

A Significant Case Study of Big Business and the Bankers

Mr. Lowenthal's Illuminating Account of the Chicago, Milwaukee & St. Paul Receivership

THE INVESTOR PAYS. By Max Lowenthal. 389 pp. New York: Alfred A. Knopf. \$2.50.

By GARDINER C. MEANS

IN "The Investor Pays" a brilliant light is thrown on an important phase of investment banking practice—that of corporate reorganization. The avowed aim of the book is "to pierce through technicalities and show the investor what actually happens to his money" when his company is reorganized.

For the purpose of making the subject clearer to the average security holder a concrete case [the receivership of the Chicago, Milwaukee & St. Paul Railway Company] 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 conduct of all such cases in every section of the country. [Preface.]

Throughout the book the author emphasizes the typical character of bringing out the parallel between the legal steps actually taken and those recommended as good receivership practice by one of the leading lawyers in the case in a series of public lectures.

The course of the receivership is set forth almost entirely in excerpts from court and commission proceedings, public lectures and published documents. In them the bankers and their lawyers speak directly, and the full interest of conflicting personalities and involved situations is thereby obtained. By the skillful handling of this material the author causes the whole development of the receivership to stand out from the mass of material and of legal technicality. He makes it appear as a campaign on the part of the bankers to obtain control of the St. Paul and the perquisites of such power without assuming enforceable responsibility to the security holders or to the general public with respect to the property.

The receivership of the St. Paul is itself a cause célèbre. By 1925, the date of the receivership, the road had become a tremendous network of 11,000 miles, with assets of three-quarters of a billion dollars and over forty thousand security holders. The receivership involved most of the large banking houses in Wall Street and the bulk of the great corporation law firms. At the centre of the stage stood the bankers, Kuhn, Loeb & Co. and the National City Company, and an imposing array of lawyers. Rarely has such a host of financial and legal talent been organized in a single cause.

The receivership appears to have grown out of a combination of declining earnings and a topheavy financial structure. The events leading up to it Mr. Lowenthal sketches only as they have a direct bearing on its understanding, and they can accordingly be dismissed here except for his emphasis on evidence in the record indicating that the individuals in control of the property had shown an important measure of irresponsibility in the conduct of its affairs. The securities of the railroad had become widely distributed and the security holders had ceased to exercise an important measure of control. In the words of the Interstate Commerce Commission, the board of directors "was a self-perpetuating body." Most of the directors neither had nor directly represented any substantial investment in the property. Nor did their actions, as reported to the commission, demonstrate that the interests of the security holders were being advanced. Indeed, the group in control of the enterprise took few steps toward balancing the company's budget. In the words of the

attorney for the St. Paul: "This property . . . had drifted into a receivership." Certain members of the controlling group disposed of their securities as disaster approached, a fact unknown to their associates.

In direct contrast to the inaction of the group in control of the St. Paul, the vigorous action of the bankers is indicated by the evidence adduced in the volume.

receivers to be appointed by the judge were nominees of the bankers; that a friendly creditor had brought the actual suit which precipitated the receivership, and that the latter was supplied with counsel friendly to the bankers. The bankers also organized so-called independent bondholders' and stockholders' protective committees. In the words of the Interstate Commerce Commission, "the

tomed throw some light on the bankers' manner of dealing with the courts, the commission and the St. Paul security holders. Between themselves and the government tribunals, between themselves and the security holders, the bankers almost invariably introduced a corporation, a committee, somebody else's lawyer, somebody else's engineer, somebody else for a veil or a shield or a sword.

With the railroad landed in re-

receivership administration and the men against whom they should have proceeded. A charitable softening of the color of past transactions was not unnatural; it was virtually ordained from the moment of the selection of receivers and their counsel, by the method of their selection.

Along the second line of action, the drafting of a plan of reorganization, the bankers were most vigorous. The actual plan finally put in force was drafted, with only minor subsequent alterations, by the principal banker and the principal lawyer in the case. The author points out that it was a legal document even more than usually forbidding. One sentence alone contained 2,250 words, or the equivalent of six pages of an ordinary book.

The document was so drafted that its adoption by a majority of the security holders would automatically give the bankers tremendous powers over the railroad property. Offered as a concrete plan, the document placed the security holders agreeing to it in the position of having agreed in advance not only to the plan outlined in the agreement but also to a grant to the bankers of "power to carry into effect any other plan they might later substitute." The author maintains that this grant of power was by no means apparent in the document itself, but rather was the net product of a series of skillfully inserted but unobtrusive clauses at widely separated places, which could be discovered only by the most painstaking and experienced search.

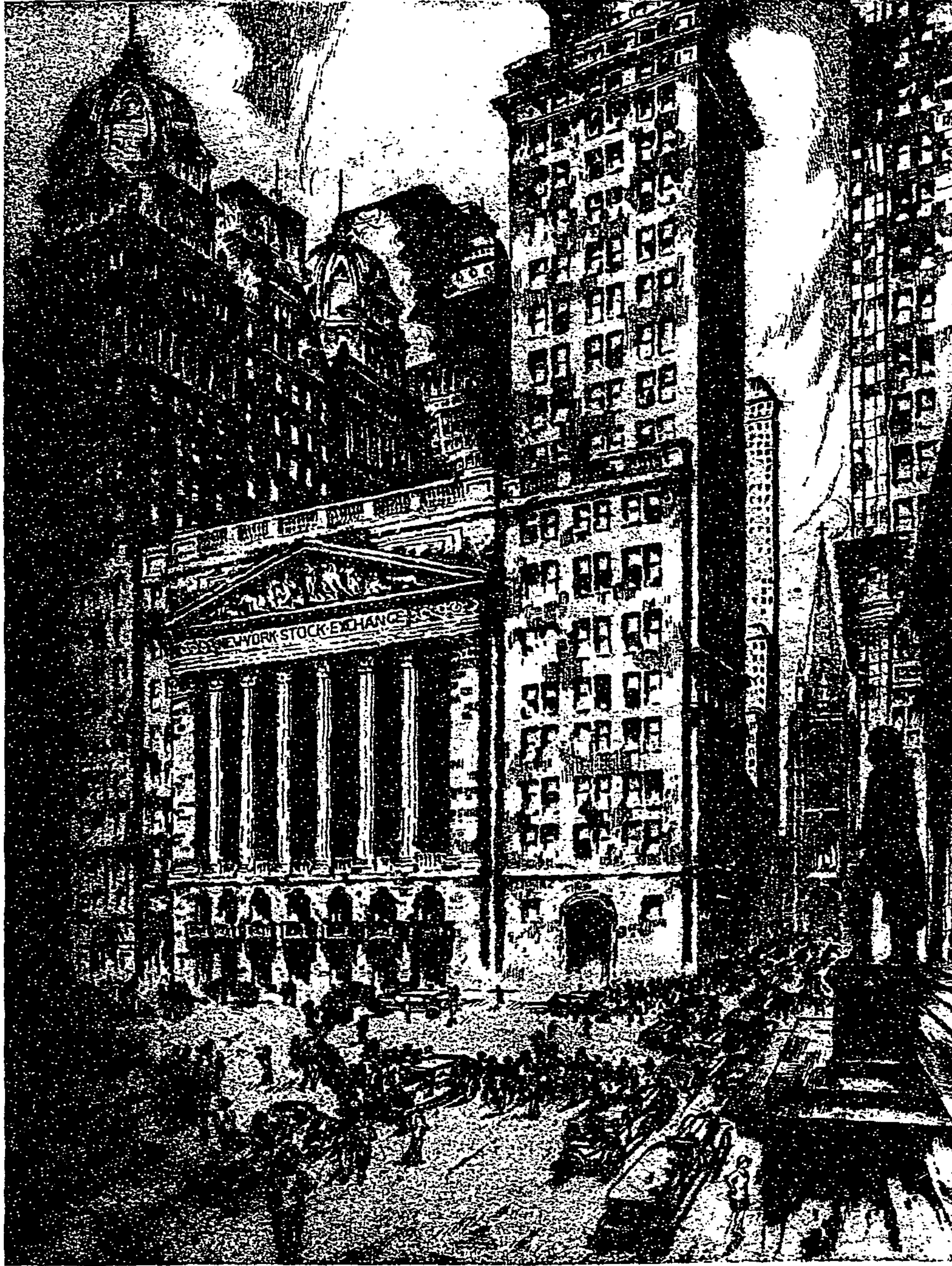
In spite of this unlimited grant of power, the so-called plan of reorganization absolved the bankers from every form of legal liability or enforceable responsibility which the minds of their attorneys could conceive. As Mr. Lowenthal puts it, the lawyers "placed above their clients an umbrella so large, so closely woven of protective threads and of such tough material that the minutest drop of liability and legal responsibility would have difficulty getting through."

By provisions in the plan an individual security holder would become a party to the agreement, accepting it in toto, by the simple act of depositing his securities with one of the protective committees.

Finally, the methods employed by the reorganization committees in obtaining the deposit of securities were such as to arouse "a storm of criticism." The representative of one independent bondholder group characterized the bankers' actions as "desperate measures being used to force through the plan with unprecedented haste over the opposition of unwilling bondholders."

Mr. Lowenthal only sketches the final stages of the reorganization—the transfer of the property to a new corporation at a sale; the issue of new securities; the fees to the bankers and their lawyers, amounting to over \$6,000,000, and finally the retaining of banker control over the new company by a voting trust. By the time the "plan" had been officially adopted, through the deposit of securities, power had been lodged in the hands of the bankers. The first phase of their campaign had been completed.

From the point of view of the layman, this book is a most readable and exciting résumé of a great receivership. From the social point of view, the book is of even greater significance. It points directly to what must be one of the major problems of the modern corporation—the development of power without responsibility. Implicit in the book is an indictment not only of current reorganization practice but also of all banking activity which aims to obtain irresponsible power.



Broad and Wall Streets.

From an Etching by Andrew Karoly. (Courtesy Schwartz Galleries.)

Mr. Lowenthal goes on to tell how, when the financial condition of the St. Paul became increasingly more precarious, the bankers discouraged the formation of the usual protective committees on the ground that such action would be premature. Then, without announcement to the public, plans were made for an immediate receivership. According to the testimony of their lawyers, the banking group arranged to have the receivership come before a judge satisfactory to them. As Mr. Lowenthal points out, "by selecting the judge who is most likely to appoint as receivers the men proposed by the bankers the latter can place a railway in the hands of their own associates or friends."

It was brought out in testimony before the Interstate Commerce Commission that two of the three

bankers . . . framed up the committee favorably to themselves, [and] put themselves on the bondholders' protective committee . . . Likewise the bankers designated themselves as the reorganization managers. When the receivership was suddenly announced, the bankers were in possession of all the important points of vantage.

Yet in no way had they made themselves subject to becoming formal parties to the receivership. In the words of Mr. Lowenthal:

Control of the St. Paul reorganization was thus centred in men habituated to assume the direction and reorganization of the public's money interests, chary of permitting public regulation of themselves and their activities and practiced in the arts of privacy. The traditions and attitudes to which they were accus-

ceivership two avenues of action presented themselves, action to increase the earnings or assets of the property and the drafting and adoption of a plan of reorganization. Along the first line, the author declares, little appears to have been done by the receivers. The salaries of the higher executives, instead of being cut, were increased by considerable amounts. The receivers made little investigation of the operations of the railroad in the period before the receivership when its revenues were declining, and ample ground existed for suspecting mismanagement. Mr. Lowenthal says, adding:

The exercise of the receivers' power to save the security holders was neutralized and defeated from the outset by the embarrassment of long-established relations between the men in the