A DEATH SENTENCE OR A NEW LEASE ON LIFE?

A SURVEY OF CORPORATE ADJUSTMENTS UNDER THE PUBLIC UTILITY HOLDING COMPANY ACT

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Ten years having passed since the enactment of the Public Utility Holding Company Act,¹ some of its more important aspects may appropriately be reviewed to see how it has functioned and, if possible, the direction in which its administration by the Securities and Exchange Commission is leading.

The enormous volume of work already accomplished under this statute forbids a comprehensive review here.² Faced with a problem of selection we have focused our attention in these pages upon corporate readjustments which, though affected by numerous provisions of the Act, have evolved primarily out of the requirements of Section II.

It may be recalled that Section II was the focal point of conflict when the legislation was before Congress in 1935. In its original form opponents called the proposal a “death sentence” in tones that struck terror into the soul of many an investor. As enacted, financial reporters and commentators have called it that on occasion, but the tone is not the same; what began as a sensational battlecry has become a mere nickname for a section number. As we shall show, there is a growing realization that a “death sentence” imposed upon a disembodied legal fiction can mean, and has repeatedly meant, a new lease on life for the flesh-and-blood investor.


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The views expressed in this article are not to be taken as the views of the Securities and Exchange Commission or of any other member of the Commission’s staff.

1. Approved August 26, 1935; Title I, 49 Stat. 833 (1935), 15 U. S. C. § 79 (1941); referred to herein as the “Holding Company Act” or the “Act.”


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I. BACKGROUND AND OBJECTIVES

To understand the full import of Section II it is necessary to have some familiarity with the general objectives and historical background of the Act. Generally speaking, it is the policy of the Act to “meet the problems and eliminate the evils” specified in Section I (b) connected with “holding companies” (which are, in brief, companies that hold voting securities of gas and electric utility companies in sufficient quantity to control the latter) engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for that purpose to compel, among other things, the “simplification” of holding-company systems. The meaning of the term “simplification” and the manner of its accomplishment constitute the substance of our discussion.

There are holding companies in many fields of enterprise, some doubtless good, some bad. We are not concerned with the question whether it is theoretically good or bad to let one corporation control another. The Act deals with holding-company problems only in the gas and electric utility field, and these problems grew out of the manner in which control was in fact exercised and held. The legislation had to deal with an existing situation, not a theory.

The kind of holding company with which we are concerned began to be recognized as a national problem in the 1920s. Originally, gas and electric utilities were typically local, not only as to operations but also as to ownership and control. They were run by men who were expected to know about producing and distributing gas and electricity. Their financial policies were pretty generally geared to those services. On the ground that economy of service would be thereby promoted, these local companies tended to acquire exclusive operating rights and thus to become monopolies in the areas they served. Though subjected early to rate regulation they were often, as now, highly profitable, and they became natural prey to high-powered speculators who possessed, in the aggregate, an amazing line of manipulative schemes. The holding-company entrepreneur of the 1920s is caricatured in a passage from one of Sinclair’s novels:

3. The term “holding company” is elaborately defined in Section 2 (a) (7), 49 Stat. 805 (1935), 15 U. S. C. § 79b (a) (7) (1941), of the Act, but the full definition is immaterial for present purposes. The controlled companies are “subsidiary companies,” which may include non-utilities and subholding companies as well as “utility companies.” Section 2 (a) (8), 49 Stat. 807 (1935), 15 U. S. C. § 79b (a) (8) (1941). The term “utility company” as used in the Act and in this article is limited to companies owning or operating facilities for the distribution of gas at retail or for the generation, transmission, or distribution of electric energy. Sections 2 (a) (3) and 2 (a) (4), 49 Stat. 804, 805 (1935), 15 U. S. C. § 79b (a) (3,4) (1941).

"J. Paramount Barnes had begun life as a broker's messenger boy, and had learned all the tricks and invented many new ones. He had organized a utilities holding company, and had been so successful that he had repeated the stunt again and again, until he had a holding company for holding companies, a colossal pyramid with himself sitting on the top, and so many subsidiaries and investment trusts and stock-issuing and dividend-receiving devices that it was to be doubted if any human brain knew the whole of that tangle of complications."

The author, with a fantasy not unfounded in fact, has his “tycoon” controlling the top company

"... by three ‘voting shares,’ having a par value of one dollar each; which meant that the colossal enterprise would rest permanently in the capable hands of J. Paramount Barnes, his personal secretary, and one of his office clerks. The concern would proceed to issue several hundred million dollars in common shares, give part of them to Mr. J. Paramount Barnes for his services, and sell the rest to the public. In their present mood millions of the plain people all over the country would rush to buy the shares of any concern about which they read in the papers, and they would start bidding up the price on the exchange so that everybody would be rich and continuing to grow richer every day."

We have no statistics on how many holding-company magnates began as brokers' messenger boys, but not a few were primarily financiers, paper-minded rather than operational in their approach to utility system problems. Some of these, possessing or commanding prime financial and legal talent, bent their efforts to the accumulation of voting control over existing utilities and other enterprises, deprived them of all semblance of independence, and smothered them under elaborate paper superstructures. The operating utilities and other businesses at the base of these pyramids furnished all the revenues derived from outside sources, and a large percentage of revenues were drained off, in numerous instances, by exorbitant service and construction fees charged against them by “service companies” belonging to the parent holding company or to the individual interests who controlled the system. What was left of the earnings after expenses, fixed charges,

5. SInCLAIR, BETWEEN TWO WORLDS (1941) 662-3.


7. The functions of system-owned and affiliated “service companies” varied widely. Some furnished engineering advice and construction work, some furnished bookkeeping or auditing services, some performed outright every managerial function that an operating company's officers and board of directors could have performed. Whatever they did, the purpose of many of them was to obtain fees (including profits often running to 100% or more) which would be treated as operating expenses or capital costs in the accounts of the paying utilities, but would be received as income by the con-
and preferred stock dividend requirements of the operating companies, had to percolate upward through tier upon tier of holding companies to pay the interest and dividends on their outstanding securities. In such systems the companies in the superstructure were used for the purpose of retaining the insiders' control while the financial investment and risk were passed on to public investors by the flotation of a myriad of holding-company securities carrying no effective power to control the management. The securities issued to the public were frequently based on inflated "book value" bearing little or no relation to the amounts actually invested in the revenue-producing properties at the base of the pyramid, and were issued on the most optimistic assumptions as to the earning power of such securities.8

Of course, there were holding-company systems created and managed in a much more conservative manner than those we have described. Some that were left in the hands of sound operating men presented a strikingly different picture, and gave rise to few of the problems that required curative legislation. But the conservative manager had an uphill fight to hold his own against the entrepreneur who was conducting raids on soundly built establishments and paying fantastic prices for voting control. If he did not sell out he was apt to be submerged in an unequal battle. Sometimes his only chance for survival was to resort to devices for the maintenance of control similar to those employed in the unconsolidated utilities. Since the companies paying the fees were under the control of the very persons who profited from the fees, the system-owned or affiliated service company was in a position to charge "services" (whether they were needed or not) at prices which were not limited by competitive conditions or even by the independent business judgment of the paying company's officers. See, e.g., Pennsylvania Power & Light Co. v. Federal Power Commission, 139 F. (2d) 445 (C. C. A. 3d, 1943), cert. denied, 321 U. S. 798 (1944).

These fees, which were passed on to the consumer in the electric and gas rates charged by the utilities, were not subject to ready analysis by state or local regulatory bodies, which usually did not have jurisdiction over the service companies or their records. New Hampshire Gas & Electric Co. v. Morse, 42 F. (2d) 490 (D. N. H. 1930); In re Utilities Power & Light Corp., P. U. R. 1930B 359 (Mo. P. S. C. 1930); Hutchinson v. Chase & Gilbert, Inc., 45 F. (2d) 139 (C. C. A. 2d, 1931). See JONES & BIGHAM, PRINCIPLES OF PUBLIC UTILITIES (1932) 605-6, 616. But cf. Smith v. Illinois Bell Telephone Co., 283 U. S. 133 (1930); Dayton Power & Light Co. v. Public Utilities Commission of Ohio, 292 U. S. 290 (1934). The problems thus raised went a long way toward explaining the need for federal legislation.

Under the Act, system-owned service companies are expressly prohibited from charging more than cost and are closely regulated as to the determination and fair allocation of cost among the companies served. Affiliated and independent service companies are also subject to regulation and federal examination. See Section 13 (b) to (f), 49 Stat. 825-37 (1935), 15 U. S. C. § 79m (b-f) (1941). For an interesting discussion of these problems see Eicher, Progress in Service Company Regulation (1941) 27 F. U. Fort. 707; Consumers and the Public Utility Holding Company Act (1941) 21 J. Bus. U. of IOWA 4.

to those used by the raiders themselves—with results that were only slightly less unfortunate for public investors following the crash of 1929.

The methods by which the holding-company structures were created, and the various means by which an enthusiastic public was induced to put its savings and its faith in even the most flimsy of them, make a very long story indeed which required years of expert inquiry to develop. The dangers inherent in the shift from local control were publicly recognized long before disaster called a halt. As early as December, 1924, the United States Senate expressed concern over the existence of undue concentration of control over the electric power industry and the financial connections of that industry. In 1925 it ordered an investigation of a limited phase of the problem, but this resulted in no immediate legislation. The need for action to protect the public interest grew more acute and, in February, 1928, the Senate adopted a resolution directing the Federal Trade Commission to make a thorough investigation of interstate utility corporations, their holding companies, associates and affiliates, and to report the results of its studies to the Senate.11

In obedience to this resolution the Trade Commission started an inquiry that took several years to complete and a great many printed volumes to report. For this project it secured the services of Robert E. Healy, a Vermont Republican formerly a judge of the Supreme Court of that State, who accepted the duties of Chief Counsel and at the outset made it plain that the investigation was to be an impartial and objective inquiry into the facts. Material obtained by the Trade Commission’s investigators, largely documentary, was presented at open hearings at which industry representatives were afforded the fullest opportunity to cross-examine, rebut, and explain. The report represents “the most thoroughgoing investigation of an American industry that has ever appeared.” Other studies, also of great interest and only less monumental, were made under Congressional and executive direction before the Holding Company Act was finally adopted.14

12. Federal Trade Commission, Utility Corporations, Sen. Doc. No. 92, 70th Cong., 1st Sess. (1935) submitted in 101 volumes. The study was substantially finished by 1935, but additional parts continued to be reported from time to time until 1937.
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It will be noted that although the legislation was placed on the statute books in 1935 under New Deal impetus, much of the spadework had been done under Republican leadership. The Act may thus be said to be a result of bipartisan effort. The business depression of the early 1930s had already demonstrated the financial instability of the paper pyramids, and by 1935 the need for federal regulation was widely recognized in Congress.\(^{15}\)

II. STATUTORY PROVISIONS AND PROCEDURES

Among the statutory provisions that had been generally accepted in the early stages of the legislation were these: all holding companies (except certain intrastate, temporary and other companies exempted under Section 3 [a]) were required to become “registered” and to file in the public files of the Commission statements containing descriptive historical and financial data regarding themselves and each of their subsidiary companies (Sections 4 and 5), and to keep such information up to date by the filing of periodical and special reports (Section 14); the issue and sale of securities by registered holding companies and their subsidiaries were subjected to statutory standards embracing analysis and clearance by the Commission (Sections 6 and 7), as were acquisitions and sales of utility properties and securities and the declaration and payment of dividends (Sections 9, 10, 12 [c], 12 [d]); “upstream” loans, i.e. loans by subsidiaries to their parents, were prohibited and other intrasystem loans regulated (Sections 12 [a], 12 [b]); a wide variety of transactions with affiliates were subjected to scrutiny and veto by the Commission (Sections 12 [f], 12 [g]); performance of services by holding companies was prohibited, system service charges were limited to cost, and service contracts and service companies were made subject to the Commission’s regulation (Section 13, and see note 7 supra); authority to prescribe accounting systems and cost-accounting procedures was given to the Commission, subject to any applicable requirements of state commissions and other regulatory bodies having jurisdiction (Sections 15, 20); bankers’ representatives were in general disqualified from acting as directors or officers of registered holding companies and subsidiaries (Section 17 [c]); and the Commission was given the necessary powers to enforce and

\(^{15}\) See 79 CONG. REC. 9042, 9063-4 (1935). According to a compilation made by members of the Commission’s staff, between September 1, 1929 and July 1, 1935, fifty-two holding companies, having about $1,500,000,000 of outstanding securities (exclusive of securities held by affiliates), and thirty-six utility subsidiaries, having approximately $353,000,000 of such securities, went into receivership or bankruptcy. During the same period, twenty-three holding companies, having about $535,000,000 of such securities, and sixteen utility subsidiaries, having approximately $152,000,000 of such securities, offered debt readjustment or extension plans following defaults in payment of interest.
carry out the Act by rules and regulations, by applications to the District Courts, and by orders (subject to direct review in the United States Courts of Appeals for the various Circuits and the District of Columbia) (Sections 18, 20, 24).

The only important conflict arose over a proposal to strike at the root of the holding-company problem by providing for the virtual elimination of holding companies from the utility field, and for close regulation of those that were permitted to remain. The Senate backed this proposal, but the House, while agreeing that close regulation was necessary, opposed the elimination of holding companies and provided only in general terms for administrative authority to limit the number of utility systems that could be controlled by any one holding-company system. The result was a compromise. Section 11 as finally adopted represented a significant victory for both consumer and investor interests. It furnishes a healthy impetus toward a return of utilities to local operational management and simplified conservative security structures; and it provides relief for ailing corporate structures through reorganization machinery not available under pre-existing law.

A return to localized management is promoted by Section 11 (b) (1) of the Act—the provision for geographical and operational "integration"; and impetus toward simplified and conservative security structures is furnished principally, though not exclusively, by Section 11 (b) (2). These provide in substance that it shall be the duty of the Commission, as soon as practicable after January 1, 1938, to require by order, after notice and opportunity for hearing, that each registered holding company and each subsidiary thereof:

1. shall take such action as the Commission finds necessary to limit the operations of the "holding-company system" to one or more "integrated public-utility systems" operating in the same general area or region, and to such related "other businesses" as are permitted by standards set forth in this section; and

16. Most of the regulatory provisions apply only to "registered" holding companies. After the Act was passed few holding companies registered until extensive litigation over the constitutionality of Sections 4 and 5 was terminated by the Supreme Court's decision in Electric Bond and Share Co. v. SEC, 303 U. S. 419 (1938).


18. A "holding-company system" consists of any holding company together with its subsidiaries. Section 2 (a) (9), 49 Stat. 808 (1935), 15 U. S. C. § 79b (a) (9) (1941). An "integrated public-utility system" consists of physical utility properties meeting certain prescribed standards as to interconnection and coordination, "confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages
shall take such steps as the Commission finds necessary “to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure” of such system, or “unfairly or inequitably distribute voting power among the security holders” thereof. The Commission must not permit more than two tiers of holding companies to continue over any public-utility company.

The machinery most frequently employed by solvent companies for effectuating the necessary structural changes is contained in Section II (e), which provides for the submission of plans formulated by the companies’ own managements. To become effective the plan must be approved by the Commission, after notice and opportunity for hearing, on the basis of the Commission’s finding that the plan (as submitted or as modified) is “necessary to effectuate the provisions of” Section II (b), and is “fair and equitable to the persons affected by such plan.” At the request of the company the Commission may apply to an appropriate United States District Court to enforce and carry out the terms of a plan theretofore approved by the Commission. If the court approves the plan as “fair and equitable” and as “appropriate to effectuate the provisions of Section II,” it may take exclusive jurisdiction and possession of the company and its assets, and may appoint a trustee to administer the assets under the direction of the court and in accordance with the plan.

19. No change may be required as to the corporate structure or continued existence of any system company which is not a holding company or which is primarily a public-utility company, except for the purpose of “fairly and equitably distributing voting power among the security holders of such company.” Questions as to the meaning and constitutionality of Section II have been raised in a number of cases which are now pending in the United States Supreme Court. North American Co. v. SEC, 133 F. (2d) 148 (C. C. A. 2d, 1943); Engineers Public Service Co. v. SEC, 138 F. (2d) 936 (App. D. C. 1943), cert. granted, 322 U. S. 723 (1944); American Power & Light Co. v. SEC, Electric Power & Light Co. v. SEC, 141 F. (2d) 606 (C. C. A. 1st, 1944), cert. granted, 324 U. S. 835 (1945).

20. Where proceedings for enforcement of a plan are instituted in the District Court, that court gets exclusive jurisdiction over all questions involved in the plan and its enforcement, and no direct appeal from the Commission’s order on such questions lies to a Circuit Court of Appeals. Okin v. SEC, 145 F. (2d) 206 (C. C. A. 2d, 1944), remanded in part, 324 U. S. 835 (1945). And it has been held that where a plan contemplates enforcement in the District Court no direct appeal from the Commission’s order lies to a Circuit Court of Appeals, even though the enforcement proceedings have not yet been instituted at the time of the filing of the appeal. Lowsbury v. SEC, 151 F. (2d) 217 (C. C. A. 3d, 1945), rehearing denied, October 2, 1945.

21. Section 11 (d), 49 Stat. 821 (1935), 15 U. S. C. § 79k (d) (1941), makes provision for the formulation of plans by the Commission or other persons and for court enforcement of such plans without the request or consent of the holding company or subsidiary company concerned. But the Commission has always favored the development of plans by company managements and has afforded them every opportunity to work out their own solutions subject, of course, to most careful scrutiny and the Commission’s power to require modifications. Up to the time of writing the Com-
For insolvent companies the familiar procedures of the Bankruptcy Act are available but, pursuant to Section II (f) of the Holding Company Act, no plan of reorganization for a registered holding company or a subsidiary thereof can be submitted to the court until the plan has been approved by the Commission after notice and opportunity for hearing.22

Proceedings under Section II (b) are instituted only after thorough study of available data by the Commission's staff.23 A "notice of and order for hearing" is issued by the Commission, directed to the companies concerned. It contains a comprehensive statement of the results of the study and outlines the matters to be considered at the hearing. Answers may be filed by the respondent companies, and other interested persons (including municipalities and state commissions and officials) may intervene or be heard. The hearing is held before a trial examiner whose function is to preside and rule on the admissibility of evidence and on procedural matters. The case is opened by counsel for the Public Utilities Division of the Commission's staff. Normally there is no dispute with respect to the basic facts, the main issues generally relating to conclusions of fact or to matters of statutory interpretation, and the practice is to introduce written statements containing factual data as to physical properties, corporate structures, and financial condition. All the participants have the right to cross-examine and produce evidence, and after the close of the hearing may file proposed findings, briefs, and exceptions to the examiner's rulings.24 The full Commission hears oral argument upon the request

mission has not found it necessary to enforce a plan under Section II (d). The procedure established by Section II takes precedence over other proceedings which would interfere with the Commission's or the Court's functions under Section II, and interference will be stayed or enjoined. Dederick v. North American Co., 48 F. Supp. 410 (S. D. N. Y. 1943); In re Standard Power & Light Corp., 48 F. Supp. 716 (D. Del. 1943); North American Co., 9 S. E. C. 617 (1941). Cf. New England Gas & Electric Ass'n, SEC Holding Company Act Release No. 4158 (1943).

22. The Commission's approval of a plan pursuant to Section II (f), 49 STAT. 822 (1935), 15 U. S. C. §79k (f) (1941), is merely a condition precedent to consideration of the plan by the District Court. No party is "aggrieved" by the Commission's order of approval and an appeal from it will not lie to a Circuit Court of Appeals. Gilbert v. SEC, 146 F. (2d) 513 (C. C. A. 7th, 1944).

23. Section II (a) provides: "It shall be the duty of the Commission to examine the corporate structure of every registered holding company and subsidiary company thereof, the relationships among the companies in the holding-company system of every such company and the character of the interests thereof and the properties owned or controlled thereby to determine the extent to which the corporate structure of such holding-company system and the companies therein may be simplified, unnecessary complexities therein eliminated, voting power fairly and equitably distributed among the holders of securities thereof, and the properties and business thereof confined to those necessary or appropriate to the operations of an integrated public-utility system." 49 STAT. 820 (1935), 15 U. S. C. §79k (a) (1941).

24. Frequently, counsel for the Public Utilities Division is called upon to serve on each of the parties a "proposed findings and opinion" which contains a detailed statement of the case together with the recommendations of the Division as to the outcome. This document serves the purpose of narrowing the issues for the parties, who may direct their objections or supporting arguments to specific points and need not, unless they wish, restate the whole case.
of any party, and issues its written opinion incorporating its findings (in narrative form) on which it bases its order.

The Commission's opinion discusses at length the reasons for the nature of its order under Section II (b), but the order itself is normally framed so as to afford management the widest latitude in selecting appropriate methods for achieving the required results.\(^{25}\) The order anticipates that the company will file a plan of compliance under Section II (e), and that in default of an acceptable company plan filed in time to effect compliance within one year (or within a period not to exceed two years if the Commission grants an extension)\(^ {26}\) the Commission may proceed under Section II (d) to consider and enforce a plan without the cooperation of the company.\(^ {27}\)

When a plan of compliance is filed the Commission issues a "notice of filing and order for hearing," summarizing the terms of the plan, listing the matters to be given particular consideration at the hearing, and requiring that copies of the notice be sent to all known security holders in addition to being published in the usual manner.\(^ {28}\) The hearings are usually attended by representatives of the various interests affected, including committees for publicly held securities, and by individual stockholders. The proceedings are conducted in much the same way as the others already described, except that the proponents of the plan open the case in support of the plan, and the function of counsel for the Public Utilities Division is primarily to see that the material facts of the case are fully explored, included in the record, and presented to the Commission. If controversy develops the case is briefed and argued as in other proceedings.\(^ {29}\) Whether or not there is a controversy, the Commission examines the plan in the light of all applicable standards and issues its findings and opinion supporting the order approving (with or without modification) or disapproving the plan.

### III. SIMPLIFICATION TECHNIQUES

The first holding companies to take action toward compliance with Section II did so in relatively simple steps. One method was for a

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\(^{25}\) This is in accordance with the Congressional intent. Curiously, the latitude given to the management was one of the main points of objection raised (un成功地) in the first appeal from an order issued under Section II (b), 49 Stat. 821 (1935), 15 U. S. C. § 79k (b) (2) (1947). Commonwealth & Southern Corp. v. SEC, 134 F. (2d) 747, 750-1 (C. C. A. 3d, 1943).

\(^{26}\) Section II (c) of the Act, 49 Stat. 821 (1935), 15 U. S. C. § 79k (c) (1941).


\(^{28}\) Under the Federal Register Act, 49 Stat. 500 (1935), 44 U. S. C. §§ 301-4 (1947), notices, orders, rules, and other documents are published in the Federal Register. The Commission does not stop there, however, but makes copies available to newspapers, services, financial publications, and hundreds of firms and individuals who have placed their names on its mailing lists.

\(^{29}\) See note 24 supra.
holding company to transform itself into an operating company by merging with its operating subsidiaries.\(^{30}\) Other methods were for the holding company to dispose of stock interests in unrelated properties, which were not retainable under Section \(\text{II} \ (b) \ (i)\), in exchange for stock interests in other properties the acquisition of which tended toward the development of an integrated utility system;\(^ {31}\) to simplify the corporate structure of its underlying system by merging several operating subsidiaries into one;\(^ {32}\) to liquidate or otherwise eliminate intermediate holding companies;\(^ {33}\) to dispose of unretainable stock interests by distributing them to the holding company's own security holders;\(^ {34}\) and to combine several steps of this kind with the eventual liquidation of the holding company itself.\(^ {35}\) Subsequent steps, involving combinations of the foregoing methods and a few others, have sometimes been of great complexity and have required special reorganization techniques applied in the light of novel factors, to be discussed below.

Not only must the Commission find such steps "necessary to effectuate the provisions of" Section \(\text{II} \ (b)\) and "fair and equitable" to the persons affected, but it must also examine each integral part to see that it conforms with special standards contained in other sections of the Act, for example: the reasonableness of the price and terms of any acquisition or disposition of assets governed by Sections \(10\) or \(12\); the character of any financing by new securities governed by the standards of Sections \(6\) or \(7\);\(^ {36}\) the adequacy of depreciation reserves and of annual charges for depreciation; the segregation, amortization, or elimination of inflationary items contained in asset accounts;\(^ {37}\) maintenance of competitive conditions in the issuance of new securities and the sale of portfolio securities;\(^ {38}\) and numerous other matters.

\(^{30}\) Montana-Dakota Utilities Co., 1 S. E. C. 299 (1936); Nevada-California Power Co., 1 S. E. C. 773 (1936).


\(^{34}\) Penn Western Gas & Electric Co., 3 S. E. C. 280 (1938).

\(^{35}\) Republic Electric Power Corp., 3 S. E. C. 992 (1938).


\(^{37}\) See Kripke, A Case Study in the Relationship of Law and Accounting; Uniform Accounts 100.5 and 107 (1944) 57 Harv. L. Rev. 433, 693.

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As we have previously indicated, we cannot undertake to review here the Commission's scrutiny into the more detailed aspects of proposed transactions subject to its approval but must limit ourselves to the broader aspects of the operation of Section II, which deal with what steps are "necessary" to fulfill its over-all objectives and what adjustments of legal rights are "fair and equitable."

Great latitude must be allowed in determining what steps are "necessary," for the methods selected for simplifying an overburdened capital structure or the structure of a complex corporate system are not usually the only methods for achieving the necessary results. Alternative methods may be just as good as the particular steps proposed in any given case. In recognition of this fact the Commission has held that a plan may be approved as "necessary" under Section II (e) if it is a suitable means of achieving results which are necessary to the effectuation of the provisions of Section II (b).39

Since Congress had made mandatory the attainment of the objectives expressed in the Act, and since all classes of security holders are afforded ample opportunity to protect their rights through participation in proceedings on the plan before the Commission and the District Courts (and, if aggrieved, through appeal from any final order relating to the plan), the consent of security holders to adjustments designed to effect the statutory purposes has been held to be unnecessary.40 The existence of a veto power by security holders might in many cases prevent compliance with the Act just as in recapitalizations under State procedures the veto power of junior security holders may operate to deprive higher-ranking classes of fair and equitable treatment.41 However, the Commission has on occasion approved


provisions in plans calling for general stockholder approval \textsuperscript{42} or even individual stockholders' acceptances.\textsuperscript{48}

There is a distinct relation between the simplification process under the Act and the manner in which a system was put together. Acquisitions made in the process of building up a holding-company system often carried with them the pre-existing capital structures of the units acquired. In addition, the capital structures of the top companies were often devised without any concern for simplicity or soundness. Such factors resulted in overstratified capital structures in some systems requiring simplification in the form of elimination of one or more classes of senior securities in an appropriate manner so as to reduce the holding company's capitalization to a single class of common stock.\textsuperscript{44} The manner in which some systems grew up resulted in the presence of corporate entities serving no useful function and making necessary their elimination, in some cases through their merger with other system companies \textsuperscript{45} and in others through transfer or distribution of their assets and their dissolution.\textsuperscript{46} The security structures of utility companies themselves were occasionally unduly complicated and distributed voting power unfairly, with the result that a thoroughgoing reorganization of such companies has been necessary in order to satisfy the


\textsuperscript{43} United Corp., SEC Holding Company Act Releases Nos. 5440 (1944), 5812 (1945), \textit{appeal pending sub nom. Phillips v. SEC}, (C. C. A. 2d, No. 16623); Electric Bond & Share Co., SEC Holding Company Act Release No. 4400 (1943); National Power & Light Co., 10 S. E. C. 827 (1941); Standard Gas & Electric Co., 7 S. E. C. 1089 (1940), \textit{plan modified}, 8 S. E. C. 481 (1941); There is normally no necessity for a general stockholders' vote on exchanges or distributions as to which individual stockholders' acceptance is provided, and such transactions have nearly always been effectuated without such vote. A vote was provided for, however, in such a situation in National Power & Light Co., 10 S. E. C. 827 (1941).


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requirements of Section II.\(^{47}\) Or the value of the assets of which the holding company must divest itself under Section II (b) (i) may sometimes be such that the retirement of holding-company senior securities is a corollary necessity.\(^{48}\)

Each system thus presents its own problems affecting its attainment of the objectives of Section II. Although the problems are varied and require specific solutions, they are nevertheless interrelated. The simplification of a system or even the correction of complexities or inequities in one company will often bring into play a wide variety of techniques, each of which complements the others and aids the summation of the entire program of compliance with the Section. While no one of the systems affected by the Section has represented all the types of situations that have arisen in the course of the Commission's administration, in order to present a concrete illustration of how specific simplification techniques are devised and applied for the solution of a system's problems we shall describe one system and the steps taken or proposed for its simplification. We shall discuss subsequently the questions which have arisen with respect to the determination of what constitutes fair and equitable treatment to various classes of security holders and other claimants whose rights are affected under a plan of simplification or its component or related steps.

An Illustrative System: The United Light and Power Company and Its Subsidiaries

The system headed by the United Light and Power Company (hereinafter referred to as "Power") is not chosen as an example of extreme complexity of structure or diversity of operations. In this respect it may be regarded as fairly representative of a number of sys-


tems, and it was of moderate size. The principal reason for giving extended consideration to Power's system is that both its development prior to the impact of Section II and the program for its simplification in compliance with that Section highlight many of the varied problems which the simplification process embraces and illustrate the interrelated nature of these problems. It is an appropriate system for analysis also in view of the fact that one phase of the plan for its simplification, approved by the Commission under Section II (e), was recently considered by the United States Supreme Court in Otis & Co. v. Securities and Exchange Commission.

Before instituting proceedings under Section II (b) with respect to this system the Commission, through the staff of its Public Utilities Division, made a thorough study of its history and structure, as contemplated by Section II (a). There has been no controversy as to the basic facts.

Power had its origin in 1910 as a small Maine corporation controlling electric, gas, and transportation companies in Iowa, Illinois, Indiana, Tennessee, and Michigan. The system had grown slowly up 49. Extremes as to both complexity and size would be well illustrated by the Associated Gas & Electric Company system, simplification of which is being carried out by trustees under the direction of the bankruptcy court and the Commission. This system in its heyday comprised scores of companies with consolidated assets stated at over one billion dollars and contained tiers of holding companies ranging to as many as eight or more levels. The parent corporation alone had outstanding twenty-two differently-styled securities, which, if further classified according to series, interest, and dividend rates, etc., comprised eighty-five different categories. See Clarke, Trustee of Associated Gas & Electric Co., SEC Holding Company Act Release No. 4985 (1944), plan approved, In re Associated Gas & Electric Co., 61 F. Supp. 11 (S. D. N. Y. 1944), aff'd, 149 F. 2d 996 (C. C. A. 2d, 1945), cert. denied, 89 L. Ed. (Adv. Ops.) 42 (1945); Associated Gas & Electric Co., 11 S. E. C. 975 (1942). 50. 323 U. S. 624 (1945), rehearing denied, 324 U. S. 887 (1945). The rule of law upon which the Supreme Court passed applies to one segment of an over-all program of system simplification. At the time of this writing, twenty-five separate applications have been filed by the system management proposing various steps in the over-all program of compliance with Section II, 49 STAT. 820 (1935), 15 U. S. C. § 79k (1941). The step considered by the Supreme Court was proposed in Application No. 14. 51. See note 23 supra. 52. A staff report dealing with the system's problems under Section II (b) (2), 49 STAT. 821 (1935), 15 U. S. C. § 79k (b) (2) (1941), was prepared and submitted to the Commission which thereupon instituted proceedings under that section. After minor corrections were made in the report at the suggestion of the respondents, the facts stated in the staff's report as thus revised were accepted as accurate and were received in evidence. Report of the Public Utilities Division to the Securities and Exchange Commission with respect to the Holding Company System of The United Light and Power Company and Its Subsidiary Companies as to Compliance with Section II (b) (2) of the Public Utility Holding Company Act of 1935 (rev. 1941); United Light & Power Co., 8 S. E. C. 837, 838-9 (1941). The facts in the revised report were supplemented by evidence at the hearings in the Section II (b) (2) proceedings, as well as at subsequent hearings under Section II (b) (1) and those on the management's numerous applications proposing successive steps under Section II (e) for compliance with Section II (b). The several proceedings have been consolidated for the sake of keeping a complete record always before the Commission. Except as otherwise noted, the historical and financial data set out in the ensuing discussion of Power's system through the year 1939 have been taken from or computed on the basis of the staff's revised report.
to 1923, when Power was reorganized as a Maryland corporation. At this time annual consolidated gross revenues were about $12,000,000. In 1924, Power, through a subholding company, United Light and Railways Company ("Railways"), acquired about 75% of the common stock of a much larger concern, Continental Gas & Electric Corporation ("Continental"). This company, also a holding company, had electric utility subsidiaries operating in Nebraska, Iowa, and Missouri, with consolidated gross revenues of about $21,000,000 annually. The properties thus acquired were mostly far removed from and were never interconnected with those previously controlled by Power.

Late in 1924, Power further acquired a substantial common stock interest in American Light & Traction Company ("Traction"), a holding company controlling mainly gas companies which operated in Michigan, Wisconsin, and Minnesota, and at more remote points such as San Antonio, Texas, and Binghamton, New York, with consolidated gross revenues of about $33,000,000 annually. The properties of Traction bore no physical or operating relationship either to Power's original group or to the Continental group. Power continued to acquire Traction's stock on the open market, for a time in active competition with the Mellon-Koppers interests, until rapidly rising prices compelled the rival forces to negotiate. Finally, in 1928, Power obtained a majority control of Traction by a deal in which it took over United American Company ("United American") from Koppers. United American had been the holding company through which Koppers had held Traction stock. In the meantime the Mellon-Koppers interests had acquired a substantial block of Power's own voting stock.

Beginning in 1924, Power also purchased stock of the Detroit Edison Company in aggressive competition with North American Company. It never succeeded in gaining control of Detroit Edison, but the contest had resulted in excessive prices being paid by both purchasers.

The last important addition to the system occurred in 1930, when Railways subscribed for 35% of the common stock of Northern Natural Gas Company, which was formed primarily to own and operate a gas pipeline from Texas to Wisconsin and neighboring states.

The growth of the system, primarily through these methods, resulted in an increase in annual gross revenues from about $12,000,000

53. Power later acquired almost 100% of Continental's common stock.

54. The Commission later determined in proceedings under Section 2 (a) (8) of the Act, 49 STAT. 807 (1935), 15 U. S. C. § 79b (a) (8) (1941), that Detroit Edison was a subsidiary of North American and was not subject to a controlling influence by Power, though the latter (through Traction) held over 20% of Detroit Edison's voting stock. Detroit Edison Co., 7 S. E. C. 968 (1940), aff'd, 119 F. (2d) 730 (C. C. A. 6th, 1941), cert. denied, 314 U. S. 618 (1941).
in 1924 to more than $84,000,000 in 1930, excluding Detroit Edison and Northern Natural.\textsuperscript{55}

Power's system in 1930 consisted of several subholding-company systems comprising some seventy-five companies of various kinds. During the 1930s and the early part of 1940 at least twenty-three corporate entities were eliminated by consolidation or dissolution, and some were sold. A number of these and other steps tending toward compliance with the Act took place after February, 1938, when Power and Railways registered as holding companies under the Act, and these were subject to the Commission's jurisdiction,\textsuperscript{56} as were other steps taken to finance construction programs,\textsuperscript{57} and to acquire additional utility properties that could be interconnected with facilities already owned.\textsuperscript{58}

In general, however, the complexities that resulted from the system's mode of growth were still present at the beginning of 1940, when the system comprised seven registered holding companies and forty-three other companies (including twenty-two electric and gas utilities, seven transportation, water or ice companies, one system service company, and thirteen companies which were engaged in other businesses). A simplified corporate chart is shown on the opposite page depicting the structure as of December 31, 1939. The solid connecting lines indicate solid control, and the dotted lines indicate holdings of less than majority voting power.

It will be seen at once from the chart that there were either three or four tiers of holding companies above the utility operating companies in the Traction, Continental, and Northern Natural Gas systems. This structure was in clear conflict with the mandate of Section 11 (b) (2), particularly the "great-grandfather" clause which made it necessary for the Commission to order prompt reduction of the tiers of holding

\textsuperscript{55} In 1930, Detroit Edison's gross revenues exceeded $53,700,000 and it paid nearly $10,000,000 in dividends on its common stock (with net income after preferred dividends reported at $11,117,000). Northern Natural was just starting in 1930, but by 1936 its gross revenues were exceeding $9,000,000 annually.


\textsuperscript{57} Madison Gas & Electric Co., 4 S. E. C. 50 (1938); Columbus & Southern Ohio Electric Co., 4 S. E. C. 278 (1938); Northern Natural Gas Co., 5 S. E. C. 561 (1939).

\textsuperscript{58} Peoples Natural Gas Co., 6 S. E. C. 166 (1939); Peoples Light Co., 6 S. E. C. 561 (1940).
A DEATH SENTENCE OR A NEW LEASE ON LIFE?

Power (H)

Service Company

Railways (H)

Twelve Other Subsidiaries

United American (H)...

United Pwr. Mfg. Co....

Traction (H)*

Iowa-Nebraska (H)

Continental (H)

One Subsidiary

(Twelve Subsidiaries

Northern Natural Gas (H)

Two Subsidiaries

Eleven Other Subsidiaries

Detroit Edison†

* The voting power in Traction held by Railways, United American, and United Power Manufacturing Company was, in the aggregate, about 52%.

† Declared not to be a subsidiary (see note 54 supra).
companies to not more than two.59 This statutory requirement works automatically, but the reasoning behind it is not hard to find. The capitalization and earnings history of the system companies provide the clue.

The capitalization of the system was highly stratified at each of the principal corporate levels by the existence of outstanding debt and preferred stocks. This stratification is shown on the accompanying chart of publicly held senior securities which are presented as a pyramid that has been inverted, starting with the operating companies at the base and progressing downward toward the point in order to illustrate the principle that the quality of the securities tends to diminish as their degree of removal from the operating base increases. The chart gives the approximate amounts of senior securities outstanding as of the end of 1939, excluding intrasystem holdings and the securities of Detroit Edison and Northern Natural Gas.60

Except for the minority interest in Traction's common stock held by the public (as shown in the chart), Power directly or indirectly held virtually all the junior equity interests in the operating and subholding companies. The junior equity interest in Power itself was represented by Class A and Class B common stocks, which were coequal except that all the voting power was vested in the Class B. It will be noted that these common stocks were subject to no less than $430,000,000 of outstanding senior securities. The junior equity represented by Power's common stocks was about $9,700,000 for the Class A and $4,200,000 for the Class B, on the basis of the consolidated balance sheet. Power had no earned or capital surplus.

In summary, from base to apex there were at least nine strata of publicly held senior securities with their several fixed interest rates (ranging from 2.75% to 6.5%) and fixed dividend requirements (ranging from 6% to 8%) which had to be paid before any earnings could be attributed to Power's common stock—not to mention the three to four tiers of corporations each with its own expenses, taxes and fixed charges other than interest. Small variations in the amount of revenues taken in by the operating subsidiaries at the base were naturally magnified with each layer of corporate expenses, fixed charges and fixed dividends, with the result that slight fluctuations in system revenues produced violent swings in the consolidated net income figures, and

59. "In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company." 49 Stat. 821 (1935), 15 U. S. C. §79k (b) (2) (1941).

60. Both of these companies had very large amounts of securities outstanding.
Operating Subsidiaries of Continental and of Traction

<table>
<thead>
<tr>
<th>Company</th>
<th>Funded debt</th>
<th>Preferred stocks</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continental</td>
<td>$50,000,000</td>
<td>$1,700,000</td>
<td>$61,700,000</td>
</tr>
<tr>
<td>Traction</td>
<td>$40,000,000</td>
<td>$10,300,000</td>
<td>$50,300,000</td>
</tr>
</tbody>
</table>

Railways

<table>
<thead>
<tr>
<th>Company</th>
<th>Funded debt</th>
<th>Preferred stock</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Railways</td>
<td>$24,400,000</td>
<td>$19,300,000</td>
<td>$43,700,000</td>
</tr>
</tbody>
</table>

Power

<table>
<thead>
<tr>
<th>Company</th>
<th>First Lien Bonds*</th>
<th>Debentures</th>
<th>Preferred stock</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Power</td>
<td>$17,250,000</td>
<td>$19,850,000</td>
<td>$60,000,000</td>
<td>$97,100,000</td>
</tr>
</tbody>
</table>

* These bonds were exceptional in that they were secured by liens on property and securities of twelve direct subsidiaries of Power hereafter referred to as the “First Lien companies,” and were therefore independent of the base formed by the Continental and Traction subsidiaries.
there existed numerous potential blocks in the intrasystem flow of cash earnings.

In the lush years when the system was put together, this leverage factor was an apparent advantage to Power's common stockholders because so much of the system's capital had been contributed by the public holders of limited-income securities, while any gains in net earnings were to be available for dividends on the common stock. Actually, however, as far as Power was concerned the leverage worked the other way and the flow of earnings—complex at best—became blocked before they reached even Power's preferred stock which was about $28,000,000 in arrears on its dividends by the end of 1939.

The earnings flow is, of course, an important factor in any holding-company structure, and the holding company's corporate net income may differ greatly from consolidated net earnings. The latter is merely a statistical figure indicating in general the amount of system net income applicable to the equity securities of the top holding company. It may be very different from what can actually be drawn up in cash by the top company because there often exist many reasons why a subsidiary cannot or should not pay cash dividends equal to the amount of its net income. For example, the subsidiary may need its cash for construction of new facilities, or for debt retirements, or for other purposes; or the payment of dividends may be restricted by indenture covenants, by charter provisions, or by law or regulatory order, for the protection of the investment of senior security holders or to insure adequate utility service to consumers. It is entirely natural that the more corporate complexities there are in the system, the more hazards there are in the flow of earnings. This is well illustrated by a comparison of the consolidated net income with Power's corporate net income in the period 1935-1939:

<table>
<thead>
<tr>
<th>Year</th>
<th>Consolidated</th>
<th>Corporate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1935</td>
<td>$2,411,652</td>
<td>$311,268</td>
</tr>
<tr>
<td>1936</td>
<td>$4,508,261</td>
<td>121,851</td>
</tr>
<tr>
<td>1937</td>
<td>$5,182,602</td>
<td>402,139</td>
</tr>
<tr>
<td>1938</td>
<td>$3,091,508</td>
<td>627,594</td>
</tr>
<tr>
<td>1939</td>
<td>$4,598,654</td>
<td>2,342,432</td>
</tr>
<tr>
<td></td>
<td><strong>$19,792,677</strong></td>
<td><strong>$3,805,284</strong></td>
</tr>
</tbody>
</table>

61. About 3% of total consolidated capitalization was represented by Power’s common stock, and the voting or Class B stock represented less than 1%.
Disregarding this factor, however, and taking consolidated figures alone, the magnification of slight changes in operating company revenues is an impressive feature of the stratified security structure. To give an extreme example of this kind of leverage in Power's system, in 1935 an increase of 5% in gross operating revenues produced an increase of 144% in the amount applicable to Power's preferred stock. The fluctuations in consolidated revenues and earnings reported for the calendar years 1931 to 1939 were as follows:

<table>
<thead>
<tr>
<th>Year Ended December 31</th>
<th>Gross Operating Revenues*</th>
<th>Income Applicable to Power's Fixed Charges</th>
<th>Net Income Applicable to Power's Preferred Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>1931</td>
<td>-6</td>
<td>-19</td>
<td>25</td>
</tr>
<tr>
<td>1932</td>
<td>-8</td>
<td>-35</td>
<td>47</td>
</tr>
<tr>
<td>1933</td>
<td>-7</td>
<td>-43</td>
<td>64</td>
</tr>
<tr>
<td>1934</td>
<td>+4†</td>
<td>-13†</td>
<td>35†</td>
</tr>
<tr>
<td>1935</td>
<td>+5</td>
<td>+40</td>
<td>+144</td>
</tr>
<tr>
<td>1936</td>
<td>+9</td>
<td>+41</td>
<td>87</td>
</tr>
<tr>
<td>1937</td>
<td>+5</td>
<td>+9</td>
<td>15</td>
</tr>
<tr>
<td>1938</td>
<td>-3</td>
<td>-28</td>
<td>40</td>
</tr>
<tr>
<td>1939</td>
<td>+5</td>
<td>+27</td>
<td>49</td>
</tr>
</tbody>
</table>

* The percentage changes in gross operating revenues have been computed from Moody, Manual of Investments, Public Utilities (1937) 498, (1940) 1625.
† The drop in income applicable to Power's fixed charges and preferred dividends in 1934, despite the 4% increase in revenues, is explained by a material increase over 1933 in operating expenses, maintenance, taxes, and depreciation.

Faced with the foregoing problems and recognizing the necessity of complying with Section II, the management of Power co-operated at the hearings and in conferences with the Commission's staff in the difficult process of deciding what steps should be taken, and in what order. After considering the major holding companies and the possibilities of eliminating each, the management concluded that Power lent itself best to dissolution as a major step toward compliance with the "great-grandfather" clause—an objective which the Commission had indicated should be achieved first.62

To achieve this step the management proposed: (a) that the properties of most of Power's directly-held subsidiaries, called the "First Lien" companies, be transferred to a single new subsidiary which would assume all liability on Power's First Lien bonds; (b) that

Power's outstanding debentures be paid off in cash at par and accrued
interest; (c) that Railways acquire all of Power's remaining assets
except the common stock of Railways itself; and (d) that the Rail-
ways common stock be distributed on a fair and equitable basis among
the holders of Power's preferred, Class A and Class B stocks. The
dissolution of United American was also proposed, and presented no
problem since that company was wholly owned by Railways. The
Commission approved these proposed steps in broad outline and issued
its order directing the respondents to proceed with due diligence to
bring about the liquidation and dissolution of Power and United
American, and to make application to the Commission for the entry of
such further orders as might be necessary or appropriate for that pur-
pose. The proposed steps were recognized as bringing about only
partial compliance with Section 11 (b), and the remaining problems
were reserved for separate consideration.

The plan as thus approved in outline was subsequently put into
effect, the detailed steps being presented to the Commission in several
applications which, with modifications, were finally approved. The
fairness of the treatment received by Power's different classes of se-
curity holders will be discussed in the next section of this article.

Concurrently with the consideration of these steps a number of
other transactions were taking place: properties and businesses were
being disposed of while others were being acquired; senior securities

63. The manner of making this distribution was to be proposed later for Commiss-
ion approval. Id. at 845 n. 11.
64. Id. at 846.
65. Id. at 848-9.
66. Cash was first provided by Railways' sale of its common stock interest in
The Commission had previously held that this investment (among others) could not
be retained by Railways under the provisions of Section 11 (b) (4), 49 Stat. 820
(1941). The cash so obtained was paid by Railways to a new subsidiary for its com-
mon stock, and the new subsidiary used such cash to purchase Power's equity in nine
of the First Lien companies, also assuming all of Power's liability on the First Lien
bonds (which were secured by assets and securities of such companies). United Light
& Power Co., 10 S. E. C. 945 (1941). Using the cash received from the sale of its
equity in the First Lien companies, Power paid off its debentures at par and accrued
interest, without premium. United Light & Power Co., 10 S. E. C. 1215 (1942), aff'd

As a final step the common stock of Railways was distributed among Power's pre-
ferred and common stockholders, 95% going to the preferred and 5% to the common.
plan approved and enforced, 51 F. Supp. 217 (D. Del. 1943), aff'd sub nom. Otis
& Co. v. SEC, 142 F. (2d) 411 (C. C. A. 3d, 1944), aff'd, 323 U. S. 624 (1945), re-
hearing denied, 324 U. S. 887 (1945).

Company Act Releases Nos. 3667, 3688 (1942), 4740 (1943), 5619 (1945); Michigan
Consolidated Gas Co., 8 S. E. C. 550 (1941); American Light & Traction Co., SEC
Holding Company Act Release No. 4774 (1943); United Light & Railways Co., SEC
Holding Company Act Releases Nos. 4497 (1943), 5943 (1945). Cf. United Light &
of the system were reduced; \(^68\) refinancings at lower interest rates were
effected or proposed; \(^69\) and greater net earnings for the system were in
prospect owing to plans for the elimination of complexities in the sys-
tem's structure. \(^70\)

Definite plans for completion of the simplification program in-
clude: retirement of Traction's preferred stock and liquidation of the
company; retirement of Continental's debentures and preferred stock;
sales of unretainable properties and businesses, and acquisition of other
utilities by Continental to complete its integration program; and re-
tirement of Railways' debt and most of its preferred stock. \(^72\)

The ultimate effect of carrying out these plans would be to leave
a system of nine or ten utility operating companies, fully integrated, the
common stocks of which would be owned by Continental, which in
turn would be almost wholly owned by Railways and would have no
senior securities outstanding. Railways itself would have no debt and
only a small amount of preferred stock. On a pro forma basis Con-
tinental's investments in subsidiaries would reflect a cost of about
$54,000,000, and the consolidated net income applicable to Railways' com-
mon stock (1944 earnings pro forma to reflect one year's opera-
tions under the proposed structure) would presumably fall within a
range of from $5,000,000 to $7,400,000. \(^72\)

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(1942), the Commission approved the payment of Traction's entire outstanding debt
out of proceeds from the sale of a nonretainable subsidiary.

69. Bonds and preferred stock of Michigan Consolidated Gas Company were re-
4954 (1944). Cf. Application No. 23, United Light & Power Co., SEC Holding Com-
pany Act Release No. 5652 (1945), which proposes to redeem Railways' debentures
using proceeds from a five-year bank loan.

70. See, e. g., American Light & Traction Co., SEC Holding Company Act Re-
lease No. 4774 (1943). See also Amended Applications Nos. 21, 25, described infra.

71. Some of these steps were proposed by the Commission (American Light &
Traction Co., SEC Holding Company Act Releases Nos. 5661, 5840 [1945]) and were
adopted in a plan filed by the Company (Amended Application No. 21, see United
Light & Power Co., SEC Holding Company Act Releases Nos. 5926, 6016 [1945]).
Others are contemplated by Application No. 25. It will be noted that they follow
logically from the Commission's opinion and order of August 5, 1941. United Light

Continental's proposed acquisitions have been approved in part (Cities Service
Power & Light Co., SEC Holding Company Act Release No. 5943 [1945]), and are
4988 [1944]).

72. The lower figure reflects federal taxes at the rates prescribed by the Revenue
Act of 1943, 58 Stat. 21 (1943), 26 U. S. C. § 101 et seq. (Supp. 1944); the larger
figure reflects the assumption that consolidated returns will still be permitted and that the
federal tax rates on corporate earnings will aggregate 50%. See Statements 21 and
26 annexed to Application No. 25, File 54-25-1-22. At the rates prescribed by the Re-
venue Act of 1945, 79th Cong., 1st Sess. (1945) P. L. 214, enacted after the above data
were submitted, pro forma earnings would of course be greater than $7,400,000.

More recently Railways and Continental submitted a refinancing program which
was approved by the Commission, as a result of which the fixed interest charges of
these two companies will be greatly reduced and consolidated net earnings increased.
It appears from the Commission's opinion that the consolidated net earnings of Rail-
ways' system for the 12 months ended September 30, 1945, pro forma to reflect the
refinancing and Federal taxes at 1946 rates, would be approximately $7,800,000.
Since no apparent purpose would be served by continuing the existence of both the holding companies, it is not unreasonable to suppose that one of them will eventually be eliminated in the interest of economy.

IV. "FAIR AND EQUITABLE" TREATMENT OF PERSONS AFFECTED

A. Contractual Claims of Security Holders

The various solutions proposed by Power and approved by the Commission for treatment of Power's bonds, debentures, and preferred and common stocks present an interesting and fairly representative sample of the treatment of contractual claims in respect of securities affected by Section II. We therefore shall use these solutions as concrete illustrations in the discussion which follows, in order to maintain a central theme for the development of the principles that have been applied in the cases that have arisen under Section II (e).

In summary, $16,000,000 of the First Lien bonds of Power were assumed by a new operating subsidiary and were permitted to remain outstanding with certain modifications, while about $1,250,000 of them were redeemed at a premium; debentures were paid off at par and accrued interest, without premium and without the consent of debenture holders; and the preferred and common stocks received, respectively, 95% and 5% of Power's remaining assets as a final step in the liquidation of the company.

As in any reorganization case, the question of fairness is a mixed question of law and financial analysis. It can be determined only after thorough consideration of the legal rights attaching to each class of securities affected and the financial data relevant to the value of those rights.

The phrase "fair and equitable" was developed by the courts in equity receiverships and was adopted by Congress in the various reorganization, arrangement, and adjustment sections of the Bankruptcy Act. The Supreme Court has stated that these words have

73. Such claims are to be distinguished from security holders' litigation claims based on mismanagement, etc., of the kind found in Taylor v. Standard Gas & Electric Co., 306 U. S. 307 (1939) and similar cases discussed below under the subheading "Ligation Claims, Defenses, and Compromises," pp. 187 to 193.


acquired a specialized meaning and signify not only that creditors are entitled to priority over stockholders to the full extent of their claims, but that every security holder, including a holder of stocks, "in the order of his priority" must receive "the equitable equivalent of the rights surrendered." This is equivalent to saying that each class must receive "full compensatory provision"—which must mean *fair value*—for the "entire bundle of rights" surrendered by such class in the reorganization.

This rule seems obvious, but it is not so easy to apply in Section 11 reorganizations as one might imagine. Examples from the Power proceedings will illustrate the problems.

(i) Treatment of "Premium" and "Marginal" Securities

One question that has proved troublesome is that which often rises when a redeemable security is to be paid off and discharged. If sufficient assets are available to make full payment the question is, shall a redemption premium be paid as in the case of voluntary redemptions, or would payment of a redemption premium result in the payment of more than the "equitable equivalent" of the rights of the security holders?

Power's First Lien bonds had a direct first lien on the securities and part of the fixed properties of twelve operating utilities which were wholly owned by Power. Thus they were of unusually high quality for obligations of a holding company, being in all substantial respects equivalent to bonds of the operating utilities themselves. Bearing interest at coupon rates of 6% and 5½% (for different series), and being well covered by assets and earnings, they were typically what we shall call, for want of a better name, "premium" securities. To have paid them off at par and accrued interest before maturity would have been clearly unfair to the bondholders.

In permitting $16,000,000 of the First Lien bonds to be assumed by a new operating company and remain outstanding while a portion


"It is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered. That requires a comparison of the new securities allotted to him with the old securities which he exchanges to determine whether the new are the equitable equivalent of the old."


79. Asset coverage was more than 250% while interest was covered by earnings more than 3½ times. *United Light & Power Co.*, 10 S. E. C. 945, 951-7 (1941).
was redeemed at a premium, the Commission in effect found that these bonds were not of themselves objectionable under Section II (b) (2), i.e. that they were not the cause of any undue or unnecessary complexity or any unfair distribution of voting power in the system. The impact of the Act fell, not upon the bonds, but upon the corporate entity that was the obligor. The obligor could not continue in existence, and something had to be done about the bonds, but there was room in the system below Power's level for continued liability on the bonds. Consequently, to the extent that Power proposed extinguishing them, that step was entirely voluntary on its part, and was subject to the provisions of the indenture applicable to voluntary redemptions. The bonds that remained outstanding were given ample new security and other benefits in substitution for such as were withdrawn from them under the plan.80

By contrast, the debentures of Power were unsecured obligations depending for payment on the general credit of the top holding company of a pyramided system. We have seen how the understructure of the system was burdened by debt and preferred stocks of subsidiaries, ranking ahead of Power's debentures.81 They had been issued at a heavy discount in the early 1920s and, although they carried interest coupons at 6% and 6⅝%, they had been traded in the market at prices consistently below par until 1941 (when it began to appear that they would be paid off at par or better by reason of the requirements of Section II [b] of the Act). In 1933 their market price had reached a low of 25.82 The market quotations for a security cannot be deemed controlling, and the Commission stated that it would not consider what price was paid by many of the holders for their debentures,83 but all the foregoing factors point to the conclusion that the debentures were far from being of premium quality. Again for want of a better name, we shall classify them as "marginal" securities.

None of the debentures was to mature according to its terms before 1973, and the indenture provided that Power, at its election, might redeem the two series by payment of their principal plus a premium of 8% and 9%, respectively, plus accrued interest. The indenture trustee and representatives of debenture holders argued before the Commission that Power's plan of paying them off in cash was an exercise of the option to redeem, and that consequently the contract required Power to pay the premium. Power had sufficient cash to pay the premium but argued that such payment would be unfair to its stockholders. It

81. See the chart p. 167 supra.
83. Id. at 1228.
took the view that its proposal was not voluntary, but was required by law since the Company had to be liquidated under the Act and the Commission's specific order. Power suggested that it pay the principal and interest immediately (thus stopping the further accrual of interest) and, if the Commission approved, that the Company put in escrow enough cash to pay the premium in the event the Commission's order of approval were set aside upon judicial review.

The Commission found that extinguishment of the debentures was required by Section ii (b), in effect holding that they created an undue complexity in the structure of the system, the capital structures of the underlying companies on a consolidated basis being such that no company could assume the liability on them, as had been done in the case of the bonds. It held that payment of the debentures was not the free exercise of an option by Power, that the indenture provisions for redemption were therefore inapplicable, and that equitable considerations apart from the contract did not lead to the conclusion that the debenture holders should receive any amount above par and accrued interest for the "bundle of rights" comprising the investment they were called upon to surrender. This opinion, being one of first impression in the administration of Section ii, stresses legal concepts and does not contain as much analysis as one could desire with respect to the investment quality of the debentures; nor does it explain why payment at principal and accrued interest was the fair equivalent of both the 6% and 6½% series when the difference in interest rates would ordinarily call for some differential in investment value.

Recently Commissioner Healy pointed to this fact in a dissenting opinion to show that the Commission had not considered investment value to be the test. On this point the majority stated:

"If payment of 100 was fair to the 6½% debenture holders, the payment of 100 to the 6% debentures would constitute somewhat more generous treatment than might be required. . . . However, there may be reasons why the face amount of a debt claim is the minimum amount which it may be accorded. . . ."

Whatever may have been the test in the case of Power's debentures, there can be no doubt that a majority of the Commission has now adopted the investment-value test to determine whether the considera-

84. Id. at 1219.
85. Id. at 1228. The Commission's order was affirmed on appeal, New York Trust Co. v. SEC, 131 F. (2d) 274 (C. C. A. 2d, 1942), cert. denied, 318 U. S. 786 (1943), rehearing denied, 319 U. S. 781 (1943).
87. Id. at p. 11.
tion given for senior securities retired under Section II is the equitable equivalent of the rights surrendered. In *American Power & Light Company*, a plan for the payment of 6% debentures at par and accrued interest was disapproved on the basis of an analysis showing the high-premium quality of these securities, the Commission majority concluding that "a valuation substantially higher than 110 would be proper if the debentures were not callable at that figure." 88

The distinction between what we have classified as "premium" and "marginal" securities is not confined to debt securities. The payment of preferred stocks at a premium was permitted in one case on the basis of an express finding that extinguishment of the stock, in view of its investment quality (which is determined by the nature of the issuing company's property and business, asset coverage, earnings history, etc.), was not compelled by Section II (b) and that, as a consequence, extinguishment proposed by the management was a voluntary act. 89 Subsequently the Commission expressed the more direct view that the investment value of a specified preferred stock was such that payment of the voluntary redemption price was fair, even though the retirement of the stock was required by the Act. 90

The Commission has held that ordinarily the redemption price constitutes the maximum that the issuing company can be allowed or required to pay upon the retirement of a redeemable security. 91

The Commission has approved numerous plans under which "premium" quality securities have been retired at a premium and "marginal" securities have been retired without premium. 92 It has not

88. *Id.* at p. 23. Indeed, one issue of debentures involved in that case was not callable until February, 1947, and the majority opinion strongly indicated that if they were to be paid off prior to the earliest call date, more than 110 (the future redemption price) would have to be paid. Subsequently, the Commission approved a plan filed by the Company which provided for payment of the callable debentures at 110 plus accrued interest, and payment of the noncallable debentures at 115 plus accrued interest. *American Power & Light Co., SEC Holding Company Act Releases Nos. 6201, 6258 (1945).*

89. *United Gas Corp., SEC Holding Company Act Release No. 5271 (1944)* (the first preferred stock "is a security which viewed apart from the context of the proposed settlement and recapitalization might be left outstanding insofar as the requirements of Section II (b) (2) are concerned").


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yet passed upon any case involving the question whether a noncallable preferred stock should be paid off at an amount above its voluntary liquidation preference.

In this respect, a difference is to be noted between noncallable debt and noncallable stock, for in the case of the latter there is usually a provision for payment at a stated figure in the event of voluntary liquidation. At present writing there is pending before the Commission the question whether the noncallable 6% preferred stock of American Light & Traction Company (a subholding company of Railways and formerly of Power) may fairly be paid off, in the liquidation of Traction, at its voluntary liquidation preference of $25 per share. Experts have submitted reports concluding that the fair value of this preferred stock is in excess of $25 per share apart from the requirement of the Act that Traction be eliminated as a corporate entity. This preferred stock is indisputably of premium quality in respect to assets and earnings coverages and in view of its dividend history. One of the experts, Edward Hopkinson, Jr., points out, however, that in view of the governing state law permitting voluntary liquidation of the company by a vote of 66⅔% of the number of shares outstanding (without distinction as to class), the obvious benefits to be gained by the common stockholders through voluntary liquidation, the nature of the company's assets (consisting entirely of corporate securities), the nonfunctional nature of the company, and the concentration of voting power in the hands of Railways (which has a predominantly common-stock interest in Traction), there is a substantial likelihood of voluntary liquidation apart from the Act. As a consequence, in his


Because of the provisions of Rule U-42 (b) the Commission has not yet had occasion to pass upon the allocation to a premium security of an amount less than the redemption premium and more than the principal amount or liquidation preference. Theoretically the investment value of such security might lie somewhere between those two amounts, though it might often be impractical to make a precise appraisal of such intermediate value. It is not necessary that payment be made in cash, it being sufficient that the otherwise equitable allocation be in the form of distribution of portfolio securities. This is so whether the securities being retired are debt securities (Standard Gas & Electric Co. supra) or preferred stock (United Gas Improvement Co. supra).

opinion, the preferred stock must be valued at a lower figure than would be the case if the issuer were an operating company less susceptible to voluntary liquidation.  

(2) Treatment of "Submarginal" and Residual Securities

One of the most controversial questions under the "fair and equitable" standard of Section ii (e) was resolved in connection with the distribution of Power's assets among its preferred and common stockholders. As we have seen, the Commission approved a plan of Power's management allocating 95% of the assets to the preferred stock as a class, and 5% thereof to the common stock as a class. Commissioner Healy, being of the opinion that the preferred stock was entitled to all the assets, dissented in an opinion that was used by representatives of the preferred stock as the primary basis of their opposition to the plan in the District Court, Circuit Court of Appeals, and Supreme Court, in each case unsuccessfully. In the Supreme Court the orders approving the plan were upheld by a vote of five to three, Stone, Roberts, and Frankfurter, JJ., dissenting, and Douglas, J. (formerly Chairman of the Commission) not participating.

At the time the plan was filed, Power had been relieved of liability on its First Lien bonds and had paid off its debentures as outlined above. Thus it had no significant liabilities, and its only significant remaining asset was the entire issue of Railways common stock. In order to eliminate Power from the holding-company system pursuant to the Commission's liquidation order under Section ii (b), it was necessary to dispose of the Railways' common stock and eliminate Power's preferred and common stocks.

94. Report of Edward Hopkinson, Jr., File Nos. 59-17, 59-11, and 54-25, Application 21. Cf. El Paso Electric Co., SEC Holding Company Act Release No. 5499 (1944), in which a premium quality preferred stock was permitted to be retired without redemption premium in view of similar legal and practical disabilities unrelated to assets and earning coverages. It is our personal view that in the peculiar circumstances of that case the transaction effected was not a true liquidation within the meaning of El Paso's corporate charter and that the preferred stock should have received more than the stated liquidation preference. Commissioner McConnaughey dissented from the decision of the Commission partly on this ground.

95. A noncontroversial point which may be noted is that no difference was recognized between the non-voting Class A common stock and the voting Class B common stock, the two groups being treated as a single class. The Commission had held that no recognition could be given in reorganization to a junior security having no equity in assets or prospective earnings of the issuing company merely because it possessed practical voting control of the company and its underlying system. Such "unfair and inequitable distribution of voting power" was determined to be in contravention of Section ii (b) (2), and cancellation of the valueless voting stock was required. Federal Water Service Corp., 8 S. E. C. 893 (1941). See also Southern Colorado Power Co., SEC Holding Company Act Release No. 4501 (1943), plan enforced without opinion, D. Colo. 1944, aff'd sub nom. Disman v. SEC, 147 F. (2d) 678 (C. C. A. 10th, 1944), cert. denied, 39 L. Ed. (Adv. Ops.) 1160 (1945).


Power's preferred stock was entitled to a cumulative preferential dividend of $6 per share annually on 600,000 shares, making the total dividend requirements $3,600,000 annually. As shown by the tabulation set out above,\(^{98}\) however, Power's corporate net income before dividend requirements had been very much less than this amount, averaging less than $800,000 per year in the period 1935 to 1939, inclusive. Even the consolidated net income had averaged only slightly more than $3,600,000 per year during the same period. As a result of Power's inability to meet its current dividend requirements, large arrears had accumulated and amounted to $38,700,000 at the end of 1942. In comparison with the securities we have classified as "marginal," Power's preferred stock was of a distinctly "submarginal" quality.

Power's certificate of incorporation provided that, in the event of Power's involuntary liquidation, its preferred stockholders would be entitled to receive $100 per share plus an amount equal to all accumulated and accrued dividends thereon before the common stock could receive anything. Thus, if the charter liquidation preference was operative the preferred stock was entitled to $98,700,000, or its equivalent in securities, before the common could participate in the distribution. On the evidence presented, the Commission found that the assets of Power could not be fairly valued at an amount approaching $98,700,000.\(^{99}\)

Power took the position that the charter liquidation preference was not operative in the circumstances, and this was the principal question of law presented to the Commission. The only other question was one of fact, or rather of financial analysis: if the charter preference was not operative, what division of assets would give to each class of stock the equitable equivalent of the rights it was called upon to surrender?

In holding that the charter liquidation preference was not operative, the Commission first pointed out that liquidation pursuant to Section 11 (b), while doubtless "involuntary," was "of a type that could not have been foreseen by the draftsmen of the corporate charter or by investors in the stock, long before the enactment of the Holding Company Act." It expressed the view that "involuntary liquidation, in the context in which that term is used in the corporate charter,

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\(^{98}\) Page 168 supra.

\(^{99}\) On the basis of testimony by an engineer retained by Power's management, the over-all value of the assets was estimated by Power at $110,000,000 as of April 30, 1942. The plan originally filed by Power proposed an allocation of 91% to the preferred stock and 9% to the common. The Commission specifically rejected this valuation and required modification of the allocation percentages. United Light & Power Co., SEC Holding Company Act Release No. 4215 at pp. 7, 19 (1943).
commotes an act of default, either financially or in respect of conduct, on the part of the corporate management representing the common stock. In short, it contemplates protection of the preferred stock from business risks such as ordinarily attend equity investment. . . .” 100

Secondly, the Commission posed the question “whether or not it would be ‘fair and equitable’, in light of the legislative purpose and policy underlying Section II of the Act, to give controlling effect to that charter provision under the circumstances.” 101

The Commission stated that decisions like those in *Case v. Los Angeles Lumber Products Co.* 102 and *Northern Pacific Railway Co. v. Boyd* 103 were “predicated on sets of facts fundamentally distinguishable.” Unlike bankruptcy and equity reorganizations brought about by financial difficulties with creditors and where actual liquidation of the enterprise is prohibited but new securities (in lieu of proceeds of sale) are distributed to claimants as though in liquidation, 104 the Section II reorganization or liquidation is pursuant to a Congressional mandate which operates even though the company affected may be in no financial difficulties with creditors. In the bankruptcy cases, claims are treated as matured by the default or impending default of the debtor. The Commission majority found no similar reason for the maturing of the preferred stock claim in the case of Power, and determined that the legislative policy was directly contrary to the maturing of such claims. For, if the preferred stock’s claim in respect of dividends were matured, it would be translated from a right to receive dividends at some time in the future, when and if earned by the company and declared by the board of directors, into an immediate and absolute claim against the assets; and by this process the operation of Section II would impart greater value to the preferred stock at the expense of the common, thus resulting in a windfall to the former class and a sacrifice of the legitimate investment value of the latter.” 105

100. *Id.* at p. 8 n. 12.
101. *Id.* at pp. 7-8. (Italics supplied.)
102. 308 U. S. 106 (1930).
103. 228 U. S. 482 (1913).
104. Cf. Utilities Power & Light Corp., 5 S. E. C. 483 (1939), *plan approved*, 29 F. Supp. 763 (N. D. Ill. 1939); Portland Electric Power Co., SEC Holding Company Act Releases No. 5132, 5470 (1944). In these cases, which came before the Commission under Section II (f) and arose under the Bankruptcy Act, the liquidation preferences of stockholders were treated as mature.

“In the case before us, the duty to liquidate arises solely by virtue of a sovereign act, and in giving effect to the Congressional mandate we must not allow the liquidation itself to add value to one class of securities at the expense of another class.”
The Commission fully recognized that the elimination of a corporate entity like Power could have been brought about for the purposes of Section II (b), by merger or consolidation as well as by liquidation, and that it was merely fortuitous that the means chosen for Power was outright liquidation. In a previous case involving the merger of a principal holding company with two others, the liquidation preferences of submarginal preferred stocks had been deemed to be inapplicable in measuring the value of the claims of that class.\(^{108}\) The same result had been reached in another proceeding where the holding company had recapitalized by issuing new common stock in exchange for its old preferred and common stocks,\(^{107}\) and the Commission was in the process of considering the case of an operating utility whose second preferred and common stocks were similarly to be exchanged for new common stock,\(^{108}\) at rates that did not give effect to the full liquidation claims provided by charter for the respective preferred stocks. In those cases the decision was not so difficult to reach because no distribution of assets in an apparent "liquidation" was involved. But should the form of the action required by Section II (b) or selected by the company be allowed to determine the substantive rights of investors? The Commission took the view that:

"... it should be immaterial whether the simplification process takes the form of a recapitalization, merger or distribution of the assets of a holding company in liquidation. In other words, the 'fair and equitable' standard requires the same recognition of substantive rights irrespective of the method employed in a particular case for attaining the objectives of Section II (b) (2)." \(^{109}\)

The Commission's conclusion on this phase of the case was that it must "judge the fairness of the plan according to legitimate investment values existing apart from the duty of liquidation imposed by the statute. The existence of the liquidation preference does, of course, enter into the question as it is one of the bundle of rights belonging to the preferred stock and affecting its normal value. The preference itself, however, will not be permitted to operate so as to be conclusive in the division of assets between the preferred and common stocks." \(^{110}\)

In view of this decision that the preferred stock's claim was not governed by the operation of the charter liquidation preference, the

\(^{106}\) Federal Water Service Corp., 8 S. E. C. 893 (1941).
\(^{110}\) Id. at p. 12.
valuation technique commonly used in bankruptcy cases lost much of its usefulness. The traditional procedure in such cases is to arrive at an estimate of the future gross income to be derived from the productive assets of the enterprise, capitalize such estimated income at an appropriate rate or rates (selected in the light of the known risk factors involved in the particular businesses under consideration), and thus reach an over-all valuation, subject to adjustment for any non-productive assets and for working capital; then, the claims of creditors and preferred stocks having matured and being of known amounts, the amounts thereof are subtracted from the over-all valuation figure in the order of their rank. In this way it can be determined whether a junior security is entitled to any participation in the reorganized enterprise, and if so, to what extent.111

An over-all valuation of Power's assets could have been made in the manner outlined, but this would be of little utility since the value of the senior claim, which was the main subject of the inquiry, would still be an unknown quantity and would have to be computed separately in any event, either in terms of a dollar amount or in terms of a percentage of the underlying equity. The task of the Commission in these circumstances, as in merger and recapitalization cases, was "to examine into the respective existing interests of the preferred and common stockholders in the earnings of the enterprise as a going concern."112

This it did by analyzing the earning power of Railways at length in order to estimate the prospective income applicable to its common stock. This involved looking into "the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance. . . ."113 Its estimate of $6,185,000 as the prospective average consolidated net income applicable to Railways' common stock, admittedly a "very liberal assumption as to earning power,"114 reflected not only an improvement in operating revenues over prior years

111. E. g., Portland Electric Power Co., SEC Holding Company Act Release No. 5470 (1944); Utilities Power & Light Co., 5 S. E. C. 483 (1939), plan approved, 29 F. Supp. 763 (N. D. Ill. 1939). When by reason of imminent debt maturities, the amounts of the senior claims are determinable, the same technique may be used in a reorganization under Section 11 (e). Jacksonville Gas Co., 11 S. E. C. 449 (1942), plan enforced, 46 F. Supp. 852 (D. Fla. 1942).

112. Puget Sound Power & Light Co., SEC Holding Company Act Release No. 4255 at p. 23 (1943). There the Commission also said:

"... in passing upon the fairness of the proposed plan, we believe it is unnecessary to arrive at any specific over-all value for Puget, because in the present situation there are no claims to be treated as matured and thus no claims to be measured against an over-all valuation figure."


but also a substantial amount of progress in reducing expenses and income deductions by reason of the simplification of the system.\textsuperscript{115}

This estimate represented the average prospective annual income in which Power's preferred and common stockholders had an interest. Since the figure exceeded the amount of Power's annual preferred dividend requirements of $3,600,000 by more than $2,500,000 per year, on the basis of the estimate Power, if it remained in existence and removed the obstacles that had earlier prevented the upward flow of cash earnings, could expect to receive a substantial amount with which to pay off its accumulated preferred dividend arrears over the course of time. After that had been done the common stock would have an interest in earnings of more than $2,500,000 per year in perpetuity.

Since it is a cardinal principle of valuation that a claim for money receivable at a future time has a lower present worth than a claim against the same person for money immediately receivable, whatever claim the preferred stock had for accumulated dividends and for future annual dividends was diminished according to the length of time that would elapse before receipt of the dividends by the stockholders. Similarly, the value of the common stock's prospect of having $2,500,000 of applicable earnings per year was affected by the length of time that would elapse before its interest in such earnings would begin. Both classes were also affected by the risk that earnings of $6,185,000 might not be fully realized, and by the chance that future earnings might exceed that amount.

Theoretically, it is possible for an analyst to estimate the present worth of dividends receivable over a term of years by applying an appropriate discount rate to the annual amounts receivable throughout the term; and by this method the present worth of the preferred dividend arrears could be estimated, once it is known how long it would take to pay them off. Also, it is theoretically possible to estimate the present worth of dividends which are to begin at a known future time and continue in perpetuity, by applying an appropriate capitalization rate to the amount of such future dividends and then discounting the resultant figure to present worth. Given the amounts receivable, the proper discount rates and the term of years involved, this would be a simple mathematical computation. But as a practical matter, no one can claim the "clairvoyant percipience"\textsuperscript{116} that would be necessary to determine these factors with mathematical certitude, in view of the numerous intangible factors to be considered. The Commission made

\textsuperscript{115} Incidentally, the figure estimated by the Commission in 1943 was about midway between the low and high pro forma 1944 earnings later submitted by the management of Railways in connection with its over-all simplification program. See note 72 supra.

no such claim, though it did estimate the prospective earnings (as it was bound to do) for the purpose of determining the respective rights of the two classes of stock in the enterprise as a going concern, and then stated that on that basis “it would take approximately 15 years for the preferred dividend arrearages to be paid in full, if all consolidated net earnings were to be applied toward the payment of current and accumulated preferred dividends.” 117 It did not find that this would happen, but the hypothesis is enough to indicate that, absent liquidation under Section 111, Power’s preferred stock was not entitled to all the future earnings of the enterprise in perpetuity but only for a term of years in the reasonably foreseeable future, and that the common stock had a prospect, though a remote one, of receiving future earnings. Under these conditions the Commission was unwilling to hold that the preferred stock should be given all the future interest in Railways’ common stock, to the total exclusion of Power’s common. It said:

“Our conclusion in this respect is of necessity one of over-all judgment and not susceptible of mathematical demonstration. In approaching the problem, we have kept in mind that there is always a margin of error inherent in any estimate of earning power. Under all the circumstances it is our view that a participation for the common stock of approximately 5%, while representing the maximum, would not exceed the permissible limits of fairness. . . .” 118

In summary, Power’s preferred, in giving up its preferential claims to assets and earnings, was to receive 95% of the system’s net earnings in perpetuity and would no longer be limited to $6 per share annually plus the accumulated arrears; and by the same token, Power’s common stock was giving up 95% of its claim to the system’s future net earnings in excess of $3,600,000 per year, beginning after preferred dividend arrearages were fully paid.

Mathematical computations presented in the Commission’s briefs on appeal from the District Court’s order approving the plan illustrate how this works out in quantitative analysis. By the receipt of 5% of the securities being distributed, Power’s common stock (on the basis of the estimated annual earnings of $6,185,000) gave up a 100% interest in an estimated $2,585,000 annually beginning some fifteen years

118. Id. at p. 19. Cf. Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510, 526 (1941): “Since its application [i. e. the criterion of prospective earning power] requires a prediction of what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment. . . .”
in the future, in exchange for which it acquired a 5% interest in annual earnings of $6,185,000 a year (or $309,250) to begin immediately. The ratio between $2,585,000 and $309,250 is about 8.4 to 1. An annuity of $8.40 a year beginning fifteen years hence hence is mathematically equivalent to an annuity of $1.00 a year beginning at once if the annuity of $8.40 a year is discounted to present value at the rate of 15.2% per year. The discount rate of 15.2%, a rate considered in financial circles as recognizing a very high risk factor, is thus the measure applied to the chance that earnings might not come up to expectation. The chances that preferred dividend arrears might not be fully paid in fifteen years is less important under the method outlined, because:

(a) to the extent that such period is lengthened, the present worth of the preferred stock's claim (as well as that of the common stock) is reduced, and the ratio between the preferred and common stock participations is not greatly affected; and

(b) since both classes received Railways' common stock, any net earnings not paid out in dividends would nevertheless tend to increase the equity of both groups of stockholders, and if the amounts withheld were invested in revenue-producing properties the income therefrom would tend to increase the future earnings to an amount in excess of the estimate, or in any event to strengthen the estimate and benefit Railways' common stock in the hands of both groups.\(^{119}\)

The application of the 95%-5% ratio, though making no pretense to mathematical accuracy, is not a negation of the "absolute priorities" rule. This was emphasized by the Commission majority as follows:

"It is pointed out in Commissioner Healy's separate opinion that the words 'fair and equitable' embodied in Section 11 have a settled meaning, as determined by the courts, and that an application of the 'absolute priorities' doctrine must result in no distribution to Power's common stock in this case. But that is because he measures the rights of the preferred stock as they would be measured in bankruptcy cases, and not merely because he follows the 'absolute priorities' doctrine in determining the consequences of the measurement. In other words, we can agree with him when he says that absolute priorities must be respected, because we think that doctrine simply means that the common stock must not be accorded any participation unless the preferred stock has been fully

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\(^{119}\) This thought was expressed in Northern States Power Co., SEC Holding Company Act Release No. 5745 at p. 23 (1945): "Of course, to the extent that earnings were retained in the business they would tend to build up the equity of the Minnesota common stock distributed. . . ."
compensated for its rights and priorities. But there the area of agreement stops, because he says further that the rights and priorities of the preferred stockholders are the same here as in bankruptcy cases, where their claims to liquidation preferences (including dividend arrearages) are treated as matured. In our view it would be unconscionable and contrary to the plain intention of Congress to so hold.**120**

This view was specifically sustained by the appellate courts.212

The Commission has employed the techniques used in this case in passing upon allocations between submarginal and residual stocks of a large number of holding and operating companies, with variations to meet the particular facts of each case.212 It has not yet been called


121. In re SEC, 142 F. (2d) 411, 419-421 (C. C. A. 3d, 1944); Otis & Co. v. SEC, 323 U. S. 624, 634-5 (1945). The Supreme Court's opinion, however, emphasizes the point that the type of liquidation involved in this case could not possibly have been foreseen at the time the charter preferences were drafted. See also, Note, Dodd, Dissolution Preferences and Public Utility Holding Company Act Simplications—The Otis Case (1945) 58 HARV. L. REV. 604; Note (1945) 93 U. OF PA. L. REV. 308; (1945) 33 GEO. L. J. 345; (1945) 13 GEO. WASH. L. REV. 372.

122. E. g., Northern States Power Co., SEC Holding Company Act Release No. 5745 (1945). In that case, which was decided after the decision of the Supreme Court in the United Light & Power Company case, Commissioner Healy issued a separate opinion concurring in the result upon the ground that the allocations could be approved on a straight liquidation basis. He took the view that the Supreme Court, in holding that the rights of Power's security holders must be judged as if Power were to be continued as a "going concern," had followed the usual reorganization approach and had not adopted a new test of measuring rights. In his view, the Court had not been presented with, and had not decided, the question whether "a proper allocation might have eliminated participation by [Power's] common stockholders." SEC Holding Company Act Release No. 5745 at p. 49 (1945).


upon to determine whether similar treatment should be applied as between unmatured debt securities of submarginal quality and residual securities having a reasonable prospect of sharing in future earnings.\textsuperscript{123}

\textbf{B. Litigation Claims, Defenses, and Compromises}

As a step in its determination of the proper remedy to be applied or of the fairness of a proposed simplification plan, the Commission examines all intrasystem relationships, including claims based on security holdings and unliquidated claims raised by, against, or between companies involved in the simplification proceedings.\textsuperscript{124} The Commission has considered that in order to determine whether proposed action meets the "fair and equitable" standard, it must inquire into the validity and extent of such claims and the defenses thereto.\textsuperscript{125} The most important questions relating to such claims have centered around the equitable principles governing abuse of the parent-subsidiary relationship which were developed in \textit{Taylor v. Standard Gas & Electric Company} (the Deep Rock case).\textsuperscript{126} In that case, a corporate reorganization proceeding under Section 77B of the Bankruptcy Act, a parent company's claims based upon notes of its subsidiary held by it were subordinated to publicly held preferred stock. The Court's action, the effect of which was to deprive the parent of participation as a creditor of its subsidiary, was based on the finding that the parent had used its power of control, exercised by virtue of its 100% common stock ownership, to mismanage and spoliate the subsidiary: the parent had organized the subsidiary with inadequate equity capital, had caused the subsidiary to give it securities in the form of debt obligations for funds advanced when equity capital was needed, had pursued harmful dividend policies in order to preserve its control, and had placed upon

\textsuperscript{123} As we have noted at p. 175 supra, a majority of the Commission has indicated that there may be a minimum of 100% for the retirement of debt by a solvent company. American Power & Light Co., SEC Holding Company Act Release No. 6176 at p. 11 (1945). Under certain circumstances, however, it might be argued persuasively that debt whose maturity is far off at the time of the reorganization should be discounted at a higher rate of interest than the contract rate of interest, and that allocation of less than principal amount would be equitable. Indeed, Commissioner Healy in his dissent pointed out that this would be a logical consequence of the majority's decision in the \textit{American Power & Light Co.} case. \textit{Id.} at p. 39.

\textsuperscript{124} Section 11 (a) of the Act directs the Commission to "examine the corporate structure of every registered holding company and subsidiary company thereof, the relationships among the companies in the holding-company system of every such company and the character of the interests thereof. . . ." 49 Stat. 820 (1935), 15 U. S. C. § 79k (a) (1941).


\textsuperscript{126} 306 U. S. 307 (1939). See also Pepper v. Litton, 308 U. S. 295, 308 (1939); Columbia Gas & Electric Corp. v. United States (C. C. A. 6th, October 9, 1945).
the subsidiary undue business risks from which the parent stood to profit.\footnote{127}

The Commission has undertaken to give most careful consideration to the important, difficult, and novel questions of law and fact relating to alleged corporate mismanagement in the cases with which it deals. Where the questions arise in proceedings before the Commission under Section II (b) (2) or II (e), the staff of the Commission participates actively in a full inquiry into the intercompany claims.\footnote{128} Where one or more of the companies is in bankruptcy reorganization and an examination of intercompany claims takes place under the auspices of the court, the Commission’s representatives have actively participated in the court proceedings and aided in the exploration of the claims\footnote{129} as part of its function in Chapter X proceedings generally.\footnote{130} From the exploration of intrasystem claims has come a clarification of the relative rights of the classes of security holders affected, which has led to disposition of the claims by compromises and other means. In some cases contributions by parent companies as a step in the retirement of their subsidiaries’ publicly held securities, and the consequent elimination of the controversies relating to the intrasystem claims, have been approved by the Commission.\footnote{131} In a number of other cases compromises, in the form of parent contributions or


\footnote{128. The Public Utilities Division carries the main burden of discovering and asserting intercompany claims where public security holders of the interested companies are not actively represented in the proceedings before the Commission. It is natural enough that managements of subsidiaries which are either identified with or under the control of the potential defendants do not often assert such claims themselves. In one interesting case, however, the management of an operating subsidiary has filed very substantial claims on behalf of the company against its parent holding companies. Recently, prior to a determination of the claims, this subsidiary petitioned the Commission to order the parent companies not to exercise their voting power for the purpose of electing new directors to the subsidiary’s board of directors. The Commission granted the petition, stating that it could not see how the directors and management of the subsidiary “can engage in a frank discussion of its plans for prosecuting claims and developing evidence or for trading out a compromise . . . in the presence of directors chosen by” the parent companies. North American Light & Power Co., SEC Holding Company Act Release No. 6153 at p. 10 (1945).}


\footnote{130. See Section 208 of the Bankruptcy Act, as amended, 52 Stat. 894 (1938), 11 U. S. C. § 608 (1940).}

\footnote{131. Florida Power & Light Co., SEC Holding Company Act Releases Nos. 2874 (1941), 4791 (1943); Cities Service Co., SEC Holding Company Act Release No. 4944 (1944).}
reduction or partial subordination of contested claims, have been embodied in plans submitted pursuant to Sections II (e) and II (f). Such plans have been approved by the Commission where it has found the compromises fell within the range of fair adjustment of the rights of the contesting classes of security holders. In one case where the Commission considered that the proposed compromise incorporated in a reorganization plan filed pursuant to Section II (f) did not accord adequate recognition to certain of the claims in litigation, it made its approval of the plan conditional upon a modification of the plan giving an increased participation to such claims. In such cases, the compromise allocations among various contestants are necessarily judged on the basis of the relative litigation strengths that appear from the factual and legal issues raised.

A striking illustration of the unusual forms which alleged intercorporate mismanagement and abuse can take is afforded in the case of the joint reorganization of Associated Gas and Electric Company ("Ageco") and its subholding company, Associated Gas and Electric Corporation ("Agecorp"). The factual background of the claims in that case is worth summarizing briefly.

Ageco and Agecorp, and the complex system of corporations under them, were dominated by Howard C. Hopson who controlled and directed the financial, corporate, and accounting policies of the entire Associated system. Most of the important officials of Ageco and its subsidiaries received their salaries not from those companies but from

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“service companies” owned by Hopson and his family, and most of the
directors were employees of such service companies and had given
Hopson their signed, undated resignations. Transactions were made
under his direction and were recorded in the manner which he desired,
books of record being commonly kept in loose leaf form and entries
were often predated, post-dated, changed, or revised at his instruction.
Under his guiding hand the Associated system expanded phenomenally,
properties and security acquisitions being effected largely through the
issuance of Ageco securities of many kinds having a wide variety of
different and often unique contract provisions. As new security hold-
ings were acquired by the system, nominal ownership was placed in
the name of a partnership consisting of employees of the Hopson serv-
ice companies, without indicating what company had beneficial owner-
ship of the securities. The records, kept under Hopson’s personal con-
trol, purported to record the beneficial ownership and transfers thereof
but entries were irregularly maintained and revised from time to time.
When beneficial ownership of the securities was transferred to particular
subholding companies it was generally recorded that such companies
were indebted to Ageco in the amount of the value of the securities
transferred. Such indebtedness was, under Hopson’s direction, changed
to stock subscriptions and back to debt on a number of occasions.

In 1932, Ageco and certain of its subsidiaries were faced with
large debt maturities which could not be met out of available funds.
Although Ageco had outstanding a large amount of debentures which
contained covenants against mortgage or pledge of the company’s as-
sets without ratably securing the debentures, Ageco attempted to issue
bonds which were to have priority over all Ageco obligations and
were to be guaranteed as to principal and interest by Agecorp. Fur-
ther, all indebtedness owing by Agecorp to Ageco was to be subordi-
nated to Agecorp’s guaranty. When counsel for the bank which was
to act as indenture trustee for the new bonds inquired as to the amount
of Agecorp’s debt to Ageco, Ageco’s counsel said that it was about
$5,000,000. On further inquiry it was said to be $50,000,000, then
$100,000,000. Finally it was admitted to be nearly $600,000,000, al-
though no mention was made of any particular form which this debt
took.

Shortly thereafter, Hopson personally went to Ageco’s safe de-
posit vault, although such visits by him were not in the usual course
of business, and removed some securities. They were apparently re-
turned four days later, and after that it appeared that the indebtedness
of Agecorp to Ageco, totaling $665,200,000 was in the form of notes
convertible into the stock of the obligor at the option of the obligor,
and also that they were subordinate to other obligations of Agecorp in the event of its bankruptcy or insolvency prior to conversion.

Thus the debt of Agecorp to Ageco, which had been referred to merely as "debt" or "notes" in the previous discussions, now appeared as subordinate obligations with a novel conversion feature. This obviously made a great difference to the debenture holders of Ageco in the event Agecorp issued obligations of its own, and in fact, Agecorp proceeded immediately to do so. Under the direction of Hopson, Agecorp also elected to convert about $600,000,000 of the notes into shares of its own common stock (all of which was owned by Ageco anyway).

In addition to these steps, Hopson sought to alleviate Ageco's financial difficulties by reducing or eliminating its debentures which had the negative-pledge covenant and which bore fixed interest. In a so-called "Recap Plan" he caused the holders of such debentures to be offered the right to exchange those debentures for debentures of Agecorp having either a smaller face amount, or bearing interest only if earned by Agecorp, or debentures of Ageco having both a lower interest rate and bearing interest only if earned. Contemporaneous attempts to enjoin the carrying out of this plan were either unsuccessful or not pursued to a conclusion, and by an intensive solicitation campaign Ageco succeeded in inducing a considerable number of exchanges.

In 1940, both Ageco and Agecorp went into reorganization proceedings under Chapter X of the Bankruptcy Act. At that time Agecorp's publicly held obligations substantially exceeded the value of its assets. Ageco's principal assets consisted of Agecorp common stock and some alleged subordinate debt of Agecorp. Thus, if recorded rights and priorities were to be followed, the holders of Ageco's debt securities, aggregating about $118,000,000 in principal amount, would receive little or nothing. The trustee for Ageco accordingly brought suit against the trustees for Agecorp attacking the recorded ownership of assets, the validity of the "Recap Plan," and the apparent priorities of the Agecorp securities. Holders of Ageco securities also litigated various claims. The record on these litigations produced "a mass of incredibly complex legal, equitable and factual contentions, defenses and cross-claims putting into issue the relative positions of practically every class of securities of both estates against other classes and posing many important and novel questions in the law of corporations, creditors' rights, bankruptcy and corporate reorganization." 135

Many of the issues had strong arguments on both sides, and the trustees of both estates recognized that an ultimate adjudication might properly take the form of a broad equitable resolution of the many al-

leged frauds and irregularities. Accordingly, after discussions with representatives of various groups of security holders, the trustees devised a “Recap Compromise,” the main feature of which was that the estates of the two debtors were to be treated practically as one, and that the debentures and certain other obligations of Ageco could be treated as of equal rank with the Agecorp debentures, subject to differentials as to the dollar amounts of claims to be allowed against the joint assets.

The compromise formed the basic feature of a plan of reorganization filed by the trustees with the Commission pursuant to Section 11 (f) of the Act. After a full examination of all the facts and issues, the Commission concluded that the proposed parity, with the submitted differentials, had “a sound and rational basis meeting the requirements of equity arising out of the confused situation in which the two debtors and their respective creditors have been placed by the actions of a common management prior to bankruptcy.” It further found that the various differentials compensated “each participating class and group in the light of its claims and litigation strength in relation to the claims and litigation strength of each other class and group, without exact measurement of each (which is impossible under the circumstances) but by practical adjustments which fall well within a permissible range of fairness and equity, having due regard to the benefits to be derived by all from the prompt termination of litigation.” 136 After the Commission approved the plan for submission to the court, the court gave its approval and its order was sustained on appeal.

The Commission’s jurisdiction with regard to intercompany claims has been hailed both as affording an adequate forum for the satisfactory investigation and recognition of claims of relatively disorganized classes of investors against holding companies subject to Section 11, and as serving as a model for the extension of much-needed remedies to stockholders generally.137

Another power of the Commission incidental to its function to effect system simplification is the protection of its processes against misuse by corporate insiders. Under the Act, the control exercised by the existing holding-company management is not disturbed by the initiation or pendency of the simplification proceedings. The corporate managers retain a position which enables them to carry on advance discussions with the Commission’s staff regarding possible simplification steps and plans and to exercise considerable control over their formulation, proposal, and consummation. It is clear, however, that Congress

136. Id. at p. 47.
137. See Hornstein, A New Forum for Stockholders (1945) 45 Col. L. Rev. 35.
did not intend that such retention of control and the perquisites of control should be used for self-advantage at the expense of public investors, and the Commission has scrutinized transactions by corporate managers so as to insure that this should not result.

In the case of Federal Water Service Co., shares of preferred stock of a company being reorganized under Section 11 were acquired by members of the management during the pendency of the proceedings. The stock was heavily in arrears as to dividends, was to be replaced in the reorganization by new common stock carrying voting control of the system, and the shares were acquired by members of the management partly for the purpose of maintaining themselves in office through the voting power to be obtained from the reorganization. The Commission viewed the members of the management as reorganization managers having fiduciary obligations to all security holders, and held that their program of buying preferred stock in the course of the reorganization placed their personal interests in conflict with those of the public security holders they were supposed to represent. The Commission said it could not find it fair and equitable to permit the management to profit from the reorganization under these conditions, and limited their participation to the amount of the consideration paid for the shares plus interest at 4%. In that case the Commission also indicated that it would apply the same equitable considerations to profits by reorganization managers from purchases made prior to but in contemplation of the institution of simplification steps or proceedings.

C. Adjustments Proposed for Individual Acceptance

In the preceding discussion of the "fair and equitable" standard we have dealt with the fairness of treatment provided for security holders irrespective of their individual consent. Another type of treatment gives security holders individually the option of accepting or rejecting offers of purchase or exchange. Where the offeror is a company subject to the Commission's jurisdiction under Section 11, and an offer to purchase or exchange outstanding securities constitutes part of the

138. The Report of the National Power Policy Committee, which served as a blue print for the Act, recommended that "... it seems administratively advisable that every opportunity be offered the owners of holding company securities to work out their own process of dismantling. That opportunity should, of course, be vigilantly guarded to protect the average investor from the exploitation threatened him almost as a matter of course under our usual methods and mores of corporate reorganization. ..." Appendix to Sen. Rep. No. 621, 74th Cong., 1st Sess. (1935) on S. 2796 at p. 58.


company's program of compliance with Section II (b), such offer must meet the "fair and equitable" standard as though it were part of a plan under Section II (e).142

In determining the fairness of proposed offers of this nature, greater latitude is allowed than in cases where the security holder has no choice, but the Commission holds the view that the choice offered to the security holder must present reasonable alternatives. The first expression of this view appears in a case under Section II (f) in which the Commission approved a plan of reorganization wherein the debtor offered creditors a choice between new preferred and new common stock for a portion of their claims. The Commission said:

"The choice as between the alternatives, in our opinion, offers merely a question of investment judgment which calls for no further comment from us."

And to this was appended the following footnote:

"We do not mean to suggest that we would approve the submission to security holders of an alternative which was plainly unfair and might be misleading. Such is not the case here."142

This approach represented a development beyond that taken by the Commission in previous holdings made in the course of related proceedings, in which a wholly-owned subsidiary of the debtor applied to the Commission for approval of an offer to purchase outstanding debentures of the debtor, with two years' interest coupons attached, at 70% of the debentures' principal amount. The applicant was to use cash in the amount of $12,000,000 or more for such purpose. The main issues argued before the Commission were whether the proposed purchases would give a preference to debenture holders availing themselves of the offer, and whether the expenditure of so much cash would undermine the ability of the system to conduct its utility operations. The Commission answered both these questions in the negative and granted the application (subject to conditions) on the basis of evidence which included an appraisal of the minimum intrinsic value of the debtor's assets, saying:

"On the basis of the record in this proceeding, and solely for the purposes thereof, it appears that creditors' claims are covered to the minimum extent of approximately 93 percent. . . .

"The saving [to be effected by purchases at 70], it appears from the evidence, will tend to protect the debtor from possible

insolvency, and would have the further effect of providing pro
tanto asset coverage for the junior securities. In this fashion then,
it appears clearly to be in the interest of junior security holders.

"The conclusion follows, therefore, that the consummation of
the proposed transaction is in the interest of all investors who will
be affected by it." 143

The only statement relating to the fairness of the price from the view-
point of the debenture holders was in the form of a finding that the
market quotations for the debentures were currently lower than 70.144

Later, the problem presented in this type of case was reviewed at
length in the case of *Engineers Public Service Company* ("Engine-
ers"), which sought the Commission's approval of a program of pre-
ferred stock purchases in the open market for which it would use about
$2,150,000 of the cash proceeds realized from the sale of a subsidiary.
The sale had been made pursuant to the requirements of Section 11 (b)
(1).

Engineers had no debt outstanding, but had three series of pre-
ferred stock with involuntary liquidation preferences totaling some
$41,800,000 plus accrued dividends. Current earnings exceeded cur-
rent dividend requirements, no dividends were in arrears, and there
was uncontroverted evidence in the record that the assets of Engineers
were fairly worth somewhat more than the involuntary liquidation
preference of $100 per share. The market quotations for the stock,
however, ranged from the low 60s to the low 70s for the several series.

Engineers was contemplating the disposal of a considerable por-
tion of its assets pursuant to Section 11 (b) (1) and, as a corollary
to the reduction of assets, it had tentative plans for reducing the
amount of its preferred stock by about 40%. The Commission, hold-
ing that the application before it was a step in the over-all program of
simplification under Section 11, stated that it was unable to find the
proposal fair and equitable in the absence of a comprehensive plan,
since the "fair and equitable" standard requires "at a minimum . . .
that some reasonable relation be shown to exist between the prices at
which it is proposed to acquire shares of preferred stock and the treat-

supplied.)

144. *Id.* at 137. See also *Utilities Power & Light Corp., Ltd.*, 5 S. E. C. 13 (1939).
It later turned out that the debentures which were not tendered for purchase were
covered more than 100% as to principal and interest, and that the debtor's preferred
stock had a substantial equity, unquestionably derived from the differential between the
price paid on the debenture purchases and the asset values underlying the debentures.
*Utilities Power & Light Corp., Ltd.*, 4 S. E. C. 131, 142 (1938).
ment which might reasonably be expected to be accorded to them under a comprehensive plan."145

The Commission did not base its decision specifically on a finding that the Engineers preferred stock was being traded in the market at a disproportionately large discount from its fair value—as it might well do in a similar case today in view of its recent holding in the *American Power & Light Company* case.146 This would appear to have been a turning point in the decision, however, because when market prices of the Engineers preferred stock later had advanced to a range between 95 and 101 for the several series, the Commission permitted a repurchase program to be instituted by the company, saying:

"... the current market prices of the three series of preferred stocks which Engineers now proposes to reacquire [by purchases in the market] are close to the involuntary liquidating prices and under the circumstances we are satisfied that the proposed reacquisition is not unfair to the security holders of Engineers."147

A similar test appears to have been applied in numerous cases involving repurchases of debt securities priced within a narrow range of the principal amount or redemption price.148 An exception was made in the case of a company which was about to liquidate and which desired to purchase its own bonds at a discount. Its assets consisted entirely of Associated Gas and Electric securities, which were subjects of litigation in the reorganization proceedings for Ageco and Agecorp outlined above, and could not be evaluated on the basis of financial analysis. The market values of these assets had been fluctuating sharply, and it was highly uncertain whether they afforded full coverage for the principal amount of the bonds sought to be repurchased. Repurchase of the bonds was not permitted.149

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145. *Engineers Public Service Co.*, SEC Holding Company Act Release No. 4114 at p. 10 (1943). Contrast this with *Electric Bond & Share Co.*, SEC Holding Company Act Release No. 4300 (1943) where the Commission found that the Company was not in a position to file a comprehensive plan under Section 11 (e) and that the repurchase program thus was not subject to the "fair and equitable" standard. And cf. *Electric Bond & Share Co.*, 10 S. E. C. 1205 (1942). Recently the Company proposed and the Commission approved a plan for distribution of $30,000,000 among the preferred stockholders as a partial compliance with a requirement that the preferred stock be eliminated under Section 11 (b) (2). *Electric Bond & Share Co.*, SEC Holding Company Act Release No. 6121 (1945).

146. SEC Holding Company Act Release No. 6176 (1945) discussed at p. 176 *supra*.


Occasionally repurchase upon the company's invitation for tenders by individual security holders has been permitted, but that method has not been favored, presumably because it puts too much of a burden upon the security holders who would have to name the price at which they were willing to tender their securities, often without sufficient facts or a reliable market to guide them. The company may be permitted to purchase its own securities in private transactions off the exchange, but may not solicit for that purpose.

A variant of the private purchase method is the exchange offer, in which portfolio securities of a company are offered in exchange for outstanding securities, at fixed rates of exchange, for acceptance or rejection by the company's security holders. By this process assets which may not be retained under Section (b) (1) are sometimes divested at the same time that senior securities are reduced or eliminated as required by Section (b) (2).

An interesting illustration of this is afforded by the United Corporation ("United"), which thus divested itself of Philadelphia Electric Company ("PE") common stock and reduced its own burdensome preferred stock structure simultaneously. PE common stock had come to United as a dividend in partial liquidation of The United Gas Improvement Company, a subsidiary of United. Its retention by United was inconsistent with the requirements of Section (b) (1), and the preference stock of United had been ordered eliminated pursuant to the requirements of Section (b) (2). As a step toward solution of its problems under both sections United proposed to offer the PE common stock, together with cash, in exchange for shares of its outstanding preference stock.

The preference stock was entitled to cumulative dividends of $3 per year, and was $5.25 per share in arrears at the time. Its liquidation preference was $50 per share plus dividend arrears. Dividends were covered by earnings 1.58 times, and the asset coverage was $48.89 per share based on the indicated market value of portfolio securities. The preference stock was quoted on the market, however, at about 36%.

151. See Electric Bond & Share Co., SEC Holding Company Act Release No. 4400 at p. 5 (1943): "... the company's declaration does not provide for tenders, presumably because of the many objections to that method that have been raised in the past...
152. See, e.g., Utilities Power & Light Corp., Ltd., 4 S. E. C. 131, 136 n. 6 (1938).
The exchange offer approved by the Commission was at the rate of 1.8 shares of PE common and $6 in cash for each share of United's preference stock surrendered for exchange, the offer being limited as there was enough PE common to retire only 45% of the United preference stock on this basis. The "package" of PE common stock and cash thus offered was found by the Commission to have a value of from $53 to $60 based on a capitalization of prospective income, and it had a ready market value of about 41, or nearly 5 points above the market price of United's preference stock. This offer seemed clearly to be fair to the stockholders who accepted. But what about United's preference stockholders who did not choose, or were not able because of the limited nature of the offer, to accept, and its common stockholders who were given no choice?

The Commission found the proposal fair and equitable to the latter by reason of the resulting increase in earnings and asset coverages of the remaining preference and common stocks. As a result of the exchanges, the earnings coverage of the unexchanged preference stock rose from 1.58 to 1.87 times dividend requirements, and the asset coverage of such stock rose from $48.89 to $56.12 per share. The net asset value of the common stock was converted, as a result of the exchange offer, from a deficit of $1.09 per share to an equity of about eight cents per share. Its applicable earnings were also greater to the extent that the earnings coverage of the preferred dividend was increased.156

V. Conclusions

In summary, one of the primary functions of the Commission under Section 11 has been to eliminate or reduce the leverage feature in equity securities of holding-company systems, to bring sound equity securities out of system portfolios into the public markets in place of the relatively weak and speculative securities of the holding companies themselves, and to do this on a fair basis that will improve and not destroy legitimate investment values. The Commission would not be human if it had made no errors along the way; but the evidence of market appraisal and of financial analysts leads to the conclusion that its efforts have so far been highly successful.

These efforts of the Commission have undoubtedly been aided in the past few years by rising markets for equity securities. It is mani-

festly impossible to segregate the benefits attributable to the operation of Section 11, in terms of dollars, from the rise in market prices due to other factors. Nevertheless, it is demonstrable that the equity securities of holding companies in general have long been traded at a discount from the market values of their underlying portfolios, which means that investors in general value the direct ownership of portfolio securities more highly than indirect interests in the same securities;\textsuperscript{157} and as a consequence, the market value of holding-company securities has tended to increase whenever liquidation or partial liquidation of the portfolio has appeared to be drawing near. This was illustrated to some extent in the United Corporation distribution just discussed. A few other illustrations may be of interest.

Just before Power filed its plan providing for distribution of Railways' common stock on a 91%-97% basis, Power's preferred stock was being traded on the New York Curb at between 17 and 22, and the common stock at around ¾. During the hearings on the plan in 1942 these prices went to 35 for the preferred and ½ for the common, and in April 1943, immediately following the Commission's announcement of its decision approving the 95%-5% allocation, the preferred jumped to 43. These stocks were replaced on the Exchange by the common stock of Railways in April 1945, when they were last quoted at 75 and at ¾, respectively; and currently, the average market price of the Railways common stock (about 27) gives the former stocks of Power an equivalent market value of 135 for the preferred and nearly 13½ for the common.

Similarly, the common stock of The United Gas Improvement Company rose at the prospect of receiving liquidating dividends in stock of Philadelphia Electric Company and Public Service Company of New Jersey, moving from 4 at the time the plan was filed, to 6 immediately after the filing, to 9½ at the time of the distribution.

The same reaction is to be noted in the case of operating company stocks which are undergoing the strengthening process of simplification.\textsuperscript{158} For example, just before the recapitalization plan of Southern Colorado Power Company was filed, its preferred stock was traded at about 32; after the Commission's approval of the plan, the price rose to 60; and by the time the District Court directed enforcement of the plan, the price was up to 70.

\textsuperscript{157} The same tendency is discernible with respect to investment companies whose securities have a public market. See the Commission's findings in Shawmut Ass'n, Securities Exchange Act Release No. 3564 at pp. 6-9 (1944).

\textsuperscript{158} The present Director of the Public Utilities Division of the Commission has recently dealt with this aspect of the rehabilitation process. Cohen, \textit{How the Securities and Exchange Commission Operates Under the Holding Company Act} (1945) 23 \textit{Electric Light and Power}, No. 6, p. 84.
These are not isolated instances, nor have we chosen the most impressive examples. Between the end of 1935 and June 30, 1944, holding companies divested themselves of 266 companies with assets of over $3 4/4 billion,\textsuperscript{159} so that there has been ample opportunity for qualified observers to weigh the evidence. One financial paper has described the results as follows:

"...there is no denying that [SEC policy] has helped investors by improving the financial status of many subsidiaries of utility holding companies. Not only have depreciation allowances been increased, but fixed debts have been reduced and property accounts have been cleaned up as a result of the SEC orders. The resulting improved financial status of subsidiaries has no doubt helped considerably in practically terminating the public ownership movement in the electric industry."\textsuperscript{160}

Another periodical predicted this course in 1941, and has commented thus while the process was under way:

"The prospect of disintegration of holding companies suggests higher prices for a number of senior securities. The break up of properties will, in many instances, afford higher property values. Then, too, the very prospect of substituting actual possession for a mere right to certain assets will have the effect of making these assets more valuable. This will be especially true of those holding company bonds and preferred stocks selling at substantial discounts from their asset values."\textsuperscript{161}

"For the most part, holding company preferreds continue to sell at a discount from estimated liquidating values. As further progress is made in completing integration, simplification or liquidation plans, this value differential should narrow or disappear. Moreover, because the outlook for operating company equities is good, improvement in investor confidence should increase further the price potentialities of selected preferred issues of public utility holding companies."\textsuperscript{162}

"As a result of the several forces discussed above, equity type preferreds have advanced spectacularly over the last two or three years. During the entire course of this market movement, it has been typical of the equity preferred to sell at rather substantial discounts from liquidating or distributable value, at least until such time as liquidation, distribution of assets, or recapitalization has actually taken place. Their sharper market movements have

\textsuperscript{159} More than sixty percent of these divestments took the form of portfolio distributions by holding companies to their own stockholders. Tenth Annual Report of the Securities and Exchange Commission (1945) 90.

\textsuperscript{160} (1943) 15 \textit{Standard and Poor's Outlook}, No. 39, p. 462.

\textsuperscript{161} (1941) 33 \textit{Moody's Stock Survey}, No. 13, p. 743.

\textsuperscript{162} (1944) 36 id., No. 37, p. 101.
often keyed in with steps (by the Company or the SEC) leading toward compliance with the Act." 163

Still another has concluded that "Probably the greatest single factor [causing increased values in holding company securities] has been completion of steps which bring corporate simplification plans nearer consummation." 164

It is thus apparent that though Section II is on occasions still referred to as a "death sentence," the sophisticated observer no longer regards even the directed reorganization or liquidation of a holding company as a step to be feared by investors. There is increased recognition that these steps in the enforcement of the Act have been "akin to a surgical operation, through which the dead skin (the top holding company) was being cut away from the pores (the operating companies) in order to allow the latter to breathe." 165

The record of operation under Section II to date speaks for itself. The simplification process is going a long way toward giving the individual investor "the kind of security he thought he was buying in the first place;" only the future can tell whether it will, as its sponsors predicted, ultimately clear up "the tangle in which holding company finance . . . left the industry and . . . reestablish a confident, stable market for good utility securities." 166

164. (1944) 24 BARON'S NATIONAL BUSINESS AND FINANCIAL WEEKLY, No. 44, p. 2. See also (1944) 16 STANDARD AND POOR'S OUTLOOK, No. 34, p. 575; (1943) 15 id., No. 12, p. 833.