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 indebtedness of the property. By bringing in the more than twenty thousand investors in St. Paul junior bonds, floated after the new railway was undertaken, the existing St. Paul financial society was transformed. A transcontinental system took the place of a middle-western road. The abounding prosperity of the St. Paul company was brought to an end.

Mr. Colpitts, the consulting engineer who was called in by the board of directors at the bankers' suggestion early in 1925, was a witness before the Interstate Commerce Commission. He said: "The difficulties of the St. Paul began with the construction of the Puget Sound extension. At that time the company was in a strong position, earning substantial margins over interest charges, paying dividends . . . and reducing its funded debt through the conversion of bonds into . . . stock." It paid "very nice dividends." After the Puget Sound railway had been built and various incidental projects completed, all that had been rosy became dark. The Commission found, after elaborate inquiry, that "the record leaves no doubt that first among the causes of the receivership was the failure of that extension to earn anywhere near a return sufficient to help the system carry the burden incurred in its construction." Indeed, as counsel for the Commission said, investment west of the Missouri failed by about ten million dollars per year to earn even four per cent interest charges. This ten million dollars was the equivalent of the interest charges on the junior bonds, whose default was primarily due to the Puget Sound venture.

The history of this undertaking is in some respects a forecast of conditions and practices which obtained in the later years of the road, up to the time of its bankruptcy. The St. Paul company lived in a railroad world where the governing rule was every man for himself, and receivership takes the hindmost. Some men carried the rule even further and assumed that each man's hand must be raised against his neighbor. Men sought alliances, but placed little or no trust in them. The period was one in which, as the Interstate Commerce Commission reported of the decision to build to Puget Sound, "personal rivalries and ambitions were free to do as they willed with a great property." Tens and even hundreds of millions of dollars of the people's savings were embarked upon uncertain ventures without adequate thought of the cost and adequate concern for the morrow.

In the early nineteen hundreds, as in the nineteen-twenties, a few men were engaged in contests for control of various portions of the nation's railroad web. Rivalries centered on the roads to the west. In the northwest, Mr. James J. Hill operated his combined Great Northern and Northern Pacific properties to the Pacific coast. In the southwest, Mr. Harriman controlled the Union Pacific system, with an outlet to the Coast. In the middle west were various important railroads, with which the Pacific coast and eastern lines both connected. Among those interior roads were the St. Paul, the Burlington, and the Northwestern.

The St. Paul was then a railroad of the first rank. Through control of this property Mr. Roswell Miller, chairman of its board of directors, and Mr. William Rockefeller had as high a station in American transportation and finance as any of the half-dozen men who dominated the trunk-line railroads.

This position of the two men, and their claim of high rank for the St. Paul, were threatened by loss of considerable of its transcontinental traffic. The story was told in the Interstate Commerce Commission's inquiry, in 1926, by Mr. Mark W. Potter. He was at one time a member of the law firm which was New York counsel for the St. Paul road, later a member of the Interstate Commerce Commission, and finally one of the receivers of the St. Paul. He testified as follows:

"For many years the St. Paul and the Great Northern and the Northern Pacific had a very close relation. . . . The St. Paul . . . was perhaps the favored connection of those lines for transcontinental business. . . . There was . . . a negotiation for the Northern Pacific and the Great Northern to acquire the St. Paul. Something happened; they did not. They acquired the Burlington instead, and then the St. Paul was just cut off like that. The Burlington became the favored connection. What happened? Your St. Paul, strong, nobody at that time thought anything could ever happen to the St. Paul; it never occurred to anyone that the St. Paul should ever take a subordinate position; everybody was buoyant and confident. . . . The Burlington became in effect the transcontinental line. The Northwestern had its close relation with the Union Pacific, a transcontinental connection, and the St. Paul was out in the cold, apparently drifting into the position of a second-class line."

This did not mean that the St. Paul would be ruined, but that it would lose much of the transcontinental business it had had with the Hill roads. Mr. William Rockefeller and Mr. Roswell Miller would not brook a lowering of their company's stature and of their own standing. At first their activity was such as any zealous but careful railroad leader would have undertaken to recover or replace the business the company had enjoyed. They maneuvered to induce Mr. Hill to restore the old arrangement, by letting him know they would otherwise have to make an alliance with Mr. Harriman of the Union Pacific. But the latter proved diffident, and to make him fall into line Mr. Miller threatened that he would build to the Coast to compete with the Union Pacific. Mr. Miller wrote the story to President Earling of the St. Paul in these words: "I rode downtown with Mr. Harriman yesterday morning" and told him that the policy of the Union Pacific would compel the St. Paul to build. "He said we could not build a line to the Coast as good as his, to which I replied we could build just as good a road as he could build. He said why don't you start it tomorrow; I said we were not ready. . . . Just then we arrived at 23rd Street where I got off, and he said he would talk further with me about this matter."

Finally a treaty was projected between the St. Paul and Mr. Gould, then in control of the Missouri Pacific. This brought Mr. Harriman to terms. Thereupon the St. Paul leaders threw their deal with Mr. Gould overboard, because the relationship with the Union Pacific was more valuable to them. "Mr. Gould was inclined to be very much enraged," wrote Mr. Miller to Mr. Earling, "because he thought that we had simply used him for the purpose of clubbing the Union Pacific."

But this round of conciliation and blustering among the New York railroad financiers did not avail the St. Paul leaders. Mr. Hill was not brought into camp. And the heads of the St. Paul put little faith in alliance or contracts with any of the railroad men. Mr. Miller wrote President Earling that one of the go-betweens had "suggested that I endeavor to get Hill and Gould together upon the matter. I told him that would be no use; that Hill would pursue his policy of discrimination regardless of what he agreed to." Fear of treachery led Mr. Miller to write, less than three weeks after the contract with the Union Pacific, "that of course everything depended upon the good faith of the Union Pacific road, in carrying out the contract"; and less than two weeks later he had already concluded that "if we do not make it [the extension to the Coast] we will be bottled up by a combination between the Union Pacific, the Great Northern and the Northern Pacific." A quarter of a century later the Interstate Commerce Commission heard the echo of this distrust when Mr. Percy Rockefeller testified: "I do not think the Union Pacific ever quite played fair with the St. Paul in that connection."

The alternatives to alliances were acceptance of possible loss of all or part of the transcontinental business, or the building of a railroad to the Pacific. The latter had been under consideration while alliances were being sought, but the project was a dangerously large one. President Earling of the St. Paul placed "the estimated cost of the entire line, Missouri River to Seattle, including equipment," at sixty million dollars. This would add almost twenty-five per cent to the investment in the St. Paul railroad property as it then stood. Mr. Earling had previously thought he could manage the western construction with even less, but the burden would still be heavy, and involved risk to the existing enterprise.

The St. Paul leaders were, however, straining to assert themselves. In September 1901 Mr. Miller wrote to Mr. Rockefeller that the St. Paul had a surplus of seventeen million dollars, and that ". . . no other road in the west has anything near this surplus or this cash. . . . It will not be possible to avoid further increase of surplus even if we pay an extra dividend. . . . If we do not pay an extra dividend, it will be easier for interests desiring control of the property to obtain control."

The air was charged with the feeling on the part of those then in control of the St. Paul that it had a great future, if only it would exert itself to defend that future.

Surveys of a western route were ordered and made. Finally, in 1905, decision was taken to build a Pacific coast railroad. Conclusive action was withheld until approval was given by Mr. William Rockefeller. He was abroad and cabled his consent, and the chairman of the board told the president of the company to go ahead.

Whatever the wisdom or unwisdom, the necessity or avoidability, of adding a road to the Coast, the men in control of the St. Paul were undoubtedly careless in their handling of the affair. They knew that other railroad construction to the Coast had, like that of the Union Pacific and the Northern Pacific, resulted in bankruptcy and reorganization and subjected investors to great losses. These facts, known to everyone, and the size of the undertaking, called for cautious and thorough planning and competent and conservative estimates of cost. Only thus could these men protect a solvent, profitable company against grave risk and potential ruin. But the St. Paul chieftains took a leap in the dark and engaged in a speculative enterprise without counting either costs or consequences. The Interstate Commerce Commission reported that the $60,000,000 estimate which the president of the road made as late as 1906, after the project was on its way, "is less than one-fourth of the money ultimately spent. In the course of our investigation we have been unable to find that any adequate engineering or traffic surveys were made. On the contrary everything indicates that the project was the result of rivalry between powerful groups."

In the Commission investigation, testimony was obtained from Mr. Pearson, chief engineer in charge of the construction west of Butte, Montana. At the time when he testified

he had become president of the New York, New Haven & Hartford Railroad. He said that the Pacific coast road was decided upon ". . . without the full knowledge, perhaps, of fully completed estimates representative of not only the cost of the main line at the very much higher standard of construction, which was later found necessary and became possible, but also of the many incidental lines and projects later found necessary for securing traffic." #17249.

He also presented some of the excuses urged in explanation of the disparity between estimates on which the work was undertaken and costs actually incurred. He said: "The situation was made worse by what it was understood was an endeavor on behalf of a competing line to purchase areas desired by the Milwaukee in order to block the entrance." This was the same difficulty about which Mr. Percy Rockefeller testified more bluntly. He said that when the St. Paul began to build westward, the Great Northern, Northern Pacific, and Union Pacific interests became active in the northwest, and the St. Paul was forced to ". . . pay a great deal more for the property, on account of the competitive conditions . . . than had been anticipated. . . . It was very vicious competition."

Ordinary caution would have led those in charge of the St. Paul to include this factor in their estimates. Their correspondence shows that they were fully aware of the danger with respect to right of way, stations and terminals, and incidental properties. An excerpt from one of the letters will make this clear. Chairman Miller wrote to Mr. William Rockefeller that it was "highly desirable that the Union Pacific know nothing of our project . . . of securing access to the vast timber resources in Humboldt County, lest they should occupy the territory before we do." For timber supply, he added, "we cannot depend on the Union Pacific, the Great Northern or the Northern Pacific. . . . They will make good promises for the sake of holding us back until it is too late, and then they will do as they please."

The engineer's statement of one of the other excuses, the cost of incidental lines and projects for securing traffic, deals with a matter which was also foreseen, or would have been foreseen by prudent railroaders. One of the surveyors wrote to President Earling four years before the decision to build to the Coast: "I cannot give you any flattering report of the future prospects of business for any railroad built through this country. West of the Cheyenne River Indian Reservation, the country is principally gumbo, alkali and soda. . . . There are no settlers of any consequence. . . . Nearly all being squatters having neither the will or inclination to improve their own or the country's condition."

John D. Ryan, a copper-mining and water-power man who was said to have been put on the St. Paul board for his knowledge of conditions in the new territory, told the Commission of the dilemma in which the road found itself. He said that it could not obtain adequate traffic in the districts through which it passed until it built feeder lines to attract settlers, and that the building of feeder lines was not justified until the traffic was there. Efforts were made to develop the territory by using lines which others had built or offered to build. Two instances cited by directors on the witness-stand were illustrative of the ill success of some of these projects. The St. Paul acquired the Jaw Bone Railroad in the Mussel Shell country, which the scoffers said was given its name because "it was built on Jaw Bone and not on real money." The St. Paul did some construction work on a feeder which some oil promoters agreed to pay for, but the road was not reimbursed because "the whole enterprise went up in smoke." Such conditions, it was apparent to anyone who cared to learn from the history of all the other transcontinental roads, were sure to confront the St. Paul; and careful planning would have recognized the cost which would result.

The evidence is inescapable that the two or three men who decided upon this $250,000,000 project made a mistake, as Receiver Potter and Consulting Engineer Colpitts called the Puget Sound extension. But to stop with that characterization is to tell only part of the story. The controlling personages in the

St. Paul affairs were careless when extreme care was needed. They neither knew nor took steps to ascertain the magnitude of the enterprise in which they were involving their company.

Accounting Methods and Published Reports

As the capital expenditures of the road for its western adventure grew to unexpected proportions, and revenues proved unexpectedly thin, the company engaged in questionable accounting methods and issued reports which subsequently led to investigation by the Interstate Commerce Commission. The company treated various expenses of operation as investments in the Puget Sound railway construction. This enabled it to report greater earnings than were actually made, and a greater property investment than the road had. The Commission, in 1914, criticized "the unlawful practices," overstatement of income, and "departures from . . . the actual facts . . . sufficiently serious to merit the strongest condemnation." Dividends which had not been earned were paid. The company reported "investment in road and equipment . . . about $100,000,000 in excess of the cash investment of the company." Depreciation charges were based on the "wholly indefensible" theory that the company's equipment had a "life approximating 100 years."

It is obvious that directors not apprised, until the Commission's report, of the erroneous book-keeping methods and the errors in the published reports would be unable to function effectively, and that security-holders would be wholly without protection.

Electrification

Mr. William Rockefeller was a director of Anaconda Copper Company, of which Mr. John D. Ryan was president. Mr. Rockefeller also acquired stock in water-power projects which Mr. Ryan was promoting in the west. Both men were therefore interested, as sellers of copper and of electric power, in electrification of the Puget Sound railway. At Mr. Rockefeller's request, Mr. Ryan was made a St. Paul director. Shortly afterwards the question of electrification came up in the St. Paul board. Mr. Ryan testified that there may have been some connection between his election to the St. Paul board and the subject of electrification, but he did not know. Contracts were subsequently entered into between his power companies and the St. Paul. In addition, Anaconda Copper Company sold the requisite copper, which took up eighteen per cent of the total cost of electrification.

The power contracts were criticized in the report published by the Interstate Commerce Commission in 1928, following its investigation of the circumstances leading up to the receivership of the railway. They were criticized also by an electrical engineer connected with the Federal Power Commission. The requirements in the contracts were so burdensome, according to the Commerce Commission, that they left "the railroad practically always in the position of having to pay for power which it does not use." Under one of the contracts "the railroad is paying for about twice as much power as it uses." In the critical years 1921 to 1924, when the company was operating at a deficit and needed to save every dollar of avoidable expenditure if it was to escape receivership, the St. Paul paid "at least $1,500,000 for power which it was unable to use."

Other aspects of the power contracts were criticized by the Commission. It pointed out that they had been made for an "unusual length of term," ninety-nine to a hundred years. Mr. Percy Rockefeller, a director of the railroad when the contracts were made, testified that the power company did not want to make a contract for so long a period, but that Mr. Goodnow, the railway's representative in charge of the matter, had insisted upon it. Thereupon the attorney for the Commission read a letter written by Mr. Goodnow at the time, in which he said: "I purposely left the term of this contract blank because I believed that we ought not to enter into a contract covering a period of more than 30 or 40 years." Asked about this letter Mr. Percy Rockefeller said that Mr. Goodnow "must have changed his mind . . . Mr. Goodnow was very temperamental, and he

would change his opinions without letting people know." At the time of this testimony Mr. Goodnow himself was dead, and the Commission reported that "with regard to the unusual length of term of the contracts, we are again handicapped by the death of those who negotiated them for the railroad."

Mr. Ryan contended that the contracts were fair, and in support of his argument told the Commerce Commission that Mr. Samuel Insull, Chicago public utility executive, "berated me soundly for making any such contract with the railway company for power. . . . Mr. Insull was very much exercised, and one feature that Mr. Insull was very much interested in was the term of the contract." Mr. Ryan acknowledged, however, that, in spite of Mr. Insull's opinion, Mr. Ryan had proceeded to make a similar contract with the St. Paul for another division of the Puget Sound extension. The Commission found that the contracts had been highly profitable to Mr. Ryan's power companies and conduced to the payment of liberal dividends on the stock in those companies owned by Messrs. Ryan and Rockefeller. With respect to one of these companies, the Intermountain, the Commission said that "there does not appear to have been any good reason for interjecting the Intermountain into this situation. The only purpose it has served has been as a vehicle for profits to Ryan and his associates."

The Commission's inquiry into this subject gave rise to discussion of the propriety of dealings between the St. Paul and power companies controlled by Mr. Ryan and Mr. Rockefeller. The attorney for the St. Paul company objected to questions seeking full disclosure on this score. He urged that the power contracts were made "some five years or more before there was any interlocking-directorate law." To this the examining attorney rejoined that "if it was condemned by law now it probably was an equally bad practice before the law." With this view Mr. Ryan disagreed. He said that the law had ". . . done more harm to legitimate, honest business than it has done good. . . . It is a good thing to permit men to serve who understand the business, and men who understand the business are very apt . . .

to have some allied interest that is almost impossible to divorce. . . . I do not think to keep men off railroad boards . . . because they happen to have some interest that has to do with railroad business has been productive of good, because I think among those men are mostly the men who are best able to direct the affairs of the railroad. . . ."

Later in his testimony Mr. Ryan said: "I don't think that you can avoid having a common interest if you are going to have the men who are of sufficient business ability and knowledge of how things ought to be done, to run the railroads of this country."

Mr. Ryan testified that he knew of no instance in which interlocking directorates had worked badly. He himself, he said, had avoided participation in St. Paul meetings where he was interested on the other side of the question. This was not Mr. Percy Rockefeller's impression. When asked whether Mr. Ryan had taken an active part in the discussion of electrification, Mr. Rockefeller answered: "Naturally, if he was on the board." Of course, many of the most important deals the St. Paul ever made were determined outside of board meetings, and in many instances the judgment of one man, Mr. William Rockefeller, in fact governed.

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."