Michigan Law Review

Volume 49 | Issue 8

1951

CORPORATIONS-VOLUNTARY REORGANIZATION UNDER THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935-VALUATION OF STOCK OPTION WARRANT

William H. Bates
University of Michigan Law School

CORPORATIONS—VOLUNTARY REORGANIZATION UNDER THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935—VALUATION OF STOCK OPTION WARRANTS—Appellant corporation submitted a voluntary reorganization plan to the Securities and Exchange Commission pursuant to sections 11(b)(2) and 11(e) of the Public Utility Holding Company Act of 1935.[1] The plan consisted of two parts. The first proposed consolidation of three of the appellant's subsidiaries into a newly formed operational company. The second part provided for dissolution of the appellant corporation, with the holders of securities therein being issued stock in the new corporation to the extent of the value of their interest in the appellant corporation. All the security holders of appellant were allowed participation in the securities of the new corporation except the holders of Class B stock option warrants, which, it was claimed, had no recognizable value. There were outstanding 497,191.5 of such option warrants, each of which entitled the holder to 1 1/6 shares of common stock upon the surrender of one warrant and payment of $50. Since 1932 the common stock had risen to a high of 18½ and had fallen to a low of ⅞ on the market. The high for the option warrants in the same period was 5 and the low was ⅛. In 1949 the high option warrant market price was ¼ and the low, ⅛.[2] The SEC found there was no reasonable expectation that the holders of the option warrants would ever participate in the earnings of the appellant corporation; it approved the plan with minor modifications concerning other securities, and conditioned acceptance upon the order of the district court as allowed by statute.[3] The district court ordered the plans carried out, but appellee, a holder of stock option warrants, secured review by the court of appeals under section 24(a)[4] of the act. The court of appeals, holding that there was no substantial evidence to support the findings of the SEC in light of the market values, ordered the plan to be reconsidered. *Held,* on appeal to the United States Supreme Court, reversed. *Niagara Hudson Power Corporation v. Leventritt,* (U.S. 1951) 71 S.Ct. 341.

Findings of administrative agencies are not usually subject to re-examination unless not supported by substantial evidence, or not arrived at in accord with legal standards. And such is the scope of review designated in section 24(a) of

[1] 49 Stat. L. 821 (1935), 15 U.S.C. (1946) §79K(b)(2), and (c).

[2] See SEC Holding Company Act Release No. 9270 (1949). The SEC determined on the basis of the circumstances that $1.39 was the closest estimate of foreseeable earnings for the Class B stock on the basis of present investment values if the Niagara Hudson Power Corporation were to continue business. With the exercise price of the warrant at $50 for 1⅙ shares of common stock, the value per share would have to rise to $42.86 before the option to purchase would be exercised. This price is more than thirty times the estimated future earnings, and 3½ times the recent market high of 12 for the common stock. Thus if the common stock sold at fifteen times consolidated earnings, a liberal estimate, to bring the market price to $42.86 would require earnings of $2.86 per share, an increase of 106% over the $1.39 estimated foreseeable earnings. The SEC maintained that this was not a reasonable expectation of participation in the old corporation.

[3] See note 1 supra.

[4] For excellent discussion of alternative review allowed under Public Utilities Holding Company Act of 1935, see 59 YALE L.J. 1365 (1950).

the Public Utility Holding Company Act of 1935.[5] There was no complaint that the current procedure had not been followed in the principal case. Thus the sole issue was whether or not there was substantial evidence for finding that the option warrants had no recognizable value. The key to valuation of interests in reorganization plans under the Public Utility Holding Company Act seems to be the extent to which the security holders of the company being dissolved can reasonably anticipate participation in the earnings of this corporation.[6] The contractual rights on dissolution contained in the charter of incorporation do not govern because the determination is to be made as though the corporation were a going concern.[7] The problem of determining the value to be assigned stock option warrants had been faced by the SEC but three times previously. In two of these cases, the option warrants were allowed participation, but in both of these instances the evidence indicated that the market value of the old common stock was always close to or above the exercise price of the warrants.[8] In the third case, the option warrants were excluded from participation because it appeared very unlikely that the market value of the old common would equal the exercise price of the warrants.[9] In this third case, the exercise price was $30, the high market value for common stock had not exceeded 6⅛ for a fifteen year period, and the option to purchase had not been exercised during that period. The facts of the principal case are equally as convincing that there was no reasonable expectation that the options in the warrants in question would be exercised.[10] The statute requires that the plan be fair and equitable,[11] but this standard would seem also to require that the senior security holders should receive the equitable equivalent of the rights they are surrendering before the junior security holders may receive anything.[12] Therefore, the ultimate question in the principal case, as in cases involving other types of securities, would

[5] 49 Stat. L. 834 (1935), 15 U.S.C. (1946) §79X. See, generally, Davis, "Scope of Review of Federal Administrative Action," 50 COL. L. REV. 559 (1950).

[6] Common stock has been excluded from participation where it had no possibility of ever receiving anything from the corporation. In re Federal Water Service Corporation, 8 S.E.C. 893 (1941). There is authority in other fields indicating that in reorganization, classes of securities may go unrecognized when informed estimates indicate no reasonable expectation of participation in future earnings. Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510, 61 S.Ct. 675 (1941); Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad Co., 318 U.S. 523, 63 S.Ct. 727 (1943); City Nat. Bank & Trust Co. v. Securities and Exchange Commission, (7th Cir. 1943) 134 F. (2d) 65.

[7] Otis & Co. v. Securities and Exchange Commission, 323 U.S. 624, 65 S.Ct. 483 (1944); Securities and Exchange Commission v. Central-Illinois Securities Corp., 338 U.S. 96, 69 S.Ct. 1377 (1949). On valuation by the SEC generally, see 93 UNIV. PA. L. REV. 309 (1945).

[8] In re Community Gas and Power Co., (3d Cir. 1948) 168 F. (2d) 740, cert. den. 334 U.S. 846, 68 S.Ct. 1516 (1949); In re Electric Power and Light Corp., (2d Cir. 1949) 176 F. (2d) 687, motion for stay of enforcement den. 337 U.S. 903, 69 S.Ct. 917 (1949).

[9] In re Commonwealth and Southern Corp., (3d Cir. 1950) 184 F. (2d) 81.

[10] See note 2 supra.

[11] See note 1 supra.

[12] Securities and Exchange Commission v. Central-Illinois Securities Corp., supra note 7; In re Community Gas and Power Company, supra note 8.

seem to be whether or not the holders of the option warrants could reasonably expect to participate in the earnings of the old corporation. The likelihood that the option warrants will be exercised, and the relative market values of the stock and of the option warrant issued for purchase of that stock, become important in determining the primary question of the warrant holder's right to participate in the earnings of the old corporation.[13] It is the value of the interest of the warrant holder in the corporation that is important, not the questionable value of the warrant on the open market which fluctuates with investment speculation. Also it must be remembered that any participation which the holders of warrants are allowed in the new corporation will be at the expense of the holders of common stock, who in the principal case seem already to have taken serious cuts in their "equities."[14] Although an "anti-warrant, pro-common stock" attitude is to be avoided, the purpose of the Public Utility Holding Company Act is to simplify the structure and stabilize the securities of corporations subject to its provisions,[15] not to protect speculative market rights. When all the circumstances are taken into account the position taken by the Court in upholding the determination of the SEC that the option warrants had no recognizable value seems to be fair and equitable to all involved.[16]

William H. Bates

[13] Although there is some question as to the amount of consideration given to the relative market values in the principal case [see concurring opinion in SEC v. Leventritt, (2d Cir. 1950) 179 F. (2d) 615], still there is no doubt that the SEC did weigh the importance of the market value. See SEC Holding Company Act Release No. 9270 (1949).

[14] See SEC Holding Company Act Release No. 9270.

[15] See note 1 supra, 49 Stat. L. 803 (1935), 15 U.S.C. (1946) §79 et seq.

[16] The fact that another solution than that reached by the SEC could have been arrived at very easily is immaterial, for the SEC should be considered expert in the field and its discretion allowed to govern, especially where technical knowledge is important and no substantial facts are in controversy. See Chicago, Burlington & Quincy Railway v. Babcock, 204 U.S. 585, 27 S.Ct. 326 (1907); American Power and Light Co. v. Securities and Exchange Commission, 329 U.S. 90, 67 S.Ct. 133 (1946).