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OF

SAMUEL O. CLARK, JR.

Director of the Reorganization Division
Securities and Exchange Commission

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THE SECURITIES AND EXCHANGE COMMISSION AND THE CHANDLER ACT

The subject of my talk tonight is the Securities and Exchange Commission and the Chandler Act. Accordingly, I shall describe in some detail the Commission's functions and its experience to date under Chapter X of that Act. Before doing so, however, I desire to discuss three general matters in connection with Chapter X: The problem of the applicability of Chapter X to pending 77B cases, the line of demarcation between Chapter X and Chapter XI cases and the independent trustee system in actual operation.

Application of Chapter X to 77B Cases

First let me deal with the matter of the application of Chapter X to 77B cases in which a petition had been approved before June 22, 1938, the date on which the Chandler Act was signed. In these cases we have found the "application" question more significant than in the cases approved between June and September 22, 1938, the effective date of the Act, or in those where the petition, filed before June 22, was approved after September 22.

You may recall that Section 276c of the Chandler Act provides that Section 77B shall continue in full force and effect with respect to cases pending on the effective date of the Chandler Act, except that

> "if the petition in such proceedings was approved more than three months before the effective date of this amendatory Act, the provisions of this chapter shall apply to such proceedings to the extent that the judge shall deem their application practicable; and". 1/

Considerable confusion prevailed during the first days of the Chandler Act as to the proper interpretation of this language. That confusion happily has now been dissipated by the recent decision of the Second Circuit Court of Appeals in the *Matter of Old Algiers, Inc.* 2/. I shall briefly summarize the facts of that case. A petition for reorganization of the debtor was filed under 77B. Reorganization of the debtor proved impractical and an order of liquidation was entered on June 3, 1938. On September 22, 1938, counsel and secretary to a creditors' committee moved the court to deem the compensation and allowance provisions of Chapter X applicable to the case and to set a hearing to consider their application for allowances. The estate was still in the course of administration - the period for filing claims not expiring until December 10, 1938.

The creditors' committee and its attorney had (in the words of the District Court) "labored diligently and earnestly to effectuate a reorganization". Under applicable 77B case law, their services were not compensable since no plan of reorganization had been confirmed. However, under Section 242 of the Chandler Act an allowance could be made for such services, whether or not a plan had been confirmed.

1/ Section 276c(2).

2/ C.C.H. Bankr. Law, §51,487 (Dec. 5, 1938).

The lower court denied the motion on the ground that the application of Chapter X to a pending case was "practicable" within the meaning of Section 276c(2) only if benefit to the estate would result, a condition impossible of fulfillment in the *Old Algiers* case. 3/ The Circuit Court of Appeals was unable to agree that benefit to the estate was the proper test of practicability. In reversing the decision the court laid down a test that is simple and workable. It is whether, in the light of the status of the case at the time, the particular provision of Chapter X can be applied as fairly and conveniently as if the proceedings had been initiated after the approval date of the Chandler Act. The court buttressed its decision with a pertinent illustration. It stated that if, in the *Old Algiers* case, administration had progressed so far that the assets had been distributed to creditors, it would be neither fair nor convenient to require a partial return of the dividends, a result which might follow the application of the pertinent sections of the Chandler Act to the proceedings.

Entirely consistent with the decision in the *Old Algiers* case, and, I believe, reflecting the same point of view are the bankruptcy rules adopted in the Southern 4/ and Eastern Districts of New York 5/ concerning the application of Chapter X to pending proceedings. These rules provide that motions and petitions in 77B cases shall state whether the relief is sought under Chapter X or Section 77B, and if the latter, why application of Chapter X is deemed impracticable.

Also consistent with the decision in the *Old Algiers* case is the decision of the District Court for the Eastern District of Pennsylvania in the recent case of *In re Tharp Ice Cream Co., Inc.* 6/ applying the provisions of Section 216(12) of the Chandler Act to a plan of reorganization proposed under 77B. The result was an amendment to the plan giving preferred stockholders the power to elect a majority of the board of directors of the reorganized company after default of preferred dividends. The court stated that the application of the above-mentioned provisions of the Chandler Act was not only practicable but eminently fair and equitable.

Likewise consistent with the *Old Algiers* case are a few decisions holding that when the consideration of a plan of reorganization filed under 77B has reached an advanced stage, it is not practicable to employ the machinery of the Chandler Act for the filing and approval of a plan. Thus in the case of *In re Gibson Hotels, Inc.*, 7/ opponents to the 77B plan moved the court for permission to file a plan under Chapter X. Their motion was made at a late stage in the proceedings - in fact hearings on confirmation of the 77B plan had been completed and the matter was awaiting the court's decision. The court, of course, held that it was not practicable to apply the Chandler Act.

3/ C.C.H. Bankr. Law, §51,387 (Sept. 30, 1938)

4/ Rule X - 30.

5/ Rule X - 26.

6/ U.S. Law Week, December 28, 1938, p. 19.

7/ 24 F. Supp. 959, (S.D. W. Va. 1938).

In general the courts have shown no hesitation in applying various provisions of the Chandler Act to pending 77B cases. In a number of 77B proceedings where plans had not been filed, the courts on their own initiative or on motion of interested parties have applied the provisions of the Chandler Act dealing with the filing and approval of plans. Two notable examples are the Chicago Rapid Transit Company and the Pittsburgh Railways Company cases, both involving large municipal transportation systems. In a number of 77B cases the courts have deemed Section 208 applicable to the proceeding and have requested the Commission's appearance or have approved our motion for leave to appear. In practice, our appearances in 77B cases have been filed at varying stages in the proceedings ranging from a time in advance of the filing of the plan up to the time of the hearing on confirmation of the plan.

In concluding my discussion of this problem, I want to point out that Chapter X of the Chandler Act need not be applied to pending 77B cases in its entirety - rather it may be applied piecemeal, section by section, as evidenced by the very examples which I have just indicated to you.

Chapter X and Chapter XI

I intend to address my comments for the next few minutes to Chapter XI and its relationship to Chapter X. As you know, the Chandler Act, in addition to revising Section 77B, contains in Chapter XI an elaborate restatement of the composition section of the old Bankruptcy Act. Section 12 of the latter had been enacted in 1898. It sanctioned the composition (and extension) of the unsecured debts of individuals and corporations who might otherwise become bankrupts, provided such arrangements were agreed to by the requisite amount of creditors.

Chapter XI, as you know, is available to both individuals and corporations, provided of course that they are of the sort who could become bankrupts under Section 4 of the Act. Since Chapter XI thus encompasses "corporations", the possibility arises of an overlap with the relief provided for corporations under Chapter X. Does the Chandler Act supply alternative procedures to the distressed corporate debtor with unsecured indebtedness? Can such a debtor weigh the advantages and disadvantages of one procedure against the other, and choose Chapter XI, perchance because it deems it possible thereby to evade administration of its affairs by a disinterested trustee? Let me give you some of the reasons why I believe this is not the case, why I consider Chapter X and Chapter XI mutually exclusive as to the types of corporation with which they are intended to deal, and why I feel that any corporate debtor with publicly held securities which resorts to Chapter XI runs a grave risk of indulging in an erroneous procedure, rendering invalid its acts under that Chapter and any securities issued as a result of the proceedings thereunder.

The initial inquiry should be directed to the practice under Section 12 of the old Bankruptcy Act. What sort of debtors utilized that Section? Principally, they were individuals. When they were corporations, they nearly always approximated individuals, in that they were closely held corporations. Even more important is the question: What sort of unsecured creditors did they deal with? The answer, as all familiar with composition cases can affirm, is that they were trade creditors, with whom the debtor dealt as a regular matter in the conduct of his business. They were not investors, holding a public issue of debentures, notes or some similar form of unsecured indebtedness. Therein, I believe, lies the touch-stone of the distinction between cases properly under Chapter X and under Chapter XI.

There is evidence of the same division of categories in the legislative history of the Chandler Act. The Senate Majority Report and the House Report declare one of the general purposes of the Act to be "To prescribe an improved composition procedure . . . . *and* a carefully prepared plan for corporate reorganizations". 8/ In the Congressional hearings on the Bill there was evidenced the common assumption that, insofar as Chapter XI included corporations, it applied only to the "small" corporation, 9/ and not to the corporation with stock publicly held by investors.

Section 12 permitted "compositions" of unsecured debts. Chapter XI does likewise. Though corporations could seek "compositions" under Section 12, the latter was not conceived to be an appropriate vehicle for corporate reorganizations. It was procedurely inadequate for such purpose; and for that reason, and because the equity receivership procedure was also defective, Section 77B was made necessary.

Section 12 was procedurely inadequate for reorganizations because it was never intended to be adequate for such purpose. Hence while it permitted an extension or settlement of unsecured debts, it authorized no impairment of "ownership" interests. The bankrupt debtor effected some settlement with his creditors, and his interest remained intact. The aim was simply to provide another chance to the individual owner or small corporation so closely held as to approximate individual ownership. Chapter XI likewise affords no authority to compel changes in a debtor's ownership interest. It authorizes alterations in unsecured debts only. 10/ As a further point, if the doctrine of the *Boyd* case and its successors is still applicable to corporate reorganizations, as is commonly believed to be the case, it is inconceivable that such reorganizations can be "fairly and equitably" consummated under Chapter XI, which as I said makes no provision for the alteration of equity interests as such.

Chapter XI, like Section 12, as I have pointed out, was designed to afford the individual debtor "another chance", if his business creditors agreed. In other words, it was designed to keep the debtor in operation and thereby afford creditors an opportunity of salvage, as against an immediate liquidation. Where creditors are public investors, such concepts are irrelevant. It is appropriate also to consider that under Chapter XI the court may retain jurisdiction after the confirmation of an arrangement, 11/ and in the event of default in the terms thereof, order the debtor adjudged bankrupt. 12/ This would be obviously incongruous in the case of corporate reorganizations.

As a final criterion, let me recall to you the purposes behind the more substantive changes in 77B which the Congress effected in Chapter X. It is to be emphasized that Chapter X was designed to revise 77B with an eye principally to affording greater protection to the interests of security holders in corporations with bonds or stock which are publicly held. This protection would be rendered abortive, and the intent of Congress nullified, if corporations with publicly owned securities were permitted to resort to Chapter XI, which was never intended to cover such cases.

8/ Senate Majority Report, p. 3; House Report, p. 3.

9/ House Report, p. 51; House Hearings, p. 39.

10/ House Report, P. 50; House Hearings, p. 36.

11/ Section 368.

12/ Section 377.

Let me illustrate the type of case which belongs under Chapter XI by reference to those cases where an attempt was made to utilize Chapter X though Chapter XI appeared to be the proper proceeding. As you are aware, Section 130(7) of Chapter X requires that a petition allege facts showing why adequate relief cannot be obtained under Chapter XI. Now the examination which we have made of all petitions filed under Chapter X of the Chandler Act indicates that there have been a number of cases which no doubt should have been filed under Chapter XI. A small number, about ten or so, have already been transferred from Chapter X to XI, pursuant to Section 147 authorizing that procedure.

A number of other cases possessing the same characteristics I have just described still linger under Chapter X, though, without a detailed analysis of facts not presented by the debtor, we cannot fairly conclude that all have been improperly filed under Chapter X. In one case the total indebtedness of the company, apparently a small retail clothing store, was some $7,500, none of which was secured. In another, the debtor was a small garage with indebtedness between $10,000 and $11,000, of which only $441 was secured by a chattel mortgage. In still another case, a retail shoe store with total indebtedness of some $33,000, apparently none secured, filed a petition under Chapter X. There are a number of other cases in which relatively little or no secured indebtedness is involved, and in none of those cases were there any issues of bonds, notes, or stock outstanding in the hands of the public.

It is of interest, I think, to note that the distinctions between Chapter X and XI were foreshadowed in the Southern and Eastern District Rules under 77B, which as you will recall, required a showing in the petition why relief under Section 12 would be inadequate. 13/ The courts themselves did not want the "hot dog stands" and "corner groceries" under Section 77B. To the extent, however, that such types of debtor required 77B because of deficiencies in Section 12, this has now been remedied by the revision of Section 12 as contained in Chapter XI. It is now possible to draw the proper lines of distinction between the kinds of cases that belong under that Chapter and under Chapter X. There is no longer reason why the cases which lack any public interest should resort to Chapter X. Nor is there any justification for the exercise of ingenuity in evading the application of that Chapter where a corporate reorganization, as commonly understood, is required.

Independent Trustee System

It is still early to draw general conclusions on the operation of the sections of the Chandler Act relative to the appointment and duties of an independent trustee; but the cases which have arisen thus far indicate quite clearly that the apprehensions expressed, when the Act was proposed, concerning the independent trustee and his functions, were groundless.

13/ Rule 77B - 2(i).

Trustees Report

You will recall that Section 156 provides that the court shall appoint independent trustees in all cases which involve $250,000 or more of liabilities. One of the most important functions of the independent trustee is to make the investigation and report required by Section 167. Section 167(1) provides that the independent trustee shall, if directed by the judge, make an investigation of the acts, conduct, property, liabilities and financial condition of the debtor and other pertinent matters relative to the operation and reorganization of the business, and report thereon to the judge. Under Section 167(5) the trustee is also required in every case to submit to the security holders, indenture trustee and the S.E.C. a report of his investigation. Several reports have been filed by trustees under Sections 167(1) and 167(5) varying from short reports, covering only one or two printed pages and apparently setting forth the results of only a preliminary examination, to detailed reports covering every aspect of the business and running to thirty pages or more. A characteristic of the more complete reports has been their familiarity with, and sympathetic understanding of, the problems confronting the debtor. Thorough and careful investigations have apparently been made of all major factors involved. The incisive analyses and sound recommendations contained in the reports could have been prepared only by men with more than a passing acquaintance with the enterprise and its problems. Let me indicate some of the more important matters covered in these reports.

All of the reports contain statements and analyses of earnings and financial condition. Lack of working capital draws specific and detailed comment. Most of the reports include careful descriptions, and in some instances valuations of the debtor's property, with particular reference to obsolete and non-productive plant and equipment. More or less detailed comment is found on the reasons for the failure of the enterprise, such as loss of markets, general business conditions, excessive overhead, etc. The employment of independent auditors is the rule and at times the conclusions of the trustee are supported by the report of an expert appraiser. Some reference is found to the role played by the management, and in one or two instances statements appear indicating that that aspect of the case must be given further study. Above all, one receives the impression that the investigator has had a fresh, independent, objective viewpoint. The reports invite confidence in the accuracy of the facts stated and in the soundness of the conclusions drawn.

Effect of the Reports

In some instances, the trustee has concluded after careful study of all the circumstances of the case that no reorganization is feasible, and has buttressed his recommendations with facts and analyses which appear to be irrefutable. I need hardly point out the wisdom of ascertaining early in the proceedings, whether or not a sound reorganization can be effected in a particular case. In that regard, it seems likely that the appointment of an independent trustee will result in a substantial saving in time and expense to all interested parties. If it were not for the independent trustee, only the debtor in the run of cases would have immediate knowledge of the facts and circumstances relative to the desirability of continuing the enterprise, and debtors have not been in the habit of proposing the issuance of their own death warrants.

Conditions precedent to a successful reorganization are given careful attention in these reports. In one case, the trustee reported that unless substantial working capital was raised, liquidation would be necessary. In others the trustee has stated or indicated that the enterprise could not support fixed charges comparable to those which previously existed. As you know debtors have been loathe to take drastic steps to reduce their charges and capitalizations especially if the result might be the elimination of some or all of the junior interests. In a number of cases in the past few years, corporations have emerged from reorganization under conditions which differed but little from those which existed prior to the reorganization. Impossible fixed charges and absurdly inflated capitalizations have continued, with the result that a second reorganization has followed fast upon the heels of the first. That type of reorganization may be eliminated in cases where the independent trustee early recognizes the limitations of the business.

In a few cases the trustee has indicated that causes of action lie for mismanagement or diversion of funds, which if realized upon by the trustee, may result in substantial cash recovery. In one case the trustee has brought to light an unexplained withdrawal by the debtor of cash equivalent to a substantial amount of the outstanding bond issue. A debtor in possession could hardly be expected to disclose that fact.

Submission of Plans by Trustees

Another important duty which the Act places upon the trustee relates to the submission of the plan of reorganization. Section 167(8) provides that the trustee shall give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan or proposals of a plan. The act contemplates that thereafter the trustee shall file with the court a plan, or reasons why a plan cannot be effected. The Act is too young yet to have permitted the filing of a large number of plans under it but experience to date indicates that the provisions of the Act which impose upon the trustee the duty of presenting the plan are working effectively. The centralization of authority for presentation of the plan has expedited the process. In compliance with the Act, trustees in several cases have made the necessary investigations, invited suggestions from creditors and stockholders and filed plans in a relatively prompt manner.

Some fears were expressed at the time of the Congressional debates on the Chandler Bill that the trustee would retire to an ivory tower and commune only with the spirits in his deliberations on a plan. That fear has proved baseless. It was never the intention of Congress that the trustee would isolate himself in working out a plan.. It has been our experience that trustees discuss their plans fully with all interested parties and take into account proposals by those parties before submitting any plan to the court. In fact, the device of round table discussions which was used in the negotiation of plans in the past, has continued in proceedings under the Chandler Act, except that an independent trustee now sits at the head of the table and the entire process is being conducted under the aegis of the court by its own officer - the trustee - as an integral unit of the proceedings.

SEC Functions

I come now to the functions of the SEC under Chapter X of the Chandler Act and its experience in the performance of those functions. As you doubtless are aware, its two principal duties are, first, to appear as a party to the proceedings upon the request or with the approval of the judge, and, second, to submit reports on reorganization plans referred to us by the Courts.

Representatives of the Commission on numerous occasions have pointed out that our functions are advisory only. My repetition of that point will, I hope, lend it emphasis. The advisory character of our functions is made clear by the Act. Section 172 provides that the Commission's report on a plan of reorganization shall "be advisory only". And it is obvious that as a party to the proceedings we possess no plenary powers. In fact, we lack one of the important prerogatives of ordinary parties to legal proceedings, -- that of taking an appeal. 14/

What is the net result of this subordinate position of the SEC in reorganization proceedings under Chapter X of the Chandler Act? Since we have been clothed with no sanctions to enforce our findings on particular issues nor to make binding upon the courts or the parties the conclusions expressed in our advisory reports upon plans of reorganization, we can make our influence felt only through the quality of the assistance and advice that we render in the proceedings. In other words it is incumbent upon us to proceed with full knowledge that from a long range viewpoint our views will find acceptance only by virtue of the inherent soundness they possess.

I want to mention briefly the facilities which the Commission has established for fulfilling its responsibilities under the Chandler Act. The work is handled by the recently created Reorganization Division, consisting at the present time of 49 lawyers, 5 accountants and 10 financial analysts. The great majority of our lawyers have had reorganization experience prior to joining the Reorganization Division, either as practicing attorneys or as members of the Commission's Protective Committee Study. Many of our accountants and analysts likewise possess years of reorganization experience.

To serve the convenience of the courts and the parties to reorganization cases, the Commission to a large extent has decentralized its work under the Chandler Act. Reorganization units have been established in all but one of the Commission's nine regional offices. Here in our New York Regional Office we have a staff of 15 lawyers, accountants and analysts.

I should like, in proceeding with a discussion of the Commission's activities under Chapter X, to deal as much as possible with our actual experience to date. As a consequence my remarks to follow will relate to our functions as a party and not to our duties with respect to advisory reports. The latter will increase as the Act grows older, but at this early stage only one case has presented us with the necessity of preparing such a report. It is our functions as a party which have bulked largest in our experience up to now.

Commission's Participation as a Party

Section 208 of the Chandler Act provides that the Commission

> "shall, if requested by the Judge, and may, upon its own motion if approved by the Judge, file a notice of its appearance in a proceeding under this chapter. Upon the filing of such a notice, the Commission shall be deemed to be a party in interest, with the right to be heard on all matters arising in such proceeding, and shall be deemed to have intervened in respect of all matters in such proceeding with the same force and effect as if a petition for that purpose had been allowed by the judge."

14/ Section 208.

Pursuant to this provision, the Commission has filed its appearance and is participating as a party in 28 reorganization proceedings. These cases are scattered among 11 states and involve such varied industries as a gold mine, an oil company, a toll bridge, an investment trust, a drug concern, a traction company, a radiator manufacturing concern, and a warehouse. In addition, we are participating in a number of real estate reorganizations. In size as measured by the total liabilities of the debtor company, the cases vary from $125,000 to $80,000,000, the latter being the case of Pittsburgh Railway Company. As I have indicated, our participation may be initiated either upon the request of the judge or upon our own motion if approved by the judge. If the former, the statute gives us no option but to accede to the judge's request and file our notice of appearance.

Of the 28 cases to which we are now a party, our notice of appearance was filed in 17 pursuant to a request of the judge. In all the remaining cases our appearance was filed with the approval of the judge, pursuant to our motion. In our opinion, such motions by the Commission under Section 208 may be, and most of them have been, granted ex-parte. In three cases, the motions were made in open court. All motions made to date by the Commission to participate as a party have been granted.

An important question of policy, which confronted the Commission as soon as the Act became effective, was the type of reorganization case in which it should move to participate. In this connection, we have considered that Congress did not intend the Commission to participate in all Chapter X proceedings. In the first place, with cases being filed at a rate of about 900 a year, the administrative burden would be intolerable. In the second place, many of the cases are small, involving only business or bank creditors and a few stockholders. In fact, as I have previously pointed out, many of the cases belong under Chapter XI, not Chapter X. As a general matter, the Commission's participation seems appropriate only if the public interest is involved. This would normally occur where there are one or more security issues of the debtor outstanding in the hands of the public. From the practical viewpoint, however, the Commission does not participate as a matter of course in cases where the investor interest is small or nominal. Accordingly, the principal question for the Commission's determination in a Chapter X proceeding, is first, whether the case involves a public interest, and second, whether that interest is sufficient standing alone or with other pertinent facts and circumstances to warrant the Commission's participation.

Assuming a public interest is present, the Commission, as a rough test, has indicated that a case involving $250,000 or more face or nominal value securities in the hands of the public warrants our participation. But mere size is not the only criterion. We are now participating in a few cases where the investor interest does not aggregate that amount. We feel that even in the smaller cases our participation is warranted where the public investors lack adequate representation, where an unfair plan has been or is about to be proposed, where the proceedings are being conducted contrary to the provisions of the Chandler Act or where other similar circumstances appear. The fact, however, that in each of the cases where we have appeared

as a party, one or more issues of the debtors' securities are publicly held, supports the emphasis we have placed upon the existence of some public interest as a condition to our participation.

As an administrative matter, our consideration of the desirability of our participation and of the numerous other issues arising in reorganization proceedings is greatly facilitated by section 265a of the Chandler Act. This section provides that the clerk of the court shall transmit to the Commission copies of every petition filed under Chapter X and of various specified documents filed in the proceedings. In practice these documents are filed with the Commission in duplicate, one set with the Washington office and the other with the Commission's regional office having jurisdiction of the case. Accordingly the Commission has on file complete sets of the more important papers in all Chapter X cases. Each petition and each subsequent document when filed is examined by us.

The petition, on its face, may indicate that the case involves no public interest, in which event the case is deemed "inactive" from our viewpoint. On the other hand, the petition may reveal the existence of a substantial public interest. In such event we would take steps to participate immediately as we feel that we can be most useful if we live with a case from its infancy. In still other cases, the extent of the public interest, if any, or the other facts and circumstances relevant to the desirability of participation are not revealed. In such cases, we request the appropriate regional office to obtain the necessary information as expeditiously as possible. On the basis of that information, a decision is made to take steps to participate, to watch the case for future developments which would make our participation desirable, or to mark the case as "inactive".

Once we become a party to a Chapter X proceeding, our activities may be as extensive and as varied as the scope of the issues arising in the reorganization. At the inception of a case we may be called upon to express our views upon the approval of the petition; at its termination upon the allowance of fees and expenses. Tonight I shall restrict my discussion principally to those matters and issues on which we have to date taken a position at court hearings.

In one case we have objected to the retention in office of the trustee and his attorney at the hearing specified in Sections 161 and 162 of the Act. In that case we claimed that neither the trustee nor his attorney met the standards of disinterestedness specified in Section 158(4) which provides that the trustee and his attorney shall not be deemed disinterested if,

> "it appears that he has, by reason of any other direct or indirect relationship to, connection with, or interest in the debtor or such underwriter, or for any reason an interest materially adverse to the interests of any class of creditors or stockholders."

The court, however, overruled our objection. Speaking generally on the matter of the qualifications of the trustee and his attorney, we believe that their objectivity is so vital to a proper functioning of important parts of the Chandler Act machinery that it is our duty to call to the court's attention any attempted whittling away of the standards so clearly specified in Section 158 of the Act.

In another case, that of McKesson & Robbins, Inc., the Commission called the court's attention to some phases of the Chapter X - Chapter XI relationship which I discussed earlier. Among the issues raised in that case by the answers filed to the petition was the question whether the petition was properly filed under Chapter X rather than under Chapter XI. The Commission supported the view that the petition was properly filed under Chapter X, for the reason, among others, that it was impossible to determine at the time the petition was filed whether or not the reorganization plan would or would not affect the debtor's secured debt and stock. Judge Coxe from the bench ruled that the petition was properly filed under Chapter X. We have just been notified of an appeal in which the correctness of this ruling is involved.

The Commission in a number of cases in which it is appearing as a party has addressed itself to the matters of fairness and feasibility of plans of reorganization.

In the matter of fairness, the guiding principles are, of course, to be found in the decisions of the courts, in cases under Chapter X, under 77B, and in equity receiverships. Let me say at once that I do not propose to enter upon an analysis of the *Boyd* case and its successor cases, nor shall I dwell on the oft-advanced arguments as to whether the doctrines attributed to those cases are applicable to proceedings under Section 77B, and by the same token, to proceedings under Chapter X. It is my personal view that, within reasonable limits, these are matters which are now becoming relatively well settled. There will be more profit in my discussion if I simply state my conception of the present trend of the decisions relating to the "fair and equitable" plan, and go on from that point to relate to you the facts of several recent Chapter X cases to which the Commission has been a party and in which the Commission addressed itself to the problems of fairness and feasibility.

I will state at the outset, as to fairness, that I am a firm believer in the so-called "strict priority" doctrine of the fair plan; that I believe the law requires that a plan provide recognition for claims in the order of their priority; that such recognition must approximate full payment in the order of priorities, either in cash or in securities of the reorganized company; and that I do not regard a plan as fair which preserves participation for equity interests where a valuation of the enterprise clearly indicates no value for such interests. In my opinion valuation for reorganization purposes rests chiefly upon reasonably estimated income, and by and large other methods of valuation have much less relative significance. Finally, it is my opinion that while the necessities of a particular case may justify a "de minimis" departure from the standards I have outlined, it is the function of the courts and the Commission to see that such exceptions remain in the "de minimis" category.

To say the same thing in somewhat different terms, I am a believer in the perhaps old-fashioned and conservative doctrine that bondholders are entitled to rely upon the promises of payment made to them, and that stockholders are supposed to bear the brunt of the risks run by a business enterprise. Some of the reorganization plans of the last decade might have led the innocent observer to believe that the contrary was true. The courts have now, as I read

the cases, swung the pendulum back to proper standards of fairness, standards consistent with the nature of the distinction between the different types of corporate securities, and with the representations, promises, and conceptions underlying them. I might say, parenthetically, that in none of the federal courts to my knowledge have the rules of fairness in reorganization plans been more emphatically and precisely stated than in the opinions of the District Court for the Southern District of New York and the Circuit Court of Appeals for the Second Circuit.

I can refer appropriately to a few of the situations in pending or completed cases under Chapter X in which the Commission has been confronted with the question of fairness in plans. Thus, in one case over 600 investors held corporate securities sold to them with the representation that these would be paid off in full before any dividends would be paid on the company's common stock. But the plan of reorganization in the case proposed to give these security holders no better treatment than would be afforded to the stockholders in general. At the hearings on the plan the Commission pointed out its unfairness in failing to recognize a priority, and our objections led to a substantial modification of the plan in this regard.

In several real estate reorganization cases the Commission has filed objections to proposed plans of reorganization on the ground that, the debtor appearing to be insolvent, the plans were unfair in permitting stockholders to participate. I might mention that in one of the cases the debtor's own schedule of assets and liabilities conceded its insolvency. Yet it is proposed in one of these cases that interest arrears on the bonds receive no recognition, and the stock participation is to be on a parity with that of first mortgage bondholders; in the second the stock is to participate on a parity with second mortgage bondholders.

Several other plans in real estate proceedings have presented us with situations in which outstanding bonds are secured by a leasehold only, yet where it is proposed that the interests of preferred and common stockholders remain unaffected though it is apparent in these cases that income would at best exceed operating costs by only a very slight margin, if at all. Unfounded optimism on the part of junior interests in such cases leads to unfair plans. It leads also to financially unsound plans, the questions of feasibility and fairness being related in this context. For the attempt to preserve numerous interests in an enterprise that can only support a few is not only unfair to the senior creditors; it is also unworkable as a matter of sound financial judgment.

Feasibility of Reorganization Plans

Section 221(2) establishes as one of the standards which must be met, if the plan is to be confirmed, the requirement that the plan must be feasible, as well as fair and equitable. That requirement establishes no new theory; yet frequently debtors have emerged from reorganization without adequate provision for working capital, and with fixed charges and capitalizations bearing no reasonable relationship to the needs and earning capacities of the enterprises.

It seems to me that there are at least three conditions which must be met with respect to every reorganization in order to arrive at a feasible plan:

(1) the debtor must emerge with adequate working capital; (2) fixed charges must, of course, be less than reasonably anticipated earnings; and (3) the capital structure must bear a fair relationship to the value of the assets with some assurance that another reorganization will not be required at the maturity of the funded debt.

The Commission has found it necessary to object to plans which did not meet those standards. The failure to provide a necessary minimum of working capital has been brought to the attention of the courts in two cases. Objections have been made to provisions for fixed charges founded on hope rather than fact. In one of these cases interest and principal payments on the first mortgage bonds held by a single holder were to be twice reasonably anticipated earnings available therefor. In other cases funded debt has been proposed which bore no reasonable relationship to property values and it seemed clear that at the maturity of the bonds the debtor would have the same debt structure and be faced again with the same problems which had caused the current reorganization. In one such instance, the Commission objected to a reorganization plan which provided in essence merely for a refunding of the outstanding securities on a par for par basis, in spite of the fact that those securities were four or five times the reasonable value of the property and that fixed charges apparently would exceed reasonably anticipated income, calculated on a sound basis. It seemed to us that that plan would provide only a prelude to another reorganization.

It is, of course, impossible to describe a pattern with respect to feasibility into which all cases should fall. Working capital requirements, fixed charges and capitalizations will differ widely from case to case; yet in any instance, this much can be said: after the plan is confirmed the corporation should be able to operate as a going concern free from those financial defects which led to the current reorganization.

I think you may be interested in a thumb nail sketch of the activities the Commission in a case where the plan of reorganization was recently approved by the court. The case presents an excellent example of the Commission's approach to questions of fairness and feasibility of reorganization plans. It also illustrates our day to day work as a party to a reorganization proceeding.

The debtor owned and operated a cold storage warehouse. Its outstanding securities and claims consisted (in round figures) of $1,600,000 first mortgage and $600,000 second mortgage bonds, $470,000 of unsecured claims, 550,000 shares of preferred stock and 50,000 shares of common. The reorganization proceedings had been pending before the court for several years - federal equity receivers having been appointed in 1932 and a 77B petition having been approved in 1937. Several plans of reorganization proposed in the interim had proved abortive. Finally, to expedite the proceedings the judge adopted the Chandler Act procedure for the formulation, filing and approval of the plan. That is to say he ordered the trustees to prepare and file a plan of reorganization with the court after giving creditors and stockholders an opportunity to submit plans or suggestions for plans to them, and also fixed a time for a hearing on the plan. The judge also requested us to file our notice of appearance and pursuant to that request we became a party to the proceedings.

The day after the filing of our appearance members of the staff commenced a study of the company's books and records, and the assembling of information from all other pertinent sources which would bear on the company's history, its financial condition and its future prospects. In the meantime the trustees had filed their plan of reorganization which had the support of the representatives of the various classes of securities. This plan provided for a bank loan secured by a first mortgage to raise money to pay off taxes and for the issuance of new second mortgage income bonds and common stock to the old security holders and holders of unsecured claims. In brief the old first mortgage bondholders were to receive one-fourth of the principal of their bonds in new income bonds, and the old second mortgage bondholders, one-fifth of their principal in the new bonds. No other classes were to receive the new bonds. Seventy-three percent of the new common stock was allocated to the old first mortgage bondholders, 13% to the old second mortgage bondholders, 8% to the holders of unsecured claims, 6% to the old preferred stockholders and a fraction of 1% to the old common stockholders.

We immediately undertook an analysis of the plan on the basis of the data concerning the company which we had obtained. Our study convinced us that no junior interests possessed any equity and that even the first mortgage bonds were far under water. Our conclusions in this regard were founded principally on an examination of the past operating results of the debtor and an estimate of future earnings. Thus we found that even on a reasonably optimistic basis capitalization of earnings would produce a valuation equivalent to less than one-third of the principal of the old first mortgage bonds. In addition such valuation was less than the aggregate funded debt which the plan of the reorganized company proposed. In the light of these findings, the substantial participation accorded junior interests (other than common stock) forced us to the conclusion that the plan was unfair. Furthermore, the amount of the funded debt proposed by the plan and the difficulty of amortizing the bond issue in any substantial amounts before its specified maturity inclined us to doubt the feasibility of the plan. These and other circumstances of the case led us to believe that the substitution of equity securities - either preferred or common stock - would present a more feasible and advantageous capital structure.

Our views in these various respects were fully presented to the trustees' attorney and to the other interested parties at a conference held a few days before the hearing. They were also presented to the court. The upshot of the hearing was an amendment of the plan which accomplished the following results: A preferred stock issue was substituted for the income bond issue. The entire issue was allocated to the old first mortgage bondholders, who in addition were to receive 80% of the new common stock. The balance of the common stock was to be distributed among the junior interests with the old stockholders receiving only about 1% of the total. In brief the old first mortgage bondholders were allocated all of the senior security issue of the reorganized company and four-fifths of the equity. However, the amended plan by allocating one-fifth of the equity to interests which were valueless kept alive the question of full compliance with the standard of fairness which I have previously discussed. Accordingly, the Commission's counsel at the hearings withheld approval of the plan, as amended, although he did emphasize how immeasurably superior it was to the plan as filed. The court approved the plan as amended.

It is interesting to note that in this case the Commission was requested by the judge to file its notice of appearance exactly sixteen days before the date fixed for the court hearing on the approval of the trustees' plan. The Commission was able to assemble the facts of the case, determine its position on the trustees' reorganization plan, hold conferences with the parties and participate in the hearing on the plan within the time schedule established by the court.

You may recall that during the debates on the Chandler Bill one of the principal criticisms of the proposal for the Commission's participation in reorganizations was the delay which would result. I am happy to say that that fear has proved groundless. In the case I am describing as well as in all other cases in which we are participating we have been prepared to go forward on all issues which concerned us, including hearings on reorganization plans, at the time fixed by the judge for the consideration of those issues.

One aspect of our procedure in the case I have just described requires special mention. In that case and in many others we have conferred fully and freely with the attorneys for the interested parties. We have found these round table discussions an effective means for mutual understanding and co-operation in solving the various problems arising in reorganization. Frequently a course of action suggested during the conference meets with the approval of all concerned. Even lacking this result we find that an interchange of views is always helpful. It is a method which I should like to see encouraged as I am sure that your work and ours in reorganization cases will thereby be expedited and benefited.

It is with the thought that an interchange of views is helpful that I have tried, as fully as is now possible, to describe the problems which are developing under Chapter X of the Chandler Act, and our experience with and reactions to them up to this time. I have been happy to be able to address you here tonight, and I hope for a continuation of free and friendly discussion between the Commission and the Bar as the most salutary method of solution of the difficult and complex problems which face both you and the Commission in corporate reorganizations.

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