SECURITIES AND EXCHANGE COMMISSION

REPORT
ON THE
STUDY AND INVESTIGATION
OF THE WORK, ACTIVITIES, PERSONNEL
AND FUNCTIONS OF PROTECTIVE
AND REORGANIZATION COMMITTEES

PURSUANT TO SECTION 211 OF THE SECURITIES EXCHANGE ACT OF 1934

PART I

STRATEGY AND TECHNIQUES OF PROTECTIVE AND REORGANIZATION COMMITTEES

WASHINGTON, D. C.

May 10, 1937

United States
Government Printing Office
Washington: 1937

SECURITIES AND EXCHANGE COMMISSION

REPORT ON THE STUDY AND INVESTIGATION OP THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES

STRATEGY AND TECHNIQUES OF PROTECTIVE AND REORGANIZATION COMMITTEES

SECTION I
STAKES OF REORGANIZATION

The reorganization system is complicated and intricate. Until recently it was known to and understood by only a small portion of the bar, and its evolution is largely the product of their ingenuity. Reorganizers and their counsel took the initiative and the responsibility for solving the perplexing and involved problems

which arise in connection with the financial readjustments of distressed companies. The system which resulted conformed by and large to the requirements and objectives of the reorganizers. But these have not always been synonymous with the requirements and objectives of investors.

Receivership, foreclosure, bankruptcy, and voluntary reorganizations, including not only debt readjustments or modifications but also such matters as charter amendments, consolidations, mergers, and sales of assets, are a part of this system. In theory, receivership and bankruptcy are the main mechanisms whereby creditors are stayed and the assets of distressed companies impounded and protected for the benefit of all investors. In theory, foreclosure is the machinery whereby secured creditors realize upon their lien and thus protect themselves against those in possession or those with junior claims. In theory, the statutory or charter machinery for charter amendments, consolidations, mergers, or sales of assets affords convenient methods for making desirable or necessary financial or business changes. But not infrequently these devices have been abused in such a way as to cause their functions to be perverted to serve the interests of reorganizers as distinguished from the interests of investors.

Reorganization and protective committees are an integral part of this system. In theory they are the vehicles whereby security [ILLEGIBLE]. From the viewpoint of investors the functions which they can perform are important ones, as we shall see. [Footnote: See Part II of this report, Committees and Conflicts of Interest (1937), Sec. 1.] In fact, however, it has frequently been the case that committees have performed these functions poorly and inadequately. At times this has been due to incompetence; at other times, to design. In the latter situations, the reorganizers have frequently used committees to protect or further their own interests as distinguished from the interests of investors. A study of reorganizations, therefore, entails an examination of the objectives of reorganization both in theory and in practice. It also involves consideration of the strategy and techniques which have been employed to reach those objectives. These can best be understood and appreciated if they are divested of their legal garb. It is in such manner that these matters are dealt with in this part of our report. But before considering the strategy and techniques which have been employed, it is essential to consider the stakes of reorganization, i. e., the objectives, for the realization of which the strategy and techniques have been designed.

As we have indicated, reorganizers and investors will at times have different objectives in reorganizations. Investors will be interested in an expeditious, economical, fair, and honest readjustment of their company's affairs. They will be concerned with having the business restored to an efficient and trustworthy management as quickly as possible, so that they may the sooner have dividend or interest payments on their investments resumed. They will be interested in

suffering the least possible impairment of their investment whether by reduction in interest or principal or by loss of security. They will want fair treatment accorded them by those whose claims are senior or junior to their own. They will be desirous of keeping reorganization costs at a minimum. They will be concerned with the cancellation of burdensome contracts and with the collection of all assets of the company, whether these assets be in the form of claims against their officers, directors, and bankers for mismanagement and the like, or otherwise. They will be desirous of having the company which emerges from the reorganization adequately financed. They will want that company to have a sound financial structure, so that there will be no immediate necessity for another receivership or bankruptcy, sometimes referred to as an "expensive luxury" at best. [Footnote: See Swaine, Reorganization of Corporations: Certain Developments of the Last Decade (1927) 27 Col. L. Rev. 901, 921.] If their company has been a preserve for exploitation, they will want to be rid of the despoilers. They will want an extravagant, wasteful, inefficient, or faithless management ousted from control and a now one installed. In other words, before the new venture is started they will want a complete accounting of the old; they will consider that no reorganization is complete unless there is such an accounting. From the investors' point of view no reorganization could be thoroughgoing unless the reorganizers adhered to these objectives of expedition, economy, fairness, and honesty.

In practice, however, all of these objectives may not be possible of realization in particular cases. Thoroughness and care in collection of assets may consume months in investigation and suit. Litigation over the priorities of claims may delay negotiation and promulgation of a plan. Uncertainty of business prospects of the company may make it desirable to declare a moratorium rather than to effect a readjustment almost doomed to early failure. Prospects of a return of prosperity may make it wise to "sue to solvency" by merely delaying any definitive plan of reorganization or waiting for earnings to increase so as to make any reorganization unnecessary. All these may make it desirable to sacrifice speed for thoroughness. [Footnote: Proceedings before the Securities and Exchange Commission in the Matter of McLellan Stores Company (1935), at 688. Thomas K. Quisenberry, whose activities In the reorganization of McLellan Stores Company we discuss subsequently in Sec. III, A, B, and C, 5, infra, testified :

"A. * * * My whole attitude was throughout that this -- if you will allow me to use a phrase I used consistently -- could be sued to solvency, that it required the interposition of no bankers, no reorganization, and the best proof of that was the actual value of the estate."-ibid.]

Furthermore concessions to junior interests may have to be made merely in recognition of their nuisance value, so as to avoid ill will or protracted litigation. Securities having a strategic position in the company and a legal right to obtain

their pound of flesh, may have to be treated liberally, lest their holders be incited to take drastic steps to have all junior claims wiped out. Claims of dubious legality may have to be recognized and awarded participation in the plan so as to avoid expensive and time-consuming law suits. In the give and take of negotiation nice legal priorities of various classes of claims will not be strictly observed. Rather the positions of these various claimants will be traded out in conference, so that only a gross approximation of their strictly legal status will be reached. Likewise collection of assets of the company in the form of claims against the management or the bankers may involve almost endless litigation and unknown expense. The vagaries of legal proof, uncertainty of jury trials, the risks attendant on appeals, may make settlement rather than litigation the preferable alternative. These uncertainties, when added to the further uncertainty of the financial responsibility of those prospectively liable, may make the course of adjustment and settlement of these claims, through payments of cash, cancellation of securities of the company in the hands of those alleged to be liable, or subordination of their claims against the company to [ILLEGIBLE] the only practicable alternative. Such concessions may entail some sacrifice of fairness in the interest of expediency, economy, and thoroughness.

In other words, any reorganization at its best is likely to result in only an approximation of the objectives which we have outlined. Concessions, settlements, compromises, practical adjustments will be the rule rather than the exception, even though these objectives are the criteria which govern the reorganization process. The outcome is that although the interests of investors are dominant throughout, practical considerations control and the investor is forced to compromise. This may be conceded to be the end result of any reorganization system, no matter how well conceived, no matter how faithfully administered.

If that result ensues, even when such high standards are adhered to, it is certain that if lesser standards are observed, investors will suffer. And such has frequently been the case, for the reason that reorganizers have at times had objectives not only different from but incompatible with those of investors, Reorganizers have frequently been interested in expeditious reorganizations not primarily to avoid expense, not essentially because of the 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, in the manner of investors, with economy in reorganization, as economy would interfere with their profits. Reorganizers at times have not been interested in fair reorganization, since fairness might seriously intrude into their own plans and affairs. Reorganizers at times have not desired honest reorganizations, in the investors' sense of the word, because such reorganizations would be costly to them. They have been motivated by other

factors. And they have endeavored -- in large measure with success -- to mould the reorganization processes so as to serve their own objectives.

Reorganizers' objectives are significant largely in terms of control of the reorganization. The emoluments of control are the stakes of reorganization. Control means profits and protection. He who controls the reorganization controls in large measure the assertion of claims based on fraud or mismanagement which the company or the security holders may have against the management or the bankers. Thus he may be able to protect himself, his associates, his affiliated interests, his friends, if he has that control. He who controls the reorganization controls the dispensation of the vast amount of business patronage present in any reorganization -- contracts with the company and with the committees for goods or services; employment of lawyers, auditors, engineers, and the like; appointment of receivers, trustees, and masters; designation of depositaries for committees; determination of banking connections and the like. He who dominates the reorganization will commonly be possessed of valuable inside information on which he can trade in the defaulted securities. He who controls the reorganization controls the selection of the underwriters for the new securities. This means in effect selection of the bankers for the new company. This in turn involves the large amount of business patronage customarily attaching to that position. He who controls the reorganization dominates the selection of the new management of the company. The management is the key to control of the company until the next reorganization. It is largely self-perpetuating due to its control over the proxies by which directors are annually elected. [Footnote: See Berle and Means, The Modern Corporation and Private Property (1932), 86-88; Douglas, Directors Who Do Not Direct (1934) 47 Harv. L. Rev. 1305, 1315-1317.] Or if the new management is selected by voting trustees under a voting trust for a term of years, the voting trustees are the key to control of the company during that term. [Footnote: See Part III of this report, Committees for the Holders of Real Estate Bonds (1936), at 198-199.] In any event control of the new company means as a practical matter control over a vast amount of business patronage. Like reorganization patronage it can be dispensed either to the profit of those in a 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.

It is readily seen how these objectives may not always be compatible with the interests of investors. Their realization may in fact redound to the great detriment of investors and cause security holders irreparable damage. These objectives will often result in a perversion of reorganization functions. They may mean that costs will mount; that assets of the company in the form of claims against the management, the bankers, and their affiliated interests will be lost; that incompetent or faithless managements will be restored to power; that investors will be exploited. Outwardly reorganizations may appear to be expeditious,

economical, fair, and honest. Often, however, those characteristics will only be illusions. Reorganizers will merely have dressed the procedure in familiar and respectable garb. In fact, these reorganization conventions will often conceal the real motives and objectives. Behind the scenes will appear a fight for control of the reorganization and of the new company. To that end the reorganization strategy and techniques have been designed. Ostensibly the reorganization will be conditioned by the requirements of the investors. Actually it will often be conditioned primarily by the requirements of the reorganizers. These conditions, as we shall see, frequently give rise to grave conflicts of interest.

Although this fight for control is not always discernible, actually it is always present to a degree. In the run of cases where the old [ILLEGIBLE] and the old bankers move quickly to obtain control over the reorganization the chances of a real fight for control, under the system which has prevailed, are not great. The reasons for this we shall subsequently explore. Nevertheless attempts of outside groups to obtain this control are usually present. Usually these are abortive, as we shall see. They commonly take the form of light encounters in the preliminary stages of the reorganization, as in the attempt of independent interests to have their own receiver or trustee appointed rather than that of the dominant group. Nevertheless the whole reorganization strategy has been designed to prevent such things happening. The techniques employed have been fashioned so as to thwart any such attempts to capture control of the reorganization and thus of the new company. From the reorganizers' viewpoint these techniques are successful if the reorganization results in an uneventful and unpublicized perpetuation of their power and control.

The real fight for control, however, is seen only when some outside group, well financed and powerful in financial circles, undertakes to obtain control of the reorganization. When that transpires, the ultimate stakes of reorganization are more clearly revealed. If the outside group is successful, reorganization results not in an uneventful and unpublicized perpetuation of the power and control of one group, but in a colorful and dramatic struggle for control. When that fight for and shift in control take place, it is easier to perceive the real objectives of the reorganizers. Under these circumstances it is easier to understand how the interests of investors may become subordinate to the selfish objectives of the reorganizers; how business may become a preserve for exploitation; how reorganizers may be merely opportunists who seize on the hapless condition of distressed companies to increase their own profits and control. The following episodes from a few recent reorganizations are offered not necessarily to show how investors were exploited or injured in such fights for control. They merely afford examples of a few of the stakes of reorganization which are available to reorganizes and supply illustrations of the reasons why the maintenance or acquisition of control of the reorganization is so important from the reorganizers' viewpoint.

SECTION IV

SUMMARY

THE STRATEGY AND TECHNIQUES OF REORGANIZATION

The Fight for Control. -- The interests of investors require that reorganizations be expeditions, economical, fair, and honest. Those who by tradition have over the years come to possess a monopoly over the conduct of reorganizations have their own objectives, not always compatible with those of investors. The systems of reorganization, the legal techniques, the protective committee system, have all been shaped to conform with the requirements of reorganizers. But self-serving objectives and mechanisms incompatible with the needs and requirements of investors have too often caused perversion of the functions of reorganization.

The personal objectives of reorganizes are significant, chiefly in terms of control of the reorganization. The emoluments of control are the stakes of reorganization. Control means profits and protection. Managements and bankers seek perpetuation of that control for the business patronage it commands, which they may take for themselves or allot to others, as they will. They seek, also, to perpetuate that control in order to stifle careful scrutiny of the past history of the corporation. Thereby, claims based on fraud or mismanagement are stilled; and disclosure of the incompetency or dishonesty of managements, which might interfere with their continuance in control, is blocked. Control for the sake of both of these objectives leads to great detriment, to investors, for as a result costs mount, assets in the form of claims are lost, and incompetent or faithless managements are restored to power.

The emoluments of control are no less desirable to groups on the outside than they are to the management, and bankers who have accompanied a corporation into reorganization. As a consequence it is not infrequently found in a reorganization supposedly devoted to the necessary financial and managerial overhauling, that the efforts of the parties are in the main spent in a fierce struggle for control. The struggle takes on varying degrees of intensity in different cases, depending upon the power, ability and prestige of those who presume to challenge the existing management and bankers. The highest of motives and noblest of ethics are professed by the opponents. Both sides seek to justify their moves in terms of the objectives which redound to the benefit of the investors in the enterprise. Primarily their objectives may be in fact the emoluments of control for the sake of the profit or protection they contain. In the struggle for these the interests of investors have been subordinated or forgotten.

The Emoluments of Control. -- The emoluments of power sought by the warring factions in reorganization can be sketched briefly. Bankers who have dominated reorganizations or have been associated with the dominant groups profit from the underwriting of new securities issued to raise new money. Future underwritings also will go to the bankers who control the new company or are represented on its board, or in other ways have established a measure of influence over its affairs. Much collateral business will also flow to these banking connections: new bond issues may require corporate trustees; and there will be need for registrars of stocks and bonds, transfer agents, warrant agents, and paying agents. If they are investment bankers, brokerage and trading accounts will also accrue as further patronage. Friendly banks become depositaries of the funds of the reorganized company, and theirs also is the major banking business, that of extending lines of credit to the reorganized company.

In a particular instance these may seem small; in the aggregate they are lucrative, and well worth fighting for. The bankers who by reason of their previous connection with the company, or because they have won the fight for its control, are predominant in the reorganization, have insured in a variety of ways that these emoluments will remain theirs. Their representatives have controlled the boards of directors. Where a voting trust put control of the reorganized company in the hands of trustees, they have controlled the trustees. It has sufficed in some cases to have minority representation on a directorate, or merely tacit agreements with the new management, whom more often than not they will have chosen. The fact of long-time association with a company, if not disrupted by a fight for control with other financial interests in the course of reorganization, may be enough to insure that the association will be perpetuated, for vested interests arise from the mere fact of association which are recognized and sanctified by investment banking custom. In other cases they may be embodied in terms in agreements between the bankers and the company. Thus, it is not uncommon to find underwriting agreements providing that the bankers would have "first call" on the company's future financing; exclusive selling agency agreements likewise recur with frequency. In its essentials the control which bankers are thus able to obtain is the grant of a monopoly.

Other important patronage accrues to those who can establish their control over a reorganized company. In some, fields directorships and voting trusteeships are in themselves lucrative. Managements want to continue their jobs for the sake of having jobs. Moreover, those who hold these positions are able to benefit from favorable business contracts between the company and their own affiliated interests. Further, as we have said, the efforts on the part of managements and bankers have also their elements of self-preservation. Underwriters seek to "save face" after the issues they have sold are defaulted; this they may accomplish in part if they are able to control the committee in the situation, thereby shaping the kind of publicity and information which security holders receive. Control over

committees enables bankers and managements to dampen efforts at investigation of, and suits against, themselves. It gives them an advantageous position in protecting their own particular investments in the company, whether or not these are of the same kind which the committees they control are purportedly representing. Thus, junior interests by obtaining control over reorganizations may be able to prevent those investments from being wiped out by the senior security holders. Furthermore, some claimants by reason of their advance knowledge of impending default and their position of influence with or domination over the company, obtain preferential treatment as respects their claims, either by way of obtaining additional security or by payment in full or in part. In the past this has not been an uncommon practice of houses of issue and their affiliated interests. Once that advantage is obtained it is obviously desirable to maintain it. Similarly, some claims may be invalid or subject to reduction because they were improperly acquired in the promotion of the company, or because their holders were on both sides of the bargain. Control of the reorganization means that such transactions will not be closely scrutinized, but will be taken as valid on their face. Payments made on the eve of receivership or bankruptcy will be deemed to have been properly made. The validity of any security so taken will be assumed.

During the term of the reorganization there is also certain intermediate patronage of value and importance to anyone who can dominate or be influential in the reorganization. One such emolument of control is the opportunity afforded to trade in securities on the basis of inside information. Those who are familiar with the details of the company's affairs, with the progress of negotiations in the formulation of a plan, with the prospects of recovery of valuable assets, with settlements to be accorded various classes of claimants, with the opportunities for sale or disposition of the property and the like, frequently have advance knowledge of matters which necessarily affect the market value of the securities. Receivers, trustees, committee members and counsel to the various parties are likely to be acquainted with such matters. From this information, they, their affiliates, and their friends are afforded an opportunity to profit should they desire to use such information. They can buy in the light of impending bullish developments or sell against proposed bearish announcements. Indeed, committees themselves may be in a position to create these developments or control the public announcements so as best to synchronize their own purchases or sales with them.

The reorganization machinery requires, or permits, the performance of various services for which fees will be paid. During the reorganization period, the property must be managed. Unless the company retains possession, either the indenture trustee will perform this function (as is sometimes the case in real estate reorganizations), or, in the event of receivership or bankruptcy, a receiver or bankruptcy trustee will be appointed. In certain types of reorganization contracts for the management of the property may be placed by the trustees or

receivers. The indenture trustee, the bankruptcy trustee, or the equity receiver will need counsel. Control over the reorganization means virtual control over the disposition of this patronage. Furthermore, the committees for the various classes of securities will ordinarily be entitled to compensation, as will their counsel. If these committees operate under a deposit agreement they will require the services of a depositary or secretary, and often of a registrar or transfer agent. In real estate reorganizations contracts are at times entered into for "committee servicing." The selection of the depositary, of counsel, and of the secretary, or the letting out of a "servicing" contract, will be in the hands of those in control of the committee. They may take the work, and incidentally the fees, for themselves. Or they may dispense the patronage among friends or affiliates.

By and large, committee fees constitute a substantial source of revenue. In some instances the desire for these fees is the major motivation for the organization of protective committees. In other cases, there are larger stakes which submerge the significance of committee fees. And in some these fees are regarded only as bits of patronage to be distributed judiciously into deserving channels. But whatever may be their varying shades of significance in different reorganization situations, these fees are substantial matters which committees seldom overlook. And in many reorganizations the committees fix their own fees without any supervision or review and hence are the arbiters of the value of their own services.

Corporate reorganization has long been regarded as one of the most lucrative fields of legal endeavor. Large fees for attorneys have been a customary incident to the rehabilitation of corporations in financial difficulties. In the aggregate, counsel fees frequently constitute the largest single item on the list of reorganization fees. The capacities in which attorneys may serve are numerous. They may act for equity receivers, for ancillary receivers, for bankruptcy trustees, for debtor corporations, for reorganization committees, for numerous security holders or creditors committees, for indenture trustees, for petitioning creditors in receivership or bankruptcy, for dissenting groups, and in a variety of miscellaneous capacities performing social services. It is not to be wondered, therefore, that these, among the richest stakes in reorganization, are eagerly sought and that the various legal positions are among the most valuable items of reorganization patronage.

But there are stakes in addition to direct compensation. Counsel for the company may be desirous of continuing as counsel for the new, or reorganized, company. The value of their professional reputations at times gives them an interest in protecting the management against the assertion of claims based on fraud or mismanagement, for often, the acts or omissions upon which such claims will be asserted had in the past received their express approval, or at least their

countenance. The same observations are apt with respect to counsel for the bankers.

To receive the benefits of both direct and indirect rewards, counsel for the dominant group, either the management or bankers or the two working in harmony, are frequently found in the key positions in the reorganization. In the selection of attorneys to represent protective committees and to serve in other capacities, counsel for the controlling group exerts considerable influence. Such attorneys are frequently found in the position which will probably wield the greatest influence and accordingly carry the largest rewards.

The size of the lawyers' bill must frequently be astounding to security holders and others. This cannot be taken to mean that their compensation is always excessive. The importance of the role of lawyers in reorganization is difficult to overemphasize. A substantial portion of all the work is performed by them. And the determination of what constitutes fair and reasonable compensation is a vexing problem. Nevertheless the vice of the situation remains despite persuasive arguments that particular jobs are well done. The vice is that the bar has been charging all that the traffic will bear. It has forsaken the tradition that its members are officers of the court and should request and expect only modest fees. This condition has prevailed to an extent throughout the profession. And it is not a new development; it is a practice of long standing. But it has been accentuated in case of the financial bar, which has been dominant in reorganizations. Part of this unseemly tendency of the financial bar to demand huge fees may be due to the business cast of law practice of that kind. Part may be due to over-specialization in financial centers with large law offices composed of dozens of lawyers, a huge overhead, and consequent artificial standards of the worth of legal services. In other words, organization for the practice of law on the large scale of mass production has contributed to the alleged necessity of computing legal fees on an overhead rather than on a service basis. Part may be due to the fact that the practice of financial law has been to a great extent monopolized by relatively few firms. This has meant setting monopolistic prices on the legal services of the select financial bar. But whatever may have been the cause, the end result has been that more conservative and modest professional standards have been discarded.

THE BANKER-MANAGEMENT CONTROL OF REORGANIZATION

The inside group -- namely, the management, the bankers, or the two together, as the case may be -- is in control of the company on the eve of reorganization. It therefore starts with certain definite advantages over any other group. Accepted reorganization practices provide numerous means and devices which enable this group to maintain and further these advantages. In the past its control has

generally rested upon three vital points: the proceedings through which the reorganization will be effected; the indentured trustee; and the committees for the security holders.

Banker-Management Control of Proceedings. -- Control over receivership proceedings is essential to the inside group primarily for the opportunity it may give them to obtain the appointment of friendly receivers and receivership counsel. If the receivers and their counsel are drawn from the members of the inside group, the likelihood is remote that the receivers will make any real effort to discover and to realize upon assets of the estate in the form of claims against the former management and their affiliated interests. Nor is there any great risk that such investigation and suit will be made if the receivers and their counsel are drawn from the panels of friends and associates of the inside group. Furthermore, in the administration of the estate, it is the duty of the receivers to determine which existing contracts should be continued or terminated, to determine whether existing business relations should be preserved or severed, in determine whether the present officers and employees of the company should be retained or discharged. If the receivers and their counsel are friendly, a continuation of those relationships which had previously been regarded as favorable by the inside group is more likely.

Prior to the enactment of Section 77 and Section 77B of the Bankruptcy Act, the favored method for effecting a corporate reorganization was through the federal consent receivership. The practice was for those in control of the corporation to get friendly creditors to institute the proceedings. Elaborate formalities were gone through to give these the appearance of an adversary suit; in effect the action would in each case be no more than the corporation voluntarily seeking the aid of the courts. To protect the consent receivership from hostile bankruptcy proceedings, resort was frequently had to the filing of a friendly involuntary bankruptcy petition; this had the effect of blocking effective action in the bankruptcy courts by unfriendly groups. The management sought jurisdictions in which they knew their reception would not be hostile, and suggested to the courts the men to be appointed as receivers. Commonly, also, counsel to the receivers would also have been associated with the corporations. This power to institute equity receivership proceedings has meant that in all likelihood the receivers appointed, if not themselves members of the inside groups, would be at least their friends or associates.

Inside groups have the same reasons for desiring trustees friendly to their interests where to accomplish reorganization resort is had either to straight bankruptcy proceedings or to action under Section 77B of the Bankruptcy Act. The latter section has in fact made it even easier to accomplish this result in providing, first, that the corporation might itself institute the proceedings for reorganization, thereby eliminating the elaborate circumventions characteristic of

the consent receivership in equity; secondly, in providing that the judge, instead of appointing a trustee in every case, might permit the debtor, i. e., the old management, to remain in possession. In such case the dominant groups thus remain in relatively secure control.

Inside groups have been adept in the use of available legal techniques not only in the institution of proceedings guided by them, but also in placing impediments in the way of receiverships or bankruptcy actions initiated by unfriendly interests seeking to protect their investment, or to wrest control from the insiders. They have met unfriendly state court actions with consent proceedings in the federal courts. Unfriendly federal proceedings have been countered with prolonged litigation over the issues raised by the pleadings, or with adroit intervention designed to shift to themselves the initiative in the appointment of receivers. In unfriendly proceedings under Section 77B of the Bankruptcy Act, venue may be contested and extended hearings held on the issues of good faith and insolvency. Appeals from adverse decisions on each of these may add to prolonging these preliminary determinations -- all necessary before the actual work of reorganization may get under way in the proceedings. In the meanwhile the inside group is preparing to institute other and more favorable actions, or it may set the machinery of protective committees into operation, in order to secure for itself the ostensible support of security holders. It may even in this interim be actively attempting to gain support for and effectuate a "voluntary" plan.

It is not in isolated instances that persons affiliated with the management of a company or its bankers are appointed as receivers or trustees. To the contrary, the practice is a common one. But the importance of appointing independent trustees or receivers cannot easily be exaggerated. In terms of the fairness of reorganization plans, an adequate investigation in these cases is the first and essential requisite. Until the various parties in interest are in a position to know what assets may be collected, they cannot pass intelligently on the merits of a particular plan of reorganization. Furthermore, the plan will commonly provide a management for the new company or supply the machinery whereby that management may be selected. Investigation of the old management may frequently be necessary to determine whether it should be once more entrusted with the stewardship of the company.

One of the most important aspects of corporate reorganization is the opportunity which it affords for a complete accounting. It is the crossroads at which the old venture and the new meet. There is an opportunity and occasion for intensive examination of the way in which the management -- the officers and directors of the corporation -- has borne its trust; and there is a chance to choose new managers if the old were faithless or incompetent. While the company is operating successfully, acts of the management are not likely to be questioned. Oppressive contracts, excessive bonuses, and peculations may not be revealed

in the routine disclosures of annual statements; and there may be no means of making the thorough investigation necessary to uncover them or no one to raise the question. But when receivership or bankruptcy takes place, the necessary animus of security holders is likely to be present; they are willing and ready to make charges against the management; and theoretically, receivership and bankruptcy make available the means of thorough investigation of the management.

The reorganization process should include a settling of accounts of the old, as well as inauguration of the new, venture. If the new or reconstituted corporation is launched before the scores of the old are settled, only half the job is done. The result may be that the new venture cloaks the rot of the old, and that the new will carry with it in the management the causes of the disintegration of the old. Certain it is that reorganization affords a rare and signal opportunity for dislodging a management. In case of the larger corporations the management is largely self-perpetuating. By reason of its control over the proxy machine it has undoubted control over the election of directors. Stockholders opposed to the policies being followed, by and large, have little chance of success in dislodging the management from its dominant position. Once in the saddle, the management remains -- at least until reorganization. If a reorganization is consummated and a faithless or incompetent management is reinstated, it means that it has been granted another indefinite tenure and becomes once more self-perpetuating. On the other hand, if the past management is subjected to rigorous scrutiny, its personnel may be bettered and the future prospects of the company improved. Unless such steps are taken security holders lose their rare and signal opportunity to break the control which their faithless or incompetent agents may have over their business.

Conservation receivership proceedings have constituted the bulk of reorganizations in equity receivership. Yet occasionally a receivership has been employed which outwardly had the same general features of the more customary conservation receivership but which functionally operated quite differently. This was the so-called "short receivership." It had as its sole objective the use of judicial machinery to consummate a plan substantially completed before the proceedings were instituted. Such a plan would have previously been submitted to security holders by the management or the bankers as a so-called "voluntary" plan. If the assents of less than 100 percent of the security holders were obtained, the management might experience difficulty and embarrassment in consummating the plan. Hence, by necessity or by preference the management would sometimes resort to receivership.

One important aspect of this procedure was the pressure that the inside group was thereby enabled to exercise upon the court's approval of such voluntary plans of reorganization. The plan was presented to the court with the support of a

substantial number of assents already behind it. There was little likelihood that the court would disapprove the plan, or would require material alterations in its terms.

In effect, where the receivership proceedings have been preceded by the submission of a voluntary plan, the reorganization process is largely free from any judicial supervision. The machinery of the law is reduced to convenient mechanics for effectuating the plan of the management and its bankers. And under Section 77B of the Bankruptcy Act this sanction of voluntary plans is not only preserved -- it is strengthened. A debtor intending to utilize Section 77B in the last stages of effecting an otherwise voluntary plan, as a means of binding dissenters and, by that token, dispensing with the necessity of cash payment to them, will find in the statute express sanction for the practice. Proponents of voluntary debt readjustments should not be permitted to have the imprimatur of federal courts placed on their plans so easily and so expeditiously.

Banker-Management Control of Trustees. -- The inside group's control over the reorganization process has necessarily involved a considerable degree of control over indenture trustees. This control over the indenture trustees has generally resulted from affiliations between the trustee and the inside group, and the latter's control of securities deposited with the committees which it had formed and which it controlled.

Control over the indenture trustee benefits the inside group in several ways. In the first place, it often enables the management and bankers to prepare for reorganization in advance of default. In the real estate field, control over the trustees and fiscal agents contributed substantially to the ability of many of the lending houses of issue to prevent or at least delay disclosure of the defaults of various issuers. And in fields other than real estate, the trustee has likewise been peculiarly susceptible to control by the inside groups as default occurs or as reorganization draws near; an instance of this is the withholding of notice of default until announcement of the formation of the inside group's protective committees.

In the second place, control over the indenture trustee frequently enables the management and banker interests composing the inside group to control certain aspects of the legal proceedings involved in reorganization. Wherever such proceedings include a foreclosure of the security holders' lien against the property, control over the trustee is of great importance. Since the moving party in foreclosure is the trustee, the inside group, with the trustee's cooperation, is in a position to time the institution of foreclosure proceedings and the sale itself, to suit its own convenience. Thus, the sale can be delayed until a suitable reorganization plan is perfected. Control of the trustee also minimizes the danger of successful procedural attacks by opposition groups. The trustee is the legal

representative of all the holders of securities issued under the indenture. Accordingly, bondholders desiring to intervene in the proceedings and oppose the program of the inside group must overcome the presumption that they are adequately represented by the trustee. The courts have usually required a showing of fraud, bad faith or serious conflict of interests, in order to overcome this presumption.

In the third place, control over indenture trustees has given the inside group control over such reorganization patronage as the trustee is in a position to dispense. In foreclosure proceedings, the trustee is entitled to a fee as complainant, and counsel for the trustee likewise receives a fee. And the trustee's foreclosure bill frequently asked the appointment of a receiver of the property, who would, if appointed, be allowed fees by the court. Similar patronage was available to the trustee even where reorganization did not involve foreclosure proceedings. In many real estate cases the trustee took possession and operated the property or employed management agencies for the purpose. In addition, there were insurance and other contracts to be awarded, incident to the management of the property.

Whether it be dispensation of reorganization patronage of the foregoing varieties or control over the strategy and procedure of reorganization, the emoluments of control in reorganization have been many and varied. To have the trustee lend its support to a plan proposed by the dominant group was of great value. At times that plan would neglect fraud and other claims against the management and the bankers. Normally the plan would provide for the management of the new company. The old management desirous of perpetuating its control would be vitally concerned in such a matter. Likewise the bankers would be financially interested in having the old management reinstated so that friendly and profitable banking connections could be resumed. As we have said, the stakes in the reorganization were many and varied. They were in every case of great moment and of substantial pecuniary value to the dominant group. Therefore the trustee in playing the game of the dominant group was aiding it in attaining those ultimate objectives. Likewise the dominant group, in order to acquire control of the reorganization (at least apart from proceedings under Section 77B of the Bankruptcy Act), was perforce required to obtain control of the indenture trustee. That it was so conspicuously successful indicates, as we have said, the sore necessity of imposing on the trustee a greater degree of independence. Reformation of the trustee in the interests of all security holders thus becomes one objective of any thoroughgoing reorganization legislation.

Banker-Management Control of Committees. -- Inside groups, seeking control over the reorganization process, move quickly to gain control over protective committees. Such control is important mainly in that it enables the inside group to obtain the apparent support of security holder behind its program. The

management and bankers of the debtor company are thus able to remain in the background, exerting their influence through protective committees which ostensibly represent the various classes of securities and other claims involved in reorganization. Control over committees facilitates control of legal proceedings, whether such proceedings take the form of receivership or bankruptcy. It also insures to the inside group control over the negotiation of the reorganization plan, control over committee patronage, and a certain amount of control over investigations and litigation concerning the past conduct of the management and the bankers.

The formation of protective committees has long been regarded a prerogative of the inside group. Bankers responsible for the original distribution of the securities in default commonly profits a "moral obligation to protect the security holders" in these situations. As a complement to their own activity in forming protective committees in response to moral obligations, outside interference with their control is deemed to be poaching on their own preserves. The existence of the moral obligation can hardly be denied, but the history of most recent reorganizations does not reveal a full performance of that obligation by the bankers. On the contrary, the evidence would seem to indicate that this professed moral obligation has frequently been assumed by the bankers, not with any genuine intention of properly discharging it, but rather as a justification of their dominant position in the reorganization process. Although management groups less frequently assert a moral obligation to protect security holders in default situations, the opinion has nevertheless prevailed among company officials and directors that they too have peculiar claims to a dominant voice in reorganization and should take the initiative in times of distress. The trouble has been that these claims have been exerted too frequently on behalf of their own interests.

In the formation of protective committees, the inside group possesses definite advantages over outsiders. The ability of any group to obtain the support of security holders depends, to a considerable extent, upon its prestige. In this respect, the management and bankers are well equipped. It is they who have managed or have been otherwise associated with the debtor company during prosperous times. By virtue of their familiarity with the company's affairs, they are regarded by some security holders as best qualified to uncover the causes of the company's past difficulties and formulate a program for its future. The bankers are normally institutions of prominence and prestige. They are accepted as financial experts. Even where evidence exists of past mismanagement or improper financial practices on the part of the inside group, some security holders have accepted the view that the insiders who have been responsible for the company's past management and financing are the persons to lead the company through the default period. Bankers and management are able to draw prominent persons into membership on their committees. These factors are

commonly influential in inducing security holders to support committees sponsored by the management and bankers.

Complete cooperation between the management of the debtor company and its bankers is useful in effecting control of committees by the inside group. There is no great likelihood, however, of dissension between these two elements of the inside group. In the first place, a company's bankers are often well represented on its directorate. To a certain extent, therefore, the management and banking interests will be identical. And secondly, the mutual advantages to be derived from management-banker harmony during reorganization provide a powerful incentive for compromising any differences which may exist. This has been recognized even to the extent of formal agreements in which support of management was obtained in return for a promised share in the control of the new or reorganized company and in the profits to be derived from the underwriting of its securities. Similarly, there has been resort to compromise in order to settle contests among various bankers of companies approaching reorganization, over control of the committees whose formation was contemplated. Settlement of differences thus prevents any serious jeopardy to the control of the inside group.

The techniques followed by banker-management groups in organizing protective committees vary only in detail. In general outline they are similar. The bankers and their attorneys generally take the initiative in selecting the committee membership. The management is usually consulted, but the security holders themselves are seldom given an opportunity to participate in the selection of committee members. Security holders themselves are seldom given direct representation. The rosters of committees sponsored by management-banker groups typically include imposing names, calculated to inspire the confidence of security holders. At times such members, though prominent and reputable, serve merely as a facade behind which the management and bankers stage an intensive drive for the support of security holders. And at times, the prominence and reputation of such members will conceal incompetence or a casual assumption of duties which require, for their proper discharge, determined effort and critical thought. Frequently their personal or affiliated interests conflict with those of the security holders whom they are appointed to represent.

Many examples of banker-management selection of committees appear in the various parts of our report. Even the absence of such affiliations by no means precludes the possibility that committee members have been selected by and represent the inside group. Nor need the latter lack influence though few or none of its representatives are on the committee. Inside groups may exert control over committees by financing their operations as well as by selecting their members. Committees dependent upon the debtor company or its bankers for their financial support are not likely to take action adverse to those interests. In sum, the

prevailing pattern of reorganization is that the bankers and management have dominated the selection, and by and large, the policies, of protective committees. Inside groups have perfected various techniques for acquiring and retaining control of security holders through the protective committee machinery. In this connection, they have been quick to recognize the importance of early action in default situations. Almost invariably, they have announced the formation of their committees before outside opposition has had time to crystallize in the form of rival committees.

One reason why the management-banker reorganizers have been able to act before outside groups could form is that they generally have advance notice of default. The rank and file of security holders are not apt to anticipate default on their securities in advance of the company's actual announcement of default. This has been due in the past partly to the inadequacy of corporate financial statements, which not infrequently concealed a company's true condition until the eve of reorganization. Even where a company's financial statements accurately and clearly portray its condition, the banker-management group is in a position to know in advance of others when the company will default on its securities. And such advance notice is typically not made available to security holders. Thus, in the reorganization of R. Hoe & Co., Inc., it appeared that Guaranty Trust Company, trustee for the bonds, and Guaranty Company, its securities affiliate, knew of the impending default on the April 1, 1932 interest payments on the bonds by the early part of March, 1932. Yet bondholders were not notified of the impending default until late in March, after the formation of the banker-management protective committees had been arranged. By the strategy of delaying announcement of default until completion of their preparations for reorganization, the inside group was thus assured of a substantial "head start" in the contest for security holders' support. The same technique is applied in voluntary reorganizations. The security holders are first brought to a full realization of the company's condition when the voluntary plan is announced. Meanwhile the management of the company and its bankers will have organized committees to recommend acceptance of the plan and prepared these committees for the drive for deposits.

In defense of the practice of withholding notice of default as long as possible, it has been argued that advance notice of default to security holders would amount to preferential treatment of those first receiving notice, and that even where the inside group is certain that a default will occur, great injury might result if notice were given prior to formal resolution by the board of directors on the question of default. But it seems clear that a main purpose in delaying announcement of default is to enable the inside group to secure a dominant position in the reorganization.

Access to the names and addresses of security holders is vitally important to any individual or group undertaking to organize security holders. Security holders lists have accordingly assumed major significance in the reorganization process. A committee having a monopoly of these lists, or having control over the sources from which names and addresses of security holders can be obtained, is in a highly advantageous position. With respect to stockholders lists, the possibility of monopolistic practices is not so great. But as the law and practice have developed, access to bondholders lists has remained almost exclusively with the banker and management group, a factor which has contributed materially to that group's ability to dominate reorganization activity.

Sources from which such lists can be compiled are largely controlled by the inside groups. To the extent that bonds or notes are registered, the registrar will, of course, have lists. But in view of the normally low percentage of registered bonds, this source is not of great value. A more important source is the paying agent, who frequently keeps a record of the names and addresses of all holders presenting interest coupons for payment. The indenture trustee seldom possesses lists in its capacity as trustee, but it frequently acts as the issuer's paying agent or registrar, and compiles lists accordingly.

As the paying agent and registrar normally act as agents of the issuing company, the security holders lists in their possession are under the control of the management of the company. Most of the important remaining sources are controlled by the bankers. Thus, the bankers themselves, as members of the original underwriting syndicate, are usually in a position to contact the members of the selling group and obtain from them the names of the customers with whom the securities were originally placed. And the bankers may have participated in the selling group themselves in which event they will have their own lists of customers. These lists are generally kept up to date, at least to the extent that transfers of securities can be traced. The bankers are also frequently acquainted with the names of large holders through their general business associations and contacts with security brokers and dealers, commercial and savings banks, and investment counsel.

It is clear that their monopoly over lists has given bankers and management an important strategic advantage over outside groups in reorganization. The matter is one of greatest moment to security holders. It does not follow from the fact of flotation of the securities that a house of issue has a monopoly on the right to represent security holders upon default. That such monopoly is contrary to the public interest is emphasized by a consideration of the questionable character of many flotations and the prevalence of conflicting interests of many houses of issue.

THE STATUS OF OUTSIDE GROUPS IN REORGANIZATION

Rarely are reorganizations controlled by groups other than the management and its bankers. Occasionally, however, a group not affiliated with or inspired by the management or houses of issue succeeds, at feast partially, in wresting control from the insiders. But in all types of reorganizations, "independent" committees appear, and individual security holders and lawyers are at work in opposition to the dominant interests. These outside groups possess wide variety in organization, character, and objectives. Their common characteristic, whether they be formal committees, informal groups, individual security holders, or individual lawyers, is opposition and attack upon the control of the reorganization by the management or its bankers, or the provisions of a plan proposed by them, or both; they may even attempt, in the case of comparatively small or medium-sized companies which do not have as allies strong investment banking interests familiar with the techniques of reorganization, to seize upon the exigencies of default to propel themselves into a position of control over the reorganization and of domination of the new company.

Opposition to inside control and management of reorganizations comes from sources as widely apart as substantial security holders and the entrepreneurial lawyer who searches out a security holder and organizes a committee. Within these broad classifications, there are many cases difficult to characterize. As in the case of the management and the bankers, motives of the independents are generally mixed; altruism and genuine indignation at corporate abuses may indistinguishably coalesce with a desire to make a profit; interest in protecting an investment may merge with desire to participate in. the profits of reorganization and the emoluments of control.

If an independent outside group does not succeed in obtaining control, it may be able to win a variety of victories and to make various profits. It may conceivably succeed in dislodging a dishonest, inefficient management and its bankers from control. It may win representation on the dominant protective committees and reap the profits incident thereto in the form of fees, inside information for trading purposes, and business and professional associations. It may win representation on the board of directors of the reorganized company; obtain improved recognition in a plan of reorganization for certain clashes of securities; or receive a cash payment as "settlement" of claims or for services actually or ostensibly rendered. It may, in addition, receive profitable contracts or support for its claim to allowances out of the estate. The stakes are high, but the odds against success are great, in view of the fact that, as indicated previously, the reorganization system has been designed with the view towards, and has resulted in, protecting the position of vested interests.

Those in control of reorganizations usually characterize all groups actively opposing them as "strikers." The term is used to connote a species of blackmail. But it is not a discriminating characterization. In the first place, in many instances the opposition group or individual has or directly represents substantial interests. In the second place, the absence of a substantial financial interest is not conclusive of the status to which the opposition is entitled. At times the insiders also have no substantial financial interest in the enterprise but are interested only in the maintenance of control. The "moral obligation" of the bankers and "duty to the stockholders" of the management are frequently mere rationalizations for activity -- not factual bases for representing security holders.

The motivation of committees or other groups which may properly be called strikers is solely entrepreneurial. Those whose primary objectives are to obtain a nuisance position and to capitalize on it for their own profit are a species of reorganization adventurers who seize on the chaotic condition attending reorganization for the opportunity it affords them to make a personal gain. In so far as they purport to act in a representative capacity or to operate under the guise of a protective committee, they are abusing a position of trust. Their objectives are not compatible with those of investors. A fundamental conflict of interest between them and the investors is present.

Likewise committees organized as "syndicates" or "joint ventures" for the profit which the members may make out of the fees collected are probably in such a conflicting position. This is likely to follow because these committees will have as their prime objective profit to themselves rather than service to the investors. The protective committee system which has been in vogue has accentuated this condition by reason of the fact that, by and large, committees have been the sole arbiters of the worth of their own services and of the propriety of their expenses.

Other conflicts of interests in addition to those mentioned pervade the committee field. These we shall discuss in greater detail in a forthcoming part of this report. Briefly, these conflicts may result from practices of committees to dispense patronage to their affiliated interests, from trading in the securities or certificates of deposit by committee members and their affiliates, from use of committees to protect their members or affiliates from claims which the corporation or the security holders may have against them, and the like. These types of conflict most frequently appear in the case of committees dominated, controlled, or sponsored by the management or the houses of issue. They have also appeared on many occasions in the case of independent or outside groups.

At times powerful outside interests, who have had no previous connection with the company, seize upon the chaos of reorganization for the purpose of entering and taking possession of the company. In some respects, they are like the striker-lawyer who similarly is devoid of financial stake or previous economic

interest in the company. But they differ significantly in composition, resources, tactics, and generally in objectives. The outside banking groups have money, power, and prestige which the usual striker cannot command. Their objectives are usually not the smaller profits which a striker gets by way of fees for services or as a settlement. The outside banking groups are generally willing, if advisable, to sacrifice these. They are seeking control of the corporation and the possibilities of the great power and profits which control entails. And for this reason, as well as because of their prestige, position, and superior resources, they use weapons other than the threats and suits of the striker. They resort to the market place. They buy up strategic claims and securities, and with these in their possession, they gain control of the company. Sometimes, for the purpose of strengthening their own position, they will form a protective committee and solicit the support of security holders; sometimes they will work without a committee.

Like the inside groups and, frequently, like the so-called independents, these outside financial interests are not immune from conflicting interests. In fact, these conflicts permeate the entire protective committee system. Their elimination is as essential towards making the outside groups effective and responsible as it is towards eliminating the abuses of the insiders. The objectives of committees and other groups cannot be compatible with those of investors, whether these committees or groups be "independent" or otherwise, unless such conflicts are resolved. Moreover, the conflicts which do exist are in fact made the more obnoxious if these groups operate under the guise of independent committees, for security holders are induced more readily to believe that in the hands of these self-styled independents their cause will be honestly and vigorously served.

An independent group usually will find arrayed against it, not only management and bankers, but a large segment of the financial society. For example, it sometimes finds it difficult to persuade any bank to act as its depositary, because of the banks' fear of antagonizing the dominant groups. More important, however, are the obstacles placed in the way of independents obtaining lists of security holders. Communication with security holders is essential if any committee is to become effective. But, as we have shown, lists are usually in the possession of or available to the insiders, through houses of issue, distributors of the securities, registrars, paying agents, and others. Only if the security represented is stock is it likely that independents can readily get the names of holders as they appear on the corporate books, but even here difficulties are at times present.

The necessity of overcoming this handicap has its effect upon the tactics and procedure of these committees. They endeavor to command the attention and support of holders by newspaper advertisements; to gather names through correspondence; and to gain interest and allegiance by dramatic moves which, they hope, will be publicized in the news sections of the daily papers, and will

attract the favorable notice of security holders. Another policy which many independents adopt is the solicitation of proxies rather than deposits. Generally speaking, they are competing with committees which are asking security holders to surrender their securities in exchange for certificates of deposit. Independent groups often proceed on the theory that it is easier to persuade persons to sign proxies than to deposit their holdings. In addition, representatives of some of them have emphasized that the deposit of securities was unnecessary, expensive and undesirable because of the broad powers vested in the committee and the irrevocable nature of the depositors' commitment.

The problem of an independent group is invariably a difficult one. Generally, opposition is not organized until the insiders are well on the way to complete control of the reorganization. For this reason, as well as the strategic position, prestige, and resources of the insiders, it is the highly exceptional case in which the independents can hope to win substantial support -- let alone enough support to enable them to put through a program of their own. As it consequence, the usual strategy of opposition groups is, in a sense, to obstruct. They seek to obtain sufficient support to block successful consummation of the program of the insiders. If this is done, they can make a deal with the insiders as a price for their cooperation. They can compel changes in the plan, the inclusion of provisions for representation to minority or independent interests, alterations in banking arrangements, and the like. They do not generally propose a definite, formulated plan or program of reorganization. Their tactics are usually to make general attacks, such as charges of mismanagement and oppression by the management and the bankers. Sometimes they will propose in a general way the outlines and objectives of a reorganization which they approve; and sometimes they will criticize a plan proposed by the insiders. Usually, however, their criticism will be general in nature, and not in terms of specific alternatives. To dramatize and publicize the charges against the management and bankers, and to exert pressure to make the desired concessions, suits are sometimes instituted based upon charges of mismanagement of the corporation, oppressive contrails benefiting the insiders, and fraud or misrepresentation in the sale, of the securities. These suits may or may not be brought in the best of faith. They may or may not be substantially founded and brought for the sole purpose of compelling restitution or reparation. In any event, such suits are common tactical weapons.

A marked departure from these tactics is to be noted where the group is a banking or commercial interest which has previously been devoid of substantial connection with the company but which is seeking to gain control of it. Attacks upon the management and its bankers, if they are made at all, are not usually the stock-in-trade of such financial interests; rather, attacks of this sort constitute a very subordinate part of their strategy. Even then, they are more a part of the

strategy to gain control than a thoroughgoing effort to start suits and to collect assets on behalf of the company and its security holders.

Through the process of buying strategic securities on claims at sacrifice prices and concentrating them in its hands, a group is able to prevent reorganization except upon terms agreeable to it. As we have pointed out in this report, the same type of practice is well known in real estate reorganizations. There, an individual or a group may buy enough securities on the market at sacrifice prices to enable it to block reorganization; or it may buy the equity in the property and with the aid of redemption statutes prevent consummation of the foreclosure except upon terms which it deems acceptable. From the viewpoint of investors, defense of this type of practice is difficult. Assurance or probability of benefit to anyone except the successful speculator is not predictable. Activity of this sort does not have the prophylactic effect upon corporate management which is frequently incident to the actions of the independent committee or lawyer. It by no means contains reliable promise of improved management. It results in the certainty that the reorganization and the corporate affairs will be managed so as to render ample returns to those who have speculated and won control. And it may mean that new capital and the financing of the reorganization will have been obtained not in the open market on the basis of the financial risk involved, but from those who have won control and who therefore are dispensing the patronage of a monopoly. For these reasons the tactics of powerful outside financial groups will commonly be more inimical to the interests of investors than the sporadic sullies of other reorganization adventurers.

To the extent that appraisal of the activities of outside litigants and groups in reorganization is possible it leads to the recognition of both beneficial and detrimental results. Even the striker-lawyer, who, operating in the most direct way for his personal advantage, creates a client by seeing to it that a friend willing to appear as plaintiff acquires a bond, and then settles his claims out of court, may confer benefits upon investors. The settlement which he obtains reduces the assets of the corporation in which investors have placed their funds; but realistically that may be at times a price paid by investors to the striker for police services. In this respect, the striker may be considered as providing a deterrent to reckless, careless, or fraudulent management or banking practices and to irresponsible or unfair reorganizations. The threat of the striker who may create undesirable publicity or financial injury causes management, bankers, and their committees to exercise care in matters which might otherwise be handled carelessly, to be meticulous in transactions which might otherwise be conducted for personal profit. Regardless, therefore, of the nature or objectives of the litigant, suits and threats of suits against the insiders have a function which cannot properly be disregarded. In this connection it is appropriate to indicate that many courts, as well as the dominant financial and legal interests generally, are apt to ignore the useful functions of outside groups, partially, perhaps,

because of the conspicuous and flagrant nature of the abuses which outside groups at times perpetrate. In their commendable zeal to protect estates from the raids of lawyers and committees who have no real interest in the situation and have performed no real services, some courts have not been solicitous of the claims of bona fide independents, and have denied them any compensation or reimbursement of expenses. Blocking an unfair reorganization and ousting disqualified persons from control are, we believe, services of value, along with activities which result in the adoption of a plan of reorganization. We believe that it is important that this point be kept in mind, lest courts, anxious to facilitate the rehabilitation of corporations and to minimize expenses, break down the salutary activities of independents. In the absence of more economical and effective methods of control over corporate management or committees, the litigant, whether he be "striker" or investor, plays an important role. However, the beneficial results of this process could be increased and the possibilities of its abuse by way of excessive payments, unsubstantial claims and preferential payments would be diminished if secret settlements were forbidden, and if complete accounting for sums expended for settlement were required.

THE SOLICITATION PRACTICES OF COMMITTEES

The strategic position which the banker management groups occupy in reorganization is not based solely upon their customary control over the proceedings, trustees, and security holders lists. Once their committees are formed, superior resources and skill in marshalling the assents, proxies or deposits of security holders also contribute to their success. These solicitation campaigns are usually well organized and effectively conducted; insiders may even employ public relations counsel to advise thorn us to strategy and tactics.

Committees organized by inside groups find the use of the good offices of the management extremely valuable. Banker-controlled managements synchronize the announcement of default with the announcement of the formation of the inside committees. In a great many instances managements have participated directly in the solicitation of deposits or assents. In voluntary reorganizations the management of the company almost invariably lends its prestige and resources to the solicitation campaign. Frequently the employees of the company are used as personal solicitors.

Committees sponsored by inside groups have also received considerable assistance from bankers in their solicitation efforts. Bankers often use their associations with customers and their sales and "advisory" organizations in support of a committee's campaign for deposits. In some reorganizations, the bankers have sent out their own circular letters recommending particular reorganization plans. The sales forces of large underwriting houses are often

used personally to solicit deposits. Special solicitors are often employed on a commission basis to contact security holders and induce them to send in their deposits or assents. Likewise, it has occasionally been considered necessary to compensate banks, dealers, brokers and their salesmen on a commission basis for soliciting deposits. This use of paid solicitors almost inevitably results in high pressure tactics. Special "solicitation units", nightly pep talks, and lectures on effective answers to bondholders' typical questions give the solicitation drive most of the characteristics of old-time stock selling campaigns.

The security holders themselves ultimately bear the cost of such solicitation, which is generally regarded as a compensable reorganization expense. Thus, the depositing security holder in effect pays for the privilege of being persuaded to consent to a partial extinction of his contract rights. He is seldom advised of this fact. Such nondisclosure is particularly indefensible in that it leads security holders to assume that they are receiving disinterested advice, when in fact they are not.

Theoretically, independent committees as well as management-banker committees could employ these methods for obtaining the support of security holders. And in some instances they doubtless have. Actually, however, these methods are more commonly employed by the inside groups. The superior resources of the management-banker groups make it more likely that those groups can finance such operations. Their superior skill in organization of a sales program also makes it more likely that they can perfect in short order an effective campaign for deposits.

Upon the formation of a committee or announcement of a reorganization plan, therefore, security holders are deluged with advertisements and circular letters, soliciting their support and attempting to persuade them of the unfairness of any past or existing attacks by competing committees. The inducements which committees will provide for deposit are many and varied. There are many intangibles which are important in a committee's campaign for deposits. These cannot be readily segregated and labeled. They embrace in part the presentation of the facts to the security holders. From the viewpoint of any committee the task will involve creation of confidence in the committee which is doing the soliciting. In case of management-banker committees this may involve a careful editing of the facts (in those cases where the waste, mismanagement, or extravagance of the management caused or contributed to the failure or where the bankers indulged in fraudulent, practices in the sale of the securities) so that no suspicion will be raised in the minds of the security holders of the competence of the committee to represent them in the reorganization. It may entail creation of a picture of strenuous and faithful service by the committee on behalf of the security holders. The temptation will be not to disclose to security holders the importance to the management and the bankers of control over the committee

and over the securities to be deposited with it. If the committee is dominantly interested in securities junior or senior to those being solicited, the committee will desire not to disclose the fact. If the committee members have other pecuniary interests to protect or embrace through control over the reorganization, suppression rather than disclosure of such facts may also be expected. In other words, the translation of the cause and effect of default will be handled delicately and subtly, so that fears may be calmed, indignation cooled, and confidence inspired. At times, such technique will produce circulars which are either untrue or misleading.

There are other more direct and specific methods which management-banker committees have employed in the drive for deposits in order to overcome the normal inertia of security holders. The pressure may be exerted by the threat of undesirable consequences from failure to deposit or through the extension of favors for deposits. The devices utilized have entailed, apart from misrepresentation or non-disclosure of material facts, many abuses of fiduciary powers and the skillful dispensation of committee patronage. They have taken the form of special services offered to depositors, which on examination merely reflect advantage taken of the security holders' unfamiliarity with the situation. Thus, they may advertise that they will file proofs of claim for depositors only, making this service appear indispensable though forms for the purpose may be obtained by any one from the court. Special favors are extended to induce the deposit by particular groups of security holders. These include institutional and other large holders, banks, clients of selected investment houses, brokers and dealers. The kinds of special treatment vary. More favorable terms with respect to possible charges and the light to withdraw are offered. Special types of deposit not subject to the control of the committee are permitted. Deposit agreements frequently give committees the power to permit security holders to participate under the agreement without depositing. Institutional holders have been permitted to take advantage of this power. Bank accounts have been opened by companies with banks that deposited their security holdings with the insiders' committees. Brokers and dealers have been paid commissions for depositing their own securities.

The threat of discrimination is often used to spur security holders to deposit. Committees have given the impression in their solicitation literature that, provision being made only for depositing, non-depositors would suffer complete loss. In some instances where committees came into funds for the payment of interest on securities, payment was actually withheld from non-depositors, either by the decision of the committee or by express provision in the deposit agreement.

The desire of security holders to hold a security that is listed on an exchange has been taken advantage of by committees. Committees may have certificates of

deposit listed. Subsequently, with the cooperation of the company, the undeposited security may be stricken from the list, thereby giving the listed certificate of deposit a superior market to the undeposited security. The mere threat that the directors may undertake to do so, if sufficiently publicized, may for a time have the same result. An advantage is also enjoyed over the certificates of deposit of other committees which are not listed. This greater market has been stressed in soliciting deposits. If both the deposited and undeposited securities enjoyed listed or unlisted trading privileges on the same exchange, attempts may even be made to stimulate purchases of the certificates of deposit to raise their market price to that of the undeposited security.

Committees, as an inducement to deposit, have held up the necessity of deposit in order to avoid receivership. Security holders have been asked to absent to voluntary plans of reorganization by depositing in order to avoid receivership. Such statements are made with the mental reservation that a "short receivership" probably is necessary as a legal device to put the plan into operation. When receivership occurs, depositors who seek to withdraw on the ground that they had deposited to avoid receivership are told that the original plan contemplated a "short" receivership, as distinguished from a prolonged receivership. A further device, then used us an '"antidote" to the receivership is declaring the plan "operative"; this is supposed to signify that the plan is "nearer to consummation." This again is intended to stimulate deposits. And, finally, the fact of receivership, once it occurs, is cited as evidence of the necessity for further deposits in order to lift the receivership.

Another device frequently used by committees in their drive for deposits is the announcement of a relatively short period for deposit. This is calculated to hasten deposit by creating the fear that unless immediate deposit is made, the security holder will be deprived of participation in a promulgated plan or will be denied the benefits of the committee's activity. Successive extensions of the closing date for deposits follow with the security holder still led to believe that each date set will be the last. Deposit agreements almost universally authorize committees to fix, in their uncontrolled discretion, the periods within which deposits will be received. A substantial proportion of deposit agreements also permit committees to assess penalties for late deposits. The threat of such penalties has been used as a pressure device to spur deposits, in virtually all of the cases where time limits are set, there is no intention to carry out the express or implied threats. The threats are used to capitalize on security holders' fears.

At times the endorsement of a plan by impartial investment services is sought for the influence that an apparently disinterested recommendation will have in the committee's drive for support. These agencies are contacted to win their favorable recommendation for a plan, sometimes before the plan is submitted to security holders. Such recommendations will be advertised in the committee's

literature. In one instance an agreement (later changed) was made with a statistical agency whereby it would study the condition of the corporation and analyze the terms of the plan to determine its merit and fairness. It was to receive a fee in the event that it recommended the plan but get nothing if it did not.

In conclusion, it may be granted that a certain amount of pressure on security holders is necessary in order to overcome their conventional and traditional inertia. Latitude must be allowed committees if investors are to be galvanized into action. But unfair and discriminating practices are other matters. Exhortation is one thing; misrepresentation and oppression another. To state the matter otherwise, pressure is needed; but it should be applied by fair means, not by foul.

The One-Sided Nature of Deposit Agreements. -- The powers vested in committees by security holders have been conferred in one of two ways: by the execution of proxies from security holders to committees, without transfer of possession of the securities; or by transfer of possession, subject to the terms of an elaborate deposit agreement. In the case of the insiders, this control has usually been obtained by use of a deposit agreement. Sometimes proxies are taken, but generally they are characteristic of the technique of independent groups. Sometimes a committee will ask for no authorization at, all, requesting merely registration of the names of the security holders. Sometimes deposit agreements will be used by independent committees. But by and large, the machinery of taking deposits is a device of the insiders.

The deposit agreements are one-sided contracts. They are not negotiated by the parties dealing at arm's length. They are prepared solely by the committee, or more realistically, its counsel. In fact, seldom does the depositor see the completed agreement. Even if he did, it is doubtful that he could understand it, for the documents are complicated, legalistic instruments. Accompanying circulars may advise the security holders of particular provisions which the committee desires to emphasize as showing its honesty of purpose or as making deposit seem not unattractive, but ordinarily the security holders are not advised of the fact that the agreements confer upon the committees powers that are as broad as the ingenuity of counsel can design, and that give the committee almost unlimited control and dominion over the securities.

The security holder who enters by depositing finds retreat by withdrawing difficult, hazardous and expensive. The almost complete dominion which the deposit agreement typically vests in the committee is made secure by reason of the legal, contractual, and practical deterrents placed in the way of withdrawal. It is indeed rare to find a deposit agreement which in terms permits a depositor to withdraw any time at his election. Sometimes the committee is given the discretionary right to permit or deny depositors the privilege of withdrawing, generally upon such terms and conditions as the committee may choose. The

exercise of this discretionary power can easily be abused, and it has been abused. Withdrawal has been permitted to accommodate friends who wished to sell their securities. On the other hand, it has been denied depositors who sought, to withdraw in order to assert claims against friends or affiliates of the committee. It has been denied at times at the expense of fairness and justice to depositors simply because the committee did not wish to relax its hold upon any of the deposited securities.

To be sure, an "absolute" right is commonly given the depositors to withdraw in certain contingencies, such as the submission of a plan of reorganization to the depositors for acceptance or rejection, or the adoption of a material amendment to the deposit agreement. But in case of amendments the committee is the judge of their materiality. And these absolute rights of withdrawal are so hedged with other limitations and conditions that they are virtually meaningless. Thus, the right of withdrawal must be exercised within a limited period of time; it is the rare case in which the time is more than 30 days; not infrequently it is as short as 10 days. Inadequate provisions for notice may mean that the period will have passed, or almost passed, before the depositor learns that his right of withdrawal has accrued. And means have been devised whereby committees by resort to technicalities and formalities have been able to defer granting the "absolute" rights of withdrawal for many months. For example, nothing short of formal abandonment by affirmative action of the committee gives rise in the usual case to a right to the return of the securities or to withdrawal upon "abandonment" of a plan. The agreement will vest in the sole province of the committee the right to determine whether conditions have so changed that the plan should be abandoned.

Furthermore, withdrawal is generally conditioned upon payment of a pro rata share of the committee's fees or expenses, or both. Assessments have been levied apparently more with reference to their deterrent effect upon withdrawal than with reference to the actual expenses which the committee has incurred. The only limitation upon the committee's power to make this assessment may be a provision that the assessment cannot exceed a specified percentage of the face amount of the funds. Committees have levied assessments which have amounted to a substantial percentage of the market price of the securities, and, in fact, as much as the entire amount of the market price, thus making withdrawal impractical if not completely useless.

Any questions of interpretation of the terms of the agreement are determined usually by the committee. The agreements give the committee power to construe their provisions and the committee's construction is made conclusive and binding. In addition, they usually permit the committee complete freedom in amending the agreement. If the amendment is deemed by the committee to be "material and adverse", the depositors are given the privilege to withdraw,

subject, however, to the obstacles customarily placed in the way of withdrawals. Committees have not hesitated to use their amending power to increase the amounts they might spend for expenses, and the fees they might charge.

Deposit agreements typically supply the machinery for paying the fees and expenses of the committee. Commonly the agreement expressly provides that the committee has a lien upon the deposited securities for fees and expenses. In addition, it is also customary to provide that the securities may be pledged for loans for these purposes. Seldom have the deposit agreements provided for independent review of fees and expenses. Furthermore, a surprising number of deposit agreements do not provide machinery even for an accounting to depositors. Where accounting provisions have appeared, they have seldom assured the depositors a reasonable opportunity to examine and to question the committee's accounts. Thus, in cases not subject to the provisions of Section 77 or Section 77B of the Bankruptcy Act, the committee is left the sole arbiter of its own charges, an evil we shall discuss at length in a subsequent part of this report.

There are a number of other objections, from the point of view of security holders, to a committee's taking deposits in any case. It is an expensive process. An elaborate agreement is necessary. The printing of this document is alone an item of considerable expense. In addition, lawyers' fees must be paid, and the time of committee members is consumed, for which payment must be made, in arranging for a depositary and determining and drafting the terms of the contract. Certificates of deposit must be engraved; lawyers must be paid to draft their form; and the depositary must be reimbursed for the work involved in the issuance, certification, and holding of the securities. Arrangements must be made for a transfer agent for the certificates. Vast sums are paid depositaries for their services in these and other connections. Similarity, if holders of the certificates are registered, payment must be made to a registrar. The costs of transmitting, by registered mail, securities to the depositary and certificates to the depositor, must be borne.

Deposit Agreements versus Proxies. -- In the light of the objections to deposit of securities and to the broad powers contained in deposit agreements, it may be questioned to what extent it is necessary for a committee to take actual possession of the securities. In turn this will require a determination of what power and authorization a committee should have to perform its functions in reorganization. For it is clear that in view of the disadvantages of deposit agreements, deposits should be permitted only where necessary for the protection of the security holders and that only those powers should be permitted a committee that are useful in the interests of the security holders. By and large, proxies afford the desirable medium of representation. The following are the reasons.

It is easier to organize security holders and to procure their united action for common purposes if they are asked merely to execute proxies rather than to deposit their securities. This results from a natural reluctance of investors to surrender possession of their securities. The reasons for this reluctance are, in the first place, inertia -- disinclination to perform the acts necessary to transmit the securities to the committee's depositary; in the second place, unwillingness to surrender to another the important rights and powers involved in deposit of securities; and in the third place, the fact that securities have frequently been pledged by the owners as collateral for loans and it is difficult to obtain their release for purpose of deposit. It is illuminating to note that independent committees customarily ask for proxies rather than deposits. This, in itself, is evidence of the greater ease of obtaining support in this manner.

A security holder who has executed a proxy can by reason of the revocable nature of proxies continue to exercise some control over the destiny of his investment. By the same token, the committee does not have blanket and virtually irrevocable control over the securities. It must incur the risk that its actions will not meet with the approval of security holders and they will revoke their proxies; or that security holders, for reasons unconnected with the activities of the committee, will sell their securities and thereby revoke the proxy. From the viewpoint of a committee which is unwilling to take into account factors other than its own power, it. may be highly advisable to have authorizations that are virtually irrevocable. But the reasons which are advanced in support of the virtual irrevocability of powers, obtained by deposit of securities, do not carry conviction. No conclusive reason appears why the deposit of bonds is necessary to negotiate a plan. It is argued that, in order to negotiate effectively, a group must demonstrate that it has control over or represents a substantial amount of securities, or that its judgment, in all probability, will be accepted by security holders. But this is a far cry from saying that deposit of bonds is necessary. Committees have effectively negotiated a plan of reorganization without having bonds on deposit. These groups have generally obtained proxies from security holders, and these proxies have been recognized by other parties in the negotiation as sufficient to vest the committee with authority to speak for security holders.

Again, it is urged that if proxies are used and revocations occur in large volume, the committee may be genuinely handicapped in other respects. It may not be certain that action which it takes, requiring approval of a designated amount of securities, will in fact be approved. This argument is not particularly persuasive. As a general matter, committees need assurance of adequate support only in connection with commitment to a plan of reorganization. Usually few issues arise, as to which committees must be certain in advance of the support of every one of their constituents. And in respect of the reorganization plan, it is clear that a prior

and general authorization to the committee should not, as a matter of equity and sound practice, operate as a commitment to the plan. Security holders should not be committed to the approval of a reorganization plan which they have not had an opportunity to consider. A contrary principle is a denial of the democratic forms upon which the theory of reorganization by majority consent is based. If approval of a reorganization plan can be obtained before the plan is submitted to security holders, real consent to that plan is not in fact obtained.

Some insist that deposit of securities, together with power to pledge the deposited securities, and a lien thereon, coupled in turn with restriction of the right to withdraw to staled contingencies and upon payment of enough to redeem the pledge and discharge the lien, is essential if committees are to finance themselves. Clear it is that committees must have some funds with which to operate; clear it also is that such funds should not be the gift of persons who may be interested in influencing the committee to the detriment of security holders. But it does not follow that committees must or should, for this purpose, take possession of securities with the collateral rights, powers and restrictions necessary to make the deposited securities serve the end. It is significant to note that the most vigorous advocates of the necessity of the deposit system are committees affiliated with the management and bankers of the company in reorganization. On the other hand, most independent, committees, working in opposition to the managements and bankers who have greater resources at their disposal, have operated without deposit of securities. Committee members have borne individual expenses; and their combined contributions have borne expenses of the committee. Counsel has taken the matter either on the basis of the promise of committee members to pay, or, perhaps more generally, in anticipation that the committee and they would receive payment in the course of the reorganization from the estate. Occasionally, they have been financed by an interested person who may or may not have been a member of the committee or a security holder, or perhaps a person who sought some advantage from the committee's operations. Sometimes, they have financed themselves by assessment upon security holders, unaccompanied by deposit of securities. The fact that these committees have operated and sufficiently financed their activities without obtaining deposit of securities is proof positive that it can be done. To a large extent, deposit of securities inspires a vicious circle. As it makes it possible for the committee to pay its expenses, so it increases those expenses by substantial amounts. The bulk of the expenses incident to the use of deposits are avoided if proxies are used. The proxy form is simple, and the cost of preparing and printing it is not, in the usual case, likely to aggregate a substantial sum. The example of many independent committees shows, we believe, that expenses not incident to or resulting from deposit can be borne by the committee itself.

For these reasons, it is our opinion that in most instances the deposit of securities should be outlawed. But, as we have indicated, there are situations

where deposit may be necessary or desirable. For example, while we have shown that committees can finance their operations without deposit of securities, it does not follow that deposit of securities for purpose of financing the committee should be outlawed in every instance. Furthermore, with respect to various technical requirements of reorganization, as we shall discuss, deposit may be necessary. It must be borne in mind, however, that while deposit may be urged as necessary for a particular act, it does not inevitably follow that the deposit should, as is currently the case, be accompanied by transfer of all rights and privileges incident to the security, except beneficial ownership.

There are a number of situations where it may be contended that deposit is necessary to satisfy technical requirements, but where in fact it is not. Thus, voluntary reorganizations, which do not proceed under court sanction, do not require deposits as a general matter. Such reorganizations are planned and engineered by the company's management and bankers, with or without the use of committees. Generally speaking, they rely for effectuation upon charter provisions empowering a majority of stockholders to bind the aggregate to certain modifications, or upon provisions in trust indentures depriving a minority of holders of bonds, debentures or notes of any remedy. Under the latter, if a necessary percentage of securities declines to sue, holders may have no remedy under the indenture. Occasionally, such reorganizations are consummated by consent of a large majority of securities mid purchase of the remainder.

So far as the stockholders are concerned, where the reorganization is effected under charter provisions as staled above, or under statutory provision making the will of the majority binding upon all, deposit of securities clearly is not necessary. Votes in person or by proxy are all that is necessary. Similarly, with respect to securities representing a creditor position in the corporation, it is not necessary that they be deposited in order to consummate the plan. All that is necessary is that they accept it, which they can do by vote followed, as in the case of the stock, by acceptance of the exchange or submission for stamping, or by proxy.

From the viewpoint of the company, however, the latter may appear to have a definite disadvantage. It may leave the security holder free, despite his vote or proxy, to join with other holders in suit on their securities, which may have the effect of gaining for them a preference or blocking consummation of the plan, or both. There must, it is true, come a time when the company knows how many securities are committed to the plan and will be voluntarily exchanged under it. Deposit of securities under the conventional form of deposit agreement is not, however, necessary for this purpose. This limited purpose does not seem to justify use of the elaborate deposit machinery, with its attendant expenses, disadvantages and dangers of abuse. The same purpose could be served, we believe, by stamping an appropriate legend upon the securities. So far as the mechanics of reorganization are concerned, the committee is interested in having

the power to intervene in any proceedings and to participate therein as a matter of right. Proxies in the usual form, authorizing the committee to act for the creditor or security holder in the reorganization, will give the committee any right to intervene which the giver would have.

The requirements for consummating the mechanics of reorganization have been regarded as proof that deposit of securities cannot be completely avoided. Relevant in this respect is the machinery of sale which is part of receivership and foreclosure proceedings. The usual reorganization under Section 77B of the Bankruptcy Act is effected without sale, though one of the alternative methods under this section does provide for sale. Presumably this latter method is based upon analogy to the equity procedure which we will hereinafter discuss. But generally in proceedings under Sections 77 and 77B of the Bankruptcy Act, it is clear that the absence of the device of a sale makes the deposit of securities unnecessary for the purpose of consummating the plan.

With respect to reorganizations in equity receivership proceedings and by foreclosure, the problem is more difficult. The traditional machinery for transferring the property of the corporation in reorganization to a new corporation has been a judicial sale. It has long been recognized that this procedure, in respect of properties being reorganized, is nothing more than formal; there is no sale in the sense of transfer for a consideration which is distributed to the vendors; in substance, there is merely a modification of rights of security holders and other creditors pursuant to a plan of reorganization, which may or may not take the form of an exchange of new securities for old. But in the present state of the law it has been assumed that the forms of sale are still necessary to effect reorganization in equity or by foreclosure. Translating this into practical, terms, it means that protective committees, their nominees or other agencies must be prepared to bid in the property at a price approved by the court and to pay for it in such manner as the court will sanction. Traditionally, payment takes the form of a tender of securities which have been deposited with the agency plus sufficient cash to pay dissenters their pro rata share of the price at which the property was bid in, and, sometimes, to pay administration expenses.

If this procedure is made necessary by local law, it follows that the security holder must at some time surrender possession of his securities. It follows also that this surrender must take the form of deposit with a committee before time of sale; otherwise, the committee will not be able to bid at the sale because of uncertainty as to the amount of securities it can tender. Where reorganization is pending in state receivership or foreclosure, therefore, and where tender is necessary to consummate the process, committees and others must have license to solicit and obtain deposit of securities. Such deposit should, of course, be strictly limited to the purposes of tender in payment of the bid price. The toleration necessary because of antiquated machinery should not be allowed to

become a general license for the entire catalogue of abuse. But with increasing use of Sections 77 and 77B of the Bankruptcy Act, the entire machinery of foreclosure becomes of less importance for reorganization purposes. Under these sections, as we have stated, the formal procedure of foreclosure and sale to effect reorganization is largely unnecessary. It will continue to have significance only in state court proceedings. A similar problem arises in connection with committees representing municipal security holders. As we elsewhere discuss, the only legal remedy which such committees have available is suit for the principal and interest of the bonds and petition for mandamus to enforce the judgment. Use and threat of use of this remedy is the powerful weapon in the hands of municipal committees to expedite favorable settlement on the part of the committee. It appears likely that use of this weapon depends upon possession of securities by the committee. In order to exert the pressure implicit in the threat of bringing suit, they must, at the time of threat, have the means at hand or readily available to effectuate the threat. And if any suit is to be brought for purposes other than obtaining an undesirable preference for one or a few bondholders, it must be brought on behalf of holders of a substantial number of bonds. It appears that, in order to bring such suit, the committee must have the bonds on deposit.

Municipal committees, as we elsewhere discuss, have found that resort to the federal courts is generally necessary in order effectively to obtain judgment and mandamus order. The courts of the state in which the debtor municipality is incorporated, by and large, have not been friendly to the debtors' creditors. Jurisdiction of the federal courts is established on the basis of diversity of citizenship; a committee composed of persons not resident in the debtor's state sues the debtor. But in order to establish such jurisdiction, the committee, in the language of the United States Supreme Court, must not hold the bonds "simply for purposes of collection". It may therefore be necessary, if municipal committees are to have access to the federal courts, that they should be allowed to obtain deposit of securities under deposit agreements broad enough to constitute them trustees of express trusts.

With the exception of cases such as we have enumerated, in which necessity for deposit can be shown, the deposit of securities for reorganization purposes should be outlawed. In those instances where deposit of securities is inescapable if the committee is to function effectively, the terms of the deposit should be narrowly restricted to the necessities of the occasion. And in such cases adequate provision should he made for independent review of certain actions taken by the committee thereunder. Thus, the committee should no longer be allowed to be the sole arbiter of the time when, and the conditions under which, a deposit may be made or a withdrawal effected; of the amount of assessments and penalties which may be levied against the security holders; and of the fees and expenses of the committee.

SECTION V

CONCLUSIONS AND RECOMMENDATIONS

The foregoing survey supplies ample evidence of the necessity of refashioning the process of reorganization to the end that primary emphasis be given to the protection of the interests of investors. There are three needs which should be met in this connection.

First: It is essential that measures should be taken to place the control of reorganizations with bond fide security holders and their direct representatives. It is their investment which is at stake in any reorganization. The right to be heard in all matters arising in a reorganization proceeding, and the privilege of submitting plans and suggestions for plans should be freely accorded them. The activities of independent groups who represent bona fide interests should be encouraged. By the same token, control of reorganizations should be denied to persons whose sole claim is derived from a position in the management of the corporation or from banking associations with it. The history of reorganization demonstrates that the objectives of such persons are often incompatible with the interests of the real owners. Racketeering groups who neither own nor represent bona fide interests should be excluded from participation in the reorganization, so that the pressure of their nuisance value will be removed. Similarly, control of reorganizations should not be subject to seizure by financial interests primarily motivated by the desire to obtain control of the new or reorganized company. Likewise, measures should be adopted to deal with those who acquire securities or claims at default prices and either capitalize on their nuisance position or endeavor to effectuate settlements or plans favorable to those who bought at depressed prices but disadvantageous to those who purchased at pre-default prices.

Second: It is essential that renewed emphasis be given to the fact that representatives of security holders in reorganization occupy a fiduciary position. It is intolerable that they or their lawyers should possess dual or multiple interests. Likewise, neither committees nor other participants in reorganization should be permitted to be the sole arbiters of their fees and expenses.

Third: It is essential that the abuses which have characterized the strategy and techniques of reorganization should be eliminated. The use of deposit agreements as means of preserving or obtaining arbitrary and exclusive control over security holders should not be permitted. The virtual monopoly on lists of

security holders possessed by the banker-management groups should be broken. High pressure salesmanship, misrepresentation and non-disclosure in solicitation methods must he controlled, so that security holders may be assured of an honest and complete portrayal of all material facts affecting their investment.

In its operation any legislative program designed to achieve these ends must involve an extension of the supervisory power of judicial or administrative agencies. The federal courts now exercise certain regulatory powers over reorganizations effected under Section 77B of the Bankruptcy Act, and, to a lesser degree, over reorganizations accomplished through the use of the federal equity receivership. In cases arising under Section 77 of the Bankruptcy Act, the court's jurisdiction is supplemented by regulatory powers conferred upon the Interstate Commerce Commission. The Securities and Exchange Commission has a measure of supervision over reorganizations of companies subject to its jurisdiction under the Public Utility Holding Company Act of 1935. Differing powers are possessed by a number of state courts and administrative bodies, some with respect to particular types of companies, such as banks and insurance companies; others with respect to corporations in general. In so far as reorganizations in federal courts are concerned pervasive controls can and should be provided. As respects other reorganizations a further degree of regulation can and should be afforded.

A. REORGANIZATIONS IN FEDERAL COURTS

The federal courts have exercised a jurisdiction over corporate reorganizations which has become traditional. Equity receiverships, and more recently Section 77B of the Bankruptcy Act, have developed a form of proceeding which in its broadest outlines is appropriate and acceptable. The federal courts have become trained and experienced in the technical aspects of reorganization. We do not believe there is any present necessity that they should be divested of control over and responsibility for the administration of these estates by placing the functions which they perform in the hands of administrative agencies. Nor do we believe that such control and responsibility over these estates should be shared by the courts and administrative agencies. Rather, we recommend that the powers of the courts over these estates be broadened, that they be provided with further and more specific standards to guide their administration of them, and that machinery be designed to afford the courts the benefits of administrative assistance in these complicated financial and business situations. That is to say, without disturbing the control by the courts, their powers should be supplemented in particular matters by administrative action. The following recommendations, suggested specifically for reorganizations under Section 77B of the Bankruptcy Act, should likewise find their counterparts in federal equity receiverships.

1. In every case a qualified and disinterested trustee should be appointed, to whom administration of these insolvent estates should be entrusted. In view of the importance of attorneys in these situations, the same standards of independence required of trustees should also be required of counsel to the trustees. Appointment of independent trustees in all these cases would supplant the system of leaving the debtor in possession or of appointing "friendly" trustees. The appointment of an independent trustee is designed not only to make it impossible to leave these estates in the hands of those whose mismanagement may have given rise to the need for reorganization but also to provide machinery whereby necessary and essential reorganization procedures may be performed within the court or under its scrutiny and supervision. In fulfillment of these objectives the, independent trustee should be authorized and directed:

a. To make an investigation in every case of the condition of the company and of the events antedating the failure, with the three-fold objective (1) of ascertaining the facts necessary for formulation of a plan; (2) of evaluating the worth of the existing management and the desirability of its retention by the reorganized company; and (3) of disclosing and diligently pursuing corporate assets in the form of claims against directors, officers, their affiliated interests and others who may have misused corporate control for their personal benefit.

b. To take the initiative and primary responsibility for preparing a plan of reorganization or to serve as the administrative adjunct of the court in bringing the various proponents of plans together and in supervising the negotiation by them of plans of reorganization.

In substance the independent trustee would serve as the vehicle for bringing into the reorganization process judicial and administrative supervision, scrutiny, and control over the formulation and negotiation of plans of reorganization. Such basic and important functions would no longer be the province of self-constituted and self-appointed protective committees, reorganization managers, and a small coterie of directors and bankers. Greater assurance would be provided that the public interest, no less than the immediate interests of creditors and stockholders, would be served by removing these important functions from those whose interests are frequently incompatible with the interests of investors. Further, with the independent trustee as the "clearing house" for proposals of plans by all properly accredited persons, there will result (or greater opportunity will be provided for) a larger measure of participation in these activities by bona fide creditors and stockholders. And, as we have stated, the presence of this officer of the court gives increased assurance that the facts essential to the preparation of plans of reorganization will be ascertained. A thoroughgoing examination of the property and liabilities of the company, the reasons for its

insolvency, the quality of its management, and the likelihood and manner of successful rehabilitation -- indispensable prerequisites to intelligent preparation of plans -- may then be ascertained. Needless and costly duplication of effort and expense in the performance of this necessary undertaking will also be avoided by centralizing the responsibility in the independent trustee. And finally a large degree of democratization of the processes of reorganization would be accomplished without running the risk of disorganization which would be entailed if these complicated and intricate financial and business problems were left to "town meeting" methods.

2. Acceptances of a plan (conditional or unconditional, preliminary or final) should not be solicited until the plan has been carefully scrutinized by the court and its submission to the creditors and stockholders authorized. This is essential for the following reasons. In judicial reorganizations scrutiny of plans of reorganization is the responsibility of the court. But adequate performance of this duly by the court has been inhibited by the practices of reorganizers. There must be removed the indefensible pressure upon the court which reorganizers are able to exert by confronting it with assents to a plan obtained from security holders prior to any review of the fairness and equity of the plan but who have been induced to give conditional approval to a plan in advance of its formulation, or to endorse the general activities of a committee or group by sending them blanket or broad proxies, or by depositing their securities with them. Under the system which has prevailed that practice has tended to shift the attention and emphasis of the court from the merits of particular plans of reorganization to the ostensible backing which various proponents have. Renewed emphasis on the fairness, equity and soundness of plans necessitates removal of the undue and unwarranted pressure which those first in the field may exert by reason of their ostensible representation of substantial groups of security holders. Such representation by and large is not real. It should no longer be used to detract attention from the fundamental and basic problem of the fairness, equity and soundness of the plan.

3. The facilities of a qualified administrative agency should be made available to the court as an aid in the administration of the estates and in the analysis of the fairness, equity and soundness of plans. This is rendered desirable by reason of the burden on the court in these cases, the complicated financial and business matters involved, and the degree of expertness required for intelligent solutions of many of these problems. This administrative assistance to the court should be provided by two measures:

a. The Securities and Exchange Commission should be given the right of intervention in all of these cases and thus accorded full participation in all phases of the proceedings.

b. Plans of reorganization should be submitted to the Securities and Exchange Commission for advisory reports before the plans are submitted to creditors and stockholders for acceptance.

These recommendations, however, have one important qualification. In periods of extensive reorganization (as during the last four years) the administrative burden would be intolerable if the presence of any one administrative agency were required in every such case. Accordingly the procedure should remain flexible, assuring such administrative aid in those cases where by reason of the amount of liabilities or the wide diffusion of securities and claims the reorganization may realistically be said to have a national interest. This differentiation of treatment would avoid the grave administrative hazards attendant on participation by the Commission in every case; it would nevertheless make it possible for the Commission to lend its assistance to the courts in necessitous cases and cases having a national interest.

4. The right of bona fide creditors or stockholders to be heard on all matters arising in a reorganization proceeding should not be restricted.

5. While control of the proceedings should lie in the hands of bona fide security holders and their direct representatives, participation in the proceedings should not be denied other interests. Thus, management should be accorded ample opportunity to be heard. By the same token, representatives of the employees of a corporation should have a right to be heard on matters connected with proposed plans of reorganization which affect their interests.

6. Indenture trustees should be given a definite status in the proceedings. They should be empowered to file petitions to initiate the proceedings or to intervene, to be heard on all matters, to file proofs of claim (but not to vote) on behalf of holders of securities outstanding under the indentures, and to receive allowances for fees and expenses.

7. Those who have purchased or sold securities in contemplation or after commencement of the proceedings should not be allowed compensation or reimbursement for expenses from the estate.

8. The court should be empowered to provide that a claim or share of stock, though otherwise allowed, should not be included within the class of those entitled to accept a plan, if the acceptance of or the failure to accept any plan is not in good faith, whether by reason of the fact that such claim or share of stock has been acquired in contemplation or after commencement of the proceedings, or otherwise. The exercise of this power would make it possible for the court to prevent racketeering groups from seizing control of the proceedings by

purchasing the securities at depressed prices and acquiring a strategic or nuisance position.

9. Every person who represents more than twelve creditors or stockholders (including committees and indenture trustees) and who appears in the proceedings shall file with the court a sworn statement setting forth the amount of securities or claims owned by him, the dates of acquisition, the amounts paid therefor, and any sales or transfers thereof. Attorneys who appear in the proceedings should be required to furnish similar information respecting their clients. This will provide a routine method of advising the court and all parties in interest of the actual economic interest of all persons participating in the proceedings.

10. Reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred by parties in interest and their attorneys in connection with the administration of the estate or with a plan of reorganization should be allowed by the court. Such allowances should not be restricted to instances where such persons have brought assets into the estate or have assisted in consummation of a plan. The standard should be sufficiently broad and flexible to give, in addition, recognition to the value of services rendered in submission of suggestions for plans, or in opposing confirmation of plans. That is to say, the principle governing allowances should recognize the value of constructive ideas, whether they are in support of or in opposition to favored plans, and whether advanced by groups or by individuals.

11. Towards the end of socializing lists of security holders, the trustee should be authorized and directed to collect lists of holders of claims and securities not only from the debtor but also from all other persons. These lists should be subject to inspection and use by all bona fide creditors and stockholders. To safeguard against abuse by distribution of copies of such lists, the court should be empowered to impound the lists and permit their inspection and use on such terms as the court may prescribe. This would make it possible, if conditions warranted, for the court to cause literature to be mailed for interested parties. Likewise the court should be empowered to refuse inspection and use of such lists by those who purchased securities or claims in contemplation of or during the proceedings.

12. Specific provision should be made that the court in passing on the fairness and equity of plans should consider whether or not the provisions for the management of the new company (or the machinery for its selection) are in the public interest and in the interests of investors. Fairness of reorganization plans should be considered not only in light of the allocation of assets and earnings among the various claimants but also in light of the allocation of control. Control in these cases is an important and valuable emolument. It should rest in the

bands of those who show promise of exercising it as a power in trust. Courts should be as solicitous in this regard as they are in determining priorities as respect assets and earnings.

13. Machinery should be designated to provide creditors and stockholders with reliable information about the condition of the company, its current operations, arid the plan of reorganization. Collection of this information and its publication should be one of the undertakings of the trustee. Reorganization facts should not be shrouded in mystery. Reliable, current information and data should be available for the information and advice of investors.

14. Jurisdiction of federal district courts should not be accorded merely by reason of the fact that the company is incorporated in the state wherein the district court is located. Rather, jurisdiction should follow the principal place of business or the place where the principal assets are located. This restriction will prevent reorganizes from shopping for friendly jurisdictions.

B. SOLICITATION BY COMMITTEES AND OTHER PERSONS IN CONNECTION WITH REORGANIZATIONS

Large numbers of reorganizations do not come within the jurisdiction of the federal courts. Some take place in state courts or under supervision of state agencies. Some are consummated wholly outside the jurisdiction of any court. All types of voluntary reorganizations fall within this latter category. We do not believe it feasible to attempt to bring such reorganizations completely under either judicial or administrative supervision by the federal government. And in case of reorganizations in state courts or before state agencies, constitutional limitations make it impossible to prescribe the same pervasive controls as in case of reorganizations before federal courts. But certain matters in connection with these reorganizations should be subjected to administrative regulation. In these respects such regulation is equally applicable to reorganizations which do come within the jurisdiction of the federal courts. These pertain largely to solicitation of proxies, deposits, and assents by use of the mails or agencies of interstate commerce.

Existing control and supervision over such solicitation are both limited and inadequate. Few adequate white controls exist, and in view of the interstate complexion of such solicitation, interstate control is of necessity limited in effectiveness. At present some committees are required to register under the Securities Act of 1933, as amended. But such registration requirements are applicable for the most part only to committees seeking deposits of securities. Those committees seeking powers of attorney or proxies are, by and large, exempt from that Act. And the power of this Commission under the Securities

Exchange Act of 1934 over the solicitation of proxies, consents and authorizations is applicable only to certain securities registered on national securities exchanges. And even in cases covered by the Securities Act and by the Securities Exchange Act, the powers of the Commission are inadequate for purposes of effective control. Thus, committees which are required lo register under the Securities Act are forced to disclose only the truth as to their organization, their affiliations and their plans. There is no power to refuse to qualify as committees those who have even palpably conflicting or adverse interests. There is no power to supervise the conduct and activities of these committees during their existence. There is no power to curtail or restrict in the public interest and for the protection of investors the powers which committees may take unto themselves.

Mere disclosure in these situations is hardly sufficient for the protection of investors. On default, investors, unorganized and largely helpless to help themselves, have little freedom of choice but to go along with those who, self-constituted and self-appointed, announce themselves as their protectors. Disclosure of the facts regarding these protectors is of little practical utility to investors. Prospective purchasers of securities have, by and large, a real choice -- to buy or not as their judgment dictates. To them disclosure of the pertinent facts surrounding the offering is of great value. But in case of these default situations the case is quite different. An investor with an investment in an insolvent company holds the securities; his investment has already been made; his choice is drastically limited. It will be of small comfort to know that those who control his destiny are incompetent or faithless fiduciaries.

In addition, disclosures in the registration statement present the facts as of the time of filing. That date is usually far in advance of the negotiation of a plan. This fact is particularly important in cases where there is no court or other agency passing on the fairness, of the plan, for the following reasons. When the committee subsequently negotiates a plan, the investor usually has no alternative but to go along with it regardless of whether it is unsound or unfair. The price of going along will be submission to such terms and conditions as the committee in its uncontrolled discretion may impose. As we have seen, committees may exact heavy tribute from depositors. But the latter are faced with a "Hobson's choice" of not depositing (or withdrawing their securities on payment of a penalty or assessment) -- with the result that they get little or nothing -- or going along with the committee and paying the committee such toll as the committee may dictate. In other words, though the registration statement contains no misstatements or non-disclosures of material facts, committees may continue lo operate under oppressive deposit agreements. The Commission is powerless to regulate or control their practices. And in many situations -- such as reorganizations in state courts, voluntary reorganizations, municipal debt rearrangements and foreign

debt readjustments -- no court or agency has any control either over the fairness of the plans or over the activities of committees.

While the Commission has broader powers in some respects under the Securities Exchange Act of 1934 over the solicitation of proxies, consents or authorizations, those powers, us we have indicated, are applicable only to a limited group of securities. Furthermore, even in those cases administrative control and supervision need to be implemented so that more effective and pervasive supervision over those who are engaged in such solicitation in these reorganization situations may be had.

This means two things. In the first place, methods must be designed to bring within a system of regulation and control committees presently exempt and immune from any supervision. In the second place, the basis for regulation must be broadened so as to require not only the disclosure of relevant facts but also to eliminate material conflicts of interest and unconscionable practices which may persist in spite of full disclosure.

Such two-fold program entails a separate statute dealing with solicitation of proxies and deposits. Committees acting in reorganizations should be required to qualify under such statute, in lieu of registration under the Securities Act of 1933, as amended, or compliance with the proxy rules of the Commission under the Securities Exchange Act of 1934. Furthermore, exemptions presently provided committees under the Securities Act of 1933, as amended, should be restricted in their application to the new statute. The statute should give the Commission power to require disclosure of all relevant facts concerning such committees. But it should also give the Commission power to refuse to allow committees to use the mails or agencies of interstate commerce to solicit proxies or deposits if it appears that they have interests which materially conflict with those of the security holders whom they undertake to represent. Furthermore, it should give the Commission appropriate power to refuse to allow committees to vise the mails and agencies of interstate commerce in such solicitation, unless the proxies and deposit agreements employed are free from oppressive and unfair provisions and contain restrictions and limitations which experience shows are necessary in the public interest and for protection of investors.

Such administrative control would provide a greater degree of assurance that those who are acting in a fiduciary or representative capacity will be freed from adverse interests and will take unto themselves only those discretionary powers necessary or appropriate for protection of investors. But in view of the fact that committees are not always an essential or necessary part of reorganization paraphernalia, some minimum control over the solicitation of assents to, or acceptances of, plans should be devised. Otherwise, groups or individuals not soliciting discretionary powers but only absents to, or acceptances of, plans

might do all the essential work of reorganization without subjecting themselves to the conditioning influences of such new regulation. This would not be desirable since conflicts of interest may be as important in connection with solicitation of assents as in case of solicitation of proxies or deposits. This condition is apt to be particularly acute in case of voluntary reorganization plans which are freed from scrutiny or supervision by any agency. Furthermore, as we develop more in detail in another part of this report, committees are not a customary or usual part of voluntary reorganization procedures. In such cases, the management commonly solicits assents to plans directly. In view of the frequent appearance of conflicts of interest in such solicitors, a minimum degree of control over solicitation of such assents is necessary. Accordingly, at least in the voluntary reorganization, the same degree of control over solicitation of assents or acceptances should be provided as in case of solicitation of proxies or deposits. Furthermore, as we have indicated above, assents to and acceptances of a plan subject to the jurisdiction of a court or other agency which has power to pass on the fairness of the plan should in general not be allowed until the plan has been carefully scrutinized by the court or agency and its submission to investors authorized.

The various component parts of such a system of regulation and control will be suggested by us in forthcoming reports. That system of control should be sufficiently broad to cover committees operating in connection with foreign debt rearrangements, municipal debt readjustments, voluntary reorganizations and reorganizations in state or federal courts. As a part of that system of regulation and control, we recommend at this time that with respect to all such reorganizations, legislation be adopted which will provide:

1. That standards of full disclosure, such as those set forth in the Securities Act of 1933 in regard to the issuance of securities, be imposed upon the solicitation of all deposits and proxies in connection with reorganizations and that present exemptions from such control be restricted.

2. That the payment of commissions for solicitation of assents to plans, or of deposits with, or proxies or powers of attorney to committees or other representatives of security holders, be controlled for the protection of investors.

3. That deposit agreements be outlawed, except where it may be shown that physical possession of the security is necessary in order to protect adequately the interests of investors; and that the powers contained in deposit agreements, in the cases where their use is authorized, be limited both in duration and in scope to the particular needs of the occasion.

4. That the solicitation of any deposit or authorization be forbidden unless the security holders are given greater freedom of withdrawal or cancellation and

greater protection against assessments and penalties for the exercise of the privilege.

5. That in case compensation and expenses of committees are not subject to supervision and determination by federal or state courts or agencies, deposit agreements or proxies be prohibited which do not contain adequate machinery for independent review or determination of such matters; and that in such cases adequate provisions for periodic accounting by the committee be required.

6. That in general solicitation of acceptances of a plan (whether conditional or unconditional, preliminary or final) be prohibited until the court, or other duly authorized agency, has carefully scrutinized the plan and authorized its submission to investors, except in those cases where the reorganization is not subject to the jurisdiction of a court or agency having such power.

The foregoing recommendations embrace a part of the controls over solicitation which we deem necessary and advisable. Others, relating to conflicts of interests and to an attempt to make those acting in a representative capacity assume the responsibilities as well as the powers of fiduciaries, will be submitted in the near future.

If the foregoing duties and responsibilities are assigned to the Securities and Exchange Commission, the question of the present organization of the Commission as administratively equipped to assume these additional tasks may also be deserving of consideration.