STREAMLINED CAPITAL READJUSTMENT UNDER SECTION 20b OF THE INTERSTATE COMMERCE ACT

With the avowed purpose of "aiding the national transportation policy" through forestalling serpentine railroad reorganizations under Section 77 of the Bankruptcy Act, Congress in 1948 amended the Interstate Commerce Act by adding a new section designated 20b.1 This amendment permits a railroad to alleviate the burden of its fixed charges in advance of the time when, because of unfavorable economic conditions, they might force the railroad into insolvency and consequent reorganization. In tactic, the amendment enables a carrier, with the approval of the Interstate Commerce Commission and the consent of 75 per cent of each class of the affected security holders, to alter or modify, apparently without limit, any class or classes of its securities, and to make the action binding upon dissenters. The plan becomes effective upon order of the Commission, and at no stage of the proceedings need resort be had to judicial scrutiny or approval.2

Were it not for the inevitable requirement of ICC approval, the atavistic procedure of the new amendment could have been lifted from a railroad director's dreams.3 Speed is substituted for safety. Legal obstacles are minimized. Under 20b, management is to initiate the readjustment plan but with full freedom to withdraw it at any time before final Commission approval; hearings and opportunity for security investor criticism are held to a minimum, and judicial confirmation is not required. The control of the Commission over the solicitation of assents to the plan is nominal and vague; no provision is made for protective committees, and only the management may solicit assents. As dissenters are bound by the majority, there is no need for


Section 1 of the new law is in the nature of a preamble to Section 20b, rationalizing its enactment. Section 3 effects minor procedural changes in Section 77 of the Bankruptcy Act, 47 Stat. 1474 (1933), as amended, 11 U.S.C. § 205 (1946), providing for re-examination by the Interstate Commerce Commission of reorganization plans previously approved, in the light of possibly changed conditions.


cash payment. The plan itself may allot the sacrifices to be made by the various classes of securities in whatever manner the management can convince the Commission is in the best interests of the public, the carrier, and the security holders, and perhaps without even lip service to the doctrine of "full priority." Antecedent federal and state readjustment procedures have been generous, but few have granted management such a "free hand," particularly when the interest of secured creditors is at stake.  

The Precedents for 20B

The essence of recapitalization or reorganization lies in the formulation of a plan which will enable a corporation to adjust its balance sheet to meet economic exigencies. But the substance of the plan, the degree to which it distinguishes hope from reality, and the manner in which it allocates burdens and benefits among security holders, reflects the men who formulate it and the standard of fairness to which they adhere. If economic circumstances require the capital structure to be adjusted downward, or fixed charges to be lessened, or bond maturities to be extended, some class or classes of securities will have to make a sacrifice. The question is—which ones?

Hitherto, if a capital readjustment procedure has been voluntary, management-sponsored, and undertaken without the effective help or hindrance of

4. Supporting the new amendment both in and out of committee hearings were four groups, each grinding an axe of a somewhat different temper, but united in their dissatisfaction with the results of reorganization under Section 77. The Interstate Commerce Commission itself, much criticized for its approval of Section 77 plans which eliminated junior security interests on the eve of a wartime boom, recommended comparable legislation as early as 1943. 57 ICC ANN. REP. 76 (1943). The recommendation was repeated in subsequent annual reports, 59 ICC ANN. REP. 23 (1945); 60 ICC ANN. REP. 26 (1947); 61 ICC ANN. REP. 25-8 (1947), and in testimony at the several hearings. Hearings on S. 1253, at 22; Hearings on S. 249, at 517-30; Hearings on H.R. 2298, at 4-31.

Representatives of railroad management, aware that conservative, incisive reorganization under Section 77, has frequently wiped out stockholders and resulted in a change of management personnel, were loud in its praise, viewing the new amendment as a "constructive proposal for the rehabilitation of railroad credit." Hearings on S. 1253, at 78, 115-6. Institutional groups representing banks and insurance companies supported the amendment, knowing that during formal reorganization security values drop and interest payments may cease. But they opposed it insofar as it proposed to terminate pending reorganizations under Section 77. Hearings on H.R. 3237, at 141-68, 180-8, 210-25; Hearings on S. 249, at 286-322, 331-462, 558-65, 582-5; Hearings on H.R. 2298, at 44-52.

A fourth group was composed of spokesmen for various junior security interests whose equity was being eliminated in current Section 77 reorganization plans. It was their hope that the amendment would provide that all such reorganizations should cease forthwith, and that new proceedings be instituted under the pattern of Section 20b. Hearings on H.R. 3237, at 15, 38-51; Hearings on S. 249, at 15-51, 158-87, 463-82. Their purpose was to preserve these equities, which the Commission and the courts had found to be non-existent, at least in the light of pre-war earnings. Hearings on H.R. 2298, at 72-6. See Wheeler, The Railroad's Strait Jacket—Section 77, Railway Progress, April, 1947, p. 1. But see SEN. REP. No. 432, PART 2, 80th Cong., 1st Sess. (1947) (minority report on S. 249).
Commission or judiciary, little or no regard has been paid to compensating the creditor interests for their lost "bundle of rights." Typically these "voluntary" plans have effected a "creditors' composition,"6 exacting a sacrifice from the creditors while leaving the management and common stock interests unscathed. This philosophy of the creditors' composition, in the form of arrangements or corporate charter amendments, has hit only the unsecured creditor or the preferred stockholder, either in the small business enterprise or in a minor recapitalization of the larger corporation. But under 20b it threatens to reach the secured creditor of an interstate railroad on a formidable scale.

In contrast, if a financial readjustment is accomplished as in Section 77 of the Bankruptcy Act under the aegis of the Commission and a bankruptcy court, the rule of "full priority," asserted in the Boyd6 case and repeatedly reaffirmed,7 establishes the precept that senior security holders must be fully compensated before their juniors are entitled to participate.8 The rule is not necessarily one of "absolute" priority, but of "full compensation" for loss of priority.9 The precise manner in which senior creditors are made whole depends upon the circumstances of the case. They may be given inferior grades of securities, or even securities of the same grade as are received by junior interests, if compensatory provision is made for the entire bundle of rights which they surrender. Mere face amount in new and inferior securities is not enough—there must be additional compensation for loss of priority to income, to control, and to assets; this requirement is not satisfied by "features normally common" to the new securities issued.10

The atmosphere in which 20b was enacted gives some cause for believing that it represents not only a negative reaction to the untidy length of comparable proceedings under Section 77, but a distaste for the safeguards the

5. Any plan which curtails the rights of some or all classes of creditors but leaves the stockholders untouched simply effects a composition of creditors for the benefit of stockholders, in violation of the full priority rule. In re Lorraine Castle Apartments Bldg. Corp., Inc., 53 F.Supp. 994 (N.D.I1. 1944), aff'd, 149 F.2d 55 (7th Cir. 1945), cert. denied, 326 U.S. 723 (1945).


latter provides, and for the standard of fairness it demands. These sentiments are not new. Spiritual forebears of 20b can be discovered in other patterns of "voluntary" readjustment—the old Section 12 of the Bankruptcy Act, the newer Chapter XI, the recently expired Chapter XV, and charter amendment procedure under state law. The philosophy of these "composition" procedures prevailed in Congress during 1947 and 1948 primarily as a result of widespread dissatisfaction with the stern railroad reorganizations of the late thirties, which foreclosed junior interests on the eve of a great boom in railroad earnings.

Creditors' Compositions

In its solicitude for the stockholder interests, 20b suggests the dubious standard of fairness applied in creditors' compositions under the repealed Section 12 of the Bankruptcy Act. While secured creditors could not be reached under Section 12, the scaling down of other obligations, with rare exceptions, was accomplished through a plan of composition giving scant regard to the principle of full priority. In theory the court was to determine

11. Section 20b as enacted was the resultant of a three-pronged drive in Congress to dull the edge of the Commission's knife in Section 77 reorganization plans, to transfer pending Section 77 reorganizations to proceedings styled after Chapter XV of the Bankruptcy Act, and to provide an extra-judicial method of security modification to fill the gap left by the expiration of Chapter XV. Various bills were offered to fulfill these tasks separately. *Hearings on H.R. 3237*, at 11-15. *S. 1253*, an earlier version of the present Section 20b, pieced these various bills together, but was pocket-vetoed by the President, ostensibly on the ground that a better bill was possible. See Memorandum of Disapproval, *Hearings on S. 249*, at 12. Changes were made, including a provision for modification of stock interest, and a limitation on the suspension of pending Section 77 reorganizations, and a new bill, *H.R. 2298*, became law on April 9, 1948. See *Sen. Rep. No. 1170*; *Sen. Rep. No. 897*, 80th Cong., 2d Sess. 1-12 (1948); *Sen. Rep. No. 925*, at 64 et seq.; *Hearings on S. 1253*, at 28, 71, 79; *Hearings on H.R. 3237*, at 229-36; *Hearings on H.R. 2298*, at 63-6.


15. This limitation rendered Section 12 unsuitable for large scale recapitalization of the sizable corporation, though permitting it to serve as a substitute for liquidation for the small businessman whose creditors were willing to allow his continued operation of the business in the hope of a recoupment larger than that to be gained from a straight sale in bankruptcy. See Donovan Report, House Judiciary Print, 71st Cong., 3d Sess. (1931); Thatcher Report, *Sen. Doc. No. 65*, 72d Cong., 1st Sess. (1932).

16. In essence Section 12 provided a means for the debtor corporation to offer terms of composition to its creditors. If its offer was accepted by a majority of the creditors both in number and amount, and if the composition was approved by the bankruptcy court as "for the best interests of the creditors," the dissenting creditors would be bound and the property returned to the debtor subject to the terms of the composition. Though secured obligations remained intact, unsecured obligations were whittled without compensation while the ownership equity was preserved, a clear violation of the full priority
the sufficiency of the composition offer by comparing it with the amount a
creditor would receive upon liquidation;\textsuperscript{17} but in practice this led to the ex-
treme of confirming the offer unless it unreasonably restricted the creditors' eventual realization of cash for their claims,\textsuperscript{18} or unless it would allot the creditors "very considerably less" than they might hope to realize through liquidation in due course.\textsuperscript{19} The concern was not with the "fairness" of the offer, but rather whether it was for "the best interests of the creditors," a phrase echoed in the language of 20b.\textsuperscript{20} And in this regard the \textit{fait accompli} of majority approval was persuasive, on the assumption that the majority should know when the totality was well off.\textsuperscript{21}

\section*{Arrangements}

The spirit of Section 12 almost survived in Chapter XI of the Bankruptcy Act,\textsuperscript{22} which was styled to the need of the small debtor, closely owned and managed, with few publicly held securities and little if any secured debt.\textsuperscript{23} Seemingly Chapter XI should not provide a model for the recapitalization of principle. See Rostow & Cutler, \textit{Competing Systems of Reorganization: Chapters X and XI of the Bankruptcy Act}, 48 Yale L.J. 1334, 1353-5 (1939).

20. "The Bankruptcy Act provided only three . . . controls on the bankrupt's freedom to determine what creditors would receive in a composition; (1) examination of the bankrupt prior to the composition offer; (2) the required majority consent by the creditors; and (3) confirmation by the judge. The provision for an examination proved ineffectual because of considerable judicial relaxation of this requirement, and the limited scope and the usual perfunctory nature of the examination. The requisite majority vote likewise was an unreliable safeguard, largely because of the absence of any machinery for controlling the solicitation of proxies or avoiding conflicting affiliations on the part of the committee members or others purporting to represent the creditors. Moreover, majority consent did not always represent the best interests of all the creditors, for there was always the possibility that it depended in part upon an uninformed or improperly biased vote. The third major check, judicial confirmation, proved inadequate . . . primarily because of the undue significance attached to majority consent and the absence of any other readily applied standard. Moreover, whatever the merits of the standards applied by the courts in determining the 'best interests of the creditors' in the composition of obligations of the small and closely-knit business concern, these standards bore little relevance to the plan of reorganization for a corporation with publicly held securities." \textit{SEC, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees}, pt. VIII, 81-2 (1940). Compare the sway to be exercised by a carrier instituting proceedings under 20b, pp. 1302-3 \textit{infra}.

23. For general discussions of Chapter XI, see Levin, Weintraub & Singer, \textit{The Third Year of Arrangements Under the Bankruptcy Act}, 18 N.Y.U.L.Q. Rev. 375 (1941); Rostow & Cutler, \textit{infra} note 16. For a clinical approach, see Comment, 51 Yale L. J. 253 (1941).
an interstate railroad, but its resemblance to 20b is in many ways striking. As in Section 12, the virtues of Chapter XI are to be found in speed and economy rather than in the protection granted to creditors, whose influence on the substance of an arrangement is limited to a vote of Yes or No on its ultimate form. Every phase is under the control of the debtor himself. He alone may institute proceedings, by filing a petition with the court, together with his proposed plan, to which acceptances may have been obtained in advance. If the plan is accepted by a majority of the creditors and is confirmed by the court, it becomes binding upon all.24

However, this summary procedure, unlike that of Section 12, is mitigated by a coherent standard of fairness by which the terms of the arrangement must be judged.25 Those who thought that the standard of Section 12 had carried over were quickly disabused. The Supreme Court in the U.S. Realty case left no doubt that plans under Chapter XI must comply with the standard of full priority, and that "in any plan of corporate reorganization unsecured creditors are entitled to priority over stockholders to the full extent of their debts and that any scaling down of claims of creditors without some fair compensating advantage to them which is prior to the rights of stockholders is inadmissible."26

Charter Amendment under State Law

In its loose procedural mechanics 20b also suggests an analogy to the seduction of preferred stockholders characteristic of corporate charter amendment proceedings under state law. The statutes of all states provide a means whereby a corporation, with the approval of a majority or two-thirds of the

25. The arrangement is to be confirmed if the court is satisfied that "(1) the provisions of this Chapter have been complied with; (2) it is for the best interests of the creditors; (3) it is fair and equitable and feasible; . . . and (5) the proposal and its acceptance are in good faith. . . ." 11 U.S.C. § 766 (1946).
26. SEC v. U.S. Realty & Improvement Co., 310 U.S. 434, 452 (1940). As Chapter XI makes no specific provision for modification of secured debt or equity interests, it was deemed inappropriate for the large corporation whose financial embarrassment demanded such revision. Haven was to be found in Chapter X instead. Id. at 447-8.

Hence, use of Chapter XI is confined to the petty concern, where compensation to the unsecured creditors for their loss of priority may be found in the preservation of the going-concern value of the business as an alternative to liquidation, and in the continued goodwill and services of the existing management, to which the success of a small concern may be closely keyed. The creditors in bankruptcy proceedings are rightfully entitled to any of the goodwill of the business necessary to the satisfaction of their claims, but where the goodwill is inextricably tied to a particular management, satisfaction for the creditors requires that that management continue. This situation and rationale does not obtain, however, where the corporation is large and its securities are widely held by the public, e.g., interstate railroads. Full compensation may then require that the creditors actively participate in the good will through the medium of common stock, voting trusts, or otherwise. See Rostow & Cutler, supra note 16, at 1357-60.
stockholders entitled to vote, may make amendments to its corporate charter. In some cases the management may have felt that the elimination of accruals was necessary to facilitate the issuance of new capital stock for money-raising purposes, but in other cases the less altruistic desire has been to channel current earnings into the hands of the common stockholders, particularly if the lean years were about to be followed by fat ones. Though sufficient money for at least partial payment of accruals may be available, the management ordinarily cannot be compelled to declare any dividends at all. Accordingly, the preferred stockholders have been offered the choice of standing on their contractual rights and receiving nothing for their pains, or assenting to the proposed modification of their contractual rights through an amendment to the corporate charter. It is in this atmosphere that charter amendment has been effected; the heavy artillery has been on the side of management, which controls the proxy system, and whose bankers customarily draw up the plan.

The malcontent who could afford the expense of attacking a charter amendment recapitalization plan had a difficult row to hoe. Courts were hesitant to upset a plan on equitable grounds unless it was rife with managerial bias; the stockholder had the burden of proving a gross unfairness tantamount to fraud or bad faith, and was faced with the presumption that the majority, in approving the plan, was advancing the interests of the corporation.

30. As a general rule the declaration of dividends is held to be an internal corporate matter within the discretion of the directors, with which a court of equity will not interfere. Spear v. Rockland-Rockport Lime Co., 113 Me. 285, 288, 93 Atl. 754, 755 (1915). See Ballantine, *Corporations* § 231 (1946).
32. The alternative of appraisal and cash payment, when available, has been unsatisfactory. Appraisal statutes usually call for the payment of "fair cash value" or "full market value," but the presence of arrearages, a sign of poor corporate earning power, often depresses the market value of the stock. See Lattin, *Remedies of Dissenting Stockholders Under Appraisal Statutes*, 45 Hary. L. Rev. 233, 258, 270 (1931); Mecl., *Accrued Dividends on Cumulative Preferred Stock: The Legal Doctrine*, 55 Hary. L. Rev. 71, 79 (1941); Note, 57 Hary. L. Rev. 594, 595 (1944).
"unfairness" evidently had to cut deeper than a mere failure to observe the Boyd doctrine of full priority. If the state statute authorizing the charter amendment had been passed subsequent to the issuance of the stock affected, a constitutional issue of impairing the obligation of contracts could be raised. But this introduced the metaphysical question of whether a right was "vested", the answer often being that it was not. Constitutional issues aside, state charter amendment procedures have been severely criticized for failing to provide adequate protection for helpless security holders whose interests may be drastically excised.

Chapter XV

The most immediate precedent for 20b is the now-expired Chapter XV. In 1939 Congress added a new chapter to the Bankruptcy Act which during the six years of its operation permitted a railroad in temporary financial straits to adopt a "plan of adjustment" enabling it to extend maturities and reduce fixed charges. The bill as drawn and passed was tailor-made to fit the exigencies of certain railroads which at the time were projecting volun-

35. See Dodd, supra note 28, at 807; Comment, 54 YALE L. J. 840 (1945); Note, 57 HARV. L. REV. 849 (1944). See cases cited note 36, infra.

36. In the "reserve power" of a state to amend a corporate charter is found sufficient authority to effect such charter amendments as do not impair "vested rights." E.g., Looker v. Maynard, 179 U.S. 46, 52 (1900).

Direct elimination of accruals has been upset by some courts on the ground that unpaid cumulative dividends are a "vested right" which no state can authorize a corporation to disturb, Keller v. Wilson & Co., 21 Del.Ch. 391, 190 Atl. 115 (1936), Lonsdale Securities Corp. v. International Mercantile Marine Co., 101 N.J.Eq. 554, 139 Atl. 50 (1927), even if the stock was issued or the dividend accrued subsequent to the statute purporting to authorize its elimination, Consolidated Film Industries v. Johnson, 22 Del.Ch. 407, 197 Atl. 489 (1937).

If, however, the accrued dividend were eliminated indirectly by the issuance of a new class of prior preferred stock, courts generally have been unable to find the disturbance of a "vested right." Shanik v. White Sewing Machine Corp., 25 Del.Ch. 371, 19 A.2d 831 (1941); Yoakam v. Providence Biltmore Hotel, 34 F.2d 533 (D.R.I. 1929). And the same result might be achieved indirectly by means of a merger or consolidation with another corporation, even if the other corporation were a wholly owned subsidiary created for the purpose. Federal United Corp. v. Havender, 24 Del.Ch. 318, 11 A.2d 331 (1940); Hottenstein v. York Ice Machinery Corp., 136 F.2d 944 (3d Cir. 1943).

37. Responsibility rests with the "charter-mongering" states, who created a race "not of diligence but of laxity." Liggett Co. v. Lee, 288 U.S. 517, 559 (1933). The procedure offered by 20b does little to mollify those critics of charter amendment practice who have suggested that security holders be provided a feasible means of participating in the formulation of a plan, or at least be given adequate disclosure of the way in which it affects their interests. BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE 38-9 (1928); RIPLEY, MAIN STREET AND WALL STREET 132-55 (1927); DOUGLAS, DIRECTORS WHO DO NOT DIRECT, 47 HARV. L. REV. 1305, 1330-4 (1934).

38. Chapter XV became law in 1939 and expired a year later. 53 STAT. 1134 (1939). It was reenacted in 1942, and continued in force until 1945, when it expired by its own terms. 56 STAT. 767 (1942).
tary plans affecting most of their outstanding indebtedness. Under the terms of the act any railroad not in an equity receivership or in a Section 77 reorganization, and which had not been for ten years, might file a plan with the Interstate Commerce Commission providing it previously had gathered assents to the plan from 25 per cent of the affected claims. If the Commission approved the plan and it was accepted by two-thirds of the affected creditors, including a majority of each affected class, it was submitted to a three-judge district court. If the court found the plan to be "fair and equitable," it was submitted for the approval of three-quarters of the aggregate claims, including three-quarters of each affected class, and if such approval was secured, the court entered an order confirming the plan, which then became binding upon all creditors and security holders.

Unlike 20b, Chapter XV was designed only as a stopgap measure to provide expedient relief for temporary difficulties. Nonetheless, it met with criticism because its casual procedure gave management the whip hand in initiating and carrying through overall plans of "adjustment" or recapitalization. And while ostensibly a court was not supposed to approve a plan which failed to conform to a standard of full priority, and was required to make an independent finding of fact, many if not most of the plans ultimately approved raised doubt as to how strictly these requirements had been observed. It is noteworthy that the Commission itself was not specifically required to find the plan "fair and equitable," that judgment being a matter of law and a duty of the court. But in many cases the approval of the court seemed anchored in a reliance on the Commission's approval in the first instance, and may have been motivated in part by economic exigencies and the pressure of advance creditor approval. The procedure of 20b, in dispensing with the need for judicial approval of the plan as "fair and equitable," may be an attempt to give de jure recognition to a procedure achieved de facto under Chapter XV.

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40. Will, The Voluntary Adjustment of Railroad Obligations, 7 LAW & CONTEMP. PROT. 519 (1940).
41. As the statute provided only for extending maturities and lowering fixed charges, rather than reducing the principal of the debt itself, courts as a rule found, at least by implication, that the affected bondholders had suffered no loss in priority requiring compensation. In one case the court approved a plan whereby each $1000 5½ bond was exchanged for $150 in cash and an $850 bond bearing 3½ interest plus 2½ contingent, non-cumulative interest. Distinguishing the Los Angeles Lumber Products decision "on the facts," the court required no adjustment of the ownership equity. In re Montana, W. & S. R.R., 32 F.Supp. 200 (D.Mont. 1940). See also In re B. & O. R.R., 29 F.Supp. 608 (D.Md. 1939); In re Lehigh Valley R.R., 34 F.Supp. 753 (E.D.Pa. 1940). But cf. In re Midland Valley R.R., 51 F.Supp. 180 (E.D.Okla. 1943), where the plan required the common stockholders to forego dividends until the last of the bond principal was paid off.
43. "The Interstate Commerce Commission has repeatedly recognized that railroads
THE RITUAL OF SECTION 77

In contrast to the inchoate procedure of voluntary or small-scale adjustment, Section 77 of the Bankruptcy Act provides a more cautious, thorough, and disinterested means for reorganizing interstate railroads. Under Section 77 the debtor carrier cannot write its own ticket to be perfunctorily punched by court and creditor. Railroad reorganizations under Section 77 require "something more than contests between adversary interests," Emphasis is placed upon giving all parties the right to be heard and to have their interests protected. The public welfare bulks large, and requires that the new capitalization be reasonable in the light of probable future earnings, and that the court and Commission have the time and opportunity to exercise an informed and considered judgment. The debtor is ousted from possession, and command given to an impartial, bonded trustee appointed by the court, who in addition to operating the carrier is required to scrutinize the past conduct of the management and report on possible irregularities or fraud. Further, the plan of reorganization is not the product of a private bargain or gentlemanly agreement, but is formulated under the aegis of the Commission, and must be approved by the court as in compliance with the requirements of the Boyd rule.

Proceedings may be instituted by the debtor carrier itself or by five per cent in amount of the creditors. If the petition is approved by the court as filed in good faith and in compliance with the terms of the Act, a date is set for a hearing on the appointment of a trustee, and the debtor is required to notify affected parties. Within six months after the filing of the petition,

proceeding under chapter XV were trying to escape from the forfeiture statute [full priority under Section 77]. The Commission did not deem this at all improper; on the contrary, it assisted the railroads to carry out their program. "Id. at 139. "All the technicalities are brushed aside under the conservation statute [Chapter XV]. Forecasting the future is also cast aside. The ICC does not undertake, in the chapter XV cases, to forecast the future earnings of the railroads being reorganized. Nor does the ICC decree forfeitures [application of full priority], either on the basis of forecast or any other basis." Id. at 140. "S. 1253 [an early version of Section 20b] adopts the basic principle of the chapter XV procedure in authorizing reorganizations without forfeiture of either bonds or stocks." Id. at 145.


46. Ibid. See also 76 Cong. Rec. 2917 (1933).
47. § 77(c).
48. See cases cited note 8 supra.
49. § 77(a).
50. § 77(c) (1).
the debtor carrier must file with the Commission a proposed plan of reorganization. Ten per cent of any class of stockholders and ten per cent in amount of creditors also may file plans, and after due notice the Commission holds a hearing at which creditors and stockholders are entitled to be heard on all proposed plans before they are asked to accept any one in particular. Following the hearing the Commission submits to the court a report recommending a plan of reorganization, which may differ from any plan previously suggested, and which in its opinion is fair, equitable, and feasible, is in the public interest, and does not discriminate unfairly against any class of creditors or stockholders.

After certification of a plan by the Commission to the court, and after due notice, the court holds a hearing at which all parties in interest may be heard in support and opposition. The court approves the plan if, inter alia, “it is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders...” Following court approval the plan is returned to the Commission for submission to each class of stockholders and creditors whose claims have been filed, for acceptance or rejection. The Commission certifies the results of the submission to the court, which confirms the plan if satisfied that it has been accepted by two-thirds of each class of stockholders and creditors voting, at which time the plan becomes binding upon all, subject to judicial review.

The procedure of Section 77 has been criticized as cumbersome in comparison with the more integrated technique of reorganization under Chapter X. There is opportunity for the plan to be shuttled back and forth between court and Commission, and the numerous hearings are frequently repetitious and productive of delay. But whatever its procedural failings, the accent of Section 77 is upon the formulation of a fair, equitable, and feasible plan under the watchful eye of an impartial government agency, whose duty it is to guard both the public interest and the priority rights of the various security holders. Furthermore, this guardianship is made effective through adequate hearings and disclosure, thorough analysis of the carrier’s financial position, and systematic application of the full priority principle.

51. §77(d).
52. Ibid.
53. §77(e).
55. Many if not most of the plans effected under Section 77 resulted in capitalizations reflecting a conservative estimate of future earnings, and as a corollary they often excluded classes of junior security holders for whom no equity was deemed to be present. Commission estimates of probable future earnings do not partake of “mathematical certitude”; determination of a proper capitalization, suited to the vagaries of an unstable economy, necessarily imports at best an “educated guess” and at worst a “crystal ball.” Increased carrier revenues, particularly those resulting from the wartime boom of the
The Procedural Mechanics of 20b

In comparison to Section 77 the procedure of the new 20b is precipitate. Proceedings are instituted by the carrier itself upon application to the Commission; no provision is made for an involuntary petition by security holders. In this respect 20b is unlike Section 77, where, under the amendments of 1935, creditors representing five per cent of the carrier's outstanding indebtedness may themselves institute proceedings; rather it resembles Chapter XV and charter amendment procedure, where initiation lay entirely with management. Unlike Chapter XV, however, the carrier need not allege that its difficulties are temporary in nature, or that it has outstanding obligations matured or about to mature. Apparently the vague suggestion set forth in the preamble of the Act will suffice—that modification is necessary to insure the "continuity of sound financial condition" and "to avoid obstruction to or interference with the economical, efficient, and orderly conduct . . . of . . . affairs." No good faith requirement is specified. As 20b is intended in part as a substitute for Section 77, apparently there is no need to allege that Section 77 proceedings are unnecessary; in fact, the mere institution of 20b proceedings supposedly raises the implication that Section 77 may well be necessary in the future unless modification is accomplished in the present.

1940's, brought cries of "forfeiture" and demands that the new capitalizations approved by the Commission be expanded to embrace those security holders previously excluded. See Sen. Rep. No. 925; Sen. Rep. No. 1170; Hearings on S. 249, at 133; Hearings on H.R. 3237, at 230. But the Supreme Court was reluctant to compel the Commission to reconsider its work. See cases cited note 8 supra; Section 3 of the statute of which Section 20b is Section 2 modifies the effect of these decisions by providing for reconsideration and revision of capitalizations by the Commission if "changed conditions" in the interim between approval of the plan and final confirmation merit such an action.

Section 20b itself can be considered a flank attack on Section 77 procedure and the full priority rule. See notes 4 and 11 supra. Both Section 77 and the Commission have been under fire from quarters irked by lengthy proceedings under governmental restraints and nostalgic for the more free and easy days of equity receiverships. "The choice lies between an existing statute under which billions of dollars of valuable securities are threatened with destruction, and a conservation statute which prevents destruction of actual values. The choice is further between Government-produced reorganizations and reorganizations developed by investors and business men. At the present time reorganization plans are on a legalistic basis; under [Section 20b] reorganizations will be on a practical business basis." Sen. Rep. No. 1170, at 173. But cf. Lowenthal, THE INVESTOR PAYS (1933); Frank, Some Realistic Reflections on Some Aspects of Corporate Reorganization, 19 Va. L. Rev. 541 (1933); Note 44 Harv. L. Rev. 838 (1931). And see Commissioner Eastman, dissenting in Chicago, M. & St. P. Reorganization, 131 I.C.C. 673, 701 (1928).

56. § 20b (2).
58. Citations note 38 supra.
59. Ibid.
60. Public Law 478, 80th Cong., 2d Sess., § 1 (1948).
61. Chapter XV required the Commission to find the carrier not in need of Section 77 reorganization. Citations note 38 supra.
Under §20b the modification plan is formulated by the carrier itself and presented to the Commission at the time of application.63 If the Commission chooses, it can require the carrier to obtain advance assurances of assent from affected security holders. This provision of the Act was thought necessary to avoid burdening the Commission with dubious plans unlikely of eventual assent, but in view of the estoppel-like pressure which advance assents may exert on the Commission to approve of a plan, this discretion may well be exercised infrequently.64 As in Chapters XI and XV, the management of the carrier represents the only source from which the initial plan can emanate.65 In this respect §20b effects a departure from proceedings under Section 77, where ten per cent in amount of the creditors or ten per cent of any class of stockholders are also privileged to submit a plan,66 and a radical departure from the principle, central to corporate reorganization under Chapter X, that the plan be formulated by an impartial trustee.67 If the Commission approves of the petition it is to set a date for public hearing and to require the carrier to give reasonable notice to security holders and other parties. This is the only notice to affected security holders, and the only hearing, that §20b envisions. No provision is made for the formation of protective committees or for their remuneration. Except for such solicitude as the Commission may show, widely scattered security holders are left to their own devices and to their own pocketbooks to see that their interests are safeguarded. In view of the usually wide dispersion of creditor and ownership interest in railroads, any real protection at the hearing must come from the Commission itself.68

Following the hearing, and if the Commission finds the plan acceptable,69 it is to direct the carrier to submit the proposed alteration or modification to the holders of each class of affected securities for acceptance or rejection. Any and all material sent to the security holders for enlightenment in regard to the exercise of their proxies must first be submitted to the Commission for its approval as to the correctness and sufficiency of the material facts. But the ghost of corporate charter amendments still haunts—the efficacy of this control is doubtful, and it appears a poor substitute for adequate representation at the hearing, or an opportunity to participate in the formulation of the plan.70

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63. §20b (2).
64. Advance approval by affected security holders appeared to create a psychic block to effective judicial scrutiny, notably in proceedings under Section 12 and Chapter XV, and in corporate charter amendment procedure.
65. Section 20b (2) makes no provision for other than management-submitted plans.
68. The provision for a hearing is laconic. "[T]he Commission shall set such application for public hearing and the carrier shall give reasonable notice of such hearing in such manner, by mail, advertisement, or otherwise, as the Commission may find practicable and may direct, to holders of such classes of securities and to such other persons in interest as the Commission shall determine to be appropriate and shall direct." §20b (2).
69. See p. 1307 infra.
70. "All letters, circulars, advertisements, and other communications, and all financial
the proposed alteration or modification is assented to by the holders of "at least 75 per centum of the aggregate principal amount or number of shares outstanding of each class of securities affected,"71 the Commission is to enter an order approving and authorizing the modification and setting forth the time it is to become binding. And at that time it is to be binding upon each holder of any security of the carrier of each class affected, and upon any trustee to an instrument under which any class of obligation may be secured.72

Situation to Which 20b Is Applicable

The language of the Act sets no limit to the scope of the alterations or modifications capable of being effected. Common and preferred stock, secured and unsecured obligations of all types (except equipment trust certificates) fall equally within its grasp.73 While its provisions are permissive and not mandatory, in that a carrier need not secure Commission approval for modifications it may lawfully be able to make in any other manner, the authority made available by the Act, like that of Congress over interstate commerce, is exclusive and plenary. For the purpose of carrying out the modifications which have received Commission approval the carrier is relieved of all restraints of law, federal, state, and local.74

Section 20b appears applicable to at least five situations in which a carrier may wish an adjustment of its capital structure. At the outset, 20b provides a substitute for Chapter XV, in permitting an extension of pressing bond maturities, and a modification of their interest rate.76 In fact, this was the first use of the new law. Significantly enough, the carrier involved—the Lehigh Valley—had previously secured a plan of adjustment under Chapter XV, and the relief it sought under 20b would have been cognizable under the earlier Act. In the Chapter XV proceeding the court had allowed the Lehigh Valley to extend maturities for ten years on three issues of senior bonds, and to postpone 75

and statistical statements, or summaries thereof, to be used in soliciting the assents or the opposition of such holders shall, before being so used, be submitted to the Commission for its approval as to correctness and sufficiency of the material facts stated therein." § 20b (2). Cf. the Securities Act of 1933, 48 STAT. 74 (1933), as amended, 15 U.S.C. § 77(aa) (1946), and the Securities Act of 1934, 48 STAT. 895 (1934), 15 U.S.C. § 78(n) (1946), which are made inapplicable to § 20b proceedings. § 20b (9) and (11). No provision is made for disclosure of lists of security holders, and it seems unlikely that any but management's views will find expression in letters or circulars. And see 94 Cong. Rec. 3271 (1948), suggesting that the Commission should make no "onerous or vexatious" provisions resulting in "censorship".

71. § 20b (2).

72. The word "class" is nowhere defined, but necessarily the Commission must determine the composition of each class as a precedent to finding whether the required security holder approval is present. Cf. Section 77, 11 U.S.C. § 205(c) (7) (1946).

73. With the exception of equipment trust certificates, any provision of any "security", as defined in § 20a of the Interstate Commerce Act, 24 STAT. 379 (1887), as amended, 49 U.S.C. §§ 1-27 (1946), is subject to alteration or modification. § 20b (1) (b).

74. § 20b (5).

per cent of the interest for five years on a large issue of junior bonds. In return for this sacrifice the bondholders received a sinking fund, and what the court termed "a very real benefit" in the form of a "reasonable assurance that the railroad . . . will continue to operate as a going concern for their benefit." It is doubtful if this met the standard of full priority. But in the current 20b proceeding the Commission has treated the bondholders less summarily, in spite of the less rigid statutory requirements as to the fairness of the plan. The plan proposes that a $71 million issue of junior bonds be cancelled and replaced with a new issue three-fourths of whose interest will be contingent upon earnings. The $50 par value is to be removed from the common stock, and each $1000 bond is to receive four shares. In addition to other benefits granted to the bondholders, the Commission required that the bond interest be cumulative for five years, and that after four years of unpaid interest, the indenture trustee might select one-third of the board of directors.

Closely allied to the Lehigh case is a second situation where the need for modification may not be so urgent but the carrier deems readjustment advisable because of uncertainty as to future economic conditions. Maturity dates of outstanding issues might be spread to enable the carrier to meet them as they arrive at reasonable intervals, and interest payments might be reduced or made contingent upon earnings if the excess of revenues over fixed charges seems imprudently low.

A third possible utilization of the new law might be found in the modernization of clumsy and antiquated indentures whose provisions appear unduly inflexible in the light of present day finance. Complicated redemption or refunding provisions, and those unreasonably hampering the powers of the indenture trustee, are illustrative.

A fourth possible use should evoke an unsympathetic reaction from the Commission. A carrier may be tempted to employ 20b in order to short-circuit, in the direction of the common stock, earnings which in fairness should accrue to the preferred stockholders or income bondholders, on whose securi-

77. In the Matter of the Application of the Lehigh Valley R.R., I.C.C. Finance Docket No. 16184 (July 8, 1948). The proposed plan places 197% of the common stock in the hands of the bondholders, and creates a sinking fund into which payments must be made before dividends may be declared. Furthermore, there may be no stock dividends while interest on the bonds remains unpaid. Whether these features sufficiently compensate the bondholders for their loss in priority must remain a matter of opinion and conjecture. See p. 1312 infra.
78. Some recent corporate bond issues arising out of reorganizations contain a "majority clause" enabling a specified percentage of the holders to modify the rights of the class. Inherent in this procedure is a method of curtailing creditor rights for the benefit of stockholders, in violation of the full priority principle. See Sen. Rep. No. 1619, 75th Cong., 3d Sess. 19 (1938); Billyou, Corporate Mortgage Bonds and Majority Clauses, 57 Yale L.J. 595, 603-6 (1948); Dodd, The Los Angeles Lumber Products Company Case and its Implications, 53 Harv. L. Rev. 713, 749 (1940).
ties cumulative dividends or interest is outstanding and unpaid. This situation
finds its parallel in the uses to which charter amendment procedure has been
put. While 20b contains no explicit "good faith" requirement, a Commission
wise to the temptations which beset management might easily construct one
from the preamble to the Act, or might reject such a proposal on the ground
that it was not in the "best interests" of all of the security holders. 80

A fifth situation might be to use 20b as an outright substitute for a Section
77 reorganization. When a carrier finds itself in desperate financial straits,
either because of mismanagement or the onset of a serious economic recession,
it nominally has open to it the choice of 20b or Section 77 as a means of drastic
capital readjustment. There is nothing in the draft of 20b to forbid its use in
such circumstances. 81 Lesser adjustments in maturities and interest rates may
be insufficient, serving only to put off the evil day, and if 20b is to be either a
useful preventive or an effective substitute for Section 77, it must be the in-
stitement of cutting down total capitalization and thereby reducing fixed
charges to a feasible minimum. 82 Unless 20b is to become an instrument of

80. See the thesis that "corporate powers are powers in trust," note 140 infra. And
see Hearings on H.R. 2298, at 53–63.

81. If a major capital readjustment is contemplated, and particularly if the carrier
has suffered a principal default, there exists the possibility of rival Section 20b and Sec-
tion 77 petitions, the latter filed with a bankruptcy court by 5% of the creditors. It is to
be noted that Section 20b contains no provisions for enjoining creditors from enforcing
their claims, such as are found in Section 77.

94 Cong. Rec. 3500 (1948) : "MR. WOLVERTON : The House conferences were con-
fident that if a petition under the new section 20b was filed by a railroad in that situation
and subsequently thereto a petition for an equity receivership or for the approval of a peti-
tion for reorganization under section 77 of the Bankruptcy Act was filed, the court before
which such proceedings were brought would not in the proper exercise of its discretion
appoint a receiver or approve a petition under section 77 while there was pending before
the Interstate Commerce Commission a petition filed under the new section 20b . . . ". The
pertinence of this commentary is doubtful. The propriety of Section 77 as opposed to
Section 20b should not turn on mere temporal priority in the filing of a petition, but should
be determined by the more important factors of the size of the carrier, the demands of the
public interest, the need for protecting far-flung security holders, and the nature and
extent of the proposed capital readjustment.

A similar problem arose in connection with the use of Chapter XI as opposed to
Chapter X. "While a bankruptcy court cannot, because of its own notions of equitable
principles, refuse to award the relief which Congress has accorded the bankrupt, the real
question is, what is the relief which Congress has accorded the bankrupt and is it more
likely to be secured in a Chapter X or Chapter XI proceeding? In answering it we can-
not assume that Congress has disregarded well settled principles of equity, the more so
when Congress itself has provided that the relief to be given shall be 'fair and equitable
and feasible'. Good sense and legal tradition alike enjoin that an enactment of Congress
dealing with bankruptcy should be read in harmony with the existing system of equity
jurisprudence of which it is a part." SEC v. U. S. Realty & Improvement Co., 310 U.S.
Cir. 1944).

82. A parallel situation arises when a carrier transfers to Section 20b from a Section
77 proceeding already in progress. Section 20b (13) enables a carrier in equity receivership
or in Section 77 proceedings, under certain conditions, to utilize 20b procedure instead. Such
"piecemeal modification" on a year to year basis, crowding the Commission's already congested docket and leaving the ultimate character of needed reductions in a state of flux, the plan of recapitalization as approved by the Commission must reflect a thorough-going analysis of a carrier's probable earnings in the future, and a reduced capital structure that is in accord. And on this assumption the duty of the Commission to the several classes of security holders, in making such amendments to the plan proposed by the carrier's management as it finds "just and reasonable," and in finally giving the plan its stamp of approval, should be coextensive with its duty under Section 77. If anything its duty under 20b should be greater, for here allowance must be made for the lack of procedural safeguards.

THE STANDARD OF FAIRNESS

The precise standard of fairness to be applied by the Commission in approving a plan of readjustment under 20b is lost in the mist of statutory vagueness. The pertinent wording of the statute itself, as remarkable for what it omits as for what it includes, is as follows:

"If the Commission, after hearing, in addition to making (in any

transfer is limited to carriers in equity receivership or under Section 77 at the time of the enactment of Section 20b, with respect to which an order confirming the sale or the plan has not been entered, or if entered, is in the process of appeal. Six railroads were in equity receivership as of April 9, 1948 (the date of enactment). Thirty-eight railroads were in Section 77 reorganization as of that date. Of these, temporary suspension of Section 77 proceedings has been granted only in one case, that of the Central R.R. Co. of N. J. Letter to the YALE LAW JOURNAL from the Interstate Commerce Commission, March 3, 1949.

The petition approved by the Commission in the case of the Jersey Central would reduce the 4% and 5% interest on the general mortgage issue to 3 3/4%, and would permit the unpaid balance of back interest to be funded in non-interest-bearing certificates without maturity. Bondholders would receive one-half of the common stock in addition to a sinking fund and other provisions giving debt reduction priority over payment of dividends. N.Y. Times, March 3, 1949, p. 39, col. 4.


84. The problem to which both Section 20b and Section 77 are addressed is as old as railroading—the chaotic nature of early railroad expansion and consolidation invited this condition. See 2 DEWING, FINANCIAL POLICY OF CORPORATIONS 985-1031 (1941). The later optimism and enthusiasm of railroad financiers aggravatated it. Most notorious was the use of collateral trust bonds to buy control of another carrier on credit, resulting in a pyramiding of securities and vastly increased fixed charges. Often the motive was financial power and control for its own sake rather than any semblance of increased operating efficiency in the public interest.

Until the debacle of 1929 it was generally assumed that a railroad, because of its monopolistic position, could comfortably sustain a heavy bonded debt. Needless to say, the opposite proved true, and with increasing competition the position of the railroads has become more difficult year by year. See N.Y. Times, March 20, 1949, §3, p. 1, col. 8. As early as the middle 1930's it seemed apparent that only in the most prosperous years might railroad earnings evaporate the water inherent in the traditional capital base; in "normal" years the heels of the common stockholder would customarily be damp.
case where such alteration or modification involves an issuance of securities) the findings required by paragraph (2) of section 20a, not inconsistent with paragraph (1) of this section shall find that, subject to such terms and conditions and with such amendments as it shall determine to be just and reasonable, the proposed alteration or modification—(a) is within the scope of paragraph (1); (b) will be in the public interest; (c) will be in the best interests of the carrier, of each class of its stockholders, and of the holders of each class of its obligations affected by such modification or alteration; and (d) will not be adverse to the interests of any creditor of the carrier not affected by such modification or alteration..."85

In many ways these words telescope the standard required for a Section 77 reorganization plan,86 and that established in Chapter XV.87 Most striking is the omission of the phrase "fair and equitable," the "term of art" which would demand that the plan follow the requirements of full priority in its allocation of sacrifice between various classes of security holders. If Congress in its drafting of the bill had intended the concepts of full priority to apply to recapitalizations under 20b, the inclusion of the words "fair and equitable" would have been a simple matter. Or if the Commission, in its testimony in the committee hearings or in its previous sponsorship of legislation along the lines of the present Act, had contemplated the application of the full priority doctrine, it is curious that, whether by accident or design, no suggestion of that contemplation is readily discerned.88 In all of the committee hearings and reports there existed a reluctance to probe the issue of full priority in intelligible terms. Conversely, there appeared no specific contention that full priority was not to apply, though some testimony tended to give rise to such an implication.89 Lobbyists for junior security interests in railroads under Section 77 reorganization at the time of the hearings, whose constituents were to be wiped out in full priority plans then pending, were among the loudest supporters of an early form of the bill. But the bill at that time made no provision for modification of stockholder interests,80 the sine qua non of full priority. Its subsequent amendment in this respect lends color to an argument that full priority may have been the standard ultimately intended.91

Apart from the question of legislative intent, the words of the statute itself give rise to a contradictory interpretation as to the standard of fairness to be applied by the Commission. That the modification must be in the "public interest" would seem to require only that the plan be "feasible," in the sense that

85. § 20b (2).
87. Citations note 38 supra. See p. 1299 supra.
91. But provision for the modification of stock interests opens the door to a procedure for the elimination of preferred stock arrearages. See Hearings on S. 249, at 62, 67.
it not expand the carrier's capital structure to the extent of endangering its future solvency.92 But the requirement that the plan be in the "best interests" of the carrier, its stockholders, and the holders of each class of its obligations affected, harks back to Section 12 of the Bankruptcy Act and creditors' compositions.93 Is a "friendly composition" to be the guide, with each class of securities participating in a bargaining process, the Commission putting its stamp of approval on the finished result unless the plan manifests a "gross unfairness"? Of course the Commission is empowered to make such amendments to the plan as it determines to be "just and reasonable," but what standard do these words import? Is a plan "just and reasonable" if it will be acceptable to 75 per cent of each class of creditors and stockholders affected, or may a dissenting creditor successfully maintain that no plan is "just and reasonable" which does not grant him the same priority of treatment as he might obtain from a reorganization under Section 77? Is "just and reasonable," in the light of §80b, tantamount to "fair and equitable" as construed with reference to bankruptcy reorganization?94

Clearly the standard of fairness cannot be drawn from the Delphic phraseology of the statute alone; it must be read in the context of the whole history of corporate recapitalization and reorganization in American law, and ultimately, perhaps, even in the light of considerations of constitutional doctrine. While the phrase "in the best interests of creditors" rattles the skeleton of Section 12 and creditors' compositions unhallowed by the rites of full priority, it must be remembered that "friendly adjustments" had no dealings with secured creditors except with their consent.95 Nor as a rule were large corporate entities such as railroads amenable to its proceedings. Moreover, the criterion of the creditors' "best interests" under Section 12 was a comparison with what they might hope to receive through liquidation. There was no alternative standard of greater fairness which might plague the conscience of a court.96

92. See United States v. Chicago, M., St. P. & Pac. R.R., 233 U.S. 311 (1913); Ecker v. Western Pac. R.R. Corp., 318 U.S. 448 (1943). Distinction must be drawn between "feasible" and "fair and equitable." "A plan may be feasible and yet be not fair and equitable; thus if a reorganization plan for a railroad, with assets worth $15,000,000 and debts of $11,500,000, were to provide for the issuance of nothing but common stock having an aggregate par value of $10,000,000, all to be distributed to the old creditors, the plan would clearly be feasible and fully protective of the public interest in the railroad's services, but it would be wanting in fairness." New England Coal & Coke Co. v. Rutland R.R., 143 F.2d 179, 186 (2d Cir. 1944).


95. See note 16 supra.

96. In Chapter XI the phrase "best interests" appears together with the phrase "fair and equitable," but has been a dead letter following the U.S. Realty case, which held that the full priority rule applied. See note 26 supra.
with a railroad there can be no thought of liquidation; in the context of an ultimate alternative in the form of a Section 77 reorganization, the “best interests” of a secured creditor may well demand at least an approximation of full priority. And a further indication that a plan under 20b must rise above the level of a creditors’ bargain is found in the constant statutory reference to “classes” of stockholders and creditors. In the philosophy of the creditors’ composition the creditors were a classless society, while the term “class” connotes some deference to the contractual rights of one class as opposed to another, in short, a concern for priorities.

From the standpoint of protecting the security holders whom the casual procedure of 20b has disenfranchised from any substantial participation in the formulation of the plan of recapitalization, the standard to be imposed by the Commission and the “just and reasonable” amendments which it may make are of the utmost importance. The original plan as submitted by the carrier is likely to provide for the least sacrifices on the part of the common stockholders and the most on the part of the secured bondholders that the management believes it can induce the security holders to accept. The situation is analogous to the offer of composition which the debtor may make his creditors under Section 12, or the corporate charter amendment which the management may attempt under the provisions of state law. The Commission, on the other hand, stands in the position of the impartial arbitrator, and to the extent that its “just and reasonable” amendments may create a new and different plan from that offered by the carrier, its position corresponds to that of the trustee in Chapter X, or to its own under Section 77.

But in measuring fairness under 20b, the Commission has a much more confounding problem. At no point is there an evaluation of the corporation's

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97. In the grab-bag of judicial catch-words the phrase “in the best interests of the creditors” has yet to achieve the dignity and station of a “Term of Art,” an honor accorded to that more exacting phrase, “fair and equitable.” But the problem presents more than a metaphysical tiff. “Fair and equitable” need not be the sole trade-mark of full priority, and the fact that a statute lacks the usual talisman need not be decisive, unless form is to be exalted over substance. See Douglas & Frank, Landlords’ Claims in Reorganizations, 42 Yale L. J. 1003, 1013-14 (1933).

98. § 20b (2), (3), (4), (7).

99. However, the question remains—how great is the concern for priorities? The problem was created by the draftsmen of Section 20b, who borrowed a phrase from Section 12, with its classless society of creditors, and employed it in a context of a hierarchy of claims.

100. Empirically, two major difficulties raised by “voluntary” capital readjustments, unaided by statute, have been the inability to deal with secured obligations, and the lack of power to bind dissenters to the decision of the majority. An additional problem is raised when the corporate enterprise is large and its obligations extensively held—alternately phrased, how to secure the necessary assents, or how to provide adequate protection for the interest of the distant investor. Section 20b deals with these problems by including secured obligations within its scope, binding dissenters, and by inserting the Commission as a buffer between management and its security holders. Clearly, the effectiveness of this buffer position will be a function of the standard of fairness to which the Commission adheres or may be required to adhere.
worth as a going concern; yet the determination of this value is fundamental to a plan of reorganization under Section 77, and serves as the basis for the participation of each class of securities with respect to their priority, and for the exclusion of others in lower rank for which no equity appears. The application of the standard of full priority to a plan under 20b means that senior security holders will have to be fully compensated for their various losses in priority before the stockholders and junior security holders will be allowed to participate. The sacrifices they make in the name of "modification" will have to be indemnified by an equivalent subtraction from the junior interests, presumably the common stockholders, and it must be something more than an equivalent face amount in securities of lesser rank. But the position of technical solvency which may be occupied by the carrier at the time of its 20b petition, in the absence of a valuation based upon a capitalized estimate of future earnings (which might show the technical solvency to be a momentary phantom destined to dissolve at the slightest economic recession), indicates that some equity exists for even the lowest class of securities. The question is how much, with the further question, in what degree and in what manner should the Commission require the equity of the common stockholders (and perhaps others) to be diluted or cut out in order to compensate the senior security holders for their loss.

If some lesser standard than full priority is to be applied, what standard should it be? The standard emerging from a one-sided proxy war? The Chancellor's foot? The Commission's conscience? Or that pusillanimous recourse and rule of thumb, "relative priority"? The standard of full priority may be procrustean, but it has at least the virtue of comparative certainty.

In dealing with a solvent carrier, however, the concept of full priority as


102. See cases cited note 9 supra.

103. This is the "something more" doctrine. "Thus it is plain that while creditors may be given inferior grades of securities, their 'superior rights' must be recognized. Clearly, those prior rights are not recognized, in cases where stockholders are participating in the plan, if creditors are given only a face amount of inferior securities equal to the face amount of their claims. They must receive, in addition, compensation for the senior rights which they are to surrender. If they receive less than full compensatory treatment, some of their property rights will be appropriated for the benefit of stockholders without compensation. That is not permissible. The plan then comes within judicial denunciation because it does not recognize the creditors' 'equitable right' to be preferred to stockholders against the full value of all property belonging to the debtor corporation." Consolidated Rock Products Co. v. DuBois, 312 U.S. 510, 528 (1941). This doctrine was reiterated in Group of Institutional Investors v. Chicago, M., St. P. & Pac. R.R., 318 U.S. 523, 553, 569-71 (1943).

104. E.g., wartime earnings.

105. Short of the standard of full priority, the latitude offered by lesser standards is as wide as the metaphors symbolizing those standards are mixed. "There is no rule for the distribution of losses in reorganization which is capable of being applied independently
set forth in the *Los Angeles Lumber Products* decision and the heterodoxy of "relative priority" as supported by the *Downtown Investment Association* decision tend to merge. Theoretically the distinction might be maintained if the Commission were to set a valuation of the carrier as a going concern, based on a capitalized estimate of future earnings, and amend every submitted plan to conform. But this procedure could find scant support in the language of the statute, and a carrier undoubtedly would withdraw its petition if the result threatened the extinction of the junior security interests. When the proposed modification takes the form of a reduction in principal or of lessened interest charges, the calculation of the loss in priority suffered by the senior security holders will be more easily measured than when the plan effects an extension of maturities, or provides that interest payments be made contingent upon earnings. Compensation may assume the guise of a sinking fund, cumulative provisions in regard to interest, bondholders' participation in the capital stock, a voting trust, or other redress. But the technical obstacles of the caprice of those who apply it except the rule of absolute priority." Moore, *Railroad Fixed Charges in Bankruptcy Proceedings*, 47 J. Pol. Econ. 100, 127 (1939). See note 108 infra.


108. The full priority rule "requires more than a simple recognition of respective priorities in the distribution under the plan; it demands full satisfaction of each class in the descending hierarchy to the extent permitted by the value of the property and allows participation of the various classes only to the extent the value of the debtor's assets reflects an equity therein for them. This marks the distinction between the full priority rule and the so-called relative priority rule. Both rules recognize the respective priorities of the various classes so that each class is dealt with according to its relative rank. But the relative priority rule permits the reduction or modification of the rights of prior classes without a corresponding sacrifice or contribution by subordinate classes, and may accord participation to inferior classes even though the value of the property is such that they have no actual equity in it." 2 *Moore & Oglebay, Corporate Reorganization* 3872-3 (1948). See Bonbright & Bergerman, *Two Rival Theorics of Priority Rights of Security Holders in a Corporate Reorganization*, 28 Col. L. Rev. 127 (1928); Gerdes, *General Principles of Plans of Corporate Reorganization*, 89 U. of Pa. L. Rev. 39, 56 (1940); Dodd, *supra* note 78. The merger of the "full" and "relative" priority doctrines would be a marriage of confusion, engendered by the difficulty in ascertaining the extent to which sacrifices by the stockholders actually "compensate" the bondholders for a loss itself difficult of calculation.

109. This would involve time-consuming studies and lengthy hearings, putting a severe strain on Section 20b's rudimentary procedure. But cf. Consolidated Rock Products Co. v. DuBois, 312 U.S. 510, 520 (1941); National Surety Co. v. Coriell, 289 U.S. 426, 436 (1933) (holding that the fairness of a plan cannot be determined absent the requisite valuation data).

110. The applicant carrier is free to withdraw its petition, apparently at any time before ultimate Commission confirmation of the proposed adjustment. § 20b (2).

111. Cf. the difficulty in determining the assessment to be exacted of stockholders as the price of their inclusion in a reorganized corporation. 2 *Dewing, op. cit. supra* note 84, at 1430.
to determining the extent to which these propitiations actually "compensate" the loss in priority create, within the limits imposed by the full priority doctrine, an indeterminate problem. Certainly compensation cannot be found in features "normally common" to the type of new securities issued.\textsuperscript{112} It is a conceivable claim that "compensation" for senior security holders may be found in the mere use of 20b rather than the more lethargic and costly Section 77. This claim would be far from persuasive. Section 77 might not be a permissible alternative if insolvency were not threatening,\textsuperscript{113} and while a part of the time and expense of Section 77 is expended on its more cautious procedure, another part is incurred by the procrastination of management itself and the hopeless appeals taken by junior security interests.\textsuperscript{114} Furthermore, there is the stricture that compensation must have a money's worth and be able to find its place in the asset column of the balance sheet.\textsuperscript{115}

In determining compensation the problem of control cannot be ignored. Because of the wide dispersion of security holdings, those nominally the "owners" of the carrier are effectively divorced from control of its affairs and are relegated to the category of proxy-signers.\textsuperscript{116} Creditors usually have no voice at all. Frequently the reorganization in bankruptcy provides the only means of ousting an inept and inefficient management which has led the corporation to financial collapse.\textsuperscript{117} The draftsmen of 20b sought an end to the need for railroad bankruptcy reorganization, and to the extent that their hopes may be fulfilled the self-perpetuating position of present carrier management is made the more secure.\textsuperscript{118} Accordingly it would appear desirable that the com-


\textsuperscript{113} Under Section 77 the carrier's petition must state that "it is insolvent or unable to meet its debts as they mature." 11 U.S.C. § 205 (a) (1946).

\textsuperscript{114} See Dembitz, \textit{Progress and Delay in Railroad Reorganizations Since 1933}, 7 \textsc{Law \\& Contemp. Probs.} 393 (1940); 60 \textsc{Icc Ann. Rep.} 23 (1946).

\textsuperscript{115} Case v. Los Angeles Lumber Products Co., 303 U.S. 105, 122-3 (1939). Particularly in Chapter XV proceedings, courts have been loath to find loss to the senior security holders in a mere extension of maturities or substitution of contingent interest for fixed charges. See cases cited note 41 \textit{supra}. \textit{But cf.} Consolidated Rock Products Co. v. DuBois, 312 U.S. 510, 527-8 (1941). And such loss as may be involved has been deemed compensated by the avoidance of the more severe bankruptcy proceedings. See p. 1305 \textit{supra}. But this confuses benefit with compensation. While bondholders, particularly institutional investors, may benefit from the speedier procedure of Section 20b, this benefit must be distinguished from compensation for loss in priority. The threat of Section 77 proceedings, used as a club to force the bondholders to take less than full compensation, is sheer coercion. \textit{Cf.} Case v. Los Angeles Lumber Products Co., \textit{supra} at 123.

\textsuperscript{116} Beale \& Means, \textit{The Modern Corporation and Private Property} 277 (1932); Dodd, \textit{The Modern Corporation, Private Property, and Recent Federal Legislation}, 54 H.
\textsc{Harv. L. Rev.} 917, 923 (1941).

\textsuperscript{117} SEC, \textit{op. cit. supra} note 20, pt. I, at 863 \textit{et seq.}

\textsuperscript{118} Frequently equity proceedings in the form of a creditor's bill spelled the continued entrenchment of the old management, in the guise of a "friendly receiver." In effect the debtor stayed in possession before, during, and after the receivership, and the only change might be in the name on the letterhead of the company stationery. \textit{See} Harlin v. Brund-
penetration of senior security holders should include the right to be represented upon the board of directors of the carrier, the extent of this representation to be governed by the extent of their sacrifice. In view of the liberal attitude which the courts have had towards the claims of security holders, the courts have held that the interests of the security holders in the property of the corporation are superior to those of the creditors, except in certain cases where the property is not widely owned. See SEC v. U.S. Realty Improvement Co., 310 U.S. 434, 454 (1940).

The Constitutional Dilemma

Two constitutional issues of major importance appear to be raised by 20b. The first is whether its enactment by Congress is an appropriate exercise of the commerce power. In view of the liberal attitude which the courts have had towards the claims of security holders, the courts have held that the interests of the security holders in the property of the corporation are superior to those of the creditors, except in certain cases where the property is not widely owned. See SEC v. U.S. Realty Improvement Co., 310 U.S. 434, 454 (1940).

Accordingly there was no appreciable effort to discover and realize upon claims against the old management. Cf. In re Insull Utility Investments, 6 F.Supp. 653, 659 (N.D. Ill. 1933). The dangers inherent in this state of affairs were well recognized by the draftsmen of Chapter X. See SEC, op. cit. supra note 20, pt. I, at 157-60, 265-83; pt. VIII, at 23-37. One of the duties of the impartial trustee in Chapter X is to report to the court any fraud or mismanagement, and any causes of action available to the estate. 11 U.S.C. § 567 (3) (1946). Section 77 has a comparable provision, 11 U.S.C. § 205(c) (1946).

Experience with Chapter XI, and to a lesser extent with Chapter XV, illustrates the doctrinal necessity of permitting the creditors to participate to the full extent of their claims in whatever goodwill is available, if the mark of full priority is to be achieved. This is wholly an intra-corporate problem, not directly related to whatever may be the optimum over-all size and nature of the capital structure. Only when the goodwill is intimately tied to a particular management, in a corporation whose securities are not widely held by the public, can the creditors whose interest has been trimmed down be compensated without at least pro tanto direct participation in the goodwill of the corporation. Most railroad corporations fall into this category. Hence the rule of the Boyd case would require direct creditor participation for sacrifices made under Section 20b, most feasibly through the medium of common stock or a voting trust. See SEC v. U.S. Realty Improvement Co., 310 U.S. 434, 454 (1940).

In the petition of the Lehigh Valley under Section 20b, the Commission approved a proposed plan allotting a substantial share of the common stock to bondholders in return for their sacrifice. See note 77 supra.

While Section 20b, as an amendment to the Interstate Commerce Act, is nominally pigeon-holed under the commerce power, and indeed was so relegated during committee hearings, it may fall under the bankruptcy power as well. The fact that the debtor may be so salting is not controlling. A solvent debtor may utilize ordinary bankruptcy procedure, if he chooses, and § 4 of the Bankruptcy Act does not demand insolvency in either the equity or bankruptcy sense. See 1 Collier on Bankruptcy 578-9 (1948). It has been suggested that a reason for using the commerce power "may have been the feeling that use of the bankruptcy power would have necessitated independent judicial examination of proposed modifications and alterations rather than only administrative approval subject to court review." Hand & Cummings, The Railroad Modification Law, 48 Col. L. Rev. 689, 692 n. 12 (1948). Under this analysis appeals under Section 20b would be governed by § 208 of the Judicial Code, 36 Stat. 1149 (1911), as amended, 28 U.S.C. § 2324 (1948), under which suits attacking orders of the Commission are heard by a three-judge district court, with direct review by the Supreme Court. 38 Stat. 220 (1913), 28 U.S.C. §§ 1253, 2325 (1948). However, Section 20b contains no express provision for judicial review, and it is possible that § 10 of the Federal Administrative Procedure Act is applicable. 60 Stat. 243 (1946), 5 U.S.C.A. § 1009 (Supp. 1948). See 5 U.S.C.A. § 1001 (a), (g) (Supp. 1948). In either case the scope of the review may amount to "independent judicial examination" coextensive with that given plans under Section 77. See 5 U.S.C.A. § 1009 (e) (Supp. 1948). For the extent of judicial review of the Commission's orders, see 2
taken toward Congressional power to legislate over matters concerning inter-
state commerce, there seems little reason to believe that this issue will present
any real obstacle. Clearly the efficient conduct of interstate railroads is a
matter of Congressional concern, and an interrelation can be shown between
their operating efficiency and their financial condition.

Much more serious is the constitutional issue presented by the mandate of
the due process clause. There is no problem if 20b is interpreted as to require
full compensation for the senior security holders before their juniors may be
allowed to participate in the recapitalized company. The senior security hold-
ers would then receive the same treatment as they could expect in an equity
proceeding or a Section 77 reorganization, and should have no grounds for
complaint. But if the wording of 20b is construed to permit modification of
the contractual rights of secured creditors, or of preferred stockholders, with-
out assuring them what has come to be considered as full compensation for
their sacrifice and loss of priority, the procedure under the Act may well fall
within the category of deprivation of property without due process of law.

Assuming arguendo that 20b contemplates something less than even a bow
to a standard of full priority in the protection it assures the senior security
holders, its procedure is novel to the history of corporate reorganization or
recapitalization. In no case, apparently, has a secured creditor been bound to
a plan of reorganization or recapitalization unless, in the light of present judi-
cial opinion, it would assure him full compensation for the loss he

124. Except on a verbal level these two constitutional issues are one, and the question
—At what point does the due process clause act as a restraint on the Commerce Power?—
is intelligible only to metaphysicians and theologians of natural law. The duality of ex-
pression, however, can help to define the problem, though it cannot resolve it. Granting
the power of the Congress to regulate the operation of the railroads, can this be done in a
manner which unnecessarily takes the "property of A for the benefit of B"?

125. "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." Louisville Trust Co. v. Louisville,
502, 504 (1913); Case v. Los Angeles Lumber Products Co., 303 U.S. 105, 115-122 (1939);
SEC v. U.S. Realty & Improvement Co., 310 U.S. 434, 452 (1940); cf. Louisville Joint
(1935).

Dep't 1911); cf. R. L. Davies v. Blomberg, 185 N.C. 496, 117 S.E. 497 (1923).
theory, at least, required the plan of reorganization to be "fair and equitable."\textsuperscript{127}

In reorganizations under the various sections of the Bankruptcy Act, "fair and equitable" as a term of art has been expanded into "the law of the land." It has been held to apply to solvent and insolvent corporations alike,\textsuperscript{128} between senior and junior creditors,\textsuperscript{129} creditors and stockholders,\textsuperscript{130} and classes of stockholders \textit{inter se}.\textsuperscript{131} It is the rule of Chapter X,\textsuperscript{132} Chapter XI,\textsuperscript{133} and Section 77.\textsuperscript{134} The development of the concept gives rise to the implication that full priority is a fundamental equitable principle\textsuperscript{135} not to be evaded, regardless of the technical niceties of reorganization procedure.\textsuperscript{136}

As to preferred stockholders, a different yardstick of full priority may be applicable, but the principle remains the same. In legal doctrine they are parties to the contract established by the corporate charter, and in this capacity may agree to modify their rights by appropriate majority action. Or under the theory of the "reserve powers" implicit in the contract which a corporation makes with the chartering state, the state legislature may provide a means of modifying rights in a manner not contemplated by the stockholders at the time the stock was issued.\textsuperscript{137} Insofar as it affects preferred stockholders the procedure of $20b$ may be deemed a method of charter amendment.\textsuperscript{138} But the power to abrogate the rights of preferred stockholders has been held not to include "vested rights," has been criticized severely for its failure to conform to a standard of fairness of full priority, and in any case, often has left the preferred stockholder his right of appraisal.\textsuperscript{139} Apart from the necromancy of charter amendment under state law,\textsuperscript{140} it is evident that the rule of full priority

\textsuperscript{128} See Consolidated Rock Products Co. v. DuBois, 312 U.S. 510, 527 (1941); In re Barclay Park Corp., 90 F.2d 595, 597-8 (2d Cir. 1937); Flour Mills of America, Inc., 7 S.E.C. 1, 22 (1940).
\textsuperscript{129} In the Matter of 620 Church St. Bldg. Corp., 299 U.S. 24 (1936).
\textsuperscript{130} Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939).
\textsuperscript{131} In re Utilities Power & Light Corp., 29 F. Supp. 763 (N.D.Ill. 1939); In re Chicago G. W. R.R., 29 F.Supp. 149 (N.D.Ill. 1939).
\textsuperscript{132} Consolidated Rock Products Co. v. DuBois, 312 U.S. 510 (1941).
\textsuperscript{133} SEC v. U.S. Realty & Improvement Co., 310 U.S. 434 (1940).
\textsuperscript{134} Group of Institutional Investors v. Chicago, M., St. P. & Pac. R.R., 318 U.S. 523 (1943).
\textsuperscript{135} See 2 Moore & Oglebay, \textit{Corporate Reorganization} 3872 (1948).
\textsuperscript{136} Northern Pac. Ry. v. Boyd, 228 U.S. 482, 502 (1913).
\textsuperscript{137} See p. 1296 \textit{supra}.
\textsuperscript{138} \S 20b (5).
\textsuperscript{139} See notes 32 and 36 \textit{supra}.
\textsuperscript{140} Short of full priority, judicial implementation of a theory that corporate powers are powers in trust might hold accountable a management seeking to use the device of charter amendment for dubious extra-corporate purposes. It seems imperative to confine such amendments to the area of valid corporate economic needs. The management as trustee owes a duty to all who invest in the corporation's securities to exercise corporate powers in a way to promote the interests of the corporation as an economic whole.
STREAMLINED CAPITAL READJUSTMENT

requires full compensation to the preferred stockholders before the common stockholders may be allowed to participate.141

The due process problem was raised in the hearings and in the committee reports on 20b. There it was argued that "the prohibition against impairing the obligation of contracts runs against the States and not against the Federal Government," and that "while the fifth amendment bars arbitrary action by Congress having the effect of impairing the obligation of contracts, Federal


In the context of Section 20b, and apart from considerations of full priority, the Commission could refuse to approve a plan designed to bilk the preferred stockholders as in neither the best interests of the carrier nor of each class of its stockholders. § 20b (2).

141. A seemingly discordant note in regard to liquidations under Sections 11 (b) (2) and 11 (e) of the Public Utility Holding Company Act, 49 STAT. 820 (1935), 15 U.S.C. §79k (1946), was struck by the Supreme Court majority in Otis & Co. v. SEC, 323 U.S. 624 (1946) in the face of vociferous dissent. Here the common stock was allowed 5% participation in the new common stock despite the fact that the preferred stock had not received compensation to the full extent of its liquidation preference. However, this decision suggests, not that the full priority rule is to be abandoned in liquidations under the Act, but rather that in applying the full priority rule liquidation preference need not be the measure of preferred stockholder interest. Nevertheless, even this minor modification of the yardstick of full priority resulted in sharp criticism, and is not found in reorganizations under Chapter X of the Bankruptcy Act, In re Utilities Power & Light Corp., 29 F.Supp. 763 (N.D.Ill. 1939), nor in those under Section 77, In re Chicago G. W. R.R., 29 F.Supp. 149 (N.D.III. 1939).

In the Otis case the SEC evidently had in mind approximating full priority, for its revised plan reduced the participation of the common stock from 8% to 5%. In the Matter of United Power & Light Co., SEC Holding Co. Act Rel. No. 4215 (1943), at 19. Furthermore, "It is pointed out in Commissioner Healy's separate opinion that the words 'fair and equitable' embodied in Section 11 have a settled meaning, as determined by the courts, and that an application of the 'absolute priorities' doctrine must result in no distribution to Power's common stock in this case. But that is because he measures the rights of the preferred stock as they would be measured in bankruptcy cases, and not merely because he follows the 'absolute priorities' doctrine in determining the consequences of the measurement. In other words, we can agree with him when he says that absolute priorities must be respected, because we think that doctrine simply means that the common stock must not be accorded any participation unless the preferred stock has been fully compensated for its rights and priorities. But there the area of agreement stops, because he says further that the rights and priorities of the preferred stockholders are the same here as in bankruptcy cases, where their claims to liquidation preferences (including dividend arrearages) are treated as matured. In our view it would be unconscionable and contrary to the plain intention of Congress to so hold." Id. at 12. See Blair-Smith & Helfenstein, A Death Sentence or a New Lease on Life? A Survey of Corporate Adjustments Under the Public Utility Holding Company Act, 94 U. OF PA. L. REV. 148 (1946).
legislation having the collateral or incidental effect of impairing existing contracts has frequently been sustained. The cases relied on for this contention were the Legal Tender Cases, the Mottley case, New York v. United States and Continental Bank v. Rock Island Ry. And Commissioner Mahaffie, testifying to the same effect before the committee, placed his reliance on the Gold Clause decision.

However persuasive these cases may be in painting a picture of the broad authority which Congress may exercise through the use of its power over interstate commerce, it cannot be maintained that this power is unlimited, nor denied that in the cases above its impact upon private obligations was incidental to its broader purposes. Not cited in the committee reports was the

143. 12 Wall. 457 (U.S. 1870); cf. Texas v. White, 7 Wall. 700 (U.S. 1868); Hepburn v. Griswold, 8 Wall. 603 (U.S. 1869).
144. Louisville & N. R.R. v. Mottley, 219 U.S. 467 (1911), upholding the constitutionality of an act forbidding the giving of free railroad passes, and designed to eliminate discrimination, favoritism, and inequality. Previous to the act the railroad had issued the passes in question in settlement of a tort claim. The court took the view that the commerce power provided sufficient basis for the legislation, and that the settlement contract had become illegal and unenforceable.
145. 257 U.S. 591 (1922), upholding the constitutionality of a new rate established by the ICC which conflicted with a charter contract between the State of New York and the New York Central Railroad.
148. But cf. Martin, Substantive Regulation of Security Devices Under the Bankruptcy Power, 48 Col. L. Rev. 62, 72-4 (1948), taking the position that due process is not a limitation on the bankruptcy power. "One may conclude that substantive due process does not prohibit Congress from modifying or even destroying property rights created or recognized as valid by the states, provided such modification or destruction is within the scope of the bankruptcy power. With reference to the bankruptcy power substantive due process would seem to mean no more than that a bankruptcy law must not be arbitrary, either in its making or in its enforcement, that is to say, it must not run counter to natural law principles [citing the Gold Clause decision]." This view is concurred with by Hand & Cummings, The Railroad Modification Law, 48 Col. L. Rev. 689, 709 n.60 (1948). Argument is difficult in such a rarified atmosphere, but even there the question still remains—Is the denial of full priority without adequate reason "arbitrary" and "counter to natural law principles" or beyond "the scope of the bankruptcy power"? However, a question formulated in such conceptual terms obscures the real issues. See pp. 1319-21 infra.
149. In the Rock Island case the court upheld the constitutionality of Section 77 on the doctrinal ground that the injunction preventing creditors from enforcing their liens affected only a "remedy" and not a "right". Continental Illinois Nat. Bank & Trust Co. v. Chicago, R. I. & Pac. Ry., 294 U.S. 648, 681 (1935). However, the magic in the bankruptcy power was held not to be endless: "But while it is true that the power of
decision holding unconstitutional the first Frazier-Lemke Act as a substantial abridgment of a mortgagee's right to the property in the absence of full payment of his debt,\textsuperscript{149} nor do these reports seem to give weight to the strength and tenacity of the Supreme Court's adherence to the principles of priority announced in the \textit{Boyd} case.\textsuperscript{151}

In the context of 20b there need be no inexorable conflict between Congressional power over interstate commerce and the rights of the individual security holder protected by the due process clause. The essence of Congressional concern under the commerce power is to see that the railroads have a financial structure which permits them to function economically and efficiently. That concern may require rearrangement of railroad securities to cut fixed charges, establish sinking funds, and stagger maturities. These are the characteristic problems of what has come to be called the "feasibility" of reorganization plans. Once these problems have been resolved, however, there ensues an apparently unrelated question falling within the ambit of the due process clause — how should the securities of the new and revised capital structure be allocated among the old investors — at whose expense is feasibility to be achieved? This is the issue of "fairness"; it is not the same as the problem of "feasibility", and is capable of independent resolution.

The manner in which the new securities are distributed to the old investors will not directly facilitate the flow of commerce or the efficiency of railroad ing, except to the extent that it affects future railroad financing, perhaps making it more difficult and expensive, by frustrating investors' reasonable expectations. Disregard for full priority might enhance the attractiveness of junior

Congress under the bankruptcy clause is not to be limited by the English or Colonial law in force when the Constitution was adopted, it does not follow that the power has no limitations. Those limitations have never been explicitly defined, and any attempt to do so now would result in little more than a paraphrase of the language of the Constitution without advancing far toward its full meaning." \textit{Id.} at 609-70. "The Constitution, as it many times has been pointed out, does not in terms prohibit Congress from impairing the obligation of contracts as it does the states. But as far back as Calder \textit{v.} Bull, 3 Dall. 386 (U.S. 1798), it was said that among other acts which Congress could not pass without exceeding its authority was 'a law that destroys or impairs the lawful private contracts of citizens.'" \textit{Id.} at 680.

150. Louisville Joint Stock Land Bank \textit{v.} Radford, 295 U.S. 555 (1935), recognized the right of the creditor mortgagee, in the event of a default, to have control of the mortgaged property through a court, and to have the income of the property collected for the satisfaction of the mortgage debt. In the undue delay in the right of the creditor to fruitful exploitation of the mortgaged property, the court found the deprivation of a "right", not a mere "remedy". But adjustments under Section 20b may well comprehend more than mere delay to the bondholders in receiving their principal. While the distinction between the destruction of a "right" as opposed to the elimination of a "remedy" may seem over-fine in this age of greater sophistication, at the nub of the dichotomy lies a solicitude for the creditor, whose clamor may be temporarily quieted, but whose property is not to be taken without full compensation, at least in the absence of extreme economic exigency. \textit{Cf.} \textit{Wright v. Bank of Roanoke}, 300 U.S. 440 (1937).

securities, but only at the expense of senior issues, whose purchasers once bitten would certainly be twice shy. However, the impact of doctrine would not end here. No issue of securities, senior or junior, would be safe; the priority of any issue might be subverted by the introduction of a new security with a superior preference.

The allocation of securities among investors raises the issue which the courts sometimes identify as "taking the property of A for the benefit of B." If the allocation of securities in recapitalization cannot be justified as serving the needs of commerce, the plan invites a question as to whether the exercise of power is "arbitrary" from the point of view of due process. The answer for the court under Section 20b may turn upon the demands of expediency in the face of a railroad emergency. But while the need for financial reform of the railroads may be pressing, it seems not so pressing as to exclude other types of plans, and other forms of financial redress—refunding, voluntary debt reduction, or even Section 77 reorganization. Without 20b the carriers will not cease operations on the morrow. On the other hand, the answer may hinge on whether the impact upon the individual is "direct" or merely "incidental."

And here the entire thrust of the statute is directed toward the senior security holder. He is not so much the innocent bystander as the bulls-eye of the target.

Of course, a court might find that the issues of feasibility and fairness, having a nexus in their influence on future railroad financing, cannot be fully separated, and that the power of Congress under the commerce clause extends to both. However deleterious the possible effect on future financing, it might be regarded as a matter of legislative concern, unsuited to judicial review. However "unfair" the treatment of the secured creditor, it might be viewed as subordinate to the overriding "benefit" accruing to interstate commerce from a plan creating a more feasible capital structure. And further, it might be held that a bondholder could conceivably gain more from the uninterrupted albeit reduced payments under 20b than from a full priority plan of delayed consummation. If these arguments were to be fully accepted, a 20b plan rejecting full priority would not be considered "arbitrary."

Nevertheless, a court, with a comprehension of the dangers inherent in a


153. The secured creditor has been the object of tender judicial regard. "[T]he position of a secured creditor, who has rights in specific property, differs fundamentally from that of an unsecured creditor who has none; and . . . the [first] Frazier-Lemke Act is the first instance of an attempt, by a bankruptcy act, to abridge, solely in the interest of the mortgagor, a substantive right of the mortgagee in specific property held as security." Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 588 (1935). It might be asserted that under Section 20b the abridgment would be "in aid of the national transportation policy" and not "solely in the interest of the mortgagor." But while an effective reduction in fixed charges might be in the public interest, a denial of full compensation to the bondholder affected by that reduction might be solely in the interest of the junior security holders.
streamlined capital readjustment

But an alternative solution is available. A court unwilling to decide such a constitutional question might penetrate the verbal obscurity of the hearings and reports and the Act itself, and discover that Congress contemplated full priority under Section 20b after all. This might be done in one of two ways. Seizing upon the language embodied in paragraph (3), a court might interpret the phrase "best interests" as implying a comparison with what a secured creditor would receive under Section 77, and hence an approximation of "fair and equitable" or full priority. Furthermore, the amorphous phrase "just and reasonable" is apparently capable of meaning almost anything, and in the context of persistent statutory reference to "classes" of security holders might "justly and reasonably" be interpreted to mean "fair and equitable." On the other hand, a second approach should appeal to a more curious court.

154. "While, therefore, the Fifth Amendment forbids the destruction of a contract, it does not prohibit bankruptcy legislation affecting the creditor's remedy for its enforcement against the debtor's assets, or the measure of the creditor's participation therein, if the statutory provisions are consonant with a fair, reasonable, and equitable distribution of those assets." Kuehner v. Irving Trust Co., 299 U.S. 445, 452 (1937).

But it must be considered that many sections of the Bankruptcy Act deal rather summarily with various "rights" of creditors, in the interest of "equitable distribution" of the debtor's assets. Cf. note 148 supra. Thus §67(a) may invalidate a judicial lien obtained within four months of bankruptcy, in derogation of state law. See 4 COLLIER ON BANKRUPTCY (Moore & Oglebay ed.) ¶67.03 (1942). And under §67(c) certain statutory liens may be subordinated to a position below that of some unsecured creditors. See 4 id. ¶67.27. Nor is the bankruptcy court bound by state decisions in construing §67(d) (3), invalidating transfers whose proceeds were used by the debtor to make a preferential transfer. See 4 id. ¶¶67.38, 67.43.

Section 70(e), the "strong arm" clause, gives the trustee the status of an ideal creditor, enabling him to challenge transactions otherwise invulnerable. Furthermore, Section 70(e) "reaches out and gathers in for the trustee all the powers of avoidance available to creditors of the estate under applicable state or federal law . . . ." 4 id. ¶70.69. "The action of the trustee is for the benefit of the estate, even though all of the creditors benefit by the avoidance which some of them could not have secured in their own behalf." 4 id. ¶70.95. Moreover, under the doctrine of Moore v. Bay, 284 U.S. 4 (1932), the transfer is avoidable in toto if at all, despite the fact that the creditor in whose stead the trustee acts might have avoided it only to the extent of his claim.

However these provisions may juggle the priority status of the several creditors, they do not attempt to subordinate in the interest of junior creditors the claim of a senior creditor whose seniority of position is unchallenged. Nor do they attempt to take from the creditors as a class in the interest of the debtor, except to the extent that the debtor is ultimately discharged from bankruptcy. But under Section 20b an attempt to dilute the interest of any or all of the creditors without a compensating sacrifice from the stockholders would accomplish just such a result.

155. See note 94 supra.
156. See p. 1309 supra.
whose conscience urges it to pursue the issue beyond the mere phrasing of paragraph (2). A perusal of the legislative history of the statute should indicate that while the underlying hope of its original draftsmen might have been to escape from the strictures of full priority, to the end of benefiting the junior security holders at their seniors' expense, this hope found its expression more in spirit than in word. At no point was there a direct commitment to a particular standard of fairness; committee reports dealing with the standard to be applied by the Commission restricted themselves to a bare recital of the terms of the bill. But the legislative history was not without opinion that a full priority standard was intended, and as the bill as finally enacted made provision for modification of equity as well as creditor interests, in contrast to earlier versions, the germ of a full priority requirement was in evidence. Confronted with this vague and diverse expression of legislative intent, and faced with the principle that a legislative enactment carries with it a presumption of constitutionality, a versatile court might invoke the familiar maxim that when a statute may be interpreted in one of two ways, it will be so interpreted as to avoid constitutional doubts. If a serious doubt is present as to the demands of the due process clause, the court would then feel itself bound to interpret 20b as requiring conformity to the standard of full priority.

THE SINE CURVE OF CAPITALISM

Railroad reorganizations come as economic retribution for a carrier's more ebullient youth, the effects of early follies being intensified by the ups and downs of the national economy. From the standpoint of sophisticated economic theory it may make little sense to have the inability to pay a maturing obligation a signal for the ritual of reorganization procedure. But in spite of the moral support this modest judgment may receive from the historical tendency of courts of equity to temper the wind to the shorn lamb, it is in derogation of the philosophy that the creditor has a moral right to full payment.

157. And see notes 4 and 11 supra.
158. See Hearings and Reports cited note 2 supra.
159. See SEN. REP. No. 897, 80th Cong., 2d Sess. 3 (1948); SEN. REP. No. 1170, at 2; HOUSE REP. No. 923, at 15.
and that the reasonable expectations of men should not be denied them without good reason. In an unstable economy, the lower the fixed costs the better; perhaps all financing should be accomplished at the equity level. But whatever the merit of this contention as it may apply to future financing, the reorganizers of the present are faced with a fait accompli in the form of a railroad balance sheet containing obligations scaled as to preference and priority.

The history of capital readjustments is replete with instances of stockholders who obtain benefits at the expense of senior security holders with a nominally superior contractual position. Equity reorganizations are the frankest example, the Boyd case notwithstanding. Creditors' compositions made no pretense to do otherwise. The device of corporate charter amendment frequently left preferred stockholders at the mercy of the common stockholders, whose alliance with the management gave them a superior strategic position. Early reorganizations under Section 77B elaborated the principle of "relative priority," a rationalization enabling courts to permit stockholder participation despite evidence that they had no equity. Whatever the readjustment mechanism, the outcome was frequently the product of an intra-corporate scrimmage in which the weapons were not technical priority rights but the more prosaic advantages of position, wealth, and combination. But judicial opposition grew, both as to the dubious manner in which some plans of readjustment were formulated, and as to the nature of the ultimate plan itself. With Section 77 and 77B, and later with Chapter X, the reorganization procedure was shaped to apply more emphatic judicial and administrative scrutiny at key points, and with the Los Angeles Lumber Products case and subsequent decisions the Supreme Court left no doubt that senior security holders were to be accorded their full priority rights.

May Congress change the rules of the game? Or is the standard of full priority within the integument of due process? When a business enterprise falls upon lean years, and the prospects for the future are cloudy, should the creditors be granted their full priority at the expense of the stockholders, or should the stockholders, in recognition of their past efforts and in the name of sweet charity, be granted at least a sliver of equity on which to rest their hopes for a better tomorrow? And what if the reorganization takes place on the eve of a boom? Does the answer depend upon the size of the business or the nature of the industry? While stockholders as a class, as opposed to creditors, are supposed to assume the risk of failure in hopes of profiting from success, stockholders of a carrier may stand on a different footing because of the rate-making function of the Interstate Commerce Commission. Furthermore, the vulnerability of a carrier to an economic recession gives reason to believe that it is thrown into reorganization not so much as a result of hapless

163. See Douglas, Democracy and Finance c. XIII (1940).
blundering on the part of management, but more because of conditions beyond management's control. Nevertheless, a person purchasing the common stock of a carrier is assumed to do it with knowledge of these conditions and in spite of them. And the person who lends money to a carrier does so with the reasonable expectation that these peculiar conditions will not make him the unwilling victim in a scheme of socialized loss.

Long-range governmental programs of control over the national economy may tend to check the cyclical nature of capitalism, and correspondingly lessen the number of future reorganizations, under whatever standard. Wise policies of debt reduction and more efficient operation can lessen the need for carrier reorganization in particular. Future financing can be accomplished with an eye to the advantages of equity issues, and a further eye to an extended use of majority clauses, with appropriate safeguards, in case bond issuance appears advisable. But, in the absence of the most exigent circumstances, it appears a dubious policy to upset existing obligations, and with statutory sanction to destroy "the promises men live by." Whether Congress in enacting 20b has actually done this, or may do it, remains to be seen.

165. The argument that "the utilization of voluntary modification procedure rather than Section 77 to accomplish a financial rearrangement would probably result in a rise in the market price of the carrier's securities," Hand & Cummings, The Railroad Modification Law, 48 Col. L. Rev. 689, 701 (1948), cuts with two edges. Consider the unhappy position of the holder or prospective purchaser of railroad first mortgage bonds which may be "modified" under Section 20b. Like railroad timetables, these railroad bonds are "subject to change without notice." See Chief Justice Marshall, dissenting in Ogden v. Saunders, 12 Wheat. 213, 353-4 (U.S. 1827).