1972

Corporate Reorganization Doctrine As Recently Applied by the Securities and Exchange Commission

Walter J. Blum

Corporate Reorganization Doctrine As Recently Applied by the Securities and Exchange Commission

Walter J. Blum†

Recent advisory reports of the Securities and Exchange Commission on proposed plans of reorganization under Chapter X of the Bankruptcy Act[1]—in *Yale Express System*,[2] in *Four Seasons Nursing Centers*,[3] and in *Imperial "400" National*[4]—afford a good opportunity to review some applications of corporate reorganization doctrine that are becoming embedded in public pronouncements of the Commission. The treatment of four issues deserves comment.

I

What significance is to be accorded an anticipated lag in projected "normal" earnings for purposes of placing a value on an enterprise in reorganization?

It is common in reorganizations under Chapter X to assume that the predicted "normal" (or "most probable") level of annual earnings will not be reached for several years. The enterprise undergoing a financial recasting has experienced difficulties that have presumably contributed to its financial distress; and, although the reorganization trustee may have turned its business affairs in a more promising direction, the full benefits of the changes cannot be expected immediately. Moreover, officials presiding over reorganizations tend to be optimistic that future performance will outdistance that achieved while the firm is under the wraps of a court proceeding linked with bankruptcy. Their optimism may occasionally be traceable to nothing more than a disposition to be gentle with junior or marginal classes of investors. Often, however, there is some substance to the notion that firms in reorganization have a competitive disadvantage in such mat-

† Professor of Law, The University of Chicago.

1 11 U.S.C. §§ 116 *et seq.* (1970).

2 Yale Express Sys., Inc., SEC Corporate Reorganization Release No. 309 (Jan. 14, 1972) (preliminary printing) [hereinafter cited as Yale Express Release].

3 Four Seasons Nursing Centers, Inc., SEC Corporate Reorganization Release No. 310 (Mar. 16, 1972) (preliminary printing) [hereinafter cited as Four Seasons Release].

4 Imperial "400" Nat'l, Inc., SEC Corporate Reorganization Release No. 312 (July 12, 1972) (preliminary printing) [hereinafter cited as Imperial "400" Release].

ters as dealing with suppliers, hiring executives, lining up repeat customers, and arranging for participation in long term projects. Any impetus to see a brighter future is apt to be even stronger when, as is frequently the case, a reorganization takes place during a period of depression for the economy in general or the industry in particular.[5]

One would logically expect that any forecasted earnings lag is to be taken into account in valuing the enterprise. If it is proper in a reorganization to derive value by capitalizing predicted "normal" annual earnings in perpetuity, it stands to reason that the resulting total should be reduced to allow for the projected interval of "subnormal" earnings.

Adjustment to reflect the earnings gap anticipated for the reorganized firm's initial years may have a significant effect on overall valuation. In *Yale Express System*, the SEC predicted a normal annual net income before interest and after taxes—this being the income figure to be capitalized in perpetuity—of $770,000; it expected the firm to reach that earnings level by the third full year following the valuation date. For the intervening two years the Commission predicted earnings of $486,000 and $625,000, or shortfalls from normal earnings of $283,000 and $155,000 respectively.[6] These shortfalls must, of course, be discounted to obtain their present (negative) values.[7] If they had been discounted by 7.7 percent, the overall capitalization rate used by the SEC in putting a $10,010,000 present value on anticipated normal earnings of the enterprise, the total value of the firm would have been reduced by about $400,000.[8]

The SEC, apparently recognizing this challenge to its valuation process, attempted to defend its failure to take the expected weak start after reorganization into account in calculating the present value of the firm:

> This is not to say that earnings of the reorganized company may

5 *See* Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565 (1950).

6 Yale Express Release, *supra* note 2, at 14–15.

7 "Discount is the reflection of the fact that a claim to a dollar at a future time is worth less than a dollar in hand today because of one or both of two factors: (1) In the interval, the 'future dollar' is not earning interest for its owner. Interest in this sense refers to the 'pure' rate of interest, meaning interest on a riskless investment for the time involved. (2) There may be some risk that the 'future dollar' will not be paid in full when the time for payment arrives. The compensation for this risk can be viewed as interest over and above the 'pure' rate of interest." W. BLUM & S. KAPLAN, MATERIALS ON REORGANIZATION, RECAPITALIZATION AND INSOLVENCY 336 (1969).

8 To reach this value the SEC multiplied estimated normal annual earnings by thirteen. The equivalent operation is to capitalize those earnings by the reciprocal of thirteen, which is about 7.7 percent (100 ÷ 13).

> not exceed [the third year] forecast, and in a given year, before or after [the third year], earnings may be more or less than presently forecast. Future earnings of the reorganized company, like those of any other business enterprise, will be subject to short-term and cyclical fluctuations, and our . . . projections [for the third year] represent only an estimated level of earnings on which to construct an approximate value for [the debtor] in light of such factors as may now be reasonably foreseen. That is all that Chapter X requires and all that humanly can be done.[9]

This explanation is not good enough. Consider a situation in which earnings immediately after reorganization are forecast to be substantially higher than a projected normal level, due to some temporary condition. The SEC confronted such an outlook nearly thirty years ago in *Philadelphia & W. Ry. Co.*[10] The company, then in reorganization, was expected to enjoy a few years of extraordinarily high earnings as a result of factors tied to the war economy. In discussing how much debt was proper for the capital structure of the firm, the Commission took a strong stand against permitting these projected "excess" earnings to be capitalized in perpetuity. It did not dodge behind the excuse that the predicted near-term excess might be balanced by uncertainties as to later earnings. An equally discriminating approach should prevail in dealing with an expected initial shortfall in predicted normal earnings.

II

In selecting a rate for capitalizing forecast annual earnings of a firm undergoing reorganization, what use is to be made of price-earnings data concerning other companies in the same industry?

If valuation of an enterprise in reorganization is to be based on estimated future earnings, it is important to choose a proper multiplier (or capitalization rate) by which to calculate their present capital value. This is a slippery matter. The most useful information would seem to be the multipliers that the securities market has in fact been registering for other enterprises conducting more or less the same range of operations. Of course, no two enterprises are exactly alike, and there is the undeniable difference that the firms offered for comparison are not in reorganization. Nevertheless, despite the lack of even near comparability among the enterprises, great attention should be paid to this market data, if only because better guidelines are seldom available.

To a considerable extent the individual differences among the re-

9 Yale Express Release, *supra* note 2, at 15.

10 13 S.E.C. 330 (1943).

porting firms might be homogenized by averaging over several years the price-earnings multiples reflected in the reported data. Such averages provide a single point of reference, or a range, for pricing the projected earnings of the enterprise in reorganization. The SEC has sanctioned this technique in numerous reorganizations under Chapter X.[11] The technique is, however, vulnerable to a major potential source of error. From the market data for the "comparable" firms it is possible to establish the ratios that prevailed between *reported current earnings* and actual securities prices for a particular reporting period. But these figures do not disclose the multiple that investors during that time put upon *expected future earnings*—the very information sought as a guideline for valuing the estimated earnings of the enterprise in reorganization. There is no way that information can be derived from the market data alone.

The significance of this shortcoming in relying on reported times-earnings figures depends upon the nature of the industry in which the firms operate. If the industry is one in which earnings have been steady or cyclical but flat, it is generally reasonable to assume that the market multiplier for current earnings does not vary substantially from the multiplier investors are using in pricing foreseeable earnings. Any disparity between the two multipliers will likely wash out if the data for several years are lumped together. If, however, the industry is one in which earnings have grown rapidly or are expected by the investment community to grow rapidly, market values will to a greater—and unknowable—extent reflect the prices investors put on anticipated future earnings rather than the prices they put on actual current earnings. The recorded times-earnings data in such an industry will therefore be grossly misleading as a guide to pricing expected future earnings for a firm in reorganization.

These considerations were clearly pertinent to capitalizing projected earnings in *Four Seasons Nursing Centers*. Investors had regarded the nursing home industry as one with enormous growth prospects. In early 1969, three years before the date of the SEC advisory report in *Four Seasons*, prices on nursing home common stocks ranged from a low of fifty-seven to a high of 700 times actual annual earnings. By late 1971, six months before the report, investors' enthusiasm had cooled somewhat; nonetheless, price-earnings ratios ranged from thirteen to ninety-three.[12] It would obviously have been absurd to capitalize projected earnings for Four Seasons by using these ranges as a guideline.

[11] *See, e.g.*, Yuba Consol. Indus., Inc., SEC Corporate Reorganization Release No. 229 (May 3, 1965).

[12] Four Seasons Release, *supra* note 3, at 32.

Both the reorganization trustee and the SEC recognized this; each ignored the market data and instead used multiples of between eleven and twelve times estimated earnings.

Although this conclusion cannot be faulted, the Commission's discussion of its reasoning leaves much to be desired. It is contained entirely in the following passage:

> The 1969 prices certainly did not reflect genuine investment values; they are symptoms of a dazzling euphoria that had gripped the market. The 1971 prices . . . are evidence of a return to some realism, although a skeptic might still discern some elements of a lingering afterglow. In any event, the 1971 price-earnings ratios for the 11 [other] companies are higher than what the trustee would accept for Four Seasons.[13]

The weakness in this rhetoric is that it bases rejection of reported price-earnings ratios on a judgment that market prices "did not reflect genuine investment values." How can the Commission possibly come by such knowledge? To presume to have it is naive. The fact is that the performance of many high-multiple stocks has borne out extreme investor optimism because there continued to be a basis for expected large improvements in earnings, and it is safe to predict that the performance of many others will do so in years to come.

The point to be made is basic. Doubt about "genuine investment values"—whatever that term may mean—should not be the test for slighting the historical data on price-earnings ratios for comparable firms. The proper reason for giving these ratios little weight is that the industry has experienced rapid earnings changes or there is evidence that the investment community expects it to do so. This is the correct position in a reorganization proceeding whether or not the judgments of investors seem to have been sound at the time and whether or not they were later vindicated.

While eye-catching price-earnings records may often be grossly misleading, it would be imprudent to ignore them altogether. A high ratio between share prices and actual earnings in an industry does signify that investors believe that the industry has great potential for earnings growth. Where this condition exists, there is need to determine its bearing on capitalizing the earnings estimated for a firm that is in the growth industry but that is undergoing reorganization.

The SEC addressed this matter in *Imperial "400" National*. The advisory report summarized the industry data in this way:

> Average multiples for [a selected group in the industry] ranged

---

13 Four Seasons Release, *supra* note 3, at 33.

> [during the first part of the current year and the two immediately past years] from a low of 22 to a high of 38, and most of the individual multiples also fell between these limits . . . . [T]he motel industry has been an investment favorite in recent years. It still is. The high rates at which motel earnings have been capitalized in recent years rest on the premise that this is a growth industry. For present purposes we accept that premise.[14]

Moving from the general to the particular, the Commission concluded: "We think that once Imperial emerges from these proceedings new management could obtain for the company some share of the growth that the market anticipates for the industry as a whole. Taking account of this factor but recognizing Imperial's static recent history, we consider a multiple of 22 realistic."[15]

This approach is unnecessarily obscure. A high multiple would be appropriate for pricing the earnings estimated for the firm in reorganization only if there is plausible reason to believe that the particular enterprise will enjoy rising earnings over a significant span of years. In the case of *Imperial "400" National,* the record could not support such a prediction. The SEC characterized the firm's financial performance in recent years as "stable."[16] Although the trustee's general manager estimated that net pretax income would increase roughly 12 percent in the then current year, for the next year he projected only a "further 4% growth"[17] in that income. The advisory report does not indicate that any consideration was given to Imperial's earnings potential for any time beyond the full year following the year of reorganization. Under these circumstances, how can it be sound to apply the relatively high multiple of twenty-two in pricing Imperial's estimated earnings on the ground that other firms in the industry have been treated by investors as growth situations?

III

Is it sensible to use multiple rates, as opposed to a single rate, in capitalizing estimated earnings of a firm in reorganization?

In early proceedings under Chapter X, the SEC assumed that to value an enterprise as a perpetuity, the projected normal earnings should be capitalized at a single rate.[18] A perceptive commentator, reflecting on these cases, pointed out that stratifying estimated earnings

14 Imperial "400" Release, *supra* note 4, at 37.

15 *Id.* at 37–38.

16 *Id.* at 32.

17 *Id.*

18 As an example, see Atlas Pipeline Corp., 9 S.E.C. 416 (1941).

into various slices and applying to each a capitalization rate that appropriately reflected the risks associated with it would tend to produce more realistic or defensible results.[19] The slices, he suggested, could arbitrarily be chosen on the basis of earnings allocable to the various classes of securities with which the firm would emerge as a result of the reorganization. Assume, for example, that the recast capital structure is to consist of debentures and common stock, and that interest service on the debentures amounts to one-third of the projected normal earnings. The stratified approach would call for capitalizing the first one-third of estimated earnings at an appropriate rate—presumably the rate of interest carried by the debentures if it approximates the going market rate. The remaining two-thirds, left over for the new common stock, would then be capitalized at a higher rate because it is less certain to be earned and therefore involves greater risk. The commentator concluded that this stratification method would serve to verify the propriety of whatever single average capitalization rate was, in effect, being applied to all of the estimated "normal" earnings. If risks were appropriately reflected, the total enterprise value would be the same whether all projected earnings were capitalized at one average rate or the various strata of those earnings were capitalized at differing rates.[20]

It came as no surprise that in readjustments under the Public Utility Holding Company Act,[21] the SEC strongly embraced the stratification approach. Indeed, some Commission opinions read as if pricing various strata of projected earnings was the only acceptable means for arriving at the total enterprise value and the value of each of its new classes of securities. This development is easily explained. It was necessary to value each class of securities in Holding Company Act proceedings in order to parcel out the new securities among claimants who were being forced to give up their old holdings. Because no class of investors was excluded from the enterprise, however, there was no need to emphasize the overall value being placed on the firm. The Commission nevertheless always seemed to be aware that the stratification approach constituted a more refined way of arriving at a proper single average rate for capitalizing total estimated earnings and thus, in effect, valuing the enterprise.

---

19 Gardner, *The SEC and Valuation Under Chapter X*, 91 U. PA. L. REV. 440 (1943).

20 "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." *Id.* at 464.

21 15 U.S.C. § 79 *et seq.* (1970).

Of present interest is the fact that the SEC has not generally carried this approach over into its analysis of reorganization plans under Chapter X. In both *Yale Express System* and *Four Seasons Nursing Centers*, the reorganization trustee employed a simplified—perhaps an oversimplified—version of it. In each proceeding, the trustee valued the enterprise by capitalizing anticipated earnings after payment of interest on proposed new debt securities and then adding the capitalized amount to the principal sum of the interest-bearing debt. Rejecting this approach in *Yale Express*, the SEC commented: "[W]e are here concerned not with the price-earnings ratio for the common stock equity, but with an appropriate multiple for earnings after taxes and before interest in order to obtain a value for the total capitalization."[22] Later, in *Four Seasons*, the Commission, citing this passage, elaborated only to the extent of saying: "For reorganization purposes, we have found it much more appropriate to determine the overall value of the enterprise by applying a proper single multiplier to earnings after taxes and before interest."[23]

Either this view is sheer nonsense or there is an explanation that is not apparent on the surface. Perhaps a clue to the Commission's strategy can be found in the results for which it contended in the two proceedings after rejecting the trustees' stratification approach. In each case, the Commission thought that the valuation reached by the trustee through application of his approach was too high—meaning that the average earnings multiplier used was too high and, accordingly, that the average capitalization rate was too low. The SEC's position thus seems founded on a belief that the stratification approach is not appropriate in Chapter X reorganizations because it tends to produce overly-generous enterprise valuations.

Is there any foundation for the Commission to reach this conclusion? One possibility is of quite limited reach. Creditors in a bankruptcy reorganization, according to doctrine of long standing, are not entitled to receive cash for the amount of their matured claims. Full compensation does not require that they be given securities that are expected to sell in the spot market at one hundred cents on the dollar. Instead, it is now well settled that they are only entitled to paper having an "intrinsic" or "investment" value equal to its face, or stated, amount.[24] As a consequence, debt securities of firms emerging from bankruptcy reorganization often carry rates of interest too low

22 Yale Express Release, *supra* note 2, at 16.

23 Four Seasons Release, *supra* note 3, at 31.

24 *See* Blum, *Full Priority and Full Compensation in Corporate Reorganizations: A Reappraisal*, 25 U. Chi. L. Rev. 417 (1958).

to price them at or close to par in the immediate future. Sometimes this is explained by saying that junior classes ought not to have their participation reduced by vagaries of the market, especially in light of experience that the market generally does not accord a warm reception to securities of recently reorganized concerns.

Under these circumstances, it would be error to construct a valuation for the whole enterprise by assuming that the segment of value reflected in its debt securities should be treated as worth par. To treat them for this purpose as worth less than par might be awkward, however. Claimants who received these securities could then plausibly assert that an award of a dollar of such new debt for a dollar of their claim could not possibly compensate them in full since the new debt is admittedly being valued at a discount in the reorganization. By adhering to a single average capitalization rate, this awkwardness can be avoided.

Another possible basis for the Commission's position against stratification is more pervasive. For many years there has been a running battle among the experts as to whether the composition of the capital structure of a firm, income tax implications apart, affects the total value of its securities. The disagreement concerns the consequences of including a "reasonable" amount of debt in the capital structure. Many financial analysts have attempted either to demonstrate empirically or through theoretical models or to argue from the psychology of investors that inclusion of a "proper" proportion of debt does enhance the aggregate market value of the complete securities package.[25] Others have countered that this cannot be correct because the risks of the enterprise are independent of the make-up of its capital structure. Some go on to argue that, even if a particular securities mix is most popular at the moment, there is no way to capture the attendant premium for the benefit of all investors in the firm. Their point is that only those investors who buy or sell at the right time could possibly get the benefit of any such premium.[26] While the doubters may seem to have the better of the controversy, most security experts continue to believe that a "wholesome" amount of leverage does augment aggregate market values.

The prevalence of this view may have a bearing on the SEC's posi-

---

25 *See* B. GRAHAM, D. DODD, & S. COTTLE, SECURITY ANALYSIS 539–50 (4th ed. 1962); D. Durand, Costs of Debt and Equity Funds for Business: Trends and Problems of Measurement 215 (Conference on Research in Business Finance, National Bureau of Economic Research, 1952).

26 The best (and classic) statement of the position is found in Modigliani & Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment: Reply*, 49 AM. ECON. REV. 655 (1959).

tion against using the stratified earnings approach to valuing an enterprise in reorganization. In both *Yale Express System* and *Four Seasons Nursing Centers,* the trustee's stratification took the form of finding a proper multiple for projected residual earnings available to the proposed new equity in the firm. In both, a comparison was made with reported market data for comparable companies. This data is confined to price-earning ratios for the equity component; in fact, the usual reports for companies do not reveal ratios between market prices of all their securities, including debt issues, and their total earnings, including interest on that debt. Any market bias in favor of leverage is, of course, likely to be reflected in the price-earnings figures for common stocks. It is possible that the Commission was concerned with preventing that bias, if it exists, from becoming still another factor contributing to overly liberal valuations in reorganizations. The Commission may be attempting to neutralize this possibility by insisting that in bankruptcy reorganizations the use of a single capitalization rate is "much more appropriate."

At one point in the *Imperial "400" National* report it seems that the Commission was about to explain its opposition to use of a stratified earnings approach under Chapter X. The Commission remarked that:

> [W]e have historically avoided the segmented income approach to valuation in reorganization cases, and sought a value for the enterprise as a whole, before interest. This preference is based on the fact that generally the debt structure is adjusted in a Chapter X reorganization. Hence what must be determined first is the value of the enterprise, upon which the pro forma debt and equity structure is necessarily premised.[27]

In short, the Commission seems to contend that the use of a stratified earnings approach to valuation is incompatible with adjusting a firm's debt structure in reorganization.

But this position is so lacking in logic that one must look more closely at the context in which it was announced. The Commission was analyzing what the trustee's financial expert did in valuing Imperial "400". It noted that "[h]e divided the projected 1972 after-tax income into two segments which he capitalized at different rates to reach an enterprise valuation . . . ."[28] The first layer consisted of the actual annual interest expense associated with the company's mortgage debt, none of which was to be affected by any of the proposed plans of reorganization. Although the actual interest rate on the mortgage debt

---

[27] Imperial "400" Release, *supra* note 4, at 34.

[28] *Id.* at 33.

was only 6.8 percent, the trustee's consultant suggested capitalizing this layer at 8 percent, that "rate [being] based on what Imperial would have to pay for new mortgage money."[29] Such an approach would have resulted in treating some $8,000,000 face amount of mortgage debt as reflecting a first layer value of about $6,600,000. The SEC rejected the suggestion as "an unnecessary refinement,"[30] commenting that "it is appropriate and convenient to focus on income after interest"—apparently because "the debtor is in an industry in which such debt is part of the normal capital structure"[31] and "Imperial's present mortgage debt is a fact and its service is fully provided for."[32] The Commission then concluded this part of the discussion by observing: "The fact that [the debt] terms are relatively favorable cannot reduce the value of the equity in the enterprise."[33]

It is puzzling to find the Commission arguing that the continued availability to a firm of relatively low cost debt cannot *reduce* the value of the equity interest. All other things being the same, the value of the equity in a viable enterprise must increase if funds can somehow be borrowed at a bargain rate. In one way or another the value of such a bargain is value captured for the benefit of the shareholders. The value of the relatively low cost mortgage debt in Imperial "400" surely increased the value of interests junior to that debt. In contending that this low cost cannot *reduce* the value of the equity, the Commission obviously had something else in mind. One can infer that it was concerned about a result that might seem to follow from pricing the first layer of projected earnings at the market, instead of the actual, interest rate for the mortgage debt. If the first layer of earnings is priced too low, it might be thought that the total value placed on the enterprise will be too low by the same amount. And, since the actual mortgage debt is given and fixed, it might be thought that the value of the remaining interests in the firm will also be reduced by that amount.

This reasoning would, however, be erroneous. The existence of a bargain interest rate on the mortgage debt neither increases nor decreases the value of the enterprise. Pricing the first layer of estimated earnings relatively low by applying the market rate of interest must be balanced by pricing the second layer correspondingly higher. The stratified earnings approach to enterprise valuation is thus equally

29 *Id.*

30 *Id.* at 34.

31 *Id.*

32 *Id.*

33 *Id.*

workable whether or not existing debt arrangements survive a reorganization proceeding or are modified in the process.

The Commission's explanation in *Imperial "400" National* of why it frowns upon the stratification approach in bankruptcy reorganizations tells us nothing other than that the Commission may be somewhat confused or that it does not wish to reveal its whole hand.

IV

A last question about reorganization doctrine, arising from material in the *Yale Express System* advisory report, goes not to valuation of the enterprise but to ascertaining whether a creditor has been compensated in full. Reorganization plans often call for an existing creditor class to share a new common stock issue with the old shareholders of the company. The new common shares are a less protected investment than the old debt security, in the sense that the debt carried a priority claim to earnings and liquidation distributions. Does this fact, standing alone, indicate that the existing creditors are being undercompensated if they receive only a dollar of new common shares, measured in terms of the enterprise's reorganization value, for each dollar of their old creditor claim? In other words, are they entitled to more than merely an even exchange?

While the proper answer to this question should not be in doubt, the SEC unfortunately seems to have muddied the waters. In 1941 the Supreme Court, in *Consolidated Rock Products,*[34] set the stage by using language that has become the touchstone of the full compensation doctrine:

> [W]hile creditors may be given inferior grades of securities, their "superior rights" must be recognized. Clearly, those prior rights are not recognized, in cases where stockholders are participating in the plan, if creditors are given only a face amount of inferior securities equal to the face amount of their claims. They must receive, in addition, compensation for the senior rights which they are to surrender.[35]

The Court went on to say that "whether in case of a solvent company the creditors should be made whole for a change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on the facts and requirements of each case."[36]

[34] Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 510 (1941).
[35] *Id.* at 528–29.
[36] *Id.* at 529.

This language was generally read as meaning that one way to deal with a reduction of quality was to compensate the creditor quantitatively. In *Deep Rock Oil*[37] the Commission, anticipating that understanding, took the position that fairness was served by awarding the old noteholders new common stock valued at about 10 percent over the amount of their claim remaining unsatisfied after distribution of new debt securities and cash. It thought this "bonus" was proper "even accepting the appraised value"[38] on which the plan of reorganization was predicated. The circuit court, using similar language, approved of a bonus about half as large as that which the Commission had endorsed.[39]

The Commission later had to deal with comparable situations in proceedings under the Public Utility Holding Company Act. It responded, however, in an entirely different manner. In essence, it took the position that a dollar of new common stock value is the investment equivalent of a dollar of old debt value or old preferred stock value, provided only that all differences in the quality of earnings—meaning the relative risks—associated with the old and new securities have been reflected adequately in valuing the respective security issues. "Thus," as the Commission observed in the *American & Foreign Power Co.* proceedings, "when the various segments of earnings applicable to the existing securities and the securities to be offered in exchange are capitalized at appropriate rates, comparative values are obtained in terms of a common denominator."[40] Where equivalence is found through this approach, there could be no occasion for a quantitative "bonus."

On first impression, this sharp divergence in handling the full compensation problem may seem justified by an important difference between the standards of fairness that govern the reshaping of corporate capital structures under the two statutes. While preserving investment values is appropriate under the Public Utility Holding Company Act,[41] reorganization under Chapter X is regarded as a substitute for liquidation.[42] This difference, however, concerns only measurement of the claims assertable in the proceedings. According to accepted principles, claims in Holding Company Act reorganizations are to be measured in terms of their investment value in an on-going enterprise; in

37 Deep Rock Oil Corp., 7 S.E.C. 174 (1940).

38 *Id.* at 194.

39 Standard Gas & Elec. Co. v. Deep Rock Oil Corp., 117 F.2d 615 (10th Cir. 1941).

40 American & Foreign Power Co., 27 S.E.C. 1, n.57 (1947).

41 Otis & Co. v. SEC, 323 U.S. 624 (1945); SEC v. Central-Illinois Sec. Corp., 338 U.S. 96 (1949).

42 Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939).

Chapter X reorganizations they are to be measured in terms of matured liquidation priorities. Neither principle pertains to deciding whether a claim, computed in accordance with the proper principle, is being compensated in full—which is the facet of reorganization doctrine now being scrutinized. Once claims have been measured correctly, the concept of full compensation need not be varied: whether an exchange of securities occurs under Chapter X or other auspices, a dollar of one type of security can be equated with a dollar of another type on the basis of a realistic assessment of the quality of earnings associated with each.

A more accurate statement is that, generally, different kinds of securities can be equated satisfactorily only on this basis. The notion that creditors who receive common stock in a reorganization are entitled to a quantitative "bonus" is inherently unsound because it fails to take account of the quality of the new common stock. The flaw in this notion becomes clearer when one recognizes that the proper rate for capitalizing projected earnings associated with the new common must depend on the position the common occupies in the capital structure of the enterprise. All other things being equal, if the firm under consideration is to have no debt outstanding, projected common stock earnings surely should attract a higher multiple than they would if the firm were to have a relatively heavy debt ahead of the common.

In *Yale Express System* the proposed plan of reorganization called for the old debenture holders and other unsecured creditors to get, for each dollar of their claim, ten cents in face amount of a new secured debt obligation and ninety cents in new common stock, valued on the basis of the valuation placed on the whole enterprise. The Commission approved this arrangement, but recommended lowering the value of the new common stock slightly, in line with its suggested smaller valuation of the firm. In its words: "Although these creditors are reduced to what is almost entirely an equity position, they are offered two compensating advantages. For 10% of their claims they will receive another debt obligation for a like amount but well secured by a lien. In addition these unsecured creditors as a class will have voting control of the reorganized enterprise.[43]

There is a troublesome negative implication in this language that the plan might have been unfair if the creditors did not end up with voting control. If control had not been so shifted, the old, fundamental question would have recurred: How does one ascertain whether a

[43] Yale Express Release, *supra* note 2, at 24.

dollar of the new common stock is the equivalent of a creditor claim of a dollar?

The answer must stem from the valuation placed on the entire enterprise. If that valuation is approved, then, logically, the value attributed to the new common stock—computed by deducting the principal or par amount of all higher ranking securities from the total enterprise value—must also be accepted as correct. Doubt about the value of the common necessarily translates into doubt about the valuation of the firm itself. The very acknowledgment of need for a quantitative "bonus" to creditors receiving the common is an admission that the firm has been overvalued. In reorganization proceedings the "correct" valuation of the enterprise should be sought. An oblique modification of that valuation by way of a "bonus" or any other device should not be condoned. The integrity of the valuation process—a process vital to the whole concept of reorganization—is already subject to enough frontal pressures.

These observations reinforce the importance of weighing carefully all the relevant factors in capitalizing projected earnings. They underscore the usefulness of double checking the selection of any single capitalization rate by considering what rates would be appropriate for the various strata of projected earnings associated with the various classes of securities that, under the plan, will emerge from reorganization. When attention is focused on the multiple of projected earnings assigned to the new common shares, there is apt to be more confidence that a dollar of such stock has a long term or an investment value of a dollar.

The main thrust of this review of four aspects of reorganization doctrine as applied in the *Yale Express System*, the *Four Seasons Nursing Centers*, and the *Imperial "400" National* advisory reports can be overgeneralized to make a simple point. The SEC would serve better in this area if it explained its principles in greater depth and if it strived to reach greater consistency in its analysis of financial relationships.