

CHAPTER III

GETTING INTO DEBT

FROM 1909 to 1916 the St. Paul company entered upon a series of financial transactions which intensified its business difficulties in the ensuing decade. The company financed itself by bond issues rather than by selling stock. The bonded indebtedness was more than trebled in eight years. At the beginning of the period the capital investment based upon stock was one and one-half times the funded debt. When the period ended, the funded debt was one and one-half times the stock investment.

This condition, as many of the experts testified, was unhealthy. Mr. Griswold, a director representing the William Rockefeller interests, and many years earlier the secretary of the Railway Securities Commission appointed by President Taft, was asked about the ratio of bonds to stock in the St. Paul financial set-up. He said that the "proportion was about two to one, and that is not, in my opinion, a very healthy capital structure." Mr. Buckner, president of the New York Trust Company, said that "the impression . . . among the bondholders" was that "the financial structure of the road was top-heavy, and it was only a question of time before a readjustment of that structure was absolutely necessary. . . . The impression was rather general among investing houses . . . that the structure was not sound." Mr. Hanauer, of Kuhn, Loeb & Company, told the United States Senate committee in 1926 that "the St. Paul's financial structure is terribly top-heavy."

The issuance of almost a quarter of a billion dollars' worth of bonds, rather than of stock, added almost ten million dollars of interest charges to the annual bill which the St. Paul had to meet. It was these additional charges which, in the bankers' opinion, required that the road be put into receivership in 1925. The error of the Puget Sound extension would not have forced bankruptcy if it had not been followed with the error of financing by bonds. Apparently, this method of financing had been a deliberate choice, since stock financing was possible at the time. Mr. Geddes, himself a banker who had participated in selling the St. Paul bonds to investors, and long a director of the road, was asked about an issue of \$34,000,000 of bonds which were sold by the road in 1909. He said that at the time the stock was paying seven per cent dividends and "was selling at a high figure." He added that he thought there would not have been any difficulty in selling stock rather than bonds, and that probably the reason which appealed at the time was that the bonds would cost the company interest charges of four per cent, whereas the stock would carry a seven per cent dividend charge. He thought that "what determined their action was to get that money as cheaply as possible." The men in charge apparently overlooked the possibility that earnings on the Puget Sound extension might not be as great as anticipated, that interest charges might not be earned, and that in the event of reduced earnings dividends can be reduced or eliminated without resulting in receivership, but failure to pay interest charges on bonds spells bankruptcy.

Another aspect of the financial structure about which Mr. Geddes was questioned was the length of time that the bonds had to run before they would have to be paid. Some \$47,000,000 of the junior bonds fell due in 1925, another \$50,000,000 were to fall due in 1932, and \$33,000,000 more in 1934. The bonds due in 1925 had been sold to the public, part in 1910, and part in 1915. Mr. Geddes said: "Unquestionably you are right. Our financial structure is very much weaker than if we did not have those serial maturities. . . . You are entirely right in saying

that if these maturities had been farther off we might have been better off." He thought that, conditions being the same, a company would be better off with long- rather than short-term loans and without having the various portions of the bonded debt become due too near to each other. Long-term loans, he felt, save a company the bankers' commissions which must be paid when bonds fall due. Those are paid, not out of earnings, but by new borrowing to pay off the old. The new borrowing is also by the sale of bonds, and on each new sale the bankers get a commission.

The evidence that the St. Paul financial structure was more or less unsound, in the top-heavy proportion of bonds to stock, in the placing of maturity dates too close to each other, and in the comparative shortness of some of the bond issues, thus came from bankers and others who testified in the Commission's investigation. Attorneys for the St. Paul bankers, Cravath, Henderson & de Gersdorff, however, told the United States Circuit Court of Appeals that "there is not a fact in the record in this case justifying the suggestion . . . that . . . the financial structure of the Railway Company . . . was improvidently created."

Those features of the railway's financial structure which the witnesses deemed unsound were first introduced in 1909. Until that year Kuhn, Loeb & Company had little to do with the St. Paul, and National City Bank had no part in its financing.

The circumstances of the National City Bank's participation in the St. Paul's financing were inquired into by Mr. Fisher, special counsel for the Interstate Commerce Commission in its investigation of the causes of the receivership. Both Mr. Hanauer, the Kuhn, Loeb partner, and Mr. McRoberts, who became vice-president of the bank in the bond financing period and a director of the railway in 1912, were questioned, as follows:

Mr. Fisher: How did the National City Bank come to be associated with Kuhn, Loeb & Company in that transaction?

Mr. Hanauer: Why, of course, there is no record to show that.

Mr. Fisher: I thought you might supply the record.

Mr. Hanauer: I can only supply my belief, and that is that I think the St. Paul asked us at the time to do this business with the City Bank.

Mr. Fisher: Did they give any reason?

Mr. Hanauer: I haven't the least idea, but one can very readily see the reason. The City Bank was the bank in which they had an account . . . and they probably gave them accommodations, and so forth. It is a usual thing.

Mr. Fisher: Were any of the directors of the St. Paul company interested in the National City Bank at that time?

Mr. Hanauer: I really don't know who the directors of the St. Paul company were at that particular time.

Mr. Fisher: Take the Rockefeller interest. Mr. William Rockefeller was at that time, I believe, a director of the St. Paul and had been for some time?

Mr. Hanauer: Yes.

Mr. Fisher: Was Mr. William Rockefeller understood to be interested financially in the National City Bank?

Mr. Hanauer: I believe so.

Two days later when Mr. McRoberts was on the witness-stand, the following colloquy took place:

Mr. Fisher: Now, take in 1912 when you came here, you came to the National City Bank?

Mr. McRoberts: I did.

Mr. Fisher: At that time was that bank operating with Kuhn, Loeb, generally speaking, on a fifty-fifty basis in financing the securities of the St. Paul?

Mr. McRoberts: I do not think they had previously, no.

Mr. Fisher: How did that relationship come about?

Mr. McRoberts: Well, through the activity of the bank in entering the field of distributing securities—handling securities; it became an active security bank. It had not been before.

Mr. Fisher: When did that take place? That change?

Mr. McRoberts: Well, about 1912.

Mr. Fisher: And through what instrumentality or influence did the National City Bank become an equal participant with Kuhn, Loeb in the banking operations of the St. Paul?

Mr. McRoberts: Well, they co-operated in a great many things, and the St. Paul was simply one of them. I think that is a correct answer to your question.

Mr. Fisher: Well, to get it directly, the point I had in mind was, did Mr. William Rockefeller's influence have largely to do with that relationship?

Mr. McRoberts: I do not think it did, no.

Mr. Fisher: You think it came about through general banking considerations?

Mr. McRoberts: Yes. I think it came about through the aggressiveness of Mr. Vanderlip [then head of the National City Bank]. I think it was rather an embarrassment to Mr. Rockefeller.

Mr. Fisher: Why could it have embarrassed him?

Mr. McRoberts: Just disturbing old relations; that is all.

With a minor exception, these two banking concerns handled all the St. Paul securities issues from 1909 to the time of the road's receivership, in 1925. Throughout the period one or more of the National City Bank directors were on the St. Paul board, and at all times men important in the bank had an important influence in the railway company. Kuhn, Loeb & Company did not have any partners on the board, even in the years before the law prohibiting such interlocking directorates. Mr. Hanauer said that "we never were as close to the St. Paul people as I believe the relationship between bankers and railroads should be. . . . We have been getting much closer to the St. Paul since their troubles in the last few years, than ever before. . . . Since about 1921 . . . we would have liked to have that very close relationship."

The other banker, National City Bank, had a close relationship to the St. Paul for many years before the receivership. This was brought out during the Interstate Commerce Commission in-

vestigation, and was illustrated by the circumstances of a re-financing transaction in 1916. This transaction was also the subject of considerable inquiry by the Commission. The refinancing arose out of the fact that wartime conditions made it possible to buy the French bonds, a large part of them in the J. P. Morgan & Company office at the time, at substantial reductions. New bonds had to be issued in this country to raise the money with which to pay for the French holdings. The profits were divided equally between the railway and its bankers, Kuhn, Loeb & Company and the National City Company. The profit received by the bankers was \$1,800,000, about five per cent on the amount involved. In the Commission hearings Mr. Hanauer, of Kuhn, Loeb & Company, admitted that his firm's net profit on other St. Paul financings never exceeded one and one-half per cent, that it averaged about one per cent, and that he considered one per cent a handsome profit. Mr. Hanauer described the 1916 deal as "a very handsome transaction. . . . The large profit to the bankers was because they did not form any syndicate, but took the risk themselves for the joint benefit of the company and themselves." In the first and principal stage of the deal they had to put up about twenty-five million dollars, on January 24, 1916, and got it back on February 1, 1916. Mr. McRoberts, at the time vice-president of the National City Bank, and a director of the St. Paul for a number of years, testified that "it might be that it was a pretty juicy piece of business for the bankers, but I doubt if they thought there would be that much when they went into it."

The Interstate Commerce Commission sought to ascertain what justification there might be for the size of the profit in the 1916 affair. The discussion centered on the question as to the duty of a railroad company's bankers to the company. In another connection the lawyer for Kuhn, Loeb & Company said that the bankers had a "quasi-professional relationship" to the St. Paul bonds which they had sold to the public. Mr. Mitchell, president of the National City Company, claimed "that our

business is professional." Mr. Hanauer agreed that the relation of the bankers to the St. Paul company was one of great trust and confidence.

The relation had been virtually one of monopoly and sizable profit. Even at an average profit of one per cent the bankers' earnings on the many bond flotations of the St. Paul road during the years 1909 to 1915 had been large. The aggregate sum was not given in the testimony. Mr. Hanauer gave detailed figures, but declined to state the total when the representative of the State of Wisconsin complained that he could make neither head nor tail of the complicated testimony on the subject and asked for a simple statement giving the bankers' profits in one lump sum. Question followed question, but still Mr. Hanauer refused to give the aggregate of the bankers' profits. He said it would be asking him to do clerical work and to this he would not submit. His answers to various questions included the following: "I haven't added them up . . . I haven't it in mind . . . I have never even figured it . . . I know of no purpose for such a thing. . . . That is clerical work that anybody can do . . . I came here to testify, not to add . . . I never thought of it as a total." Mr. Hanauer's lawyer, Mr. Swaine, of the firm of Cravath, Henderson & de Gersdorff, objected that "Mr. Hanauer did not come up here to perform book-keeping." The aggregate was obviously large, and the connection was obviously a profitable one. The business had all been in the bankers' hands without competition, except on one issue, with respect to which the New York vice-president wrote that "Mr. Hanauer was very vehement in his protests."

Of the 1916 financing, the Interstate Commerce Commission said the following:

"The transaction is defended on the ground that in it Kuhn, Loeb & Company were not acting as the bankers for the St. Paul. That is exactly the point. They had acted as bankers for the St. Paul as far back as 1880; since 1909 they and the National City Bank had exclusively handled vast sums for the St. Paul;

and yet at this opportunity to render to the St. Paul an important banking service the banker-railroad relation was suspended and profits greater than regular banking compensation were received."

At the time of the 1916 deal the railway was in no position to protect itself on financial matters. The Commission reported that after Mr. Roswell Miller's death, a few years earlier, the company was without adequate financial direction. The president of the company, Mr. Earling, was a very sick man. Mr. Percy Rockefeller testified, in another connection, that Mr. Earling "had a couple of collapses . . . two of them quite serious. . . . In the directors' meetings, when he would try to talk for a few minutes, he would become very weak and we all had the feeling that he might faint at any minute, and it happened so many times in succession that it made us all very nervous."

The vice-president of the road, with whom Kuhn, Loeb & Company took up the proposed transaction, called in Mr. Percy Rockefeller, prominent in the National City Bank. He was the only board member active in the matter. The Commission reported that, on the evidence before it, "the other directors when questioned could remember little or nothing of the transaction." The board at the time was in no position to supply independent action, or to deal at arm's length with the National City Bank, one of its bankers. Of the thirteen men on the board, five were directors or officers of the bank, a sixth was given a participation in the financing deal, and two others had been made directors at the desire of Mr. William Rockefeller. Among the remaining five were the sick president, the vice-president who turned the matter over to Mr. Percy Rockefeller, and a director living in the west, who, if like the later directors from that region, probably attended few meetings and may have had no knowledge of the matter.

With the board thus balanced heavily toward the National City Bank, the deal takes on special significance and the words of the Interstate Commerce Commission become particularly pertinent. It said: "While Kuhn, Loeb & Company seem to have

done most of the work in connection with the transaction the bankers' share of the profits was divided evenly between them and the National City Company."

Mr. Hanauer of Kuhn, Loeb & Company was questioned by Mr. Fisher, the Commission's special counsel, to bring out the relation between Mr. Rockefeller and the bank.

Mr. Fisher: Was Mr. Percy Rockefeller at that time closely associated with the National City Bank?

Mr. Hanauer: I cannot testify as to that. The records I believe show when he was a director. I don't remember.

Mr. Fisher: Well, was it not your understanding throughout this entire series of transactions that Mr. Percy Rockefeller was largely interested in and closely associated with the National City Bank?

Mr. Hanauer: I have not the date in mind when the Clayton Act went into effect. Before that time there was absolutely no reason—no legal restriction on a director of a railroad company also being a director of a banking house or of a bank with which that company did business.

Mr. Fisher: Pardon me—

Mr. Hanauer: And whether he was a director at that time—

Mr. Fisher: I have no objection to your anticipating a possible interpretation of your answer and making an argument against it. You may be wrong in your anticipated interpretation, but I would like to get an answer to the question first, because we are off and down the road on some other issue.

Mr. Hanauer: I cannot testify from actual knowledge of the dates on which Mr. Rockefeller was a director of the St. Paul Railroad or of the National City Bank.

At the time of the deal both Mr. Percy Rockefeller and his father were directors of the railway and the bank and were members of the St. Paul's executive committee.

The interlocking of the bank and the railway at the time of the 1916 refinancing was carried to such lengths as to violate even

the rule laid down by Mr. Ryan, the defender of interlocking directorates. During the inquiry into the power contracts he made with the St. Paul, he was asked what he would have done if seven of the railway's thirteen directors had been directors of his power company when a transaction between the two concerns was pending. He said: "If there was any such proportion of directors, before I took the business I would have some of them resign." He felt that there should be a "quorum on each board" having no common interest in companies doing business with each other.

The Commission investigation of the 1916 refinancing was conducted under an order of inquiry into "the history, management, financial and other operations . . . of the . . . St. Paul Railway Company." It followed a great public outcry against the receivership, and a widespread demand for full light on all transactions which might have any bearing on the past conduct of the company. But one of the banker's attorneys, Mr. de Gersdorff of the New York law firm of Cravath, Henderson & de Gersdorff, intimated that the Commission ought not to have inquired into the 1916 deal. He said, when Mr. Hanauer was under examination: ". . . how this transaction can be material at all to the present inquiry, I cannot see."

The relation of the bankers to the road, at the time of its receivership, was that of persons who had owned its securities, but had passed them on to the public. National City Bank had invested in a large amount of the junior bonds. But Mr. Mitchell, its president, "became skeptical of the future of the St. Paul," and his bank began selling its junior bond holdings after Mr. William Rockefeller's death in 1922. "Nevertheless," so runs the report of the Interstate Commerce Commission, "in 1923 the National City Company published an elaborate brochure on the St. Paul, which, while not definite, would give one the distinct impression that this well-informed organization believed that the St. Paul had 'turned the corner.'"