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"SECURITIES AND EXCHANGE COMMISSION AND CORPORATE REORGANIZATIONS"

ADDRESS

of

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Securities and Exchange Commission
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Corporate Reorganizations.

The recent protective committee study and investigation by the Securities and Exchange Commission has emphasized anew the necessity for a revitalization of the trustee or fiduciary relationship in corporate reorganizations.

The reorganization system was and still is complicated and intricate. Up to recent years its processes were a closed book to laymen and were known to and understood by only a small select portion of the bar. The limited extent to which the system was understood even by the bar is well illustrated by the scarcity of legal literature on the subject. This was due in no small part to the fact that the evolution of the system was largely shaped by the ingenuity of reorganizers and their select counsel who took the initiative and the responsibility for solving the perplexing and involved problems which arise in connection with the financial readjustment of distressed companies. Furthermore, since the evolution of the system was in the hands of reorganizers, it was quite natural to expect that the system would by and large conform to their requirements and objectives. Such was the case. The result was that the reorganizers' rather than the investors' point of view and philosophy were in the ascendency.

The reasons for all this are not difficult to divine. In the first place, many reorganizations proceed upon a wholly voluntary basis from beginning to end, without the intervention of any governmental agency, commission or court. This is the case in mergers, consolidations, sales of assets, exchange plans, recapitalizations and the like, all of which frequently entail alterations and modifications of rights of investors as fundamental and basic as those effected by reorganizations consummated in

receivership or bankruptcy. In these voluntary procedures the techniques, strategies and devices employed are by and large determined by the reorganizers, who dominate and control the entire proceedings. If in such cases the interests of investors are eclipsed, (and they frequently are) it is because the self-interest of reorganizers demand it or make it expedient. To be sure, there is jurisdiction on the part of courts of equity to enjoin many such plans on the ground that they are unfair or inequitable; and suits by investors to obtain such injunctions are not infrequent. Yet there are several reasons why such remedy falls far short of effective control. First, its cost puts the remedy out of the reach of the average investor who more often than not cannot afford the time and expense to fight the management and their capable lawyers in the courts. Secondly, scattered investors do not organize for mutual protection, especially where the outcome of litigation, as in these cases, is highly uncertain. Thirdly, injunctions in such cases are likely to issue only where there is gross inequity or unfairness bordering on fraud. The result is that for all practical purposes investors are left to fight the matter out with the management and to decide the issue with ballots. In view of the preeminently strategic position of the management in such cases, the result has been that the reorganizers rather than the investors have controlled the situation.

But even as respects reorganizations through equity receivership or foreclosure proceedings, control of the system rested primarily in the hands of reorganizers; the courts played only a secondary role. To be sure, the fact that reorganizations took place in court had important consequences. Courts were prone to regard the reorganization receivership as a lawsuit or litigated matter. Issues of fact and law were from time to time presented. But the

legal issues presented in this fashion though numerous were restricted in scope. Courts did not assume a broad jurisdiction. In fact, some state courts even now do not pass upon such basic questions as the fairness of the reorganization plan. But even after the courts began to pass upon the reorganization plan they frequently took the view that if there was nothing illegal or oppressive in the plan, it should be approved. As to the subtler questions of fairness and sourdness and feasibility of the plan, they frequently made no decision. With respect to the activities of committees and other agencies purporting to represent security holders, they were apt to give scant or only superficial attention. The personnel of committees, the content of proxies and deposit agreements, the practices of committee members, the fees and expenses of committees and the like were left to the conventions of the reorganizers. In other words, courts were constrained to act preeminently in a restricted judicial role. This is not intended as criticism of the courts. The machinery was so geared and the procedure so designed that the courts could hardly do more than attempt to prevent illegality or the grosser forms of inequity.

Under Section 77B of the Bankruptcy Act there was something of a shift in emphasis. The courts were given broader and more express powers. But the improvement though clear was slight. The courts remained largely the arbiters of issues, carefully selected and nicely framed so as to present a justiciable matter. These issues presented particularized, dessicated problems. Though the courts were given some powers over committees, for most practical purposes the committees were immune from supervision and control. As a consequence the reality of reorganizations was something that took place out of court. It was dealt with by the groups in control who frequently had their own selfish interests to serve. Thus the reorganization system came

to be based upon the theory that reorganization was a process wherein the legal matters were left to the courts; business matters to the reorganizers. In effect the resultant system was largely dependent upon the conventions of the reorganizers.

It was but natural to expect that such a system would be prone to disregard the fiduciary relationship between reorganizers and investors. The objectives of reorganizers are often different from and incompatible with the objectives of investors. Investors are interested in an expeditious, economical and fair readjustment of their company's affairs. They are concerned with having the business restored to an efficient and trustworthy management as quickly as possible and with the least possible impairment of their investment. They want fair treatment accorded them by those whose claims are senior or junior to their own. They are desirous of keeping reorganization costs at a minimum. They may want an extravagant or faithless management ousted from control, claims against such persons collected for the benefit of the estate, and a new management installed. They want the new company to have a sound financial structure so that there will be no early necessity for another reorganization. From the investors' point of view, no reorganization could be satisfactory unless the reorganizers adhered to these objectives. But reorganizers have frequently been interested in expeditious reorganizations not primarily to avoid expense, not essentially because of any desire to have dividend and interest payments quickly resumed, but largely because of their desire to consummate a reorganization of their own liking. Reorganizers frequently have not been concerned with economy in reorganization, since economy would interfere with their reorganization profits. Reorganizers at times have not been interested in fair reorganizations since fairness might seriously impair certain strategic investments of

their own. Reorganizers at times have not desired honest reorganizations, in the investors' sense, because such reorganizations would be costly to them. They have been motivated by other factors which are significant largely in terms of control. Control of reorganization means profit and protection. Those in that position control in large measure the assertion of claims based upon fraud or mismanagement which the company or the investors may have. Thus reorganizers may be able to protect themselves, their associates and their friends from such claims. Those who control reorganizations control the dispensation of vast amounts of business patronage, such as contracts for goods and services, employment of lawyers, auditors, engineers, appointment of receivers, trustees and masters, designation of depositaries, choice of banking connections and the like. Those who dominate reorganizations are commonly possessed of valuable information which enables them to trade advantageously in the defaulted securities. Those who control reorganizations control the selection of underwriters for the new company and the selection of the new management. The management and the bankers for the new company are the key to control of the company and the large amount of business patronage customarily flowing from it. Like reorganization patronage it can be dispensed either for the benefit of those in the dominant position or to widen their zones of influence and power. In a realistic sense the acquisition of control for such objectives is the goal of reorganizers.

The realization by reorganizers of such objectives may operate to the great detriment of investors. These objectives often involve mounting costs, the loss of assets of the company in the form of claims against the management, restoration to power of an incompetent or faithless management, the production of an unfair plan, and the exploitation of investors. Outwardly, reorganizations may appear to be expeditious, economical and honest. But often those characteristics will be only illusions.

These conflicts of interest between reorganizers and investors have persisted in spite of the basic fiduciary relationship of reorganizers to investors. That such fiduciary relationship exists is clear. In the management of corporations it is now well recognized that those in control owe an obligation to the minority to exercise their power for the benefit of all, not for the primary or exclusive benefit of the majority. The doctrine that corporate powers are powers in trust is generally accepted today. It recognizes that the increments of value inherent in control belong to the corporate body, not to those who by one legal device or another may happen to be in the saddle. It is the expression of an elemental equitable principle (clear only to those whose vision is not blurred by the intricacies of corporate finance) that those in direct or indirect control of other people's money should not escape the rigors of that stewardship. The vitality of our corporate system requires recognition of that principle both in law and in business ethics.

This equitable doctrine is as applicable to the critical reorganization periods of corporate history as it is to the more normal phases of management. In fact, it is out of episodes arising in these connections that that equitable principle has been given the greatest impetus. Its application means that in these readjustments majorities can neither exact tribute nor can they utilize the corporate paraphernalia in more subtle ways for their own aggrandizement.

This equitable principle moreover is not indigenous to corporate management. As indicated, it flows from the fact of the existence of power over other people's money. Hence it is not restricted to cases where officers, directors, and stockholders are exercising corporate powers obtained from by-laws, charters or statutes to operate or to reorganize their companies. It extends to situations where any group moves into a strategic or dominant position. Thus the essential work of reorganizations (apart from voluntary

readjustments which for the most part involve the exercise of corporate powers) has been performed by committees. These groups are formal or informal, united by community of interests in a common cause and bound together either loosely by revocable proxies or powers of attorney or tightly by iron-clad deposit agreements constituting, by and large, irrevocable grants of authority to the committee members. When representative of a majority of the class or classes of investors for whom they act, they occupy a strategic and dominant position. Theirs has been the task to formulate plans; to investigate or cause to be investigated the circumstances surrounding the failure for the purpose of ascertaining causes of action which may exist for the estate or for the investors; to make articulate the needs or requirements of the investors; to supply the leadership or dynamic force necessary in view of the lethargy and helplessness of scattered investors. Because of the important functions thus performed by committees, those who control them stand in a peculiarly strategic position to control and condition the entire reorganization process. Minorities are substantially helpless at their hands. The dominant groups are dictators of the destinies of at least the class of securities being represented -- whether that class be bonds, debentures or stock. The existence of their power -- whether it be dependent upon strategic investments, revocable proxies or iron-clad deposit agreements -- supplies the necessary ingredient for the creation of a fiduciary relationship. In recent years that equitable principle has been increasingly recognized by the courts in reorganization situations. And even reorganizers have recognized it at least to the extent of rendering it lip service.

Hence the insistence by the Securities and Exchange Commission upon the recognition of this fiduciary concept in these reorganization situations is not novel. As a result of a generation of struggle by minorities against oppression and overreaching at the hands or reorganizers, that concept has

been so woven into the fabric of reorganization law as to become more and more of a distinct pattern. But while it has become quite universally recognized in equity, it has to date failed to be a real force in conditioning the practices of reorganizers. The reasons for that are several.

There is first the impelling fact that there is no regular, systematic patrol of this field of finance. Against the contingency that a court of equity may be induced to invoke that equitable principle, reorganizers may proceed their own way with some confidence. Only litigation at the hands of some minority group can thwart them. Only if their conduct is palpably outrageous will serious minority action be incited. To be sure there may be occasional sorties against them by "strikers". But the stakes are so great that these suits may be bought off with ease. Investors by and large cannot afford to invoke the aid of the chancellor. As I have indicated, the time and cost attendant upon such suits place them out of the reach of the average security holder. Litigation of this character turns so much on intricate and involved factual material not susceptible of easy presentation or proof that its outcome is always uncertain. It takes a large investor bent on reparation or a substantial group of small investors incited to joint action by momentous events to challenge seriously and in good faith the reorganizers. These contingencies are unlikely to occur. As a consequence the aid of the chancellor is not apt to be sought. The absence of a system of automatic application of the equitable principle governing these situations makes that principle only a minor force or conditioning influence. It finds expression only to the extent that reorganizers deem it expedient to invoke it or to the degree that their business ethics reflect it.

But it would often be contrary to the immediate self-interest of reorganizers to adhere to the letter or the spirit of this ancient equitable doctrine. As I have stated, the objectives of reorganizers are often

incompatible with the objectives of investors. Disregard of the basic standards of fiduciary relationships may be essential if reorganizers are to serve their own objectives first. If they are adequately to protect their own investments in junior securities they may be impelled to obtain control over the senior securities. If they are to retain control of the new company, they may feel compelled to suppress thorough investigation of the past. If they are to capitalize on inside information coming to them as reorganizers, they will need to trade in the securities. If they are to get the benefit of the vast amount of reorganization patronage normally available, they will have to have the power to dispense it to themselves or their affiliates. Realization of these objectives would most commonly entail disregard or violation of the equitable principle governing the reorganizers' relationship to investors. Hence reorganizers might be expected to obtain the aid of astute lawyers to guide them around the shoals of their fiduciary duties.

This was done. Legal methods were sought at almost every turn to escape fiduciary responsibilities. A few examples will suffice. It was contrary to the common law and to elementary principles of equity for a trustee or fiduciary to make a profit from his trust by selling or buying from the trust or entering into any similar contract or engagement. He was, of course, entitled to reasonable fees. But other transactions between the trustee and the trust were voidable irrespective of fairness. They were voidable even though entered into by an affiliated interest of the trustee. In the words of Justice Cardozo, the rule was rigidly enforced lest creation of exceptions subject that equitable principle to "disintegrating erosion". Nevertheless, those equitable doctrines were given nothing but formal recognition in the reorganization field. It was the desire of committee members to work out a method whereby they or their affiliated interests could become pecuniarily

interested in the property, securities or other matters connected with the old or new company. One legal method seized upon was to waive or modify those equitable principles by contract. Thus the vast majority of deposit agreements provide that committee members or their affiliated interests have complete freedom to become pecuniarily interested in such matters. Similarly, the right to trade in securities is customarily granted to committee members and their affiliated interests by express provisions of deposit agreements. In well over a majority of cases this practice prevails. Indeed, it is significant that only in a few isolated cases are the types of practices mentioned limited or outlawed. The extent to which the entrepreneurial rather than the fiduciary philosophy has permeated the reorganization field is also illustrated by the manner in which committees have provided for their compensation and expenses. With rare exceptions, committees are the sole judges of the amount and reasonableness of their fees and expenses. They are subject only to such maximum limitation as may be contained in the agreements. In the language commonly found in deposit agreements these fees and expenses are fixed "in the sole and uncontrolled discretion of the committee" with the result that committees sit in judgment in the worth of their own services without supervision or scrutiny by any independent agency.

At times, by reason of these contractual provisions, committees have resembled syndicates or joint adventurers (rather than fiduciaries) whose chief objective was the realization of as large a monetary reward as possible. They have presented the sorry spectacle of fiduciaries exculpating themselves from the normal incidents of their stewardship. Nevertheless, it has been concluded by many lawyers that such immunity clauses are effective to permit these fiduciaries to make profits not otherwise available to them. Reliance has been placed upon two exceptions to the general equitable rule.

One is that the trustee may deal with the trust property to his own advantage so long as he acts in good faith and provided such transactions are expressly authorized in the trust articles. The other is that the trustee may so act if the beneficiaries consent, provided the trustee has made full disclosure of all relevant information he possesses and provided the transaction is fair and reasonable.

The question of whether or not these immunity clauses are effective to waive or modify that equitable principle has seldom been litigated and consequently never been definitely determined. The cases allowing such immunity by reason of express authorization in the trust articles are hardly in point since they are all instances where the settlor of the trust has been disposing of his own property. And on the other hand, the cases granting such immunity where the beneficiaries have consented and where the trustee has made full disclosure are hardly sufficient to give validity to the transactions. The one-sided nature of these complicated agreements which the security holders never see, which they probably could not understand if they did see, and which are dictated exclusively by the committee, can hardly be said to amount to consent within the meaning of the exception to the rule. Within the meaning of the rules governing the relationship between trustee and beneficiary or between agent and principal, there has been no disclosure of the trustee's or agent's adverse position in language which is clear and unequivocal. In other words, as a legal matter these exculpating clauses would seem to be of doubtful validity.

Nevertheless, the records are replete with instances where committee members and their affiliated interests, by reason of their reliance upon these clauses, were obtaining business patronage as a result of their dominant or inside position. Whether in view of their apparent vulnerability in equity the law would soon evolve so as to override them and render them nugatory is,

of course, problematical. Such an evolution would in any event entail years of development. Security holders in these situations are not apt to litigate such issues for the reasons I have previously given. The paucity of cases in the books indicates the substantial period of time necessary for the slow accretion of the law in this matter. Meanwhile, the business of reorganization must be conducted. And under the system as devised, reorganization practices persist which violate the spirit, if not the letter, of the equitable principles governing fiduciaries. The oppressive practices which have prevailed argue strongly against waiting idly for the lag of the law.

That is the view of the Securities and Exchange Commission as reflected in its various reports to Congress on this general subject and in the legislation which it has sponsored before the Congress.

The various recommendations of the Commission bearing on this subject of fiduciary standards for reorganizers are embodied in two bills pending before Congress -- the Lea Bill and the Chandler Bill.

The Lea Bill is of general application to protective committees and other persons who solicit authorizations to represent security holders in connection with reorganizations, readjustments and debt arrangements. Like the Securities Act of 1933, it is grounded on the postal power and the commerce power, and is to be administered by the Securities and Exchange Commission. The bill applies to solicitations in connection with proceedings for reorganization under Section 77B, or in connection with receivership or foreclosure proceedings in Federal or State courts. It also applies to a limited group of voluntary readjustments, and to municipal debt arrangements and foreign debt arrangements.

The bill prohibits any person from soliciting by use of the mails or means or instrumentalities of interstate commerce, any proxy, deposit, or

assent, unless a declaration is effective as to such action by such person, and unless a proper prospectus accompanies or precedes such solicitation. And legislative standards are set up as to the terms and conditions upon which proxies and deposits may be solicited. The creation of these standards will supply assurance that those who represent security holders in reorganizations will adhere to the high standards of fiduciaries. Thus, it is provided that the terms of solicitation (to be expressed in the proxy, deposit agreement or other instrument employed by declarant) must include adequate provision for independent review and determination of the fees and expenses of declarant. Likewise, provision must be made for at least an annual report and accounting by declarant in the form required or approved by the Commission; copies of the report and accounting are to be filed with the Commission. In other words, no longer will the spectacle be presented of fiduciaries sitting in judgment on the worth of their own services to the beneficiaries of the trust. And there will be assurance that the beneficiaries will be kept fully advised of the finances of their trust.

Furthermore the deposit agreement or proxy must contain adequate provisions for penalties upon trading by committee members, their attorneys, solicitors and affiliates, so long as the fiduciary relationship continues. Similar penalties must be imposed upon the acquisition by committee members or their affiliates of any pecuniary interest in any contracts, arrangements or undertakings with the issuer during that period. Thus, no longer will committee members, and other representatives of the security holder be permitted to use their position of trust as an opportunity for personal profit and gain.

The bill also establishes certain legislative standards with respect to the qualification of committee members. It will be necessary that representatives of security holders be persons whose associations and interests would

qualify them as interested solely in the performance of their trust. Committee membership is to be limited to persons who have a *bona fide* interest in the situation; that is, persons who own or at least represent securities of at least one of the classes to be solicited. The representation of two or more classes of security holders whose interests are themselves in material conflict is barred by the bill, unless the public interest or the protection of investors otherwise requires. And finally, principal underwriters of outstanding securities of an issuer, and officials of such underwriters, are barred from serving on protective committees for securities of that issuer. Too often, it has been shown, the interests of underwriters are incompatible with the interests of the security holders.

The Chandler Bill, which is a revision of the existing bankruptcy laws, includes in Chapter X a complete rewrite of Section 77B of the Bankruptcy Act. This bill was passed by the House at the last session of Congress and was pending before the Senate at the time of adjournment. Significant with respect to the question of the fiduciary obligations of reorganizers are its provisions concerning trading. The bill provides that the judge shall deny compensation for services to any committee, attorney, or other person, acting in the proceeding in a representative or fiduciary capacity, if he has purchased, acquired or transferred any claims or shares of stock after the commencement of the proceeding. This provision cannot be regarded as novel or extreme; it merely codifies the enlightened judicial viewpoint expressed in a few 77B cases where the issue has been presented. But the measure should go far to discourage protective committeemen and other fiduciaries from buying or selling the debtor's securities on the basis of their inside information concerning its condition and prospects.

This legislative program should go far towards revitalizing the trustee or fiduciary relationship in corporate reorganizations. To some extent such measures will be branded as disruptive since they run counter to the dominant philosophy of reorganizers. This dominant philosophy is the philosophy of the "street". It is an entrepreneurial philosophy which has caused the virtual disappearance of the ancient standards for trustees, has levelled those standards down to those of the market place and has tended to bring the whole reorganization system into disrepute. Such conditions cannot be tolerated by a government sensitive to the reasonable requirements and objectives of investors. The price of restoring those ancient standards will be the loss of this entrepreneurial philosophy. Such restoration will introduce conservative practices. It will no longer be the rare fiduciary who does not profit directly or indirectly from his trust. Universal recognition in this field of the principle that no man can serve two masters will provide a permanent safeguard to the interests of investors. Accordingly, such restoration of these ancient standards, while disruptive as respects some reorganizers, will be constructive from the viewpoint of investors.