THE INVESTOR PAYS

*

THE WORLD DEPRESSION

AND A WAY OUT

A GUIDE THROUGH WORLD CHAOS

by G. D. H. Cole

"Ought to be read by everyone wishing to understand the problems of today. Nowhere will the intelligent man find a simpler, surer and saner guide through the intricacies of the world's economic problems . . ."

—Sidney and Beatrice Webb.

THE TWELFTH HOUR OF CAPITALISM

by Kuno Renatus

"Mr. Renatus is one of the comparatively few who have made a real contribution to the literature of the world economic crisis."—*Barron's*. "I think it comes as near to identifying the principal trouble in this crisis as is possible."

—Thomas F. Woodlock, in *The Wall Street Journal*.

These are Borzoi Books published by

ALFRED · A · KNOPF

THE INVESTOR PAYS

MAX LOWENTHAL

THE INVESTOR PAYS

#17249.

NEW YORK MCMXXXIII

ALFRED · A · KNOPF

PUBLISHED JUNE 2, 1933
SECOND PRINTING JULY, 1933

Manufactured in the United States of America

TO

FLORENCE GIDEON WEBSTER

THE INVESTOR PAYS

PREFACE

This book is written to explain what happens when large companies go downhill. A great many investors are at this moment involved in losses through the failure of concerns in whose securities they have put their money. Some of these companies are being put through reorganization. For most investors this is a process too technical and intricate to understand. They know that before the receivership they had an engraved certificate, either a bond or a share of stock. After reorganization, in place of their original certificate, they get a different piece of paper. They know that whereas they used to get an assured return from their investment, after reorganization they often get no income at all, or a precarious one, or a security which they are sooner or later forced to sell at a sacrifice. But how this comes about, what goes on during receivership, how a reorganization is arranged, whether they get all they are entitled to get—these things are Greek to most investors.

This book seeks to pierce through technicalities and show the investor what actually happens to his money. For the purpose of making the subject clearer to the average security-holder, a concrete case has been chosen. This case is the biggest receivership in American history. By and large, its story is typical of most reorganizations of companies in which bondholders and stockholders have their money. Some of the men active in that case participate in most large corporate reorganizations, and in great measure set the standard for the conduct of all such cases in every section of the country.

To those who have given me access to copies of official records in their possession, I express my appreciation. A number of friends have generously assisted with the manuscript, and to them, and in particular to Marion Denman Frankfurter, I am deeply obligated.

MAX LOWENTHAL

April 26, 1933

CONTENTS

PART I

DRIFTING INTO RECEIVERSHIP

PART II

RECEIVERS AND REORGANIZERS

PART I

DRIFTING INTO RECEIVERSHIP

CHAPTER I

THE OWNERS AND DIRECTORS

THE receivership of the Chicago, Milwaukee & St. Paul Railway Company, which occurred in 1925, was the greatest in American history. No bankruptcy had ever involved such enormous stakes, either of money or of railway mileage. The St. Paul, as the road was called, had become, by 1925, a transcontinental network of eleven thousand miles, reaching into one-fourth of the states of the Union. The shrinkage in the market value of its securities, from 1909 to 1925, was $455,000,000. This deflation of almost unexampled proportions continued even when the rest of the American world had begun to rush forward with the inflation of the nineteen-twenties.

The task of clearing away the wreckage of the old St. Paul financial structure and erecting a sound one in its place attracted some of the men highest in financial affairs. This was just at the end of the first quarter of the century, and it was not until 1931 that the final incident in the reorganization drama was brought to a close. The personages who took part are therefore contemporaries, less well known than some of the great names associated with the early history of the railway company, but no less important in the domain of business. Leadership in the St. Paul property passed to Kuhn, Loeb & Company, one of the two institutions at the pinnacle of banking in this country, and to the National City Bank, at that time the largest bank in the land. The reorganization crew was recruited among the executives of the largest insurance and trust companies and banks of the country, and included almost every first-rank law firm in Wall Street.

The part which the reorganization group played in St. Paul history is to be the principal subject of this book. But in order to insure a better understanding some attention will first be given to events before 1925.

The corporation which stood before the world as the owner of the St. Paul railway property until its reorganization in 1928 was in fact an association of over forty thousand persons. These were the real owners of the property. They were of three principal classes: the holders of the first mortgage bonds, the owners of the so-called junior bonds, which were either second mortgage bonds or of similar standing, and the stockholders, owning either preferred or common stock.

The owners of the first mortgage bonds were entitled to receive their interest regardless of the company's ability to pay the interest on the second mortgage bonds. The St. Paul property earned enough to pay the interest on its first mortgage bonds. The owners of those bonds were therefore not affected, even though the two lower classes of this financial society, the owners of the second mortgage bonds and of the stock, were forced to undergo a revolution. The peace which the first mortgage bondholders enjoyed at that time will not be disturbed in the course of the present narrative. They will be disregarded and attention will be devoted exclusively to the lower ranks of the St. Paul association.

The junior bondholders and the stockholders, for years prior to the receivership, were numerous, and scattered all over the world. Life-insurance companies and savings banks owned millions of dollars' worth of the junior bonds. Hence equivalent amounts of the people's savings lodged in those institutions were invested in the St. Paul Railroad. Some of the money of endowed universities, such as Harvard and Yale, was invested in this property, so a committee of the United States Senate was informed.

The amount invested per person varied greatly. At one extreme were some of the French bondholders, whose individual holdings were very small. At the other extreme were some of the insurance companies and charitable foundations. Four of the life-insurance companies had among them about eighteen million dollars' worth of the junior bonds. One fire-insurance company had nine millions. The stock of the company was similarly held in amounts ranging from the very small to the very large.

Many investors had owned their St. Paul securities for years, and had paid high prices for them, in some instances as much as two hundred dollars per share. As President Byram of the railroad testified before the Interstate Commerce Commission, St. Paul stock "had long been a gilt-edged investment stock." Such was the repute of the stock that even in the 1907 panic its market price, according to one of the directors, did not drop below a hundred dollars per share. The junior bonds had also been bought, and for many years had been held, as gilt-edged investments. They were deemed so safe that, though only secured by a second mortgage on the road, they paid interest as low as four to four and one-half per cent.

The type of individual investor who belonged to the St. Paul society by owning some of its bonds is pictured in the testimony of Mr. Thomas Read, a Brooklyn business man who testified before the Interstate Commerce Commission after the road had been put into receivership. He said: "I will have been in business sixty years next April. . . . Every dollar of my money has been made on the level, and I supposed when I was buying those bonds I did something in that style. . . . I studied the thing. . . . You will find the older men always have thought well of the St. Paul; put their shoulders right up to it." Mr. Read had bought the St. Paul bonds which were to fall due in 1925. They were not paid, but instead became the occasion for its receivership. Mr. Read said: "Can I tell you why I bought them? . . . I could see my way clear if my life was spared to getting out of the ferry business. . . . The St. Paul road had an unbroken record, since 1864. Us old fellows were partial to the St. Paul road as it was. It was the premier road for years. This coupon, the last one on this 1925 issue, is the first one they passed in sixty-four years. Well, you see how I am situated, and I cannot do much now, but I figured on something like that, rather than any stock, and it was a low rate of interest. I could have sworn they would have paid on that account, and I considered that the St. Paul road had the lowest interest-bearing rate the last two decades. . . . I bought as I could; for instance, sold other things that I had."

In the years immediately before the receivership, some of the larger interests in the company sold their St. Paul shares and bonds. One insurance company sold a block of three million dollars of the bonds at fifty cents on the dollar, and a fire-insurance company, in the months before that event, picked up several millions of dollars' worth of the bonds at similar receivership levels. The Metropolitan Life Insurance Company, premier in its field, tried to dispose of its St. Paul junior bonds, beginning in 1924, but it wanted eighty cents on the dollar and was left with most of its holdings.

With one exception, the great family fortunes invested in St. Paul shares and bonds—those of the William Rockefeller, the Armour, and the George B. Smith families—were gradually sold in the years of the railway's decline. The buyers included, in addition to ordinary investors, some who bought as a speculation when the prices began to fall. To a considerable extent, therefore, the complexion of the St. Paul society had altered, particularly in the group which theoretically elected the directors who governed the company. In place of large individual holders appeared the names of stock-brokers acting for speculators.

The smaller stockholders tended to remain in the company. In a selection of representative letters from security-holders, written shortly after the railway was put into receivership, were communications from men and women, old and young, living in large cities, in small towns, or in rural sections—a seamstress, a cripple, a police-court judge, a small business man, a small

banker, an apothecary, a newspaper man. One trustee responsible for the money of other people wrote that "the preferred stock was considered one of the very best trust investments."

The attitude of the individual investor who held on to the end was probably like that of one woman who wrote: "I have twenty-five shares of the common stock, it cost me $85½. It took several years of hard work to buy it. I was told I would get good returns . . . on my money thinking some day I would get it. . . . But no doubt being a small stockholder and poor I'll have little to say."

The men who had the say in St. Paul affairs were of course the directors. They were selected nominally by the stockholders, but actually by the board members themselves. As Mr. Stanley Field, a connection of the Marshall Field family in Chicago and one of the directors, said: "That would seem to be more or less automatic. When your term expired your name was put up again." Vacancies due to resignation or death were filled in a manner described by other directors, when they appeared for examination before the Interstate Commerce Commission during its investigation of the St. Paul receivership. Mr. Percy Rockefeller said that in filling vacancies "it is always necessary to have more or less of a program. . . . There were many occasions when, after the formal transaction of the business of the day, the directors and officers would sit around and discuss things informally." It was his impression that the selections were entirely determined by the board itself; the stockholders sent in the proxies requested by the board, and formal action was taken in "the usual routine of an annual meeting."

The board was selected by the four interests which originally had large stockholdings—the Rockefellers, William and Percy, Mr. Armour, the Harkness family, and those who had inherited from the George B. Smith estate or had represented it. As already noted, these interests one by one (with the exception of the Harkness family) disposed of their St. Paul securities. The men they put on the board held almost no stock. Some of these who bought stock after their appointment soon disposed of it. As one director said: "I saw the gross and net earnings constantly decreasing . . . and I thought to myself there was only one result possible and I decided that I wanted to get out. . . ." Mr. Buckner, who was head of the New York Trust Company and had been put on the board by the Harkness interests, said that he bought some shares "in 1923, and realized that I had made a mistake and sold them a few months afterwards. . . ." This selling of their stock by the directors was not communicated to the investing public, or to their own associates on the board. Even as late as the receivership the Harkness representative most active on the board did not know that the Rockefeller family had disposed of its St. Paul securities.

No Rockefeller was on the board at the time of the receivership. The son had resigned in 1921 and the father had died in 1922. Mr. Percy Rockefeller's resignation was due to his membership on other boards, particularly that of the National City Company, which did a large amount of business with the St. Paul Railroad Company. Congress had passed a law against interlocking directorates, which was designed to prevent any man from sitting on both sides in negotiations between railroads and banks or concerns which did a large business with railroads. Mr. Percy Rockefeller testified: "I never could understand what the Clayton Act [the name given to the law, after the Congressman who sponsored it] meant. It was worded very peculiarly, and I never could get anybody to explain exactly what the Clayton Law did mean." But he added: "I did not want to do anything that would be illegal," and, confronted by the need of choosing between the railway and his other concerns, he chose to remain on the directorates of the National City Bank and other companies rather than on the board of the railway.

He continued, however, to be a highly important factor in St. Paul affairs. He attended meetings of the St. Paul board of directors and of its executive committee from time to time. His attendance was not noted in the minutes, but he and various directors testified before the Interstate Commerce Commission

that the old relationship was not cut off by the resignation. "I tried to keep in touch," said Mr. Rockefeller, "but of course not in intimate touch, the way I did previously. . . . I occasionally would get in touch with various members of the board, or officers . . . and occasionally I attended the meetings of the board." He continued to receive the confidential weekly reports of operations which were sent to the directors, "as a matter of courtesy." The vice-president in charge of the company's New York office wrote to the president's office to "insure his receiving everything of interest," but Mr. Rockefeller, when asked how the vice-president got his impression that this was appropriate, said: "I haven't any idea."

He had been of such importance when formally on the board that, requested to name any "important matter in which the vote of the board of directors was contrary to your views," he replied that it was hard to remember over twenty years, but "momentarily I do not recall one." After his resignation the attitude of the principal officers toward his right to participate in the company's affairs apparently changed little. The New York vice-president wrote to Mr. Rockefeller: "I enclose herewith an advance copy of the annual report of the company. . . . This report will be presented to the Board for formal approval. . . . I will appreciate receiving any suggestion you may wish to make . . . in order that any necessary changes may be made prior to presentation in final form." Asked about this, he testified that "it may have come in the usual form."

Despite Mr. Rockefeller's resignation the president of the railway "continued to consult him frequently," and between meetings of the executive committee and of the board telephoned him in New York and consulted him at his office in the Standard Oil building, at 26 Broadway. President Byram made it his business to see Mr. Rockefeller "frequently and we talk about things." Testifying in the court proceedings about the acquisition of a subsidiary railroad, the president said: "I advised with him about that, as I did with everything concerning the St. Paul Railroad, and as I have continued to do since. Mr.

Rockefeller is a man that I have great confidence in, and I value his advice highly, and I often seek him."

Questioned about this close relationship, Mr. Rockefeller testified: "I have written back and forth with Mr. Byram on the topics that came up from time to time. . . . Any information that came to my attention that I thought would be interesting I always passed on to him. . . . I felt that when information came to me that was of interest to the property that it was the proper thing to do to pass it along to the operating officials, and many letters that I wrote Mr. Byram were simply prompted by that suggestion. . . . Simply a friendly suggestion. . . ."

When the St. Paul Railroad approached receivership, Mr. Rockefeller, President Byram, and a representative of the Harkness family were the three men with whom the railway company's eastern lawyer held an important conference and to whom he submitted detailed memoranda bearing on the road's financial structure. The lawyer did not know that Mr. Rockefeller and his family had sold their St. Paul securities.

While the government of the St. Paul company was in the control of the board, supplemented unofficially by the participation of Mr. Percy Rockefeller, much of the power rested of course with the officers. As Mr. Rockefeller said, "no corporation can be run excepting through the executive officers, and the directors must rely on them for their most reliable information." The president of the company had for many years been Mr. Earling, but he became ill and had always been disliked by Mr. Ogden Armour. The latter proposed that Mr. Byram, an official of the Burlington road, be made president. Mr. Rockefeller testified that the executive committee of the board "discussed the matter for about a year, back and forth. . . . It took them a long time . . . to find a president. . . . The determination . . . was very largely on account of Mr. Armour's insistence on it. . . . That insistence gradually gained momentum as other people's names dropped out." Mr. Byram was elected president in 1917.

Mr. Rockefeller said that the president "in a general way supervised the financial affairs. . . . He had been an operating man up until the time he came to the St. Paul." In the opinion of Mr. Harkness, one of the directors, and others, Mr. Byram had had no particular experience with financial operations. Mr. Hanauer, member of the banking firm of Kuhn, Loeb & Company, who had most to do with the St. Paul reorganization, testified that "Mr. Byram came into the property and he was mostly in Chicago. He was not a financial man. They had no financial man in New York."

An outline of the government of the St. Paul company would be incomplete without reference to its bankers, their connection with the company, and the part they played in its affairs. The bankers were Kuhn, Loeb & Company, who had done financial business for the road since 1880, and the National City Bank, which shared in that business from 1909 onwards. Both were New York concerns. Mr. Hanauer testified that "the general character of the business of the firm of Kuhn, Loeb & Company is the selling of large issues of securities, largely that of railroads in the United States. They have also reorganized a number of railroads, and are what are usually called international bankers as well."

The National City Bank had an affiliate under the name of the National City Company, which was in fact, though not in form, a department of the bank. Until Mr. Mitchell, president of the company, came to the concern, in 1916, the bank had directly acted as one of the St. Paul bankers. Subsequently its affiliate appeared in its stead. Besides being the largest bank in the country, it had some sixty offices in the United States and abroad, thousands of miles of private wire connections, and a large force of securities salesmen in direct contact with investors the country over.

As the St. Paul association drifted into receivership and suffered reorganization, the constitution of its membership and its government was approximately as follows: The owners of $128,000,000 of junior bonds were scattered throughout the world and had no voice in the company's affairs. The owners of $233,000,000 par amount of stock theoretically had a voice, but said nothing; they were made up in part of one large stockholding by the Harkness interests, in part of speculative holders, and in part of small investors who had clung tenaciously to securities which shrank and shrank in market price, until many of the older stockholders had witnessed the gradual disappearance of over ninety-five per cent of their money. The board of directors, as the Interstate Commerce Commission reported, "was a self-perpetuating body." Most of them neither had nor directly represented any substantial investment in the property. Since 1913, according to the Commission, "the executive management" of the company "appears to have been uninformed, inexperienced, and incompetent to handle large financial transactions, or to determine large financial policies."

This was the society which it was determined in 1925 should be recast. The circumstances of that determination and recasting will be made clearer by a consideration of the events which made such a decision necessary.

CHAPTER II

THE GREAT MISTAKE

RISE in operating costs, competition of the Panama Canal, agricultural and business depression in the northwest, and lack of surplus earnings to apply toward necessary improvements were listed by the board of directors as causes of the St. Paul failure. But, as the Interstate Commerce Commission said, this road "became bankrupt at a time when general railroad conditions had greatly improved." Circumstances special to the St. Paul therefore deserve consideration.

The Puget Sound Railway

At the turn of the century the St. Paul line reached as far west as the Missouri River. In 1905 decision was taken to build from the Missouri to the Pacific coast. The main line of this new system was completed in 1909. Feeder lines, electrification, and other projects incidental to the Puget Sound extension, as it was called (though it was a large railway in itself), were not finished until near the end of the next decade.

This building of a new railroad to be added to the old St. Paul line was begun as a tail to a kite, but became an entirely different affair. To a quarter of a billion dollar, long-established and profitable railway was added a quarter of a billion dollar, newly constructed and unprofitable railway. The financial structure was vastly changed by eventually trebling the bonded