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ADDRESS

of

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SOME PROBLEMS OF REORGANIZATION, READJUSTMENT
AND RECAPITALIZATION.

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In addressing myself to the title "Some Problems of Reorganization, Readjustment and Recapitalization", I do not propose to discuss the broad problems of financial policy which should guide in the formulation of reorganization plans. I wish to talk to you today not of the aims of reorganization, but of the technique, and of the impact of our Commission's present and prospective legislation upon that technique. I want to explain to you the effect of our present laws upon reorganizations, to point out to you some of the defects in the system of controls now in force, and to describe to you a few of the ways in which we hope, with the aid of further legislation and with your cooperation, to bring about a clearer understanding of the proper functions and responsibilities of corporate management in protecting the interests of the investor in reorganizations.

The Securities and Exchange Commission administers three statutes: the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935. With the two latter Acts we have here no great concern; the Holding Company Act deals with the affairs of electric and gas utility holding companies and their subsidiaries, and the Securities Exchange Act deals primarily with the listing of securities on exchanges and with the practices of security traders. The problems which you may meet under the latter Act will arise only if your securities are listed on an exchange, and will be largely limited to the mechanical problems of insuring continuance of listing during and after reorganization, and to compliance with the Commission's proxy rules. The Act which may apply at one or another point in every reorganization, and without careful attention to which no reorganization should be projected, is the Securities Act of 1933.

In outline the Securities Act is very simple. Broadly, it says two things. The first is that no one shall sell securities by fraud of the common or garden variety - the kind of fraud which in every civilized country puts the unscrupulous behind the bars whenever they can be caught. In so saying, the Securities Act says no more than society and the law have said for centuries. It merely codifies the prohibition, and charges a Federal agency with enforcing it.

The second aim of the Securities Act is more novel. Even those of you who are not lawyers have heard of the old legal principle of "caveat emptor" - "let the buyer beware". That was all very well in a simple civilization, where commerce largely consisted in the sale of things which could be seen, touched, tasted, smelled, and generally tested out by the buyer as easily as by the seller. The buyer who failed to examine his purchase before putting down his money couldn't complain if he found afterwards that he had bought a pig in a poke. But in the business of selling such extremely intricate merchandise as securities the old rules of responsibility no longer make sense. The growth of industrial capitalism has resulted in an increasing necessity for industry

and trade to finance their operations with the money of the public at large, and a concomitant necessity for the worker to find some way of employing his savings other than in his own business. When the owner of a complex business proposes to expand, and raises the necessary money by the sale of securities to people who need an investment but live perhaps thousands of miles away, and who would lack the equipment to analyze what they were getting even if they could see the plant and go over the books, it is clear that the old equality of buyer and seller is gone, and that a rule predicated on equality, if still enforced, is merely a rule relieving the seller of responsibility for disclosing facts which he alone can know.

The Securities Act, then, in its second branch, embodies a recognition of a duty not imposed at common law, but made necessary by modern conditions. Under this Act it is not enough to refrain from telling lies in selling your securities; you must also take active steps to disclose to the public the basic facts about your business which the buyer has no practical way of learning except through such disclosure. If you don't tell the whole story, you, rather than the buyer, must beware; but if you do, then you and the buyer are on the equality which gave rise to the old rule, and if the buyer makes a mistake in judgment it's his own hard luck.

Thus we have the paraphernalia of the Securities Act: registration statements, prospectuses, exemptions, deficiencies, stop orders - undoubtedly a complicated mechanism to the layman, or even to the lawyer, unless he is well versed in the work, but all directed to the one point: when you are trying to bring the public into your enterprise you must tell the public everything about your enterprise that a reasonably intelligent man would need to help him decide whether he wanted to come in.

As I have thus described the effect of the Securities Act, it has apparently little to do with the readjustment of outstanding securities by reorganization or recapitalization. Such operations do not involve bringing the public into a new enterprise, and presumptively the man already in an enterprise, as stockholder, bondholder or the like, is in a better position to know what is going on than the prospective investor who is asked to come in for the first time. But with the growth of the modern system of investment this presumption too has become outmoded: just as the small investor can't be expected to do his own investigating when asked to purchase securities, so he can't be expected to keep himself fully and adequately informed of current affairs after he has joined the enterprise. What can the thousands upon thousands of stockholders of the modern giant corporation know about the ramifications of their business, and how could they be expected, from their own knowledge and by exercise of their own powers of investigation, to appraise the necessity of reorganization; or to evaluate the merits of a plan of readjustment submitted to them for acceptance or rejection? Yet theirs is the money which makes the enterprise go, and theirs are the interests being reorganized. Here, no less than in new financing, then, we find the need for a more modern standard of business morality, calling for full and truthful disclosure by companies or committees seeking to persuade

investors to waive their rights or to accept new rights in place of old; and to meet this need, the Securities Act extends the duty of registration to include cases which involve no new financing, but merely readjustment of outstanding issues. Subject to certain exemptions in situations where the presence of other safeguards may reduce the necessity for registration, registration is required in any reorganization involving the "sale" of a security. The term "sale" as defined in the Securities Act is a broad one, including not merely the sale of securities for cash, but such activities as the solicitation of deposits of securities with protective committees, and the offering of new or modified securities in exchange for outstanding issues. A wide variety of activities not thought of by the man in the street as involving "sales" may fall within the statutory definition, and may call for registration with the Commission.

Why, then, do I question the adequacy of the Securities Act as an instrument for dealing with reorganizations?

In the first place, I am concerned with certain mechanical difficulties encountered in applying the procedure of the Securities Act to the specialized problem of reorganizations. In a very real sense I think it may be said that the application of the Act to such problems is an accidental accretion of jurisdiction. Not that the framers of the Act didn't know what they were doing; they had an acute sense of the needs of the "investor in reorganization". But their main purpose was to establish standards of disclosure in new financing and their mechanics were specifically adapted to that end. For example, having in mind new financing the framers provided that the issuer alone could sign a registration statement, and exempted from restriction persons other than the issuer and underwriters and distributing dealers. Since the issuer alone can sign a registration statement, no registration can be required until there is an issuer in being. Consider the result. Suppose two corporations proposing to consolidate into a new corporation, having a new capital structure, with entirely different rights and priorities as between the several classes of securities. Each corporation must go to its stock holders and procure their consent to the plan. Proxies are secured, the vote is taken, the plan is approved and becomes binding on the stockholders, the requisite papers are filed with state authorities, and then, and only then, there comes into existence the legal being which alone can file a registration statement setting out the facts the security holders should have had when asked to consider the plan. If a statement is then filed, the only protection which the Securities Act purports to afford - the protection of adequate disclosure - is afforded at the point of time where its utility is least. And that is not all; the Act by its terms applies only to "sales" of securities, and the ordinary submission of a proposed plan of consolidation or recapitalization is not a "sale" of securities as that term is used in the Act. In many such cases the entire program may legally be consummated without any regard whatsoever for the disclosure requirements of the Securities Act.

Secondly, you will recall that I referred just now to certain exemptions from the necessity of registration under the Securities Act in cases where it might be thought that other safeguards were present which made registration superfluous. Time will not permit me to go into detail in describing these provisions. Broadly, they exempt two types of reorganizations: (1) reorganizations involving voluntary exchanges with existing security holders exclusively, where no new cash is put up by the security holders and where no commissions are paid to agents or others for soliciting the exchange; and (2) reorganizations under Section 77B of the Bankruptcy Act, or in other proceedings where the fairness of the plan is approved, after due notice and hearing, by a court or quasi-judicial administrative body. In the former case, where the investor is not called upon to put up any new cash, and where a condition of the exemption protects him from the blandishments of high-pressure reorganization salesmen, I suppose it was felt by Congress that the need of the security holders for adequate and detailed information regarding the corporate affairs might well be outweighed by their interest, in common with the issuer itself, in speedy and economical readjustment. In the case of court reorganizations, apart from the general undesirability of providing for duality of control between court and Commission without a preliminary study of the problem to determine a sound allocation of functions, it was undoubtedly believed that the supervision of a court in reorganization proceedings would afford to security holders a protection at least as well adapted to their needs as a registration statement and prospectus under the Securities Act. Although I naturally have no statistics on the point, I think it probable that the number of reorganizations involving registration and the use of a prospectus is greatly exceeded by the number carried through in such a way as to come within some one of these exemptions, and thereby avoid registration with the Commission.

Yet can it fairly be said that the alternative safeguards supposed by Congress to exist have really proved their merit? I doubt it. Experience has shown, I think, that an inequitable reorganization can be put through by reason of security holder ignorance or impotence even though no batteries of glib salesmen are employed to puff the plan, and no brokers are subsidized to advise acceptance. In reorganization the investor is peculiarly helpless, and must rely on the word of management anxious to retain control, or of a committee which may have concealed interests materially in conflict with his own. And as to court proceedings, surely the safeguards of judicial scrutiny have proved largely illusory. I have no thought of charging that the courts have not, by and large, discharged their functions in these proceedings to the best of their ability - and many of the judges who sit upon these cases are extremely able. But the judges have crowded calendars, and they are judges, trained to the law, and without the knowledge, equipment or facilities for probing into the affairs of complex industrial enterprises and deciding whether particular proposed plans are fair or feasible. When a judge is presented with a plan formulated or recommended by management or large banking or creditor interests, he no more than the investor can determine whether the plan was devised purely in the interest of special groups. When, as often happens, the presentation of the plan is accompanied by formal acceptances by the rank and file, presented on their behalf by the debtor or committees pursuant to authority obtained before any plan existed and retained only because of investor ignorance or inertia, the judge has no alternative but to confirm the plan. Many a judge has said in open court "I think this plan is wretchedly unfair to the

bondholders, or the stockholders; but I can't prove it, and I haven't the time or the facilities to draft you a better one, and if you all say you want this one it is useless for me to refuse".

Finally, and most important, disclosure is not enough. Even if we revised the mechanics of the Securities Act, and revoked the exemptions now conferred upon reorganizations, the Securities Act would be but a thin shield to the investor in reorganization. As I have told you, the Securities Act proceeds on the theory of adjusting the rule of "let the buyer beware" to modern conditions. It says no more than that if the seller wants to bargain with the buyer, he must give the buyer the information upon which he may base his judgment of the bargain. Having done that, the Act leaves them to bargain on equal terms with each other, the buyer, if not satisfied, retaining his cash or spending it elsewhere. Further government cannot go without becoming investment counsel.

But in reorganizations, the investor is not a buyer. He cannot, if he isn't satisfied with what is offered him, retain his cash or spend it elsewhere. If he doesn't like the plan, he cannot draft another one; he has neither the time, the money, nor the equipment. His alternative is only to keep his defaulted security - and suffer the usual fate of the dissenter - or take what management or his protective committee offers him. Give him all the information in the world and his so-called "choice" is the same. To protect the investor in reorganization we must start earlier in the game.

That is what we hope Congress will permit us to do. You have all read of the legislation now pending before Congress, the Barkley Bill, the Chandler Bill, and the Lea Bill, based upon the exhaustive study of reorganizations and reorganization technique conducted over the last few years by Commissioner Douglas. I have no time to analyze these bills in full, but can only describe to you a few of the provisions of the Chandler and Lea Bills which bear on my own argument.

First the Chandler Bill. That is a thoroughgoing revision of the entire Bankruptcy Act, including as one of its significant sections a revision of the reorganization statute familiarly known as Section 77B. Paramount among the new provisions is the requirement that a disinterested trustee be appointed in every case involving \$250,000 or more. Such a trustee will act as an arm of the court in investigating the financial condition of the debtor, the reasons for its plight and the possibilities of adjusting its affairs on a sound basis, and will thus furnish the court and the investor with the necessary information upon which judgments of the plan may be based. But he will do more; he will be empowered himself to propose a plan, and will therefore serve as a focal point for investor participation in the formulation and negotiation of the plan. The Commission too will take a greater part, for all plans may be submitted to it by the court for examination and report, and will be required to be so submitted in all cases where the scheduled indebtedness exceeds \$3,000,000. Such reports as the Commission may make will of course be advisory only, without binding effect, but the report must itself accompany all solicitations of acceptances of the plan. As solicitations will be permitted only after the Commission's report and the judge's order approving the plan, judges will no longer be restrained by the argument of accomplished fact from following their own best judgment in the approval of plans.

The Chandler Bill, so far as we are here concerned with it, deals only with reorganizations under Section 77B. The Lea Bill, by contrast, in its present form deals with substantially all types of reorganizations, readjustments and recapitalizations, including reorganizations under Section 77B. But it approaches the problem from a different angle. Instead of concerning itself with the legal forms and procedures for effecting the substance of reorganization under the Bankruptcy Act, the Lea Bill seeks to probe into the fundamental standards of business morality which, in times of financial stress, control the relations between the investor and his protective committee or the management of his enterprise. Disclosure of relevant facts is required; but disclosure is not enough, and the Bill seeks further to eliminate the material conflicts of interest and unconscionable practices which may persist in spite of full disclosure. No longer may the banker or underwriter seeking control of the reorganized company use the unorganized and terrified investor as a means to gain his end; no longer may the large stockholder use the voice of the holder of defaulted bonds to improve his equity; no longer may the committee member use the information gained by virtue of his position to secure himself large profits by trading in the securities he is supposed to represent, or constitute himself the sole judge of the value of his services and enforce his claim for fees by a lien on the securities entrusted to him. Too long has it been forgotten that representatives of security holders in reorganization occupy fiduciary positions; and it is our earnest hope that this Bill may serve to reemphasize the importance of those simple principles of honesty and fair-dealing which have commonly been thought to attach to other fiduciary relations, and to give to the investor in reorganization the right to the disinterested investor representation without which his investment becomes the plaything of dominant groups seeking to subserve their own ends.

Now, gentlemen, if you will bear with me just a few more minutes, I will try to bring what I have been saying more closely into touch with the particular problems you have in mind. I have little doubt that while I have been talking you have been wondering whether this legislation is not based upon the unworkable assumption that management is wicked and should be hamstrung for the public protection. Many of you, perhaps, have been reiterating in your minds one of the charges most earnestly levied against the Lea and Chandler Bills: that the former prohibits management from formulating plans of readjustment and submitting them to the security holders, and will thereby effectively bar the possibility of any readjustment being consummated without the delay and expense of Court proceedings; and that the latter has the effect of throwing out the old management while the property is in the hands of the Court, and thereby of depriving the enterprise of the services of its old management at the time when their familiarity with the problems of the business is most sorely needed.

I think I can answer these questions. I do not think - no one in his senses thinks - that business management as a class is bad. I know as well as you that management in general is honest and efficient, and that business crises or failures may result from general credit conditions, from unforeseeable technological developments, and from a thousand and one causes other than dishonesty or mismanagement.

Unfortunately, however, there is no blinking the fact that the depression, with its long tale of financial embarrassments or failures in almost every type of business, has left in its wake a series of examples of exploitation of the investor which cannot be overlooked. The developments of the last few years have led to a widespread public mistrust of management as a fiduciary responsible for the representation of investment interests in times of stress. I refer to this mistrust in no spirit of criticism, but as a sober fact the existence of which, however you may deplore, I do not believe you will dispute. Now, such a feeling of public mistrust, whether or not justified, is not a good thing for the public welfare. Under our capitalistic system, in which so vast a proportion of the public wealth is entrusted by its owners to the management of business and industry, confidence of the investor in the integrity of management is absolutely essential. Without such confidence our economic and social system cannot survive. It is your job no less than ours to recreate, preserve, and increase this confidence, and to that end to eliminate so far as possible all mutual misunderstanding of objectives.

So, I say to you that these bills do not hold all management to be bad. They do not automatically exclude the old management from participation in the conduct of the business of an embarrassed debtor in 77B proceedings. They do not prohibit the promulgation by management of voluntary readjustment plans. What they do do, is to attempt to redefine the nature of the fiduciary obligations owed by management to security holders in times of stress. They recognize that when a business has reached a point of financial embarrassment, adjustment must necessarily be made between the conflicting rights of creditors and stockholders of various classes, and they conceive that at that point it becomes humanly impossible for management alone to discharge adequately its fiduciary responsibility with equal fairness and impartiality to every class.

Let me endeavor by an illustration to explain to you the manner in which these bills seek to restate the nature of the fiduciary duties of management to the investor in times of readjustment or reorganization. Imagine a corporation having but two classes of securities, a preferred and a common stock. Dividends on the preferred stock, which is non-voting, are in arrears, and the point has been reached where management decides that a healthy financial structure requires that the arrears be wiped out, and the company be put on a pay as you go basis. Under the Lea Bill management is not prohibited from preparing a plan of readjustment, and seeking to put the plan through, backing its efforts by all the arguments it can bring out of its experience and knowledge of the company's affairs and prospects. That is an important, a vital function of management, the conscientious performance of which will greatly facilitate effective readjustment procedure. What the bill recognizes, however, is that management was elected by the common stockholders, and that in all human probability not only the sympathies but the direct financial interests of management are with the people who elected them, the common stockholders. So the bill says to management: Go to the common stockholders with your plan, disclosing to them, of course, the facts essential to indicate

to them the precise terms of the plan and the necessity therefor. Represent them, if you will, in the negotiations with the preferred stockholders. Bring into these negotiations representative groups of preferred stockholders, and explain to them what you want to do and why you want to do it. Argue with them all you like. The one thing you may not do, is to seek to represent in the bargaining the preferred stockholders, with whose interests in nine cases out of ten your own will be in material conflict. If the negotiations are to constitute in any true sense negotiations between parties on an equal footing, the preferred stockholders must be represented by persons of their own choosing, allied to them and to them only in interest. If their proxies are to be sought they may be sought only by persons who themselves hold preferred stock, and whose other interests are not such as to subject them to the strain of conflicting loyalties.

Similarly with the Chandler Bill. This bill does not require that as soon as a concern gets into 77B, management shall be thrown out on its ear. Rather, as I have said before, the bill seeks to redefine the nature of the fiduciary duty owed by management to the security holders who by no fault of their own have been drawn into the vortex of reorganization, and to draw the line between those functions which management is best equipped to perform, and those which in their nature demand the services of an independent and impartial trustee, charged, as an officer of the court, with representing and enforcing the interests of the security holders. Such a trustee does not replace management. He is specifically authorized by the bill to employ the officers of the debtor to continue the operation of the business, at salaries to be fixed by the court. Management may therefore at a fair salary continue to serve its real principals, the creditors and stockholders, may continue to supply its knowledge and experience to the conduct of the business and to the formulation of a plan. Therein, I believe, lies the true function of management in reorganization proceedings. Only if management seeks to go further - to preserve to itself the opportunity so often afforded in the past of preventing investigation of the causes of the crisis which led to reorganization, to cover up possible causes of action against its own members, to retain control of the proceedings and of the reorganized company - only then is the demand of management to be denied. I do not think you will question that it should be denied.