CHAPTER XXXI

NO TRESPASSING

THE portion of the reorganization which dealt with fees and expenses did not receive the Interstate Commerce Commission's approval, but was reserved by it for further inquiry. An assessment of nine million dollars had been imposed on the stockholders, this being the maximum amount which would be available for receivership and reorganization fees and expenses. This meant to the stockholders an assessment of four dollars per share —a figure as large as the entire market value of the common stock shortly after the company was put into receivership. It was contemplated that whatever part of this sum was not used would be returned to the stockholders or be paid to the new company. According to an early estimate by Mr. Hanauer, at least half of the nine million dollars would be used for fees and expenses. How much more might be used was not disclosed to the Commission, which said in this connection:

"The evidence which was presented in respect of the total expenses of reorganization was not revised to date when introduced in this proceeding, and . . . such estimates are over 18 months old. It would appear that at this later date estimates more nearly approximating actual figures could be furnished.

"The record is insufficient to enable us to arrive at an opinion as to the reasonableness of the expenses and the public interest affected thereby. Jurisdiction of this proceeding will be reserved for the purpose of taking further testimony as to the expenses of

the reorganization, the nature and scope of the services performed for the compensation and fees claimed. . . ."

The reorganizers were of course deeply concerned by the Commission's decision to investigate the subject of fees. If as a result of its investigation the Commission cut down the fees, the bankers and their lawyers might lose what amounted to good-sized fortunes. The amounts involved were obviously worth fighting for.

The bankers and their lawyers took up the battle. They went to the federal court to get an injunction against the Commission's effort to inquire and supervise. The suit was nominally in the hands of the St. Paul company's attorneys, Mr. Field and Mr. Dynes, but Mr. Swaine and another partner in the firm of Cravath, Henderson & de Gersdorff acted as counsel in the case. In addition, the reorganizers retained the foremost advocate of the time in large financial litigation, Charles E. Hughes, who before long was appointed to the Chief Justiceship of the United States. The reorganizers then chose another great advocate, John W. Davis, a former Solicitor General of the United States, and head of the law firm acting for J. P. Morgan & Company.

The courts before which able and distinguished lawyers were to argue this lawsuit had special need for all the facts requisite to the making of a fair and wise decision. The rights of thousands of investors who could not speak for themselves were to be determined in their absence. If the Commission supervised the St. Paul fees and found that any of them were excessive, the security-holders would benefit. The excess would go back to the twenty thousand stockholders or would be paid to the reorganized company, in which forty thousand stock- and bond-holders were financially interested. On the other hand, if the attorneys could prevent Commission examination of the fees, these security-holders would lose their chance of getting a direct or indirect refund of a possibly large amount.

The manner in which the bankers' attorneys arranged the lawsuit increased the need for giving the courts all the appropriate facts. The outward appearance given to the litigation was a confusing one. The fact that the interest of the security-holders was opposed to the interest of the bankers was obscured by bringing the lawsuit against the Commission in the name of the financial society of the St. Paul investors. This society, the reorganized St. Paul company, was used by the bankers as their instrument to uphold the interests of the bankers and to oppose the interests of the security-holders. The latter, financially affected by the lawsuit in an amount conceivably large, were not only absent from the court-room, but were in effect being represented through their own corporation as adverse to their own interests.

Other considerations made it necessary that the courts have the full facts. The ruling in this case might determine the rights of even greater numbers of investors in other reorganizations. The lawyers might also seek to use a decision favorable to themselves in the St. Paul case as a barrier to Commission scrutiny of their fees in railroad consolidations, involving billions of property values.

The lawyers also raised the suggestion of unconstitutionality. It was their contention that Congress did not give the Commission power to supervise reorganization fees, and they intimated that if Congress tried to do so, it would be violating the United States Constitution. Any case in which a court is asked to decide that Congress is without the power to enact legislation is in a high sense a public case. It can affect the people in a myriad of ways not immediately apparent in the particular controversy before the court. To decide such cases the courts must have all the facts bearing on the reasonableness or unreasonableness of the governmental powers which are being assailed.

All agreed that railroad finances were a proper subject of regulation by Congress and had been made the subject of regulation by the Commission. Since railroads require additional capital from time to time, and it is necessary that investors should be willing to buy railroad bonds and stocks, Congress and the Commission had concerned themselves with seeing that investors' money paid for railroad use should actually reach the railroads, and that any deductions for bankers' or other charges should be

reasonable. The government had also tried to protect investors against financial practices which might lead them to regard railroad securities with distrust.

The problem before the courts in considering the case brought by the St. Paul bankers was therefore one to be solved in the light of what actually takes place in railroad finance. The courts had to consider whether particular methods of regulation are reasonably related to what goes on during reorganizations, not only in full public view, but also backstage. Upon the bankers who were accusing the Commission of usurpation of power rested the duty of giving to the court all the pertinent facts and preventing any erroneous impression.

The bankers' attorneys presented facts to two courts. One was a special court made up of three federal judges, as required by law in such cases. The other court was the United States Supreme Court, to which the case went on direct appeal in 1929 after the victory of the bankers in the special court.

The bankers' attorneys gave these courts an account of the reorganization from which one would draw the following conclusions: St. Paul security-holders themselves created the committees; the committees called in the bankers; the bankers acted as the agents of the bond- and stock-holders; the stockholders came into the reorganization freely; they turned millions of dollars over to the bankers as their agents, to be paid by those agents to various persons for fees; the arrangement was a strictly private matter, like the hiring of a lawyer by an individual stockholder.

The following is from a legal paper with which the injunction suit against the Commission was started. The attorneys had Mr. Scandrett, the new St. Paul president, swear that its statements were true.

"During the month of March, 1925, for the purpose of protecting their respective interests in said receivership proceedings and in any ultimate disposition of the property of the railway company, certain holders of the preferred stock of the railway company, formed a preferred stockholders committee . . . certain holders of the common stock of the railway company formed a common stockholders committee . . . and certain holders of the . . . bonds . . . formed a bondholders committee. . . .

"The committees requested the private banking firm of Kuhn, Loeb & Co., of New York, a co-partnership, and the National City Company, a New York corporation . . . to prepare and submit to them for their consideration a plan for the reorganization of the railway company in the interest of such security holders as might join therein."

On behalf of the Commission the Supreme Court was told that the bankers had organized the committees, and controlled the situation. The bankers' attorneys replied that the statement was unfair, because introduced to "create the impression that the Managers controlled the entire situation, including the appointment of the committees." They mentioned the statements sworn to by President Scandrett. Some lawyer in the government employ had accepted Mr. Scandrett's representations on this score at face value and had formally admitted that they were true. This ended the matter so far as the bankers' attorneys were concerned. It apparently made no difference to them that neither Mr. Scandrett nor the government lawyer had any personal knowledge of the facts. The bankers' attorneys did not suggest that the truth be ascertained. They said that the government was bound by the acquiescence of the government lawyer. In consequence, the St. Paul security-holders whose money was at stake were also to be bound. Their own corporation, by their own president, had made the statements which the government lawyer had the power to seal as true, no matter what the real facts might be.

Other statements by Mr. Swaine and his associates included items which busy judges, if they desired, could verify only by plowing through the lengthy reorganization documents he had drawn. He told the courts not only of the broad powers he gave the bankers when he wrote those papers, but also of the broad duties which he thought he had imposed on them. He said: "As more particularly appears from the reorganization plan, the re-

organization plan gave to the reorganization managers broad powers and discretion, and correspondingly broad duties, in the protection of the interest of depositing bondholders and depositing stockholders."

The lawyers told the United States Supreme Court that ". . . the committees, the managers and their respective counsel . . . acted at all times as agents of the depositing security holders. . . . The managers, as agents of the depositing security holders, were authorized to fix the compensation of the Committees, depositaries, sub-depositaries and counsel. . . ."

Mr. Swaine told the courts that ". . . the depositing security holders were not under the domination of the Managers or the Committees, but were free agents to deposit their securities under that plan which, in their opinion, was for their best interests."

It was Mr. Swaine who had written into the reorganization papers the provision that stockholders must pay their onerous assessments on time or forfeit their stock. It was under his draftsmanship that the money paid by the stockholders passed into the control of the bankers. None of it could ever get back to the stockholders or even to the new St. Paul company, such was his writing of the documents, unless the bankers should decide to give it back rather than pay it to their lawyers, their committees, and their other nominees. But as Mr. Swaine told the facts to the United States Supreme Court, this is what his documents provided:

"The moneys out of which such payments were to be made remained at all times the moneys of the depositing stockholders, and were to be disposed of by their agents, the Managers, in accordance with the Plan.

"At their option, the Managers were permitted either to return such moneys to the depositors or to pay it over to the new company as additional working capital. Until this election was made, the fund remained the private property of those who had contributed to it."

The form in which the lawsuit was cast by the bankers' attorneys became for them clothed with reality. They intimated to the

United States Supreme Court that the Commission's effort to protect the investors' dollars was an effort to coerce the investors and their company, and "destroys . . . the existing property right of the depositing stockholders."

The attorneys also told the Supreme Court that the Agreement Mr. Swaine had drawn constituted a contract by the security-holders. Of course, they had never signed it and probably could not have understood what it contained. Concerning its provisions for the millions of dollars of fees, Mr. Swaine said in his brief: ". . . the contract thus made was an ordinary business arrangement by which certain private persons were to perform services for certain other private persons and were to be paid for such services."

The attorneys forgot about the tens of thousands of St. Paul investors who had neither seen nor had any dealings with, nor conceived that they might in any way approach, Mr. Hanauer, or Kuhn, Loeb & Company, or Mr. Mitchell or other officers of the National City Bank, or Cravath, Henderson & de Gersdorff, or Shearman & Sterling, or Davis, Polk, Wardwell, Gardiner & Reed.

In establishing the claim that this was all a private affair, the attorneys urged that the bankers were not subject to regulation by the Commission. The Supreme Court was told that the new company, but not a single one of the bankers, was the party to the proceeding in which the Commission dealt with the reorganization—although the bankers and their lawyers were the persons who started and conducted that proceeding, and the new company was simply a technical device in their hands. In making their point to the Supreme Court, the lawyers were merely bringing down to date Mr. Hanauer's earlier answers to Mr. Grady, that Kuhn, Loeb & Company were private bankers and not regulated under any law.

The attorneys also argued that the money paid by stockholders for fees was not in the control of the new company, which was subject to Commission supervision, but of bankers who were not subject to regulation. Their lawyers further claimed

that the new company was not a party to the Agreement of Reorganization, just as they claimed that the bankers were not parties to the Commission proceeding. It was Mr. Swaine and his firm who had determined what the new company—then a piece of paper in their control—should sign and should not sign. Their own employees were at the time the officers of this nominal corporation, and the lawyers directed them to sign a separate document agreeing to carry out the Reorganization Agreement, but not to sign the main document itself. Out of such "technical distinctions" and "legal forms," to quote words of Justice Stone of the Supreme Court, the bankers' attorneys drew the conclusion that the reorganizers' fees were not subject to Commission regulation.

The attorneys in the Department of Justice who were arguing the Commission's side of the case tried to tell the Supreme Court the realities. They presented a concrete example of the danger of excessive fees in situations controlled by bankers, taken directly out of St. Paul history, from the official evidence in the Commission's investigation and the Commission's official report. This was the 1916 refinancing transaction, handled by the bankers and Mr. Percy Rockefeller, when most of the St. Paul directors were friendly to the bankers and inactive in the matter, and the bankers made a profit of $1,800,000. The government brief quoted the Commission's report and introduced the quotation with these words:

"The Commission's report . . . suggests cogent reasons why the public interest might require scrutiny of the expenses and fees which under the Plan the Managers might determine. The Commission stated that these banking houses had taken a banker's profit of over 5% in retiring certain of the old company's bonds when 2% 'would have been generous' and that the risk which the bankers stressed in justification of the large profits which they realized was largely non-existent."

The bankers' attorneys thought that this illustration of the size of the St. Paul bankers' fees when there was no regulation had no relevance to the question whether the same bankers' reorganization fees should be free from Commission regulation. They said: "It is difficult to find any reason for the injection of matters so foreign to the case at bar, unless there was a purpose to arouse prejudice and divert the attention of the court from the matters in controversy."

When the Department of Justice ventured to refer the Supreme Court judges to the Commission's report of its St. Paul investigation, the bankers' attorneys said it was unfair to mention that report since the evidence on which it was based was not before the court. They did not suggest placing the record before the court nor indicate that they and their clients had long known all that was in the record. They were content to have the case decided on the facts as they had told them to the court.

Five judges of the Supreme Court, accepting as true the representations of the bankers' attorneys, concluded that the arrangement for fees was a private matter not subject to regulation. Three judges felt, however, that the public interest was involved. These three were Justice Stone, who wrote the dissenting opinion, Justice Holmes, and Justice Brandeis. Their opinion contains the following:

"The preservation of the transportation system and the stability of its credit essential to its preservation depend . . . upon the ability of all to attract the investment of funds in their securities.

"If such investments are impaired by receiverships . . . followed by reorganizations of excessive cost, and if railroad shareholders compelled by the necessities of their situation, must contribute to the rehabilitation of their properties excessive amounts upon which the reorganized carrier may not earn an adequate return, railroad credit in a broad sense is affected, the permanency and stability of the transportation system as a whole is impaired, and the public interest suffers.

"No one familiar with the financial and corporate history of this country could say, I think, that railroad credit and the marketability of railroad securities have not been profoundly affected, for long periods of time, if not continuously, by the

numerous railroad reorganizations, in the course of which junior security holders have found it impossible to save more than a remnant of their investment, and that only by the assumption of a heavy burden of expense, too often the result of wasteful and extravagant methods of reorganization."

The case before the Supreme Court also involved the question whether the reorganizers had dealt fairly with the Commission and with the receivership court. An old established rule denies an injunction to any applicant who has himself dealt unfairly in the matter out of which his request for an injunction arises. To paraphrase what judges and lawyers have long said, he who seeks relief in equity must come to court with clean hands.

The minority judges of the Supreme Court observed that the Commission let the major portion of the reorganization become effective on condition that the portion relating to fees should be subsequently investigated. They also saw that the Commission had not been warned of the intention to challenge its jurisdiction over the fees. None of the judges saw, because the record was not before them, how the managers and their group had so conducted themselves as to lead the Commission and the courts to believe the very contrary of what was finally done. More than a year before the managers finally submitted their plan to the Commission, the chairman of one of their stockholders' committees was a witness in the Commission's investigation. His testimony about the managers' fees included this passage:

Mr. Geddes: . . . The different committees have agreed to a certain sum to be paid the reorganization managers for their services.

Mr. Grady: And how much is that sum?

Mr. Geddes: That sum is fixed on, I think, a little over a million dollars.

Mr. Grady: How much over?

Mr. Geddes: I think it is a million and twenty thousand dollars; that sum was agreed upon by the committees subject to the approval of the Interstate Commerce Commission.

It has been seen how closely Mr. Hanauer and his attorneys were following the testimony in the Commission's investigation. They probably knew at once of this evidence about the agreement of the committees. If it was not the intention of the bankers to carry out any such agreement, or if they felt that the committee chairman was in error, they had full opportunity to set him and the Commission straight. The record shows nowhere any disclosure by the bankers that Mr. Geddes had misinformed the Commission, or any warning that they intended to repudiate what Mr. Geddes stated under oath to the Commission.

Some months later they put Mr. Roosevelt on the witness-stand, in the proceedings to get their reorganization plan approved by the receivership court. This was more than a year after the Roosevelt committee had given its support to the managers' reorganization as modified.

Mr. Roosevelt testified, in answering a question put by Mr. Swaine on the subject of the bankers' fees, that "I have always understood since the Katy case, that the Interstate Commerce Commission passed on those matters." So far as the record shows, Mr. Swaine did not challenge this statement and did not warn Mr. Roosevelt or the court that the bankers would fight any attempt by the Commission to supervise the fees.

Even later, when Mr. Swaine asked the Commission to consider the bankers' plan with favor, he did not put on record any warning of their intention to repudiate the Commission's power to inquire into the fees. On the contrary, the record shows that he so conducted himself in the hearings before the Commission as to give a wholly different impression.

The Commission called for memoranda in support of the fees which had been estimated by Mr. Hanauer. These were produced. Indeed, Mr. Swaine himself placed in evidence one of the memoranda of one of the committees. In his presence an attorney from the office of Shearman & Sterling, the National City Bank lawyers, said that a similar statement of the bondholders' committee would shortly be presented to the Commission. In complying with the request of the Commission for

memoranda detailing their own services "in earning the fees provided for under the reorganization plan," the bankers and their lawyers sought to justify the fees by submitting a description of their work, seventy-three pages long. Later, with Mr. Hanauer on the stand, Mr. Swaine examined him in the Commission proceeding as follows:

Mr. Swaine: I show you a memorandum headed "Statement of the nature and extent of the services performed and to be performed by the reorganization managers and their counsel in earning the fees provided for under the reorganization plan . . ."

Mr. Hanauer: Yes. That is the statement. Of course, no possible statement could be prepared telling in full detail the services over a period of two and a half years, and the future, of reorganization managers under any such plan.

Mr. Swaine: This is a correct statement, however, of the services which the reorganization managers have rendered?

Mr. Hanauer: Yes.

Mr. Swaine: May I state for the record, since it is a composite statement of services as counsel—and I am willing to be sworn if the Director desires—it is a correct statement of the services of the reorganization managers' counsel, a correct summary of those services; that I was a member of the firm of the counsel in charge of those services and have personal knowledge of them.

Their evident acknowledgment that the Commission had jurisdiction over the reorganization fees, and the implication that the bankers were not going to repudiate such jurisdiction, appear also from the briefs they submitted to the Commission.

The facts showing this course of conduct were not in the record upon which the United States Supreme Court was asked to grant an injunction. One fact, however, did appear in that record. The receivership court had directed that the deed for the railway property should not be given to the reorganized company until the Commission had approved the reorganization securities. Justice Stone, in a minority opinion, said that when the new company got such approval, took the Commission's order to the receivership court, and asked for the deed, the new company was in effect telling the receivership court that the company expected to comply with the Commission's order.

The Judge concluded that the fair thing to have done, if the new company was not going to comply with the Commission's condition, was to disclose the fact right away, and if it wanted to litigate, to do so before taking advantage of the Commission's order.

"If [the new company] were unable or unwilling to comply with the order as made, equity and good conscience required, at least, either disclosure of that fact to the District Court before securing the transfer of the railroad property to it; application, upon full statement of the facts, to the Commission to exercise the jurisdiction, which it had reserved, to approve a modified plan; or prompt initiation of the present proceedings to test the validity of the order before a situation had been created prejudicial to the public interest and to the Commission's performance of its duties.

"Instead, [the new company] adopted a course of conduct consistent throughout only with its apparent purpose to comply with the order; and now, without tendering any excuse for the belated disclosure of its real purpose, it asks relief from the condition only after it has enjoyed benefits which it cannot be said would have been granted without the condition."

The question then before the judges was whether the new company had come to court with clean hands when it asked for an injunction against the Commission. The majority judges decided that the new company was entitled to an injunction. Whether they felt that the company's conduct was subject to any censure at all, cannot be gathered from the opinion.

As has been indicated, neither the majority nor the minority judges had knowledge of all the facts bearing on the question whether the applicant for an injunction came to court with unclean hands. The bankers' attorneys had not made available to the special court and the Supreme Court the records of the evidence taken in the Commission's investigation of the St. Paul receivership, or in the receivership court proceedings, or in the proceedings to obtain the Commission's approval of the reorganization.

The judges were therefore deprived of an adequate opportunity to see the actual relation between the new company and the bankers in the injunction litigation. The majority judges, accepting the representations of the attorneys who were in court technically as attorneys for the new company, assumed that the bankers and the new company were quite separate and apart from each other. They did not realize that when the new company came to court or Commission, it was merely the mouthpiece of the bankers.

A good deal of this was unknown to the minority as well as to the majority judges. But from such little as the minority judges could gather in the record before the court, they concluded that the new company was the "creature and *alter ego*" of the bankers. These judges said that in its treatment of the receivership court and the Commission the bankers' *alter ego* had violated even the elementary standards of fairness. Justice Stone, in the minority opinion, speaking for himself and Justices Holmes and Brandeis, said:

". . . Even if it be held that the condition which the Commission attached to its order was beyond its authority, I should still have thought the present case not a proper one for a court of equity to lend its aid to the [new company]. . . .

"The failure to conform to those elementary standards of fairness and good conscience which equity may always demand as a condition of its relief to those who seek its aid, seems to require that such aid be withheld from [the new company]."

In the thousands of volumes of judges' opinions it would be difficult to find a stricture so severe, by judges so distinguished, upon the corporate conduct of men so high in finance and at the bar.