1974

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FEASIBILITY IN CHAPTER X REORGANIZATIONS

DAVID R. KING†

I. INTRODUCTION

IN REVISING THE BANKRUPTCY ACT in 1938, Congress amended the provisions dealing with corporate reorganizations, replacing section 77B with Chapter X. Chapter X provides that a court may approve or confirm a plan of reorganization only after determining that the plan is "fair and equitable, and feasible." To arrive at this conclusion, a federal court must necessarily inquire into two major areas: the feasibility or practicability of the new corporate financial structure, and the fairness with which creditors and equity holders of the debtor are allocated participation in the reorganized enterprise. This article will focus upon the first inquiry, the nature of feasibility, exploring the factors that are, and those that should be, considered in determining whether the new corporate structure is feasible. There is a great need for this analysis since in the past, this area has been given sporadic and incomplete treatment, with little or no attempt to formulate an overall policy as to the requirements of feasibility under Chapter X.4

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4. The subject of feasibility has received minor treatment in a popular treatise: 6A COLLIERS ON BANKRUPTCY §§ 11.07 (14th ed. 1972) [hereinafter cited as COLLIER]. Feasibility, has also been discussed in several casebooks: W. BLUM, MATERIALS ON INSOLVENCY AND REORGANIZATION (rev. ed. 1960); W. BLUM & S. KAPLAN, MATERIALS ON REORGANIZATION, RECAPITALIZATION AND INSOLVENCY (1969); V. BRUDNIEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE (1972) [hereinafter cited as BRUDNIEY & CHIRELSTEIN], and has been explored in several older law review articles: Blum, The Law and Language of Corporate Reorganization, 17 U. CHI. L. REV. 565 (1950) [hereinafter cited as Blum, The Law]; Calkins, Feasibility in Plans of Corporate Reorganization Under Chapter X, 61 HARV. L. REV. 763 (1948) [hereinafter cited as Calkins, Feasibility]; Note, Feasibility in Corporate Reorganization, 4 STAN. L. REV. 125 (1951).

Recently, the Commission on the Bankruptcy Laws of the United States [hereinafter cited as Bankruptcy Commission] has recommended a complete revision of the bankruptcy and reorganization process. The Bankruptcy Commission was created by the Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468. It filed the REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES
Chapter X's requirement of feasibility is derived from former section 77B(f)(1) of the Bankruptcy Act, and focuses upon the overall economic soundness of the plan. Although the concept of feasibility has been described in various ways, Judge Kirkpatrick aptly summarized the requirement as follows:

A plan is feasible if it does not provide for an excessive capital structure, if it gives the new company a reasonable prospect for survival, and if the net earnings which the new company may reasonably anticipate over the indefinite future will be sufficient to meet the interest and dividend requirements of the new securities to be issued.

The Securities and Exchange Commission (Commission or SEC) has developed its own interpretation, stressing that feasibility acts to ensure "the emergence of the debtor from reorganization in a solvent condition and with reasonable prospects of financial stability and success." In essence, feasibility is required for the purpose of avoiding the cost and embarrassment that would result if the reorganized enterprise were to encounter financial distress again.

To insure against such an occurrence, reorganization plans must be workable; the synonym "feasible" is an appropriate label for this concept because it combines more euphoniously with "fair," and

5. Former § 77B(f)(1) provided:

After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors and stockholders, and is feasible. Bankruptcy Act § 77(B)(f)(1), ch. 424, § 77B(f)(1), 48 Stat. 919 (1934), as amended, 11 U.S.C. § 621 (1970). See S. Rep. No. 1916, 75th Cong., 3d Sess. 35 (1938).


9. 10 SEC ANN. REP. 151 (1944). The Commission stated:

The extent to which [1944] reorganizations are attributable to lack of feasibility in previous reorganizations is indicated by the fact that numerous Chapter X proceedings involved companies which had already undergone reorganization in equity receivership proceedings or under Section 77B of the Bankruptcy Act. In order to avoid a similar record as to Chapter X cases some years hence, with its attendant expense and injury to investors, the Commission urges that adequate consideration be given to feasibility.
The intent is clear: any corporation in need of reorganization probably represents a high degree of risk. Therefore, the standard of feasibility requires that the court minimize this risk for the reorganized debtor. While it is not necessary that success be guaranteed — a requirement which would be impossible to fulfill — the court must be assured that there is reasonable potential for success.

It is important to keep in mind that feasibility represents but one part of the entire reorganization process. Professor Thurman Arnold described the process of corporate reorganization as follows:

The ritual of corporate reorganization... is perhaps the most interesting of all our legal rituals from a ceremonial point of view, because it is the most complicated mystery of all... [It] is a combination of a municipal election, a historical pageant, an antivice crusade, a graduate-school seminar, a judicial proceeding, and a series of horse trades, all rolled into one — thoroughly buttered with learning and frosted with distinguished names. Here the union of law and economics is celebrated by one of the wildest ideological orgies in intellectual history. Men work all night preparing endless documents in answer to other endless...

11. Risk here is defined in terms of the risk of a subsequent bankruptcy both to investors in the particular reorganized debtor, and to the economy as a whole. The emphasis upon insuring against the debtor's return to the reorganization courts is evident in both SEC and judicial reports. Note, however, that with respect to public utilities, the risk could be defined as the likelihood of interruption of the extant dividend policy. As the experience with regard to Consolidated Edison has recently shown, this is often tantamount to bankruptcy, due to a utility's high capital demands and classic rejection of retained earnings as the major financing source. This particular aspect of risk has not been adequately articulated by the SEC. Aside from the risk associated with a failure to meet fixed charges (and forced reorganization), there arises the thorny issue of whether the inherent risk attached to the particular collection of capital goods operating in the particular industry is increased or decreased by the added administrative costs and possible reduction of both sales and earnings associated with the reorganization process. A simple way to pose this problem is to hypothesize two identical companies — one entirely financed by equity, the other by debt — and to determine whether the latter corporation will be any riskier than the former if it must subsequently go through reorganization and emerge with all equity capital structure. See Baxter, Leverage, Risk of Ruin and the Cost of Capital, 22 J. Fin. 395 (1967); Robicheh & Myers, Problems in the Theory of Optimal Capital Structure, 1 J. Fin. & Quan. Anal. 1 (1966).
12. See Gerdes, General Principles of Plans of Corporate Reorganization, 89 U. Pa. L. Rev. 39 (1940), where the author stated: The first objective of a reorganization should be the production of a sound economic unit — a corporation able to operate its business successfully and pay a reasonable return to those having interests in it. Unless this is accomplished, losses will continue, liquidation or another reorganization at a subsequent date will be necessary, and all losses sustained in the intervening period will diminish the amounts which could have been distributed to creditors and stockholders if liquidation or an effective reorganization had occurred in the first place. The statutes recognized this objective by requiring that the court must find that the plan is "feasible."
documents, which other men read in order to make solemn arguments. At the same time practical politicians utilize every resource of patronage, demagoguery, and coercion beneath the solemn smoke screen.

Although to the casual observer the complications seem most forbidding, actually the dialectic of this process is very simple. It consists in the endless repetition in different forms of the notion that men must pay their debts, in a situation in which neither men nor debts in any real sense are involved.

By way of organization, this article initially attempts to analyze the concept of feasibility. Next, it offers an examination of the various economic and financial concepts which must be considered in evaluating a debtor’s capital structure. There is then an attempt to assimilate the SEC’s view of feasibility, with the ultimate goal of providing concrete guidelines as to particular elements of the concept. Finally, the paper concludes with a framework for a contemporary theory of feasibility.


Nor will this article attempt to formulate a detailed quantitative analysis of the relationship between various feasibility issues and the predicted risk-of-ruin of a firm. For that, the reader is referred to the following: Altman, Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy, 23 J. FIN. 589 (1968); Baxter, supra note 11; Beaver, Financial Ratios as Predictors of Failure, 4 J. ACCT. RESEARCH 71 (1966); Beaver, Market Prices, Financial Ratios, and the Prediction of Failure, 6 J. ACCT. RESEARCH 179 (1968); Bierman & Thomas, Ruin Considerations and Debt Issuance, 7 J. FIN. & QUANT. ANAL. 1361 (1972). The potential of such studies is great: for if by using discriminant analysis, one can isolate various “causes” of bankruptcy, then theoretically an inquiry into the feasibility of any given capital structure can focus upon these variables and produce a company with less chance of ruin. However, it must be emphasized that this analysis is only theoretical, as there is a big jump from isolating factors which caused a given set of companies to fail to the use of this information to keep another “new” enterprise — albeit one that uses the same capital as its predecessor — from bankruptcy. The modeling process holds great promise in this area. See E. ALTMAN, CORPORATE BANKRUPTCY IN AMERICA (1971), where the authors develop a sophisticated bankruptcy prediction model.
I. THE ECONOMIC CONTEXT OF FEASIBILITY

A. The Liquidation-Reorganization Game

Professor Arnold was accurate in his observation that the coupling of law and economics in a corporate reorganization is "celebrated by one of the wildest ideological orgies in intellectual history." How can a firm possibly claim to have a value as a going concern if its net income falls short of its fixed charges, and why should this firm be given protection from the certain death a market regime mandates? The problem is ensconced in the rather nebulous area where law and economics intersect. From an economic point of view "failure" means nothing more than an excess of average costs (in historical sense) over average receipts. That is, while potentially the return upon investment in this enterprise surpassed the potential return upon available alternative investments, the realized returns upon the enterprise in question have fallen far short of expectation.

Failure in this sense, however, does not necessarily cause the firm in question to cease operation or default upon any of its fixed obligations. Many firms are failures in this economic context and yet do not withdraw from the industry. Since the economic definition of failure does not take into account the existence or discontinuance of the entity, there remains much potential for Thurman Arnold's ideological orgy. A firm bases its decision to continue operations upon expected returns and its ability to cover current costs. Therefore, a company may be a failure for many years and yet due to the absence of legally enforceable debt, it is never unable to meet its current obligations, and thus remains in the industry.

However, the orgy is not concluded, even if financial troubles should lead to default, and bankruptcy, for the capital goods, as opposed to the specific enterprise itself, may nonetheless continue to be used in production for a considerable time interval, thereby affecting the total output and price of the commodity or service concerned.

15. See text accompanying note 13 supra.
16. In terms of diagrammatical analysis, average total cost exceeds average revenue. N. Buchanan, The Economics of Corporate Enterprise 332-35 (1940). See also Buchanan, Economics of Corporate Reorganization, 54 Q.J. of Econ. 28, 29 (1939).
17. E. Altman, supra note 14, at 2. See also P. Van Arsdell, Corporation Finance 1474-77 (1968), attempting to clearly distinguish business, economic, and legal failure.
18. This issue continually arises. To the extent that an all-equity capital structure for reorganized enterprises is insisted upon, will there be an inevitable increase in the number of "failures" remaining in business? Or is a further reorganization merely delayed? Compare this to the well-known revolving door aspect of railroad reorganizations. Is this "good" for our economy?
19. N. Buchanan, The Economics of Corporate Enterprise 335 (1940).
The degree to which resources are withdrawn depends upon the degree to which it is possible to liquidate and distribute the capital goods or to adapt them to the production of alternative goods and services. Many capital goods are so highly specialized that they are not adaptable to uses other than those for which they were originally designed. If the only alternative to continuing the present use of these goods is to sell them for scrap, then the production process will continue if the liquid funds obtained from selling the capital goods for scrap, when invested elsewhere, will yield a lower return than that obtainable from using the capital goods as before. A whole succession of "enterprises," however defined, may come into being and pass out of existence before these capital goods are in any way withdrawn from the industry. This fact has important economic consequences: a comparatively long interval may be required before needed adjustments to the level of capital employed in a particular industry can be made. Years may pass before this misdirected investment in capital will cease to exert its influence upon the supply curve. When a corporation attempts a Chapter X reorganization, all of these issues are unfortunately embodied in the simple query, "Can this corporation be reorganized, or should it be liquidated?"

Aside from the economic and legal issues, there is another force — the institutional inertia which dictates that an enterprise once formed shall not die:

Institutions once formed have the persistency of all living things. They tend to grow and expand. Even when their utility both to the public and their own members has disappeared, they still survive. The economic theory that marginal business concerns will be eliminated by competition has just about as much truth in it as a theory that marginal churches which do not actually increase the comfort and happiness of their members tend to eliminate themselves. Sometimes they do; sometimes they do not.

Habit, as well as sentiment, is a powerful factor. In the anarchy of the soft-coal industry in West Virginia, the writer stated:

20. Id. at 334 n.23. The author stated:

This is a matter of common observation familiar to everyone. For instance, most street railway companies in the United States now earn a negligible return on the basis of past historical capital investment. Yet the equipment being highly specialized in the form of tracks, cars, wires, etc., it is next to impossible to adapt it to other uses and its scrap value net after disinvestment costs is very small. As a consequence such enterprises continue to operate so long as they succeed in securing an income from selling transportation service greater than the direct out-of-pocket costs involved in producing that service by an amount at least equal to a fair return on the net scrap value of the equipment. When the returns fall below that the tracks are torn up and the cars sold for kindling wood and scrap iron. Id.
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has seen a coal-mining company go bankrupt only to be taken
over by its creditors, who go bankrupt, only to be taken over
by their creditors, who go bankrupt, and so on.

The economic law which is supposed to cause marginal busi-
esses to be eliminated does not work at all when it deals with
organizations whose members prevent each other from express-
ing the doubts which all of them feel. No one likes to change
his former position before his fellows. There is nothing so in-
elastic as a great organization of any kind because of men’s pas-
son for appearing consistent in public. 21

A consideration of the subject of feasibility must necessarily in-
clude all these issues, particularly if feasibility is viewed as inco-
sistent with a high degree of risk that the debtor may be forced
to seek another reorganization. 22 Before any plan can be effectuated,
the court must decide if liquidation is more appropriate than reorgani-
tion. The basic economic issues have been explored above; stated
simply, the sum of the individual values of the various components
of production — capital goods — is often less than their value in
combination. 23 Many management representatives would state this
proposition differently. To them, the traditional factors of produc-
tion — labor, raw materials, and capital — make up every economic
unit, and only the presence of a fourth factor, managerial organization,
makes the synergistic combination possible. Managerial organiza-
tion, however, is irreplaceable, and unlike the other three factors, cannot
be regained except at an excessive cost. 24 To management, economic

22. See notes 10 & 11 supra.
We must not create the impression, on the other hand, that when business
teprises fail they are always reorganized. Where only a small fraction of the
total investment is represented by capital goods with a high degree of specificity,
the alternative of liquidation is the better choice. . . . [An] important . . . factor
inducing liquidation rather than reorganization is that the total value of the
assets considered as individual items in separation is not greatly different from
their value in the particular combination in which they happen to stand with
reference to one another at the time of failure. An insurance company's invest-
ments in bonds, mortgages, etc., derive little or none of their worth from the
fact that they happen to be contained in one portfolio; on the other hand, a rail-
road line is something more than a pile of steel rails, wooden sleepers, tieplates,
and six inch spikes. . . . Liquidation is called for in the [first] but reorganization
in the [second].
Id. (emphasis in original).
as DRUCKER].

Note that to a certain extent, the relative priority rule mirrors this view.
The relative priority rule holds that in the absence of bad faith or fraud, the alloca-
tion of securities in a reorganization should be determined by arms length bargaining
among the participants including the debtor's management. See 2 BONRIGHT, THE
VALUATION OF PROPERTY 864-70 (1937); 2 DEWING, FINANCIAL POLICIES OF COR-
policy must be designed to preserve the ultimate expression of managerial organization, the corporation. Bankruptcy laws are viewed as efforts to save this factor of production, the social interest of a production-oriented society in the survival of corporate identity and productive integrity being almost absolute. To a certain extent, all these policies are recognized by the reorganization court under the guise of “maintaining the going concern value of the debtor.”25

The basic legal issue is much simpler: Should the company be liquidated or not? The traditional method for determining the answer to this issue is that of valuing the enterprise as a going concern and comparing this to its liquidation value.26 If the liquidation value is greater, then the firm should be dismantled. The standard of feasibility requires that at least this much be done, thus making the extensive valuation process as important to the feasibility question as it is to the absolute priority rule.27

While it is beyond the scope of this article to discuss all instances where liquidation is preferred over reorganization, it should be noted that even a plan of liquidation subject to Chapter X must also meet the statutory test of feasibility.28 Neither case law nor the relevant statutes make an exception for plans of reorganization that by their terms contemplate a gradual liquidation.29 Of course, feasibility in this context must have a slightly different meaning, stressing the realization of maximum asset values with minimal deception of

For a discussion of the absolute priority rule, see note 39 infra.


26. See Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 510, 525 (1941), where the Court stated: “Findings as to the earnings capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization.” Id. Contra, In re Universal Lub. Sys., Inc., 150 F.2d 832, 835 (3d Cir.), cert. denied, 326 U.S. 744 (1945), wherein the Third Circuit refused to value the debtor by capitalization of earning because there were no “earnings” to capitalize — past earnings were nonexistent, and present earnings were due entirely to the war effort. Yet the court approved as feasible a reorganization plan providing for continuation of the business. Id. at 834-35. On the mechanics of valuation, see generally 6A COLLIER, supra note 2, ¶ 11.05; Field, Valuation for the Purpose of Corporate Reorganization, 16 ROCKY MT. L. REV. 13 (1943); Gardner, The SEC and Valuation Under Ch. X, 91 U. PA. L. REV. 440 (1943).


It is not precisely clear how the concept of investor deception is derived from the statutory mandate of a feasible plan. However, this theoretical problem has never troubled the SEC, which, in its capacity as a party to the reorganization, sees itself as actively concerned with every issue arising thereunder. The net effect is a merger of the Commission’s role under the Bankruptcy Act with its position as an administrator of the various Securities Acts. It seems to have consistently defined deception in the broadest possible terms without regard to the applicability vel non of the anti-fraud provisions of the Securities Acts, and has viewed deceptive securities as automatically violative of the feasibility standard.

If new investment is necessary to proceed with a plan of reorganization, the court faces an additional task. It must assume the function of the capital markets as the allocator of investment funds. In this role, the court must decide whether the investments should be made, and if so, under what terms and conditions, using as a guide the hypothetical results of an arms-length bargain in the same factual situation. Additionally, the court must guard against realization of windfall profits by insiders, and must take steps to prevent deception of new investors. Finally, the decision to liquidate or reorganize will clearly be affected by the extent to which the reorganization court, or the SEC, facilitates or impairs the task of securing any new capital required for a feasible reorganization.

If the court determines that the debtor’s business should continue, it has determined only the reorganization value of the company, and not the market value. Market value is a real value which cannot only be expressed in monetary terms, but realized in cash. The courts do not deal with market value of the debtor.

The market value of a distressed business or its assets is not to govern the rights of those financially interested in the company. More particularly the creditors are not to foreclose and force a sale or valuation of assets at prevailing market prices. Instead junior interests are to be protected from forced sales and the impact of unfavorable market conditions. It is the fulfill-

The policy reasons for this conclusion have been fully explored over the years; therefore further elaboration is not necessary. It is sufficient to emphasize the distinction between reorganization value and market value. Reorganization value is what the court believes the market value of the insolvent company would be if the past were forgotten, and if the corporation would function as the court expects it to in the future. It is a purely fictional value which is not realizable in dollars. In fact, it is helpful not to express it as a dollar amount; rather one should think of it in terms of "reorganization tickets"—pieces of paper (stocks, bonds, etc.) which represent a right to participate in the reorganization. Reorganization value, whether determined by creditors, stockholders, the trustee, the SEC, or the courts, is never the estimate of a person who is willing to invest his own resources. Accordingly, it is a matter of opinion and belief, and cannot be objectively ascertained or verified.

B. The Link Between the Absolute Priority Rule and Feasibility

The issue of fairness arises because reorganization value and market value are not the same, and because it is virtually impossible to predict in advance what the relationship between the two values will be. If reorganizations were predicated upon real dollar value, presumably cash or its equivalent in securities would be allotted to the creditors in the order of their contractual priorities. No problem of fairness would arise when a creditor with a $100 claim received $100 in cash or a security with a market value of $100. Conversely, the problem would be evident if that same creditor were to receive either $80 or $120 in cash. However, no objective allocation is possible when the medium of payment is the reorganization ticket, which lacks a specific dollar value. Given this situation, someone must decide whether the dis-

33. Blum, The Law, supra note 4, at 566.
34. Id. at 565-71.
35. Id. at 578.
36. Id. at 572.
37. The classic distinction between payment in cash and payment in reorganization tickets was recognized in Guaranty Trust Co. v. Chase Nat'l Bank, 194 Misc. 628, 86 N.Y.S.2d 505 (Sup. Ct. 1949), aff'd, 277 App. Div. 767, 97 N.Y.S.2d 542 (1st Dept. 1950), aff'd, 302 N.Y. 658, 98 N.E.2d 474 (1951), cert. denied, 342 U.S. 819 (1951). In this decision, which involved the reorganization of the Denver & Rio Grande Western Railroad, the senior bondholders were given new securities in the reorganized company equal in face amount to the face amount of the debt. The old senior bonds, however, were secured by certain collateral that had not been subject to the bankruptcy court's jurisdiction. After completion of the reorganization, the
tribution of these tickets was fair and equitable. The guidelines specified in the bankruptcy statute are referred to as the absolute priority rule.\textsuperscript{38}

An extensive discussion of the absolute priority rule is beyond the scope of this article;\textsuperscript{39} however, it is important to note that the rule might require that creditors be paid in securities of the reorganized enterprise that can be sold at face value immediately\textsuperscript{40} or at some reasonably proximate time in the future.\textsuperscript{41} If feasibility standards are

\textit{New York court was forced to decide between competing claims for the collateral. The old junior bondholders, who as a class had received only partial compensation in the reorganization, claimed the collateral upon the ground that the senior bondholders had already been made whole in the reorganization. However, the court awarded the collateral to the old senior bondholders, holding that "the pledge [of collateral] was made under contract which guaranteed full payment of the [senior] bonds ... actually and not merely fictionally and constructively." 194 Misc. at 632-33, 86 N.Y.S.2d at 510 (emphasis supplied).}

38. The absolute priority rule, in its basic form, provides that in reorganization plans, creditor interests are superior to shareholder interests (and secured creditor interests are superior to unsecured creditor interests), and must be satisfied in full before any satisfaction of the shareholder interest (or unsecured creditor interest) occurs. See Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 115-16 (1939).


41. See Frank, \textit{Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act}, 18 N.Y.U.L.Q. REV. 317, 340 (1941). In this regard, Judge Frank, former Chairman of the SEC, stated:

[The SEC believes] that senior securityholders are entitled to receive more than mere paper securities of a face amount equal to their claims; and that the securities they receive should be such as to give them really compensatory treatment for their claims. In other words, the new securities should be intrinsically sound, so that there is a reasonable prospect that they will have values equal to their face amounts, or in the case of stocks, equal to the values put upon them for reorganization purposes.

\textit{Id.} (footnotes omitted).
designed to insures the existence of a healthy reorganized debtor whose securities are not selling at a substantial discount, then this full satisfaction rule may also be a test of feasibility.

The fairness and feasibility requirements also interact in another manner. The number of creditors and old shareholders sharing in the reorganized venture will be determined by the valuation of that enterprise. The higher the value, the greater the number of people "satisfied in full" with reorganization tickets in the reorganized debtor and, quite obviously, the lower the valuation, the lesser the number of people who will participate. If there were some way to maximize this value, it would seem to follo...
of analysis, in reality they are constantly interacting. It is not only the raw amount of debt which affects the valuation of the enterprise; almost any other facet of feasibility can have at least a psychological effect upon the value of the firm. Perhaps one of the best known examples of this is the increase in market price of corporate bonds due to the presence of a sinking fund.43

One further note is in order. We have seen that for the purpose of feasibility and fairness the court must determine the total value of the enterprise. When distributing new participations in the reorganized enterprise, the court must also fix the value of each of the new segments awarded to the old security holders, to see that the latter "have been made whole."44 Many commentators have pointed out that it is theoretically possible for the sum of the values of the participations distributed to exceed the value of the enterprise as a whole.45 This result indicates that the reorganization court should use an entirely different technique: first, it should determine the new capital structure, thus determining the basic issues of feasibility before those of fairness; second, it should assign a measure of inherent risk to each of the segments of the expected earnings stream;46 and finally, the reorganization court should allocate these segments among the parties, with the most certain segments being given to those participants with the highest contractual priorities. This process may, in practice if not in logic, produce a total value of the firm greater than that which a nonsegmented valuation approach would produce, thus allowing more to participate in the reorganized venture.47

In any case, differential tax treatment of the segments with respect to both the debtor and the recipients of those segments could produce the same effect. For example, a corporation which can take advantage

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43. 1 A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 239 (5th ed. 1953) [hereinafter cited as DEWING].
45. See generally Blum, Full Priority and Full Compensation in Corporate Reorganizations, A Reappraisal, 25 U. CHI. L. REV. 417 (1958); Brudney, supra note 39; Brudney & Chirelstein, supra note 4, at 147.
46. For example, the court should determine the percentage risk associated with earning the first $10,000 to pay bond interest, the percentage risk associated with earning the next $5,000 to pay preferred stock dividends, and so on.
47. The SEC and the ICC appear to have different valuation approaches, although the theoretical underpinnings of each agency’s technique remains unclear. In Chapter X, the SEC estimates the future earnings and life expectancy of the enterprise as a whole, determines the appropriate capitalization rate, and then computes the value of the reorganized firm. The ICC, in section 77 proceedings, also starts with an estimate of the enterprise’s total expected earnings, always taking the stream of earnings in perpetuity, but does not explicitly choose a single capitalization rate, nor does it reveal a final figure for reorganization value. The ICC only calculates “how large a capitalization can be supported by the predicted earnings.” See, e.g., Ecker v. Western Pac. R.R., 318 U.S. 448, 457–61 (1942). The ICC’s technique was described in considerable detail by Swaine, supra note 14, at 1195–99.
of the intercorporate dividend exclusion might desire participation in the reorganized enterprise in preferred stock form rather than the same participation in income bonds. However, an individual might not prefer one form over the other. If a participant has a loss upon his holdings, and would like to recognize that loss, the value to him of the kind of participation that will allow this loss to be recognized will be different from that of the same treatment to the person who has no losses, or who has losses but no gains against which to offset them.

C. Negotiation Dynamics

The remaining interaction between fairness and feasibility is merely a corollary to the factors previously described. The new capitalization will necessarily equal the reorganization value as determined by the court. Initially, it might seem that the easiest way to allocate the new participations would be to give the old senior creditors what they had, with the old junior creditors receiving any reorganization tickets that may be left over. However, this is rarely possible; and to the extent that feasibility limits fixed charges against the reorganized enterprise, the old seniors will generally have the nature of their participations changed. The compensation for the deterioration of quality that invariably results must of necessity come out of the old juniors' shares. This of course gives rise to inevitable argument.

First, the juniors will try to influence the court to offer the seniors exactly what they had had before — a substantial amount of debt. The resulting enterprise would be highly leveraged, but the juniors would have nothing to lose by trying.

Second, the juniors will try to endow the new reorganization tickets with what Professor Blum has aptly described as "rococo qualities," in the hope that these features will be treated as compensatory benefits.

48. INT. REV. CODE OF 1954, § 243. Section 243 entitles a corporation to a special deduction of 85 percent of dividends received from a domestic corporation subject to the income tax. Id.

49. See text accompanying notes 71-83 infra.

50. There is authority which supports the use of prior issues for participation in the reorganized corporation. See Guthman, supra note 39, at 748-49. Guthman lists the generous use of prior bonds and preferred stock as a desirable reorganization technique. He contends that this use is desirable because it has the following advantages:

(1) the total market value of the securities is maximized;
(2) the distributable income is increased to the extent that interest charges, unlike dividends, reduce the income subject to income taxes;
(3) priorities are more easily defined and preserved;
(4) the reorganization is speeded by a plan that preserves priorities and so far as possible gives the same kind of securities as previously owned to the various groups of claimants.

51. Blum, The Law, supra note 4, at 584.
The variety of capital structures suggested by parties to Chapter X reorganizations pays tribute to the inventiveness of counsel for the junior interests in this area:

Finally, if both of the above tactics fail, the juniors will rely upon their last weapon, delay, a factor which always favors the junior interests. If the juniors are the former holders of common stock, they are able to continue the business of the debtor, albeit most often under a trustee, using the assets which now belong to the old seniors. These assets are therefore subjected to all the risks of the marketplace, with any possible gain limited to accumulation of interest. Since the old seniors probably invested with the expectation of a fixed cash return, they want to settle the issue quickly in order that the steady cash flow might begin once more. Conversely, the juniors were willing to forego this fixed return and speculate upon the increase in residual values over time, and therefore are content to wait, hoping that the outlook for the debtor will improve, be it by better management, a change in economic conditions, war, or sheerest luck.

Into this situation comes the SEC, armed, of course, with its feasibility guidelines. The feasibility concept limits the range of solutions the parties may formulate. With respect to the first two tactics, feasibility mandates that certain solutions not be accepted as a matter of policy. The public must be protected, either from the economic and social consequences of another imminent bankruptcy, or from the risks of future investment in a venture inherently deceptive both upon a macroeconomic scale in terms of imperfect allocation of new investment, and upon a microeconomic scale, in terms of the sale of overvalued and deceptive securities to individual investors. The standard of feasibility is designed to protect this public interest. With respect to the third tactic, the courts have yet to formulate an adequate solution.

The determination of feasibility is within the competence of the district judge, subject to review only upon a "clearly erroneous" standard. Such a determination, as does any other finding mandated by the Bankruptcy Act, "calls for an informed, independent judgment" by the

52. Attorneys and security holders are attempting to develop new forms of qualitative compensation. Among the suggested forms is the use of an abnormally high sinking or purchase fund, payable out of earnings, to retire the securities distributed to the old senior creditors. Payment to this fund would be a condition precedent to the payment of dividends upon the new common stock that had been distributed to the old junior creditors. See Swaine, supra note 14, at 1212.

53. Blum, The Law, supra note 4, at 584.

judge. This procedure clearly precludes the practice which existed under the old section 77B whereby courts frequently viewed the feasibility of a proposed plan as a matter of business judgment, a matter much better determined by the parties to the reorganization than by the court.

The SEC has the responsibility of providing the court with an impartial, expert opinion addressed to the problems faced in this area. Although the Commission's reports are only advisory in nature, and the courts have frequently disagreed with the SEC, its influence whether by appearance and oral argument, or by formal written report, cannot be denied.

III. THE SEC AND FEASIBILITY

A. Introduction

Throwing the corporation into bankruptcy was a little different from an equity receivership, though it is impossible to say exactly where the difference lay. Lawyers, however, felt that the equity receivership was a little better because they themselves had invented all the rules in this procedure, and they were not bothered by the legislature as in bankruptcy. Hence the equity receivership was preferred, but if a student wanted to ask a lawyer just why, he got no such simple explanation. Instead he was referred to a large number of books. The subject was simply too colossal to be talked about simply . . . .

No one was permitted to talk naturally about the facts of financial life and politics.

However, Congress sent the SEC to the rescue. As designed, its function is to bring the truth about the financial problems of the debtor

57. H.R. Rep. No. 1409, 75th Cong., 1st Sess. 48 (1938). In recommending the revision of the Bankruptcy Act, the House Committee on the Judiciary contemplated: The court will have the benefit of expert and disinterested advice to aid it in the solution of the complicated financial and legal problem [sic] involved in the typical large reorganization. This should fill a long-felt need and be welcomed by both courts and investors. It should provide a further check on the exercise of reorganization powers and give additional assurance that the interests of investors will be served.
58. T. Ampron, supra note 13, at 237.
out into the open. As a party to the proceeding and as expert advisor, the SEC places its facilities at the disposal of the court. The bankruptcy court in all cases may, and if the corporation's indebtedness exceeds $3 million, must, submit a reorganization plan to the SEC.

The court may not approve a plan so submitted until the SEC has filed its advisory report or has notified the court that it will not file one. Since the Commission's report will eventually go to the stockholders or creditors, the SEC is forced to use a minimum of "legalese" and a maximum of the straight talk that reorganization proceedings were so desperately in need of before the Chandler Act.

The SEC, in carrying out the statutory mandate, takes the issue of feasibility quite seriously. First, the SEC regards it to be axiomatic that one reorganization is enough for any company.

Although security holders' representatives frequently regard the fairness of the plan as their principal concern, the full protection of their interests requires also that the plan be feasible so that it will not hamper future operations or compel another reorganization. As the SEC staff wrote a large portion of Chapter X, the Commission's reputation as an expert in the feasibility area would be somewhat tarnished if a debtor whose plan it had approved as feasible were to require a second reorganization.

Second, the SEC, which now views itself as the guardian of the securities market, insists that the "new securities shall not by their terms or otherwise be deceptive to subsequent purchasers." This issue is not confined solely to the question of whether or not a worthless security is deceptive, although the SEC often speaks in such terms. The SEC also closely scrutinizes and regulates the material printed upon the securities. For example, it insists that an income bond be referred to as a preferred stock. As a consequence, the SEC views the "standard" forms of securities as nondeceptive, and therefore a plan with too much embellishment has less chance of obtaining SEC approval.

61. Id. § 573 (1970).
62. Id. § 575 (1970). Recent economic developments have caused a tenfold increase in the work of the SEC. The Commission reviewed 117 reorganization petitions in fiscal 1974, but it estimates it will process 1,225 petitions in the current fiscal year and 1,500 in fiscal 1976. The Wall Street Journal, Feb. 4, 1975, at 4, col. 6.
64. PROTECTIVE COMM. REPORT, pt. VIII (1940).
65. 8 SEC ANN. REP. 28 (1942). However, securities issued in a Chapter X reorganization are exempt from the prospectus requirements of the Securities Act of 1933. See generally 1 L. Loss, SECURITIES REGULATION 584-88 (2d ed. 1961).
66. According to Professor Blum, feasibility standards "probably include a restriction on trimming new securities with rococo qualities which tend to be misleading."

King: Feasibility in Chapter X Reorganizations
The SEC's third bias evinces itself in the Commission's attempts to slow down the initial reorganization machinery in certain cases, thereby preventing an opportunist from rushing the court into a premature judgment. The tangled web of conflicts and the immense valuation problems posed by a dying venture are more than sufficient to tax the limits of the judicial process. The Commission insists that time be taken to develop an adequate record as to the prospects of the debtor, particularly its future earning capacity, before the court examine any plan. The assets of a faltering business are not to be disposed of until there has been a sufficient opportunity to determine what disposition will be most advantageous to all the interested parties, nor can the trustee propose a swift reorganization to avoid a complete investigation of the old management. If the trustee is in the midst of making significant changes in the debtor, such as selling off a large percentage of nonincome producing assets, then the SEC insists that no reasonable estimate of future earnings be made until the extent and effectiveness of these changes is clear. The emphasis is upon predictability; the SEC will not grant its approval until there is an accurate and complete picture of the future earning capacity of the reorganized debtor.

Perhaps it is proper to add a fourth bias to this list. The SEC deals with investors and how they invest their money. It is not concerned with taxes; rather, it views tax consequences as within the sole province of the Internal Revenue Service (IRS). Thus, since tax matters are "the I.R.S. business, if they want to be a party to the

67. Blum and Kaplan explain: "[R]eorganizations under Chapter X . . . involve some of the law's most difficult problems of analysis, adjustment of rights, and litigation." Blum & Kaplan, Absolute Priority, supra note 39, at 654.


69. Blum, The Law, supra note 4, at 566. This is particularly true where the trustee proposes to sell all the assets to a buyer who insists upon an immediate sale. Cf. In re Solar Mfg. Corp., 176 F.2d 493 (3d Cir. 1949). In Solar, the proposed "emergency" sale by the trustee involved a price of $525,000, and the assets were eventually sold for $815,000. 16 SEC ANN. REP. 118 (1950). See In re American Bantam Car Co., No. 21881 (W.D. Pa., filed April 19, 1950), noted in 17 SEC ANN. REP. 126 (1951). The Commission has always been suspicious of proposed emergency sales. See generally 39 SEC ANN. REP. 120-21 (1973).

reorganization, they can become one."

Unfortunately, it is more than simply the concern of the IRS—it is very much a concern of the participants who have a great deal of money involved in the decision. Chapter X reorganizations are governed by sections 371 and 372 of the Internal Revenue Code of 1954, and a transfer of assets from the old corporation to a new corporation for the latter's "stock or securities," which transfer meets the requirements of these sections, will result in nonrecognition of gain or loss to the corporation on the transfer. The basis of the assets in the hands of the old corporation carries over to the new corporation, and no gain or loss will be recognized by the shareholders or creditors. In addition, the "continuity of interest" requirement applies to reorganizations pursuant to section 371. Without elaboration, it has been held that the creditors of an insolvent enterprise will usually be regarded as the owners of the equity of the emerging corporation and thus will be treated as holding the continuity of interest trait. The kinds of reorganization tickets that these participants receive will thus determine the applicability of these nonrecognition provisions. The tax objectives of the parties may be in conflict, with

71. Comment of former SEC employee Bob Ginzburg upon being asked if the SEC ever considered the tax incidents of a reorganization plan, March 13, 1974. See also Imperial "400," Inc., SEC Corporate Reorganization Release No. 313 (Aug. 29, 1973), 2 S.E.C. Docket 377, 389 (1973), where the SEC declared that an uncertain tax status after the acquisitive reorganization would not delay the Commission's approval of the plan, because "[n]ot every means for consummating a plan must be firmly established in all their intricate details in order to merit judicial approval of the plan." Id. This seems inconsistent with the SEC's general reluctance to approve of anything with an uncertain future. The SEC otherwise requires that a plan be detailed and complete, and the failure to provide concrete programs concerning operational and financial changes is a factor in the determination that a plan is not feasible. In re Imperial "400" Nat., Inc., 374 F. Supp. 949, 959 (D.N.J. 1974). Further, it would appear deceptive to distribute securities without an indication of whether the transaction is taxable. But cf. Indiana Lime. Corp., 18 S.E.C. 178, 198 (1945).

73. Id., § 372.
74. Id. Note the SEC's early actions in actively seeking to have section 270 of the Bankruptcy Act (dealing with tax basis) modified in favor of the debtor. 6 SEC ANN. REP. 57-59 (1940).
75. INT. REV. CODE OF 1954, § 371(b).
76. This doctrine generally requires that the owners of the former corporation retain a continuing equity interest in the reorganized debtor. See B. Bittek & J. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.11 (1971).
79. Interacting with the continuity of interest problem is the question of what constitutes "securities" for the purpose of section 371(b) of the Internal Revenue Code. See Treas. Reg. § 1.371-1(a)(5). A related issue is whether the takeover can
some desiring to avoid nonrecognition treatment in order to take immediate advantage of a loss, while others who acquired their interests upon a speculative basis and who may actually have a gain might desire to defer recognition of that gain to some time in the future. When the debtor is acquired by a presently operating corporation, as opposed to a corporation formed specifically for the purpose of reorganization, the tax picture becomes even more confused.

An acquiring corporation may also desire to preserve and carry over the corporate net earnings loss, capital loss, or deficit in earnings and profits. If there is a substantial earnings and profits account, it may be advantageous to attempt to eliminate that account. The reorganization can also be structured to avoid recognition of any discharge of indebtedness income and recapture of depreciation and investment credits. Even the debtor's methods of accounting will have to be considered in structuring the reorganization. As a result, the participants may differ among themselves as to tax objectives, and may differ with the management that will emerge from the reorganization. Although the SEC does not object to the proponents arranging their plans with specific tax objectives in mind, there is no indication that the SEC or the

avoid the problem by treating "securities" as "property" under section 361 of the Code, so that where the exchanging shareholder is a corporation, it can avoid section 371 and utilize section 361. Compare Neville Coke & Chem. Co. v. Commissioner, 148 F.2d 599 (3d Cir.), cert. denied, 326 U.S. 726-27 (1945), with Seiberling Rubber Co. v. Commissioner, 169 F.2d 595 (6th Cir. 1948).

The Commission on the Bankruptcy Laws of the United States would amend several sections of the Code to make the tax treatment of Chapter X reorganizations similar to that of other corporate reorganizations. I BANKRUPTCY COMMISSION REPORT, supra note 4, at 277-97. See Plumb, supra note 78, at 239-43.


81. Krantz, Loss Carryovers in Chapter X Reorganizations, 16 TAX. L. REV. 359, 361 (1961); Glancy, Carrying Losses Through Chapters X and XI Reorganizations, 28 TAX LAW. 27 (1974). Note that this net operating loss carryforward is an asset of the debtor, even if it can not be sold as such, and enters into the valuation of the debtor. See In re Imperial 400 Nat'l, Inc., 374 F. Supp. 949, 954-56 (D.N.J. 1974).


Under the plan of reorganization filed by the debtor in Riker, unsecured creditors would receive $250,000 in cash and 5 percent convertible debentures in the principal amount of $2,250 million. A secured creditor, the plan's proponent, was to supply the cash needed to consummate the plan ($500,000), and was to receive 1,440,000 shares of the common stock of the reorganized company. Holders of the old preferred and common shares were also to receive 360,000 shares of the new common stock, or 20 percent of the total outstanding, even though the creditors were not receiving full compensation for their claims. The only reason for this allocation was tax oriented, and the Commission acknowledged this; it held that the participation of the old stockholders was still fair and equitable and met the requirements of the absolute priority rule. The plan's proponent, according to the SEC, was entitled to all the common stock of the reorganized venture for his contribution of fresh
courts have considered either who should be benefited, or if a party should receive tax benefits, whether such benefits should be considered as compensation to it. Further, there is certainly no indication why the SEC does not view the failure to reveal these tax incidents as deceptive. The area remains open to bargaining among the parties.

B. Amount of Debt

Perhaps no other issue represents to both the courts and the SEC the concept of feasibility more than a discussion of the amount of debt a corporation may safely issue. The benefits of using debt are well known, and the general dynamics of the reorganization bargaining result in the SEC's serving as the proponent of a low debt structure. In the late 1930's, keeping debt at a minimum was popular as the plague of excessive debt financing was viewed as one of the major causes of the great depression. The argument has continued for years, and remains unsettled even today.

In 1948, one commentator was daring enough to summarize the specific guidelines that the Commission then followed. No one has since repeated his mistake, nor will this article attempt the impossible. Circumstances have changed too much since the late 1930's to expect the SEC to be completely consistent. Corporate debt has grown enormously. With the publication of an important book advocating debt financing, and the advent of a long, sustained boom in the economy, the 1960's heard the final death knell to the "demon-debt" image, at least as far as management was concerned. Yet the rhetoric of the SEC indicates that the change has yet to reach Washington. When
capital, and the allotment, presumably for tax reasons, of 20 percent of the new
common to the old stockholders was a "gratuity" which the proponent was free to
grant since it was not at the expense of the creditors.

In Phoenix Gems, an acquisitive reorganization with a healthy small corporation in a parallel line of business, the Commission approved a plan whereby the reorganized debtor issued 80 percent of its shares to acquire all the stock of the proponent's healthy firm, and 20 percent of its shares to others with claims against the debtor.


84. Calkins, supra note 4, at 769. Calkins concluded:

[T]he maximum amount of senior issues considered feasible by the Commission, and likely to be approved by the courts, will consist of bonds and other fixed debt obligations which (1) have an overall fixed-charge coverage (interest and sinking fund requirements) of approximately three times for industrial firms and two times for public utilities, (2) have an asset-protection ratio of between 100% and 200%, preferably in the form of fixed assets, and (3) do not exceed 50% of the capital structure.

85. G. DONALDSON, CORPORATE DEBT CAPACITY (1961) [hereafter cited as DONALDSON].
presented today with the argument that a debtor should be allowed to use a high percentage of debt to secure a tax advantage, the SEC responds with the same "answer" it offered in the 1940's:

It has also been urged that the creation of as large a bond issue as is proposed will result in tax savings as compared with a smaller funded debt or an all stock capital structure. We do not believe that speculation as to the nature and extent of the tax statutes which may be enacted in the immediate future or over the life of the reorganized debtor is suitable or appropriate. However, even if tax savings can be predicted, that element should not outweigh the necessity for a sound capital structure within the limits of feasibility. In view of the uncertainty as to the debtor's future earnings we are of the view that the bondholders' interests would be best served by foregoing whatever tax advantage may accrue from a bond issue to make more certain that resort by this enterprise to the reorganization courts for the third time with the attendant expense, delay and possible disruption of business will not be necessary.

The SEC appears to use several tests to determine whether or not a plan provides for excessive debt. The primary test is one of the earnings coverage; "[w]hether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a sine qua non to a determination of the integrity and practicability of the new capital structure." The SEC has always viewed feasibility as requiring that there be "prospective earnings of sufficient certainty, stability, and amount to warrant the imposition of a fixed liability and to provide an adequate margin of safety for the payment of interest and the retirement of bonds at their maturity dates." In 1948, one commentator stated that the SEC favored a ratio of earnings three times the amount of the overall fixed charge for industrial companies and a ratio of two times for public utilities. Although the SEC rarely mentions specific coverage ratios, circumstances have changed. It is submitted that the minimum coverage ratio for industrial companies is now between two and two and one-half.

90. See, e.g., Selected Inv. Corp., 39 S.E.C. 37, 51-52 (1959) (plan whose coverage was predicted to be as low as 2.3 times in a pro forma statement for the next 5 years approved as feasible); Four Seasons Nursing Centers of America, Inc., SEC Corporate Reorganization Release No. 310, at 56-57 (March 16, 1972), [1970-1973 Transfer Binder] Bankr. L. Rep. 64,399, at 73,975 (SEC 1972) (approving a 2.4 ratio).
It should be noted that the earnings coverage should be realized even in the lean years, thus necessitating an extensive examination of the degree of fluctuation inherent in the debtor's earnings pattern.\(^{91}\) If the income is subject to such wide fluctuations that it is impossible to predict how "lean" the lean years will be, the SEC insists that contingent obligations be substituted for fixed ones.\(^{92}\) Obviously, there is no absolute rule,\(^{93}\) and very often a combination issue with part fixed and part contingent interests may be used.\(^{94}\)

The SEC also appears to use a second test, one that focuses upon the balance sheet. The SEC believes that there should be a conservative relation between assets upon one hand, and the fixed charge securities upon the other. However, this relationship has not been precisely determined as the Commission has only mentioned it on rare occasions.\(^{95}\) One commentator has indicated that the SEC prefers that the combined value of funded debt and preferred stock issues not exceed the value of fixed assets.\(^{96}\) The case law is not clear because the phrase "asset value" is often used without indication of whether reference is being made to tangible asset value or going concern value. In any case, it is submitted that the SEC has abandoned this test, and it is doubtful that it ever intended to use it.

The use of this balance sheet criterion where a debtor's earnings are directly related to its historical costs can be rationalized. In the reorganization of the Pittsburgh Railway Company,\(^{97}\) the SEC urged

92. See, e.g., Minnesota & Ont. Paper Co., 7 S.E.C. 456, 539-40 (1940); Philadelphia & Reading Coal & Iron Co., 10 S.E.C. 714, 716 (1941). *Accord, Financial Handbook* § 22, at 12 (4th ed. J. Bogen 1964): "If the earning power of a business tends to disappear entirely in depressions, serious consideration should be given to the substitution of contingent interest bonds or stock for all outstanding fixed interest debt." *Id.*
93. While the SEC approved a plan with approximately 16 percent debt in the reorganization of the Pittsburgh Railway Company, it noted that it "would prefer that the capital structure of a company such as this contain no mortgage bonds in view of the volatile nature of earnings in the Railroad industry and the practice of financing equipment through direct debt obligations." Elmer E. Bauer, 31 S.E.C. 432, 440 (1950).
94. See, e.g., Broadway-Exchange Corp., 15 S.E.C. 256, 270-71 (1944); Cenwest Corp., 15 S.E.C. 352, 360 (1940).
95. Flour Mills of America, Inc., 7 S.E.C. 1 (1940); La France Indus., 5 S.E.C. 917 (1939).
96. Calkins, *supra* note 4, at 768, citing Minnesota & Ont. Paper Co., 7 S.E.C. 456 (1940). *See* Flour Mills of America, Inc., 7 S.E.C. 1 (1940); La France Indus., 5 S.E.C. 917 (1939). In *Minnesota & Ontario Paper*, the Commission approved as feasible a bond issue that represented "not quite 50 percent of the total value for reorganization of all the assets . . . and approximately 70 percent of the going concern value of the fixed assets." 7 S.E.C. at 539.
the Pennsylvania Public Utility Commission to follow the technique of \textit{Consolidated Rock Products Co. v. DuBois}^{98} and stress the capitalization of estimated earnings. Although the issue revolved around finding a total value for the enterprise, the Pennsylvania Commission insisted upon valuing the debtor at original cost less accrued depreciation (or depreciated reproduction cost if this was less) rather than capitalizing the prospective earnings.\textsuperscript{99} Stressing the function of a "rate base" system of regulation the Public Utility Commission said:

We do not read the Rock Products decision as enunciating a rule that prospective earning power is the sole criterion to apply in formulating capital structures for utilities in process of reorganization. The Rock Products case involved an industrial company, whose charges and services are not affected with a public interest....

The prospective-earning-power-alone criterion, if applied to utilities, might give rise to mischievous and vexatious situations. A utility is entitled by law to a fair return, and no more, on the fair value of its properties. A grossly over-capitalized utility undergoing reorganization might have present earnings sufficient, and only sufficient, for a fair return on the fair value of its properties, but its prospective earnings, if and when realized, might be substantially in excess of a fair return on the then fair value of its properties. .. On the other hand, if rates or fares were not reduced, so as to enable interest and dividends to continue to be earned in full, the public would be deprived of the reasonable rates on fares to which it is entitled by law. A ceiling on reorganization securities — say depreciated original cost or depreciated reproduction cost, whichever is lower — would be a powerful deterrent to the arising of such a vexatious situation, as such costs are elements of fair value.\textsuperscript{100}

The courts, however, have adopted the SEC's position.\textsuperscript{101}

A third test used by the SEC is one which compares the amount of funded debt to the total capital structure. Again, a substantial amount of speculation is involved in determining whether the SEC uses any fixed standard. The figure of 50 percent has been suggested,\textsuperscript{102} but it has never received any direct support from the Commission as a standard. The cases in which the debt ratio has been specifically mentioned

\textsuperscript{98} 312 U.S. 510 (1941).
\textsuperscript{99} W. D. George, \textit{PA. PUB. UTIL. COMM'N} 65, 74-75 (1941).
\textsuperscript{100} Id. at 75.
\textsuperscript{101} See, e.g., \textit{In re Chicago Rys.}, 160 F.2d 59, 68 (7th Cir.), cert. denied, 331 U.S. 808 (1947), \textit{noted at} 13 SEC ANN. REP. 100-01 (1947). Unlike the decision of the Pennsylvania Public Utility Commission, this case was decided after the Supreme Court's decision in \textit{Group of Inst. Inv. v. Chicago, M., St. P. & Pac. R.R.}, 318 U.S. 523 (1943), where the Supreme Court stressed the importance of valuation by earning capacity in section 77 railroad reorganizations. \textit{Id.} at 540-41.
are not consistent, and the SEC has not always been persuasive in arguing that it was too high. In sum, the debt ratio seems to have little meaning when standing alone; yet at times, the Commission has cited Judge Frank and attempted to utilize the high debt ratio argument:

Among the most important aspects of sound structure in the Commission's opinion, is a reasonably small percentage of debt and a substantial value behind the common stock equity. Much of the financial disaster of the past, in its opinion, has been due to top-heavy debts in corporate financial structures. Conversely, much wild speculation and market manipulation is encouraged by the existence of 'poker chip' equity securities with little or no value behind them.

Thus in reorganization plans we condemn too heavy a load of senior securities. This attitude is not inconsistent with our support of the rule of full compensation for senior claims . . . . On the contrary, both positions discourage trading on a thin equity . . . .

C. General Terms of the Debt Issues

The SEC, acting out its role as guardian of the securities market, has always insisted that the nature of any debt obligation had to be clearly stated. For example, a company in liquidation should never

103. Compare Cenwest Corp., 15 S.E.C. 352, 360 (1944) (approving a real estate company in which 78 percent of total capitalization was debt, stating that this was the maximum permitted by the requirements of feasibility), and Third Ave. Transit Corp., 37 S.E.C. 236, 242 (1956), Third Ave. Transit Corp., 37 S.E.C. 258, 271 (1956) (both approving a 69 percent debt ratio), with Keeshin Freight Lines, Inc., 29 S.E.C. 724, 746-50 (1949) (54.8 percent debt was "top heavy," even though fixed charges were covered "from 6 to 10 times, before federal income taxes and from 4 to 5 times for the first 6 years after federal income taxes"). Id. at 746.

104. See, e.g., Atlas Pipe Corp., 9 S.E.C. 461, 441 (1941), wherein the SEC disapproved of a plan calling for 93 percent of the capital structure to be senior securities as unsound. Id. However, this plan was subsequently adopted by the court in In re Atlas Pipe Corp., 39 F. Supp. 846 (D. La. 1941). See Green River Steel Corp., 37 S.E.C. 507, 524-25 (1957). There, the SEC concluded that a plan calling for 96.3 percent debt was not feasible. However, this plan was also adopted by the court in In re Green River Steel Corp., [1957-60 Transfer Binder] BANKR. L. REP. ¶ 58,939 (N.D. Ky. 1957), noted in 23 SEC ANN. REP. 153-55 (1957).

105. In this regard, note the following New York Stock Exchange's standard for delisting firms which combines an interest coverage and debt ratio test:

When the company . . . issues a debt security and . . . on a pro forma basis after interest charges on all debt, including the new issue, there would be either before or after income taxes and earnings deficit or earnings would be nominal - and - on a pro forma basis common stock equity is less than 25 percent of the capitalization.


106. See note 41 supra.

107. Frank, supra note 41, at 344-45 (footnotes omitted).

issue certificates that clothe the enterprise with the appearance of an ongoing venture. 109

Subordination of the debt issues has given the SEC trouble, and the SEC surely views subordination to future claims as being inconsistent with the inherent nature of a debt obligation. 110 The Commission also views contingent payment of interest as inconsistent with the nature of debt obligations. 111 Generally, it sees no reason for the label "income bonds," and contends that such obligations should be called preferred stock. 112 As was previously mentioned, an obligation contingent in part appears to be acceptable, but the contingent portion must have a reasonable chance of being earned, and the company should only be able to withhold payment of the interest as it is earned under extraordinary circumstances. 113 Note that the tax sys-


110. In Greiss-Pfleger Tan. Co., 5 S.E.C. 72 (1939), the plan of reorganization provided for issuance of "capital income debentures" having no lien against any asset and being subordinate to all present and future creditors. Contingent but cumulative interest was payable only from earnings, upon a sliding scale; the issue matured in 15 years, but was convertible into stock. The SEC insisted that this be called preferred stock. Id. at 82-84. However, the court approved the plan. 5 SEC ANN. REP. 19-20 (1940). See also Flour Mills of America, Inc., 7 S.E.C. 1, 27 (1940).

111. See Arlington Disc. Corp., No. 48421 (S.D. Ohio, filed July 3, 1967), noted in 37 SEC ANN. REP. 185-86 (1971). There, the debentures were "too contingent," and thus were illusory and deceptive.

112. See Green River Steel Corp., 37 S.E.C. 507, 525-26, 37 S.E.C. 568 (1957), where the SEC concluded that it was inherently deceptive to label an issue as a "debenture" where no interest was payable for the first 2 years and the noncumulative interest was payable only if certain earnings after other interest and sinking fund requirements had been met for that year and preceding years; Third Ave. Transit Corp., 37 S.E.C. 113, 156 (1956); Chicago & W. Towns Ry., 35 S.E.C. 290 (1953). See also Philadelphia & W. Ry., 13 S.E.C. 330 (1943).


Also revelent in this regard is the SEC's refusal to recognize the substantial difference between taxation of an interest payment and that of a dividend payment. In Chicago & W. Towns Ry., 35 S.E.C. 290 (1953), the SEC objected to a plan providing for income bonds. In response to a claim that the bonds would provide a greater tax advantage than stock, the Commission responded:

It may be urged, however, that the reorganized company may benefit from reduced Federal income taxes if income bonds are issued. This is not persuasive. The extent of such tax reduction, if any, would depend upon the company's income for income tax purposes, the continuance of present tax statutes which cannot be considered certain, and, of course, only on the actual payment of the constant non-cumulative interest on the bonds. A factor such as possible tax reductions ought not to outweigh the necessity that reorganization produce a sound capital structure meeting the statutory requirements of feasibility. Id. at 299 (footnotes omitted).

On the importance of this tax distinction in the regulated industry context, see Stevens, Participating Debt Versus Other Securities in Capital Structure Readjustments, 28 GEO. L.J. 1021 (1940). Note that the courts are not bound to accept the SEC's advice, and often they do not. E.g., In re Greiss-Pfleger Tan. Co. (S.D. Ohio 1939), noted in Calkins, Feasibility, supra note 4, at 769 n.28; In re Green River Steel Corp., 35 S.E.C. 113, 156 (1956); Bankr. L. REP. ¶ 58,939 (N.D. Ky. 1957); In re Philadelphia & W. Ry., 51 F. Supp. 129 (E.D. Pa. 1943).
tem also operates upon the recipient level: a corporate creditor might wish to have preferred stock rather than debt because of the intercorporate dividend exemption, or debt rather than stock if there are statutory bars to holding equity. There is no indication that the SEC considers those preferences in forming its policy of insisting upon "pure" as opposed to "hybrid" securities. Perhaps it views these tax related problems as uniquely suited to resolution by interparty bargaining.

Of course, all the factors the Commission considers have effects upon the price of the security. While one commentator has contended that the apparent intent of the SEC is to have the bonds quoted at or slightly above par, there is little support for this position. At a minimum, it can be said that the Commission will object to a substantial discount upon the bonds, particularly if the company intends to retire the securities at that depressed price. While setting an appropriate interest rate is, of course, related to this, it is a subject that is more related to the absolute priority rule. The rate of interest must be compared to the yield of the securities exchanged to ensure that the parties are made whole. If the interest rate is lowered, then compensation must be made by adjusting the quality differences; for instance, by increasing the allocation of securities made to that particular group. In general, first the interest rates will be set at levels roughly comparable to the costs incurred by similar healthy companies, and then the allocation will be determined. It remains to be seen whether the SEC will use the current high interest rates as guides, but it appears unlikely that the courts will want to brand the debtor with debt bearing interest at greater than 15 percent.

D. Sinking Fund Provisions

It is important to grasp the statutory provisions dealing with sinking funds. Section 216(9) of the Chandler Act provides that a plan:

may include, where any indebtedness is created or extended under the plan for a period of more than five years, provisions for the retirement of such indebtedness by stated or determinable payments out of a sinking fund or otherwise, (a) if secured, within the expected useful life of the security therefor or (b) if unsecured, or if the expected useful life of the security is not fairly

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ascertainable, then within a specified reasonable time, not to exceed forty years...  

The legislative history expresses the concern that "there are in our economic society two major forms of credit systems — long and short terms; that the economic chaos which has come upon us has been due in some measure to unsound financing on long term credit" in that "[b]ond issues have not provided adequate methods of amortization." The suggestion is clearly that large bond issues should be amortized over their life spans, yet the Bankruptcy Act provision for amortization is entirely optional. This section was designed to encourage the gradual amortization of debt without requiring mandatory sinking funds where none were necessary.

However, the SEC reads this statute differently; to them, a plan is not feasible unless it provides that all indebtedness will be retired by maturity, or by the time that the major income-producing assets of the company are exhausted. The courts have not always agreed with the SEC upon this matter. While the Commission has not established any fixed standard for sinking funds, it has approved the retirement of a fixed amount of the bonds each year, and, as an alternative, the use of a fixed percentage of net earnings to retire a portion of the debt each year. It also appears to have approved provisions


122. Professor Calkins says the Commission prefers that 2½ percent of the face amount of the bonds be retired each year if the fixed sum method is used, and that 50 percent of net earnings after payment of bond interest and taxes be spent if the fixed percentage method is used. Calkins, Feasibility, supra note 4, at 771. Cf. In re Quaker City Cold Storage Co., 71 F. Supp. 124, 128 (1947), suggesting a 50 percent of earnings figure.

Under section 7(c) of the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79(l)(c) (1970), the SEC requires first mortgage bonds of issuers subject to that Act to have an annual sinking fund equal to not less than 1 percent of the aggregate principal amount of the bond issue. S.E.C. Public Utility Holding Company Act Release No. 35-19103 (Feb. 16, 1965).
for deferring the sinking fund payments if the installment would deprive the company of sufficient working capital.\footnote{124}

In light of the optional nature of statutory sinking fund provisions, and in view of the sharp disagreement as to who is the primary beneficiary of a sinking fund,\footnote{125} it is surprising that the SEC has never explained the rationale of its policy of requiring them. Admittedly, the SEC is supported by the fact that a substantial majority of outstanding debt issues do have sinking funds,\footnote{126} but there are real problems to which the SEC has not addressed itself. For example, if the bonds or debentures are selling at a discount, then presumably the corporation, or more accurately, the stockholders who hold the equity in that corporation, are harmed and the bondholders benefited; yet the SEC strenuously objects to any plan providing for the systematic purchase of debt upon the open market or by tender, presumably at a discount. The Commission takes this position: "The expectation that bonds may be repurchased at a discount in itself impels toward the conclusion that the plan is not feasible."\footnote{127} The other aspect of the problem is the result which obtains when the debt sells at a premium.\footnote{128} In this situation it is the bondholders who are hurt if their securities are redeemed at less than market value. This can be cured by the use of a call premium, but the SEC has never insisted upon one. Even then, it is not clear whether the call premium would adequately compensate the bondholders.\footnote{129} Notice how this issue interacts with the fairness question: fairness or feasibility requires that a reorganization ticket be able to be sold at or near face value either immediately or at a reasonable time after the reorganization is consummated. The SEC has not adequately responded to

\footnote{124. Minnesota & Ont. Paper Co., 7 S.E.C. 456, 542 (1940).}
\footnote{125. Compare 1 A. DEWING, supra note 43, at 250-51, indicating that a sinking fund's primary purpose is to protect the stockholders, with J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 276 (1968), arguing that "[t]he sinking fund works to the disadvantage of common stockholders."}
\footnote{126. F. THOMPSON & R. NORGAARD, SINKING FUNDS: THEIR USE AND VALUE 31-39 (1967). The authors report that during the period 1965-1967, over 80 percent of the publicly offered issues had sinking funds, and that in 1963, over 96 percent of the private placements had them.}
\footnote{127. Indiana Lime. Corp., 18 S.E.C. 178, 196 (1945); accord, Broadway-Exchange Corp., 15 S.E.C. 256 (1944) ("[I]t is highly objectionable to issue bonds containing an express promise to pay a stated principal sum, when it is to be expected that the bonds can be retired only at a very substantial discount." Id. at 270.); Boston Met. Bldgs., Inc., 31 S.E.C. 854, 872-75 (1950). But cf. Greiss-Pfleger Tan. Co., 5 S.E.C. 72, 82 (1939), where the Commission indicated that while the ability to buy up debentures at a significant discount was a plus in the feasibility question, it was a minus as to the fairness issue.}
\footnote{128. This does happen; see note 208 infra.}
\footnote{129. Fraine & Mills, Effect of Defaults and Credit Deterioration on Yields on Corporate Bonds, 16 J. FIN. 423 (1961). ("For the continuing investor, the call premium is, in effect, inadequate 'Liquidated damages' for loss to be suffered on reinvestment." Id. at 427.)}
either of these questions, yet it continues to insist upon sinking funds. Its policy reflects the belief that a company once in trouble may be there again, unable to pay off or refinance the obligations at maturity.130 Thus the Commission implies that the firm is not competent to manage its funds wisely, and therefore requires it to join a "corporate Christmas Club."131 A sinking fund also serves to reinforce the clear distinction between ownership and creditor interests that the SEC prefers: securities should be pure, not hybrid, the debt portion being only a temporary contribution to the firm's capital structure.132

E. Convertible Securities and Warrants133

While the Commission has approved the use of convertible bonds, it has avoided discussing them.134 From the recipient's standpoint, the convertible offers the advantage of a "two-way play":135 it allows the bondholders to profit from a rise in value of the common stock while simultaneously giving them some protection from adverse economic conditions in the form of a fixed interest rate. In the typical context, the investor pays for this advantage twice — paying a premium for a conversion feature and a premium for a protective feature.136

130. An investor with these fears will pay less for the same bond without a sinking fund. Cf. Jen & Wert, Imputed Yields of a Sinking Fund Bond, and the Term Structure of Interest Rates, 21 J. Fin. 698, 708 (1966). It has been suggested that the sinking fund be viewed as a form of compensation to the bondholders. Guthman, supra note 39, at 752. See also note 52 supra. However, it seems dubious that a sinking fund can in any way affect the operation of the absolute priority rule.
132. 1 A. Dewing, supra note 43, at 239. Dewing concludes:
The increase in market price of corporation bonds by reason of the presence of a sinking fund is one of the most interesting aspects of corporation finance, because its causes are essentially psychological. The stockholder recognizes the permanence of his investment, but the bondholder clings to the fiction that his security must be redeemed in money by the corporation at a certain definite time. He assumes that the bonded lien on the corporation's assets is but temporary and that the stockholders look forward to the time when the corporation shall be free from debt. The presence of the sinking fund covenant is evidence of the conscious acknowledgment by the corporation of this presumption — and the bondholder is willing to pay something for this acknowledgment.

Id.
133. Because they share common economic and financial attributes, convertible securities and warrants are considered together, despite the fact that the SEC does not consider them to be the same.
136. J. Van Horn, The Function and Analysis of Capital Market Rates 167-69 (1970); Baumol, Malkiel & Quandt, The Valuation of Convertible Securities,
This is reflected by the interest rate on convertibles, which is usually below the rate that would be required for a straight debt security of the same company. With less fixed charges, the use of convertibles, as compared to an equivalent issue of nonconvertible bonds, reduces the risk of ruin of the enterprise. While it seems that holders of the common stock should benefit by this reduced risk, they actually face the prospect of having their equities diluted. Even so, the convertible security can be viewed as beneficially delaying and reducing this dilution of the common stock.  

Alternatively, it has been argued that conversion is most likely to occur when the conversion price is materially below the price at which the corporation could issue stock and when it may not need the money. In the reorganization context, the convertible debenture faces many of the same objections as a warrant. First, are the senior security holders “made whole” by the underlying debenture, and if they are, what is the need for the convertibility option? If the seniors are not made whole by the underlying debenture, and the convertibility feature is part of their compensation package, is this scheme fair to the new junior who will bear the downside risk of the enterprise while having any upside gains diluted by conversion? The SEC has focused upon these issues in its treatment of warrants. 

Warrants may be issued separately or in conjunction with another security, usually with preferred stock or debt. Where issued with a debt security, the warrant may be detachable from the underlying security, or may only be transferable with the security attached. In either case, the principal distinction between warrants and con-


137. Katzin, supra note 135, at 361.


139. The Commission argued that the use of warrants was unfair where a proposed plan satisfied $12 million worth of claims with the following package of securities: (1) convertibles worth $1.5 million, (2) 85 percent of the common stock, worth $9 million, and (3) warrants worth $1.5 million. Imperial “400” Nat’l, Inc., SEC Corporate Reorganization Release No. 313 (Aug. 29, 1973), 2 SEC Docket 377, 385 (1973). The SEC first objected to the use of warrants in a Chapter X proceeding, contending that a warrant was neither an appropriate instrument to impose upon a debtor undergoing reorganization, nor an acceptable currency for paying off creditors of the debtor. Id. The Commission declared:

[1] If the plan is interpreted as intending to satisfy, in full, the claims of creditors and preferred stockholders in conventional securities (debentures and stocks), with the warrants added as a bonus to creditors, the plan would be grossly unfair to the common stockholders . . . . [The common stockholders are] entitled to protection against invasion by senior claims and interests. A bonus to creditors would be at the expense of the stockholders and would violate their rights. Id. at 385 (footnotes omitted). It should be noted that in reviewing the same plan, the Commission did not object to a convertibility feature on the debentures.
vertible debt instruments is that the warrant results in a cash contribution to the enterprise when the option is exercised. For example, there is little difference between a convertible debenture worth $100 which is convertible into ten shares of stock, and the same nonconvertible security with an attached warrant to purchase ten shares of stock at $10 per share, regardless of whether such shares can be separated. However, the Commission has treated the feasibility of including warrants in the proposed capital structure as a subject uniquely deserving of direct comment. To the SEC warrants are "inherently deceptive" and that is as true today as it was in 1939.

It is instructive to catalog the SEC's objections to the use of warrants. The first objection is a contention that there is a statutory mandate against warrants. The Commission has argued that warrants may violate the statutory policy of section 216(12)(a) of the Chandler Act prohibiting nonvoting stock, and the mandate of section 216(12)(b) which requires that the charter of the reorganized enterprise contain provisions which are "fair and equitable and in accordance with sound business and accounting practice, with respect to the terms, position, rights and privileges of the several classes of securities of the debtor." However, this argument appears to be weak and the SEC has not used it to any great extent.

140. Id. at 385. The Commission concluded:

A warrant . . . is a highly speculative security. It does not give its holder any present interest in the reorganized company. It has no voting power or any right to participate in dividends or earnings. The value of the warrant depends predominantly on market factors and is particularly sensitive to market fluctuations in the underlying security.

In Chapter X a warrant is not an appropriate instrument to impose upon a debtor undergoing reorganization. Nor are the warrants an acceptable currency for the purchase of a company in reorganization. Accordingly, creditors of [the debtor] cannot be required to surrender . . . claims . . . in exchange for such an instrument.


Note that section 77(b)(3) of the Bankruptcy Act specifically provides that a reorganization plan for a railroad corporation "may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan," 11 U.S.C. § 205(b)(3) (1970). This provision is merely permissive and not "mandatory," and the creditors and stockholders in question must have some equity before being allowed to participate in the reorganization. See Ecker v. Western Pac. R.R., 318 U.S. 448, 476 (1943). See also 10 REMINGTON ON BANKRUPTCY § 4244 (1947).

143. See notes 193–98 and accompanying text infra for a description of the motive behind Section 216(12) and its relationship to feasibility.
The SEC’s second objection is that long-term option warrants are unsound from the standpoint of the company. They are not likely to be exercised at a time when the company has an urgent need for capital, but when the company needs it least. In fact, the obligation of the company under a long-term contract to sell shares of its common stock at stated prices at the option of the prospective purchasers may constitute an impediment to further equity financing.\(^{144}\)

The Commission is saying three things in this passage. First, the warrant will be exercised when the exercise price is much less than the price at which the corporation could issue common stock. Second, it will be exercised when the corporation does not need the money.\(^{145}\) Third, the outstanding warrants act as a brake upon the upward price movement of the common stock. However, in the reorganization context these arguments are muted, as the SEC is seeking to impose low debt capital structures upon companies which will most often have limited growth prospects either because of a general decline in the industry or from the stigma of bankruptcy. Even with an optimistic outlook, returning to the equity markets is indeed an extremely long range alternative for these debtors.

\(^{144}\) Childs Co., 24 S.E.C. 85, 121 (1946) (footnotes omitted) (emphasis added).

This should be compared to the SEC’s requirements with respect to the disclosure of the effect of outstanding warrants in a registration statement under the Securities Act of 1933:

If a material amount of options or warrants has been or is to be issued to promoters, underwriters, finders, principal stockholders, officers or directors, certain disclosure in regard thereto should be made in the prospectus.... Such additional disclosure should ordinarily include the following: that for the life of the options or warrants the holders thereof are given, at nominal cost, the opportunity to profit from a rise in the market for securities of the class subject thereto, with a resulting dilution in the interest of security holders; that the terms on which the issuer could obtain additional capital during that period may be adversely affected; and that the holders of such options or warrants might be expected to exercise them at a time when the issuer would, in all likelihood, be able to obtain any needed capital by a new offering of securities on terms more favorable than those provided for by the options or warrants. Similar disclosure should also be made where securities with conversion privileges are issued to the above persons.


\(^{145}\) With convertible debentures, the company has more flexibility as to the time of exercise. By calling the debentures at any time when conversion is profitable, the company can force the holders to convert or sell their debentures back to the company at a price that is often less than the current market value. This is, of course, unlikely to occur when the convertible securities are held by controlling persons or by those tied with management; the SEC’s actions with respect to Securities Act registration statements recognize this. See note 144 supra.
The SEC has also developed a third objection:

[Long-term option warrants are also objectionable from the standpoint of the public interest. Since they constitute merely a call on common stock they are likely to be subject to extraordinarily wide fluctuations on the market. Their extreme market instability is no doubt increased by the difficulty of determining their value.]

With this objection the Commission is fulfilling its role as the guardian of the securities markets. Conditions have changed since the SEC first stated these objections in 1946. The financial community has achieved a greater level of sophistication in valuing warrants and a fuller understanding of their market behavior. At the same time, the merger movement of the 1960's brought a greater awareness to the investing public of the nature of warrants and related convertible bonds. In 1946, the Commission stated that, "[i]t is significant that the New York Stock Exchange has refused in recent years to admit long-term warrants to trading and at the present time none are listed on the Exchange." This policy was altered in 1970, and by the end of 1972, 12 issues of warrants, representing 11 issuers, were listed upon the Exchange and generated a volume of 53.5 million warrants per year. Yet the SEC remains fast in its position that the warrant is too speculative a security to merit its approval, and refuses to consider it an acceptable form of compensa-

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147. Id. at 122.
148. NEW YORK STOCK EXCHANGE, COMPANY MANUAL § A11 (1968) (Rights to Subscribe); id. § B6, at B124-25 (1971) (Standards of Eligibility for Listing Long Term Warrants). The Exchange concludes:

Warrants must be to purchase the common stock of the issuing company, which stock is currently, or will be concurrent with the warrant, listed on the NYSE. Each warrant shall represent the right to buy at least one share of common stock, with the warrant holder not entitled to any privileges of the holder of common stock including dividends, pre-emptive rights or voting rights.

... [T]he Exchange can, where circumstances warrant, take into consideration ... factors which could have a bearing on the warrant holder's ultimate expectation of exercising his warrant ...

The aggregate of shares purchasable upon exercise of the warrants being considered for listing shall not exceed 20% of the total common stock outstanding of the issuing company at the time of the issuance of such warrants, unless shareholder approval of the issuance is obtained. However, the Exchange will not list warrants where the total outstanding would represent more than 50% of the common stock outstanding ...

Id.

149. NEW YORK STOCK EXCHANGE, FACT BOOK 18 (1973). As of March 31, 1974, 12 companies had 13 issues of warrants, totaling 65 million warrants in all, listed on the exchange. They were worth $311 million. New York Stock Exchange, Stocks and Warrants Listed on the N.Y.S.E. (April 4, 1974).
The sum and substance of the above three complaints of the SEC is that the warrants are not suitable as reorganization tickets. However, principal discussion of warrants has shifted to a murky fourth objection where feasibility and fairness meet — the argument that warrants are not feasible because they are not fair. Warrants can be given to two groups of people, those who are “made whole” in the reorganization process and those who are granted only a limited participation in the reorganized entity. With respect to the former, the Commission’s argument is simple: a creditor cannot be made whole with warrants because warrants are not suitable, as reorganization tickets, as previously discussed; and if the creditor is made whole without the warrants, it is unfair to the other participants to give him warrants. In the latter arena, where creditors or stockholders who are faced with the prospect of not being awarded any participation at all in the new enterprise try to claim a minimal participation in the form of warrants, the SEC faces additional problems. Warrants here can be viewed as protection for the marginal participants from an erroneous low valuation of the enterprise. Issuing warrants to these individuals will cost the enterprise nothing if the valuation is correct and the warrants expire. However, if the valuation is too low, the price of the common stock will rise and the warrants will be exercised, thus giving these people the share of the enterprise they should have received when the company was reorganized. Furthermore, the cash received from the exercise of the warrants can be used to retire the debt issued at the reorganization, thus returning more of the enterprise to its original owners or junior.

150. See 14 U. CHI. L. REV. 84, 92 (1946) (warrants do not meet a “reasonable investment standard”); note 140 and accompanying text supra.
153. The Proposed Act represents the most recent expression of this “second chance” idea. Section 7-303(3) provides that a plan of reorganization may include, if the plan is based on an estimated valuation which would preclude other participation by any class . . . provisions for delayed participation rights . . . conditioned on the court’s determination within a period specified in the plan but not later than five years from the date of confirmation that the reorganized debtor or the successor under the plan has attained a financial status that warrants such participation.

II Bankruptcy Commission Report, supra note 4, at 241. Rather than specifically authorizing warrants, this section appears to allow the valuation of the debtor to “float” within a period to be examined later. Blum & Kaplan, Absolute Priority, supra note 39, at 674. See generally Rochelle & Balzersen, Recommendations for Amendments to Chapter X, 46 Am. Bankr. L.J. 93, 99-102 (1972). Yet the drafters of the Proposed Act rejected the suggestion that these rights be made nontransferable, thus leaving the path open for the issuing of warrants. II Bankruptcy Commission Report, supra note 4, at 262 n.39.
creditors. The unfairness of this idea is clear: creditors have been forced to take a riskier ticket — straight equity — at the reorganization. It is unfair to subject these people to the downside risk of receiving no dividends while diluting their chance of upside benefits from appreciation in value of the enterprise.

Provisions for management stock options raise similar problems. While they are primarily designed to serve as employment compensation, and are therefore tailored to both personnel objectives and to income tax considerations, options can have the same equity-diluting effect upon the corporation's capital structure. Note, however, that to the extent they replace fixed charges for salary with the contingent dividend expense upon the underlying stock, the options can actually reduce the risk of ruin of the enterprise. The SEC has not yet responded to this argument.

It is clear that management cannot "contribute" its services in exchange for a portion of the reorganized enterprise. The Supreme Court of the United States in Case v. Los Angeles Lumber Products Co. specifically held that the strategic value that management may possess — the ability to control the enterprise and hinder the reorganization process — is not to be regarded as a thing of value which can be relinquished in exchange for a participation in the new enterprise. However, options are not sought to be included upon that theory; rather, they are viewed by their proponents simply as incentives for employees. The reorganization contest is viewed as a particularly appropriate time to make provisions for the employees, as the corporation is making a fresh start.

The SEC views the employee stock option with the same disfavor with which it views warrants. In Selected Investments Trust

154. Guthman, supra note 41, at 752; Calkins, Corporate Reorganization Under Chapter X: A Post-Mortem, 3 J. FIN. 19, 27 (1948) (both advocating the use of warrants).
155. Blum, The Law, supra note 4, at 598.
156. 308 U.S. 106 (1939).
157. Id. at 122. But cf. Horowitz v. Kaplan, 193 F.2d 64, 75 (1st Cir. 1951), affg In re Waltham Watch Co., 97 F. Supp. 189 (D. Mass.), cert. denied, 342 U.S. 946 (1952), where the court approved a plan which gave large stock options to a manager, not previously a stockholder, whose services were essential to the corporation. Id. The court distinguished Case v. Los Angeles Lumber Prods. Co., 308 U.S. 426 (1932), upon the basis that in Case the plan had not had any binding employment agreement and the options had not been limited to managers. 97 F. Supp. at 73-75. See text accompanying note 55 supra. Section 7-303(4) of the Proposed Act would adopt the district court opinion reversed in Case and allow the participation by management which is not presently permitted under the absolute priority rule. II Bankruptcy Commission Report, supra note 4, at 254.
158. In fact, there is evidence indicating that the Commission has confused the two. See Imperial "400" Inc., SEC Corporate Reorganization Release No. 313 (Aug. 29, 1973), 2 SEC Docket 377, 393 n.26, citing Childs Co., 24 S.E.C. 85, 120-22 (1946) (dealing with long-term warrants) and Selected Invs. Trust Fund,
Fund, the SEC evaluated a plan which provided for management stock options. In rejecting the plan, it stated:

The proposal for [stock options] raises substantial questions of policy as well as fairness.

... ...

Stock options, whatever their propriety and appeal as incentives to good management for solvent and proven enterprises, do not appear appropriate for inclusion in a plan of reorganization on the eve of an insolvent Debtor's financial rehabilitation. At their best, they represent a long-range forecast as to untried management's capabilities to realize sanguine expectations. At their worst, they are media for speculation and sources of dilution of increments in value which should first be applied for the benefit of investors, especially those who have suffered from financial reverses of the enterprise.

However, the Commission at the same time appeared to leave open the possibility of continued vitality for stock options by suggesting specific modifications of the option plan.

The same problem was confronted a decade later in the reorganization of the Westec Corporation. The Commission initially rejected a plan providing for stock options, but the trustee modified the plan, following the hints the SEC had suggested 10 years earlier in Selected Investments. In a supplemental report, the Commission gave a guarded approval while in effect declaring that it was not actually approving anything because the stockholders were merely being informed that they would be asked to vote upon the stock option plan in the future. With that accomplished, the SEC abandoned the embarrassing position of arguing that a procedure followed...
by most of our country's larger corporations was not feasible because of unfair dilution of stockholders' equity.\footnote{The SEC has recognized the need to attract management and has approved the use of stock option for companies subject to the Public Utility Holding Company Act of 1935. Middle South Util., Inc., 40 S.E.C. 509 (1961). However, it has refused to allow options to be issued to employees of registered investment companies. State Bond & Mtge. Co., SEC Investment Company Act Release No. 4685 (Aug. 25, 1966).}

In summary, it is clear that convertible bonds, long-term warrants, and stock options have not received similar treatment by the SEC. The warrant differs from the convertible bond in that cash rather than the senior security must be contributed to the enterprise when it is exercised, yet the dilution and valuation problems remain.\footnote{It is interesting to note that while the Childs Co. reorganization was still pending before the Commission (the final report was not issued until August 13, 1947), the SEC faced the issue of the acceptability of convertible debentures in the capital structures of companies subject to the Public Utility Holding Company Act of 1935, and chose to openly discuss the valuation and dilution problems. Public Serv. Co., 26 S.E.C. 338, 350-52 (1947). The Commission stated: A convertible debenture combines the investment features of a debenture with the speculative aspects of a long term option warrant to obtain stock at a fixed price. So long as the market value of the stock is close to the conversion price, the price of the debentures will be determined by the investment value of the debentures \textit{qua} debentures plus whatever value is attributed to the option to purchase stock at that price in the future. If, however, the market price of the stock rises above the conversion price, the price of the debenture will fluctuate with the value of the stock. Should the price of the stock become very high and raise the price of the debenture proportionately, the latter will lose all of the stability normally associated with a debenture and because of the low yield the holder will be interested in retaining it only as a convenient means of speculating in the stock into which the debenture is convertible. The fact that the debenture gradually loses its investment quality and takes on the speculative characteristics of common stock may frequently confuse and delude the investor. Furthermore, the conversion feature, being essentially an option to obtain common stock, is an interest that has been carved out of the common stockholders' equity. As such, it represents a potential share in both the company's surplus and future earnings, a fact often overlooked or misunderstood by investors in the appraisal of common stock values. The value of the conversion privilege is, therefore, based on the opportunity to share in the profits of the company, without the normal risks of ownership, by obtaining the stock at a lower price than the value of the stock equity at the time of conversion. In the instant case, the conversion price has been fixed at $40, approximately the current market value of the stock. Conversions effected when the market price of the stock has risen above that price not only require the company to issue stock at a lower price than would be obtained through a public offering but result in a dilution of the equity of existing stockholders. Because of the difficulty in predicting future market fluctuations and measuring the amount of that dilution, it is unlikely that stockholders will be adequately compensated for this dilution in the price they can obtain either for the warrants they acquire or for the debentures, if they are sold before the market price of the common stock has risen. In addition, the possibility that additional shares equal to 25 percent of the total shares now outstanding may be issued under the conversion option makes it extremely difficult to appraise the stock on the basis of its present earning power and a statement regarding its earnings per share may frequently mislead an unwary investor. Id. (footnotes omitted). Yet the Commission approved the debentures, requiring only that the conversion period be shortened from 12 years to a little over 4 years, with the idea that the conversion feature should not be outstanding when the company would most likely have to go to the capital market again.}

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Probing the Commission’s collective psyche is not easy; however, it is suggested that the SEC believes the following:

(1) A warrant is not the conservative, “pure” security that a convertible debenture is; it is the security that the aggressive companies try to sell to the speculator. Even the New York Stock Exchange refused to list warrants for years. Conservative financial policy thus dictates the elimination of warrants.

(2) The conversion of a debt instrument into a contingent charge security decreases the risk of ruin of a company although that risk may be more theoretical than real as the very act of conversion is a sign of prosperity rather than adversity. The same effect might be had if, upon the exercise of any outstanding warrants, the company used the money received to retire some of its debt. But a company in reorganization cannot be trusted to do this.

(3) Warrants are challenges to the SEC’s ability to value the debtor correctly and its capacity to inject a note of finality into the reorganization proceeding. When a convertible debenture is converted, the security holder is merely exchanging his tickets for different ones. Moreover, this often occurs at a time chosen by management. Warrants, however, are merely slips of hope given away with the idea that eventually they might be worth something. Until they blossom or are expired, the reorganization, at least psychologically, can never come to an end.

As far as management stock options are concerned, the Commission now realizes its lack of control over the situation. The real demand for this sort of compensation comes from modern executives. The SEC, in line with its policy of ensuring that the debtor has competent management and is able to attract competent executives from outside the company with no conflicts of interest, has relaxed its standards in this area.

F. Preferred Stock

The feasibility requirements for preferred stock often closely resemble those for debt obligation, even to the extent of requiring a sinking fund in some cases. However, as noted previously, the

167. See Blum & Kaplan, supra note 39, where the authors state:

The essence of a bankruptcy reorganization, which binds all parties whether or not they accept the plan, involves imposing on them some kind of principled, disciplined conclusion as to value in the face of inescapable uncertainty. And a conclusion without an end is no conclusion.

Id. at 679.


169. See note 71 and notes 113 & 114 and accompanying texts. supra.
Commission carefully avoids any comparative analysis of the respective tax consequences of preferred stock as opposed to debt, for either the reorganized debtor or the recipient.

The SEC requires that the description upon the certificates be accurate, and will not tolerate the use of the label "stock" when the underlying obligation to the recipient is actually an interest in a contemplated liquidation. Although there is much flexibility, in that a wide variety of terms for the proposed preferred stock are acceptable, there must be an actual intention coupled with an apparent ability to pay dividends in cash, and not stock, or the security will be viewed as deceptive. This treatment is in direct contrast with SEC's tacit acceptance of the fact that dividends on the common stock will often be nonexistent or nominal in the years immediately following reorganization. Evidently, preferred dividends may be cumulative, noncumulative, or participating, depending upon the nature of the reorganized debtor, but it must be reiterated that the Commission does not look favorably upon complex, hybrid securities. The SEC generally does not find inherently objectionable provisions which restrict or postpone payment of preferred stock dividends where such restriction or postponement is not due to prospective inability to pay, but instead is part of an express or implied, predetermined policy to retire debt as expeditiously as possible. This is in accord with the Commission's belief that the less debt the corporation bears, the less the risk of a forced liquidation or second reorganization, and this, quite naturally, is a paramount requirement for reorganized debtors. On the other hand, the SEC will not approve the plan if excessive arrearages, which cannot foreseeably be paid by the reorganized debtor will result.

171. Compare La France Indus., 5 S.E.C. 917, 932--33 (1939) (fact that cash dividends on preferred stock will not be paid for several years following reorganization indicates frailty of plan so as to be unfeasible), with Jade Oil & Gas Co., SEC Corporate Reorganization Release No. 289 (Sept. 15, 1969) (provisions in plan calling for stock dividends where it was clear that no cash dividends were contemplated or possibly found to be unfair but not infeasible). See note 71 supra.
172. See, e.g., Jade Oil & Gas Co., SEC Corporate Reorganization Release No. 289 (Sept. 15, 1969), where the Commission stated that "[t]he cumulative feature of the proposed Series A is inappropriate in the case of an enterprise, like reorganized Jade, which will be promotional and speculative in character and oriented to the hope of capital gains rather than to dividend income."
173. See note 65 and accompanying text supra.
175. Higbee Co., 8 S.E.C. 777, 796--97 & n.29 (1941); San Francisco Bay Toll-Bridge Co., 6 S.E.C. 863, 871--72 (1939); La France Indus., 5 S.E.C. 917, 932--33 (1939). In Higbee, the SEC observed:

Normally a plan could not be considered feasible which contemplated the accumulation of unpaid dividends on the preferred stock for a maximum period of 10 years, and a minimum period of nearly 5 years if present earnings are maintained.
Voting powers must be granted to the preferred stock in accordance with the section 216(12)(a) prohibition against provisions in the plan for nonvoting stock, but the exact nature of this right to vote may vary. The proposed preferred shareholders must also be granted preemptive rights, and, in appropriate cases, it may also be required that there be a protective ban upon any extraordinary borrowing by the reorganized debtor without at least their two-thirds approval. Finally, the Commission has read the last phrase of section 216(12)(a) to require that the proposed preferred shareholders gain voting control of the corporation in case of dividend default, although there can be some flexibility.

G. Common Stock

As a general proposition, the SEC approves and encourages the inclusion of large amounts of common stock in a plan, yet this has not stopped the SEC from examining the nature of the stock proposed to be issued. The Commission often must evaluate a Chapter X plan of slow liquidation which calls for the issuance of stock or participation certificates. In some instances, where the possibility of deception is especially acute, the SEC has required that these be labeled "liquidation certificates," in order to fully inform the new holders of such interests of their true nature. Recently, the SEC has carried the distinction between a proposed liquidating company and a proposed going concern one step further than the mere relabeling of the participation tickets.

As we have said, however, in this case the dividend accumulations will not result from an inability of the company to earn the dividends, and if earnings continue at the present level the funded debt should be fully paid off in about 5 years and all arrears and current dividends in the following year.

Higbee Co., supra at 796 n.29.

176. 11 U.S.C. § 616(12)(a) (1970). For an illustration of the various ways in which voting rights of preferred stock within proposed reorganization plans may differ, see Childs Co., 26 S.E.C. 362, 362-63 (1947) (cumulative voting with 12 votes per share); Penn Timber Co., 17 S.E.C. 107, 110 (1944) (cumulative voting with one vote per share, one class of stock having the contingent right to be the sole voting stock); Sayre & Fisher Brick Co., 10 S.E.C. 64, 67 (1941) (cumulative voting with four votes per share, and sole contingent voting rights upon dividend default); Higbee Co., 8 S.E.C. 777, 781 (voting within class to elect three of seven directors).


179. 11 U.S.C. § 616(12)(a) (1970). This phrase mandates "adequate provisions for the election of directors representing such preferred class in the event of default in the payment of cash dividends." Id. See Higbee Co., 8 S.E.C. 777, 797-98, 800 (1941) (proposed preferred shareholders gain voting control upon the failure to pay six quarterly dividends).


They have disapproved any recapitalization and attendant issuance of certificates at all where the reorganized debtor is designed eventually to liquidate. Moreover, with respect to the deception by mislabeling issue, the SEC views as deceptive a plan which provides for the issuance of common stock where there is clearly no chance of dividends being paid upon the stock. The emphasis must be upon "clearly" as the rationale behind the Commission's insistence on common stock financing is the permissive nature of dividend payment. Thus it appears as long as payment of at least a nominal dividend on common can be projected, the SEC will be satisfied. Conversely, when dealing with reorganization of public utilities, the need for a continuous dividend stream to attract investors is vital to the utility's health, and accordingly the certainty of dividends upon common stock must be much greater. Approved plans have also required that dividends upon common stock only be paid out of surplus accumulated after the date of the reorganization, or only so as not to impair capital; but, on the other hand, dividends may not be unreasonably restricted. Additionally, in certain instances the Commission will object to the proposed creation of an excessively large balance sheet capital surplus from which dividends may be declared as part of the reorganization plan.

While the absolute number of shares to be issued pursuant to recapitalization is usually within the discretion of the proponent of the plan, the SEC has objected to an excessive number of low-priced

183. Parkwood, Inc., 43 S.E.C. 1067, 1079 (1969) (where trade creditors were to receive under the plan certificates of participation, the SEC recommended that they receive nontransferable certificates or that no certificates be issued at all and a list of participants be filed with the court instead); Bevis Shell Homes, Inc., 41 S.E.C. 982, 990 (1964).


185. Cf. Inland Gas Corp., 38 S.E.C. 320, 355-56 (1958) (reorganization plan for public utility approved as feasible despite prospective inability to pay dividends on common stock as the common stock was to be distributed to a consenting private holding company and not to the public).


187. F.L. Jacobs Co., 42 S.E.C. 979 (1966). The reorganization plan in Jacobs proposed an issue of 15-year debentures whose indenture required that 40 percent of the company's annual net income be deposited in a sinking fund for retirement of the debt. It further required that no dividends be paid upon the common stock until one-half of the principal amount of the debentures had been redeemed or otherwise retired, or a $1 million bank loan, taken out to consummate the plan, had been paid in full, whichever occurred first. The SEC concluded that the plan was feasible and that it would be fair and equitable if it were amended to remove the dividend restriction. Id. at 987-88. It is interesting to note the Commission's logic: the plan was unfair precisely because it was feasible without the dividend restriction. The SEC's report pointed to adequate earnings coverage, sufficient working capital on hand, a positive cash flow, and the fact that the bank's loan was well secured. The Commission concluded that there was no need for the restriction which rendered the plan unfair. Id.

It should be noted that although there generally is an optimum price for shares of common stock due to the round-lot purchase system and the strange collective psyche of investors, the Commission has made no apparent attempt to influence the price of the common stock of the reorganized debtor such that it approximates this optimum.

The issue of the distribution of voting control is concerned more with fairness than with feasibility. Quite obviously, to the extent that feasibility demands that a creditor take an equity position in the reorganized enterprise, fairness dictates that along with the new risks assumed he be given a pro rata allocation of voting power. In the distribution of rights and privileges among the reorganization tickets, section 216(12) is the court's guide; it mandates that the reorganized debtor's charter include:

(a) provisions prohibiting the debtor or such corporation from issuing non-voting stock, and providing, as to the several classes of securities of the debtor or of such corporation possessing voting power, for the fair and equitable distribution of such power among such classes, including, in the case of any class of stock having a preference over other stock with respect to dividends, adequate provisions for the election of directors representing such preferred class in the event of default in the payment of such dividends; and

(b) provisions which are fair and equitable and in accordance with sound business and accounting practice, with respect to the terms, position, rights, and privileges of the several classes of securities of the debtor or of such corporation, including, without limiting the generality of the foregoing, provisions with

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189. See In re Phoenix Gems, Inc., Civil No. B–21072 (D. Ariz., filed Dec. 23, 1971), discussed in 38 SEC ANN. REP. 123–24 (1972) (SEC recommended that plan be amended to reduce proposed 18 million shares to 1.8 million shares); Jade Oil & Gas Co., SEC Corporate Reorganization Release No. 289 (Sept. 15, 1969) (SEC objected to proposed issuance of 8 million shares of common stock of a highly speculative oil venture as it would magnify the volatility of the issue and recommended instead issuing 250,000 shares).

190. The most favorable price range for stocks listed with the New York Stock Exchange is $18–25. NEW YORK STOCK EXCHANGE, COMPANY MANUAL § A14, at A–255 (Aug. 15, 1955). However, there is also a requirement for listing a minimum of 1 million shares. Id. § B1, at B–3 (Jan. 5, 1970).


192. The Commission has stated:

Fairness of reorganization plans should be considered not only in light of the allocation of assets and earnings among the various claimants but also in light of the allocation of control. Control in these cases is an important and valuable emolument. It should rest in the hands of those who show promise of exercising it as a power in trust. Courts should be as solicitous in this regard as they are in determining priorities as respects assets and earnings. PROTECTIVE COMM. REPORT, supra note 6, pt. 1, at 903.
The requirements are clearly mandatory, and were inserted by the Senate in an attempt to incorporate some of the features of the proposed Borah-O'Mahoney Federal Licensing Bill. The intent seems clear: while the control of the court over the debtor ends upon consummation of the plan, this provision is designed to insure a continuing degree of federal influence over the capital structure and corporate practices of the reorganized enterprise. By institutionalizing protective mechanisms via the corporate charter, the reforms that the reorganization process brought to the enterprise can be perpetrated beyond the time when direct judicial supervision ceases.

195. Id. at 7.
196. S. 3072, 75th Cong., 3d Sess. (1938). See Hearings on H.R. 8046 Before the Senate Comm. on the Judiciary, 75th Cong., 2d Sess. 12-13 (1937-38); Heuston, Corporate Reorganizations Under the Chandler Act, 38 Colum. L. Rev. 1199, at 1213-14 (1938); Krotinger, supra note 191, at 644 & n.86. Upon the concept of federal licensing, see generally 1 L. Loss, SECURITIES REGULATIONS 107-11 (2d ed. 1961); H. Reuschlein, THE SCHOOLS OF CORPORATE REFORM (1950). Note that the SEC also considered the alternative of federal corporate licensing in 1938 as a solution to the problem of over-aggressive charter soliciting upon the part of certain states "whose objective in regulating corporations is revenue, rather than the protection of security holders." Protective Comm. Report, supra note 6, pt. VII, at 412-13.
197. The SEC has recognized the importance of this control device:
    The Commission also gives its attention to the drafting and preparation of corporate charters, bylaws, trust indentures, and other instruments which are to govern the internal structure of the reorganized debtor. The Commission strives to obtain the inclusion of various provisions in these instruments which will assure to the investors a maximum of protection, adequate information with regard to the enterprise, and a fair voice in the management.
14 SEC ANN. REP. 90 (1944).
198. The SEC recognized this idea:
    Another aspect of fairness, and of feasibility ... relates to the conditions which attach to such new securities. The area thus opened to judicial scrutiny in reorganizations embraces all features of securities, which would be of significance in any flotations — including, among others, the protective indenture provisions of bonds and debentures and the dividend and voting aspects of stocks. A host of other factors might be enumerated. All have significance in any evaluation of the fairness of reorganization plans, since they relate to the measure of subsequent protection which will be afforded to each of the interests which the plan apportions among the varied claimants.

This idea of institutionalizing protection pervades much of the SEC’s actions in the feasibility area and its focus is as varied as the boundless imagination of American business entrepreneurs. The classic example is the McKesson & Robbins, Inc. reorganization. There, the debtor had facilitated, through inept and inadequate auditing practices, the embezzlement of several million dollars by the debtor’s president and others. The SEC undertook a study of those auditing practices, and made specific suggestions with respect to desirable changes in auditing practices in general. At the Commission’s urging, these recommendations were incorporated into the corporation’s by-laws.

Another example is the reorganization of the Tower Credit Corporation, where the plan’s promoter sought to turn what had basically been a credit corporation into a real estate venture. The history of the proceeding showed that the plan’s proponents, who were to control the reorganized company, had a strong self-interest in selling heavily mortgaged, unimproved land to the enterprise. The SEC also found that the proponents would in all probability attempt to have the reorganized debtor grant large stock options to them. At the insistence of SEC, a provision was added to the plan requiring that for a period of 5 years after emerging from reorganization, (1) purchases of unproductive real estate (other than those made in the normal course of business), (2) the grant of stock options to officers and directors, and (3) any charter amendments had to be approved by a majority of the stock, exclusive of the stock owned directly or beneficially by the proponents of the plan.

Perhaps the best example of the manner in which the SEC attempts to extend their control of the reorganized debtors through the guise of feasibility is its persistent demand that the common stock be accorded preemptive rights and cumulative voting, regardless of whether the applicable state corporation law so requires. The SEC has even rejected a provision which would enable offerings of con-

 enumerateated,” the Commission cited many features traditionally discussed under the rubric of feasibility. Id. at 157 n.253. See also Teton, Reorganization Revised, 48 Yale L.J. 573, 607-09 (1939).

199. 8 S.E.C. 853 (1941).

200. Id. at 855.


vertible debentures to be exempted from the common shareholders' preemptive rights without their approval. These requirements have generally been listed in the SEC advisory reports either under the heading of "fair and equitable plan," or under "other matters;" the lines between the various requirements which the Commission sees embedded in Chapter X are obviously not very clear.

The SEC has also waged a war against voting trusts; they are seen as permanently crippling the stockholders' power to keep the reorganized debtor out of trouble (and presumably out of the reorganization court again). Using statutory terminology, they are seen not only as unfair, but according to the SEC they render the capital structure unfeasible. The SEC's position is that in light of the disenfranchisement hardship worked upon proposed shareholders there is rarely any need for the stability a voting trust provides. There is little statutory authority for this nearly complete ban upon voting trusts, and, in fact, the references in sections 216(11) and 221(5) to "voting trustees" seem impliedly to sanction them. Accordingly, the courts have not generally shared the SEC's distaste for the voting trust. Financial writers have also been more receptive. Dewing points out that the voting trust is able both to insure continuity of management

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We are not suggesting that the reorganized company should remain permanently under this bar. If management believes that pre-emptive rights should be modified to permit the issue of convertible securities, it can secure such modification by a vote of stockholders specifically directed to this proposal. We do not consider such modification a proper proposal for inclusion in the plan. Present security holders voting on the plan do not have the opportunity to address themselves to this specific feature of the plan. Their only alternatives are to vote for or against the plan in its entirety.

208. Id. 12 SEC ANN. REP. 91 (1946).


210. Sections 216(11) and 221(5), which require the inclusion of "equitable" provisions within the plan with respect to the procedures for election of directors, officers, or voting trustees, and mandate that there be court satisfaction with the identity, qualifications and affiliations of these persons, are both especially suggestive of congressional approval of the use of the voting trust device, where appropriate, in the reorganized debtor. See 11 U.S.C. §§ 616(11), 621(5) (1970).

211. One reorganization court stated:

The question is whether the voting trust provisions render the plan unfair or impair its feasibility. The answer to that question, I believe, depends upon the circumstances of each case and the purpose which the voting trust is intended to and will subserve. Like any other instrument in the arsenal of corporate management it may be intended as a tool or a weapon. In this instance, I think a voting trust for a reasonably short period will serve a very desirable purpose. In re Lower Brdwy. Props., Inc., 58 F. Supp. 615, 619 (S.D.N.Y. 1945). See In re Quaker City Cold Storage Co., 71 F. Supp. 124, 131-32 (E.D. Pa. 1947) (10-year trust approved).
while the corporation is recuperating and to prevent speculators from gaining control of the enterprise. Further, any abuses can be minimized by (a) court selection of the trustees, (b) requiring security holder approval for certain actions, (c) limited duration, and (d) provisions for removal of the trustee. The New York Stock Exchange, like the SEC, has had a consistent policy disfavoring voting trusts, and since 1926 has refused to list voting trust certificates. However, it has created an exception to this rule where voting trust certificates are issued under court direction pursuant to Chapter X reorganizations, and if "circumstances in a particular [Chapter X] case were such that the 'new' common stock were eligible for listing, the fact that the court had ordered issuance of voting trust certificates of a reasonable life in lieu of direct issuance of the common stock would not be a bar to listing of the voting trust certificates."

These opposing opinions notwithstanding, the SEC continues to view voting trusts with alarm, except in isolated cases, arguing that any need for a voting trust is a short run exigency that cannot outweigh the long term dangers that invariably accompany the loss of corporate democracy. The outlawing of the voting trust appears to be another method whereby the Commission attempts to regulate the reorganized debtor, and even the particular industry, long after the reorganization has been consummated. Similar to its requirement that cumulative voting and preemptive rights be accorded proposed

213. 1 DEWING, supra note 43, at 113-16.
215. Id.
216. Letter from Arnold Kotler, Manager, Policy Division, New York Stock Exchange, to the author, March 18, 1974. The issuer of securities resulting from the reorganization would have to meet the original listing standards if it was delisted during the course of the reorganization, including the three year's earnings requirement. Id.
218. PROTECTIVE COMM. REPORT, supra note 6, pt. III, at 198-99 (commenting that the extensive use of voting trusts in the reorganization of real estate companies has resulted in a large "concentration of power . . . [of] great economic significance, and that effective measures were to be instituted through the reorganization process, to control this power.

shareholders,\textsuperscript{219} it matters little what the applicable state law states regarding voting trusts.\textsuperscript{220} In this respect it is seeking to impose a continuing federal influence on the reorganized debtor. Without any apparent justification, the SEC also disregards the fact that the scope and duration of a voting trust can be modified so as to remove some of the objectionable features and decrease the chance of abuse.\textsuperscript{221}

Brief mention should also be made here of the functional difference between the power to form the new management of the reorganized entity and the fair distribution of voting control.\textsuperscript{222} Section 221(5) requires that the reorganization court must be satisfied with the qualifications of the new management before approving the plan,\textsuperscript{223} reflecting a congressional intent to give the court freedom to excise inefficient or disloyal old management from the debtor. Section 216(11) adds that the reorganization plan "shall include provisions which are equitable, compatible with the interests of creditors and stockholders, and consistent with public policy, with respect to the manner of selection of . . . directors, officers, or voting trustees . . . ."\textsuperscript{224} This section "directs the scrutiny of the court to the methods by which the management of the reorganized corporation is to be chosen."\textsuperscript{225} This provision, adopted at the suggestion of the SEC, is intended to make it possible for the reorganization court to frame the mechanics or means of selecting future managements — managements that "will carry forward the reorganization in the interests of the parties."\textsuperscript{226}

To reiterate, the concept of feasibility with respect to the SEC is nothing more than a highly calculated estimate that a reorganized and recapitalized debtor will succeed financially in the future. The Commission hopes to avoid a second reorganization or liquidation through bankruptcy, and it realizes that mere faith is not enough. Moreover, the SEC has an interest of its own to protect, namely its reputation for financial expertise. It certainly would not further such a reputation if a state court, subsequent to consummation of an SEC approved plan, criticized the Commission for failing to include cumulative voting or preemptive rights, or for including an unfair voting

\begin{itemize}
    \item \textsuperscript{219} See notes 205-07 and accompanying text supra.
    \item \textsuperscript{220} The courts, however, have held that any state law restrictions on voting trusts must be observed. \textit{E.g.}, Bakers Share Corp. v. London Terrace, Inc., 130 F.2d 157, 159 (2d Cir. 1942).
    \item \textsuperscript{221} See note 211 and accompanying text supra.
    \item \textsuperscript{222} For an extended analysis, see generally Krotinger, supra note 191.
    \item \textsuperscript{225} S. REP. No. 1916, 75th Cong., 3d Sess. 35 (1938).
    \item \textsuperscript{226} \textit{Hearings on H.R. 6439, Amended and Reintroduced as H.R. 8046, Before the House Comm. on the Judiciary, 75th Cong., 1st Sess.} 143 (1937).
\end{itemize}
trust, or for allowing an unsavory management to gain control of the
debtor and proceed to loot it. To the extent that the Commission be-
lieves a plan will facilitate such events, that plan is not feasible because
it fails to meet the standard of being consistent with “public policy” —
“something more than just the old concepts of a selfish creditor interest
and a selfish stockholder interest” is required. 227

H. Effect on the Future Cost of Capital

In line with the Commission’s future-oriented view towards feasi-
bility, the effect of a plan on the ability of the reorganized debtor to
secure additional amounts of capital is certainly an important element
to consider. 228

Much has been written on the question of whether or not the
reorganization process influences the debtor’s prospective cost of cap-
ital. 229 The Commission, rather than struggling with theoretical cost of
capital problems, simply takes the position that a corporation emerges
from Chapter X reorganization as a healthy, expanding enterprise. 230
As such, the chances are strong that it will ultimately resort to the
capital markets, albeit after an interim period to allow the stigma
of bankruptcy to dissipate. 231 One need hardly be a financial expert
to realize the difficulties that a reorganized debtor must contend with
in attempting to attract new capital from the investing public, although
the experience of debt securities distributed in reorganizations has been
surprisingly good. 232 The Commission believes that a feasible plan
must not hinder the difficult task of securing additional financing.

Accordingly, the SEC attempts to manipulate the proposed plan
in order to enable the debtor to have adequate access to both short-
and long-term credit in the future. 233 The insistence on an adequate
sinking fund also reflects this concern. Lowering the company’s risk
of default and strengthening the firm’s credit is more important in
attracting new investors than an extensive dividend record in the early

227. Id. at 182 (statement of then SEC Commissioner, now Mr. Justice, Douglas).
229. The arguments pro and con are explored in a book by Professor Altman.
E. ALTMAN, CORPORATE BANKRUPTCY IN AMERICA (1971).
230. The obvious exception is where limited life is admitted. See notes 180-83
and accompanying text supra.
231. For a brief discussion of the SEC recognition of the earnings lag phenomenon,
see Blum, Corporate Reorganization Doctrine as Recently Applied by the Securities
232. See generally W. HICKMAN, CORPORATE BOND QUALITY AND INVESTOR
EXPERIENCE (1958); Calkins, supra note 154.
233. See Indiana Lime, Corp., 18 S.E.C. 178, 195 (1945) ; McKesson & Robbins,
448 U.S. 305, 323 (1980).
years after reorganization. In the same vein, the SEC will also act to limit the amount of common stock issued, in order that the shares outstanding can achieve a nonspeculative investment status, and thus someday become a suitable vehicle for financing. In connection with this predilection to increase the price of the reorganized debtor's common stock is the Commission's clear repugnance to the use of warrants which are viewed as an unnecessary risk of dilution and thus a brake on the upward price movement of the stock.

Simplification of the reorganized debtor's capital structure can also affect the future cost of capital. For example, divisional mortgages, collateral trusts, and other complexities which impede financing can be eliminated. The structure of parent-subsidiary relationships can also be rearranged to this end.

There are other examples of how the plan of reorganization can provide for future financing, but their discussion is unnecessary; yet, they are reflective of a general attitude of the Commission rather than a focused analysis of the tools of corporate finance. One cannot help observing that reorganization plans invariably try to sell the great new opportunities ahead and the dynamic nature of the reorganized enterprise. The Commission, not being able to write its own plan, must confront these claims, and parry them with the baton of feasibility by inquiring into where the needed cash for all this growth is going to come.

I. Simple Capital Structure

The element of simplicity in the capital structure of the reorganized debtor has always been a prime consideration of the SEC in assessing the feasibility of a plan. Aside from its obstructive effect on the debtor's ability to raise additional capital, a complex capital structure seems to be per se unfeasible. In Consolidated Rock Products Co. v. DuBois, the Supreme Court reviewed a Ninth Circuit ruling that a class of claimants whose debt was secured by specific properties could be compensated out of those properties alone; thus, the fair and equitable standard was violated if several old, separately secured debt issues were replaced with a single new issue representing an interest in all of the


235. See note 189 and accompanying text supra.


237. See note 166 and accompanying text supra.


239. 312 U.S. 510 (1941).
properties. To the SEC, this was folly and would have "disastrous practical consequences." In their amicus brief, the Commission pointed out that the Bankruptcy Act required a plan to be feasible as well as fair and equitable, and argued that the circuit court's holding might make feasibility impossible in some cases:

If the holding of the court below is correct, a plan of reorganization which fails to preserve priorities of separate lienors . . . cannot be fair. Yet in many cases any plan attempting to preserve separate liens would necessitate so complicated a capital structure that it would not be feasible. Consequently, in some cases, no plan of reorganization complying with the statutory standards would be possible.

The Supreme Court agreed with the Commission and said that there was absolutely no need to preserve separate liens. Mr. Justice Douglas lent further support to the SEC's policy of favoring simple capital structures by stating:

Moreover, the substitution of a simple, conservative capital structure for a highly complicated one may be a primary requirement of any reorganization plan. There is no necessity to construct the new capital structure on the framework of the old.

Feasibility, in the view of the Commission, thus contemplates a simple capital structure. This would appear to include a prohibition against embellishing the new securities with various fringe features which might be misleading. This role is coterminous with the Commission's role as the protector of the securities markets, since it focuses on those factors which made intelligent and well-informed investment decisions by investors more unlikely. Post-reorganization assessment of newly created securities is sufficiently difficult without the exacerbating effect of a complex capital structure. Further, such a structure serves to mask the true impact of the plan and hinders a full SEC analysis of the satisfaction of investor and creditor claims.

The SEC approaches the issue of simplicity of capital structure with a degree of flexibility. In most instances where the structure is

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242. Id. at 51-52.
243. 312 U.S. at 530.
244. Id. at 531. The Court also seemed to have denoted feasibility as the source of this requirement. Id. at 528.
245. See Frank, supra note 41, at 345-48.
complex, the Commission will complain of, but not object to, the plan on feasibility grounds.\textsuperscript{247} The SEC realizes that creating an additional priority class of securities is often more manageable than returning the plan to the reorganization court for inquiry into how much "extra compensation" a class of old security holders may be entitled to in units of a new single class of stock.\textsuperscript{248}

Note, however, that the endeavor to simplify capital structures cannot obscure the fact that the reorganization court is one of limited jurisdiction.\textsuperscript{249} Accordingly, in the case where a subsidiary is not undergoing reorganization, either because no petition has been filed by or against it or because it is not eligible for relief under Chapter X, the jurisdiction of the reorganization court in which the parent's proceeding is pending presents special problems with respect to the subsidiary. The reorganization court generally interprets its jurisdiction over the parent as narrowly limited to the parent's property ownership, that is, to the stock held by the parent corporation. As stated by one circuit court, "Ownership of all the outstanding stock of a corporation, however, is not the equivalent of ownership of the subsidiary's property or assets."\textsuperscript{250} This parent-subsidiary distinction must be recognized even where both the parent and the subsidiary are in reorganization in different jurisdictions.\textsuperscript{251}

Consistent with this approach is the general rule that section 116(4) of the Bankruptcy Act\textsuperscript{252} does not authorize the Chapter X court to enjoin a suit against a subsidiary of the debtor merely because its stock is held by the debtor in reorganization.\textsuperscript{253} If the sub-


\textsuperscript{248} See, e.g., Inland Gas Corp., 29 S.E.C. 377, 402-03 (1948).

\textsuperscript{249} "Congress did not give the bankruptcy court exclusive jurisdiction over all controversies that in some way affect the debtor's estate." Callaway v. Benton, 336 U.S. 132, 142 (1949) (footnote omitted). See generally 6 COLLIER, supra note 4, \S 3.11.


\textsuperscript{251} See In re Tonkawa Ref. Co., 502 F.2d 1341, 1343 (10th Cir. 1974).


\textsuperscript{253} See In re South Jersey Land Corp., 361 F.2d 610, 613 (3d Cir. 1966). Cf. In re Adolf Gobel, Inc., 80 F.2d 849 (2d Cir. 1936) (under \S 77B); In re Madison Mfg. Corp., 22 F. Supp. 99 (S.D.N.Y. 1937) (under \S 77B). Note, however, that a reorganization court does have the power to enjoin a subsidiary from wasting its own assets, at least where it is doing so at the direction of the debtor. Cf. In re Associated Gas & Elec. Co., 11 F. Supp. 359 (N.D.N.Y. 1935) (under \S 77B), \textit{noted in} 30 ILL. L. REV. 796 (1936). It has also been suggested that where the stock of a wholly-owned subsidiary is the \textit{major} asset of a debtor in reorganization, the court may act to protect the value of that stock by restraining a state public utility commissioner from reducing rate schedules of the subsidiary, and by restraining the officers of the subsidiary from consenting thereto. In re Portland Elec. Power Co., 97 F. Supp. 877, 882 (D. Ore. 1949).
sidiary is solvent and thus cannot be forced into reorganization, it may refrain from participating in the parent’s proceeding, and the reorganization court cannot adjust the rights of the subsidiary if it does so.254 If the subsidiary is insolvent, a petition by or against it may be filed in the court where the reorganization proceeding of the parent corporation is pending under section 129,255 or under the regular venue provisions of section 128.256

This distinction between the parent and the subsidiary must also extend to the parent’s ability to effectuate a workable plan of reorganization with creditors. Although a plan may incorporate the sale or transfer of the assets of a subsidiary not in reorganization, the provision, since it is in the nature of an offer, has no binding contractual force on the subsidiary until accepted. Of course, if accepted, the subsidiary comes within the jurisdiction of the court sufficiently to give the court new powers to protect and insure the consummation of the plan.257

There are, of course, exceptions to this general rule. The distinction between parent and subsidiary may be disregarded when they are so completely one that the subsidiary cannot be considered to have a separate legal identity.258 The court will look behind the corporate entities involved to deal with the situation as “equity” may require, not only for the purpose of holding the parent corporation for debts created by the insolvent corporate subsidiary which is a mere instrumentality of its parent, but also to allow creditors of the parent to reach assets held by the subsidiary.259 This instrumentality concept has evolved from well established corporate law precedents260 and from equity receiverships.261

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254. See Commercial Cable Staffs' Ass'n v. Lehman, 107 F.2d 917, 920 (2d Cir. 1939) (under § 77B), noted in 49 YALE L.J. 590 (1940). If the parent corporation is involved in a reorganization, the subsidiary is not a necessary party thereto. In re Commonwealth Light & Power Co., 141 F.2d 734, 736 (7th Cir.), appeal dismissed, 322 U.S. 766 (1944) (under § 77B), noted in 43 MICH. L. REV. 811 (1945).


257. Cf. Commercial Cable Staffs' Ass'n v. Lehman, 107 F.2d 917 (2d Cir. 1939) (by implication) (under § 77B).

258. E.g., In re Parkview-Gem, Inc., 2 BANKR. L. REP. ¶ 65,309, at 74,492 (8th Cir., July 1, 1974). See generally 6 COLIER, supra note 4, ¶ 3.11, at 500-01.


261. See, e.g., Commerce Trust Co. v. Woodbury, 77 F.2d 478, 487 (8th Cir.), cert. denied, 296 U.S. 614 (1935); Trustees Sys. Co. v. Payne, 65 F.2d 103, 107 (3d Cir. 1933). Note that under section 115, the reorganization court has all the powers “which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor.” 11 U.S.C. § 313 (1970).
The classic example\(^{262}\) of the reorganization court's misuse of its limited power over subsidiaries can be found in the reorganization of a complex interrelationship of companies in the Pittsburgh transportation system.\(^{263}\) On appeal, the Third Circuit, stressing the public interest and the necessity of dealing with the reorganization from the practical economic viewpoint, and of treating the various companies as a single entity,\(^{264}\) seemingly went too far in framing a convenient reorganization by disregarding the distinction between legal ownership and physical operation.\(^{265}\) Though the case has not been overruled, its vitality is in doubt.\(^{266}\) Recently, however, the need to enlarge bankruptcy court jurisdiction to deal effectively with complex corporate structures has been judicially recognized.\(^{267}\)

### J. Cash Flow

The subject of adequate working capital is treated last because of its signal importance to the feasibility inquiry. If inability to meet principal or interest payments when due is the factor which precipitates bankruptcy, then it would seem that the apparent cause of insolvency is inadequate working capital. The emphasis is on "apparent" because the Commission must confront the more basic question of why the working capital was inadequate.\(^{268}\) So too, if one of the objectives of feasibility is to decrease the risk of financial embarrassment in the future, the SEC must demand that any plan provide not only enough working capital for immediate needs, but also provide a margin for contingencies.

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\(^{263}\) 155 F.2d at 479-80.

\(^{264}\) Id. at 485.

\(^{265}\) 6 Collier, supra note 4, ¶ 3.11, at 50 n.7.


The SEC's approach to the working capital problem in terms of feasibility seems to be short-term oriented. At times, it has included references to quick ratios in its reports, and has even focused upon the working capital to funded debt relationship. If immediate cash is needed, a new securities offering or a loan may be planned. However, the SEC does not believe that the plan can be approved as feasible until the success of the anticipated financing is somewhat assured, and the reorganization court should retain jurisdiction over the debtor, if necessary, until the advent of the anticipated financing. It should also be noted that the trusteeship period can be used to accumulate earnings and build up working capital. The trustee also has the power to dispose of unnecessary assets and unprofitable portions of the debtor's business, and thus attempt to accumulate cash.

With regard to long-term cash flow analysis, many financial authorities feel that the standard tests for determining an appropriate level of debt financing should be discarded in favor of a cash flow approach. By analyzing long-term cash flow patterns, it is hoped that the firm will be able to calculate its real ability to service its debt. The debt capacity question is seen as just one part of a broader problem of determining the capacity of the enterprise in question to assume additional amounts of fixed cash outflows of any nature:

With regard to the threat of cash insolvency, debt is no different from any other contractual obligation to pay fixed amounts at fixed dates in an uncertain future and, indeed, is not essentially

269. The SEC considers the adequacy of working capital to be part of the feasibility inquiry. See Silesian-American Corp., 31 S.E.C. 1, 72-73 (1950); cf. Protective Comm. Report, supra note 6, pt. VIII, at 160.


271. Deep Rock Oil Corp., 7 S.E.C. 174, 195 (1940) (the SEC thought that the debtor should have no funded debt at all, but approved a large debt issue as feasible "in the light of its apparent ability to meet the interest charges thereon and the fact that the debtor would have working capital equal to approximately 90 percent of the face amount of its funded debt").


274. The Chapter X trustee has these powers which are vested in a straight bankruptcy trustee. 11 U.S.C. § 587 (1970).


different from noncontractual fixed payments which must continue if the business is to continue. An illustration of this fact is seen in the increasing awareness that rental payments under a lease or sale-and-leaseback arrangement contain inherently the same risk element as an equivalent debt service charge.

Thus the risk of debt is seen as a part of the overall problem of the balancing of the amount and time of cash inflows and cash outflows. Virtually all businesses face some degree of uncertainty in the amount and timing of cash inflows, and the existence of inflexibility in cash outflows presents the hazard of inability to match outflows and inflows at some point in time.

Viewed in this way the measurement of the risk of debt becomes a part of a general appraisal of expected variations in total cash inflow, on the one hand, and of the controllability of total cash outflows, on the other. From this appraisal management can form a judgment as to the probability of the event of insolvency and the extent to which the probability is increased by the substitution of a given amount of debt for equity as a source of permanent financing.277

The SEC has yet to adopt this approach in its entirety, although it has recognized the use of the projected cash flow method of valuation in certain circumstances.278

IV. ON DEVELOPING A THEORY

There has never been expressed a unitary concept of the methodology employed by the SEC in determining the feasibility of a Chapter X reorganization plan. In all likelihood, this is due to the staggering variety and complexity of the reorganization plans the Commission has faced in its advisory role in Chapter X proceedings. Its expertise in handling these difficult problems cannot be challenged, and with that in mind, perhaps it would be best to begin the analysis with what the Commission could do in interpreting the feasibility requirement.

Initially, the SEC could interpret feasibility as mandating a complete purge of the debtor, such that the characteristics which precipitated the inability to pay debts as they matured were shorn from the debtor in a neat fashion, and the debtor could be permitted to return to the business world without a risk of recurrent financial dilemma. Additionally, discredited management should be thoroughly investigated and prosecuted, as provided for in Chapter X.279 Where the

277. DONALDSON, supra note 85, at 7-8.
279. Pursuant to section 167, the court has the power to order the trustee to investigate the old management and sue for misconduct or mismanagement. 11 U.S.C.
management has been at fault, the reorganized debtor’s charter and the various securities contracts should be rewritten, mindful of preventing future managements from damaging the debtor or taking unjustified financial risks. Most important, the amount of debt which the debtor can lawfully issue should be severely restricted, since in most reorganization situations, overextension with respect to debt is the prime cause of financial distress. Such restrictions could be imposed without a sense of retribution or punishment as other corporations, not subject to reorganization, have similar undesirable features. However, reorganization is the opportune time for the visitation of the SEC’s expertise and powers upon the debtor; the investment contracts have matured, the court has stepped in to preserve the entity, and significant policy judgments must be made as to the future status of the corporation. To quote at length from a classic exposition of this view:

Historically, of course, we are committed to the practice of regarding some part of capital as debt, and correlatively, the holders of that debt have the status of current-account creditors for purposes of creditors’ remedies. It is probably impossible to change the deep-seated habit of treating bondholders as creditors for such purposes. And so long as default on capitalized debt is regarded as the occasion of reorganization proceedings, it is desirable that the resulting reorganizations be drastic. If we must have a judicial proceeding after default on capitalized debt, that proceeding should thoroughly purge the finances of the business. And the administration of Chapter X, at least, promises that reorganization will have adequate purgative features.

An acceptable reorganization system should, however, do more than is done by Chapters X and XI to control the future financial structure of reorganized enterprises, in the interest of preventing the recurrence of uneconomic insolvency proceedings. Ideally, such a policy would be expressed by a prohibition in the charter of the new company against any form of capitalization resulting in fixed charges or fixed maturities. All capital returns would be contingent on there being earnings above operating expenses, priority of risk being expressed by priority of claim to income. If habits of finance and of thinking about finance among those who constitute the capital market will keep reorganizers from writing such utopian terms into articles of incorporation, they should at least be required to restrict the quantity or pro-

§ 567 (1970). See generally 6 COLLIER, supra note 4, § 7.20. Where the debtor is in possession, section 168 allows an examiner to be appointed for this and other purposes. 11 U.S.C. § 568 (1970). The reorganized debtor or the trustees have full power to continue this investigation and prosecution of these causes of action after the plan is submitted or confirmed; and in fact, a plan is not “fair” unless it adequately preserves these causes of action and provides for their prosecution. In re Philadelphia & Reading Coal & Iron Co., 105 F.2d 354, 356 (3d Cir. 1939). See generally 6A COLLIER, supra note 4, § 10.22.
portion of an enterprise's capital which may be obtained through borrowing. The control of capital structures through reorganization should go further. It is generally regarded as dangerous to have much of the capitalization of a business represented by securities on which a fixed maximum return is payable. Such a financial structure promises a new default with every considerable fluctuation of income, and tempts the directors to speculative managerial policies. If the capitalization of a company carries large fixed or maximum charges, its management, usually holding equities, stands to gain disproportionately from a course of action, however risky, which increases the existing over-all rate of return on capital. And so far no device short of charter restriction has developed for protecting the corporation against its management in this particular of financial policy.

Any substantial revision of the system of corporate reorganization through bankruptcy should start with a reconsideration of the economic function of such proceedings, and should serve the definite policy of making them an occasion to rebuild the financial structure of the debtor enterprise. The plan of reorganization should give management all the discretion it needs to meet the future financing requirements of the business; but that discretion should be restricted so as to forestall the danger of over-speculative business policy, and the waste of premature reorganization.

The implication seems clear — if the court is given the opportunity to step in and halt the dissolution of the debtor, it would then benefit all interests to effect a thorough reconstruction of its financial framework. The debtor cannot and should not be relied upon to take care of itself once it is free of the court's supervision, and therefore, a complete revision of the enterprise's finances is required.

Although there is much to be said for and against this purgative approach to feasibility, manifestly, part of this theory pervades the SEC's performance under Chapter X. For example, the Commission has always stressed the importance of a thorough investigation of the former management by the trustee, and this investigation takes precedence over any desire to speed up the reorganization process. The theory starts in a very difficult area, as it represents an extreme fascination with the interplay between the economic and legal define-

282. See, e.g., id. The duty of the trustee to investigate is required by Chapter X. See note 279 supra. As one commentator recently reflected: [O]ne cannot but be impressed with the recurring theme that the troubles of the debtor are due in a large part to the sins of its past management. An independent trustee is necessary to discover these sins, to punish the sinners and to recover the loot.

tions of financial failure in order to justify heavy-handed intervention at this point in time. The ultimate result sought would appear to be the emergence from reorganization of a debt-free corporation.\textsuperscript{283}

This theory, steeped in the idea of purging the debtor of the ability to incur any significant debt, obviously had its genesis in the wake of the Great Depression, when stabilization of the economy was the government's primary concern. In both the late 1930's\textsuperscript{284} and 1940's,\textsuperscript{285} there was a great fear of debt financing among economists, and perhaps an even greater fear of the chain reaction effect of bankruptcy on the economy. The thought prevailed that the main cause of the depression was excessive debt financing, and ergo, limiting debt was an effective way to limit fluctuation in the economy.\textsuperscript{286} The reorganization and bankruptcy process could directly contribute to economic recovery and stabilization by eliminating a large amount of debt and supplanting it with equity.\textsuperscript{287}

There is no need to treat extensively the various countervailing arguments to the SEC's theory. It is clear that the SEC was not empowered to execute the policy underlying this theory,\textsuperscript{288} and it is equally apparent that Congress, had it so desired, could have required a 100 percent equity capital structure to be used in all reorganizations. In any event, the economic postulates behind this theory have come under attack; the "New Economics" holds that government fiscal and monetary policy suffices to keep the country out of another depression. The economic boom of the 1960's and the great proliferation of debt

\textsuperscript{283} This idea has been stated:
All corporations should be held to a Spartan simplicity in their capital structures. There should be the sharpest distinction between investors and creditors; and, where this distinction becomes impaired through financial adversity, reorganization should be compulsory and immediate. It would seem wise, indeed, to require the maintenance of a predominant residual equity and to limit narrowly (say to 20 percent) the percentage of contractual obligations to total assets.
H. SIMONS, ECONOMIC POLICY FOR A FREE SOCIETY 60 (1948).

\textsuperscript{284} See Simons, Rules Versus Authorities in Monetary Policy, 44 J. Pol. Econ. 1, at 6-7 (1936), where the author stated:
An approximately ideal condition is fairly obvious — and unattainable. The danger of pervasive, synchronous, cumulative maladjustments would be minimized if there were no fixed money contracts at all — if all property were held in a residual-equity or common stock form. With such a financial structure, no one would be in a position either to create effective money substitutes (whether for circulation or for hoarding) or to force enterprises into wholesale efforts at liquidation. Hoarding and dishoarding (changes in velocity) would, to be sure, still occur; but the dangers of cumulative maladjustment would be minimized.
Id. See also Friedman, The Monetary Theory & Policy of Henry Simons, 10 J. LAW & Econ. 2 (1967).

\textsuperscript{285} See Jones, Investment Prospects, 2 J. Finance 15 (1947) (warning that the country faced another depression if savers continued to invest in debt).

\textsuperscript{286} See generally I. FISHER, BOOMS AND DEPRESSIONS (1932).

\textsuperscript{287} Jones, supra note 285, at 26-27.

\textsuperscript{288} The SEC's role in Chapter X proceedings is merely advisory. See text accompanying note 59 supra.
financing during those years is proof of the faith in that belief. However, it remains clear that a general aversion to debt appears in almost any reorganization. In this sense, the view of feasibility presented is not so much a theory as a general attitude, and that attitude has endured.

Another attitude, diametric to that described above, conceivably could also have been adopted by the SEC. If the first approach to feasibility maximizes SEC intervention, this second approach is designed to minimize it. It reflects the belief that no need for intervention exists at the time of reorganization; the capital structure of the reorganized debtor will be determined by the market valuation process, and the debtor will obtain that structure which maximizes the value of the stockholders' equity. On a theoretical level, there are many factors which affect the capital structure of a corporation. The market, as the grand and invisible allocator of investment funds in our society, ultimately evaluates these factors. In the nonbankruptcy situation, the corporation would issue incremental amounts of the least expensive form of financing (debt) until the point is reached at which the cost of capital is minimized. That capital structure will maximize the value of the equity in the firm. This market theory poses the deceptively simple question of why can't the management be allowed to ascertain which is the value-maximizing mix of securities to issue, especially if management is identified with the common shareholders. Notice that while the purgative theory of feasibility makes a judgment about the societal and economic harms of a subsequent reorganization of bankruptcy, this market theory makes no such policy decision. Contrawise, the market theory confronts an area the first theory avoids - maximizing the value of the firm, thereby maximizing the number of participants in the reorganization.

In light of the previous exposition of the economic environment of Chapter X reorganizations, the basic problem with the market theory seems clear - everything about a reorganization suggests total abandonment or avoidance of the market processes. Congress provided for reorganizations to avoid the natural and foreseeable market response to a corporation which cannot pay its debts as they mature - piecemeal liquidation of the debtor. The market place is prevented from arbitrating the rewards and penalties due the various investors in the financially distressed corporation. Further, the reorganization mechanism is not geared to the market value of the entire enterprise, but

289. J.F. Weston & E. Brigham, Managerial Finance 264-66 (4th ed. 1972), lists the following as the most important determinants of a firm's capital structure: (1) growth rate of future sales; (2) stability of future sales; (3) competitive structure of the industry; (4) asset structure of the firm; (5) control position and attitudes toward risk of owners and management; and (6) lenders' attitude toward the firm and industry.
rather to the reorganization value of the firm. Cash value in the market is rarely relevant since it is alien to the process. The point is that the securities of a debtor have no market value during a reorganization, other than as pieces of hope. The reorganized debtor cannot issue incremental amounts of debt until the lowest net cost of capital is reached, and given this situation, the market will not respond. The mix of securities issued pursuant to a plan is in no way connected with or a function of the market valuation of the debtor. There is no market to indicate whether to issue six percent debt or eight percent debt, or whether to halt the issue of debt and start to issue equity. Since the recipients of these reorganization tickets, whether they are debt or equity, do not have a choice of investing in the debtor or another company, the reorganization court's deliberations upon feasibility are not circumscribed by the limitations of the market place.

It is only after the reorganization is complete that a market develops so as to assess the securities issued. The price at which they sell operates as a link between the reorganization value and the market value of the debtor as a whole, although even then, the prices of the securities are artificially depressed due to the stigma of the reorganization. In this context, the question of fairness arises precisely because this link, which acts as a basis for comparison, is a totally unknown quantity until the reorganization process and its concomitant shock wave have run their course.

Thus, the SEC and the courts must act in lieu of the market to shape the debtor's new capital structure. This intervention reflects a judgment that the debtor should not be trusted to formulate its own plan of reorganization with any miscalculations rectified later on a trial and error basis. Yet the market theory does have a practical effect on Chapter X reorganizations. The SEC, notwithstanding its expertise in the area, does not act as a substitute for the parties to the reorganization as it is empowered to submit a proposed plan of reorganization to the

290. There are, however, two exceptions. The court must take into account the real, cash value of the reorganization tickets distributed under a plan when trying to fix an upset price for a dissenting class under sections 216(7) (b) and 216(8) (a). See 11 U.S.C. §§ 616(7) (b), (8) (a) (1970). To the extent that this price is to be a realistic one, the court must guess at the market price of the debtor and the price the reorganization tickets will command after the process is completed. The courts have shown some confusion in this regard. Compare Keeskin Freight Lines, Inc., 29 S.E.C. 724 (1949), with In re Keeskin Freight Lines, Inc., 86 F. Supp. 439 (N.D. Ill. 1949). See also Blum, The Law, supra note 4, at 593. Under sections 216(7) (c) & 216(8) (b), the court has the alternative of protecting a dissenting class by satisfying their claims with a direct payment of cash. 11 U.S.C. §§ 616(7) (c), (8) (b) (1970). Presumably, this also requires the court to examine the relationship between reorganization value and the estimated market value of the reorganization tickets which the class had a right to receive. See generally 6A Collier, supra note 4, at 92.16.
court. The parties who do formulate and submit plans, however, have the weight of self-interest behind them and in all probability they will follow the rational rules of the market in order to attempt to maximize the value of the firm. The SEC can do no more than disprove the plans as either subject to excessive risks or as irrational in light of the financial risks to be undertaken.

These two contrasting theories discussed above are merely polar ends of a conceptual continuum of the extent to which the SEC or the court will intervene in a reorganization proceeding. Neither the SEC nor the court is capable of constructing an entirely new enterprise upon the remains of the old, for this could not be accomplished without the ideas of the various parties who composed the old enterprise, be they management, employees, or creditors. These are parties who have the responsibility and interest of maintaining the reorganized debtor, not the court. However, the SEC and the court cannot allow the parties a completely free hand in restructuring an enterprise in which they have varying and potentially conflicting interests.291

The bottom line to all this is that feasibility is dictated neither by the SEC nor by management; it is negotiated.292 The give and take between the various parties, the court, and the SEC takes place long before the SEC undertakes to render a formal advisory report on a proposed plan of a reorganization. The SEC’s attitude is not one of replacing completely the influence of the market, but rather one of mediation during the reorganization process. It is a brake, not a dictator — a brake on each of various parties’ demands that they each know what is best for the reorganized debtor.

With this as a premise, some commentators have suggested possible analogies to other instances of judicial intervention in the formation of a capital structure. Professors Brudney and Chirelstein have suggested that the Deep Rock doctrine293 and the doctrine of “thin” incor-

291. It must also be doubted that railroad management can in the future be relied upon, without restrictions contained in the capital structure itself, to keep a reorganized capital structure sound. The investments of management are usually in junior securities indeed, usually in stock. This will accentuate management’s natural interest to raise money at the lowest cost possible, that is, through the issue of the most senior securities available at the time. Even creditor representatives in management will be inclined to keep the cost of new money down, at the expense of sending the debt ratio up. This is not at all to criticize either equity or creditor management: the inducements referred to are compelling and it would require a farsightedness beyond the qualities of most human beings to resist them.

292. See Blum & Kaplan, Absolute Priority, supra note 39, at 653; See also 2 DeWing, supra note 43, at 1270-73, 1277-81, 1288-90, 1335, 1367.

293. See text accompanying notes 295-97 infra.
poration represent judicial intervention under similar circumstances made after, however, rather than before, the issuance of the debt. 294 For example, in *Taylor v. Standard Gas & Electric Co.*, 295 commonly referred to as the *Deep Rock* case, a parent corporation had totally dominated its subsidiary, and had become its creditor in an enormous sum. The record was replete with instances of mismanagement and waste, all at the order of the parent company, most of them being to the benefit of the parent and to the detriment of the subsidiary. The Supreme Court approved the district court's subordination of the parent's creditor claims to the claims of the noncontrolling preferred shareholders. 296 Unlike the Chapter X situation, the judicial intervention occurred after, rather than before, the issuance of the debt obligation. Yet the intervention was a response to conditions similar to those found in Chapter X reorganizations; there was no brake on the amount or terms of the debt the parent could cause the subsidiary to issue, nor was there any market response to the increase in the extent of the subsidiary's reliance upon debt. The parent could denominate its interest in the subsidiary as debt or equity at will, and the facts of the case reveal a willingness to do just that. 297 The point is that there were no external restraints of any kind upon the subsidiary's capital structure.

The analogy, of course, is not perfect. Feasibility, posing the problem of the firm's capital structure before the debt is issued, focuses on the protection of the economy as a whole from a predilection for excessively risky debt financing. Protection, supervision, and mediation are needed due to the negotiation dynamics of the reorganization process. On the other hand, the *Deep Rock* doctrine 298 focuses more narrowly upon the prevention of a windfall by prohibiting a party from taking pecuniary advantage of a corporation over which that party had complete control, inconsistent with his or her equity, position and deleterious to the other interests of the corporation. 299

294. *Brudney & Chirelstein, supra* note 4, at 328.
296. *Id.* at 324.
297. *Id.* at 315–20.
299. *But cf.* Atlas Pipe. Corp., 9 S.E.C. 416, 446 (1941), where a group of oil companies were to be given the entire equity interest in the reorganized debtor under a plan which the SEC felt provided for an extremely excessive amount of debt. The group also wanted to contribute needed cash and get back a fully secured, priority creditor interest in return. The SEC objected to this feature, comparing it to the *Deep Rock* case "involving as it does the operation of controlled corporations with inadequate equity investment, and the practice by controlling interests of making such investment as loans." *Id.* Compare this to the court’s holdings in the *Costello* case, discussed at text accompanying notes 301–05 infra.
The thin capitalization cases also provide a useful analogy, of which *Costello v. Fazio* is perhaps the best example. As in the *Deep Rock* area, *Costello* represents judicial evaluation of capitalization after, rather than before, the issuance of the debt in question. However, the particular facts of the case forced the court to deal with the propriety of actions taken at the time of the formation of the capital structure. Three partners of an existing partnership with $51,000 of capital contributions decided to incorporate. At a time when the enterprise was only "'two jumps ahead of the wolf,'" the partners took back $6,000 in stock and $45,000 in demand notes with no specified interest rate. Upon review of the corporation’s bankruptcy proceedings, the Ninth Circuit held that the notes had to be subordinated to the claims of other creditors, despite the admitted absence of the kind of fraud and mismanagement which characterized the *Deep Rock* case. The court emphasized that taking the debt obligations left the corporation undercapitalized and the former partners should have known of "'[t]he likelihood that business failure would result from such undercapitalization.'" Yet there was no showing that any interest or amortization payments had ever been made on the loans that could have further weakened the corporation’s precarious financial structure. The implication seems clear; the court, focusing on the point in time when the capital structure was formulated, implied that, at least in the face of possible adversity, the essential capital contributions to an ongoing business must be treated as a permanent investment in that corporation and that the creation of debt, at least in this instance, does not so qualify. It should be noted that in *Costello* there were no market restraints on the amounts of debt or equity the corporation could issue, and therefore, the incorporators were not compelled to make a comparative market analysis of the yields demanded at various debt-equity ratios; rather, they were able to make their own unfettered determination as to the form of their investment.

In the Chapter X situation, similar dynamics may be present. The formation of a "new" corporation in the face of a real or perceived risk of subsequent bankruptcy is the standard setting of reorganization proceedings. The feasibility inquiry allows the reorganization court

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300. The reference is to the thin capitalization cases within the context of corporation law, and not tax law, in which the tax courts have recharacterized debt as equity.

301. 256 F.2d 903 (9th Cir. 1958).


304. 256 F.2d at 909.

305. *Id.* at 908-09.
to intervene in order to prevent the undercapitalization that the Costello court characterized as "inequitable conduct . . . not in acting to the detriment of creditors then known, but in acting to the detriment of present or future creditors, whoever they may be." 306 Significantly, the Chapter X context broadens the scope of this judicial protection; the interests of creditors, workers and even the economy as a whole may be injured if undercapitalization causes a reorganized debtor to suffer a subsequent bankruptcy, or deceives investors into miscalculating the value of a security, or causes any other detrimental effects to investors and the securities markets generally. The greater interests at stake perhaps justify the earlier and more heavy-handed intervention. Note that the Costello court wasn't concerned with whether or not the substitution of demand notes for stock increased the inherent risks of the corporation's financial failure. At least in the hands of the major stockholders, the notes did not add any fixed charges to the corporation's expenses, but merely operated to reorder priorities upon failure and subsequent liquidation.

It has often been stated that the purpose of the feasibility inquiry (and, perhaps the entire scheme of Chapter X) is to maintain the going concern value of the enterprise. 307 The act of filing for reorganization represents a determination that judicial intervention is necessary to insure that the corporation remains intact as a functioning entity which has more social value than it would have upon its liquidation. 308 Further, some commentators have suggested that in Chapter X reorganizations any difference between the going concern value and the liquidation value must go to the creditors (assuming, of course, that the corporation is insolvent), as mandated by the absolute priority rule. 309 Professor Blum, however, disagrees.

306. Id. at 911.
308. As one commentator has noted:
In the social reality of today, however, shareholders are but one of several groups of people who stand in a special relationship to the corporation. The corporation is permanent, the shareholder is transitory. It might even be said without much exaggeration that the corporation is really socially and politically a priori whereas the shareholder's position is derivative and exists only in contemplation of law. This, for instance, is the position taken in our bankruptcy laws which put the maintenance of corporate integrity above the rights of the shareholders. We would not have needed the experience of the Great Depression of 1929-1930 to show us that society must insist on the maintenance of the "going concern" and must if necessary sacrifice to it the individual rights of shareholders, creditors, workers, and, in the last analysis, even of consumers.

Druucker, supra note 24, at 20-21.
and states that, "the basic objective of reorganization [is to insure that] [j]unior interests receive something of value, out of the extra value, which would have been denied them under a market place regime." However, these interests only receive part of this "extra value," since it is allocated among the parties by a plan that must be fair and feasible. Fairness alone cannot dictate the allocation because an infinite variety of qualitative and quantitative participation is possible — some of these possible participations (at least theoretically) even changing the absolute amount of "extra value" to be distributed. Feasibility must be considered because some of these formulas are unacceptable, and in this way fairness and feasibility constantly intersect. If the feasibility of a plan is judged on one level only — the less risk the more feasible the plan is — then feasibility is solely a brake on the allocation that the junior interests will try to command for themselves. It is submitted that the SEC has adopted to some extent this unidimensional approach to feasibility. The sole exception is the F. L. Jacobs Co. reorganization, in which the proposed plan was feasible to such an extent that the Commission viewed as unfair a provision that would limit dividends on the common stock until a substantial amount of the debt of the reorganized debtor was retired. Professor Blum takes a slightly different approach from the SEC, viewing feasibility in a much broader fashion as encompassing plans which are less than optimally feasible, as this is defined by the SEC. He notes that the fairness inquiry is often narrowed (possibly through SEC intervention in the valuation process), and the feasibility inquiry becomes the active center of controversy between participating classes. In this vein, Blum points out:

A two-directional relationship between fairness and feasibility is brought into focus. As a plan is thought to exceed the limits of feasibility it tends to seem unfair to seniors. As a plan is thought to fall short of the limits of feasibility it tends to seem unfair to juniors. In this sense it might be said that in reorganization doctrine fairness and feasibility are merely two different impressions of the same panorama.

The problem with this approach is that it is predicated upon the view that "the reorganization process was designed to preserve for juniors the greatest possible amount of value consistent with both full compensation for seniors and adequate protection of the public interest as re-

310. Blum, The Law, supra note 4, at 596.
312. Blum, The Law, supra note 4, at 587.
flected in the canons of feasibility. Thus, Blum sees the goal of reorganization as maximizing the value of the junior interests and not those of the seniors. One difficulty which arises here is that the legislative history of Chapter X avoids any discussion of the social and economic policy issues of who was intended to be the prime beneficiary of a corporate reorganization. Using a technique known well to the legal profession, the drafters of Chapter X took a substantive issue of political and economic significance and rendered a procedural solution; the advances of Chapter X over equity receivership were more procedural than substantive. The Supreme Court, at the time when the Chandler Act was adopted, had already accepted the burden of designating who was to benefit, and to what extent. Contrary to Professor Blum's commentary, the drafters were addressing themselves to the success of a reorganization, and not the priority schemes when they specified that a plan be feasible.

V. CONCLUSIONS

Articles analyzing the principal aims and features of Chapter X are legion, and it is not intended that this article be added to that list. Yet this much is apparent; Chapter X was designed to change the reorganization process as it had developed under equity receivership and section 77B. Its purpose was to modernize the reorganization procedure and change it from a privately contested "battle of wits,
strategy and endurance into a study and solution of a problem in financial rehabilitation with conscious attention to the business principles and the public interests involved. Improved procedures and the SEC's disinterested expertise were intended to move the reorganization process steadily forward in each case. In reality, Chapter X was meant to be a simplification of a complex procedure that had evolved to the point of being unworkable. Feasibility must be interpreted in this context.

The various theories and analyses of the concept of feasibility undoubtedly are accurate to a certain degree. Yet, as overall guidelines for the SEC and the courts, they all appear to miss the mark, at least in comparison to the deceptively simple concept that introduced this article — risk of ruin. Feasibility is, above all, a requirement that the emerging corporation be a healthy one. It is not necessary that the proposed plan guarantee fabulous financial success, or, for that matter, even contemplate the reorganized debtor existing beyond the economic lifespan of its major assets. All that is required is that the plan show a means by which the reorganized debtor will avoid a re-reorganization or bankruptcy. This is the meaning of feasibility — the reorganized debtor must be capable of emerging as a viable corporate entity and not as a permanent cripple of the business world.

The actual controversies over feasibility, be they reflected in the SEC advisory reports or the judicial reporters, have strayed from this simple standard for the feasibility inquiry. The SEC in particular has used the concept of feasibility to serve a host of purposes in one case, only to face the problem of rationalizing its approach in the next. No doubt the seeming morass of advisory reports could have evolved into a unified statement of the feasibility concept, useful to the

5. To tighten up the provisions for the enforcement of the criminal provisions of the law.
6. To minimize evasions by bankrupts and to grant certain new privileges in favor of bankrupts.
7. To make more effective the discharge provisions of the act.
8. To perfect the sections relative to preferences, liens and fraudulent conveyances, and the title of the trustee.
9. To provide a more workable partnership section.
10. To prescribe an improved composition procedure, including certain of the so-called "relief provisions" of the act for individual compositions and extensions and a carefully prepared plan for corporate reorganizations, retaining the desirable permanent provisions of the new legislation and eliminating cumbersome, overlapping, and inconsistent provisions; also providing for wage-earner amortizations and real-property arrangements by unincorporated persons; and in general, to modernize and bring up to date the bankruptcy law of our country. S. Rep. No. 1916, 75th Cong., 1st Sess. 3-4 (1938); H.R. Rep. No. 1409, 75th Cong., 1st Sess. 3 (1937).
317. Frank, supra note 41, at 351.
318. See the comments of Thurman Arnold, set out in the text accompanying
drafters of proposal plans of reorganization, if the SEC had approached each with a stable concept of risk of ruin, but it did not. For example, feasibility may have started out as a measure of the risk of subsequent failure, but the SEC quickly merged its role under Chapter X with its role as the protector of the securities markets, and the concept of "inherently deceptive and therefore not feasible" was created. From here, the next step was predictable. Confusing its functions under Chapter X with those as administrator of the federal securities laws, the SEC became extremely sensitive to the possibility of deception in the issuance of securities of a reorganized debtor. Yet the Commission is not blameworthy by itself for this result. Though Chapter X may provide for an independent expert relating tried and tested financial principles to the reorganization court, the reality of the proceedings dictates otherwise. The SEC operates in a bargaining atmosphere; it bargains with the other parties before the court, and actively negotiates for changes in the various plans with them. The Commission does not advocate the "ideal" plan in any sense of the word; it merely attempts to get the court to choose a plan with which it can be content. Once the features of the plan, or plans, to which the SEC has objected have been culled, the SEC will maneuver to get before the court that which it considers to be the best plan proposed.

The published advisory reports represent the select few of all the reports which the SEC feels will best illustrate certain of those objectionable features, and give future reorganization participants and the bar a general idea of what exactly is desired. These published reports undoubtedly represent the most coherent ones written — perhaps we can say, the most coherent of the incoherent. This cross section of feasibility problems surely needs and deserves a clearer definition than its guardian, the SEC, has bestowed upon it. However, the Commission may not be willing to tip its hat, so to speak, and in this manner feasibility retains sufficient flexibility of which the SEC makes powerful use.