THE RÔLE OF BANKING GROUPS IN CORPORATE REORGANIZATIONS

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Corporate reorganizations constitute one occasion on which banking interests have hitherto exercised a high degree of control in the affairs of American corporations. Several reasons account for this fact. But the recent Chandler amendments to the federal Bankruptcy act are intended to eliminate or at least greatly reduce the rôle of bankers in reorganizations. These amendments restrict the activities of bankers largely to offering suggestions, and place the active responsibility for drafting and putting into effect reorganization plans in the hands of disinterested trustees and the courts with advice and counsel from the Securities and Exchange Commission. In providing for the quick, prompt reorganization of large corporations by setting up a procedure that can be arbitrary and summary in its treatment of investors, the state has been compelled to accept responsibility for seeing that the relative treatment of different groups of claimants be fair and just. Such a change in the locations of authority does not assure us of "good" reorganizations. Public agencies will have to be equipped to do the job well. The Chandler amendments also make it difficult for bankers to use the occasion of reorganization to acquire continuing control of the corporation concerned. Two important possible consequences of the Chandler amendments are: (1) reorganizations will become more drastic in their treatment of financial structures; and (2) there will be more liquidations of small and medium-sized corporations than there have been in the past.

In his paper on financial control of large corporations, delivered at the 1938 meeting of the American Economic Association, Professor Gordon distinguished between the possession of power and the exercise of entrepreneurial control.[1] He said that banking interests exercise more or less complete control of large corporations during financial reorganization. But he pointed out that such control is exercised only "sporadically." With the passage of the Chandler amendments to the Bankruptcy act at the most recent session of Congress it begins to look as if even such sporadic control would cease. If this turns out to be true, it will constitute a significant change in the control of one restricted but important area of American corporate enterprise—the area within which occurs, first, the recasting of corporate financial structures to fit demonstrated earning powers, and, second, the restoration of corporate working capital previously dissipated. Hitherto, bankers, meaning for the most part investment bankers, have played a dominant rôle in this area.

During the period from January 1, 1931, to July 1, 1935, the *Commercial and Financial Chronicle* listed the names of the members of 341 protective committees and 105 reorganization committees. A check-up of these persons reveals that the protective committees may be classified as follows:

Banker majority	232
Banker minority	32
Institutional investor majority	20
Institutional investor minority	2

[1] *Am. Econ. Rev., Proceedings,* March, 1939, pp. 85-99.

Non-banking	22
Not identified	25

A similar check-up of the 105 reorganization committees gives the following classification:

Banker majority	76
Banker minority	18
Institutional investor majority	1
Institutional investor minority	2
Non-banking	5
Not identified	5

I have used "banker" here to mean an officer or partner in a commercial bank, an investment banking house, or a brokerage firm. "Institutional investor" means an officer of an insurance company, investment trust, or savings bank. It will be noticed that the number of committees classified exceeds the total number examined. This is, of course, due to the fact that there is some over-lapping. A committee might have a banker majority and an institutional investor minority. I do not present these figures as examples of refined statistical technique. They do, however, certainly substantiate the accuracy of the general belief that bankers have hitherto played a highly important part in corporate reorganizations in the United States.

This domination of corporate reorganizations by banking houses is not especially surprising as long as positive legal obstacles have not prevented it. Bankers who have sold securities to customers can plausibly cite their moral obligation to protect the interests of those customers. Furthermore, they are likely to have fairly complete and accurate lists of bondholders, lists which give them the inside track in soliciting deposits and proxies under protective committee agreements. Frequently they have participated with the management of a corporation in working out the preliminaries to setting in operation the machinery of reorganization. Sometimes they have precipitated the very need for reorganization by refusing to underwrite the refunding of maturing obligations. Usually the indenture trustees for bond issues have been named by them and are closely affiliated with them. In the eyes of most investors, banking houses, at least in the past, have possessed reputations for undertanding the baffling intricacies of finance and the complexities of various types of security issue. In the absence of any public agencies to which they could turn it is not surprising to find investors willingly entrusting the protection of their rights to men who seem to be experts, who have a legitimate reason for being interested in the investors' welfare, and who usually are able to be first in the field to offer their services.

The increasing importance of large institutional investors in recent corporate reorganization probably marks the beginning of a decline in the

importance of banking houses in the same field. Sections 77 and 77b of the Bankruptcy act, both designed to facilitate the process of reorganization, contained many provisions which have tended to reduce the importance of the rôle played by banking houses. At the same time we must not forget that certain types of institutional investors such as insurance companies and investment trusts usually are in varying degrees affiliated with banking houses, in some cases even dominated by common interests.

Chapter 10 of the Chandler amendments to the Bankruptcy act extends further application of the general principles of sections 77 and 77b.[2] This principle is that of facilitating corporate reorganization through providing effective means for compelling dissenting minorities to accept plans in the making of which public authorities have largely replaced private financiers and corporation lawyers.

Until we have had some experience with the provisions of chapter 10 in actual cases, it is not possible to be sure just how much it has altered the reorganization procedure of section 77b. The process of judicial interpretation sometimes does strange things to statutory enactments. But the clear intent of chapter 10 is to reduce the rôle of banking groups in reorganizations to that of offering suggestions to the trustees and judges who really draw the plans. It is significant that a "disinterested trustee" who administers the affairs of a corporation during reorganization and prepares a plan of reorganization for submission to the court must, among other qualifications, not have been an underwriter of any of the outstanding securities of the company or within the previous five years have been the underwriter of any of its securities. Nor can he have been within the previous two years a director, officer, or employee of the corporation or of an underwriter of its securities. Indeed he cannot have been an attorney for the corporation or for an underwriter of its securities.

Even in offering suggestions to trustees and courts, attorneys or committees acting for creditors or stockholders are closely regulated. They must file with the court factual information about whom they represent and the amount and time of acquisition of the claims or stock represented if the acquisition has been within the year preceding the filing of the petition asking for reorganization. Furthermore, and this is very important because it touches the pocket nerve, the compensation going to such committees is subject to the complete control of the judge who is to allow "reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred." But even before such compensation can be authorized the person or persons requesting it must have sworn that he or they have not purchased or sold the claims or stock, after having assumed

[2] The Chandler amendments left section 77, applying to railroads, unchanged. Section 77b, applying to other corporations, was replaced by chapters 10 and 11 of which only chapter 10 affects large corporations with complex financial structures.

to act as a fiduciary in its behalf, without the prior consent or approval of the court.

It would be possible to cite further provisions of chapter 10 pointing directly to the elimination of bankers from the reorganizations of corporations which are to avail themselves of its expeditious procedure. But I shall merely assert that a careful reading of its provisions shows that Congress has followed the recommendations of the Securities and Exchange Commission and by and large has attempted to eliminate private banking groups from any important rôle in the reorganization of corporations under the federal Bankruptcy act. Gone are the "emoluments of control" as the S.E.C. so aptly called them. Gone is the inside track to fees for underwriting new security issues; gone are the lucrative fees to depositaries and protective and reorganization committees under agreements drawn by the committees themselves; gone is the power to protect oneself against damage and rescission suits brought by former customers; gone is the disposal of a mass of lucrative patronage to friends and affiliates.

In fact about the only rôle that is left to bankers in corporate reorganizations is that of advising customers and of bidding for the privilege of selling new securities if new issues are required under the plan. Since the new reorganization procedure greatly reduces the possibility of effective dissent by recalcitrant minorities one principal reason for selling new securities under a plan of reorganization—to get cash with which to pay off dissenters—has disappeared. New issues may still be necessary in particular cases where working capital must be rebuilt. There seems to be no reason to suppose that banking houses will not be willing to accept such underwriting business where attractive issues can be arranged. If new issues in recently reorganized corporations cannot be made sufficiently attractive to induce banking houses to try to sell them to their customers, they should not be sold. The scrutiny by bankers of potential new issues is a legitimate function in a capitalistic economy. The scrutiny should be cold and impartial. It is most likely to be so if the bankers have had nothing to do in the circumstances out of which the need for the new issues has arisen.

In transferring control of corporate reorganizations from private to public agencies we are recognizing that the process of melting down and recasting the property rights of security holders in modern corporations is one affected with a public interest. That somewhat vague thing "the general public" requires that its financially ailing corporate service agencies be promptly restored to good financial health or be liquidated and the available resources put to use in a different combination. The interest of the smaller part of the general public which holds securities in a sick corporation requires a fair and just allocation of the burden of reorganization, one which respects at least the relative equities of the situation. In providing for quick, prompt reorganization of large corporations by setting up a

legal procedure that can be arbitrary and summary in its treatment of investors, the state is compelled to accept the responsibility of seeing that the relative treatment of different groups of claimants is fair and just. It simply cannot leave the process in the hands of the old management and banking houses which, because of previous connections, have an inside track. Disinterested trustees, the Interstate Commerce Commission, the Securities and Exchange Commission, and judges with enhanced powers have to take the places of friendly receivers, self-appointed protective and reorganization committees of bankers and lawyers, and judges who have to pretend to labor under the delusion that they are dispensing abstract justice, not participating in a very practical and concrete modification of property rights.

The reorganization of modern corporations must be carried out largely by public agencies if it is to be done in a wholesome, socially acceptable way. But we must not assume that we have guaranteed that it will be well done when we turn responsibility for it over to such agencies. The idea of having disinterested trustees in charge of corporations during their reorganization is sound in the abstract. Such trustees can vigorously and with undivided interest bring suits and recover damages from faithless executives, directors, and bankers. The Securities and Exchange Commission has shown that in a number of recent cases the management and the bankers have been vitally concerned to keep reorganization under their control in order to protect themselves against such suits. Furthermore, disinterested trustees should be able to work out reorganization plans without bias or partisanship.

But when one reads the carefully drawn legalistic definition of a "disinterested trustee" in section 158 of chapter 10 of the Chandler amendments one may wonder if the lawmakers in applying abstractly correct legal principles have not overlooked the concrete necessity of having a business enterprise run by someone who knows something about it. One feels in reading section 158 that the definition of a "disinterested trustee" stacks the cards in favor of the selection of an attorney whose principal qualification is that he has previously had no contact with the corporation or its bankers. This is, after all, a negative qualification. It may be possible to build up through the years a new public profession of reorganization trustees. Certainly we should hope that it would have to be numerically a small profession. In any case disinterested trustees will have to retain the services of officers and employees who are familiar with the affairs of the corporation being reorganized.

To a lesser extent there is the problem of providing adequately trained staffs for the administrative agencies such as the Interstate Commerce Commission and the Securities and Exchange Commission which occupy important advisory positions in the new system of reorganization. We do not solve an economic problem when we turn it over to an essentially legal-

istic administrative body. We merely substitute new means for old. Reorganization of large corporations by private financiers has hitherto been cursed with too much predatory chicanery and blessed with too little sense of professional responsibility. But in a great many cases it has operated fairly well. There have been "good" reorganizations in effecting which the professional skills of bankers and lawyers have played important parts. The process is not one calling merely for disinterested honesty and high moral standards. It does not require nearly as much esoteric financial and legal knowledge as financiers and lawyers have made it seem to require. But it does require some professional financial competence to recast corporate financial structures with one eye on the desirability of doing justice among conflicting groups of investors and the other on the need for assuring the corporation of access to new sources of capital funds. In the past investors have paid heavily for such financial competence when they have gotten it. Too often they have paid heavily for it and have not gotten it. (See the Chicago, Milwaukee and St. Paul Railway reorganization of a dozen years ago.) The point is that any improved system of corporate reorganization will have to provide for financial competence as well as for disinterest and impartiality on the part of the new agencies which are to carry on in place of the old. Conflict and contention among private protective committees have often resulted in a kind of balance of pressures out of which workable and generally satisfactory reorganizations have emerged. It remains to be seen how much better public agencies can do the job, and how much cheaper they can do it.

In the past bankers have frequently used control of corporate reorganizations to insure themselves of at least some measure of continuing control in the corporations concerned. This has been done by including in reorganization plans various devices such as: voting trusts, direct provisions for banker representation on boards of directors, banker selection of the entire original board of directors, designation of the principal executive officers, and restrictions on the voting power of certain classes of new stock issues. Through skillful use of such devices banker control of corporations has fed itself. One may grant that frequently the results have been far short of an assumption of continuing entrepreneurial control in Professor Gordon's sense of the term. Nevertheless, banker control of the reorganization process has frequently contributed to fostering the possession of power by bankers, power which may eventuate into entrepreneurial control. Even short of that it has been a matter of significant interest to students of corporate control.

Chapter 10 of the Chandler amendments strikes at this source of banker control. It requires every plan of reorganization to "include provisions which are equitable, compatible with the interests of creditors and stockholders, and consistent with public policy, with respect to the manner of

selection of the persons who are to be directors, officers, or voting trustees, if any, upon the consummation of the plan, and their respective successors." Furthermore, it requires that the charter of every corporation organized or to be organized for the purpose of carrying out the plan must include "provisions prohibiting the debtor or such corporation from issuing non-voting stock, and providing as to the several classes of securities of the debtor or of such corporation possessing voting power, for the fair and equitable distribution of such power among such classes, including in the case of any class of stock having a preference over other stock with respect to dividends, adequate provision for the election of directors representing such preferred class in the event of default in the payment of such dividends." It is obvious that several difficult problems of interpretation will arise here. What is "fair and equitable distribution" of voting power? Exactly when are preferred dividends in default?

The actual changes in the reorganization process brought by recent legislation will begin to manifest themselves soon. Perhaps they will not be as sweeping as this paper suggests they will be. But certainly they can be very great if the public agencies involved live up to what seem to be their statutory responsibilities, and are diligent and aggressive in playing their parts.

I venture to suggest that two broad changes of major importance may result. First, reorganizations will become more drastic in their treatment of the financial structures of the corporations concerned. The pruning away of dead wood in capital structures will cut deeper than it has in the past. There will be much more respect paid to principles of absolute as opposed to relative priority among security issues than there has been hitherto. Junior equities will take the beatings in reorganizations. Bankers in charge of reorganizations have often preferred relative to absolute priority because it arouses less concentrated resistance and it facilitates the sale of new securities to the junior security holders who are allowed to keep part of their old equities. Naturally, too, reorganization committees of bankers are inclined to go easy in using the pruning knife on security structures. But disinterested trustees, administrative commissions, and judges will no longer have to worry about the resistance of dissenting minorities. They are not obliged to think of junior security holders as potential buyers of new securities under the plan, one important reason for selling new securities—to provide cash for paying off dissenters—having been eliminated. They can and probably will deflate capital structure more drastically and more preponderantly at the expense of junior equities than has hitherto been the case. (See the recommendations of I.C.C. examiners in recent railway reorganizations under section 77.)

Second, I believe it possible that there will be more liquidations of corporate properties than we have had in the past. Bankers naturally prefer

reorganizing a company to liquidating it. They can make money out of reorganizing. If the job has to be done again later on so much the better. I do not believe that this is an unfairly cynical view of the attitude of bankers toward corporate reorganization. Bankers make money out of doing things to and with corporations and their securities. Is it unreasonable to suppose that they tend to keep particular corporate enterprises intact in situations where liquidation of resources and their recombination in other ventures might be fundamentally more economical? In the case of small and even medium-sized corporations with not too highly specialized assets, public agencies are much more likely to liquidate than are bankers. I do not say they will do so but I believe that they are more likely to do so. In many situations we should get better use of resources if properties were liquidated instead of reorganized. The enterpreneurship of bankers in reorganizations has frequently not been consistent functionally with the entrepreneurship of competitive economic theory. It remains to be seen whether closer public control of the process of reorganization will effect any appreciable reform.

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