ADDRESS

of

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Let me state to you my notion of the basic theories underlying these controls over reorganizations. There is a tremendous public interest involved in holding company systems. It has been estimated that about $10,000,000,000, face amount, of public utility operating and holding company securities are outstanding; and it is estimated that there are about 23,000,000 customers of electricity and gas companies in this country. The interests of both investors and consumers are involved in the reorganization of constituents of a holding company system. The investors' interest is obvious -- to a substantial extent, a holding company system is a group of units organically connected and financially interrelated. The consumer interested in reorganization derives from the fact that efficient service and low rates are, in large part, the results of stable, conservative capitalization and able, effective management. Both of these factors are directly affected by reorganization.

Without adequate regulation of reorganizations, therefore, the scheme for control of holding company systems embraced in the Act would be vitally deficient. And of this control scheme, a right to be heard concerning appointment of trustees or receivers; a veto power on plans plus the privilege to propose plans; and regulatory jurisdiction over protective committees and solicitation practices, are all important parts.

Some of you are undoubtedly familiar with the Commission's position on trustees in 77B proceedings. As I understand it, the Commission believes that in every large estate, an independent trustee should be appointed. A trustee who is independent of affiliation with the management or any other interest in the company can provide the sort of reappraisal of the company's management and its operating and financial policies which is highly important to its successful reorganization. He can exercise an objective scrutiny over claims, and he is in a position to ascertain and prosecute causes of action which will benefit the estate, without regard to the persons against whom such causes of action exist. In addition, he can perform the great service of formulating and assisting others to formulate beneficial plans of reorganization, freed from the influence of and suspicion sometimes generated by personal interest. As I have stated, however, this philosophy is not wholly embodied in the Holding Company Act. That Act merely allows the Commission to be heard on the qualifications of the person to be appointed trustee; it does not require the court to appoint a trustee.

Nevertheless, in one major reorganization under the Holding Company Act, the Commission successfully urged that a trustee be appointed for a company in 77B proceedings. In the 77B proceedings of Utilities Power and Light Corporation, in the Northern District of Illinois, an order had been entered continuing the debtor in possession. This order was entered at the time the company filed its petition in 77B.

The facts were such as to lead the Commission to believe that it was particularly necessary in this case that an independent trustee be appointed. Utilities Power and Light Corporation is a registered holding company with electric, gas and various non-utility subsidiaries scattered over this country and Canada. The system had been built up by Harley Clarke. Mr. Clarke had been virtually eliminated from the company shortly before institution of the 77B proceedings. Nevertheless, he still asserted an interest.

acceptance of a plan until it has been approved and transmitted to creditors and stockholders, and unless the specific consent of the court has been obtained prior to the solicitation. The Act also requires that disclosure be made concerning the interests of any person or committee who appears in the proceedings representing more than twelve creditors and stockholders; and there is an exceedingly important provision requiring the disclosure of lists of security holders upon direction of the court.

It is my belief that these controls over solicitation practices are not in themselves adequate to assure honesty and democracy in the reorganization process, although they are a great advance over the practice which has heretofore prevailed. As I have mentioned, provisions in the Holding Company Act and in rules adopted pursuant to the Act provide additional controls over solicitation in respect of the reorganization of a registered holding company or any of its subsidiaries.

I have already indicated my view that controls over reorganization plans are only partially effective if they are not coupled with comprehensive regulation of protective committees and solicitation practices. For example, students of reorganizations have often pointed out that under the old procedure, the equity court had no real choice but to approve the reorganization plan agreed upon by the dominant protective committees. Customarily, these committees had on deposit with them a majority of the securities affected by the reorganization. Disapproval of a plan proposed by the committees did not reinfranchise the security holders. It merely required the various committees to renegotiate and rebargain, and the results of such renegotiation were not likely to be radically different from the plan originally submitted to the court. In addition, and perhaps more fundamentally, the practice of soliciting deposits or proxies which constituted a blanket power of attorney to the protective committee was a violation of basic notions of decency and fairness in a democratic society. In effect, it was a mock plebiscite at which the constituents of the protective committees had only one alternative -- to vote Ja.

The rules of the Securities and Exchange Commission, pursuant to the authority of the statute, are designed to accomplish the following things, generally speaking: To prevent solicitation of consents to reorganization plans which are not yet in being -- that is to say, to prevent protective committees or others from soliciting blanket powers of attorney to draft unspecified kinds of reorganization plans and to cast the vote of security holders for unspecified and undefined plans, selected at the absolute discretion of the committee; to prevent solicitation of consents to any plan unless such solicitation is accompanied by an analysis of the plan by the Commission; to prevent protective committees or others from obtaining deposit of securities unless it can be demonstrated that deposit is necessary for purposes which cannot adequately be served by proxies; and to permit solicitation in any event only after disclosure has been made of the interests and affiliations of the persons who are soliciting or are causing the solicitation to be made.

On the other hand, we have recognized the practical desirability of permitting a group of interested persons to act in the role of financial and legal representatives of security holders in connection with the negotiation of reorganization plans and to appear before governmental bodies in respect

The company's 77B proceedings were precipitated by its inability to meet the maturity of its debentures and certain short-term loans. A plan of reorganization was formulated by various interests in the company and filed with the Securities and Exchange Commission. I shall not trouble you with the details of this plan. Suffice it to say that the $733,000 of 1st Lien Bonds were to be undisturbed; the remainder of the new capital structure was to consist entirely of common stock. To the debenture holders and general creditors, common stock was to be issued; and common stock was also to be issued in exchange for the secured notes. The plan also provided for alloting to the old common and preferred stock an aggregate of 739 shares of new common.

The Commission disapproved the plan for a variety of reasons. I think it will illustrate the Commission's operations in connection with reorganization plans, if I briefly recapitulate some of these reasons, with as little detail as possible. I shall not even mention all of the factors which led to disapproval. In the first place, the Commission pointed out that Genesee's income was largely derived from one subsidiary, Pavilion Natural Gas Company. Pavilion had transferred $196,000 from its depreciation reserve to its earned surplus account, where it was available for the payment of dividends to Genesee. This transfer had been made without the approval of the New York State Commission and, accordingly, violated the uniform system of accounts prescribed by that Commission. The Securities and Exchange Commission concluded that if the New York State Commission reversed this transfer or required the company to restore the amount transferred out of earnings, Genesee would be in a position where it could not meet its interest requirements on its lien bonds. This factor introduced an element of doubt with regard to the earnings of Genesee and its financial condition so serious as to make it impossible to approve the plan.

The Commission further concluded that there was no value in the company for the stock either on an assets or earnings basis. The Commission did not go so far as to hold that allocation of the small interest contemplated by the plan to this stock would of itself vitiate the plan; such was unnecessary to its decision in the matter. It pointed out, however, that in the particular circumstances, the stock alloted to the old stockholders was sufficient to vest the old management group with voting control. This factor, coupled with the lack of any equity for this stock, prevented a finding that the plan was fair.

The Commission's opinion did not rest with the refusal to approve the plan which had been filed with it. It proceeded to make further suggestions with respect to a new plan. The first suggestion was that Genesee and the holding company on top of it should be dissolved or liquidated. The next was that the New York State operating companies of Genesee should be merged or consolidated into a single operating company. The last suggestion related to the creation of a sound structure for the reorganized company.

I think that a careful study of this opinion will disclose a great deal concerning the Commission's technique in dealing with reorganization plans under the Holding Company Act. Let me summarize the Commission's approach, as I understand it: In order to test the fairness of a reorganization plan,

it is first necessary to arrive at an estimate of value of the property. The primary factor in arriving at this estimate is a capitalization of "reasonable prospective earnings". This "value" is then to be divided among the various classes of security holders and claimants in the order of their priority. Each class must obtain a "completely compensatory" allotment of securities in the reorganized company before any participation can be allowed to a junior class.

Some people have called this the logical or mathematical theory of reorganization. I think it can better be referred to as the constitutional theory. It is based upon a regard for the rights embodied in contracts. It insists that to each shall be accorded participation in a reorganization plan in accordance with his legal claim.

You will note that the basis of this theory is a determination of value. It is at this point that the mathematical character of the theory which I have described becomes lost. Value cannot be determined simply by the application of mathematical formulae. On the other hand, it is not simply a matter of guess work, as some people would like to have us believe. There are certain fairly definite financial standards to be applied in order to ascertain the value of a property. As I have said, I believe that the important criterion for reorganization purposes is earnings. So far as investors are concerned, a property is not worth more than it can earn.

But even a determination of earnings is not easy, particularly in respect of a holding company. All that glitters is not gold; and all that appears on the books of a company as earnings cannot always be confidently accepted as such. In addition, there is ever present the problem of determining which earnings figures to take as the basis for a determination of value. Figures for the last available twelve months may not give a dependable answer; nor can one always accept an average of the earnings of several years as the appropriate figure. Reorganizers, and particularly those who are interested in the equity, are always confident that better times lie ahead. It is curious that regardless of their pessimism about the state of the Nation for other purposes, they are always optimistic about the value of their business for reorganization purposes.

I think that it is only fair to permit a moderate amount of optimism to influence judgments as to earnings for this purpose. That is to say, reasonably prospective earnings are the criterion; and in my experience, reasonably prospective earnings are always established at a higher rate than the past record of the company would indicate. But here again, there is not unlimited latitude. "Reasonably prospective earnings" does not mean unreasonably possible earnings, although if you look at the forecasts of earnings supplied by a company in a reorganization, you will believe that the two things are synonymous.

In the case of a public utility operating company, subject to the control of a State commission, another perplexing factor enters into the determination of earnings as a basis for valuation. Let us assume that an appraisal of the physical properties of a company indicates that it is earning 10% upon the figure which should properly be allowed as its rate base. The State commission has not caught up with the company, and there are no proceedings pending to require a reduction of the company's rights. The question which this state of facts obviously presents is whether earnings, of themselves, furnish a reliable basis for valuation. You can