Book Reviews

THE INVESTOR PAYS. By Max Lowenthal. New York: Alfred A. Knopf. 1933. pp. 406, lx.

THIS book dramatizes for the layman the St. Paul Reorganization. The professed object is to acquaint him with the mysterious process of reorganization which he has known only as an occasion for surrendering one piece of paper and accepting another, perhaps also paying an assessment. There are eight characters or groups of characters in the cast: (1) the road itself, whose securities once had a premier investment standing; (2) the thousands of scattered security holders, who "owned" the road; (3) a few large investors, notably the Harkness interests; (4) the directors (except for the Harkness representatives, they were never very active and became altogether quiescent after selling out some time prior to the receivership); (5) the dominating personalities of the road, William Rockefeller, and after his death, Percy Rockefeller (The Clayton Act forced Percy to resign the title of director because of his antagonistic banking connections. Nevertheless he continued to direct. He too sold out prior to receivership); (6) the road's president, H. E. Byram; (7) its bankers, Kuhn, Loeb & Co., later forced to share their position when the newly formed investment affiliate of the National City Bank "muscled" in;[1] (8) the Kuhn, Loeb lawyers, Cravath, Henderson and de Gersdorff. The bankers became reorganization managers. The actual management was by Hanauer of Kuhn, Loeb and Swaine of their lawyers. Others whose titles might have suggested that they had something to do with reorganization do not belong in the dramatis personae.[2] They appear in the book either as minor carrion snatching at loose entrails or as making up the chorus.

The prologue of the play tells how Hill and Harriman brought about the affiliation of their western roads with the Burlington and Northwestern, thus diverting Pacific coast traffic from the St. Paul; how William Rockefeller and the then chairman, Roswell Miller, like kings of old whose mistresses had been insulted, took up this challenge; how they plunged the road into war with little thought of the cost to its owners. The war took the form of building the Puget Sound extension. The cost vastly exceeded expectations. Hoped for earnings did not appear. As a result the road could not earn its increased fixed charges. There is given a catalogue of minor instances of mismanagement. This includes among other items: contracts, made without adequate independent representation of the road, which were highly favorable to interests of directors, Percy Rockefeller and John D. Ryan; financing too heavily with bonds, some of too short maturity; misleading accounting; excessive bankers' profits in a transaction in 1916, when the board was heavily loaded with National City directors; favoritism in coal contracts; acquisition of other small

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1. There were no Kuhn, Loeb representatives among the directors prior to the receivership. Many of the directors were, however, affiliated with the National City Bank. William and Percy Rockefeller were interested in this bank.

2. One possible exception is Ecker, Chairman of the bondholders' committee whose importance Lowenthal takes some pains to minimize. While his life insurance company was interested as a large holder of bonds, he had been in two previous reorganizations managed by Kuhn, Loeb and Company. Thus his personal interest was to follow their lead.

roads at excessive prices when the St. Paul was obviously drifting toward insolvency.[3] The immediate crisis was the prospective maturity of $47,000,000 of junior bonds, part of those sold to finance the western extension. These would mature June 1, 1925. The road was in no shape to refund them. Thus the prologue gives way to the play itself, *reorganization.*

Lowenthal gives both the real reorganization and a play within the play—the fictitious drama staged by the bankers and their lawyers for courts and public. In the fictitious story the directors employ expert engineers to make a survey, learn from them that the road can not earn existing charges, realize it would be futile to attempt to extend the $47,000,000 of maturing bonds, decide to default interest payable three months previously on other junior bonds, and vote to have the road consent to a receivership which one of its creditors happened to be seeking. On March 18, 1925, United States District Judge Wilkerson appoints receivers. As defaults occur the trustees of the junior mortgages intervene and ask for foreclosure. Certain bond and stockholders organize protective committees. The committees induce the bankers to prepare a plan and agree to it when it is prepared, and ask the bankers as reorganization managers to carry it out. The majority of bond and stock holders agree to it and turn over their holdings to designated depositaries. The stockholders pay an assessment. With the bondholders' bonds and part of the stockholders' money the managers buy in the property at foreclosure sale, turn it over to a successor corporation in return for securities of the successor and distribute these pursuant to the plan. Those bondholders who do not choose to participate are offered instead their share of the proceeds of the sale. The stockholders also raise a separate fund for fees and expenses. After the sale the trial court and, on appeal, the Circuit Court of Appeals, find the plan fair. A majority of the Interstate Commerce Commission approves the issue of new securities. The Commission unsuccessfully attempts to reserve jurisdiction to investigate the reasonableness of the fees. At suit of the new company it is held beyond their power to interfere with the private contract which left to the absolute discretion of the reorganization managers the disposition of the fund raised by the stockholders.

The real story bears little resemblance to the bankers' story. We find that Hanauer of Kuhn, Loeb and their lawyer, Swaine, precipitated the receivership, decided on their plan and jammed it through without giving either security holder or public authority any real voice in the matter. Hanauer began making contacts with French Bondholders in March, 1924. Later he got the road to obtain a list of junior bondholders presenting December 1 coupons for payment. He made arrangements for the consulting engineers employed in the name of the road. Swaine's office had a creditor's bill for receivership printed in January, and had secured Ralph M. Shaw of Chicago to sound out Judge Wilkerson as to his availability and willingness to appoint the desired receivers, before even the friendly creditor had been found who was to "employ" Shaw's office or the directors had met to authorize the road's joining in the friendly creditor's application for a receivership. Meanwhile they had seen to the choice of committees and depositaries, so that their committees were prepared to announce themselves by newspaper advertisement on the morning of the receivership.

The advantage of being the first to move was not thrown away. With a finesse and subtlety amounting to genius, Hanauer and Swaine wove their web of influence, dispensed patronage and so arranged control of future patronage that practically everyone who counted was bound to them by gratitude or fear or hope. The National

3. Percy Rockefeller and his business associate, Pryor, had a hand in one of these deals. Pryor got a commission and generously turned it over to the Owenoke, a close corporation in which they each owned one third of the stock. Rockefeller became a director of the newly acquired road so that he could continue to have pass privileges although no longer a St. Paul director.

City Company was allowed to share the title and fees of reorganization managers. Their counsel got the job of counsel for the bondholders' committee. Two of the three receivers were indebted to them for their present positions and might have something to hope for from the reorganized road, to be controlled by voting trustees chosen by the reorganization managers. They had brought the receivers' counsel into the picture, first as attorneys for the friendly creditor. The engineers they had engaged in the name of the railway continued to work for them, now ostensibly acting on behalf of the bondholders' committee. Once the deposits of the security holders were obtained, they would be entitled to speak on behalf of the owners when the court came to pass on such fees (to receivers and trust companies and their counsel) as were payable out of the trust estate. The committee members owed their positions in part to the fact that theirs were supposed to be names to conjure with in rallying security holders to the bankers' standard; their fees were payable out of the fund raised under the plan and were subject to absolute discretion of the bankers; and, moreover, there might be other opportunities to "serve" in connection with other reorganizations. The bankers had arranged the personnel of the bondholders' committee and had seen that there was but one committee for the two groups of junior bondholders. They had chosen as chairmen of the stockholders' committees two men whose interests primarily arose out of their relations to bondholders. These chairmen dressed up their committees with names whose owners for the most part held no stock. The managers persuaded the committees not to solicit deposits until a plan had been agreed on. Thus, when the plan was presented, if any members did not like it they would not yet be in a position to speak for security holders at large. The plan presented and accepted by the committees gave the bankers complete control over the securities when deposited. The committees were never more than brackets of names hired by the bankers. At most, the members looked over the plan and saw nothing wrong with it.

Since the committees were rubber stamps for the managers, the committees' patronage was the managers' patronage. Through their committees the managers named as depositaries and sub-depositaries and registrars 14 of the 16 largest New York banks and trust companies, and 24 large banks in other metropolitan centers. Lowenthal suggests that through them the managers spread their fan of influence over the lesser banks who were customers of these large banks, and over the brokers who borrowed chiefly from the larger banks. No steps were necessary to influence investment bankers throughout the country. Kuhn, Loeb and the National City Company originated a good part of the business they relied upon for their stock in trade. Their lists of customers holding St. Paul securities were of course made available to the bankers, as was the list collected by the road itself which had been turned over to the receivers.

In addition to creating a bias of self interest in favor of their plan in everyone to whom the security holders might be expected to look for advice, the managers backed up their solicitations in the names of the eminent protective committees with positive statements in support of the plan by the two receivers, whom they had chosen but who appeared to the public only as officers of the court, and by the consulting engineers, whose motives for subserviency to the bankers were also not publicly known. In addition, advertisement after advertisement appeared and circular after circular was mailed setting time limits for deposits, extending the time, giving a last chance. These carried veiled but unmistakable threats of penalties for failing to act within the time limits.

Opposition, so-called "independent," committees sprang up with objections, but as these could not hope to compete with the bankers in influence or prestige little depended on the merits of their criticisms.[4] The security holder was not thereby offered

4. Conversely, independents with prestige but with unsound objections might force some concessions. Lowenthal does not explore the possible motives of self interest which may actuate opposition groups.

a choice of plans, merely a choice of bets as to which group would ultimately succeed in reorganizing the road. The discriminating might prefer the plan of the independents but he would realize that the undiscriminating rank and file would inevitably support the bankers. If the bankers' threats meant anything, it might prove costly to back the wrong horse.

The independents' only chance was to secure court or commission support, but the cards of procedure dealt by the bankers' lawyers were stacked against them. Only when permission was sought to issue new securities would the commission have any say, and the receivership judge saw before him only creditor and road and the trustees foreclosing their mortgages on behalf of all bondholders. If later someone with a reorganization plan should turn out to be the successful bidder there would be time enough to consider its fairness on motion to confirm the sale. Till then objectors were not entitled to be parties to the suit. The court would not even venture to advise security holders that they might safely withhold deposits until it could pass on the plan.

Meanwhile the mortar of the banker-built edifice was allowed to set. Once they got in their deposits of bonds and their cash from stockholders the bankers were sure to be the only bidder. They could confront court and commission with a *fait accompli.* They could urge that the question was not as to whether this was the best plan, but whether it was so outrageous as to justify continuing the receivership until a better could be agreed upon. They could urge that the plan was presumptively fair because security holders had agreed to it. These arguments were used. One impressed the courts that the plan was fair; the other convinced a majority of the commission that it had better be left undisturbed. This left the bondholder with the illusory option of coming into the plan or receiving a sum substantially less than the price at which he could sell what was offered him by the plan. The stockholder's only alternative was to pay his assessment or lose his stake in the road.

This devastating explosion of the myth that security holders agree on a plan, this unsurpassed exposition of just how one of the great private banking houses can arrange a reorganization, is the real contribution of the book. There is plenty more to satisfy the lay audience's appetite for hissable villains. By insinuation and quotation they are given the impression that the plan was unfair, the fees exorbitant, and the methods of counsel unethical. Lowenthal doesn't make direct charges himself. He is merely stringing together with connecting narrative relevant bits from 20,000 pages of pleadings, testimony and opinion in the records of investigation and litigation concerning the reorganization. He builds largely on admissions of witnesses identified with the bankers. Occasionally he has to rely on testimony of adverse witnesses. If caustic comment is necessary to clinch a point he can always find appropriate words spoken by the "independents" or written by a critical dissenting commissioner or judge. The atmosphere of conspiracy which exudes from the book is made more plausible because the bankers chose to veil their power. They strove to help maintain the illusion that directors direct and protective committees protect. Thus they are put in a sinister light when the true situation is dragged from reluctant witnesses. Many of those identified with the bankers' party made bad witnesses. Hanauer and Swaine knew when to disarm opponents by admitting what could not be denied. But such sorry figures as president-receiver Byram tried to deny whatever opposing counsel asked them to admit. Lowenthal's most brilliant and effective trick is to tell the simple ungarnished tale of what was happening, then contrast it with testimony of bankers' witnesses or arguments of their lawyers.

The lawyer with some experience in reorganization practice will probably be outraged by the book. He will be indignant at Lowenthal for making his cherished, familiar, necessary fictions take on a sinister cast. He will see nothing reprehensible in what was done by Hanauer and Swaine, the principal villains of the book. He might confess most of Lowenthal's story and seek to avoid his implications by saying

that the bankers owed an obligation to those to whom they had sold securities; that a federal receivership was necessary to be sure of a unified administration of property lying in many states; that this had to be arranged privately lest unfriendly creditors jump in and get preferences, or, even worse, a state receivership; that directors such as Lowenthal describes could not be trusted with the secret that a receivership had actually been decided on, and hence it was necessary to be prepared to apply for receivers immediately after getting formal approval of the board; that it was desirable to get receivers familiar with the road, in whom the bankers had confidence and with whom they could work; that scattered security holders are utterly incapable of intelligent appraisal of their own best interests; that predatory speculative groups would mislead them to their destruction unless the bankers took the lead; that effective leadership must be founded on recognition of human frailty, must control patronage and use it to prevent other potential leaders from dividing counsel, must use intimidation as well as persuasion on those to be led; that while the dispensation of patronage smooths the way, a very vital factor is the reputation for fairness and sound business judgment of those assuming to direct; that the desire to preserve this vital business asset gives the bankers a motive for working out a fair plan. What Lowenthal portrays as deceptive methods of persuasion he might seek to justify as within the legitimate scope of argument, or excuse as minor indiscretions committed in the heat of battle. The procedure followed might be justified by citing precedent, and by claiming that judges are not competent to decide the complex business questions involved in reorganization.

This defense for those who were guiding the reorganization still leaves little to be said for the minor characters of the book—the frankly predatory, and the yes-for-a-fee fiduciaries. Moreover, it calls for redefining the lawyer's place in the state. The reorganization lawyer decidedly does not act as an officer of the court helping it to administer justice. He, as bailiff for his lord, the banker, is helping him administer justice for the vassal security holders and helping his lord to keep courts, commissions and other representatives of the sovereign people from interfering with this private jurisdiction. Of course he loyally believes that this is better justice than the sovereign could supply. Though philosophically maintainable, this defense is not politically apt. It runs counter to obvious popular emotions. Hence the manifestation of bankers' power has had to be veiled with the fiction of private agreement and popular prejudice neatly turned to advantage by championing liberty of contract and by urging the catch phrase that it is unfitting for courts, a fortiori commissions, to make contracts for security holders. Lowenthal's book makes the reader ask himself whether it is any more fitting for bankers to do so.

Quite evidently Lowenthal does not think it is. In an article written since the book, he thus (in part) summarizes reorganization abuses: "preparation of plans without hearing; control of the voting machinery by a few, to the exclusion of the body of security holders; depriving the latter of a vote on reorganization plans; fees and expenses disproportionate to the services rendered and the results achieved."[5] He evidently visualizes something more than supplanting the rascal bankers with true friends of the people, equipped in their turn with sufficient patronage to stifle opposition and to put over their fictitious agreement. Unfortunately he leaves us with the vaguest picture of how a reformed system might be worked.

This article shows that the new amendment to the bankruptcy act may not have achieved its sponsors' purpose to take control of railroad reorganizations away from the Wall Street Bankers and put it in the combined hands of the Interstate Com-

5. Lowenthal, *The Railroad Reorganization Act* (1933) 47 HARV. L. REV. 18, 20. The article contains an excellent discussion of other abuses of the old system and their treatment by the Act. The reviewer's only quarrel is with the limited scope of Lowenthal's discussion of the basic problem.

merce Commission and the Courts.[6] The sponsors' notion was that after the fullest opportunity for discussion the commission should recommend a plan to security holders for adoption by two-thirds vote of each class affected, subject to court approval. Lowenthal complains that the same type of banker-chosen committees are still functioning, that they are endeavoring to gather up the security holders' votes in advance so that the commission can only reorganize by leave of the bankers.[7] Democratic rule has not yet become a reality.

Any attempt to introduce democracy into reorganization practice calls for analysis of just what a corporate reorganization does. The fundamental assumption is that the enterprise has failed to live up to minimum expectations. Default has given rise to theoretical legal remedies of various creditors. But these remedies may be uncertain in scope, realizable only after protracted litigation, and more calculated to harm others interested in the enterprise than to fulfill the defeated expectations of those to whom the remedies belong. Different bond issues may be secured by mortgages on segments of a railroad, each vital to the system and useless by itself. The necessity of pooling their securities is obvious, but unfortunately there is no mathematical basis for determining the settlement. Again, foreclosing bondholders may have to compromise with junior interests to avoid delay, or resort to them as the most likely source of new money. What terms shall they offer? These are the commonplace problems of reorganization. Forty thousand scattered bondholders cannot settle them at town meeting. Vicarious negotiation is inevitable.

If this negotiation is to be effective and expeditious the negotiators must be able to speak with authority. Bondholders' representatives cannot defend in open debate the concessions they are about to make without convincing the stockholders that better terms should be offered them. The atmosphere of disappointed hope which hangs over the whole enterprise makes it peculiarly difficult to satisfy everyone. If practically all, or two-thirds, or even a bare majority have to ratify a plan when made, then the negotiators must so arrange it that they already have the ratifying votes in their pockets when they start to bargain. The alternative is a chaos of interminable talk.

Just because the traditional reorganization technique has used the illusion of ratification by security holders to smooth its way with them and with the courts, there is no reason why the reformer should run after such a will-o'-the-wisp and try to provide for genuine ratification. If he wishes for democracy, let it be a representative democracy. Let machinery be provided for bondholder election of representatives by plurality or majority vote, or by cumulative voting, with open or closed primaries, with requirement that candidates disclose, or free themselves from, inconsistent interests; place limits upon campaign expenditures, et cetera. Then give the representatives thus chosen the power to bind their whole class by the bargain they will make. The reformer may object that the holders of any one large issue of bonds are too scattered, and the occasion for their cooperation too ephemeral, for them to cooperate intelligently whatever the safeguards. Inevitably those who sold them the bonds could count on at least a majority vote. To dislodge the bankers, the reformer will be forced to change his democratic slogan and call in Democracy at large. Those who can command investors' proxies must give way to the appointees of those who can win at the polls. There is no use disguising the fact that this would involve a tremendous shift of power. Whether the power is left in the bankers, transferred to public authority or somehow shared between them, it should be openly conferred. Neither should be hamstrung with a requirement of security holder ratification only obtainable by deception and coercion, by bribery and paying blackmail, all at the security holders' expense.

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6. This statement of purpose is paraphrased from remarks of Chairman Couzens of the Senate Interstate Commerce Commission, quoted by Lowenthal, *supra* note 5, at 37.

7. It is of course by no means clear that the device used will be upheld by the courts.