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THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION IN CORPORATE REORGANIZATIONS

ADDRESS

of

EDWARD C. EICHER

Commissioner, Securities and Exchange Commission

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THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION

IN CORPORATE REORGANIZATIONS

Little more than a year has elapsed since the amended Bankruptcy Act gave the Securities and Exchange Commission certain functions in connection with proceedings for the reorganization of corporations conducted in the federal courts. At Cleveland a year ago Mr. Jerome N. Frank, then Commissioner and now Chairman of the Securities and Exchange Commission, discussed the background of the law and presented the threshold views of the Commission as to its prospective operation. In my remarks today I shall seek to avoid as far as possible any repetition of the ground covered in the address of Chairman Frank.

I shall endeavor instead to describe in some detail our actual experiences during the past nine months of earnest and, we believe, constructive effort in carrying out our duties under the mandate that Congress has given us. These duties, as you know, assume two aspects: first, to become a party to reorganization proceedings pending or to be pending in the federal district courts, under certain conditions and with certain limitations; and second, to render advisory reports to the courts with respect to reorganization plans, under other conditions and limitations.

You will recall that the legislation which gave the Commission these functions aroused considerable agitation when it was proposed. Perhaps this should not have caused any surprise, for of necessity it uprooted some traditional devices that had been developed throughout the decades of reorganization experience, -- devices calculated to meet not the needs of investors but rather the needs of corporate management and of professional reorganizers. Regrettably, the two needs were not always identical.

It is doubtful whether the legal profession generally was very much disturbed by the new landmarks that were set up by Chapter X of the Chandler Act. Those relatively few lawyers, however, who had specialized in the reorganization of corporations and had contributed to the evolution of the law and procedure in that particular field, did not regard the new legislation with complete favor. Certainly their representatives were neither hesitant nor secretive in expressing their opposing views on the subject at the Congressional hearings and elsewhere.

Predictions of dire consequences, always vouchsafed when changes are contemplated in the law, were freely indulged in here. It was foretold, among other things, that the injection into reorganization cases of any public agency such as the Securities and Exchange Commission would cause so much delay that the interests of investors would be bound to suffer. It was further foretold that the Commission would soon be playing the role of dictator in reorganization proceedings, with the result that every requirement of the Commission in connection with reorganization plans would as a matter of course be accepted by the parties and by the courts. These and other objections to the various provisions of the Act were strenuously urged.

That was more than a year ago. Today, after almost ten months of experience under the Act, the Securities and Exchange Commission is in a position to supplement discussion of the underlying principles of the new legislation with a recital of the results actually accomplished. I realize, of course, that ten months of experience is hardly long enough to warrant definitive generalization. Naturally, many problems will from time to time arise under the Act which have not yet come into view. But enough history has already been made to supply material for an interim report of progress under the Act and of the contributions by the Securities and Exchange Commission to the fruition of Congressional intendment.

It is gratifying to be able to advise you, in the first place, that Chapter X of the Chandler Act has been received generally by both bench and bar not only with grace, but also in most instances with genuine satisfaction. This has been especially true of those provisions governing the activities of the SEC in reorganization cases. For the moment I should like to dwell on the broader phase of the Commission's experience under the Act to date, comprehending its functions as a party in reorganization proceedings. It is in this connection that the courts have most clearly indicated their appreciation of the technical assistance that the Commission's expert staff can provide in complex reorganization matters.

We are now participating as a party in 87 reorganization proceedings involving 87 principal debtors and 18 additional subsidiary debtors. In about two-thirds of these cases we are appearing at the request of the court. In all the others our appearance was filed after approval by the judge of our motion to participate. As against the numerous cases in which we are now participating, most of them at the invitation of the judges and the remainder with their approval, there is one case in which our motion to participate was denied. The same judge, however, has admitted us as a party in other reorganization proceedings.

The Commission is most gratified, of course, with this evidence of judicial acceptance of our participation in reorganization proceedings. It means that the Commission has become an integral part of every reorganization under Chapter X that involves a substantial public interest (a term I shall later define) and of almost all such cases instituted under Section 77B which had not reached an advanced stage when the Act became effective.

As you might well suppose, the 87 cases in which we are participating quite naturally are scattered over a broad territory and represent a wide variety of businesses and industries. The cases are scattered among half the states in the country and embrace some thirty or more diverse industries including: a drug concern, traction companies, an investment trust, paper manufacturing concerns, a radiator concern, a toll bridge, several oil companies, a gold mine, several warehouses, a tanning company, a coal company, and numerous hotels, apartment houses, and other real estate companies. The amount of publicly held securities in these bankrupt corporations exceeds $450,000,000, but in individual cases publicly held securities vary from about $100,000 to over $50,000,000. In half a dozen instances the publicly held securities aggregate in each case over $20,000,000, with several additional cases aggregating $10,000,000 or more.

Those of you lawyers who have not participated jointly with us in one or more cases pending under the Act may be interested in a description of the technical facilities established by the Commission to serve the courts and the parties in reorganization cases. The work of the Commission under the Act is handled by the Reorganization Division in Washington and by reorganization units in the field. The total professional staff assigned to Chapter X work consists at the present time of fifty-four attorneys and twenty-seven accountants and financial analysts. Most members of our staff have had experience in reorganization cases before coming to the Commission. Considerably more than half of the total manpower is located in eight of the Commission's nine regional offices. Larger units have been established in those regions where the case load has been most heavy; notably New York, Cleveland and Chicago. In other regions the units are considerably smaller, commensurate with the lesser volume of work available. Our purpose in thus decentralizing the organization has been to meet the needs of the courts and the parties and to avoid the delay and expense that might have attended our endeavor to exercise all of our functions directly from Washington. This does not mean that the Commission has delegated any power of decision as to major problems.

We do not, to be sure, participate as a party in all the cases that arise under Chapter X; in fact, the ratio is roughly one appearance out of 11 cases instituted under the Act.

Because of the availability of so large a portion of our staff in the field, and also because of the provisions of the new Act that require the prompt transmission to us by the courts of copies of all petitions and some other specified filings, our consideration of the question of participation is greatly facilitated. In the larger cases our appearance is generally noted within one or two weeks after the petition has been filed. In the smaller cases, where the decision as to participation is necessarily a close one, the various regional offices will promptly undertake a preliminary study to obtain the data necessary for an informed judgment on the question.

On the basis of the accumulated information we arrive at our decision to do one of three things, namely, to participate, to observe the case for additional developments which might later indicate the desirability of participation, or to carry the case as inactive. Frequently, while we are engaged in weighing the countervailing factors, our problem is resolved by the judge, who on his own motion requests that we enter the case. This request is, under the Statute (Section 208), a judicial mandate leaving us with no option but to comply.

You may be interested at this point in a brief resume of the factors which influence our own decision to move into a case. It is well-known, of course, that the more important provisions of the Bankruptcy Act, now embodied in Chapter X, were designed to assure greater protection for the interests of the public investor. The Commission, therefore, conceives that its duties and responsibilities under the Act call for its participation chiefly in cases involving a definite public interest. Accordingly, we have avoided those cases concerning closed corporations where the parties in interest are bank and merchandise creditors and usually a small group of stockholders.

The mere existence of a public investor interest, however, does not automatically persuade us to move for participation. One important consideration in this connection is the size of the case and the extent of the public interest involved. Generally speaking, the Commission does not seek to participate in cases involving less than a quarter of a million dollars face amount of securities outstanding in the hands of the public. As might be expected, however, there are occasional exceptions to this rough and ready rule of thumb. In those exceptional instances there were special factors which indicated the desirability of our participation, such as a questionable corporate history, or the proposal of an entirely improper plan of reorganization, or inadequate representation for the public investors, or violations of various provisions of the new Act, and the like. But in all of the cases there does exist some public investor interest which is, of course, the controlling guide to our participation.

I should like now to describe some of the numerous and diverse issues on which we have to date made known our views inside and outside the court room. In general, it is to be said that our activities in this connection may be as extensive as the issues arising in the proceedings and as varied in their scope. I mention first our function in securing compliance with the provisions of the new Act. Through our examination of the court documents filed with us in all cases, including also those in which we are not participating, we have been able to detect numerous violations of Chapter X. I do not mean to convey the impression that all, or even most, of these violations are intentional. More often than otherwise, they are due merely to ignorance of the passage of the statute or of one or more of the provisions there contained. Occasionally they are due to sincere but rather clearly erroneous interpretations of the statute. It is the exception to find a wilful disregard of the statute. Whenever we perceive any such violation of or noncompliance with the statute, we attempt to rectify the situation. Usually, in cases in which we are not parties, a conference with the attorneys in the case is sufficient to dispose of the matter. In cases to which we are parties, the same procedure is initially followed and is generally successful. If, as occasionally happens, we are unable to convince the attorneys of the soundness of our position, we do what other parties do when negotiation fails, namely, file a motion in court.

Among the more important violations of the Act have been those connected with the provisions that notice be given of the various hearings required by the statute. Occasionally, we have been compelled to advise the parties of their failure to give notice to security holders under Section 161, or of its inadequacy even when given, of the hearings on the questions of continuance in possession of the debtor or the retention in office of the trustee. We have similarly been compelled to object in one case to the failure to give notice of the hearings under Section 171 for the approval of a plan. In a number of instances applications for interim allowances to the trustees and their counsel have been made without the requisite hearing on notice to all creditors, security holders and parties. All of these matters are, in our opinion, of vital importance to the security holders. In all instances we have been able to accomplish a correction of the violation without undertaking any court action.

As a final instance in connection with the general problem of notice, I should like to call attention to a situation that developed in one of the larger cases in which we are participating. Due to the size of the case, frequent ex parte applications were being made, some of which involved issues of substantial importance. A remedy for the situation was found through the simple device of eliminating ex parte applications and orders. After conferences with the trustee and his counsel, it was mutually agreed that, henceforth, forty-eight hours notice would be given to us and to all the other parties to the proceeding of any application submitted to the court. There are no longer ex parte applications in this case. We are eminently satisfied and, I take it, so are the other parties to the case. Seldom is there any matter which cannot be adjusted or clarified prior to submission of the order, and this has been accomplished in the case in question without any appreciable additional burden on the administration of the estate. The favorable results that have been obtained by this entirely friendly arrangement in the case mentioned might well serve as a sign post for other cases.

A most important phase of our activity in discerning and correcting noncompliance with the Act, wherever possible, has been in connection with the independent trustee. As you all know, a truly impartial and disinterested trustee is an indispensable cog in the wheel that propels reorganizations toward the objectives which Chapter X was designed to achieve. It is the trustee who is charged with the initial duty of assembling the basic operating and financial data without which no intelligent judgment could be formed concerning reorganization. It is he who is charged with the duty of scrutinizing the corporate history of the debtor. It is he, finally, who is charged with the duty of formulating and filing an appropriate plan for the reorganization of the company. These are new and important duties. They are intended primarily to afford the courts and the security holders unbiased and uncolored information and opinion. And in order to accomplish these objectives, the statute provides that the trustee shall be disinterested according to standards there prescribed.

We regard the objectivity of the trustee, and incidentally of his attorney, who must likewise measure up to similar standards of disinterestedness, as so vital to the proper functioning of the Chandler Act that we have been jealous of any attempt to undermine the prescribed standards. Where there has been doubt in our minds as to the qualifications of the trustees, we have undertaken thorough-going examinations into the facts. In three cases to date we have discovered sufficient evidence of conflicting interest to warrant our appearance in court for the purpose of urging the removal of trustees. In one of these cases, where it appeared that the "independent" trustee had been, at the time of his appointment, in charge of the debtor's operations, the trustee resigned after the filing of our motion, just before testimony was to be taken at the court hearing. In the second of the cases, the court removed the trustee after hearing in open court. We were also successful in convincing the court that counsel for the trustee, who was similarly disqualified under the statute, should likewise be removed. However, in the third case that we raised the question, we did not meet with success. Although we felt strongly that both the trustee and his attorney were disqualified from acting under the statute, the court disagreed with our view and continued them in office.

There have been additional problems of noncompliance with the various provisions of the statute bearing on the independent trustee. In a few cases independent trustees were not appointed, although liabilities of the several debtors were in excess of $250,000, which is the statutory dividing line. In all such instances, however, the omission was apparently unintentional, for when we directed attention to the violation, it was promptly cured. In another case, which had been instituted under Section 77B prior to the enactment of Chapter X, an *interested* trustee prepared and attempted to file a plan of reorganization. The plan, under Section 77B, could have been filed by the debtor, whose officers had participated in its preparation. But the parties did not follow this procedure, perhaps because of the continued reverses suffered by the company over a long period of years. It was thought desirable to have the trustee file the plan instead. We then advised the court that trustees generally could not file plans under Section 77B and that this particular trustee was disqualified from filing under Chapter X because of his long association with the management of the company. The court accepted our view and appointed a disinterested trustee.

In still other cases questions have been raised concerning the powers of the disinterested trustee as contrasted with the interested trustee. As you know, the court can in unusual cases designate as an additional co-trustee an officer, director, or employee of the debtor. But the duties of the co-trustee are strictly limited to assisting the independent trustee in the operation of the business. Accordingly, we have raised objection to an order directing both the disinterested trustee and the co-trustee to prepare and file a plan. And we have likewise raised objection to an order stripping the disinterested trustee of the power to participate in the operation of the business and confining his functions to the formulation and submission of a plan. In both instances our views were acceded to, and the orders were amended.

I shall touch upon only one other general phase of our efforts to remedy noncompliance with the provisions of Chapter X, namely the protective committee and the indenture trustee. We have had occasion to take steps to secure compliance with the provisions of Section 211, which require disclosure by committees and indenture trustees of certain relevant information concerning their security holdings. We have also devoted considerable time and effort to a most controversial question which has arisen in numerous cases, namely intervention by committees and indenture trustees. We have consistently opposed formal intervention as such. I shall not attempt any discussion of the numerous arguments that have been advanced on both sides of the issue. It would be impossible to convey to you in the short time remaining the extensive statutory analyses and legal contentions appearing in more than a dozen briefs filed in various of the district courts and the several additional briefs filed in the circuit courts of appeals. In short, however, it is our position that since the new statute affords committees and indenture trustees, -- and indeed all creditors and security holders -- broad rights to notice and to be heard, intervention, as a general rule, is unnecessary. The cause which must be shown under the statute to authorize intervention can rarely, if ever, be shown by committees and

indenture trustees who are entitled to receive notice and in fact do receive notice and enjoy an opportunity to be heard on all matters. In only one of the many cases dealing with this question has our view on intervention been rejected to date. I might add that we regard the results achieved in this regard as salutary, since they serve to minimize the unfair advantages which previously accrued to intervening groups as against non-intervenors.

Several additional problems bearing only on the activities of committees have engaged our attention from time to time. You are doubtless familiar with those provisions of the Act that are designed to prevent any solicitation of assents to a plan or authority to accept a plan prior to its approval by the court. Chairman Frank, in his address of last year, explained at length the important reasons underlying the enactment of these provisions. In brief, it is their purpose to assure security holders the information essential to the exercise of an informed and unfettered judgment concerning the plan, and to remove from the courts the indefensible pressure that customarily attends "majority" support of a plan that is frequently neither fair nor feasible. Consistently with our understanding of the purposes of the statute we have in some cases objected to committee solicitation of security holders prior to approval of a plan by the court. In one such case, the solicitation was promptly discontinued, primarily, however, because of the misleading character of the solicitation material. Another case, which presents the question squarely as one of law, is now pending.

I mentioned a few moments ago the Commission's interest in obtaining full compliance with the provisions of the law regarding the independent trustee. The Chandler Act is too young, of course, to draw hard and fast conclusions on the operation of the sections relative to the appointment and duties of the independent trustee; but to digress briefly from the subject of the Commission's duties, I want to point out that the cases arising thus far indicate quite clearly that the apprehensions expressed when the Act was proposed were groundless.

Reports on the trustee's automatic investigation of the debtor under Section 167 (5) of the Act have been filed in most cases, varying from short documents of one or two pages setting forth the results of only a preliminary examination to detailed voluminous reports covering all aspects of the business. The more complete reports have characteristically indicated 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 such 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 inspire confidence in the accuracy of the facts stated and in the soundness of the conclusions drawn.

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. Although it is not always clearly recognized, a question of "fairness" exists in the very process of arriving at a decision whether a reorganization would be "fairer" to creditors than would a liquidation. Often the relevant considerations have at times been unduly weighted in favor of reorganization. In every large situation, the management of course will desire the continuation of their control and the preservation of the common stock interests which they may possess. If able to control the proceedings, these interests could operate compellingly against liquidation, though the latter might be more advantageous to creditors. Added to these, often, is a natural unwillingness to undertake the drastic step of liquidation when reorganization offers a means of temporizing that may preserve good-will and avoid litigation. 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 that bear on the desirability of continuing the enterprise, -- and debtors have not been in the habit of proposing the issuance of their own death warrants. It seems likely that the appointment of an independent trustee will result in this connection in worthwhile savings of time and expense to all interested parties.

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. It is common knowledge that debtors have been loathe to take drastic steps to reduce their charges and capitalizations, especially if the price of doing so 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 useless and self-deceiving reorganization may be avoided in cases where the independent trustee early recognizes the limitations of the business.

In a few cases the trustee has called attention to the existence of causes of action for mismanagement or diversion of funds, which if realized upon by the trustee, may result in considerable 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.

The fears sometimes expressed that the requirement for an investigation and report by the trustees would cause serious delay in the progress of the proceedings has proved unfounded. In practically all cases the reports have been promptly filed, in the light of all the circumstances involved. In those few instances to the contrary, we have taken the liberty, with some measure of success, of indicating the desirability of expediting the investigation and report. So far as we know, there have been no complaints other than those few made by us of any hindrance to the proceeding by reason of the necessity for securing and submitting this basic data which is indispensable to an intelligent consideration of reorganization.

The final important function of the trustee, as I have already mentioned, is the formulation and submission of the reorganization plan. The Act is too young to have called for the filing of a large number of plans to date. The experience thus far, however, has been encouraging and 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, have invited suggestions from creditors and stockholders and have filed plans in a relatively prompt manner.

It was predicted at the time of the Congressional debates on the Chandler Act, 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, including the SEC, and take into account all proposals by the 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.

No discussion of the working of the independent trustee system would be complete without some mention of the attitude of the bench toward the innovations prescribed in the Act. Although the independent trustee was a primary target for criticism in the discussions preceding the enactment

of the statute, he is now appointed as a matter of course. The comparatively few cases, where there had been some undermining of the provisions of the statute, either through oversight, or erroneous interpretation of the Act or perhaps in some instances through deliberate attempts at evasion by some parties, are the exception. As a general rule, there is complete compliance with the statute and no real opposition remains to the trustee's appointment.

You may be interested to know that in a few cases which had been instituted under Section 77B, wherein debtors had accordingly been continued in possession, several judges have since deemed it desirable to take advantage of the new Act and have installed independent trustees. The expressed purpose of these appointments was to avoid the interminable wrangling and confusion which had theretofore effectively stalemated any adequate progress toward reorganization. It was anticipated that the injection of genuinely disinterested trustees would expedite the proceedings, which had already been pending for protracted periods. In one such case a plan has already been worked out through the collaboration of the trustee, the various parties and the SEC. Only recently this plan was confirmed, less than four months after the appointment of the trustee.

Lest it be assumed that the Commission's role in cases under Chapter X has been primarily that of a policeman, -- whose lot, I can assure you, is often not a happy one, -- let me return to the subject of the Commission's participation by describing for you our activities in relation to reorganization plans. As was contemplated by the new statute, the various phases of our activities in this connection are the ones that have bulked largest in our experience to date. We are, of course, interested in all aspects of plans, including the appropriate capital structure for the new company, the fairness of the allocation of the available securities among old security holders, the terms and provisions of the new securities, provisions for working capital, management and the like.

In order that we may exercise an intelligent judgment on these questions, our most important preliminary task is to assemble the essential information bearing on the physical and financial condition of the company, the causes of financial collapse, the quality of its management, its past operating performance and future prospects and the reasonable value of its properties. Our information on these matters is obtained from the usual sources. We exercise no subpoena powers and rely primarily on voluntary cooperation on the part of the trustees and the parties. Frequently our own accountants are afforded the opportunity of examining the books and records of the company. Occasionally, we have secured important additional information through the cross-examination of witnesses in court. This information is usually buttressed by the independent research of our analytical staff into the general economic factors effecting the company and the competitive conditions in the industry.

With this backlog of essential information we are prepared to write our advisory reports, to participate in the numerous hearings on plans and in the extensive negotiations which almost invariably precede the filing of plans and that frequently smooth the way toward substantial agreement on important provisions. In one or more of these ways, we have already made known our views in court on most of the important problems arising in connection with reorganization plans. I should like to indicate to you what our position has been on the more controversial of these issues.

Let me state at the outset that our views as to the appropriateness of the capital structure proposed in any plan and as to the fairness of the allocation of securities are bottomed firmly on the reasonably prospective earning power of the enterprise. We share the opinion of financial experts generally and of most courts that for reorganization purposes earning power is the most reliable guide to value. And the value of the debtor's properties will be, of course, the significant measuring factor in determining the total capitalization that can safely be proposed for the enterprise and the distribution of available securities amongst old security holders. The nature and extent of the various types of securities that can appropriately be issued within the confines of a safe total capitalization will be governed primarily by the prospective earning power of the company.

In talking in terms of appropriateness of capital structure I am referring generally to the financial soundness of plans. Frequently in the past, companies have emerged from reorganization under plans calculated to invite if not insure recurrent insolvency. Inadequate working capital, excessive fixed charges and capitalizations bearing no reasonable relationship to the needs and earning capacities of the enterprise, masquerading contingent charges which through their cumulative characteristics postpone but do not eliminate the inexorable maturity date and which frequently paralyze operations through destruction of credit, inadequate provisions for the retirement of debt -- all these have in the past contributed toward recurrent insolvencies. We believe that plans containing any of the features just described are financially unsound and that they fail to meet the important standard of feasibility reenacted in Chapter X.

We have found it necessary in a number of instances to take exception to plans which in our opinion contained one or more of these objectionable features and thereby failed of feasibility. In several cases we have brought to the attention of the courts the inadequacy of working capital and have secured the requisite revisions in the plans. In other cases we have objected to proposed fixed charges which were either in excess of or were not sufficiently covered by reasonably to be anticipated earnings. We have also in some cases objected to plans which proposed a structure of funded debt bearing no reasonable relationship to property values. It seemed plain in those cases that the debtors would have the same or possibly even larger debt structures at the maturity of the bonds and would then

be compelled to undergo reorganization again. In one such instance, the plan provided merely for a refunding of existing securities on a par for par basis, despite the fact that their face value was four or five times the value of the property and that fixed charges would apparently exceed prospective income, calculated on a sound bases. We have also been confronted with plans which offer as the panacea large blocks of cumulative income bonds. In one such case the charges on the issue would have been in excess of the earning power of the company, even before making allowance for depreciation charges, which were in this case substantial. Accordingly, it seemed likely that accumulations of interest would continually accrue and increase the debt of the company. By the same token, there seemed little likelihood of any appreciable retirement of the bonds during the life of the issue to counterbalance this increase in debt. As a consequence, it seemed plain that at the maturity of the bond issue the company would be burdened with a larger debt, while at the same time the value of its properties, against which no depreciation reserve was being set up, would be considerably lower. It seemed to us clear that the plan would serve only as a prelude to another reorganization and we so advised the interested parties. I might add that we were able to convince them of the desirability of material modification in the plan.

I have attempted to describe to you the position we have already taken in many cases on the financial soundness of plans and the relation of this question to feasibility and the appropriateness of the capital structure proposed. It is, obviously, difficult to design a pattern with respect to feasibility into which all cases will fall. Working capital, fixed charges, contingent charges and capitalization will differ widely from case to case. In general, however, we take the position that the sum of these factors should enable the new company to emerge from reorganization free from those financial debilities which encourage renewed insolvency.

We are very deeply concerned also with one further aspect of the appropriateness of capital structures, which stems largely from our interest in the public investor. As you doubtless know, securities issued under plans effected in Chapter X proceedings are not ordinarily subject to registration with the Commission under the Securities Act of 1933. Particularly because of the consequent absence of adequate information to the public generally, we have objected to proposals to issue securities which in our opinion would be misleading and deceptive not only to those to whom they would initially be issued, but also to those who would be likely purchasers in the public security markets. This situation has arisen in several cases where plans have proposed the issuance of securities which were in our opinion completely valueless. In another case the plan proposed the issuance of securities termed capital income debentures, which although designated as debentures were in substance a preferred stock. Among other unusual characteristics, these debentures were to participate in management and were to be subordinated to all claims of any nature, both present and future. Although we submitted an advisory report in this case objecting to the plan on several counts, including, of course, the nature of the securities I have described, the plan was approved by the judge.

Perhaps the most controversial of the issues continually arising in our consideration of reorganization plans is the issue of fairness. On this question, we of the Commission cling to the perhaps old-fashioned doctrine that bondholders are entitled to rely upon the promises made to them and that the risks of the enterprise must first fall on the stockholders. We believe that a fair plan must provide full recognition for claims against the prospective earnings in the order of their priority, either in cash or new securities or both. We do not regard a plan as fair which accords recognition to interests where there is clearly no remaining value — i.e., capitalized earning power — for such interests, and where no fresh contribution in money or money's worth is made.

It is of interest to note in this connection that the Circuit Court of Appeals for the Third Circuit has just ruled, in the *Philadelphia & Reading Coal and Iron Co.* case, that solvency, and by that token, value, is appropriately to be determined in advance of consideration of any plan of reorganization.

In most of the cases in which we are participating and in which plans have thus far been proposed, we have been obliged to raise the issue of fairness. Perhaps this was to be expected in view of the practice that was prevalent under Section 77B, to effectuate unfair plans through the now generally prohibited device of obtaining security holders' assents prior to court scrutiny of the plan. It is none-the-less amazing in view of the relatively well-settled status of the law on the question of fairness and the inherent soundness of the principles established by that law.

You may be interested in a brief sketch of some of the more important cases in which the question of fairness has been raised and of the results accomplished through our participation. In a number of real estate cases pending under Section 77B since the early part of 1937 plans had been proposed which left equity interests undisturbed, although the companies were insolvent and the bondholders were called upon to accept burdensome sacrifices. In two of these cases the judge had already indicated that he was going to deny confirmation of the plans, principally on the grounds of unfairness to the bondholders. It appeared to the judge, however, that there was little hope of obtaining from parties then before the court modifications of the plans which would cure their objectionable features. Accordingly, the judge requested us to participate in the cases; and availing himself of the additional enabling machinery of Chapter X, he appointed a trustee in one case and an examiner in the other. Within a few months, after considerable discussion among members of our staff, the interested parties and the appointed court officials, both plans were amended to provide, among other things, for fresh contributions in money's worth by the equity interests. It is expected that both plans will shortly be confirmed by the court in which they are now pending.

In two other old Section 77B cases, pending before another judge, plans of a similar nature were likewise modified after negotiation with the interested parties and have already been confirmed. Not long before the plans in these cases had been confirmed, the same judge had entered orders confirming plans in two other cases. Both debtors appeared to be insolvent yet the plans provided for the issuance of 70% of the new stock to the old stockholders, who made no new contribution. Approximately a month after the orders of confirmation had been entered, a bondholder in each case

moved to vacate the orders on the grounds that the plans were unfair. Upon invitation of the judge, the Commission's attorneys examined the cases and advised the judge that we concurred in that view. The judge thereafter vacated the orders of confirmation and directed that the plans be amended so as to provide for the issuance of a much larger proportion of the new stock to the bondholders.

Apart from the encouraging results as to fairness reached in these cases, which I offer as examples, I should like to emphasize the manner in which the use of the facilities established by the Chandler Act expedited the proceedings in the four cases first mentioned. Each of those cases had been instituted under Section 77B in early 1937. Each case had apparently reached a stalemate, with no immediate progress toward reorganization in sight. In each case the judge availed himself of some or all of the facilities of the Chandler Act to expedite the reorganization. And in each case satisfactory results were reached within a few months after our entrance into the case.

In another case which had been pending before the court for six years, first in equity receivership and then under Section 77B, and in which several reorganization plans had proved abortive, the Court finally adopted the Chapter X procedure, directed the trustees to prepare and file a new plan and invited us to participate in the case. 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 plan proposed by the trustees. The Commission was able to assemble the essential facts, determine its position on the plan, hold conferences with the parties, participate in the hearing on the plan, and accomplish substantial modifications, all within the time schedule established by the court.

In still another case investors held corporate securities that had been sold to them with the representation that they 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 accorded to the stockholders in general. At the hearings on the plan the Commission pointed out its unfairness in failing to recognize the priority of these security holders, and our objections led to a substantial modification of the plan in this regard. Although this proceeding was instituted after the enactment of the Chandler Act, the modified plan has already been approved by the Court, accepted by the security holders, and confirmed, all within the space of ten months.

I want to make it clear that we have not always been successful in having our views with respect to fairness accepted by the parties and the courts. In a number of instances we have received setbacks in situations where we felt strongly that the plans in question were unfair. The most notable instance of such a setback has occurred quite recently in a case I have already referred to in another connection. In that case, the judge has approved a plan, despite our adverse report, in which recognition was accorded to common stockholders although concededly they had no equity remaining in the property, and in which substantial recognition was accorded preferred stockholders although the value remaining in the enterprise after satisfaction of senior claims justified, in our opinion, only minor recognition.

I have mentioned in passing the advisory reports which form a second aspect of the Commission's functions in these reorganization cases. This function of the Commission has not bulked large in our experience to date. Most of the larger cases where an advisory report will eventually be submitted - there are some twenty of these - have not yet progressed to the point where a reference could appropriately be made. There have already been, however, four cases in which advisory reports have been prepared and submitted by the Commission. All of these were submitted in 77B proceedings in each of which the judge had deemed the application of the provisions of Chapter X practicable. Two of the four cases involved liabilities in excess of $3,000,000. In each of the remaining two the reference was optional and the Commission was requested to submit its report.

Two of those reports approved in all substantial respects the plans of reorganization proposed. In both cases, however, we were able, by prior discussion with the interested parties in which we pointed out our objectives, to effect modifications of the plans that eliminated objectionable features, including features which rendered the plans unfair. In one of the cases, the unfairness arose by reason of the proposed issuance of warrants to equity interests which, if exercised at the prices contemplated, would have diluted unduly the interests of senior holders. This feature was entirely eliminated from the plan through discussion with the parties before it was filed in court. The case also presents another instance of the expediting accomplishments under Chapter X. The company had filed under Section 77B in February, 1938. We were invited to participate in December of 1938. By the end of March, 1939, the plan had been filed, hearings held, the plan referred to us and our report submitted to the court. The plan was approved by the court in April and within four weeks of its transmission to security holders it was accepted by the required percentage, and was confirmed in the month of May.

The foregoing review covers rather fully the Commission's activities up to this time under Chapter X. It seems to me to demonstrate strikingly that there is general satisfaction with the Act and with our participation in reorganization proceedings by the courts. Our experience to date, as illustrated by the examples it has been my pleasure to describe for you, amply justify, in my opinion, the enactment of the new legislation. They indicate without question that beneficial results have been accomplished through the participation of the Commission in reorganization proceedings. I believe also that they carry with them their own empirical contradiction of the prophecies made before the enactment of the legislation to the effect that the Commission would arrogate to itself the functions of the courts in reorganization cases, and that its participation in these proceedings would delay the consummation of fair and feasible reorganization plans.

It goes without saying, that the Commission and its personnel, in common with all mankind, are liable to fall into that occasional error which differentiates the human from the divine. We do claim, however, that no motives of self-interest influence our conclusions, and that our constant polar star is that public interest which persuaded Congress to enact the legislation. The ownership of corporate securities has become so widely diffused among our people, that when rough financial weather overtook the

corporate bark, no one but the management, with its monopoly of the bondholders' lists and the proxy machinery, enjoyed the opportunity to practice the slogan of rugged individualism. We believe, therefore, that the services of an impartial and technically trained staff such as ours does contribute definitely not alone to the greater good of the greater number but also to greater justice for that greater number.

As I close, there occurs to me a favorite story of the Reverend James Shera Montgomery which may illuminate my concluding comments. Dr. Montgomery is the Chaplain of the House of Representatives, under the helpful influence of whose daily inspirational invocations I sat as a member of the lower branch of Congress for six years. He tells of a traveller who was making his first tour of the American Great Plains. After traversing hundreds of miles of barren, -- literally desolate -- countryside, he unexpectedly came upon a flourishing farmstead, well-improved and yielding bounteously of nature's gifts. He saw the owner at the gateway and stopped to commend him upon the fine appearance of his farm, concluding by saying, "The Lord has been rich in his blessings to you; he has blessed you indeed." To this the owner responded, "Well, I'm not saying the Lord has been any hindrance to me, but you should have seen the place when he was running it all by Himself."

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