more readily than if the traditional concept of unsegmented valuation is retained. In turn, such a change in doctrine will inevitably alter the permissible pattern for distributing securities under a plan of reorganization.²⁰

¹⁸ *Trost, Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 U.C.L.A.L. Rev. 540 (1973).

¹⁹ If the concept of "excess" value were adopted, it would apparently be necessary for the court to make two findings of value in each proceeding, namely liquidation value and reorganization value, instead of finding only reorganization value.

²⁰ The absolute priority doctrine has been accepted and referred to as a standard

Another of the Bankruptcy Commission's criticisms of the absolute priority doctrine deserves attention: "Unfortunately, the rigidity of the rule has frequently resulted in the destruction rather than the protection of interests of public investors. Public debt security holders (frequently subordinated to trade and financial institution debt) and public equity security holders are frequently eliminated from participation in a reorganization by reason of the strict application of a statute designed primarily for their protection."²¹ Interpreting this statement is not easy. It seems to deal with situations in which reorganization value is less than the aggregate of senior claims; it seems to argue that in such situations Chapter X was designed to preserve an interest in the firm for (public) juniors at the expense of the (institutional) seniors. This is a strange reading of history. Chapter X clearly was designed to protect investors, whether seniors or juniors and whether public or private; but it was to do so by preserving for them any going concern or other value to which they could rightfully lay claim—after the claims of more senior interests, if any, had been satisfied in full.

Chapter X was drawn against a factual backdrop of senior debt held largely by public investors, in opposition to equity investment often drawn from other than widespread public sources. At present the prevailing pattern may be different; holders of senior debt may largely be institutional investors and public investment may be mainly in the form of subordinated debentures or preferred or common stock. It would be peculiar, however, to make the new pattern a premise for reconstructing the strict priority doctrine in order to erode the position of current seniors and benefit current juniors on the theory that the juniors are now more likely to be public holders. Is the standard of fair distribution in reorganizations to change depending upon current fashions in financing? Is the rule to be different in cases where senior debt is publicly and not institutionally held?

III

These criticisms of the absolute priority doctrine have given rise to a variety of suggested changes in the standard of fairness to govern reorganizations in bankruptcy. Although none of these suggestions is wholly new, each is worth exploration in view of the new interest stimulated by the recent Bankruptcy Commission report.

of fairness in a number of matters outside the reorganization field—for example, in discussions about the fairness of mergers. One might wonder how these other areas would be affected by a modification of the absolute priority doctrine in bankruptcy reorganizations under each of the proposals discussed in the text.

²¹ REPORT OF THE BANKRUPTCY COMM'N, *supra* note 17, pt. I, at 256.

One type of proposal for relaxing the absolute priority doctrine seeks to adjust the weight given involuntary liquidation rights in a bankruptcy reorganization. Today the courts view reorganization as a substitute for liquidation and conclude that the rights of investors in reorganizations should, at least in theory, be ordered and measured as if an involuntary liquidation were under way. The thrust of this position is best illustrated in the case of a large preferred stock arrearage, which is entitled to priority over common stock in an involuntary liquidation. In reorganization, preferred stock has priority over the common up to the full dollar amount of the arrearage—even though the arrearage rights do not bear interest, could have been eliminated by charter amendment or merger, and are not mandatorily payable except on liquidation.

Strict adherence to this liquidation standard would take into account only liquidation features of securities in measuring claims in reorganizations; any feature that affected the quality or market value of the security before liquidation, such as interest rates, would be irrelevant. Owners of bonds commanding a market premium due to an exceptionally high rate of interest (gauged by current market rates) have no claim in reorganization for the premium; holders of bonds selling at a discount due to a below-market rate of interest have a claim for the full principal amount of the obligations. From some perspectives it does appear anomalous to measure claimants' rights only in liquidation terms when in fact a reorganization has permitted the enterprise to continue in operation. No doubt this incongruity goes far to explain why the liquidation standard has in practice never been pushed to its logical conclusions and why high interest rate bonds have generally received "better" treatment in reorganizations than low interest rate bonds.²²

But every proposal to modify the liquidation standard runs into the hard problem of specifying the circumstances to which a new standard should apply. The most extreme proposals call for measuring every claim in reorganization on the assumption that the enterprise is to continue rather than be liquidated.²³ This approach resembles the investment value standard that was used for readjustment purposes in pro-

²² These matters are discussed in Blum, *supra* note 2.

²³ The liquidation standard is used to measure claims against the debtor and its property, and the relationship among claimants. The value of the debtor's property, out of which the claims are satisfied to the extent possible, is measured on the basis of a going concern concept in Chapter X proceedings. It is not inconsistent or inappropriate to assume continuation of the enterprise to determine its value and to use a liquidation concept to measure the extent of claims and the relation between claimants. The purposes of the two standards are different. See Green River Steel Corp., SEC Corp. Reorg. Release No. 105 (Jan. 24, 1957).

ceedings under the Public Utility Holding Company Act.²⁴ Use of a nonliquidation standard was warranted there because the enterprise was undergoing change not voluntarily, not because of financial difficulty, but because of the legislative mandate to break up or simplify certain public utility holding company systems.

In reorganizations brought on by financial difficulties a standard that disregards liquidation claims is manifestly unfair in that it defeats important expectations: it in effect gives senior security holders, who bargained for specific protection in case of financial distress, smaller claims as the enterprise moves into a more precarious position. Once one retreats from this sweeping but unfair position, however, there is no obvious way to prescribe which rights should be measured by the liquidation standard and which by a going concern standard.²⁵

IV

Another type of proposal for relaxing the absolute priority doctrine would give the reorganization judge wide discretion to depart from it if he found that strict adherence would not be in the best interests of those it is intended to benefit. These suggestions generally stem from the complaint that reorganization proceedings are longer and more costly than necessary. They are also usually premised on the thought that rigid conformity to absolute priority contributes to this result either by stimulating junior interests to fight harder to avoid exclusion from the reorganized firm, or, especially where circumstances are genuinely extraordinary, by making it impossible to compromise in a reasonable manner that takes particulars into account.

Although the suggestions in this vein have recently been directed against absolute priority, there was an extended period during which they were most often heard in connection with controversies over the proper scope of Chapters X and XI.²⁶ The main contention apparently was that all investors, including senior security holders, would, under some circumstances, be better off in a cheaper and shorter Chapter XI

²⁴ 49 Stat. 820 (1935), 15 U.S.C. §§ 79 to 79z-6 (1970).

²⁵ See Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganizations: New Directions*, 67 HARV. L. REV. 553 (1954); Blum, *The "New Directions" for Priority Rights in Bankruptcy Reorganizations*, 67 HARV. L. REV. 1367 (1954); cf. Frye, *supra* note 2.

²⁶ The literature evaluating proposals to combine Chapters X and XI into one new chapter includes Quittner, *Should a Chapter X½ be Enacted for Rehabilitation of the Middle Size Corporation?* 42 REF. J. 37 (1968); Rochelle & Balzersen, *Recommendations for Amendments to Chapter X*, 46 AM. BANKR. L.J. 93 (1972); Weintraub & Levin, *From U.S. Realty to American Trailer Rentals: The Availability of Debtor Relief for the Middle-Sized Corporation*, 34 FORDHAM L. REV. 419 (1966).

adjustment than in a Chapter X reorganization, despite the latter's procedural and substantive safeguards for senior interests. This dichotomy brought the absolute priority rule into focus, because it is one of the main substantive safeguards available under Chapter X but not Chapter XI. History is revealing here. Once the courts took a more expansive view of the proper reach of Chapter XI and became less sympathetic to the transfer of cases from Chapter XI to Chapter X, interest in relaxing the Chapter X strict priority doctrine seemed to decline sharply.²⁷

The trouble with conferring this wide discretion on the reorganization judge is patent. A chief concern behind the adoption of the absolute priority doctrine was to prevent junior investors from gaining participation in a reorganized entity by trading on the nuisance value of otherwise worthless claims. Explicit authorization of judicial discretion would again legitimate and encourage that technique. A mass of experience reveals that courts have generally been prone to accept compromises in order to expedite termination of lengthy proceedings over complicated corporate financial matters and to avoid having to make and carry out hard decisions. Nothing suggests that this temptation will be less in the future.

The ultimate weakness in permitting this exercise of discretion relates to valuation. Although one might be able to value the nuisance participation given to juniors (and thus the cost to seniors), there is no way to value the benefit to seniors that derives from expediting the reorganization proceedings through a compromise. The value of an uncalled bluff or an unfulfilled threat is never ascertainable. It is therefore sheer guesswork whether on balance the seniors will be better

²⁷ The history is set out in Weintraub & Levin, *Chapter VII (Reorganizations) as Proposed by the Bankruptcy Commission*, 47 AM. BANKR. L.J. 323 (1973). See also SEC v. United States Realty & Improvement Co., 310 U.S. 434 (1940); General Stores Corp. v. Shlensky, 350 U.S. 462 (1956); SEC v. American Trailer Rentals Co., 379 U.S. 594 (1965); Grayson-Robinson Stores, Inc. v. SEC, 320 F.2d 940 (2d Cir. 1963); SEC v. Canandaigua Enterprises Corp., 339 F.2d 14 (2d Cir. 1964); *In re KDI Corp.*, 477 F.2d 726 (6th Cir. 1973).

It is important to remember that reorganization under the Bankruptcy Act is a drastic remedy and is usually sought in circumstances where voluntary adjustments are not feasible and where there is a need for judicial power to coerce dissenters. Voluntary adjustment can take place outside the reorganization process if there are no dissenters or if consent can be achieved by other forms of coercion. Conditions are most favorable when there are only a few creditors or the creditors are in direct association, even though there may be large numbers of equity investors. Voluntary arrangements with creditors may be coupled with an internal recapitalization to achieve an overall plan. Similarly, the SEC and the courts are less likely to insist on transfer from Chapter XI to Chapter X when senior creditors are owed large amounts but are few in number than when the same amount of debt is outstanding but is more widely dispersed. A dispersion of equity interests, moreover, is unlikely to change the result.

or worse off as a result of the give and take. By its very nature such a compromise is unreviewable, except perhaps where the deal is so outrageous as to be deemed unconscionable or irrational.

Some observers with long memories might wish to add a caveat based on experiences prior to acceptance of the absolute priority doctrine. It was common for proceedings to be stretched out by juniors in order to enhance the nuisance value of their position. A well understood strategy was developed by juniors to puff up tenuous or doubtful claims, leading to something of a vicious circle: acceptance of compromise on nuisance claims encouraged assertion of more claims, which in turn led to a greater willingness by courts to accept compromises in order to terminate reorganization proceedings.

It has been recently argued that this history is not relevant because there now is adequate judicial control of the reorganization procedure. The absolute priority doctrine, it is said, was fashioned when judicial surveillance of the reorganization process was less sophisticated and against a background of unhealthy dominance or collusion in reorganizations by management and investment bankers—a dominance that frequently resulted in plans that were unfair to public senior investors. With reorganization proceedings now carefully observed or controlled by courts and the SEC, the argument is that this potential unfairness has virtually been removed. Because courts can determine when plans that depart from strict application of the doctrine are nevertheless fair to senior classes, it is asserted that the need for absolute priority is no longer present.²⁸

That reasoning is misleading. It implies that all or most judges recognize a fair deal or a good business arrangement when they see one. It also assumes that there has been full disclosure and a complete understanding of the impact and ramifications of the proposed reorganization plan. Even more important, if plan negotiations are to be kept in bounds and if judicial review of plans is to be meaningful, the reorganization system cannot do without the ability to articulate why a deal is fair or reasonable from a business point of view. The potential for that exposition is a great strength of the absolute priority doctrine; its absence is a great weakness of any nebulous test based on a doctrine of "it looks all right to me."

²⁸ In a sense, proposals to relax the strict priority rule constitute a rejection of the SEC's expertise in the reorganization field. In its much praised Committee Study Report, see 1940 REPORT, *supra* note 12, the SEC emphasized the potential for unfairness, dilatory tactics, and undesirable allocations of securities if the strict priority doctrine were not applied. Moreover, in its role as a commentator upon reorganization plans, the SEC has issued numerous position statements advocating absolute priority.

The Bankruptcy Commission has offered its own version of a seemingly gentle but possibly wide-reaching plan for discretionary relaxation of the absolute priority rule. In the case of a corporation with publicly held securities, a plan of reorganization would at most need to be supported by findings that there is "a reasonable basis for the valuation on which the plan is based" and that there is "a reasonable probability" that the consideration distributed to creditors and stockholders is full compensation for their respective interests.²⁹ These propositions may actually reflect current application of the absolute priority doctrine. The wording, however, is apt to encourage some reorganization courts to expand the limits of fairness under the doctrine. The language could be taken to mean that in place of full compensation, as understood under existing standards, senior investors are entitled to something less—perhaps best labeled "probable full compensation"—whatever that signifies.³⁰

There is an obvious explanation for the recent coolness of the Bankruptcy Commission and certain commentators towards the absolute priority doctrine. Their main dissatisfaction may not be with the doctrine itself, but with the fact that rigid adherence to the doctrine is a major impediment in the path of another innovation: the development of a single procedural framework for handling all corporate readjustments under the Bankruptcy Act, merging Chapters X and XI into a unified new chapter. The real preference appears to be not so much a relaxation of the fairness standard as it is the replacement of the present bifurcated system (which conceals the question of the governing doctrine of fairness in the struggle over the "appropriate" chapter for securing relief) at the expense of the strict priority concept.

An unavoidable dilemma is admittedly present in the current system, which necessarily lodges a large degree of discretion in reorganization judges regarding the appropriate forum—a discretion that is often difficult to review. By allowing a proceeding to go forward under Chapter XI, a judge can deny unsecured senior investors the protection of the absolute priority doctrine. The latitude of this discretion, however, is probably more confined than that which would accompany a doctrine predicated upon the "sound business deal," or an equivalent departure

²⁹ REPORT OF THE BANKRUPTCY COMM'N, *supra* note 17, pt. II, at 252 (section 7-310(d)(2)(B) of the proposed Bankruptcy Act of 1973).

³⁰ "This is, of course, a considerable modification of Chapter X's 'fair and equitable' test at least as interpreted by some court decisions, in that the valuation under [the commission's proposed new] Chapter VII may not necessarily be that based upon a capitalization of estimated earning power if 'there is a reasonable basis' for another valuation." Coogan, *The Proposed Bankruptcy Act of 1973: Questions for the Non-Bankruptcy Business Lawyer*, 29 BUS. LAW. 729, 752 (1974).

from the strict priority rule. By now, it is generally understood that certain distress situations properly belong under Chapter X with its absolute priority rule. Junior interests, however, would rarely refrain from contending that to allow them to participate in the reorganized enterprise would be a "good" or "sound" arrangement.

In a few reorganizations it can perhaps be concluded in the light of hindsight that all classes of investors would have been better off if a deal proposed by junior interests had been validated, even though it did not comport with the absolute priority doctrine. This relatively infrequent situation should not be given much weight in fashioning the general law of reorganizations. For that task, the critical question is whether, taking account of all reorganizations, fairness—especially to senior investors—will more often result from explicitly giving judges broad and amorphous discretion to depart from absolute priority notions, or from denying them that discretion, always bearing in mind that considerable discretion is indirectly and inherently involved both in determining the appropriate procedure for relief and in passing upon the valuation of the firm.

An alternative method of relaxing the absolute priority rule is to place the power to make departures in a super-majority of those senior investors unfavorably affected by the relaxation of the rule, rather than in the reorganization judge. This proposal runs contrary to the deeply embedded notion that even a two-thirds or three-fourths majority of a class should not be permitted to impose an unfair plan on a dissenting minority. A forceful argument can nevertheless be made that, given proper judicial and administrative scrutiny and exclusion of cross-voting by seniors with conflicting interests, a very large (say a nine-tenths) majority of the relevant senior investors should be able to waive rights conferred on their class by the absolute priority doctrine.

V

Another type of proposal for relaxing the absolute priority rule focuses on the interests of stockholders who are also managers of the company undergoing reorganization. Like the plans for discretionary abandonment of strict priority, these proposals grow out of the historical relationship between Chapter X and Chapter XI. Both chapters originally contained the requirement that a plan of reorganization be "fair and equitable." The courts, after absolute priority had been read into the "fair and equitable" clause of Chapter X, were presented with the question of how compositions could be acceptable under the "fair and equitable" language of Chapter XI. This problem was critical be-

cause it was widely understood that Chapter XI was specifically designed to work out compositions, primarily with trade creditors; indeed, the chapter was considered a replacement for the prior composition section of the Bankruptcy Act.

The answer to the question was not long in arriving, and on the whole it has been both sound in theory and workable in practice. Chapter XI compositions between debtor and creditors can survive the fair and equitable test, even where the debtor is clearly insolvent, because the usual Chapter XI composition preserves values for the debtor that are not accessible to the creditors anyway. In the typical situation, the debtor is an owner-operator of the enterprise and the creditors are businessmen or financiers who can fend for themselves in negotiating compositions.³¹ According to the theory, something of value—whether it be called good will, know-how, or trade connections—inheres in the owner-operators of the distressed business, and this value would disappear if they were forced out of the firm or if the business were liquidated. Since that value cannot be captured for creditors, fairness is not violated if an arrangement under Chapter XI leaves that value in the hands of the owner-operators, especially since the chapter requires consent by a stated majority of sophisticated creditors. The corollary is that creditors are entitled to not less than they could realize through an immediate liquidation of the enterprise. This standard of protection has come to be regarded as reflecting the best interest of the creditors; in time the “fair and equitable” language in Chapter XI was replaced with an explicit “best interest of the creditors” test.³²

The answer does have one weakness and it has not gone unnoticed, especially as the scope of Chapter XI has been broadened by court decisions. In some corporations undergoing Chapter XI reorganization, overlap between the shareholders and the operators of the business is not complete, and some of the creditors are not of the “fend for themselves” type. When there is substantial variance between stock ownership and management, a Chapter XI arrangement—which of course requires creditors to give up rights—would always seem to fail the absolute priority test. By and large this difficulty has been glossed over, probably because the overwhelming majority of Chapter XI cases appear to involve a close identity between owners and managers. It would no longer be possible to disregard the underlying problem if Chapters X and XI were telescoped into a single framework.

To meet the problem, it has been proposed that shareholders be en-

³¹ See, e.g., *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434 (1940).

³² The history is summarized in the dissenting opinion in *General Stores Corp. v. Shlensky*, 350 U.S. 462, 471-72 (1956) (Frankfurter, J., dissenting).

titled to participation in a reorganized firm whenever they contribute value to the enterprise as managers, whether the plan would presently come under Chapter X or Chapter XI. The most recent version of this approach to relax absolute priority is contained in the legislation proposed by the Bankruptcy Commission. The commission's plan would permit stockholders who "will make a contribution which is important to the operation of the reorganized debtor or the successor under the plan" to participate "on a basis which reasonably approximates the value, if any, of their interests, and the additional estimated value of such contribution" ³³ On initial impression this proposed change seems to be a logical extension of the old Chapter XI notion that value inhering exclusively in the owner-operators of a corporation cannot be considered as value available to creditors. The extrapolation is, however, not free of difficulty.

In a reorganization proceeding many practical consequences flow from the timing of a determination whether good will or going concern value inheres in the owner-operator and is available to others. Under the present system this determination is in effect made when a decision is reached on the appropriateness of Chapter XI. If the statute is changed to provide a single procedural system for corporate readjustments, the determination could be made at the outset of the proceedings—perhaps together with the decision whether to leave the existing management in control or to appoint an independent trustee—or later, when the terms of a plan are reviewed. The former alternative is preferable. One can only speculate about the feasibility of appointing an independent trustee and later entertaining the argument that some good will does inhere in the ousted management group. ³⁴ There is also the intriguing possibility that a management group will be left undisturbed at the outset, only to have the contention raised later that no

³³ REPORT OF THE BANKRUPTCY COMM'N, *supra* note 17, pt. II, at 242 (section 7-303(4) of the proposed Bankruptcy Act of 1973).

Cf. Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939), in which the court stated that "findings below that participation by the old Class A stockholders will be beneficial to the bondholders because those stockholders have 'financial standing and influence in the community' and can provide a 'continuity of management' constitute no legal justification for issuance of new stock to them. Such items are illustrative of a host of intangibles which, if recognized as adequate consideration for issuance of stock to valueless junior interests, would serve as easy evasions of the principle of full or absolute priority" *Id.* at 122.

³⁴ As a knowledgeable practitioner has recently observed, the structure of Chapter X assumes a sort of devil theory of management: "[O]ne cannot but be impressed with the recurring theme that the troubles of the debtor are due in a large part to the sins of its past management. An independent trustee is necessary to discover these sins, to punish the sinners and to recover the loot." Coogan, *supra* note 30, at 743.

going concern value inheres in the owner-operators. In a unitary procedural framework, if the role of the owner-operators is not determined at the outset, the unfortunate tendency may develop of allowing management to retain control of the enterprise in order not to prejudice the later decision on participation by the owner-managers.

The logic of the proposed change calls for a distinction between those equity owners who make a management contribution and those who do not, even though this approach may result in allowing part of a class of stockholders to participate while excluding others in the same class. It would be necessary to define precisely what holdings are to be regarded as management shares. Is the category, for example, to include shares held by the wife of a manager? By his children? By a family trust in which he has an interest? The difficulty of the large question is seen in the elaborate attempts of the Internal Revenue Code to attribute, under some circumstances, the shares of one person or legal entity to another for income tax purposes.³⁵

The approach also requires measuring the "non-monetary" contribution that specific shareholders make to the enterprise. The change proposed by the Bankruptcy Commission would necessitate putting an exact value on the shareholder-manager contribution. The "best interest of the creditors" test circumvented this difficulty: in a "proper" case, part or all of the value in excess of liquidation value could (at least in theory) be claimed by the shareholders through a composition. In a typical composition between a closely-held corporate debtor and its trade and institutional creditors, the results should be the same as that now reached under Chapter XI; all value above liquidation value can be viewed as inhering in the shareholders and hence as reflecting a contribution by them if the enterprise is continued. But this is not the case when the "going concern" value inheres in only some of the shareholder-managers. It is almost impossible to quantify the value of the contribution made by particular shareholders.

Much of the difficulty can be traced to confusion over the nature of "going concern" value. In the typical Chapter XI corporate situation, the practical choice is either to liquidate the business or to bring about an adjustment that is satisfactory to both the shareholders and the requisite majority of creditors. It is realistic to assume that the creditors do not wish to take over the equity position and carry on the business; their interests are not those of long-term investors. Given the alternative of imminent liquidation, the going concern value can properly be thought of as all value in excess of liquidation value. The entire going

³⁵ See INT. REV. CODE of 1954, § 318.

concern value is beyond the reach of the creditors. In sharp contrast are those situations in which "special" shareholders can make a contribution to the enterprise as managers, but because their potential contribution is not unique and they can be replaced, there is no need to liquidate the firm if they cease to be associated with it. Although the "special" shareholders by hypothesis add value, the measure of it cannot reasonably be tied to liquidation value. In these cases the going concern value can realistically be captured by creditors if hiring other management provides a viable alternative to liquidation.

It was noted earlier that the Bankruptcy Commission and certain commentators have argued that, as a general principle, distribution of the going concern differential (reflecting the difference between immediate liquidation value and value as a reorganized concern) should be a proper subject for negotiation and division between shareholders and debt-holders in reorganizations.³⁶ The weakness of this argument now emerges. When reorganization value falls short of total creditor claims, shareholders should have no equity in the firm and should be cut out unless the going concern differential inheres in the particular shareholders as irreplaceable operators of the business and not merely as holders of common shares.

There is yet another difficulty with the proposed change. Assume that some shareholders add measurable value to the corporation as managers. It is illogical to reward them for that contribution by giving extraordinary participation in the reorganization to their stockholdings. The value is added by them only as managers, and not as stockholders. Logically, they should be compensated as managers and not as stockholders—whether in cash, stock options, or by other arrangements.

This direct approach avoids the other difficulties noted with the proposed change. There would be no occasion to distinguish among those in a single class of shareholders. There would be no need to provide rules for determining precisely what shares are to be treated as owned by the shareholder-managers. And there would be a sounder guideline by which to determine how much compensation a particular shareholder deserves for serving as manager.

One might appropriately ask whether there are situations in which stockholders make special contributions to a corporation as owners rather than as managers. On occasion it is urged that totally inactive shareholders can benefit the corporation by having their names associated with it—by knowing the right people in government, industry, or the financial world. Perhaps these benefits are real. But in all cases the

³⁶ See text and notes at notes 17-18 *supra*.

special equities urged by these stockholders should be ignored. Contributions of this kind are impossible to quantify; their existence is likely to be tenuous or debatable; and they are least deserving of compensation in terms of sound notions of fairness. All the vices of nuisance claims can accompany their recognition as a legitimate ground for participation in reorganizations. If it is important to have the use of the names or connections of certain persons, they can perhaps be hired like product endorsers or consultants.

It has also been repeatedly urged that one good reason to include old shareholders in a reorganization is that they may constitute the only available source of additional capital for the enterprise. This contention may have had a basis in fact at an earlier date. Current data do not support the belief that old shareholders are a fruitful source of additional funds when the public capital markets are unlikely to provide funds. In recent years shareholders have seldom contributed new capital; at best, they have tried to ward off liquidation by convincing others to put in new resources to keep the enterprise going.

VI

The most common type of proposal to modify the absolute priority doctrine is to relax the finality of the reorganization valuation. These suggestions rely on a deceptively simple argument. Valuation determines the classes of claimants that can participate in the reorganized entity. The process of arriving at a valuation by capitalizing estimated earnings involves prediction founded on much guesswork. There is always a possibility that earnings will be higher than forecast, or that interest rates will drop significantly, or that market price-earnings ratios will rise substantially. If any of these events takes place, the enterprise will be worth more on a future date than the initial reorganization valuation. Those investors who have not been allowed to participate because of the "mistakenly" low valuation will suffer an alleged injustice. The contention is that it is only fair to arrange at the outset for a squeezed-out class to come back into the enterprise if the future is markedly better than predicted in arriving at the initial reorganization valuation.

By now the shortcoming in this line of thought is quite familiar: the future just might be worse than predicted. Proper valuation takes into account the probabilities of falling short of predictions as well as of exceeding them. The participating classes that receive equity interests in the reorganized corporation or debt securities with fixed interest rates take the risk in both directions. To require them to share good fortune with an excluded class while demanding that they bear the

full burden of bad fortune would provide them with less than full compensation for their claims.³⁷

This logical answer has never satisfied those who sympathize with junior classes in reorganizations, nor those who are skeptical about the entire valuation process. Early in the development of reorganization doctrine, they argued for issuing warrants to a marginally excluded class of investors, the warrant being viewed as an interest whose value was contingent on the success of the reorganized enterprise. When the SEC took a strong stand against issuance of warrants in reorganizations—in part on fairness grounds but largely on feasibility notions³⁸—the “second guessers” suggested that additional stock be issued at a future time to the excluded class if the affairs of the enterprise exceeded initial expectations.

The most recent version of the “second chance” idea is contained in the legislation proposed by the Bankruptcy Commission.

³⁷ For a crisp presentation of this relationship, see *Spitze v. Stichman*, 278 F.2d 402, 405-06 (2d Cir. 1960).

³⁸ The case against the issuance of long-term warrants has been well stated by the Securities and Exchange Commission in *Child's Co.*, 24 S.E.C. 85, 121-22 (1946):

Long-term option warrants are unsound from the standpoint of the company. . . . In fact, the obligation of the company . . . may constitute an impediment to further equity financing.

Long-term option warrants are also objectionable from the standpoint of the public interest. Since they constitute merely a call on common stock they are likely to be subject to extraordinarily wide fluctuations on the market. Their extreme market instability is no doubt increased by the difficulty of determining their value. Graham and Dodd make the following supplementary comment in their discussions of warrants:

The basic fact about an option warrant, therefore, is that it represents *something that has been taken away* from the common stock. . . . Warrants to buy stock, even at a price about the market, therefore detract from the present value of the common stock, because part of this present value is based upon the right to benefit from future improvement. . . . The option warrant is a fundamentally dangerous and objectionable device because it effects an indirect and usually unrecognized dilution of common-stock values. . . .

It is significant that the New York Stock Exchange has refused in recent years to admit long-term warrants to trading and at the present time none are listed on the Exchange.

See also 14 U. CHI. L. REV. 84, 92 (1946) (footnote omitted):

[T]he issuance of such “immediately valueless paper” may at least be questioned both on the ground that it adds to the complexity of capital structures which should be simplified, and on the ground that the issuance of these interests tends to place on the market securities which do not meet a reasonable investment standard. Furthermore, the existence of warrants or participation rights decreases the value of common stock given to participants with more senior claims to the extent that while the new common stockholders must bear the first impact of future losses, they will not get the full benefit of future gains.

It should also be noted that the SEC requires corporations registering securities under the Securities Act of 1933 to include in their registration statements and prospectuses a “boilerplate” paragraph setting forth, as a matter of necessary disclosure with respect to warrants or options to buy stock of the registrant corporation, the nature of the potential dilution and the impediment to future financing attributable to such warrants or options.

A plan of reorganization . . . may include, if the plan is based on an estimated valuation which would preclude other participation by any class of creditors . . . or equity security holders of the debtor, provisions for delayed participation rights for such a class or classes [or] holders . . . conditioned on the court's determination within a period specified in the plan but not later than five years from the date of confirmation that the reorganized debtor or the successor under the plan has attained a financial status that warrants such participation . . .³⁹

Although this change in absolute priority doctrine involves the unfair asymmetry of risks that characterizes all "second look" propositions, the ramifications of the particular recommendation deserve a closer look.

One possible reading of the proposal is that it would permit a court to authorize a second (but higher) valuation of the enterprise several years after confirmation of a reorganization plan. It is difficult to credit that interpretation. The valuation process is usually the stickiest part of reorganization procedure; it is expensive, time-consuming, sensitive, and controversial. Inviting a full replay several years later would undermine the process by denigrating the first stage and rendering its result vulnerable to erosion at a later date.

A narrower reading of the proposal is that it would allow a review, at the end of a specified time span, of only limited aspects of the initial valuation analysis. One model could be the "earn-out" formulas commonly used in corporate acquisitions, under which the amount of stock in the acquiring company transferred to the shareholders of the acquired company ultimately depends on the earnings record of the acquired company during a certain period immediately following the acquisition. By way of illustration, a reorganization plan could provide for comparing forecast earnings and actual earnings at the end of five years.

This is easier said than done. The formula would have to specify whether the controlling experience is to be highest earnings, average earnings, or mean earnings during the period. Unfairness to the old seniors would be compounded if the highest level of earnings were determinative, a point most easily seen if highest earnings are achieved somewhat prior to the last year of the contingency period and there is a subsequent downtrend.

Moreover, a built-in conflict of interest in stating earnings would exist between the old juniors, who wish to validate their contingent participations, and the old seniors, who wish to stand pat on the initial

³⁹ REPORT OF THE BANKRUPTCY COMM'N, *supra* note 17, pt. II, at 241 (section 7-303(3) of the proposed Bankruptcy Act of 1973).

distribution. Companies have, within accepted accounting conventions, considerable flexibility and room for maneuver in stating earnings over the span of a few years. As with earn-out deals, a carefully executed contingent participation arrangement pursuant to a plan must set ground rules for computing actual earnings during the trial years. It may also be imperative to spell out limitations on the freedom of management to pursue policies that are calculated to maximize earnings a few years down the line at the expense of earnings in the years immediately ahead. In some situations it may also be necessary to restrict other corporate activities, including mergers, sales of divisions, abandonments, product shifts, and various financial readjustments.

In practice, it may be difficult to keep an earn-out type of contingent arrangement from turning into a general reopening of the valuation question. Theoretically the two formulations are quite distinct. If valuation were re-examined at a fixed time after confirmation of a plan, attention would focus upon projected earnings from that date forward and upon proper capitalization rates at that date. In contrast, a contingent earnings arrangement is in principle concerned only with "actual" earnings between confirmation of the plan and the fixed date. Whether a reorganization court could in practice keep revaluation arguments and pressures from contaminating contingent arrangements is a matter of speculation. Consider an extreme situation: although the enterprise has not registered earnings during the contingency period above original projections, there is a broad consensus that, shortly after the cutoff date, earnings will increase significantly. These facts do not validate the contingent rights; they arguably call for a higher valuation. Yet can anyone be sure what a court would do with the rights of the parties under these circumstances?

A related difficulty needs to be explored. The heart of a customary earn-out scheme is reaching a quantitative relationship between actual earnings and the number of additional shares to be distributed if there is a favorable earnings record. In corporate acquisitions this relationship is established through arms-length bargaining in what amounts to a market transaction. Although a reorganization plan is almost certain to reflect a degree of direct or indirect negotiation among classes of investors, the purpose of having a standard of fairness is to establish discernible boundaries for proper dealings. An earnings contingency arrangement is in this respect no different from any other distributional aspect of a reorganization plan.

The task of working out the relationship between earnings and the contingent distribution is challenging. As an illustration, consider a reorganization in which, if no contingency arrangement were permitted, old stockholders would be cut out of the enterprise and the whole

equity in the reorganized firm would be allocated to old bondholders because the enterprise had a value less than their priority liquidation claim. Assume that the valuation was appropriately reached by capitalizing projected earnings.⁴⁰ The key question for present consideration is how to integrate an earnings contingency arrangement into the valuation process.

The ultimate hurdle has already been placed and marked. If the valuation process were conducted in proper fashion, it would be unfair to the old bondholders to introduce a contingency element into the distribution. Under the initial valuation they are (it is assumed) entitled to the entire equity after reorganization. To dilute their position in the future through a contingency aspect is to force them into the unfair gamble of heads loses all—tails wins only part. If this hurdle is simply ignored, is it possible to delineate an analytical approach to fixing the amount of contingent participation for old shareholders?

The problem can be illuminated by further developing the illustration: assume the bondholders have a priority liquidation claim of \$5,000,000 and the enterprise is valued for reorganization purposes at \$4,000,000—leaving a negative equity for the old shareholders. This valuation was reached by capitalizing estimated annual future earnings of \$400,000 at 10 percent. The valuation process included an adequate review of both the likelihood that earnings would be larger or smaller than \$400,000 and the risk rates associated with these other possible levels. The distribution of earnings, probabilities, and risk rates may be summarized as follows:

<u>Earnings level</u>	<u>Likelihood</u>	<u>Risk rate</u>
under \$100,000	over 95%	6%
100,000	95	7
200,000	80	8
300,000	65	9
400,000	50	10
500,000	35	11
600,000	20	12
700,000	5	13
over 700,000	less than 5	more than 13

The plan of reorganization calls for an all common stock capital structure; 400,000 shares are to be allocated immediately to the old bondholders. The problem, to repeat, is how to go about fixing the terms on

⁴⁰ In this illustration nothing turns on whether the valuation process consisted of applying an appropriate single capitalization rate to the estimated most probable earnings, or applying some form of probabilities analysis to projected earnings and then ascertaining an appropriate weighted capitalization rate. This point is illuminated in V. BRUDNEY & M. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 63 (1972).

which added shares are to be contingently distributable five years later to the old shareholders.

At first glance it may be urged that the old stockholders should receive nothing unless earnings reached the \$500,000 level by the cutoff date, and that their participation should increase dollar for dollar above that mark. The argument can be simply stated: it was decided during the valuation process that 10 percent was the proper weighted rate at which to capitalize actual earnings; application of that rate to earnings of \$500,000 (in a procedure that combined an earn-out formula with a revaluation technique) would result in a valuation of \$5,000,000—a sum that just equalled the priority claim of the old bondholders. At a \$600,000 earnings level the enterprise would be worth \$6,000,000, entitling old shareholders to one-sixth of the equity; at a \$700,000 earnings level the enterprise would be worth \$7,000,000, entitling the old shareholders to two-sevenths of the equity. If earnings reached \$1,000,000 the old shareholders should, on this reasoning, end up with one-half of the total.

Further reflection on the illustration indicates the fallacy of the suggested hybrid approach. The initial \$4,000,000 valuation took into account the probabilities that the firm would earn more than \$400,000 a year. The likelihood of doing so, however, was not great enough to merit putting more than a \$4,000,000 value on the enterprise. Assume that five years later the firm earns not \$400,000 but \$1,000,000. This fact alone would not warrant applying a 10 percent capitalization rate to actual earnings and then treating the enterprise as worth \$10,000,000. At the time of initial valuation, the likelihood of earning \$1,000,000 was placed at much less than 5 percent and the appropriate risk rate was placed at much more than 13 percent. If the unlikely happens, there is no reason to think that the 10 percent risk rate will still be the proper one at which to capitalize the earnings that have in fact materialized. Nor is it satisfactory, if the proposed revision is adopted, to stick with original projections of earnings and risks. To do so would mean denying contingent participation to old shareholders and negating the very purpose of the proposal.

No defensible middle course between these unacceptable extremes has yet surfaced, and the prospects for finding one are not bright. Contingency arrangements in all probability will have to rest on sheer compromise or arbitrary formulas, unsupported by an analytic structure that would permit meaningful review. In essence, the basic question is: how large a free ride are the old stockholders entitled to? The answer is almost bound to be: whatever they can get!

It now becomes apparent that there likewise is no analytic basis for

deciding when a junior class is entitled to some contingent participation—as opposed to being excluded altogether. Once more the illustration is helpful. If, as earlier assumed, the priority claim of the bondholders is \$5,000,000 and the firm is valued at \$4,000,000, should the old stockholders be heard to argue for some contingent participation on the ground that there is an estimated 35 percent chance that annual earnings would reach \$500,000 (giving a \$5,000,000 valuation if capitalized at 10 percent)? The answer is clearly no. If the argument were accepted, it could be used by the old stockholders even if the claim of the bondholders totaled \$10,000,000. For under the estimates, there is some chance—although much less than 5 percent—that the enterprise will earn \$1,000,000 a year.

The problem of allotting delayed participation rights to marginally excluded claimants has an exact counterpart in the problem of augmenting the distribution to marginally included classes. Change the illustration so that the bondholders' priority claim was only \$3,000,000 and debenture holders were next in line with a priority claim of \$2,000,000. Assume that under the plan \$3,000,000 of new shares go to the old bondholders, the remaining \$1,000,000 of new shares go to the debenture holders, and the old common stockholders are wholly excluded. Should a favorable earnings record result in giving additional securities to the excluded common stockholders without first enriching the participation of the partially compensated debenture holders? Or should the contingency arrangement first benefit the debenture holders, and, if so, on what terms? Would it be necessary to reopen and reconsider the allocations to other participating classes as well?⁴¹ And what type of proceeding would need to be developed to make these determinations?

The problems of defining a fair standard are underscored by considering once again, for contrast, an uncoerced corporate acquisition. An "earn-out" contingency arrangement reflects a bargain in which the acquired side accepts a smaller, unconditional amount initially in exchange for a shot at receiving a larger overall total if future earnings are good.⁴² The reorganization situation is never comparable. There is no sense in which the old shareholders can be considered as accepting

⁴¹ A senior class that receives "full" compensation in a reorganization does not necessarily receive full payment in current market values. See *Guarantee Trust Co. v. Chase Nat'l Bank*, 302 N.Y. 658, 98 N.E.2d 474 (1951). Would a reopening under a reorganization plan also encompass adjustment of the interest rate on the new debt securities?

⁴² For a general description of the earn-out concept, see Hecht, *Earn-Outs*, 2 *MERGERS & ACQUISITIONS*, No. 4, at 2 (1967), and Hecht, *The Certificate of Contingent Interest: A Primer*, 3 *MERGERS & ACQUISITIONS*, No. 6, at 5 (1968).

less now in order to get more later—for the simple reason that they are, by hypothesis, entitled to nothing now.⁴³

It may not be reasonable or proper to single out earnings as the basis for contingency participation when other variables might also change during the period. Inflation, for example, could drive up earnings but drive down the applicable multiplier even more—thus causing a lower overall valuation. The company could earn more by taking on higher risk operations, which would call for an upward revision in the capitalization rate. The worth of the enterprise could be heavily affected by newly ascertained needs for replacement or rehabilitation not yet reflected in projected earnings. All these factors may be as relevant as the earnings record; but to take them into account would necessitate a second full-scale valuation of the firm.

This discussion may be charged with slighting the extraordinary uncertainties and variables of the valuation process. Valuation of a going concern, however, is always an uncertain thing. The essence of a bankruptcy reorganization, which binds all parties whether or not they accept the plan, involves imposing on them some kind of principled, disciplined conclusion as to value in the face of inescapable uncertainty. And a conclusion without an end is no conclusion.⁴⁴

The contingent participation arrangement proposed by the Bankruptcy Commission could conceivably be implemented in another way. The conditional rights could be tied not to the earnings of the enterprise but to the performance of its shares in the market. That arrangement would present many of the same problems raised by an earn-out type contingency scheme, and some additional ones as well. The most crucial question would again concern the quantum of allowable contingent participation. To return to the illustration a final time: suppose that all the new shares are awarded to the old creditors to satisfy their liquidation priority claim of \$5,000,000, which is greater than the total value of the new equity. At the end of five years, let it be assumed, the market price of a share, when multiplied by the number of

⁴³ It should be emphasized that reorganization is an alternative to liquidation, and that the juniors would get nothing in liquidation.

⁴⁴ This discussion brings to mind an anecdote told by Tom Corcoran about the time when he served as law clerk to Justice Holmes. The Justice used to take late afternoon walks with his clerk in the outskirts of Washington. One day, while walking across an open meadow, they came to a railroad track, which they followed to the bumper at its end. The Justice ordered: "Salute that, son." Corcoran said, "I knew the Justice well enough to do what I was told first and to ask questions afterwards. So I saluted and then said, 'Mr. Justice, why did I salute that?'" Justice Holmes then announced, "Son, there are damn few things in this world that really come to a final conclusion, and when you see one of them, it's entitled to respect."

shares outstanding, indicates that the entire equity is then worth \$20,000,000. On these facts should the issued shares be quadrupled, with all additional shares (constituting three-fourths of the total) distributed to the old shareholders who were awarded conditional participation? Of course not! Market prices are notoriously unstable. Moreover, a giant leap is involved in using the market price of a small number of traded shares to value the equity as a whole. And even if these two difficulties could be transcended, it would still be wrong to put the entire risk of loss on the old creditors (who are the new unconditional shareholders) and to confer the possibility of gain on the old shareholders (who receive only conditional participation).

If the simplistic allocation system based on stock prices is rejected, some other calculus is needed. But, as in the case of conditional participations based on earnings, none comes to mind and none has been suggested by the proponents of delayed participation.⁴⁵

Several other troublesome aspects of both an earnings and a stock price model of conditional participation should not go unnoticed. It would be undesirable to permit unlimited transferability of the contingent rights, because of the high potential for deception;⁴⁶ yet it would be harsh to prohibit all transfers. Limited transferability is a possibility, but policing the rules would require considerable administrative effort. Parallel problems arise concerning matters within the reorganized corporation. During the contingency period, should the firm be permitted to increase its outstanding debt or recapitalize or merge with another firm? What antidilution provisions should be required? Rules would obviously be needed to free the hands of those who run the corporation and to safeguard the position of those holding contingent rights. Striking a sound balance is not easy.

There is a further difficulty, which is the mirror image of the problem of placing a value on the contingent rights. Any contingency not hopelessly remote is likely to adversely affect the market prices of the securities issued unconditionally under the plan; indeed, the possibility of dilution will have the same impact on market prices as warrants or securities convertible into common shares, and will justifiably be subject to the same criticism. Contingent participation, moreover, probably dampens investor acceptance of any securities newly offered by the reorganized company during the contingency period, thus making it more

⁴⁵ Someone might be interested in thinking through the problems that could arise if a reorganization plan had provisions for both a distribution to manager-owners and a contingent distribution. It would be difficult to avoid unraveling complicated reciprocal and interrelated adjustments.

⁴⁶ See the discussion concerning long-term warrants at note 38 *supra*.

difficult or costly for the reorganized company to finance future growth.⁴⁷

One last argument in favor of contingent participation arrangements remains to be examined. Given the imperatives of the absolute priority doctrine and the uncertainties of valuation, junior classes frequently resort, as previously noted, to a strategy of delay; the hope is that the earnings picture for the enterprise will improve and set the stage for a higher valuation—one that will enable them to stay in the enterprise or increase their share of participation. If juniors were granted contingent participation rights, the argument runs, they would be less inclined to rely on the delay technique; hence, the reorganization process would be expedited.

The possibility of such a trade off should not be summarily dismissed. It would seem, however, that the case for contingent participation for an otherwise excludable junior class on this ground is no different from the case for nuisance claims. It might even give juniors a new reason to delay the proceedings. Once contingent arrangements are authorized by law, there is nothing to discourage a junior class from stalling so that they can insist upon a larger contingent participation for themselves after conditions for the enterprise have started to improve. The most direct way to deal with a deliberate slowdown is to design measures to defeat the strategy. That approach surely is more promising than a change in substantive rules calculated to buy cooperation from those most likely to gain from delay.

In the final analysis, all second chance or second look arrangements in reorganization plans are directly at odds with a central element of any senior investment contract that contains customary default provisions. These provisions are designed to terminate the ability of the juniors to continue their "hold" on the capital contributed to the enterprise by the seniors. A long contingency period, which gives the enterprise a chance to recover, prevents the seniors from releasing this "hold" until the period has come to a close.

A relevant comparison is afforded by mortgage moratoria legislation, which allows the mortgagor additional time to cure a default before his interest in the security is finally foreclosed. This legislation has generally been upheld as constitutional and considered fair when the mortgagee receives the income from the property during the extension period.⁴⁸ In the corporate reorganization situation the old creditors, who become the new stockholders, are generally unable to draw out

⁴⁷ See *Public Serv. Co.*, 26 S.E.C. 338 (1947).

⁴⁸ See *Wright v. Vinton Branch of the Mountain Trust Bank*, 300 U.S. 440 (1937).

the earnings as dividends during the contingency period. Reinvestment of earnings by the firm during that period may actually contribute to a rise in earnings or share prices. If the old shareholders were to benefit from reinvested earnings, they would, in effect, be pulling themselves up by another's bootstraps. If the old juniors keep a hold on the capital attributable to senior investment during the contingency period, to be consistent the seniors should be entitled to interest on their old debt securities throughout the period. It is manifestly unfair to deny them both creditor status with respect to accrual of interest and full stockholder status because of the overhanging contingency to which their equity position is subject.

It has long been recognized as improper to force the old seniors into a "gap" position during a reorganization proceeding. An effective date for transformation of rights from creditor to ownership status must be part of the plan.⁴⁹ Prior to the effective date the seniors are entitled, with minor exceptions, to have their creditor claims increased by the running of interest on their old securities. After that date they are entitled to be treated as full fledged shareholders and to take the risks and receive the full benefits normally associated with ownership.

VII

The starting point for a summary assessment of proposals to modify the absolute priority doctrine is the proposition that the doctrine serves primarily to (1) set limits on direct and indirect negotiations among those who have invested in an enterprise, and (2) structure those negotiations within a framework that facilitates judicial review of the results. All proposals to alter the doctrine can be assessed in terms of their potential impact on these functions.

Proposals to base the measurement of claims on the going concern value of securities instead of on their liquidation priorities need not affect the process of valuing the enterprise, the pace of the reorganization proceedings or the reviewability of the reorganization plan. In a few situations these proposals may favor senior classes who hold "premium" grade securities (such as bonds carrying relatively high interest payments); but in most situations they would favor junior classes at the expense of seniors. The major and decisive infirmity is that this change would undermine a crucial aspect of the bargain embodied in the senior securities: as corporate financial conditions worsened and the

⁴⁹ The importance of the effective date in this respect is nicely illustrated by adjustments made to the plan of reorganization in the Chicago, Milwaukee, St. Paul & Pacific Railroad Co. reorganization. See 254 I.C.C. 707 (1943).

seniors were most in need of the default protection for which they had bargained, the change would reduce the magnitude of their claims and hence their participation in the reorganized enterprise.

Proposals to authorize judicial discretion to approve "good business deals" or to recognize nuisance claims, so that reorganizations may be expedited, would undercut the very essence of the absolute priority doctrine. They would give junior classes playing cards they now lack and to which they are not now entitled; no strong showing can be made that bribing the juniors with a modicum of participation will keep them from seeking more. In any event, the soundness of the business deal and the fairness of the bribe are virtually immune from effective judicial review. Only a version of the "unconscionable bargain" notion could possibly serve as a backstop—and that notion has been notoriously ineffective in other areas of the law.

Proposals to allocate to the shareholder-manager group all or some of the going concern value—meaning the excess of reorganization value over liquidation value—could greatly expand the permissible limits of negotiation. Old shareholders, especially those associated with operation of the enterprise, would be encouraged to dredge up a large variety of benefits they arguably could confer on the firm. Moreover, these "insiders" would often be in a position to raise issues about the extent of their shareholdings and the value of their special contributions to the enterprise. It is not easy to visualize the precise stage in the proceedings at which these matters would receive consideration. At the outset of the reorganization it would frequently be difficult to know enough about the role the owner-managers might play in the future of the firm. Even if some special contribution on their part is recognized, its treatment would seem to be dependent, at least in part, on the participation (if any) accorded shareholders generally. Only after that matter had been determined would it be feasible to decide how much additional participation should be tied to the special contribution of the "insiders." This last judgment would be particularly difficult to review judicially unless the "extra" is regarded as payment for services to be rendered—in which case it should be given to the recipients not as shareholders but as employees or consultants to the firm.

Proposals to authorize contingent participations for junior classes wholly or partially excluded from unconditional participation in the reorganized enterprise would likewise expand the boundaries of permissible negotiations and further reduce the possibility of effective control through judicial review. It seems most unlikely that a rational system could be developed for determining the proper magnitudes for contingent participations. In practice conditional participations would

probably reflect rough compromises, producing results similar to arrangements that recognize the nuisance value of worthless junior claims.

Taken together, these observations suggest that there is no persuasive case for relaxing the doctrine under the existing structure of Chapter X. The doctrine as it now stands and operates, however, would not be fully compatible with a statutory change of the type proposed by the Bankruptcy Commission, replacing Chapters X and XI with a single framework for both corporate reorganizations and compositions. In developing any such unified system, its effect upon the governing standard of fairness would need to be carefully noted and handled. Inadvertent destruction or erosion of the absolute priority doctrine should not be permitted to occur under a procedure adopted for other purposes.

A unified framework requires a basic choice in its design: a determination whether the strict priority doctrine or a composition standard is to apply has to be made near the beginning of each reorganization; or, in order to preserve a function for the strict priority rule, one or more of the modifying proposals has to be adopted, even though doing so may seriously weaken the doctrine. Under either alternative, it will be important to focus upon the policies underpinning the strict priority standard and consider how they will be affected by adoption of a unified framework. The total impact of unification on strict priority should be a major factor in determining whether the procedural advantages of unification outweigh its substantive costs.