United States Senate

April 10, 2003

The Honorable William H. Donaldson
Chairman, Securities and Exchange Commission
450 Fifth St.
Washington, D.C. 20549

Dear Mr. Chairman:

We are writing to seek the views of the Securities and Exchange Commission on Section 414 of H.R. 975, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2003. This legislation recently passed the House and may soon be considered by the Senate. We would appreciate your views regarding section 414, which would amend the current conflict of interest standard found in section 101(14) of the Bankruptcy Code, 11 U.S.C. § 101(14). Because these changes raise concerns about the proper role for investment banks during the bankruptcy process, we believe the expertise of the Commission may be helpful in evaluating them.

Section 414 would weaken the current conflict of interest standard by allowing investment banks that have had a close financial relationship with the debtor to play a major role in the bankruptcy process. Allowing banks that were an active part of a company's financial decline to profit from restructuring the company's assets may be unjust, especially to investors and pensioners who have suffered financial damage. Moreover, the appearance of a conflict of interest may not only harm the public's confidence in the bankruptcy process, it could strike many as reversing progress Congress and the SEC have made in the direction of greater corporate accountability and increased investor protection. Given that section 414 was included in earlier versions of this legislation, we believe it should be evaluated in light of the real and apparent conflicts of interest evidenced in the wave of corporate scandals of the last few years.

The Proposed Changes

Trustees in bankruptcy are called upon to manage the assets of the bankrupt debtor and to evaluate any claims that may be brought by or against the estate. The trustee has a fiduciary duty to creditors and cannot have a bias in favor of any group of creditors or parties against whom the estate may have a claim. In order to avoid any conflicts of interest, section 327 of the Bankruptcy Code requires that professional persons who are retained by the trustee are "disinterested." Section 101(14) currently excludes a number of persons from qualifying as a "disinterested person," including creditors, equity security holders, insiders, and investment bankers for outstanding or recently issued securities. These categories of persons are currently subject to a per se exclusion. Section 414 of H.R. 975 would not amend the restrictions on creditors, equity security holders, or insiders. However, it would delete investment banks from the per se exclusion.

Potential Conflicts of Interest

The rationale for section 101(14), as applied to investment banks, is that investments bankers for outstanding or recently issued securities would face a conflict of interest in advising the trustee because of their close financial relationship with the debtor prior to bankruptcy. For example, the trustee may be called upon to evaluate the conduct of parties involved in the issuance of securities prior to the debtor filing for bankruptcy. Such a review would likely involve an assessment of the actions by any investment banks that engaged in underwriting of outstanding or recently issued securities or that advised the debtor regarding its capital structure. In those cases, an investment bank advising the trustee would be in the position of evaluating its own conduct prior to the bankruptcy filing. Other potential conflicts could arise as well.

We understand that section 101(14) was reviewed by the Commission on Bankruptcy Laws during the 1970's and the Commission recommended retaining essentially the current version. It was again reviewed by the National Bankruptcy Review Commission, which concluded in its final report in 1997 that: "Strict disinterestedness standards are necessary because of the unique pressures inherent in the bankruptcy process."[1] The National Bankruptcy Review Commission also recommended against "replacing disinterestedness with a less rigorous showing of a materially adverse conflict."[2] Several national experts, including Judge Edith Jones of the United States Court of Appeals for the Fifth Circuit, Arthur Levitt, former Chairman of the SEC, Dean Nancy Rapoport of the Houston Law Center, and Professor Elizabeth Warren of Harvard Law School, have also recommended against weakening the current disinterested person standard.

The views expressed by these organizations and individuals raise serious questions about the appropriateness of these changes. Indeed, we have concerns about the wisdom of weakening conflict of interest standards when our financial markets are still plagued by a lack of confidence in the standards of corporate behavior.

We would appreciate your informing us in writing of the Commission's views regarding Section 414 of H.R. 975at your earliest convenience. Thanks very much for your assistance.

Sincerely,

Patrick Leahy

PATRICK J. LEAHY
U.S. Senator

Paul Sarbanes

PAUL S. SARBANES
U.S. Senator

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[1] See National Bankruptcy Review Commission: Final Report, p. 874 (Oct. 20, 1997).

[2] Id. at 876.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

May 22, 2003

The Honorable Patrick J. Leahy
United States Senate
433 Russell Senate Office Building
Washington, D.C. 20510

The Honorable Paul S. Sarbanes
United States Senate
309 Hart Senate Office Building
Washington, D.C. 20510

Dear Senators Leahy and Sarbanes:

Thank you for requesting the Commission's views on Section 414 of H.R. 975, which would amend the "disinterested person" definition in the conflict of interest standards of the Bankruptcy Code to remove the specific provisions covering investment bankers. On May 7, in response to a question from Senator Sarbanes at a hearing of the Senate Committee on Banking Housing and Urban Affairs on the Impact of the Global Settlement, I expressed my personal views about this amendment. Now I am pleased to convey the view of the Commission, which is that, while it may be possible to draft language that would address some of the concerns of the proponents of the amendment, Congress should proceed very cautiously before loosening any conflicts of interest restriction. While we recognize that this one-size-fits-all statutory exclusion is controversial, we believe that it would be a mistake to eliminate the exclusion in a similar one-size-fits-all manner at a time when investor confidence is fragile.

The current "disinterested person" requirement was adopted at least in part in response to a 1938 study by the Securities and Exchange Commission that provided extensive documentation and analysis of abuses in corporate reorganizations. The study concluded that a firm that served as underwriter for a company's securities should not advise the company about distributions to those security holders in a reorganization plan. It further found that such a firm should not advise the company about potential claims against those involved with the company prior to the bankruptcy, since this often would involve an assessment of transactions in which the firm participated. However, we should note that in the 65 years since the 1938 study was issued, bankruptcy practices and procedures have improved significantly with the addition of a dedicated bankruptcy judicial system, the establishment of the U.S. Trustee's office, and the strengthening of active creditors' committees.

We are aware of the arguments of proponents of the amendment that the current statutory exclusion is too broad because it covers firms that participated in *any* underwriting of the debtor,

even if it was years ago and the firm has had no further involvement with the debtor. However, if the exclusion is eliminated entirely, we are concerned that the general protection in the statute — which relies on the judge, at the outset of the proceedings, to forbid those with materially adverse interests to the estate, its creditors, or its equity security holders from advising a company in bankruptcy — may well be insufficient.

We appreciate the opportunity to comment on this proposed amendment. If you or your staff need any further information, please contact my office.

Sincerely,

William H. Donaldson
Chairman