RAILROAD REORGANIZATION UNDER SECTION 77 OF THE BANKRUPTCY ACT: NEW LEGIS- LATION SUGGESTED

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I

SCOPE AND PURPOSE OF INQUIRY

AN estimate of Section 77 of the Bankruptcy Act¹ cannot be in one dimension. It is more than a procedural statute, for under it old rights can be destroyed and new ones created. Enacted March 3, 1933, the last day of President Hoover's administration, it co-exists in the same plane with established railroad reorganization procedure in Equity receiverships, with the Interstate Commerce Act, the Reconstruction Finance Corporation Act,² and with other federal laws directly or indirectly affecting railroad reorganization. Aside from the practical problems to which it gives rise, the strictly legal ones raised by Section 77 will tend to be handled and even solved subordinately to the exigencies of public policy; and public policy in turn must throw the searchlight back to original causes and forward to ultimate objectives. So our estimate is in three dimensions; and the third extends from the past into the unknown future.

In the past, the searchlight recalls to us the steam transportation industry, built and developed for three-quarters of a century as a service monopoly, under economic conditions generally spacious; and, in an atmosphere of exploitation and speculation, well supported by an investing public in the face of chronic failure and of reorganization often marked by chicanery of financial and legal technicians, and occasionally by sensational scandal.³ Today, this same industry is stripped of its

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1. 47 STAT. 1474-82, 11 U. S. C. A. § 205 (1933).

2. 47 STAT. 5, 15 U. S. C. A. § 602 (1933).

3. See Report of Coordinator Eastman to the I. C. C., Doc. No. 119, 73d Cong., 2d Sess. (1934) 3; LOWENTHAL, *THE INVESTOR PAYS* (1933); HOWARD, *WALL STREET FIFTY YEARS AFTER ERIE* (1923); dissenting opinion of Commissioner Eastman, Chicago, Milwaukee & St. Paul Reorganization, 131 I. C. C. 673, 701 (1928).

monopoly, and its resources are being progressively further invaded, by the internal-combustion engine on hard surfaced highways, and by other new transportation methods;⁴ and, in the current emergency, it is almost wholly dependent for financial help upon government loans. In the future, while exposed to further potentialities of competition,⁵ it faces, at least as a privately owned industry, a huge debt to the government;⁶ and, under the Securities Act⁷ and the Securities Exchange Act,⁸ new burdens and strict limitations in connection with its enlistment of private capital. The idea of government ownership, advocated a decade ago only by persons regarded as isolated extremists, has suddenly penetrated into great financial institutions where some prophets predict its advent and personally advocate it as the investors' only salvation.⁹

In a sense, the current financial emergency did not cause the present plight of the railroads; it only served to accelerate and intensify it. Even before the general collapse, the relative shrinkage in rail earnings during the final peak years of the boom had been causing serious alarm among informed observers. The fundamental impairment which has overtaken the normal opportunity of the railroads for service to the public is perhaps the gravest factor of their problem. Just as they were confronting the corroding effects of encroaching social obsolescence, they were abruptly thrust into a world catastrophe.

Against the background of these considerations we shall briefly summarize Section 77; examine the progress actually being made under it; discuss, from the viewpoints of workability and of public policy, its advantages and main defects; point out, without undertaking to solve, the most serious legal questions which might delay or even destroy Section 77's availability; and suggest legislation which seems essential to the fulfillment of its purpose.

4. In the report of March 10, 1934, by the Federal Coordinator of Transportation to Congress, SEN. DOC. NO. 152, 73d Cong., 2d Sess. (1934) it was estimated that in 1932 the railways handled only 53.9% of the actual freight tonnage moved.

5. See, e.g.: Leo J. Flynn, *Coordination of Motor Transportation*, Report of Attorney-Examiner to I. C. C., SEN. DOC. NO. 43, 72d Cong., 1st Sess. (1932); I. C. C. REP., DOC. NO. 23,400: in re *Coordination of Motor Transportation* (April 6, 1932). For discussion and full bibliography see MOULTON, *THE AMERICAN TRANSPORTATION PROBLEM* (Brookings Institute, 1933).

6. As of November 12, 1934, the Chairman of RFC reported a total aggregate of loans to railroads of \$423,801,021; with repayments to October 31, 1934, of \$70,631,455. As of September 15, 1934, agreements had been executed for loans to railroads by the Federal Emergency Administration of Public Works aggregating \$188,531,500.

7. 48 STAT. 74, 15 U. S. C. A. § 77a et seq. (1933).

8. 48 STAT. —, § 1, 15 U. S. C. A. § 78a et seq. (1934).

9. But see discussion by Coordinator Eastman, Doc. No. 119, 73d Cong., 2d Sess. (1934) 13-21, and his conclusions at page 30 wherein he says: "Nevertheless, I am not now prepared to recommend resort to public ownership and operation. This is for the

II

THE ACT SUMMARIZED

Briefly, under Section 77, the railroad company voluntarily, or five per cent in amount of its creditors, may institute in a Federal district court the proceeding for invoking the court's custody. On a voluntary petition the court will, and on a contested involuntary petition it may, take jurisdiction of the company, not as a bankrupt, but as a "Debtor," on the ground either that the company is insolvent or is unable to meet its debts as they mature. The court, according to Subdivision (c), "may" appoint a trustee or trustees whose powers and duties are akin to those of a receiver in equity, with this addition among others—that he must soon file as a public record a list of all bondholders and stockholders with their addresses, if known.¹⁰ The Interstate Commerce Commission after hearings duly held for the presentation of proposed reorganization plans, is to recommend a Plan, which, among other things, besides limiting allowable reorganization fees and expenses, and being fair as between classes of security holders, and safeguarding (as will later be shown) the rights of non-assenting creditors or stockholders constituting one-third or more of their class, must be financially advisable and compatible with the public interest.¹¹ But the Commission may not finally certify its approval of a Plan to the court until two-thirds in amount of every class of creditors and of stockholders "whose claims or interests would be affected by the Plan," shall have accepted such Plan;¹² with this further proviso, however—that such acceptance by stockholders is not required for confirmation by the court if it finds (a) that the company is insolvent, or (b) that the Plan does not adversely affect the stockholders, or (c) that they are bound by the company's ac-

principal reason that the country is not now financially in a condition to stand the strain of an acquisition of these great properties, imposing burdens which cannot be definitely foreseen and might well, in present circumstances, be disproportionately severe. The danger would be enhanced by the fact that there would be a comparatively long period before the new system could be got into smoothly running order, and by the further fact that the railroad industry is now in a stage of accelerated evolution. This is true, indeed, of the entire transportation industry, and it is at least questionable whether the railroads alone could well be nationalized without including other forms of transport to some considerable extent. The British Royal Commission of 1930 was unanimously of the opinion that such inclusion would be necessary."

10. Subdivision (c), Clause (9).

11. Subdivision (d).

12. Unless the Plan gives adequate protection to non-assentors aggregating more than one-third of their class as to stockholders, by sale at fair upset price or by appraisal of old or new securities; as to creditors by sale subject to liens, by sale free from liens at a fair upset price, or by appraisal of old or new securities. [Subdivisions (e) and (g), Clauses (5) and (6)].

ceptance of the Plan.¹³ Subdivision (g), Clause (5) sets forth protection which the reorganizers must provide: first, for the non-assenting creditors constituting one-third or more of their class, second, to the non-assenting stockholders constituting one-third or more of their class, whose acceptance of the Plan is dispensed with by application of one of the three tests above, and, third, to the non-assenting stockholders constituting one-third or more of their class where their consent is not thus dispensed with, through tests (a), (b), or (c) above. Such protection to creditors consists, at least, of either (1) the sale of the property subject to their liens, if any; or (2) the sale free of such liens, if any, at not less than a fair upset price set by the Commission, together with payment to the creditors at their election of either the amount of their old claims or the amount offered in exchange for them under the Plan. In cases where the stockholders' acceptance of the Plan is not dispensed with as noted above, the protection to the dissenting stockholders constituting more than one-third of their class is similar to that accorded bondholders; that is, they may have a sale at not less than an upset price, or else payment on the basis of an appraisal by the Commission, either for what their old stock, or the new stock or rights offered them, may be worth.

Two points which will be discussed later, are to be noted about the court's confirmation of the Plan, under Subdivision (g); first, that the court in confirming the Plan need not find it to be compatible with the public interest, and second, that, by language difficult to construe otherwise, the court seems to be expressly prohibited from confirming any plan unless the Commission shall have certified its approval of it; for, says the concluding part of Subdivision (f): "No plan of reorganization shall be confirmed in any proceeding under this section except upon the approval of the Interstate Commerce Commission certified to the court." Subdivision (h) provides that "the confirmation of the plan shall discharge the debtor from its debts except as provided in the plan"; and that "in the event that the judge should disapprove the plan he shall file an opinion stating his reasons therefor."

The Act does not purport to abridge the remedies available in equity; it even expressly contemplates that Equity receivers of railroad companies may still be appointed by federal or state courts.¹⁴ Moreover, it provides that if there be a failure to effect reorganization in a Section 77 proceeding, the court (apparently even on its own motion) may ter-

13. Subdivision (e).

14. Subdivision (k).

The following Class I railroads were in Equity receivership prior to March 3, 1933, and are still in that status, (together with the courts and the dates of appointment of the receivers): Ann Arbor Ry. Co., U. S. D. C., N. D. Ohio, December 4, 1931; Pittsburg, Shawmut & Northern Ry. Co., U. S. D. C., W. D. Pa., N. Y. Sup. Ct., Aug. 1, 1905;

minate the proceeding by dismissal;¹⁵ and that the court in its order of dismissal may provide for direct transfer of the properties to an equity receiver whether acting under a federal or state court.¹⁶ On the other hand, it also provides for a method by which a company in equity receivership may take advantage of the Act.¹⁷

III

ACTION UNDER SECTION 77

Altogether fourteen proceedings have thus far been instituted under Section 77, of which one (by a small property) has been dismissed. Of those pending there are five involving Class I roads, instituted on the dates, in Federal district courts, in cities, as follows: Missouri Pacific Railway Company, filed on March 31, 1933 (in St. Louis); Chicago and Eastern Illinois (the C. & E. I.), April 18, 1933 (in Chicago); St. Louis & San Francisco Railway Company (the Frisco), May 16, 1933 (in St. Louis); Chicago, Rock Island and Pacific Railway Company (the Rock Island), June 7, 1933 (in Chicago); and Chicago, Indianapolis & Louisville (the Monon), December 30, 1933 (in Chicago). The other eight cases involve minor properties, only two having been instituted in the year 1934.¹⁸

Wabash Ry. Co., U. S. D. C., E. D. Mo., Dec. 1, 1931; Central of Georgia Ry. Co. U. S. D. C., S. D. Ga., Dec. 20, 1932; Florida East Coast Ry. Co., U. S. D. C., S. D. Fla., Sept. 1, 1931; Georgia & Florida Ry., U. S. D. C., S. D. Ga., Oct. 20, 1929; Mobile & Ohio Ry. Co., U. S. D. C., E. D. Mo. (transferred June 6, 1932 to U. S. D. C., S. D. Ala.), June 3, 1932; Norfolk Southern Rr. Co., U. S. D. C., E. D. Va., July 28, 1932; Seaboard Air Line Ry. Co., U. S. D. C., E. D. Va., Dec. 23, 1930; Fort Smith & Western Ry. Co., U. S. D. C., W. D. Ark., June 1, 1931; Minneapolis & St. Louis Ry. Co., U. S. D. C., D. Minn., July 26, 1923; Missouri & North Arkansas Ry. Co., U. S. D. C., E. D. Ark., May 5, 1927. None of them have thus far filed under Section 77.

No railroad receivership proceedings in Equity seem to have been instituted since March 3, 1933, excepting the following (1) Wilmington, Brunswick & Southern Ry. Co., Superior Court, Brunswick County, N. C., March 17, 1933; (2) Louisiana Southern Ry. Co., Civil District Court, Parish of Orleans, La., Aug. 2, 1933; (3) Tennessee, Kentucky & Northern Ry. Co., Chancery Court, Davidson County, Tenn., Nov. 24, 1933.

It is estimated that altogether about 40,000 miles of rail are in court custody, whether in Equity or bankruptcy.

15. Subdivision (c), Clause (7).

16. Subdivision (k).

17. Ibid.

18. These cases are: (1) Akron, Canton & Youngstown, N. D. of Ohio, E. D., April 3, 1933; (2) Fonda, Johnstown & Gloversville Rr. Co., N. D. N. Y., April 20, 1933; (3) Meriden & Bigbee River Ry. Co., S. D. Miss., E. Div., May 30, 1933; (4) Arkansas Valley Interurban Ry. Co., D. Kan., 2d Div., July 12, 1933; (5) Spokane, International Ry. Co., E. D. Wash., Sept. 27, 1933; (6) Chicago, South Shore & South Bend Rr. Co., N. D. Ind., Sept. 30, 1933; (7) Kansas City, Kaw Valley & Western Rr. Co., D. Kan., 1st Div., May 10, 1934; (8) East St. Louis, Columbia & Waterloo Ry. Co., E. D. Ill., Oct. 31, 1934.

The slow rate of progress of these five major Section 77 cases toward a reorganization plan has been in marked contrast to what the Act contemplated and what its framers apparently expected.¹⁹ Under the Act and the special bankruptcy rule promulgated by the Supreme Court for practice under it, before the Commission can hold a public hearing upon a plan of reorganization, the debtor or trustee must have filed in court a classification of creditors and of stockholders, an act of such simplicity that it could in most cases have been easily accomplished within a few days after the filing of the petition. Yet in the *Missouri Pacific Case* it took the debtor seventeen months to do this; in the *Rock Island Case* seven months; in the *Monon Case* eleven months; and in the *C. & E. I. Case* seventeen months; while on December 1st the classification order had not yet been filed in the *Frisco Case*. The only proposed comprehensive plan yet presented in any of the five cases was filed in the *C. & E. I. Case* on June 27, 1934, by a bondholders' protective committee and the first hearing on a plan has been set for December third.²⁰ In number and tempo, the steps taken to date in these five cases by the parties in interest compare none too favorably with the steps in the average railroad equity receivership proceeding over a similar period; and in some of them there seems to be a slowing-up during the past six months.

Another significant fact is that although rail earnings have been gravely declining since about May, 1934, and several companies are today in a worse condition than were some of the five companies when they brought themselves under Section 77, they seem to have avoided filing under it.

Aside from the reasons presently to be mentioned which specially account for the evident reluctance to make use of Section 77, there may be this one—that managers of companies which should now be in court custody are hoping for an amendment of the Reconstruction Finance Act in the approaching Session of Congress which will remove the adequate security restriction from the Reconstruction Finance Corporation's (RFC's) lending power, since some of those companies seem to have no substantial free assets left to pledge.²¹

19. See President Hoover's message to the Congress, Jan. 11, 1933, Doc. No. 522, 72d Cong., 2d Sess. (1933); also H. R. REP. No. 1897, 72d Cong., 2d Sess. (1933) 8.

20. Due to pending litigation the outcome of which could affect the road's earnings, this hearing has been adjourned to Feb. 5, 1935.

In the case of the Frisco, a plan was formulated in 1932, in order to enable the company to obtain a loan from RFC to avert the Equity receivership which followed, and which, as a plan, affecting part of the security structure, is still technically on file with the Commission.

21. In this connection, neither the Reconstruction Finance Corporation Act, nor the procedure under it in the Commission or in the RFC, up to now, has taken any cognizance

Uncertainty in the face of practical and legal problems raised by Section 77 itself largely accounts for the retardation of action under Section 77 and of failure to use it. But before discussing these, it should be said that there are present special and unprecedented circumstances, with which reorganization has not ordinarily been faced in the past, and which would induce hesitation in any proceeding whether in Equity or in Bankruptcy, among these being: first, that private credit being paralyzed, there is missing the dynamic motivation of the underwriting banker, ordinarily the Plan's centralizing impetus. Although he has received much justifiable criticism, his work has often been highly constructive. It is realized that, unless RFC's assistance should still be available, or bankers' courage should revive, a sufficient sum in actual cash reserves may have to be earned by the property itself, while under court control, to defray all or a substantial part of the expenses of reorganization, to pay off dissenters in cash where required by the Act, and to start the new company on its way with working capital—funds ordinarily in the past largely underwritten by the banker. Second, Section 77, Subdivision (e), conditions the Commission's final approval of any Plan on its having first obtained acceptance by two-thirds of the securities of each class, "whose claims or interests would be affected by the plan"; otherwise the Plan may be confronted with heavy and uncertain cash burdens. In the past it has been the banker with his exclusive possession of bondholder lists and his ramifying connections who has herded in the bonds to be credited on the reorganizers' bid at foreclosure sale. In the present state of widespread fear and distrust, the existing protective committees are in general far from having enlisted the statutory two-thirds; and the provisions of the Securities Act of 1933 affecting protective committees have had a markedly retarding effect upon the formation of new ones. Some consideration is now

of the mortgage bondholders or other creditors of the applicant for a loan. At a time when there has been grave concern generally among railroad bondholders over pumping government funds into the yawning deficits of companies in or approaching a state of collapse, the bondholders have apparently been receiving no formal notice from Washington of contemplated loans to the companies; and thus wedge after wedge, in the form of senior mortgage bonds issued or free assets delivered in pledge to RFC, has been driven between the rails and the intermediate and junior bondholders. Under such conditions, companies' officers representing the stock have tended to gamble away the position of the bondholders while playing the remote hope of prosperity's sudden return, a gamble originally justified in large measure by the government's exigent and summary policies for averting general collapse before it had supplied its many emergency props beneath the monetary and banking structure. There seems to have been no organized or formal protest by bondholders against this *ex parte* procedure in the making of RFC loans; yet it has intensified the gravity of the reorganization problem, and should be remedied in some way, whether by statute or by procedural regulation, so that bondholders may be heard, and allowed to oppose, or to bear part of the responsibility for, loans made by the government.

being given in some quarters to eliminating the two-thirds consent requirement on the ground that protection by the Commission and Court seems to be adequate; but it would seem that the mortgage bond investing public, both present and future, would hardly favor their rights in reorganization being subject to disposal without having a definite voice in the terms of surrender. A third difficulty not usually met with in railroad reorganization in the past is this: The catastrophic loss of traffic to highways and waterways is in some cases necessitating unprecedented programs of rail abandonment, which involve much accounting study and I. C. C. proceedings of unknown duration. The results of these prospective abandonments, if allowed, are baffling, especially as to their bearing upon the rights, under a Plan, of holders of bonds under divisional mortgages on properties marked for abandonment.

But perhaps the sluggish progress of cases under Section 77 can be mainly accounted for by the new rights and safeguards accorded by it to the stockholder with which the bondholders must reckon either for acquiescence or for challenge, and which will be dealt with below.

IV

NEW CONTRACTUAL PATTERNS FOR RAIL SECURITIES

Our appraisal of Section 77 will be projected against the assumption that sound public policy requires the preservation of Transportation as privately owned industry and that, as such, Transportation will be depending on private investors satisfied with their rights under the railroad securities which they must be induced to buy, presumably through bankers willing to underwrite them.

We shall consider directly how those rights should be reformed; but first, for better orientation in our consideration of Section 77, it should be said that from the viewpoint of public policy, the nature of the legal rights of the future investor in railroads is of distinctly secondary importance as far as the preservation of private ownership is concerned. Overshadowing in their necessity are: first, the simplification by eliminations, and the recasting into integrated coherence, of the entire rail service;²² second, the comprehensive and consistent coordination and

22. See SEN. DOC. NO. 119, 73d Cong., 2d Sess. (1934): letter of Jan. 31, 1934 from Joseph B. Eastman, Federal Coordinator of Transportation, to the Interstate Commerce Commission, and transmitted by its Chairman to the Senate. The Coordinator, (p. 21 et seq.) discusses plans for consolidation into a single system, or a very few systems, but states his unwillingness to recommend such plan now. "Whatever the abstract merits might be, from the viewpoint of practicality any consolidation plan in this country which would retain the principle of competition but greatly limit its present application would arouse a storm of controversy of such intensity that it is doubtful whether the ship could ever make port." See, also, INTERSTATE COMMERCE ACT § 5, 24 STAT. 379 (1887), 49 U. S. C. A. § 5 (1929); MOULTON, *op. cit. supra* note 5, at 846.

federal regulation of all agencies of commercial transportation including also trucks, buses, boats, aircraft, and pipe lines;²³ and third, the federal government's gradual withdrawal of all such agencies from state and local taxation except for carrying only those expenses of local government as are actually due to their presence; since, if sound financing of such transportation agencies under federal regulation is to be had, they must be free from irrelevant exactions incident to supporting in large measure the varying and often improvident budgets of the States and their taxing subdivisions.²⁴

But let us return to the problem of safeguarding private ownership in the rails by insuring their financial support through private investment. The greatest single advance achieved by Section 77 is in its affording the Commission's guidance from the beginning of the reorganization process, and in its requirement that the Plan have the Commission's approval before being finally submitted to the court. But the terms of Section 77 would not support the Commission's or even the court's insistence upon the new company's incorporating into its certificate of incorporation, its mortgages, and its stock certificates any substantial part of the definite principles of financial and corporate policy which the mistakes of the past indicate to be highly desirable. In connection with the issuance of new securities, whether in reorganization or otherwise, the Commission should be given power by mandatory or permissive statute to require that the following principles or their equivalents be woven into the contractual pattern of bonds and of stocks. In the case of bonds, there should be, first, a requirement that there be established and maintained, say, a minimum of fifty per cent margin of value above the amount of the mortgage, such value to be determined strictly on the basis of capitalized earnings, with the provision that if such margin should shrink, the deficiency must be satisfied before dividends can be paid; second, for all mortgages, as an assurance against unforeseeable obsolescence, minimum normal rates of amortization down to some proportion of the outstanding amount, the rate of amortization,

23. See Report on Coordination of Motor Transportation, 182 I. C. C. 263 (1932); Flynn Report, *supra* note 5.

24. See Bureau of Railway Economics, Special Series No. 61 (Washington, 1934) "Railway Taxation": Taxes on Class I railroads (including very minor federal taxes) are there shown (p. 11) to have risen in ratio from 12.68% of net operating revenue in 1916 to 22.70% thereof in 1926; and 38.04% thereof in 1932. In the peak year for earnings of 1929 state and local taxes paid were \$306,115,061; and in 1932, when many roads were not meeting maturities, and some not meeting operating expenses, these taxes (p. 13) were \$262,705,576. For 44 States and the District of Columbia an analysis is made (p. 15) of the final disposition of state and local steam railway taxes for either the years 1930 or 1931, and the estimate is that of the total of \$308,135,420 reported, 45.8% was spent for schools, 13.9% for highways, and 40.3% for all other purposes.

and also the proportion of the debt so retired or protected to be graduated according to the order of priority of the lien, so that such rates and proportions shall be greatest in the junior mortgages; stock to be issued, whether by way of dividend or otherwise, against the new equity thus created;²⁵ third, effective representation of bonds on the directorate (presumably through the mortgage trustee);²⁶ fourth, in place of the mortgage trustee's present customary status of what amounts in the main to an aloof clerkship up to the time of its receiving instructions to act on defaults, the establishment of the trustee's strict affirmative accountability as active fiduciary (contractual immunity being prohibited) to look after the interests of the bondholders during times of normal operation and to report to them directly upon policies of the company and the condition of their investment in it. In the case of stocks, provision should be made for, first, the unqualifiable right of

25. In the framing of statutes and of regulations covering this difficult subject, due consideration should be given to each of the three principal points of view about it. One, widely held by experts in the field of railroad finance, is that rates make no provision for a return sufficient to retire any part of the capital of the roads, whether in the form of bonds or stock, and as a consequence a sinking fund works hardship upon the holders of junior bonds and stock by diverting to the unnecessary retirement of underlying debt what should rightfully be income upon their holdings. This assumes that rates cannot adjust to a new financial policy.

Another view would provide for a sinking fund until indebtedness is cut down to a reasonably low proportion of the entire capital structure, the sinking fund to operate, however, only as a diversion to the payment of the sinking fund of earnings which otherwise would be applied to the payment of dividends on stock; and when payments are made, the stock should receive stock dividends in lieu of the cash which would otherwise have been received but for its payment upon the sinking fund—in effect the principle suggested in the text above. But under this second principle some contend that, if there were no earnings applicable to payment on the stock, then the sinking fund should not operate.

The third view would require regular sinking fund payments in any event, whether earnings be available or not. This is the type of arrangement ordinarily employed in the past where there has been any sinking fund at all. Unless properly safeguarded, it has this defect: that, where no funds are otherwise available for the sinking fund, they have in many instances had to be raised through the sale of junior securities upon unfavorable terms, thus actually leading to a wasteful increase of funded debt instead of to its decrease as contemplated by the indenture.

26. For instances of permissive provisions in state statutes for voting by bondholders, see Del., Laws 1933, 379, c. 91; also OHIO CODE ANN. (Throckmorton, 1921) § 8636.

For discussions, see GRAHAM and DODD, *SECURITY ANALYSIS* (1934) 210, c. XIX; also, SMITH, "United States Shipbuilding Co." in *TRUSTS, POOLS & CORPORATIONS* (ed. by Ripley, 1916) 428-429; DEWING, *CORPORATION SECURITIES* (3rd ed. 1934) 236; and also DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* (Rev. ed. 1926) 78-79.

For instances where the indentures have conferred voting power on the bondholder even in the absence of default see: the Erie Rr. Co. Consolidated 4s due 1996, Chicago, Terre Haute & South Eastern Ry. Co. Income 5s due 1960, and Mobile & Ohio Rr. Co. General 4s due 1938.

cumulative voting; second, some regulatory supervision by the Interstate Commerce Commission over voting trusts; and third, the requirement, under penalty, of thoroughgoing, affirmative truth in railroad annual reports in place of what has been in the past too much of a cryptic obscurity to the average small private investor. And finally, as to all securities, provisions should be inserted which will in the event of reorganization subject the holder, upon the consenting vote of a substantial proportion, say, a majority or two-thirds of the outstanding amount, to such alteration of his rights as an administrative body or court of competent and final jurisdiction may find necessary. In so far as such provision might in some jurisdictions be deemed to impair negotiability, statute could largely safeguard the point. Such majority power would particularly call for special protection of the minority by some statutory regulation of protective committees.²⁷

The proposals regarding the required margin of value above the amount of the mortgage and the rate of amortization merit further discussion. In the case of a factory, or an office building, an apartment house, a farm, or a city home, there is normally a sufficiently free and reliable marketability as perhaps to justify a 50 per cent or higher ratio of mortgage debt to "physical" value, i.e., value based on some cost criterion. But when a railroad must be sold, there is no such thing as a free market for it, and it is a practical certainty that the only bidder will be the creditors, whose only hope will lie in its earning value. Sound business therefore requires that from the outset, in computing the margin of value above the amount of a railroad mortgage, we use a value based not on cost but on prospective, and later upon actual and prospective, capitalized earning value. A similar conclusion may be reached as to the rate of amortization. So long as the railroad as a private industry is to be subject to the risks of competition and obsolescence, any mortgage without some definite provision for a sinking fund may develop into a business misfit. The mortgage bondholder in the past has carried too large a proportion of the risks of the enterprise; if he is to continue as the basic support of the railroads at low interest rates, his security should be in fact a security. Reasonable

27. Sections 211 and 212 of H. R. 9323 (73d Cong., 2d Sess. 1934) from which the Securities Exchange Act of 1934 was evolved, provided for an amendment to the Securities Act of 1933 giving the Federal Trade Commission close regulatory supervision over protective committees. These two sections were stricken out in conference. However, Section 211, as it appeared in the Securities Exchange Act of 1934 as finally enacted, authorized and directed the Securities and Exchange Commission to make a study of, and a report on protective committees. See also Lowenthal, *The Stock Exchange and Protective Committee Securities* (1933) 33 COL. L. REV. 1293; Lowenthal, *The Railroad Reorganization Act* (1933) 47 HARV. L. REV. 18; Douglas, *Protective Committees in Railroad Reorganizations* (1934) 47 HARV. L. REV. 565.

sinking fund requirements will actually safeguard the stockholder, whose interest otherwise tends to be extinguished by each financial depression. Such statute should not undertake to standardize by named percentages these new contractual principles as to maintenance of relationship between value and mortgage debt or as to rate of amortization; each case should stand on its own facts; and this calls for an administrative flexibility, attainable if the Commission be directed by the statute to apply the principles to each new issue in such ways as in its discretion may seem proper.

A special reason why some suggestion, at least, of these broader, long-range considerations should precede our more direct examination of Section 77 itself is this: Although it was pushed to adoption on March 3, 1933, as an emergency measure, Public Act Number 420, enacting Section 77, contained no emergency recitals and stands as a permanent part of the Bankruptcy Act, which had theretofore excluded railroads from its purview. As a permanent statute it seems that, even should Section 77 prove workable and effective in its present form and within its present limits, it does not constitute, standing alone, a significant instrument of public policy. It can operate only upon such situations as may be brought within its field; and as we shall presently see, there are causes at work which are seriously retarding its use in its present form. It does not require that a Section 77 proceeding must result in *reorganization*; and furnishes only a tentative theatre for an attempt to reorganize by composition or cooperation. It undertakes to provide justice; but it sets no new constructive standards of justice for the reorganization of business wrecked largely by unsound operating, financial, and contractual conditions which statute could in great part eradicate. We cannot be content with new procedural therapeutics for prostrated rail properties. We need to insure the survival and health of the entire service; and for this we need heroic clarity, not only for changing our economic public policy toward Transportation, but also for reconstructing the foundation of private rights which underlies Transportation's existence and maintenance as private industry. This is the crucial period in which the problem must be surrounded and attacked progressively from all fronts if we are to arrest our ominous drift into the stupendous difficulties of government ownership.

V

SECTION 77 AS THE STOCKHOLDERS' WEAPON AGAINST THE TRUST FUND PRINCIPLE

Resuming our examination of Section 77 itself, it is apparent that one special objective of that section, an objective which at first impression, as a measure of relief, has something to recommend it as an idea for

the emergency, could hardly have been incorporated in a statute to fit into Equity railroad reorganization procedure, because it is so totally in conflict with the established principles of Equity. In Equity, the foreclosure sale ordinarily wipes out the stockholder, and his only salvation lies in the place offered to him by the Plan. That place he is apt to purchase with funds which, in turn, constitute part of the new company's working capital. But in the pending emergency, the stock equity should not, if a sound and valid method could be evolved, suffer permanent extinguishment of an interest which, with recovery of general conditions, might regain at least some of its value. Today the stock interest in a company in reorganization, even when allied with banking support, has hardly been able to command funds or credit such as might salvage its position under a plan. Congress, in accepting the device of Subdivisions (e) and (g) as sponsored by the then Solicitor-General, was apparently moved to relieve this plight of the stockholder. In doing so it gave to the stockholders the leverage of an unprecedented power for compelling the creditors to accord to them what they might regard as their proper place in the Plan; for, as we have seen, those subdivisions are so drafted as to require consent of two-thirds of the stock to the Plan, unless the creditors can convince the judge either that the corporation's assent to the creditors' plan has been given, or that the Plan does not adversely affect the stockholders, or that the company is insolvent.²⁸ As will presently be seen, this last condition for avoiding dominance of the stockholder, is so difficult to satisfy under the peculiar and settled definitions of bankruptcy law, that such stockholder dominance is a strong probability. If the creditors, in connection with their Plan, are unable, for instance, to prove the company's insolvency, then they must take care of non-assenting stockholders amounting to one-third or more—either by a sale of the properties at an upset price as determined by the Commission, or by paying such stockholders for their stock in the old company (or the new) as the Commission may appraise its value. In other words, apparently in the hour of the creditors' decision as to whether or not they will accord to the stockholders the position they demand under the Plan, they may face as an alternative the uncertain burdens either of having to meet cash payments under an upset price to be later fixed by the Commission, or of assuming cash payments to the stockholders in undetermined amounts to be based on the Commission's future appraisal of the value

28. The two-thirds consent of stockholders is also unnecessary if the judge finds that the Plan makes adequate provision for the protection of the stockholder's equity by a sale at a fair upset price, or by appraisal of his old or new securities [subdivision (e) and subdivision (h) clause (5)].

of the properties. And in such future estimate and appraisal, the creditors will presumably encounter the Commission's historical involvement with the concept of "physical value" based largely on cost instead of on earning power, which dates from the valuation amendment of March 1, 1913, and which will be discussed later.²⁹

This extreme change whereby it may well be the stockholders instead of the creditors who can legally and legitimately dominate a reorganization is Section 77's outstanding innovation. Through it the banking interests which have ordinarily in the past profited largely from stock equities captured out of reorganization have obtained their first formidable weapon of offense against the principle that "the properties of a corporation constitute a trust fund for the payment of its debts," as repeatedly applied by the Supreme Court. In 1868 Justice Clifford in *Chicago, Rock Island and Pacific Railroad Company v. Howard*,³⁰ came to express this principle for the court in a case where, the railroad being in financial difficulties, stockholders had effected an arrangement with bondholders for a sale of the properties which would have been advantageous to the stockholders but prejudicial to unsecured creditors. In upholding the contentions of the latter, Justice Clifford declared that:

"Equity regards the property of a corporation as held in trust for the payment of the debts of the corporation, and recognizes the right of creditors to pursue it into whosoever possession it may be transferred, unless it has passed into the hands of a *bonâ fide* purchaser; and the rule is well settled that stockholders are not entitled to any share of the capital stock nor to any dividend of the profits until all the debts of the corporation are paid."³¹

In 1890 Justice Brewer in *Chicago, Milwaukee and St. Paul Railway Company v. Third National Bank of Chicago*³² found that a lease from one railroad to another had the effect of preventing application of the former's property to the satisfaction of its debts, and again stated the principle, saying: "The properties of a corporation constitute a trust fund for the payment of its debts; and, when there is a misappropriation of the funds of a corporation, equity, on behalf of the creditors of such corporation, will follow the funds so diverted."³³ In 1899 in *Louisville Trust Company v. Louisville, New Albany and Chicago Railway Company*,³⁴ the court again had occasion to rely on the same principle in connection with a transaction where it appeared that bondholder and stock-

29. *Infra*, notes 56-59 and accompanying text.

30. 7 Wall. 392 (U. S. 1868).

31. *Id.* at 409.

32. 134 U. S. 276 (1890).

33. *Id.* at 286.

34. 174 U. S. 674 (1899).

holder interests had united through foreclosure proceedings to circumvent unsecured creditors, and Justice Brewer said:

" . . . the stockholders' interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors. And any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors, comes within judicial denunciation."³⁵

In 1913 in *Northern Pacific Railway Company v. Boyd*³⁶ the Court, speaking through Justice Lamar, cited the foregoing cases and reaffirmed their principle in upholding the claim of a non-assenting creditor against the new corporation reorganized pursuant to arrangements between bondholders and stockholders. In 1934 the principle had an impressive reaffirmation in *First National Bank of Cincinnati v. Flershem*,³⁷ where the court, through Mr. Justice Brandeis, condemned both an upset price and a plan of reorganization which had prejudiced the rights of the non-assenting creditors.

The trust fund principle constitutes the towering doctrine in the field of Equity reorganization.³⁸ It would stand squarely in the path of according to stockholders such a position in reorganization proceedings as would enable them to salvage values out of the property while non-assenting creditors have not been paid in full. This trust fund principle perforce is to be read into every contract obligation of the old company; therefore, when a bankruptcy statute undertakes to interfere with the operation of the principle, it is apt on that account alone to be challenged on the score of due process.

VI

DUE PROCESS AND THE MINORITY NON-ASSENTING BONDHOLDER

But let us first consider, from the due process standpoint, the effect of the Act upon the minority non-assenting bondholder vis-a-vis the majority alone, and assuming that the Plan provides nothing for the stockholders. The Plan, if typical, yields to the minority bondholder, for example, only the right to receive securities in a new company in lieu of his old bonds and, although a dissenter from the Plan, he has no optional alternative right, as under Equity procedure, to receive

35. Id. at 684.

36. 228 U. S. 482 (1913).

37. 290 U. S. 504 (1934).

38. See Cutcheon, *An Examination of Devices Employed To Obviate The Embarrassments to Reorganizations Created By The Boyd Case*, SOME LEGAL PHASES OF CORPORATE FINANCING REORGANIZATION AND REGULATION (1931) 35; Swaine, *Reorganization of Corporations: Certain Developments Of The Last Decade*, Id. at 133, (1927) 27 COL. L. REV. 901.

cash at the hands of the court in satisfaction of his old interest, whether as his proportionate part of proceeds of a sale of the property, or as the appraisal value of his interest. The question seems never to have been directly dealt with by a federal court as to whether such treatment of the minority bondholder pursuant to a federal or state statute would constitute a violation of due process.³⁹

Under Anglo-American law, since long prior to 1787, the mortgagee on foreclosure sale has had the optional right either to accept the proceeds of a fair competitive sale (if not more than the amount of his claim), or, if the highest bid at such a sale be insufficient to pay the debt, to bid in the property for himself and have the amount of his bid credited on the mortgage debt; in other words (aside from the right to a deficiency judgment), the mortgagee has traditionally had an optional right either to the proceeds of a fair competitive public sale, or to the property itself.⁴⁰ As to the right of the mortgagor to have the property for the amount of the debt, this is so generally familiar as to require no exposition here.

The mortgagee's alternative right to the proceeds of a fair competitive public sale was protected by various measures designed to prevent the property from selling for less than its fair value. Both where the sale was conducted by the mortgagee under power, and where it was sold by the court in a foreclosure suit, the value of the property came to be protected, first, by redemption; second, by valuing the property; third, by "opening" bids, i.e. setting them aside; fourth, by providing in the decree a "reserved bidding" or a "reserved price" (i.e. an upset price). In the first half of the eighteenth century, biddings were

39. Although the courts have entertained constitutional attacks upon Section 77 and allied sections in the Bankruptcy Act, as yet this particular constitutional objection seems not to have been considered: *In re Chicago, R. I. & P. Ry. Co.*, 72 F. (2d) 443 (C. C. A. 7th, 1934) (involving Section 77); *In re Parmenter*, 70 F. (2d) 929 (C. C. A. 7th, 1934) and *In re Victor*, 70 F. (2d) 937 (C. C. A. 7th, 1934) (involving Section 74); *In re Ambassador Hotel Corp.* (memorandum opinion by Judge Woolsey, S. D. N. Y., June 28, 1934) (involving Section 77B); see, however, *Canada Southern Ry. Co. v. Gebhard*, 109 U. S. 527 (1883) discussed *infra* Part VIII.

40. It seems hardly practicable, under the writer's limitations of time and space, to labor here the distinction between right and remedy, on which so many constitutional decisions in this category have pivoted. It is at least sufficiently relevant to be borne in mind. But the premise that it is the invasion of rights which is effected by Section 77 seems (as will be seen in the discussion in Part VIII) to have been assumed by Chief Justice Waite in *Canada Southern Ry. Co. v. Gebhard*, 109 U. S. 527 (1883), and to have been implicit also in the views expressed in 1932 by the then Solicitor-General. In a brief and lucid review of cases and discussion of this distinction between right and remedy Judge Learned Hand recently translated it into degrees of invasion. See his opinion in *In re Inland Dredging Corporation*, 61 F. (2d) 765 (C. C. A. 2d. 1932). For a recent liberal-conservative application of the distinction see Chief Justice Hughes' opinion in *Home Building & Loan Association v. Blaisdell*, 290 U. S. 398 (1934).

opened for inadequacy of price where a higher bid was offered.⁴¹ Such precedents for safeguarding the price at public sale came early to be followed in America.⁴²

With the advent of the multiple-bond mortgage upon great railroad properties it became difficult to maintain the unitary mortgagee's ancient alternative right to either cash proceeds of a fair sale or to the property itself. In major railroad mortgage foreclosure sales, under conditions almost invariably met, there could be but one bidder for the property—namely, that one, representing the protective committees and the reorganization manager, who held the majority of outstanding mortgage bonds which could be credited at their par value on any bid he might make to acquire the property. Equity courts then came to employ the upset price (the antique “reserved bidding”) for affording to the dissenting bondholder—a fractional mortgagee—the equivalent of the first part of the mortgagee's old right, i.e. to the fractional proceeds of what would have been presumably a fair competitive sale had competition existed. Although circumstances (particularly the strategy of the reorganization group) have ordinarily led to upset prices being set which were substantially lower than what the capitalized earnings of the property have called for—still, Equity has in principle been trying to preserve the first alternative of the ancient option, namely, a fair price.⁴³ The equivalent of the other alternative, i.e. the right to the property itself, Equity in principle rescued and revived when it developed the procedure of subjecting to its own test of fairness the Plan of reorganization and its offer to the old bondholder of a fractional share in the properties, i.e. the securities in the new company.⁴⁴ Thus Equity has gradually been developing a technique for preserving in principle the old Anglo-American alternative right of the mortgagee either to the proceeds of a fair sale or to the property itself, although it must be said that until recently

41. In *Ryder v. Gower*, 6 Brown (P. C.) 148 (1766) this was done even months after confirmation of the sale. The safeguard in connection with a sale or a re-sale under a decree, of valuing the property and reserving a price in the decree, seems in the first part of the nineteenth century to have been a long established practice in English courts of equity. See 1 Jur. (O. S.) 525 (Rolls ct. 1837); *Ellis v. Deane*, [1847] Beatty Ch. Rep. 5 (Ireland, 1827); *Ex parte Ellis*, 3 Deac. & C. 297 (Westminster, 1833); *Ex parte The Commercial Bank of London*, 9 L. T. 782 (Bank. Ct., 18); *Wolff v. Vanderzee* 20 L. T. 353 (1853), citing 3 De Gex, Fisher & Jones 177, and 12 Vesey 495.

42. See *Williamson v. Dale*, 3 Johns. 290 (N. Y., 1818); *Forman v. Hunt*, 3 Dana 614 (Ky., 1835).

43. See Weiner, *Conflicting Functions of the Upset Price in a Corporate Reorganization* (1927) 27 COL. L. REV. 132.

44. See Bonbright and Bergerman, *Two Rival Theories of Priority Rights of Security Holders In a Corporate Reorganization* (1928) 28 COL. L. REV. 127; Swaine, *supra* note 39; Payne, *Fair and Equitable Plans of Corporate Reorganization* (1933) 20 VA. L. REV. 37.

the progress of this principle has fluctuated and that it has been frequently obscured in actual practice.⁴⁵

Under Section 77 a Plan, after being accepted by two-thirds of a class of bondholders, may be approved by the Commission, and confirmed by the Court. That Plan may allot securities to the minority non-assenting bondholder and may withhold from him, as an alternative to the allotted securities, all right to cash whether from a sale or otherwise.

If these allotted securities be readily marketable, this fact may well be sufficient to answer the contention that the cutting off of this ancient alternative right to cash constitutes a taking of his property without due process. The old bondholder has received a new bond readily saleable in the stock market. Thus he may exercise, not in court but in his office, as between a telephonic selling order to his broker and the use of his safety-box, the bondholder's old option between the proceeds and

45. Equity's struggle of the past fifty years or more to achieve protection for the minority bondholder equivalent to that accorded the unitary mortgagee has resulted in principles thus far often frustrated in practice. The old unitary mortgagee had the actual choice between price and property. In Equity procedure the railroad bondholder seldom in the past has been given by the court any such a choice of rights, because the upset price has been usually named in the decree of sale, whereas such courts as developed a concern as to the Plan have ordinarily postponed until after the sale their examination of it and their decision as to its fairness. The first clear decision in any circuit that the Court's examination of the Plan must precede the entry of the decree of sale was in *Habirshaw Co. v. Habirshaw Co.*, 296 Fed. 875 (C. C. A. 2d, 1924). The upset price fixed by the decree, generally set in disregard of earning value at a figure suggested by the reorganizers, was nearly always so low that the bondholders, confronted also with the deadline dates and penalties advertised by the reorganizers, were driven into depositing their bonds under the Plan irrespective of what might be its unfairness. Then, (due partly to the conditions just mentioned) when by skillful timing the successful bidder's motion to confirm the sale was made, weeks or months later, the Plan had gained such an impetus and such a large proportion of consents (whether free or coerced), that the decimated minority could hardly have fair conditions under which to present such objections to it as might be legitimate. By that time the momentum of the Plan, and the difficulties incident to disturbing it have been such that only a judge with a specially acute financial brain and uncommon courage would disapprove it. The battles in the courts against these tactics, showing a general up-hill advance in standards, have been thoroughly surveyed in various law journal articles, some of which are cited in notes 43 and 44, *supra*. Fortunately, as late as May, 1933, the standard of fairness to be observed in the formulation of the Plan has received at last a definite elevation and clarity from the opinion of Mr. Justice Brandeis in *National Surety Co. v. Coriell*, 289 U. S. 426, 435 (1933), where he said: "The non-assenting creditors were entitled to have the plan and their objections considered in an orderly way, and to a decree based on adequate data," which means that in an Equity proceeding the Court must before entering a decree of sale determine upon the fairness of the Plan in the light of the fullest financial and other information. There has been a slow upthrust of justice through much accumulated wrong; but a comprehensive reform of reorganization procedure calls for protection at far more points than the Supreme Court has been able to supply it within the range of opportunity thus far afforded.

the property; in other words, this bondholder still has both of his ancient rights.⁴⁶

But suppose, even under a plan which eliminates the stockholder, the new securities be offered to the bondholder with restrictions on his right of sale, or that they be not marketable or that the bondholder be offered nothing at all under the Plan. Then the old right to cash on a fair basis has been indeed cut off by Section 77. If the due process question were properly raised, as to Section 77's coercion into such a Plan of a non-assenting bondholder group of less than one-third of the class, much force would have to be allowed to the answering contention that the safeguards to the non-assenting bondholder provided by statute through the hearings before the Commission and the Court on the fairness of the Plan, and the approval by the former and confirmation by the latter, are the full equivalent of such protection as the traditional process of Anglo-American law has generally in actuality yielded to the unitary mortgagee; but it should perhaps be said that, where a Plan which excludes the stockholder yields only a non-marketable security to the minority non-assentor, the statute would be more apt to be upheld if it were to provide, at some point, the alternative right of cash payment for the non-assentors' old securities on the basis of an appraisal.⁴⁷

46. For a case where receipt of marketable securities was held to be the equivalent of cash, see *Geddes v. Anaconda Mining Co.*, 254 U. S. 590, 598 (1921).

47. No real discussion of Section 77 from the constitutional side can omit to mention that a question might well be raised as to whether or not, in its provision for the Commission's and Court's respective functions in sanctioning the Plan, Section 77 has created an unconstitutional encroachment on the Judiciary in violation of the division of powers, which, besides being a source of working friction, could aggravate the seriousness of the due process questions here considered.

Subdivisions (d), (e) and (f) provide that when the Commission shall have arrived at its approval of a Plan, "the Commission shall thereupon certify the Plan to the Court together with its approval thereof; . . . and that no Plan of reorganization shall be confirmed (by the Court) in any proceeding under this section except upon the approval of the Interstate Commerce Commission certified to the Court." There are these further features: In Subdivision (d) the Commission is directed, in initially recommending a Plan or in finally approving it for confirmation to the Court, to find among other things, that it "will in its opinion be equitable, will not discriminate unfairly in favor of any class of creditors or stockholders . . . and will be compatible with the public interest." As to the Court's function, Subdivision (g) directs that the judge shall confirm the Plan if satisfied as to this point, among others: that the Plan approved by the Commission "is equitable and does not discriminate unfairly in favor of any class of creditors or stockholders"; and the judge is not required by (g) to be satisfied, as must the dominant Commission, that the Plan "will be compatible with the public interest." Section (h)'s provision that "in the event that the Judge should disapprove the Plan he shall file an opinion stating his reasons therefor" indicates that he can stop the Commission's Plan; but, unless the phrase "except upon the approval of the Interstate Commerce Commission" in Subdivision (f) can be

VII

DUE PROCESS AND THE STOCKHOLDER'S NEW POWER OVER THE
BONDHOLDERS

Enough has been said to indicate that Section 77's coercion of the minority non-assenting bondholder into the Plan at the hands of the

construed away, or unless a right of judicial review can be so read into the statute as to check its seeming result, the circumstance remains that the Commission can also stop any Plan of the Court. And this might occur even though the basis of the Court's divergent view may be, for instance, its opinion as to the proper construction or effect of after-acquired property clauses, or of some other contractual provisions in the indentures of opposing mortgage trustees; or its application of the trust fund doctrine or of the due process test to the rights of the parties in interest. It is difficult to say how far, if at all, the constitutional problem of encroachment is reduced by the provision in Clause 7 of Subdivision (c) which apparently enables the judge to dismiss the proceeding on his own motion, "if a plan of reorganization is not proposed or accepted, or, if proposed and accepted, is not confirmed within such reasonable time as the judge may . . . allow." In theory this permits the judge in a case of conflict to avoid dictation by the Commission through the device of dismissing the proceeding. But is not the judge seriously constrained by being relegated to such a radical step as throwing out the entire proceeding in order to avoid the Commission's dominance? To be encroachment must there be total eclipse?

This question might turn on the contention that, under its express bankruptcy power, Congress is free to vest the entire function of reorganization, as part of that power, exclusively in a legislative body instead of in the judiciary. One answer to this might be that under 34 & 35 HEN. VIII (1543), the powers later vested in bankruptcy commissioners were exercised by the Lord Chancellor, who thereafter seems always to have had the power of appointing and removing commissioners; that under 5 GEO. II (1732) c. 30, in his general functions, the Commissioner acted essentially as official agent of the majority of unsecured creditors, and that the judges had direct control of such major matters as the bankrupt's conduct, warrants for his apprehension, his imprisonment by the commissioner for non-conformity if challenged by habeas corpus, and confirmation of his discharge; that by 12 GEO. III (1772) c. 47 and 16 GEO. III (1776) c. 47, the Chancellor's power to grant discharges over objections by unsecured creditors was extended; and that the United States Bankruptcy Act of 1800 at once vested in the District Courts the general power of the English Chancellors, a power since steadily extended. So it may well be contended that the division of powers, so far as the express power of bankruptcy is concerned, was fixed in 1787, or at any rate in 1800; and there is some room for the doubt as to whether the line of cleavage, if so made, may be ignored as Section 77 apparently would do. For the status of this indispensable body of experts, the Commission, as "quasi-judicial," although derivatively legislative, see: *Terminal Railroad Ass'n v. United States*, 266 U. S. 17 (1924); *Dayton Goose Creek Ry. Co. v. United States*, 263 U. S. 456 (1924); *Baer Bros. Mercantile Co. v. D. & R. G. Rr.*, 233 U. S. 479 (1914); I. L. SHARFMAN, *THE INTERSTATE COMMERCE COMMISSION* (N. Y. Commonwealth Fund, 1931) c. X; WILLOUGHBY, *CONSTITUTION OF THE UNITED STATES* (2d ed., 1929) 299-357. For a most enlightening conspectus of the entire philosophy of the constitutional relation between the federal judiciary and administrative bodies see *Crowell, Deputy Comm'r, v. Benson*, 285 U. S. 22 (1932) (majority opinion by Mr. Chief Justice Hughes, dissent by Mr. Justice Brandeis comprehensively annotated, and able briefs by the Solicitor-General and opposing counsel). Whether in amending Section 77 or in reforming Equity procedure, it seems that the proper line of division of powers needs to be re-surveyed, and that Congress can well afford from the practical viewpoint to observe that line, especially because of the ascendancy of the Commission in its field.

majority of his class could give rise to a serious due process contention; and also to indicate what seems the most reasonable answer to it. But a far more serious question of due process seems to be raised by the unprecedented power given by Section 77 to the stockholder over the reorganization, not only contrary to the trust fund principle as developed by the Supreme Court in the interest of all creditors,⁴⁸ but also inconsistently with the Anglo-American traditional exclusive right of a secured creditor to the whole value in his security until his debt be paid. The test would come especially, where a non-assenting minority creditor would be forced by the Act to accept securities under a Plan negotiated between the majority and the stockholders.

Essentially, the stockholder is collectively the mortgagor, who for centuries has had his equity of redemption, to which the mortgagee's rights have always been subject. But, as specially pointed out above in Part V, Section 77 gives the stockholder a new power in reorganization; and the question then may come as to whether this is such a retroactive impairment of the mortgagee's rights as to violate the due process requirement. The bondholders in their plan must take care of non-assenting stockholders of one-third or more, unless it can be established that the Plan adequately safeguards their rights; or unless the bondholders can establish to the Court's satisfaction that the plan does not adversely affect the stockholders, or that the company has accepted the plan, or that the company is insolvent.

That insolvency, under the precedents of bankruptcy law, is difficult to prove is such a truism as to justify little discussion here. In clause 15 of Section 1 of the Bankruptcy Act of 1898 it is provided that "a person shall be deemed insolvent . . . whenever the aggregate of his property . . . shall not, at a fair valuation, be sufficient to pay his debts." Professor Bonbright, in his usual discerning and realistic way, undertook a few years ago to evolve from decided cases, both state and federal, relating to bankruptcy, some consistent theory of valuation in connection with determination of solvency.⁴⁹ His impression from the federal bankruptcy cases apparently was that, even where market value is available as a criterion, the courts do not make use of it, and that they constantly tend to base their determination upon cost. If this is correct in connection with property, such as urban real estate, so variously available as practically always to command some sort of a market, how much more certainly true would it be as to railroad property, for which there is never a market but always just one

48. See Part V, *supra*.

49. Bonbright and Pickett, *Valuation To Determine Solvency Under The Bankruptcy Act* (1929) 29 Col. L. Rev. 582.

possible purchaser? If any case under Section 77 should come to the point where solvency is to be determined by the court, it is believed strongly probable that the courts will adhere to the cost principle as the prime factor in valuation. This probability is particularly supported by the consideration that the federal decisions have been in the main consistent in requiring that valuation shall under no circumstances be determined on the basis of the probable price at a forced sale, whether public or private, but shall be estimated in terms of a "free" sale, that is, a sale "between one who wants to purchase and one who wants to sell the property."⁵⁰

In the light of this fixed method for determining value under the bankruptcy statutes, it is suggested, for immediate clarification, that if Section 77 is to be retained, it should be either amended to give special statutory meaning to "insolvency" as there used, or there should be an elimination from it of the requirement on the creditors to prove insolvency, and a condition less onerous be substituted for enabling creditors to avoid coercion from the stockholders.⁵¹

As things now stand, unless the Commission will take the responsibility of finding that the property is hopelessly impaired and eventual recovery of its earning power an impossibility, the stockholders are apt to have the right either to cause the property to be put up for sale at an upset price to be determined by the Commission, or to demand payment for their old stock, or for the new stock allocable to them under the Plan, at such value as appraisals by the Commission shall determine. And in its setting of an upset price, or in its appraisal of the value of

50. *Grandison v. Nat. Bank of Commerce*, 231 Fed. 800, 804 (C. C. A. 2d, 1916). See 4 REMINGTON ON BANKRUPTCY (1923) § 1747-1750; *In re Kassel*, 195 Fed. 492 (C. C. A. 2d, 1912); *Abdo v. Townshend*, 282 Fed. 476 (C. C. A. 4th, 1922); *Huttig Mfg. Co. v. Edwards*, 160 Fed. 619 (C. C. A. 8th, 1908); *In re Foley*, 140 Fed. 300 (E. D. Pa. 1905); *Boone v. Merchants' & Farmers' Bank*, 285 Fed. 183 (E. D. N. C. 1922); *In re Cleveland Discount Co.*, 9 F. (2d) 97 (D. C. Ohio 1924).

In the Section 77 *Frisco* proceeding in the Federal District Court at St. Louis, the Commission has made a serious attempt to bring about a determination as to the solvency of the debtor and has, thus far, failed. Pursuant to an order, issued on July 24, 1934, from Division 4 of the Commission, an application was made to the court by its counsel, to determine "whether or not the St. Louis-San Francisco Railway Company is insolvent." The matter was set down for hearing before the Special Master on October 15th; counsel duly attended in St. Louis; and determination as to insolvency was postponed presumably until the Spring of 1935. Perhaps counsel for bondholders, in acquiescing in this turn of affairs, were at least partly motivated by the apprehension that the court would adhere to a value primarily based upon costs, which might force the bondholders to deal with the stockholders as to a Plan, on the assumption of an artificial solvency.

51. Incidentally, it is extremely difficult to foresee on what other misfit bankruptcy precedents a Section 77 proceeding could still be impaled—precedents which were evolved by courts during centuries of winding up the affairs of small tradesmen, and which would now obscure or obstruct the reorganization of vast transportation systems.

securities, what test of value will the Commission employ? In the absence of statutory guidance, would it be affected by the criteria of value as established by the Supreme Court under the Valuation Act of 1913,⁵² under the recapture clause of the Transportation Act of 1920,⁵³ and under the Consolidations Law of 1921, (Section 5 of the Interstate Commerce Act),⁵⁴ all of which to a greater or less extent, expressly direct or permit cost, and even reproduction cost, to enter into the valuation figure? In determining value under all three of these categories, namely, (1) for ratemaking purposes and in connection with the issue of "confiscation"; (2) for ascertaining a "fair return" as a basis for recapture of earnings; and (3) for authorizing two or more carriers to consolidate—the Commission is, by the express terms and fundamental policy of the statutes, required to give consideration to costs, both original and of reproduction. Against these definite statutory standards, the Commission's persevering attempts to develop, particularly in the Section 5 cases, a rational "commercial value" which veers away from cost, could not be expected to make more than limited headway in the the cases handled by it under these three powers.⁵⁵

However, in surmising how the Commission will determine value under Section 77, in fixing upset prices, or in making appraisals, without the guidance of any expressly imposed statutory standard, we have its action in another class of cases from which inferences may well be drawn. Under Section 20a of the Transportation Act of 1920, proposed new issues by carriers of securities, and of certain other classes of obligation proposed to be issued by carriers must have the Commission's authority. To grant such authority, the Commission must, among other things, find the object of such issuance to be lawful, compatible with the public interest, and necessary and appropriate; but the Commission is not required to test the soundness of the carrier's proposed new obligations in terms of the value of its property. Thus there was no obstacle to prevent the Commission's striking out a new path for itself and concerning itself with earning power, present and reasonably prospective, as the sole, or at least the predominant, basis for approving the new obligations. Yet, on several occasions, in these Section 20a cases, the Commission has followed its ingrained habit of searching into costs. The

52. 37 STAT. 701 (1913), 49 U. S. C. A. § 19a (1926).

53. 41 STAT. 488-91 (1920), 49 U. S. C. A. § 15a (1926).

54. 41 STAT. 480 et seq. (1920), 49 U. S. C. A. § 5 (1926).

55. Selected cases illustrating the Commission's varying development of "commercial value" in Section 5 cases are: re New York Central Unification, 150 I. C. C. 273 (1929), 154 I. C. C. 489 (1929); New York Central Acquisition of Ulster & Delaware Rr. Co., 175 I. C. C. 65 (1931); Alton Railroad Acquisition, 175 I. C. C. 301 (1931); Boyne City, Gaylord & Alpena, 180 I. C. C. 538 (1932); Ft. Worth Belt Control, 187 I. C. C. 88 (1932).

outstanding case is that of the Chicago, Milwaukee and St. Paul reorganization.⁵⁶ The majority opinion acceded to the figure of \$640,000,000 as the value of the properties in connection with the securities approved by it for issuance. Commissioner Eastman, dissenting, pointed out that this figure had been found on the basis employed by the Commission in *Re Excess Income of St. Louis and O'Fallon Railway Company*.⁵⁷ Commissioner Lewis in his separate dissent, urging a much lower valuation, said in part: "However, an 'O'Fallon value' would be only for purposes of rate making and recapture;"⁵⁸ and "What can be accepted as a sound basis of value for reorganization purposes? . . . The answer to the question of what is a reasonable guide in this instance seems to lie in earning power, . . ."⁵⁹

In view of this marked tendency of the Commission, even when free from any statutory constraint, to emphasize costs and to depart from capitalized earning power as the predominantly determining factor in valuation, the Commission may well be expected in fixing upset prices or appraising securities under Section 77, to be unduly influenced by costs.⁶⁰ This would be particularly probable in view of the major motive of Section 77, which apparently is to rescue stock equities.

In the case of an upset price, at no matter what figure, the stockholders, bidding against creditors who can apply their debts against the price they may bid, must themselves offer enough to "bail out" the creditors, and then raise the cash for operating the property. Naturally they would avoid such a course and would choose instead to follow the alternative offered by Subdivisions (e) and (g), i.e. receiving cash for their appraised interest, since, instead of putting up cash, they would receive cash, and on the Commission's appraisal, which, partic-

56. 131 I. C. C. 673 (1928).

57. 124 I. C. C. 3 (1927).

58. 133 I. C. C. 673, 714 (1928).

59. *Id.* at 715. The Commission's regard for physical valuation data even when without statutory constraint is further shown by its decisions on RFC loans. See *Hearings on H. R. 7116 and 7117*, 72d Cong., 1st Sess. (1932) 544; MOULTON, *op cit. supra* note 5, at 416.

60. For an arresting objective view of our American thinking on value, see *Grand Trunk Railway of Canada v. Regem*, 92 L. J. 57 (P. C. 1922). Former President Taft was one of a statutory tribunal of three which was to determine the value of the stock of the Grand Trunk Railway of Canada with a view to the acquisition of that system by the Government. The majority of two having decided that the value of the stock should be ascertained on the basis of the property's actual and potential net earning capacity as capitalized, and that on this basis the stock had no value, Mr. Taft, dissenting, reported the value of the stock to be over \$40,000,000 basing this finding upon "the value of the physical assets." In his review of the minority report the Lord Chancellor stated that the majority had been "justified in refusing to embark upon an inquiry (as to selling value or replacement cost) which . . . would have had no legitimate bearing on the question which they had to determine."

ularly if based in part on "physical value," would be as advantageous to the stockholder as it would be burdensome to the bondholder. Thus, as matters stand today, where there is an actual or potential non-assenting stockholder group of one-third or more, Subdivision (g) apparently catches the bondholder in the nutcracker. On the one hand, he is likely to be forced to provide for the stockholder under the Plan because of the bankruptcy courts' arbitrary standard for determining value as the price at an imaginary free sale. And, on the other hand, the bondholder in buying out the stockholder will probably be required to pay in terms of a standard of value based by the Commission to a substantial extent on "physical value" instead of on capitalized earnings. It seems fair to conclude that, when holding such an advantage as this, the stockholder can force a hard bargain upon the bondholder in connection with the Plan. His demands may be too strong to be met even by bondholders faced with the alternative of a deadlock, and a dismissal by the court of the Section 77 proceedings. But we must test Section 77 as producing a Plan evolved under such conditions.

And this brings us back to due process. Disregarding the fundamental trust fund doctrine as developed consistently by the Supreme Court,⁶¹ Section 77 undertakes so to operate on the rights of bondholders under the mortgage as to force them as secured creditors to surrender a substantial part of their security to the stockholder. This result was motivated perhaps by emergency considerations and for that reason there should be an open-minded approach to it. Yet it can cut deeply into the rights of creditors, particularly non-assenting minority bondholders, where the two-thirds majority has reached an agreement with stockholders on a Plan. Novel stockholders' rights can thus be created which go so far beyond the mortgagor's old Anglo-American right of redemption, as seemingly to present a serious due process question for disposal.

In a case where the Plan would provide substantially for stockholders, the requirements of due process seem definitely to suggest for the minority non-assentor at some point in the proceedings, the ancient free choice between price and property, i.e., cash and securities. In order to make a free choice between two objects, the chooser must simultaneously know both. The preservation of this optional right could be accomplished under Section 77 if it were amended so that, after the Court's confirmation of the Plan, it would refer to the commission the appraisal of the non-assenting bondholder's old interest, and would provide for him a final opportunity to choose between cash and the securities which the Plan offers to him. But it is suggested that even such provision for the non-assentor might be held insufficient to validate the statute,

61. See Part V, *supra*.

if the security offered to him under the Plan should be found by the Court to represent an unfairly small share in the property.

VIII

THE DUE PROCESS RESTRICTION AS A SAFEGUARD TO THE BONDHOLDER AGAINST CONGRESS' EXERCISE OF ITS BANKRUPTCY POWER

The questions of due process just stated now serve to focus our attention upon Chief Justice Waite's opinion in *Canada Southern Railway Company v. Gebhard*,⁶² decided at the October 1883 term. That opinion contains language which has been understood by some as sanctioning, at any rate by dictum, a federal bankruptcy statute which would force a non-assenting minority into a plan, as does Section 77. In fact, the favorable action on Section 77, first by the committees and later by both houses of Congress, was apparently based largely upon the written opinion of the then Solicitor-General who, in turn, had based his assurance of the constitutionality of legislation of this kind upon certain selected language from Chief Justice Waite's opinion.

In *Canada Southern Railway Company v. Gebhard*, the mortgage was on a railroad property owned by a Canadian company and wholly located in Canada. The trustee and paying agent under it was a New York bank; and the plaintiff in error, a citizen and resident of the State of New York who had dissented from a reorganization, had tendered the coupons of the old bonds for payment to the paying agent, and had instead been offered securities in the new company. In Canada the statutory policy of the British Parliament had existed long prior to the date of the mortgage, of confirming reorganization "arrangements" where consent to them had been given by a substantial proportion of bondholders;⁶³ and as found by the Court, all powers of

62. 109 U. S. 527 (1883).

63. Largely, perhaps, because of the relatively favorable ratio in England between traffic density and capital investment, and the consequently lower coefficient of risk, the English investor has been willing to lend without security to English private railroad enterprise. A concrete and typical sample of the English railway debenture bond itself is to be found reproduced in *Bowen v. Brecon Railway Co.*, L. R. 3 Eq. 541 (1867). The status of the obligation is determined by the Act of 30 & 31 Vict. (1867) c. 127; see also 23 HALSBURY'S LAWS OF ENGLAND (1907) 631-634. The English decisions have fully established that not only does the English debenture bond have no lien upon the real property of the railway, but that it has not even a lien upon its personal property or earnings until after the company shall have gone into the hands of a receiver under the "Arrangements Act." See *In re Hull, Barnsley and West Riding Junction Railway Co.*, 40 Ch. D. 119 (1888); also *re Liskeard & Caradon Railway* [1903] 2 Ch. 681. In 1 LINDLEY ON COMPANIES (6th ed. 1902) 345, the author says that the priority clause in an English railway debenture bond does not even preclude an ordinary judgment creditor

the British Parliament for the purposes of the case, had passed to the Canadian Parliament. Mr. Choate, in his brief for the plaintiff in error, quoted the statement of Dwarris that "the authority of the English Parliament in the enactment of law has no bounds, it is transcendant, it is possessed of sovereign and uncontrollable power . . . The validity of an act of Parliament cannot be drawn in question by the Judicial Department"; in other words, that Parliament knows no due process, or any other restriction, upon its powers.

Following are excerpts from Chief Justice Waite's opinion (our italics) in which the Court's majority held the non-assenting bondholder bound by the reorganization plan as so sanctioned under Canadian law:

"Two questions are presented for our consideration: 1. Whether the 'Arrangement Act' is valid in Canada, and had the effect of binding non-assenting bondholders within the Dominion by the terms of the Scheme; and 2. Whether, if it did have that effect in Canada, the courts of the United States should give it the same effect as against citizens of the United States whose rights accrued before its passage.

"1. There is no constitutional prohibition in Canada against the passage of laws impairing the obligation of contracts, and the Parliament of the Dominion had, in 1878, exclusive legislative authority over the corporation and the general subjects of bankruptcy and insolvency in that jurisdiction. As to all matters within its authority, the Dominion Parliament has 'plenary legislative powers as large and of the same nature as those of the imperial parliament. . .'" (Page 532)

* * *

"In the absence of statutory authority or some provision in the instrument which establishes the trust, nothing can be done by a majority, however large, which will bind a minority without their consent. *Hence it seems to be eminently proper that where the legislative power exists, some statutory provision should be made for binding the minority in a reasonable way by the will of the majority; and unless, as is the case in the States of the United States, the passage of laws impairing the obligation of contracts is forbidden, we see no good reason why such provision may not be made in respect to existing as well as prospective obligations.* (Page 535)

* * *

"The confirmation and legalization of 'a scheme of arrangement' under such circumstances,* is no more than is done in bankruptcy when a 'composition'

from obtaining a sale of surplus lands and payment out of their proceeds in priority to debenture bondholders.

In other words, the British contract is an unsecured promise to pay, made subject to the limitations of the "Arrangements Act"; while the American contract is a promise secured by a mortgage of real property, a mortgage guaranteed for its integrity by the common law system.

agreement with the bankrupt debtor, if assented to by the required majority of creditors, is made binding on the non-assenting minority. In no just sense do such governmental regulations deprive a person of his property without due process of law. They simply require each individual to so conduct himself for the general good as not unnecessarily to injure another. Bankrupt laws have been in force in England for more than three centuries, and they had their origin in the Roman law. The Constitution expressly empowers the Congress of the United States to establish such laws. Every member of a political community must necessarily part with some of the rights which, as an individual, not affected by his relation to others, he might have retained. Such concessions make up the consideration he gives for the obligation of the body politic to protect him in life, liberty, and property. Bankrupt laws, whatever may be the form they assume, are of that character. (Page 536)

* * *

"Whatever disabilities are placed upon the corporation at home it retains abroad, and whatever legislative control it is subjected to at home must be recognized and submitted to by those who deal with it elsewhere. (Page 537)

* * *

"It follows, therefore, that anything done at the legal home of the corporation, under the authority of such laws, which discharges it from liability there, discharges it everywhere. (Page 538)

* * *

"The Dominion parliament had the legislative power to legalize the plan of adjustment as it had been agreed on by the majority of those interested, and to bind the resident minority creditors by its terms. This power was known and recognized throughout the Dominion when the Corporation was created, and when all its bonds were executed and put on the market and sold. It is in accordance with and part of the policy of the English and Canadian Governments in dealing with embarrassed and insolvent railway companies and in providing for their reorganization in the interest of all concerned. It takes the place in England and Canada of foreclosure sales in the United States, which in general accomplish substantially the same result with more expense and greater delay; for it rarely happens in the United States that foreclosures of railway mortgages are anything else than the machinery by which arrangements between the creditors and other parties in interest are carried into effect, and a reorganization of the affairs of the corporation under a new name brought about. It is in entire harmony with the spirit of bankrupt laws, the binding force of which, upon those who are subject to the jurisdiction, is recognized by all civilized nations. It is not in conflict with the Constitution of the United States, which, although prohibiting States from passing laws impairing the obligation of contracts, allows Congress 'to establish . . . uniform laws on the subject of bankruptcy throughout the United States.' (Pages 538-9)

"Unless all parties in interest, wherever they reside, can be bound by the arrangement which it is sought to have legalized the scheme may fail. All home creditors can be bound. What is needed is to bind those who are abroad.

Under these circumstances the true spirit of international comity requires that schemes of this character, legalized at home, should be recognized in other countries." (Page 539)

Thus the Supreme Court seems to have assumed that a minority dissenting holder of bonds under a mortgage on property in the United States could not be constitutionally forced into a plan of reorganization by any domestic statute which would impair the obligation of the contract, and the Court's decision in *Canada Southern Railway Company v. Gebhard* was based squarely upon comity alone.

Yet the two paragraphs quoted above from page 536 and from pages 538-9 of Chief Justice Waite's opinion have been used as if they were authority for Section 77's constitutionality, and for that reason they must be reckoned with, whether as dictum or otherwise. What was his meaning? An obvious explanation which seems to account fully for the first paragraph, and at least largely for the second, is this: A fundamental consideration for a court, when deciding whether or not comity shall move it to recognize and enforce a foreign law invoked against a resident, is whether the foreign law is against public policy or morality as conceived in the forum. Chief Justice Waite had pointed out, in the passage quoted from page 532, that such a statute in America would impair the obligation of the minority bondholder's contract, and in the *Sinking Fund Cases* the Supreme Court through Justice Waite,⁶⁴ himself representing the Court's majority, and through Justice Bradley,⁶⁵ speaking for the dissenting minority, had declared that contract impairment may be the gravamen in a due process violation. It was then logical (as did the Chief Justice's language, page 536) to lay the basis for the operation of comity by pointing out that, although an American statute like the Canadian one would be unconstitutional here as working an impairment of contract obligations, it would nevertheless not be against the general public policy as expressed in bankruptcy laws which for three centuries have called upon the individual to part with some of his rights.

But the following later language of the Chief Justice in the *Canada Southern Case* on page 539 does not seem wholly to lend itself to this explanation: "It [the Canadian statute] is not in conflict with the Constitution of the United States, which, although prohibiting States from passing laws impairing the obligation of contracts, allows Congress 'to establish...uniform laws on the subject of bankruptcy through the United States.'" This sentence taken out of its context and standing alone, and even to a lesser extent in its environment, can reasonably be said to

64. *Union Pacific Ry. Co. v. United States*, 99 U. S. 700 (1878).

65. *Central Pacific Rr. Co. v. Gallatin*, 99 U. S. 700 (1878).

be tantamount to the Court's suggesting (by way of mere dictum it is true) that Congress in a bankruptcy statute could validly force the minority bondholder into a Plan. If intended as such dictum its force is somewhat weakened by the Supreme Court's declaration four years previously through Chief Justice Waite himself in the *Sinking Fund Cases*⁶⁶ that impairment by Congress of a contract obligation may constitute a violation of the due process restriction in the Fifth Amendment; and is weakened further by the Court's later development of the "trust fund" doctrine for safeguarding all creditors in reorganization, which doctrine is impliedly written into every obligation held by a creditor.

Yet even if so discounted, Chief Justice Waite's dictum must still be reckoned with, and for this reason: The Solicitor-General on June 17, 1932, transmitted a memorandum to the Senate in the first Session of the 72nd Congress in connection with pending predecessors to H. R. 14,359—the intermediate, and almost final, vehicle of Section 77. In the predecessor bills, Section 76 relating to corporate reorganizations was the section which raised this same question of due process now raised by Section 77. Later, in February 1933, at the Second Session, when H. R. 14,359 was being reported upon favorably to House and to Senate (without any public hearing having been held) this memorandum of the Solicitor-General was expressly referred to as a source of reliance of the two reporting committees.⁶⁷ In his memorandum the then Solicitor-General, quoting authority, argued, among other things, that, although the proposed statute contemplated cutting down and reorganizing the obligations of debtors neither insolvent nor bankrupt, it would still be a law "on the subject of bankruptcies" as provided by the Constitution; that bankruptcy laws are constitutionally permitted to invade private rights further than other laws and "*that the power of Congress over the relations of debtors and creditors is unlimited by the Constitution, except for the requirement that laws on the subject must be uniform.*" In the concluding part of his memorandum the Solicitor-General dealt with the provision for corporate reorganizations (Section 76) and discussed its constitutionality as it affected both the minority stockholder and the minority bondholder. In this connection he quoted in full from Chief Justice Waite's opinion in *Canada Southern Railway Company v. Gebhard*⁶⁸ the two paragraphs also quoted above from pages 536 and 538-9, and then concluded: "The proposed Section 76 is in entire harmony with the view of the United States Supreme Court as to the nature of bankruptcy laws."

66. *Supra* notes 64, 65.

67. SEN. Doc. No. 1215, 72d Cong., 2d Sess. (1933), to which the Solicitor-General's memorandum was attached as Exhibit A.

Having apparently accepted such premises as the above with regard to the unlimited constitutional power of Congress while dealing with "the subject of bankruptcies," it is natural enough that the then Solicitor-General should have accorded such force as he did to Chief Justice Waite's dictum. But these premises are certainly open to question in view of the fact that the Supreme Court seems never to have disclaimed jurisdiction for scrutinizing bankruptcy statutes for their compliance with constitutional requirements. On the contrary, in the very Supreme Court case, *Hanover National Bank v. Moyses*,⁶⁸ reviewed at length by the Solicitor-General in his memorandum to the Senate, the Court considered at length an attack on the Bankruptcy Act on the score of due process, saying in part on page 192: "Congress may prescribe any regulations concerning discharge in bankruptcy that are not so grossly unreasonable as to be incompatible with fundamental law, and we can not find anything in this Act on that subject which would justify us in overthrowing it." So that it is erroneous to suggest (as Chief Justice Waite has been understood to do in his remarks in the *Canada Southern Case*), that the exercise by Congress of its bankruptcy power is immune from the due process requirement. If bankruptcy laws were not restricted by constitutional limitations, then why should the courts repeatedly have entertained constitutional attacks upon them?⁶⁹ So it seems that we must find that Congress, in the exercise of its bankruptcy power must satisfy due process; must, in dealing with corporate reorganization, preserve, whether in bankruptcy or in equity, such safeguards, or the equivalents of such safeguards, for the protection of the rights of a secured creditor, as the settled maxims of Anglo-American law require.

We shall therefore simply adopt as our premise that Congress, in pursuing any and all of its powers must observe the limitations of due process as ascertained by the Court in connection with the exercise of the power being tested; or, in other words, to use the language of Story, that . . . "due process of law in each particular case means such an exertion of the powers of government as the settled maxims of the law permit and sanction, and under such safeguards for the protection of individual rights as those maxims prescribe for the class of cases to which the one being dealt with belongs."⁷⁰ In the "particular case" of Section

68. 186 U. S. 181 (1902).

69. *Hanover National Bank v. Moyses*, 186 U. S. 181 (1902); *In re Klein*, 14 Fed. Cas. No. 7,865, p. 716 (1843) [also reported in 1 How. 277 N. (U. S. 1842)]; *In re Reiman*, 20 Fed. Cas. No. 11,673, p. 490 (S. D. N. Y. 1874); and note 39 *supra*.

70. 2 STORY, CONSTITUTION OF THE UNITED STATES (4th ed. 1873) 665. In *Tumey v. Ohio*, 273 U. S. 510 (1927) Chief Justice Taft, referring, at page 523, to *Ownbey v. Morgan*, 256 U. S. 94 (1920), and to *Murray's Lessee v. Hoboken Land and Improvement Company*, 18 How. 272, 276-280 (U. S. 1855), said: "These cases show that, in determining what

77, as it would dispose of the rights of the holder of a bond issued under a mortgage on real estate in the United States, we shall inquire what the settled maxims of Anglo-American law do permit and sanction in disposing of the rights of a creditor secured by a mortgage, and what safeguards for his rights those maxims do prescribe. The answer, instead of requiring a detailed study here of all English bankruptcy laws beginning with those of Henry the Eighth, can for our purposes, be made in a few long strides spanning about 250 years.

An odd book printed in London in 1676 is "The Judges' Resolutions upon the Several Statutes Concerning Bankrupts" noted as being "by George Billingham of Grays-Inns, Esq." On pages 148-9 appears the following quaintly stated principle for guiding the Commissioners in Bankruptcy in performing the condition of the bankrupt's mortgage by paying off the mortgage creditor in full in order to obtain the mortgaged property for the estate:

"As to a condition, lands, goods, etc. of the Bankrupt, made over by him upon condition or power of Redemption the Commissioners before the time of the performance of the condition, may appoint under their hands and seals, such as they shall think fit to perform the condition; and after such performance, shall dispose of such lands or goods for the Creditor's advantage, as fully as of any other bankrupt estate. 21 Jac; Cap. 19 vid. devant Sec. (51)."

Eighty-four years later, in 1760, "The Solicitors Guide and Tradesman's Instructor Concerning Bankrupts" printed for J. Worrall at Dove in Bell-Yard near Lincoln's Inn, tells us at page 11 that "The Commissioners have Power to sell Lands mortgaged, on Tender and Payment of the mortgage money, 2 Rep. 25"; and at page 13 that "Mortgagees, or Persons that have a pledge of the Bankrupt's Goods, having Security for their Debts in their Hands, are not Creditors within the Statutes."

On April 4, 1800, was enacted our first national bankruptcy act in which at Section 63 it was provided "that nothing contained in this act shall be taken or construed, to invalidate or impair any lien existing at the date of this act, upon the lands or chattels of any person who may become a bankrupt."⁷¹

In the following year, 1801, Thomas Cooper published at Philadelphia "The Bankrupt Law of America compared with the Bankrupt Law of

due process of law is under the Fifth or Fourteenth Amendment, the Court must look to those settled usages and modes of proceeding existing in the common and statute law of England before the emigration of our ancestors, which were shown not to have been unsuited to their civil and political condition by having been acted on by them after the settlement of this country."

71. Passed April 4, 1800; repealed December 19, 1803.

England" in which he made the following abstracts of leading English cases under the English bankruptcy acts, (the titles or dates of the cases where in parentheses being of our insertion):

"When a creditor has a specific pledge (as a mortgage) not equal in value to the amount of his debt, and is desirous of coming in under the commission, he must get the pledge to be fairly and publicly sold with due notice and then he may be admitted creditor for the deficiency. *Ex Pte. Bennet 1 Atk. 528.*"⁷²

"Hence every creditor applying to prove should be called on for his security, that if he chooses to resort to the estate, the creditors may have the benefit of the remedy he has rejected. *Ex Pte. Grove. 1 Atk. 105. (1747) Ex Pte. Bennet 2 Atk. 528.*" (1743).

If there be a mortgage, and the mortgagee wishes to resort to the estate, he must get the mortgaged premises sold, and come in as a creditor for the deficiency. *4 Br. Ch. Cas. 548.*" (Uncaptioned Order, 1794)⁷³

It is unnecessary to trace the repetition of this fixed standard of justice through the sequence of our American bankruptcy statutes. The foregoing records of legal authority, sufficiently indicate that the settled maxims of three hundred years of Anglo-American bankruptcy laws safeguard the creditor who is secured by a mortgage from the debtor, by rigidly insuring to him exclusive right, not only as against the mortgagor, but also as against other creditors, to the full value of the mortgaged property, with the further right to prove with other creditors for any deficiency. It is of course true that impairment of the unsecured creditor's contract rights such as bankruptcy laws have traditionally effected incident to discharge of the debtor, could not be invoked as a violation of due process. In other words, in its exercise of its bankruptcy power, Congress encounters areas where it may validly invade property rights in ways prohibited to it in connection with the use of other powers. But we find that, from the outset, English bankruptcy laws protected the secured creditor as their favorite child in his exclusive right as against other creditors (and more certainly as against the bankrupt) to the proceeds of the mortgaged property to the extent necessary to recoup himself fully. If this is correct, then it would seem that there was no specially valid reason, even as a matter of expediency strictly from the viewpoint of the stock interest, for making a bankruptcy law the vehicle for effectuating and expediting railroad reorganization; and that any compulsion effected by Section 77 on the minority bondholder at the hands of the majority to force him to share his security with the stockholder, or for that matter, any subjection of the non-assenting minority bondholder directly to the majority, would be neither more nor

72. P. 186.

73. P. 266.

less valid through being carried in a bankruptcy statute, instead of in a law clarifying and expediting the Equity reorganization process.

IX

REFORMED AND EXPEDITED EQUITY PROCEDURE VERSUS AN AMENDED SECTION 77

The following conclusions, questions and courses of action are submitted for consideration.

1. Just now there is an immediate logical reason for the reform of the Equity process. Section 77 provides that every proceeding under it is tentative and shall fall into Equity if there should fail to develop the requisite concurrence between class majorities, the Commission and the Court. Does it not seem, then, to be sound policy in any case to effect a reform of Equity railroad reorganization procedure?

If amendment of Section 77 should undertake to eliminate the tentative character of procedure under it as an attempted composition, and to transform the proceeding into one which could end only in a final reorganization, then there are three questions which should be asked. If Section 77 shall have been so amended, is the jurisdiction of Equity courts in railroad reorganization to be abolished? If not, then what justification could there be for the maintenance of two distinct and parallel procedural systems for effecting railroad reorganization, both systems administered by identical judges subject to the one juridical hegemony of the Supreme Court? If Equity procedure is not to be abolished for reorganization of railroads, and if two paralleling systems are undesirable, then is it not the abolition of Section 77 which is indicated by sound public policy?

2. It is understood, of course, that many considerations of public policy, and, particularly, of political expediency must enter into the decision as to whether or not Section 77, invented by a former Administration, should be supplanted by a statutory reform of Equity procedure effected in this one. It is not contended that it would be impossible to amend Section 77 so thoroughly as perhaps to make it a workable makeshift for the emergency; in fact some of the remedial changes here suggested could well be fitted into it. But such an amendment of Section 77 would have to be so drastic as to work a complete transformation of it both as to theory and as to practice; and we should face now the results of this.

It is seldom profitable to patch up a mistake. To amend Section 77 so that, as a bankruptcy law it would have only such scope as could be had by a reformed Equity process, would make of Section 77 a misfit and would work a distortion of procedural functions which could be productive of much waste and confusion. There are unforeseeable points

at which the administration of such a new Section 77 could be obscured or obstructed by precedents in bankruptcy, the whole technique of which is geared by tradition to a winding-up of the affairs of small tradesmen by distribution of assets, composition and discharge. If there is now to be reform of the reorganization progress, why not let it be a logical reform of Equity procedure, which is flexible and readily adaptable for the purpose?

If by amendment there be removed from Section 77 the unworkable features and constitutional dangers discussed above, everything left remaining in Section 77 could, it is believed, be as well carried in a statute reforming the Equity process. The supposed constitutional immunity of a bankruptcy statute, when dealing with the rights of a bondholder, was the *raison d'être* of Section 77, but it was almost certainly an illusion. If the due process test comes to be applied to a non-assenting minority bondholder's being compelled by a majority and the Commission to surrender part of his security to the stockholder, Section 77 is apt to fall, for it is repugnant both to the trust fund doctrine and to the settled maxims of Anglo-American law relating to a mortgagee's rights.

It would seem that this result of invalidity could not be averted by eliminating the majority's power and substituting, as is being suggested in some quarters, the Commission's and Court's power, independent of majority consent, to compel such a surrender by the non-assenting bondholder. Although in an absolute sense the majority's consents are not essential to the constitutionality of such compulsion, a court is apt to give them weight in the equation of reasonableness. Far more hazardous, constitutionally speaking, might be a final disposition of the bondholder's rights by the Commission, excluding, or even seriously encroaching on, the courts in a juristic field which for centuries seems to have been theirs. If the courts must have the final say in the matter, the last vestige of special relevancy of bankruptcy jurisdiction for coercing the non-assenting bondholder seems to have been dissipated.

3. Section 77 was designed and expected to speed up reorganizations. In this it has been ineffectual. Wherever speed can be employed without undue injury, there should be means available to attain it. Yet, quick stabilization of mortgage debt values is not acutely important as it was two years ago in the unrelieved confusion of events; so that pursuit of stabilization now should not, in any given case, be at the expense of fairness or soundness.

Some of the reorganization cases, whether now pending under Section 77 or in Equity, can be more speedily disposed of than others, because of relative simplicity of capital structure and of other factors involved; but in all of them the stockholders' moral claim must be met in a considerate and orderly way with a view to preserving their interest, so

that in case recovery comes it shall not come unfairly to enrich the present junior bondholders. On the other hand, public policy requires that there be not sanctioned by the Commission and Court, in order to take care of the stockholder, a flood of stock or of rights, mere sentimental symbols of a vanished equity and predicated on bare hopes of value, the existence of which stock or rights on the market in later years would have an effect similar to that of the watered stock of earlier days.

In some cases, where there is no present value whatever based on earning power for a new equity for the old stockholders, but where the Commission, in working out an expedited Plan, sees a reasonable prospect of earnings in the future to support the issuance of stock on some basis, perhaps an appropriate method for protecting the stockholders might be as follows: Some form of stock warrant option would be issued to them for, say, a Class B stock, the terms of its acquisition to be not fixed, but subject to later determination by the Commission after notice to creditors and hearings, within say seven years after reorganization, if the earning power then attained suggests the existence of a revived value fairly apportionable on some terms to the old stock interest. This kind of option, in turn, would require, among other things, that the preferred or Class A stock issued under the Plan to junior bondholders be, in any case, entitled to cumulative dividends before issuance of Class B stock, and to some minimum and maximum current dividend ahead of Class B stock if it should be issued; that Class B's voting rights be highly fractional, or wholly deferred until the retirement of the preferred or Class A stock; and finally that the terms for acquiring Class B stock be based solely on actual current earnings, as found by the Commission at the time for exercising such option, above those earnings required for satisfying prior engagement of the new company's income. Such finding of earnings should be conditioned also upon applying, for the years intervening since the reorganization became effective, proper standards of accounting as to maintenance and depreciation, such standards, for instance, as the average of upper Class I railroads were employing in such years.⁷⁴ This new principle in reorganization could be employed in normal times as well as in abnormal ones if it be safeguarded by valuation based strictly on earning power and by the Commission's active regulatory control of the new company's maintenance

74. It should be suggested here that, during the months or years of court custody before reorganization, when the actual management of the property is in the hands of the personnel associated with the old stock control, the court's custodian, be he receiver or trustee, should have the active help of the Commission's service and accounting officers, coupled with their duty to make periodic reports to the Commission and the Court, with a view to protecting the property from unsound maintenance and depreciation policies or other errors.

and depreciation policies until the old stockholders' rights in the new company are finally fixed.

But however the stockholder problem is to be handled, it is plain that the solutions of these situations cannot be standardized, and that each must be designed and timed according to the inherent factors of the particular case. Does it not seem, then, that the sound process for these cases is one wholly alien to the short-cut traditions of bankruptcy and entirely suited to the procedure of Equity?

4. We suggest a method for reforming the normal Equity process of railroad reorganization, and for adapting such process to the emergency:

(a) For efficiency and fairness (without special regard to speed), statutes could be passed and special rules of court adopted which would give the court pervasive jurisdiction for impleading parties and enforcing its orders; would require the proper filing of lists of all creditors and stockholders; would regulate through the Commission, the creation and practices of protective committees; would make the selection of reorganization managers subject to the Commission's approval, and require them to report to the Commission on a preliminary plan and thereafter, under its supervision, to prosecute and report upon such plan or on such modifications of it as may prove necessary.

The foreclosure sale would have no significance excepting to pass title, without the formality of an upset price, unless under special circumstances, since the minority non-assenter, not receiving a marketable security, would presumably receive cash representing the appraised value of his interest. The statute would provide that, in formulating the Plan, the Commission would be guided by a valuation based strictly upon earning power. A minority non-assenting creditor or stockholder, receiving a new marketable security under the Plan would be bound by it, if approved by a majority, the Commission and the Court.

A statute of the foregoing character and scope, affecting Equity procedure, should work a real improvement in the efficiency and soundness of railroad reorganizations in normal times, and should constitute a solid foundation for any special emergency legislation.

(b) Since, in the emergency, enforced speed should be available in any appropriate situation, such a statute as the one above summarized, for reorganization under normal conditions, should be augmented by a permissive emergency statute and by special rules of court based on it, which at any time in the course of a receivership could be brought into operation by the Chief Justice in his discretion on submission to him of a joint certification by the District Court and the Commission, together with a brief summary of the record and of the hearing as to the issuance of such certificate. Under such statute and rules the Chief Justice could give to the judge to whom the case has been assigned and perhaps to some associate judge or judges (whether circuit or district) the special

status of reorganization judge or judges for that case, with power to sit and hold hearings at any place, including the District of Columbia, as to the financial and operating policies of the receiver, the plan of reorganization, or any other appropriate matters. Such reorganization judge or judges, through the duration of such special emergency status, would be under special mandate of priority; upon emergency order of the court, service on parties and witnesses might be effected through mail and telegraph of summonses, notices and subpoenas (later to be confirmed by any necessary signatures, seals and deliveries); while drastically early dates and short intervals would be set for notice by publication to creditors and others in foreign parts, for the institution or filing of foreclosure proceedings and claims, and for governing all steps in pleadings, in hearings, in the making of reports by the Commission or by special masters, in the filing of exceptions, and in the taking and handling of appeals.

It would seem most fortunate if Section 77 can have indirectly served the useful purpose of leading Congress into reforming the normal railroad reorganization process in Equity, and also of providing a method for using that process to meet an emergency condition. If this course can be given early and serious consideration, it is believed that the amending of Section 77 will appear quite inexpedient.