"THE HANDLING OF CHANDLER ACT CASES - A CASE HISTORY"

ADDRESS

of

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The topic which was selected for this talk is somewhat of a misnomer. It includes the phrase "case history". There is no such thing as yet under the Chandler Act. It is possible to have a story which is part history and part prophecy, but inasmuch as no reorganization under Chapter X of the Chandler Act has as yet been completed, I am not going to be able to give a complete historical picture.

Mr. Weiner last week covered very well the functions of the Securities and Exchange Commission in reorganizations and told you what a reorganization was, but let me repeat just for a moment if I may.

A corporation finds itself in financial difficulties, either because its expenses have required too large a portion of its income, or because a funded debt, an issue of bonds which are in effect promissory notes, has come due at a time when it is not in a position to pay them. It is not able to arrange to get money from some other source and substitute the new indebtedness for the old. Thus it finds itself in a position where its creditors or some persons who have an interest in the concern may be able to throw it into receivership or cause it difficulties through impairment of credit. It wants some method whereby it can continue as an economic factor in the community and continue to employ those who look to it for support, without the ever present danger of a cessation of its activities through legal intervention.

With the enactment of Section 77B of the Bankruptcy Act the corporation could apply to the court and obtain a scaling down of the bulk of what it owed for rent, for material it had purchased and other obligations which it had incurred, and obtain an extension on account of the bonds and indebtedness which were due. It could throw out of the picture completely the common stock if the value of the net assets no longer was such that that common stock represented an equity in the company. The corporation, after reorganization, could start off with a clean slate with the reasonable expectation that it would continue to function and not be harrassed or worried by financial difficulties resulting from lean years now past.

We now come to how reorganization is effected under the new Chapter X of the Chandler Act which is a revision of 77B with some very material changes, including the introduction of the Securities and Exchange Commission into the picture as a party. Any proceeding in court is necessarily initiated by a pleading. In a proceeding under Chapter X, this pleading takes the form of a petition. That petition, when filed by the corporation itself, states that the corporation was formed at such and such a time; that it was engaged in a certain type of business which is specified; that it has certain financial obligations; that it has certain assets; that it is unable to meet its obligations as they mature, or that it is insolvent; that there is a reasonable basis for believing that it can be reorganized; and that it can function if properly reorganized. The petition prays that the court stay any other legal proceeding that may be instituted against the company, that it appoint a trustee, if such is required under the Chandler Act, and give relief generally. This is known as a voluntary petition. A petition filed by some one other than the debtor is known as an involuntary petition. The debtor is given an opportunity to answer an involuntary petition before it is approved. The petition when it is filed and approved immediately operates as a stay preventing other litigation. The court appoints a trustee and directs that trustee to file a schedule of the debtor's liabilities and the assets. A copy of the petition is sent to the Securities and Exchange Commission

immediately so that we know almost as quickly as do those interested in the city where the proceeding is instituted what petitions have been filed under Chapter X of this Act.

The Reorganization Division has created a study section through which these new petitions flow. Consideration is given to the statements of fact which are set forth therein. In the Reorganization Division we are primarily interested in investors. Just how much in the way of bonds and stock sold through the marts of financial trade are now in the hands of individuals scattered throughout the country. These individuals may have depended upon the return from these investments as a means of livelihood. During the period of financial stress they may have received no return on account of the money which they spent in acquiring these securities. These investors may receive a return after a proper reorganization has been effected or they may be squeezed out of the picture unless due care and consideration is given to the reorganization plan.

Recommendations are made in the study section as to facts which should be ascertained by the regional office involved for the purpose of aiding us to determine whether or not this is the type of case in which we believe we should intervene. Investor interest, as I have already indicated, is of paramount importance and I have yet to see a report that has not recommended at the head of the list that we ascertain the extent of the holdings of the debtor's securities.

The reorganization of a corporation of necessity moves as rapidly as possible. I say that in fear and trembling for some reorganization cases have taken a notoriously long time. It is said to be particularly true of railroads under Section 77 of the Bankruptcy Act. But there are many cases where the court sets the case down immediately with a series of successive dates on which the trustee shall file his plan of reorganization and on which a public hearing will be held on the plan and the whole thing moves expeditiously. As I have said, there have been delays in reorganization cases. If there are delays in reorganization cases in the future, the Securities and Exchange Commission may, regardless of the facts, be held responsible for them.

So it is necessary that we ascertain immediately as many facts as possible about this particular corporation which says that it needs to reorganize. We want to know what it is that brought this corporation to the bankruptcy court. It may be that improvident management is largely responsible for the situation, but there are many questions that must be answered. For instance, was the general economic situation such that the demand for the goods of this corporation declined to such an extent that the corporation could not make money, and is this decline permanent or temporary? It is impossible to say in any particular case before we become a party whether that or this thing is the matter into which we must inquire. Each case stands on its own. Each case is a separate problem and little if any specific aid can be derived from our experience in previous cases.

There are two ways in which the Commission can become a party to the case, as Mr. Weiner pointed out to you last week. The judge can ask us to come in, which amounts to a command, or we can ask the judge to let us come in. Assume one of those two things has happened, the judge approves our entry in the case and we file a notice of appearance. We become a party to the case just as all other intervenors become parties. The bondholders are entitled to intervene and become parties. If there was a second issue of

bonds or debentures, those bondholders or debenture holders are entitled to come in and be parties. The holders of various types of stock are entitled to intervene. Ordinarily they all act through groups of individuals known as protective committees. Such committees are supposed to be agents and representatives of the respective classes of individuals which they represent.

Now that we are in the case, it is required that notice be given to the Securities and Exchange Commission of any proceeding, and we receive a copy of each paper which is filed in the cause. We are entitled to be in court when every hearing is held, and if a matter is presented in which we are interested and would like to have our say, it is only necessary to obtain recognition of the court to make such statement as we desire.

In the meantime our financial analysts and our attorneys are making a study of the case. All the sources of information could not possibly be enumerated. We start with standard services such as Poor's, Moody's, and Standard Statistics. We get the reports which have been written by the protective committees and we can, if necessary, go into the books of the corporation. It may even be necessary to go into newspaper files for the purpose of determining what was common knowledge regarding this particular corporation as of a particular time during its business career. We have found in some instances that the unhealthy situation in the corporation which led to its bankruptcy started way back at the initiation of the corporation for reasons which were common knowledge at that time, although their full import may not then have been appreciated.

During this time the trustee presumably has not been inactive. He is required under the Act to file a report with the court in which he advises regarding the management of the corporation, its financial set-up, and other pertinent facts which he may discover. His purpose in making that report and the purpose of the statute requiring that report is primarily to determine whether or not he thinks a plan of reorganization can be effected.

His report heads up in that recommendation. If his investigation of the management and the general economic picture in the industry indicates that a fair, equitable and feasible plan of reorganization cannot be effected, he tells the court that, in his opinion, a reorganization is impracticable and that the best thing for the corporation to do is to liquidate, sell its assets and pay its debts, and if anything is left, distribute that among the stockholders of the corporation. As long as the management was left in control of the corporation during the bankruptcy proceeding it is very clear that the management would rarely suggest that it liquidate itself. And so this trustee who is independent, and who has no prior connection with the company at all, must make this report within a comparatively short time after he takes office as trustee. If liquidation is necessary, it does not take long to find this out, and all parties are better off if the proceeding is not dragged out for a number of years.

We shall assume in our hypothetical case that he recommends that a plan of reorganization can be effected which will permit the company to proceed. To the extent that the trustee is cooperative, the result of his investigation will be available to us. He may have obtained evidence and a knowledge of the situation which we do not have when he makes his report.

One of the most important things in reorganization is the question of management. It may well be, without leveling any serious criticism against the management of an organization, that uneconomic practices have developed which have continued over a long period of time, practices which were initiated during the lush days of the 1920's and which are still being done because they always were done that way.

And so the trustee, being a new broom, presumably is able to step into this program and effect economies that result in the reduction of the current expenses of the debtor -- the reduction of payrolls, the reduction of the amount expended for materials which were purchased, even going so far as to reduce the wattage in the electric light bulbs in order to reduce the amount of current which is being consumed.

We, of course, work in close cooperation with the trustee. When he reaches the point where he can estimate how much the corporation will take in and how much it must spend to do business, he is ready to begin formulating a plan of reorganization. He calls in the bondholders, the creditors, and the stockholders, who of course are owners of the business. They will appear, not in a town meeting, but through their representative who are their protective committees, each of whom may have a plan of reorganization of its own to propose. The trustee, at this meeting, perhaps will say: "We will pay off the current trade creditors in full. We have enough cash to do that. We have an issue of first mortgage bonds on which we are required to pay $60,000 a year interest. We shall have more than $60,000 income, but I think we had better cut that in half and pay only $30,000. Instead of paying off the bonds, we are going to extend them for ten years with the thought that in ten years the situation will have changed so that we can re-finance. In exchange for this concession in interest and the extension of the maturity date of the bonds, we will give the bondholders a block of the new common stock. We have some preferred stock which was originally issued and sold to investors and that stock does have an equity. In other words, there are enough net assets in the business so that the holders of the preferred stock have an interest in it. We will give them common stock. On the other hand, the holders of common stock have no interest in the business and we drop them out of the picture."

This situation is probably best given to you in analogy by comparing it to a house you might buy. You buy a house, paying $1,000 cash for it. You give the bank a first mortgage or deed of trust for $5,000, and a second mortgage or deed of trust for $2500, and the house costs you $8500. You have an equity of $1,000 in the house. The mortgage is foreclosed. At the auction the house brings $6,000. The first mortgage holder gets his $5,000 in full. The second mortgage holder who had a claim against the house for $2500 can't get more than $1,000 because that is all that is left, so he loses $1500. You as the owner of the equity, which originally you paid $1,000 for, get nothing.

The trustee says that he likes this plan.

The common stockholders immediately object. The preferred stockholders do not want common stock - they want to keep their preferred position. The first bondholders see no reason in the world to decrease their interest from 6% to 3%. The result is something of a dog fight over which the trustee attempts to keep order. He proceeds by compromise and by what has been aptly

termed "horse trading" and eventually that group comes out with a plan of reorganization which is more or less satisfactory to all the parties.

The Securities and Exchange Commission representative has temporarily stepped out of the picture. We do not participate in the drafting of plans of reorganization. There is a distinction here between plans of reorganization under the Chandler Act and plans of reorganization under the Public Utility Act of 1935. Under the 1935 Act the Commission is empowered to propose its own plan of reorganization, although to date it has never done so. Chapter X of the Chandler Act covers reorganization of the ordinary industrial organizations. It takes care of manufacturing organizations, local street railway companies, and apartment houses, but does not cover banks or railroads. The Securities and Exchange Commission is not the reorganizer for the industries of the country.

The Securities and Exchange Commission, however, does have a very definite function to perform in connection with these reorganizations and so as soon as the plan is drafted we are brought in. Perhaps the conference is continued and -- getting away from history and into prophecy -- we will say that the same individuals attend, plus the Securities and Exchange Commission representative. I think probably the position of our representative is going to be one of interrogation. Every provision of the proposed plan may well be greeted with a "why?" and it will be up to the various gentlemen sitting about the table to present the reasons for the particular provisions in the plan. If the Commission's representative is of the opinion that some one or more of the provisions of that plan, or the plan in its entirety, is inequitable, unfair and not feasible, it is his duty to say so. What his yardstick is to be, I can't for the life of me tell. Certainly there will be broad principles of policy that we can use as lighthouses. As I have already indicated, each one of these reorganizations stands on its own, and the representative of the Commission will have to use his judgment and act on his own responsibility in discussing the provisions of the plan.

Assuming that all amendments and recommendations have been made, the plan is finished and ready to be sent to the court. A copy of it, of course, comes to the Commission.

The court then sets a date at which time a hearing is had upon the plan itself. In the old days, under 77B, plans were presented to the court in a similar way except that there was no office for the purpose of clarifying the proposals, other than the court itself. In many instances a great many plans were presented and the judge had to pick out the best plan or the best provisions in all the plans in order to reorganize a company. Sometimes only one plan was proposed and occasionally that plan was presented by a combined group representing all of the interests in the corporation. At times that group was collusive, and although one committee was supposed to represent the preferred stockholders it, in fact, did not. Perhaps it represented the bankers who originally sold the securities, or it may have connived with the management which was attempting to put over a plan of reorganization which would retain control of the corporation in the old management and would decrease the interest the bondholders were entitled to have, by virtue of their lien, to a point which was unfair and inequitable. In other words, it would be the same thing as in the house situation that I told you about. Instead of waiting for foreclosure, you as equity holder get together with some people who are supposed to represent the mortgagees,

but do not, and decide that the first mortgage holders should take a new mortgage for $2500, cancelling the old $5,000 one, that the second mortgage holder should take a new mortgage for $1,000, cancelling the old $2,500 one, making a total of $3500, and if the property is worth $6,000, your equity of $1,000 is not only preserved but is increased to $2,500.

The Chandler Act, through the appointment of an independent trustee who has no connection with the company whatever and through the introduction of the Securities and Exchange Commission into the picture, is supposed to see that the plan which finally goes into effect does not result in such a situation as this, but is one which is fair and equitable and feasible.

An invitation is extended to all individual bondholders, all individual stockholders, all the creditors and to the Securities and Exchange Commission to come to this hearing before the Judge and state their objections to the plan if there are any objections. Amendments may be suggested, or an entirely new plan proposed. If necessary, evidence may be introduced in support of or in opposition to a particular plan, and finally the judge makes up his mind as to which of the proposed plans are worthy of consideration.

Here again the Securities and Exchange Commission comes into the picture. At that stage of the proceedings the court may, if the debtor's schedule of liabilities amounts to less than $3,000,000, and must, if more, refer the plan he deems worthy of consideration to the Securities and Exchange Commission for a report. That report is the culmination of the investigation and the study which the Commission has been conducting since it first became a party to the case. It may be that the report will cite no objections to any of the provisions of the plan. It may be that it will disapprove of some. It may be that it will disapprove of the plan in its entirety. The conclusions which the Commission has reached, plus the reasons for these conclusions, will be embodied in that report. The reasons, of course, are the facts which have been developed during the Commission's investigation. The Chandler Act provides that, when this plan which the court has deemed worthy of consideration has been sent to all interested parties asking their approval, a copy of the Commission's report, if a report has been prepared, shall be sent with it. A copy of the trustee's report made shortly after he was appointed shall also be included.

Our position in this reorganization is entirely advisory. We may think that a plan is one of the worst that was ever presented and the judge may still deem it worthy of consideration and the creditors, the stockholders, and the judge can put it into effect. We can't stop it at all. Our function at this stage of the proceeding is one of disclosure. If we think a plan is a bad one and so state in the report, together with the bases for our conclusions, the stockholders and others to whom the plan is submitted for assent may approve it in spite of what we say. The Act provides that if 2/3 of the creditors and 2/3 of the owners in each class accept the plan of reorganization, the court then may confirm and promulgate it, in spite of our adverse report.

With the order of the court putting this plan of reorganization into effect, the bankruptcy proceedings are terminated, the trustee is discharged, the corporation has a clean slate, a new management, a new financial set-up, and the reorganized corporation proceeds to function.

After this has been done, the gentlemen that have participated in the reorganization file with the Court petitions for the allowance of their fees. These petitions will be filed by the trustee, the attorneys, and those who represented the bondholders, stockholders, and individual creditors. The court will, if necessary hear testimony as to the time that they spent on the case, how productive it was and how valuable their services were to the reorganization.

Incidentally, under 77B, fees were allowed only for affirmative service, for proposing constructive suggestions, and as a result it sometimes happened that improvident provisions of plans were not attacked because those who would normally attack them did not take the time to do so because even if those provisions were thrown out no credit would be given for that work in computing the fee. The courts under the Chandler Act will welcome and will compensate for any effort to expunge inequitable, unfair and unfeasible provisions of plans of reorganization.

When the court determines how much shall be allowed as fees and expenses then the case is closed. Incidentally, regardless of the fact that the Commission never had any intention of requesting fees, a clause was put into the Chandler Act to the effect that under no circumstances would the Securities and Exchange Commission be awarded fees or expenses.

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