CHAPTER XXIV

THE SECURITY-HOLDERS' POSITION

THE plan which Mr. Hanauer brought back from White Sulphur Springs specified, as already noted, only some parts of the bankers' reorganization. Mr. Hanauer proposed that the bondholders should get new bonds for old bonds, and the stockholders should get new securities for old securities and for seventy million dollars in cash. The future value of the new securities was vitally dependent on the kind of management and control the new company was to have. But those portions of the reorganization were to be left to the managers' subsequent decision, along with the constitution of the reorganized society which would fix limitations upon the men in control, in favor of the rank and file of the bond- and stock-holders.

Security-holders who wanted to come into the reorganization could not insist on knowing these other parts of the plan. They could either agree to entrust large sections of the reorganization to the bankers or stay out altogether. This was the effect of the legal papers which the attorneys for the bankers prepared.

A good deal more was required of the bond- and share-holders before they could get into the reorganization. They must agree to leave it to the bankers to substitute holding-company securities for operating-company securities if the bankers preferred to reorganize in that way. The St. Paul security-holders owned bonds and shares of an operating company. The Hanauer plan said they were to get securities of a new operating company—

bonds protected by a mortgage on the railroad property, and stock which had a direct interest in the railroad property. But the bankers were to have the option of changing this, and issuing instead bonds of a holding company, secured by the shares or the bonds of an operating company. Recent financial history has demonstrated that the difference between the two types of securities may be the difference between something and nothing.

An investor in the old St. Paul company who was willing to take these chances in the hope of salvaging as much of his money as possible would still be unable to enter the reorganization unless he agreed to some more things. He had to agree that the enterprise in which his money was tied up could be vastly changed if the bankers so decided. They were to have the right to make contracts, binding on the reorganized company and the security-holders, for the acquisition of more railroads, or "any other conveniences or arrangements which they [the bankers] may deem necessary or desirable."

The St. Paul security-holders had had one experience with adding railroads, beginning twenty years before. Their company, sound and profitable, was started on the road to bankruptcy by the Puget Sound extension. The security-holders had had other experiences when the Terre Haute and Gary roads were acquired. But now they must agree, as a condition to the privilege of a reorganization, that the bankers could repeat this process if they desired.

The bond- and stock-holders must also agree, in advance, that the bankers should have the right to cut off part of the existing St. Paul system. They could also make consolidations of corporations.

In short, if a bond- or stock-holder wanted to be in on the reorganization, he had to agree to something so vague and wide open that it could become altogether different from what he expected. He had to agree in advance that the bankers might change the scope of the St. Paul railroad enterprise, the nature and quality of the reorganization securities, and the corporate structure. A St. Paul security-holder who had the time to study

the printed document and the talent to understand it might appropriate the words of Mr. Grady when he was being offered certain information: "Don't you see the hole in that proposition? You can throw a dog through it."

Nevertheless, if a security-holder wanted to go into a reorganization of the St. Paul, he had to take this proposal of the bankers, with all its holes, or get no reorganization at all.

This was not the end of the conditions to which the bond- and stock-holders had to agree. The St. Paul reorganization document, which gave the bankers the right to alter much of the substance of the Hanauer plan while retaining its form, did not even limit them to keeping the shell of that plan. They were given authorization to throw the shell away, as well as the contents, and to substitute an entirely new plan, different in form and in substance from that which was in the printed papers. Anybody who wanted a share in the reorganization would have to agree to this condition also.

But at this point provision was made for a possible chance of escape by security-holders. They were given a right to "withdraw." This right, upon examination, becomes somewhat illusory.

It was not every change in the Plan that would entitle security-holders to free themselves from the lawyers' Agreement of Reorganization. To get free, it would be necessary that a protective committee organized by the bankers should withhold its approval of the change. If the bankers' committees supported the bankers' alteration, and this door of escape remained shut, there was another door also in the control of the bankers and their committees. This other egress for security-holders would be unlocked if, and only if, the bankers or a committee should decide that a change proposed by the bankers would "adversely affect to a material degree the interests of any class" of security-holders. The governing circumstance was not the fact that a change in the plan was opposed to a security-holder's interests, but that the bankers or their committee should say that it was opposed.

The bankers and others might have quite contrary views on such a question. This was illustrated in November 1925, when a change was made which Mr. Colpitts, the consulting engineer who was advising the bankers, did not like. He later testified that it "would be detrimental to the interests of the property in the future. I said so to Mr. Kahn [of Kuhn, Loeb & Company] at the time, and I feel so now. . . . It was stretching the requirements for fixed charges to the limit."

The change was desired by some bondholders and was acceded to by the bankers. If, however, Mr. Colpitts was right, it might some day involve the bondholders in another bankruptcy of the road, and thus might be really adverse to the interests of those who did not want the change. But no bondholders were given the right to withdraw. Neither the bankers nor the bondholders' committee organized by the bankers declared that the altering of the plan would "adversely affect to a material degree the interests of" the bondholders.

Had the bankers or the committee made such a declaration, a bondholder desiring to free himself would find it difficult to exercise his new-won privilege. He would have to pay money to get free. Under the Agreement of Reorganization the bankers could insist upon his paying three amounts before he could withdraw from their control. He could be required to pay, first of all, "such taxes as may be imposed upon the transfer or delivery of the securities withdrawn."

Secondly, he could be required to pay (but not in excess of one per cent of the face amount of his securities) expenses of the reorganization managers, and other items, "as apportioned by the Reorganization Managers in their sole and unrestricted discretion." In the case of common-stockholders this one per cent of the face amount was really ten per cent of the market value.

Third, the security-holder would have to pay, before he could regain his liberty, ". . . if the Reorganization Managers in their discretion shall require, such sum as the Reorganization Managers in their sole and unrestricted discretion shall fix as

the ratable proportion to be borne by such certificate holders of all indebtedness, obligations, and liabilities of the Reorganization Managers and of the Committee representing such securities in respect of the acquisition of property which or substitutes for which shall then be held by the Reorganization Managers or such Committee."

This third amount might be unlimited. To be sure, the security-holder who made such a payment would get a part interest in whatever property the managers had acquired. He would be free from the reorganization, but could then be imprisoned in a pool controlled by the bankers, holding property which they had purchased.

In brief, the managers might so conduct affairs that any security-holder who tried to withdraw from their control would be obliged to pay a good deal of money in order to exercise that privilege. Anyone hardy enough to pay out his money would then be confronted with the danger that he might have no place to go. If he tried to get back into the reorganization, the bankers could make him pay again for the privilege of returning. It was not likely that many security-holders would pay money to get free and run the risk that they might have to pay a second time in order to give up their freedom.

Any security-holder who thought he could take all these chances would do so in the belief that the bankers could be shorn of their powers and blocked by someone, somehow. That would be a gamble, with the odds against the security-holder. He would have to assume that such powerful banking houses as Kuhn, Loeb & Company and the National City Company could be beaten. Not many security-holders would pay money for the opportunity to run this hazard.

Whoever took the chance would have to be quick about it, or he would lose even such a privilege of withdrawing. The Agreement of Reorganization gave him for this purpose just thirty days after the managers published notice that they were permitting withdrawals. This notice had to be printed in two New York newspapers. It made no difference if a security-holder

did not live in a city where the advertisement was printed or did not subscribe for the newspaper which carried the advertisement or did not notice the advertisement even if he took the paper. Whether the security-holder knew that he could withdraw or did not know it, his right expired. The Agreement said that if he failed to pay as required within the time limit, he, ". . . whether or not having actual notice thereof, shall be irrevocably and conclusively deemed and taken to have assented to the proposed modification or substitute plan, and whether or not otherwise objecting shall be bound and concluded thereby as fully and effectively as if he had actually assented thereto."

There was a provision in the document that security-holders could furnish their names and addresses and get notice by mail. Even then the Agreement put all the risk on the security-holder. It said: "But neither the failure to mail any such notice . . . nor the failure . . . to receive any such notice. . . . shall affect any proceedings taken upon or pursuant to notice . . . given by publication as aforesaid."

The lawyers who wrote the reorganization agreement were not quite through. They provided that a bondholder or stockholder who was willing to subject his interests to the bankers in the manner described would have to do something more. His consent to their reorganization, whether in the form of a proxy or of an agreement consenting to all the conditions and requirements imposed by them, would be insufficient to enable him to get into the reorganization. To get in, he would have to deliver his bonds or his stock to the people acting for the bankers. He would have to let the bankers borrow money and pledge his securities with the lender. He would have to agree that the bankers should have the right to become ". . . vested with legal title to, and all the rights, power and authority of absolute owner of, all such bonds, shares of stock. . . ."

When Mr. Swaine put this provision into the Agreement, he was following the advice of Mr. Cravath. The latter in his 1916 lecture had urged upon the assembled lawyers that "the purpose of the agreement should be to place the committee practically

in the position of owners of the bonds."

The investor who turned his bonds or stock over to the managers, through the committees as channels, would be given a receipt, called a certificate of deposit. That receipt was to be "in such forms as may be prescribed by the Reorganization Managers." The form of receipt which they prescribed recited (the quotation is from the receipt for bonds, but it was similar for stock) that ". . . said bond has been deposited subject to the terms and conditions of [the Plan and Agreement of Reorganization]. . . . The holder hereof assents to and is bound by the provisions of said agreement by receiving this certificate. . . ."

The Agreement of Reorganization tied this even tighter. It said: "Holders and recipients from time to time of certificates of deposit for securities so deposited shall be irrevocably bound and concluded by the Plan and this Agreement and the terms thereof, and be conclusively and finally deemed for all purposes to have assented to the same and to have conferred the powers in the Plan and in this Agreement mentioned upon . . . the Reorganization Managers. . . . By accepting or holding any certificate of deposit . . . every recipient or holder thereof shall thereby become a party to the Plan and to this Agreement. . . ."

Still the lawyers were not quite through with the security-holders. They knew that after the papers were printed, the bankers would have to go to work to induce the owners to send in their bonds and stocks. The lawyers also knew that the process of urging would include circular letters to St. Paul investors. This involved the danger that such letters might contain erroneous statements, and that security-holders might be induced to act in reliance upon those statements. Ordinarily if one man is induced to agree to something by the erroneous statement of another, the first man can cancel the agreement. The lawyers for the St. Paul bankers tried to print this rule out of the St. Paul reorganization. They put the following words into their Agreement:

". . . no . . . circular . . . by the Committees . . . or the Reorganization Managers . . . is intended or is to be taken as

. . . inducement for deposit or assent under the Plan and this Agreement . . . and no defect or error therein shall release any deposit thereunder or affect or release any assent thereto, except by written consent of the Reorganization Managers."

Was it conceivable that the St. Paul security-holders would agree to all the conditions introduced by Mr. Swaine into the Agreement, as well as all the powers, privileges, and immunities conferred by it upon the bankers? His senior partner told the association of lawyers whom he addressed in 1916: ". . . you will be surprised to find how willing security holders are to place almost unlimited power in a committee of reputable men."

One explanation may be found in the fact that security-holders are not likely to have the slightest idea of what is in an Agreement of Reorganization. Any investor who asked to see the Plan and Agreement promulgated by Kuhn, Loeb & Company and the National City Company would receive what the United States Circuit Court of Appeals called "long and complicated instruments." They measured generously up to the description which Mr. Cravath gave of such papers when he described them to the Bar Association:

"There can be no doubt that instruments of this class have attained proportions, both in length and elaborateness of provision for all conceivable eventualities, of which the wildest imagination of the practitioner of fifty years ago could form no conception. . . . The provisions of the modern reorganization agreement . . . are the result of the experience and prophetic vision of a great many able lawyers."

The St. Paul bond or stock holder who tried to read the Plan and Agreement which Mr. Cravath's firm wrote for the St. Paul bankers would be reading the temporary constitution of the St. Paul financial society. Of this society the bankers were the head, and the security-holders were to be the members. Their constitution was seven times as long as the Constitution of the United States.

The reader of the St. Paul constitution therefore must realize at the outset that he had many words to read. But he also had to

read language much of which would have little more meaning for him than Sanskrit. The meaning of various phrases in the Constitution of the United States, which has occupied much time of many judges for more than a century and a quarter, is as clear as a nursery jingle, when compared with the technical legal jargon in the St. Paul papers.

The investor would also have to be prepared for intensive study of sentences too long to be understood without making diagrams of them. One sentence reached the length of 2,250 words, as many as are printed on six pages of this volume. He would have to read all this in a forbidding format. The printed lines of the St. Paul agreement had almost twice as many words as a line of this book, one and one-half times as many lines to the page, two and one-half times as many words to the page. With extra large pages, extra long lines, and a multiplicity of words, the type was extra small. A facsimile of so much of one of the divisions of the Agreement as is the equivalent of a full page is reproduced on pages 304 and 305 of this volume.

The security-holder might decide that he wanted to examine, not all the rights given to the bankers, or all the obligations imposed on the security-holders, but only what was said on some particular point. He would have to go through the whole document nevertheless. It had neither table of contents nor index. If, before he reached the end, he found words bearing on his point, he could not rest assured that he need read no further. Later on, there might be more words on the same point, limiting or in effect nullifying the words which he found first.

Of course, the security-holder who tried to read the Agreement of Reorganization would be attempting what Mr. Cravath did not expect him to be able to do. Mr. Cravath thought that the security-holders would content themselves with the Plan, the first part of the document. This, he urged, should be (the words have been quoted before) "clear, succinct and accurate, and, so far as possible, free from legal technicalities."

Mr. Swaine's success in complying with Mr. Cravath's injunction to achieve clearness, succinctness, and freedom from legal

technicalities may be gauged from a reading of that part of the Plan which described the new bonds that the St. Paul bondholders were to receive.

FIVE PER CENT. ADJUSTMENT MORTGAGE BONDS

The Five Per Cent. Adjustment Mortgage Bonds will be limited to the total authorized principal amount at any one time outstanding of not exceeding $230,950,800 plus any amount thereof which may be issued in connection with the liquidation of the 6% Note of the Railway Company, dated November 1, 1920, held by the United States Government and will mature January 1, 2000. They will be secured by a mortgage and deed of trust to a trustee or trustees to be selected by the Reorganization Managers, which is to embrace the properties embraced in the First and Refunding Mortgage and from time to time becoming subject thereto, subject, however, to the First and Refunding Mortgage and to the mortgage securing the Fifty Year Five Per Cent. Mortgage Gold Bonds and to the prior payment out of the mortgaged property of all bonds at any time issued and outstanding under said mortgages. The Adjustment Mortgage will provide restrictions for the release from the lien thereof of property subject thereto.

The Adjustment Mortgage Bonds will bear interest, payable annually or semi-annually, at the rate of five per cent. per annum, but required to be paid, prior to the maturity of the principal, as hereinafter provided, only out of the New Company's net income ascertained in accordance with the accounting rules of the Interstate Commerce Commission, or other analogous Federal authority, from time to time in force, but without deduction for interest on the Adjustment Mortgage Bonds or for the sinking fund under the Adjustment Mortgage. The net income of the New Company thus to be applicable to the payment of interest on the Adjustment Mortgage Bonds is herein called the available net income. The interest on the Adjustment Mortgage Bonds will be non-cumulative prior to January 1, 1930, but will be cumulative from and after January 1, 1930, but accumulations of interest shall not bear interest. At the maturity of the principal, all arrears of cumulative interest

shall be payable. Interest on the Adjustment Mortgage Bonds issued in exchange for bonds deposited under the Plan shall be computed from February 1, 1925, to which date interest on the deposited bonds is to be adjusted as provided in Article VI. Interest on any Adjustment Mortgage Bonds which may be issued in connection with the liquidation of the 6% Note of the Railway Company dated November 1, 1920, held by the United States Government, shall be computed or adjusted from the date to which interest is paid on said Note.

The Adjustment Mortgage will provide that the New Company shall on or before April 1, 1936 and on or before April 1 in each year thereafter, so long as any of the Adjustment Mortgage Bonds shall be outstanding, pay or set apart as a sinking fund, as hereinafter provided out of the available net income of the New Company remaining after payment of full cumulative interest on the Adjustment Mortgage Bonds, an amount equal to one-half of one per cent. of the authorized principal amount of the Adjustment Mortgage Bonds; and such obligation shall be cumulative. The sinking fund shall be applied to the purchase either at public or private sale at not exceeding their principal amount together with full cumulative interest, or to the redemption, of Adjustment Mortgage Bonds, all bonds purchased or redeemed for the sinking fund to be kept alive and the interest paid thereon from time to time to be added to the sinking fund and applied in the same manner. Adjustment Mortgage Bonds will be redeemable for the sinking fund only, on any interest payment date on or after April 1, 1936, at the principal amount of the bonds redeemed together with full cumulative interest.

The Adjustment Mortgage will provide that until January 1, 1930, the date after which interest on the Adjustment Mortgage Bonds will become cumulative, no dividends on any class of stock at the time outstanding shall be paid in any year, or set apart for payment in any year, unless interest on the Adjustment Mortgage Bonds for such year at the full rate of five per cent. per annum shall have been paid or set apart for payment; and that no dividends on any class of stock at the time outstanding shall be paid in any year, or set apart for payment in any year, after January 1, 1930, unless the full cumulative interest on the

Adjustment Mortgage Bonds shall have been paid or set apart for payment, and after April 1, 1936, unless, in addition to said interest, the full cumulative sinking fund payments under the Adjustment Mortgage shall have been paid or set apart.

After reading through to the end of the Plan, the St. Paul security-holder would realize that he must read the Agreement also if he would know what he was agreeing to. It was the Agreement that dealt with the powers, privileges, and immunities of bankers, and restrictions on the owners of the securities. But there was another reason to compel him to go on. On the last page of the Plan reference was made to the Agreement, as follows: "The provisions of the Agreement shall govern in case of conflict between the Plan and the Agreement."

It was, of course, possible for the forty thousand security-holders to go to various lawyers and learn from them what was in the legal papers. But the problem of expense might be too great an obstacle. The average lawyer, not experienced in what is an esoteric department of law and finance, would be met with the necessity of protracted and exhausting study in order to analyze the Plan and Agreement. Most security-holders did not have a big enough investment to justify expenditure for so much of a lawyer's time and labor.

Recourse could then be had to the men who are skilled in this special field. They are few in number, as stated in the introduction to the addresses before the Bar Association of New York City, as follows:

"The task of supervising the legal phases of the work of reorganizing and refinancing great corporate enterprises . . . is performed by a relatively small number of lawyers. . . . The dominant figure . . . in every such undertaking, is that of the banker and the guiding spirit is the banker's lawyer. Bankers who are qualified by wealth, experience, and influence to undertake such affairs are few in number; in direct ratio, the membership of what may, not unappropriately, be denominated 'the financial bar' is also limited."

FACSIMILE OF FIRST PART OF ONE OF THE SIXTEEN DIVISIONS OF THE REORGANIZATION AGREEMENT. THE MATERIAL APPEARING ON THESE TWO PAGES IS THE EQUIVALENT OF ONE PAGE OF THE AGREEMENT.

SIXTH. The Reorganization Managers may organize, or procure to be organized, one or more new companies wherever in their discretion they may determine, or they may adopt or use any company or companies whether now existing or not, and they may make or cause to be made consolidations, increases of capital stock and changes of stock having par value into stock without par value, creation and issuance of securities, leases, sales, purchases, agreements and other arrangements by or between any such companies or with other companies, firms or individuals; they may make or cause to be made conveyances or transfers of any properties or securities acquired by them or with their approval and may take or allow to be taken such proceedings as they may deem proper for the purpose of creating the new securities provided for in the Plan, and for carrying out all or any of the provisions of the Plan and of this Agreement. The Reorganization Managers may cause the ownership of all or any property of the New Company to be either a direct ownership or ownership through bonds or through the shares of stock, or both, of any other company, and may cause any mortgage or mortgages securing bonds of the New Company to be either a direct lien upon any particular property, or a lien upon the bonds or shares of stock, or both, of any company owning such property.

The Reorganization Managers may prescribe the form and terms of all charters, certificates of incorporation or articles of association or amendments thereof, regulations and by-laws of any corporations that may be utilized in the reorganization and of all certificates of stock, bonds, notes, trust certificates and other securities at any time to be issued and all mortgages, trust indentures, trust agreements, applications for authority and all other instruments at any time to be executed, issued, filed, entered or made in connection with carrying out the Plan. All references in the Plan and this Agreement to the delivery of Preferred Stock or Common Stock of the New Company shall be understood to mean and include trust certificates in respect of such stock issued as provided in the Plan. The Reorganization Managers may proceed under the Plan and this Agreement, or any part thereof, with or without foreclosure or enforcement of one or more of the existing mortgages and trust indentures constituting liens upon property of the Railway Company, and, in case of sale upon such foreclosure or enforcement, they may exercise any power conferred by this Agreement either before or after any such sale or sales. In every case all the provisions of the Plan and of this Agreement shall apply equally to and in respect of any physical property embraced in the reorganization and to and in respect of any securities representing any such property, it being intended that, for all purposes hereof, any such property and any securities representing such property may be treated or accepted by the Reorganization Managers as substantially identical. In case, in the opinion of the Reorganization Managers, any other or separate plan shall be necessary or expedient to effect the reorganization of any subordinate or other company or as to any property constituting a part of the System of the Railway Company, or for any consolidation or arrangement with, or for any sale, lease or purchase to or from, any company or companies now in existence or to be hereafter formed, the Reorganization Managers may promote or promulgate the same and may participate therein, and may (with the consent of the Committee, if any, representing such securities) deposit thereunder any securities thereby affected or to which such separate plan shall relate, or the Reorganization Managers may enter into any agreement with any committee representing holders of securities of any class necessary or expedient for such purposes. The Reorganization Managers may make equitable provision for any case of lost or destroyed securities, and provide for and make or cause to be made such issues of scrip as shall be necessary appropriately to represent any fractional interest in the new securities, and, to such extent as they shall deem necessary they may distribute such scrip to the Depositors, and may, in their discretion, settle for and adjust any such fractional interest in cash, or credit or pay such cash to the Depositors in lieu of distributing to them such scrip. They may issue or cause to be issued temporary or interim certificates to represent the new securities or any of them. They may, in their discretion, set apart and hold or place in trust, or permit to be set apart and held or placed in trust, any part of the new securities to be issued and any cash which may be received from sales of new securities or otherwise, as they may deem suitable for the purpose of securing the application thereof for any of the purposes of the Plan or of this Agreement. The Reorganization Managers may receive and dispose of, or allow to be received or disposed of, by any other person, firm or corporation, in accordance with any of the provisions of the Plan and of this Agreement, the new securities to be created; and they may vote, or cause or allow any person, firm or corporation to vote, upon any or all stock until the same shall be transferred or distributed, as contemplated by the Plan, to the persons, firms or corporations entitled ultimately to receive the same. The Reorganization Managers may dispose of such of the new securities to be

It is obvious that the ordinary investor could not afford the legal services of a member of "the financial bar." The St. Paul investor desirous of knowing the agreement which he was asked to make with the bankers was therefore thrown on his own resources. If he had attempted to explore the documents, he would have perished in the jungle of impassable words.