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HOLDING COMPANY ACT - "FAIR AND EQUITABLE" PLAN

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HOLDING COMPANY ACT — "FAIR AND EQUITABLE" PLAN — Should the words "fair and equitable" in section 11 (e) of the Holding Company Act[1] be construed differently than the same words in section 77B of the Bankruptcy Act?[2] The Securities and Exchange Commission faced this question in disposing of a proposed plan of merger involving Utility Operators Company and subsidiaries. A divided commission gave an affirmative answer[3] to the above question, holding "fair and equitable" in the Holding Company Act to permit relative priority. This holding merits particular interest since the United States Supreme Court has held the same words as used in section 77B permitted only absolute priority.[4] The doctrine of absolute priority in effect comes down to this: no junior class of security holders may participate in the reorganized corporation unless all senior security holders are fully compensated.[5] That rule, firmly fixed in proceedings

[1] Public Utility Holding Company Act, 49 Stat. L. 822, § 11 (1935), 15 U. S. C. (Supp. 1939), § 79 l.

[2] Bankruptcy Act, 48 Stat. L. 912, § 77B (1934), 11 U. S. C. (1935), § 207.

[3] Matter of Federal Water Service Corp., S. E. C., Holding Company Act Release No. 2635 (1941).

[4] Case v. Los Angeles Lumber Products Co., 308 U. S. 106, 60 S. Ct. 1 (1939).

The decision in the Los Angeles case rested on the Court's construction of the words "fair and equitable" as used in section 77B of the Bankruptcy Act. A construction of those words in the statute was made necessary in order that the Court might determine the conditions under which stockholders of the insolvent debtor corporation could participate in a plan of reorganization under section 77B of the Bankruptcy Act. It was held that the plan did not recognize the "equitable right" of the bondholders to be preferred to stockholders against the full value of all property belonging to the debtor corporation, since the full value of that property was not first applied to claims of the bondholders before the stockholders were allowed to participate.

The Los Angeles Lumber Products case is discussed in the following: 28 CAL. L. REV. 633 (1940); 8 GEO. WASH. L. REV. 1107 (1940); Calkins, "Valuation in Corporate Reorganization," 16 NOTRE DAME LAWY. 18 (1940); 7 UNIV. CHI. L. REV. 549 (1940); Swanstrom, "Stockholders' Participation in Reorganization," 28 GEO. L. J. 336 (1939); Dodd, "The Los Angeles Lumber Products Company Case and its Implications," 53 HARV. L. REV. 713 (1940); 34 ILL. L. REV. 589 (1940); 38 MICH. L. REV. 695 (1940); 17 N. Y. UNIV. L. Q. REV. 287 (1940); 13 So. CAL. L. REV. 349 (1940); 25 WASH. UNIV. L. Q. REV. 279 (1940); 49 YALE L. J. 1099 (1940).

[5] Northern Pacific Ry. v. Boyd, 228 U. S. 482, 33 S. Ct. 554 (1913). The Boyd case involved equity reorganization. Boyd recovered a judgment against the Coeur D'Alene Railroad and Navigation Company. Prior to the date of the judgment, the properties of the Coeur D'Alene Company had been absorbed by the Northern Pacific Railroad Company, which in turn had been reorganized into the Northern Pacific Railway Company. The latter was held liable to Boyd for the amount of the judgment he held. The Court stated that the transfer of the debtor's property without first paying the creditors of the Coeur D'Alene Company was a fraud on the creditors and that creditors had to be compensated in full before a security holder of the debtor corporation could participate in the reorganized company.

For further discussion of the priority problem, see: Case v. Los Angeles Lumber

both in equity reorganization and under the Bankruptcy Act, was rejected by the Securities and Exchange Commission, Commissioner Healy dissenting, in the application of the Holding Company Act to the situation presented in the case of Utility Operators Company and subsidiaries.

The commission was confronted with the priority question in connection with a proposed merger[6] involving Federal Water Service Corporation (hereinafter called "Federal"), Utility Operators Company, the parent of Federal, and Federal Water and Gas Corporation, a wholly-owned subsidiary of Federal. Utility Operators Company is but a holding company.[7] Federal Water and Gas Company never actively engaged in business. Federal owned its outstanding securities, consisting of ten shares of common stock, $100 par.[8] Federal is solely a holding company, having a controlling interest in various subsidiaries rendering utility service in thirteen states. Its outstanding securities consist of debentures, preferred stock, Class A common stock and Class B common stock. Even on the basis of asset values as shown on the books, which the management admits are excessive,[9] Federal has a capital surplus[10] deficit of $3,848,865. In addition there exists an

Products Co., 308 U. S. 106, 60 S. Ct. 1 (1939); Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510, 61 S. Ct. 675 (1941); In re Utilities Power & Light Corp., (D. C. Ill. 1939) 29 F. Supp. 763, appeal dismissed (C. C. A. 7th, 1940) not reported; FINLETTER, BANKRUPTCY REORGANIZATION 417-418 (1939); 2 GERDES, CORPORATE REORGANIZATIONS § 1082 (1936); TRACY, CORPORATE FORECLOSURES § 294 (1929); Swaine, "Reorganization—The Next Step: A Reply to Mr. James N. Rosenberg," 22 COL. L. REV. 121 (1922).

[6] The applicants filed the plan under section 7 of the act. The commission held that the standard "detrimental to the interests of investors" contained in section 7 is not identical with the standard of "fair and equitable," set out in section 11 (e). However, it was stated that the plan must be considered in the light of section 11 (e).

Prior decisions of the commission indicate that the test "detrimental to the interest of investors" involves consideration of the question whether the terms of the proposed plan are within the permissible limits of bargaining indicated by the rights and priorities of the various classes of security holders. Applying this test to the proposed merger, it was held an allocation of new common stock to the A stockholders was proper.

[7] Utility Operators Company owns the entire amount of Federal's Class B common stock, 6,536 shares of the same company's preferred stock, $3,000 of its debentures, and $600 of miscellaneous assets. These are the only assets held by the company. The company is not indebted.

[8] Federal Water and Gas Company is not registered under the act, but being a subsidiary of a registered holding company, it is subject to the act in certain respects.

[9] The proposed plan of merger provides for the scaling down of assets to a figure regarded as reasonable as of the date of merger, and the writing off of certain intangible assets, e.g., "commission on capital stock" and "organization expense."

[10] Under the head of "capital surplus" are variously included such increments of net worth as paid-in surplus, whether paid in at organization or subsequent to organization on the basis of favorable operations, revaluation credits, surplus from donations of

earned surplus[11] deficit of $3,865,070. Under normal conditions the entire voting power of the company resides in the holders of the Class B stock. However, the preferred and Class A stocks, due to dividend arrearages, now carry with them a majority of the voting rights. Class B stockholders still possess 42.73% of the voting power even though the entire book value of the B stock is wiped out due to the large capital deficit.

The primary purposes and reasons for reorganizations in the principal case are as follows: (a) removal of deficits, for during the time they impair the capital represented by stock having a preference on the distribution of assets,[12] the paying of dividends on any class of stock will be illegal under the Delaware law; [13] (b) scaling down of assets; (c) removal of heavy dividend arrearages on the preferred and Class A stocks by issuing new common stock of the reorganized company in turn for a surrender of past dividend rights; (d) compliance with section 11 (b) (2) of the Holding Company Act[14] by simplification of the structure of the holding company system.

stock and property assessments, and gains from the favorable reacquisition or disposition of a company's own stock or obligations. Variations in practice exist as to the inclusion of these unrelated items under the single caption "capital surplus." PATON, ACCOUNTANTS' HANDBOOK, 2d ed., 965 (1936).

[11] " 'Earned Surplus' is the balance of the net profits, net income, and gains of a corporation after deducting losses and after deducting distributions to stockholders and transfers to capital-stock account." PATON, ACCOUNTANTS' HANDBOOK, 2d ed., 966 (1936).

[12] The preferred stock of Federal entitles the holder thereof to an involuntary liquidating value of $100 per share plus accrued dividends, except the $4 series, whose involuntary liquidating value is $62.50 per share plus accrued dividends. Voluntary liquidated value is $110 per share plus accrued dividends for all classes of preferred except the $4 series, which has a voluntary liquidating preference of $68.75 plus accrued and unpaid dividends.

Upon liquidation, Class A stock is entitled, subject to prior rights of the preferred stock, to $50 per share plus accumulated dividends, any remaining assets to be shared equally with Class B stock.

[13] Del. Code (1935), c. 65, § 34.

[14] Section 11 (b) (2) requires the commission to make such orders as are necessary to insure (a) that the corporate structure of each registered holding company and its subsidiaries does not inequitably and unfairly distribute voting power among its security holders, and (b) that its corporate structure does not unduly or unnecessarily complicate the structure of the holding company system.

The commission held that the voting power still retained by the Class B stockholders was clearly unfair and inequitable due to the fact that the capital deficit wipes out in full the book value of the B stock. It further held that Federal's deficits, its inability to pay dividends, and the large arrearages present complexities that clearly violate the act. The commission concluded that, due to the inconsistencies existing between the act and Federal's existing condition, Federal was faced with compulsory simplification under the above section of the act unless it could alter its corporate structure by some other method.

The proposed plan of merger provided for the issuance of new common stock at a par value of $12 per share.[15] The problem of prime significance confronting the commission and of sole importance for the purpose of the present discussion is the proper allocation of this new common stock among the various security holders of Federal. The majority of the commission approved the provision in the plan allocating 5.38% of the new common stock to the present holders of the Class A stock, the remaining 94.62% going to the preferred stock.[16] The question of priorities in reorganization under the Holding Company Act is thus squarely raised, for due to the large deficits on Federal's books there was no book value for the Class A stock.[17]

[15] The commission refused to approve the plan's provision for a new common stock of $12 per share par value. The refusal was based upon future financing difficulties attaching to a $12 par stock, due to the fact that Federal's past business experience and prospective earnings caused the commission to believe, and rightly so, that the stock could not be sold in the market for its par value. This factor no doubt would cause future financing difficulties due to the existence of a Delaware law to the effect that stock may not be sold as fully paid at a price below its par.

[16] The management of Federal purchased a considerable amount of preferred stock, at low prices, during the period in which the reorganization plan was being discussed and formulated. There was no evidence to show that the management acted with malevolent intent or in bad faith. Under the proposed plan, the shares so purchased would share in the plan on a parity with all other preferred stock of the same series. The commission held, however, that such a provision in the plan was detrimental to the interests of investors, unfair, and inequitable. The basis for such a conclusion was that the directors and officers of a corporation are fiduciaries and should not trade in the securities of that corporation during the process of formulation of a plan for reorganization of the company.

Upon refusal to approve the provision in the proposed plan relating to preferred stock so purchased by the management, the commission did not indicate definitely what the treatment in the plan of such stock should be. However, it was suggested that a formula should be devised which would limit the participation of such stock to an amount which takes into account the purchase prices paid, plus the accumulated dividends since the dates of the respective purchases.

The enforcement of the fiduciary obligations of officers and directors in similar fact situations is again stressed by the commission in Matter of Derby Gas & Electric Corp., S. E. C., Holding Company Act Release No. 2875 (July 12, 1941).

[17] The large deficits and the financial condition of Federal in general necessarily led the commission to conclude that the book value of the Class B stock had been wiped out and that said stock had no basis on the facts present to claim an interest in prospective earnings. For like reasons the commission refused to approve a provision in the plan providing for a "staggered board" of directors whereby the Class B stockholders would have a majority representation on the board of directors of the reorganized company for a period of two years. In the words of the commission: "The exaction of retention of control for almost two years . . . cannot be regarded as within the permissible limits of bargaining, because the Class B stockholders have nothing of value to bargain with. Under the circumstances, the proposed continuation of the Class B

Was the commission correct in finding under the statutory formula of "fair and equitable" an equity in the Class A stock, based on prospective earnings, which would entitle it to participate in the reorganized company?

It is conceded that the conclusion of the commission is a justifiable one if the words "fair and equitable" in section 11 (e) of the Holding Company Act call for the application of the doctrine of relative priority. However, should the words "fair and equitable" in section 11 (e) be construed differently than the same words as used in section 77B of the Bankruptcy Act? It is submitted that the answer should be in the negative.

The United States Supreme Court in interpreting the words "fair and equitable" in the Bankruptcy Act has consistently held that such a statutory formula sets up the rule of absolute priority.[18] Undoubtedly the Supreme Court in reaching such a conclusion attempted to determine the particular meaning which Congress attached to these significant words. Prior to the Bankruptcy Act of 1934 the courts had been called up to declare the principle which should govern in the treatment of the various equities in corporate reorganization. The cardinal principle which was enunciated by the Supreme Court was that of absolute priority. At the time of the adoption of the Bankruptcy Act it had become settled law in equity reorganization that the Court would insist on the application of the principle of absolute priority.[19] The language of the Bankruptcy Act did not indicate that Congress intended to supplant the "fixed principle" of the *Boyd* case. Therefore the Court's construction of the words "fair and equitable" in section 77B of the Bankruptcy Act appears to be a most reasonable one.[20]

stock's control of the board is both detrimental to the interest of the senior investors and results in an unfair and inequitable distribution of voting power."

The plan of merger did not provide for an allocation of new common stock to the Class B stockholders of Federal, the plan stating that Class B stock was to be surrendered and cancelled.

[18] Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510, 61 S. Ct. 675 (1941); Case v. Los Angeles Lumber Products Co., 308 U. S. 106, 60 S. Ct. 1 (1939); FINLETTER, BANKRUPTCY REORGANIZATION 417-418 (1939).

[19] Northern Pacific Ry. v. Boyd, 228 U. S. 482, 33 S. Ct. 554 (1913); Rosenberg, "Reorganization—The Next Step," 22 COL. L. REV. 14 (1922); 2 GERDES, CORPORATE REORGANIZATIONS § 1082 (1936); TRACY, CORPORATE FORECLOSURES § 294 (1929).

[20] Section 221 of Chapter X (Corporate Reorganization) of the Chandler Act has incorporated the provisions of 77B. Four other sections in different phases of the Chandler Act use the expression, "fair and equitable"; viz.: section 336 of Chapter XI (Arrangements), section 472 of Chapter XII (Real Property Arrangements by Persons other than Corporations), section 656 of Chapter XIII (Wage Earners' Plans), section 725 of Chapter XV (Railroad Adjustments).

In the case of Securities and Exchange Commission v. United States Realty

Likewise in interpreting the meaning of the standard "fair and equitable" set up in section 11 (b) (2), we should view the picture as it appeared to Congress when those words were made a part of the statute. As we have seen, prior to the enactment of the Holding Company Act of 1935 the words "fair and equitable" had attained a fixed and definite meaning in the field of judicial construction. It surely is not a misstatement to say that Congress and the Congressional committees at the time of the adoption of the Holding Company Act were fully aware of the fixed meaning which had become attached to the words "fair and equitable." Yet there is nothing in the act itself, in the Congressional Record or in the Committee Reports[21] which supports the contention that Congress intended the words "fair and equitable" to be used in any other sense. In fact, a view of the history of the bill[22] which culminated in the legislative enactment of the Holding Company Act indicates the contrary. The words were deliberately used without qualification; their meaning was apparently not contested or questioned in Congressional discussions leading up to the enactment of the Holding Company Act in its present form. Had Congress intended to attribute a new meaning to the words "fair and equitable" it could easily have so stated.

The majority of the commission stated that if it had seen fit to require liquidation, under the powers given it in section 11 (b), the principle of absolute priority would apply. The protection accorded the rights of the various classes of security holders should not be widely varied, in the absence of substantial reasons for so doing, solely because of the particular remedial action taken by the commission under the Holding Company Act. The fact remains that the corporate structure of Federal did conflict with the provisions and purposes of the act.[23] As a result the commission, under section 11 (b), had the power to take corrective action. To deny application of the doctrine of absolute priority, because an order calling for liquidation of Federal was

& Improvement Co., 310 U. S. 434 at 452, 60 S. Ct. 1044 (1940), the Court said: "'Fair and equitable,' taken from § 77B and made the condition of confirmation under both Chapter X or Chapter XI are 'words of art' having a well understood meaning in reorganizations in equitable receiverships and under section 77B which is incorporated in the structure of both Chapters X and XI." The Court added that the plan or arrangement must conform to the rule of the Boyd and Los Angeles cases. The Court made it very clear that the words "fair and equitable" in Chapters X and XI are to be construed in the light of the Boyd case.

[21] S. REP. 621, parts 1 and 2, 74th Cong., 1st sess. (1935); H. REP. 1318, parts 1 and 2, 74th Cong., 1st sess. (1935); H. REP. 1903, 74th Cong., 1st sess. (1935).

[22] S. Bill 2796, 74th Cong., 1st sess. (1935).

[23] See supra, note 14.

not required, is to vary the well established construction of "fair and equitable" without a sound reason.

The presence of imminent liquidation is not the basis of the principle announced in the *Boyd* case and reaffirmed in the *Los Angeles* and *Consolidated Rock* cases.[24] The doctrine of absolute or strict priority is founded on proper recognition of contractual rights.[25] The priority rights inhere in the contractual relationship between the parties involved and should not be made to depend on such extraneous facts as the presence or absence of imminent liquidation.

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[24] While these cases involved corporations insolvent in the bankruptcy sense, the Supreme Court in affirming the doctrine of absolute priority in the Consolidated Rock case stated that the doctrine applied "whether a company is solvent or insolvent in either the equity or bankruptcy sense." Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510 at 527, 61 S. Ct. 675 (1941).

[25] Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510, 61 S. Ct. 675 (1941); Case v. Los Angeles Lumber Products Co., 308 U. S. 106, 60 S. Ct. 1 (1939); Northern Pacific Ry. v. Boyd, 228 U. S. 482, 33 S. Ct. 554 (1913).