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THE S.E.C. AND CORPORATION REORGANIZATIONS UNDER CHAPTER X OF THE BANKRUPTCY ACT

ADDRESS

of

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before the

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THE S.E.C. AND CORPORATION REORGANIZATIONS UNDER CHAPTER X OF THE BANKRUPTCY ACT

From a narrow "bread-and-butter" point of view, I suppose that the statutes administered by the Commission have been of little direct concern to the Rhode Island Bar. It is my impression that you are not often confronted with SEC questions. So far as I recall, none of you has participated in any of the corporate reorganization cases to which the Commission has been a party under Chapter X of the Chandler Act during the two and a half years this Act has been in effect.

It need hardly be said, however, that every lawyer should have a genuine professional interest in the work of the administrative agencies extending beyond and apart from the immediate concerns of daily practice. As a government lawyer, I am encouraged by the fact that such an interest on the part of the Rhode Island Bar would appear to be the only logical explanation for my presence here this afternoon.

The Commission's duties and powers are to be found in seven statutes: the Securities Act of 1933; the Securities Exchange Act of 1934; the Public Utility Holding Company Act of 1935; Chapter X of the Chandler Act, passed in 1938; the Trust Indenture Act of 1939; and the Investment Company Act and Investment Advisers Act of 1940. I plan to discuss this afternoon only the Commission's work in connection with corporate reorganizations under Chapter X of the Bankruptcy Act. This is the aspect of the Commission's work with which I had the closest contact, and this fact gives me a natural personal preference for the subject. I also believe that a detailed account of one particular branch of the Commission's work should give you a more real -- and I hope, more interesting -- picture than would a hop, skip and jump sketch of the entire field.

WORK OF THE PROTECTIVE COMMITTEE STUDY

The Commission's interest in corporate reorganizations stems from Section 211 of the Securities Exchange Act of 1934. That section, in broad summary, authorized and directed the Commission to make a study and investigation of corporate reorganization practice and to report the results to Congress together with the Commission's recommendations.

To undertake this task, the Commission, shortly after its formation in 1934, organized a special section known as the Protective Committee Study. Mr. Justice William O. Douglas, then a member of the Yale Law School faculty, was appointed director, and he continued immediate direction of the Study after his appointment as a member of the Commission in 1936.

The first task of the Protective Committee Study was to assemble the relevant factual data. Over a year was spent in this phase of the work -- analyzing and tabulating information obtained in questionnaires; conducting investigations and holding public hearings to develop the full details of 20 odd major reorganizations; examining the court records of a year's total of 77B proceedings in New York and Chicago; studying the work in the reorganization field of other agencies, such as the California Corporation Commission and the Michigan Public Trust Commission.

The result was the acquisition of a wealth of information. This information was then collated, conclusions drawn and the Commission's report to Congress prepared. Chapter X, which is an extensive revision of old 77B, was the direct outgrowth of this report.

I shall not attempt to discuss in any detail the Commission's findings. In sum they showed that ordinarily the reorganization process was not conducted primarily in the best interests of the security holders; that the security holders themselves had little real voice in the disposition of their investments; that such abuses as trading on inside information in the securities of the company in reorganization were common; that the costs of the proceedings were tremendous; that unfair and unsound plans were frequently pushed through without adequate study of the company's needs, and upon the basis of incomplete, if not misleading, information to the security holders and the courts.

In making its recommendations to Congress, the Commission proceeded upon certain premises with which I think there should be little disagreement. One is that the reorganization process is essentially a business proposition; thus, for example, when a company fails, it would seem sensible first of all to find out the cause of the trouble and to make certain that the company would come out of court with the cause eliminated. Another is that the reorganization process should be managed by persons free from interests conflicting with the interests of security holders. Another is that security holders should not be asked to agree to any modification of their rights, nor should a court be asked to approve a plan, except on a basis of complete information as to the material facts. Another is that since the company is financially sick, the occasion should call for reasonable economy -- not for community feasting.

PROVISIONS OF CHAPTER X

In accordance with these views, Chapter X was designed to remedy the faults in the existing practice, first by placing control of the reorganization process in the hands of a disinterested officer of the court -- the independent trustee -- and by giving him the initial responsibility for administering the estate and formulating a plan on an efficient, business-like basis; second, by assuring every security holder full opportunity for an informed participation in all phases of the proceeding; third, by enlarging the supervisory powers and responsibilities of the judge; and fourth, by providing both the parties and the courts with the assistance of an expert, independent agency, the SEC.

The procedure which Chapter X sets up can be briefly outlined:

First, upon approval of a petition for reorganization, the judge must, in the case of any company whose indebtedness is $250,000 or more, appoint a disinterested trustee; that is, a trustee who is free from any personal interests in the company either directly or by affiliation. Counsel for the trustee must likewise be disinterested.

Upon his appointment, the trustee is required to make an investigation of the debtor's financial condition, and also, if directed by the judge, of the acts and conduct of its management. He then reports the results of this investigation to the judge and to the security holders, and notifies the security holders that they may submit to him their suggestions for a plan.

On the basis of his investigation of the debtor's affairs and in the light of suggestions received from security holders (either individually or through their

representatives), the trustee then prepares and files a plan of reorganization, and a hearing on the plan is held. At this hearing, objections, amendments, or wholly new proposals may be presented by the management, or by any creditor or stockholder.

After the hearing, the judge, under Section 174, may refer any plan or amendments which he finds worthy of consideration to the SEC for an advisory report. If the debtor's scheduled indebtedness exceeds $3,000,000, the reference is mandatory. Upon receipt of the Commission's advisory report, the court decides whether in his opinion the plan is "fair and equitable, and feasible."

If the plan is approved by the judge, it is then for the first time forwarded to security holders for acceptance. The plan must be accompanied by a summary of its provisions approved by the judge, the judge's opinion, if any, approving the plan (or a summary which he has approved), and the Commission's report, if any, or a summary of the report which it has prepared.

In other words, a plan of reorganization is not prepared until the trustee has made an independent study of the company's affairs. In deciding whether the plan is fair and feasible, the judge has the benefit of that study, the evidence and arguments presented at the hearing on the plan, and -- if one is filed -- the Commission's advisory report. He makes that decision before any attempt is made to obtain the acceptances of the security holders; he is thus free from the influence of an accomplished fact which loomed so large in 77B. On the other hand, the security holders, before they accept the plan, not only have the benefit of the information contained in the trustee's report and of the SEC's analysis, but they also have the assurance to be had from the judge's conclusion that the plan is fair.

If the plan is accepted by the required percentage of creditors and stockholders, who are affected by it, a further hearing on confirmation is noticed and held. At this hearing, a last opportunity is given to raise any question as to the fairness and feasibility of the plan, and the court, among other things, must pass upon the management of the reorganized company. If the plan is confirmed, it is then put into effect.

In addition to the provisions of the Act with respect to the preparation of advisory reports by the SEC, Section 208 provides for Commission participation in the proceeding generally. Under this section, the Commission shall, if requested by the judge, or may upon its own motion if approved by the judge, file a notice of appearance in the proceeding; thereupon the Commission is deemed to be a party in interest, with the right to be heard on all matters arising in the case. The Commission does not, however, have any right of appeal.

Miscellaneous other provisions of the Act may be mentioned. An officer of the company may be appointed as an additional trustee, but solely to aid the disinterested trustee in his operation of the business. Similarly, an attorney who is not disinterested may be retained for specific purposes not connected with the plan. Security holders are given the right to be heard on all matters arising in the proceeding, either as individuals or through agents or committees. However, committees and other representatives of security holders are required to file a statement with the court showing their origin, interest, and representation before they may be heard. No compensation may be allowed to any fiduciary or representative of security holders who buys or sells securities of the debtor in the course of the proceeding. All major determinations must be made by the judge, and cannot be referred for determination to the referee; however, in an appropriate case these matters may be referred to a special master for hearing and report, and the referee may be the special master.

WORK OF THE COMMISSION IN GENERAL

It should be emphasized that the Commission's functions under Chapter X are unique from the standpoint of administrative responsibility. The Commission adopts no rules and regulations; it has no quasi-judicial powers to approve or disapprove any course of conduct the parties may wish to take, as it has under the Public Utility Holding Company Act, or as the Interstate Commerce Commission has in railroad reorganizations under Section 77. The Commission's only right is to have plans referred to it for an advisory report when the debt exceeds $3,000,000, and to receive certain notices and copies of papers filed in the proceedings. In all other respects, the Commission has simply the privilege of filing an advisory report and of taking part in the proceedings as a party, if the judge wishes, and with the further limitation that it cannot take an appeal. It was apparent from the outset that the success of the Commission's undertaking would depend entirely upon its ability to show the courts by actual performance that it could be of real assistance in the proceedings.

To accomplish this, the Commission recognized that the first essential was a competent staff of lawyers, analysts and accountants, most of whom would be located in the Commission's field offices where they could work closely with the parties. This was not the kind of a job that could be handled out of Washington. Accordingly, when the Commission's Reorganization Division was organized, special units of the Division were established in each of the ten regional offices. (Matters arising in the New England area are handled by the Boston office.) In addition, a staff was formed in the Washington office with the duty of reviewing the work of the field units, formulating all general questions of policy, and acting as immediate liaison with the Commission itself. The Division as a whole now includes 58 attorneys and 30 analysts and accountants, of whom well over half are located in the regional offices.

The second essential, which the Commission recognized, was that its participation in these cases should not be over-formalized. It would, of course, prepare its formal advisory reports. As a party, it would be represented at all important hearings in the proceedings, and, on appropriate occasions, file legal and financial memoranda in support of its views. But equally important would be the assistance and cooperation that the Commission would give the trustee and the other parties to the proceedings by informal conference and discussion. Accordingly, the Commission's staff has made it routine practice to consult and confer informally with the trustee, the parties and their attorneys with respect to each problem as it arises in the proceeding in order to give them the benefit of the Commission's views and constantly widening experience.

The Commission early adopted the policy of moving on its own initiative to participate in cases only where there was a reasonably substantial public interest in the debtor's securities. It has generally avoided cases where all the interests, debt and stock are closely held. As a rule of thumb, it has taken as a test of public interest a distribution of $250,000 in amount of securities among 100 or more persons.

From September, 1938, the effective date of Chapter X, through January 31st of this year, the Commission had participated on its own motion in 77 proceedings, and had had its motion denied in only one instance -- this was in a proceeding, originally instituted under 77B which the judge believed was too far advanced to warrant the application of any of the provisions of Chapter X; the Commission has since participated in a number of other cases in that same court. In addition, during this period, the Commission participated in 84 proceedings at the invitation of the judge rather than upon its own motion. These figures, I believe, are their own commentary.

Once the Commission has become a party to a proceeding, the first effort of its staff is to acquaint itself fully with all the facts. These will concern the physical and financial condition of the company, the cause of its failure, the quality of its management, its past operating performance and future prospects, and the reasonable value of its properties. In assembling this information, the attorney and analyst in the regional office who are assigned to the case will generally work through consultation with the trustee, his counsel, and the other parties to the proceeding. The information thus acquired is complemented by independent examination of the debtor's books and records by the Commission's accountants, and by the independent research of the Commission's analytical staff into general economic factors affecting the particular company and competitive conditions in the particular industry. The results of these studies provide a solid factual basis for the future direction of the Commission's activity in the case.

Meantime, the trustee is usually working on his investigation and report required by the statute. In accordance with the policy which I have previously described, the Commission's staff makes available to him the information which it possesses, and gives him all the assistance it can in shaping the scope and direction of the investigation. After he has drafted his report, the trustee will generally wish the Commission's reactions to it, and again the staff will give him the benefits of its criticism. This practice of round-table conference and assistance is followed throughout the proceedings with respect to the myriad of legal and financial questions which normally arise in the course of the administration of an estate and of the formulation of a plan. The parties will normally be fully acquainted with the Commission's views long before they are formally presented to the court.

CONTROLLING LEGAL AND FINANCIAL PRINCIPLES

In assisting the parties to a Chapter X proceeding to formulate a plan of reorganization, and in taking its positions in court and in its advisory reports, the Commission is guided by the principles enunciated in two Supreme Court decisions -- Case v. Los Angeles Lumber Products Co., Ltd., 308 U.S. 106, and Taylor v. Standard Gas & Electric Company, 306 U.S. 307.

Absolute Priority Rule

The Los Angeles decision is a revitalization of the absolute priority rule as the standard of fairness of a plan. In 1913, in Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482, and again in 1926 in Kansas City Terminal Ry. Co. v. Central Union Trust Co., 271 U.S. 445, the Supreme Court had laid down the rule that a plan of reorganization which recognized stock interests without first giving full recognition to the prior claims of creditors was unfair. This rule meant, to take a simple example, that if a company had outstanding a bond issue of $500,000, and its assets were worth only $250,000, a fair plan had to exclude the stockholders; the rule recognized that contractually and fairly the company should belong to its creditors. An exception would be made only to the extent that there was justification on the particular facts of the case for giving the junior interests an opportunity to buy into the reorganized company upon the payment of a fresh consideration.

Some lower courts, and the Supreme Court in 1936 by necessary implication in In re 620 Church Street Building Corp., 299 U.S. 24, recognized the applicability of this rule to 77B proceedings. Yet it is not an overstatement to say that in actual practice as many, if not more, plans were consummated in violation of this rule than in accordance with it. The idea had developed that a plan would be fair if each class of security holders gave up something and otherwise retained its relative position. This was the so-called relative priority theory.

From the beginning, the Commission was guided in its work under Chapter X by the absolute priority rule, and in a number of cases was successful in persuading the parties and the courts that plans which did not conform to this rule were unfair. But there continued to be many unbelievers.

In the spring of 1939, the Supreme Court granted certiorari in the Los Angeles Lumber case. This was a Section 77B proceeding. The debtor's principal liability consisted of the principal and accrued interest on a bond issue aggregating $3,807,071. Its assets were valued at $830,000. Nevertheless, under the plan the bondholders would receive but 77% of the assets of the enterprise, represented by stock having an asset value and liquidating preference of only $641,375. The remaining 23% would go to stockholders. The Circuit Court of Appeals for the Ninth Circuit had upheld the District Court's confirmation of the plan.

The Commission, in conjunction with the Solicitor-General and the Interstate Commerce Commission, filed a brief with the Supreme Court as amicus curiae, urging a determination that the absolute priority rule govern in reorganization proceedings under the Bankruptcy Act (that is, under Section 77, Section 77B and Chapter X), and accordingly a decision that the plan before the Court was unfair.

The Court, in a unanimous opinion, handed down a decision in accordance with the views expressed by the government. It held that since the value of the debtor's enterprise was less than the amount of its liabilities, there was no basis upon which stockholders could be given any participation under the plan. In addition, the Court pointed out that while a participation may be given to a junior class for which there is no value on the basis of a new contribution, that contribution first must be necessary to the enterprise, and secondly must take the form of a tangible consideration "in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." It, therefore, further held that the stockholder participation provided in the plan was not legally justified by the assertion that a substantial portion of it was held by the old management, whose "financial standing and influence in the community" would be of value to the company and whose participation would provide a "continuity of management."

The argument has been made that the decision in the Los Angeles case applied only as between creditors and stockholders, and that it did not require recognition of priorities between senior and junior classes of stock. This argument, however, is utterly inconsistent with the theory of the Supreme Court's reasoning. The Commission has rejected it both in its approval of plans under the Utility Act and in taking its position on plans proposed under Chapter X. On this point the Commission has had the agreement both of the District Courts before whom the questions arose and of the Circuit Courts of Appeal for the Third, Seventh and Tenth Circuits. In re Oscar Nebel Co., decided without opinion July 11, 1940, No. 7394 (C.C.A. 3rd)(unreported); In re Utilities Power & Light Corp., 29 F. Supp. 763 (N.D. Ill., 1939), appeal dismissed without opinion by the Circuit Court of Appeals for the Seventh Circuit March 9, 1940; and Standard Gas & Electric Co. v. Deep Rock Oil Corp., decided January 13, 1941, and the earlier decision in the same case, Standard Gas & Electric Co. v. Taylor, 113 F.(2d) 266 (C.C.A. 10th, 1940), cert. den. 85 L. Ed. 85, November 12, 1940. See also In the Matter of Porto Rican American Tobacco Co., 112 F.(2d) 655 (C.C.A. 2d, 1940).

The absolute priority rule preserves in reorganization the contract rights and expectations of investors. If an investor buys a bond, and the company fails, his claim must be fully compensated before anything can be allocated to unsecured creditors or to stockholders. If he buys a preferred stock, he has to take his turn after the creditors, but his claim will be compensated before anything is allocated to the common stock. This is entirely conservative doctrine. The only striking

thing is the extent of controversy and litigation which has been necessary to establish the doctrine and which often is still necessary to assure its application.

Determination of Value

Under the absolute priority rule, the first consideration in formulating a fair plan of reorganization is to determine the value of the enterprise for reorganization purposes, and so ascertain what there is available for distribution to existing security holders. It is here, I should point out, that the real distinction between reorganization and forced liquidation is found. In forced liquidation, the debtor's assets are disposed of at a forced sale and the proceeds distributed to the various claimants. Reorganization substitutes going-concern values for the forced sale values of liquidation, with the object of yielding greater ultimate returns to the senior interests, and allowing wider participation by junior interests if the values permit.

The Commission, consistently with the views expressed by most courts and financial writers, 1/ has adhered to the position that for the purposes of reorganization, going-concern value should be determined by a capitalization of the company's reasonably prospective earnings. The problem is one of business analysis; any businessman -- particularly if he wishes to stay in business -- values an enterprise by its earnings prospects. The original cost of the properties, or their reproduction cost, ordinarily have little or no significance.

In estimating the reasonably prospective earnings as a basis for determining value, there must, of course, be taken into account a multitude of factors; for example, the debtor's past earnings record, its competitive position, the outlook for the industry, the prospect for internal savings, a more efficient and aggressive management, etc.

The determination of value is always one of the major problems in a case, if not the major problem.

Determination of Priorities; Deep Rock Doctrine

After a conclusion is reached as to the value of the debtor's assets, the next problem is to determine the rights and priorities of the various creditors and stockholders in those assets. This determination usually involves familiar questions of contract and property law, such as the legal validity of claims, the scope and validity of mortgage liens, the availability of free assets in which unsecured creditors may participate, etc. However, in the light of Taylor v. Standard Gas & Electric Company, and succeeding opinions of the Supreme Court, there must also be ascertained whether equitable considerations exist which require an alteration of the ostensible legal and contract priorities.

The Taylor case involved the reorganization of the Deep Rock Oil Corporation, and enunciates the so-called "Deep Rock doctrine." The Deep Rock Oil Corporation had outstanding in the hands of the public $10,000,000 face amount of notes (with over $2,000,000 of accrued interest) and $5,000,000 par value of preferred stock,

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1/ Cf. Temmer v. Denver Tramway Co., 18 F.(2d) 226 (C.C.A. 8th, 1927); In re Consolidation Coal Co., 11 F. Supp. 594 (Md. 1935); In re Wickwire Spencer Steel Co., 12 F. Supp. 528 (W.D. N.Y. 1935); Bonbright, Valuation of Property (1937), 875-881, 883-893; Dewing, Financial Policy of Corporations (3d Ed. 1934), at 1140; Finletter, The Law of Bankruptcy Reorganization (1939), at 557-567.

on which there were large arrearages of dividends. 96% of the common stock was owned by Standard Gas & Electric Company. Standard controlled the management of the debtor.

Upon institution of the reorganization proceedings, Standard also filed a claim against the debtor on an open account which showed a balance due Standard of over $9,000,000. As a creditor claim, this open account would appear to have entitled Standard to a participation ahead of the preferred stock.

The validity of Standard's open account was challenged, and extensive hearings were held on the claim before a special master. Before he had made his report, however, a compromise was reached recognizing Standard's claim for $5,000,000, the amount allegedly representing net cash advances. A plan was then adopted which provided for the issuance of new debentures and common stock. The new debentures and 8% of the common stock would go to the old noteholders. Standard would receive 73% of the common stock of the new company on its open account claim, and the preferred stockholders, the remaining 19%.

This plan came before the Supreme Court in 1939. The Court in a unanimous opinion, reviewed in detail the evidence in the record showing Standard's mismanagement of the debtor. The Court pointed out that Deep Rock found itself bankrupt in part "because of the abuses in management due to the paramount interest of interlocking officers and directors in the preservation of Standard's position, as at once proprietor and creditor of Deep Rock," and that it was impossible "to recast Deep Rock's history and experience so as even to approximate what would be its financial condition . . . had it been adequately capitalized and independently managed and had its fiscal affairs been conducted with an eye single to its own interests" (p. 323). The Court held that under circumstances such as these the lower court should have exercised its equitable powers to subordinate Standard's creditor claim to the interests of the preferred stock, and that the plan which did not so provide was unfair.

After the Supreme Court's decision, the SEC became a party to the Deep Rock reorganization in the District Court. Upon reconsideration of a plan of reorganization, Standard argued that the Supreme Court's decision meant only that its participation in the reorganized company should be made junior to that accorded to the preferred stockholders, but that it should receive some recognition.

The Commission took the position that the original claim was subordinated, and that since the value of the enterprise was less than the claims of the noteholders and the preferred stock, there was nothing left, under the Los Angeles decision, upon which Standard's claim could be given any participation under a plan. The District Court agreed with this position. Upon appeal, the action of the District Court was affirmed by the Circuit Court of Appeals for the Tenth Circuit, and the Supreme Court denied Standard's petition for certiorari. Standard Gas & Electric Co. v. Taylor, 113 F.(2d) 266 (C.C.A. 10th, 1940), cert. den., 85 L. Ed. 85, November 12, 1940.

In the light of this doctrine of equitable subordination -- the Deep Rock doctrine -- it is necessary wherever a parent of a subsidiary corporation, or any other controlling person, asserts a claim prior to other investors, that an examination be made into the question whether the legal priority should be recognized in equity. In two recent opinions, Pepper v. Litton, 308 U.S. 295 (1940) and American Mutual Life Insurance Co. v. City of Avon Park, Florida, 85 L. Ed. 112 (1940), the Supreme Court has emphasized this responsibility of the bankruptcy courts, as courts of equity, in all proceedings under the Bankruptcy Act. The

scope of the doctrine remains to be pricked out as varied fact situations are presented in new cases. Its application presents one of the most important and difficult questions with which the Commission and the courts are confronted in reorganization proceedings today. (I may mention in passing that a case now on appeal to the Circuit Court of Appeals for the Sixth Circuit to which the Commission is a party -- the Inland Gas Corporation case -- is likely to shed a great deal more light on the subject.)

Determination of Feasibility

A plan, however, must not only provide for the distribution of new securities in accordance with these various considerations of fairness; it must also be feasible; that is, the plan must enable the company to come out of reorganization on a sound, financial basis.

The first requisite is that the company be able to earn an operating profit; if that is impossible, liquidation is necessary. As the Circuit Court of Appeals for the Eighth Circuit has said: ". . . it was not the intention of Congress in enacting § 77B to place crutches under corporate cripples, fit subjects for liquidation, and send them out into the business world to be a menace to all who might purchase their securities or deal with them on credit." Price v. Spokane Silver & Lead Co., 97 F.(2d) 237, 247 (C.C.A. 8th, 1938). In the second place, there must be assurance that the conditions are present which are needed for the company to realize upon its ability to earn a profit; if new working capital is needed, for example, the plan must provide these funds. In the third place, the capital structure of the reorganized company must conform to its earning power and to the value of its assets; for example, a plan is obviously not feasible which imposes annual interest charges of $200,000 upon a company with prospective annual net earnings of $100,000.

These are essentially business considerations, which the Commission insists should be approached on a solid, conservative basis. Only by such an approach can there be reasonable assurance that the close of one reorganization will not be the prelude to the start of another.

WORK OF COMMISSION IN FORMULATION OF
SAN FRANCISCO BAY TOLL-BRIDGE PLAN

I do not want to create the impression, however, that the Commission's views in these proceedings are always accepted by the parties or by the courts. Although I know of no case where Commission participation has not resulted in a substantial contribution, the Commission doesn't always win on every count. That is one reason why I think the story of the San Francisco Bay Toll-Bridge Company reorganization is a good case history to illustrate the Commission's work in connection with the formulation of a plan.

This company owns a toll-bridge which crosses the lower end of San Francisco Bay. After its opening in 1929, the bridge had its ups and downs -- figuratively speaking; the opening of the new San Francisco-Oakland Bridge in 1936, with a consequent diversion of traffic, made it mostly "down".

The company filed its petition for reorganization under Chapter X in August 1939. At this time, the company had outstanding in the hands of the public $4,303,000 face amount of 6½% bonds, with approximately $700,000 of accrued and unpaid interest -- a total secured claim in round numbers of $5,000,000; $2,000,000 face amount of 7% debentures, with approximately $1,100,000 of overdue interest -- a total junior debt in round numbers of $3,100,000; 8,750 shares of 8% cumulative preferred stock with dividend arrearages of almost $700,000; and 128,650 shares of common stock.

Since the debtor's liabilities exceeded $3,000,000, any plan would have to be referred to the Commission for an advisory report. Shortly after the petition was filed and approved, the Commission obtained leave to file a notice of appearance and become a party to the case.

At the time the petition was filed, the debtor had been trying to put through a voluntary plan of reorganization, and had obtained the assents of more than the percentage of each class of securities required by the Act. A copy of this plan was attached to the petition. The parties had the hope -- if not the actual belief -- that this plan could be put through under Chapter X, on the basis of the assents already obtained, in the manner that prevailed under 77B. The members of a bondholders' committee believed that they were committed to acceptance of this plan.

We advised the parties that the procedure they contemplated was inconsistent with the procedure of Chapter X. We pointed out that under Section 176 of the Act, the assents obtained prior to the institution of the proceedings were invalid, and impressed upon the bondholders' committee the fact that they could act for the best interests of the security holders in the proceeding entirely free from any prior commitments. We emphasized to the trustee and his counsel that although at the appropriate time a plan might properly be suggested to the trustee by the debtor, this did not relieve him of the responsibility for making his own independent study of the debtor and for taking the initiative in formulating a plan of reorganization on the basis of that study. We also pointed out that the debtor's

plan was unfair on its face, irrespective of what further study might show as to the value of the company's assets and its earnings prospects. For example, the plan provided participation for all classes of securities, but did not recognize the claim either of the bonds or the debentures to accrued interest, thus violating the absolute priority rule. (The necessity that accrued interest as well as principal be fully recognized was established in In re Barclay Park Corp., 90 F. (2d) 595 (C.C.A. 2d, 1937).)

The trustee proceeded to make his independent investigation, and he did not adopt the debtor's proposed plan. However, the plan he did propose was itself unfair and unfeasible.

This plan provided that the reorganized company should have a capital structure consisting of $4,303,000 of new 6½% income bonds to mature in 1977, a preferred Class A stock, a Class B stock, and a Class C stock. The bondholders would receive all the new bonds, in purported satisfaction of the principal of their claim, and the Class A stock for their accrued interest. The debentures would receive all the Class B stock; and the preferred and common stock would divide the new Class C stock.

At the hearing on the plan, it was brought out that under the terms of the franchise the bridge would become a public highway in 1977; accordingly, the present value of the enterprise would be the total of the bridge's prospective earnings over the next 37 years discounted to their present worth. The evidence, as the Commission analyzed it, showed estimated gross revenues of not more than $300,000 a year, and net revenues of no more than $180,000. A discount rate of 8 to 10% would give the bridge a present value of between $1,700,000 and $2,100,000, far less than the amount of the bondholders' claims.

Accordingly, at the hearing on the plan, counsel for the Commission expressed the opinion that the plan was unfair in permitting any class of security holders other than bondholders to participate. It was also pointed out that the plan was not feasible, since, among other things, it provided for a bonded debt greater than the value of the assets securing it, and carrying interest charges a third again as large as the maximum estimated net earnings.

The court agreed with the Commission that there was no value in the enterprise justifying a participation in the plan by either the preferred or the common stock, and it directed the trustee to amend the plan to exclude them. The court concluded, however, that the value of the property was sufficient to include the debentures and referred the plan to the Commission for an advisory report with the debentures still receiving a participation.

In its report, the Commission analyzed in detail the evidence as to value, and reiterated its conclusion that the value was substantially less than the amount of the bondholders' claims. It further emphasized the plan's lack of feasibility. It pointed out that on the basis of the estimated earnings, the company's debt would increase rather than decrease

with the running of the franchise; that no distribution could ever be made on the Class A or the Class B stock; that "At the maturity of the bonds, only eight and one-half months before the bridge becomes a public highway, the company's initial debt of $4,303,000, instead of having been retired, will have increased to approximately $8,000,000, and arrearages of dividends on the Class A stock will total approximately $2,000,000."

After filing of the advisory report, conferences on the plan were renewed. Counsel for the Commission brought to the court's and parties' attention the fact that while there was no value remaining for the debentures in the mortgaged properties, there was a question in the case, which had not previously been explored, as to whether a certain amount of the cash on hand was not a free asset in which the debenture holders would have a right to share. This proved to be the case. Because the amount involved was too small to justify a security distribution, it was agreed that it would be reasonable to make a cash distribution of $15 per $1,000 debenture. The parties, in accordance with the opinion expressed in the advisory report, recognized that, whatever their form, all the securities of the reorganized company would be distributed to the present bondholders.

Agreement on the form of the new securities, however, proved impossible. The parties were willing to reduce the interest rate on the bonds to 3% which offered some possibility that the bonds could be paid off in full by maturity. This was an improvement. They would not agree, however, to a reduction of principal to an amount less than the value of the assets.

The parties had a basis for this refusal which was not without force -- namely, the tax consequence. Section 270 of Chapter X, as it then stood, required that upon reorganization a company's tax base would be reduced by the amount of the canceled debt. If this company not only eliminated its debenture debt but also reduced its bond debt substantially, it would have no tax base left. Therefore, the company would be able to take no deduction for depreciation in determining its annual net income; and if the debtor's assets were sold (and the possibility of a sale to the state existed), the entire proceeds of the sale would represent a taxable gain.

The Commission fully recognized the importance of the problem. In fact, this case merely brought to a head a problem which had concerned the Commission for some time. Experience had shown that the tax provisions of Section 270 were working at cross-purposes with one of the usual requirements of a feasible plan of reorganization -- namely, appropriate reduction of funded debt.

We suggested to the parties, for their exploration with the Treasury Department, a possible way to avoid the tax consequences to the debtor, but this would have meant a taxable reorganization to the individual security holders. Since a number of bondholders did not wish to be compelled to take a gain or loss on their holdings, the parties refused to consider the possibility.

At the same time, the Commission began consultations with the Treasury Department, with a committee of the New York City Bar Association which was also interested in the problem, and with Chairman McLaughlin of the Sub-Committee on Bankruptcy of the House Judiciary Committee, on the desirability of some form of legislation to remedy the situation. The matter was referred to the legislative counsel of the House, and an amendment to Section 270 was proposed which limited the reduction of the tax base to the fair market value of the property. This amendment was passed and became law on July 1, 1940; it eliminates the tax difficulty which Section 270 formerly presented.

Nevertheless, the parties to the Toll-Bridge case were unwilling to reduce the amount of the new bond issue. Their principal argument, now that the tax problem was out of the way, was that the larger issue might be advantageous in any effort to negotiate a sale of the bridge. The Commission believed this contention was inadequate, as against its position that the distribution of a bond issue, secured by assets worth approximately half the face amount of the debt, would place upon the market an unsound and probably deceptive security.

The court, I am sorry to say, approved the plan with a $4,000,000 bond issue; but this plan was a vast improvement over the proposals which the Commission had successfully opposed during the course of the proceeding.

WORK OF THE COMMISSION IN VARIOUS MATTERS INVOLVING ADMINISTRATION OF ESTATE

While my discussion this afternoon has centered chiefly upon matters concerned with the formulation of a plan of reorganization, it should be remembered that a reorganization proceeding will also present a great many other problems in connection with the day-by-day administration of the estate. Before I close, I want to give you two or three random examples of Commission experiences with problems of this type.

McKesson & Robbins -- Sale of Certain Assets

In the McKesson & Robbins case, for instance, the trustee proposed last spring to sell a distillery owned by the company which was not necessary in its operations. He had a buyer in mind, and requested blanket authority to sell to that buyer at a price not less than $1,700,000. The trustee and the purchaser were prepared to close at $1,777,000, less commissions approximating $88,000 to be paid by the company. The Commission, together with a stockholders' committee, opposed this request. The Commission suggested that the trustee should first make a further canvass of the market, enter into an agreement with the highest bidder subject to court approval, and then request court approval of that specific agreement at a duly noticed hearing. Judge Coxe agreed that this was the sound way to handle the matter. As a consequence, higher offers were received, and the original bidder increased his offer to $2,000,000, with no liability to the company for commissions. The net result was a gain to the company of approximately $300,000.

Penfield Distilling Company -- Fraudulent Committee

In a case in the mid-west -- the Penfield Distilling Company -- we ran into a fraudulent protective committee. Shortly after the proceeding started, we learned that certain persons, designating themselves a protective committee, were soliciting security holders for powers of representation and funds for expenses and compensation on the basis of fraudulent representations. Upon motion by the Commission, the judge, after hearing, enjoined the group from making any further solicitations and ordered them to account for the funds already obtained. On appeal, the Circuit Court of Appeals for the Sixth Circuit sustained the judge's action without opinion. In the Matter of The Penfield Distilling Co., 113 F.(2d) 939 (C.C.A. 6th, 1940).

Fees and Expenses

In every case, there is ultimately the question of allowances for fees and expenses. Here the Commission's staff makes certain that the applications contain full information as to the nature and extent of the services for which compensation is sought, that the necessary affidavits are submitted, and that adequate notice of the hearing is given to creditors and stockholders. A study is then made of the amount of work, and the kind of work, that the different

applicants have done. At the hearing the Commission informs the judge of the merits of the respective applications and of what the company can reasonably afford to pay for the work.

This undertaking is not always popular with the parties. But its value to the courts is indicated by the fact that in two large 77B reorganizations, which had progressed too far when Chapter X was passed to justify Commission participation in the formulation of a plan, the judges requested our appearance to assist them on the fees. These were Judge Bondy in the Radio-Keith-Orpheum case, and Judge Coxe in the Postal Telegraph case -- both in the Southern District of New York.

Trading by Parties -- Los Angeles Lumber Products Co.; Otis v. Insurance Building Corp., 110 F.(2d) 333 (C.C.A. 1st, 1940)

In connection with the fee hearings, the Commission always makes a careful examination to find out whether the applicants have bought or sold any of the debtor's securities during the proceedings. A shocking example of trading by an insider was brought to light in the Los Angeles Lumber Products Company case, after the case had gone back to the District Court following the Supreme Court's decision. We discovered that during the course of the reorganization one of the debtor's attorneys had gone into the market and bought up $267,000 face amount of its bonds for approximately $70,000. On the basis of the prevailing market prices, he stood to realize a personal profit on these transactions of approximately $170,000.

The Commission has opposed the grant of any allowance to this attorney, and has also urged the court either to limit his proof of claim to the amount paid for the bonds or to give the debtor the benefit of the transaction by imposing a constructive trust upon the securities. The judge presently has the matter under advisement.

The Commission has been vigorous in urging a strict enforcement of the provision in the Act -- Section 249 -- against trading in the debtor's securities by attorneys or by other parties to the proceedings who are acting in a representative capacity. In this, the Commission has had the aid and support of the decision by the Circuit Court of Appeals for the First Circuit in Otis & Co. v. Insurance Building Corp., 110 F.(2d) 333 (1940), the leading case on the subject. There the Court upheld the Commission's contention that Section 249 was properly construed to prohibit flatly any compensation to any committee, attorney, or other representative of security holders, who voluntarily purchases or sells the debtor's securities in the course of the reorganization. The Court agreed that under the statute the district judge had the discretion to make an exception only where the securities were otherwise acquired or transferred; that is, where the securities were acquired or transferred involuntarily, as, for example, by inheritance or bequest. In an opinion written by Judge Peters (in which Judge Magruder and Judge Mahoney concurred), the Court forcibly stated the purpose of the statute in this language: "It is doubtless true that the statute, thus construed, may work a hardship in some cases, -- as in this; but such sporadic cases are inconsiderable

compared to the large object sought to be achieved by the law, which is to fix a standard of conduct by persons acting in fiduciary capacities, in these cases, so high as to prevent any possible clash between selfish interest and faithful performance of duty."

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By way of summary, I can best repeat a story which Commissioner Eicher tells apropos of the Commission's work under Chapter X. It seems that a traveler, after crossing miles of barren, desolate countryside, unexpectedly came upon a well-improved, flourishing farmstead. He stopped to commend the owner upon the appearance of his property, and concluded by saying, "The Lord has been rich in His blessings to you; He has blessed you indeed." The farmer scratched his head a bit, looked around, and replied, "Well, I ain't saying the Lord has been any hindrance to me, but you sure should have seen the place when He was running it all by Himself."