CORPORATE REORGANIZATION UNDER THE HOLDING COMPANY ACT

ADDRESS

of

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BEFORE THE

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At the outset, I wish to express my gratitude for the privilege of addressing the members of your organization. Some of you may be of a relatively small group of lawyers who have appeared before the Commission in various Holding Company Act reorganizations. If so, you must bear with me for a repetition of matters with which you are already familiar. I am going to address my remarks primarily to those members of the Association who I assume are well at home in the field of bankruptcy reorganizations and equally familiar with the typical recapitalizations and mergers accomplished under state statutes, but are less familiar with the problems under the Holding Company Act. You are aware, of course, of the strict respect for the liquidation priorities of senior securities which the Supreme Court has always required in the typical reorganization accomplished in equity receivership or in bankruptcy. In sharp contrast are the results reached in a typical recapitalization or merger under state law dealing with the rights of preferred and common stockholders of a solvent company which has substantial arrears on preferred dividends. As you are well aware, the standard of fairness which has generally been used by the equity courts to test such recapitalizations is whether the particular plan is so unfair as to amount to constructive fraud. I refer to the opinion of the Circuit Court of Appeals of the Third Circuit in *Hottenstein* v. *York Ice Machinery Co.*, 136 F. (2d) 944 (C.C.A. 3, 1943). In such recapitalizations the consent of common stockholders is necessary to put the plan through, and even though they may have little or no equity in the existing structure, they are in a position to exact a substantial price for putting the preferred stockholders in a position to receive dividends.

It is against that brief background that I wish to talk to you today about reorganizations under the Holding Company Act for the purpose of complying with Section 11 (b) of that statute. A typical reorganization under that section differs from both the bankruptcy situation and the typical recapitalization of a solvent company under state law. Unlike the former, no class of security holders has the power to precipitate a change in the existing situation; unlike the latter, no class has the power to block such a change. Corporate reorganization under the Holding Company Act is designed as a means of effecting compliance with the geographic integration standards of Section 11 (b) (1) and with the standards of Section 11 (b) (2) relating to corporate simplification and equitable distribution of voting power. Section 11 (b) makes it "the duty of the Commission, as soon as practicable after January 1, 1938 *** to require by order after notice and opportunity for hearing ***" the taking of action necessary to bring about compliance with the standards of Section 11 (b). Section 11 (c) prescribes the time within which such an order shall be complied with. Section 11 (d) authorizes the Commission to apply to a Federal Court to enforce compliance with such an order; provides that the enforcement court may take exclusive jurisdiction and possession of the respondent company and its assets wherever located; for the administration of those assets by a trustee or otherwise, and that they may be disposed of "in accordance with a fair and equitable reorganization plan which shall have been approved by the Commission after opportunity for hearing."

Section 11 (e) provides for the filing by any registered holding company or subsidiary of voluntary plans before the Commission; for Commission approval thereof if the plan is found "necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected"; and for court enforcement upon application of the Commission at the request of the proponent company. As in the case of action under 11 (d), the court enforcement involves taking exclusive jurisdiction over the company and its assets, and disposition thereof pursuant to the plan.

While this is a somewhat telescoped description of the statutory provisions, I believe that except for procedural requirements such as opportunity for hearing before the Commission and the Court, it includes virtually the whole story. You will note that Section 11 provides a minimum of specification as to procedural detail and the utmost flexibility as to method of achieving the statutory objectives. Congress was aware of the great variety and complexity of problems which would be presented by the different holding company systems, and did not wish to over-particularize. It used as its pattern the devices which had been developed by the courts in connection with anti-trust decrees, adding only the provision for an administrative forum for the development of plans in the first instance. You will not find in Section 11 any parallel to the mandatory requirements of Chapter X for independent trustees with specific duties as to investigation, and in connection with the formulation of plans; nor are there specific provisions for proof and classification of claims, or for votes of security holders. On the other hand, the Commission is given ample power to provide for such techniques in so far as appropriate in a particular situation.

Just how far a Section 11 reorganization should follow the procedural patterns of a bankruptcy reorganization is largely a practical problem of administration rather than a matter of statutory prescription. It will be appreciated that there are certain differences between a Section 11 reorganization and a bankruptcy reorganization. The bankruptcy court normally begins its acquaintance with the bankrupt upon the institution of the bankruptcy proceedings. A long period of administration may be necessary before the situation is ripe for reorganization, and unfortunate experience with the so-called short receivership techniques has led to special statutory safeguards to make sure of an adequate and independent investigation of plans before their submission to security holders. By contrast, the Commission, which has the initial responsibility for plans under the Holding Company Act, has had the benefit of preliminary contact with the company in the course of its various regulatory duties, including studies and hearings with specific reference to Section 11. This makes it possible to short-cut much of the bankruptcy reorganization procedure, and in most instances, to accomplish a quicker and cheaper reorganization than would be possible under Chapter X.

In one or two instances the company in question has been confronted with maturing bonds which could not be paid off, and except for the existence of the Holding Company Act, would ultimately have been reorganized under Chapter X or liquidated in a straight bankruptcy proceeding. Instead, the machinery of Section 11 has been utilized with the approval of all interested persons because of the advantages of economy and expedition afforded by its more flexible procedure. For example, the Jacksonville Gas Company was badly over-capitalized with a maturing bond issue. The company filed a Section 11 (e) plan of reorganization. It was reorganized with an expedition and economy which I believe would hardly have been possible had it been necessary to resort to the less flexible machinery of Chapter X. The total expenses of the reorganization were in the neighborhood of $50,000 as compared to an estate valued at approximately $2,500,000, and the entire period from the filing of the application with the Commission to the Court's opinion approving the plan took just under six months. The Commission's opinion in this case is reported as Holding Company Act Release No. 3570; the Court's opinion approving the plan is reported in 46 Fed. Sup. 852.

Returning to a consideration of the framework of Section 11 reorganizations: When a plan of reorganization is filed under Section 11, the Commission, as I have already stated, in order to approve the plan, must find that it satisfies two standards: first, it must be necessary to effectuate the provisions of that Section, i. e., the integration or simplification of the system, and secondly, it must be found to be fair and equitable. The second of these standards I am sure has a familiar ring to all of you, since the term used is identical with that prescribed as the test for reorganization in bankruptcy.

I have felt that you might be interested in a basic problem which has arisen in several important cases before the Commission in connection with the application of the "fair and equitable" standard. A statement of the problem and a discussion of the manner in which it has been dealt with by the Commission and the courts will reflect a distinction between reorganizations under the Holding Company Act and those in bankruptcy. In dealing with this problem I shall confine myself to a discussion of the decided cases, in which there has been a difference of approach between Commissioner Healy and the rest of the Commission. The ultimate resolution of that difference of opinion is for the courts, and my purpose here is simply to discuss the action thus far taken by the Commission and such courts as have considered the question. I intend to stay within the text of the Commission's published findings, but I should like to have you bear in mind that the discussion is based upon my own interpretation of those findings.

The problem I have referred to typically arises in those situations where there is a question of allocation between the common and preferred stockholders, and the preferred stock has substantial dividend arrearages. The arrearages, under the usual contract, constitute an additional claim on liquidation for their full face amount just like the principal of the preferred stock, but unlike the latter, do not bear any return. Thus where the earnings of the company exceed the current preferred dividend requirements, the arrearages can be liquidated and the common can then share in future earnings. To illustrate this, let us suppose that a company has $1,000,000 of $6 preferred stock outstanding on which for one reason or other $400,000 of dividend arrearages have accumulated. Its prospective earnings are around $80,000 a year. Capitalizing the earnings at 7%, which might well be a very favorable rate in the particular circumstances, the enterprise value is around $1,100,000 or less than the total claim on liquidation of the preferred of $1,400,000. Yet if the prospective earnings materialize, the arrearages will be liquidated in about 20 years and the common will then have a claim to $20,000 a year, which then might well be a valuable claim. Whether this would ever happen may be a gamble, but in many situations it would be a quite attractive gamble and tickets in such gambles in the form of shares of stock may have and have had a substantial sale value.

You are all familiar with the answer of the courts in bankruptcy reorganizations to problems of this type. Applying the "fair and equitable" standard, they have held that the creditor is entitled to the full face value of his claims and that if such claims are in excess of the present capitalized value of earnings, the stockholders must be cut off from whatever prospects of future participation they might have had but for the reorganization. Similarly, as between classes of stockholders, a junior class may not participate until senior claims have been fully compensated for their liquidation preferences.

As stated by Mr. Justice Douglas in the decision in *Case* v. *Los Angeles Lumber Company*, the words "fair and equitable" as used in the reorganization statutes are words of art which had been given a fixed meaning in equity receivership reorganizations, and this meaning was that the creditors had an absolute priority to the payment of their claims in full. Until such claims are satisfied, the junior claimant is entitled to no participation.

This result has come to be represented in the terminology of the reorganization bar by the phrase "absolute priorities" used in the Los Angeles Lumber Case. You may remember that the Commission filed a brief amicus curiae before the Supreme Court in that case urging that result. At the same time, in cases involving competing claims between preferred and common stockholders in reorganizations under Section 11 (b), a majority of the Commission has taken the view that the doctrine of absolute priorities has a different application. We believe the use of the same term is consistent with this different application. In other words, we are satisfied that the treatment accorded cases in the typical situation dealt with under Section 11 (b) is not a departure from the absolute priorities doctrine. It represents merely its application to circumstances different from those characteristic of a bankruptcy reorganization and may properly be described by the same term unless some distinguishing description may be useful for purposes of sharper definition.

The first opinion in which the Commission explored the problem and articulated its views was in the Federal Water Service Case, 8 S.E.C. 893, involving a plan of reorganization of that company. Federal had a comparatively small amount of debt not affected by the reorganization, followed by preferred, Class A and Class B stocks. The plan ultimately approved by the Commission substituted a new class of common stock for the existing stocks and allotted approximately 95% to the existing preferred, approximately 5% to the existing Class A, and eliminated the Class B entirely. The Commission was unanimously of the opinion that the Class B stock was so far under water as to be not entitled to participate on any theory. The Commission was also unanimous in holding that the assets of Federal had a fair value worth substantially less than the liquidating preference of the preferred stock including arrears. A majority of the Commission found that, absent reorganization, there was a reasonable possibility of the company ultimately earning enough to pay off the arrears of preferred dividends and paying something on the existing Class A common stock. The Commission concluded that this possibility entitled the Class A stock to some recognition in a fair and equitable plan of recapitalization, and that 5% of the new common stock was a fair equivalent for the surrender by the Class A stockholders of their existing position in the company.

The Commission, of course, recognized that this result was contrary to that which would have been required in a bankruptcy reorganization. I shall read a fairly generous sample of its opinion which I think clearly expresses the basis of its reasoning not only in this but in the subsequent cases which I shall discuss.

> "As in the equity receivership cases, the object of reorganization in bankruptcy is to prevent imminent dismemberment at the hands of creditors and the consequent liquidation which would otherwise occur. The reorganization provisions of the Bankruptcy Act thus operate in a context which is the same as that found in the *Boyd* and related cases. Accordingly, when in that context Congress provided in the Bankruptcy Act that a bankruptcy reorganization plan must be 'fair and equitable', the Supreme Court held

that Congress intended that those words should be given the same meaning as they had been given in the same context in those equity 'insolvency' cases. In that context, the touchstone of the 'fair and equitable' standard - the recognition of contractual rights - requires compensation for a matured right to a liquidating priority. In such cases, where creditors, absent assumption of jurisdiction by a court of bankruptcy under the reorganization provisions, would have had the common law right, or right in straight bankruptcy, to dismember the corporation, it is 'fair and equitable' to distribute the assets on the basis of the contractual rights of the parties as if in liquidation. This is so, even though reorganization rather than liquidation occurs in such situation, because *equity and bankruptcy reorganizations are in substance liquidations on a going-concern basis.* The enterprise is preserved and recapitalized, and security holders receive a distribution of new securities representing interests in the reorganized company, instead of distribution of the proceeds of an actual liquidation. But there is no reason for departure from the contractual rights applicable to liquidation situations."

I now omit a paragraph to which I shall return in a moment and continue.

"To ignore the significant absence of a liquidation atmosphere when construing those words" [fair and equitable] "is to do violence to their long history. In all systems of law the words 'fair and equitable' have always connoted the opposite of rigidity. It would be strange, indeed, if these words - with their historic connotations of flexibility - should acquire an invariable and inflexible meaning without regard to the fact situation to which they are applied; for this would mean that the rationale - recognition of contractual rights - would not apply to the contractual rights existing in the particular case, but would apply to the contractual rights existing in the *Boyd* case and the bankruptcy reorganization cases. We are convinced that, absent liquidation, there is an important difference in the context and in the legal rights to be recognized and that this difference in rights requires a difference in the legal - or the equitable - consequences."

Again I omit a few lines and continue the quotation:

"Absent liquidation, the liquidation preference of a senior class of stock is only an inchoate right to a future payment, which has no definite maturity date, and which will not mature into a present claim despite failure to pay dividends. In addition to this inchoate right to a liquidation preference, the senior stock has present rights to current and accumulated dividends. This right, however, is not absolute, as is a creditor's right to interest; it is only a relative right *vis a vis* junior classes of stock. These junior classes, conversely, have rights *vis a vis* the preferred stock. Ordinary preferred stock is limited to a fixed amount of dividends, and thereafter does not further share in earnings. Thus the junior stock has a leverage position. At particular times this position may be disadvantageous (as it now is to the junior stocks of Federal) and with a comparatively small change in earnings it may be advantageous. Thus - as the securities markets frequently recognize - the fact that the enterprise may not be worth the liquidation

preference of a senior security does not demonstrate that the junior securities have no value. Conversely, the value of the senior securities is not the entire value of the enterprise even if that value is less than the liquidating preference of the senior securities, for the existence of the junior securities and the rights pertaining thereto detract from the value which the senior security would have if it had the only interest in the corporation."

Commissioner Healy dissented from both the reasoning and result, taking the position - which he has maintained throughout - that the Commission in cases under Section 11 is bound by the "fair and equitable" standard to follow the bankruptcy technique, and in not doing so fails to compensate the preferred fully for its priorities on assets and earnings.

I should now like to return to a paragraph which I omitted before, which is not in accord with the views subsequently followed by the Commission. As you will recall from the portion of the opinion I first quoted, the Commission distinguished between the liquidation atmosphere of the bankruptcy reorganization, or in other words its nature as a substitute for a foreclosure liquidation, and the absence of such atmosphere in a Section 11 reorganization such as was involved in that case. The Commission then went on to say, by way of dictum, that where Section 11 (b) would require liquidation, and the Section 11 (e) plan was pursuant to or in anticipation of an order directing dissolution, the same result should be reached as in bankruptcy since the same atmosphere of liquidation would be present.

Precisely this situation was presented in the next case of this series, involving United Light and Power Company. Power was the top company of a complex holding company pyramid. The Commission had determined that the continued existence of Power was contrary to the simplification standards of Section 11 (b) (2) and had directed its dissolution. Substantially the entire assets of Power consisted of common stock of a subsidiary company, United Light and Railways. The plan involved the transfer of all of the other assets of Power to the Railways Company and the distribution of the common stock of Railways among the preferred and common stockholders of Power. The plan thus was one of liquidation and was in an atmosphere of liquidation as that term had been used in the dictum in the Federal Water Service case. In addition, the Commission found that the present value of the assets of Power, on any reasonable basis, was less than the liquidation preference of the preferred stock, including the substantial arrearages. Thus if the bankruptcy technique were employed, as suggested in the dictum, the common stockholder would be excluded from any participation despite the fact that, as found by the majority of the Commission, there was a substantial possibility that the common stock would have a future claim to earnings in the absence of liquidation. Since in many instances the choice between a series of reorganizations within the system and the liquidation of a particular company within the system is simply a choice between alternative methods of accomplishing the same result, the difference in substantive consequences if the Federal Water Service dictum was followed led to a reconsideration of its theoretical basis.

In bankruptcy reorganizations there is no liquidation, in the sense of a sale of assets to outside interests; there is an avoidance of such a liquidation. The court is not enforcing the contract of the parties in the situation created by the statute; it is rather giving them a substitute for the right which the statute abrogates, the right to foreclose and liquidate. Thus it is not the atmosphere or the situation created by the statute which is controlling in determining the treatment of the respective claimants, but the situation which it forcibly supersedes. This was recognized and applied in that portion of the opinion of the Commission in the Federal Water case which dealt with the problem then before the Commission, namely, the recapitalization of Federal as proposed to be accomplished through a statutory merger. It was not until the United Light and Power case that the Commission had occasion to carry this line of reasoning through to its logical conclusion. The decision in that case holds that in plans under Section 11, whether of reorganization or liquidation, the security holders should receive compensation for the rights and expectancies which they would have had in the absence of the interposition of the statute, no class being either enriched or impoverished through the carrying out of the paramount public policy established for the benefit of all security holders alike.

The underlying premise of the case is that the reorganization provisions of Section 11 were meant to accomplish the social and economic objectives of Section 11 in such a manner as to conserve and protect every legitimate investment stake in the existing structures. This does not mean attempting the impossible by endeavoring to make good the extravagant dreams of promoters; nor does it mean enabling the holders of plainly worthless equity securities to capitalize upon unfair voting provisions or the control of proxy machines. It does mean, however, that each class of security holders having a reasonable prospect of receiving income under the existing structure, should receive the fair equivalent in value of that prospect. In short, the Commission, like the Court in the Los Angeles Lumber case, excludes compensation for securities having only a "strategic" or "nuisance" value, and the principles applied by it bear no relation to the composition or bargaining process which underlies the usual voluntary reorganization under state law.

I said before that we believe the approach of the Commission to be consistent with the doctrine of absolute priorities as giving the preferred stockholder full compensation for his prior rights. The preferred stockholder is given the equivalent of the claims he had in the absence of the statutory scheme. He is deprived only of the claims which he would have had if his claim to arrearages were to be accelerated by reason of the impact of the statute despite the fact that he had no independent contract right to such acceleration. To borrow a metaphor, the Holding Company Act, in our opinion, is intended as a shield to investors against the unreasonable exactions of controlling groups, not as a sword by which any class of security holders may appropriate to themselves the legitimate contract expectations of others.

On this basis the majority of the Commission found that the common stockholders of Power were entitled to participate in its assets. Our measure of the going-concern values inherent in the respective securities, however, led us to the conclusion that the plan filed by the management over-valued the common stock and afforded it too high a participation. We therefore refused to approve the plan as filed but stated that we would approve it if the participation given the common stock was reduced to a level within the permissible range of fairness as determined. The plan as modified was resubmitted and approved. Commissioner Healy dissented on substantially the grounds he had previously set forth in his dissent in the Federal Water Service case.

At the request of the company and in accordance with the mechanics provided by Section 11 (e), the Commission petitioned the Federal District Court for the District of Delaware, the company's state of incorporation, to enforce the plan. At the hearing before that Court, which also was required by the statute to find the plan fair and equitable before enforcement could be granted, a preferred stockholder appeared and objected to the plan as being unfair to his class, on the grounds set forth in the dissenting opinion of Commissioner Healy. Judge Leahy of the District Court upheld the opinion of the majority of the Commission and approved the plan. His opinion, which is to be found in 51 Federal Supplement at page 217, stated, in part:

> "In my opinion, the expression 'fair and equitable' should be given its ordinary non-technical meaning. As stated before, the dominant purpose of the Act is the protection and enhancement of public-utility security values through integration. But the application of the 'absolute priorities' test would in many cases wipe out the interests of stockholders who, save for the passage of the Act, would be entitled to a continuing participation in the enterprise. The expression 'fair and equitable', in its ordinary connotation, does not impel such a result; and I will not ascribe such an unnatural intention to Congress. Moreover, it must be apparent that, as I have indicated above, there are many ways to effectuate the purposes of the Act, and, in many cases, the junior securities' holders would be entitled to a participation if other methods of reclassification are utilized. The choice of procedural alternatives should not affect the substantive rights of the common shareholders."

You will notice that Judge Leahy uses the term "absolute priorities" as expressing the bankruptcy result and apparently views the result under Section 11 as a departure from the application of the rule. Professor Dodd of the Harvard Law School, in his recent article on this line of cases in the January 1944 Harvard Law Review, takes the position that the result of the Commission is consistent both with the application of "fair and equitable" as a term of art and the application of the so-called absolute priority rule. He states:

> "The difference between bankruptcy reorganization plans and recapitalization plans of utilities which are solvent in both the bankruptcy and equity sense is not due to any difference in the meaning of the words 'fair and equitable' in the applicable statutes. It is due to the difference between the impact of insolvency on creditors' claims and the impact of simplification on the claims of preferred shareholders. The difference is one between the absolute claim of the creditor to payment and the contingent claim of the preferred shareholder to priority if liquidation occurs. Congress did not give the S. E. C. the power to adopt criteria of fairness inconsistent with those required by the absolute priority rule. It merely gave it power to apply the absolute priority rule to the special situation presented by Section 11 reorganizations."

The United Light & Power case was decided by the Commission on April 6, and Judge Leahy's opinion approving the plan was handed down on July 30, 1943. The objecting stockholder has appealed from Judge Leahy's order and the appeal is now pending in the Circuit Court of Appeals for the Third Circuit.

Since the Commission's decision in United Light & Power the problem of allocation between preferred and common stockholders has been presented to the Commission in several cases involving plans of reorganization of operating utility companies. Aside from a consideration of the somewhat different incidence of the standards of the Act on operating companies from those applicable to holding companies, the opinions of the Commission in these cases have followed the general pattern I have previously discussed. I therefore feel that there would be little profit in a detailed description of these opinions. I should like to point out, however, that two of these plans, those proposed for Puget Sound Power and Light Company and Southern Colorado Power Company, have been approved by the Federal District Courts to which they were brought by the Commission for enforcement. The Puget case which was in the District Court of Massachusetts was uncontested. The Southern Colorado case was contested by a preferred stockholder who has appealed from the decision of the District Court of Colorado to the Circuit Court of Appeals for the Tenth Circuit.

In choosing to discuss a line of cases which mark the development of an approach to what I conceive to be a somewhat novel problem, I have brought you into a field in which there is a difference of opinion on the Commission itself. In closing, however, I should like to emphasize the unanimity of the Commission in a vast majority of cases which have come before it under Section 11, and the conviction of all of the members of the Commission that the reorganization machinery of Section 11 is practicable and capable of accomplishing economically and fairly the allegedly impossible task of unscrambling the great holding company systems. I believe that this point of view is shared by the increasing number of holding companies and their counsel that have seriously attempted to comply with Section 11.