SELLING OUT CORPORATE REFORM: ELIMINATING THE "DISINTERESTED PERSON" REQUIREMENT FOR INVESTMENT BANKERS ADVISING CHAPTER 11 DEBTORS

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"(An investment advisor) should continuously occupy an impartial and disinterested position as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in any respect."[1]

". . . no man can serve two masters; and considering that human nature must be dealt with, the rule (inhibiting conflict of interests) does not stop with actual violations of such trust relations, but includes within its purpose the removal of any temptation to violate them."[2]

INTRODUCTION

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA")[3] eliminates a 67-year-old conflict of interest rule prohibiting retention of an investment banker in reorganization where the investment banker participated in

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1. H.R. DOC. No. 477 (1939).

2. United States v. Miss. Valley Generating Co., 364 U.S. 520, 550 n.14 (1961) (quoting Mich. Steel Box Co. v. United States, 49 Ct. Cl. 421, 430 (1914)).

3. The BAPCPA became effective on October 17, 2005. Bankruptcy Abuse Prevention & Consumer Protection Act of 2005, Pub.L. No. 109-8, 119 Stat. 23 (codified as amended at 11 U.S.C. §§ 101-1502 (2005)).

the sale of stocks or bonds of the debtor-company prepetition. First codified as the "disinterested person" rule[4] in the 1938 amendments to the Bankruptcy Act, this categorical proscription resulted from the joint efforts of the Securities and Exchange Commission ("SEC") and the National Bankruptcy Conference. The rule's purpose was to eliminate a species of "bankruptcy patronage"[5] where retention guaranteed the investment banker continuous influence over the management of the debtor, the ability to obtain preferential treatment of its own claims, and a means to conceal its own improprieties.

The new BAPCPA legislation, flattering itself with the nomenclature of "bankruptcy reform legislation," substitutes a selective and discretionary disinterestedness standard for investment bankers, eliminating the categorical proscription enacted to prevent proven abuses in bankruptcy. As a consequence, BAPCPA undermines recent efforts at corporate reform in several important respects. Specifically, the change reintroduces the specter of conflict of interest into bankruptcy reorganization proceedings contrary to the Sarbanes-Oxley Act of 2002 ("SOX") and its attendant regulations, which labored to eradicate the same conflicts prepetition. SOX was intended to root out conflicts of interest clouding transparency[6] in financial transactions, including those typically ser-

4. *In re* Big Rivers Elec. Corp., 355 F.3d 415, 433 (6th Cir. 2004) (alteration in original) (citations omitted).

> In each of these forty-year increments - in 1898, in 1938, in 1978 - Congress legislated against the backdrop of centuries of common law decisions about the duties of trustees and other fiduciaries as well as against the backdrop of courts construing statutes in the context of similar common-law traditions. And in each instance, Congress incorporated these principles and traditions . . . "to give effect in Chapter X proceedings to the historic maxim of equity that a fiduciary may not receive compensation for services tainted by disloyalty or conflict of interest" . . . "A disinterested person should be divested of any scintilla of personal interest which might be reflected in [that person's] decisions concerning estate matters."

5. E. Merrick Dodd, Jr., *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations*, 38 COLUM.L.REV. 223, 251 (1938).

6. Transparency is not interchangeable with improved disclosure of information in the marketplace. Instead, transparency requires meaningful disclosure of information that allows an understanding of a firm's exposures and risks without distortion. Miriam F. Miquelon-Weismann, *Corporate Transparency or Congressional Window-Dressing? The Case Against Sarbanes-Oxley as a*

viced by investment bankers.[7] Subsequent congressional and SEC investigations into both the Enron and WorldCom debacles revealed severe damage inflicted by the investment banking industry to America's capital markets as a direct consequence of prepetition conflicts of interest. Eliminating the categorical disqualification of investment bankers from advising debtors now allows reorganization to become less transparent than the financial circumstances which led to insolvency. This creates an odd discontinuity between prepetition and postpetition legal standards. Under the new rule, the investment bank, whose unsound advice may have led the firm down the path to bankruptcy, may be retained to play a significant role in untangling the same failed transaction it once recommended.

The timing of the change in the law is likewise suspect. It comes at the height of investor distrust in the marketplace, fueled by the series of recent corporate scandals resulting in over $200 billion dollars in investor losses.[8] America's capital markets are its "crown jewel" where "a third of the wealth of the country at the height of the market was tied up in that stock market."[9] As contributors to these massive corporate failures, investment bankers share direct responsibility for the damage to America's capital markets.[10] BAPCPA's loosening of ethical restraints for investment bankers at the peak of rampant unethical conduct is unsound and unjustified, particu-

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Means to Avoid Another Corporate Debacle: The Failed Attempt to Revive Meaningful Regulatory Oversight, 10 STAN. J.L. BUS. & FIN. 98, 113 (2004) [hereinafter Miquelon-Weismann].

7. *See* Letter from Paul S. Sarbanes, U.S. Senator, and Patrick J. Leahy, U.S. Senator, to William H. Donaldson, Chairman, Sec. & Exch. Comm'n (Apr. 10, 2003) and Letter from William H. Donaldson, Chairman, Sec. & Exch. Comm'n to Paul S. Sarbanes, U.S. Senator, and Patrick J. Leahy, U.S. Senator (May 22, 2003), *available at* http://www.leahy.senate.gov/press/arch 2003.html, *reprinted in* 150 Cong. Rec. H220 (daily ed. Jan. 28, 2004).

8. Miquelon-Weismann, *supra* note 6, at 136.

9. Interview by Hedrick Smith with Lynn Turner, former Chief Accountant, Sec. & Exch. Comm'n (Apr. 5, 2002), *available at* http://www.pbs.org/wgbh/pages/frontline/shows/regulation/interviews/turner.html.

10. *See* SEC. & EXCH. COMM'N, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION: SECTION 703 OF THE SARBANES-OXLEY ACT OF 2002, STUDY AND REPORT ON VIOLATIONS BY SECURITIES PROFESSIONALS 1 (2003), *available at* http://www.sec.gov/news/studies/sox703report.pdf.

larly since it comes only three years after SOX tightened regulations on this very same conduct.

Proponents of the new rule argue that retention of an investment banker should be decided under the same selective, discretionary standards applied to other retained professionals in reorganization, ensuring that banks are treated "like everybody else." As applied to other estate professionals, the previous rule required disqualification by the court only upon a showing of "an interest materially adverse" to the debtor.[11] In reality, however, investment bankers can't be treated "like everybody else" because of the significant differences in the power and control wielded by investment bankers, both pre- and postpetition.

In fact, the endemic structure of investment banking is unique because the underwriter provides advice to both sides of the buy/sell transaction during the course of an issuance. Investment bankers not only advise the issuer on how best to market its public offering, they also persuade their own retail customers and independent buyers in the marketplace to buy. In this fiduciary straight jacket where loyalty is owed in some measure to both the seller and the buyer, the investment banker provides information about the strength of the issuer and the value of the company. The investment banker lends its reputation to the deal, assuring clients and customers that the information is truly transparent in the sense that the disclosure of information about the issuer has been accurate and meaningful. The buyer relies on the investment banker's reputation and implicit representation that truly accurate information has been provided about the issuer. Such advice to the buyer will not only financially benefit the issuer but it will also benefit the investment banker, who receives enormous fees

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11. *See In re* Marvel Entm't Group, Inc., 140 F.3d 463, 475-76 (3d Cir. 1998). The discretionary standard is generally applied by the courts as follows, the meaning of:

> "[I]nterest materially adverse" in the definition of a disinterested person [under the discretionary standard] overlaps with that of "interest adverse" in the first prong of § 327(a) and, together, they form one hallmark with which to evaluate whether professionals seeking court-approved retention (or to remain retained by the estate) meet the absence of adversity requirements embodied in the bankruptcy code.

In re Vebeliunas, 231 B.R.181,189 (Bankr. S.D.N.Y. 1999).

from the issuer. It is this pervasive influence and unique fiduciary position, as well as the inevitable temptation for abuse, which account for the differences in the legislative treatment of investment bankers and other retained professionals under prior bankruptcy law.

If any lesson was learned from Enron, WorldCom, and the endless string of other corporate disasters, it is that adequate federal supervision of Wall Street is lacking. The notion that a bankruptcy court can effectively supervise such a complex web of fiduciary relationships postpetition, which the SEC could not supervise prepetition, is disingenuous. Thus, the only workable solution is a return to the categorical proscription eliminating investment bankers from serving as investment advisors to debtors postpetition.

The abrupt departure from over half a century of legal precedent may be tied to the economic interests that ostensibly fractured the congressional will to maintain the same stringent ethical standards of corporate governance in the context of bankruptcy reform. The elimination of the categorical disqualification rule for investment banks conspicuously corresponds to the recent shift in Wall Street earning potential. Previously, investment banks profited from servicing acquisitions and mergers. As the demand for these services declined, investment bankers shifted their attention to lucrative retention as investment advisors to bankruptcy trustees of debtor companies.[12] However, categorical disqualification prevented investment bankers from accepting any fees in reorganization.

This financial bone tossed to the powerful clique of Wall Street lobbyists may signal a future retreat from SOX and a return to bankruptcy patronage or it may amount to nothing more than a mere pyrrhic victory. The SEC can act to prevent investment bankers from doing what they might do under BAPCPA by using SOX and the securities regulations to restrict them from engaging in conflicted practices or those that give rise to the appearance of impropriety. The new SOX regulations were passed before Congress abolished the categorical restrictions under the bankruptcy code and thus address only

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12. "[T]here has been a recent deluge of investment bankers/advisors into the bankruptcy theater due to the change and complexity of Chapter 11 and reduced merger and acquisition opportunities." *In re* Drexel Burnham Lambert Group, Inc., 133 B.R.13, 24 (Bankr. S.D.N.Y. 1991).

prepetition conduct. But the message is clear. The SEC eliminated conflicts that were endemic to the sale and exchange of the issuer's shares to protect the capital markets. Presumably, the SEC will not tolerate the same misconduct postpetition. Simply put, because reorganization is the usual consequence of corporate failure, it makes the best sense to continue the unyielding practice of keeping Wall Street out of the clean-up process after it helped create the mess.

I.
ORIGINS OF THE CATEGORICAL DISINTERESTEDNESS REQUIREMENT

The SEC and the National Bankruptcy Commission combined their efforts to secure protection for investors in the marketplace by codifying disinterestedness as an ethical rule, prohibiting conflicts of interest in the affairs of the debtor. An examination of the reasoning behind the rule in the context of early reorganization practice demonstrates a continuity of purpose to remedy proven abuses in the investment banking industry.

A. *1898-1938: The Rise and Fall of "Bankruptcy Patronage"*

The Bankruptcy Act of 1898[13] was the first federal law to offer companies protection from creditors in the form of "equity receiverships."[14] Pursuant to section 37 of the 1898 Act, the Bankruptcy Court appointed referees "to assist in expeditiously transacting the bankruptcy business pending in the various courts of bankruptcy." However, section 39(b) disqualified any referee from acting in a case "in which they are directly or indirectly interested; practice as attorneys and counselors at law in any bankruptcy proceedings; or purchase directly or indirectly, any property of an estate in bankruptcy." With the exception of authorizing the retention of stenogra-

13. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed 1978), [hereinafter 1898 Act].

14. The creation of the equity receivership is only a predecessor to corporate bankruptcy provisions. Equity receiverships were designed to deal with the post civil war railroad insolvencies. *See* Harvey Miller & Shai Waisman, *Does Chapter 11 Reorganization Remain A Viable Option For Distressed Businesses For The Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 160 (2004) [hereinafter Miller & Waisman].

phers, the Act was silent regarding the retention of outside professionals. The creditor's committee or the court hired all trustees, and all matters involving the trustee were subject to court review.[15] Nonetheless, the referee was obliged to be a disinterested party in exercising his extensive powers over the debtor's estate.[16] Through judicial expansion of the use of railroad equity receiverships to assume control of a defaulting railroad and its assets, federal district courts created the functional equivalent of a national reorganization system and the precursor of reorganization under the Bankruptcy Reform Act of 1978.[17]

As part of the protectionist legislation creating the SEC and its powers following the stock market crash of 1929, Congress directed the SEC in 1934 to make an investigation and study of "the work, activities, personnel and functions of protective and reorganization committees" and to report the results, along with recommendations for further legislation, to Congress.[18] Around the same time, Senator Hastings organized the National Bankruptcy Conference, a group of attorneys formed to draft bankruptcy legislation.[19] In an attempt to unify the efforts of the two groups, Congressman Chandler requested that the SEC group meet with members of the National Bankruptcy Conference.[20] As a result, Chapter X, entitled "Corporate Reorganizations," was introduced as part of the bankruptcy reform legislation known as the "Chandler Act of 1938."[21]

The findings contained in SEC's voluminous six-part report to Congress dealing with the various phases of corporate and other reorganizations[22] demonstrated the need for a legis-

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15. 1898 Act, *supra* note 13, § 44, 30 Stat. at 557.

16. 1898 Act § 38, 30 Stat. at 555.

17. Miller & Waisman, *supra* note 14, at 161-63.

18. Securities and Exchange Act of 1934, 15 U.S.C. § 78jj (repealed 1987).

19. DOUGLAS G. BAIRD, POLICY OF THE NATIONAL BANKRUPTCY CONFERENCE AND ITS CONFEREES REGARDING RELATIONSHIP WITH CONGRESS ON PENDING BANKRUPTCY LEGISLATION 1 (2004), *available at* http://www.nationalbankruptcyconference.org/images/bylawsdec.03_exhibit_1.doc.

20. H.R. DOC. NO. 93-137, pt. 1, at 243 (1973).

21. Chandler Amendments of 1938, Pub. L. No. 75-696, 52 Stat. 840 (1938) [hereinafter Chandler Amendments].

22. SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PRO-

lative fix to an otherwise tainted bankruptcy process that fostered conflicts of interest and financial self-dealing. Two of the reports focused on the issue of conflict of interest in the retention of professionals in bankruptcy and the need to eradicate the problem through reform legislation: THE STRATEGY AND TECHNIQUES OF PROTECTIVE AND REORGANIZATION COMMITTEES (May 10, 1937) ("Reorganization Report") and COMMITTEES AND CONFLICTS OF INTEREST (June 21, 1937) ("Conflicts Report"). The SEC's proposals for amendment to then section 77B of the Bankruptcy Act were directly incorporated into the Chandler Act as the new Chapter X, sections 157 and 158 authorizing corporate reorganizations.[23]

The Reorganization Report furnished shocking and definitive evidence that the failure to appoint disinterested trustees and conflict-free banking professionals, including underwriters, damages the interests of the estate and investors: "Rarely are reorganizations controlled by groups other than the management and its bankers . . ."[24]

> Whether it be dispensation of reorganization patronage . . . or control over the strategy and procedure of reorganization, the emoluments of control in reorganization have been many and varied. To have the trustee lend its support to a plan proposed by the dominant group was of great value. At times that plan would neglect fraud and other claims against the management and the bankers . . . [T]he bankers would be financially interested in having the old management reinstated so that friendly and profitable banking connections could be resumed . . .
>
> Inside groups, seeking control over the reorganization process, move quickly to gain control over pro-

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TECTIVE AND REORGANIZATION COMMITTEES (1936-37). The titles and dates of the separate parts include: PART IV: COMMITTEES FOR THE HOLDERS OF MUNICIPAL AND QUASI MUNICIPAL OBLIGATIONS (May 2, 1936); Part III: Committees for the Holders of Real Estate Bonds (June 3, 1936); Part VI: Trustees under Indentures (June 18, 1936); Part I: Strategy and Techniques of Protective and Reorganization Committees (May 10, 1937) [hereinafter Reorganization Report]; Part V: Protective Committees and Agencies for Holders of Defaulted Government Bonds (May 14, 1937) and PART II: COMMITTEES AND CONFLICTS OF INTEREST (JUNE 21, 1937) [HEREINAFTER CONFLICTS Report].

23. Dodd, Jr., *supra* note 5, at 224.

24. REORGANIZATION REPORT, *supra* note 22, at 878.

> tective committees. Such control is important mainly in that it enables the inside group to obtain the apparent support of security holders behind its program. The management and bankers of the debtor company are thus able to remain in the background, exerting their influence through protective committees which ostensibly represent the various classes of securities and other claims involved in reorganization. Control over committees facilitates control of legal proceedings . . . It also insures to the inside group control over the negotiation of the reorganization plan, control over committee patronage, and a certain amount of control over investigations and litigation concerning the past conduct of the management and the bankers . . .
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> Complete cooperation between management of the debtor company and its bankers is useful in effecting control of committees by the inside group. . . [T]he mutual advantages to be derived from management-banker harmony during reorganization provide a powerful incentive for compromising any differences which may exist. This has been recognized even to the extent of formal agreements in which support of management was obtained in return for a promised share in the control of the new or reorganized company and in the profits to be derived from the underwriting of its securities . . .
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> It does not follow from the fact of flotation of the securities that a house of issue has a monopoly on the right to represent security holders upon default. That such monopoly is contrary to the public interest is emphasized by a consideration of the questionable character of many flotations and the prevalence of conflicting interests of many houses of issue.[25]

The Reorganization Report examines specific corporate failures and concludes that a vigorous investigation and prosecution of claims against prior management and its bankers can only succeed "if the trustee is freed of all ties with those against whom he may be charged with the duty of asserting these

25. *Id.* at 873-78.

claims."[26] Indeed, the Conflict Report describes these practices as "glaring examples of conflicts of interest" that allow insiders to control "collateral business advantages" incompatible with the interests of the investors."[27]

This conflict of loyalty is repeatedly stressed in the Conflicts Report:

> A committee composed of bankers is not apt to investigate their own past conduct for the purpose of determining whether or not they are liable to the security holders. Once a committee is in the service of more than one master, the investors, as one of these masters, are likely to suffer.[28]

Even the desire to maintain control to dole out the "emoluments of control," including lucrative bankruptcy patronage, represents a conflict of interest with investors.[29]

Additionally, the report identifies a conflict of interest between investment bankers and the debtor where prepetition business relationships likely provided the investment banker with an influential position in management.

> If houses of issue, moreover, have participated in the management of the corporation, or have been influential in it, they are very likely to have had business transactions with it in addition to the origination and distribution of its securities. These business transactions may have taken the form of loans to the corporation or market operations for its account in its own stock . . . Default and reorganization may bring with them investigation and suits based upon these transactions.[30]

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26. *Id.* at 916.

27. CONFLICTS REPORT, *supra* note 22, at 295.

28. *Id.* at 7.

29. *Id.* at 9. The SEC concluded:

> The temptation will be strong to make liberal concessions to bankers' affiliates. Determination of the reasonableness of underwriting fees and commissions in any event is usually difficult . . . For such reasons a conflict of interest arises; it is to the interests of security holders to obtain the service at the least expense; it is to the interest of the bankers to obtain as generous and as liberal an award as possible.

Id. at 307.

30. *Id.* at 187.

In short, the Conflicts Report identifies at least four major conflicts of interest between the investment bankers and the debtor's estate. First, as a result of their advance knowledge of an impending default and their position of influence with respect to the debtor, investment bankers may obtain preferential treatment of their claims which is detrimental to the interests of the security holders. Second, the claims of investment bankers may be invalid or subject to reduction. If the reorganization is under their control, a thorough examination of their claims may not occur. Third, investment bankers generally seek an inside position in the new company with the hope of obtaining valuable new business in the reorganization. Finally, control over the proceedings may serve to insulate the investment banker from an investigation or suit arising out of dubious transactions with management resulting in the corporate failure in the first instance. The SEC repeatedly refers to these conflicts as actual and glaring.[31] At the risk of these conflicts being made public, investment bankers must necessarily engage in a "blame game" to "save face" and valuable business reputation,[32] all to the detriment of investors. Thus, equity receiverships offered shareholders little transparency with respect to the financial transactions that contributed to the insolvency. Once the corporation failed, management and its bankers had even greater motive postpetition to cover up and recover their respective financial positions. Until the Chandler reforms, equity receivership was nothing more than a convenient resting place for management and their bankers to regroup often to the continuing detriment of the investors.

B. *Transparency Through Disinterestedness: 1938 Bankruptcy Reform*

The Chandler reform amendments directly addressed these particular conflicts of interest and made dramatic changes to bankruptcy practice. In fact, the SEC bankruptcy reforms clearly established that a company's bankers and their attorneys were precluded either from serving as the trustee or advising the trustee.[33] Disinterestedness was the key provi-

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31. *Id.* at 226, 246-47.

32. *Id.* at 247.

33. DAVID A. SKEEL JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 120 (2001) [hereinafter SKEEL, JR.].

sion.[34] Newly enacted Chapter X mandated that the trustee and its advisors be outsiders, with no significant pre-bankruptcy connection to the bankrupt company.[35]

Specifically, Chapter X, section 157 of the Act allowed the trustee to retain an attorney to assist in the proceedings with the sole requirement being that the attorney be "disinterested."[36] Section 158 provided four definitions of "disinterested," three of which specifically addressed direct or indirect relationships with the "underwriters" of the company.[37] The Act further provided that a person would not be deemed to be disinterested if he was the underwriter of any securities of the debtor within five years of the filing of the petition; was an officer, director or employee of any such underwriter within two years of filing the petition or an attorney for the debtor or any such underwriter; or "by reason of any other direct or indirect relationship to . . . the debtor or such underwriter, or for *any reason* an interest materially adverse to the interests of any class of creditors or stockholders."[38] The Act unmistakably singled out and prohibited the professional retention of any person who by reason of his relationship with an underwriter of the debtor or for *any* reason had an interest materially adverse

34. *Id.*

35. *Id.*

36. Chandler Amendments, *supra* note 21, §157, 83 Stat. at 888. Section 157 provides in pertinent part:

> An attorney appointed to represent a trustee . . . shall also be a disinterested person . . . for any specified purposes other than to represent a trustee in conducting the proceeding under this chapter the trustee may, with the approval of the judge, employ an attorney who is not disinterested.

37. Chandler Amendments, *supra* note 21, §158, 83 Stat. at 888. Section 158 provides in pertinent part:

> A person shall not be deemed disinterested . . . if . . . (2) he is or was an underwriter of any of the outstanding securities of the debtor or within five years prior to the date of the filing of the petition was the underwriter of any securities of the debtor; or (3) he is . . . a director, officer or employee of the debtor or any such underwriter, or an attorney for the debtor or such underwriter; or (4) it appears that he has, by reason of any other direct or indirect relationship to, connection with, or interest in the debtor or such underwriter, or for any reason an interest materially adverse to the interests of any class of creditors or stockholders.

38. Chandler Amendments, *supra* note 21, § 158(4), 83 Stat. at 888 (emphasis added).

to the shareholders and creditors. The obvious legislative goal was to dismantle bankruptcy patronage and eliminate the glaring conflicts incompatible with investor interests. Here, the SEC's preference was not disclosure-based legislation or transparency as the remedy. Instead, the SEC supported aggressive governmental regulation of the process.[39] Under this agenda, rigid enforcement of the disinterestedness requirement was mandatory and caused the traditional power groups to lose significant control over the debtor.[40]

C. *Reorganizations Under Title 11-Bankruptcy Reform Act of 1978: Still No Sympathy for Wall Street*

The Bankruptcy Reform Act of 1978 ("1978 Act") was heralded as the new era for corporate bankruptcies, merging existing Chapters X, XI and XII into the newly enacted Chapter 11, providing for corporate reorganizations.[41] Yet with all of the massive changes to the bankruptcy system,[42] the upheaval left the Chapter X categorical disinterestedness requirement intact. Wall Street banks had disappeared from reorganization practice after the Chandler Act reforms, and it was that continued absence in the framework of the 1978 Act that "made it much easier for current progressives to embrace the new Chapter 11 reorganization framework."[43]

Even replacing the role of the SEC in corporate reorganizations with the appointment of an entity known as the "U.S. Trustee," (seen as the demise of the SEC's oversight role in bankruptcy proceedings), did not diminish the SEC's success in keeping Wall Street out of the process. The legislative philosophy prohibiting conflict of interest and the political forces in opposition to a system of bankruptcy patronage remained unbroken in the wake of dramatic changes to the landscape of bankruptcy reorganization by the 1978 Act. Ostensibly, Con-

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39. SKEEL, JR., *supra* note 33, at 116-19.

40. Miller & Waisman, *supra* note 14, at 169. The consequences in reorganization were likewise significant. More than 500 companies filed for Chapter X in 1938. The number dropped to sixty-eight in 1944 and then fluctuated around one hundred per year for much of the 1950's and 1960's. SKEEL, JR., *supra* note 33, at 125.

41. Miller & Waisman, *supra* note 14, at 176.

42. For a detailed description of the major changes to reorganization and corporate bankruptcies as a result of the 1978 Act, see *id.* at 172-89.

43. SKEEL JR., *supra* note 33, at 224.

gress understood that political hostility had traditionally been directed at the domination of Wall Street in reorganization, not at the fact of reorganization itself, even when it involved large corporations.[44]

D. *Expansion of "Disinterestedness:" Bankruptcy Reform Act of 1994*

Wall Street was to remain an outsider even with the advent of the next major bankruptcy reform. In fact, the Bankruptcy Reform Act of 1994 ("1994 Act") expanded the definition of the disinterestedness rule and, concomitantly, the scope of potential disqualification under the rule's application. Pursuant to section 327 of the 1994 Act,[45] a debtor or trustee is empowered to employ a professional that meets certain statutory requirements, including the condition that the professional is a "disinterested person" as defined in section 101(14).[46] This definition automatically disqualifies investment bankers and their attorneys from serving as estate profes-

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44. *See id.* at 183.

45. Bankruptcy Reform Act of 1994, 11 U.S.C. § 327(a) (2005). Section 327(a) provides in pertinent part:

> [T]he trustee, with the court's approval, may employ . . . professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

46. Bankruptcy Reform Act of 1934, 11 U.S.C. § 101(14) (2005). Section 101(14) provides in pertinent part: "disinterested person" means person that –

> (A) is not a creditor, an equity security holder, or an insider;
> (B) is not and was not an investment banker for any outstanding security of the debtor;
> (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;
> (D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
> (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason.

sionals if: (1) they are or were investment bankers for any outstanding security of the debtor; (2) within three years of filing the petition, they have been an investment banker for a security of the debtor, or the attorney for such investment banker, in connection with the offer, sale or issuance of a security of the debtor; (3) within two years of filing the petition, they were a director, officer, or employee of the debtor or the investment banker; or, (4) they have any interest materially adverse to the bankrupt estate or any class of creditors or equity security holders. Thus, the disqualification is broad in scope and directed at investment bankers who sell or sold securities of the debtor, lawyers for the investment bankers and even employees, officers and directors of the investment banks.

The definition in section 101(14) is adapted from section 158 of Chapter X of the 1938 Act, although it is expanded and modified.[47] The term "investment banker"[48] in section 101(14) replaced the term "underwriter" used in section 158 to clarify the application and to avoid conflict with the definition of the term "underwriter" in section 2(11)[49] of the Securities Act of 1933.[50] The desire to accomplish uniformity in the

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47. *See* H.R. Rep. No. 95-595 (1977), S. REP. NO. 95-989 (1978).

48. The key role of investment banks is to advise companies in raising money. Investment banks raise funds in capital markets and through private placements. They can sell the company's equities in the stock market through an IPO, initial public offering or secondary offering or advise on debt issues to the public markets. Commercial banks differ from investment banks in that commercial banks generally take deposits and make commercial and retail loans. In recent years the distinction has become less clear as commercial banks have begun to offer more investment banking services. Brokerages assist in the purchase and sale of stocks, bonds and mutual funds. Often brokerages and investment banks operate out of a single firm. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) [hereinafter Gilson & Kraakman].

49. Consolidated Appropriations FY 2001, Pub. L. No.106-554, § 1(a)(5), 114 Stat. 2763 (2000) (formerly ch. 38, Title I, § 2, 48 Stat. 74 (1933)). Section 2(11) provides in pertinent part:

> The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking . . .

50. 15 U.S.C.A. § 70(b)(11) (2001); H.R. REP. No. 595, at 256 (1977), *reprinted* at U.S.C.C.A.N. 5963, 6214; S. REP. NO. 989, at 132 (1978), *reprinted* in U.S.C.C.A.N. 5787, 5918.

disinterestedness requirement between the securities acts and the bankruptcy code dates back to the cooperative efforts between the SEC and the National Bankruptcy Conference in the 1930's.[51]

The National Bankruptcy Review Commission, established pursuant to the 1994 Act,[52] detailed the historic three-fold purpose of the disinterestedness requirement and its "strict" application:

> First, 'strict standards are necessary in light of the unique nature of the bankruptcy process.' Second, strict disinterestedness requirements are necessary to preserve public and judicial confidence in the bankruptcy system. Third, ethical standards for bankruptcy practice should be consistent with state ethical rules.
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> . . . a *strict* disinterestedness standard is designed to eliminate *any* conflicts that might cause the trustee and his professionals to favor one party over another . . . or to refuse to pursue possible claims or avenues of inquiry because of any direct or indirect pressures . . . The purpose of the rule is prevent even the emergence of a conflict irrespective of the integrity of the person under consideration.[53]

In fact, section 326(d) of the 1994 Act provides that a trustee may be denied reimbursement of expenses and compensation if diligent inquiry is not made regarding whether any professional person hired by the trustee is disinterested.[54] The section manifests a clear congressional intent to penalize non-

51. *See, supra* pt. II.A.

52. The National Bankruptcy Review Commission was an independent commission established pursuant to the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994). The Commission issued its report to Congress on August 12, 1997. [hereinafter NBRC Report], *available at* http://govinfo.library.unt.edu/nbrc/facts/html.

53. *Id.* at 873-74 (emphasis in original).

54. 11 U.S.C.A. § 326(d) provides in pertinent part:

> The court may deny allowance of compensation for services or reimbursement of expenses of the trustee if the trustee failed to make diligent inquiry into facts that would permit denial of allowance under section 328(c) . . . or with knowledge of such facts, employed a professional person under section 327 . . .

conforming behavior under the rule through the forfeiture of professional fees.

Significantly, the Commission rejected several proposals advanced between 1996 and 1997 to discard the categorical disinterestedness requirement.[55] The Commission concluded that the concern for public confidence in the bankruptcy system and adherence to ethical principles were the hallmarks of the legislative history. The Commission specifically relied upon and reaffirmed the SEC's conclusions and recommendations that led to the Chandler Act of 1938.[56] This legislative philosophy remained unbroken and was incorporated into the conflict of interest provisions of the Sarbanes-Oxley Act of 2002.

II.
"DISINTERESTEDNESS" REVISITED: THE COLLAPSE OF CORPORATE GOVERNANCE

A. *Targeting Conflict of Interest: The Relationships Between Investment Bankers, Research Analysts, The Issuer and The Public*

The Enron bankruptcy revealed a corporate pandemic of conflicts of interest. Specifically, the relationships between Enron corporate management and its investment bankers provide the classic paradigm of ethical misconduct grounded upon the same financial self-interest, at the expense of the investors, identified by the SEC in the 1930's. A closer look at the tripartite relationship among investment bankers, their research analysts and the issuer-debtor is instructive in underscoring the importance of the disinterestedness requirement in both the events leading up to the corporate failure and in unwinding the corporate debacle in bankruptcy. The desirability of consistency in the legislative ethics requirements both pre- and postpetition is critical to the goal of providing investors true transparency in financial transactions. Investors rely on information to make decisions. Fiduciary relationships and trust in the marketplace inform the reliability of such informa-

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55. NBRC Report, *supra* note 52, at 870-883.

56. H.R. DOC. No. 93-137, pt. 1, at 247 (1973) ("The Commission on the Bankruptcy Laws is of the opinion that the conclusions and recommendations of the protective committee study and the Congressional policy embodied in the Chandler Act are still valid.").

tion. The complicated set of relationships attendant to public offerings demands the strict regulatory control provided by SOX in lockstep with categorical restrictions in reorganization. A break in legislative continuity severs the continuity of ethical guarantees that provide protection to investors.

Investment bankers serve two principle functions in the sale of securities as part of a public stock offering. First, the investment bankers are distributors for the issuer, providing the sales force and facilities needed to sell the stock to the public.[57] Second, they provide a form of risk-sharing in connection with "firm commitment underwriting," spreading the issuer's risk that a change in market conditions will affect the price of the security or the number of units that can be sold.[58] As a practical matter, the investment banker provides the issuer its reputation: a representation in the marketplace that the investment banker has evaluated the issuer's business condition and is willing to stake its reputation on the value of the issuer.[59] This representation alone can make or break the offering, and the issuer is likely to pay a premium for this opinion.

In order to substantiate this opinion, broker-dealers providing investment banking services[60] to issuers employ securities analysts to help sell the stock by obtaining information about the issuers. The SEC recognizes the importance of securities analysts to the efficient operation of the securities market. In theory, the analysts' expertise and close scrutiny of corporate disclosures and financial statements should position them to notice where the problems are in the company and challenge the company on issues that management would prefer to avoid.[61] The analyst's job is to present a fair and accu-

57. Gilson & Kraakman, *supra* note 48, at 616-17.

58. *See id.* at 616 n.183.

59. *Id.* at 620.

60. NASD Rule 2711 defines investment banking services to "include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial advisor in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs or similar investments; or serving as a placement agent for the issuer." NASD Manual, *available at* http://www.nasd.com (follow "Rules & Regulations" hyperlink; then follow "NASD Manual" hyperlink).

61. *See,* Regulation Analyst Certification, Exchange Act Release Nos. 33-8118; 34-46301; (July 25, 2002); 67 Fed. Reg. 51,510 (proposed Aug. 8, 2002).

rate picture of the issuer unimpeded by promises of future compensation or economic gain in exchange for that opinion. Plainly, a broker-dealer's representation about the issuer in the marketplace is dependent upon the research analyst's findings. Thus, the success of the broker-dealer in landing the lucrative business of the issuer is tied to the opinion supplied by the analyst. Theoretically, the dynamic of the tripartite relationship should provide the necessary checks and balances, assuming all three parties are acting independently, unencumbered by profit expectations. As the Enron corporate debacle proved, however, that is precisely where the system fell apart. Investment bankers and their research analysts proved that they could no longer be trusted as a primary restraint against corporate wrongdoing. In fact, they directly participated in the unethical conduct and financial self-dealing.

B. *The Enron Conflicts of Interest Revealed by Congressional Investigators*

Specifically, the Congressional investigation of Enron[62] revealed the complete failure of research analysts, employed by reputable brokerage firms offering investment banking services, to ethically perform their function independent from economic pressure brought to bear from the broker-dealers.[63] Greed fueled that economic pressure, particularly the expectation of handsome brokerage fees if the investment banking services accomplished the goals of the issuers to raise capital on their stock. The Enron Report emphasizes that investment banking fees are extremely lucrative and investment banks "compete fiercely for these deals."[64] Accordingly, issuers, like Enron, that have a lot of investment banking business are unlikely to choose a bank or a broker-dealer whose analyst is criti-

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62. On March 5, 2003, a bankruptcy court examiner's 2,100 page report disclosed that on December 31, 2000, when Enron reported outstanding debt of $10.2 million, it should have reported debt of $22.1 billion. By November 2001, Enron's debt was underestimated by as much as $25 billion. Brant Goldwyn, *Bankruptcy Report Details Enron's Use of SPEs To Manipulate Income and Debt*, 35 SEC. REG. & L. REP. 470 (2003).

63. STAFF OF COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, 81-88 (Comm. Print 2002), *available at* http://www.senate.gov/~gov_affairs/100702watchdogsreport.pdf [hereinafter Enron Report].

64. *Id.* at 82.

cizing their stock; similarly, banks and broker-dealers are unlikely to utilize analysts who issue recommendations that hamper their ability to secure lucrative deals. For example, the Senate Permanent Subcommittee on Investigations revealed a memorandum from investment bankers at Merrill Lynch to its president indicating that Enron was pressuring Merrill Lynch to improve its rating in 1998 by threatening to withhold investment banking business. Shortly thereafter, an analyst reporting on Enron was forced to resign. He was replaced by an analyst who immediately changed Enron's rating to "buy."[65] The Merrill Lynch memorandum offered direct proof of the conflict of interest problem inherent in the tripartite business relationship between issuers, brokerage houses providing investment banking services, and research analysts.

In short, brokerage houses have engaged in a long running conflict of interest by failing to enforce the firewall separating the firms' stock analysts from their investment banking interests. In fact, research analysts who should have been completely insulated from investment banking pressure frequently accompanied investment banking personnel on sales pitches and "road shows" involving potential customers.[66] This practice directly contradicted the conflict of interest rules designed to ensure that stock recommendations are not tainted by efforts to obtain investment banking fees.[67] The conflicts also spill over into reorganization. Indeed, it is precisely the same set of conflicts that the National Bankruptcy Commission criticized in articulating the three-fold purpose for the legislative expansion of the definition of disinterestedness in the 1994 Act.[68]

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65. Enron Report, *supra* note 63, at 82-83 (citing *The Role of Financial Institutions in Enron's Collapse: Hearing before the Permanent Subcomm. On Investigations, Senate Governmental Affairs Comm.*, 107th Cong., S.Hrg.107-18 (2002), *available at* http://www.gpoaccess.gov/chearings/index.html); *See also* Miquelon-Weismann, *supra* note 6, at 99 n.3 (describing the details of Merrill's termination of leading stock analyst John Olson).

66. NASD Rule 2711(c)(5)(A) (2005): "A research analyst is prohibited from directly or indirectly: (A) participating in a road show related to an investment banking transaction."

67. NASD Notice to Members 05-34 (2005), *available at* www.nasd.com (follow "Rules & Regulations" hyperlink; then follow "NASD Manual" hyperlink).

68. *See* NBRC Report, *supra* note 52.

C. *The WorldCom Conflicts of Interest Revealed in Bankruptcy*

As the WorldCom corporate debacle[69] surpassed Enron in spectacular investor losses[70] and the company plunged into bankruptcy, court-appointed examiner Dick Thornburgh surfaced the grossly improper relationship between the debtor and its investment bankers. In his final report to the bankruptcy judge, Thornburgh concluded that the investment bankers aided and abetted former WorldCom CEO, Bernie Ebbers'[71] breach of fiduciary duties by giving him extraordinary IPO's and secondary stock offerings.[72] The investigation revealed that Ebbers engaged Salomon Smith Barney, Inc. ("Salomon") as WorldCom's primary investment banker. Salomon took a leading role in more than 20 transactions and received more than $100 million in fees.[73] In return, Salomon provided unprecedented personal loans and fraudulent IPO financial benefits to Ebbers.[74] In one transaction, Salomon and Citibank entered into an arrangement whereby Citibank took over $11 million dollars of Ebbers' personal loans. At the same time, Salomon guaranteed Citibank against any loss on

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69. WorldCom, now doing business as MCI, has superseded Enron as the largest corporate bankruptcy in the nation's history. Apart from wide-ranging financial statement fraud that included manipulating line costs, improperly classifying revenues, and improperly capitalizing line costs, WorldCom also misled state taxing authorities. The company tried to reduce its state tax liability by hundreds of millions of dollars by licensing certain intangible assets, such as "management foresight," to subsidiaries and then charging them billions of dollars in royalties. By characterizing certain income as royalties, the company hoped for a tax break. Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner at 1-7, *In re* WorldCom, Inc., Case No. 02-13533 (AJG) (S.D.N.Y. 2004) [hereinafter Thornburgh Report].

70. Enron Report, *supra* note 63, at 1 n.1.

71. Ebbers was sentenced to 25 years in prison in July 2005. Carrie Johnson, *Ebbers Gets 25-Year Sentence For Role in WorldCom Fraud*, WASH. POST, July 14, 2005, at A01.

72. The term "IPO" generally refers to a company's first issuance of stock to the public or its "Initial Public Offering." As noted above, the company seeking to issue an IPO, the issuer, will retain an underwriter, usually an investment banking firm.

73. Thornburgh Report, *supra* note 69, at 188-219.

74. Regulators "opposed allocation of IPOs to corporate executives in return for investment banking and other business, a practice commonly referred to as 'spinning.'" *Id.* at 143. In one IPO, Ebbers "received the third highest allocation of stock of any investor." *Id.* at 155. As the shares increased in value, Ebbers could "flip" or resell the stock in a short period of time resulting in enormous profits to Ebbers. *Id.* at 167.

the combined personal loans of Ebbers. At this point, the personal loans amounted to $53 million, all secured by Ebbers' WorldCom shares.[75] Thornburgh concluded that Salomon continually provided Ebbers IPO profits and loans because Ebbers was in a position to award, and did award, significant WorldCom investment banking business to Salomon.[76]

> Such personal receipt of the financial favors in exchange for WorldCom's investment banking business would support a claim that Ebbers breached his fiduciary duties of loyalty and good faith to WorldCom. Such evidence would support the conclusion that Salomon/SSB knowingly aided and abetted Mr. Ebbers' breach of fiduciary duty.[77]

Like Enron, WorldCom's selection criterion for hiring an investment banker was simple: "it made sense to engage a well-known Wall Street firm with analysts who likely would support the transaction."[78] In fact, WorldCom employees, along with Salomon investment bankers, engaged in "road shows" to solicit interest in the IPO from institutional investors.[79] The Thornburgh Report chronicles millions of dollars of injudicious and fraudulent financial transactions generated through the incestuous relationship between the issuer, corporate management, the research analysts and the investment bankers, all to the ultimate detriment of the investors.

Logic dictates that the selection criteria by a corporation in reorganization, bent on restructuring its capital structure and marketing a new issuance, is the same as it would be prepetition. It only makes sense to hire a Wall Street firm with analysts likely to support the transaction. Indeed, the proponents of the new legislation went further and argued that it only makes sense to hire the *same* Wall Street firm postpetition to save costs in administration.

This logic has been proven to be flawed. As the 1938 SEC report documents, reorganization becomes a "resting place" for the conflicted investment banker, offering both the opportunity to conceal misconduct and obtain an insider's advan-

75. *Id.* at 124.
76. *Id.* at 122, 128.
77. *Id.* at 128.
78. *Id.* at 136.
79. *Id.* at 145.

tage in servicing the next offering. History proves that self-restraint succumbs to the attractive temptation for abuse, and neither the SEC nor the bankruptcy court has the ability to adequately police this situation.

III.
SARBANES-OXLEY ACT OF 2002: THE PROMISE OF CORPORATE REFORM

The Senate investigation of Enron warned that the SEC's foundational assumption that it could depend on private entities as the first and primary restraint against corporate wrongdoing "proved terribly wrong."[80] Recognizing that the proper functioning of the U.S. markets rests on the "cornerstone principle" that all individuals have access to accurate basic information about the companies in which they invest, and that the stock market suffers from a crisis in investor confidence where such transparency is lost, legislative reform was viewed as a necessary protection against actual and perceived conflicts of interest. The ethical abuses engendered by investment bankers and research analysts became a centerpiece for reform in clear recognition that these "private sector watchdogs"[81] could no longer be trusted. The investment bank as the traditional "information and reputational intermediary"[82] evaporated with a concomitant loss of investor confidence in the marketplace.

Title V of SOX amends the Securities and Exchange Act of 1934 by inserting new Section 15D entitled "Securities Analysts and Research Reports"[83] in an effort to:

> [E]stablish structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are separated by appropriate professional partitions within the firm from the review, pressure, or oversight, of those whose involvement in investment banking activities might potentially bias their judgment or supervision.[84]

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80. Enron Report, *supra* note 63, at 2.
81. *See id.* at 4-5.
82. Gilson & Kraakman, *supra* note 48, at 618.
83. Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. § 501(a) (2002) (enacted).
84. 15 U.S.C. § 78O-6(a)(3).

In repairing the broken relationship between investment bankers and their research analysts, Congress hoped to eradicate the tripartite conflict of interest that contributed to the financial failures of the issuers. The goal was to return to theoretical independence among issuers, investment bankers and research analysts in an effort to reach a transparent and disinterested relationship that investors could rely upon in making investment decisions.

The legislative reforms were followed by regulatory changes promulgated by the SEC and the self regulatory organizations[85] ("SRO's," including New York Stock Exchange and the National Association of Securities Dealers).[86] NASD Rule 2711, approved by the SEC for implementation, not only reconstructs the firewall between research analysts and broker-dealers but goes a step further and expressly prohibits "compensation" to the analyst for favorable results designed to increase investment banking business. Rule 2711(e) provides:

> No member may directly or indirectly offer favorable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.[87]

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85. The concept of self-regulation is part of the Securities Exchange Act of 1934. By this Act, Congress granted cooperative organizations of investment bankers, dealers and brokers, self-regulatory authority over their members in order to attain the highest standard of legal and ethical behavior in the securities markets. 15 U.S.C. § 78o-3 (2001); S. REP. No. 1455, 75-1455, at 4 (1938).

86. NASD and NYSE Rulemaking, Exchange Act Release No. 34-48252 (July 29, 2003), *available at* http://www.sec.gov/rules/sro/34-48252.htm.

87. Thus, the reform legislation:

- Restricts the ability of investment bankers to pre-approve research reports
- Ensures research analysts are not supervised by persons involved in investment banking activities
- Prevents retaliation against analysts by employers in return for writing negative reports
- Establishes blackout periods for brokers or dealers participating in a public offering during which they may not distribute reports related to such offering
- Enhances structural separation in registered brokers or dealers between analyst and investment banking activities

The legislative and regulatory reforms were accompanied by a global settlement entered into by Merrill Lynch, Salomon Smith Barney and other investment bankers totaling $1.4 billion in fines, penalties and restitution funds for investors arising out of the conflicts of interest engaged in by these brokerage firms to the detriment of investors. The regulators viewed the settlement as a means of attaining balanced reform in the industry and bolstering confidence in the integrity of equity research.[88] In short, the SOX legislative reform and punitive monetary sanctions were aimed at restoring lost investor confidence in the marketplace occasioned by the investment banking industry's disregard for investor interests. Investment banks could no longer be trusted to serve as a primary restraint against corporate wrongdoing. Indeed, both the Enron Report and Thornburgh's Report in the WorldCom bankruptcy separately concluded that investment bankers had literally become "partners in crime" with the debtor-issuers.

IV.
REVERSING LEGISLATIVE COURSE: BAPCPA REVISIONS 2005

Between 2002 and 2005, nothing about the proven distrust of the investment banking industry, predicated on conflicted interests, had changed. Indeed, the pattern of distrust steadily mounted as the continuous string of corporate failures

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- Requires specific conflict of interest disclosures by research analysts making public appearances and by brokers or dealers in research reports including:
  - o Whether the analyst holds securities in the public company that is the subject of the appearance or report
  - o Whether any compensation was received by the analyst, or broker or dealer, from the company that was the subject of the appearance or report
  - o Whether a public company that is the subject of an appearance or report is, or during the prior one year period was, a client of the broker or dealer
  - o Whether the analyst received compensation with respect to a research report, based upon banking revenues of the registered broker or dealer.

88. SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices, Exchange Act Release No. 2002-179 (Dec. 20, 2002), *available at* http://www.sec.gov/news/press/2002-179.htm.

aided by unethical investment banking practices surfaced in the marketplace.[89] At the height of consumer distrust in the marketplace, Congress eliminated the categorical disqualification of an investment banker who serviced the issuer prepetition from serving as the advisor to the trustee of same issuer-debtor postpetition.[90] The result is a legislative anomaly. While tightening the conflict of interest provisions under SOX applicable to investment bankers, Congress eliminates a conflict of interest rule designed to disqualify investment bankers to avoid the same ethical abuses associated with the need for enacting similar provisions under SOX in the first instance. Economic interests best explain this fracture in regulatory philosophy.

A. *The Lobbyists' Perspective*

Representative F. James Sensenbrenner, a proponent of the change, argued that it was inefficient and costly to bar investment bankers who are familiar with a company's inner workings from advising it in bankruptcy.[91] The argument favoring amendment was predicated on nothing more than

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89. Enron Report, *supra* note 63, at 3.

> That the Enron collapse, moreover has been followed by a seeming flood of allegations about large-scale financial fraud at other prominent companies, including WorldCom, Global Crossing, Tyco, Adelphia, and Rite Aid, precludes any easy characterization of Enron a simply a "bad apple" or the lapses of gatekeepers and regulators as isolated breakdowns in an otherwise sound system.

90. Section 101(14) was amended by BAPCPA to read as follows:

> (14) 'disinterested person' means a person that -
> (A) is not a creditor, an equity security holder, or an insider;
> (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer or employee of the debtor; and
> (C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

11 U.S.C. § 101(14) (2005). See, *supra* note 46, for a comparison with the language of the predecessor statute.

91. 150 CONG. REC. H220 (daily ed. Jan. 28, 2004) (statement of House Judiciary Chairman Sensenbrenner).

that sparse statement.[92] Its genesis can be traced to a two page letter, dated March 8, 2005,[93] sent to each senator and jointly authored by several of the most powerful financial services lobbyists in America including the: American Bankers Association, Bond Market Association, Financial Services Roundtable,[94] Futures Industry Association and Securities Industry Association. The Securities Industry Association is ranked second in the country in the list of Security and Investment lobbyists, by total political spending for the period 1998-2004: $42,085,059.[95] The Bond Market Association followed in a close sixth position in the ranking, having expended $22,235,850 during the same period.[96] These trade associations argued that the disinterestedness standard "subjects investment banks to a different standard than that which applies to other professionals."[97] As applied to certain other professionals, there is no per se rule of disqualification. Instead, the bankruptcy judge exercises discretion in evaluating whether there is a materially adverse interest to the estate.

Pointing out the ostensible legal disparity between the Code's treatment of investment bankers and "other professionals" begs the question as to the reason for the difference in

92. Parenthetically, the Congress and SEC had rejected the argument in 1937: "It does not follow from the fact of flotation of the securities that a house of issue has a monopoly on the right to represent security holders on default. That such a monopoly is contrary to the public interest is emphasized by a consideration of the questionable character of many flotations and the prevalence of conflicting interests of many houses of issue." *See* Reorganization Report, *supra* note 22, at 877-78.

93. Letter from American Bankers Association, The Bond Market Association, Financial Services Roundtable, Futures Industry Association and the Securities Industry Association to members of the United States Senate (Mar. 8, 2005), *available at* http://www.sia.com/securities/pdf/414Industry Letter.pdf [hereinafter Letter].

94. The Financial Services Roundtable is reported to represent the largest financial-services companies in the United States. FSR retains the law firm of Winston and Strawn to lobby on its behalf. THE HILL, Oct. 12, 2005, *available at* http://www.hillnews.com.

95. Statistics Compiled by the Center for Public Integrity (2003-04), *available at* http://www.publicintegrity.org/lobby/profile.aspx?act=industries&in=93.

96. *Id.* Compare to the contributions for the same period by: NASD, ranked 8th, $7,530,760; Chicago Mercantile Exchange, ranked 9th - $7,255,000; CBOE (18th) - $2,985,000; New York Stock Exchange (20th) - $2,687,900; and the New York Mercantile Exchange (23rd) - $1,945,000.

97. Letter, *supra* n. 93.

the first instance. This distinction was the reason behind the codification of the disinterestedness rule as applied to investment bankers/underwriters in the 1938 Chandler Act. The SEC determined then, as now through the Enron and WorldCom investigations, that the investment banking industry wields unequalled power and influence in the public markets. That power is likewise exercised in reorganization proceedings, though sometimes covertly. The immense consequences of a breach of fiduciary duty by investment bankers in the marketplace, as evidenced by the spate of recent corporate failures, demonstrates the need for the higher standard of ethical scrutiny previously offered through categorical disqualification.

When the need for stricter ethical rules to protect investors from further damage to their economic interests in reorganization is balanced against the claim that the disinterestedness requirement prevents "healthy competition" for the provision of bankruptcy services, thereby increasing Chapter 11 costs,[98] the financial hardship to investors is demonstrably a weightier cost. The BAPCPA amendment is simply not supported by a true cost comparison of competing interests in the reorganization process. Not surprisingly, the lobbyists avoided that line of argument with the certain knowledge that a financial analysis would strike a formidable blow at amending the Code.

Moreover, the SEC's investigation in the 1930's proved that rather than increasing competition for the debtor's reorganization business, the retention of interested bankers led to a monopoly by the issuing house over the business and the proliferation of bankruptcy patronage. Ironically, it was this participation of the interested banker in reorganization that resulted in the enactment of the disinterestedness rule to cure the anti-competitive climate that dominated reorganization. Simply, the SEC and Congress have repeatedly concluded through continuous legislation and increased regulation that the investment banking industry is not like "other professionals" in terms of control and impact in the marketplace. There is no compelling reason to reach a different conclusion in the bankruptcy court, where economic pressures and self-interest arguably provide an even greater incentive for abuse.

98. *Id.*

B. *The Opposition's Perspective*

The reaction from the opposition was swift and critical, albeit weakened through the absence of meaningful congressional support.[99] Senator Sarbanes, a co-sponsor of SOX, opposed the change, calling it "absurd,"[100] pointing out that the amendment could create the anomalous result of Salomon Smith Barney, which bankrolled and advised WorldCom on its failed business and financial strategy, representing the interests of the company's employees, bondholders and other creditors while WorldCom was in bankruptcy. Senator Leahy referred to this scenario as a "blatant conflict of interest."[101] Arthur Levitt, former SEC Chairman, said:

> I haven't read a single argument made by the investment banks that would persuade me that the prohibition should be changed. What we are talking about is a significant potential conflict of interest, and I think it is outrageous that investment banks would even try to go down this road.[102]

The opposition underscored the conflict between the BAPCPA amendments and the SOX legislation, designed to re-establish investor confidence in the marketplace. Congress was warned:

> It is not a provision to ensure investor confidence, or to enhance protection for employees, pensioners, or creditors of ailing companies. This is a provision to enrich an already wealthy interest group . . . Don't open this stable door.[103]

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99. Consumer groups in favor of the disinterestedness rule remaining intact also lobbied Congress. *See* Letter from The Consumer Federation of America, Consumers Union, U.S. Public Interest Research Group, Consumer Federation of America, Consumer Action, and National Consumer Law Center, to Senators Leahy and Sarbanes (Mar. 3, 2005), *available at* http://pirg.org/consumer/pdfs/bankruptconflictltr.pdf.

100. 151 Cong. Rec. S2306 (daily ed. Mar. 9, 2005) (statement of Sen. Sarbanes).

101. 151 Cong. Rec. S2306 (daily ed. Mar. 9, 2005) (statement of Sen. Leahy).

102. 151 Cong. Rec. S2406 (daily ed. Mar. 10, 2005) (statement of Chairman Levitt).

103. 151 Cong. Rec. S2406 (daily ed. Mar. 10, 2005) (statement of Professor Warren).

However, Congress made the conscious choice to open the "stable door" and did so without much debate on the issue. Perhaps the financial influence of the lobbyists and the softening of congressional will to impose stricter standards on corporate governance post-Enron explain the departure from 67 years of congressional wisdom. One thing is certain: the record is devoid of a cogent explanation.

V.
Conclusion: Selling Out Corporate Reform: The Divergence Between Bankruptcy Reform and Corporate Governance

BAPCPA offers no logic or identifiable need to support dislodging categorical disqualification at the very moment that proven distrust of the investment banking industry required dramatic legislative reform prepetition. While corporate transparency is the ultimate goal of corporate governance and ethical reforms, the elimination of the categorical disqualification rule allows reorganization to become less transparent than the suspect financial circumstances that led to insolvency. It does not make sense to hold management and its bankers to a higher standard of conflict-free business dealings before insolvency than after failure. The knowledge that investment bankers failed to stem the tide of wrongdoing prepetition should not be ignored when the *same* investment banker is retained by the trustee postpetition to work out the failure to which the banker most certainly contributed.

Transparency in reorganization cannot be entrusted to the failed integrity of the private sector. Nor can supervision of the industry be entrusted to the bankruptcy court, particularly in view of the SEC's own failure to supervise prepetition. History provides unequivocal proof that the investment banking industry cannot be trusted to act as a self-regulated watchdog and prevent financial self-interest from overcoming its own fiduciary obligations. For these reasons, a categorical prohibition is the only solution.

Unquestionably, the ethics paradigm applied to investment bankers in the context of corporate governance by SOX, as a protection device for shareholders, applies with equal force in bankruptcy reorganization. Indeed, investment bankers in their capacity as investment advisors in bankruptcy have long been held to be fiduciaries.[104] Justice Frankfurter observes that in reorganization the court rejects the "lax view of fiduciary obligations and insist[s] upon their scrupulous observance."[105] The inquiry, according to Justice Frankfurter, does not end when an individual is labeled a fiduciary. The label only begins the analysis giving direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? What are the consequences of his deviation from duty?[106]

The categorical disinterestedness requirement protects investors who rely upon professionals retained in bankruptcy to herald their interests and ameliorate their losses. It is for this very reason that conflicted professionals were disqualified from receiving compensation in bankruptcy where they failed to act independent of financial self-interest.[107] Justice Douglas concludes that a:

> Fiduciary who represents security holders in a reorganization may not perfect his claim to compensation by insisting that although he had conflicting interests, he served his masters equally well or that his primary loyalty was not weakened by the pull of his secondary one. Only strict adherence to these equitable principles can keep the standard of conduct for fiduciaries "at a level higher than that trodden by the crowd."[108]

The SOX amendments and attendant regulations provide such ethical guidelines for investment bankers and research analysts in an effort to provide real transparency in financial transactions and protect America's capital markets. Selling out to Wall Street lobbyists by dismantling the categorical rule of disqualification for investment bankers under BAPCPA undermines the promise of corporate reform and will, in the end, cost America far more than the price paid.

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104. United Artist Theater Co. v. Walton, 315 F.3d 217, 230 n.14 (3d Cir. 2003).

105. *See* Sec. and Exch. Comm. v. Chenery Corp., 318 U.S. 80, 85 (1943).

106. *Id.*

107. 11 U.S.C.A § 503.

108. Woods v. City National Bank & Trust Co. of Chicago, 312 U.S. 262, 269 (1941).