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by

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The Lawyer and The Federal Securities Act

The invitation which I received to address you this evening told me that many of the members of your Bar Association were students. The implication was that instead of being promoters of programs for the reform of the morals of non-members, you were a socially minded group with an intellectual interest in current problems of the law. This was such a novel condition to find in Bar Associations that the very uniqueness of the situation excited my interest and desire to be with you this evening.

If you were professors of law perhaps the most timely thing I could do would be to break to you the news that there is a Securities Act and that there is a Securities Exchange Act. Or I could tell you that the New Deal had done to the professor what Huey Long would do to wealth - bring it out from hiding and redistribute it among everyone - not preserve it for just a favored few. If you were counsel to the wasters of high finance perhaps the most touching message I could bring you would be that those Acts were the only things which stood between depression and recovery.

If you bore the true hallmark of your profession, I could rest by telling you that the chief accomplishment of those Acts was to make finance more difficult and more expensive. But since you have been represented to be true students of the law, I cannot hope to merit your wakefulness by such oblique attempts at intellectual endeavors. Nor can I take the risk of speaking on such matters which you might believe to be wholly non-controversial.

One of your professors tells you that the most exciting thing which ever happened to him was to get the thrill of seeing civilization pushed forward a millimeter or two when one court finally adopted his theory of de facto corporations. Another informs you that the problems of ultra vires may not be exciting but that if stockholders were made liable for ultra vires contracts the problems of corporation law would be solved. Another professor tells you that his great regret was that he did not run his stock pool before 1934.

I can speak of but one regret and one excitement. In the first place I speak as a youth deeply ingrained with respect for American traditions but with great disrespect for those of our elders (in law as well as in business) who gave us as an inheritance the ethical and moral standards of corporation finance. In the second place I speak with excitement about the opportunities which are accorded leaders of the Bar to make finance respectable and to make the gray beard not just the sign of age and of successful promotions, but a symbol of wisdom.
It is sad but true that the high priests of the legal profession were active agents in making high finance a master rather than a servant of the public interest. They accomplished what their clients wanted accomplished and they did it efficiently, effectively and with dispatch. They were tools or agencies for the manufacture of synthetic securities and for the manipulation and appropriation of other people's money. In doing this they followed the tradition of the guild. In fact they were applying the teachings of their professors. They never took seriously the true nature of their public trust. They failed to act as conditioners of their clients' programs. They neglected their foremost function - to create and maintain financial practices which were respectable, honest and conservative. And it is sad but true that but for the activities of shysters and strikers they would have reached greater excesses than they did.

This condemnation of the high priest of our profession has not been common even in recent years. While the gods of finance were crashing at the feet of the Senate Committee on Banking and Currency, our high priests escaped unscathed. Nevertheless they are one of the chief roots of our financial evils. As stated by one columnist, the crop of "All-American Larcenists" which the world of high finance produced during the last decade, doubtless had enormous native ability, but such ability might have gone unnoticed, or at least not have reached such advanced stages of maturity and development had it not been for the astute coaching of the high priests of our profession. These coaches of ours probably did not supply all of the ideas. But they did marvelously well in supplying the technique and finesse whereby the "All-American Larcenists" succeeded in their subterfuge and tricks. Certainly not all the glory should go to the players and none to the coaches. To quote Mr. Pegler, our sport-political commentator:

"*** No man could have brought off some of the miracle swindles*** unless he had larceny in his soul and the true pickpocket instinct. I do not think, for instance, that the greatest corporation lawyer that ever lived could have perpetrated such magnificent swindles if he had had nothing but honest men to work with.

"They would have balled up their signals and crossed their interference, and most of the time they would have been running toward the wrong goal, because an honest man has a dumb instinct for the honest way of doing, and no coach in the world can reverse him.

"So let it be understood that I give all due credit to the innate thievery of these financiers before proceeding to acknowledge the greatness of those forgotten men, their lawyers, who taught them the fine points of the game and elevated robbery from a rough, rowdy thing, practiced with blackjack and gum, to a beautiful science and moved it out of the alleys into the great marble temples where stocks are traded.***

"But just as a fine natural football player needs coaching in the fundamentals and schooling in the wiles of the sport, so, too, it takes a corporation lawyer with a heart for the game to organize a great stock swindle or income tax dodge and drill the financiers in all the precise details of their play."
"Otherwise, in their natural enthusiasm to rush in and grab everything that happens not to be nailed down and guarded with shotguns, they would soon be caught offside and penalized, and some of the noted financiers who are now immortalized as all-time All-American larcenists never would have risen beyond the level of the petty thief or short change man."

More seriously and sedately a similar observation has been made by Mr. Justice Stone who said with his customary directness and penetration:

"One might cite many examples but it suffices that in the struggle, unique in our history, to determine whether the great economic forces which our industrial and financial world have created shall be brought under some larger measure of control and, if so, what legal devices can and should be selected to accomplish that end, it is a matter of public comment that the practicing lawyer has been but a minor participant. It is unnecessary, and it would be unbecoming for me to express any opinion upon the merits of that controversy or the methods of its solution. It is enough for present purposes that in one of the most critical periods of our history, when a major public problem is the choice of remedies for our economic ills and the mutual adjustment and reconciliation of those remedies with legal doctrine, the practicing Bar of the Nation has not attained its accustomed place of recognized leadership."

And at another place he says:

"At its best the changed system has brought to the command of the business world loyalty and a superb proficiency and technical skill. At its worst it has made the learned profession of an earlier day the obsequious servant of business, and tainted it with the morals and manners of the marketplace in its most anti-social manifestations. In any case we must concede that it has given us a Bar whose leaders, like its rank and file, are on the whole less likely to be well rounded professional men than their predecessors, whose energy and talent for public service and for bringing the law into harmony with changed conditions have been largely absorbed in the advancement of the interests of clients."

Service to the client has been the slogan of our profession. And it has been observed so religiously that service to the public interest has been sadly neglected. To such low levels had finance degenerated that in the decade preceding the Securities Act the one effective agency of public control of finance was the shyster and striker. At times he fleeced his bona fide clients as badly if not worse than our financiers, under the tutelage of our high priests, had been taught to fleece them. At times he was merely tutor to short change artists rather than coach to "All-American larcenists". At times his pleas were more vocal than meritorious. And at times he was nothing more nor less than counsel for Blackmail Inc.
Nevertheless his omnipresence generated fear and hesitancy. Few documents were ever drafted without thought of him. Few transactions were ever decided upon without some reflection as to their vulnerability at his hands. No method of procedure was adopted without consideration of its weaknesses on his attack. In other words his presence served to condition to some extent the programs of counsel to the masters of high finance. He probably averted some excesses. Reorganization plans were less flagrant than their proponents desired. Prospectuses were more studiously drawn. Surplus and capital were subjected to careful, though ingenuous scrutiny.

He was able to exercise this slight control not because of his astuteness and skill but because of the extreme vulnerability of the financial processes involved once the full glare of publicity was cast upon them. When the scandals began to creep into the newspapers, when the opposition began to circularize the investors, the plans of the high priests of our profession became precarious. Consents became harder to obtain. Investors became more difficult to handle. The high pressure methods lost some of their effectiveness. Long chances which might otherwise have been taken became too risky.

In the aggregate, however, his control was slight for several reasons. In the first place he too often had his price. In the second place his raids or attacks were only occasional and at the most vulnerable points. And thirdly his opposition came not so much on the issuance of particular securities as at a later stage such as reorganization.

The great need was for the continuing influence of an administrative agency which would condition and control the practices of the high priests of our profession. That need was first satisfied in this country by the advent of the Securities and Exchange Commission.

I have not mentioned the part the courts played in this conditioning process. Their limitations were too obvious for extended comment. First they usually acted ex post facto, at a stage when it was too difficult and delicate a task to untangle complicated financial messes and when castigation of culprits rather than compensation of victims was more often than not the only action possible. More important, however, are the following. The high priests of our profession have abiding and abundant confidence in our courts. And students of the law of finance know how well that confidence is justified. The courts have no doctrine which our high priests need fear. Poorly trained players may fumble. Well coached financiers need not. The judicial process in finance took its cues from the bishops of our guild. It adopted their system. It adhered to their philosophy. It adopted their point of view. Perhaps it was natural that such result should follow. The great development in that branch of the law came when the social and economic incidences of exploitation of investors were not so conspicuous. Diffusion of investments had not reached such a high point as at present. Absentee ownership had not been so fully developed. An individualistic philosophy was dominant.
And the one distinguishing earmark of the law of finance is its individualistic philosophy. There has been talk of sociological jurisprudence in law. But there it little in the law of finance. There has been discussion of realism and realists. There is too little of the former and two few of the latter in finance. There has been abundant evidence of the liberalism of the courts in dealing with social legislation. But the literature of finance is almost void of liberalism. The opinions of judges are mute evidence of the success of the bishops of our guild in obtaining legal sanction for their practices, their systems, and their philosophy. There are of course exceptions. But when one recites names such as Brandeis and Stone, Swan and Hand, and Mack and Clark and lists a few decisions, he has spoken most of what he may with honesty speak.

This is not to impugn the character or integrity of the courts. As stated above it is but a natural phenomenon to find the law of finance molded by the legal bishops. The bishops of our guild were influential in selecting the archbishops of our judiciary. And the archbishops usually had the training of the bishops before ascending the bench.

The high priests of our profession would not deny the desirability of regulation of finance any more than they would deprecate the introduction of general equitable principles into the law of finance. You will find their records replete with resolutions to that effect. But they would rest more comfortably with regulation diverted to the fly-by-night, to the bootlegger of securities.

The need for that regulation will be perennially acute. But until the elite of our profession can bring to their own work a larger degree of social consciousness, there can be but little time and energy to convert the stock peddling heathens in our midst. It is safe to say that if the mores and ethical standards of our legal bishops were changed, we would have solved the major problems in finance. Their forms, their practices, their methods are copied by the lesser lights. They set the fasion. They determine the format for most legal documents in this field. It is common for them to state in certificates of incorporation that interested directors may be counted for purposes of a quorum at a meeting at which a contract with such interested directors is authorized; or may vote on resolutions authorizing such contracts. It is common for them to provide in deposit agreements that members of protective committees may trade in the deposited securities or in the certificates of deposit. It is common for them in trust indentures to hedge in and qualify the obligations of the trustees so as to make his role almost entirely passive and almost completely negative, and to allow him to engage in a multiplicity of activities, hostile to those of his cestuis. It is typical for them to set up protective committees with deposit agreements so carefully drawn as to make them a protective cloak for committee members who in spite of palpably adverse interests are allowed by their legal advisers to assume a fiduciary position.
When you begin to see the high priests of our profession outlawing certificates of incorporation certain practices, when you see them dealing forthright with investors under deposit agreements and disallowing certain transactions, when you see them persuading their stockholder-clients not to form bondholders protective committees, when you see them disallowing a corporate trustee to assume antagonistic roles, then you may assume that a fundamental change is in process and that its leavening effect will be felt throughout the whole profession. Until that transformation takes place you can with confidence state that any such administrative agency as the Securities & Exchange Commission has before it the most difficult and at the same time most significant task in the history of American finance. For it must be remembered that the finesse, the subtlety and the art of finance are imponderable forces not easy to master, not simple to direct. So long as the high priests of our profession are not imbued with the spirit of legal statesmanship, administrative control in the field of finance must continue to reap the criticism of any progressive or reform measure. And if, in absence of fundamental change in ethical and moral standards of our high priests, such criticism turns to praise and opposition to confidence, then you may rest assured that administrative control has become stodgy, that high finance has won another pyrrhic victory. These bishops of our profession do not serve well even their own long term selfish interests. The price of their practices is the destruction of the system they love so well. It has been said that when ten percent of our masters of finance deal covetously with other people's money, no great upheaval or reform will follow. But when the percentage reaches thirty or forty percent, the strain on moral indignation is too great. If that is true, it would likewise follow that, if an occasional bishop of our guild showed piratical tendencies, only raised-eyebrow-departments would take notice. But when the trend becomes so pronounced as it has in recent decades, it is a wonder that these high priests have not been the object of special investigation by the Congress.

There may have been an appreciable change in the attitude of our leaders since the Securities Act. I doubt it, though those closer to the line of action may differ. But I do not believe that by one masterful stroke the tone and quality of law practice in finance has been greatly elevated. That might have come among the lawyers (as I have reason to believe it has among accountants) if the Act had included them among those liable under its provisions. But the long tentacles of the Act do not reach that far. I do not imply that financial practices have not been improved. I think there is tangible and conclusive evidence that they have. But there is hardly any evidence that our bishops have adopted new canons of ethics, that their pronouncements are any more persuasive, that their efforts at truthfulness are any less oblique, or that their desire or willingness to serve two or more masters is any less avid. I think they may be on the threshold of making a new discovery - that they can train scriveners and the best products of our law schools to become artists in making registration statements, artists who can tell the truth, the whole truth, and nothing but the truth and still chisel the heart out of the Securities Act. Once the drafting of registration statements becomes a game, blurred disclosure may become substituted for fundamental alteration and modification of ethical standards and financial practices.
To state it another way, I do not believe that the ancient and equitable principle that no man can serve two masters has much appeal to them even when placed on the basis of political or economic expediency. If it did have even such half-hearted appeal, I would have no occasion to make any investigation of reorganization and protective committees under Section 211 of the Securities Act. This investigation is not an historian's research project. It deals with current reorganizations - cases where plans have not been confirmed, where deposits are still being solicited, where committees are still wrangling, where investors are still paying for the battle for control being waged by opposing banking or management groups.

I see in this cinema of current events no great change in the ethical standards of the masters of our guild. Corporate trustees are still being advised to assume conflicting positions or not advised not to assume them. Committee members are still being advised that they may trade with impunity in the property of their trust by virtue of the protective features of their deposit agreement. Stockholders are still being allowed to serve on committees to protect the bondholders against the stockholders. Committee members are still made the sole and exclusive judges of the reasonableness of their expenses. Protective committees are still being employed as insulating or protective devices for the members - to render them immune from liability to depositors. Equities are still being appropriated not for bondholders but for those who are in feverish haste to assume or retain control for purposes of keeping solvent and afloat their affiliated interests.

And back of the whole scene sits the lawyer. He is not only the director of the play - he is in charge of stage settings, he writes the dialogue, he selects and trains the actors. He is responsible for the tone, the quality, the finish of the play. It is his production, and so it is that you cannot study reorganizations without studying him. To study protective committees without him is to study them in vacuo. To study reorganization plans without him is to reduce the question of fairness of such plans to a mathematical formula. To attempt a diagnosis of committee policy without him is to eliminate the policy formulator. Around him the whole reorganization process revolves. He supplies the initiative, the drive and in part the profit motive that gives the reorganization procedure momentum and power.

Thus when one studies reorganizations he does not have to turn aside to take in the lawyers. Rather he would have to turn aside if he did not take them in. It is then but natural to find the true story of a particular reorganization in the files (or if you do not get there soon enough, in the heads), of the lawyers. And this means in the files (or in the heads, as the case may be) of the high priests of our profession. For it must not be overlooked that they are the ones who conceived and developed the system as we know it. It would be idle to study the imitative practices of those of lesser rank. We can trust the bar associations to do that for us.

And when you begin to study reorganizations in this way the first closed door you encounter is that to the lawyer's files. You are informed that the law - not the high priests - closed this door, for it is assumed that the attorney-client privilege has almost constitutional sanction. The indignation expressed is of a righteous quality. In fact it is probably at this stage of reorganization that the lawyers reach their most sanctimonious level. The intonations of fiduciary duty, of fair dealing, of honesty, of ethical conduct,
are unequalled for their depth of feeling. More righteous or more self-denying attitudes cannot be imagined. It brings out the best tradition in our guild, when the high priest gallantly refuses to make the great sacrifice for his client.

If this attitude prevails, a study of reorganizations cannot be successful. If this attitude prevails, bishops of our profession will have as their aids in perpetuating the old system of reorganization not only the weight of the guild tradition but also the sanction of the law. And if such sanction were given here, progressive measures of reform might leave untouched the major problems in finance. I could give you a legal dissertation on the unavailability of the attorney-client privilege in this situation. But I will not do so. After all, the question is not for me to decide. But I believe that when courts and legislatures finish with this problem, the vestigial remnants of that doctrine will not serve as an insulating device for lawyers to render them immune from investigation but will be reserved as a protective cloak for the clients in the kind of contests out of which the rule emerged.

Had you the time and patience and had I the chalk, I could sketch for you typical situations presented in our investigations which illustrate the types of problems fundamental to reform of the reorganization system. Without time, patience, and chalk, it could not be done. The legal aspects are too intricate to talk glibly about them. The financial processes are too involved for plain oratory. The finesse, the subtlety, the art of the processes are too delicate and too imponderable to be described succinctly. My assurance to you that it is an amazing story cannot be expected to bring conviction. I could develop highlights of particular reorganizations by illustrations of how certain underwriting houses earned their overhead on defaulted bonds and made enormous profits—by acting as trustee and paying agent, by acting as committee, by acting as depositary, by placing all insurances on the property, by managing the property, by acquiring the equity of redemption, by trading in the securities, and by emerging from the reorganization with control over the property. But these examples would be grosser forms of the practices I have been mentioning.

Yet all examples I might cite would have one element in common. And that is the spectacle of fiduciaries or trustees with interests adverse and antagonistic to those of their beneficiaries or cestuis. The elemental proposition is a simple and ancient one. But the profit motive has caused it to be discarded completely, or relegated to an obscure position, or treated with mere formalism by many leaders of our profession.

That is to say, that as a result of the advice of these leaders, the intricacies of finance have found little place for some of the more fundamental principles governing the relations and conduct of man (even a man of finance) to his fellow men. When we observe lesser lights employing such low ethical standards, we can mark their acts as excesses which develop in any involved and intricate situation. But when we observe many of our leading legal lawyers indulging in such excesses, we become dubious of the vitality of our legal system.
You may have implied that the gist of my remarks is that no man should serve two masters. If that is your impression, you are in error. To limit our legal bishops to merely two masters in a single transaction would be to rock the very foundations of the structure which they have built so well. But I feel that we would have made a most significant and almost revolutionary achievement if we made it impossible for a man to serve more than two masters.