BENCH MEMO

1/17/49

Nos. 226, 227, 243, 266, O.T. 1948
Cert to CCA 3

SEC v. Central-Illinois Securities Corp.

The facts are set out at length in the cert memo, together with summaries of the SEC's action and the Action of the DC and CCA. Cert memo, pp. 1-4.

(1) The first problem stated in the cert memo is that presented by the petition of the common stockholders, No. 266. They contend that the DC had power to substitute the figure of $100 for the figure of $110 arrived at by the SEC. Their grounds are that the involuntary liquidation price of $100 is determinative, or in the alternative that the "fair and equitable" standards of the Act were complied with by the DC in its valuation and that the "equitable equivalent" of the rights surrendered by the preferred shareholders could not on this record exceed $100.

The SEC and both lower courts agreed that the involuntary liquidation price was not controlling. Although the common stockholders insist otherwise, I think it quite clear that Otis & Co. v. SEC, 323 U.S. 624, settles this point adversely to them. The ground upon which the common stockholders would distinguish the Otis case, the fact that there both common and preferred stockholders were to receive participations in a continuing holding company enterprise, is expressly rejected as a basis for decision by the Court in that case. 323 U.S. at 638.

The common stockholders can fare no better on the alternative ground they urge for leaving the decision of the DC undisturbed. If the valuation standards employed by the SEC were incomplete or erroneous, there is no valuation figure arrived at by the SEC by use of the correct valuation standards. To permit the DC to substitute ~~his~~ its valuation figure would be to exclude the SEC from participation in the valuation process. The CCA 3 was correct in requiring remand to the SEC, if the valuation standards employed by that agency were erroneous.

(2) The CCA held that a district court under §11(e) has a broader power to reject the SEC's valuations than does a CCA directly reviewing the fairness of a plan under §24(a), which permits any person aggrieved by "an order issued by the Commission under this title" to secure review in the CCA upon the administrative record and under the "substantial evidence" rule. Language making the SEC's findings of fact conclusive if supported by substantial evidence is lacking in §11(e).

It is the SEC's position that the question decided by the DC and the CCA, viz., whether the SEC employed the correct meth of valuation, is one of law and was properly reviewed by the DC. The CCA is criticized for treating the decision of the DC that the plan approved by the SEC was unfair as one of fact. "Certainly," said the CCA, "we cannot say that this conclusion [that of the DC] was clearly erroneous." (R.39.) The question given the most attention by the CCA was that of the extent of th power to reject SEC determination in review under §11(e).

If the question is not one of law, says the SEC, the questi of scope of review becomes material, and this Court should hold that §11(e) grants to the DC a scope of review similar to that exercised by a DC under §77 of the Bankruptcy Act, and that this scope of review is not "widely different . . . than would apply under Section 24." Moreover, if the issue is not one of law, it is a question of policy for the SEC to decide under any theory of review, says the agency.

I think that the question of whether preper methods of valuation have been employed by the SEC is one of law, and that the DC and CCA had power to review the question whatever theory of scope of review is applicable. It is therefore unnecessary to reach the question of whether review under §11(e) is similar to review under §24(a). This is the position of the SEC. It is reenforced by the approach of the Court in Otis & Co. v. SEC, supra, in which the question of whether preferred stockholders were given "fair and equitable" treatment by a plan was treated as a question of law and no reliance was placed upon limitations on scope of review.

(3) The SEC's valuation of the rights of the preferred sto holders was an attempt to apply the doctrine of the Otis case. In that case the plan provided for receipt by both common and pr ferred stockholders of securities in a lower echelon company. The plan was held "fair and equitable" although it allowed participation by common stockholders before the preferred stockhold had received securities whose present value was equal to the preferred's full liquidation preference. It was held that "the rights of stockholders of a solvent company which is ordered by the Commission to distribute its assets among its stockholders m be evaluated on the basis of a going business and not as though liquidation were taking place." Preexisting contract provisions naming an involuntary liquidation price "which produce results at varience with a legislative policy which was not foreseeable at the time the contract was made" were inoperative not merely because the business happened to continue in another form in that case but because "Congress did not intend that its exercise of power to simplify should mature rights, created without regard to

the possibility of simplification of system structure, which otherwise would only arise by voluntary action of stockholders or, involuntarily, through action of creditors." By "giving value to the rights of the preferred in a going concern rather than as if by sale and distribution," the SEC "recognizes and applies the doctrine of full priority."

The SEC conceived its task to be to determine whether the plan gave each security holder "from that which is available for the satisfaction of his claim, the equitable equivalent of the rights surrendered." The SEC determined, in accordance with undisputed testimony, that the current worth of the preferred, or its "investment value" on a going concern basis, was at least equal to the call prices. It concluded that it was not fair and equitable to pay the preferred any less than the call prices which were regarded as fixing a ceiling on the claims of the preferred. While the SEC found that "retirement of the preferred stock will be of immediate benefit to the common stockholders," it found it unnecessary to place a dollar value upon the interes the common stockholders surrendered and received under the plan.

The SEC was indisputably correct in holding that the *Otis* case required it to give the preferred stockholders "the present value or investment worth . . . on a going concern basis," and that the involuntary liquidation price was only one factor in valuation. Because the preferred was to be retired by payment in cash, the agency's focus was different than it had been in *Otis*

The CCA criticized the SEC for failure to give "substantial consideration to the future earning power of Engineers and its subsidiaries." The SEC answers that here the preferred is paid in cash; no earning power in the form of participation in the enterprise was apportioned to the preferred, as was the case in

Otis. The "future earning power" of the cash received by the preferred could only be appraised by determining the investment opportunities open to the preferred stockholders. ~~Itxxxxxx~~ The SEC believes that "the most workable hypothesis for finding a fair equivalent between cash received and the security surrendered under the compulsion of the plan, is that of reinvestment in a security of comparable risk." The question asked was, "How much money would it cost the preferred stockholders to replace their securities with comparable ones?" In appraising what the preferred stockholders surrendered the SEC was primarily concerned not with the total of Engineers' prospective earnings, but with the degree of risk that future earnings would be sufficient to maintain the preferred dividend.

The CCA also found error in the SEC's failure to make a finding as to the value of the common stock. The SEC's answer is adequate: it found that it was beneficial to the common stocl to retire the preferred for cash even at the call price; moreove it found that the plan accorded the preferred, which was entitle to absolute priority, no more than fair compensation for the rig surrendered.

The CCA thought the SEC in error in valuing the preferred "as if the Act had never been passed" but refusing to consider the common by the same standard. The SEC states that it did not value the preferred as if the Act had never been passed, but as if the present reorganization required by §11(b) of the Act had not been required. This explanation destroys whatever color of merit there may have been in the CCA's remarks on this matter It is also to be remembered that the findings that the common ben fited by the elimination of the preferred and that the preferred received no more than the equitable equivalent of the rights surrendered imply consideration of the effects of the Act, apart from the reogganization proceedings.

The DC held that the SEC had erred in failing to consider various "colloquial equities" in valuing the preferred. Among these equities were losses occasioned by the Act, adverted to above, ~~and~~ as well as the issue price and market history of the preferred and the dividend histories of the preferred and common. Issue price and market history have little bearing upon the present value of the preferred, and to the extent that they had such bearing they must have been considered in arriving at the valuation. And present value is the determinative factor, as a analogous case observed. Schwabacher v. United States, 334 U.S 182, 199. As for the dividend histories of the preferred and common, the principal factor being the accumulation of earnings in the system, the SEC notes that dividend policies were dictat primarily by tax considerations. ~~axxxmingxthatxthe~~ The common were in any event fully compensated for their sacrifices. It i important that even had management pursued a liberal dividend policy, the preferred would probably have been worth more than the call prices.

The common stockholders attempt to argue that a doctrine c frustration should be applied: The Act made the continuance of the contract to which preferred shareholders were parties im-possible; all the preferred shareholders are entitled to recove is their contribution to the enterprise. The common stockholde rely upon the CCA 2 decision in New York Trust Co. v. SEC, 13 F.2d 274, which held the doctrine they urge applicable to valu-ing the amount to be paid bondholders. The bondholders were not