CHAPTER XIX

LAWYERS AND CONFLICTS OF INTEREST

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The importance of the role of the lawyer in reorganization is difficult to overestimate. This is true whether his client is a trustee, protective committee, the reorganization managers, a receiver, or the debtor. Here more than in other situations the lawyer is the strategist, technician, and economic adviser. He not only tells the client what he may lawfully do; commonly he decides what may be wisely, properly, and profitably done. The lawyer will often deny this. He will insist that he is only an amanuensis, a boss draftsman, or a clearing house of ideas. But this denial may be attributed either to professional modesty or to a desire to cultivate or perpetuate the fiction that his judgments and opinions are limited to the law. The fact remains that in reorganizations the lawyer reigns supreme. That supremacy may be partly clue to the fact that reorganization strategies and techniques, involving as they do complicated legal machinery, call for the participation of lawyers much as ordinary litigation does. And it may in part be due to the fact that in these reorganization situations either the questions of law and business fact are subtly blended or the distinctions between them are blurred and indistinct. Whatever may be the cause, the result is that the lawyer is the determinant influence over the whole debt-readjustment process.

I mention this fact not to bear evidence against the profession nor to criticize it for performing such important roles in reorganizations. Rather I emphasize the matter for substantiation of my theme that the quality of reorganization practices is in large measure dependent on the lawyer. [FN 1]

Counsel for the debtor commonly selects the forum for and method of reorganization. In the case of equity receiverships, he often prepares the papers long in advance of default, ready to be filed by a fictitious adversary lawyer on behalf of a fictitious hostile creditor. Upon default he causes the papers to be filed and receivers to be appointed. He also can—and does—exert influence upon the choice of the receivers. Upon this choice, plus the choice of counsel to the receivers, depends in a large measure a great many issues of paramount importance—the character and administration of the estate; the perpetuation or discontinuance of contracts; the investigation of and suits against management, bankers, and their allies; and other such vital matters. In other words, if he succeeds in his plans and outwits hostile creditors, counsel for the company is able to keep the old management in the saddle and in control of the reorganization.

Before or concurrently with the institution of receivership or bankruptcy proceedings, the management and the bankers normally form protective committees. Perhaps it is not well known or clearly recognizable that many committees have been selected to a great extent by counsel to the management or the bankers. But, indeed, the history of protective committees clearly shows that more commonly than not the attorney has become the focal point for their organization and activity. He also has played a dominant and often determinant role in the formulation of the policy of committees. One familiar with the operations of protective committees is led to the conclusion that counsel commonly are more important in determining policies than are members of a committee. He who selects committees and determines or is influential in determining their policies can condition and perhaps control the whole reorganization process. He can pervert these processes to the selfish ends of those whose interests do not lie with the security holders; or he can bring into a position of dominance and power those who are genuinely interested in protecting the security holders rather than themselves.

The work of committees commonly entails preparation of proxies, deposit agreements, and solicitation literature. Whether or not particular provisions should be included in proxies or deposit agreements has been the decision of the attorney. He may insert in these agreements such a broad sweep of powers as to vest in the committee almost unlimited control and dominion over the deposited securities with few residual rights for the security holders. Furthermore, he may design these agreements to afford the committee members and their affiliated interests protection against the normal incidences of fiduciary obligations. In spite of the fact that courts have treated committee members as trustees, he may attempt to give the committees complete freedom to trade in the securities, to profit from the trust, and to act as freely as if they were launched on an entrepreneurial rather than a fiduciary venture. Or he may take steps to provide the security holders with protection against the overreaching or greed of the committee members by providing for independent review of their fees and expenses, by outlawing trading activities, and the like. The strategist and technician in all such matters is the lawyer. He can, if he likes, insulate his immediate client, the committee, from his ultimate client, the security holders; or he may provide his ultimate client with real protection.

Similarly in case of the solicitation material, the lawyer has been both draftsman and editor. If that literature has been illuminating and fair, it is the result of his scrutiny and supervision. If it has been false or misleading, or if material facts have been hidden in fine print, or the truth has been told in such devious ways as to be incomprehensible—and such examples are numerous—the blame may likewise be placed on him. He has disclosed what he deems wise, necessary, or expedient for the objectives of his client. These examples are merely illustrative.

The prominence of the lawyer extends down to the close of reorganization and includes the negotiation and consummation of a plan of reorganization. He is in large measure responsible for its honesty, efficiency, and thoroughness. That is not to say that committee members, receivers, trustees, and the like do not have their own ideas. But the lawyer has given those ideas force and direction and has molded them to meet the immediate objectives of his client. And at times the client has abdicated, so to speak, leaving the lawyer in sole command.

I know of no reason why the lawyer should not take or assume this heavy responsibility. As an officer of the court he is accustomed to act in a fiduciary role. The traditions of his profession likewise make him peculiarly fitted for this exacting stewardship. But there has been a degeneration of the bar in these situations. Conflicts of interests have had their corroding influence. One of the foremost canons of professional ethics reads:

It is unprofessional to represent conflicting interests, except by express consent of all concerned given after a full disclosure of the facts. Within the meaning of this canon a lawyer represents conflicting interests, when in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose.

If the letter and the spirit of this canon were consistently observed, there would be little need for thoroughgoing reorganization reform. To state the matter otherwise, observance of the letter and spirit of that canon would in and of itself constitute the one most important and basic reorganization reform.

This is not to imply that a committee, receiver, trustee, or creditor is not entitled to representation, though his motives not be noble. Nor does it imply that there is not due a client all the protection that the law affords him. A lawyer for a committee who outwits the lawyer for another committee by use of legitimate reorganization strategy may not be deserving of a gold star for public service. Neither is he subject to condemnation. But when as lawyer for one committee he outwits himself as lawyer for another committee the process of degeneration has set in.

I speak somewhat crudely. But these situations are not uncommon. At times, to be sure, the conflict is more tenuous and subtle; it concerns itself with the spirit, not the letter of the canon. A few illustrations will suffice.

Thus, where a house of issue has undertaken to discharge its "moral obligation" to security holders by forming a protective committee, we often find its counsel has become counsel to the committee. It may seem at first blush to be a noble and laudatory move on the part of the bankers to set up committees to espouse the cause of those to whom the bankers have sold securities. And as a

concomitant it may seem wholly consistent for counsel to the bankers to become counsel to the committees. But the vice of the situation is that the objectives of the bankers are not always compatible with the objectives of the investors. In fact, we frequently see that one of the grave risks of the bankers is that security holders may sue them in fraud and rescission for misrepresentations on the sale of the securities. Bankers in control of a committee may be able to suppress or thwart such attempts. They may do so, for example, in case of rescission claims by getting the securities deposited under agreements which make withdrawal impossible except on such terms and at such times as the committee desires. Counsel to the bankers who is also counsel to the committee is thus in an ambiguous position. On the one side are the security holders; on the other side are the bankers. He cannot genuinely protect one without sacrificing the other. It is not difficult to see which client will receive the more conscientious treatment. After all, the committee is a transitory thing; the bankers are more or less permanent. Aggressive action against the latter, or failure to afford them adequate protection, may mean the loss of future retainers.

The consequences are similar where the management of the company forms a creditors' committee and counsel to the debtor becomes counsel to the committee. The conflict here may often be more acute and basic. In the first place the officers and directors may be legally responsible to the corporation for their wrongful acts. In the interests of the security holders represented by the committee it will be desirable and beneficial to have those claims asserted and collected for and on behalf of the estate. From the selfish viewpoint of the management it will be desirable to have any investigation or suit stifled. The lawyer in this dual position cannot serve both masters with undiluted loyalty. In fact we see, at times, counsel to the committee defending the officers and directors in suits brought against them by representatives of the estate. In the second place, the management, though not legally liable, may have been so incompetent or reckless as to make their ouster from the corporation not only desirable but necessary for the future protection of investors. In negotiation of a plan it may be that the interests of the investors would be served only by providing for a new management. But if counsel to the old management is negotiating the plan for the investors, it is easy to predict that that course will be unlikely.

It may be that in particular situations of this sort the transactions complained of were consummated as a consequence of the advice of this selfsame lawyer. Or the lawyer may have been one of those officers or directors. This of course aggravates the situation. In such cases he is beyond all doubt unqualified to represent security holders. But even though the attorney may not have been so directly associated with the particular transactions, his intimate relations with the management frequently give him a definite disability to represent security holders with vigor and undiluted loyalty.

We frequently find the former counsel for the company acting as counsel to the receiver or trustee in bankruptcy. The result of this position carries the gravest dangers to investors, since the attorney occupying this position determines the diligence with which assets will be collected, claims scrutinized and causes of action prosecuted. If, as I have said, there are claims against officers or directors or their affiliates, the investigation of these claims may be stifled and assertion of them suppressed. This will be to the interest of the management; it will be against the interest of security holders.

The obvious and direct nature of these conflicts often makes counsel for the company or the bankers hesitant to appear formally as counsel to committees or to the receivers or trustees in bankruptcy during reorganization. In such instances, the attorney for the company or its banker is more likely to work backstage and refrain from appearing for these other parties as a matter of record. From this comparatively inconspicuous position he may be wielding great power in the formulation of policies. The distinction between this type of representation and formal appearance as counsel is purely technical. The conflict is not eliminated by refraining from appearing publicly as counsel to a committee or the receivers or trustees in bankruptcy. That is merely nondisclosure of a highly relevant fact.

At times lawyers undertake to represent both junior and senior interests in reorganizations. Thus, attorneys for short-term creditors or junior security holders will not infrequently be found representing first-mortgage bondholders. Such dual representation of conflicting interests means that the dominant client will receive protection; the subordinate client will suffer. The chances are that the latter will not receive that portion of the assets, earnings, and control of the new company which they justly deserve. The lawyer cannot press for a larger share for the junior interests without diluting the position of the senior claimants. Nor can he exact a full measure of protection for the senior claimants without putting the junior interests at a great disadvantage.

We find lawyers in reorganizations in still other conflicting positions when counsel to trustees under indentures permit themselves to become associated with other groups in the reorganization. Being the party who put into operation the machinery of foreclosure after a corporation defaulted upon its bonds, the indenture trustee was an essential cog in equity reorganization proceedings. For the foreclosure cleared off all liens and claims so that a reorganized company could start afresh, burdened by no obligations except those which the plan or reorganization expressly preserved.

This same indenture trustee would have had a number of duties before any need of reorganization arose. He may have had the duty to guard the release and

substitution of collateral securing the bonds issued under the indenture. He may have had the duty to oversee the application of the moneys raised by the bond issue. For generally the offering circular describing an issue of bonds to prospective investors specifies the use to which the proceeds will be put. Control over application of the proceeds is essential in order that the investor shall obtain what he bargained for. But the investor cannot do this himself; it is a job for a single agency. And it is in the course of things a function which only a trustee can perform.

If a trustee has been derelict in performing these duties, and a number of other important obligations which the indenture may impose upon it, it is the duty of the protective committee representing the bondholders to compel the trustee to make restitution. This will not happen if counsel to the committee and to the trustee are identical. The result may be seriously prejudicial to the holders of the securities issued under the indenture. This is not an academic matter, for at times we observe counsel to the trustee, who is also counsel to the committee, in court defending the trustee in suits brought by the security holders represented by the committee.

Furthermore, the trustee owes duties to all bondholders. A committee commonly represents only a majority of the bondholders. The history of reorganization demonstrates that majorities are not adequate champions of the interest of minorities. The trustee who has thus become affiliated with the committee by virtue of counsel to the trustee becoming counsel to the committee, has thrown its weight on the side of the majority and is no longer an effective representative of those who have not deposited with the committee against the oppressive or unreasonable actions of the committee. Thus, in case of foreclosures, the committee will be interested in cutting down the bid upon foreclosure so as to give minorities a bare minimum. Non-depositors on the other hand are interested in a high bid to increase their distributive share. If the trustee is affiliated with the committee through common counsel, it is likely to accede to the committee's desires. And indeed, if such counsel gave the trustee an opinion that the committee's bid was unduly low, it would be acting in a manner prejudicial to its other client— the committee.

In a sense the matters which I mention are purely ethical ones. But they also have broader implications, since this frequent duality of the role of the lawyer in reorganizations has a definite impact on our social and economic life. Furthermore, it is symptomatic of a condition which pervades the field of finance. Thus, throughout the entire field there is a discernible trend for a few to move into a position of command and domination over financial empires. Lawyers have been their professional tutors. This is not necessarily grounds for condemnation of lawyers from a narrow professional point of view. It may merely indicate that the lawyers are serving assiduously the interests of their clients. But in view of

the kind of system which has been created, it suggests that frequently the lawyer has been not a constructive but a corroding influence.

Throughout the entire field of finance one sees a system designed by lawyers, whereby persons win their profits by reason of the fact that they are on both sides of the bargain. This is the easy route to financial success. He who dominates the company can dictate the terms on which he will do business with it. There has been in large segments of business a contest to get that control because it means profits. The self-serving transactions out of which these profits are made are often involved, intricate, and mysterious. Their legal garb often is awe-inspiring or baffling. Only an analyst or lawyer may be able to fathom them. Actually, however, the fundamental problem is neither intricate nor involved. It is not one reserved for analysts, financiers, or lawyers. It is so simple that he who runs may read and understand. It is basically nothing more or less than a man serving at least two masters—security holders on the one hand; himself on the other. I say it is nothing more nor less than a man serving at least two masters, because more often than not finance has a plurality rather than a mere duality of interest. When that plurality or duality of interest enters, history has it that one of his several self-interests will be served first.

It is disturbing to see this condition in the field of business and finance. It is a danger sign to all those who are genuinely interested in preserving capitalism. It is particularly a dangerous trend because the lawyers, who are officers of the court, not only participate in it; they are at times its guiding and controlling influence. Those whose courage and vision might well carry the day in public interest and in the interests of investors are subservient to their dominant clients. They are willing not only to become, as Mr. Justice Stone has said, "the obsequious servant of business," [FN 2] they have neglected the element of public trust inherent in their profession.

In sum, not only finance but also the bar needs reeducation on the simple and obvious principle that no man can well serve, directly or indirectly, two or more masters.

[FN 1] The part played by lawyers in corporate reorganizations received careful scrutiny in the Protective Committee Study directed by Mr. Douglas. A novel feature of the hearings was that lawyers as well as their clients were called on to testify. Mr. Douglas once described the role of the lawyer in reorganization as follows:
"And back of the whole scene sits the lawyer. He is not only the director of the play—he is in charge of stage settings, he writes the dialogue, he selects and trains the actors. He is responsible for the tone, the quality, the finish of the play.

It is his production, and so it is that you cannot study reorganizations without studying him. To study protective committees without him is to study them *in vacuo*. To study reorganization plans without him is to reduce the question of fairness of such plans to a mathematical formula. To attempt a diagnosis of committee policy without him is to eliminate the policy formulator. Around him the whole reorganization process revolves. He supplies the initiative, the drive and in part the profit motive that gives the reorganization procedure momentum and power." Talk before the Duke Bar Association, Durham, N.C., April 22, 1934.

[FN 2] "The Public Influence of the Bar," an address delivered at the dedication o£ the Law Quadrangle, University of Michigan, June 15, 1934, published in the *Harvard Law Review*, Vol. XLV1II, No. i (November, 1934).