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Recommended Citation

Walter J. Blum, "Corporate Reorganizations Based on Cash Flow Valuations," 38 University of Chicago Law Review 173 (1970).

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Corporate Reorganizations Based on Cash Flow Valuations

Walter J. Blum†

In its Advisory Report[1] on the Trustee's proposed plan for reorganizing the Jade Oil and Gas Co. under Chapter X of the Bankruptcy Act, the Securities and Exchange Commission for the first time in over a decade discussed and applied a projected cash flow method of arriving at value for reorganization purposes. Because the proceedings involved a somewhat unusual situation, the analysis put forward by the Commission perhaps should not be scrutinized too closely. But inasmuch as cash flow valuation has been gaining in acceptance under a variety of circumstances,[2] the case may come to be treated as an important development in official doctrine. That possibility prompts a few observations about the Report.

Only a relatively brief background sketch of the circumstances in *Jade* is needed. The company, small and independent, was engaged in exploring for oil and gas, largely in high risk ventures. It had not been successful and had run up a history of heavy economic losses. The company eventually got into financial difficulty, defaulting on a relatively large bank loan. During its financial troubles, new common shares were issued to certain individuals in exchange for property and to creditors who were willing to convert their claims into equity interests. Some of these new shares were resold to the public under conditions that constituted an unregistered public offering by Jade in violation of the Securities Act of 1933. The SEC brought an action seeking to enjoin Jade and others from engaging in this conduct again, and the

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1 *In re* Jade Oil & Gas Co., Great Lakes Gas Corp., SEC Corporate Reorganization Release No. 289 (Sept. 15, 1969) [hereinafter cited as Jade Release]. On January 26, 1970 the district judge approved the Trustee's proposed plan of reorganization, amended slightly but not in ways germane to the discussion in this article. An order determining that the amended plan had been accepted by the requisite number of creditors and stockholders was entered on April 15. As of October 1, the hearing on confirmation had not been concluded, having been continued for processing through the Securities and Exchange Commission the registration statement covering preferred stock to be issued under the approved plan.

2 *See* Blum & Katz, *Depreciation and Enterprise Valuation*, 32 U. CHI. L. REV. 236 (1965).

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company consented to the entry of a decree which, among other things, provided that it would file a voluntary petition for reorganization under Chapter X. After such a petition had been filed, an independent Trustee was appointed by the court, and he submitted a plan of reorganization.

The question of enterprise value was, as usual, of central importance in passing upon the fairness of the reorganization plan. Valuation would determine which classes of claimants or investors could participate in the reorganized company, as well as the extent of that participation.[3] In general, omitting some factors not important for purposes of this discussion, three such classes conceivably could be affected by resolution of the valuation issue in *Jade*: secured creditors holding claims in the amount of $4,100,000; unsecured creditors holding claims in the amount of $4,200,000 (the largest being the bank loan in default); and common shareholders. Related to the treatment of these classes was the fact that an outside group—apparently the main force behind the Trustee's plan—offered to put up $2,500,000 of new money in return for a comparatively large preferred equity position.

This reorganization proposal was predicated on an overall valuation of $21 million to $23 million. For liquidation purposes, in sharp contrast, the Trustee valued Jade at only $7.8 million. Liabilities totalled about $9.6 million.

The Trustee arrived at reorganization value by projecting a cash flow pattern and capitalizing the anticipated annual flow at 3%, which is equivalent to valuing the firm at 33⅓ times the projected annual cash flow. The SEC objected, asserting that the Trustee's estimate of cash flow was too optimistic and that the capitalization rate he adopted was not conservative enough. It did agree, however, that valuation should be based on cash flow rather than on "probable 'earnings' computed in accordance with generally accepted accounting principles."[4] In doing so, it noted that "small, independent, exploratory oil companies are often valued"[5] on such a cash flow basis because in their circumstances it is difficult to develop the traditional concept of "probable earnings." This difficulty, said the Commission, arises because "small oil companies do not necessarily behave in a conventional profit-maximizing way."[6] Their success depends on "substantial discoveries rather than . . . normal, steady growth," and therefore "a vigorous ex-

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

4 Jade Release at 10.

5 *Id.*

6 *Id.*

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ploration program," giving rise to high deductions for discovery and development costs in computing net income, "may be regarded as more important than net income."[7]

Under the Trustee's plan—again in general—the secured creditors other than the bank would be paid immediately; a substantial part of the bank's claim would likewise be paid immediately, and the balance of about $3 million would be paid over an eight to ten year period; the unsecured creditors would receive preferred shares convertible into common stock; the common shareholders would receive new common shares; and the new money group would receive prior preferred shares convertible into common stock. Assuming full conversion of all preferred shares to be issued under the plan, the division of the equity interest in the reorganized debtor would give the unsecured creditors 25.7%, the new money group 30.5%, and the old common stockholders 43.8% of the total.

In assessing the fairness of the plan, the Commission objected most to the treatment of the unsecured creditors as compared to that accorded the old common shareholders. Instead of providing the old stockholders with 43.8% of the new equity, a slice which was 70% larger than that awarded the unsecured creditors, the Commission suggested that they should be given only a "modest participation" of about 5%. The unsecured creditors, it argued, should be entitled to "almost 60% of the stock and control of the reorganized company."[8]

The way in which the Commission came to its judgment about this allocation between unsecured creditors and old shareholders merits attention. One acquainted with past performances of the Commission might have expected it to utilize cash flow analysis in a fashion which paralleled its usual application of the probable net earnings technique. This exercise would have involved taking two steps: (1) fixing a valuation by associating the projection of most probable net earnings with an appropriate capitalization rate; (2) assigning to the unsecured creditors whatever portion of that value was required to satisfy the maturity or face amounts of their claims in full, and then (putting aside the treatment of new money contributors) leaving the residue, if any, to the old common shareholders.[9] Substitution of a cash flow for a net earnings approach to valuation would seem to call for changing only the first of these two steps. Reorganization value, under the change, would be derived by projecting both positive and negative cash flows

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[7] *Id.*

[8] *Id.* at 23.

[9] *See* Blum, *Full Priority and Full Compensation in Corporate Reorganizations: A Reappraisal*, 25 U. CHI. L. REV. 417 (1958).

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and applying to them proper discount rates to take into account both the foreseeable risks and the estimated time dimensions.[10]

If the Commission had proceeded as expected, the old common shareholders would have been wholly excluded from participation in the event that reorganization value (calculated apart from the infusion of new money) had fallen short of the total of all creditors' claims. What makes the Report noteworthy is that the Commission appears to have taken an altogether different route.

This route can be easily traced. The Commission first pointed out that "[t]he present worth of the unsecured creditors' projected receipts [meaning estimated cash flow available for satisfying claims of unsecured creditors] is obviously a good deal less than the $4.2 million to which they are now entitled."[11] Then it observed that "[i]f we applied a discount rate of 8% to determine the present worth of the assumed receipts by these creditors over . . . [the relevant time span], those assumed receipts would have a present value of about $2.47 million."[12] It qualified this observation by noting that "the retirement of Jade's unsecured debt would, absent reorganization, take a far longer period,"[13] and that "[h]ence the present worth of the future receipts, though we cannot measure precisely, would be substantially below the calculated amount of $2.47 million."[14] Next the Commission took into account that Jade had some valuable unproductive assets which were not brought into the cash flow projection. Accepting the Trustee's valuation of $1.7 million for these items, it remarked that "[t]his [sum]

10 "Use of the net cash receipts differs from the usual method of valuation whereby an enterprise which is not limited by the exhaustion of wasting assets is valued by capitalizing estimated net operating income. In the case of an enterprise of unlimited life, with a need for replacement of facilities, net operating income is estimated after deduction of accruals for depreciation. In determining net cash receipts, accruals for depreciation and depletion are ignored, as such, and only the actual capital expenditures are deducted. This method of valuation recognizes that the net cash receipts for any year may consist of current earnings and a return of capital through which the investment is reduced from year to year. To the value so determined must be added the present worth of the salvage value of the physical assets which will accrue to the enterprise when operations on its present properties are terminated and such value as may be attributed to any tax loss carry-over which the Debtor has. In addition, assets presently owned which are not required to produce the estimated future earnings, in particular, cash and other current assets in excess of working capital requirements, represent an additional element of value. Where additional capital investments are required to produce the income as estimated, the discounted value of such investments must be deducted from the total valuation to arrive at the portion applicable to the present investors." *In re* Parker Petroleum Co., 39 S.E.C. 548, 559-60 (1959).

11 Jade Release at 17.

12 *Id.* at 17-18.

13 *Id.* at 18.

14 *Id.*

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would just about cover the deficiency on the claims of the unsecured creditors if realistically we could, as we obviously cannot, assume a present worth of $2.47 million for future receipts as heretofore indicated."[15] Somehow the Commission then moved to the conclusion that the old common stockholders should be limited to "a modest participation."[16] It tried to bolster that conclusion by a reminder that "[t]he present common stockholders chose to invest in this venture, and that choice need not be treated as though it were a wholly lost bet—especially since investors want to put substantial new equity capital into the very same business."[17] Finally, apparently for balance, it added, "However, in passing on the extent to which minimal participation by the present common can be permitted due regard must, of course, be given to the prior rights of creditors whom the plan would reduce to stockholder status."[18] This minimal participation, as stated above, turns out to be about 5%.

How sound is the Commission's ultimate conclusion that fairness calls for leaving the old stockholders with a modest slice of the equity? The best approach to this question might be to examine some weak spots that can be detected along the outlined route.

Perhaps the most serious weakness is the cavalier fashion in which the Commission arrived at a rate for discounting the projected cash flow attributable to the claims of unsecured creditors. The justification it offered for making present value calculations on an assumed 8% rate is that "[t]his is the rate for the secured creditors. The unsecured creditors whose position is much riskier are certainly entitled to at least that same 8% rate."[19] Such an explanation is unsatisfying. In saying that "this is the rate for secured creditors," the Commission apparently was doing no more than acknowledging the fact that under the proposed plan the bank, "by far the largest secured creditor, will be entitled to interest at the prime rate plus 1% but in no event less than 7% per annum."[20] This is not equivalent to finding that a new loan would be made on those terms at the time the Commission was reviewing the plan. A lender not already committed and not faced with the difficulties of collecting a defaulted loan might well demand a higher return, and *that* figure would be the better gauge of market conditions. But even if 8% turned out to be the proper rate for discounting that part of the projected cash flow associated with the claims of secured

15 *Id.*
16 *Id.* at 22.
17 *Id.* at 22-23.
18 *Id.* at 23.
19 *Id.* at 17 n.17.
20 *Id.* at 16 n.15.

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creditors, 8% could not conceivably also be the proper rate for discounting the estimated cash flow associated with the claims of unsecured creditors. In any business enterprise a projected second layer of cash flow is less certain to be realized than the top tier; and this is all the more so in the case of a risky venture such as Jade. Use of a 10%, to say nothing of a 12% or a 15%, discount rate for the second layer belonging to the unsecured creditors would have left no value available to the old common stockholders.

The Commission's superficial treatment of discount rates, along with its apparent unwillingness to eliminate the old common shareholders from participation altogether, probably explains another weakness of the Report. Let it be assumed, contrary to what the facts seem to indicate, that 8% was the appropriate rate at which to discount the projected cash flow attributable to the claims of the unsecured creditors. The Trustee's proposed plan called for replacing the claims of unsecured creditors with an equity position in the enterprise superior to that of the new shares earmarked for the old common stockholders. In such an arrangement, a dollar of new stock under some circumstances might logically be viewed as equivalent to a dollar of old unsecured claim. This equivalence is possible because the projected cash flow attributable to the old unsecured claim may be identical to the projected cash flow attributable to the new preferred stock and therefore it would be proper to use the same discount rate in each case—here assumed to be 8%.

The Commission, however, objected to giving the old unsecured creditors a preferred stock position. Instead it suggested modifying the proposed plan so that both the old unsecured creditors and the old common shareholders would receive the same class of new stock. In that kind of arrangement, the 8% discount rate assumed to be appropriate for the old creditor claims would necessarily be improper for purposes of valuing the estimated cash flow attributable to the new stock, even though most of these shares were to be awarded to the unsecured creditors. The cash flow associated with the new stock must on average be riskier than the cash flow associated with the old claims because a larger cash flow must be postulated in placing a value on the new shares. This point is familiar, having been made repeatedly by the Commission in reorganizations in which valuation was established by a net earnings approach. The usual statement of it is that when an old senior class is being compensated solely with new paper of lower quality, some of which is also being distributed to an old junior class, fairness requires that the old seniors be given more than a dollar of new paper for each dollar of their old claim.[21] The use of a

21 The most quoted statement of the point is that of the Supreme Court in Consolidated

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cash flow valuation approach should not detract from the soundness of this principle.

Rock Prods. Co. v. Du Bois: "[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. If they receive less than that full compensatory treatment, some of their property rights will be appropriated for the benefit of stockholders without compensation." 312 U.S. 510, 528-29 (1940).

An application of this position is to be found in the SEC's Advisory Report in the reorganization of Deep Rock Oil Corp. under Chapter X of the Bankruptcy Act. A plan proposed by the reorganization committee representing noteholders called for allocating new common shares to noteholders for part of their claims and also to preferred shareholders. "On the appraised value," said the SEC, "the noteholders' claims, after deducting the . . . new debentures [to be issued to the noteholders] would approximate in amount almost 70% of the remaining equity. . . . Under the plan the noteholders would receive 80%. Considering the substantial sacrifices which they must bear, we are of the opinion that an 80% participation in the equity of the debtor is not in excess of that to which the noteholders are entitled, even accepting the appraised value." *In re* Deep Rock Oil Corp., 7 S.E.C. 174, 193-94 (1940).

A dollar of value assigned to new common stock is not necessarily less than full compensation for a dollar of old creditor claim. The anticipated earnings or cash flow associated with the new stock might be capitalized at a high enough risk rate to make a dollar of value assigned to the new shares equivalent to a dollar of old claim. The SEC discussed this possibility in analyzing a plan under the Public Utility Holding Company Act, calling for a parent company to exchange its creditor position for a predominantly equity position in the reorganized subsidiary:

"We agree that recognition must be given to the differences in quality of income which occur under the plan. The difficulty in reorganizations which involve exchanges of senior securities for junior securities and the converse is to find a standard by which the gain or loss in quality may be measured. In general, there are two methods. One involves a comparison of the availability of earnings and the degree of certainty that they might be paid to the security holders; the other involves a capitalization of the segments of applicable earnings at appropriate rates from which a comparison of the long-term values of the securities is made. It is obvious, however, that in applying the first method alone, beyond determining that there should be a substantial difference between the more certain claim of a debt security and the less certain claim of a junior security, the final determination of the amount of the appropriate differential is a matter of the broadest judgment and subject to the greatest controversy. For this reason, we believe that the second method, though not mathematically conclusive, supplies a more objective basis for a comparison; for there the common denominator is the value of each security expressed in dollars. For example, if a $1,000 3% bond which is conceded to have a long-term value of $1,000 is to be exchanged for shares of common stock which have a long-term value of $20 per share, it would seem that the proper number of shares to be given in exchange would be 50 shares; and by this method the differential in earnings would automatically be solved. To carry the example further, if the applicable common stock earnings are $1.50 per share, the holder of the bond would receive a claim of $75 per annum on such earnings in exchange for his claim to $30 of interest.

"Thus, 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 valuations are obtained in terms of a common denominator. The element of *quality* is thus taken into consideration and no longer remains a subject for the exercise of judgment unlimited by objective factors. In the illustration we posed, the bondholder with

The Commission's once-over-lightly treatment of discount rates in *Jade* stands out all the more sharply when compared with its Advisory Reports in other reorganizations. In applying the probable net earnings approach to valuation, the Commission generally has been fairly careful in documenting its selection of capitalization rates. There is no reason to be less sensitive to risk and time differentials when valuation is approached through a cash flow technique.

The Commission recognized this a decade ago in the Parker Petroleum reorganization,[22] which also involved a small independent company engaged in the exploration and development of oil and natural gas properties. A petroleum engineer brought in by the reorganization Trustee applied a discount rate of 6½% to his cash flow projections. In choosing this discount rate he stated that it was based on the "current interest rates and the rising trend of interest rates."[23] On cross examination, however, "it developed that in selecting the rate he merely related it to the going interest rates charged by banks for loans made to solvent and good risk oil companies where the loans are limited to varying percentages of the fair market value of a collateralized oil property with proven reserves."[24] The Commission also noted that the engineer "gave no weight to the risk factors in the instant situation nor to the fact that an entire enterprise was being valued."[25] After rejecting the 6½% rate as not being acceptable "as a discount rate for the determination of going concern value of the Debtor,"[26] the Commission sought to determine a proper rate. In doing so it insisted that consideration should "be given to the relatively high interest rates currently in effect and to the rising trend of interest rates."[27] Taking into account "all the competing considerations which are both favorable and unfavorable," the Commission formed the "opinion that a 10% discount rate applied to the net cash receipts . . . would appropriately measure the business risk of the enterprise and the other relevant considerations. . . ."[28]

Had equal attention been paid to the comparable issue in *Jade,* the appropriate discount undoubtedly would have exceeded 10%. Interest

a $30 claim for interest would receive a claim on common stock earnings of $75 in exchange. This differential represents compensation for the difference in quality." *In re* American & Foreign Power Co., 27 S.E.C. 1, 51 n.57 (1947). *See* Blum, *supra* note 9, at 434-37.

22 *In re* Parker Petroleum Corp., 39 S.E.C. 548 (1959).

23 *Id.* at 561.

24 *Id.* at 563.

25 *Id.*

26 *Id.*

27 *Id.* at 565.

28 *Id.*

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rates were significantly higher in 1969 than in 1959, and there is every indication that the enterprise in *Jade* was more risky than that in *Parker Petroleum*.

Failure of the Commission to bear down on choice of discount rates can easily be confused with acceptance of an old fallacy regarding fairness in bankruptcy reorganizations. Some commentators have contended that if projected net earnings—and presumably this argument would also be applied to a cash flow analysis—exceeded all charges associated with service and amortization of all existing creditor claims, the old shareholders necessarily must have an equity in the enterprise and accordingly cannot be cut off entirely.[29] This position has validity in the case of reorganizations, such as those under the Public Utility Holding Company Act, which are not a substitute for liquidation and for that reason are viewed as occasions on which shareholders are entitled to retain the investment value of their rights in an on-going enterprise. The error in applying it, however, in bankruptcy reorganizations,[30] which do function as a substitute for liquidation, can readily be detected by considering an admittedly extreme set of circumstances. Assume that annual net earnings for a company undergoing reorganization are estimated in perpetuity at $100,000 and that 10% is the "proper" capitalization rate, producing a reorganization value of $1 million. Also assume that the company went into reorganization because it was unable to repay or refinance a $2 million issue of 25 year non-sinking fund 3% bonds which had just matured. Very clearly the projected annual earnings of $100,000 exceed the $60,000 annual interest charges on the old bonds. But this relationship does not imply that the old shareholders still have an equity in the company—in fact, the bondholders' claims exceed the valuation by $1 million. The mistake in thinking that the old stockholders have an equity arises because attention is paid to the interest rate on the old bonds, which have matured. That rate is not relevant in placing a present value on anticipated future net earnings—or, for that matter, on cash flows. Nor is that interest rate relevant in determining the amount for which the bondholders have a claim. This sum is to be measured as though the company were in liquidation. The investment value of the bonds, even though presumably equal to the liquidation claim in the extreme example used here, is of no significance.

The Commission has steadily held the view that the investment

29 *See* Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization: New Directions*, 67 HARV. L. REV. 553 (1954).

30 Blum, *The "New Directions" for Priority Rights in Bankruptcy Reorganizations*, 67 HARV. L. REV. 1367 (1954).

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value standard of measuring claims is inappropriate in bankruptcy reorganizations. There is a danger, however, that the consequences of that standard will creep in under disguise if creditor claims are measured by discounting at too low a rate the predicted cash flows or probable earnings attributable to them. In this connection reference to the Public Utility Holding Company Act seems particularly appropriate in thinking about the 5% equity participation which the Commission sought to give the old shareholders in *Jade*. The leading precedent for applying the investment value standard instead of the liquidation standard in measuring claims under that act is the Supreme Court opinion in *Otis & Co. v. SEC*,[31] involving a recapitalization of the United Light and Power Company. Application of the Bankruptcy Act liquidation standard would have eliminated the old common shareholders altogether. The Commission argued successfully that they were entitled to participate in the continuing enterprise because a part of the estimated earnings would eventually be available for their benefit. And, strange coincidence, the extent of that participation, based on application of the investment value standard for measuring claims, was just about 5%!

By not coming to grips with selection of proper discount rates, the Commission avoided confronting the impact of recent extraordinarily high interest levels on reorganizations in bankruptcy. This challenge, which is likely to surface often during periods of high interest rates, involves a crucial question of fairness. The crux is quickly located: In measuring the adequacy of compensation given to creditor classes senior to the marginally participating group, are the prevailing high interest levels to be accepted as the relevant figures or are they to be adjusted in some way or are they to be ignored? An extreme illustration again might be helpful. Assume that the interest rate for riskless paper of all maturities has stayed close to 10% throughout the last year. Assume also that a company in reorganization under the Bankruptcy Act has outstanding some long-term debt instruments bearing a 4% interest rate. Does fairness permit forcing the old creditors to stay locked in at 4% when the current riskless rate is 10%? Or does fairness require that any newly issued or extended paper assigned to the old creditors be measured by valuing projected flows of earnings or cash so as to take into account both the current 10% riskless interest rate plus a proper allowance for the risks associated with the particular estimated flows? These formulations of the basic questions may well be put too broadly. Should it make any difference that the debt at stake was not in default when reorganization proceedings were instituted? Or that the debt was

31 323 U.S. 624 (1945).

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in default only in the technical sense that a bankruptcy proceeding is sometimes said to mature all claims? Or that the debt was in default but the obligation had not reached its stated maturity date? Or that the debt had matured naturally but could not be refinanced? No comprehensive theory of fairness in reorganization can avoid meeting these hard questions.[32] The Commission might advance that theory by speaking out on the questions whenever the opportunity to do so is present.

A last weakness in the Commission's commentary lies in its use of the argument that the old shareholders must still have an equity in the enterprise because outsiders are willing to invest new money in it. The fresh money group of course would be concerned about the division of the equity between itself and those whose dollars are already committed to the venture. It is most unlikely, however, that the group would be interested in how the share of the equity going to the others would be divided between the unsecured creditors and the old shareholders, except as that division might expedite or delay adoption of the plan as a whole. Thus, the willingness of the newcomers to have the old shareholders continue in the enterprise can signify nothing about the fairness of the plan.

One must conclude that the Report in *Jade* is not a jewel. The weaknesses cumulate so as to leave the impression that the doctrine of absolute priority in bankruptcy reorganizations is being mildly slighted or eroded.[33] Whether this effect was intended or whether it is due to the Commission's limited experience in applying the cash flow method of valuation, the Report deserves to be largely ignored.

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32 Some of these questions are explored, but not fully, in Blum, *supra* note 9, at 423-25. It does not seem appropriate to develop the analysis further in this comment.

33 In this connection, compare the position taken by the SEC in *Jade* with that advanced by it in Protective Comm. for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414 (1968), commented on in Blum, *Some Marginal Notes on TMT Trailer Ferry Reorganization: The New Math?*, 1968 SUP. CT. REV. 77.

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