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INTANGIBLE VALUES IN REORGANIZATION

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THE ULTIMATE boundaries of reorganization law, the latter stemming from the constitutional power over bankruptcy legislation, do not yet appear to have been revealed. Judicial expressions concerning the Congressional effort to provide a modern reorganization machinery, revealed through Chapter X of the Chandler Act, seem to leave many questions unanswered. Among them, especially concerning the plan of reorganization, are such points as (1) what constitutes sufficient consideration from equity interests to allow the holders thereof to participate in the plan; (2) have large percentages of acceptance any value or weight in the determination whether a proposed plan should be approved; and (3) should the interests of creditors, paramount as they are in a statutory reorganization, yield before a judicial determination that the plan is unfair as a matter of law?

Questions of that character arise because Congress declared that: "The judge shall confirm a plan if satisfied that . . . (2) the plan is fair and equitable, and feasible."[1] As that provision possesses mandatory effect,[2] the courts have taken to themselves the duty of deciding first that the proposed plan is "fair and equitable," and second that it is "feasible." Since the latter calls for the exercise of a business judgment rather than a legal one, there has been little tendency on the part of the courts to pass upon the question of the feasibility of any particular plan.[3] With respect to the former, however, courts have not been so reticent since the decision in *Case* v. *Los Angeles Lumber Products*

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[1] 11 U. S. C. A. § 621.

[2] Brown v. Gerdes, 321 U. S. 178, 64 S. Ct. 487, 88 L. Ed. 659 (1944).

[3] In the case of In re Dover Boiler Works, 38 F. Supp. 701 at 706 (1941), the court said it was "leaving to the creditors and stockholders . . . the question of the economic business wisdom of the plan proposed."

Company,[4] which case construed the effect of similar phraseology in former Section 77B.[5] It was there stated that the words "fair and equitable" were words of art which had acquired a fixed meaning through prior judicial interpretation, words which meant, regardless of common understanding, that a plan which deviated from the "strict priority" rule, developed by a divided court in the days of equity reorganizations,[6] was necessarily unfair and inequitable as a matter of law. The fact that large percentages of the interested persons had voted in favor of the plan there concerned was deemed to be no criterion as to its fairness.

In the wake of that decision, and particularly in cases involving Section 221(2) of Chapter X of the Chandler Act, have come such statements as that the test of fairness and equitable treatment applies alike to both solvent and insolvent corporations;[7] that prior rights must be observed and cannot be sacrificed while equity interests go unchanged;[8] that a court may not discriminate between members of the same class or classify creditors arbitrarily without due regard to economic status;[9] but that it is not

[4] 308 U. S. 106, 60 S. Ct. 1, 84 L. Ed. 110 (1939), rehearing denied 308 U. S. 637, 60 S. Ct. 258, 84 L. Ed. 529 (1939). Justice Douglas, on the Supreme Court but a short time when he wrote the opinion, came to the bench from the chairmanship of the Securities and Exchange Commission. This commission, prior to 1938, had conducted its own survey of practices under Section 77B and had published an exhaustive report which levelled its principal attack on past management and its alleged control of reorganization proceedings. Surprising to many active practitioners in the field, the new concept in sequestration proceedings of continuing the debtor in possession was condemned even though many judges had encouraged the practice in the interest of economy of time and money as well as to preserve the good-will of the debtor's business. The ideas of the commission, revealed in such survey, extended into the revised act and appear in the provisions for a disinterested trustee with the duty to prepare the plan and the many provisions for investigation of past management. The various dicta of Justice Douglas in the Los Angeles Lumber Products Co. case must be read against this background.

[5] 11 U. S. C. A. § 207(f)(1).

[6] Northern P. R. Co. v. Boyd, 228 U. S. 482, 33 S. Ct. 554, 57 L. Ed. 931 (1913).

[7] In re Consolidated Rock Products Co., 114 F. (2d) 102 (1940), affirmed in 312 U. S. 510, 61 S. Ct. 675, 85 L. Ed. 982 (1941).

[8] Ibid. See also In re United Light & Power Co., 51 F. Supp. 217 (1943), affirmed in 142 F. (2d) 411 (1944), and in 323 U. S. 624, 65 S. Ct. 483, 89 L. Ed. 511 (1945); Whitmore Plaza Corporation v. Smith, 113 F. (2d) 210 (1940). The mere contingent possibility of violation of prior rights is not enough, however, according to In re Universal Lubricating Systems, 150 F. (2d) 832 (1945), cert. den. 326 U. S. 744, 66 S. Ct. 58, 90 L. Ed. (adv.) 45 (1945).

[9] Geist v. Prudence Realization Corp., 122 F. (2d) 503 (1941), affirmed in 316 U. S. 89, 62 S. Ct. 978, 86 L. Ed. 1293 (1942). See also In re Janson Steel & Iron Co., 47 F. Supp. 652 (1942).

necessary that the plan be the fairest one that could be drafted.[10] All these, and other, pronouncements have been made upon the basis that whether a given plan should be approved because "fair and equitable" is a matter of law to be determined by a court without regard to the expressed wishes of large majorities of the interested parties.

As the reorganization statute was enacted for the special benefit of the businessman, he should not lightly surrender to the lawyer and the court the part Congress has assigned to him. For that matter, public interest, recognized by assigning to the Securities and Exchange Commission a function in the proceedings,[11] should not be lightly cast aside. If the plan is "fair and equitable" in the eyes of those most vitally concerned, it comes with some surprise to be told that it cannot be approved because it is not so regarded by those concerned with the question solely as an exercise in law. Creditors, realizing that the wastage of liquidation is often as irredeemable as that of war, well may express astonishment to be told that because "bondholders might fare worse as a result of a foreclosure and liquidation than they would by taking a debtor's plan"[12] still that fact has no relevant bearing on whether a proposed plan meets the test of the statute when so interpreted.

Only the bankruptcy power can afford protection to both debtor and creditor against the needless waste produced by an unwise use of credit. Financial crises which have threatened the life of the Republic have been tempered by bankruptcy measures enacted from time to time, but it was not until the depression of the '30's that Congress responded to the emergency by passing laws which went beyond the stage of mere composition. Even the Supreme Court has noted that the constitutional power has not

[10] In re Radio-Keith-Orpheum Corporation, 106 F. (2d) 22 (1939), cert. den. 308 U. S. 622, 60 S. Ct. 377, 84 L. Ed. 519 (1940).

[11] 11 U. S. C. A. § 572.

[12] Case v. Los Angeles Lumber Products Co., 308 U. S. 106 at 123, 60 S. Ct. 1, 84 L. Ed. 110 at 124 (1939).

been enlarged, but merely given wider exercise with each new measure.[13] By so doing, Congress called upon all to make concessions of the kind often necessary to maintain the body politic.[14] It is regrettable that the courts have been hesitant in following the expressed intention of Congress designed to so enlarge the scope of the reorganization process that it might become a vital force in our economy.

The depression years are past, but a new phase is beginning with the business reconversion following upon a war-time expansion. With the removal of protective controls and subsidies, optimistic results are expected but private enterprise is re-emerging in a climate rendered unhealthy by labor monopolies and trends toward socialism and collectivism. Business casualties are inevitable. What consideration, then, should be given to a wise evaluation of the assets, the past earning records and the future earning prospects of these prospective Chapter X debtors; what recognition should be accorded to the value of past management in aiding the process of rehabilitation; what allowance ought to be made to equity interests unfortunately facing destruction? If judicial hesitation and tentative fumbling nullify the Congressional intent by untoward interpretation of the Chandler Act, further action by Congress to overcome such interpretations will become essential.

Classes of creditors and stockholders admittedly must preserve their ranks during reorganization, in the absence of reason for subordination, so that elimination of some, in the event there

[13] In Continental Ill. N. B. & T. Co. v. C. R. I. & P. R. Co., 294 U. S. 648 at 671, 55 S. Ct. 595, 79 L. Ed. 1110 at 1125 (1935), the court, commenting upon the several bankruptcy statutes, said: "Taken altogether, they demonstrate in a very striking way the capacity of the bankruptcy clause to meet new conditions as they have been disclosed as a result of the tremendous growth of business and development of human activities from 1800 to the present day. And these acts, far-reaching though they may be, have not gone beyond the limit of congressional power; but rather have constituted extensions into a field whose boundaries may not yet be fully revealed."

[14] Chief Justice Waite, speaking in Canada Southern R. R. Co. v. Gebhard, 109 U. S. 527 at 536, 3 S. Ct. 363, 27 L. Ed. 1020 at 1024 (1883), once said: "Every member of a political community must necessarily part with some of the rights which, as an individual, not affected by his relation to others, he might have retained. Such concessions make up the consideration he gives for the obligations of the body politic to protect him in life, liberty and property. Bankrupt laws, whatever may be the form they assume, are of that character."

should not be enough assets to reach down to them after taking care of senior classes in full, is inevitable. Proper appraisal of all of the assets of the debtor, of the utmost importance in order that the readjustment be fair and equitable in fact, therefore becomes a matter of paramount concern. Such appraisal should reveal not only what the debtor owes but also what it owns. The former may be a question of law, but the latter involves considerations of both law and fact hence the guidance of practical business judgment in valuing intangibles such as good will, business policies, management and the like should not be disregarded. Creditors faced with the stark reality that a demand for complete payment, either in money or property, would be futile realize that payment may eventually be had only from securities which will be made good or redeemed by the labor and skill of the managing stockholders of the debtor. As participation by the latter is permissible only if it can be said they have contributed money or money's worth to the reorganized debtor,[15] it would seem to be implied that if sufficient of the creditors are willing to allow such participation then they must have appraised the intangible benefit arising from a continuity of management as being equal to the value of that participation even though it might not find record in the balance sheet set up by accountants for the new company. Their practical business judgment, evidenced by the record of their acceptance of a proposed plan allowing for such participation, should not be lightly disregarded because some judge may feel that the rule of priority, whether "strict" or not, is being disregarded. It is not a case of taking from the "haves" in order to give gratuitously to the "have-nots," highly objectionable though that may be in a free capitalistic society, for recognition is being given to all of the values which are to be found in a modern corporate enterprise.

If the liquidation were a simple case in which only cash was to be distributed, it would not be difficult to pay the money out

[15] Marine Harbor Properties, Inc. v. Mfrs. Trust Co., 317 U. S. 78, 63 S. Ct. 93, 87 L. Ed. 64 (1942), rehearing den. 317 U. S. 710, 63 S. Ct. 254, 87 L. Ed. 566 (1942); In re Utilities Power & Light Corporation, 29 F. Supp. 763 (1939). A necessity for such new contribution must be shown according to In re Associated Owners, Inc., 32 F. Supp. 828 (1940).

according to the relative standings of the parties. When reorganization operates to parcel out future prospects, however, any oversimplification may produce a loss by ignoring certain of these intangible values in order to protect bare legal rights. The mere suggestion of prospective earning power brings in elements and factors which cannot be confined by legal rules applied without benefit of the experience of the business world. Business men know that there is intangible value to be found merely in the fact that the enterprise is functioning for it possesses an *esprit de corps* that often cannot be replaced or rebuilt except with years of effort.[16] While anticipated earning capacity can, at best, be only a prediction and not a mathematical certainty, still the market value of any property is measured by a prediction as to the use to which it can be put and the profit apt to be derived therefrom. A total valuation of the physical assets of the enterprise taken without regard to its earning capacity would be inadequate not only to determine the fairness and feasibility of a plan but also to test the solvency of the debtor. If earning capacity is to be considered at all, it should be a proper factor to be taken into account for the purpose of allowing equity interests and management to participate or else the proceedings will descend to the level of a mere duel between conflicting groups with the auction block conspicuously in view. Since anticipated profits help determine the value of an enterprise, the question then becomes one as to who can make it earn the most. The experience and standing of the old management is more likely to assure the obtaining of profitable contracts by the debtor, so Justice Douglas' statement that such intangibles reflect mere "vague hopes and possibilities"[17] which have no place in the assets column of a balance sheet is, to say the least, unrealistic. Other judges, fortunately, have felt otherwise.[18]

[16] Securities & Exch. Com. v. United States R. & Imp. Co., 310 U. S. 434, 60 S. Ct. 1044, 84 L. Ed. 1293 (1940).

[17] Case v. Los Angeles Lumber Products Co., 308 U. S. 106 at 123, 60 S. Ct. 1, 84 L. Ed. 110 at 123 (1939).

[18] In Securities & Exch. Com. v. United States R. & Imp. Co., 310 U. S. 434 at 454, 60 S. Ct. 1044, 84 L. Ed. 1293 at 1303 (1940), the court said: "In cases where subordinate creditors or the stockholders are the managers of its business, the preservation of going-concern value through their continued management of the

If it be felt that such participation would be unfair to the rights of minority groups of preferred creditors, whether silent non-acceptors or even articulate objectors, it should be remembered that the judge, by reason of the requirement that the plan obtain judicial approval, is in a position to see to it that the participation granted is not the product or result of oppression brought to bear on minority interests. The problem is more likely to be one of protecting majority groups from striking or recalcitrant minorities. If liquidation is the objective, dissidence of the minority is not serious. But where the majority wish to save the business along with its good will and other intangibles, control over minorities is essential. The services of the Securities and Exchange Commission are available for it was never intended that that body should be assigned merely the task of reading audits and appraisals of physical properties. There is nothing startling in the proposition that creditors may yield some part of their claims in order to salvage the greater part thereof. The minority group, in the absence of constitutional definitions of property and the manner by which it is to be valued, can only contend that they cannot be deprived of property rights without just compensation. If that compensation is provided in the form the intangible values they are, in the absence of fraud or oppression, left without basis for complaint.

In the present status of the law, the fact that a plan has been accepted by a large majority of the interested groups is said to be no adequate test of its fairness and equitability. Justice Douglas seemed to have feared that to permit such fact to have weight would make the court into a "mere ministerial registry of the vote of the several classes of security holders."[19] Such vote is,

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business may compensate for reduction of the claims of the prior creditors without alteration of the management's interests, which would otherwise be required by the Boyd case." The spirit of the decisions in Ecker v. Western Pacific R. Corp., 318 U. S. 448, 63 S. Ct. 692, 87 L. Ed. 892 (1943), and Consolidated Rock Products Co. v. DuBois, 312 U. S. 510, 61 S. Ct. 675, 85 L. Ed. 982 (1941), would also seem to conflict with that displayed in the Los Angeles Lumber Products Co. case.

[19] Case v. Los Angeles Lumber Products Co., 308 U. S. 106 at 114, 60 S. Ct. 1, 84 L. Ed. 110 at 119 (1939). In Metropolitan Holding Co. v. Weadock, 113 F. (2d) 207 at 209, the majority of the court, per Hicks, C. J., indicated that despite the fact that the plan had had the approval not only of the Public Trust Commission of Michigan but of the requisite percentage of the bondholders, still this was "not *a*

of course, not the only test but it is idle to say that it should not be a strong element for there would be no good reason for requiring such a large percentage of acceptances nor the setting up of elaborate machinery to safeguard the voting if it were not to possess some weight. While the vote is not a substitute for the judicial finding of fairness, it is one of the many facts helpful to the court when asked to exercise its discretion. The more that discretion is exercised without being fettered by archaic and inappropriate rules, the less likely it will be that the court will become a mere "ministerial registry." Judicial consideration of the fact of creditor approval will no more make the court a mere registry than does the parade of witnesses to and from the stand make the trial judge a mere comptometer of witnesses to become an umpire only if there is an equal number on both sides of the case. The right to vote in a truly democratic manner is not a vain exercise and creditors might well take issue with the statement that their acceptance of a plan, predicated upon their own self-interested determination that it is one most likely to succeed, is of no value in fixing its fairness and feasibility. The more learned the court be in academic legal theories, as distinguished from the possession of sound practical business experience, the more weight it should accord to the ideas of the interested participants.

The rules of economics are no more malleable than those of any other science. The holder of municipal bonds must accept the reality that he can look only to the taxing power and the ability to pay taxes for payment of his claims.[20] He cannot put the municipality out of business. The farmer's creditor knows that his rights may have to yield, under Section 75, to the right

test of fairness." Italics added. Simons, C. J., dissented on the ground that while the court was "not bound by the consent of the bondholders, nor by the approval of the plan by state or federal commissions, the self-interest that induces the former and the opportunity for detailed investigation that leads to the latter, make them highly persuasive of the fair and equitable character of the plan." From "not the only test" of Justice Douglas, the phrase descends to "not a test" in the case noted. Is this not reminiscent of what Justice Frankfurter complained about in Faitoute Iron & Steel Co. v. Asbury Park, 316 U. S. 502 at 513, 62 S. Ct. 1129, 86 L. Ed. 1629 at 1637 (1942), when he criticized a statement as "one of those inaccurate generalizations that has gained momentum from uncritical repetition."

[20] 11 U. S. C. A. § 401 et seq. See also Faitoute Iron & Steel Co. v. Asbury Park, 316 U. S. 502, 62 S. Ct. 1129, 86 L. Ed. 1629 (1942).

of the farmer to retain his land at present values even though the farmer's proposal lacks the good faith and feasibility required in corporate reorganizations.[21] There is recognition in such situations of a public interest that is being subserved by the prevention of unnecessary deflation and of the damage caused by liquidation that is too long delayed. While private corporations are not legislative favorites, there is the same real disservice being done to them and their creditors by the insistence upon bare legal rights without regard to the eventualities of actual loss. Real progress will be made, in a field the boundaries of which have not yet been fully revealed, when it is thought safe and proper to re-establish the parties in interest in control of the debtor's property, even during reorganization, and when recognition is given to the intangible values provided by continued management. In the interest of true conservation of assets and genuineness of rehabilitation, it is hoped that time will come soon.

[21] 11 U. S. C. A. § 203. See also John Hancock Mut. L. Ins. Co. v. Bartels, 308 U. S. 180, 60 S. Ct. 221, 84 L. Ed. 176 (1939).