The Securities and Exchange Commission Looks at Corporate Reorganization Plans

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**Comments**

**THE SECURITIES AND EXCHANGE COMMISSION LOOKS AT CORPORATE REORGANIZATION PLANS**

A significant aspect of the federal government’s program for controlling “big business” is found in the authority of the Securities and Exchange Commission to supervise reorganization plans. The Public Utility Holding Company Act of 1935\(^1\) contains the first and most sweeping grant of this new power. Section 11(f) of that Act provides that, in the reorganization of any corporation

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subject to its provisions, the approval of the Commission is prerequisite to the submission of any proposed financial plan to the reorganization court. With the passage of the Chandler Bankruptcy Act in 1938, the influence of the Commission was extended to the reorganization of other types of corporate enterprises. Under the latter Act, it is provided that, in all cases involving indebtedness of more than $3,000,000, proposed plans of reorganization deemed worthy of consideration by the judge must be submitted to the Commission for examination and advisory report. In reorganizations involving a smaller amount of debt, the proposed plans may be, but are not required to be, submitted to the Commission for such reports. The Commission is taking its duties seriously and has indicated that, in the interest of the public good, it will carefully scrutinize each plan even though none of the parties immediately concerned have made any objection to its terms.

Holding Company Act of 1935. Quite apart from its program of economic planning in which the 'death sentence' provisions play so prominent a part, the Act provides a basis for realigning the legal principles of corporate practice. . . . The broad objective of the Act is to protect investors, consumers and the public in general from certain abusive practices in corporate finance and management. These practices were regarded as particularly objectionable in the public utility field where corporate structures and securities had attained a high degree of complexity. The Act proposes to eliminate some of these practices and modify others by a comprehensive program of simplification which is designed to narrow the gap between ownership and management and affects the securities of the individual company, its corporate structure, and the set-up of the holding company system to which it belongs."


5. In the Matter of Utilities Power & Light Corp., S.E.C. Holding Company Act Release No. 1655, July 28, 1939, p. 27, n. 45, citing National Surety Co. v. Coriell, 289 U.S. 426, 53 S.Ct. 678, 77 L.Ed. 1300 (1932). Compare the following language "It is the duty of the court to pass upon the feasibility of the plan of reorganization. Although the plan were unopposed, the court should not approve any feature fundamentally unsound. Especially when the objectionable feature is a new holding company whose securities when issued may be sold to the public. . . ." In re American Department Stores Corp., 16 F. Supp. 977, 979 (Del. 1936).
Our purpose here is to examine the first fourteen reports which the Securities and Exchange Commission has handed down, under the two statutes mentioned, with a view of determining what criteria the Commission is adopting in passing upon proposed reorganization plans. The fundamental standards are readily seen. Fairness and feasibility of the plans appear to be required by both Acts; the basic designs of the Holding Company Act provide important factors for consideration where corporations subject to it are concerned; further, it is apparent that—taking a broad view of its tasks—the Commission is considering all elements which it deems important in the protection of suppliers of capital from losses due to irresponsibility of management. We shall endeavor to ascertain how the Commission is interpreting and applying these standards in specific cases.

**FAIRNESS**

The Chandler Act specifically provides that reorganization plans thereunder shall be "fair and equitable" and the Commission has ruled that, in examining plans as required by Section 11(f) of the Holding Company Act, it must give consideration to the standards supplied by other sections of that Act. Section 11(e) provides that the plan must be "fair and equitable to the persons affected by such plan."

In determining "fairness" the Commission has felt that it must look to the established precedents of the courts (in equity, under Section 77B of the old Bankruptcy Act and under Chapter

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6. As of May 1, 1940, the Commission has handed down six opinions dealing with reorganization plans of corporations subject to the Holding Company Act and eight advisory opinions under the Chandler Act. For a statistical analysis of corporate reorganizations instituted under the Chandler Act during 1939, see S.E.C. Corporate Reorganization Release No. 20, Statistical Series Release No. 390, Feb. 29, 1940.

7. See note 1, supra.

8. For a discussion of problems arising from the increasing divergence of interest between ownership and "management" of modern corporations, see Berle and Means, The Modern Corporation and Private Property (1932) passim, especially Book I, c. VI, and Book II.

9. Chapter X, §§ 174, 221. These sections require that the plans shall not be approved by the judge unless the plans are "fair, equitable and feasible." Cf. Bankruptcy Act of 1898, § 77B(2)(1). Questions of "feasibility" are discussed infra, p. 706 et seq.

X of the 1938 Act). The Boyd case\textsuperscript{11} was cited and its "fixed principle" that non-contributing stockholders may not participate in the new plan at the expense of senior security holders,\textsuperscript{12} was relied upon in the first reorganization plan opinion which the Commission handed down\textsuperscript{13} and has been consistently followed in all subsequent opinions. The recent decision of the Supreme Court in Case v. Los Angeles Lumber Products Co.\textsuperscript{14} has stated the comparatively extreme view that the only basis for stockholder participation in the reorganization of an insolvent corporation is a fresh contribution in "money or money's worth." Securities and Exchange Commission opinions rendered since the date of that decision have cited it\textsuperscript{15} as authority for adherence to "strict

\textsuperscript{11} Northern Pacific Ry. v. Boyd, 228 U.S. 482, 33 S.Ct. 386, 57 L.Ed. 931 (1913), noted in (1913) 27 Harv. L. Rev. 467. Formerly regarded as a "veritable demon incarnate" by the reorganization bar (see Cravath, The Reorganization of Corporations in Some Legal Phases of Corporate Financing, Reorganization and Regulation (1917) 153, 197) the Boyd doctrine does not appear to arouse the same hostility today (see Swaine, Reorganization of Corporations: Certain Developments of the Last Decade in Some Legal Phases of Corporate Financing, Reorganization and Regulation (1931) 133, 134). The view that the doctrine is unduly favorable to minorities, giving them opportunities for dilatory tactics, is still, however, a familiar criticism. See Rodgers and Groom, Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act (1933) 33 Col. L. Rev. 571, 588; Swaine, Corporate Reorganization Under the Federal Bankruptcy Power (1933) 19 Va. L. Rev. 317, 328.

\textsuperscript{12} "The doctrine of the Boyd case and its successor, the Kansas City Railway case [K. C. Terminal Ry. v. Central Union Trust Co., 271 U.S. 445, 46 S.Ct. 549, 70 L.Ed. 1028 (1936)] is to the effect that a fair plan must give adequate recognition to the legal priorities of creditors as against stockholders. This doctrine is frequently amplified so as to require that similar recognition be given to the legal priorities existing between various classes of creditors." Dodd, The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations (1938) 38 Col. L. Rev. 223, 235. See also Frank, Some Realistic Reflections on Some Aspects of Corporate Reorganization (1938) 19 Va. L. Rev. 541, 551.

The S.E.C. has stated the "fairness" issue succinctly, saying "... we must determine whether the treatment accorded to the various classes of creditors and stockholders adequately recognizes their respective rights and priorities in the light of the assets and earnings available for such purposes." In the Matter of Utilities Power & Light Corp., S.E.C. Holding Company Act Release No. 1655, July 28, 1939, p. 19. See also Finletter, Principles of Bankruptcy Reorganization (1939) c. VI.


\textsuperscript{14} 307 U.S. 619, 60 S.Ct. 1, 84 L.Ed. 22 (1940), noted in (1940) 53 Harv. L. Rev. 485. See Dodd, The Los Angeles Lumber Products Case and its Implications (1940) 53 Harv. L. Rev. 718. See also Miller, Reorganization Plans Under Chapter X, supra note 2, at 488-490. The reorganization arose under Section 77B of the old bankruptcy act. It had been asserted that the rule of the Boyd case was inapplicable to proceedings under that section. In re Burns Bros., 14 F. Supp. 910 (S.D.N.Y. 1936); In re Peyton Realty Co., 18 F. Supp. 822 (E.D. Pa. 1936).

\textsuperscript{15} In the Matter of Reynolds Investing Co., Inc., S.E.C. Corporate Reorganization Release No. 19, Feb. 5, 1940, p. 9; In the Matter of San Fran-
priority" principles and have specifically rejected plans which were based on the theory of "relative priority,"16 saying that "the mere allocation of securities and amounts identical to those of existing claims gives no assurance of the fairness of any plan; participation by junior interests must be predicated upon the existence of value in the debtor's properties sufficient to cover senior claims."17 In its most recent opinion,18 the Commission was met with the argument that, if the corporation in reorganization were not actually insolvent, strict legal priorities would not need to be preserved, and junior security holders who had some remaining equity could "contract" with creditors for some sacrifices upon the part of the latter.19 The Commission disallowed this contention, determining that the "full priority rule" must be followed even though the debtor corporation were solvent.20

Since the right of a class of security holders to participate in a plan of reorganization depends upon whether the valuation of corporate assets shows the existence of an equity for that class,

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16. Advocates of this theory would give old security holders the same relative position in new securities and would not exclude those shown to have no equity. It is "really a theory of priority of income position, rather than a theory of priority of principal." (Note (1939) 39 Col. L. Rev. 1030, 1035). This theory seems never to have been specifically recognized by the courts (Note (1935) 35 Col. L. Rev. 549, 550-553) and has been rejected by the Commission, eo nomine in the Matter of Utilities Power & Light Corp., S.E.C. Holding Company Release No. 1655, July 28, 1939, p. 26, and its principles refuted in the Matter of San Francisco Bay Toll-Bridge Co., S.E.C. Corporate Reorganization Release No. 21, April 2, 1940, p. 11, the Commission pointing out that mere "formal" preservation of the legal ranking of securities is not enough to insure "fairness." The relative priority theory was first advanced in Swaine, Reorganization of Corporations: Certain Developments of the Last Decade (1927) 27 Col. L. Rev. 901, 912. See also Bonbright and Bergerman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization (1929) 28 Col. L. Rev. 127; Foster, Conflicting Ideals for Reorganization (1935) 44 Yale L. J. 923.


19. Id. at 22.

20. Id. at 23. The Commission conceded that no solvency cases had reached the Supreme Court under Section 77B or Chapter X, but relied upon several leading cases in lower federal courts where the debtor was considered solvent, quoting one opinion, viz., "... I do not believe a bankruptcy court is authorized in a bankruptcy proceeding to do anything else than to follow the priorities that would be followed in any other proceeding... the Bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment." See Miller, supra note 2, at 488, n. 38, for citation to a case implying that, if the corporation is not insolvent in the bankruptcy sense and all bondholders agree, certain sacrifices may be asked of the bondholders.
the starting point in considering the fairness of any plan involves estimation of the value of the enterprise.\textsuperscript{21} In determining "value," the Commission has repeatedly stated that, "for purposes of reorganization, reasonably prospective earnings of the enterprise constitute the true measure of its value."\textsuperscript{22} Elements such as book values, original or historical costs, and reproduction cost new less depreciation, are regarded generally as of evidentiary significance only insofar as they bear upon the question of earning power.\textsuperscript{23} Consideration is frequently given to these factors, not because they are direct standards of value for reorganization purposes, but because they may have a bearing on future earnings, particularly in instances where earnings are regulated by rate-making bodies.\textsuperscript{24} Any existing likelihood that state rate-making bodies may alter the rate scale in the near future is recognized as a factor in computing future gross income as the basis for determining value,\textsuperscript{25} and immediate prospects of an upturn in business have been considered in supporting a higher "valuation" than other factors would have seemed to justify.\textsuperscript{26} Capitalization bases are determined by the amount of risk involved in the operation of the particular business.\textsuperscript{27} The existence of a contingent interest may


Past earnings are substantially indicative of future earnings only if the essential factors involved in producing them have not been subjected to substantial change. (\textit{In the Matter of Flour Mills of America, Inc.}, supra at 8-12). In calculating the present value of future earnings, the earnings must be "discounted at a rate of return which may be considered appropriate in view of the risks inherent in the enterprise." (\textit{In the Matter of San Francisco Bay Toll-Bridge Co.}, supra at 12). See Bonbright, \textit{Valuation of Property} (1937) 238; Finletter, op. cit. supra note 12, at c. VII.


\textsuperscript{25} Ibid.


\textsuperscript{27} In the Matter of Griess-Pfleger Tanning Co., S.E.C. Corporate Reorganization Release No. 13, June 16, 1939, p. 8; In the Matter of La France Industries, S.E.C. Corporate Reorganization Release No. 16, Sept. 1, 1939,
preclude accurate valuation, however, and in such a case the Commission has permitted a tentatively higher valuation and inclusion in the new plan of stockholders whose equity was likewise contingent. 28

Consistently following the rule that “the priorities of the respective classes of security holders must be fully recognized,” 29 the Securities and Exchange Commission has disapproved every proposed plan which has given any appreciable recognition to security holders whose equity disappeared with the new valuation. 30 In three decisions, the Commission has proscribed the continued influence of such stockholders in the management of the reorganized company, 31 and in the Utilities Power & Light opinion, 32 it was made clear that a plan would be regarded as unfair although the only recognition accorded such old stockholders consisted in giving them warrants to subscribe for new shares at a price which would not be advantageous unless the earnings of the corporation should substantially increase. 33 In the latter holding, the Commission rejected the argument that the federal bankruptcy power did not authorize the exclusion of the stockholders 34


28. In the Matter of Reynolds Investing Co., Inc., S.E.C. Corporate Reorganization Release No. 19, February 6, 1940, p. 10. It should be noted that the plan at issue involved the liquidation of the company. It is suggested that, in the absence of this factor, the unusually high valuation would not have been permitted.

29. Id. at 5.


and dismissed a contention that the relative priorities of security holders, established in the charter of the debtor corporation, have no application except upon dissolution, liquidation, or other distribution of capital to security holders.35

Two of the plans which have been reviewed by the Commission under the Chandler Act involved the proposed “gradual liquidation” of the corporation under the continued supervision of the court.36 In each of these opinions, it was stated that the contemplated liquidation afforded no grounds for exception from the requirements of fairness and feasibility.37 The “gradual liquidation” scheme proposed in the Penn Timber Company reorganization38 necessitated a rather unique application of the “strict priority” rule. The plan provided for the court's retention of jurisdiction over the new corporation, the sale of its assets and the distribution of its proceeds over a period of at least ten years.39 During that period a moratorium would, in effect, prevail upon the exercise of creditors' rights; and two funds were to be set up, one for ratable distribution to the bondholders and the other to be used for the purchase of such bonds as could be bought at a discount on the open market during the ten year moratorium. The proponents of the plan testified that the purpose of this second fund was to permit the purchase of bonds at prices which would enable the building up of an increment for the junior interests, these junior interests being otherwise without any re-

35. Id. at 25.
38. Supra note 27.
39. In disapproving the plan as not “feasible,” the Commission pointed out that the shortest possible time in which the proposed plan could be expected to wind up corporate affairs was forty-five years! In the Matter of Penn Timber Co., S.E.C. Corporate Reorganization Release No. 8, March 17, 1939, p. 8. The Commission also took exception to the prolonged retention of jurisdiction by the court, saying “If it is intended to impose upon the Court such duties as are imposed upon it by a reorganization proceeding or a receivership, it is difficult to reconcile this provision with the provision for management which apparently contemplates the operation of the enterprise as an ordinary corporation by its own Board of Directors. As an additional consideration there is the legal problem presented by the keeping open of an estate for an indefinite length of time after an apparent consummation of a plan of reorganization.” In the Matter of Penn Timber Co., supra, at 15-16.
main equity in the enterprise. The Commission condemned this scheme in unequivocal terms, pointing out that the increment would be built up entirely at the expense of senior creditors who were forced—by the moratorium—to throw their bonds on the market at sacrificial prices. Reiterating the principle that inclusion of the junior interests could be justified only upon the basis of a new consideration moving from those interests, the Commission stated its position broadly:

"It seems immaterial to us in judging the fairness of the plan to distinguish between the various devices that may be adopted for giving one class of security holders participation at the expense of another and prior class. Where such a result will follow from the provisions of the plan, regardless of what the particular provisions may be, we believe that the plan must be condemned as unfair."

The gradual liquidation system, as such, is not proscribed, however. In the Reynolds Investing Co. opinion the Commission approved such a plan despite the fact that some equity might admittedly be thereby created for non-contributing junior interests. Conceding that such a plan seems inconsistent with "strict priority" principles, the Commission felt that that consideration was outweighed in the particular case by the benefits which the senior creditors might derive from the gradual liquidation. It was further pointed out in the opinion that those who elected to sell their securities in advance of redemption or ultimate liquidation had some assurance that they would not be required to sell at an excessive discount in order to secure immediate payment. This assurance consisted of requirements for continued interest payments during the so-called moratorium and for adequate disclosure of the data necessary for an intelligent appraisal of the value of the debentures each time tenders were solicited, and a provision that substantial retirements must be made at the end of the first three years following consummation of the plan. The Commission said:

"In view of these characteristics of the plan, it may be argued that, although an equity may be created for junior security holders because some debenture holders may elect to accept immediate payment instead of awaiting ultimate distribution,

41. S.E.C. Corporate Reorganization Release No. 19, Feb. 6, 1940.
this creation of an equity does not result from the imposition of sacrifices on debenture holders but from purely voluntary and adequately informed action on their part." 42

It has been made clear, nevertheless, that in any case where senior creditors are subjected to a delay in realization upon the assets subject to their lien, considerations must be found which can be said to be compensation for such delay. 43

Certain circumstances have been recognized as justifying the subordination of senior interests to legally inferior claims. A striking example of such exceptions to “strict priority” principles is the so-called “instrumentality doctrine” which the United States Supreme Court has recently set forth in Taylor v. Standard Gas and Electric Co. 44 In that case it was held that, in reorganization of a wholly controlled subsidiary company, open account claims of the parent holding company must be subordinated to the rights of preferred stockholders. The court pointed out that the parent company had been in complete control of the subsidiary and recited “abuses in management due to the paramount interest of interlocking officers and directors in the preservation of Standard’s position as at once proprietor and creditor” 45 which were felt to justify non-adherence to strictly legal priority rights. This application of the rule that the corporate entity will not be regarded when so to do would work fraud or injustice has been cited by the Securities and Exchange Commission in its approval of a reorganization plan which involved another subsidiary of the same holding company and in which the open account claims of the latter were again treated as inferior to the rights of preferred stockholders. 46

Various factors have also been considered as affording reason for the inclusion of junior interests which would seem to have no remaining legal interest in the reorganized corporation. Where

42. Id. at 9.
43. In the Matter of Penn Timber Co., S.E.C. Corporate Reorganization Release No. 8, March 17, 1939, p. 6; In the Matter of Reynolds Investing Co., Inc., S.E.C. Corporate Reorganization Release No. 19, Feb. 6, 1940, pp. 6, 7. (An investment trust being involved in the latter case, it was particularly important that the length of the period allotted for liquidation of all assets should not subject the senior security holders to speculative risks of market depreciation beyond those necessarily incident to an orderly liquidation. The proposed period of eight years was felt by the Commission to be too long under the circumstances).
the realization upon certain potential assets depended upon the result of pending litigation against the directors of the old company, the Commission permitted the inclusion of stockholders who might be said to have a sort of contingent equity.\textsuperscript{47} It was made clear, however, that the participation of these interests was entirely dependent upon the success of the legal action. In another case the Commission permitted the allocation of a "relatively insignificant" portion of the new stock to the old stockholders because a substantial amount of the old common stock was held by operating men employed by the reorganized company's subsidiaries, and it was felt that their participation in the plan involved an element of good-will which might be of importance to the senior security holders.\textsuperscript{48} Permitting the participation of stockholders without equity solely because of their "nuisance value" is regarded by the Commission as a practice having only doubtful merit.\textsuperscript{49} Participation has been permitted, nevertheless, as a compromise of claims which debenture holders (who had no remaining equity) had asserted to certain cash.\textsuperscript{50} Although the Commission based its decision primarily upon this factor, the pressing necessity of securing the debenture holders' cooperation and assent to the plan was also mentioned as a factor justifying their participation,\textsuperscript{51} and stock purchase warrants were permitted to be given to the old stockholders in order to obtain their consent to certain charter amendments.\textsuperscript{52} In several cases the insignificance of the amount of participation allowed the jun-

\textsuperscript{47} In the Matter of Reynolds Investing Co., Inc., S.E.C. Corporate Reorganization Release No. 19, Feb. 6, 1940.


\textsuperscript{49} In the Matter of Utilities Power & Light Corp., S.E.C. Holding Company Act Release No. 1655, July 28, 1939, p. 27. See also Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 22 (1939), in which the United States Supreme Court said that new consideration in "money or money's worth" is the only basis for stockholder participation in the reorganization of an insolvent corporation.

\textsuperscript{50} In the Matter of Detroit International Bridge Co., S.E.C. Corporate Reorganization Release No. 9, March 24, 1939, p. 6. The debenture holders were given 7.7% of the new stock.

\textsuperscript{51} Ibid. The stock of a Canadian subsidiary was pledged to secure the debentures and a reorganization of the Canadian company to complete the reorganization of the debtor would, under Canadian law, require the cooperation of the debenture holders or would necessitate an expensive foreclosure proceeding. Such a foreclosure would have meant elimination of the Canadian corporation, which it was felt desirable to preserve.

\textsuperscript{52} The passage of the amendments would preclude necessity for the formation of a new corporation and would avoid possible difficulties which might arise through the transfer of bridge franchises to such new corporation. The stock purchase warrants were said to be of "little if any value." Id. at 6-7.
ior interests has been mentioned as a reason why objection should not be made to their participation. Where, however, a quantitatively insignificant allocation of stock to the old stockholders was sufficient to give them the balance of power over a narrow margin of voting control between the public and the old management, the Commission strictly forbade such allocation. Further, as concerns relatively small inequities in a proposed financial plan, the Commission has twice indicated that approval of the plan by the various senior creditors—if they are in a position to form independent judgment—is to be regarded as a factor in determining that the plan is "fair" as to them.

In the Genesee Valley Gas Co. reorganization, various secured notes were placed in separate categories due to differences in the collateral securing them and there was wide discrepancy between the treatments accorded the several classes. The Commission


54. In the Matter of Genesee Valley Gas Co., Inc., 3 S.E.C. 104, 116 (Holding Company Act Release No. 981, Jan. 24, 1938). Approximately 2% of the new stock (739 shares) was to go to the old stockholders. Although this was less than the 2.82% which the Commission deemed a "relatively insignificant portion of the equity" in the United Telephone case, the 2% represented much power. With that 2%, the old management would have had 51.4% of the voting power. Without it, the majority control would be lost. Cf. In the Matter of San Francisco Bay Toll-Bridge Co., S.E.C. Corporate Reorganization Release No. 21, April 2, 1940, pp. 4, 14, where a plan was held unfair because the old debenture holders (without equity) were given new Class B stock, although the Class B stock had only 2% of the voting power, ranked behind all other securities (and hence had no actual value under the circumstances), and only one share was given for each $1,000 claim. Note that this opinion was rendered after the Supreme Court opinion in Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 22 (1939), had stated that only a new contribution in "money or money's worth" would justify participation by such junior interests.


57. Most of the secured notes (totaling $121,000) were allocated new common stock on a basis of 100 shares for each $1,000 claim, but a $2,600 note—held by the corporation's president and well secured—was to be given
mission conceded that variant quality in security might justify some difference in treatment if nothing were allocated to the old stock, but it disapproved the plan in the instant case and stated that there could be no justification for such differentiation in a case where, without assessment, the old stock was to participate in the reorganized company. In another case, the rule _de minimis_ was followed in permitting slightly preferential treatment of certain bonds as against other bonds which were more favorably secured. The comparative records of past interest payments and the compromise of claims and potential litigation are other items which have been considered by the Commission in allowing difference in treatment of security holders under reorganization plans.

The courts have acknowledged that differences in priority of contract rights may be recognized in various ways. Of these methods, the Commission would appear to favor that of the allocation to various classes of different amounts of the same new security. In the _Utilities Power & Light_ report the Commission pointed out that it is not necessary to allocate, to holders of senior securities, new securities prior in rank to those allocated to holders of junior securities, and it indicated that alterations in priority under the new plan could be adequately compensated in terms of the relative amounts of a single type of new security. It was indicated that, particularly under the Holding Company Act, deviation from such method would be inadvisable, since that Act makes clear the Congressional intention that unsound and complex capital structures should be avoided. Another method of

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1,000 shares of the new common, on a basis of 616 shares per $1,000 claim. The Commission said that "such a glaring differentiation of treatment . . . is arbitrary in the extreme. . . ." Id. at 114.

58. Ibid. If junior interests are to be given anything, senior claims should be accorded their full legal rights without regard to the relative quality of collateral security.


60. Id. at 10.


62. Kansas City Terminal Co. v. Central Union Trust Co., 271 U.S. 445, 46 S.Ct. 549, 70 L.Ed. 1028 (1936). The following methods have been approved: (1) Distribution of a higher ranking security, (2) Issuance of different amounts of the same security, (3) Providing for payment of disparate assessments, (4) Giving securities with various income yields, and (5) Combinations of the other methods. See Note (1935) 35 Col. L. Rev. 549.


recognizing legal priorities which the Securities and Exchange Commission has approved is the giving to senior creditors new debentures with an earlier maturity date than that of similar debentures given to inferior creditors.65

FEASIBILITY

A plan of reorganization must not only be fair, but it must also be "feasible." The issue of feasibility is whether or not, under the proposed plan, the reorganization proceedings can be terminated and the company left with sufficient working capital for its immediate needs.66 "Feasibility" is specifically required by the Chandler Act as a prerequisite to court approval of a proposed plan,67 and the Securities and Exchange Commission is given an opportunity to render advisory opinions as to whether or not it deems such plan worthy of court approval.68 Although the Holding Company Act contains no similar requirement, the language of the Securities and Exchange Commission opinions under that statute reveals that the Commission is considering whether or not the proposed reorganization plan will set the company on its feet or will leave it in such condition as to precipitate another failure.69 In approving one plan, the Commission pointed out that its adoption "should place the Company in a sound position both from the standpoint of earnings and ability to meet its financial obligations."70 "Soundness" of a plan, in view of this language, would appear to be practically synonymous with "feasibility."71 Appar-


71. It is interesting to note that the problem was discussed under an italicised heading, Soundness of the Plan, similar to the heading Fairness of the Plan in the same case and headings Feasibility of the Plan in several of the Chandler Act opinions. In the San Francisco Bay Toll-Bridge opinion (S.E.C. Corporate Reorganization Release No. 21, April 2, 1940, pp. 5-6) the various factors of "feasibility" were enumerated, viz., "These include the soundness of the proposed capital structure of the reorganized company and
ently following a similar line of thought, the Commission has refused to approve a plan the success of which was wholly contingent upon an unpredictable external event.\(^7\) The Commission reasoned that approval of the plan would lack the "finality" which administrative action should have, but this seems merely another way of stating that a plan will not be approved unless it appears certain that, if it be adopted, there will be a substantial chance of economic rehabilitation of the enterprise.\(^7\)

Where it appears that under a proposed plan the reorganized company will be able to pay the reorganization expenses, keep up with its new schedule of fixed charges and have sufficient working capital to continue its operations, such plan is recognized as "feasible."\(^7\) On the other hand, a plan which imposes an overburdening proportion of senior securities\(^7\) or under which it is clear that, for other reasons, another reorganization will be subsequently necessary, the plan will be disapproved.\(^7\) Feasibility demands that the debtor's difficulties should be resolved in the single proceeding.\(^7\)

The interrelation between "fairness" and "feasibility" is interesting. In the \textit{Griess-Pfleger Tanning Co.} opinion\(^7\) a proposed plan was held "unfair," it being pointed out that the very factors which made for feasibility, i.e., the cutting down of fixed charges, were accomplished solely at the expense of the first mortgage bondholders who were not given in return the compensation to which they were entitled.\(^7\)

In one opinion under the Holding Company Act, a plan was approved although it was quite apparent that there was insufficient

\(^7\) of the several classes of securities proposed to be issued. . . ." (Italics supplied.)


73. See Note (1938) 38 Col. L. Rev. 680, 684.


75. In the Matter of La France Industries, S.E.C. Corporate Reorganization Release No. 16, Sept. 1, 1939, p. 18. The weight of cumulative preferred dividend requirements was considered as well as that of bond interest charges.


77. Ibid.


79. Id. at 11.
ent economic justification for the existence of the company (a holding company) and no reorganization could result in its recovery as a going concern. In approving the plan, the Commission pointed out that liquidation seemed to be the only "feasible" solution and that it granted its approval primarily because of the belief that the simplification of the security structure to be effected by the plan would facilitate such liquidation. In one of the cases involving a "gradual liquidation" plan, the Commission recognized that, where there is no intention of reviving the concern permanently, "feasibility" requirements may be somewhat relaxed. On this theory it approved a plan although the new senior securities had a "face or redemptive value" which would have been excessive but for the fact that liquidation was contemplated, and although it was plain that debenture interest requirements would have to be met from the new company's capital assets. The "gradual liquidation" plan in another case, however, was so grossly impractical that it was felt that its adoption could not be justified for any reason. The quality of management is, of course, a vital factor in the practical operations of any business. Accordingly, the Commission has indicated that, where the history of the company shows that its past difficulties may be attributed in some part to errors of judgment on the part of the old management, the requirement of "feasibility" demands that a new management take over the affairs of the reorganized company.

OTHER OBJECTIVES OF THE HOLDING COMPANY ACT

In determining whether to approve or disapprove a plan of reorganization submitted to it, under Section 11(f) of the Holding Company Act, the Securities and Exchange Commission is guided by the basic principles expressed elsewhere in the Act.

81. Id. at 11.
83. In the Matter of Penn Timber Co., S.E.C. Corporate Reorganization Release No. 8, March 17, 1939, p. 10. The proposed liquidation involved the sale of timber lands on a plan which the Commission found would take at least forty-five years. Over that period of time interests requirements of various obligations would become so large as to necessitate a new reorganization.
Section 11 (b) expresses a threefold objective: the creation of geographically integrated public utility systems,86 the elimination of unnecessary complexity in the structure of holding company systems,87 and the distribution of voting control of the reorganized corporation fairly and equitably among the security holders.88 Simplification of the capital structure of the corporations which make up each holding company system is another objective, drawn from Section 7.89

Approval of a plan which promoted geographical integration of a holding company “system,” whose activities had been widely dispersed, was given by the Securities and Exchange Commission in the Utilities Power & Light opinion.90 In that case, the company in reorganization was a holding company whose investments consisted largely of widely scattered properties devoted to both utility and other purposes.91 The new plan provided that all voting stocks were to be sold and that the reorganized company should be purely an investment company, being thus entirely eliminated from the holding company structure. In another case, the Commission approved the liquidation of a holding company, pointing out that a holding company operating small and widely scattered gas utility companies had little economic justification.92 Where an approved plan accomplishes nothing as regards the integration requirements of Section 11, the Commission has made it clear that the reorganized company will continue to face the necessity of taking such action in this respect as the Commission may require.93

88. Ibid.
91. The subsidiaries consisted of box factories, broadcasting stations, motion picture theatres, a coal mine and a small railroad in Canada. The utility properties were for the most part incapable of physical interconnection and the relation of many of the non-utilities to the utilities was either non-existent or so remote as to be imperceptible. Id. at 4-5.
93. In the Matter of the United Telephone and Electric Co., S.E.C. Holding Company Act Release No. 1193, Aug. 5, 1938, p. 10. "Nothing herein contained shall be construed as a finding that the operations of the company are limited to a single integrated public utility system and to such other businesses as are reasonably incidental or economically necessary or appropriate to its operations within the meaning of Section 11(b)(1) of the Act.
The expressed policy of reducing the unnecessarily complex structure found in some holding company systems has been constantly adhered to by the Commission. Where the proposed plan would result in a relatively simple structure this factor has been cited in the report approving the plan.\textsuperscript{94} Where, however, a holding company system of four tiers was involved and the plan revealed no effort at simplification thereof, the Commission expressed its sharp disapproval.\textsuperscript{95} Pointing out that this was not essential to the decision, the plan having been disapproved as "unfair," the Commission clarified its position on this point, saying that the absence of any provisions for "eliminating" applicant's existing holding company system was a distinct limitation in the scope of the plan and that

"... the crucial factors underlying the system (and which have made necessary the present reorganization) urge something more than a mere palliative—removal of three uneconomic structures from the back of an income-producing unit might well be considered as the first requirement of any effective therapeutic."\textsuperscript{96}

The requirement of "fair and equitable distribution" of voting control, aimed at the unfettered discretion sometimes exercised by "management" in perpetuating its own power,\textsuperscript{97} is considered by the Commission in its examination of proposed plans.\textsuperscript{98} Accordingly, it has disapproved the allocation of a most minute portion of common stock to the old stockholders where such allocation would have been sufficient to permit retention of voting control by the old management.\textsuperscript{99}

The avoidance of unsound and complex capital structures is a goal continually sought by the Commission, under the mandate

\textsuperscript{96} Ibid.
\textsuperscript{97} See Berle and Means, op. cit. supra note 8, at 84-118.
of Section 7. In the Securities and Exchange Commission opinions considered herein it is to be noted that the approved plans are unanimous in providing comparatively simple capitalization for the reorganized companies, and the Commission has, from time to time, made it plain that this is no coincidence, stating that such simplicity is "undoubtedly" in the interest of investors.

**Miscellaneous Factors Considered**

Other considerations which appear to have been regarded by the Securities and Exchange Commission in its examination of financial plans submitted to it, seem to center largely around the objective of protecting the investing public. In the *San Francisco Bay Toll-Bridge* opinion, the issuance of securities without value or which were otherwise possibly deceptive to prospective purchasers was strongly disapproved. The Commission pointed out that, under Chapter X of the present Bankruptcy Act (as well as under old 77B), securities distributed in pursuance of a reorganization plan are expressly exempt from the registration requirements of the Securities Act of 1933; accordingly there is no public filing to put the public on notice as to the material facts concerning issuance of the securities. The exemption is based on the view that the Court's approval and confirmation of a reorganization plan affords adequate protection to investors. Since subsequent purchasers are entitled to assume that securities issued in the course of an approved reorganization plan are in accord with requirements of sound finance, the Commission must carefully scrutinize proposed plans to see that unsound security issues are not placed on the market. In so doing, the Commission has considered a variety of factors which it has deemed important for the protection of investors. The establishment of sinking fund provisions contemplating rapid retirement of obligations has met with the approval of the Commission, as has the incorporation

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103. In the Matter of San Francisco Bay Toll-Bridge Co., S.E.C. Corporate Reorganization Release No. 21, April 2, 1940, pp. 6, 10.

into the plan of cognate protective features. Where, in order to secure the cooperation of common stockholders, it was proposed that stock-purchase warrants, with "little if any value," be issued to stockholders, the Commission opposed this element of the plan. Clearly demonstrating its interest in the welfare of potential purchasers, the Commission questioned the advisability of issuing securities without value "in view of the possibilities of transfer to persons less well advised," and it stated that, if the benefits derived from the issuance of the warrants justified their inclusion in the plan, consideration should be given to restricting their transferability. Similarly, where the value of proposed issues of preferred and common stock was entirely contingent upon the outcome of certain litigation, the advisory opinion of the Commission recommended that the voting trust certificates which represented this stock should plainly indicate to prospective purchasers the contingent nature of the interest and should also show that the preferred stock was to have no rights of participation until the debentures were completely retired and the common stock none until the preferred be retired. The Commission further suggested that "as a further means of avoiding misapprehension or possible fraud" in the last-mentioned case, it would be more desirable for the trust certificates issued to be designated by some name other than stock, e.g., Class A and Class B participation certificates.


105. In the Matter of Utilities Power & Light Corp., S.E.C. Holding Company Act Release No. 1655, July 28, 1939, p. 20. The "protective features" approved included, inter alia, a provision that no dividends should be paid on the common stock until "the principle amount of the new debentures outstanding shall have been theretofore reduced to less than 25% of the assets of the New Company,..." (id. at 12) A requirement that a two-thirds vote of both preferred and common stock should be required to authorize the creation of any additional funded debt (id. at 13), and a requirement that—upon the accumulation of $1.87½ unpaid preferred dividends—the preferred stockholders should be entitled to elect two-thirds of the board of directors (ibid).

106. In the Matter of Detroit International Bridge Co., S.E.C. Corporate Reorganization Release No. 9, March 24, 1939, p. 7. See also In the Matter of Flour Mills of America, Inc., S.E.C. Corporate Reorganization Release No. 22, April 11, 1940, p. 26, where the issuance of valueless stock purchase warrants was said to be "contrary to public policy." It was further pointed out that, if the corporation should become prosperous and the warrants become valuable, the fact that they were outstanding might hinder possible future financing. Hence the issuance of the warrants was felt to be unsound from the point of view of the corporation.


108. Id. at 10-11.

109. Id. at 11.
The issuance of hybrid-type securities is looked upon with disfavor by the Commission. In the Griess-Pfleger Tanning Co. opinion, disapproval was expressed of the proposed issue of so-called “Capital Income Debentures.” These securities were to have no lien against the property of the company, bore contingent interest—cumulative but payable only if earned—were to be subordinated to the claims of all existing and future creditors, and were to have an important part in the control of the company. The Commission pointed out that these “debentures” would be in substance merely a preferred stock and should be frankly labeled as such. “Such a security,” said the Commission, “is unsound and deceptive and will place the initial holders, as well as subsequent purchasers and sellers, at a serious disadvantage in their dealings with one another.” Similarly, the issuance of income bonds was made a matter of objection by the Commission on the theory that such contingent interest bonds might indicate rights the realization of which may well prove illusory. It was stated that a sound reorganization plan should not include the issuance of securities with charges exceeding probable earnings, even though such charges be contingent.

A device which has been the subject of criticism as one of the means of divorcing control from ownership in corporate affairs is the “voting trust.” Accordingly, it should be expected that the Securities and Exchange Commission would look upon the establishment of such a trust with disfavor. In the case of the United Telephone and Electric Co., however, the Commission was confronted with certain practical considerations which it deemed sufficient to justify approval of the establishment of such a device. The approved plan provided for the surrender of voting control by the old common stockholders and gave 97.18% of such control to the persons who had been holders of the old preferred stock. These persons were utterly inexperienced in the management of corporate affairs and, if those affairs were to be managed efficiently, it was necessary to obtain a new chief executive from outside. An executive of sufficient ability and experience to direct the varied affairs of the corporation could not be obtained, however, without assurance of some security of tenure. Widely scattered holdings of the stock created a possibility of frequent

111. Id. at 12.
113. See Berle and Means, op. cit. supra note 8, at 77-78.
shifting of management by means of active proxy campaigns among the inexperienced stockholders.\textsuperscript{115} Reasonable continuity of service could be promised to executives if a five year voting trust were set up.\textsuperscript{116} Accordingly, the Commission gave its approval to the plan conditioned upon certain changes, which included a provision that, if the voting trust were not terminated by the referendum to be held at the end of three years, any stockholder could withdraw his securities from the trust. Moreover, the fact that the principal creditors whose interest was at stake were insisting upon the adoption of the voting trust device was stressed by the Commission in its approving opinion. In addition the voting trustees were required to register as a holding company so as to permit retention of control by the Securities and Exchange Commission.\textsuperscript{117} In a recent advisory opinion,\textsuperscript{118} handed down under the Chandler Act, a proposed voting trust was not disapproved. The Commission suggested, however, that its purpose (retention of control by bondholders who also were holders of the voting stock) might be accomplished in a "less cumbersome manner" by attaching the stock to the bonds.\textsuperscript{119}

\textbf{Conclusion}

Recent proposals to extend the authority of the Securities and Exchange Commission over investment trusts\textsuperscript{120} have given rise to much controversy.\textsuperscript{121} The root of the problem lies around

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  \item \textsuperscript{115} For a discussion of methods and difficulties involved in a proxy campaign, see Berle and Means, op. cit. supra note 8, at 81-84, 88.
  \item \textsuperscript{116} A different device was used to secure stability of management in the \textit{West Ohio Gas Co.} opinion (S.E.C. Holding Company Act Release No. 1284, Oct. 22, 1938, p. 11). The initial board of directors being elected for a three-year term.
  \item \textsuperscript{117} With similar limitations, the creating of a voting trust was approved in another case, at the instance of the holders of collateral trust bonds who thereby obtained control of the company for five years. The ownership of 98\% of the new common stock was in the holding company which had been in control of the old company. It was felt that protection of the collateral trust bondholders justified the creation of the voting trust, as against a contention that it unduly complicated the structure of the holding company system. In the Matter of Great Lakes Utilities Co., 2 S.E.C. 129 (Holding Company Act Release No. 595, April 5, 1937).
  \item \textsuperscript{118} In the Matter of San Francisco Bay Toll-Bridge Co., S.E.C. Corporate Reorganization Release No. 21, April 2, 1940.
  \item \textsuperscript{119} Id. at 5 and n. 8. The S.E.C. suggested further that, if the voting trust device were used, provisions for notice to the holders of the bonds should be adequate to permit them to actually exercise the control which it was intended that they should have.
  \item \textsuperscript{120} See the bill proposed by Senator Wagner and Mr. Lee, March 14, 1940, S. 3580.
  \item \textsuperscript{121} See, for example, "Bankers Accused by S.E.C. of 'Baiting'," New York Times, March 20, 1940, p. 1, col. 3, and Editorial, A Letter to the S.E.C., id. at 26, col. 2.
\end{itemize}
two questions: (1) Is it advisable, as a matter of governmental policy, to further extend the power of such an administrative body? (2) Has the Commission abused the power already granted it by Congress? The first of these issues is beyond the scope of this discussion, but the opinions considered above may shed some light upon the second.

From this survey it may be concluded that, insofar as the reorganization plan opinions handed down to date are concerned, the Securities and Exchange Commission has not attempted to go beyond its legislative mandate or even to go to extreme limits possibly permitted by the broad language of the Act. In determining the fairness of proposed plans, adherence to accepted legal criteria has characterized the opinions and, in its determination of feasibility (or "soundness") of proposed capital structures, the Commission has not required standards beyond those of sound fiscal policy. In promoting the purposes of the Public Utility Holding Company Act, the Securities and Exchange Commission has carefully avoided the appearance of arbitrary conduct. It has not, for example, dogmatically prohibited the use of voting trusts, although it has made it plain that it will not countenance the use of any device which will "unnecessarily" complicate capital structures or permit abuse of fiduciary authority.

The moderation and flexibility with which the Securities and Exchange Commission has handled the complex problems presented by proposed corporate reorganization plans heretofore considered by it, merit much commendation. By avoiding dictatorial practices, the Commission has set an example which, if consistently followed by all administrative boards and commissions, would considerably enhance the respect with which administrative law, as a system, is now regarded.

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CHARACTERIZATION AS AN APPROACH TO THE CONFLICT OF LAWS

Litigation may in a sense be divided into two categories. The ordinary case involves operative facts and issues which are connected with only that legislative jurisdiction in which the court sits and the court simply applies the law of the forum. The second category—the conflict of laws case—involves operative facts

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