In the Supreme Court of the United States

OCTOBER TERM, 1942

No. —

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

The Solicitor General, on behalf of the Securities and Exchange Commission, prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the District of Columbia entered April 27, 1942.

OPINIONS BELOW

The opinion of the Court of Appeals and the dissenting opinion of Justice Miller (R. 139–155) are reported in 128 F. (2d) 303. The Findings and Opinion of the Commission dated March 24, 1941 (R. 63–79, 115–132) are reported in 8 S. E. C. 893. The Supplemental Findings and Opinion of

the Commission (R. 104–113) and the Report of the Commission on a Plan of Reorganization (R. 97–104), both dated September 24, 1941, are reported in S. E. C. Holding Company Act Release No. 3023.

JURISDICTION

The judgment of the Court of Appeals was entered April 27, 1942 (R. 155). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, made applicable by Section 24 (a) of the Public Utility Holding Company Act of 1935.

QUESTION PRESENTED

Directors and officers of a registered holding company purchased preferred stock of the company during a period in which the management of the company, which they controlled, proposed to the Securities and Exchange Commission successive plans of reorganization pursuant to the Public Utility Holding Company Act of 1935. The Commission denied effectiveness to a plan which provided that the preferred stock so purchased should participate in the reorganization on a parity with all other preferred stock. Thereafter the plan was amended to provide that the preferred stock so purchased, unlike all the other preferred stock, would not be converted into stock of the reorganized company, but might be sold to the reorganized company at cost plus interest.

Over the objection of the directors and officers involved, the Commission approved the plan as amended.

The question is whether the Court of Appeals erred in setting aside the Commission's findings and order which determined that it would be detrimental to the interests of investors and unfair and inequitable within the meaning of the Act to allow the preferred stock so purchased to participate in the reorganization on a parity with all the other preferred stock.

STATUTE INVOLVED

The pertinent provisions of the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 803, are set forth in the Appendix, *infra,* pp. 20–28.

STATEMENT

Prior to the consummation of the merger approved in the Commission's order (R. 111–113), Federal Water Service Corporation (hereinafter called "Federal") was a registered holding company incorporated in Delaware controlling subsidiaries which operated water, gas, electric and other properties in thirteen states and in one foreign country (Tr. 457–458). The respondents all were stockholders in Federal and, with the exception of Chenery Corporation, a family holding company controlled by C. T. Chenery, the president of Federal, were either directors or officers of Federal or its parent, Utility Operators Company, or

both (R. 13, 85–86). The individual respondents and C. T. Chenery controlled Utility Operators, which owned all of the outstanding shares of Federal's Class B common stock (R. 63–64). Since this stock represented 42.73% of the voting power in Federal, and since the other voting stock was scattered among public holders, respondents and C. T. Chenery controlled Federal through Utility Operators (Tr. 14, 1597). Federal Water and Gas Corporation (hereinafter called "Federal Gas") was a wholly-owned inactive subsidiary of Federal with no important assets (R. 64).

Federal registered as a holding company under the Act on November 8, 1937. Concurrently, it filed with the Commission a declaration under Section 7 of the Act with respect to a plan for the alteration of the rights of its security holders. The plan was designed to eliminate a mounting capital deficit and to release earnings for payment of dividends on its stock (Tr. 10), which at the time consisted of preferred, Class A and Class B shares of the stated value of approximately 15, 13½ and 2½ million dollars, respectively (Tr. 40). The preferred shares had dividend and liquidation preferences over the Class A and Class B shares and the Class A shares had comparable preferences with respect to the Class B (Tr. 3–4). No dividends had been paid since 1931 and in none of the years 1932 to 1937 had income, even on a consolidated basis, been sufficient to meet the preferred dividend requirements (Tr. 47–73). On November 7, 1937, dividend arrearages on the preferred amounted to nearly $6,000,000 and on the Class A to approximately $7,000,000 (Tr. 41). If an admitted excess of book values of investments over their true values had been corrected on the books, the surplus deficit would have exceeded the stated value of the Class B stock and impaired the stated value of the Class A (Tr. 40–41, 92–95).

This circumstance furnished an important incentive to recapitalization, since under Delaware law no dividends could be paid on any class of stock as long as the capital represented by any class having a preference on distribution of assets was impaired (R. 65).[1] As was indicated by the Commission (R. 66), another incentive to voluntary recapitalization was the fact that Federal was confronted with the prospect of compulsory simplification of its capital structure under Section 11 (b) (2) of the Act.

Through their control of Utility Operators, the principal asset of which was the Federal Class B stock, the management of Federal had a greater interest in the Class B stock than in the preferred or Class A shares. The plan embodied in the declaration filed by Federal on November 8, 1937, and two somewhat different plans subsequently

[1] General Corporation Law of Delaware, Section 34 (1935); Del. Rev. Code (1935), § 2066.

proposed by Federal, called for participation by the Class B stock in the reorganized company. These plans were discussed informally with representatives of the Commission, and formal hearings on each were held before a trial examiner. Ultimately all of these plans were withdrawn. A principal obstacle to approval of them was the provision for participation by the Class B stock, which had no existing or prospective equity in the assets or earnings of the enterprise. (R. 67.)

On March 30, 1940, the management filed a fourth plan (Tr. 782–799). This plan proposed a merger of Federal, Utility Operators and Federal Gas. There was no provision for participation by the Class B stock, which was to be surrendered for cancellation; but a provision for a "staggered" board of directors would — initially at least—retain the existing management in control. The preferred and Class A shares of Federal were to be converted into common shares of the surviving corporation. (R. 67–69.) Hearings on the plan were held before a trial examiner, after which tentative findings and an opinion were prepared by the Commission and served on the parties. Thereafter, counsel for Federal and counsel for the Commission filed briefs and were heard in oral argument before the Commission. (R. 67–68.) On March 24, 1941, the Commission issued findings and an opinion denying effectiveness to the plan on three

grounds. (R. 63–79.) One ground was that the par value of the common stock to be issued was fixed at too high a figure. A second ground was that the "staggered" board provision would result in an unfair distribution of voting power. The third ground presents the only issue now involved.

With respect to this ground, the Commission found that during the period from November 8, 1937, to June 30, 1940, when Federal's plans of reorganization were on file or under discussion with the Commission, the respondents purchased a total of 12,407 shares of Federal's preferred stock. Most of these shares were purchased on the over-the-counter market. They were purchased at prices below the book value of the common stock of the surviving corporation into which they were to be converted under the plan. There was testimony that after individual stockholders had complained of some of the purchases, the respondents adopted a policy of not buying stock while particular plans were in contemplation but not announced publicly, and the Commission did not find fraud or concealment of information. (R. 71–72.) The Commission concluded, however, that the respondents had a fiduciary obligation to the stockholders not to trade in stock of the corporation during the period involved, and it made ultimate findings that, unless amended, the provisions in the plan allowing the preferred

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shares purchased in violation of this obligation to participate on a parity with all other preferred shares would result in the terms of issue of the new securities being detrimental to the interests of investors and in the plan being unfair and inequitable within the meaning of Sections 7 and 11 of the Act (R. 77–79).

On July 1 and August 12, 1941, after further informal discussions, the management filed amendments to the plan of merger (Tr. 1030, 1046). These included provisions, to which respondents agreed subject to a reservation of any right they might have to review the Commission's action, that no stock in the surviving corporation would be issued for the preferred shares in Federal bought by petitioners after November 8, 1937. Instead, respondents were to sell and the surviving corporation was to buy the shares at the prices paid by respondents plus 4% interest, less the amount of any profits which may have been made by respondents on any sales of the shares. (R. 80–85.)

On August 15, 1941, respondents filed an application for leave to intervene in the proceedings before the Commission and requested the Commission to reconsider the case and to deny effectiveness to the amended plan unless modified to allow the preferred stock purchased by them during the period in question to participate in the reorganization on a parity with the other preferred stock (R. 85–94). The Commission granted

the respondents leave to intervene and to file briefs (R. 96–97). Thereafter, on September 24, 1941, the Commission issued a report on the amended plan (R. 97–103) and issued supplemental findings and an opinion in which, adhering to the views expressed in its earlier opinion on the issue here involved (R. 108), it approved the amended plan (R. 104–111). By order of the same date, the Commission permitted the declarations embodying the amended plan filed by Federal and the other two companies to become effective forthwith subject to the condition that the reorganization and merger be completed prior to November 1, 1941, and to other conditions not necessary to mention here (R. 112–113).

On a petition for review of the Commission's order, in which respondents raised only the issue now involved (R. 1–10), the Court of Appeals, one judge dissenting, upheld respondents' contention that the Commission should have permitted equal participation by the preferred stock purchased by them during the period in question (R. 139–155). Judgment was entered on April 27, 1942, reversing the Commission's order and remanding the cause for further proceedings in accordance with the court's opinion (R. 155).

REASONS FOR GRANTING THE WRIT

In 1937 and thereafter during the next three years Federal Water Service Corporation, a regis-

tered holding company, filed with the Securities and Exchange Commission various plans of reorganization which the management had formulated and which it sought to have the Commission approve pursuant to Section 7 of the Public Utility Holding Company Act of 1935. During the same period, while the plans were under discussion with the Commission, the respondent Chenery Corporation, which was controlled by the president of Federal, and the other respondents, who were certain officers and directors of Federal or its parent company, purchased preferred stock of Federal on the over-the-counter market. In disapproving the fourth plan proposed by the management, and in thereafter approving the plan as amended, the Commission held, in effect, that the preferred stock so purchased should not be converted into stock of a new corporation on the same basis as the other preferred stock, but should be sold to the new corporation at cost, plus interest, less any profits which the holders may have made on sales of other preferred shares similarly purchased.

The Commission grounded its action on findings that, if the preferred stock so purchased were permitted to participate in the plan on a parity with the remainder of the preferred stock of the same series, the terms of issuance of stock of the new corporation would be "detrimental to the

* * * interest of investors" and the plan would not be "fair and equitable to the persons affected" within the meaning of those provisions of Section 7 (e) and Section 11 (e) of the Act, respectively (R. 77, 79). In reversing the action of the Commission, the majority of the Court of Appeals held that the findings were unauthorized by the Act and that the Commission had made a policy determination which was open only to Congress. Whether the Commission's findings are proper under the Act is the sole question presented. It has not been disputed that if they are proper, the treatment of the stock in the plan as amended was appropriate and the order of the Commission valid (see *supra,* pp. 8–9).

1. The question is one of public importance in the administration of the Act and, therefore, should be reviewed by this Court. In several cases now pending before it, the Commission is faced with substantially the same issue as was before it in the instant case.[2] Since each of those cases and any additional similar cases which may arise would

[2] In *Derby Gas & Elec. Corp.*, Holding Company Act Release No. 2875 (July 12, 1941), the Commission made findings similar to those herein. In *The Middle West Corporation*, Holding Company Act Release No. 3580 (June 5, 1942), the Commission withheld decision because of the decision of the Court of Appeals in the instant case. The pendency of at least six other cases involving the issue decided herein has been ascertained from the Commission's files.

be reviewable in the court below,[3] it is appropriate that certiorari be granted in the instant case to settle the difference between the Commission's view and that of the Court of Appeals. Moreover, a determination by this Court will establish a precedent with respect to the extent of the fiduciary obligations of officers and directors of companies needing reorganization which will be an authoritative guide in the hundred or more other situations where—as shown by a study made by the staff of the Commission—recapitalization appears to be required by the standards of Section 11 (b) of the Act (Appendix, *infra,* p. 24).

2. The decision of the court below adopts an erroneous interpretation of the Act and should be reversed in order to effectuate the policies declared by Congress.

Section 6 prohibits registered holding companies from issuing or selling securities and from altering the rights of holders of outstanding securities except, insofar as here material, in accordance with effective declarations filed by them with the Commission under Section 7 (Appendix, *infra,* p. 22). Under paragraphs (d) (6) and (e) of Section 7, however, a declaration cannot become effective if the Commission finds that the proposed issuance or sale of securities or alteration of rights of security holders would be "detrimental to the public interest or the interest of investors or consumers" (Appendix, *infra,* p. 23). As is further provided in paragraph (f), an order permitting the declaration to become effective may contain such terms and conditions as the Commission finds necessary to assure compliance with the foregoing or other standards specified in Section 7 (Appendix, *infra,* p. 23). The words "detrimental to the public interest or the interest of investors or consumers" are not defined in the Act, but with all other provisions of the statute are to be construed in the light of the policy of the Act to safeguard the interests of investors, consumers and the public (Section 1, Appendix, *infra,* pp. 20–21).

[3] Section 24 (a) of the Act (Appendix, *infra,* p. 27) permits any "person or party aggrieved by an order issued by the Commission" to file a petition for review in the United States Court of Appeals for the District of Columbia, regardless of where he may reside or have his principal place of business.

The evident intention of Congress to accord the Commission a broad scope of judgment appears further from Section 11, which also is applicable in the instant case, as was held by the Commission (R. 122–123, 130–131). Under subsection (b) (2) (Appendix, *infra,* p. 24), it is the Commission's duty to order registered holding companies and their subsidiaries to take such steps as the Commission finds necessary to ensure that the structure of holding company systems is not unduly or unnecessarily complicated or that voting

power is not unfairly or inequitably distributed among security holders. Subsection (e) (Appendix, *infra,* pp. 24–26) provides that any registered holding or subsidiary company may submit a plan to the Commission "for the purpose of enabling such company * * * to comply with the provisions of subsection (b)." Approval of the plan is made contingent upon findings by the Commission that the plan, as submitted or as modified, is "necessary to effectuate the provisions of subsection (b)" and is "fair and equitable" to the persons affected by it.

Thus, Congress specifically committed to the Commission the duty of determining whether a proposed change in the rights of security holders would be detrimental to the interests of investors and whether a proposed redistribution of voting power would be fair and equitable. In addition, it authorized the Commission to impose conditions or require modifications. The power of the Commission with respect to changes in the rights of security holders is not limited to changes as between different classes of holders, but extends as well to changes within a particular class. Accordingly, if consistent with the statutory objectives and standards there is an appropriate basis for the Commission's determination in the instant case, the court below should not have reversed. *United States* v. *Lowden,* 308 U. S. 225, 231, and cases cited; *Gray* v. *Powell,* 314 U. S. 402.

We submit that there is such a basis. The Commission held, in substance, that in the process of formulating and presenting to the Commission a plan of reorganization, the management of a registered holding company occupies a fiduciary position toward all the security holders affected by the plan and, under decisions of courts of equity in analogous situations, should not be permitted to obtain advantages by trading for profit in stock of the company even though in the particular case there is no finding of fraud or concealment (R. 72–77, 108). This conclusion tends to promote the statutory purpose of safeguarding the interests of investors and the public, is in accord with sound principles of equity, and does not conflict with anything in the terms or history of the Act.

The management of a registered company in formulating and effecting a plan of reorganization acts in a representative capacity for all the security holders and is in a peculiarly powerful position. Excepting the Commission, only the management may initiate or amend a plan.[4] In a

[4] See *Republic Service Corp.*, Holding Company Act Release No. 3513 (May 9, 1942), in which the Commission held that an individual preferred stockholder could not file a plan of reorganization under Section 11 (e). In cases where a proceeding is instituted by the Commission under Section 11 (b) and application is made to a court under Section 11 (d) to enforce the Commission's order, the plan may be proposed by the Commission or by any person having a bona fide interest in the reorganization.

case such as the present, it may withdraw its proposals at any time before approval and may even fail to carry out a plan after approval. Frequently, through control of timing, control of the provisions of the plan, or through possession of information which is not fully or generally known by the security holders, it could realize profits at their expense if permitted to deal in the securities. The possibilities of abuse and of errors of judgment in representing the security holders which might result from shifts in the interests of management as between different classes of securities call for holding the officers and directors subject to the same standard of conduct as must be observed by trustees and members of protective committees.

It has long been settled that in order to eliminate the cause of evil, a trustee may not purchase property embraced by the trust "though he has done so for a fair price, without fraud, at a public sale." *Michoud* v. *Girod,* 4 How. 502, 557 (1846); *Magruder* v. *Drury,* 235 U. S. 106; *Meinhard* v. *Salmon,* 249 N. Y. 458. Cf. *Woods* v. *City Bank Co.,* 312 U. S. 262, 268. And this rule, for reasons which apply equally in the instant situation, has been extended to members of protective committees in decisions subsequently codified in Section 249 of the Bankruptcy Act (11 U. S. C. § 649).

Under these decisions [5] members of protective committees who dealt in securities of the corporation pending the reorganization have been precluded from obtaining compensation for services rendered during the reorganization. This would seem to be a more severe sanction than that applied in the instant case. The respondents here were precluded only from realizing profits, a result identical with that which Section 212 of the Bankruptcy Act [6] (11 U. S. C. § 612) authorizes a court of equity to reach and which, indeed, a court might reach in the absence of express statutory authorization by application of principles inherent in the standard "fair and equitable." See *American United Mutual Insurance Co.* v. *City of Avon Park,* 311 U. S. 138, 145–146.

[5] *In re Paramount Publix Corp.*, 12 F. Supp. 823, 828 (S. D. N. Y.), affirmed 83 F. (2d) 1015 (C. C. A. 2); *In re Republic Gas Corp.*, 35 F. Supp. 300 (S. D. N. Y.). See *Otis & Co.* v. *Insurance Bldg. Corp.*, 110 F. (2d) 333 (C. C. A. 1); *In re Mountain States Power Co.*, 118 F. (2d) 405 (C. C. A. 3). The fiduciary obligations of members of protective committees toward the security holders they undertake to represent are not dependent upon the existence of an express trust or upon whether securities are deposited with them. *United States* v. *Buckner*, 108 F. (2d) 921, 926–927 (C. C. A. 2), certiorari denied, 309 U. S. 669. Compare (Note) *Duty of Member of Protective Committee to Disclose Information Before Purchasing Stock From Non-Depositor* (1936), 46 Yale L. J. 143, 148.

[6] Section 212 of the Bankruptcy Act expressly authorizes the court to limit claims or stock purchased by a committee during a reorganization proceeding under that Act to the actual consideration paid therefor.

The court below (R. 143–144, 145–146) relied on Section 17 (b) of the Act (Appendix, *infra,* pp. 26–27) and, in conjunction therewith, on the common law rule of a majority of states, including Delaware, that officers and directors are not trustees of the individual stockholders and are free to trade in stock of the corporation provided they do so without practicing fraud or, in some jurisdictions, concealing knowledge of special facts. Cf. *Strong* v. *Repide,* 213 U. S. 419.[7]

Section 17 (b), which is similar to Section 16 (b) of the Securities Exchange Act of 1934, provides that profits realized by directors or officers from purchases and sales, or sales and purchases, of securities of the corporation within any period of less than six months shall inure to the benefit of the corporation. The court below thought that this provision should be read as prohibiting the Commission from adding any other restriction upon the normal right of directors and officers recognized at common law to purchase securities of the corporation (R. 145, 149–150). However, the common law rule has been developed in private litigation in suits brought by individual stockholders and, so far as we are aware, has not been applied to a reorganization situation in any

[7] The cases are collected and discussed in Yourd, *Trading in Securities by Directors, Officers and Stockholders* (1939) 38 Mich. L. Rev. 133.

case arising under a statute setting up standards comparable to those of the present Act. Nor is there anything in Section 17 (b) or in its legislative history to indicate that Congress meant to limit the power of the Commission in proceedings under Sections 7 and 11. The decision of the Commission herein is in accord with expanding notions as to the scope of the fiduciary obligations of officers, directors and principal stockholders (cf. *Pepper* v. *Litton,* 308 U. S. 295, 306–307; and cases *supra,* pp. 16–17), and is in any event authorized by the Act as a reasonable exercise of administrative judgment.

CONCLUSION

Because of the importance of the question presented, the petition for a writ of certiorari should be granted.

Respectfully submitted, Charles Fahy

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JULY, 1942.

CHESTER T. LANE,
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