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THE DOCTRINE OF STRICT PRIORITY IN CORPORATE RECAPITALIZATION

INVESTMENT contracts commonly recognize two ways in which the investor is compensated for his risk-taking. If the enterprise should succeed, the shareholder will receive a return out of earnings, and the creditor will receive his capital back at a fixed or determinate date; if the enterprise should fail, the investor will be paid upon liquidation out of the proceeds of the sale of corporate assets. In either case the investment contract provides for priority in the distribution of earnings or assets according to the position of the security in the hierarchy of the corporate securities determined by the amount and terms of investment. A succession of lean years may, however, confront a corporation with a serious dilemma. To pay interest on bonded indebtedness or to pay off dividend arrearages out of earnings may so deplete funds that operating expenses cannot be met; to put off payment may so injure the market position of the corporation's securities that new money, needed for future production, will not be forthcoming, and serious business difficulties, perhaps insolvency, may result. Under such circumstances, a method of rewriting the liability side of the corporate balance sheet to reflect the corporation's changed financial condition is necessary to attract new investment and to preserve the corporation as a going concern.¹ Reorganization and

1. W. & J. SLOANE, NOTICE OF SPECIAL MEETING OF STOCKHOLDERS, Oct. 5, 1944, Open Letter, is typical of explanations offered stockholders as reasons for a proposed recapitalization. See also Note (1941) 89 U. of PA. L. REV. 789, 790; Comment (1941) 39 MICH. L. REV. 1201, 1203.

recapitalization are two means of accomplishing this end. Both involve in substance the issuance of new securities for old, the term "reorganization" being generally used to include exchanges which affect debt and "recapitalization" those which involve only stock interests.²

Investment contracts are usually drafted with reference only to distributions on liquidation, which rarely take place. They do not often expressly provide for priorities in the distribution of new securities in case of reorganization or recapitalization. In reorganization, it has finally been agreed that contractual priorities are to be respected.³ No plan is "fair and equitable" unless senior claims in the hierarchy of corporate securities are "fully compensated" before junior claims participate in the reorganization.⁴ Thus, where assets are insufficient to cover more than unpaid interest on bonds, junior creditors and stockholders will receive nothing. While the application of the rule is not without ambiguity, especially where an effort is made to achieve plans which are "feasible" as well as "fair and equitable," the rule is now finally securely enthroned.

Recapitalization and reorganization are functional equivalents. Both are means of recasting the security structure to meet basic changes in the value

The SEC listing of purposes of recapitalizations is perhaps the most comprehensive: "The stated reasons advanced by the management for the plans vary. The desire not to impair the working capital of the company which large cash payments on dividend accumulations would involve; the need for rehabilitating the credit of the company impaired by the existence of large dividend arrearages; the desire to resume regular payment of current dividends; the wish to improve the market for the companies' securities; and the broad purpose of revising and simplifying the capital structure—these and other similar motives and reasons of business exigency are asserted by the management as demonstrating the need for these recapitalization plans." SEC REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATIONS COMMITTEES, Part VII (1938) 126. See also Note (1941) 26 MINN. L. REV. 387, discussing depression period problems.

2. See KEHL, CORPORATE DIVIDENDS (1941) 214; Note (1941) 19 N.Y.U.L. Q. REV. 196, 197, n. 9; BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1940) 212-3, 217.

3. Northern Pacific Ry. v. Boyd, 228 U. S. 432 (1913).

4. The *Boyd* case (*Id.* at 505), quoting Louisville Trust Co. v. Louisville Ry., 174 U. S. 674, 684 (1899), states: "any arrangement of the parties by which the subordinate rights and interests of stockholders are attempted to be secured at the expense of prior rights of either class of creditors. . . ." was invalid. The *Boyd* rule, as presently stated, is that creditors must be awarded full compensation for their claims before the rights of stockholders can be considered. For the result of its development in subsequent cases see *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106, 118, 121 (1939) (affirming the *Boyd* rule and showing the importance to reorganization law of the full compensation principle; and stating that an unsecured creditor is guaranteed protection although stockholders may have made contributions); *SEC v. U. S. Realty & Improvement Co.*, 310 U. S. 434, 452 (1940); *In re Peyton Realty Co.*, 18 F. Supp. 822, 823 (E. D. Pa. 1936); *Coriell v. Morris White, Inc.*, 54 F. (2d) 255, 258 (C. C. A. 2d, 1931) (creditor allowed to make decision as to whether he will accept new form of security in payment of his debt); *Kansas City Terminal Ry. v. Central Union Trust Co.*, 28 F. (2d) 177, 183 (C. C. A. 8th, 1928) (creditor must accept a fair offer).

of the assets and the financial condition of an enterprise. There is thus no reason not to apply the principle represented by the *Boyd* case in recapitalizations. The fact that the financial difficulties of the business are so mild that they can be met without affecting the corporate debt is no reason why the contractual rights of investors should be less thoroughly protected than in reorganization.⁵ But this supposition is not yet consistently borne out in recapitalizations under state law or under the Public Utility Holding Company Act.⁶

STATE LAW

Under state law earning preferences on preferred stock have been abolished without reference to the *Boyd* rule in the distribution of the new securities. In Delaware and New York statutory authorizations of merger and reclassification of preferred shares have been construed to allow the elimination of arrearages of cumulative and unpaid dividends without any other test of fairness than a favorable shareholder vote.⁷ Indeed, Delaware law has declared that a recapitalization plan approved by two-thirds of the share-

5. The similarity of purpose between reorganization and recapitalization may be seen in the statement: "Corporations, insolvent or financially embarrassed, often find it necessary to scale their debts and readjust stock issues with an agreement to conduct the same business with the same property under a reorganization." *Northern Pacific Ry. v. Boyd*, 228 U. S. 482, 502 (1913). See *Ecker v. Western Pac. Ry.*, 318 U. S. 448, 453 (1943). See also Dodd, *Fair and Equitable Recapitalizations* (1942) 55 HARV. L. REV. 780, 783: "Insofar, then, as recapitalization plans designed to eliminate accruals are instituted for the purpose of facilitating common-share financing, such recapitalization plans do promote the financial health of the enterprise and thus serve a purpose somewhat similar to that served by the scaling down of interest charges which is typical of reorganizations."

6. See notes 7 to 14 and 21 to 23 *infra*.

7. *Havender v. Federal United Corp.*, 11 A. (2d) 331, 337 (Del. Sup. Ct. 1940) (sanctioning merger with wholly-owned subsidiary); *Porges v. Vadsco Sales Corp.*, 32 A. (2d) 148 (Del. Ch. 1943), and *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del. 1944) (allowing elimination of arrearages through share reclassification and issuance of new class of stock); *Hottenstein v. York Ice Machinery Corp.*, 136 F. (2d) 944 (C. C. A. 3d, 1943). In construing the merger statute, DEL. REV. CODE (1935) §§ 2091-2093, courts have assumed the responsibility of determining whether the proposed action was violative of shareholders' legal rights, just as New York courts, while they have said that whether shareholders "will be better off as minority stockholders in a corporation having an immense amount of unpaid cumulative dividends or as majority stockholders in a corporation having no unpaid cumulative dividends is a question of business judgment," have determined "whether or not the proposal is violative of their legal rights." *Zobel v. American Locomotive Co.*, 182 Misc. 323, 325, 44 N. Y. S. (2d) 33, 35 (Sup. Ct. 1943), construing the New York consolidation statutes, N. Y. STOCK CORP. LAW §§ 86, 91. For New York cases holding that the legislative "reserved power" covers all aspects of share reclassification (N. Y. STOCK CORP. LAW §§ 36-37) see *Hinckley v. Schwarzschild & Sulzberger Co.*, 107 App. Div. 470, 478, 95 N. Y. Supp. 357, 363 (1st Dep't 1905); *Matter of Silberkraus*, 250 N. Y. 242, 165 N. E. 279 (1929). For a careful summary of this view see Curran, *Minority Stockholders and the Amendment of Corporate Charters* (1934) 32 MICH. L. REV. 743. However, the case of *Davison v. Parke, Austin & Lipscomb*, 285 N. Y. 500, 35 N. E. (2d) 618 (1941), specifically refused to allow the elimination of arrearages under the legislative "reserved power," following the line of case law begun by *Roberts v. Roberts-Wicks Co.*, 184 N. Y. 257, 77 N. E. 13 (1906), which

holders of each class cannot be upset save upon a showing of "bad faith."⁸ In most of these cases it is an ill-disguised fact that the elimination of arrearages has been undertaken not to meet real business difficulties but only to enable dividends to be paid sooner upon common stock. Thus, recapitalization is often a device for modifying the preferred-stock contract in favor of management's common shares without any compensating benefit to the preferred shareholders or to the corporation.⁹

established the theory that cumulative preferred shareholders had a "vested right" to payment of their arrearages. Cases restricting the scope of legislative power are *Colby v. Equitable Trust Co.*, 124 App. Div. 262, 108 N. Y. Supp. 978 (1st Dep't 1908); *Yeakam v. Providence Biltmore Hotel Co.*, 34 F. (2d) 533 (D. R. I. 1929); *Albrecht, Maguire & Co. v. General Plastics, Inc.*, 256 App. Div. 134, 9 N. Y. S. (2d) 415 (4th Dep't 1939); *Breslav v. New York and Queens Elect. Light and Power Co.*, 249 App. Div. 181, 291 N. Y. Supp. 932 (2d Dep't 1936); *Wiedersum v. Atlantic Cement Products, Inc.*, 261 App. Div. 305, 25 N. Y. S. (2d) 496 (2d Dep't 1941). In Delaware this view was adhered to only so long as *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 190 Atl. 115 (1936), was the law. Today, the *Har-ender* case, *supra*, has superseded it. See generally BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1940) 267. Thus until passage of the 1943 amendment to the Stock Corporation Law to allow elimination of arrearages, note 10 *infra*, New York authority for elimination of arrearages by indirect charter amendment was limited.

In some states, such as Ohio, Virginia, and now New York, arrearages may be eliminated by charter amendment, provided two-thirds of the shareholders of each class consent. OHIO GEN. CODE ANN. (Page, 1937) §§ 8623-14, 8623-15; VA. CODE ANN. (Michie, 1942) § 3780; N. Y. STOCK CORP. LAW § 36. However, most states, even Delaware, consider the step too drastic and give recapitalization plans involving elimination of arrearages individual attention. Even this precaution seems insufficient to assure full compensation to shareholders for their lost arrearages in the issuance of new capital stock.

The only insurance of fairness in recapitalization plans in New York and Delaware today is the requirement of a two-thirds vote of approval by all classes of shares. *Goldman v. Postal Telegraph, Inc.*, 52 F. Supp. 763, 768 (D. Del. 1943); *MacFarlane v. North Am. Cement Corp.*, 16 Del. Ch. 172, 157 Atl. 396 (1928); *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198, 202 (D. Del. 1944).

8. *Zobel v. American Locomotive Co.*, 182 Misc. 323, 328, 44 N. Y. S. (2d) 33, 37 (Sup. Ct. 1943). The difficulty in proving fraud may be inferred from the remarks of Justice Walter, ". . . I of course am not to be understood as holding that a court of equity could not intervene where fraud or bad faith is shown. No such showing is made in the papers now before the court. True, plaintiffs say that the plan is so unfair to the preferred stockholders, in favor of the common stockholders, that it amounts to fraud, but . . . that is here nothing more than an emphatic way of saying that as a matter of business judgment plaintiffs would rather keep what they now have." Delaware not only requires no statutory standard of fairness, but also demands that the stockholder prove "bad faith" or "gross unfairness" to incur judicial disapproval of a plan. *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198, 202, 205 (D. Del. 1944); *Porges v. Vadsco Sales Corp.*, 32 A. (2d) 148, 151 (Del. Ch. 1943).

9. *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198, 203 (D. Del. 1944) (plan admittedly to benefit of common stockholders was allowed although company could well have paid something on preferred arrearages); *Hottenstein v. York Ice Machinery Corp.*, 136 F. (2d) 944 (C. C. A. 3d, 1943) (arrearages were eliminated and common stock was awarded 17% interest on recapitalization although arrearages exceeded equity above par value of cumulative preferred stock).

Recapitalization for the benefit of common shares is denounced by Professor E. M.

The 1943 amendment to the New York Stock Corporation Law,¹⁰ declared constitutional in *McNulty v. W. & J. Sloane*,¹¹ allows a corporation to eliminate arrearages of cumulative unpaid dividends by charter amendment on the approval of two-thirds of the stockholders of each class. Although the Sloane Company made over \$1,000,000 profits in 1944, recapitalization was requested in order to pay dividends sooner on common stock and "to conserve its current cash for the termination of . . . war contracts and for restoring maximum peacetime activities."¹² Pursuant to the amendment, management proposed a redistribution of ownership and voting interests and the elimination of arrearages. Although the plan itself was approved at a meeting of all classes of shares, a preferred shareholder later brought suit to test the validity of the amendment. In declaring direct elimination of arrearages to be within the legislative "reserved power," Judge Shientag failed even to mention the desirability of strict priority in the distribution of new securities and did not indicate how the priority of the preferred shares was to be measured in such a distribution.¹³ Possibly he regarded the right of appraisal provided by the statute to dissenting shares as sufficient com-

Dodd in Note (1944) 57 HARV. L. REV. 894, 899: "It would be better not to permit . . . [recapitalization] at all than to allow it to become a means of transferring corporate earnings from the pockets of the preferred to those of common shareholders."

10. N. Y. STOCK CORP. LAW § 36 (E) allows the "creation, alteration or abolition . . . of any provisions or rights in respect of . . . (b) any cumulative . . . dividends, whether or not accrued, which shall not have been declared. . . ."

11. *McNulty v. W. & J. Sloane*, 54 N. Y. S. (2d) 253 (Sup. Ct. 1945).

12. W. & J. SLOANE, NOTICE OF SPECIAL MEETING OF STOCKHOLDERS, Oct. 5, 1944, Open Letter and p. 16. The statement of Net Sales and Profit or Loss shows a steady increase of profits from 1942-1944.

13. Judge Shientag upheld the amendment as to dividends accruing before or after passage of the act. After elaborating on the breadth of the legislative "reserved power" to authorize the alteration of a shareholder's rights by charter amendment, he assails the contention that the right to arrearages is vested. The problem as he sees it is not whether the right is vested, but rather the legislative intent as to it. See *Matter of Kinney*, 279 N. Y. 423, 18 N. E. (2d) 645 (1939). In support of the legislature's power he argues that a preferential right is a valuable one but "does not give rise to a chose in action which may be alienated or devised." These arguments appear to sidestep the main issue. To say that a preference right is or is not a property right seems as irrelevant as the "vested rights" theory which the Judge properly disregards. The question he fails to answer is whether any amendment is permissible if management can obtain a favorable shareholder vote, even if not made on terms fully compensatory to senior shareholder interests. 54 N. Y. S. (2d) at 260.

After reading the *Sloane* opinion, one is no clearer as to when and under what restraints the corporation may undertake recapitalization. If the amendment is construed, as here, to wipe out restraints on full corporate power such as those laid down in the *Wiedersum* case (allowing changes in capital stock to operate only prospectively) and the *Davison* case (refusing to allow elimination of arrearages without specific legislative authority), what protection of preferred stock contract rights remains? See *Wiedersum v. Atlantic Cement Products, Inc.*, 261 App. Div. 305, 25 N. Y. S. (2d) 496 (2d Dep't 1941); *Davison v. Parke, Austin & Lipscomb*, 285 N. Y. 500, 35 N. E. (2d) 618 (1941). If the courts conclude, as does Judge Shientag, that questions of "administrative control" or "prior judicial approval" are not within the scope of judicial review, one may well ask what legal or equitable devices

compensation for the loss of preferential rights involved in the elimination of arrearages.¹⁴ But appraisal rights are hardly a sufficient alternative to strict priority in the distribution of new securities. Assuming appraisal value to be largely dependent upon the market value of the stock, appraisal cannot, as a practical matter, fully compensate the stockholder for surrendering his interest in the corporation; for, whereas the opportunity to realize corporate earnings in the future may be appreciable, the market value may well be low because of past arrearages. The result seems to be that a dissenting shareholder may retain or release his interest in the corporation without being fully compensated for loss of preferential rights.

The principal argument in Delaware and New York for upholding recapitalizations of the *Sloane* variety is that by implication the power to amend is part of the shareholder's investment contract with the company. The shareholder purchased stock, the courts say, subject not only to the explicit terms of his contract with the corporation, but to the implied condition that under statutory authority the charter could be amended by the corporation.¹⁵ The argument, while orthodox, is irrelevant. The power to amend, like other corporate powers, is a power in trust. The management

do exist to insure the "fairness" of a plan to all classes of shares? 54 N. Y. S. (2d) at 262. The importance of this question is stressed in *Dodd, Fair and Equitable Recapitalizations* (1942) 55 HARV. L. REV. 780.

14. In declaring the amendment sufficient to the legislative purpose sought to be accomplished, Judge Shientag states, "The Legislature sought to guard against possible evil consequences by requiring a sufficient notice to stockholders, and a vote by the holders of record of two-thirds of the outstanding shares of each class of stock and by giving dissenting stockholders the right to an appraisal of their holdings and payment for them in cash." (Emphasis supplied.) *McNulty v. W. & J. Sloane*, 54 N. Y. S. (2d) 253, 262 (Sup. Ct. 1945). Statutes typically call for appraisal of the "value," "fair cash value," or "full market value" of stock. The New York statute calls for payment of "the value" of the appraised stock. N. Y. STOCK CORP. LAW §§ 21, 87. Under any method it appears that arrearages will lower the market value and lessen the stockholder's cash payment because of the relatively low earning power of the corporation. See Lattin, *Remedies of Dissenting Stockholders Under Appraisal Statutes*, (1931) 45 HARV. L. REV. 233, 253, 270. Professor Dodd says, "The fair value of preferred shares in an enterprise with . . . [a poor] dividend record is a matter of great uncertainty, so that the amount which a shareholder would recover in appraisal proceedings is largely unpredictable. For that and other reasons, few shareholders exercise their appraisal rights even when there is strong reason for regarding the terms of a merger as unfair.

"An appraisal right is not as a practical matter an adequate substitute for judicial scrutiny of the fairness of a recapitalization plan." Note (1944) 57 HARV. L. REV. 894, 895.

Without an appraisal right, however, the stockholder's "option" to exchange old stock for new or to remain in the same position is even less of a safeguard to the "fairness" of the plan, since more often than not the shareholder feels compelled to accept the plan. Meck, *Accrued Dividends on Cumulative Preferred Stock: The Legal Doctrine* (1941) 55 HARV. L. REV. 71, 79; Note (1940) 8 U. OF CHI. L. REV. 134, 136-7; Note (1941) 54 HARV. L. REV. 488, 491; Comment (1941) 39 MICH. L. REV. 1201, 1203.

15. Meck, *supra* note 14, at 74, discusses the enlargement of the term "corporate charter" to include all constitutionally acceptable amendments, and the development of the charter into a tripartite contract: a contract between the corporation and the state, another between the corporation and its stockholders, and a third between the stockholders inter

and the majority can arrange for its exercise only for a proper corporate purpose. It should be used fairly, in the light of the ideas of fairness developed by the reorganization cases which have followed and interpreted *Northern Pacific Railway v. Boyd*. If the altered financial condition of the corporation requires recapitalization or reorganization, the blow should fall first on the most junior interests. If recapitalization according to absolute priority would eliminate the junior class of shares from future participation, management can refuse to recapitalize in the hope of eventually paying off dividend arrearages. It then has the prospect of ultimately achieving a sufficiently liquid position to pay dividends on common stock. If business conditions really demand recapitalization, and if enforcement of the absolute priority rule would eliminate common from future participation, management should face the fact that common presently has no equity. Such instances arise frequently in reorganization cases.¹⁶

sese. Thus an individual's rights are affected not only by the amendments to the charter, but by the amount of reserved power of the legislature to authorize amendments, and by the number and value of all classes of shares issued. See also 2 DEWING, FINANCIAL POLICY OF CORPORATIONS (4th ed. 1941) 1247-8, note *r*, for a presentation of both the view for and against violation of a shareholder's contract rights through charter amendment; Note (1941) 89 U. OF PA. L. REV. 789, 792; Ober, *The Problem of Funding Accrued Dividends in Maryland* (1941) 5 MD. L. REV. 345 (discussion of same three types of contracts without explicit listing); Note (1937) 23 VA. L. REV. 579 (similar *twofold* contractual relationship discussed); *Johnson v. Fuller*, 36 F. Supp. 744, 747 (E. D. Pa. 1940).

For cases upholding the view that the investor consents in advance to certain changes in his contract when such changes are approved by the requisite number of shareholders see *Morris v. American Pub. Util. Co.*, 122 Atl. 696, 701 (Del. Ch. 1923); *Peters v. U. S. Mortgage Co.*, 114 Atl. 598 (Del. Ch. 1921); *Consolidated Film Industries, Inc. v. Johnson*, 197 Atl. 489, 493 (Del. Sup. Ct. 1937); *Federal United Corp. v. Havender*, 11 A. (2d) 331, 338 (Del. Sup. Ct. 1940); see also Note (1941) 89 U. OF PA. L. REV. 789, 792; Note (1941) 54 HARV. L. REV. 1368. It appears that whether cases hold valid or invalid the power to eliminate accrued dividends, the majority of them admit of the basic authority of corporations to alter charters for a variety of purposes.

Note (1941) 89 U. OF PA. L. REV. 789, 793, sums up briefly the fields in which the amendment power has been exercised, listing capital stock, voting rights, and shareholder liability as the most often sanctioned. *Matter of Dresser*, 247 N. Y. 553, 558-9, 161 N. E. 179, 182 (1928), allowed issuance of a new class of stock under authority to "alter preferences," while *Davison v. Parke, Austin & Lipscomb*, 285 N. Y. 500, 505, 35 N. E. (2d) 618, 621 (1941), although refusing to allow elimination of arrearages without specific authority, stated "the preferential rights that may be altered by filing an amended certificate are not, however, expressly defined or limited by statute."

The gradual enlargement of general statutory powers of a corporation to include the elimination of arrearages, *Zobel v. American Locomotive Co.*, 44 N. Y. S. (2d) 33 (Sup. Ct. 1943), has paved the way for statutory approval without simultaneously demanding of the corporation an affirmative showing of the fairness of a recapitalization plan.

16. The most recent examples are *Ecker v. Western Pac. Ry.*, 318 U. S., 448, 475, 478 (1943) where stockholders' and unsecured creditors' interests were declared to be without value in reorganization of the railroad; *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pac. R. R.*, 318 U. S. 523, 541-2 (1943), eliminating preferred and common shareholder interests on reorganization.

PUBLIC UTILITY HOLDING COMPANY ACT

Unlike state statutes, the Public Utility Holding Company Act specifically provides that recapitalizations under Section 11 shall be "fair and equitable,"¹⁷ presumably adopting that phrase as embodying the doctrine of strict priority.¹⁸ The SEC, however, has consistently upheld the participation of common shares in recapitalization even where liquidation has been specifically decreed and the liquidation preferences of preferred found to exceed the going concern value of corporate assets.¹⁹

The position of the SEC results not from a rejection of the principle of strict priority, but from its denial of the need to measure priorities by the liquidation preferences of preferred shares. The Commission recognizes the *Boyd* rule as a means of enforcing the preferences of investment contracts, which, in the case of preferred stock, are the fixed-amount preference on liquidation and the percentage preference as to income during the life of the business. Furthermore, it recognizes the adoption of the "fixed principle" of the *Boyd* rule in the "fair and equitable" standard of Section 11(e).²⁰ But the SEC, and the majority of the United States Supreme Court, assert that recapitalization is not "liquidation" within the meaning of the preferred stock contract.²¹ Thus, in arriving at a "fair and equitable" participation of the various classes of stock, the Commission considers liquidation preferences only one factor in an "over-all valuation" in which "the immediately

17. 49 STAT. 822 (1935); 15 U. S. C. § 79 k(b) (1940).

18. In the *Matter of Federal Water Service Corp.*, 8 SEC 893, 924 (1941), where Commissioner Healy stated: "The words 'fair and equitable' are 'words of art' and embody a 'fixed principle,' which has had a well understood meaning for sometime. It is the 'rigorous standard' of the *Boyd* case, as the Supreme Court has called it." See *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106, 120 (1939).

19. In the *Matter of United Light and Power Co.*, SEC Holding Company Act Release No. 4215, April 6, 1943. And this is true even where liquidation of the corporation involved has been ordered. In a prior case it had been stated that:

"In some instances the appropriate Commission order under Section 11(b) might require liquidation. In such cases a Section 11(e) plan would be a substitute for liquidation, and the words 'fair and equitable,' on such facts, would yield the same result as if the company were the debtor in a bankruptcy reorganization proceeding." In the *Matter of Federal Water Service Corp.*, 8 SEC 893, 910 (1941).

Yet in the *United Light and Power Co.* case, *supra*, the Commission refused to apply strict priority even though the recapitalization plan provided for the liquidation of the United Light and Power Co. This decision has been recently upheld by the United States Supreme Court in the case of *Otis & Co. v. SEC*, 65 Sup. Ct. 483 (U. S. 1945).

20. See note 18 *supra*.

21. "The exercise of legislative power by Congress through section 11(b)(2) to accomplish simplification as a matter of public policy and the Commission's administration of the Act by dissolution of this particular company [Maryland's United Light and Power] results in a type of liquidation which is entirely distinct from the 'liquidation of the corporation, whether voluntary or involuntary,' envisaged by the charter provisions of Power for preferences to the senior stock." *Otis & Co. v. SEC*, 65 Sup. Ct. 483, 487 (U. S. 1945). See also In the *Matter of United Light and Power Co.*, SEC Holding Company Act Release No. 4215, April 6, 1943, pp. 8-9; In the *Matter of Puget Sound Power & Light Co.*, SEC Holding Company Act Release No. 4255, April 28, 1943, p. 22.

operative rights (e.g., rights to dividends)" are more important.²² Provided reasonably anticipated earnings exceed the present dividend requirements of preferred, common stock may then be said to have some value and to be entitled to participation.²³

The reason for the SEC's refusal to measure priorities by the liquidation preferences of preferred is most clearly discerned in the distinction made between reorganization, where "liquidation is in the air," and recapitalization. It is only in reorganization cases, says the Commission, that "the touchstone of the 'fair and equitable' standard—the recognition of contractual rights—requires compensation for a matured right to a *liquidating* priority." The Commission feels that since creditors, ". . . absent assumption of jurisdiction by a court of equity or a court of bankruptcy under the

22. *In the Matter of Southern Colorado Power Co.*, SEC Holding Company Act Release No. 4501, August 24, 1943, p. 16. See also *In the Matter of United Light and Power Co.*, SEC Holding Company Act Release No. 4215, April 6, 1943, p. 13, stating that although it may not be necessary to make an over-all valuation of the enterprise, it is necessary "to examine into the respective existing interests of the preferred and common stockholders in the earnings of the enterprise" to weigh the fairness of a proposed plan; *In the Matter of Virginia Public Service Co.*, SEC Holding Company Act Release No. 4618, Oct. 16, 1943, p. 27, reasoning that "the interests of the common stock must be measured by an evaluation of senior claims as a whole, giving proper emphasis to those claims that are immediately operative (such as the claims to interest and preferred dividends), and giving less significance to those claims (such as the liquidation preference of the preferred stock) which are inchoate rights."

23. See *In the Matter of Community Power and Light Co.*, 6 SEC 182, 193 (1939). In discussing common's right to participation, the Commission says, "At the present time the corporate earnings exceed the preferred dividend requirement and the forecasts of future earnings point to a still further improvement. It may be assumed, therefore, that, although it will take many years before the present common stock can hope for a return, especially in view of the crippling effect of the present capital structure, nevertheless there is an eventual prospect which must be regarded as having a present value. . . . Nevertheless, the possibility that there may eventually be dividends available for the common stock is such that we cannot say that the common stock has no value, and we therefore believe that it is entitled to some participation in the company."

The idea in full is that, since the *anticipated* earnings exceed the dividend requirements of preferred as they exist under the corporate structure prior to recapitalization, an amount will be left over at the end of each fiscal year to be applied to the payment of dividend arrearages. Assuming earnings will continue as anticipated, arrearages will be paid off at the end of a certain number of years. Thereafter the excess of earnings over preferred dividend requirements will be available to common. No matter how remote the time when common *would* receive earnings, if it were not for the intervention of recapitalization under the Public Utility Holding Company Act, the eventual possibility is said to constitute a worth vested in common which must be recognized by granting common participation in the recapitalization.

In KEHL, CORPORATE DIVIDENDS (1941) 217-8, the author also measures common's right to future participation by the degree to which the current earnings of the corporation are "in excess of the annual dividend requirements on the preferred. . . ." But the comparison here offered of *Community Power and Light* case, *supra*, and *In re Utilities Power & Light Corp.* 29 F. Supp. 763 (N. D. Ill. 1939) shows that when preferred capital itself was seriously impaired there was no reason to give common a continuing interest.

In granting common shares a participation the Commission raises a vexing problem: how and by what criteria is the *amount* of participation to be measured. For example, in

reorganization provisions, would have had the common law right . . . to dismember the corporation, it is 'fair and equitable' to distribute the assets on the basis of the contractual rights of the parties as if in liquidation."²⁴ Later the Commission remarks concerning recapitalization, "In such cases, apart from Section 11(b) of the Holding Company Act, no one has the right to force liquidation of the enterprise."²⁵

The Commission's contention seems to be that strict priority measured by liquidation preferences is employed in reorganization to compensate creditors for the statutory abrogation of their right to force liquidation and to share in the assets of the dissolved corporation. Since preferred shareholders have no such right, strict priority as measured by liquidation preferences is not applicable to recapitalizations under the Public Utility Holding Company Act.²⁶

Otis & Co. v. SEC, 65 Sup. Ct. 483 (U. S. 1945), assuming the rightfulness of common's participation, why was a 4.5% participation in the new securities allowed rather than 15%?

The difficulty in measuring common's participation is aptly illustrated in *In the Matter of American Utilities Service Corp.*, SEC Holding Co. Act Release No. 5114, June 22, 1944, where a plan which excluded common completely was disapproved after analyzing the corporate earning power from the following viewpoints: (1) amount of reasonably foreseeable earnings, (2) amount of such which may be prudently distributed, (3) increase resulting from the reinvestment in the business of such portion of these earnings as are not distributed, (4) the length of time probably required to pay off accrued arrearages, (5) the making of due compensation to the preferred stockholders for giving up their preferential position, (6) the possible reduction in fixed charges, (7) amounts potentially realizable if the company is liquidated. On the basis of these measures, common were awarded a 15% interest. The issue arises as to how much window dressing is allowable to maintain an interest for common shareholders before it is apparent their present equity is nothing. None of the above represent an accurate index for measurement.

24. *In the Matter of Federal Water Service Corporation*, 8 SEC 893, 909 (1941); see also *In the Matter of United Light and Power Co.*, SEC Holding Company Act Release No. 4215, April 6, 1943, pp. 9-10. In the latter the Commission says, "Creditors and other claimants are prevented from foreclosing or otherwise compelling an actual liquidation, but new securities are distributed among them according to their contractual and other rights determined as though in liquidation."

See also Dodd, *The Relative Rights of Preferred and Common Shareholders in Recapitalization Plans Under the Holding Company Act* (1944) 57 HARV. L. REV. 295, 301.

25. *In the Matter of Federal Water Service Corp.*, 8 SEC 893, 909 (1941).

26. Even where the liquidation of a corporation is ordered under Section 11 of the Public Utility Holding Company Act the Commission refuses to apply the doctrine of strict priority. See the *United Light and Power* case discussed in note 19 *supra*. The "fair and equitable" standard specifically set out by Congress in § 11(e) would seem to have no application to any possible kind of recapitalization under the Act, unless one accepts the rationalization of the *Otis & Co. v. SEC* case that strict priority is being applied by the Commission to going concerns. 65 Sup. Ct. 483, 489 (U. S. 1945).

In the *Otis* case, *supra*, the dissenting opinion argued that, pursuant to the dictum of the Commission in the *Federal Water Service Corp.* case, the *Boyd* rule should apply because the Commission had ordered the dissolution of *United Light and Power*. As the majority opinion points out, "liquidation" pursuant to a Section 11 order is not "liquidation" within the meaning of the preferred stock contract because the business of the dissolved corporation is continued. The dangers of the dissenting opinion's view are well pointed out by

The distinction made by the Commission is extremely vulnerable. If the *Boyd* doctrine only compensates creditors for loss of their right to enforce liquidation, no grounds can be discerned for applying strict priority in favor of preferred *shareholders* even in reorganization. Yet it is clearly established that in reorganization senior stock claims, as well as creditors' claims, must be fully compensated before participation by junior securities is allowed.²⁷ One might protest that reorganization is "liquidation" within the meaning of investment contracts, and that therefore, unlike recapitalization, reorganization matures preferred claims.²⁸ But here the argument lifts itself by its bootstraps. If reorganization were really liquidation, it would not be necessary to compensate creditors for loss of their "right" to liquidate. Obviously reorganization does not involve dissolution of the corporation and distribution of assets any more than recapitalization; both preserve corporations as going concerns. Moreover, the SEC's distinction is vulnerable from another aspect. The conception of "strict" priority as compensation for the abandonment of a supposed common-law right to judicial sale misses the practical point that, under the rules of fairness developed by the courts, reorganization must be shown to be an alternative to liquidation preferable to creditors. Reorganizations cannot be confirmed unless they are shown to provide more for creditors than they would receive upon liquidation. In many instances, of course, as with railroads or utilities, there is no real alter-

Professor E. M. Dodd in Note (1945) 58 HARV. L. REV. 604, 609. As Professor Dodd remarks, ". . . one can hardly doubt that the average security holder of Power would have been far more likely than not to have assumed that the extent of his participation in the simplified enterprise would be substantially the same regardless of what the method of simplification might be." But we can hardly go along with the next sentence: "It may, therefore, fairly be said that to characterize a plan which accomplishes that result as a fair and equitable plan is to keep faith with the spirit of the *Boyd* doctrine even if it is to fail to adhere to its letter." Rather, we agree with Professor Dodd's next remark: "For the underlying purpose of the doctrine is that the reasonable expectations of corporate creditors and corporate investors with respect to their priorities shall not be defeated as a result of changes in the financial structure of an enterprise." *I.e.*, the *Boyd* rule should apply to enforce investment contracts in any kind of a recapitalization.

27. Junior securities may otherwise participate only if they contribute new money to the reorganized corporation. Such contribution is desirable when a corporation seeks new money essential to its success. "Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made." *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106, 121 (1939), citing in accord both the *Boyd* case and *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U. S. 445 (1926).

28. *In the Matter of Federal Water Service Corp.*, 8 SEC 893, 910-1 (1941). The majority opinion also sagaciously counsels that "We must, as Mr. Justice Holmes warned, 'think things not words.' It will not do to argue that a reorganization is a reorganization, no matter why begun or under what circumstances, . . ." Thereafter the opinion blandly proceeds: "Such reasoning assumes that the contractual rights which underlie the 'fair and equitable' test are always *liquidation* rights. As we have just shown, this is not true in *non-liquidation* situations." (Emphasis supplied.) For some reason it seems that whereas "it will not do to argue that reorganization is always reorganization," it will do very well to argue that liquidation is always liquidation—even when it is reorganization. 8 SEC at 911 (1941).

native to reorganization, and it is artificial and misleading to talk of liquidation as being "in the air."²⁹

Other arguments of the Commission do not proceed in terms of the application or non-application of a rule of strict priority measured by liquidation preferences; rather they are phrased to justify the participation of common shares in the recapitalized corporation.³⁰ For example, it is asserted that the limitation upon preferred's right to receive dividends is a valuable right vested in common; for, if the statute did not exist, common would have the opportunity to realize the *possibility* of receiving earnings after the corporation had paid off dividend arrearages of preferred. This heretofore existing right is said to have a worth which must be compensated in the recapitalization.³¹ But an argument based on a hypothesis contrary to fact is hardly cogent; the statute does exist, and cuts off any right of the common shares to avoid recapitalization. Equally, if, for a strong corporate financial reason, recapitalization is necessary under state law, rights can hardly be measured as if recapitalization were unnecessary and could have been refused.

Beneath the reasoning—or rationalizing—of the Commission and the courts lies the traditional categorical distinction between "debts" (bonds) and "ownership claims" (stocks). The Commission seems to feel that the application of strict priority in recapitalization to the extent of the liquidation preferences of preferred stock would be treating preferred-stock claims as matured debts.³² But, if preferred claims were actually treated as ma-

29. See *First National Bank of Cincinnati v. Flershem*, 290 U. S. 504 (1934); and the following sections of the National Bankruptcy Act: 52 STAT. 886 (1938), 11 U. S. C. § 530 (7) (1940); 52 STAT. 887 (1938), 11 U. S. C. § 546 (3) (1940); 52 STAT. 899 (1938), 11 U. S. C. § 636 (1940).

30. See *In the Matter of Community Power and Light Co.*, 6 SEC 182 (1939); *In the Matter of Federal Water Service Corp.*, 8 SEC 893 (1941); *In the Matter of United Light and Power Co.*, SEC Holding Company Act Release No. 4215, April 6, 1943; *In the Matter of Puget Sound Power & Light Co.*, SEC Holding Company Act Release No. 4255, April 28, 1943; *In the Matter of Southern Colorado Power Co.*, SEC Holding Company Act Release No. 4501, Aug. 24, 1943; *In the Matter of Virginia Public Service Co.*, SEC Holding Company Act Release No. 4618, Oct. 16, 1943. See also *Otis & Co. v. SEC*, 65 Sup. Ct. 483 (U. S. 1945).

31. See discussion in note 23 *supra*. *In the Matter of International Paper and Power Co.*, 2 SEC 1004, 1023-4 (1937), Commissioner Healy states in a dissent:

"It is difficult to observe without some concern the extent to which stockholders, in many companies, who in good faith believed they were paying their money for a genuinely preferred position, have . . . through the bargaining leverage of common stockholdings, been euchered, cajoled, coerced, elbowed and traded out of their legal rights." As Professor Dodd says, "The bargain between preferred and common shareholders, that the former shall be preferred in liquidation but shall have no power to compel liquidation, is a bargain which is well understood by investors." He later states that the Chandler Act and the Investment Company Act have outlawed the bargain between shareholders whereby common may elect directors and control the enterprise although the value of the assets of the corporation might be less than preferred liquidation preferences. Dodd, *supra* note 24, at 301.

32. See *In the Matter of Federal Water Service Corp.*, 8 SEC 893, 910-1 (1941), where the majority opinion speaks of a senior class of stock as "an inchoate right to a future pay-

tured, they would be entitled to payment in cash after judicial sale of corporate assets, while the strict priority proposed here does not pretend to give preferred any right to cash payment. Given recapitalization, which is a realignment of ownership interests within a corporation, the rule declares only that in reorganization or recapitalization the status and participation of preferred stock in the new securities is to be measured by its liquidation preferences. The actual distribution of assets in accordance with the extent of ownership would still be contingent upon future actual liquidation.

CONCLUSION

The idea behind the *Boyd* case can be used to enforce the preferences set forth in investment contracts in situations not mentioned in those contracts: reorganization and recapitalization. To date the net result of the failure to apply the *Boyd* doctrine in recapitalization has been effectively to emasculate cumulative preferred stock contracts, and to make them inherently misleading to investors. Since recapitalization under state law and under the Public Utility Holding Company Act cuts off preferences in the payment of dividends and the distribution of assets upon liquidation, the preferred stockholder pays more money, takes more risk of loss, and has less chance of gain than the common stockholder. In all honesty to the investing public, the fact that preferred stock rights may possibly be wiped out in recapitalization should be made explicit in the stock contract. Otherwise, in an economy which depends upon the free flow of capital from private investors to corporations the circumvention of investment contracts in recapitalization may well restrict investment, limit the usefulness of a desirable form of investment contract, and endanger the success of corporate enterprise.

ment, which has no definite maturity date. . . ." It is also said that the present right to current and accumulated dividends ". . . is not absolute, as is a creditor's right to interest; it is only a relative right *vis à vis* junior classes of stock."