CHAPTER XVII

PROTECTIVE COMMITTEES

This statement was made before the Interstate and Foreign Commerce Committee of the House on June 8, 1937, during consideration of the Lea Bill to regulate protective committees. It summarizes the principal findings of the Protective Committee Study with respect to protective committees and their practices.

There is at present the problem and the necessity of affording to the individual investors of this country protection against a type of abuse and exploitation with which existing legislation cannot cope—the abuses on the part of protective committees in reorganization. That problem is not precisely a new one; but its importance has been given renewed emphasis as a result of the vast reorganization experience born of the depression. The present need for regulation has been more than amply disclosed by recent governmental investigations, including those by a Select Committee of the House, a Special Committee of the Senate, and by the reports of the Securities and Exchange Commission, which in Section 211 of the Securities and Exchange Act was directed by the Congress to undertake a study and investigation of work, activities, personnel, and functions of protective and reorganization committees. [FN 1] At the direction of Congress the Commission submitted in its recent reports a series of recommendations [FN 2] with respect to the regulation of such committees. The facts enumerated in those public records afford a firm foundation for the desirability of and need for the Lea Bill.

The years just past have seen thousands upon thousands of corporate debtors (issuers of millions in securities purchased by every segment of the American public) arrive at the stage where they have been unable to meet their obligations. Often in these cases, liquidation and a distribution of assets to security holders have been impracticable if only for lack of buyers. Often, too, it has been unwise, where sound business judgment pointed out that a hope of greater salvage lay in restoring the distressed corporation to the status of a going concern. This could be accomplished only if its creditors agreed to a moratorium on its debts, or consented to an extensive scaling down of its obligations. And in a thoroughgoing readjustment of its financial structure, fairness and equity required of stockholders that they give up at least as much as the sacrifices called for from creditors. It is this process of extensive financial readjustment, commonly called reorganization, which has given rise to the problems with which the Lea Bill deals.

In these reorganizations the individual investor has come to play an anomalous and insignificant role. In every case it is his investment which is at stake, yet the processes of reorganization have so evolved, or have consciously been so fashioned that he is usually given recognition only when his consent is necessary to the consummation of a plan, whether it be a voluntary plan or otherwise. Even then this recognition has at times been of the most perfunctory kind. In other respects the security holder is largely helpless to help himself, or to join with others in his position in an effort at joint action. The impact of this is felt when we consider the existing obstacles in the way of individual action by the investor. Merely by reason of the fact that he is one of many security holders involved in an intricate, difficult situation, and the fact that his average holdings are small, he cannot undertake the burdensome expense of active participation in court proceedings for reorganization or in the negotiations that lead to a completed reorganization. Apart from the question of expense, which might well cost him more than the value of his investment, the average investor does not possess the training, the experience, or the skill which these complicated problems demand.

The problem of protection of investors in these situations has many angles to it. Part of it relates to the adequacy of the reorganization machinery in the Federal courts to protect investors against the reorganizers. This phase of the program, insofar as reorganizations under Section 77B of the Bankruptcy Act are concerned, is in my judgment adequately covered by the Chandler Bill (House Report 8046) [FN 3] presently before the House Committee on the Judiciary. Another phase of the problem concerns the representative role of the corporate trustee who, all agree, should assume more active duties in defending and promoting the interests of bondholders, noteholders, and debenture holders in these default situations. That phase is in my judgment adequately covered by the Barkley Bill (S. 2344) [FN 4] presently before the Senate Committee on Banking and Currency. Other phases of the problem are covered by the Lea Bill which in conjunction with the Chandler and Barkley Bills presents an integrated and pervasive treatment of the whole, though each bill is independent of the others. The two phases of the Lea Bill which should be noted involve (1) protective committees; and (2) a limited participation by an administrative agency (the Securities and Exchange Commission) in certain types of reorganization proceedings. I will deal with these two phases of the problem in that order.

As I have indicated, the helplessness of the average investor to help himself has led to the necessity or at least the desirability of some kind of group action. This need has been supplied usually by protective committees. These committees are usually composed of three or more individuals, though occasionally a corporation has served as a committee. These committees may be formed as a result of meetings of security holders. This is rather uncommon. They usually have come into being, self-constituted and self-appointed, with an announcement of program and purpose and with a plea to security holders for support. Their sponsors are

usually the management of the debtor company and its investment bankers, not security holders or their authorized representatives. [FN 5] These committees may merely communicate with security holders without attempting to obtain powers of attorney from them. Customarily, however, they seek a power of attorney. This may be in the form of a revocable proxy or in the form of an irrevocable deposit agreement. The proxy is a simple instrument listing such specific or general powers as the committee desires or deems useful or necessary; the deposit agreement is a more complicated instrument. Usually deposit under the deposit agreement means loss by the security holder of effective control over his securities as well as a grant of broad powers from him to the committee. [FN 6]

Within this broad framework committees have operated. They have had important functions to perform, although committees are, in many situations at least, not necessary parts of the reorganization paraphernalia.
These functions can be outlined briefly. [FN 7] For one, united action on the part of investors is sometimes necessary, under the provisions of trust indentures, in order to induce action, such as foreclosure, by indenture trustees for the protection of bondholders. Experience and investigation have shown that recalcitrant, inactive trustees need the spur of a vigilant committee, representing substantial numbers of bondholders, if such trustees are to be made to take steps for their protection.

Again, the mobilization of security holders is necessary if they are to exercise a continued and careful scrutiny over the administration of the debtor in those cases where receivership or bankruptcy occur. Another function is the investigation and enforcement of claims against managements and their affiliates, with the consequence that assets may be added to the estate and all security holders aided. There may also be claims running to security holders individually which result from misrepresentations in the original sale of the securities. Committees may perform this signal function at much smaller cost than could individual investors, thoroughly investigating these claims, and laying the basis for their enforcement. Or there may be certain types of class suits which committees can bring.

Further, in the negotiations and compromises over the terms of the readjustment that are an indispensable part of all reorganizations, committees have in the past been able to supply a service which scattered, disorganized, security holders could not undertake because of its complexity, difficulty, and time-consuming nature. In these negotiations the aid of experts, engineers, attorneys, and the like, may be needed; only group action made it possible in many cases to put such facilities within the reach of the average security holder.

It is the function, also, of committees, able to commandeer expert knowledge, to subject all plans to critical appraisal and examination from the point of view of, and in the interests of, the security holders whom they ostensibly represent. And, since confirmation of a plan of reorganization, in the last analysis, depends on the consent of the creditors and stockholders, it is the function of committees to marshal consents to proper plans, and lead opposition to those believed to be unfavorable to the class of security holders for whom they are acting.

I have mentioned above the fact that customarily committees have been sponsored by the management of the debtor company or by the investment bankers, not by security holders or their authorized representatives. This has been due to several circumstances. [FN 8] Over and above the inertia and lack of leadership among investors is the fact that if the individual security holder attempts to organize his fellow investors, he will find himself faced at the outset with an insuperable obstacle. He does not know who are his fellow investors, nor can he find out. The lists of security holders are the exclusive possession of the debtor or of the investment bankers for the debtor, and in the main they will deny access to these lists or their use by the individual security holder. Furthermore, they have had inside knowledge of impending default and so have prepared in advance of public announcement of default a solicitation campaign in support of their own committees. The result has been that they have been first in the field with all of the advantages which that means. As a consequence the debtors (which, in any realistic sense, means the corporate management) together with the investment bankers for the corporation have been able to control the effective formation and operation of protective committees. The individual investor has had little choice but to throw in his lot with committees sanctioned and sponsored by banker-management groups. These groups have been able to prevent the effective operation of committees by others; and they have been able, out of motives and for purposes on which I shall enlarge, to set up their own committees and in practical effect to dominate the vehicles supposedly representing the security holders.

I cannot emphasize too strongly that committee members are fiduciaries. As such they owe exclusive loyalty to the class of investors they represent. They owe that class diligence, efficiency, and single-minded devotion. But these fiduciary standards have been frequently flouted to the ultimate detriment and distress of countless numbers of investors. This condition has prevailed, not exclusively in case of management-investment banker committees, but conspicuously in such cases. In the welter of conflicting interests, ulterior objectives, and self-serving actions which flow from investment banker-management dominance over committees, these committees have lost sight of their essential functions which they can perform to advance the interests of investors.

There are two aspects of the manner in which committees have violated these fiduciary standards. The first relates to conflicts of interests; the second to the exercise of the fulsome powers which committees have taken unto themselves.

1. Conflicting Interests. [FN 9] As to conflicting interests, the Lea Bill supplies an effective check to the conditions described in our reports. It provides some assurance that those acting in fiduciary and representative positions will be free from conflicting interests. The Securities and Exchange Commission has pointed out at length in its reports the evils and abuses that have flowed from the disregard and violation of this fiduciary principle. The manner in which these conflicts have inhibited proper performance by committees of their functions can be best illustrated in case of committees dominated by the management [FN 10] and the investment bankers.

Where committees have been dominated by such groups, the question of legal responsibility of the management for its acts of omission and commission has rarely been raised by those committees. Though assets may be brought into the estate by the investigation and enforcement of all claims against officers and directors, it has obviously been to the self-interest of managements to resist their assertion and enforcement. This they have been able to do by virtue of the control they have obtained over protective committees. Again, although in many cases no legal responsibility can be spelled out against existing officers and directors, their conduct of the corporation's affairs has been so reckless or so inefficient as to justify the installation, in whole or in part, of a new management. On the other hand, it is to the self-interest of the management to stay entrenched in the business, for the sake of fees, salaries, and bonuses which come to them from their positions, and for the other important patronage which can be dispensed to their affiliated interests. Incompetence and questionable activities on the part of officers and directors will tend to be a closed book if the management can control the protective committees in the situation. [FN 11] As a result, the very causes of failure are often perpetuated in the new and reorganized business. The searching investigation of management that is of primary importance in every reorganization is blocked and prevented. The harm to security holders from such practices is incalculable. The only remedy is to insure, so far as practicable, that persons with such conflicting interests are not members of, and do not control, protective committees.

Adverse interests have frequently arisen also because of the connection of investment banking firms with reorganizations. [FN 12] They, together with managements, have had a virtual monopoly over security-holder lists; they have had inside knowledge of impending defaults; they have had great familiarity with the techniques and strategy of reorganization. These, and other factors, have given them a position of dominant importance in the processes of reorganization. Though they have explained their participation in terms of the "moral obligation"

which they profess toward those who purchased defaulted securities from them, the Securities and Exchange Commission's investigations and reports have demonstrated that this obligation is more often than not merely an excuse for the investment banker to be active in the situation.

Their active participation in reorganization has been rife with conflicting interests. Their control or influence over protective committees, though shared with the management of a corporation, inevitably leads to the suppression of claims which may exist against both. The diligent investigation into the possible misrepresentation and fraud in the sale of securities, which I mentioned earlier as a notable function of committees, goes by the board when committees are subject to the influences of the very persons who sold those securities. Further, the very close connections between the investment bankers and the management have led to mutual support in the perpetuation of their positions. Partners in the banking houses are frequently directors of the corporation. Often, too, they are a part of the management, though they or their representatives hold no official position as officers or directors. The management's liabilities may frequently be their liabilities also. And just as in the case of managements, so do investment bankers desire to continue their connections with the company for the sake of the emoluments to be derived from such connection. The latter means to the underwriter getting the business of originating and distributing the corporation's securities, inside information on the course of its business, profitable market operations, and a veritable host of other business patronage. In sum, if control of the corporation is shifted to the new group, the prospect, apart from liability for past misconduct, is one of loss of future profits because the banker's connection with the corporation has not been continued.

Then, also, underwriting houses may have an existing financial stake in the securities of the corporation, in the form of outstanding short-term credits, or securities of the corporation other than the securities which committees controlled by them ostensibly represent. Their self-interest in such cases has made them poor fiduciaries. [FN 13] Through control over committees they have been able to reduce the risk that such claims would be excluded from the reorganization plan, or in other ways given treatment which they consider unfavorable. Over and above all else is the desire to "save face," a factor which in my judgment has done more to produce unsound reorganization plans than any other single factor.

All these factors combine to make the representation on, and control over, committees by houses of issue an undesirable, and in many ways, a definitely harmful practice. This observation is equally applicable to all types of reorganization situations whether foreign or municipal debt rearrangements, voluntary readjustments, or reorganizations in court proceedings.

The foregoing conflicts of interest are largely *sui generis* so far as the management and the houses of issue are concerned. There are others which are applicable to all types of committees. Thus not infrequently stockholders are found serving on bondholders' committees and bondholders on stockholders' committees. The result has been that the pecuniary self-interest of the committee members has been opposed to the pecuniary interests of the beneficiaries of these trusts. As a consequence representation by the committee has not been vigilant and aggressive in the cause of the security holders. The loyalty of the committee has been diluted by the incentive to serve their own selfish ends first.

Further, members of the committee have at times acquired their securities at such low prices as to create a grave conflict of interest. A committee which has purchased bonds at 10 cents on the dollar can make 100 per cent profit by effecting a settlement at 20 cents. But investors who had purchased at or near par would under those circumstances be suffering grave losses.

Out of such circumstances are serious conflicts of interest born. These are merely illustrative. They indicate the nature of one important problem with which the Lea Bill deals.

2. Activities of Committees. One type of conduct by committees and their affiliates which has resulted in injury to security holders is trading in the securities of the corporation undergoing reorganization. [FN 14] By reason of inside information, committee members have frequently been able to profit from their position of trust by buying or selling securities. This practice has permeated the whole field. It has been incompatible with the ancient standards for trustees. But committees have attempted to legalize it by virtue of contractual provisions in their deposit agreements, whereby the depositing security holders are presumed to waive the legal disabilities which the committee members otherwise would have.

Another serious departure from fiduciary standards has been common in connection with the charges for fees and expenses of protective committees. [FN 15] By and large, committee fees constitute a substantial source of revenue; they may at times be the major motivation in the organization of committees. The-striking fact has been that, with such exceptions as allowances under Section 77B of the Bankruptcy Act, committees have been able to fix their own fees, without independent supervision or review. They are themselves the arbiters of the value of their own services. This shocking lapse from the standards of fiduciaries would no longer be possible under the Lea Bill.

Another phase of committee activities which requires thoroughgoing regulation is their solicitation practices. One item of this is the use of paid solicitors in the marshaling of assents to plans, or the solicitation of proxies or deposits

authorizing the committee to act generally on behalf of the security holder. Special solicitors employed on a commission basis contact security holders; almost inevitably this practice results in "high pressure" tactics. In other ways, too, pressure is frequently exerted on uninformed investors, as, for example, by threats of discrimination and undesirable consequences if they fail to assent or deposit their securities with a committee. A catalogue of tricks and dodges utilized by committees to exert pressure upon security holders is set forth in the recent reports of the S.E.C. to the Congress. [FN 16] I will not stop at this point to relate these; it suffices to emphasize again that they involve innumerable departures from the proper standards of conduct for fiduciaries. These standards the Lea Bill will enforce, and security holders would under it be relieved of the indefensible pressure tactics of committees.

Another source of oppression of investors is the one-sided contract known as the deposit agreement. [FN 17] These are complicated documents which the average investor would rarely understand even if he saw one, which he seldom does. These agreements fix the authority and the powers of the committee. Since they are prepared by committees and their counsel, their terms inevitably give to the committee almost complete dominion over deposited securities and at the same time immunize them from any real responsibility. But there is no mutuality in these agreements. The security holder, once he deposits his bond or stock with a committee, finds withdrawal either impossible or difficult and expensive. By and large, committees through the vehicle of deposit agreements exercise an arbitrary power over the investor's right to withdraw, and over every other right that the investor would otherwise possess by reason of his ownership. For example, a committee controlled by a house of issue may succeed, if it obtains deposit of securities, in effectively cutting off rescission rights of depositors. The form and content of such agreements and the occasions for their need must be carefully regulated in the interests of the investor rather than of the committee. Too long have they been employed as instruments of oppression.

Such conditions as I have enumerated have not been isolated and infrequent—they have been persistent and widespread and of a truly national nature. They have permeated the whole reorganization field from real-estate cases to foreign-debt rearrangements. They have meant that the functions of protective committees have been perverted if not destroyed. As a result, the investor has been at the mercy of self-constituted and self-appointed committees whose objectives are frequently incompatible with the objectives of investors. They are interested in concealing claims for fraud or mismanagement; investors are interested in collecting on those claims. They are interested in keeping the past a closed book; investors are interested in examining the past to determine whether or not the management has been so incompetent or faithless as to be discharged rather than restored to power. They are interested in reorganization profits; investors are interested in economy and fairness. They are interested in effecting

a reorganization which will "save face" for them; investors are interested in thoroughgoing reorganizations. For such reasons, the interests of reorganizers and the interests of investors are often incompatible.

Existing law is not adequate to deal with these situations. Large numbers of protective committees do not come under any regulation or control. So far as the states are concerned, few adequate controls exist; and in view of the interstate complexion of most protective committee activities, intrastate control is of necessity limited in effectiveness. The solicitation of proxies, deposits, and assents, by use of the mails and of agencies of interstate commerce, is likewise free of regulation to a great degree. Existing federal control and supervision over such solicitation are both limited and inadequate.

At the present time some committees are required to register under the Securities Act of 1933, as amended, but such registration requirements are applicable, by and large, only to committees seeking deposits of securities. Committees which seek powers of attorney or proxies are, by and large, exempt from that Act. This result flows from the fact that only in some circumstances are proxies so constituted as to come within the definition of "security" under that Act. Nor is the application of the registration requirements at all pervasive in the case of committees seeking deposit of securities, by reason of the many exemptions of which protective committees may avail themselves under the Act. For example, under section 3(a)(2) of the Securities Act there is included within the category of exempted securities the certificates of deposit for any security issued or guaranteed by any state or by any political subdivision of a state. This means that the Act cannot be brought to bear upon committees acting for the holders of municipal obligations, committees which, as indicated in Part IV of the S.E.C.'s report to the Congress, are sorely in need of regulation. Similarly, the disclosure of full and material information from many other types of committees has been inhibited by the exemptions provided in section 3(a)(10) of the Securities Act. Under this provision certificates of deposit receive an exemption where the terms and conditions of their issuance and exchange for outstanding securities are approved by any court, or official or agency of the United States, or other governmental authority expressly authorized by law to draft such approval. My observation is that too frequently such approval has been *pro forma*. Courts, overburdened and unacquainted with technical details of these situations, have not afforded the measure of scrutiny to be desired. They have not been given a sufficiently specific and adequate standard against which to apply the legislative mandate. Further, under section 3(a)(9) of the Act, solicitation activities on the part of corporate managements seeking to effectuate so-called voluntary plans for reorganization may be free of desirable requirements for full and adequate disclosure. Furthermore, the power of the Securities and Exchange 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, while the powers of the Commission over committees under Sections11 and 12 of the Public Utility Act of 1935 extend only to securities and reorganizations of registered holding companies and subsidiaries thereof.

This brief examination of the narrow scope of existing Federal regulation over the solicitation of proxies, deposits, and assents indicates the first conclusion to which the Commission was led in its study and investigation of protective and reorganization committees under Section 211 of the Securities Exchange Act of 1934. (1) In the first place, the present controls must be given a broader base. Methods must be designed to bring within the Federal system of regulation and control the many committees presently exempt and immune from any supervision. In practical operation, it is our belief that this can be best achieved by an extension of the presently limited supervisory power of the Securities and Exchange Commission. But this step alone will not suffice. (2) Even where the Commission today possesses jurisdiction over the solicitation activities of committees, its powers need to be strengthened materially. This will be equally true in the event of the extension of the Commission's present jurisdiction. Its administrative control and supervision needs to be implemented so that more effective and pervasive supervision over those who are engaged in such solicitation may be had.

This is necessary because if committees are made to meet merely registration requirements they will be forced to disclose only the truth as to their organization, and affiliations, and their plans. But in reorganization situations mere disclosure is hardly sufficient for the protection of investors. To the ordinary prospective purchaser of securities disclosure of the pertinent facts surrounding an offering is of great value, since by and large he may buy or not, as his whim or judgment indicates. But upon default investors in these reorganization situations, for the most part unorganized and to a great extent incapable of self-help, have little freedom of choice. Their only choice, and it is not a real one, is to go along with those who by virtue of long tradition and practice in corporate reorganizations have come to possess dominance over the organization and operation of protective committees, or to proceed by themselves. The latter course is a futile one. Hence the investor is in effect forced to throw his lot in with those who, self-constituted and self-appointed, announce themselves as his protectors. Disclosure of all the pertinent facts concerning the committee will be of small comfort to the investor; his choice is hardly expanded though he knows that those who control the destiny of his investment are incompetent or faithless fiduciaries. In other words, the basis for administrative regulation must be broadened so as to require not only the disclosure of relevant facts but also to permit some restraint on the conduct and activities of committees and some check on their personnel at the time of their formation and during their existence. There is required the power to refuse to qualify as committees those who have

palpably conflicting and adverse interests. There is need to curtail and restrict in the public interest and for the protection of investors the powers which committees may take unto themselves, and the unconscionable practices which may persist in spite of full disclosure. This is not a wholly new departure for congressional action. The beginnings of such type of control over committees are to be found in Sections 11 and 12 of the Public Utility Holding Company Act of 1935 where the Commission is given powers to make rules and regulations governing the solicitations by committees and others in case of registered holding companies and subsidiaries thereof. With the benefit of the rich experience born of the depression and of the experience under the present statutes, a broader program should be undertaken.

Such a program should be built on the firm foundations of the other Acts. It should be envisaged as an evolutionary development of present controls, not as a radical or revolutionary development. It entails a separate statute dealing with solicitation of proxies and deposits. Such a statute is conceived as an extension and evolution of the regulatory acts now administered by the Securities and Exchange Commission. Committees acting in reorganizations would be required to qualify under such statute, in lieu of registration under the Securities Act of 1933, as amended, or compliance with the pertinent provisions of the proxy rules of the Commission under the Securities Exchange Act of 1934 or comparable rules under the Utility Act. Furthermore, exemptions presently provided committees under the Securities Act of 1933, as amended, would be restricted in their application to the new statute. This system of control must be sufficiently broad to cover committees operating in connection with voluntary reorganizations, foreign debt rearrangements, municipal debt readjustments, and the solicitation of proxies, deposits, and assents by use of the mails or agencies of interstate commerce in connection with reorganizations in state or Federal courts.

Such administrative control would provide a greater degree of assurance that those who are acting in a fiduciary or representative capacity will be free 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 assents 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 [FN 18] which are free from scrutiny or supervision by any agency. Furthermore, 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, 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.

In summary, such a statute would give renewed emphasis to the fact that representatives of security holders in reorganizations occupy a fiduciary position. The standards of fiduciaries require that neither they nor their lawyers should possess dual or multiple interests. Likewise, they require that neither committees nor their lawyers should be permitted to be the sole arbiters of the value of their services to security holders. Such a statute would eliminate the abuses which have characterized the strategy and techniques of reorganization. It would not permit the use of deposit agreements in oppressive and undesirable ways. It would break the virtual monopoly which the inside groups made up of bankers and managements have over lists of security holders. It would control high pressure salesmen, so that security holders would be assured of an honest and complete portrayal of all material facts affecting their investment. In other words, it would give investors protection on a national scale against the abuses which the recent depression has portrayed in such flagrant fashion.

Participation in Reorganization Proceedings by the Securities and Exchange Commission

Control over the reorganization process in the interests of investors entails more than the foregoing supervision over committees. Some strengthening of the reorganization proceedings themselves is necessary. Insofar as reorganizations under Section 77B are concerned, the Chandler Bill makes significant and noteworthy reforms. Some elements of those types of reform are needed in other counterparts of the reorganization system. They are appropriate to incorporate in an amendment to the Securities Act of 1933, since they pertain to the power and functions of the Securities and Exchange Commission.

The present reorganization system is composed of a variety of procedures. In the first place, many different sorts of debtors utilize that system. It is not only the industrial, real estate, utility, and commercial corporation which has sought reorganization. Many municipal corporations have endeavored to work out debt rearrangements. [FN 19] Numerous foreign governmental obligations, widely held by American investors, have gone into default and these have needed

readjustment. [FN 20] In the second place, the methods and techniques of reorganization have varied widely. The hard-pressed domestic corporation may seek a haven in equity receiverships or the bankruptcy courts, and thereby stay the efforts of creditors to collect upon their individual debts while the effort at over-all readjustment goes on. Or while yet able to meet their obligations, domestic corporations have sought to forestall impending receivership or bankruptcy by effectuating so-called voluntary plans of readjustment. [FN 21] In the case of domestic corporations, these voluntary plans may run the gamut from mere moratoria, primarily affecting claims of creditors, to consolidations, mergers, and sales of assets, primarily affecting stockholders. The latter have been made possible (if security holders consent in sufficient numbers) by corporate-charter or trust-indenture provisions, or by statutory authority granted by the debtor's state of incorporation.

From the standpoint of regulation of security holders' committees, these *voluntary* reorganizations present an anomalous situation, for it frequently happens that no committees appear in such reorganizations. The plan is commonly formulated by the management and bankers of the corporation, and is directly submitted by them to the security holders for their assent. In such circumstances, some minimum control over the solicitation of assents or acceptances by the debtor corporation is necessary. And even more important is the fact that such voluntary plans are not subjected to any scrutiny or review as in the case of reorganizations in the Federal courts. The management alone is the arbiter of the fairness of the plan. As a consequence, great inequities have been done to security holders. A management, heavily interested in the common stock, has foisted on the preferred stock by means of divers threats and practices, plans of readjustment which have been unfair and inequitable. A management, faced with the dire threat of being ousted from power by means of receivership or bankruptcy, has by high-powered tactics and by transforming the company's treasury into a war chest, coerced senior claimants into receiving junior interests. These and like cases have been of frequent occurrence in the voluntary field. State corporation laws afford little protection to investors. Those who dissent may obtain a rather tenuous appraisal right. They may, if they have adequate funds, resources, ingenuity, and perseverance, be able to obtain injunctive relief from the courts. But there is no large or substantial measure of protection in these ways. The states have provided no system of administrative supervision over those readjustments. And it is unlikely that they can effectively do so, in view of the orgy of competition among the states for the corporate business.

These are compelling reasons for a Federal administrative agency such as the Commission to assume a more important role in such cases. A signal and important function, however, which such an agency may perform in this type of case, is to undertake for the benefit of investors (or at least to have the power in necessitous cases to make) a careful scrutiny and examination of the plans

which managements and bankers seek to have consummated. At least a modest advance toward this objective can be made by vesting such power, if not the duty, in the Securities and Exchange Commission. As I have said, the investor in this type of case lacks the protection which an honest and qualified protective committee might give him; and since the reorganization takes place out of court, he lacks the protection ordinarily supplied in some measure in judicial reorganizations by the judge's scrutiny and approval of submitted plans of reorganization. The ordinary investor, left in such cases to his own devices, has been easy prey for self-seeking managements and bankers. Administrative review of these plans in the form of reports to security holders on them can go far toward amelioration of that prevailing condition.

This recommendation is equally applicable to reorganizations in the courts, even though protective committees participate actively. In the last analysis, however worthy and necessary are the other functions which I have already enumerated, the ultimate objective of most protective committees' activity should be the accomplishment, expeditiously and economically, of fair and equitable plans of reorganization. In the achievement of this objective, the assistance of a qualified administrative agency can be of enormous service, both to the courts and to investors.

This administrative assistance, as I have just said, should take its most important form in the work of preparing advisory opinions on the merits, the fairness, and the feasibility of suggested plans of reorganization. Apart from so-called voluntary plans, the work of preparation of such plans; the arm's-length negotiations over their terms between representatives of conflicting classes of securities; the "trading-out" of disputed claims —all these repose traditionally in the hands of security holders and their representatives. In another connection, *i.e.*, the Chandler Bill, the Commission has recommended that an officer of the court, an independent trustee, be made an active participant in these processes in order to supply to them the presence of a disinterested, objective guardian of the interests of all the security holders. That is a matter which goes beyond the scope of the Lea Bill. But it seems altogether consistent with the purposes of the Lea Bill to make provision for the close and careful scrutiny and examination of reorganization plans—the end product of any committee's activities—in order to supply a double-barreled assurance that committees have done their work effectively and honestly.

It is only after an objective determination of the merits of a plan that it can be said that a reorganization has or has not fulfilled its purposes. The identical determination is the decisive factor in deciding whether or not protective committees have sufficiently performed the functions which give them their only excuse for being. In this way the administrative analysis of plans and advisory reports thereon would give to investors increased assurance that their

representatives have or have not done their work well; it would give them also protection at the stage when protection is most sorely needed; *i.e.,* before they are compelled to vote upon the plan.

In those cases where reorganization takes place under the aegis of a court, provision for such administrative assistance should be of immeasurable benefit to the courts also. For the growing need for such administrative assistance is the result, from another angle, of the flood of reorganization cases which engulfed the courts in the period of the recent depression. They made unprecedented demands upon the experience, skill, and judgment of judges in complex and intricate financial and business matters. Judges, however, are not, and do not profess to be, financial experts. However great their legal training and native intelligence, they are not always in a position to discharge completely the responsibility which is theirs, to see that only those plans are approved and consummated which are fair in their allocation of assets and earnings and which, among other things, give adequate assurance that honest and competent management will assume control of the reorganized company. This is not to say that the courts have done an inadequate job; frequently they just do not have the necessary time to spend on these complicated questions. Rather, an even better job than they have done could be accomplished if they could avail themselves of expert administrative assistance in unraveling the intricate complexities of the many financial matters that enter into every plan of reorganization for larger corporate enterprises.

Such assistance would not usurp power from the courts, but it would strengthen and implement them in the performance of their onerous and burdensome reorganization functions. Such reports would deal with the fairness and equity of the treatment accorded to various classes of security holders and claimants by the terms of the plan, and the adequacy of the steps taken to discover, disclose, and collect all assets of the corporation or of individual security holders. This would include all causes of action against officers and directors of the corporation and the underwriters of its securities. Such reports could treat also of the reasonableness and propriety of the fees and expenses of the reorganization; and would examine carefully into the provisions made in the plan for the management of the reorganized corporation in order to ascertain whether such provisions are in the interests of the security holders. It could examine into any other material and significant phases of the plan.

A similar provision is embodied in the Chandler Bill, of which I made mention earlier. That provision, however, deals only with reorganizations under Section 77B of the Bankruptcy Act. A large area of such administrative assistance may remain in Federal equity receiverships, a field equally deserving of attention and in the past, equally, if not more, susceptible to the abuses which I have already discussed. The two provisions need to be carefully integrated, and, in

combination, should effectively cover all occasions on which there is resort to any Federal courts in the course of effecting a reorganization. In addition, should a state court or agency wish of its own initiative to call upon the Commission for its aid in the scrutiny and analysis of reorganization plans, provision should also be made empowering the Commission to render advisory reports when it is requested to do so by such state court or agency.

As a companion measure, the Commission should be given the power to intervene in reorganization proceedings, so that as a party in interest it could perform additional advisory functions in the courts. [FN 22] There have been in the past necessitous cases where throughout the whole proceeding security holders have not had the benefit of able and disinterested advice and representation. That is to say in many proceedings there has not been an articulate, well-informed investor point of view. The Commission on intervention would not be representing any particular class of security holders. It would be present in the case in the public interest and in the interest of investors to see that unfairness or inequity was not done, that honesty in administration took place, and that reorganizes were not engaged in exploitation. The right of the Commission to intervene and to be heard on all phases of many of these cases would, in my judgment, supply a conditioning influence over the whole proceeding and supply the court with counsel and advice which in many cases have been sorely lacking.

In conclusion, the existence of widespread and persistent abuses in the reorganization field calls for vigorous and aggressive action—action as constructive and as progressive as that which produced the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935. There is such a national investor interest at stake in these reorganizations that mild or temporizing remedies will not suffice. The necessary reforms call for revisions in the present system along the evolutionary route made apparent by the experience of the last four years.

[FN 1] "Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees." The various parts of this report are listed above at page 172.

[FN 2] S.E.C. Report, Part I, at 903-907; Part II, at 528-534; Part V, at 738-741: Part VII, at 412—415.

[FN 3] Enacted June 22, 1938 (Public No. 696—75th Congress, 3d Session).

[FN 4] Enacted August 3, 1939 (Public No. 253—76th Congress, 1st Session).

[FN 5] S.E.C. Report, Part I, at 341 *et seq*.

[FN 6] S.E.C. Report, Part I, at 585-670.

[FN 7] S.E.C. Report, Part II, at 1-8.

[FN 8] S.E.C. Report, Part I, section ii; Part III, section ii; Part IV, at 67-73.

[FN 9] S.E.C. Report, Part I, section i; Part II, *passim*.

[FN 10] S.E.C. Report, Part II, section ii.

[FN 11] S.E.C. Report, Part I, at 157-160.

[FN 12] S.E.C. Report, Part II, section iii; Part III, section iv.

[FN 13] S.E.C. Report, Part II, section v; Part III, section iv.

[FN 14] S.E.C. Report, Part II, at 315-351; Part III, at 132-152.

[FN 15] S.E.C. Report, Part I, at 195-210; Part II, 351-394.

[FN 16] S.E.C. Report, Part I, at 457-485.

[FN 17] S.E.C. Report, Part I, at 585-670.

[FN 18] S.E.C. Report, Part VII, section vi.

[FN 19] S.E.C. Report, Part IV, section iii.

[FN 20] S.E.C. Report, Part V, section i.

[FN 21] S.E.C. Report, Part VII, *passim*.

[FN 22] The Commission now has this power, subject to the approval of the court, in proceedings under Chapter X of the amended Bankruptcy Act.