Indiana Law Journal

Volume 9 | Issue 7 Article 7

4-1934

Corporate Reorganizations-Can Securities of the New Corporation be Forced on Recalcitrant Creditors?

CORPORATE REORGANIZATIONS—CAN SECURITIES OF THE NEW CORPORATION BE FORCED ON RECALCITRANT CREDITORS?—The reorganization plan submitted in the recent Coriell case provided that all the assets of the

---

[14] Block v. Hirsh (1921), 256 U. S. 135, 154; People v. La Fetra (1921), 230 N. Y. 429, 440, 130 N. E. 601.

[15] Chastleton Corp. v. Sinclair (1924), 264 U. S. 543, 44 S. Ct. 405, reversing (1923), 290 Fed. 348; Johnson v. Jones (1925), 48 S. D. 260, 204 S. W. 15.

[16] Preamble of the act after setting forth the conditions in Minnesota at that time, reads, "Whereas, it is believed, and the Legislature of Minnesota hereby declares its belief, that the conditions existing as hereinbefore set forth has created an emergency of such nature that justifies and validates legislation for the extension of the time of redemption from mortgage foreclosure and execution sales and other relief of a like character; and Whereas, The State of Minnesota possesses the right under its police power to declare a state of emergency to exist, and Whereas, the inherent and fundamental purposes of our government is to safeguard the public and promote the general welfare of the people, etc."

[17] Blaisdell v. Home Building and Loan Assn. (1934), 54 S. Ct. 231, 235.

insolvent company be transferred to a new corporation, all claims under $100 paid at once in cash, claims of creditors having priority by law, fees and expenses of receiver paid or assumed by the new company and all other creditors receive 20% in unsecured notes of the new company and 80% in its preferred stock. The receiver made no recommendation and the creditors' committee made no written report, nor was there any itemized statement of assets and liabilities. Bank creditors and the larger merchandise creditors urged acceptance of the plan, but a substantial minority of the unsecured creditors objected strenuously, urging that no inventory of assets had been made by the receiver or under court order, nor the liabilities so determined. They claimed that bank creditors had been preferred and protested against disposing of the assets otherwise than for cash after public sale and without competitive bids being sought. The District Court ordered the receiver to accept the plan and business was begun under its provisions. The Circuit Court of Appeals reversed this decree, holding that a court of equity lacks the power to compel a creditor of any kind to accept stocks or promises to pay in the future in full extinguishment of his claim without being afforded the alternative of receiving his full share immediately in the proceeds of the conventional sale of the property in cash, but that here the creditors' rights could be protected by having an appraisal of the assets and ascertaining their value as if sold at public sale and then paying the creditors their proportionate shares and if payment were not made in cash, these amounts could be collected by sale of the property transferred to the new corporation. The dissenting creditors petitioned for a writ of certiorari to review this decree and the Supreme Court thereupon reversed the decree of the Circuit Court and vacated that of the District Court and remanded the case for further proceedings on the ground that the District Court's procedure was improper in that it had no definite, detailed and authentic information, that there was no valuation of assets by a disinterested appraiser, nor report of operations under the receiver, nor accurate determination of creditors with the amounts of their represtive claims.[1]

The principal case leaves undecided that long debated question of whether dissenting creditors can be forced to accept securities in the new corporation in settlement of their claims. There have been several lower federal court cases and many dicta on both sides, but as yet there is no Supreme Court decision on this point.

The question was left unsettled by the Boyd case[2] which allowed an unsecured creditor, suing nine years after the foreclosure sale and reorganization thereunder, to upset that sale because such creditor had not been allowed to participate on terms at least as favorable as those offered stockholders. The great clamor which greeted this decision failed to consider, however, the full import of it. True, it does require that creditors must be recognized in any reorganization in which stockholders are recognized, but the court says further, "This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of the stockholders' retaining an interest in the reorganized

[1] National Surety Company v. Coriell (1933), 53 Sup. Ct. R. 678.

[2] Northern Pacific Railway Company v. Boyd (1912), 228 U. S. 482, 57 L. Ed. 931.

company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer, he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it. If, however, no such tender was made and kept good, he retains the right to subject the interest of the old stockholders in the property to the payment of his debt." It must be remembered, of course, that this is sheer dictum.

Six years later it was held in the Frisco reorganization[3] that a judicial determination in receivership proceedings of the fairness of a reorganization plan is binding upon creditors, even those who have not filed their claims in the proceedings, and that any effort by them to pursue the reorganized company may be enjoined. This, while not completely in point, would seem to be an indication in the affirmative as to the power of the court to force acceptance by recalcitrants. The same position was taken four years later by a lower federal court in the Rock Island case.[4] This case, while going somewhat farther in its decree, is not very strong on the facts, since about 95% of the creditors assented to the plan and the non-assenters offered no serious objection. The court concluded, however, that ascertainment of the cash value could be had by the decree without any sale and the value was fixed by the court in new stock without any cash alternative.

Judge Manton gave a similar decree[5] forcing creditors to accept ten-year debentures, no cash price being fixed for dissenters.

Those who argue on the affirmative side of this question have cited the Gebhard case[6] as authority, but it must be regarded as mere dictum, since there the court was considering the effect of Canadian legislation which would not necessarily have to comply with the requirements of due process of law, at least, according to American ideas. However, the court went on to say that legislation like that Great Britain has, whereunder minority interests are bound to accept securities when the plan is approved by the court, could be enacted here within the limits of our constitution, but whether the court can force such interests to do so in the absence of legislation was left unsettled.

Perhaps the clearest and most direct opinion now available was delivered in the Phipps case,[7] where it was held that when a decree approving reorganization secured or offered to unsecured creditors their just and equitable shares of the beneficial interests in the reorganized company, the court may lawfully enjoin enforcement of claims of such creditors by execution against the property or otherwise than as provided in the decree.

[3] St. Louis-San Francisco Railway v. Wall (1918), U. S. D. C., E. D. Mo., E. Dic., Cons. Cause Eq. No. 4847 (not reported). Cited in Vol. VIII of Lectures on Legal Topics, Some Legal Phases of Corporate Financing, Reorganization and Regulation. Lecture by Robert T. Swaine at P. 143. Chicago, 1931.

[4] Chicago, R. I. & P. Ry. Co. v. Lincoln Horse & Mule Commission Co. (1922), 284 Fed. 955 (C. C. A., 8th).

[5] Re Bijur Motor Lighting Company (1914), Judge Martin T. Manton of C. C. of A. for the 2nd C. sitting in the D. C. (not reported). Cited in 22 Col. L. R. 14.

[6] Canada Southern Railway v. Gebhard (1883), 109 U. S. 527, 3 Sup. Ct. 363.

[7] Phipps v. Chicago, R. I. & P. Ry. Co. (1922), 284 Fed. 945, 28 A. L. R. 1184 (C. C. A., 8th).

The court has power, it is said, to require the non-assenting minority to accept payment, like the majority, in the stock and securities of the reorganized corporation. Such creditors have then no recourse against the new company. This seems to be, from a business point of view, a just and desirable result.

There is one Supreme Court case, that of the Kansas City Railway,[8] which approaches the issue in our principal case. It was held there that a plan was fair and binding on unsecured creditors which offered them securities of the same grade as, but in a larger amount than those offered to stockholders The court said that unsecured creditors may be protected through other arrangements which distinctly recognize their equitable right to be preferred to stockholders against the full value of all property of the debtor corporation and afford fair opportunity under existing circumstances to avail themselves of this right. If they refuse a fair offer on such principles, they cannot attack the reorganization in a court of equity. While this decision forces the creditors to take securities to which they objected, it does not appear that the creditors had made any plea for cash payment, but were only insisting that their claim be preferred in its entirety to that of the stockholders. All that was before the court in this case were questions which themselves assumed the very point the case involved. The court criticizes these questions as lacking precision and it is possible that if the question of alternative cash payment had been brought up by the creditors, we might at least have had a definite answer.

There are some well-considered opinions and lower court decisions definitely on the other side. Judge Learned Hand set aside a sale to the reorganized company under a plan whereby general creditors were to get preferred stock in the new company, saying,[9] "A bankruptcy court under no circumstances will, or indeed, can compel creditors to accept an aliquot interest in the assets of the bankrupt under the guise of a sale. . . . The dissenting creditors must be paid in cash their own proportion of the bid, which is their inviolate right. . . . They have the right to have those assets (of the bankrupt) converted into money and nothing can invade or impair that right, unless it be by statute."[10]

A Michigan case[11] allowed the creditor to assert his claim against the reorganized company, but the facts there were stronger in his favor than in most cases, for there was evidence of fraud, the offer being for stock unauthorized by the Railroad Commission and which, if issued, would violate certain statutes.

It was said in Harding v. American Sumatra Tobacco Co.,[12] "To deprive a creditor of his usual remedies and force him into membership in the corporation which he only credited seems to me to be of very dubious correct-

---

[8] Kansas City Terminal Railway Company v. Central Union Trust Company of New York (1926), 271 U. S. 445, 46 Sup. Ct. 549.

[9] In re Prudential Outfitting Company of Delaware, Inc. (1918), 250 Fed. 504 (D. C., S. D. N. Y.).

[10] See also Kneeland v. American Loan Co. (1890), 136 U. S. 89, 34 L. Ed. 379, and Merchants' Loan & Trust Company v. Chicago Railways Co. (1907), 158 Fed. 923 (C. C. A., 7th).

[11] Wabash Railway Company v. Marshall (1923), 224 Mich. 593, 195 N. W. 134.

[12] Harding v. American Sumatra Tobacco Company (1926), 14 Fed. (2d) 168 (D. C., N. D. Ga.).

ness, however convenient and cheap it may be to reorganizers and however justly disappointing to recalcitrant minorities, who may be trying to force the majority to buy them out to get rid of them."

Obviously the right of unsecured creditors must be preserved, but must it be preserved at the expense of a much larger group of also meritorious parties and can it not be adequately preserved otherwise than in cash after a forced sale? It is practically impossible for a large corporation to reorganize without bringing in the old stockholders, first, because they control the technical ability to run the business and second, because they are more ready to put up the necessary funds in view of their previous investment. If creditors must be paid in cash, reorganization is unreasonably checked. Often it occurs that these creditors themselves are at a disadvantage in forced sales and distribution afterward. Their share of the proceeds may be, and, in fact, usually is only a fraction of their just claim. On the other hand, if the reorganized company were allowed to carry on the business, probably a much higher per cent of their claims would eventually be paid the unwilling participants.

Even if this were not true, it seems inharmonious with equitable principles that the technical rights of a few objectors should preclude a large majority of willing participants from a chance to recover their larger losses. Whether the obstructive tactics of selfish minorities are less dangerous than the chance of tyranny by the majority has not been decided by the highest tribunal or by any great weight of authority among lower courts. It would seem, however, assuming that the reorganization plan has been approved after deliberation by an accurately informed court, and a large majority of the interested parties assent, that the courts should have the power to make the plan binding, even though there is no sale and no cash is distributed to the dissenters. Upon consideration of the more recent decisions and dicta, it would seem that there is a trend toward recognizing such power in the courts, even in the absence of legislation.

M. C. M.