

THE BANKERS ASSUME COMMAND

Nor in form, but in fact, not with notice to the investors, for whom the directors were in effect trustees, but privately, the board surrendered some time in advance the flickering power which oncoming receivership was to extinguish. The directors had not been selected, even theoretically, to deal with matters of corporate life or death, or to determine whether there should be a revolution in the financial society of which they were the nominal governors. These questions were for the owners of the property, to be decided by them or by representatives chosen for the purpose. But the board did not consult the owners, either on underlying problems or as to the persons in whose hands should be the preliminary decisions necessary to be made. One or another of the directors approached officials of several insurance companies which held St. Paul bonds, to see (as one director put it) "if we could get their sympathy. . . . We could not get any sympathy from the bondholders." But the directors considered that it was hopeless to go to the security holders in general, and did not do so. "It was an ideal situation for the bankers to control," the Interstate Commerce Commission reported. "This they promptly did."

The bankers had sold the bonds to the investing public, and the interests of their customers, as well as the business name and goodwill of the bankers, were involved. Mr. Hanauer, of Kuhn, Loeb & Company, testified on the point as follows:

Mr. Hanauer: Bondholders have a right to expect that you will, as far as you are able, watch the situation in a company, and if the time should ever come when you should step in on behalf of bondholders to protect their interests, that you will do so.

Mr. Fisher: Step in in what way?

Mr. Hanauer: Step in in calling bondholders together.

The bankers did not call the bondholders together, but did step in. They had other inducements than the protection of those who had bought the bonds in the past, for, as was said by Mr. Buckner, head of the New York Trust Company, "the bankers . . . are not philanthropists." Adjustment, reorganization, or other possible solutions of the difficulties of distressed corporations generally bring some compensation to bankers. As it turned out, the bankers of the St. Paul became its reorganization managers and as such received a million dollars in fees. To be sure, Mr. Hanauer testified that he would not undertake the task again for twice this amount and felt that the security-holders had a bargain when they obtained the bankers' services for this figure. This view was expressed under the discomfort of an inquiry by the Interstate Commerce Commission, following on the heels of a blunt and stormy inquiry by a committee of the United States Senate, and in the midst of much newspaper publicity. The banker's opinion may have been based upon the rate of compensation which his firm was accustomed to receive in a less contentious atmosphere rather than upon any intrinsic smallness of the fees in this case.

The bankers of the company had another business interest in the matter. The adjustment of the affairs of a financially embarrassed concern may lead to a change in control and may thus affect or destroy profitable relationships which various persons, such as bankers or lawyers, have had with the property. The reorganization of the St. Paul company enabled new counsel to obtain the post of eastern attorneys for the company, in the place of the men who had held it for many years; and the same thing may happen to bankers as well. Bankers' future relation to a

property can be buttressed by obtaining control in the preliminary stage of adjustment.

The process whereby this was done in the St. Paul matter was the subject of questioning in the Commission's investigation. Some of the witnesses showed considerable shyness and labored under conflicting recollections of what took place. As the events at this point throw light on what followed, it will be helpful to review some of the evidence.

At the outset it should be noted that although the St. Paul was a middle western and western railroad, the locale of most of the conferences and decisions leading up to its receivership was New York City. Of its thirteen directors, eight were in New York. Five of the six directors on its executive committee were New Yorkers. Four of the five members of the special committee to deal with the problem of the 1925 maturities had their offices in New York. The bankers were New York concerns. A number of companies holding large blocks of junior bonds had their main offices in New York or its vicinity. The railroad maintained a New York office for the conduct of its financial affairs. The bankers were thus within a few blocks' distance of most of the leading actors in this financial drama. As it was put by one director who worked closely with the bankers, "We were all in a very small locality."

It was in Paris, however, that the bankers made their first move. Mr. Hanauer conferred there with representatives of the French bondholders in March 1924. This was fifteen months before the French bondholdings would fall due, and at a time when not even the special committee of directors had appointed itself to consider what should be done about the 1925 maturities. After it began to deliberate and concluded it was all at sea, as Mr. McHugh testified, it repaired to the office of Kuhn, Loeb & Company and met with members of that firm and officers of the National City Company. The decision reached at that conference has already been mentioned—they determined to await the results of the railway's fall business.

In the interim Mr. Hanauer conferred with President Byram

and one of the other directors and also made important preparations. He said to the company's vice-president stationed at its financial office in New York: "December 1, 1924 . . . is going to be your and our last opportunity [to] find out who owns these bonds, and I think you should arrange for some machinery by which, when the coupon on December 1, 1924 is paid, a very careful record is made of the holdings." He shortly thereafter gave to Mr. Sparrow, another officer of the road, a letter of introduction to the London bankers who were agents of Kuhn, Loeb & Company and who acted for the St. Paul in paying the interest coupons there presented for payment. These bankers were asked to get the names and addresses of bondholders whose coupons were paid in London. In consequence an invaluable list of bondholders was obtained, enabling those who had access to it to secure the great advantage of early and direct communication with about seventy-two per cent of the owners of bonds maturing in 1925. The purpose of these preparations was said to be that of proposing a voluntary readjustment to these bondholders, but this was never done, and the list served the bankers when they became reorganization managers and asked bondholders to support the managers' plan of reorganization.

The special committee of directors met the bankers again, at the end of the year, in the Kuhn, Loeb offices. Early in January 1925 they conferred again. It was on that occasion that the firm of Coverdale & Colpitts, consulting engineers, was retained to make a study of the property. The part which the bankers had in the decision to make the investigation and in the choice of that firm throws light on the position which they were occupying in the situation, as the report of the engineers was deemed one of the crucial factors in the affair. Mr. Hanauer testified that "if Coverdale & Colpitts report was unfavorable, that a receivership would follow, and if it was favorable, a refunding scheme would be tried."

The bankers' relation to the decision to make an engineering study and to select Coverdale & Colpitts for the purpose was at first left somewhat inconclusive by the testimony in the

Commission's investigation. President Byram said that "the bankers decided that we should have a report. That is, they wanted a report." At an earlier point the following answers were given to questions by a member of the Commission:

Commissioner Eastman: Did they also suggest that Coverdale & Colpitts be employed?

Mr. Byram: They left that to us to decide, and we inquired around and we found that Coverdale & Colpitts were the recognized engineers employed in practically all cases of that kind or all important ones and that led us to select them.

Commissioner Eastman: You say that was left to you to decide?

Mr. Byram: Yes. The bankers merely made the suggestion that we ought to have a report.

Commissioner Eastman: Do you mean by that that they did not leave it to you to decide whether a report should be made?

Mr. Byram: Oh, yes. They could not do otherwise, but they suggested that a report of that kind would be useful and we agreed with them. The selection of the engineers was left in our hands.

Commissioner Eastman: Were not both things left in your hands?

Mr. Byram: Yes, but you indicated they also suggested we should employ Coverdale & Colpitts. I would not want that impression to remain.

Later Mr. Grady, of Wisconsin, took up the questioning, as follows:

Mr. Grady: At whose suggestion did you decide upon Coverdale & Colpitts?

Mr. Byram: At the suggestion of the committee.

Mr. Grady: And the committee decided upon the suggestion of whom?

Mr. Byram: I don't know.

.....

Mr. Grady: Is it not a fact that they were retained at the request of Mr. Hanauer of Kuhn, Loeb & Company? Wasn't he the man who suggested their names?

Mr. Byram: No.

Mr. Grady: Are you sure of that?

Mr. Byram: Yes.

When the special committee met in the Kuhn, Loeb offices early in January, it told Mr. Hanauer that it wanted to employ Coverdale & Colpitts. "They asked," said Mr. Hanauer, "how it could be arranged that they immediately take it up, and we immediately telephoned to Coverdale & Colpitts' office. Mr. Coverdale came around and we introduced him, and they made the arrangement." It later appeared in evidence that the engineers had known several weeks or months in advance that they might be employed for this work, and when their partner was asked how they came to know this, he could not remember.

As the Commission's investigation proceeded, it became clear that the proposal for the employment of Coverdale & Colpitts was made by Mr. Hanauer. He also advised that a public announcement of the employment of the engineers be made in the name of the St. Paul company, because "the purpose of such an outside examination might not be understood if it leaked out, as it was bound to leak out." Mr. Hanauer thought that he might even have drafted the statement to be issued by the board.

Mr. Colpitts, the engineer who took charge of the investigation, testified that shortly after he was employed, he talked to Mr. Hanauer, but it was "to get any light that he might have on the situation, just as I talked to anyone whom I felt might help us." Before starting west Mr. Colpitts saw the banker, and "my discussion with Mr. Hanauer amounted to this, I think: 'I understand you are going out west over the St. Paul,' said Mr. Hanauer, 'and I hope you have a nice trip.' That is about all it amounted to." However, the bankers prepared the list of governing questions to be answered by the engineers. The Interstate Commerce Commission reported that "ostensibly Coverdale &

Colpitts were retained by the railroad; as an actual matter they were working for the bankers."

The party traveled on a special train. A vice-president of the National City Company, one of the St. Paul bankers, accompanied Mr. Colpitts in his western inspection of the road and kept in touch with his bank, reporting developments during the trip. The bank officials knew the engineer's conclusion before the party had returned to Chicago. Mr. Colpitts testified that "it was the night before we reached Chicago on the return trip. Of course, Mr. Byram and a number of others also were very anxious to know how my mind was working on the problem, and I think it was Mr. Byram who asked me if I would not come back to a room on the train and talk the whole thing over. I said I would. There were present at that conference Mr. Byram, Mr. Hoyt [of the National City Company], Mr. Mason [a director], and myself."

When the party reached Chicago, Mr. Colpitts stayed over for two or three days, while the others went to New York at once. There Mr. Byram promptly went to see Mr. Hanauer and said (this is Mr. Hanauer's testimony): "they had had a very satisfactory trip; as far as agreeing with Coverdale & Colpitts, they had some differences of opinion, that in the main he felt their report would be a very correct statement of conditions on the St. Paul. I said: 'That is very nice, but what is going to be Colpitts' answer to my question whether this company can live on if they can refund these . . . 1925 bonds?' Mr. Byram said: 'Their report on that is going to be adverse.' I said: 'Well, you know what that means.' . . . He said: 'Yes, I'm afraid so. . . .'"

A few days later Mr. Colpitts saw Mr. Hanauer and confirmed Mr. Byram's statement. It was only after reporting to Mr. Hanauer that Mr. Colpitts met with the special committee of directors, and subsequently with the board.

The first question before the bankers was whether efforts should be made to deal only with the \$47,000,000 of bonds maturing in 1925. One way of dealing with these bonds would be to ask their holders to postpone the date when they would have

to be paid. Voluntary extension of the date, according to Mr. Hanauer, "simply meant giving a man one piece of paper instead of another." A considerable proportion of the bondholders might refuse such a proposal, but this would not make it impossible to deal with the 1925 maturities. Other help was at hand. One director said that "Mr. Harkness had indicated his willingness, if a plan could be evolved, to stand by in a very big way towards taking up the slack of any dissenting bondholders." The Interstate Commerce Commission had indicated to Mr. Byram in the fall of 1924 that the government would be willing to release from the loan previously made to the St. Paul by the government some \$26,000,000 par amount of salable bonds. The money obtained by such a sale could also be used in paying off part of the 1925 bonds. In addition, various large bondholders had volunteered their co-operation.

Mr. Colpitts testified that extension of the 1925 bonds was "talked about until everybody was black in the face." But he felt that he could not recommend it. The bankers also decided against it. Mr. Hanauer said that "bondholders . . . want to be assured that if they do make that sacrifice, it is a permanent matter, and that at the end . . . they are not going to be in the same hole. . . ." He felt that extension of the maturity of the 1925 bonds would not solve the difficulty. The engineer estimated that in five years the deficit would be some \$28,000,000 or \$29,000,000, if the railroad were going to continue the payment of \$10,000,000 interest charges on the junior bonds every year. That was the consideration that governed the bankers. Mr. Hanauer felt that perhaps the decision to readjust the entire financial structure should have been made two years earlier. He said that "the 1925 maturities had very little to do with it, except to make a peg where you had to say: 'Well, don't let us try to struggle along any further.'"

Mortimer Schiff, of Kuhn, Loeb & Company, had told the special committee in December 1924 that there was danger of continuing to run on too long, citing as an example the Alton railroad case, where "there had been a good deal put in to con-

tinue the road in meeting its obligations which had been lost because in the long run they had had to have a reorganization, and this had really hurt the road rather than help it because it had taken up more of its assets." Director McRoberts, himself a banker, felt from the time of the creation of the special committee, in June 1924, "that unless we could finance the road so that it could have a clear field to go through, and maintain its high standing, that it would be very much better for everybody involved . . . to have a reorganization then before it became a run-down property and difficult to handle."

On the other hand, a number of the men in the group dealing with St. Paul affairs at the time of Coverdale & Colpitts report still felt it desirable to deal with the 1925 maturities alone and to avoid reorganization of the entire junior bond structure. But the decision of the bankers was controlling. Testimony by Mr. Byram, in response to questions by the Attorney General of the State of Wisconsin, follows:

Mr. Ekern: The fact is that these bankers refused to assist you in any way financially and that was brought home to this special committee . . . is not that true?

Mr. Byram: Yes. . . .

.....

Mr. Ekern: Then the decisive thing in relation to this receivership was the advice of these two banks?

Mr. Byram: Yes.

Mr. Ekern: And their refusal to grant you financial assistance? Now, if this—

Mr. Byram: Wait a minute, hold on. They did not refuse. They advised us. I do not like to use that word "refuse," and I will not submit—

Mr. Ekern: I withdraw that.

Mr. Byram: All right. As I said, they advised us. . . .

Mr. Ekern: I withdraw the question.

Mr. Byram: Yes. I don't like that word. It is not a nice word to use.

It later appeared, however, that Mr. Byram had written to one of the bondholders, after the company had been put into receivership, as follows: "Our friends, after carefully looking into the future prospects . . . reluctantly decided that they could not undertake the refinancing of the June maturity. . . ."

The bankers' decision to have a default on the bonds maturing in 1925 was in fact a decision to default on five times that amount. All the bonds of the same second mortgage class as the 1925 bonds, and other bonds of similar rank, were to be defaulted. Of these, \$50,000,000 were not due until seven years later, \$33,000,000 were not to mature until 1934, \$27,000,000 were not payable until 1949, \$72,000,000 did not have to be paid until 2014. Thus, forty per cent of the bonds thrown into default were not payable before a quarter of a century or more had passed, and thirty per cent of the total defaulted bonds would not be payable until almost a century had elapsed. But the bankers' view that the probable earnings of the road would not be sufficient to pay each year some ten million dollars of interest charges on the first mortgage bonds and similar obligations, another ten million dollars of interest charges on the junior bonds, and several millions for needed improvements, appeared to them to justify this wholesale readjustment. The readjustment of the junior bonds would also involve a readjustment of the stockholders' rights. The bankers' decision therefore required reorganization of securities in the par amount of almost half a billion dollars, \$228,000,000 of bonds and \$233,000,000 of stock—amounts which constitute the St. Paul case the biggest railroad reorganization in history.