CHAPTER XVIII

MUNICIPAL DEBT READJUSTMENT

The Protective Committee Study took Mr. Douglas deep into the field of defaulted municipal debts and their readjustment. [FN 1] This paper, read before the United States Conference of Mayors at Washington, D.C., in November, 1936, is based largely on that experience.

Four years ago local government defaults had once again become so widespread as to assume the proportions of a Federal problem. I say once again, for it will be recalled that during each of our previous periods of local government default—of which there were several during the last century—the United States Government was called upon to protect through its judiciary the interest of municipal security holders. When the defaults began to recur a few years ago, the sole governmental mechanism for dealing with them was the judicial machinery, comprising the device of writs of mandamus which had been developed by Federal courts for this purpose during the last century. This judicial machinery was primarily designed for cases which might be termed "wilful repudiation." Hence these writs had limited utility. [FN 2] In the first place, where the debtor was insolvent, these writs had no magic in them which permitted creditors as a whole to collect. And for the most part local government defaults of the present era reflect not repudiation but inability to pay, due to either temporary or more deep-seated conditions. In the second place, the role of litigation will always be simply ancillary to the main process of negotiation.

Hence, when the present era of defaults arrived, it was speedily recognized that voluntary negotiation of readjustment plans under circumstances as peaceable and free from the irritant of litigation as possible was the only practicable procedure. But a local government default-is more often than not an extremely complicated situation. Groups with great diversity of interest are involved, each with a different stake in the situation. Bargaining power is unequally distributed as between groups, and even within groups. In the typical situations, moreover, the outstanding securities are scattered throughout a large part of the United States and sometimes throughout the world. Many of the holders are small investors in no position to take independent legal action or even to inquire into the situation. Furthermore, even though plans of debt readjustment are worked out by the debtor and representatives of the creditors, there is no effective way to bind minority or dissenting creditors to the plan. The necessity of dealing with the minority effectively but nonetheless fairly gave rise to a demand for a Federal bankruptcy law applicable to such debtors. [FN 3] This, as you know, resulted in 1934 in the National Municipal Debt Readjustment Act, which was held to be unconstitutional by the Supreme Court in the spring of this year. [FN 4]

The end result is that these problems remain for the most part unregulated and free from supervision. No effective machinery has been supplied by the states. The matter rests where it always has—for the most part in the hands of debtors and creditors.

The common pattern for these current debt readjustments has been negotiation between creditors and debtors. Normally, the creditors have been represented by protective committees. [FN 5] Last year, 1935, there were in existence or had recently been in existence over two hundred such committees. These committees have been self-constituted and self-controlled. In their hands rested the fate of thousands of bondholders. Vested with broad powers, they proceeded to negotiate debt-readjustment plans with no check or restraint except their own consciences. They proceeded to fix their own fees and expenses without the scrutiny or supervision of anyone—certainly not of the bondholders. At times they were in positions irreconcilable for fiduciaries— representing their own adverse interests on the one hand; purporting to represent the bondholders on the other. To conclude that committees in this field should be regulated and controlled in the interests of investors is not to deny that these committees have and should continue to perform important functions. It emphasizes that the functions which they perform are so important and so essential that precaution should be taken lest these functions be perverted. I am confident that no fair-minded student of the subject—that is, one who has no special interests to serve—can effectively dissent from the decision that independent supervision, scrutiny, and control over these committees are necessary if investors are not to be exploited. The issue is not whether there should be any such regulation; the issue is the kind and degree of supervision which are necessary and adequate.

Although this problem is of interest and importance to municipalities, it is essentially an investor's problem. I stated that normally protective committees had been used to represent creditors in negotiations. But negotiation is not always present. Not infrequently the debtor attempts to consummate a plan through the good offices of a fiscal agent, [FN 6] without negotiation with representatives of the creditors. Such fiscal agent is likely to be a bond house which either originated the security issue in the first instance or at least participated in its retail distribution. One reason for the prominent position of such bond houses in such plans is that they have access to the lists of purchasers of the security. They also have the cooperation of other dealers, in tracing and contacting such holders.

Complete data with respect to such fiscal agents and their activities do not exist for the nation as a whole. But enough is known to render it certain that no program for insuring adequate representation to holders of defaulted securities through supervision and control over protective committees would be complete unless it included as a component part some provision for the regulation of the activities of these fiscal agents. The activities of fiscal agents which require regulation are activities approaching fraudulent practices, which unless checked also work to the ultimate detriment of municipal debtors.

The undesirability of neglecting this phase of the problem becomes clear if we consider the very real potentialities—indeed, probabilities—of abuse which inhere in the fiscal agency practice. It is, in the first place, very difficult in any given case to tell for whom the fiscal agent is working in the absence of full disclosure. Ostensibly the interests of the agent may lie with the investors; actually, they may be with the debtor. The agent is usually a bond house. Where a committee for the bondholders is formed, such a bond house is usually found supporting the committee, indeed taking some initiative in its organization, if not serving as a committee member. Even in cases where no committee is formed such a bond house is often found working with an informal creditor group in an endeavor to negotiate, on behalf of the creditors, interim collection on account of interest and eventually a final plan. Such activities the bond house justifies on the grounds that it owes a moral obligation to the security holders to render this kind of service. Furthermore, some of the holders of the obligations are customers of the bond house, who may expect the bond house to look out for their interests. Preservation of its good will may thus be the actual or ostensible reason why the bond house becomes very active.

But in the fiscal-agency arrangements now under discussion the bond houses are retained by the debtor taxing district and urge the debtor's plan of adjustment upon the creditors. It is then in the hire of the debtor. Its commission in part, and frequently in the entirety, is dependent upon its success in inducing the great majority of the creditors to accept the terms of composition offered. Yet the more intensive the independent inquiry, if any, conducted by the fiscal agent into the capacity of the debtor to pay, the greater its expenditure and the less its net profit on the transaction. There are, furthermore, only conscience and integrity to prevent the fiscal agent from trading in the securities affected. The market value of these securities will have dropped with announcement of default. Once a plan is put through their value will rise. The temptation will always be strong for these agents to capitalize on their inside information by buying at default prices and selling when the plan is put through. Furthermore, a plan may be grossly unfair to the investors even though the fiscal agent doubles his money on such purchases and sales. A settlement at fifty cents on the dollar may be vicious from the viewpoint of those who have purchased at or near par. But for those who have purchased at twenty-five cents on the dollar, the settlement will be inordinately favorable. A fiscal agent who is in such a position as a result of his purchase of bonds at default prices has a distinct conflict of interest as respects the investors. If he purports to represent them without disclosure, he has perpetrated a fraud.

Surely these circumstances point to a need for full and free disclosure by bond houses acting as fiscal agents if the ordinary run of customers of the bond houses are not to be victimized. But instances have been reported wherein a fiscal agent has in one such transaction collected its commission from the debtor for effecting the refunding, made a profit from its own trading in the securities affected, and has even taken commissions from some of the bondholders who were under the impression that the bond house was representing them. These are not merely fraud upon the investor. Some of the examples I have cited may even be violations of the fiduciary duty which the fiscal agent owes to the municipality, its principal, and for which the agent might be held accountable. Taken together these cases are, furthermore, illustrative of practices that can result only in ultimate disillusionment on the part of investors, with the consequence that the credit standing and borrowing abilities of municipalities whose fiscal agents indulge in such practices may suffer permanent impairment.

There are other forms of abuse, which can only be described as out and out rackets. Unscrupulous dealers have at times been known to propose default to low-grade taxing districts for the sole purpose of earning a fee by effecting a refunding on a scaled-down basis. The incentive held out to the taxing district in such cases is, of course, the prospect of a reduced debt and, in consequence, lower taxation. Such proposals have, moreover, been accepted; and an exchange of bonds on the basis of questionable representations has been successfully negotiated by the dealer with its customers.

The vicious potentialities of the fiscal agency when it is subject to no supervision or check stand out in bold relief. These are accentuated by the difficulties in any attempt to evaluate the fairness of any plan. The capacity of a debtor municipality or taxing district to pay, which is the supposed basis of any fair plan, is at best a matter of very technical estimate based on a great many problematical future variables. Even assuming possession of all the facts as of a certain date bearing on this capacity to pay, there is nevertheless always room for a very wide difference of estimates when that is projected over a future period of years. The ordinary investor whose adherence to a compromise plan is solicited cannot have all those facts, and could not evaluate them if he had. There is the impossibility of ascertaining the fairness of any plan solely by examination of its terms. The percentage of consent obtained is a poor criterion of fairness. In the absence of complete disclosure of the qualifications and interests of the several parties to the negotiation, and of the methods whereby the consents were obtained, such criterion may be wholly false and misleading. In the interests of investors the least which can be done is some check over the manner and method by which such consents are obtained.

Much of the mischief inherent in the conflicting position of the fiscal agent is obvious. Indeed, the mere circumstance that a commission from the debtor is involved affords an incentive to bond houses to negotiate hasty refundings without adequate assurance that they will stand up. There are instances where municipalities and local subdivisions had, during the few years prior to their open defaults, staved off the evil day through a series of exchanges of maturing obligations, which could not be met, for new short-term refunding bonds. It soon transpired that those, in turn, could not be met at maturity. Hence there was an open default. But for each of these exchanges a bond house acting as fiscal agent received a fee from the debtor. Yet the fiscal agent later admitted that at the time of negotiating some of those exchanges it did not expect that the debtor would be able to meet maturities on the new bonds. Investors, however, were led to believe quite the opposite.

Some instances of refundings carried out in bad faith by fiscal agents have been reported. These involve obligations of municipalities deriving their major source of revenue from a municipal utility or from the proceeds of special state taxes allocated to local subdivisions. Debtors and their agents have been known in some such cases to proffer refunding bonds which could never be paid without the proceeds of the special tax, and, at the same time, lobby for repeal of the tax law. Or to make the plight of the debtor look sorrier, the fiscal agent may be tempted to encourage concealment or diversion of these assets. Where the major source of revenue is from a utility, there may be nothing to prevent the disposition of the utility. In any event, its revenues could not be reached by mandamus. But these matters are carefully concealed from the investors by the fiscal agents, who, in fact, may purport to be protecting them. Though these episodes have doubtless been only occasional, they nonetheless emphasize the need for some check and restraint.

The problem of control over fiscal agents, like the problem of control over protective committees, is, therefore, in large measure a phase of the problem of control over the fairness of municipal debt-adjustment plans. It should be remembered that the great bulk of the taxing districts still in default are relatively small units. Protective committees are less likely to be organized in such cases. Hence, much of the field is in consequence left open to the fiscal agent. The timeliness of this problem is therefore apparent. I am certain that no municipality will disagree with the conclusion that there is proper place for regulation designed to check and control fraudulent or near-fraudulent practices of fiscal agents.

What kind of control over these fiscal agents should be provided? The first step seems clear.

The minimum which should be required is complete disclosure by such fiscal agents. [FN 7] They should be under a duty to disclose to investors the terms of their agency, including compensation; their own holdings and trading in the securities affected; and their interest, if any, in any plan which they sponsor. Underwriters of other types of securities are required to make comparable disclosures when they go to the public with offerings of securities and penalties are imposed on them by the Securities Act of 1933, as amended, for false and misleading statements of material facts. No one can deny the value and prophylactic effect which these requirements have had on our securities markets and thus on investors. Such requirements of disclosure insofar as they deter fraud and overreaching and bring to investors material facts concerning the issue offer some assurance that the high functions performed by underwriters will not be perverted, as they frequently were before 1933.

Basically the same considerations apply to the private fiscal agents in these municipal default or refunding situations whether or not actually or technically these agents are underwriters. There is no reason why we cannot move immediately toward the objective of requiring from these agents complete disclosure of their own activities.

Such disclosure should produce beneficial results. It should tend to protect investors and debtors alike by deterring these fiscal agents from fraud and from self-seeking impropriety. In such a constructive program investors and debtors have a community of interest. For the large number of refundings worked out conscionably and fairly, such disclosure would entail no burden. But recognition of this principle in municipal financing would afford some assurance that exploitation would be curbed.

[FN 1] S.E.C. Report, Part IV, *passim*.

[FN 2] S.E.C. Report, Part IV, section iii.

[FN 3] S.E.C. Report, Part IV, section vii.

[FN 4] As subsequently revised this Act, now Chapter IX of the Bankruptcy Act, was held constitutional by the Supreme Court in *Lindsay-Strathmore Irrigation District v. Bekins*; 304 U.S. 27 (1938).

[FN 5] S.E.C. Report, Part IV, section v.

[FN 6] S.E.C. Report, Part IV, section iii.

[FN 7] The Securities Act of 1933 does not apply to municipal securities. While some of the earlier drafts of the bill had included municipal securities, there was considerable opposition to such a provision, and this class of securities was ultimately exempted from the provisions of the Act.