



Consumer Federation of America



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March 3, 2005

The Honorable Patrick J. Leahy  
Ranking Member  
Senate Judiciary Committee  
Committee  
Washington, DC 20510

The Honorable Paul S. Sarbanes  
Ranking Member  
Senate Banking, Housing and Urban Affairs  
Washington, DC 20510

Dear Senators Leahy and Sarbanes:

The undersigned national consumer organizations strongly support your amendment to strike a little noticed provision of pending bankruptcy legislation (S. 256) that would weaken current conflict-of-interest standards in the bankruptcy code. This provision would, for the first time, allow investment bankers to offer advice in bankruptcy restructuring cases about companies with which they have had a close financial relationship prior to bankruptcy. **As advocates for small investors, we applaud you for moving to eliminate this significant threat to the interests of investors, employees and pensioners.**

Section 414 of pending bankruptcy legislation would loosen the current standard for “disinterested” parties that are allowed to advise bankruptcy management or trustees as they attempt to restructure debtor companies in a manner that is fair to investors and other creditors. Of the several parties that are automatically banned from offering advice because of obvious conflicts of interest, Section 414 removes only one: investment banking firms. This means that the same firms that underwrote and sold stocks and bonds for a bankrupt company – firms that in some cases may have participated in structured finance deals with the company or otherwise played a significant role in financial decisions that helped to land the company in bankruptcy –

could now be allowed to offer restructuring advice to the management or trustee responsible for maintaining impartiality and representing the interests of creditors.

Corporate bankruptcy experts tell us that reexamining the financial transactions that led to bankruptcy is one of the most significant responsibilities of the post-bankruptcy management (often called debtor-in-possession, or DIP, charged with the duties of a trustee to protect all creditors and investors.) This review includes determining what role, if any, that outside advisers and financial partners played in bringing about a company's downfall. Another of DIP management's most important responsibilities is determining the best source of financing for any restructuring. An investment banking firm has obvious conflicts in both roles and is very unlikely to be an advocate for review of its own previous work or the deals in which it participated. It is quite possible, for example, that an investment banker would discourage bankruptcy management or trustees from pursuing legal claims against the banking firm for illegal activities of that firm that contributed to the bankruptcy. The landmark settlement with the leading investment banks over their stock research practices shows just how poorly these firms have handled comparable conflicts in the past.

Imagine how the public would have reacted if the investment banks that were later found to have profited enormously from structured finance deals with Enron had been hired to offer advice in the Enron bankruptcy. Indeed, if the participants in Enron's earlier financial dealings had managed the investigation, it is quite legitimate to wonder how many of these financial misdeeds would have come to light in the first place. Without existing conflict-of-interest prohibitions in place, it is possible that some of the same firms that have come under investigation by the SEC for illegal activities in the current corporate scandals might very well have been allowed to serve as "objective" advisors in this and other bankruptcy proceedings. This scenario is possible because, as you know, it often takes months or longer to unravel the role of investment banking firms in such cases, particularly cases that do not receive the media and congressional scrutiny of an Enron or Worldcom collapse.

In response to these conflict-of-interest concerns, investment banking interests offer a familiar refrain. We can offer better advice, they say, because we are intimately aware of the distressed company's financial situation. This response is eerily similar to that offered by the accounting industry, as it loudly insisted that a conflict did not exist when accountants served as both internal and external auditors or received lucrative consulting contracts from the same companies that they audited. But, if there is one lesson we should have learned from the recent corporate crime wave, it is that conflicts of interest matter. Investors paid dearly to learn that lesson. And the markets have paid through the loss of investor confidence.

Representatives of the securities industry have also contended that this provision will merely provide bankruptcy officials with the discretion to make a judgment about whether a particular investment firm should be involved in a bankruptcy case. But what if the details of an investment firm's involvement with a bankrupt firm do not come to light for months or longer, as was true in the Enron case? By that time, a lot of damage could already have been done to investor interests, and the credibility of the process would have been hopelessly undermined.

For example, the *Wall Street Journal* reported on May 14, 2003 that investment firm UBS Warburg, “was far more involved in the inner workings of HealthSouth than previously disclosed and maintained an unusually close relationship with HealthSouth’s embattled founder, Richard Scrushy.” Yet, if Section 414 of the bankruptcy bill had been law, it is entirely possible that UBS Warburg could have been allowed to serve as “objective” advisors in the HealthSouth bankruptcy case.

Congress and the SEC have devoted considerable time and energy over the past few years to eliminating just these kind of conflicts in an effort to restore investor confidence. The SEC has made important strides, for example, in implementing the Sarbanes-Oxley corporate reform law and in cracking down on Wall Street conflicts of interest. More recently, the National Association of Securities Dealers (NASD) has been considering whether to place new limits on investment banking firms’ ability to write fairness opinions for deals in which they are involved, since these firms could benefit financially if a merger or acquisition is approved. By allowing new financial conflicts, section 414 of S.256 runs completely contrary to this trend.

**Investment firms that have previously advised a bankrupt company have a *prima facie* conflict of interest and should continue to be automatically prohibited from offering advice in a bankruptcy restructuring case.** We commend you for moving to eliminate the conflicts-of-interest that this bill would allow.

Sincerely,

Barbara Roper  
Director of Investor Protection  
Consumer Federation of America

Travis B. Plunkett  
Legislative Director  
Consumer Federation of America

Susanna Montezemolo  
Policy Analyst  
Consumers Union

Linda Sherry  
Editorial Director  
Consumer Action

Edmund Mierzwinski  
Consumer Program Director  
U.S. Public Interest Research Group

John Rao  
Staff Attorney  
National Consumer Law Center