CHAPTER XXVIII

THE SECURITY-HOLDERS ARE OFFERED AN OPTION

The organized opposition of the independent committees was disposed of by the bankers in several ways. Some of the independents effected a settlement with them. Others did not. It was then open to the bankers to compose all differences with their opponents by agreeing to submit the dispute to a neutral tribunal. This, however, would have given the arbitrator power to consider not alone the bankers' plan, but also any other. They did not subject themselves to any such risks to their control of the reorganization and of the reorganized company. They chose, instead, to adopt the process of compulsion.

The bankers' attorneys did not acknowledge that the security-holders who still held their own securities were going to be compelled to accept the bankers' plan. The lawyers expended much argument on the theory that all security-holders had an option to receive in cash their share of the price at which the property would be sold, or to take reorganization securities instead. But all the arguments merely gilded a legal fiction.

The way it was handled by the managers at the auction was to pay so little for the property that security-holders would be spiting themselves if they stayed out of the reorganization. Stockholders could not get cash in any amount. The price paid by the bankers at the auction sale was less than the amount of the bonds, so that nothing would be left over, even theoretically, for the

old stock. What was left over for the bonds was less than the price at which the old bonds could be sold on the stock exchange. This was a sure way to convert the cash part of the option into a mere figment.

This is in accordance with established reorganization practice. The receivership court in the St. Paul case was given the benefit of a study of the subject made by Mr. Sunderland, a member of the law firm of Davis, Polk, Wardwell, Gardiner & Reed. His firm were the regular attorneys of J. P. Morgan & Company and were acting in the St. Paul case for the Guaranty Trust Company. They had participated in many large reorganizations and knew what bankers did in such cases. Mr. Sunderland told the court that the cash option which bondholders always get is less than the market price of their bonds. They get the option of receiving a part, usually forty to seventy per cent, of the amount they could have netted if they had sold their bonds through brokers on the stock exchange in the period when defaulted bonds are usually at their weakest—after the announcement of receivership and before the announcement of reorganization.

Shearman & Sterling, the National City Bank lawyers, warned the court against requiring a "price" for the property which would make the cash part of the bondholders' option "approach too nearly the market value of the bonds." The lawyers said that if the cash option were too close to the market price of the bonds, "there could never be a reorganization."

In a lecture to the New York City Bar Association in 1927, while the St. Paul "sale" was before an appellate court, Mr. Swaine said that it was sufficient if reorganizers paid a "price" for a property which would give bondholders a cash option of two-thirds the amount they could get for their bonds in the open market.

The procedure was discussed by Mr. Wetmore, the Chicago banker, when he was a witness in the court proceeding with respect to the value of the Terre Haute railway. Years before it was turned over to the St. Paul, the Chicago bankers had reorganized the Terre Haute. Mr. Wetmore was asked about the

bearing of the "sale" price in that reorganization on the real value of the property. He said:

"Now, you dwell on this feature, we paid . . . [$11,000,000] * . . . bonds in the reorganization of the property. You know, as well as I do, in bidding a piece of property on reorganization has nothing to do with the value of it, and it is a thing for the purpose of driving into camp those minority holders, the security-holders that do not want to go in on the reorganization. . . . That property later was valued by the Interstate Commerce Commission at $23,000,000. . . ."

The lawyers in the St. Paul reorganization apparently had a different view. They continued to urge their theory upon the court. Apparently, Mr. Sunderland's expert study of what had been done in past cases was not at all embarrassing to their theory. They argued that bondholders did not have to be content with the bankers' bid for the St. Paul property. This bid, when made, was $140,000,000. The lawyers argued that independent bondholders could put in a higher bid. It was a public auction, they reiterated; everyone was free to attend the sale and put his own price on the property. Mr. Sunderland himself said to the court, when the St. Paul sale had been held: "There was afforded an opportunity to the whole world to indulge in the greatest freedom of bidding, and that there was afforded unlimited opportunity to raise bids until the bidding was exhausted. . . ."

Before the sale Shearman & Sterling, the National City Bank attorneys, prepared a brief in the name of the bondholders' committee, in which they asked the court to take action which would "encourage anyone anxious to bid at the sale to do so. . . ."

The attorney for the objecting bondholders apparently made no headway when he urged upon the court the following: "We gain nothing by closing our eyes to a fact which everybody knows exists, that this road when it is sold will have but one possible bidder; namely, the reorganization managers under this

* The official record shows the amount as $1,100,000. This is probably an error in transcription.

plan which they have promulgated."

The evidence and court discussions did not reveal who would be in a position to bid more than $140,000,000 and such higher amounts as might be needed to exhaust the bidding. Obviously, one source would be bankers. If there were any of these with the courage and power to stand up against Kuhn, Loeb & Company and the National City Bank combined, it was the firm of J. P. Morgan & Company. But two of the banks known as Morgan banks were attached to the St. Paul bankers' reorganization, and the Morgan lawyers were taking part as attorneys for the Guaranty Trust Company, itself subject to the reorganizers' orders.

There was some discussion, also, of the question whether a custom prevailed in the banking world which would influence all other bankers to keep hands off. Mr. Hanauer submitted a sworn statement to the court touching upon "the alleged impossibility of procuring banking support for any plan in opposition to the Reorganization Plan" of Kuhn, Loeb & Company and the National City Company. Mr. Hanauer said: "It is not true . . . that there can be no free and open market for the property of the Railway Company at public sale or that there is a well-recognized custom in the banking community that other bankers will not enter into competition with the regular bankers of a property in connection with the reorganization of the property and that such custom has prevented any other banking institution having sufficient resources for the purpose from giving banking support to any plan in opposition to the Reorganization Plan"

Light was thrown upon this question by J. P. Morgan & Company, who rarely issue statements for publication, but did so in this case. The following is quoted from the New York *Times:*

"A report that J. P. Morgan & Co. would back Mr. Jameson in bidding against the banking combination of Kuhn, Loeb & Co. and the National City Bank, which hold more than 80 per cent of the bonds of the bankrupt road, was denied by a partner of that firm, who said that when the St. Paul first experienced

financial distress some of the security holders asked them to take a hand in its reorganization, but they declined, on the ground that it would not be fair to Kuhn, Loeb & Co."

The banking firms large enough to consider whether they could by any possibility command the strength for such a struggle were themselves bankers of large railroads and industrial corporations. The danger of retaliation by houses of the standing of the St. Paul bankers if their sphere of influence happened to be intruded upon by others was of course always present.

Whether or not there was such a custom as that disclaimed in Mr. Hanauer's affidavit, on the subject of a free and open market at the auction of large railroad properties, is not conclusively disclosed by the St. Paul record. Published records with respect to other roads indicate a tendency on the part of important banking organizations to be considerate of each other in such matters. More than a quarter of a century before the St. Paul reorganization, when Kuhn, Loeb & Company were asked by Mr. Harriman to reorganize the Union Pacific, they declined unless J. P. Morgan & Company, who had been the Union Pacific bankers, would first approve.

Subsequently, when there was a struggle between Mr. Harriman and James J. Hill for control of the Northern Pacific, Kuhn, Loeb & Company were anxious lest Mr. Morgan misunderstand their attitude toward him. The Morgan firm were the Hill bankers, and Kuhn, Loeb & Company were the Harriman bankers. Mr. Schiff of the latter firm wrote to Mr. Morgan, saying:

"Since, as I am informed, you have decided to stay abroad for the present, I believe I am justified, caring much as I do for your respect and good opinion, to write to you, in an endeavor to set forth the occurrences which led to the unfortunate situation which has recently prevailed here, but which I feel has been neither of our making nor of our seeking. . . .

"I trust you will accept my assurance that nothing was further on the part of Union Pacific interests than to do aught meant to be antagonistic to you or your firm, and that, as far as my partners and I are concerned, we have at all times wished, as we continue

to do, to be permitted to aid in maintaining your personal prestige, so well deserved. . . ."

If Mr. Hanauer, who was trained under Mr. Schiff, was correct when he said in 1926 that there was no custom which would prevent independent bidding for the St. Paul, bondholders opposed to the bankers would still have the problem of finding the necessary backers for a bid. It would be a serious matter for any bidder. If he made a bid and could not raise all the money to comply with it, he would stand to lose the required deposit. This was to be either cash or St. Paul bonds—over $6,000,000 of cash or $18,000,000 of bonds.

No one but the St. Paul bankers had control of sufficient bonds to put through a plan without a great amount of cash. The only organized independents at the time of the sale controlled about eight per cent of the bonds. In consequence they had to face the possibility of paying ninety-two per cent of their bid price in cash. This would be $128,000,000 in cash even at the price paid by the St. Paul bankers, and a good deal more as the bidding rose.

It was hardly possible to secure so large an amount of cash for the purpose, except by first calling for public subscriptions to a reorganization of the St. Paul. This might have been self-defeating. The St. Paul would thereby be reorganized, but not for the security-holders of the old company. Such a reorganization, with the St. Paul security-holders eliminated altogether, would probably be rejected by the court or the Commission.

Even if this obstacle could be overcome, independent reorganizers would find it difficult, if not impossible, to get public subscriptions in the amount required, or through a bankers' underwriting. The sum to be raised was too large. The minimum which independents would be obliged to have available was three times the maximum necessary for a suggested revision of the bankers' plan, which Mr. Ecker said would ruin that plan. A proposal having been made to the court which would involve the reorganization managers in the need of providing such a maximum, Mr. Ecker said that "the burden of finding such

money is in my opinion so great that the reorganization could not be effectively completed." Obviously, cash requirements at least three times as large were beyond the range of other banking houses, even if there had been any to provide the means for competitive bidding.

The practical disadvantages and inequalities of independent bidding were described by Commissioner Eastman when the St. Paul reorganization was being disposed of by the Commission. He said: "In a sale under foreclosure the debts in default can be used in payment of the purchase price, but those not holding evidences of such indebtedness must pay cash. As a practical matter this makes it impossible, in the case of a great railroad property like the St. Paul, for other interests to bid."

The auction of the St. Paul railroad was turned into a gala occasion, when most of the important figures in the receivership and reorganization gathered at Butte, Montana, to be in at the death of the old company, and to usher in the new with a legal ceremony. The journey of the reorganizers from New York to Montana, where the sale was to be held, was widely heralded in the press.

The following is from the Chicago *Tribune* of November 20, 1926:

"Upon arrival in Chicago yesterday, attorneys representing the great New York banking group that is expected to buy the Chicago, Milwaukee & St. Paul railroad at the foreclosure sale at Butte, Montana, next Monday, took $20,000,000 in certificates from their vest pockets and handed the papers to Attorney Herbert A. Lundahl, special master who will conduct the sale for the federal court. . . .

"Jerome J. Hanauer, operating head of Kuhn, Loeb & Co., and author of the reorganization plan, and Pierpont V. Davis, vice president of the National City bank, were the financiers of the party from New York. Robert T. Swaine and Donald C. Swatland, attorneys for the reorganization committee, were the ones who deposited the $20,000,000. Frederick H. Ecker, chairman of the bondholders' committee, will join the party at St.

Paul. H. E. Byram, receiver and operating head of the road, and Mark W. Potter and Edward J. Brundage, receivers, were also in the westbound group. The legal expenses of the reorganization will run into millions."

The New York *Times* of the previous day reported among those who were also to be present at the sale Mr. Guy Cary, of Shearman & Sterling, the National City Bank lawyers, and Mr. Edwin S. S. Sunderland, of Davis, Polk, Wardwell, Gardiner & Reed, the attorneys for the Guaranty Trust Company. The *Times* added a special Chicago dispatch, dated the 18th, as follows:

"When the Olympian of the Chicago, Milwaukee & St. Paul Railroad leaves this city at 11 o'clock tomorrow night it will bear a group of bankers, railroad officials and lawyers representing probably a quarter of a billion dollars in purchasing power, bent upon acquiring the great Milwaukee system at the auction sale in Butte, Mont. next Monday. It seems practically certain that the Reorganization Committee backed by Kuhn, Loeb & Co. and the National City Bank will buy in the property."

The Chicago *Daily News* had a staff correspondent present at the sale. He described the scene in these words:

"A crowd of Butte citizens stood in the snow outside the railway station and packed themselves in around the entrance. The sale was to have been conducted from the icy steps, but at the last moment a table was prepared for the master just inside.

"Messrs. Hanauer and Ecker with their counsel, who acted as their agents, were on one side and near by were the receivers, Mark W. Potter, Edward J. Brundage and Harry E. Byram, and their counsel, who acted as their agent, Ralph M. Shaw of Chicago. In the outer circle were the large group of railway officials, attorneys and lesser fry.

"A festive air pervaded the hearing. The reorganization group were in high spirits and they bubbled over with good feeling as the proceeding continued and no semblance of opposition manifested itself."

The correspondent noted especially the pleasure of Messrs. Hanauer and Ecker, who "smiled broadly as they stood along-

side the table which [*sic*] the master stood at the entrance of the station." The forty minutes of the proceedings were devoted in part to the master's reading of the legal notice of sale, which consumed twenty-two minutes, and in part to the reading of the bids for the reorganization managers, which consumed eighteen minutes. In addition, the master announced that the only bidders were the managers' nominees. The Butte sale was like the many Mr. Cravath had attended and of which he told in his lecture: "Counsel who have acted frequently for reorganization committees have spent a great many anxious hours preparing for the unexpected bidder, but in my own experience he has never appeared."

With the forty minutes in Butte, the St. Paul bankers had completed the necessary steps for getting control of all the St. Paul securities. If their plan could pass muster with court and Commission, the bankers would have no further need for solicitation of security-holders, conciliation of opponents, compromise, or arbitration. They had in the vaults of their depositaries only eighty-one per cent of the bonds and seventy per cent of the stock. But once they could get by the government authorities, the managers had actual control over all the bonds and all the stock.