THE SEC AND VALUATION UNDER CHAPTER X

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The forthright reaffirmance of the absolute priority rule by Mr. Justice Douglas in the Los Angeles Lumber Products Co. case ¹ served to focus attention on the difficult problem of valuation of corporate assets in reorganization,² for value determines not only which classes of security-holders may fairly be granted continued participation in the enterprise and the extent of that participation, but also the amount and character of sail, in the form of capital structure, that the reorganized company may safely carry without undue danger of capsizing again and without permitting valueless securities to reach the market.³ It was not until some sixteen months later, however, that the Court gave a clear answer to a vital question which remained, that is, what is the measure of value for purposes of reorganization? Are criteria such as book value, original or reproduction cost, or forced sale value, employed in valuation for various purposes, significant in a proceeding designed to free the corporation from the accumulated burden of past misfortunes and mistakes and to give it a fresh start as a continuing enterprise? In the Consolidated Rock Products case ⁴ Mr. Justice Douglas gave the answer which the SEC,⁵ writers on

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² For early recognition of the new importance given to the problem of valuation by the Supreme Court's opinion in the Los Angeles case, see Dodd, The Los Angeles Lumber Products Company Case and Its Implications (1940) 53 Harv. L. Rev. 713; Note, The "Fair and Equitable" Rule in Modern Corporate Reorganization (1940) 25 Iowa L. Rev. 793, 798-799. Recent legal periodical material dealing with the valuation problem in reorganization are Field, Strict-Priority-of-Liens Policies of Federal Agencies (1942) 9 Am. Law S. Rev. 1518; Note, Valuation by the SEC in Reorganizations (1941) 55 Harv. L. Rev. 125; Note, Distribution of Securities in Corporate Reorganization (1941) 51 Yale L. J. 85; Note, Bankruptcy: Corporate Reorganization: Survey of Chapter X in Operation (1941) 18 N. Y. U. L. Q. Rev. 399, 461. The problem is dealt with to some extent in Frank, Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act (1941) 18 N. Y. U. L. Q. Rev. 317. For recent discussions of railroad valuation for reorganization purposes, see Bourne, Findings of "Value" in Railroad Reorganizations (1942) 51 Yale L. J. 1057; Field, supra; Note, Effect of the Consolidated Rock Products Decision on Railroad Reorganizations under Section 77 (1942) 51 Yale L. J. 967; Note, Valuation and Capitalization of Railroads in Reorganization (1941) 54 Harv. L. Rev. 655.

³ The SEC put the matter directly and forcefully in San Francisco Bay Toll-Bridge Co., 6 S. E. C. 863, 867 (1940): "It is self-evident that a company should not emerge from reorganization with obligations that it cannot reasonably hope to meet according to their terms. It is likewise self-evident that the reorganization should not serve to place upon the market securities which are without actual value or are otherwise deceptive."


⁵ In its Chapter X reports the SEC has, subject to the qualification stated in note 9 infra, consistently looked to prospective earning capacity to determine value.
corporation finance and some judges had been giving, that in determining value for purposes of reorganization "the criterion of earning capacity is the essential one" and that "valuations for other purposes are not relevant . . . or helpful . . . except as they may indirectly bear on earning capacity." Thus in particular was the SEC vindicated in its adherence to the capitalized earnings method in its advis-


7. For example, prospective earning power was the criterion adopted in Highland Towers Co. v. Bondholders' Protective Committee of Highland Towers, 115 F. (2d) 58 (C. C. A. 6th, 1940); In re Pittsburgh Hotels Corp., 17 F. Supp. 640 (W. D. Pa. 1936). It was employed as one of several criteria in In re Utilities Power & Light Corp., 29 F. Supp. 763 (N. D. Ill. 1939), appeal dismissed, C. C. A. 7th, March 9, 1940; In re Gibson Hotels, Inc., 24 F. Supp. 859 (S. D. W. Va. 1938).


9. Book values were specifically rejected in Griess-Pfleger Tanning Co., 6 S. E. C. 630 (1939), depreciated original cost in San Francisco Bay Toll-Bridge Co., 6 S. E. C. 863 (1940), and depreciated reproduction cost in La France Industries, 5 S. E. C. 917 (1939).

In a number of cases the SEC has agreed with the premise upon which plans submitted to it were based, that in the light of the company's history, present condition and future prospects liquidation in some form, immediate, gradual, or deferred, was preferable to indefinite continuance of the enterprise. In these cases going concern value, which pretty clearly would have been far less than liquidation value, was not used, except to discount prospective earnings during the interim period when liquidation was deferred. See, for example, Reynolds Investing Co., 6 S. E. C. 699 (1940); United Coal & SEC Corp. Reorg. Release No. 43 (June 21, 1941); Porto Rican American Tobacco Co., 7 S. E. C. 311 (1940), order approving plan affirmed, In re Porto Rican American Tobacco Co., 112 F. (2d) 655 (C. C. A. 2d, 1940). Cf. Penn Timber Co., 4 S. E. C. 630 (1939), 7 S. E. C. 166 (1940), SEC Corp. Reorg. Release No. 46 (Sept. 2, 1941) (company's business consisted of liquidating timber lands held by it). On the questions of liquidating value versus going concern value, see BONBRIGHT, VALUATION OF PROPERTY (1937) 239. If the enterprise has consistently lost money before depreciation and interest, as was true, for example, with respect to the pulp and paper operations at the International Falls Plant in Minnesota and Ontario Paper Co., 7 S. E. C. 456 (1940), there is no reliable basis for finding a going concern value and liquidation value must be used.

In McKesson & Robbins, Inc., 8 S. E. C. 853 (1941), the Commission used the liquidating value of the company's liquor department, which was greater than its going concern value, in spite of the fact that it was not proposed that the department be liquidated so long as it continued to show an adequate return on invested capital.

In Philadelphia & Reading Coal & Iron Co., SEC Corp. Reorg. Releases Nos. 50A (Dec. 23, 1941), 52 (March 21, 1942), 55 (July 25, 1942), the Commission agreed with the trustee that the company's uncertain future made it impracticable to forecast earnings for more than five years; value was determined by taking the present liquidating value of non-essential properties and adding the liquidating value of essential properties at the end of the five-year period and prospective interim earnings, both discounted to present worth. It should be noted that there was no intention to liquidate at the end of five years or at any other foreseeable time; such evidence as there was, however, indicated that no greater value would result from the capitalization of maximum earnings in prospect beyond the five-year period.

In Atlas Pipeline Corp., SEC Corp. Reorg. Release No. 42 (June 7, 1941), the Commission, reporting on a plan which contemplated the continued operation of a marginal insolvent petroleum refiner and distributor whose life expectancy seemed short, suggested (p. 28) that "in view of the new company's short prospective life and the marginal nature of its operations, it is important to the Debtor's security-holders that the terms and quality of the new securities they are to receive should constitute payment to them as certain and as much as liquidation would produce." It seems clear that if liquidating value is greater than going concern value and if in the light of the latter value the company is insolvent, fairness to creditors should require liquidation.
ory reports on plans submitted to it under Section 172 of the Bankruptcy Act.  

In National Radiator Corp., 4 S. E. C. 690 (1939), the Commission accepted reproduction cost as a ceiling value. Since the company's history was written largely in deficits, attributable in some measure to bad management, estimating future earning capacity under a new management would have been pure guesswork. Reproduction cost was insufficient to permit participation by more than the single class of creditors, so that no problem of right to participate was raised. There was no discussion of liquidating value. Under the facts of the case the use of reproduction cost as a maximum value seems unobjectionable.

10. Section 172 of the Bankruptcy Act provides that after hearing in the district court on the plan or plans filed by the trustee or by the debtor or by any creditor or stockholder, and before approval of any plan, "the judge may, if the scheduled indebtedness of the debtor does not exceed $3,000,000, and shall, if such indebtedness exceeds $3,000,000, submit to the Securities and Exchange Commission for examination and report the plan or plans which the judge regards as worthy of consideration. Such report shall be advisory only." 52 Stat. 890 (1938) 11 U. S. C. A. § 572 (1940).

Section 173 provides that the judge shall not approve a plan submitted to the SEC until the Commission has filed its report or has notified the judge that it will not file a report, or until the expiration of such reasonable time for filing a report as the judge has fixed, whichever first occurs. 52 Stat. 891 (1938), 11 U. S. C. A. §§ 573, 574 (1940).

Curiously enough, the monograph on the SEC (Sen. Doc. No. 10, Part 13, 77th Cong., 1st Sess.) prepared by the investigating staff of the Attorney General's Committee on Administrative Procedure deliberately refrains from discussing the Commission's functions under Chapter X on the ground that they are "advisory only." This omission brought a sharp rebuke from Chairman Frank of the Commission in a letter to the Director of the Committee, dated July 9, 1940 (printed as Appendix F of the monograph) in which he states, inter alia, that "the Commission's advisory reports are having an immense effect on the substantive law of corporate reorganizations: The Commission's views in Chandler Act cases (1) on reasonably foreseeable earning power as the criterion of 'value' in reorganizations and (2) on priorities as between classes of securities, are being established as the law of the land." It is noteworthy that the Commission was active in the preparation of the Government's brief in both the Los Angeles and Consolidated Rock cases.

The capitalized earnings measure of value has also been applied by the Commission in its consideration of reorganization plans for holding companies and their subsidiaries under Section 11(f) of the Public Utility Holding Company Act, which provides in part that "a reorganization plan for a registered holding company or any subsidiary thereof shall not become effective unless such plan shall have been approved by the Commission after opportunity for hearing prior to its submission to the court." 49 Stat. 822 (1935), 15 U. S. C. A. § 79k(f) (1940).

The argument is sometimes made that although the capitalization of reasonably prospective earnings is the appropriate way to determine the reorganization value of industrials, different considerations apply in the case of utilities, whose rates are fixed by state regulatory bodies with reference to some other measure of value such as original cost, reproduction cost, prudent investment or book value. These measures of value, however, would seem to be relevant only insofar as they may affect earnings. As the Commission has tersely put it, "Valuation for ratemaking purposes is not the same. There the question is how much the utility will be allowed to earn—if it can. Here the question is how much it can earn—even if allowed." Genesee Valley Gas Co., 3 S. E. C. 104, 112, n. 19 (1938). See Finletter, The Law of Bankruptcy Reorganization (1939) 562, 568-569; I Dewing, Financial Policy of Corporations (4th ed. 1941) 376, n. dd. It is clear, however, that measures of value employed in fixing rates, while not direct standards of value for reorganization purposes, may have an important bearing on prospective earnings and hence should not be ignored. For example, "if a subsidiary is earning, let us say 15 percent upon the figure which should properly be allowed as its rate base, even though there are no proceedings pending before the state commission to require a reduction of the company's rates, it will be apparent that the record of past earnings will not be a reliable basis for estimating future earnings as there is a great deal of danger that gross income will be reduced materially by action of the state commission. Where there is reason to suppose that this type of situation exists, fairness requires that the valuation expert take into consideration the likelihood of such reduction." Utilities Power & Light Corp., 5 S. E. C. 483, 501 (1939). Cf. Derby Gas & Electric Corp., SEC Holding Co. Release No. 2875 (July 12, 1941). If, on the other hand, the established rate limits the
As its name suggests, the capitalized earnings method requires, first, determination of reasonably prospective earnings and then capitalization or discount of such earnings at a rate which will fairly reflect the probable risk attendant upon their realization. The result, plus the realization value of whatever non-productive assets there may be, equals enterprise value for purposes of reorganization. This company to an unreasonably low return on its proper rate base, or is markedly lower than rates of comparable companies in surrounding areas, it would seem that the likelihood of a rate increase should be taken into consideration. Hence, while rate bases and rates cannot create earning power which is not potentially there, it is clear on the one hand that they may free potential earning power from legal restraint, and on the other that they may impose a ceiling on earnings. By way of analogy, consider the possibility that profits of industrials during wartime may be limited to a return, say, of 6% on invested capital.

11. Reference to prospective earnings of course does not imply an attempt to discover future enterprise value. Future earnings are significant only because present value depends upon them. See FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION (1939) 559-560.

12. For a good statement of the theory of rate choosing employed by the SEC see Minnesota & Ontario Paper Co., 7 S.E.C. 456, 491-492 (1940): "The rate at which the earnings are to be capitalized must be predicated upon the risks inherent in the business and the degree of uncertainty that attaches to the continuation of the earnings. An estimate of the prospective earnings of a business enterprise, even though based on reasonable and appropriate premises, is subject to risk and uncertainty of realization. If the company has a long established record of profitable operations and if no materially adverse change in conditions is foreseeable, the degree of risk and uncertainty is reduced. Likewise, if the company has an established position in an industry in which cyclical fluctuations have not been severe or which gives evidence of marked future growth, the degree of uncertainty is minimized." The second quoted sentence is the Commission's answer to the not uncommon argument that all risks are reflected in the estimate of prospective earnings and that hence considerations of risk should not influence the choice of a capitalization rate. For an interesting criticism of the Commission's position, see Field, Strict-Priority-of-Liens Policies of Federal Agencies (1942) 9 AM. LAW. S. REV. 1518-1522.

13. It is clear, as the SEC has consistently recognized, that non-productive or non-operating assets, which do not contribute to earnings, should be valued separately. See Bonbright, VALUATION OF PROPERTY (1937) 239. Included in this category are such assets as excess working capital or cash, excess or abandoned plant, other non-productive real or personal property held for liquidation, and miscellaneous investments unrelated to the business of the company. See, for example, McKesson & Robbins, Inc., 8 S.E.C. 833 (1941). It would seem that such assets should be appraised not at their immediate forced sale values, since as the enterprise is to continue no forced sale will be necessary, but rather at the probable sum they will bring if sold within a reasonable time. See FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION (1939) 565. If substantial deferment of the sale appears likely, it would seem that the estimated selling price should be discounted to present worth.

It has been decided, however, that bonds held by the debtor as investments with no idea of liquidation should be valued at par rather than at their lower market value unless it is shown that they are in default or are inadequately secured and will not be paid. In re Warren Bros. Co., 39 F. Supp. 381 (D. Mass. 1941), 43 F. Supp. 173 (D. Mass. 1942). Cf. Hutchinson v. Fidelity Inv. Ass'n, 106 F. (2d) 431 (C. C. A. 4th, 1940); In re Cleveland Discount Co., 9 F. (2d) 97 (D. Ohio 1924). The bonds held by Warren Bros. Co. were 41/2% obligations of the Cuban Republic, maturing in 1955 and 1977 and selling at 54 and 57 cents on the dollar respectively, received by the company in exchange for defaulted Cuban bonds previously held by it. There was evidence that other Cuban issues were selling at higher prices and that the market for the 1977 issue was due "somewhat to abnormal conditions," but this was not particularly stressed by the court.

14. The Commission has indicated, however, that this technique will not be applied to all reorganizations. In Federal Water Service Corp., 8 S.E.C. 893 (1941), a divided Commission took the view that to find a merger recapitalization plan designed to satisfy the provisions of Section 11 (e) of the Holding Company Act to be fair and equitable in granting minor participation to holders of the common stock it was sufficient to find that such persons had "a reasonable expectation of receiving earnings
method, the statement of which in broad outline is so simple, presents
difficult problems when its application is attempted in a concrete case.
Since both the determination of reasonably anticipated earnings and
the choice of a capitalization rate require a forecast of a future which,
as now, may be exceedingly difficult to predict, the end result can be
at best, in the words of Mr. Justice Douglas, merely "an estimate, as
distinguished from mathematical certitude." 15 But want of better
tools does not justify failure to make the most efficient use of the tools
at hand so that the estimate of value will "be based on an informed
judgment 16 which embraces all facts relevant to future earning capac-
ity and hence to present worth, including, of course, the nature and
condition of the properties, the past earnings record, and all circum-
stances which indicate whether or not that record is a reliable criterion
of future performance." 17

Through units of the Reorganization Division established in
regional offices 18 the SEC has evolved and is steadily improving a
method of unearthing and analyzing the basic information upon which
an informed estimate of enterprise value may rest. 19 Upon becoming
a party to a Chapter X proceeding, 20 which ordinarily occurs at an
early stage, it begins to collect and analyze relevant information about
the company and its affairs, including data concerning its present and
past physical and financial condition, the competence and fidelity of its

at some future time, and that this expectation cannot be dismissed as negligible." No
effort was made to value the company's assets. It appeared, however, that even their
book value was less than the liquidating preference of the preferred stock, without
taking into consideration large dividend accruals. Chapter X, Section 77B, and old
equity reorganizations were distinguished on the ground that they were "in substance
liquidations on a going-concern basis," whereas in this Section 11 (e) proceeding
liquidation was not "in the air." Cf. Community Power & Light Co., 6 S. E. C. 182
(July 12, 1941) at 18. There is discussion of the Federal Water Service case in Dodd,
Fair and Equitable Recapitalizations (1942) 55 Harv. L. Rev. 780, 793-795; Dean and
Gilchrist, Corporate Reorganization (1941) 26 Corn. L. Q. 537, 566-568; Note, Dis-
tribution of Securities in Corporate Reorganization (1941) 51 Yale L. J. 85, 107-111.
And see 2 Dewing, FINANCIAL POLICY OF CORPORATIONS (4th ed. 1941) 1256, n. ff.;
Dodd, The Los Angeles Lumber Products Company Case and Its Implications (1940)
53 Harv. L. Rev. 713, 746-747.


16. The term "informed judgment" seems to derive from the statement of Mr.
Justice Brandeis in National Surety Co. v. Coriell, 289 U. S. 426, 436 (1933) that
"every important determination by the court in receivership proceedings calls for an
informed, independent judgment." In pre-Chandler Act days it was frequently pretty
difficult for the district judge to get the facts and analyses upon which an informed
judgment must rest.


18. Almost from the outset the Chapter X activities of the Commission were
largely decentralized through use of its regional and subregional offices located in key
cities throughout the country. See SEC 6th Ann. Rep. (fiscal year ended June 30,
1940) 182-185.

19. See Frank, Epithetical Jurisprudence and the Work of the Securities and
Exchange Commission in the Administration of Chapter X of the Bankruptcy Act

20. As of September 30, 1942, the SEC had become a party to 210 proceedings
for the reorganization of 251 corporations and was then actively participating in 112
such proceedings. SEC Corp. Reorg. Release No. 56 (October 14, 1942).
management, the causes of its financial collapse, and its past operating record and policies, adjusted for unusual or non-recurring conditions or items. To analysis of the company is added a broad study of the industry and competitive conditions within it and a consideration of general economic factors likely to affect the industry and the debtor. 

From the outset the Regional Office staff works in close collaboration with the independent trustee. There is usually an early conference between the trustee and his counsel and the regional attorneys and analysts assigned to the case, at which arrangements are made to give the latter access to such necessary information concerning the company's affairs and finances as will enable them to become familiar, in a preliminary way, with the company's financial condition and the problems of the reorganization. As the SEC possesses no subpoena power under Chapter X, primary reliance is placed upon voluntary co-operation by the trustee and the parties. Frequently the Commission's own accountants are permitted to examine the books and records of the debtor. The debtor's plant and properties are examined. Management and operating policies, past and prospective, are subjected to careful analysis to determine their effect upon earnings. Information is obtained not only from the debtor's officers, directors and departmental heads, but also from trade associations and competitors, who frequently prove to be surprisingly well informed with respect to the debtor's internal management and affairs. Cross-examination of witnesses in court is a further means of gathering material. Use is also made of ordinary sources of information, such as statistical services and trade publications, and the broad inquiry into general economic factors affecting the debtor and the industry is facilitated wherever possible by resort to studies and statistical data prepared by one or more government agencies or departments.

The course of the investigation is marked by frequent informal conferences between members of the Commission's regional office staff and the independent trustee. These informal meetings, which afford an opportunity for exchange of information and views, are of the very essence of the Commission's work. The tangible product of the investigation is the completion by the Commission of a careful and thorough preliminary financial report, which is made available to the trustee to aid him in preparing his report under Section 167 (5) of the Act.

21. In addition to conferring with the trustee the Commission's staff, when requested, meets with parties, protective committees and their counsel.

22. Section 167 (5) provides that the trustee "shall, at the earliest date practicable, prepare and submit a brief statement of his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, in such form and manner as the judge may direct, to the creditors, stockholders, indenture trustees, and Securities and Exchange Commission, and such other persons as the judge may designate." 52 Stat. 890 (1938), 11 U. S. C. A. § 567 (5) (1940).
Trustees, appointed by the district court without affirmative suggestion from the SEC, vary widely in background, ability and training. If the trustee is thoroughly competent, as was the case, for example, in the McKesson & Robbins reorganization, his report will ordinarily reflect the joint efforts of himself and the SEC. If, however, as sometimes happens, the trustee is not particularly well-equipped to assemble and analyze the necessary material, his report is likely to follow closely the preliminary report of the Commission. Before the trustee's plan is filed every effort is made to iron out, through informal discussion, any differences of opinion which may exist between the SEC and the trustee with respect to the fairness and feasibility of the plan, so that the plan as filed will have informal SEC approval. While informal approval at this stage will not bind the Commission in its report on the plan submitted to it after court hearing, it indicates the probability of ultimate approval by the Commission. At the hearing on the trustee's plan, and any other plans that may be filed, the Commission attempts to see to it that sufficient evidence is put into the record to enable the court to determine what plan or plans are worthy of consideration and to permit the Commission, in reporting on the plan or plans submitted, to base its factual premises so far as possible upon evidence in the record. If the evidence offered seems inadequate, the Commission endeavors to supplement it through the witnesses of the trustee and others or by calling its own experts. The plan or plans found by the court worthy of consideration are referred to the Commission for a report under Section 172 of the Act. There is no hearing before the Commission. The report on the plan or plans submitted is drafted by the Regional Office staff, subject to review by the Reorganization Division in Philadelphia and by the Commission itself. After the Commission's report has been filed in court and copies have been made available to the parties, there is a further judicial hearing. If, according to Sections 174 and 175 of the Act, the court finds the plan to be fair, equitable and feasible and enters an order approving it, the plan and a summary thereof approved by the judge go to the security holders for approval or rejection accompanied by a copy of the judge's opinion, if any, and either a copy or a summary of the Commission's report. Final confirmation of the plan by the judge is preceded by another hearing, and one of the prerequisites to confirmation is that the judge be satisfied that the plan is fair, equitable and feasible.

The worth of the characteristically careful company, industry and
general economic studies made by the Commission in assembling the
basic information necessary to an intelligent application of the capital-
ization of earnings method may, perhaps, best be judged by observing
in some detail their influence upon the Commission’s determination of
enterprise value in a specific case. Although for this purpose the Com-
misson’s report on the plans for any one of a number of companies
might be used, that on Flour Mills of America, Inc. is not only
characteristic, but also suggests a problem to which consideration will
be given later on.

Flour Mills of America, Inc., was a holding company, having as
its sole assets all the stock of two subsidiaries engaged in the milling
and distribution of flour and by-products and in the operation of
grain elevators, and together forming one of the largest flour milling
groups in the hard winter wheat belt of the Southwest. The events
leading up to the organization of the debtor and its subsidiaries in
1926 and the character of their financing were suggestive of difficulties
to come. In 1925 the president of the milling and storage company,
which became the debtor’s principal subsidiary and which had enjoyed
a successful growth since 1912, foresaw hard times ahead for his com-
pany as the result of conditions created by the war and its aftermath.
At a stockholders’ meeting late in 1925 he called attention to serious
excess milling capacity caused by rapid expansion to meet the extraor-
dinary war demand for flour, falling per capita consumption of flour
caused by the wartime educational campaign to divert consumer
demand to other cereals, and the drop in exports caused by unsatisfac-
tory conditions abroad. Excess capacity resulting from these factors
had led and seemed likely to continue to lead to destructive competition
and price-cutting. He advised his stockholders to accept an offer of
$3,600,000 for the business, a sum which in his opinion was more than
it was worth. This advice was taken and the business was sold to a
group of investment bankers, who also purchased the assets of another
successful milling company, the properties purchased being transferred
to the debtor’s subsidiaries. To finance the transaction about $6,000,000
of the debtor’s notes and preferred stock were sold to the public against

26. These studies are not confined to reorganizations in which a formal advisory
report is filed. For example, in In re Plankinton Bldg. Co., 40 F. Supp. 517 (E. D.
Wis. 1941) the district judge refers to the “exhaustive and careful study of the prop-
erty and the past record of the debtor” made by the SEC over a period of eight months.
27. Among the more detailed and extensive reports filed by the Commission are
50A (Dec. 23, 1941), 52 (March 21, 1942), 55 (July 25, 1942); The Higbee Co., 8
S. E. C. 777 (1941); Atlas Pipeline Corp., SEC Corp. Reorg. Release No. 42 (June
7, 1941); Minnesota and Ontario Paper Co., 7 S.E.C. 456 (1940); Deep Rock Oil
Corp., 7 S. E. C. 174 (1940); McKesson & Robbins, Inc., 8 S. E. C. 853 (1941).
net assets which had cost less than $5,000,000, and most of the debtor's common, in addition to half a million in cash, went to the bankers as commission. Immediately after their acquisition the physical properties of the subsidiaries, which had cost $3,143,000, were written up to $8,700,000. In spite of this expansive financing, profits were shown for the next decade, but beginning with the fiscal year 1935-36 there occurred a succession of losses after depreciation and interest, and a consequent depletion of working capital, which finally culminated in a filing under Chapter X in 1939.

As of March 1, 1940, the debtor had outstanding twenty-year 6½ per cent. notes in the amount of $2,661,000, together with unpaid interest of $245,000, 25,000 shares of no par preferred carried on the books at $2,500,000, together with accrued dividends of $1,158,000, and about 500,000 shares of common.

Although ordinarily a company's past earnings record, adjusted to allow for unusual conditions and reasonably foreseeable changes, serves as a useful indication of prospective earnings, in this case investigation showed that the earnings realized by the debtor during its profitable period were not, when analyzed, a reliable guide to future earning power. Up to 1930 the milling operations had actually shown a profit, but under conditions very different from those of early 1940. During this early period a highly profitable business had been conducted in the sale of family flour and flour for small bakeries, but a large part of this business had been lost and efforts to win it back had proved unavailing. Furthermore, the decline in per capita domestic consumption and in exports indicated a prospective future demand insufficient to justify the volume of flour produced by the debtor up to 1932. From 1930 through 1935 the profits shown were highly colored by the extensive successful speculation in grain engaged by the debtor's management, which apparently overshadowed normal milling operations during this period. As it was impossible to segregate the results of this speculative activity from those of milling operations, earnings for these years were deemed not to constitute a reliable guide to the future. In 1936 the company lost money, but as this loss was largely attributable to unprofitable speculation and an unusually small volume of business the results for that year were thought not to be indicative of the future. Likewise, 1938 was ruled out because of unusual conditions then prevailing in the industry, especially the adverse movement of feed prices.

This left 1937 and 1939 as possible base years. Results for 1939, in which a profit of $99,500 before interest, depreciation and taxes

29. About half the common received by the bankers was later donated back to the company, which sold or gave it to officers, employees and others.
was realized after adjustment for actual or anticipated economies,30 were reasonably attributable to milling operations, as to a lesser extent were also the results for 1937,31 when a loss of $77,500 was incurred. Keen competition within the industry, induced by excess capacity, seemed likely to continue, and statistics failed to show any trend in the percentage of total production accounted for by the region in which the operations of the debtor's subsidiaries were conducted. On the basis of milling profits per barrel it appeared that industry conditions in the Southwest in 1937 and 1939 were not seriously, if at all, abnormal. The prospect of continued competition seemed to foreclose the likelihood of any substantial increase in the debtor's production, which had been relatively static since 1937. In the absence of a substantial rise in wheat prices working capital appeared adequate to sustain that production.

Upon the basis of the foregoing analysis the Commission concluded that the adjusted results for 1937 and 1939 could fairly be relied upon to indicate prospective earnings. The disinterested trustee, however, had based his plan upon estimated prospective annual earnings32 of $295,000 before, and $250,000 after, depreciation, an estimate obviously far in excess of any which could be reached upon the basis of the results for the two years used by the Commission. In estimating earnings the trustee had relied upon the testimony of a witness, who, assuming a continuation of the present volume of business, forecast a higher profit margin in the future comparable to that presently realized by other millers. There was, however, no evidence that operating methods or policies could be changed to produce a higher profit margin or that management in the future could better the results of the past. The Commission, furthermore, was inclined to question the adequacy of the trustee's depreciation allowance of $45,000, which was only about half the annual depreciation actually charged by the company for the last four years. Without fixing a figure of its own the Commission concluded that the trustee's estimate of $250,000 of earnings after depreciation was far too high.

But the trustee not only reached a high earnings figure; he capitalized earnings at the low rate of 8%, which, adding in the realization

30. Economies, actual or prospective, for which adjustments were made consisted of prospective elimination of expense of carrying dormant property held for liquidation, reduction in insurance costs and reduction in salaries.

31. An undetermined portion of the 1937 earnings was apparently attributable to unnecessary speculation in grain, which, however, was mild in comparison with that of earlier years.

32. In estimating earnings the trustee relied in part upon "the probability that the United States is now and for some time will be in the upward stage of the economic cycle." See Amended Plan of Reorganization, prepared and filed by Thornton Cooke, Independent Trustee (July 31, 1941) at p. 2.
value of non-productive properties, gave him a value of $3,200,000 for the corporate assets. It appeared from the testimony that this rate was chosen in order to produce a value high enough to warrant some recognition of the claim of the preferred stockholders. This, said the SEC, was putting the cart before the horse; the right of the preferred stockholders to continued participation depended upon the value of the enterprise, not vice versa. The serious risks inherent in the business, abundantly apparent in the light of the Commission's analysis of its poor record of earnings and precarious future, led the SEC to conclude that the least conservative capitalization rate which could properly be used was 12%, which when applied to even the trustee's estimate of earnings gave an enterprise value considerably less than the noteholders' claim. Hence the company appeared to be clearly insolvent. The Commission concluded that the trustee's plan was unfair to the noteholders in allocating participation to the preferred stockholders, and that even accepting the trustee's valuation, it was still unfair inasmuch, inter alia, as the plan not only offered the noteholders no compensation for their claim to accrued interest but offered them in exchange for their old notes new income notes which would bear a lower rate of interest and would pretty clearly have a market value substantially below the face amount of the old notes. The Commission concluded, furthermore, that it would not be feasible to saddle such a risky enterprise with the substantial amount of fixed obligations provided for in the trustee's plan. A plan submitted by a noteholders' committee, which assumed the debtor to be insolvent and which called for an issue of common stock to the noteholders as the sole securities of the new company, was thought to be both fair and feasible.

The Commission's careful report, however, failed to impress the district judge, who in a memorandum opinion§ found the debtor to be solvent and the value of its assets to be "reasonably in the amount asserted by the trustee," and indicated that if the trustee's plan were amended to compensate the noteholders for accrued interest it would be approved. When the trustee's plan, bearing a substantially satisfactory amendment covering accruals, again came before the Commission for a report, the Commission, while reiterating its belief that the company was insolvent, felt obliged to conclude that, upon the basis of the court's finding of value, the plan was fair, although still not feasible. The amended plan was subsequently approved by the court.

§3. The court's memorandum opinion does not appear in the law reports, but is referred to by the Commission in its supplemental report, 7 S. E. C. 30 (1940).
§4. Flour Mills of America, Inc., 7 S. E. C. 1, 30 (1940).
The foregoing sketch of the considerations involved in the process of reaching a valuation figure in the *Flour Mills* case is revealing in that it demonstrates on the one hand the need for the kind of careful investigation and analysis which the SEC employed, and on the other the utter impossibility of reaching a valuation figure that bears the imprint of even approximate mathematical certainty. At every stage of the valuation process difficult and uncertain decisions of judgment must be made which may have a marked effect upon the final result. The very fact that such decisions are implicit in the process makes reference to a mathematical formula, the capitalization at a definite rate of future earnings found in a definite amount, something of an illusion. For example, in the *Flour Mills* case prospective earning...
capacity will vary according to what answers are given to a host of difficult questions, none of which admit of a categorical answer. Is excess milling capacity likely to continue and, if so, to what extent? What of future per capita consumption of flour? Has consumption been stabilized, or is the declining trend of the past likely to continue, or, on the other hand, be reversed? What is the outlook with respect to substitute products? Are exports likely to remain at a low level? What of the possible effects of a war and post-war economy upon domestic and foreign demand for flour? How much weight should be given to the loss of profitable sales of family and small bakery flour? Can this business be regained? What consideration should be given to the speculative activities of the company's president inseparably interwoven with its normal operations? What is the proper base period? Should years in which such speculation was substantial be eliminated as base years or should some kind of adjustment be attempted? Or were past conditions so different from probable future conditions as to make resort to any base period unrealistic? If a base period is employed, what adjustments should be made in earnings for the base years to compensate for abnormal and non-recurring items? Is the competitive position of the debtor within the industry likely to improve, deteriorate, or stay the same? In what condition is the debtor's plant? What capital improvements or replacements will be required in the foreseeable future? Has proper depreciation been charged? What adjustments should be made for actual or anticipated economies? To what extent are past results attributable to the skill or mistakes of management? What changes in methods and policies of operation are apt to occur, and what is the probable quality of future management? To what degree are credit difficulties responsible for the debtor's condition, and what chance is there that they can be eliminated? To what extent should the possibility of more burdensome taxation be taken into account? Are milling costs and the costs of raw materials likely to increase or decline, and is the price of flour likely to keep pace with costs? At what point in the business cycle are we now and what is likely to be the future trend of business conditions?

cation, however, wherever possible, to apportionment of value between lien and free assets which are the same seems also desirable. In cases, however, where such treatment is not feasible, as, for example, in the Paper Company case, a resort to book value ratios may be the only method available.

37. Intelligent appraisal of the quality of past and future management and its effect upon earnings is both difficult and important. See Dewing, Financial Policy of Corporations (4th ed. 1941) 293, 298. That "a vital element in the feasibility of any plan is the quality of management" was specifically recognized by the Commission in National Radiator Corp., 4 S. E. C. 690 (1930), wherein it appeared that the company's drab past was in part the product of bad management.

38. Recognition of the cyclical nature of certain industries is obviously important. For example, would a short-term application of the capitalized earnings method to U. S. Steel in 1932 have shown an equity for the common?
Obviously a prospective earnings figure derived from the answers to these and other similar questions can possess few of the attributes of mathematical certainty. And the high content of educated guesswork implicit in the choice of a capitalization rate assumes impressive significance in view of the fact that a small difference in the rate will cause a comparatively large difference in the valuation figure. The occasional availability of price-earning ratios employed in the sale of comparable enterprises under more or less similar conditions and reference to capitalization rates employed in fixing the market price of securities of comparable companies may diminish to some extent the amount of guesswork that goes into the selection of the rate. But a study of the SEC advisory reports leaves one with the rather distinct impression that the choice of rate is governed in large part by “feel” derived from living with the reorganization and acquiring a thorough familiarity with the debtor’s affairs and peculiar problems. In spite of the Commission’s warning in the Flour Mills case it seems not unlikely that implicit in the choice of a rate may be the desire to rationalize a predetermined result, as, for instance, the retention of the common stockholders in the enterprise. For example, employment of the deceptively exact rate of 8.7 per cent. in the McKesson & Robbins case resulted in a value sufficient to warrant continued participation by the common stockholders, whereas a 12 per cent., or probably even a 10 per cent., rate, either of which would have conformed more closely to the rates for industrials suggested by Professor Dewing, would

39. A classic statement of Mr. Justice Holmes may not be wholly inapplicable to the present context. In Chicago, B. & O. Ry. v. Babcock, 204 U. S. 585, 598 (1907) he suggested that an administrative judgment may “express an intuition of experience which outruns analysis and sums up many unnamed and tangled impressions; impressions which lie beneath consciousness without losing their worth.”

40. See p. 449 supra.

41. McKesson & Robbins, Inc., SEC Corp. Reorg. Release No. 41 (March 29, 1941). What the SEC actually did in this case was to take the value found by the trustee, determine at what rate reasonably prospective earnings found by the Commission would have to be capitalized to give this value, and conclude that this rate was not unreasonable.

42. I DEWING, FINANCIAL POLICY OF CORPORATIONS (4th ed. 1941) 335-337. According to Dewing, value determined by use of a 10% rate is “the highest value that can possibly be assigned to an industrial business.” He adds that “very few are on this level.” For other classes of industrials, each group more speculative than the preceding group, he suggests rates of 12½%-15%, 16½%-20%, 25%, 30% and, finally, for certain personal service businesses, not much less than 100%.

By way of analogy, the following classification of price-earnings ratios for industrial common stock suggested by Badger writing in 1925 is interesting:

Class I—Low Risk—12%-14.99%
Class II—Medium Risk—15%-19.99%
Class III—High Risk—20%-24.99%
Class IV—Very High Risk—Over 25%

BADGER, VALUATION OF INDUSTRIAL SECURITIES (1925) 123. Obviously, however, apart from the fact that it is dated, the foregoing table is of limited significance with respect to enterprise value. The capitalization rate applied by a purchaser to the common stock earnings may, and logically should, apart from factors separable from earning power such as voting control, be higher than that applied to the earnings of the entire business, which, unless the capitalization is in common alone, includes earnings subject to a lesser risk of non-realization.
have forced their exclusion. It seems reasonable to assume that in adopting the less conservative rate the Commission was influenced not so much by the niceties of risk as by a conviction derived from knowledge of the company and its affairs that holders of the junior equity should not be eliminated. Hence mathematical formulae may yield to human judgment. It is obviously important, however, that the final judgment be an informed and critical judgment founded upon thorough investigation and analysis of all relevant material.

As each reorganization presents a unique package of facts and problems that require individualized treatment a horizontal cataloguing of segments of SEC valuation technique would be of doubtful value. Separated from its context, the fact that in a particular case the Commission employed a five-year base period or a 10 per cent. rate is of little significance. The valuation process is one of weaving many threads into a meaningful pattern; if the threads are separated the pattern disappears. Nevertheless, it may not be wholly inappropriate to call attention to certain guideposts of more or less broad relevance. Thus, except where company or industry conditions have changed so radically as to make an effort to adjust past earnings to present and prospective conditions a highly artificial process, the Commission has resorted to past earnings, properly adjusted for such specific matters as abnormalities in volume, price structure, credit position or working capital, attributable, for example, to the reorganization, actual or potential increase or reduction in profit margins, loss of old or

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43. Elements of rationalization were also pretty clearly present in The Higbee Co., SEC Corp. Reorg. Release No. 39 (March 25, 1941), where the rates of 9.8% and 7.7%, before and after federal income tax, were approved.

44. A partial horizontal catalogue will be found in Note, Valuation by the SEC in Reorganizations (1941) 55 Harv. L. Rev. 125.

45. The caveat stated in The Higbee Co., 8 S. E. C. 777, 784 (1941) must be borne constantly in mind: "In examining the past earnings of a debtor in reorganization for guidance in estimating reasonably anticipated future earnings, consideration must always be given to the possibility that past conditions and the past policies of management may have been such as to effect substantially the usefulness of such past earnings as a guide."

In the following instances changed conditions were thought to render at least some of the earnings record an unreliable guide to future earnings: Flour Mills of America, Inc., 7 S. E. C. 1 (1940); Deep Rock Oil Corp., 7 S. E. C. 174 (1940); Atlas Pipeline Corp., SEC Corp. Reorg. Release No. 42 (June 7, 1941); The Higbee Co., supra; La France Industries, 5 S. E. C. 917 (1939); McKesson & Robbins, Inc., 8 S. E. C. 853 (1941) (drug manufacturing department); Sayre & Fisher Brick Co., SEC Corp. Reorg. Releases Nos. 47 (September 12, 1941), 54 (June 1, 1942); Porto Rican American Tobacco Co., 7 S. E. C. 301 (1940); Minnesota and Ontario Paper Co., 7 S. E. C. 456 (1940).

46. In Griess-Pfleger Tanning Co., 5 S. E. C. 72 (1939) the Commission specifically recognized that the reorganization had necessitated price shading. Likewise, in La France Industries, 5 S. E. C. 917 (1939) it was recognized that volume and profits had suffered from tightness of working capital and credit caused by the company's being in reorganization.


development of new sources of income, inadequate or excessive depreciation and other reserves, non-recurring receipts or expenses, existing or potential economies, and for such general matters as company, industry and general economic trends, as affording the best evidence of future earning capacity. In making adjustments the Commission has steered a middle course. While willing enough to consider favorable factors that appear to be solidly grounded and of more than temporary significance, it has not hesitated to ignore the many prognostications of improvement, so characteristic of reorganization plans, that appear to be largely the product of wishful thinking. At temporary war profits it has been inclined to look askance. The restrictive influence of such wartime controls as price

49. E. g., Deep Rock Oil Corp., 7 S. E. C. 174 (1940).
50. Except for companies headed toward liquidation or whose life is limited so that no capital replacement is contemplated, the Commission has insisted upon the deduction of depreciation in computing prospective earnings. But there has been little discussion of how to compute depreciation.
51. E. e., Flour Mills of America, Inc., 7 S. E. C. 1 (1940) (elimination of excessive provisions for insurance and contingencies); Deep Rock Oil Corp., 7 S. E. C. 174 (1940) (elimination of excessive allowance for bad or doubtful accounts).
52. Examples of non-recurring items eliminated will be found in Flour Mills of America, Inc., 7 S. E. C. 1 (1940); Deep Rock Oil Corp., 7 S. E. C. 174 (1940); San Francisco Bay Toll-Bridge Co., 6 S. E. C. 863 (1940); Atlas Pipeline Corp., SEC Corp. Reorg. Release No. 42 (June 7, 1941); McKesson & Robbins, Inc., 8 S. E. C. 853 (1941); The Philadelphia and Reading Coal and Iron Co., SEC Corp. Reorg. Releases Nos. 50A (December 23, 1941), 52 (March 21, 1942), 55 (July 25, 1942); Minnesota & Ontario Paper Co., 7 S. E. C. 456 (1940).
54. Particular attention was paid to trends in Atlas Pipeline Corp., SEC Corp. Reorg. Release No. 42 (June 7, 1941); La France Industries, 5 S. E. C. 917 (1939); Flour Mills of America, Inc., 7 S. E. C. 1 (1940); McKesson & Robbins, Inc., 8 S. E. C. 853 (1941); National Radiator Corp., 4 S. E. C. 690 (1939); The Philadelphia and Reading Coal and Iron Co., SEC Corp. Reorg. Releases Nos. 50A (December 23, 1941), 52 (March 21, 1942), 55 (July 25, 1942); Minnesota & Ontario Paper Co., 7 S. E. C. 456 (1940).
55. A typical statement of the Commission's position is that in Flour Mills of America, Inc., 7 S. E. C. 1, 8 (1940): “A debtor's record of earnings, adjusted and weighted to give account to unusual conditions and reasonably foreseeable changes, provides a guide to a determination of earnings reasonably to be anticipated in the future.”
56. See the caveat in Atlas Pipeline Corp., SEC Corp. Reorg. Release No. 42 (June 7, 1941) at p. 18, that “even though the predicted savings may be reasonably anticipated over the short term, there is a substantial question whether they would be available to the Debtor over an extended period.”
ceilings and WPB orders has been recognized. Base periods have ranged from five months to five years and capitalization or discount rates from 8.7 per cent to 15-20 per cent. Curiously enough, the advisory reports do not indicate that the Commission has paid much attention to the impact of federal income and excess profits taxes upon future earnings, although a consideration of their probable effect would seem to be becoming increasingly urgent.

While on the whole the Commission's valuations can hardly be characterized as unduly pessimistic, the fact is that district judges, in those instances in which they have disagreed with the Commission on value, have taken a more optimistic view. Jacking up value is an

61. Deep Rock Oil Corp., 7 S. E. C. 174 (1940). Other periods used by the Commission were nine months, one year (three reports), one year with second half estimated, two separate years, three years (two reports). Bonbright, writing in 1937, states that writers agree that it is generally better to average the earnings of a three to five year period, or occasionally even a ten or fifteen year period, than to capitalize the earnings of one year, but recognize the undesirability of any fixed formula. I Bonbright, Valuation of Property (1937) 253.
62. McKesson & Robbins, Inc., 8 S. E. C. 853 (1941). Strictly the rate was merely held to be not unreasonable. A rate of 7.7% was approved by the Commission in The Higbee Co., 8 S. E. C. 777 (1941), as applied to earnings after federal income tax, but this was equivalent to a rate of 9.8% before such tax. In San Francisco Bay Toll-Bridge Co., 6 S. E. C. 863 (1940) the Commission suggested 8%-10% as a proper discount rate, but the company was so insolvent that it didn't matter which was used.
64. In The Philadelphia and Reading Coal and Iron Co., SEC Corp. Reorg. Releases Nos. 50A (December 23, 1941), 52 (March 21, 1942), 55 (July 25, 1942), the Commission replied to an argument for a large bond issue on the ground that it would save income taxes by saying that the income tax saving might be offset by increased excess profits taxes resulting from the reduction of the invested capital base, that there was no sense in considering taxes anyway in view of uncertainty with respect to future earnings and federal tax laws, and that even if a large bond issue would bring about some immediate tax savings that was not enough to justify sacrifice of feasibility. See also Ulen & Co., SEC Corp. Reorg. Release No. 43 (June 21, 1941) p. 20. The only other references to income and excess profits taxes are in The Higbee Co., 8 S. E. C. 777 (1941) and McKesson & Robbins, Inc., 8 S. E. C. 853 (1941), and these are inconclusive in that the Commission in neither case goes beyond the reference. The difficulty suggested in the Philadelphia and Reading report of estimating heavier future taxes does not justify ignoring them. Failure to give them adequate weight is bound to result in serious miscalculation of prospective earnings. Adjustment for them would certainly be no more speculative than many adjustments customarily made.
65. Thus, for example, in In re Atlas Pipeline Corp., 39 F. Supp. 846 (W. D. La. 1941) the court, approving a trustee's plan for a refiner of petroleum and distributor of petroleum products based on a valuation much higher than that thought proper by the SEC, characterized the Commission's views as "somewhat cold blooded." Although the trustee's figures, ignoring completely the company's drab past, were based on current results which by means of various optimistic but to some extent questionable adjustments were made to appear extremely rosy, the court expressed the opinion that the trustee had adopted "a reasonable and conservative basis for his calculations." It is noteworthy that the Commission's valuation, based on prospective earnings of $120,000 before depreciation and interest as against the trustee's figure of $263,000, and a discount rate of 12%-15% as against the trustee's capitalization rate of 10%, has.
obvious device for circumventing the absolute priority rule. It is a ready tool for judges unwilling to cut out stockholders in order that bondholders, many of whom may have acquired their bonds at a heavy discount,66 may benefit. There may be a reluctance to break too sharply with the familiar old-fashioned pattern of reorganization, where except in cases of gross insolvency the normal technique was to launch the new company with a slightly revamped capitalization which in substance more or less approximated that of the old. This procedure, while apt to produce a palliative and not a cure, was nevertheless quick and painless; it got the company out of court in a hurry and since everyone remained in the picture the chance of appeal was minimized. Speed and finality are features which from the judge's point of view itself been characterized as visualizing "an industrial Utopia." Note, Valuation by the SEC in Reorganization (1941) 55 Harv. L. Rev. 125, 130.

Prior to the Consolidated Rock Products decision it was sometimes possible for a district judge to justify a higher valuation than that urged by the SEC on the ground that capitalized earnings were not the sole measure of value. This is what happened, for instance, in In re Reb Holding Co., 35 F. Supp. 716 (E. D. Wis. 1940), decided in the interim between the Los Angeles and Consolidated Rock Products decisions. Although in the light of the latter decision it now seems clear that the value of the productive assets of a continuing enterprise is to be determined by capitalizing earnings, a federal district judge who had the Consolidated Rock Products opinion before him, has recently held, on objections to a master's reports on value, over the protest of the SEC and citing merely the Reb case and other lower federal court cases antedating the Consolidated Rock Products decision, that capitalization of reasonably prospective earnings "is not the sole, or necessarily the controlling factor in reaching a conclusion respecting the value of productive assets." In re Warren Bros. Co., 39 F. Supp. 381 (D. Mass. 1941). Actually, adherence to the master's "appraisal value," based largely upon appraisal by the debtor's officers, resulted in a slightly lower value than that reached by capitalizing prospective earnings as found by the master at 8%, the rate found by the master to be reasonable.

66. Generally speaking, in the absence of fraud the price paid by a senior security holder for his security does not affect the measure of his participation under the plan or reorganization. Standard Gas & Electric Co. v. Deep Rock Oil Corp., 117 F. (2d) 615 (C. C. A. 10th, 1941), cert. denied, 313 U. S. 564 (1941); In re Radio-Keith-Orpheum Corp., 106 F. (ad) 22 (C. C. A. 2d, 1939), cert. denied, 308 U. S. 622 (1939), rehearing denied, 309 U. S. 564 (1940); Security-First Nat. Bank of Los Angeles v. Pacific Northwest Land & Navigation Co., 68 F. (2d) 557 (C. C. A. 9th, 1938), cert. denied, 299 U. S. 613 (1937), rehearing denied, 300 U. S. 696 (1937); In re Utilities Power & Light Corp., 29 F. Supp. 763 (N. D. Ill. 1939), appeal dismissed, (C. C. A. 7th, March 9, 1940); In re Celotex Co., 12 F. Supp. 1 (D. Del. 1935). In addition to its contractual basis the foregoing rule, if the securities are widely held and actively traded, finds support in considerations of practical convenience. The Court of Appeals for the District of Columbia has recently held, one of its three judges dissenting, that the Commission lacked power to impose, as a condition of approval of a merger recapitalization plan for a holding company, a limitation upon the extent to which officers and directors could profit from the purchase, during the period of reorganization, of preferred stock of the company. Chenery Corp. v. SEC, 128 F. (2d) 303 (App. D. C. 1942), cert. granted, 63 S. Ct. 52 (1942). This holding is contrary to the position previously taken by the Commission in Federal Water Service Corp., 8 S. E. C. 893 (1941) (preferred stock claim of management) ; Derby Gas & Electric Corp., SEC Holding Co. Release No. 2875 (July 12, 1941) (preferred stock claim of parent company) ; North American Light & Power Co. Holding Co. System and The North American Co., SEC Holding Co. Release No. 3233 (December 31, 1941) (debenture and preferred stock claims of parent company). Section 212 of Chapter X provides, with respect to agents, attorneys, indenture trustees and committees that the judge "may limit any claim or stock acquired by such person or committee in contemplation or in the course of the proceeding under this chapter to the actual consideration paid therefor." 52 Stat. 895 (1938), 11 U. S. C. A. §612 (1940).
are attractive. Thus, in the case of LaFrance Industries, a three year old reorganization of a solvent fabric company, it is not surprising to find the district judge concluding his approval of the trustee's plan, which had the support of most of the security holders but was based on a valuation which in view of the company's earnings record and future prospects seemed to the SEC far too high, with the statement that "the choice appears to be between approving a reasonably satisfactory reorganization which can be put into effect immediately, or postponing reorganization to some indefinite date in the distant future in the hope of working out a more nearly perfect plan." 

Ordinarily the district judge, even in the case of a plan reported by the Commission to be neither fair nor feasible, does not state his approval in a written opinion, so that we are left to speculate about his reasons. Sometimes, as in the Deep Rock Oil case, the reasons for the court's action seem fairly clear. This involved the reorganization of an operating subsidiary of Standard Gas & Electric Company. Prior to the Commission's entry into reorganization an independent committee for preferred stockholders had taken a successful appeal to the Supreme Court from the confirmation of a plan which gave Standard most of the new common on the strength of an open account claim. The result of the Supreme Court's opinion was to subordinate Standard's claim to that of the preferred stockholders. The district judge, acting upon the trustee's appraisal as of September 1,

67. La France Industries, 5 S. E. C. 917 (1939).
69. The common failure of district judges to support their approval of the plan with a written opinion is at least unfortunate. Although Sections 174 and 221 of the Bankruptcy Act respectively provide merely that the judge "shall enter an order approving the plan or plans which in his opinion . . . are fair and equitable, and feasible," and "shall confirm a plan if satisfied that . . . (2) the plan is fair and equitable and feasible," these provisions must now be read in the light of the precept of Mr. Justice Douglas in the Consolidated Rock Products case that "findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization." In order that his findings with respect to earning capacity and value may bear the imprint of the "informed judgment" upon which the estimate of earnings and value must be based, it would appear at least desirable and perhaps necessary for the district judge to support his findings with a reasoned written discussion of the relevant facts. The worth of such a supporting opinion is particularly obvious in cases where the trustee and the Commission have expressed divergent views concerning value. Not only would such an opinion, identifying the basic facts and discussing their proper interpretation and application to the problem of value in the light of the conflict of views, afford tangible assurance of adequate consideration by the judge, but if rendered at the approval rather than at the confirmation stage would also be of considerable assistance to the security holders in making up their minds how to vote on the plan.
72. Standard's contention that this was not the result of the Supreme Court's opinion was overruled in Standard Gas & Electric Co. v. Taylor, 113 F. (2d) 266 (C. C. A. 10th, 1940), cert. denied, 311 U. S. 699 (1940).
1936, based upon various measures of value, including a variation of reproduction cost, originally found that the debtor's properties were worth not more than $17,000,000, and the Supreme Court agreed.\footnote{Taylor v. Standard Gas & Electric Co., 306 U. S. 307, 314 (1939).} A plan granting participation not only to the senior claimants, note-holders, but also to preferred stockholders, was subsequently submitted to the SEC for a report. After careful study the Commission, while professing to be "not unmindful of the fact that the preferred stockholders were responsible for the appeal to the Supreme Court which was successful in overturning the original unfair plan," concluded that the company was insolvent and that it therefore could not "recommend to the court that the equities urged in favor of the preferred stockholders on account of their successful appeal justify the diversion to them of values which belong to the noteholders." \footnote{Deep Rock Oil Corp., 7 S. E. C. 174, 194 (1940).} The district judge, however, apparently found himself unable to commit the ungracious act of shutting the door in the face of those who had carried the burden of the appeal that had knocked out Standard's claim. Acceptance of the trustee's later appraisals, which were for the most part not derived from capitalization of prospective earnings, as a proper basis for determining the value of the enterprise enabled him to justify the grant of a substantial participation to the preferred stockholders.\footnote{The district judge did not file a written opinion to support either his order of approval or his order of confirmation. The approval order, entered May 28, 1940, was based on the trustee's later appraisal figure of $16,250,000, as of November 30, 1939, and the confirmation order, entered July 24, 1940, upon the trustee's still later appraisal figure of $15,240,415 as of May 20, 1940, following interim distribution of $2,400,000 to the noteholders. No appeal from the orders of approval and confirmation was taken by the noteholders. Standard, however, which in addition to its creditor's claim held a small fraction of the preferred shares, appealed unsuccessfully, but did not question the findings with respect to value. Standard Gas & Electric Co. v. Deep Rock Oil Corp., 117 F. (2d) 615 (C. C. A. 10th, 1941), cert. denied, 313 U. S. 564 (1941).}

The \textit{Flour Mills} case\footnote{Flour Mills of America, Inc., 7 S. E. C. 1 (1940).} and in particular the \textit{Griess-Pfleger} case\footnote{Griess-Pfleger Tanning Co., 5 S. E. C. 72 (1939).} are suggestive of another possible explanation for judicial disagreement with the Commission on valuation. It will be recalled that in the \textit{Flour Mills} case the trustee's amended plan, which was approved by the district court, was based on prospective annual earnings of $250,000 after depreciation, capitalized at 8 per cent. This gave a value sufficient to permit the preferred stockholders to participate with the noteholders in the new company. Although its studies indicated that the estimate of earnings was too high, the Commission did not feel called upon to make an estimate of its own, as it concluded that the risk of non-realization of prospective earnings was such as to render improper the employment of a capitalization rate less conservative than 12 per cent. Application of a 12 per cent rate to even the trustee's
estimate of earnings resulted in a showing of insolvency and required the exclusion of everyone save the noteholders. If for purposes of discussion we assume the correctness of the trustee's estimate of earnings, we are faced with a result which superficially at least may seem somewhat startling. The noteholders, who had been entitled to annual interest of less than $190,000, would receive an enterprise capable of earning $250,000 a year.78

This result is present also in the Griess-Pfieger case. There the independent trustee for a tanning company had come forward with a plan providing for participation not only by the bondholders but also by the holders of the preferred and common stock. The SEC, applying a 10 per cent. rate to what it termed a not unreasonable earnings estimate of $150,000 after depreciation, and adding in the realization value of non-operating assets, concluded that the value of the enterprise just about equalled the bondholders' claim. Had the equity holders been excluded, the holders of the 51/2 per cent. bonds, whose annual interest requirement was about $90,000, would have received an enterprise with reasonably prospective earning power of $150,000 a year. It may well be that the district judge, who approved the trustee's plan, was troubled by this prospect.

It is clear, of course, that a bondholder who is forced to relinquish his senior creditor position in return, say, for common stock, finds that he has assumed increased risk. He has exchanged the distinctive rights of a creditor for those of an owner. If immediate borrowing is necessary to raise new money he will be in a junior position from the outset and in any event will run the risk of being subordinated to future creditors. The risk attached to the realization of prospective earnings on his stock is in all likelihood greater than that attached to the realization of interest on his bonds when they were issued.79 One appropriate way to compensate the bondholder for this assumption of greater risk is to increase his prospective income. How great the increase should be is plainly not susceptible of statement in terms of a precise mathematical formula, but a valuation which results in a startlingly great increase for the senior claimants may suggest the possibility of an inappropriate capitalization of prospective earnings.

78. This figure, it is true, was before taxes. Obviously, furthermore, not all net earnings would be paid out as dividends to the stockholders. The old noteholders, however, as sole stockholders, would control the company and earnings plowed back would enhance the value of their holdings.

79. But not necessarily greater than the risk of non-realization of interest when he acquired the bonds, provided the acquisition was made at a time when the company was in or headed toward reorganization. Badger calls attention to the fact that bonds of a company headed toward receivership have tended to sell on a price-earnings ratio comparable to that of common stock of a non-defaulting concern. BADGER, VALUATION OF INDUSTRIAL SECURITIES (1925) 54.
This problem may be approached from a somewhat different angle and brought into sharper focus by a consideration of the following hypothetical case. Suppose that an industrial in a relatively stable industry with a good record of earnings and a reasonably bright future is capitalized as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>4% bonds</td>
<td>$5,000,000 (face)</td>
</tr>
<tr>
<td>6% preferred</td>
<td>3,000,000 (liquidating preference)</td>
</tr>
<tr>
<td>common</td>
<td>10,000,000 (par)</td>
</tr>
</tbody>
</table>

Assume that a bond maturity coincides with a temporary financial panic so that refunding is impossible, the bonds are defaulted and the company files under Chapter X. Assume further that reasonably prospective earnings are found to be $900,000, and that these are capitalized at 10 per cent., giving a going concern value of $9,000,000. As the bondholders' and preferred stockholders' claims are $5,000,000 and $3,000,000, respectively, the common stockholders would be entitled to receive no more than $1,000,000 in assets value, or one ninth of the total. For purposes of illustration suppose the enterprise emerged from reorganization with a capital structure patterned upon the old, as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>4% bonds</td>
<td>$5,000,000 (face)</td>
</tr>
<tr>
<td>6% preferred</td>
<td>3,000,000 (par)</td>
</tr>
<tr>
<td>No par common</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

Of the annual earnings, $200,000 would be consumed in interest on the bonds, and $180,000 in dividends on the preferred. As the bond interest would be covered 4\(\frac{3}{2}\) times, it would seem not unreasonable to suppose that the bonds would sell at par in a normal market, and as there would be overall coverage on the preferred of 2\(\frac{1}{2}\) times, it would seem that it too might normally command par. The plan would hence appear feasible as well as fair to the bondholders and preferred stockholders. It will be observed, however, that of the prospective earnings of $900,000, the sum of $520,000, or nearly 60 per cent., would be left for the common, which according to our computation had a maximum going concern value of only $1,000,000. This

80. In McKesson & Robbins, Inc., 8 S.E.C. 853 (1941) the SEC indicated that fairness to the old debenture holders required that the market value of the new securities allocated to them be equal to their claims. Cf. Porto Rican American Tobacco Co., 7 S.E.C. 301 (1940), order approving plan affirmed, In re Porto Rican American Tobacco Co., 112 F. (2d) 655 (C. C. A. 2d, 1940).
81. A "normal market," like a reasonably prudent man, is perhaps a will-o'-the-wisp; as a standard, however, the term has some utility.
82. That a portion of this might be absorbed by sinking fund requirements would seem unimportant, as the sinking fund would operate to the ultimate benefit of the common stockholders.
hardly makes sense. The apparent absurdity of holding that stock which will receive over half the company's total earnings represents only one-ninth of the value of the enterprise would be of little practical consequence provided the company should emerge from reorganization with the foregoing structure. If the common stock is to realize $520,000 in earnings, it will make little difference to its holders that it has been found to have a going concern value of only a million. If, however, the company was reorganized under an all common stock plan, the consequence to the old common stockholders of holding their interest to represent a going concern value of only a million would be very great, for they would then be entitled to receive a maximum of only one-ninth of the new common, upon which they could expect to realize annual earnings of no more than $100,000. Actually, they might receive even less than one-ninth of the new common, as the bondholders and preferred stockholders might be held entitled to some extra stock as compensation for loss of position, and it is even possible that the common stockholders might be shut out entirely. The bondholders, on the other hand, would receive a minimum of five-ninths of the common, upon which they would realize annual earnings of $500,000 as against their former interest of $200,000, and the preferred stockholders at least three-ninths of the common, upon which they would realize earnings of $300,000 as against their former dividend of $180,000.

It may be suggested that the apparent absurdity and unfairness encountered in the foregoing examples result from the use of a flat 10 per cent. capitalization which on its face fails to recognize that different segments of earnings are subject to varying degrees of risk that they will not be realized. This suggests the propriety of capitalizing each segment of earnings at a rate which will fairly reflect the risk attached to its realization. For example, if the company has a stable record of earnings and indicated prospective earnings of $900,000, it would seem that the risk that it will not earn at least $200,000 is relatively slight. This might then safely be treated as a fixed charge and capitalized at, say, 4 per cent. into 4 per cent. bonds for the old bondholders, which, interest being covered 4 1/2 times, might reasonably be expected to sell at par in a normal market. If we take $180,000 as the next segment of earnings, it is clear that the chance that it will not be earned, while somewhat greater, is still comparatively slight. This segment might safely be treated as a preferred stock dividend and capitalized at, say, 6 per cent. into 6 per cent. preferred for the old preferred stockholders,

83. The market would certainly consider the common worth more than a million dollars; that is, it would apply to earnings a less conservative capitalization rate than 52%.
which, since there would be overall coverage on its dividend of 2½ times, might be expected to be worth par in a normal market. If we
take as our last segment the remaining earnings of $520,000, it is
apparent that the chance that it will not be realized is comparatively
great, and that a considerably higher capitalization rate, say 15 per
cent., should be employed. Use of a 15 per cent. rate would give a
-going concern value of about 3½ million to this last segment, which
might reasonably be capitalized as common stock for the old common
stockholders. The result would be a going concern value of about
11½ million.84

Whatever merit the varying rate technique may possess lies in
the fact that it, as does the market, recognizes that different degrees of
uncertainty attach to the realization of different segments of earnings.
In the foregoing example, for simplicity's sake, the first two segments
chosen corresponded exactly to the interest and dividend requirements
of the old bonds and preferred. It is apparent, however, that other
segments might have been used, appropriate adjustments being made,
where necessary, in the allocation of securities for changes of position.
For example, it might appear desirable to simplify the corporate
structure and to capitalize the first $400,000 of prospective earnings
into new preferred, which, being the senior security, might reasonably
be capitalized at 5 per cent. and be expected to sell at par in a normal
market. If the remaining earnings were capitalized into common at
15 per cent., approximately the same total value would result. Even
were the new capitalization to be in common alone, it would seem
appropriate in computing total value to take into account the fact that
the realization of different segments of earnings is subject to different
risks.

In opposition to use of the varying rate it may be urged that it
multiplies questions soluble only in terms of business judgment. In
lieu of the determination of one flat rate, it requires not only the deter-
mination of earnings segments but also the fixing of a different rate
for each segment. Furthermore, its use will normally result in a deter-

84. If, in the example given, prospective earnings had been $800,000 instead of
$900,000, capitalization at a flat 10% rate would shut out the common completely, al-
though under the old set-up $420,000, or over 50% of earnings, could have been left
for the common. Application of a varying rate might work out somewhat as follows:
the first $200,000 of earnings capitalized at 4% into 4% bonds for the old bondhold-
ers; the remaining earnings capitalized into common, the first $300,000 segment at, say,
10% and the second $300,000 segment at, say, 15%. This would result in a going
concern value of $10,000,000. Of the new common shares representing $5,000,000 of
going concern value the old preferred stockholders would be entitled to receive the
fair equivalent of their old stock. Just how much new common would be a fair equiva-
 lent would depend upon a balancing of their higher income and perhaps increased vot-
ing power against their loss of position. The important point, however, is that, irre-
spective of the precise division, use of a varying rate would seem to justify substantial
participation by the old common stockholders.
mination of the capital structure before enterprise value is determined, but this, while somewhat unconventional, does not seem open to serious objection. Finally, it may be urged that if in our illustration we had used a flat rate of 8 per cent. instead of 10 per cent. we would have reached approximately the same value that was obtained by employing varying rates. In other words, it may be argued that the flat rate should be a composite of the varying rates, and that there is, therefore, no need for departure from the conventional flat rate method. This would seem, theoretically at least, to be so. There would seem to be less chance of serious error, however, in taking several small jumps, guided in each by reference to what appears to be a fitting financial structure and subject more or less to market check in fixing segment risk, than in taking one relatively unguided big jump. Hence, at the very least, employment of the varying rate would appear to be a useful means of discovering what the composite rate ought to be.

**CONCLUSION**

In the equity receivership and 77B days of industrial corporate reorganization a district judge, wishing to test the fairness and feasibility of a plan by the capitalized earnings method of valuation, had no dependable means of obtaining the mass of relevant company, industry and general economic information which, competently analyzed, is the flesh and blood of any "informed" judgment of going-concern value. His was a choice between reliance on the company's reported earnings, which without adjustment were likely to be a most untrustworthy guide to the future, or reliance on the suspect testimony of interested experts called by the parties. The expense of conducting the battle of figures

85. It was held in *In re Philadelphia & Reading Coal & Iron Co.*, 105 F. (2d) 357 (C. C. A. 3d, 1939) that the issue of solvency must be determined before the plan is approved; but this does not mean that a determination of value must precede the determination of the capital structure.

86. In appraising the worth of a compromise between the asset-value method and the capitalized earnings method of enterprise valuation whereby a portion of the earnings are allocated to the satisfaction of a relatively low rate of return attributed to fixed assets and the remaining earnings capitalized at a higher rate as applicable to intangibles, Bonbright suggests that the technique may involve an "overrefinement." "Everything," he says, "depends on the choice of the two rates of capitalization; and we know no more about the proper choice of these rates than is known about the choice of the single, overall rate. Even the basic assumption that excessive earnings are the more evanescent earnings has never been well documented by statistical evidence." 1 BONBRIGHT, VALUATION OF PROPERTY (1937) 243. In their context Bonbright's comments seem appropriate. Apart from the difficulty of allocating earnings between fixed and other assets there was no assurance that a lower capitalization rate should be applied to the earnings of the former than to those of the latter. It is doubtful, however, whether Bonbright's criticisms are properly applicable to the problem we have been discussing, since in the first place there is no doubt that realization of well-protected segments of earnings is less uncertain than is realization of less well-protected segments, and, in the second place, the market affords some indication of what the rates should be.

87. Bonbright put the dilemma neatly when he said that "a court must choose between the tremendous errors implicit in a capitalization of audited reported earnings, and the tremendous errors implicit in a capitalization of prejudiced prophecies." 1 BONBRIGHT, VALUATION OF PROPERTY (1937) 251.
was such as virtually to exclude from participation the security holders who declined to go along with an organized group. The clear and imperative need of the judge was for unbiased expert assistance. Such assistance is now being supplied under Chapter X by the SEC and, to some extent, by the independent trustees. As an SEC chairman has said, the Chandler Act technique of advisory reports and Commission participation in the proceedings as a mere party "fits into the traditional pattern of the judicial process so that courts and bar not only do not resent but actually welcome it." The judge is left free to make up his own mind, and experience so far seems not to have borne out the fears of those who envisioned him reduced to the status of a rubber stamp.

90. Dewing, for example, expressed doubt that the judge would approve a plan unsatisfactory to the SEC. 2 DEWING, FINANCIAL POLICY OF CORPORATIONS (4th ed. 1941) 1320.