INLAND GAS CORPORATION--AN EPIC OF CORPORATE REORGANIZATION

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Dean Esterly, members of the faculty, students, and guests:

When I was invited by Dean Esterly to address you, I readily accepted the invitation. Any opportunity to revisit the School of Business Administration, from which I was graduated nearly 21 years ago, is always a source of pleasure to me. I propose to explore with you certain facets of corporate life, generally known only to lawyers and financial analysts familiar with reorganization matters.

The Securities and Exchange Commission is concerned with the administration and enforcement of seven different statutes enacted by Congress. Under one of those statutes, Chapter X of the Bankruptcy Act, the Commission serves as an expert adviser to the Federal courts in connection with corporate reorganizations. My area of responsibility, as Chief Financial Analyst of the Division of Corporate Regulation of the SEC, extends to three statutes, namely, the Public Utility Holding Company Act of 1935, the regulatory provisions of the Investment Company Act of 1940, and Chapter X of the Bankruptcy Act. Having a rather rich field of experience from which to draw for today's topic, I selected the controversial and fascinating case history of the

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financial collapse of a not very large natural gas system some 29 years ago, which system, incredible as it may seem, is still in reorganization.

The principal corporate entities involved in this matter are Inland Gas Corporation, Kentucky Fuel Gas Corporation, American Fuel & Power Company, and The Columbia Gas System, Inc. I shall frequently refer to the first three-named corporations, together with two minor subsidiaries of American Fuel, collectively as the American Fuel system, since American Fuel & Power Company is the top parent company in that group. These three corporations are in reorganization under Chapter X of the Bankruptcy Act. The fourth-named corporation, Columbia, is, of course, not in reorganization, but is, rather, a very large, solvent public utility holding company controlling nine natural gas distributing companies and five natural gas pipe line companies. Its consolidated assets at June 30, 1959, aggregated $1,107,567,000.

Because of the complex cross-holdings of securities in the American Fuel system, I request your indulgence and ask that you look at two exhibits which I have had distributed to you in advance. Appendix A depicts graphically, as of August 31, 1959, the relative proportions of holdings of debt claims, exclusive of accrued interest, and shares of capital stock between the companies in the American Fuel system and Columbia. Appendix B contains a statement, as of the same date, of the dollar amounts of debt claims existing against the three debtor corporations, including accrued and unpaid interest computed at contract rates.

You will note from Appendix A that Columbia is a 76.4% stockholder of American Fuel and also a creditor of each of the three debtor corporations. American Fuel, in turn, owns 72.6% of the common stock of Inland and 91.1% of the common stock of Kentucky Fuel. Kentucky Fuel owns 26% of the common stock of Inland, while the general public owns 1.4%. Appendix B indicates that the aggregate principal amount of outstanding debt of the three debtor corporations, as at August 31, 1959, after eliminating intercompany items, amounted to $9,637,994, while inclusion of accrued and unpaid interest at contract rates to August 31, 1959, increases the aggregate debt to $26,751,465.[1/]

The principal assets of the American Fuel system are owned by Inland. This company is, indeed, the heart of the system. Inland purchases, produces, transmits, and sells natural gas, with its sales being made either directly to industrial consumers or to associated operating companies which resell to industrial consumers. Its physical assets are situated in eastern Kentucky and include, in addition to gas-producing acreage, a pipe line and a gathering system together with auxiliary equipment.[2/] Kentucky Fuel and American Fuel are both nonoperating

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1/ See Appendix B, note (a), regarding the inclusion, for purposes of comparative analysis, of certain debt securities retired as of June 30, 1959, primarily from the proceeds of a bank loan.

2/ On the basis of 1958 figures, Inland purchases 79% of its gas requirements from Tennessee Gas Transmission Company, a nonaffiliate, and 2% from local production sources, and produces 19% from its own wells. In 1958, the latest calendar year for which audited figures are available, Inland's total gas sales amounted to 16,431,196 Mcf, resulting in gross operating revenues of $6,404,197. Net income amounted to $744,697. At December 31, 1958, net utility plant per books was stated at $3,047,137. The physical properties, however, are considered to be worth substantially in excess of this amount. Net current assets at the same date amounted to $4,739,489.

companies.[3/]

Inland was incorporated in March 1927, Kentucky Fuel in May 1928, and American Fuel in July 1928. The first two were organized for the purpose of producing, transporting, and selling natural gas to industrial consumers, while the third was organized as a holding company to consolidate their operations and management. American Fuel acquired control of Inland and Kentucky Fuel through an exchange of its stock for majority interests in their stocks. All three companies were promoted by the same persons and financed by the same group of bankers, and each sold debt securities to the public. A substantial amount of the Inland stock had originally been issued to the promoters and underwriters as compensation for services, while all of the Kentucky Fuel stock had originally been issued to the promoters without cost. An aggregate of $13,452,000 principal amount of debt securities was issued to the public as follows: Inland--$4,400,000 of 6-1/2% First Mortgage Bonds and $1,500,000 of 7% Debentures; Kentucky Fuel--$4,000,000 of 6-1/2% First Mortgage Bonds and $1,000,000 of 6-1/2%

3/ Kentucky Fuel disposed of its physical properties to Inland some 21 years ago and its sole assets consist of an inconsequential amount of cash plus its stock investment in Inland. American Fuel's assets, at the end of 1958, in addition to its stock and debt investments in Inland and Kentucky Fuel, were represented by some $500,000 of cash or temporary cash investments, plus the common stocks of two small operating companies.

The two operating companies are Inland Gas Distributing Company and Carbreath Gas Company. Sometime prior to September 30, 1959, all of the assets of these two subsidiaries were transferred to the Inland Trustee, but pending consummation of a plan of reorganization dated February 25, 1958, filed by the Inland and American Fuel Trustees, separate books are being kept for these two subsidiaries.

Debentures; and American Fuel--$2,000,000 of 7% Convertible Gold Notes and $552,000 of unsecured Demand Notes.[4/] American Fuel advanced moneys to the subsidiaries both from the sale of its debt securities as well as from the sale to the public of additional common stock.[5/]

The American Fuel system suffered from the beginning from an excessive amount of debt and an inadequate amount of common equity capital. During this early period, Inland and Kentucky Fuel incurred substantial operating losses. Neither company had been able to earn the burdensome interest charges on its outstanding bonds and debentures since their issuance. In 1929, as well as in 1930, American Fuel advanced funds to enable Inland and Kentucky Fuel to meet their interest requirements as well as for other purposes.

Meanwhile, Hope Engineering Company, a firm which had a substantial financial interest in American Fuel and had been managing the properties of Inland and Kentucky Fuel, made a survey on the basis of which it determined that the only hope for survival of the American Fuel system

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4/ The underwriters received aggregate commissions of $734,505 on the sale of the Inland debt securities and $98,098 in payment for financing expenses; $550,000 commissions on the sale of the Kentucky Fuel debt securities; and $66,141 in payment for financing expenses; and $440,000 commissions and expenses on the sale of the American Fuel Gold Notes.

Kentucky Fuel used a substantial portion of the proceeds of its debt financing to purchase certain gas acreage and equipment and to purchase its present holdings of Inland stock from stockholders of Inland.

5/ American Fuel sold 1,200,000 shares of its common stock for $550,000 cash. These were in addition to the shares issued in exchange for controlling interests in Inland and Kentucky Fuel.

lay in a large expansion of its markets. It concluded that a pipe line could be built from Kentucky to Detroit, Michigan, where large amounts of natural gas could be sold to industrial consumers who were not then supplied with natural gas. Hope formed a syndicate with two other corporations--one an investment trust, and the other a successful builder, operator, and promoter of natural gas enterprises--to promote and build such a pipe line. The pipe line was to pass through the heart of the territory then occupied and served by subsidiaries of Columbia. The Syndicate acquired control of American Fuel in March 1930 through the purchase for cash of 76% of the company's common stock--1,000,000 shares of original-issue stock, and 450,000 additional shares from one of the earlier promoters. The Syndicate agreed to make any advances necessary to meet monthly sinking fund payments due on the Inland and Kentucky Fuel bonds and debentures for one year beginning April 1, 1930, so as to prevent default until those companies could be put on a paying basis through development of additional markets.

The Syndicate moved ahead on the pipe line project to Detroit, organizing corporations to build and operate the pipe line and to carry out related activities; acquiring options on rights-of-way; securing a permit for crossing the Ohio River; and beginning actual construction. Contracts were also made with some of the larger industries in Detroit providing for sales estimated at over 19,000,000 cubic feet of gas per day. On October 9, 1930, the Syndicate formally petitioned for a franchise to lay mains to deliver gas to industrial consumers in Detroit. At this point, the roof literally caved in on the American Fuel system.

To explain this statement, I must go back a little. Prior to the organization of the American Fuel system, Columbia enjoyed virtual freedom from competition in the field occupied by its subsidiaries in Kentucky, Ohio, and West Virginia. With the advent of the American Fuel system, however, the situation changed materially. Since the Columbia subsidiaries served domestic consumers as well as industrial consumers, they were subject to regulation by the State public-utility commissions and to the franchise requirements, and also in certain instances to the rate requirements, of the various municipalities in which they sold natural gas. As such, they could be required by the State and municipal authorities to change their industrial rates or to give preference to domestic consumers in the event of insufficient gas supply for both domestic and industrial consumers. The American Fuel system, however, selling only to industrial consumers under private agreements, was free from State and local regulation, and, therefore, whenever it came into competition with the Columbia system, it had a substantial competitive advantage over the Columbia system. Thus, during 1928, 1929, and the greater part of 1930, the American Fuel system took away from Columbia some of its large industrial customers.

During 1929 and 1930, Columbia was engaged in developing a plan to build a natural gas pipe line from its Kentucky and West Virginia fields to the eastern seaboard cities of Washington, Baltimore, and Philadelphia. The project required a large increase in Columbia's gas reserves in West Virginia and eastern Kentucky. It regarded the gas acreage held by the American Fuel system as desirable. Columbia knew of the precarious financial condition of Inland and Kentucky Fuel and that the indentures securing their

bonds provided that, upon default in interest or sinking fund payments, the indenture trustees should institute foreclosure proceedings upon the request of holders of 25% of their bonds. In anticipation of such happening, and to place itself in a position to force foreclosure and sale of the properties with an opportunity to purchase them at foreclosure, Columbia, in January 1930, began secretly to purchase Inland and Kentucky Fuel bonds on the open market at but little discount from par, and by the end of April 1930, it had acquired 26% of the Inland bonds and 28% of the Kentucky Fuel bonds. Columbia thereupon stopped buying bonds for the time being and watched the development of the Syndicate's projected pipe line.

During this time, Columbia was also engaged in plans to supply natural gas to the Detroit area. When Columbia learned on October 9, 1930, that the Syndicate had formally petitioned for a franchise to lay gas mains in Detroit, Columbia's first response was a resolution of its executive committee, adopted the very next day, to build a pipe line from Toledo, Ohio, to Detroit. Since the Syndicate's guarantee of sinking fund requirements precluded the use of bonds to precipitate a receivership, Columbia deemed it necessary to purchase the controlling stock interest in the American Fuel system. Accordingly, on October 30, 1930, Columbia purchased the Syndicate's 76% stock ownership and other holdings in the American Fuel system at a price of $2,826,789, giving the Syndicate a clear profit of $350,000. Columbia also agreed to hold the members of the Syndicate harmless by reason of various obligations they had undertaken with respect to the sinking fund requirements of Inland and Kentucky Fuel, as well as in connection with the Detroit pipe line project. This

purchase, together with its purchases of bonds and debentures of Inland and Kentucky Fuel in the early part of 1930 and again in the latter part of that year, resulted in a cost to Columbia for its investment in the American Fuel system of $6,318,625. It is interesting to note that, as a result of the Syndicate's sale to Columbia, Hope Engineering Company, organizer and member of the Syndicate, lost the opportunity to build a $20,000,000 pipe line at an estimated fee of 4%. Columbia, therefore, made a supplementary contract with Hope whereby Columbia guaranteed to employ Hope to perform natural gas engineering work on at least $20,000,000 worth of construction projects over the next three years for a fee of 4%--an obligation which it later discharged by paying Hope $400,000 without any work being done by Hope.

Upon gaining control of the American Fuel system, Columbia immediately caused the abandonment of the Detroit project. By the use of certain of its debt claims, Columbia promptly caused receivership proceedings to be instituted against Inland and Kentucky Fuel on December 1, 1930, in the United States District Court for the Eastern District of Kentucky, and a nominee of Columbia, who had been president of Inland, was appointed receiver of both Inland and Kentucky Fuel. Thus, Columbia proved the accuracy of a forecast and a threat made by Columbia's president earlier that year, when he said: "If anyone thinks Columbia will allow a ditch to be dug across the State of Ohio, he is just crazy," and that if Columbia came into the picture it would have to "put the company [American Fuel] through the wringer." (Opinion of the United States Court of Appeals for the Sixth Circuit, 151 F. 2d 461, 468 (1945)). The crucial role played

by Columbia in the collapse of the American Fuel system is described in these words of the Court of Appeals (151 F. 2d at 469):

> "The prospect of recovery and possible profit in what may now seem to have been initially an improvident investment by security holders, lay in the achievement by American Fuel and its subsidiaries of an expanded market to be opened up by the Detroit pipe line. The realization of their hopes was forever destroyed by the activities of Columbia in assuming control of the American Fuel System, terminating further pursuit of the Detroit plan and placing the companies in receivership."

Columbia continued the operation and management of American Fuel and its subsidiaries other than Inland and Kentucky Fuel until March 21, 1934, at which time an equity receiver was appointed for American Fuel by a Court of Chancery in Delaware. The company's small operating subsidiaries followed it into receivership. In the latter part of 1935, trustees were appointed for the various system companies under section 77B of the Federal Bankruptcy Act, which had been enacted in 1934, and upon amendment of the Bankruptcy Act in 1938, the proceedings were placed under Chapter X.

Actions brought against Columbia in 1938 by the Trustee of Inland and Kentucky Fuel to recover damages under the Federal antitrust laws--i.e., the Sherman Act and the Clayton Act--were dismissed in 1940 on the ground that the causes were barred by applicable statutes of limitations. Subsequent to these adverse rulings, the Trustee of Inland sought to compromise all claims by and against Columbia, and the District Court entered an order approving a compromise. The Court of Appeals for the Sixth Circuit, however, in August 1941 (amended in September 1941) reversed the lower court's order and indicated that all claims and stock interests of Columbia acquired in violation of the Clayton Act should be rejected. (122 F. 2d 223).

The Court of Appeals stated (122 F. 2d at 228):

> "The facts in the record impel the conclusion of this court that Columbia's conduct was for the purpose of destroying the debtors and their subsidiaries, and that by its acts, it drew to itself the lifeblood of all the debtors and picked the flesh from the bones of these corporate entities and now, under the terms of the settlement approved by the lower court, is to have a share of the skeleton."

But Columbia had not been a party to this litigation, and further hearings were needed to determine the extent to which its claims had been acquired in violation of the Clayton Act. In a subsequent decision in October 1945 (clarified in November 1945), after many months of trial in the District Court, the Court of Appeals modified its earlier indication calling for outright rejection of Columbia's claims, and instead directed their subordination to the claims of all other creditors of every class. (151 F. 2d 461). At that time, it appeared that there would be no practical difference between subordination and rejection, since it was assumed that the value of the Inland estate was less than the aggregate of the claims of Inland's public creditors. In accordance with the views expressed by the SEC, the Court pointed out that, apart from any question as to possible antitrust violations, Columbia's conduct was such that it would be inequitable to permit Columbia--which, as a controlling stockholder, had violated obligations it owed to security holders of the system--to participate in the reorganization prior to the satisfaction of the claims of all other creditors. The United States Supreme Court refused to review this far-reaching decision. (329 U.S. 737 (1946)).

The proceedings since that date have been marked by the filing of various plans of reorganization by the Trustees and by extensive litigation

arising therefrom. Most of the litigation has arisen from the continued increases in the valuation of the assets of the American Fuel system. In the course of the proceedings, significant rulings have been made by the courts defining and redefining the rights of the various parties in interest. In a decision in 1946 involving this very reorganization, the United States Supreme Court held that questions relating to interest during reorganization are to be determined by a balancing of equities between creditor and creditor or between creditors and the debtor, and in the circumstances there present, it disallowed interest on overdue interest coupons on Inland's First Mortgage Bonds.[6/]

In March 1949, the Inland Trustee filed a plan, which, as later revised, was based on a system valuation of $5,600,000, and which provided for Columbia to participate in the residual equity of Inland after payment to the public creditors of Inland and before any payment to the public creditors of American Fuel and Kentucky Fuel. Incidentally, this valuation should be considered in the context of the fact that, prior to the filing of this plan, cash generated by Inland's operations had enabled the system to pay some $5,653,000 in principal and interest on publicly-held debt of the system.[7/] The plan was approved by

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6/ Vanston Bondholders Protective Committee v. Green, 329 U.S.156, 165 (1946).

7/ Thus, Inland had paid off in full its publicly-held First Mortgage Bonds in the principal amount of approximately $2,650,000, together with about $2,600,000 of interest thereon, and Kentucky Fuel had made an interim cash distribution to the public holders of its First Mortgage Bonds of nearly $403,000. (See Appendix B, note (b), with respect to the question of allocation of this latter item as between principal and interest.)

the District Court, but was rejected by the Court of Appeals in March 1951. The Court of Appeals held that the public creditors of American Fuel and Kentucky Fuel were "quasi-creditors" of Inland and entitled to participate as such in the residual equity of Inland before any participation could be given to Columbia. (187 F. 2d 813). It ruled that the participations of the public creditors of American Fuel and Kentucky Fuel were to be measured by the respective stock ownerships of American Fuel and Kentucky Fuel in Inland--i.e., in the correlative relationships of 72.6% for American Fuel and 26% for Kentucky Fuel. This was in accord with the SEC's views. However, contrary to the SEC's position, the 1.4% public stock interest in Inland was denied participation in the equity of Inland on the ground that it did not represent a creditor position. This denial of a participation to the minority stockholders of Inland, while at the same time according a participation to creditors of the parent companies on the basis of such companies' ownership of Inland stock, affected the course of subsequent litigation, which time will not allow me to discuss.

A subsequent plan filed by the Trustees in June 1952, which, as later amended, was based on a new system valuation of $8,800,000, provided for the public creditors of Inland to be paid in cash from a bank borrowing, and for cash and new common stock to be distributed solely to the public creditors of American Fuel and Kentucky Fuel on account of their claims. Here, too, in considering this valuation figure, one should note that the aggregate amount of payments made to the system's public creditors prior to the filing of this plan now totaled about $6,387,000.[8/] The plan provided for no participation whatso-

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8/ Subsequent to the cash distributions already noted, Inland paid some $734,000 interest on its publicly-held Sinking Fund Debentures.

ever to Columbia. It was approved by the District Court and affirmed by the Court of Appeals in March 1954. (211 F. 2d 381). The plan never became effective, however, because after the United States Supreme Court refused to review the case, the asset value of the estate had increased to the extent where the plan was presumably no longer fair.

Subsequent plans of reorganization were filed by the Trustees on the basis of cash offers received for the physical assets from two pipe line companies, but the plans had to be dropped when the offers were withdrawn.

An additional important ruling came in a decision by the District Court in December 1955 that the Inland stock owned by Kentucky Fuel had never actually been pledged under the mortgage securing the Kentucky Fuel First Mortgage Bonds, and that, consequently, the bonds and debentures of Kentucky Fuel were of equal rank and entitled to pari passu treatment. And in March 1956, the District Court further ruled that the public holders of these bonds and debentures, being unsecured creditors, were not entitled to be paid any post-bankruptcy interest on their claims. This decision, opposed by the SEC, was affirmed by the Court of Appeals, one judge dissenting (241 F. 2d 374), and the United States Supreme Court declined to review the decision. (355 U.S. 838).[9/] The public holders of the American Fuel Gold Notes, however, were not affected by the Court's ruling because American Fuel had pledged its Inland stock as security for its Gold Notes.

9/ This ruling has been held to preclude the payment of interest to the public creditors of Kentucky Fuel from and after the date the company went into receivership on December 1, 1930, rather than from the date Section 77B proceedings were instituted against the company in October 1935. (262 F. 2d 510).

The value of the Inland estate continued to grow during the proceedings. Although Inland's earning power had initially been insufficient to pay the interest charges on its heavy debt structure, the operations of the company, beginning in the late 1930's, aided by favorable economic conditions, generated sufficient cash, which as I have indicated, was distributed to public creditors of the system. Further cash distributions, in addition to those I have mentioned, increased the total amount of distributions by the end of 1957 to approximately $9,409,000.[10/]

A new reorganization plan was filed by the Trustees in February 1958. It was predicated on a new system valuation of $11,030,000, and provided for a bank borrowing and payment in full of principal and interest on the publicly-held American Fuel Gold Notes (which payment has since been made in the amount of $4,905,632.50);[11/] payment of the principal only on the publicly-held Kentucky Fuel bonds and debentures;[12/] and distribution to Columbia, in recognition of its claims, of all the equity in Inland, as reorganized, represented by the entire issue of a new class of common stock. The aggregate payment to the Kentucky Fuel bondholders and debenture holders

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10/ The additional cash distributions subsequent to the $6,387,000 previously noted consisted of approximately $2,155,000 in full payment of principal and interest on the Inland Sinking Fund Debentures held by the public and approximately $867,000 in partial payment of accrued interest on the publicly-held Gold Notes of American Fuel.

11/ A $4,000,000 bank borrowing incurred for this purpose has since been substantially reduced in amount.

12/ In addition, the public debenture holders of Kentucky Fuel would receive payment of a single interest coupon which was in default prior to December 1, 1930, the date of receivership.

would thus amount to $2,466,316--a figure which is based on treating the bulk of a prior cash distribution as a payment of principal rather than interest, and which is less than one-third of their aggregate claim to principal and interest as of August 31, 1959, of $7,658,823. As against the proposed distribution to the Kentucky Fuel public creditors, Columbia would receive 100% of the equity having a value, based on the foregoing over-all valuation, of about $3,021,000. This would exceed Columbia's claims against Inland for principal, and the excess would necessarily represent a payment on Columbia's claims against Inland for interest.

Both the SEC and certain bondholders of Kentucky Fuel contended that the value of the equity allocated to Columbia was substantially in excess of $3,021,000. The District Court, however, accepted the valuation of the Trustees' expert, and in January 1959, the Court of Appeals affirmed the District Court on this as well as on other points of appeal, including the failure to pay any interest to the public creditors of Kentucky Fuel, and the recognition of claims of Columbia before recognition of the 1.4% public common stock interest in Inland and of the public common stock interest in American Fuel. (262 F. 2d 510). In April 1959, the United States Supreme Court denied petitions for review. (359 U.S. 979).

Prior to consummation of the Trustees' plan, the appellant bondholders of Kentucky Fuel proposed certain alterations and modifications of the plan. They reflected an estimated valuation of the system's assets, as of approximately August 31, 1959, of some $14,638,000, and were supported by purchase commitments from institutional investors and underwriters.13/

13/ This valuation figure of $14,638,000 represents the sum of (a) the pro forma capitalization proposed by the bondholders in the amount of $9,015,160 (consisting of $4,250,000 of new bonds and $4,765,160 par value of new common stock), plus (b) an estimated $5,623,000 of system cash at August 31, 1959, before giving effect to the payment in full of the principal and interest on the publicly-held Gold Notes of American Fuel.

In addition to providing for full payment of principal and interest on the publicly-held American Fuel Gold Notes from funds on hand and to be raised by the sale of long-term debt securities to institutional investors, they provided for payment to Columbia of $5,780,537 in cash, representing the principal plus interest on its secured claims against Inland plus the principal only of its unsecured claims against Inland, and for issuance to the Kentucky Fuel public creditors of new common stock having an aggregate par value of $3,265,160, or about $800,000 in excess of the amount they would receive under the Trustees' plan. However, the Kentucky Fuel public creditors would have the option to receive cash equal to the par value of the stock proposed to be issued to them. In addition, they would receive the right to subscribe to $694,650 par value of new common stock for cash.

The bondholders' proposals were opposed by the Trustees and by Columbia. Since Columbia would supposedly receive only $3,021,000 in equity value under the Trustees' plan on the basis of the Trustees' valuation, one must ask why Columbia should resist proposals which would yield it $5,780,000 in cash. Can it be that Columbia does not really value the system's assets at the amount urged by the Trustees and accepted by the courts, but rather at some larger amount, perhaps approximating the value embodied in the bondholders' proposals? We must remember that institutional investors and underwriters are not prone to throw money away, and therefore they would hardly be likely to commit themselves to purchase the securities provided for in the bondholders' proposals unless they were convinced as

to the value of the underlying assets. If we apply this higher value to the distributions proposed under the Trustees' plan, the allocation to Columbia would be worth approximately $6,447,000, as compared with the figure of $3,021,000 based on the Trustees' valuation. It would also exceed the $5,780,000 cash payment proposed to be made to Columbia under the bondholders' proposals.

On January 27, 1960, the Court of Appeals, one judge dissenting, upheld the District Court's order rejecting the proposed modifications and directing consummation of the plan. The majority opinion analogized the length of this reorganization proceeding with that of _Jarndyce_ v. _Jarndyce_ in Dickens' _Bleak House_. It stated that the bondholders' proposals were really a new plan, not merely modifications of the Trustees' plan, and that it was too late to consider a new plan. The dissenting opinion, which agreed with the view which had been expressed by the SEC, stated that, on the basis of the purchase commitments received from institutional investors and underwriters, there would be available for reorganization purposes approximately $3,500,000 more in cash than under the Trustees' plan, and that further hearings should be held to reconsider the distributions under the Trustees' plan. We have been advised that the appellant bondholders will seek review by the United States Supreme Court.

I think it is appropriate now to end the presentation of facts, for as students of corporate finance, you will want to cull out some useful principles from this unique and tangled web of corporate affairs. That this case may be regarded as being _sui generis_ in many of its aspects, including its extension for a generation in the life of man, does not

vitiate the development of such principles. Incidentally, in connection with the length of the proceedings, I am reminded of an actual event which occurred some time ago, which, I believe, lends emphasis to this aspect. Four years ago, in 1956, an attorney, who had been in this proceeding for many years, introduced his 25-year old son to the court. This son was also a lawyer. He had been born after the proceeding had started, and while his father was engaged in the case, he had finished public school, high school, college, and law school, and had been admitted to the bar.

I suggest the following points as meriting your consideration:

1. The United States Supreme Court has held in the landmark case of Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1939), that a controlling stockholder who inadequately capitalizes a subsidiary corporation and then uses his position of control to work a "history of spoliation, mismanagement and faithless stewardship," will have his debt claims against the subsidiary subordinated to the interests of other creditors and public preferred stockholders in a subsequent reorganization of the subsidiary. In the instant reorganization, although Columbia had nothing to do with the original organization and financing of any of the companies in the American Fuel system, and although Columbia had acquired its creditor position before it became a stockholder of American Fuel, nevertheless, because Columbia used its subsequently-acquired position of control to wreck the enterprise, the equitable doctrine of subordination was extended by the court to provide that the claims of the public creditors would rank ahead of the debt claims of Columbia. I think the court properly recognized the need for invoking the equitable doctrine of subordination.

2. I think the court also correctly applied the doctrine of subordination in cutting across corporate lines to give the public creditors of the system a participation ahead of Columbia's debt claims. But I think it did not do so in excluding from participation the small public minority stock interest in Inland. I believe it was unfortunate that the court thereafter applied strict legal rules in disallowing post-bankruptcy interest to so-called unsecured creditors injured by the controlling stockholder, Columbia, while at the same time allowing such interest to other creditors secured by the same kind of asset--Inland stock--underlying the unsecured claims. The irony of this disparate treatment is that, because the Inland estate increased in value far beyond expectation, the residual equity to be distributed to Columbia under the Trustees' plan is so large that it exceeds not only the principal of its secured and unsecured claims against Inland but also the interest thereon to boot. The later holdings of the court thus largely dissipated its earlier holdings on subordination.

3. Valuation of an enterprise represents, in the final analysis, the application of unbiased and informed judgment to a mass of financial, operating, and statistical data. It is most important that the person making the valuation keep himself fully informed as to the state of the art of the particular industry of which the enterprise is a constituent part, as well as of important changes which have taken place in the nature of business of the enterprise itself. In the instant proceedings, the valuation submitted on behalf of the Trustees' plan was more than $3,500,000 less than the amount at which sophisticated institutional investors and

underwriters, only one year later, agreed to purchase the enterprise. This difference is particularly unusual since it must be borne in mind that a very substantial part of the system's assets are comprised of net current assets, and therefore the difference is one which must be measured solely in terms of the physical assets. It raises a very serious question as to the soundness of the analysis of the Trustees' expert.

Perhaps the discrepancy arose basically from his failure to appreciate the fact that, although Inland for many years had been essentially a producer of natural gas--a wasting asset--and to some extent a purchaser of locally-produced gas, beginning around 1951 it had gradually changed over to being primarily a purchaser of gas from a major natural gas pipe line company.[14/] Informed opinion holds that the natural gas industry has a much longer life expectancy than was formerly considered reasonable. In such circumstances, it would seem that a natural gas company, such as Inland, which is protected by long-term contracts of supply, should not be valued as though it were a clock running down to a halt.[15/] In my opinion, therefore, he should either have capitalized the reasonably foreseeable earnings of Inland as a going concern on the basis of an analysis of earnings-price ratios of other natural gas companies selected for comparison, giving due weight to

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14/ Thus, in the previous year, 1950, Inland produced 65% of its gas requirements from its own wells, purchased 31% from local sources of supply, and purchased only 4% from Tennessee Gas Transmission Company. In the following year, 1951, these proportions were, respectively, 58%, 17%, and 25%. By 1958, they had become 19%, 2%, and 79%, respectively.

15/ It may also be noted that Inland has long-term contracts of sale with its two largest industrial customers.

the fact that Inland is both a purchaser and a producer of natural gas, or else he should have applied to the method which he did employ, namely, discounting to present worth his estimates of future net cash receipts, appropriate analytical techniques which would recognize the likelihood that Inland's commercial life would last for more than the mere twenty years which he had assumed. An obvious method of recognizing the likelihood of a longer life expectancy would be the selection of a discount rate which would give weight to this favorable consideration. The SEC, in its advisory report, also employed the discounting method, but used a longer period of life expectancy, higher estimates of net cash receipts, and lower discount rates than did the Trustees' expert, and thereby arrived at a higher valuation than he did. My own personal preference, however, in a case such as this would be to capitalize reasonably foreseeable earnings on a going-concern basis.

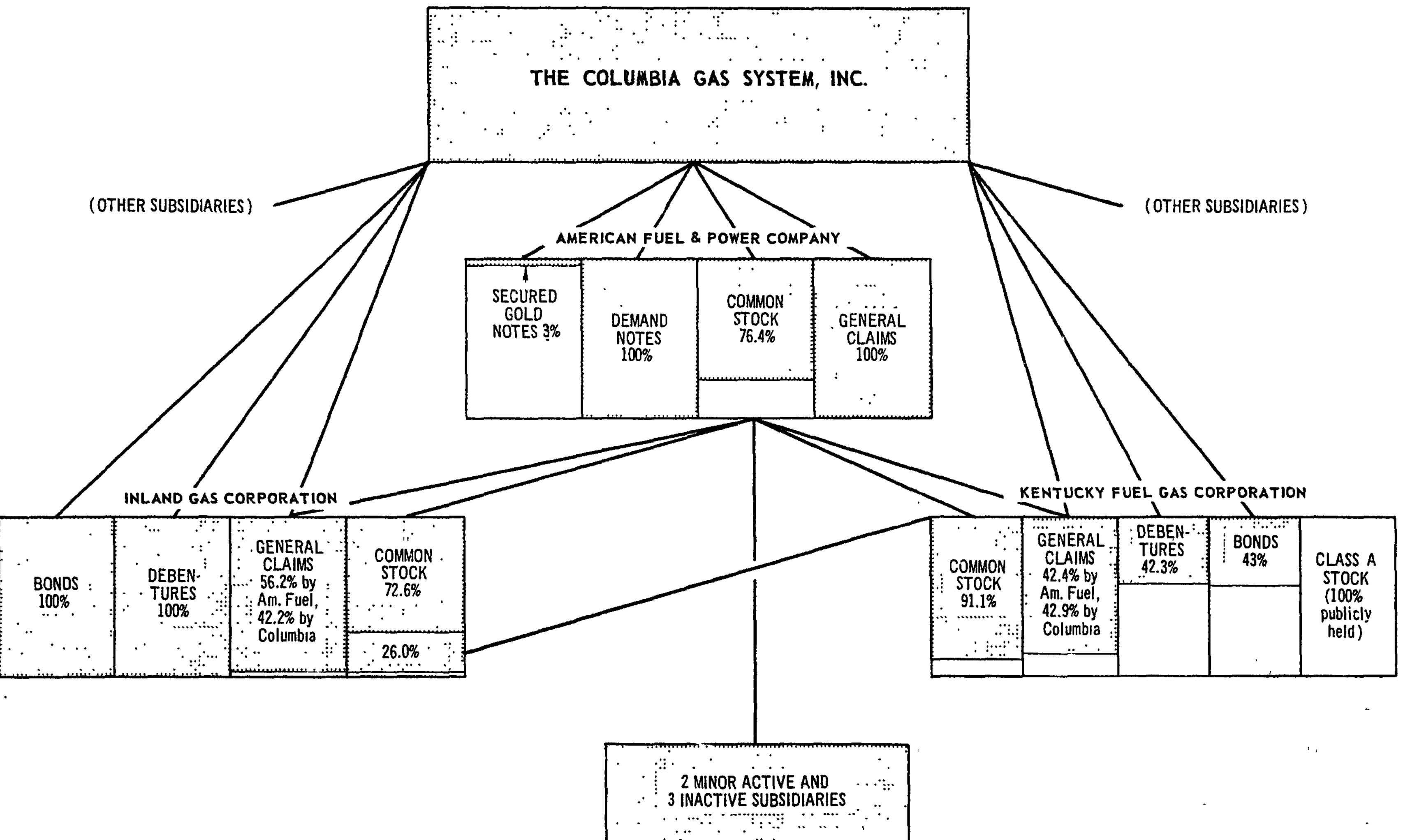
4. The general principle that justice delayed is justice denied is ordinarily a sound one. In the instant reorganization, however, we have seen that many security holders have benefited from the extended proceedings. Thus, had Inland been reorganized at an early date, probably the only ones who would have participated in the reorganized company would have been the public holders of the first mortgage bonds and debentures of Inland, with the latter class being paid less than its full claim. There would have been no participation to the public creditors of American Fuel and Kentucky Fuel. As the proceedings continued over the years, and as Inland began to prosper, the enhancement in the value of the estate was of such magnitude as to permit cash payments of some $14,315,000 to the system's public

creditors, leaving to be resolved the controversy as to the relative distributions between the public creditors of Kentucky Fuel and Columbia. In any event, while the proceedings appear to have lasted an inordinately long time, I believe the delay has conferred an overriding benefit on the public creditors as well as Columbia.

Thank you.

RELATIVE PROPORTIONS OF HOLDINGS OF DEBT CLAIMS AND CAPITAL STOCK BETWEEN THE AMERICAN FUEL & POWER COMPANY SYSTEM AND THE COLUMBIA GAS SYSTEM, INC.

Based on Principal Amounts Only of Secured and Unsecured Claims and Shares of Outstanding Capital Stock as at August 31, 1959



NOTE: As of June 30, 1959, the public holdings of 7% Gold Notes of American Fuel, including all accrued interest to that date, were paid off in cash in an aggregate amount of $4,905,632.50. The funds for this payment were obtained principally from a $4,000,000 bank loan made by the Inland Trustee. For purposes of comparative analysis of the classes of creditors in the American Fuel system as they existed prior to such date of payment, this appendix, although dated as of August 31, 1959, includes the public holdings of the 7% Gold Notes.

AMERICAN FUEL & POWER COMPANY SYSTEM

Statement of Debt Claims Against the Debtor Corporations, Including Accrued and Unpaid Interest Computed at Contract Rates, As at August 31, 1959

	Principal Amount	Interest	Total Claim
AMERICAN FUEL & POWER COMPANY			
7% Gold Notes publicly held a/	$1,905,100	$3,000,532	$4,905,632
7% Gold Notes held by Columbia	60,000	122,500	182,500
6% Demand Notes held by Columbia	552,000	963,008	1,515,008
Other unsecured claims of Columbia	17,301	-	17,301
Total	$2,534,401	$4,086,040	$6,620,441
KENTUCKY FUEL GAS CORPORATION			
Advances due American Fuel	$ 64,825	$ 111,801	$ 176,626
Claims of general creditors	22,427	-	22,427
6-1/2 % First Mortgage Bonds publicly held	2,236,600 b/	3,849,747 b/	6,086,347 b/
6-1/2% Debentures publicly held	542,000	1,030,476	1,572,476
6-1/2% First Mortgage Bonds held by Columbia	1,685,871	3,157,003	4,842,874
6-1/2% Debentures held by Columbia	397,600	755,937	1,153,537
6-1/2% Unsecured claims for advances by Columbia	65,606	123,288	188,894
Total	$5,014,929	$9,028,252	$14,043,181
INLAND GAS CORPORATION			
Advances due American Fuel	$ 335,936	$ 653,576	$ 989,512
Claims of general creditors	10,022	-	10,022
6-1/2% First Mortgage Bonds held by Columbia	1,571,054	2,985,400 c/	4,556,454
7% Sinking Fund Debentures held by Columbia	320,100	651,670	971,770
6-1/2% Unsecured claims for advances by Columbia	252,313	473,910	726,223
Total	$2,489,425	$4,764,556	$7,253,981
Combined Total	$10,038,755	$17,878,848	$27,917,603
Deduct intercompany debt owed to American Fuel	400,761	765,377	1,166,138
Total for System	$ 9,637,994	$17,113,471	$26,751,465

See following page for notes.

a/ As of June 30, 1959, the public holdings of 7% Gold Notes of American Fuel, including all accrued interest to that date, were paid off in cash in an aggregate amount of $4,905,632.50. The funds for this payment were obtained principally from a $4,000,000 bank loan made by the Inland Trustee. For purposes of comparative analysis of the various classes of creditors in the American Fuel system as they existed prior to such date of payment, this appendix, although dated as of August 31, 1959, includes the public holdings of the 7% Gold Notes.

b/ During the course of the proceeding, a payment of 18% of the principal amount of the Kentucky Fuel bonds, or $402,588, was made by the Trustee of Kentucky Fuel. The computation in this appendix applies such payment against accrued interest, although on the Trustee's books the entire payment was credited to principal. On the basis of the book figures, therefore, the total of principal plus accumulated interest as of August 31, 1959, amounts to $5,677,342, as compared with $6,086,348 shown in this appendix.

However, for purposes of a plan dated February 25, 1958, filed by the Trustee of Inland and Kentucky Fuel, the Trustee has credited $72,689.50 of the $402,588 payment against defaulted interest due December 1, 1930, and, since interest subsequent to December 1, 1930, was disallowed by the courts, the balance of the payment of $329,898.50 was applied in the reduction of the principal amount of bonds. On this basis, the adjusted principal of the Kentucky Fuel bonds would amount to $1,906,701, as compared with $2,236,600 shown in this appendix.

c/ Includes $230,018 of additional interest on first mortgage bonds of Inland owned by Columbia for the period during which distributions made on November 21, 1939, and October 16, 1944, applicable to such bonds, were impounded. The impounding terminated on December 31, 1946, when the cash was restored to the Inland Trustee. Such interest has not been accrued on the books of the Inland Trustee for the periods mentioned.