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The Rise and Fall of the SEC in Bankruptcy

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Abstract

As commentators have long pointed out, once established, administrative agencies are almost impossible to kill. Scaling back the authority of an agency is somewhat easier, but even retrenchment proves difficult. Given these political realities, the trajectory of the Securities and Exchange Commission ("SEC") in corporate bankruptcy is remarkable. Led by William Douglas (head of the SEC before his appointment to the Supreme Court), the New Deal reformers and their allies in Congress transformed corporate reorganization practice by enacting the Chandler Act of 1938. In addition to destroying the influence of Wall Street bankers and lawyers, the Chandler Act positioned the SEC at the heart of the reorganization process. At first, the SEC did in fact play a dominant role in bankruptcy. But over the next several decades, the SEC slowly lost its grip. The end came in 1978, when Congress ushered the SEC out of bankruptcy almost completely as part of its next major reform.

This Article addresses a single question: what happened? Why did the SEC, whose oversight had been seen as crucial to investor protection, disappear from bankruptcy? Drawing from recent positive political theory on Congressional institutions, I argue that the answer to these questions lies in the initial structuring of the SEC's role. In their zeal to destroy the Wall Street banks and lawyers who had previously dominated reorganization practice, William Douglas and the other New Deal reformers strengthened the hand of two interest groups, the general bankruptcy bar and bankruptcy judges, who each had strong incentives to resist SEC oversight. Congress's enactment of the Chandler Bill, rather than a companion bill considered at the same time, further compounded the SEC's troubles by subjecting subsequent reforms to a committee (the Judiciary Committee) that is more likely to favor bankruptcy lawyers than the SEC.

Although these political factors explain the SEC's near disappearance from bankruptcy, this Article concludes that the time may now be ripe for the SEC to increase its profile once again, though in a more limited way than the New Deal reformers envisioned. Many of the securities law issues that the SEC regulates, from takeovers to securities trading, now figure prominently in major corporate reorganization cases as well. Regulation by the SEC would be the best means of coordinating the treatment of these issues inside of bankruptcy and out.

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INTRODUCTION

The history of codified corporate reorganization as we know it in the United States dates back to a series of New Deal bankruptcy reforms enacted in the 1930s. Prior to these reforms, the principal mechanism for reorganization had been the equity receivership, a common law process that was often controlled by the troubled firm's managers, investment bankers and lawyers.¹ Only after the reorganization plan was in place was there judicial review-- too late, the New Deal reformers believed, to protect investors' interests.² If the reformers' objectives could be distilled to a single aim, their goal was to inject ongoing governmental oversight into the reorganization process.

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¹ I discuss the emergence of equity receiverships in the nineteenth century as a mechanism for reorganizing troubled railroads, and the subsequent evolution of the device, in detail in another article. David A. Skeel, Jr, *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1323 (1998). For a widely-cited description of the process by a leading member of the reorganization bar, see Paul D. Cravath, *Reorganization of Corporations*, in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 153 (1917).

² Jerome Frank was among the New Deal reformers who lodged this complaint against the receivership technique. Jerome Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541 (1933).

New Deal reformers did not always agree as to how intrusive the governmental oversight should be. In a famous exchange in the pages of *Harvard Law Review*, Max Lowenthal and William Douglas (then a Yale Law Professor, later to become Chairman of the Securities and Exchange Commission and then Supreme Court Justice) debated precisely this issue with respect to railroad reorganization. Lowenthal insisted on governmental control of the entire process,³ whereas Douglas contended that government actors need only police negotiations among the parties themselves.⁴ Yet, underlying their jousting was a shared, deeply held view that small investors needed a governmental regulator to champion their interests.

Four years later, with the Chandler Act of 1938⁵ and thanks in no small part to Douglas himself, the New Deal reformers seemed to have achieved precisely this result. In addition to dramatically altering the old equity receivership process, the Chandler Act authorized the SEC to intervene throughout a reorganization proceeding, and required any reorganization proposal to be submitted to SEC review. Small investors, it appeared, had their champion in bankruptcy.

Yet little more than a decade later, the SEC's authority in bankruptcy started eroding. Troubled firms began to evade SEC oversight by invoking bankruptcy provisions designed for small firms, rather than the chapter for publicly held debtors. Although the SEC seemed to have Supreme Court precedent on its

³ Max Lowenthal, *The Railroad Reorganization Act*, 47 HARV. L. REV. 18 (1933).

⁴ William O. Douglas, *Protective Committees in Railroad Reorganizations*, 47 HARV. L. REV. 565 (1934).

⁵ Ch. 575, 52 Stat. 840 (1938)(repealed 1978).

side,⁶ it slowly began to lose its grip. In 1978, when Congress once again enacted major bankruptcy reform, the SEC was ushered out of bankruptcy almost completely.

Even a moment's reflection suggests how remarkable these developments were. It has long been obvious that, once established, administrative agencies are almost impossible to kill. Scaling back the authority of an agency is somewhat easier, but even retrenchment proves remarkably difficult. Yet in the space of several decades, the SEC went from being the principal player in sizable reorganizations, to having almost no role at all.

This Article seeks to answer a single question: what happened? Why did the SEC, whose oversight was seen as so crucial to investor protection, disappear from bankruptcy?

One possibility is that, while SEC oversight was essential early on, its oversight became less important thereafter. Although this "public interest" explanation has some intuitive appeal, it proves implausible on inspection.⁷ If anything, there was more concern about investor vulnerability, rather than less, during much of the time period in question.

Drawing from recent positive political theory literature on Congressional institutions, I argue that the most important factors in the SEC's demise have a very different source: the structural design of the

⁶ In *United States Realty and Improvement Co.*, 310 U.S. 434 (1940), the Supreme Court prohibited a debtor, some of whose debt was publicly held, from evading the provisions designed for publicly held debtors. The SEC thought this resolved the issue, *see* SIXTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 55-57 (1940) but, as we shall see, the SEC's optimism proved to be premature.

⁷ Another possibility is that the Chandler Act was never efficient, and market pressures assured its erosion (consistent with the Chicago school view that legislative decision making, like markets, is generally efficient over time; *see, e.g.*, Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 48 Q.J. ECON. 371 (1983)). An important problem with this argument is that many scholars (particularly law-and-economics scholars) view the current bankruptcy framework as even more problematic than prior law. For further discussion, see Part IV, *infra*.

SEC's role. The most important problem, from the SEC's perspective, was the interest group dynamic created by the Chandler Act. The reforms that the SEC pushed through unintentionally strengthened the hand of two already influential interest groups, bankruptcy lawyers and bankruptcy judges,⁸ both of whom had a strong incentive to undermine SEC authority. Bankruptcy lawyers chafed at SEC interference with the reorganization process, and for bankruptcy judges, the SEC introduced delay and a competing source of authority.

Ironically, if the SEC hadn't forced Wall Street investment bankers and the elite reorganization bar out of the corporate reorganization process, these interest groups might later have provided countervailing influence in favor of the SEC-- much as investment bankers and the securities bar do for the SEC in corporate and securities law today.

Congress's enactment of the Chandler Bill, rather than the Lea Bill, an alternative bill that was considered at the same time, compounded the SEC's interest group troubles, since this meant that subsequent legislative reforms would come before the Judiciary Committee rather than the House Interstate Commerce and Senate Banking Committees.⁹ Judiciary Committee oversight magnified the influence of bankruptcy judges and the bankruptcy bar, whereas the SEC would have enjoyed much more influence in the Banking and Commerce Committees, before which it testifies on a regular basis.

⁸ During much of the time period we are considering, bankruptcy judges were referred to as "referees." For simplicity, this Article will call them "judges" throughout.

⁹ Securities legislation comes before the Senate Banking Committee, rather than the Interstate Commerce Committee as in the House, due to a historical accident. In the 1930s, Senator Fletcher insisted that the Banking Committee (which he chaired) have jurisdiction over securities legislation, because the Banking Committee had overseen the lengthy securities investigation that arguably spawned the securities reforms. *See* RALPH F. DeBEBTS, *THE NEW DEAL'S SEC: THE FORMATIVE YEARS* 34 (1964).

Together, these structural factors proved fatal to the SEC's oversight of bankruptcy. To an important extent, neither was inevitable, as the positive political theory literature often seems to assume.¹⁰ To the contrary, we will see throughout the article that the wiring stemmed from conscious decisions by William Douglas and others-- decisions they could have made differently.

Although the focus of the analysis is historical, it has obvious implications for the study of legislative design. The article also offers specific advice for the current SEC. By re-establishing a small portion of its prior authority, I argue, the SEC could turn back history a bit, and actually improve the chapter 11 reorganization process. In recent years, corporate bankruptcy has, for the first time since the New Deal, taken on many of the characteristics of general corporate law, with securities trading and even tender offers playing an important role in the bankruptcy process. Based on its residual role in bankruptcy, and its wide-ranging authority on securities law issues, the SEC could bring a much-needed coherence to issues such as the proper scope of claims trading in chapter 11 cases.

The Article proceeds as follows. In Part I, I briefly recount the history of the SEC's rise and fall in bankruptcy. In Part II, I consider and reject the public interest explanation for the SEC's disappearance. I then turn, in Part III, to the heart of the analysis. After describing the positive political theory literature on agencies and committees, I explore in detail the structural factors that led to the SEC's demise, as well as the effect of budget reductions in the early 1950s. I focus in particular on William Douglas's influence on the initial reforms, and then as a Supreme Court Justice in the 1950s. I go on, in Part IV, to speculate

¹⁰ Jon Macey's important article on structural design-- which he refers to as "ex ante wiring"-- is an example of the tendency to assume that legislative outcomes are predetermined by the relative strength of competing interest groups-- and to downplay factors such as accident and conscious choice. Jonathan R. Macey, *Organizational Design and the Political Control of Administrative Agencies*, 8 J.L. ECON. & ORG. 93 (1992).

as to how things might have been different and suggest a renewed role for the SEC, then finish with a brief conclusion.

I. THE SEC AND ITS ROLE IN BANKRUPTCY: A BRIEF HISTORY

The SEC and its role in corporate reorganization both date to the same New Deal securities reform, the Securities Exchange Act of 1934.¹¹ During the deliberations that produced a companion reform, the Securities Act of 1933, lawmakers had vigorously debated whether to vest enforcement authority in the Federal Trade Commission ("FTC"), or to create a new governmental agency.¹² In the end, the latter view prevailed and, with the 1934 Act, the SEC was born. The Act instructed the President to appoint a five member commission with no more than three members from a single political party.¹³ President Roosevelt

¹¹ Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. sections 78a-78kk)(1988 & Supp. 1993). Subsequent references will be cited as "Securities Exchange Act, section __." The Securities Exchange Act completed a reform process begun a year earlier with the Securities Act of 1933, Pub. L. No. 22, 48 Stat. 74 (codified as amended at 15 U.S.C. section 77a-77aa)(1988 & Supp. 1993). The 1933 Act governs initial public offerings, whereas the 1934 Act regulates ongoing disclosure by publicly held firms, as well as the proxy process and other issues.

¹² The Wall Street business community lobbied hard against vesting authority in the FTC, due to concerns that the Commissioner, James Landis, and current staff of the FTC were liberal and unsympathetic to business interests. Although President Roosevelt publicly stated that he preferred the FTC as regulator, many observers detected a willingness to compromise. Compromise he did, and the SEC was created as a result. For a thorough discussion of these developments, see DeBEBTS, *supra* note 9, at 56-85.

¹³ Securities Exchange Act, section 4.

selected Joseph Kennedy as the SEC's initial chair, and filled out the Commission with similarly prominent initial appointees.¹⁴

Although the 1934 Act had less to say about the SEC's role in bankruptcy, it nevertheless played a crucial role. Congress had enacted preliminary bankruptcy reform at the same time as its securities law initiatives. This legislation, also passed in 1933 and 1934, simplified and largely codified the equity receivership process investment bankers and reorganization lawyers had used to reorganize railroads for decades.¹⁵ The Securities Exchange Act of 1934 added only one piece to the bankruptcy puzzle: it authorized the SEC to conduct an exhaustive study of reorganization practices, and to report back to Congress on its findings.¹⁶

¹⁴ In addition to Kennedy, the initial choices included Ferdinand Pecora, who had become famous for his role in the hearings that led to sweeping bank reforms, and three members of the FTC: Landis, Mathews and Healy. For discussion, see DeBEDTS, *supra* note 9, at 86-111. There is an obvious irony in the fact that Roosevelt drew a majority of his selections from the FTC, given that the formation of the SEC was spurred by the business community's distrust of the FTC's current leadership. One possible explanation is that the selections illustrate the limits of the business community's clout. Another is that, even with the influx of FTC personnel, business leaders believed they would be better able to capture the SEC -- perhaps due to the narrow scope of the SEC's authority. *See, e.g.*, Macey, *supra* note 10 (single constituency agencies such as the SEC are more easily captured than multiple constituency agencies).

¹⁵ Both reforms were framed as amendments to the existing Bankruptcy Act. The first added (among other things) railroad reorganization ("Section 77") to the Bankruptcy Act; Act of March 3, 1933, 47 STAT. 1474 (1933), 11 U.S.C.A. section 204 (1934); and the second added corporate reorganization; Act of June 7, 1934, 48 STAT. 912 (1934)("Section 77B"). For a more detailed discussion, see Skeel, *supra* note 1.

¹⁶ Securities Exchange Act, sections 4, 211. Specifically, Congress instructed the SEC to focus on the "protective committees" that were formed to coordinate widely scattered stock and debt holders in connection with a reorganization. Protective committees functioned as follows. The creators of the committee, who often were the troubled firm's underwriters or other insiders, encouraged investors to deposit their securities with the committee pursuant to a deposit agreement that gave the committee's representatives wide discretion to negotiate the investors' treatment under the reorganization plan. The strategy required that a large majority of investors deposit their securities, since the reorganizers were required to pay dissenting investors in cash. For a complete overview, see Cravath, *supra* note 1.

The SEC's study began quietly enough, with the SEC appointing William Douglas to oversee the investigation. Douglas was an obvious choice. As a Yale Law School Professor, he had contributed to the Donovan and Thacher investigations that inspired the initial New Deal bankruptcy reforms, including the corporate reorganization section, Section 77B.¹⁷ But his investigation would take corporate bankruptcy in an entirely different direction. Whereas the initial reforms had largely rubberstamped existing practice, the eight volume SEC report called for sweeping changes to address what Douglas and his investigators perceived as pervasive abuses.¹⁸

Legislative efforts to inject greater oversight into corporate bankruptcy eventually centered on three different bills in the 1930s.¹⁹ The first, known as the Sabbath bill after its sponsor and chief proponent,

¹⁷ Douglas's participation in the Donovan investigation stemmed from an extensive study he and several co-authors conducted on personal bankruptcy. See William Clark, William O. Douglas & Dorothy S. Thomas, *The Business Failures Project-- A Problem in Methodology*, 39 YALE L.J. 1013 (1930); William O. Thomas & Dorothy S. Thomas, *The Business Failures Project--II. An Analysis of Methods of Investigation*, 40 YALE L.J. 1036 (1931); William O. Douglas, *Some Functional Aspects of Bankruptcy*, 41 YALE L.J. 329 (1932).

Like Douglas's work, the Donovan and Thacher reports focused almost entirely on personal bankruptcy-- corporate reorganization was considered almost as an afterthought. REPORT ON THE ADMINISTRATION OF BANKRUPTCY ESTATES, 71ST CONG., 3D SESS. (House Comm. Print, 1931)(Donovan Report); STRENGTHENING OF PROCEDURE IN THE JUDICIAL SYSTEM: THE REPORT OF THE ATTORNEY GENERAL ON BANKRUPTCY LAW AND PRACTICE, 72D CONG., 1ST SESS. 90-93 (Sen. Doc. No.65, 1932)(Thacher Report)(brief description of proposals to "simplify" reorganization). But corporate reorganization proved to be the centerpiece of the 1933 and 1934 reforms, and was Douglas's sole concern once he was named to run the protective committee study.

¹⁸ 1-8 SECURITIES AND EXCHANGE COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937-1940)[hereinafter, SEC REPORT]. The dominant theme of the reports is that the Wall Street investment bankers and lawyers who managed the reorganization process focused more on their own fees than on the interests of investors. The reports document these charges with case studies of numerous large receivership cases.

¹⁹ For a useful overview of the bills (and several other proposals), see John Gerdes, *Section 77B, the Chandler Bill and Other Proposed Revisions*, 35 MICH. L. REV. 361 (1937).

Representative Adolph Sabath, was developed before the SEC became actively involved in bankruptcy reform. Based on extensive investigations of receivership practice, the Sabath bill proposed that conservators be appointed to oversee nearly every bankruptcy case.²⁰

The second and third bills, the Chandler and Lea bills, were eventually treated as companion legislation. The Chandler bill initially comprised a wide range of bankruptcy changes, many of them technical in nature, that a group of lawyers and law professors who had joined together as the National Bankruptcy Conference devised after the first round of 1930s bankruptcy reforms.²¹ In 1936, shortly after it released its first damning conclusions about reorganization practice, the SEC intervened.²² The SEC focused entirely on corporate reorganization, proposing dramatic change in this context. Most controversially, the SEC proposed that a trustee be appointed in place of the existing managers when a firm filed for bankruptcy. The SEC also proposed that it be given extensive oversight authority in all large

²⁰ See Conservator in Bankruptcy, Hearing Before the Committee on the Judiciary, House of Representatives, on H.R. 9 & H.R. 6963, at 1 (75th Cong. 1st Sess. 1937)(hearings on H.R. 10634 appended)(hereinafter, *Sabath Bill Hearings*). Henry Garson, the analyst for the Sabath Committee, characterized the conservator as necessary to police deposit agreements, protective committees and the overall bankruptcy process. *Id.* at 32-50.

²¹ The voluminous house report on the Chandler Act gives a good, brief chronology of the formation of the National Bankruptcy Conference, and of the developments leading up to the version of the Act that eventually passed. Revision of the National Bankruptcy Act, H. Rep. No. 1409, at 1-3 (75th Cong. 1st Sess. 1937)(hereinafter, *Chandler Report*). The principal hearings were held before the House Judiciary Committee in 1937; Hearing before the Committee on the Judiciary, House of Representatives, on H.R. 6439, reintroduced as H.R. 8046 (75th Cong. 1st Sess. 1937)(hereinafter, *Chandler Hearings (House)*); and before the Senate Judiciary Committee in 1937 and 1938; Hearing Before a Subcommittee of the Committee on the Judiciary, Senate, on H.R. 8046 (75th Cong. 2d Sess. 1937 & 1938)(hereinafter, *Chandler Hearings (Senate)*).

²² See *Chandler Hearings (House)*, *supra* note 21, at 2-3 (Statement of Representative Chandler)(noting that the SEC intervened after he had introduced H.R. 6439 on April 15, 1937, and proposed a complete re-write of Section 77B's provisions on corporate reorganization).

cases.²³

The Lea bill made its way to the House Interstate Commerce Committee at the same time as the House and Senate Judiciary Committees heard hearings on the Chandler bill.²⁴ Whereas the Chandler Bill addressed the entire bankruptcy process, the Lea Bill centered its attention on the influence of investment bankers. The bill would have prohibited investment bankers from soliciting votes on reorganization prior to bankruptcy, and would have subjected the "deposit agreements" used to effect a reorganization to extensive SEC scrutiny.²⁵

The Chandler Bill was the bill that eventually passed. Widespread opposition to the creation of a conservator had doomed the Sabbath Bill,²⁶ and concerted attack by investment bankers stymied the Lea Bill. But the SEC successfully linked its corporate bankruptcy reforms to the Chandler Bill's global reconsideration of the Bankruptcy Act. The initial effect of the Chandler Act was to cripple managers, investment bankers, and the reorganization bar²⁷-- each of whom was all but excluded from the bankruptcy

²³ 52 STAT. 888, 11 U.S.C.A. § 156 (1938)(trustee requirement, as enacted); 52 STAT. 890, 11 U.S.C.A. § 572 (1938)(SEC report on reorganization plan, as enacted). For a more detailed description of these changes and the controversy they engendered, *see* Skeel, *supra* note 1, at 65-68.

²⁴ To Amend the Securities Act of 1933, Hearing Before the Committee on Interstate and Foreign Commerce, House of Representatives, on H.R. 6968 (75th Cong. 2d Sess., June 8- July 21, 1937)(hereinafter, *Lea Hearings*).

²⁵ *Id.* at 20-34 (Statement of William O. Douglas, SEC Commissioner)(describing the effect of the proposed bill).

²⁶ The chief criticism of the conservator was that it would create a costly governmental bureaucracy, and would bog down the bankruptcy process. *See, e.g., Sabbath Hearings, supra* note 20, at 89 (statement of W. Randolph Montgomery, Counsel, National Association of Credit Men).

²⁷ The Chandler Act excluded managers and investment bankers from the process directly, by replacing managers with a trustee in every case and precluding prebankruptcy solicitation of votes, which crippled the protective committee strategy used by the firm's investment bankers. With all of their principal clients shut out of the process, the elite reorganization bar disappeared also. *See* Skeel, *supra*

process-- and to give the SEC enormous influence.

Although the Chandler Act was a huge success for the SEC, the SEC's hegemony proved to be temporary. The seed for the SEC's eventual demise in bankruptcy lay in an important gap in the legislation's coverage. The SEC's reforms were located in a single chapter of the Bankruptcy Act, Chapter X. It was clear to everyone that the drafters assumed that publicly held debtors would always reorganize under Chapter X-- and only that chapter.²⁸ But nowhere in the Act did Congress explicitly *require* that publicly held firms use Chapter X, rather than Chapter XI, the much more flexible, manager-friendly chapter that governed smaller corporations.²⁹

The SEC quickly realized that managers might steer their firms into Chapter XI in order to avoid Chapter X, and sought to close the loophole both legislatively and judicially. With the Supreme Court's decision in *United States Realty and Investment Co.*,³⁰ the SEC seemed to have succeeded.³¹ *United*

note 1, at 1371 n.174.

It is worth emphasizing that only the reorganization bar disappeared. The general bankruptcy bar remained influential, as we will see.

²⁸ Eugene V. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1335 (1949).

²⁹ Unlike Chapter X, Chapter XI assumed that a firm's managers would remain in control, and did not contemplate SEC intervention. Ironically, the Chandler Act not only failed to require large firms to use Chapter X, but it also suggested that firms could only use Chapter X if they demonstrated their need for this chapter. *Id.* at 1362. This threshold barrier appears to have been a holdover from the previous reorganization provision, Section 77B, which firms and their managers had been much more anxious to invoke.

³⁰ 310 U.S. 434 (1940).

³¹ Prior to the decision, the SEC had introduced legislation that would have required any firm whose securities were held by 100 or more investors to use Chapter X. A House report commented favorably on the proposal, but concluded that *U.S. Realty* obviated the need for legislative action. H. Rep. No. 2372, 76th Cong. 2d Sess. 2 (1940).

States Realty refused to permit a corporation whose capital structure included publicly issued securities to reorganize in Chapter XI. For the next decade, the issue seemed settled. But debtors continued to try to evade Chapter X and, in 1956, the Supreme Court once again considered whether publicly held firms could use Chapter XI. Although the Court foreclosed the debtor in that case from using Chapter XI, it refused to insist that all publicly held debtors look to Chapter X. Speaking through, of all people, now-Justice William Douglas, the Court held that the choice between Chapter X and XI depended on the "needs to be served."³²

The "needs to be served" standard left just enough room for lawyers to argue for Chapter XI. Initially, the firms that circumvented Chapter X and the SEC were middle-sized firms that had issued public securities, since these firms could most credibly argue that public oversight was unnecessary.³³ But debtors continued to push the edges of the envelope, and by the late 1960's many large firms had made their way into Chapter XI.³⁴ Rather than serving as the undisputed guardian of the reorganization process, the SEC frequently was reduced to squabbling about firms' jurisdictional decision whether to choose one chapter or the other. To be sure, the SEC could and did use the threat of a jurisdiction battle, for instance, to extract concessions for public security holders in cases that remained in Chapter XI. But its role was

³² *General Stores Corp. v. Shlensky*, 350 U.S. 462, 466 (1956).

³³ See Benjamin Weintraub, Harris Levin & Lawrence G. Novick, *Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation*, 24 FORD. L. REV. 616 (1956)(defending the use of Chapter XI); Benjamin Weintraub & Harris Levin, *A Sequel to Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation*, 26 FORD. L. REV. 292 (1957)(same).

³⁴ See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, 93d Cong., 1st Sess. 246 (1973)(hereinafter, "*1973 Commission Report*")("it is readily apparent that Chapter XI has evolved into the dominant reorganization vehicle and very substantial debtors are able to reorganize in Chapter XI").

steadily shrinking.

For the SEC, the end came when Congress completely overhauled the bankruptcy laws in 1978. The SEC stridently argued that its oversight was essential for protecting investors, and sought to reestablish its authority in bankruptcy.³⁵ But by this time, Congress had little interest in what the SEC had to say.³⁶ Rather than tightening up the bankruptcy process, Congress collapsed Chapter X and XI into a single, flexible reorganization chapter, chapter 11. Like old Chapter XI, chapter 11 permitted a debtor's current managers to stay in control, authorized deviations from absolute priority, and almost entirely excluded the SEC from the bankruptcy process.³⁷

The SEC did not suddenly disappear, of course. In corporate law, the SEC continued (and continues) to play a crucial regulatory role. But in corporate reorganization, once a central facet of its oversight authority, the SEC was all but gone.

Why, in a world where agencies rarely seem to retrench, did the SEC disappear so completely from bankruptcy? That is the question we will wrestle with for the remainder of this Article.

³⁵ See Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 108-118 (1997)(describing lobbying over the Bankruptcy Act's reorganization provisions and the role of the SEC).

³⁶ Some observers, by contrast, were appalled by the prospect that the SEC would no longer be in a position to protect investors' interests. See, e.g., Anne Colamosca, *The Bankruptcy Hustle*, NEW REPUB., Feb. 17, 1979, at 15.

³⁷ See 11 U.S.C. §§ 1107 (assuming "debtor-in-possession" will manage debtor's affairs); 1129 (permitting consensual deviations from absolute priority); 1109 (SEC may raise any issue, but may not appeal any judgment).

II. A JOB WELL DONE? PUBLIC INTEREST EXPLANATIONS FOR THE SEC'S

DISAPPEARANCE

In order to explain the SEC's surprising disappearance from bankruptcy, I will employ the methodology of public choice and positive political theory, which focus on structural factors and assume that the relevant players generally pursue their own self interest.³⁸ But there also may be a simple public interest explanation for the decline of SEC influence. So let us first consider the public interest account.

A public interest explanation of the history I have just described would go something like this. In the 1920s and 1930s, the capital markets were rife with fraud. Small investors had little access to reliable information, and were therefore vulnerable to a variety of manipulative schemes.³⁹ In bankruptcy, the problem was that small investors were persuaded to deposit their securities with protective committees that negotiated on their behalf, which gave investment bankers and their lawyers carte blanche to sell out investors' interest in return for exorbitant fees.⁴⁰

³⁸ While many scholars use these terms synonymously, others define "positive political theory" more narrowly, as a related discipline that places particular emphasis on the strategic relations among institutions. For an extensive overview of public choice (and brief description of positive political theory), see David A. Skeel, Jr., *Public Choice and the Future of Public Choice-Influenced Legal Scholarship*, 50 VAND. L. REV. 647 (1997)(reviewing MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW: READINGS AND COMMENTARY (1997)).

³⁹ This was a pervasive theme of the hearings that led to the New Deal financial and securities reforms. For a political account of the concerns and the reforms, see MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994). Perhaps the most influential book sounding this theme was LOUIS D. BRANDEIS, OTHER PEOPLES' MONEY (1914).

⁴⁰ The most prominent book length discussion of these concerns was Max Lowenthal's scathing chronicle of the St. Paul railroad receivership. MAX LOWENTHAL, THE INVESTOR PAYS (1933). See, e.g., *id.* at 187-93, 279-82 (suggesting that deposit agreements shifted control entirely to the investment bankers overseeing the process).

The New Deal reforms addressed many of these problems. Just as the securities acts and banking reforms helped to police financial manipulation, the Chandler Act tackled the most significant abuses in corporate reorganization by insisting on an independent trustee and regulatory review of the reorganization process.⁴¹ To be sure, the Chandler Act did not eliminate financial abuse in bankruptcy. Yet, a public interest perspective might suggest, by the 1950s the capital markets were so much more transparent (or investors sufficiently sophisticated) that the elaborate oversight apparatus of Chapter X was no longer necessary. The SEC had fulfilled its mission, and it was therefore appropriate that the SEC would fade from the bankruptcy scene.

Although the public interest story is plausible in some respects, it proves quite problematic on inspection. If anything, the public interest story gets the chronology exactly backwards. In the early years of the Chandler Act, markets were so dormant-- and unsophisticated investors largely absent-- that aggressive SEC intervention arguably was unnecessary. By the 1950s, however, the capital markets were humming once again, and small investors had returned, which raised renewed concerns about financial manipulation.⁴² If protecting small investors was an important concern of the Chandler Act, it seems odd that the SEC would begin to lose its grip in bankruptcy just as fears about investor welfare were once again

⁴¹ Chandler Act section 156, 11 U.S.C. section 156 (repealed 1978)(mandatory trustee); Chandler Act section 172, 11 U.S.C. section 582 (repealed 1978)(SEC review of reorganization plan in cases over \$3 million).

⁴² Dean Joel Seligman discusses these concerns in detail in his already-classic history of the SEC. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 273-289 (rev'd ed. 1995). He notes, for instance, that "[a]ccompanying the [1953-1955] market rise was evidence of the most widespread pattern of speculative activity and securities fraud since the late 1920s." *Id.* at 273. Perhaps the most spectacular scandal during this period was a pattern of widespread fraud on the American Stock Exchange that came to light later in the decade. *Id.* at 282-289.

on the rise.

The SEC's stance is similarly puzzling for a public interest perspective. Although one must of course be cautious about assuming that SEC views were synonymous with the public interest,⁴³ it bears noting that the SEC continued to insist that large bankruptcies be directed to Chapter X, where the SEC could protect investors' interests. In each of the three Supreme Court cases addressing the choice between Chapter X and Chapter XI, for instance, the SEC filed briefs urging the Court to adopt a blanket rule requiring firms with publicly issued securities to reorganize under Chapter X.⁴⁴

I do not mean to suggest that the public interest explanation is entirely off the mark. Whether Chapter X was the appropriate approach to corporate reorganization in the 1950s was, and is, debatable.⁴⁵ But a public interest explanation presumably would assume that the Chandler Act and SEC oversight were initially necessary, and only later became less essential. As we have just seen, the market developments of the 1950s seem to contradict, or at least raise questions about, this story. Something more must have been going on. And it was.

⁴³ Although the SEC's role is to protect the public interest, its interests may diverge from those of public investors in some circumstances-- particularly where the public interest might justify a reduction in the SEC's authority.

⁴⁴ For further discussion of the SEC's arguments in these cases, see Part III(E), *infra*.

⁴⁵ Current chapter 11 has spawned a lengthy debate in recent years. For a critical review of the proposed alternatives to chapter 11, see David A. Skeel, Jr., *Markets, Courts and the Brave New World of Bankruptcy Theory*, 1993 WISC. L. REV. 465. Interestingly, the article that triggered much of the debate, Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992) offers evidence suggesting, at least on the authors' interpretation, that Chapter X was a superior approach.

III. WIRED FOR DEMISE: STRUCTURAL FACTORS AND THE FALL OF THE SEC

To develop a more compelling explanation for the SEC's unlikely demise, we need to turn in a different direction: to positive political theory and the insights it offers into legislative decision making. Since the SEC is an independent agency, the literature on agencies is of particular interest. The literature on committees will also prove relevant.

In the section that follows, I briefly review the existing literature. I then turn to the SEC and its role in bankruptcy. What we will see is that both the structure of the SEC's role in bankruptcy and the choice of its oversight committee were crucial factors in its demise. We will also see that each of these factors stemmed not from some inevitable interest group compromise, but from conscious decisions by William Douglas and other New Deal reformers.

A. Positive Political Theory: A Brief Overview

1. The autonomy of agencies (or lack thereof)

The lightning rod for the recent literature on agencies was a 1971 book by William Niskanen. Niskanen argued that Congress has little control over agencies once they are established, due in large part

to informational assymetries, and that the goal of agency bureaucrats is to maximize the agency's budget.⁴⁶

A number of subsequent commentators challenged Niskanen's claim of agency autonomy, and pointed out various devices Congress can use to reign in an agency. The most obvious means of control is ex post oversight. Thus, if an agency shifts in an undesirable direction, Congress can subject the agency to scrutiny, as it did with the Federal Trade Commission in the 1970s.⁴⁷ Similarly, Congress can use its control over appropriations to reward some agencies and punish others.⁴⁸

Congress is not limited to ex post oversight, however. Of particular importance for our analysis of the SEC, Congress can also use its initial design of an agency as a device for influencing subsequent events. Thus, some commentators have argued that Congress intentionally builds delay into the agency rulemaking process in order to make it more difficult for agencies to secretly shift directions, or to enhance the influence of a dispersed interest group such as consumers.⁴⁹ In addition, Congress can "hardwire" an agency to promote particular interest groups over time. An agency whose jurisdiction affects a variety of

⁴⁶ WILLIAM A. NISKANEN, *BUREAUCRACY AND REPRESENTATIVE GOVERNMENT* (1971). Niskanen later adjusted his arguments, and responded to some of his critics, in William A. Niskanen, *A Reflection on BUREAUCRACY AND REPRESENTATIVE GOVERNMENT*, in *THE BUDGET-MAXIMIZING BUREAUCRAT: APPRAISALS AND EVIDENCE* (Andre Blais & Stephanie Dion, eds., 1991).

⁴⁷ See, e.g., Barry R. Weingast & Mark J. Moran, *Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission*, 91 J. POL. ECON. 765 (1983).

⁴⁸ See RICHARD F. FENNO, JR., *THE POWER OF THE PURSE: APPROPRIATIONS POLITICS IN CONGRESS* (1966).

⁴⁹ See Matthew D. McCubbins, Robert G. Noll, & Barry R. Weingast, *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431 (1989). For a careful discussion of how agency decision making procedures actually affect the participation of consumers and other groups, see Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1 (1998).

groups, for instance, is likely to develop much differently than an agency that answers only to one.⁵⁰

Both individually and in the aggregate, Congress's controls are imperfect. Agencies inevitably will develop informational advantages in the areas they regulate, for instance, and correctives such as built-in delay are blunt at best. One context where one would expect to see evidence of agency autonomy, and of the limits of Congressional control, is when the agency has become obsolete. Focusing on precisely the agency with which we are concerned, the SEC, Jon Macey has argued that agencies will forestall elimination by presenting a distorted picture to Congress of the need for regulation and by attempting to poach on the jurisdiction of other agencies.⁵¹ In his view, the SEC deliberately obscures evidence that efficient markets have diminished the need for regulatory oversight, and has tried to expand its base by usurping authority from several other agencies.⁵²

The SEC's resiliency in other areas stands in stark contrast to its disappearance from bankruptcy. Before we begin to unravel the mystery, we must first consider one more facet of legislative decision making.

2. Committees or Congress: Who Controls?

⁵⁰ See Macey, *supra* note 10 (contending that single constituency agencies will be captured by that constituency, whereas agencies that respond to a variety of interest groups will not).

⁵¹ Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARD. L. REV. 909 (1994).

⁵² Macey's illustrations of the SEC's jurisdictional squabbles include, among others, its battle with the Commodity Futures Trading Commission over regulation of futures, and its ongoing disputes with bank and broker-dealer regulators over the regulation of treasury bills and other investment devices. *Id.* at 939-43.

Our brief discussion of agencies treated Congress as a whole as the source of any relevant oversight. But Congress conducts much of its business through committees (and subcommittees). The question whether Congress or a particular committee is more likely to be calling the shots has also provoked a lively debate.

The debate parallels our discussion of agency autonomy in important respects. One view suggests that, while Congress theoretically is the principal (as with agencies) and oversight committees are its agents, committees have enormous influence over legislative outcomes. At the threshold stage, committees control whether an issue is ever considered-- and once enacted, whether legislation is revisited.⁵³ When conference committees are set up to reconcile differences between the House and Senate versions of a bill, members of the relevant oversight committees almost always predominate, which gives the committee yet another opportunity to influence the shape of legislation.⁵⁴

As with agencies, an opposing view emphasizes that Congress can limit the divergence between a committee's views and those of Congress as a whole. The most potent control is control over the composition of committees. Several commentators have argued that party leadership exerts substantial

⁵³ Weingast and Marshall are perhaps best known for emphasizing the importance of a committee's ability to determine whether legislation is revisited. Barry R. Weingast & William J. Marshall, *The Industrial Organization of Congress: or, Why Legislatures, Like Firms, Are Not Organized as Markets*, 96 J. POL. ECON. 132 (1988)

⁵⁴ See Kenneth A. Shepsle & Barry R. Weingast, *The Institutional Foundations of Committee Power*, 81 AM. POL. SCI. REV. 85 (1987)(emphasizing that committee's "ex post veto" is crucial since, if committees' influence were limited to the decision whether to consider legislation, they would lose control once they let legislation go forward).

Commentators who emphasize committee independence also point to factors such as the seniority system, which operates as a norm that committee leadership will be chosen based on length of service.

influence over the selection and transfer process.⁵⁵ As a result, they contend, committees are more likely to mirror the views of Congress (or, more precisely, the majority party), and less likely to consist of preference outliers than the committee autonomy view tends to suggest.⁵⁶

Each of these perspectives proposes a distributional view of committees: committees secure gains for either Congress's, the majority party's, or their own constituents. Still another view emphasizes the informational role of committees. On this view (which echoes more traditional theories of committee behavior), the members of each committee develop expertise on the issues covered by the committee. This division of labor provides benefits for Congress as whole, rather than securing gains for a particular constituency.⁵⁷

As with agencies, the most plausible view combines these perspectives. Committees enjoy some but not complete autonomy, and provide expertise but also promote distributional objectives.⁵⁸

⁵⁵ JAMES COX & MATTHEW D. McCUBBINS, *LEGISLATIVE LEVIATHAN: PARTY LEADERSHIP IN THE HOUSE* (1993). Cox and McCubbins contend that parties act as legislative cartels, employing congressional processes to further party goals.

⁵⁶ More precisely, Cox and McCubbins argue that the membership of committees with broad-based jurisdiction will reflect the perspectives of the majority party as a whole, whereas committees whose decision making affects a narrower constituency will be staffed by representatives with a particular interest in that constituency. Cox and McCubbins add a catch-all category, "mixed" committees, for committees whose jurisdiction does not fit neatly with either the broad or narrow category.

⁵⁷ The principal proponent of the informational theory of committees is Keith Krehbiel. KEITH KREHBIEL, *INFORMATION AND LEGISLATIVE ORGANIZATION* (1991).

⁵⁸ For a similar argument, see Kenneth A. Shepsle & Barry R. Weingast, *Positive Theories of Congressional Institutions*, 19 *LEGIS. STUD. Q.* 149 (1994)(defining informational perspectives and the party influence view as part of a "third wave," and concluding that they supplement rather than replace the distributional account).

As we return to the role of the SEC in bankruptcy in the discussion that follows, we should keep in mind that two implicit questions underlie the analysis. First, does positive political theory provide a more compelling explanation of the SEC's demise than other possible explanations, such as a public interest account? Second, if so, which factors seem to have proven particularly significant? The analysis suggests that positive political theory does hold the key to our puzzle, and explores the small constellation of factors that, together, eventually sealed the SEC's fate.

B. Budget Control in the Eisenhower Years

As noted in our previous discussion, Congress' control over an agency's annual budget is an important source of ex post oversight. By starving wayward agencies and rewarding loyal ones, Congress can significantly constrain agency discretion. Similarly, Congress can counteract the decisions of previous Congressional majorities by altering budget allocations.⁵⁹

During the Eisenhower administration, Congressional control over budgets had a dramatic effect on SEC activities. Starting in the early 1950s, Congress sharply curtailed the SEC's budget, forcing the

⁵⁹ Stated differently, Congress can use budget allocations to curb or punish "bureaucratic drift," but if a future Congress holds different views-- due to "coalitional drift"-- it also can use budget decisions to undermine the prior Congress' priorities. See Kenneth A. Shepsle, *Bureaucratic Drift, Coalitional Drift, and Time Consistency: A Comment on Macey*, 8 J.L. ECON, & ORG. 111 (1992)(describing trade-off between efforts to constrain bureaucratic drift and those aimed at coalitional drift).

SEC to reduce its staff by several hundred employees.⁶⁰ The cuts stemmed less from a specific desire to constrain the SEC, than from a general concern by President Eisenhower to reduce government spending.⁶¹ But the effect was the same. The reduction in staff forced the SEC to reign in many of its enforcement activities. Of particular importance for our analysis, one of the SEC's responses to its budgetary dilemma was a conscious decision to scale back the SEC's presence in bankruptcy.⁶²

It is important not to overstate the significance of the Eisenhower-era budget cuts and the SEC's retrenchment in bankruptcy. First, although it retrenched somewhat, the SEC maintained an active presence in bankruptcy. Throughout the 1950s, the SEC regularly intervened in corporate reorganization cases.⁶³ Nor did the SEC change its regulatory posture. The SEC continued to insist on investors' need for the protections of SEC oversight, and continued to challenge debtors' efforts to evade Chapter X.⁶⁴

Second, after several years of cuts, Congress began to restore the SEC's budget in the mid 1950s. By the end of the 1950s, complaints that the securities markets were not being adequately policed had

⁶⁰ SELIGMAN, *supra* note 42, at 266-68 (describing effects of Eisenhower's 1954 and 1954 budgets).

⁶¹ *Id.* at 266 (discussing Eisenhower administration's preoccupation with reducing government spending).

⁶² Seligman notes that on at least one occasion, the SEC declined a judge's request to intervene in a Chapter X case as a result. SELIGMAN, *supra* note 42, at 270.

⁶³ The SEC chronicled these activities in its annual reports. *See, e.g.*, 1956 SEC ANNUAL REPORT 172-73 (SEC participated in 33 proceedings involving the reorganization of 52 firms in 1956); 1957 SEC ANNUAL REPORT 146 (SEC participated in 37 proceedings involving 57 firms in 1957).

⁶⁴ *See, e.g.*, 1956 SEC ANNUAL REPORT 178-79 (describing SEC's activities in *Shlensky* case); 1957 SEC ANNUAL REPORT 156 (describing SEC's successful arguments in *S.E.C. v. Liberty Baking Corporation*, 240 F.2d 511 (2d Cir. 1957), *cert. den.*, 353 U.S. 930 (1957)). *See also* Part III(E), *infra* (discussing SEC's contention that the Supreme Court should adopt a blanket rule directing all debtors with publicly held securities into Chapter X).

prodded Congress to expand the SEC's budget well beyond its pre-cut levels.⁶⁵ Although much of this money went to the SEC's stock market investigations, some also made its way into its bankruptcy activities.

The SEC's continued bankruptcy presence and the restoration of its budget in the late 1950s make clear that the original budget cuts do not, by themselves, explain the SEC's disappearance from bankruptcy. Their principal effect was to magnify the SEC's vulnerability to serious structural flaws in its bankruptcy authority.

C. Interest Groups and the Structure of SEC Oversight

We come now to the most remarkable factor in the SEC's demise, the initial structuring of its oversight authority. As it turns out, the *ex ante* wiring story has two distinct phases. The first centers on the successful efforts of President Roosevelt and his Democrat allies in Congress to pave the way for governmental oversight of bankruptcy by commissioning an SEC bankruptcy study in the Securities Exchange Act of 1934. The second, which is our particular focus, began in 1938, when the Chandler Act transformed corporate bankruptcy and gave the SEC wide-ranging bankruptcy authority.

The analysis that follows describes the two phases in turn. We then will consider one final structural factor-- the choice of oversight committee-- in Section D.

⁶⁵ SELIGMAN, *supra* note 42, at 277.

1. Dividing the opposition: the 1934 Securities Act

Prior to the 1930s, the stock markets and corporate disclosure were regulated almost entirely by the states and by the markets themselves.⁶⁶ An important priority for President Roosevelt when he took office in 1933-- one which enjoyed widespread public support-- was to introduce sweeping federal reform to cure the deficiencies of state and self-regulation.⁶⁷ The reforms Roosevelt and his supporters had in mind would affect the entire spectrum of corporate and securities law, including not just stock market regulation and federal disclosure requirements, but also regulation of broker-dealers, mutual funds and indenture trustees. The wish list also included major changes to existing bankruptcy law.⁶⁸

An obvious danger was that the reforms would step on the toes of so many different interest groups that interest groups would band together and derail the entire package.⁶⁹ The New Deal reformers devised

⁶⁶ The state laws that regulated (somewhat haphazardly) disclosure were and are referred to as "blue sky" laws-- a reference to the concern that securities manipulators would sell investors investments backed up by little more than the clear blue sky if states did not provide protective regulation. See Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991)(describing blue sky laws as supported by farmers and small businessman seeking to protect their access to credit).

⁶⁷ See, e.g., SELIGMAN, *supra* note 42, at 19 (discussing Roosevelt's emphasis on finance in his nomination speech, and his promise to 'let[] the light of day on issues of securities, foreign and domestic, which are offered for sale").

⁶⁸ Interestingly, Roosevelt himself seems initially to have favored disclosure-based regulation, rather than the more intrusive reforms that some of his advisors advocated in their concern to destroy the "money trust" banks. As enacted, the securities laws were closer to Roosevelt's view. William Douglas's private correspondence makes especially clear that he thought the 1933 Act did not provide nearly enough substantive governmental oversight. See, e.g., William O. Douglas, Letter to Adolph A. Berle, Jr., William Douglas Papers, Container #2, Library of Congress (Dec. 29, 1933)("I think the Securities Act is a rather laborious and untimely effort to turn back the clock").

⁶⁹ DeBEDTS, *supra* note 9, at 82.

an ingenuous solution to this problem. Rather than proposing the entire package at once, the reformers began with their highest initial priority-- securities reform. With the Securities Act of 1933 and the Securities Exchange Act of 1934, the reformers took on a relatively narrow (and quite unpopular) set of interest groups-- the stock exchanges and Wall Street bankers.⁷⁰

Tucked inconspicuously into the 1934 Act were provisions instructing the SEC to conduct studies of both investment advisers and the use of protective committees in corporate reorganization cases.⁷¹ The plan was to use the studies as the basis for subsequent reforms. By leaving these reforms for later, the reformers isolated the likely interest group opposition to each.⁷² Even better, the 1934 Act enhanced the likelihood of subsequent success by providing for extensive empirical studies that could be used to buttress the case for reform.⁷³

This structural strategy proved to be a smashing success. With the interest group opposition divided and the SEC studies in place, the reformers passed a series of important reforms later in the New

⁷⁰ More sweeping than the securities reforms, and part of the same legislative effort, were the banking reforms that implemented federal deposit insurance and separated commercial and investment banking. For discussions of the legislative history of the financial reforms, see ROE, *supra* note 39; Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 691-98 (1987).

⁷¹ Securities Exchange Act of 1934, sections 4, 211, 15 U.S.C. 78d, 78jj; DeBEDTS, *supra* note 9, at 140.

⁷² DeBEBTS, *supra* note 9, at 82.

⁷³ With the SEC's protective committee report, this role was all but explicit. In the house hearings on the Chandler Act, Douglas himself suggested that the reports were "in the nature of briefs in favor of the Chandler Bill." *Chandler Hearings (House)*, *supra* note 21, at 199 (statement of William Douglas, SEC Chairman). See also E. Merrick Dodd, Jr., *The Securities and Exchange Commission's Reform Program for Bankruptcy*, 38 COLUM. L. REV. 223, 225 (1938)(defending the SEC proposals but noting that the SEC reports are "essentially briefs" and "we should be on our guard against the easy assumption that the picture [suggested by the reports] ... is one which is in no need of retouching").

Deal, including the Chandler Act in 1938, the Trust Indenture Act of 1939,⁷⁴ and the Investment Advisers Act of 1940.⁷⁵ In this first stage, then, the ex ante wiring was both conscious and extraordinarily effective. When it came to the specifics of SEC oversight of bankruptcy, however, the structural strategy of the Chandler Act backfired, for reasons we will explore below.

2. Ex Ante Wiring and the Chandler Act

As planned, the SEC's protective committee study proved pivotal in the process that led to the Chandler Act in 1938. As noted earlier, the study mushroomed, and William Douglas and his SEC staffers did not produce the first volume of their report until 1936. In 1935, Congressman Chandler had introduced the initial version of the Chandler Act, which focused on the bankruptcies of individuals and small businesses, and incorporated a wide range of changes proposed by the National Bankruptcy Conference.⁷⁶ Based on an extensive investigation of equity receiverships, Congressman Sabath proposed his alternative bill in 1936.

By 1937, it was clear that the Chandler Act (possibly together with the Lea Bill, which arose as a parallel reform in 1936) would be the principal source of bankruptcy reform. Although the SEC had

⁷⁴ Pub. L. No. 38, 53 Stat. 1149 (1939)(codified as amended at 15 U.S.C. sections 77 aaa-uuu (1988).

⁷⁵ 15 U.S.C. section 80a (1988)).

⁷⁶ See supra note 21 and accompanying text. Among the prominent academic commentators who participated in this effort was Professor James McLaughlin of Harvard Law School. McLaughlin published several articles detailing the changes he and the National Bankruptcy Conference deemed necessary to bankruptcy reform. See, e.g., James A. McLaughlin, *Aspects of the Chandler Bill*, 4 U. CHI. L. REV. 369 (1937).

played little role in developing the Chandler Act, it dramatically intervened in early 1937, shortly after publishing the first of its protective committee reports.⁷⁷ The SEC proposed to graft an entirely new chapter for regulating the reorganization of publicly held corporations onto the initial version of the Chandler Act, which had largely ignored this area of bankruptcy. On its face, the SEC's intervention was an enormous success. Because the National Bankruptcy Conference was much more concerned about general bankruptcy practice (that is, individuals and small firms), its members grudgingly accepted the complete overhaul of corporate reorganization that was eventually passed as Chapter X of the Bankruptcy Act.⁷⁸

If we take a closer look at the structural effects of the Chandler Act, however, we begin to see the fault lines in the reformers' edifice. Ironically, from a structural perspective, Chapter X proved to be *too* complete a victory for the SEC. Rather than simply reforming existing reorganization practice, and interposing the SEC as policeman, Chapter X completely cleaned house. The prohibition of prebankruptcy solicitation, together with strict new disinterestedness requirements, ushered the Wall Street investment banks out of the reorganization practice they had long controlled.⁷⁹ The passage of the Trust Indenture Act

⁷⁷ See *supra* note 22 and accompanying text.

⁷⁸ The National Bankruptcy Conference approved the SEC's proposed reforms at a meeting in March, 1937, but the meeting was sparsely attended and the vote was apparently close. *Chandler Hearings (House)*, *supra* note 21, at 363-65 (statement of John Gerdes). During the hearings, several members of the NBC criticized aspects of the SEC reforms, especially the mandatory trustee requirement. See, e.g., *id.* at 284 (statement of Alfred N. Heuston)(criticizing trustee proposal and proposed SEC oversight of corporate reorganization).

⁷⁹ As noted earlier, with prebankruptcy solicitations prohibited, investment bankers lost much of their comparative advantage, which stemmed from their ability to coordinate scattered bondholders through the protective committee device. See *supra* note 16. The disinterestedness requirements further undermined their role by restricting the ability of a debtor's prebankruptcy advisors-- precisely the bankers who had previously organized protective committees-- to represent creditors in bankruptcy.

of 1939 the following year further undermined the influence of investment banks. Most importantly, the Trust Indenture Act outlawed voting provisions that purported to bind all bondholders to changes approved by a majority vote.⁸⁰ The voting prohibition made it much more difficult for a firm's investment bankers to restructure its obligations outside of bankruptcy, just as the Chandler Act prevented the bankers from retaining their authority after the firm filed for bankruptcy.

Less obviously, the Chandler Act also destroyed the influence of the reorganization bar. With little role for the investment banks, and with existing managers be replaced by a trustee, reorganization lawyers' two principal clients were gone. It wasn't long before the elite reorganization bar was gone, too.⁸¹ Within a few years, firms such as Cravath, Swaine & Moore, whose initial prominence stemmed in important part from its role (most famously, through Paul Cravath and his successor, Robert Swaine) in dozens of prominent railroad reorganizations,⁸² had all but disappeared from reorganization practice.

By crushing each of these interest groups, the Chandler Act eliminated the most likely source of future support for SEC oversight in bankruptcy. Counterintuitively, perhaps, the SEC would have been much better off in the longrun if they had weakened the interest groups rather than destroying them. Weakened interest groups may develop symbiotically with their regulators.⁸³

⁸⁰ For an extensive discussion and critique of the voting prohibition, section 316 of the Trust Indenture Act, see Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987).

⁸¹ For a more detailed discussion, see Skeel, *supra* note 1, at 1370-71.

⁸² The rise of the Cravath firm, and its exploits in numerous early reorganizations, is chronicled in the Robert Swaine's classic biography of the firm. ROBERT T. SWAINE, *THE CRAVATH FIRM AND ITS PREDECESSORS* (1946)(two volumes)

⁸³ This point is somewhat analogous to Richard Doernberg and Fred McChesney's argument that lawmakers can maximize their interest group support by adjusting but not eliminating the burden of tax reform on an affected group; and by threatening to withdraw benefits. Richard L. Doernberg & Fred S.

A comparison with the SEC's role under the 1933 and 1934 securities acts is both striking and instructive in this regard.⁸⁴ In order to pass the securities laws, New Deal lawmakers had to overcome resistance from the same investment banks that the SEC targeted with its bankruptcy reforms. As with the Chandler Act, the securities laws interposed the SEC as regulator in an area where investment bankers previously had enjoyed wide latitude. But in contrast to the Chandler Act, the securities laws preserved an important role for investment bankers (and Wall Street lawyers) in securities issuance.⁸⁵ However much they may decry SEC intrusion, each of these interest groups now has a powerful incentive to ensure that the SEC retains its regulatory authority; and each has sided with the SEC in the SEC's jurisdictional battles.⁸⁶

In bankruptcy, the New Deal reformers unintentionally failed to wire this kind of future support into

McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913 (1987).

⁸⁴ The analysis that follows applies even more strongly to the regulation of banks under the New Deal banking reforms. Although Wall Street banks strenuously resisted the reforms, they now routinely side with bank regulators in jurisdictional disputes.

⁸⁵ *See generally*, Macey, *supra* note 51, at 922 ("The predictable phenomenon of agency 'capture' [of the SEC] ... has led to subsidies to favored constituencies, particularly securities analysts, institutional investors, market professionals ... and retail brokerage firms")(footnotes omitted).

I do not mean to suggest that the securities reforms left the existing interest groups untouched. Many observers believe that the new disclosure requirements helped destroy the near monopoly of J.P. Morgan and several other investment banks over public securities offerings, since their expertise was less necessary in more transparent securities markets. *See* George D. Smith & Richard Sylla, *The Transformation of Financial Capitalism: An Essay on the History of American Capital Markets*, 2 FIN. MKTS INST'S & INSTRUMENTS 1 (1993) (arguing that mandatory disclosure made bankers' role as reputational intermediaries less important). Even with this important change, however, Wall Street lawyers and bankers remained the central players.

⁸⁶ *See, e.g.*, Macey, *supra* note 10, at 104-105 (securities industry has supported SEC in its jurisdictional disputes with the CFTC, whereas futures industry, which the CFTC regulates, has sided with the CFTC).

their bankruptcy reforms.⁸⁷ In addition to eliminating powerful interest groups such as Wall Street bankers who might later have supported the SEC, the Chandler Act also left the SEC exposed to interest groups who had precisely the opposite incentives. First, those bankruptcy lawyers who did continue to participate in bankruptcy practice had good reason to resist the SEC, since the SEC was seen by many as interfering with what would otherwise be private negotiations among the parties toward a reorganization plan.⁸⁸ These lawyers, who came from the general bankruptcy bar, had little in common with the elite corporate reorganization bar that had been wiped out by the Chandler Act. In sharp contrast to Cravath, Swaine and their peers, general bankruptcy lawyers were seen by many as faintly unsavory. But the bar also proved surprisingly successful as an interest group, due in part to effective nationwide organization (through the National Bankruptcy Conference and the groups, such as the Commercial Law League and the American Bar Association, that comprised it), and also to its expertise in a difficult area of law.⁸⁹

In addition, the battle over the contours of corporate reorganization took place primarily in the courts, and the initial decision makers, bankruptcy judges and the district court that oversaw them, had their own reasons for looking askance at SEC involvement. In cases filed under Chapter X, SEC involvement

⁸⁷ "Unintentionally" may be too strong a word. Douglas and others were so concerned to break Wall Street's grip on corporate finance that they might have refused to adjust their proposals even if they had known how future events would unfold.

⁸⁸ As noted earlier, this concern dates back to the hearings on the Chandler Act, where many critics decried the disruptive effect the SEC's reforms would have on private negotiations. *See, e.g., Chandler Act Hearings (House)*, *supra* note 21, at 284 (statement of Alfred N. Heuston, Bar Association of the City of New York)(arguing that SEC involvement will slow reorganization process down); *Chandler Act Hearings (Senate)*, *supra* note 21, at 83-85 (statement of Garrett A. Brownback)(same).

⁸⁹ I have described the historical influence of the general bankruptcy bar in detail in other work. *See, e.g.,* David A. Skeel, Jr., *Bankruptcy Lawyers and the Shape of American Bankruptcy Law*, 67 *FORDHAM L. REV.* 497 (1998).

slowed down the proceedings,⁹⁰ and the SEC's reports on reorganization plans could quite easily be seen as an intrusion on the court's oversight role.⁹¹

The posture of the cases in which the SEC challenged a debtor's attempt to use Chapter XI offers tantalizing circumstantial evidence that the courts were in fact unsympathetic to the SEC. At the trial level, courts frequently rejected the SEC's efforts to force a case back to Chapter XI.⁹² It was only at the appellate level-- with courts not involved in the day-to-day oversight of the bankruptcy case-- that the SEC's success rate improved somewhat.⁹³

In short, the interest group dynamic left in place by the Chandler Act spelled disaster for the SEC.

⁹⁰ See, e.g., Weintraub, Levin & Novick, *supra* note 33 (contrasting flexibility and speed of Chapter XI to Chapter X).

⁹¹ Large creditors also appear to have opposed Chapter X, at least in part due to its cost and complexity. See Posner, *supra* note 35, at 111 (large creditors lobbied for the simplified procedures that were enacted as chapter 11).

⁹² See, e.g., Allen F. Corotto & Irving H. Picard, *Business Reorganizations Under the Bankruptcy Reform Act of 1978-- A New Approach to Investor Protections and the Role of the SEC*, 28 DePAUL L. REV. 960, 965 n.19 (1979)("Much of the law addressing whether chapter X or XI was appropriate for the rehabilitation of a particular debtor was a result of appeals initiated by the Commission from lower court denials of its transfer motions").

Bankruptcy history does pose one puzzle for this view, however. When the bankruptcy judges proposed their own bankruptcy reform bill in the 1970s, the bill proposed that the SEC retain its role, rather than calling for removal of the SEC as one might predict. The explanation for this appears to lie in the facts that the judges were most concerned to protect their own status (and voice in the reform process), and that their bill largely rubberstamped existing practice in other respects. The judges made little attempt to defend their reorganization proposals when this aspect of the bill was challenged, which suggests that we cannot read much into their proposed inclusion of the SEC. See, e.g., Posner, *supra* note 35, at 117 (describing judges' disinclination to defend their reorganization proposals).

⁹³ *Id.* at 969 (citing several cases from 1960s and 1970s that granted motions to transfer to Chapter X). I discuss the Supreme Court cases, particularly *Shlensky*, and Douglas' role as a member of the Court, in Part III(E), *infra*.

With bankruptcy lawyers and judges against the SEC, and no similarly powerful constituency in favor,⁹⁴ it is not surprising that the SEC subsequently lost its grip.⁹⁵

One possible objection to the analysis thus far is that perhaps the unfavorable interest group climate simply reflected the realities of legislative compromise rather than a miscalculation or accident, as I have suggested. On this view, the balance of power when the Chandler Act was enacted may have supported a temporary role for the SEC rather than a permanent one. This might be the case, for instance, if the political climate favored destruction of the influence of Wall Street bankers and lawyers, but was not sympathetic to a permanent SEC presence in bankruptcy.

On inspection, such a hypothesis has little evidential support. It is clear that the SEC had sufficient influence to assure itself a lasting role-- after all, the problem was that the SEC and its allies insisted on provisions that were, in a sense, too sweeping. The reformers clearly believed they could both transform existing practice and establish a permanent role for the SEC in bankruptcy.⁹⁶

⁹⁴ Once Wall Street bankers and lawyers disappeared from bankruptcy, the SEC's principal constituency was small creditors-- creditors with too limited a stake to justify participation and who thus may have benefitted from SEC efforts to police reorganization on their behalf. *See* Posner, *supra* note 35, at 109-110. But creditors of this sort exerted little influence in the legislative process that led to the 1978 Code. *Id.* at 111.

⁹⁵ In addition to its judicial activities, the SEC also proposed legislation, similar to its 1940 proposal, that would have prohibited firms whose outstanding securities were held by one hundred or more investors from using Chapter XI. But no hearings were held, and the legislation went nowhere. *See generally* 1973 *Commission Report*, *supra* note 34, at 246.

⁹⁶ In his apologia for the SEC, for instance, Jerome Frank drew parallels between the SEC and the ICC's role in railroad reorganization, and emphasized the need for ongoing oversight. Jerome Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U. L. REV. 317 (1941).

D. A Final Structural Problem: the Oversight of an Unsympathetic Committee

The interest group dynamic reflected in the Chandler Act was the most striking effect of its initial structure. But there was a second structural factor as well: the choice of oversight committee. As with interest groups, the committee structure dramatically undermined the SEC's longterm prospects.

As we have seen, three different bankruptcy bills emerged in Congress in the 1930s.⁹⁷ The Judiciary Committee, the committee that had jurisdiction over general bankruptcy issues,⁹⁸ drafted and held hearings on the first of the bills, the Sabath Bill. The Chandler Bill, which, even more than the Sabath Bill, focused on the bankruptcies of individuals and small firms, also made its way through the Judiciary Committee. By contrast, because it targeted publicly held corporations and proposed to amend the Securities Act of 1933, the Lea Bill came before the Banking Committee in the House and the Interstate Commerce Committee in the Senate. The Sabath Bill predated SEC involvement and drew only tepid support from the SEC,⁹⁹ whereas the SEC was actively involved with the Chandler and Lea bills.

⁹⁷ See notes 19-27 and accompanying text (describing the Sabbath, Chandler and Lea bills and the hearings held on each).

⁹⁸ Judiciary Committee jurisdiction over bankruptcy dates back to the formation of the committee in early nineteenth century. See LAUROS G. McCONACHIE, CONGRESSIONAL COMMITTEES 213 (1974)(describing formation of Judiciary Committee in 1813 and scope of its jurisdiction).

⁹⁹ The SEC's lack of enthusiasm stemmed, most obviously, from the timing of the bill, and was reflected in tensions between the Sabath committee and the SEC's protective committee study due to their overlapping jurisdiction over real estate reorganizations. For a fascinating inside account of the tension between the Sabath Committee and the SEC's protective committee project, see Memorandum from Abe Fortas to William Douglas, William Douglas Papers, Container No. 328, Library of Congress (Oct. 7, 1935)(describing meeting between Fortas and Congressman Wilcox of the Sabath Committee and expressing concern that, if the SEC helped to thwart the Sabath Bill, the Sabath Committee might take similar action against any subsequent SEC proposal). See also Interview between Mr. Boland and Mr. Comer, William Douglas Papers, Container No. 29, Library of Congress (Jan. 10, 1935)(notes of

William Douglas and the SEC threw particular weight behind the effort to insert their reforms into the Chandler Act, but also lent vigorous support to the even more sweeping Lea Bill.¹⁰⁰ The Lea Bill reforms were so far-reaching, however-- requiring SEC oversight not just of bankruptcy, but also of nonbankruptcy workouts¹⁰¹-- that the bill collapsed after sustained attack by investment bankers and others.¹⁰² Rather than compromise the bill to increase its odds of passage, Douglas refused to back down from any of its principal reforms.

The failure to make the Lea Bill more palatable meant that the Judiciary Committee, not the Banking and Interstate Commerce Committees, would oversee the SEC's role in bankruptcy.¹⁰³ To see why this aspect of the ex ante wiring was so important, consider the SEC's relationship with the Banking and Interstate Commerce Committees. Because the securities laws were (and are) subject to their oversight, the SEC already had ongoing contact with these committees. During the 1940s and thereafter, the SEC appeared before these committees dozens of times. This ongoing relationship has created both familiarity

Boland)(suggesting that Sabath Committee might introduce legislation in order to "nullify the authority which the Protective Committee Study now has to investigate the [real estate bond reorganization] field").

¹⁰⁰ See, e.g., *Chandler Hearings (House)*, *supra* note 21, at 162-199 (statement of William O. Douglas, SEC Chairman)(testifying in favor of Chandler Bill); *Chandler Hearings (Senate)*, *supra* note 21, at 9-15 (same); *Lea Hearings*, *supra* note 24, at 105-126 (statement of William O. Douglas, SEC Chairman)(describing and testifying in favor of Lea Bill).

¹⁰¹ See, e.g., *Lea Hearings*, *supra* note 24, at 20-34 (statement of William Douglas, SEC Chairman)(describing Lea Bill and arguing that extension to nonbankruptcy workouts was necessary due to inadequacies of state regulation).

¹⁰² For just one illustration of investment bankers' complaints, see *id.* at 136 (statement of Orrin G. Wood, Investment Bankers Association of America)(suggesting that investment bankers favor full disclosure, but Lea bill would go radically beyond this).

¹⁰³ This is because the SEC's bankruptcy authority was codified as a part of the Bankruptcy Act, rather than through amendments to the 1933 Securities Act as the Lea Bill proposed.

and a presumption of expertise when the SEC speaks on its activities under the securities laws.¹⁰⁴ The SEC would have enjoyed precisely the same benefits with respect to its role in bankruptcy if the Lea bill had passed.

The SEC's relationship with the Judiciary Committee stands in marked contrast. Unlike with the Banking and Interstate Committees, the SEC did not appear before the Judiciary Committee with any regularity, since the Judiciary Committee does not have jurisdiction over the other areas that the SEC regulates. When bankruptcy issues did arise, moreover, the SEC did not have anything like the unique claim to expertise it enjoyed in the securities law context. Not only did the SEC's expertise cover only a small part of bankruptcy-- corporate reorganizations involving major firms-- but the SEC had to compete with two very broad-based and similarly sophisticated interest groups, bankruptcy judges and bankruptcy lawyers, whose expertise did include all of bankruptcy. In contrast to the SEC, each of these groups *does* consult with members of the Judiciary Committee on a regular basis.¹⁰⁵

To be sure, bankruptcy judges and bankruptcy lawyers would also have participated in any hearings before the Banking and Interstate Commerce Committees. But if the SEC's role had been framed

¹⁰⁴ These benefits derive from the SEC's status as a repeat player. Because the SEC expects to appear before the Banking and Interstate Commerce Committees on a regular basis in the future, it has a strong incentive to provide accurate information, lest it lose its future credibility. The committees recognize this and, as a result, will pay particular attention to the SEC's testimony. *See generally* ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984)(describing cooperation in repeat play situation of parties who would otherwise have an incentive to defect).

¹⁰⁵ In his oral history for the University of Michigan Law School, Professor Frank Kennedy, reporter for the 1973 Bankruptcy Commission Report, described the ongoing relationship between the National Bankruptcy Conference and the Judiciary Committee as follows: "Over the years, whenever any bankruptcy legislation was being considered ... the House Judiciary Committee and the Senate Judiciary Committee always informed us, and asked us to comment on these proposals, and paid considerable respect to the views that were expressed by the NBC members." FRANK R. KENNEDY, *ORAL HISTORY* 26 (April, 1989).

as an extension of the securities laws, and hearings were limited to the regulation of publicly held firms, the SEC's status both as a repeat player and as an expert on precisely this set of issues would have given it an enormous advantage.¹⁰⁶ From this perspective, it is not surprising that the SEC proved so ineffective in Congress on bankruptcy issues in the 1950s and thereafter.¹⁰⁷

Let me pause to consider two possible objections to my claim that committee choice is an important structural factor. First, as we have seen, several recent commentators have challenged the view that committees enjoy substantial autonomy within Congress.¹⁰⁸ If Congress (or the majority party) rather the relevant committee determines outcomes, one might expect roughly the same outcomes with one oversight committee as with another. But such a strong view, that committees are simply ciphers for Congress is implausible, as noted earlier.¹⁰⁹ Particularly given the complexity of bankruptcy legislation, and its often ambiguous political implications, the choice of oversight committee is likely to be unusually important in this

¹⁰⁶ This point can be put in another way. In the positive political theory literature, McCubbins, Noll and Weingast have argued that committees' discretion over legislative outcomes is as broad as, and bounded by, the "lens" defining the set of points that Congress, the President and the Committee all would agree to. McCubbins, Noll & Weingast, *supra* note 47. Because different committees have different preferences, the lens will vary somewhat depending on the which committee has oversight authority. The SEC has more influence on the preferences of the Banking and Commerce Committees, than the Judiciary Committee. As a result, the lens of possible outcomes would be more favorable to the SEC if the Banking and Commerce Committees had jurisdiction.

¹⁰⁷ In its legislative efforts on securities law issues, the SEC often came up empty in the 1950s, but it enjoyed a dramatic resurgence in the 1960s. *See, e.g.*, SELIGMAN, *supra* note 42, at 290-348 (describing role of William Cary as SEC chairman); Barry R. Weingast, *The Congressional-Bureaucratic System: A Principal Agent Perspective (with Applications to the SEC)*, 44 PUB. CHOICE 147 (1984)(arguing that the SEC's success in the 1960s stemmed from changes in Congress, rather than changes endogenous to the SEC). As we have seen, these halcyon days came at precisely the same time as the SEC was losing its authority in corporate reorganization.

¹⁰⁸ *See supra* notes 55-56 and accompanying text.

¹⁰⁹ *See supra* note 58 and accompanying text.

context.¹¹⁰

The second objection is a variation on one we saw earlier. Perhaps the only way for the SEC to get what it wanted in bankruptcy was to cast its lot with the Chandler Bill, which already had substantial momentum by 1937. While this objection is in fact plausible, it seems likely that a moderated Lea Bill could have passed-- perhaps along the lines of the alternatives I explore in Part IV. The benefit to the SEC of working through the Chandler Bill is that it enabled the SEC to achieve reforms that might not have fit neatly within legislation designed to amend the securities acts-- such as the requirement that debtors' managers be replaced by a trustee in bankruptcy.¹¹¹ This benefit came at the substantial cost, however, of subjecting the SEC to the oversight of an unsympathetic committee.

E. Douglas as Justice: The Unlikely Thunderbolt

Thus far, we have focused on the legislative process, in which William Douglas figured prominently. Douglas continued to play a crucial role after becoming a Supreme Court Justice in 1939, as the author of a number of important decisions construing the Chandler Act. Few are so puzzling at first glance as his

¹¹⁰ For a somewhat analogous point in the banking context, see Jonathan R. Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1276, 1288-90 (1989)(complexity of banking regulation, and difficulty for general public of appreciating its implications, creates significant opportunities for rent-seeking).

¹¹¹ Unlike provisions for disclosure or SEC review, which would parallel the SEC's authority outside of bankruptcy, the trustee requirement lay at the heart of the bankruptcy process.

opinion in *General Stores Corp. v. Shlensky*,¹¹² which ultimately helped to erode the SEC's authority in bankruptcy. This Part concludes by briefly considering the *Shlensky* opinion, both to make sense of Douglas's perspective and to fit the decision into our overall story.

The puzzle of *Shlensky* is that Douglas could have made it much more difficult for substantial firms to evade Chapter X by adopting a strict rule requiring all publicly held debtors to use this chapter. But he did not. Douglas held, instead, that the choice of chapters depended on the "needs to be served," and in doing so left room for future debtors to invoke Chapter XI in order to avoid the stricter requirements and SEC oversight of Chapter X. How could it be that the same man who fought so hard (as SEC chair) to establish the SEC as investor's champion in bankruptcy, also helped (as Supreme Court Justice) to hasten the SEC's decline?

One possible explanation for the tenor of *Shlensky* is that, by 1956, the SEC was run by Eisenhower appointees. Perhaps Douglas so abhorred their (*laissez faire*, Republican) view that he had little sympathy for their perspective. This seems implausible, however, given that the SEC was arguing not for less governmental authority, but for an absolute rule requiring debtors to use Chapter X if they had issued any publicly held stock or debt.¹¹³ That is, the SEC sought precisely the kind of oversight authority Douglas and others had built into the Chandler Act.

¹¹² 350 U.S. 462 (1956).

¹¹³ The SEC took this position in both of the first two Supreme Court decisions on the Chapter X-Chapter XI choice, *Securities and Exchange Commission v. United States Realty & Improvement Co.*, 310 U.S. 516 (1956) and *Shlensky*. In the third and final Supreme Court decision, *Securities and Exchange Commission v. American Trailer Rentals Co.*, 379 U.S. 594, 607 (1965), the SEC argued, quite similarly, for an absolute rule requiring Chapter X whenever the reorganization would alter the rights of any public security holder.

Another possibility is that Douglas's own views had simply changed in the eighteen years since the Chandler Act had been enacted. Perhaps he no longer felt as great a need for SEC oversight in corporate reorganization, and for the other protections of Chapter X.

A memo Douglas wrote in 1940, shortly after joining the Court, casts important light on his subsequent opinion in *Shlensky*, and strongly undermines both of these possible explanations.¹¹⁴ In setting out his thoughts on the *U.S. Realty* case, in which he did not formally participate,¹¹⁵ Douglas strikes many of the same themes he would later sound in *Shlensky*. Of particular note, he insists that the choice of reorganization chapter should be discretionary, explicitly criticizing the "government's position that all cases where a debtor has outstanding public offerings of securities automatically fall under Ch.X."¹¹⁶ There are similar parallels between Douglas's efforts in the memo and in the *Shlensky* opinion to clarify the parameters of a court's choice of reorganization chapter. In each case, Douglas suggests that courts should consider whether a debtor could propose a Chapter XI reorganization plan that is "fair and equitable."¹¹⁷

¹¹⁴ William O. Douglas, Memo, No. 796, Securities and Exchange Commission v. U.S. Realty & Improvement Company, Douglas Papers, Container No. 50, Library of Congress (undated)(hereinafter, "Douglas Memo").

¹¹⁵ A diary Douglas kept during his first year on the Supreme Court casts fascinating light on his decision not to participate. Douglas himself did not believe that his recent departure from the SEC, which was a party in the case, required recusal. But Chief Justice Hughes strongly favored recusal, apparently because Hughes hoped to line up five votes for his own view. See Douglas Diary, Container No. 1780, Library of Congress (May 27, 1940). Hughes' gambit failed, as Justice Stone's majority opinion tracks Douglas's views in many respects, and Hughes wound up in dissent. (There is in fact reason to believe Justice Stone was well aware of Douglas's views-- a note from Justice Frankfurter saying "Bill, hadn't you better send a copy of this memo to Stone?" is attached to the 1940 memo in Douglas's files).

¹¹⁶ Douglas Memo, *supra* note 114, at 1.

¹¹⁷ *Id.* at 3-4; *Shlensky*, 350 U.S. at 466, 467. As discussed below, "fair and equitable" was a term of art that Douglas construed in opinions shortly before and shortly after *U.S. Realty* as requiring that a reorganization plan satisfy the absolute priority rule. The references to "fair and equitable" in *Shlensky* are particularly striking given that Congress eliminated the "fair and equitable" requirement from Chapter

If the debtor could not propose a plan that satisfied both the "fair and equitable" standard and the other requirements of Chapter XI,¹¹⁸ Douglas concludes, it must use Chapter X.

If, as the 1940 memo strongly suggests, Douglas's view did not change, why did he refuse to direct all publicly held debtors into Chapter X? The most obvious explanation is that *Shlensky* is a direct manifestation of Douglas's judicial philosophy-- though one with unfortunate consequences for the SEC. Particularly in his bankruptcy work, Douglas was deeply committed to the legal realist view that lawmakers must look beyond the laws themselves¹¹⁹-- which often offer little insight into how things actually work-- and to take a more functional approach to legal decision making.¹²⁰ Douglas's "needs to be served" standard is precisely this kind of approach. Although he believed that every debtor belonged in one of the two chapters, either Chapter X or Chapter XI,¹²¹ Douglas also believed that the choice should turn on the particular debtor rather than an artificial rule such as the presence or absence of publicly issued securities.

XI in 1952. Although one would not want to push the speculation too far, it is at least possible that Douglas hewed to his earlier analysis even in the face of subsequent legislative changes.

¹¹⁸ Until Congress deleted the "fair and equitable" requirement from Chapter XI, satisfying this and the other requirements of Chapter XI was in fact quite tricky, as discussed below.

¹¹⁹ Thus, Douglas described his early bankruptcy study as an effort to strip away the legal rules and focus on the factors influencing bankruptcy filing decisions. His goal was to use this "scientific" process to propose specific legislative changes. The press release announcing Douglas's study of personal bankruptcy, for instance, quotes him as saying, "it is believed that information respecting causes of failures will make possible more scientific legislation in the bankruptcy field. Yale University News Statement, William Douglas Papers, Container No. 32, Library of Congress (Nov. 24, 1930).

¹²⁰ For a similar conclusion about Douglas's views on bankruptcy, see John W. Hopkirk, *William O. Douglas-- His Work in Policing Bankruptcy Proceedings*, 18 VAND. L. REV. 663 (1965)(emphasizing Douglas's "functionalist" perspective).

¹²¹ Douglas Memo, *supra* note 114, at 1 ("Chapter X and Chapter XI are mutually exclusive").

An additional, practical consideration may have been the SEC's limitations as an overseer.¹²² The SEC could not realistically intervene in every case involving publicly issued securities; nor would it want to. Even the most avid reformers believed that the SEC's resources were best spent focusing on cases where public investors' interests were most at stake-- cases with widely scattered security-holders or complicated capital structures. SEC oversight of closely held debtors that happened to have a few publicly issued securities could prove to be more a distraction than anything else.

If the Bankruptcy Act had been left as it stood in 1940, and bankruptcy judges had applied *Shlensky* (and *U.S. Realty*) as Douglas envisioned, the SEC might have held on to its power. But this was not to be. Legislatively, a crucial change had come in 1952, when Congress deleted the "fair and equitable" requirement from Chapter XI. As construed by the Supreme Court (most notably, in two early Douglas decisions),¹²³ this requirement had made it extremely difficult for debtors with publicly held securities to reorganize under Chapter XI. In each of these cases, Douglas interpreted "fair and equitable" treatment as embodying the "absolute priority rule," a pre-Chandler Act requirement that all higher priority creditors be paid in full before any value could be given to lower priority creditors or shareholders.¹²⁴ Although the

¹²² It is also possible that Douglas could not have lined up five votes for an opinion establishing stricter criteria-- after all, four justices dissented in *Shlensky*, arguing that the debtor should have been permitted to invoke Chapter XI. But the striking parallels between Douglas's 1956 *Shlensky* opinion and the 1940 memo suggest that the exigencies of Supreme Court voting were not the only factor-- and in fact may not have played a role.

¹²³ *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939)(construing "fair and equitable" requirement as term of art incorporating the absolute priority rule); *Consolidated Rock Products Co. v. DuBois*, 312 U.S. 510 (1941)(same).

¹²⁴ The absolute priority rule, which remains in effect (in modified form) in current law, has generated an almost endless stream of controversy and discussion in the bankruptcy literature. For an overview and a proposal relating to the so-called "new value" exception to the absolute priority rule, which has captured much of the attention of courts and commentators (and will be resolved by the Supreme Court this term),

requirement made sense in Chapter X, it posed problems in Chapter XI, because Chapter XI prohibited any modification to the rights of a debtor's shareholders.¹²⁵ If both requirements were stringently applied, nearly every publicly held firm would be forced into Chapter X, since debtors could not easily honor absolute priority and, at the same time, leave shareholders' interests entirely intact.¹²⁶ By deleting the requirement, Congress preserved a Chapter XI option for a wide range of firms that might otherwise have been ushered straight into Chapter X.¹²⁷

The pressure for this change came from the same interest groups we have seen throughout the analysis-- most importantly, from bankruptcy lawyers and organizations that reflect their interests, such as the National Bankruptcy Conference. The elimination of the fair and equitable requirement, together with *Shlensky's* "needs to be served" standard, built significant lee-way into the choice between Chapter X and Chapter XI. Added to this was the fact that the lower courts, not the Supreme Court, were the ones who decided the vast majority of cases. Even if the Supreme Court itself might have directed every case with

see Bruce Markell, *Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991).

¹²⁵ As originally designed, Chapter XI was a simple "composition" procedure that permitted a debtor to restructure its unsecured obligations, but required that all secured claims and stock be left intact. For a description, see Rostow & Cutler, *supra* note 28.

¹²⁶ If the debtor was solvent, and thus could pay its creditors in full, it obviously could satisfy both requirements, but not many debtors are solvent. Douglas' 1940 memo suggests that both requirements also should be seen as satisfied in closely held firms where the shareholders also are its managers, and the firm's going concern value would be lost if the managers were displaced. Douglas Memo, *supra* note 114, at 4.

¹²⁷ The significance of this change is implicit in Douglas's *Shlensky* opinion (and explicit in Justice Frankfurter's dissent). Although Douglas makes several puzzling, unexplained references to the "fair and equitable" requirement, *see supra* note 117, the principal basis for directing the debtor into Chapter X was that Chapter XI reorganization would not be "feasible" given the debtor's bleak prospects. *Shlensky*, 350 U.S. at 467. Feasibility provides a much weaker constraint on debtors (and sympathetic bankruptcy judges) than the fair and equitableness requirement would.

a potential public interest into Chapter X, the "needs to be served" standard left plenty of room for debtors' attorneys to argue for Chapter XI, and for sympathetic bankruptcy judges to agree.

It is impossible to know whether Justice Douglas anticipated that *Shlensky* would contribute to the SEC's decline in bankruptcy; and whether, in hindsight, he might (or could)¹²⁸ have opted for a clearer rule.

What is clear is that *Shlensky* and the events surrounding it reinforced the interest group dynamic set in motion by the Chandler Act; the discretionary standard left an important opening for debtors and their lawyers, and in doing so spelled trouble for the SEC.

The climax of this trouble came when Congress replaced the Bankruptcy Act with the Bankruptcy Reform Act of 1978 (the "Bankruptcy Code"). The 1978 Code was several years in the making, starting in a sense with the 1973 Report of a bipartisan bankruptcy commission and including extensive hearings in 1975 and 1976.¹²⁹ The SEC repeatedly defended its oversight role in the hearings; and in fact the Senate version of the legislation that eventually passed would have preserved the SEC's role.¹³⁰ Much of the bankruptcy bar, and many bankruptcy lawyers, by contrast, lobbied for a more flexible reorganization procedure-- one that left the process largely to the parties, and minimized the role of the SEC.¹³¹ When the dust settled, the flexible, debtor-friendly procedure won out, and the SEC was ushered off center stage.

¹²⁸ The uncertainty here is due to the possibility that Douglas might have had trouble securing five votes for a more sweeping holding-- particularly given the discretionary tone of the principal precedent, *U.S. Realty*.

¹²⁹ In his extensive analysis of the political economy of the 1978 reform, Eric Posner gives detailed consideration of each of the steps that led to the legislation that eventually passed. Posner, *supra* note 35.

¹³⁰ See, e.g., *id.* at 117 (describing Senate bill and SEC testimony arguing for continued governmental oversight).

¹³¹ *Id.* at 116-18.

The Bankruptcy Code did not eliminate governmental oversight altogether. The Code did provide, on an experimental basis, for a United States Trustee program which subsequently became permanent. But the U.S. Trustee's powers are strictly circumscribed, and the program has been embattled from its inception.¹³² In large bankruptcies, the U.S. Trustee's principal role often is to quibble about requests for attorney's fees-- a far cry from the majestic role that William Douglas had carved out for the SEC in the Chandler Act of 1938.

IV. HOW MIGHT THINGS HAVE BEEN DIFFERENT?

I have argued thus far that although budget constraints contributed to the SEC's eventual disappearance from bankruptcy, the structural parameters of the SEC's role were the single most important factor. By ushering the SEC's potential interest group allies, Wall Street investment banks and lawyers,

¹³² For a critical assessment of the U.S. Trustee's performance, see Peter C. Alexander, *A Proposal to Abolish the Office of United States Trustee*, 30 U. MICH. L.L. REF. 1 (1996).

out of bankruptcy, the Chandler Act exposed the SEC to opposition from far less sympathetic interests such as bankruptcy judges and the bankruptcy bar. Subjecting the SEC's authority to the oversight of the Judiciary Committee, rather than the Banking and Commerce Committees, reinforced the SEC's vulnerability.

Having performed an analytical autopsy of what went wrong for the SEC, let us consider, by way of contrast, how things might have been different. The most obvious alternative (and one which was urged at various times in the hearings) would have been for the SEC to police disclosure and fraud in bankruptcy, but not to purport to pass substantive judgements on quality, much as it does in the securities markets outside of bankruptcy.¹³³ Just as it scrutinizes public offerings, for instance, the SEC could approve or disapprove the disclosure statements sent to investors in connection with a reorganization plan. The SEC might also regulate creditors committee activities and issues such as claims trading.

Such a strategy would have counteracted both of the structural problems that hastened the SEC's demise in bankruptcy. Because these responsibilities would be a natural extension of the SEC's securities law authority, the Senate Banking and House Interstate Commerce Committees would have been the obvious choice as oversight committees. The SEC would be far better positioned to preserve its role under these circumstances, where legislative concern would be limited to bankruptcies involving publicly held firms and the SEC would be the principal source of expertise. Moreover, the SEC could have expected support from the Wall Street bankers and lawyers who participated in firms' disclosure process.

¹³³ Importantly, several investment bankers testified that they would support SEC oversight in a disclosure-based regime-- thus reinforcing my suggestion that Wall Street bankers and lawyers might have served as an aggressive supporter of the SEC had the SEC not eliminated their role in bankruptcy. *See supra note* 102.

Interestingly, the framework I have just described is similar in many respects to the regime Douglas proposed for railroad reorganization in his famous exchange with Max Lowenthal.¹³⁴ Although Douglas saw the need for a strong governmental presence (for railroads, this meant the ICC), he contended that regulators should police negotiations among the parties rather than dominate the process themselves. Had the reformers limited the SEC's role in this fashion, and if (a huge if, given Douglas's animus) the reformers had preserved at least a limited role for Wall Street bankers, the SEC might still be overseeing the reorganization of publicly held corporations.

One can of course debate whether such a framework would be more efficient than existing chapter 11. Not the least of the advantages would be a greater coordination between corporate law and corporate bankruptcy in a world in which the SEC played a prominent role in both contexts-- among other things, one might expect a more seamless relationship between nonbankruptcy disclosure and the disclosure requirements for a reorganization plan. It is also quite possible-- perhaps counterintuitively-- that an enhanced governmental presence would diminish the existing bias toward reorganization.¹³⁵

Whether or not an SEC-influenced framework would be superior, the important point is that the SEC might have retained a preeminent role in bankruptcy if its authority had been structured differently.¹³⁶

¹³⁴ Douglas, *supra* note 4.

¹³⁵ Current commentators tend to recoil at the prospect of governmental intervention in the markets, but both the New Deal reformers and former Chapter X tended to discourage reorganization, just as the proposed alternatives to chapter 11 do.

¹³⁶ To underscore this from a different perspective, contrast the SEC's role under an even more sweeping New Deal reform, the Public Utility Holding Company Act of 1935 (PUHCA). Through its so-called "death penalty" provision, section 11, PUHCA authorized the SEC to force the vast, interconnected firms that dominated the utilities industry to simplify their holding company structures. For a good description, see SELIGMAN, *supra* note 42, at 241-264. The effect of PUHCA was both more dramatic and more controversial than the Chandler Act, requiring a great deal of President Roosevelt's political

Interestingly, the nature of corporate reorganization practice has changed so dramatically in the past decade that, by adopting an approach similar to the one Douglas and the reformers rejected in the 1930s as too narrow, the SEC could restore a meaningful role for itself in bankruptcy. Spurred by the debtor-friendly approach adopted by Chapter 11 of the 1978 Code, and the numerous high profile reorganization cases that followed in the wake of the corporate takeover wave of the 1980s, corporate reorganization practice has once again risen to the prominence it had prior to the New Deal. From Weil, Gotshal to Wachtell, Lipton, Rosen & Katz and even Cravath itself, the elite New York law firms have once again staked out a prominent position in corporate reorganization; and the lines between corporate law and bankruptcy have once again blurred. One sees tender offers and corporate control contests both outside of bankruptcy and within.¹³⁷

Given the SEC's oversight of these issues outside of bankruptcy, it would make obvious sense for the SEC to play a similar role in large bankruptcy cases. Perhaps the best illustration is claims trading. In

capital. DeBEDTS, *supra* note 9, at 117-120. Yet the SEC not only succeeded in restructuring the utilities industry, but the SEC also retained its oversight authority long after it had accomplished the initial restructuring. Although the SEC had essentially completed its restructuring of the utilities industry within a decade, it has retained its oversight role. The SEC itself finally recommended shifting control back to state regulators several years ago. SEC Report, Division of Investment Management, The Regulation of Public Utility Holding Companies (June, 1995)(recommending repeal).

The analogy between PUHCA and bankruptcy is obviously incomplete, but the structure of PUHCA deviated from the Chandler Act along precisely the lines we have been considering. Once the initial restructuring was underway, utility firms were relatively sympathetic to SEC oversight, so that the SEC did not have any obvious, powerful interest group opposition. Moreover, the oversight committees for PUHCA were ones that knew the SEC well, the Senate Banking and House Interstate Commerce Committees. With a sympathetic committee and no interest group opposition, the SEC never faced a serious threat to its authority, in striking contrast to the SEC's fate in bankruptcy.

¹³⁷ For a brief overview of takeovers and related developments in bankruptcy, see Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 103-106 (1995).

recent years, the market for debt securities and other claims against Chapter 11 debtors has mushroomed, raising a variety of concerns, ranging from investor protection to the potentially adverse tax effects of claims trading on a debtor's reorganization.¹³⁸ The SEC would be the natural agency to address these concerns. The SEC could police fraudulent claims trading, just as it polices misrepresentation and insider trading outside of bankruptcy, for instance;¹³⁹ and the SEC could adapt its disclosure requirements to claims traders who acquire a significant percentage of a class of claims.¹⁴⁰

To be sure, a renewed SEC role would also have downsides, such as the risk that the agency would interfere with bankruptcy court decision making. This suggests that the bankruptcy court rather than the SEC should be the one to determine whether the disclosure statement for a proposed reorganization plan provides "adequate information," despite the fact that this requirement was deliberately modelled on securities law disclosure standards.¹⁴¹ But on issues where the SEC already has a presence, such as

¹³⁸ The tax concern is that active trading can destroy a firm's net operating losses, because the IRS requires that a minimum percentage of existing security holders remain in place if the reorganized firm wishes to use the old firm's NOL's. For a discussion of the literature on claims trading, and a proposal that court's prohibit most trading after the beginning of the case, see Frederick Tung, *Confirmation and Claims Trading*, 90 Nw. U. L. REV. 1684 (1996)

¹³⁹ Securities Exchange Act, section 10(b) and Rule 10b-5 already give the SEC the authority to police insider trading and misrepresentation with respect to "securities," and the SEC has in fact prosecuted an increasing number of actions in bankruptcy cases in recent years.

¹⁴⁰ Under Securities Exchange Act, section 13(d) and Rule 13d-1(a) a person or group that acquires more than 5% of any class of equity securities must make extensive disclosure within 10 days. The SEC might use a similar (although presumably more limited) approach for acquisition of a major debt interest in a publicly held Chapter 11 debtor.

¹⁴¹ Bankruptcy Code section 1125(b)(prohibiting reorganization plan from being submitted for a vote under the court approves the accompanying disclosure statement as containing "adequate information"). Under current law, the Chapter 11 voting process is exempt from the securities laws. See Bankruptcy Code section 1125(e). See also Bankruptcy Code section 1145 (broad exemption of Chapter 11 process from the Securities Act of 1933).

policing market behavior, the SEC could play a valuable role. If lawmakers gave the SEC a bit more leeway in Chapter 11, the effect would be to further reconnect corporate bankruptcy to corporate law generally, a link that was severed more than sixty years ago.

CONCLUSION

The Chandler Act of 1938 was in many respects an enormous success for William Douglas and the New Deal reformers. In one bold stroke, the Chandler Act transformed corporate reorganization and vindicated Douglas's sweeping indictment of the reorganization practices perfected by Wall Street bankers and the reorganization bar. If we take a longer perspective, however, things look quite different. The reformers' central goal in bankruptcy was to assure permanent governmental oversight of the bankruptcy process. Although the SEC assumed this mantle in the early years, its presence steadily declined thereafter. As of 1978, the SEC was gone.

In this Article, I have offered a detailed explanation of what went wrong. I have argued that the SEC did not simply fade gracefully from the scene, as a public interest explanation might suggest. Quite to the contrary, the SEC fought to preserve its role, and many observers were shocked to see the 1978 Code put an end to meaningful SEC oversight. The actual explanation lies, instead, in a series of political factors. Most importantly, the SEC's role was structured in such a way as to make its status unusually precarious. The Chandler Act magnified the strength of the SEC's interest group opposition by destroying

the SEC's likely allies, and exposed the SEC to the oversight of an unsympathetic committee. The budget cuts the SEC faced in the 1950s reinforced the SEC's vulnerability by prompting it to scale back its bankruptcy role early on.

Throughout the analysis, I have emphasized that the SEC's demise was not foreordained. Its rise and fall both stemmed in important part from conscious decisions made by William Douglas and others. Had Douglas been more flexible early on, the SEC might have been forced to compromise on some of its goals for bankruptcy. But the SEC might also have secured itself a far more permanent role as investors' champion in corporate reorganization. Interestingly, the time could be ripe for a renewed, although more limited, presence in corporate reorganization. Whether the clock can or will be turned back remains to be seen.