

*THE PLAN*

THE reorganization plan which the two receivers supported was the work of Mr. Hanauer, assisted by Mr. Swaine, his lawyer. The other principal banker, Mr. Mitchell, testified that "after the early discussions of the fundamentals, Mr. Hanauer went into seclusion and started to work on the plan." Just as his first act with respect to the 1925 emergency of a middle-western and western road was performed far away, in Paris, so when its reorganization was planned he was far away, in White Sulphur Springs. Mr. Hanauer told a United States Senate committee: "I gave up a summer holiday in Europe in order to make this plan possible, and locked myself in a room at the White Sulphur Springs, with Mr. Swaine, our counsel, to try to work it out."

The principal author of the St. Paul reorganization plan was described by Mr. Fisher, the Harkness lawyer, in his statement of its origin: "He has had probably more experience than almost any other person in the United States in plans of this character, and I have always heard that he and Mr. Swaine spent several days some place down south going over it nights and days until they got the plan in shape."

Having completed the plan, Mr. Hanauer and Mr. Swaine started north and had it printed. It was then confidentially circulated among the chairmen and the attorneys of the three committees organized by the bankers. Mr. Buckner, speaking

with the authority of chairman of the preferred-stock committee and head of the New York Trust Company, one of the most important financial institutions in America, appraised the plan as follows:

"It came out as a completed document, and we had very few changes to suggest. I think as a plan it is the most instructive, clear, and sound that I have ever read, taking into consideration the size and the number of securities involved. We were amazed to find such a fair plan suggested, and it was simply another one of Mr. Hanauer's masterpieces."

Mr. Hanauer's own opinion of his plan was expressed in answer to Senator Couzens of Michigan, at the Senate committee hearing:

*Senator Couzens:* Generally speaking, you think this is the best plan to be devised for financing the Milwaukee road at this time?

*Mr. Hanauer:* I think it absolutely the best plan. It is the soundest plan in the world. Gentlemen, we have had a broad experience in putting railroads on their feet. The railroads we have set upon their feet extend from the Atlantic to the Pacific, from the Great Lakes to the Gulf. . . . Every one of those companies is a strong company and giving good service. We are proud of them. The country can be proud of them. . . .

The skill to which Mr. Buckner referred was not in Mr. Hanauer's discovery of the problems to be solved by reorganization. His attorneys said that "the major problems of the St. Paul reorganization were fairly obvious." Mr. Buckner probably had in mind the solutions which Mr. Hanauer devised.

Three major problems were mentioned—that some of the junior bonds were payable too soon, that for some years the property could not earn enough to pay interest on those bonds, and that the company might need more capital for future improvements. Mr. Hanauer solved all three problems. He disposed of the early maturity dates by providing that the junior bonds should be postponed to a date seventy-five years later.

As for the difficulty that the St. Paul property was not earning enough to pay interest charges on the junior bonds, he provided that interest should not be paid when it was not earned. He solved the third problem, the need for future capital, by providing that new bonds could be sold to raise more money.

The Interstate Commerce Commission did not share Mr. Buckner's opinion of this plan. By its provisions the old junior securities were in effect changed into something like preferred stock. But Mr. Hanauer did not call it preferred stock. He called it an income or adjustment bond. This device was sharply criticized by the Interstate Commerce Commission, which was required under a Congressional statute to consider the new financial arrangement. The Commission said that ". . . securities of this sort are hybrid things and have no place in a thoroughly sound financial structure. Were we dealing here with a new enterprise at its inception, and were it a question of a capital structure to be provided for that enterprise, the bonds and stocks of which were to be sold to the public, it would probably be our duty to disallow the inclusion of such a security in that structure."

Three members of the Commission, in a dissenting opinion, went further in this criticism. They said:

"The public interest . . . demands . . . that no class of securities issued in connection with the reorganization shall masquerade in a misleading guise, and that all securities which have the general characteristics of stock shall have a voice in the management of the property. . . . So far . . . as the . . . bonds are concerned, it is conceded that they sail under false colors. For most practical purposes they are not one whit better than preferred stock with cumulative dividends. But notwithstanding their real character, they masquerade as bonds and are not given voting power.

"The excuses offered for these nondescript securities . . . are . . . (1) that the bonds which they will replace are to a considerable extent held by savings banks which are not permitted

to hold stock. . . . If it is unsound practice for these savings banks to hold preferred stock, it is equally unsound for them to hold the proposed . . . bonds. Why should we connive in what is in effect an evasion of the safeguards imposed by law?"

The Commission also criticized Mr. Hanauer's solution of the third of the three problems outlined by the bankers' attorneys, the need of securing additional capital in future years for improvements and other purposes. The Commission said that Mr. Hanauer's proposal for securing additional capital by the sale of more bonds would prevent the sale of stock as a means of raising money. It said that the plan would make "still more remote the possibility of stock financing." Commissioner Lewis, in a separate opinion, said that "the effect must be still further to crowd stock out of use in financing." One of the grave defects of the old St. Paul financing, commented on by expert witnesses, was the top-heavy relation of bonds to stock, due to the raising of additional capital from 1909 onwards by the sale of bonds rather than stock.

The faultiness of the Hanauer plan in its provision for the raising of funds in future years led three members of the Commission to join in the following statement:

"When a railroad has been unable to meet its obligations and has fallen into receivers' hands, the 'proper performance by the carrier of service to the public' and the 'public interest' clearly demand that any reorganization shall leave the carrier, so far as practicable, with a sound financial structure which will reduce to a reasonable minimum the danger of recurring insolvency and which will make it possible to secure capital for future needs in a manner conforming to sound financial principles.

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"If anything is clear, it is that under this financial structure, and unless earnings in the future average much better than the past gives reason to anticipate, it will be utterly impracticable for the new company to finance by new issues of stock, and that

the financing of its future needs *must* be done by . . . bonds . . . except to the extent that capital requirements are met by diversion from earnings at the expense of the adjustment-bondholders.

"The financial unsoundness of the practice of securing new capital wholly or even largely by continual increases in funded indebtedness is strikingly illustrated by the history of the St. Paul itself. It was one of the principal factors leading up to the receivership. In the past this practice might under wise management . . . have been avoided. But under this proposed new financial structure it becomes, in all probability, compulsory and inevitable. . . .

"Risk of disaster through an unsound structure is clearly a risk that ought to be avoided, if possible. . . ."

The Hanauer plan had a fourth important financial provision. Mr. Hanauer felt that seventy million dollars would be required to reorganize the property. The stockholders were asked to provide this money, and the bondholders to submit to sacrifices in order that the reorganization managers should be able to get the money from the stockholders. The seventy-million-dollar feature of the plan therefore subjected both classes of security-holders to burdens. Mr. Hanauer told the Senate committee that "such a tremendous amount of bonds are making a terrible sacrifice." The stockholders also, he later told the committee, "are here making a sacrifice."

The stockholders, as various of the witnesses said, were doing more than assuming a large burden. Some of them were being forced out. To meet the difficulty the bankers proposed to help them obtain loans in order to finance the assessment. This would subject the stockholders to the uncertainties and risks of carrying securities on margin. The bankers also suggested that stockholders who could not manage the entire assessment might sell off new bonds which they were to receive for part of their new money. If, however, a great many of them had taken this advice, an avalanche of selling would have resulted, breaking the

market price of the bonds. The Iselin committee, representing independent stockholders, said to the Interstate Commerce Commission:

"The price the stockholder might get for his bonds was speculative, because it depended upon the amount of such bonds which might be dumped on the market. This was something impossible for anyone to judge. It was not surprising, therefore, that many stockholders, in the face of this assessment, sold their stock and were foreclosed of the opportunity of recouping some of their losses."

Two other solutions were available to the bankers. One was to obtain money by the bringing of lawsuits against directors and officers for neglect of duty, and against bankers and others whose close relation to the company had at times brought them undue profits. But so far as the record shows, the attitude of the bankers on the subject of reducing the need for a seventy-million-dollar assessment by urging lawsuits against those previously connected with the property may not have been substantially different from that of one of the company's employees, who said: "Every officer and everybody connected with the St. Paul road in my forty years' experience, to my knowledge, has been as clean as a hound's tooth."

The second solution was to eliminate, so far as possible, the need for the seventy million dollars of additional money. Over fifty million dollars of it was to be used under the bankers' plan to pay off debts of the St. Paul company to the government.

Before receivership, efforts had been made to induce Congress to pass a law permitting the government to postpone for a number of years the date of payment of money due to it from railroads, and to reduce the interest rate in the existing debts. This was during the short session of Congress, and the bill did not go through. Congress was to reconvene before the St. Paul reorganization was completed, but Mr. Hanauer made no provision in his plan to reduce the assessment on the stockholders in case Congress passed the proposed legislation.

Independent stock- and bond-holders promptly called atten-

tion to this hole in the bankers' plan. The bankers finally yielded in order to satisfy one group of independents and changed their plan. But they were inept in so far as Congress was concerned. When a committee of the Senate considered the subject, the bankers stayed away. Senators were distrustful of what had been done in bringing on the receivership, of the benefits the bankers might obtain by the enactment of the statute, and of the fees. The bankers continued to stay away from the hearings, and the atmosphere became more and more impregnated with distrust. Some extracts from the proceedings will bring this out.

At the opening session of the committee, former Senator Frelinghuysen appeared for a committee opposed to the bankers' plan.

*Mr. Frelinghuysen:* I want to make this statement, that without any conspiracy to put it in the hands of a receiver, if there had been bankers with courage the relief afforded by the reduction of interest would have put the road in such a position that they could have made their own arrangements for refunding.

*Senator Gooding:* I think that is good, Senator—"without a conspiracy." I think that tells the story.

*The Chairman:* Do you mean by that that there was a conspiracy?

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*Mr. Frelinghuysen:* . . . I will change that. Instead of "without a conspiracy" I will say "without prearranged plans."

*Senator Couzens:* The evidence before the Interstate Commerce Commission indicates clearly, in my judgment, that there was a conspiracy. I do not see how anybody can deny it.

As the bankers remained at a distance, and session followed session in the committee hearings, Senators became more and more insistent that they be given binding assurances that the stockholders, and not the bankers, would get the benefit of the proposed legislation.

*Senator Couzens:* I was going to suggest that Congress may want some better assurance than appears in the record here. . . .

*Mr. Thom:* What better evidence would they want than the agreement?

*Senator Couzens:* The agreement is not very definite. . . . There is still a doubt left, or would be in my mind, whether the full benefit of this legislation would accrue to the stockholders of the Milwaukee.

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*Senator Couzens:* . . . I will not favor this bill unless the committee gets some assurance. . . . Before I consent, Senator Gooding, I intend to have that assurance.

*Senator Gooding:* Yes, there are some things we must know and understand. There is no doubt about that.

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*Senator Gooding:* Before this bill can pass we shall have to be able to assure the Senate that the Kuhn, Loeb people are not going to come in and have the benefit of the reduction in interest.

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*Senator Couzens:* And I want to put the responsibility of getting this information from Kuhn, Loeb & Company upon the parties here who are urging the passage of the bill.

*Mr. Prentice:* Why, we are fighting Kuhn, Loeb & Company. They will give us no assurance. Kuhn, Loeb & Company are opposed to this bill, we have always charged.

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*Senator Gooding:* I cannot support it with the spirit I should like to support it on the floor—and certainly there is no question of my sincerity in behalf of this measure—unless I am satisfied before I go on the floor as to all the surrounding conditions and am able to properly champion it.

Finally, independents who were urging the Senate committee

to approve the proposed statute, and members of the committee, demanded that the bankers appear before it.

*Mr. Frelinghuysen:* Mr. Chairman, we cannot compel Kuhn, Loeb & Company to come here and make a statement as to their underwriting commissions. It is not in our power. It is in the power of this committee, and it is a very important point that you have made.

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*Mr. Prentice:* . . . If we are now asked to produce assurances from our enemies as to what they will do in regard to this legislation may we not ask the committee for a subpoena for the members of the firm of Kuhn, Loeb & Company to appear before the committee and state frankly their position?

*Senator Couzens:* . . . I think they ought to be subpoenaed.

*Mr. Prentice:* That will be eminently satisfactory to us . . .

*Senator Gooding:* I have had a resolution on my desk for some time for an investigation of the Milwaukee by the Senate.

None of the bankers appeared at the next session of the committee, and the need for having them come and testify was mentioned.

*Senator Couzens:* I understand when we adjourned the former hearings . . . that it was understood representatives of Kuhn, Loeb & Company and of the National City Company, the reorganization managers of the . . . St. Paul Railway Company, would be heard.

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*Senator Bruce:* . . . If it is necessary to call a representative of Kuhn, Loeb & Company and the National City Company before this committee as to paying a fee and seeing that it is a reasonable one, I do not see any objection. . . . If we cannot be satisfied on that I suggest that we approve this bill immediately as to all

railroads except the . . . St. Paul railway, and approve it conditionally as to that road.

*Senator Gooding:* That would be an unfortunate situation. I am afraid we would not be able to get it enacted by the Senate under those circumstances. . . . Yet, Mr. Chairman, I am quite sure it will help in the passage of this bill if we will call the representative of Kuhn, Loeb & Company before this committee.

When Mr. Hanauer and Mr. Davis, the vice-president of the National City Company, finally appeared before the Senate committee, the damage had been done. A year earlier, in the short session of Congress, President Byram had felt after his appearance before the committee that the atmosphere was distinctly favorable to the bill. But now even the interests of other railroads in getting the desired legislation were endangered by the Senators' concern with the manner in which St. Paul affairs had been handled.

*Mr. Thom [attorney for all the railroads]:* . . . Now, to permit a controversy over the St. Paul to be the turning-point in this matter will be to entirely ignore the other railroad debtors to the government and prevent them from getting relief because of some situation in respect to the St. Paul.

*Senator Gooding:* That is where your danger lies, Colonel Thom. We might as well meet it.

Before the bankers had gone on the stand, as well as during their testimony, there was a feeling among the Senators that there had been dishonesty and wrecking in connection with the affairs of the St. Paul.

*Mr. Dick [of Roosevelt & Son, bankers]:* The St. Paul railroad is in bankruptcy and the junior mortgages are being foreclosed. The junior mortgagees are taking income bonds, and being in that position, and in return for that they say to the stockholders: You must pay off this government debt.

*Senator Gooding:* Is that a part of the wrecking scheme, in your judgment?

*Mr. Frelinghuysen:* I say it is.

*Senator Gooding:* Let us put the cards on the table here and get after things from the bottom up.

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*Senator Couzens:* I believe there have been charges of crookedness bandied about as to connection with subsidiary roads around Chicago. I do not understand it.

*Mr. Hanauer:* . . . We never knew that the . . . St. Paul railroad was having any thought about taking the . . . Terre Haute . . . railroad. . . .

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*Senator Couzens:* You say you were never consulted and had no knowledge of the . . . St. Paul railroad purchasing these two lines? . . . Leasing and purchasing.

*Mr. Hanauer:* No, sir.

Mr. Hanauer felt that a gross injustice had been done to the bankers, and expressed his feeling at the last committee hearing he attended.

*Mr. Hanauer:* There has been so much criticism upon the part of people who have not had information. . . . And not only has that occurred in the newspapers, but in the United States Senate. . . .

*Senator Wheeler:* You said there had been misrepresentations on the part of Senators. . . . What misrepresentations have been made?

*Mr. Hanauer:* . . . Naturally it hurt us very much after the effort we had made to save this company, and after the constructive work we had attempted to do in these negotiations, to hear, without any indication of what it was based upon, and for it to be published in probably every newspaper in the United States

that "Here come Kuhn, Loeb & Company, the greatest wreckers of them all."

*Senator Wheeler:* The greatest wreckers of them all, did you say?

*Mr. Hanauer:* Yes. I pointed out in my last testimony, and when you were not present, Senator Wheeler, that our record of having put weak railroad companies on their feet extends to all sections of the country. . . . And they one and all are giving good service to their communities. And as I said then, if you call that wrecking, maybe it is lucky we are doing the wrecking.

One method of dispelling suspicions was open to the bankers. The Interstate Commerce Commission carried great weight in Congress, and if it had reported that the bankers' plan was fair and sound, and that the fees to be received by them, their lawyers, and their associates were reasonable, such a finding would have been most helpful. The plan itself was printed in a long document, difficult to understand. The fees appeared to be large, running into millions of dollars. Senators did not themselves have time to make an exhaustive study of the reorganization. A formal decision by the Commission would have been received by them with confidence. But, as will be noted later, the program of the bankers' lawyers was to defer the Commission's consideration of their reorganization plans until the very last, and to prevent altogether, Commission scrutiny of the fees. In consequence this method of facilitating legislation for the sake of the security-holders was barred.

A member of the Interstate Commerce Commission appeared before the Senate Committee. Though he could not say the plan was fair or the fees reasonable, he did agree with the independent security-holders that the passage of the bill "would greatly lighten the load upon the stockholders, and probably decrease the number who might find it necessary to sacrifice their holdings because of their inability to raise the money necessary to pay the assessment." But nothing would now avail. That feature of Mr. Hanauer's plan which provided for immediate payment

of government loans due several years later, and for the raising of the requisite money by assessing the stockholders for the purpose, remained unchanged. And this was not wholly unwelcome to at least some in the banking group, including Mr. Mitchell, president of the National City Bank.

*Mr. Grady:* Personally you have never interested yourself in any way towards securing the passage of that law that would thus relieve twenty-three thousand stockholders?

*Mr. Mitchell:* Personally for the benefit of the stockholders I would be very glad indeed to see this thing through. As a citizen of the United States I do not believe in it.

*Mr. Grady:* I thought we would get it. Your feelings are sort of criss-crossed on it. You have one feeling for twenty-three thousand stockholders, and an opposing feeling on behalf of the citizenry of the United States, is that what you mean to say?

*Mr. Mitchell:* As one interested in the economics of the situation I doubt its soundness.

Of course, no loss would fall on the bankers, though forfeiture might fall upon stockholders. The latter had no ardent champions among the managers to prevent, through the legislation in question, that dislodgment of stockholders which was an inevitable consequence of the bankers' plan. The bankers were bound by their compromise with the Iselin committee to favor what Mr. Mitchell deemed unsound economics, but both the inactivities and the activities of the bankers contributed to a result consistent with his view of sound economics and to the defeat of stockholders who could not shoulder the burdens imposed by Mr. Hanauer's plan.

A smaller part of those burdens was due to the requirement of cash to pay, not the government, but the fees of receivership and reorganization. This was brought out by one of the Senators.

*Senator Couzens:* As I understand, there is some objection to the amount to be raised from these stockholders, because of the

reorganization manager's fees, expenses, and so on. You are not relieved from that by any provision of this bill on the refunding of the debt, are you?

*Mr. Dick:* No.

The bankers' plan provided that these fees should be paid in cash. This increased the size of the cash assessment imposed on the stockholders. A number of the recipients of fees in the receivership and reorganization had already profited by their relationship with the St. Paul property in the past or were to profit by such a relationship immediately after the reorganization or had both past profits and future assurances. If such participants in the fees had taken securities instead of cash or had agreed to defer payment to a later date, the assessment on each of the more than two million shares of stock would have been decreased to the extent of about a dollar per share. This decrease would have been the equivalent of about ten per cent of the prevailing market price of the common stock and would have been substantial. But such a method of helping stockholders who were hard pressed, by requiring co-operation from persons who had already profited from the bankrupt company or were to profit from the reorganized company, was not a part of Mr. Hanauer's plan.

On the plan as a whole, Mr. Buckner of the New York Trust Company volunteered this pithy comment: Mr. Hanauer "wrote it . . . and he wrote well."