

THE FINANCIAL COLLAPSE OF  
THE PENN CENTRAL COMPANY

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STAFF REPORT OF THE  
SECURITIES AND EXCHANGE COMMISSION  
TO THE  
SPECIAL SUBCOMMITTEE ON INVESTIGATIONS  
Hon. HARLEY O. STAGGERS, *Chairman*  
(With comments on H.R. 12128 by SEC and ICC)



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(II)

## FOREWORD

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On the occasion of the publication of the "Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations on the Financial Collapse of the Penn Central Company," I feel it appropriate that we take a comprehensive look at the Penn Central bankruptcy, its causes and its results, and the adequacy of the laws and regulatory agencies which administer those laws.

The collapse of the Penn Central is the single largest bankruptcy in our nation's history. The ramifications of that bankruptcy extend far beyond those unfortunate enough to have been stockholders. For them, as for those whose pensions were dependent upon investments in Penn Central, the bankruptcy was a major tragedy. In addition to these investors and pensioners, however, the bankruptcy had a major impact upon our national economy. The run on commercial paper caused by the Penn Central collapse could have created a serious liquidity crisis for our nation's businesses except for the timely action of the Federal Reserve Board. The Eurodollar offerings which were being encouraged as a means of curtailing balance of payments deficits lost their investment attractiveness in the overseas markets. Indeed, the interruption of commerce which is so dependent upon our highly complex and interwoven transportation system was threatened.

A great many recommendations have come out of different studies of the Penn Central Collapse. The first recommendations were included in a Staff Study by the Special Subcommittee on Investigations entitled "Inadequacies of Protections for Investors in Penn Central and other ICC-Regulated Companies." This report limited itself to the interplay of the Interstate Commerce Act and the Federal securities laws. Thereafter, in an extremely careful and detailed study the staff of the House Committee on Banking and Currency reported on its investigation of "The Penn Central Failure and the Role of Financial Institutions." Now, we have the recommendations of the SEC as a result of its staff study. The time has come for serious consideration of what Government can do to protect the public interest including the following:

1. *Elimination of exemptions for rail and motor carriers from the Federal securities laws.*—The securities of carriers regulated by the Interstate Commerce Commission are generally exempt from the disclosure requirements of the Federal securities laws. Similar exemptions are not available for airline carriers regulated by the Civil Aeronautics Board; wire carriers regulated by the Federal Communications Commission or gas and electric carriers regulated by the Federal Power Commission. The intent of Congress in 1933 in creating the first of these exemptions for ICC regulated carriers was based on the assumption that the extensive regulation of rail securities then being

exercised by the ICC would be the best protection for investors. At that time the SEC did not exist and motor carrier securities were not regulated by the ICC. Thirty-nine years later, the SEC does exist and the reasons for exempting rail and motor carrier securities no longer seem valid.

On December 8, 1971, I introduced H.R. 12128, a bill "to extend the protection provided by the Federal securities laws to persons investing in securities of carriers regulated by the Interstate Commerce Commission." The SEC fully supported this proposed legislation. The ICC, on the other hand, generally opposed it. The comments of both agencies regarding H.R. 12128 are included at the end of this volume.

2. *Improved legislative and regulatory control over diversification of transportation companies.*—Transportation carriers in their function as utilities operating under a public license are in a position to monopolize a segment of the national economy and thereby insure a guaranteed source of funds. Diversion of those guaranteed funds out of the transportation business and into other endeavors offering a more attractive investment return is increasing. There are today significantly more transportation holding companies and holding companies with transportation components than there were a decade ago. There is also greater concentration among the major transportation companies.

One motor carrier, in order to further its program of diversification, was found by the ICC to have exceeded its standard for an acceptable working capital ratio and unreasonably mortgaged the carrier's operating equipment. The experience of the Penn Central with diversification proved that profits on acquired non-rail operations are often illusory while the out-of-pocket costs of acquisitions are quite real. In the same vein the increasing diversification by air carriers may result in unreasonably encumbering airline operating equipment while the costs of acquisition exceed the real benefits thereof.

The record is not clear that diversification is absolutely bad. In the final analysis the process of diversification by transportation companies might possibly prove to be the boon to the transportation industry which its supporters claim. On the other hand, it may be that transportation holding companies will indulge in many of the same abusive practices which electric and gas holding companies engaged in before the passage of the Public Utility Holding Company Act of 1934. Until a thorough analysis is made of the public interest benefits for diversification by the regulated transportation utilities, a proper conclusion may not be reached. In order to make this analysis, I have instructed the staff of the Special Subcommittee on Investigations to collect and study all the available data on diversified transportation companies and to report back to me.

3. *Federal incorporation of companies regulated by the ICC and CAB.*—Public utility oriented companies which are regulated by the ICC and CAB serve a national interest. As such, they cannot enjoy the same latitude of business discretion as unregulated companies. Directors and officers of those regulated companies may find a conflict in their responsibilities to their stockholders and in their responsibilities to serve the public interest. Incorporation of such companies under Federal laws could insure uniformity of corporate and individual accountability.

4. *Increased regulatory restrictions on dividend policy.*—For a considerable period before the bankruptcy, Penn Central and its pre-



ecessors had maintained a policy of paying dividends out of borrowings rather than admit there were no real earnings. Stockholders were led to believe they were being paid dividends when in effect they were really receiving repayments of capital. It was this policy in particular which lulled the small investors into trusting in the safety of their investments.

In a period of severe negative cash flow, Penn Central continued to pay attractive dividends through massive borrowings at higher and higher interest rates. The great bulk of these borrowings were ultimately subject to ICC approval. Apart from any considerations of fraud under the Federal securities laws, a policy of mortgaging future operations to maintain a current dividend policy not justified by current operations should scarcely be the practice of a regulated utility. A temporary market aberration may warrant occasionally retaining an established dividend in excess of earnings, but not indefinitely.

In the event regulatory controls over dividend policy cannot be implemented with existing laws, new legislation may be needed. I am requesting the ICC to consider this matter and report back to me.

5. *Extraterritorial application of the Federal securities laws.*—One of the more unfortunate aspects of the Federal securities laws is the limitation of their enforcement to the United States. Capital markets today are not territorial, and overseas investors are not solely large financial houses. Foreign investors apparently are not entitled to the full disclosure protections which U.S. residents enjoy. They should be.

Eurodollar offerings by major American corporations have played an important role in limiting the outflow of U.S. investment. They have also introduced individual European investors to the American capital markets. When Penn Central had exhausted all reasonable capital sources in the United States, it was able to borrow overseas because of the goodwill established by other U.S. companies. Unless overseas investors can rely upon the protections assured to American investors, their confidence in U.S. investment will not be retained.

6. *Restrictions on interlocking directorates.*—Since 1914 Section 10 of the Clayton Antitrust Act has prohibited a carrier from having any dealings in securities in excess of \$50,000 per year with another corporation having the same officers or directors except pursuant to competitive bidding under regulations established by the ICC. A note or other evidence of indebtedness including commercial paper is a security. A number of banking and other financial institutions made loans to and engaged in other commercial transactions with Penn Central while maintaining their control relationships through membership on the Board of Directors of the carrier. I am specifically requesting the ICC to examine the record in fulfillment of its responsibility under Section 10.

The SEC report carefully documents the great conflict of interest situations in which the banking and financial institutions found themselves whenever they had dealings with the Penn Central. One bank with an interlocking director chose to make indirect loans "because a direct loan would constitute a conflict of interest." In sum, any benefits from interlocking directorates seem clearly outweighed by the potential abuses which might flow from such relationships. An outright prohibition of interlocking directorates between public utility oriented companies and banking and financial institutions may be in the best interests of the public, the regulated companies and their financial counselors.

7. *Insulation of commercial banking functions from bank trust departments.*—The flow of information into a banking institution which is performing vital commercial banking functions must be of utmost confidentiality. A bank trust department is no more entitled to intrude upon the confidentiality of that banking relationship than any member of the general public.

Whether or not the trust departments of the banks serving Penn Central did intrude upon this relationship I am not in a position to say. It seems to me that the mere appearance of evil is enough to warrant stricter regulatory controls divorcing the commercial and trust departments for all purposes including research and investment advice and interchange of personnel.

The law is quite clear that the actual use of confidential information to profit on a securities transaction is prohibited. To avoid the appearance of evil, I am requesting the SEC to consider whether pursuant to its rule making authority it could and should adopt a rule limiting the investment activity of a trust department when a commercial banking relationship exists.

The chronicling of the Penn Central fiasco is not yet complete. Other reports can be expected. The efforts of the staff members of the SEC who were involved in the preparation of this report are to be commended. Their report will find an important place in the histories of the Penn Central bankruptcy.

HARLEY O. STAGGERS,  
*Chairman, Special Subcommittee on Investigations,  
 Committee on Interstate and Foreign Commerce.*

## LETTER OF TRANSMITTAL

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SECURITIES AND EXCHANGE COMMISSION,  
*Washington, D.C., August 3, 1972.*

HON. HARLEY O. STAGGERS,  
*Chairman, Special Subcommittee on Investigations, Committee on  
Interstate and Foreign Commerce, House of Representatives,  
Washington, D.C.*

DEAR MR. STAGGERS: I am pleased to transmit a copy of our staff's comprehensive report of its investigation into the relationship between the Federal securities laws and the financial collapse of the Penn Central Co. We initially disclosed this investigation in testimony before your committee in September 1970. Since that time, the Commission's staff has taken over 25,000 pages of testimony from 200 witnesses, studied tens of thousands of pages of exhibits and examined relevant records of 150 financial institutions. Their report summarizes one of the most extensive evidentiary and analytical records ever accumulated in a single inquiry by the Commission's staff. This extensive inquiry was needed not only to fully understand the application of the Federal securities laws to the Penn Central affair, but also to point the way to possible modifications of these laws and their implementing regulations.

I believe this report brings into sharp focus a cogent analysis of the factors behind not only the failure of a major railroad merger but also a failure to recognize in timely fashion and bring to public attention a crumbling structure in which shippers, passengers, creditors, investors, governments, and the public at large had such a major interest.

Because the Commission is considering possible enforcement actions, I am refraining at this time from commenting specifically on possible violations of existing law which might subsequently be alleged in such actions. I believe, however, that it is appropriate for me to bring some of the broader and deeper implications of this report to the attention of the Congress, members of the business community who are required to comply with the securities laws, and lawyers, accountants, and other professionals who assist the Commission in securing compliance with these laws.

The basic securities laws, enacted almost 40 years ago, provide for a fairly comprehensive pattern of disclosure and regulation. For almost 40 years the Commission has worked steadily at implementing the laws and adapting the emerging regulatory pattern to the needs of a more sophisticated, more sensitive, and more involved investing public. This report brings out areas in which both the basic law and the implementing regulations should be strengthened.

The first thing I would point out is that the securities laws contain exemptive provisions which permitted Penn Central and those involved in its financing and investments to operate free of several

important components of the regulatory and disclosure pattern which the Congress and the Commission have established under the securities laws.

The first of these exemptions frees companies regulated by the Interstate Commerce Commission from registering securities sold to the public with Securities and Exchange Commission. You introduced legislation in December 1971 (H.R. 12128), which would eliminate the exemptions for ICC-regulated carriers under the Federal securities laws. We have supported that legislation. It seems to me that in an era where so many corporations engage in multiple activities, exemptive provisions which permit the regulated and the unregulated to engage in the same kind of activities should be reexamined to assure that no corporate entity, regardless of what its principal activity may be, would, in any particular activity, be held to any lesser standards of scrutiny or disclosure than others.

Another exemption frees the sale of short-term corporate or "commercial" paper from registration requirements. The Securities Act of 1933 exempts commercial paper if used for "current transactions" and having a maturity "not exceeding 9 months." The Commission in the past has given broad meaning to the "current transactions test." Regardless of the maturity and the "current transaction" test, the railroad company's paper was exempt from registration as a security issued by a common carrier with the approval of the ICC as provided in section 3(a)(6) of the Securities Act of 1933. The anti-fraud provisions of the 1933 act apply to the sale of securities exempt from regulation, although commercial paper having a maturity up to 270 days is not a security for purposes of the Exchange Act of 1934.

The staff report unfolds a picture of commercial paper which was continuously rolled over so as to serve the purpose of long-term financing and used not to finance commercial transactions but to meet cash requirements arising from physical improvements and operating losses. Also, the report demonstrates scanty investigation of the strength of the company, reliance on the management's verbal assurances about the financial condition and prospects of the company, and little or no effort to transmit to buyers information about the company and developments which threatened its solvency. When Penn Central went into bankruptcy in mid-1970, American corporations had some \$40 billion of commercial paper outstanding. You will remember that the shock waves set off by the \$80 million loss in Penn Central paper placed enormous strain on our banking system as more than \$2 billion in bank money went to help corporations pay off maturing commercial paper. Only strong and prompt action by the Federal Reserve Board prevented what could have been a liquidity crisis disastrous to the health of the entire economy.

While the staff report identifies the Penn Central situation and its impact on the commercial paper markets as one resulting primarily from a lack of adequate disclosure concerning the issuer of the commercial paper and the dissemination and digestion of that disclosure by the appropriate segments of the investing public, we also have reviewed generally the regulatory framework within which commercial paper is issued. We believe that Congress should give consideration to amending the exemptions for commercial paper in order to provide more definite standards, for example, as to such matters as the denominations in which it may be offered and sold, in

order to prevent this type of unregistered security finding its way into the hands of the investing public in general, rather than financial institutions, as it appears Congress originally intended.

The cornerstone of public confidence in our securities markets and of the securities laws is full, accurate, and meaningful disclosure, made on a timely, equal and public basis to all investors. The Commission's staff report shows a wide margin of failure on the part of Penn Central in meeting this standard. The report itself and, in capsule form, its Introduction detail this failure.

When evaluating the disclosure lessons to be learned from the Penn Central affair, it is important to keep in mind that although the securities laws exempted Penn Central from filing registration statements, sale of the company's securities was subject to antifraud rules and the company was required to file financial statements with the Commission. However, this latter requirement could be satisfied by financial statements based on ICC's accounting rules, which are primarily designed for ratemaking purposes and which do not call for the special requirements designed by the Commission to protect investors.

As we review the disclosure history of Penn Central, we get a picture of high euphoria and inflated prospects about the savings to be achieved by the merger with the manifest difficulties ignored or overlooked. When these difficulties emerged as painful realities, they were inadequately disclosed. The annual reports put out for 1968, 1969, and 1970 obscured the railroad's further movement into debt amid mounting operating losses. Instead they emphasized that efficiencies, improvement in service, and new exciting revenue sources were just around the corner. The Commission has not sought to control the content of the annual reports sent out to stockholders. However, for most public companies, it does control the form and content of the quarterly and annual financial reports filed with the Commission. We have been encouraging companies to include in the annual reports sent to shareholders the kinds of detailed breakdowns and supplementary information which we have required to be included in the reports submitted and filed with the Commission, because we think these breakdowns and supplementary data have a special value to investors. We have been only partially successful and, accordingly, we have released a proposal that, in filing their reports with the Commission, companies be required to indicate the items of information which have not been covered in the annual reports sent out to stockholders. We believe this will simplify the task of financial services in bringing to public attention the information filed with the Commission but not included in reports and help close the information gap between reports mailed to shareholders and reports filed with the Commission.

The staff report shows that as both the operating and liquidity condition of Penn Central deteriorated, its management made increasingly strenuous efforts to make a bad situation look better by maximizing reported income. An elaborate and ingenious series of steps was concocted to create or accelerate income, frequently by rearranging holdings and disposing of assets, and to avoid or defer transactions which would require reporting of loss. Accounting personnel testified that they were constantly under intense pressure from top management to accrue revenue optimistically and underaccrue expenses, losses, and reserves, to realize gain by disposing of assets and

to charge losses to a merger reserve which would not take them through the income statement. Gains were reported on real estate transactions in which the realization of benefits to the company depended on operating results far into the future and in which there was little if any real change in the character or amount of assets owned by Penn Central. In this connection, the Commission has already taken administrative action to order correction of reported figures in the case of Penn Central's subsidiary, Great Southwest Corp.

The whole pattern of income management which emerges here is made up of some practices which, standing alone, could perhaps be justified as supported by generally accepted accounting practices, and other practices which could be so supported with great difficulty, if at all. But certainly the aggregate of these practices produced highly misleading results. The accounting profession is in the course of reorganizing and accelerating its efforts to create more uniform accounting standards. A special committee of the AICPA is undertaking a redefinition of accounting objectives. This report underlines the urgency of those efforts. It is essential that the end result of applying accounting principles be a realistic reflection of the true situation of the company on which a report is prepared. Here, there was no adequate presentation of the fundamental reality that reported income was not of a character to make a significant contribution to the pressing debt maturities and liquidity needs of Penn Central, nor was it of the sort that might reasonably be expected to be evidence of continuing earning power.

The public was left unaware of the absence of cash flow and the magnitude of the cash loss. Management implied in its public statements that the cash drain came from improving the road's facilities when in fact it came from poor operations.

Effective December 31, 1970, the Commission introduced a requirement to file a source and application of funds statement designed to bring out an issuer's flow of cash and the source and use of cash resources. This applies to all reporting companies except those subject to ICC and other governmental agency accounting regulations. The report's findings emphasize the importance of requiring that all companies make this kind of specific disclosure in order to alert investors to liquidity problems.

I have directed that the Commission's staff undertake a study of other ways in which the liquidity position of a corporation can be more realistically disclosed. At a minimum, it would seem that improved disclosure of pending debt maturities and contractual commitments requiring cash outflows in the near future and the cash resources available to meet them would be required so that the financial viability of publicly traded corporations would be brought out as clearly as their operating performance.

I would also urge the national stock exchanges to review their listing standards with a view to requiring that reports to shareholders also bring out the relationship between liquid resources, borrowing power, and imminent obligations to establish public disclosure of the continued financial viability of a listed corporation.

Despite the absence of cash earnings, Penn Central continued to pay dividends at an annual rate of \$56 million until November 1969. The company had to pay high interest for the dividend money and face high cash demands with no idea of where the needed cash would come from. In these circumstances, we believe that there is an obliga-

tion on the part of management to make full public disclosure of the considerations and implications as well as the source of dividend payments.

In its annual reports, Penn Central obscured the source of its income and losses. Railroad operating losses were combined with other income sources until the underwriters forced a recasting of the figures in the offering circular. To fully enlighten investors on the principal sources of income and loss for a multiproduct company, in 1970 the Commission adopted a rule requiring a breakdown of sales and earnings for each line of business producing 10 percent of revenues.

The staff report clearly brings out the value of the requirement to file a registration statement. Penn Central, because it was under the jurisdiction of the Interstate Commerce Commission, was not required to register its public offerings with this Commission. It was required to apply to the Interstate Commerce Commission for permission to increase its debt obligations and ICC did find that the proposed increases in its debt were in the public interest but it had no explicit responsibility for investor protection. Because the civil liability provisions of the securities laws do apply to the sale of railroad securities, despite the absence of a requirement that offerings be filed with, and subject to review by the Securities and Exchange Commission, the threat of civil liability made it necessary for underwriters and their counsel to apply SEC disclosure standards to the offering circular to be used in the sale of Penn Central securities. The staff report shows how the scrutiny applied and disclosure required by underwriters and lawyers made it impossible for Penn Central to offer the securities of a failing company to investors. It is encouraging to note that Penn Central management failed in its demand that the law firm acting for the underwriter remove from the assignment a lawyer who was particularly diligent in demanding full and unvarnished disclosure.

While the underwriters and their counsel resisted the distribution of an offering circular that did not contain what they believed to be adequate disclosure, the placing of the entire focus of disclosure on the offering circular does not appear, under these circumstances, to have been the most appropriate way to make public the rapidly deteriorating financial condition of the company. Some analysts were able to put items of information together to arrive at a judgment that the solvency of Penn Central was threatened. If Penn Central management had met its obligation of disclosure, it would, by direct statements, have been bringing out and putting together the factors which these analysts used in arriving at that judgment. It might also be noted that in order to evade this obligation, a Penn Central public relations officer suggested that requests for information about the status of the company might be dealt with by "saying that we are considered to be in registration at this time and are not free to talk." Over the last year, the Commission has emphasized strongly that the imminence of a security offering does not relieve management of the obligation to make prompt and independent disclosure of new material developments.

The staff report shows how Penn Central, when unable to obtain needed financing in this country, turned to foreign markets for funds. This source of funds is an extremely important one, which we can lose if we permit a credibility gap to develop with respect to disclosure made by companies offering securities abroad. Consideration should be given to steps necessary to assure a high quality of disclosure on the

financial condition and performance of U.S. corporations whether they are dealing in domestic or foreign markets.

The staff report examines the role of the directors. The responsibility of directors is primarily a matter of State corporate law. But directors have a responsibility to see that their corporation and the management they select obey the Federal securities laws.

It is difficult to see how this responsibility can be satisfactorily discharged unless the directors themselves obtain from management information which is adequate in both quantity and quality. To be adequate, this information has to be both factual and judgmental. It has to deal with the past, present, and future. This was brought out very effectively by a new director, joining the Penn Central board in May of 1969, in a memo to the chairman of the board pointing out that lists of new equipment did not particularly help him discharge his responsibilities as a director and spelling out the kind of information about objectives and performance and about problems and plans for overcoming them which he would need to do his job as a director. Today's more sophisticated investor needs, perhaps in a broader and more general way, the same kind of picture and he is entitled to it if the disclosure process is to do as well in the future as it has done in the past in maintaining general public confidence in our securities markets. The Commission, taking a look at the future, has paid increasing attention to the role, the qualifications, the responsibilities, and the independence of corporate directors, which appear to be called for. Last month the Commission released a statement endorsing the establishment of audit committees composed of independent directors. The staff report points up the critical importance of the whole subject of the responsibility of directors, the greater utilization of public and independent directors, the professionalization of their function, providing staff support for directors and judging their performance not on the basis of hindsight but on the basis of the reasonableness of their judgments in the circumstances and at the time it was exercised.

The report also examines the way three major banks handled their obligation under the securities laws to assure that nonpublic information obtained in the course of commercial lending is not used by the trust department in its investment decisions. These institutions recognized this obligation and set up procedures, with varying degrees of adequacy, to meet it. The report points up the possibilities of conflicting responsibilities where such inside information is available to operating divisions of the institutions and the need for adequate procedures to prevent misuse of such information where this situation exists.

Lastly, the report goes into the circumstances surrounding sales of Penn Central securities by management officials during this period in connection with the question whether sales by some individuals occurred while they were privy to material adverse inside information concerning the company. If this occurred, it might involve violations of existing law, and accordingly, I express no view at this time on the question. In addition, the report's analysis of the activities of a private investment fund composed primarily of principal corporate officials and their financial advisers raises questions of possible conflicts of interest and misuses of inside information and suggests the need for consideration of additional controls in this area.



The report represents the culmination of a lengthy and exhaustive inquiry by our staff. I hope it will be a catalyst for considering significant improvements and reforms in the securities field. In this letter of transmittal, I have tried to indicate some recent improvements in our rules which are relevant to the problems brought out by this report and to suggest other measures that should be considered.

Respectfully yours,

WILLIAM J. CASEY, *Chairman.*



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## INTRODUCTION

The bankruptcy of the Penn Central Transportation Co. on June 21, 1970 came as a surprise to much of the public, including many Penn Central shareholders. Only 2½ years earlier the company had been formed by the merger of the Pennsylvania and the New York Central railroads to fanfares of optimism. The merged road was going to be more efficient and was going to produce sizable earnings. In addition, diversification into real estate development and other areas was seen as the beginning of a profitable conglomerate growth. These heady prospects sent the stock price soaring from approximately 20 in the early 1960's, when the merger was first announced, to 84 in the summer of 1968, 6 months after merger. The day after the filing for reorganization the stock sold for 6½. The loss to shareholders, bondholders, and other investors from the collapse of Penn Central is measured in billions of dollars. Many of these investors were older people who had invested in Penn Central because of its apparent solidity and its long record of dividend payments. The Commission's investigation was conducted to determine whether the events surrounding the collapse of this major corporate enterprise were associated with violations of the Federal securities laws.

## SCOPE OF INVESTIGATION

The staff undertook a thorough and extensive investigation of Penn Central, comprehending all aspects which seemed relevant to its collapse. This report is a distillation of that investigation, concentrating on certain areas which the staff determined were most critical from the viewpoint of the Commission's responsibilities.

The inquiry focused primarily on the events occurring between the merger on February 1, 1968 and the bankruptcy. However, in some instances, where the staff believed it was necessary for a full understanding of the facts, premerger conditions were also examined.

The report is arranged in four major parts. Part I involves the company's possible failure to disclose adverse information to the investing public. Within this area, the staff examined the operational and financial condition of the company and compared this with the representations made by management. The staff also inquired into many of the accounting practices of Penn Central to determine whether they provided adequate and accurate disclosure. Examination was made of the affairs of Great Southwest Corp., to determine whether adequate disclosure was made of the affairs of this important subsidiary. The role of the directors in overseeing the conduct of management and in insuring adequate disclosure was examined. The second major area of investigation, Part II of the report, relates to possible trading on nonpublic information by individuals and institutions. Part III describes the role of Penn Central's commercial paper dealer and a commercial paper rating service. The final area, Part IV, involves an examination of a private investment club in which several

Penn Central financial officers were members and which raised issues of possible misuse of position by these officers.

Nearly 200 witnesses were called to testify and approximately 25,000 pages of testimony were taken. Among the witnesses were most of the major officers and directors of the corporation during the relevant period. Voluminous documents were examined either on site or by requesting that they be submitted to the Commission's offices. Every officer or director who to the staff's knowledge had any significant trading was subpoenaed and statements obtained through affidavits or in the form of testimony. In connection with the trading inquiry the roles of approximately 150 institutions were examined through document submission or testimony. As a result of this analysis, those treated individually in this report were selected for special study.

### ORGANIZATION OF PENN CENTRAL

Because the Penn Central organization went through several changes and contained numerous subsidiaries, a brief note on the organization and the names used in this report may be helpful. When the New York Central and the Pennsylvania railroads merged on February 1, 1968 the resulting company was called the Pennsylvania-New York Central Transportation Co. The name was then changed to the Penn Central Co. On October 1, 1969 the name was changed to the Penn Central Transportation Co. upon the formation of a parent holding company which took the Penn Central Company name. For convenience, the name Penn Central is often used in this report to refer to the Penn Central complex generally. When reference is made specifically to the entity containing the railroad in a context which might be confusing, the name Transportation Co. is used. When reference is made specifically to the holding company in a context where the reference might be unclear, the entity will be described as the holding company. The Transportation Co. owned 100 percent of the common stock of Pennsylvania Co., an investment company, which is often referred to in this report as Pennco.

## SUMMARY

### RAILROAD DIFFICULTIES: MERGER AND OPERATIONS PROBLEMS (I-A)

Penn Central, despite attempts to convince the public to the contrary, was predominantly a railroad company and its future was tied inexorably to these activities. Thus, before assessing the information being disseminated to the public, it is essential to understand what was occurring in the operations area in general and more particularly the circumstances surrounding the merger itself.

The merger of the Pennsylvania and the New York Central railroads had been born out of the weakness of the two constituent parts. Despite such an inauspicious beginning, however, and the obvious dangers involved in such a situation, little thought appears to have been given to the basic feasibility. In the premerger period management had conducted a study which purported to show sizable savings through the elimination of duplicate facilities and in other areas. The study, however, bore little relation to the consequences of merger of the two roads. The merger involved more than was revealed in the study; it involved complicated and costly rebuilding of two roads into one. The resulting burden on the merged railroad would be twofold: (1) ample funds would be needed for capital expenditures; and (2) operational problems could be expected. This presented, in reality, a bleak picture because the roads had no cash for the expenditures and no planning or ready skills commensurate with the operations problems. Planning staffs were formed and consultants were hired but to little avail. There was no adequate supervision or decisionmaking in the planning process. Some departments, such as the accounting department, never even got to the meaningful planning stage. In the crucial area of operations, a detailed plan was prepared but was then abandoned just before the merger. Little or no training of employees whose jobs would be affected was conducted.

In the postmerger period, as attempts were made to combine the operations of the two roads, severe service problems materialized and the losses on railroad operations increased at an astounding rate. Management blamed the postmerger difficulties on elements beyond their control including unions, the ICC, Government in general, the necessity of continuing unprofitable passenger operations, high interest rates, inflation and the recession. Without denying that these matters had an adverse impact on Penn Central, as they had on other companies and other railroads, they do not explain the postmerger plunge. It appears that the collapse was a result of entering a complex and costly merger without adequate planning and adequate financial and management resources. Conflicts among senior management officials further complicated the problem.



## INCOME MANAGEMENT (I-B)

Absent a major restructuring of the railroad operations, the drift into bankruptcy was inevitable. The only question was the timing—how long the company could keep going. The answer lay in great part in Penn Central's ability to borrow money and otherwise finance the continuing deficits from the railway business and the ability of the company to generate earnings was a major feature which lenders would consider. For some time prior to merger, management had engaged in efforts to inflate reported earnings and, as the earnings plummeted due to merger-related problems, these efforts intensified. The devices utilized involved not only rail operations but even more importantly the company's real estate and investment activities.

In summary, all possible avenues of increasing reported income or avoiding actions which would reduce reported income were explored. Stuart Saunders, chairman of the Penn Central board, established the policy and looked to other members of the top management team to implement it. All were expected to watch for available opportunities, within their own areas of expertise. The accounting department made a substantial contribution by watching for devices whereby they might stretch accounting principles to cover novel situations, emphasizing form over substance on a number of major transactions. Accounting personnel were expected to select the accounting method that would provide a maximization of income in every possible instance. This resulted at times in the taking of inconsistent positions. In other cases top management brought pressures on the accounting department to accelerate or delay the recording of certain items in the interest of improving currently reported earnings. While it was recognized the benefit was generally only temporary and would have to be made up in the future, the hope was that by then the operational conditions would be improved. At times the pressures reached such a point that management ran into resistance from accounting department personnel who were concerned with possible criminal liability arising out of the schemes which were being suggested. And even on legitimate transactions, Penn Central was often forced, by the immediate pressures for income, to take actions because of the short term advantages, although from a longer term viewpoint the action was detrimental to the company. Reported income in these situations was a reflection of weakness, not of strength. Also relevant, considering the financial condition of the company, was the noncash generating nature of many of the earnings being recorded.

## FINANCES (I-C)

Although management was able to soften the reported losses by methods described above, they faced an enormous cash drain of approximately half a billion dollars between the time of merger and the time of the bankruptcy. This loss was an inescapable reality for management.

Much of the loss was caused by the deficits from rail operations. The payment of approximately \$100 million in dividends in the post-merger period also contributed to the drain. The borrowings needed to meet the cash drain required large interest payments in this period of high interest rates. When the borrowings reached their peak, the interest charges on the additional borrowings were approaching \$50

million a year. Cash was even needed to support Great Southwest, a real estate development subsidiary which management claimed was helping to support the railroad.

The financial crisis was known to management even at the time of the merger. Penn Central was forced into short term borrowings because most of its assets were unsaleable, were mortgaged or were otherwise restricted and Penn Central was not an attractive vehicle for long term financing. By the beginning of 1969 management realized that Penn Central was approaching the limits of its borrowing capacity and that a continuation of the cash drain would spell disaster. The drain never lessened.

The continuing cash drains created increasing difficulties for management and an increasing need to conceal the true conditions. Every additional borrowing created greater restrictions through pledges of assets and restrictive provisions in the borrowing agreements, and as the need for borrowing increased, the necessity of concealing the real reasons for the borrowings became greater. Toward the end management was faced with a potential runoff of commercial paper if the company's condition became public and with an inability to raise cash through public offerings where disclosure through public offering circulars would be required. Penn Central's last financing was done at high interest rates in foreign markets where the lenders were still willing to lend to a "name" company.

#### PUBLIC OFFERINGS (I-D)

The only public offerings of securities were made in late 1969 and early 1970 through Pennsylvania Co. (Pennco), an investment company subsidiary of Penn Central. Pennco's principal assets were large holdings of the stock of the Norfolk and Western and the Wabash railroads and the stock of the "diversification" subsidiaries including Great Southwest, Arvida and Buckeye Pipeline. Pennco had been used earlier in 1969 to raise \$35 million through a private placement of collateral trust bonds. By late 1969 much of Pennco's most valuable asset, the Norfolk and Western stock, was pledged and its large holdings of Great Southwest stock which at one time had a high value in terms of quoted market prices was rapidly diminishing in value because of adverse developments in Great Southwest.

A \$50 million debenture offering was completed in December 1969. This was easily sold because it was convertible into Norfolk and Western stock. Within 2 months of the completion of that offering, Penn Central began efforts to sell a \$100 million debenture offering. This offering was never completed.

The offering quickly encountered difficulties related to the overall problems of Penn Central at that time. The offering in its originally announced form contained warrants for the stock of Great Southwest Corp. and of Penn Central Co., a holding company which had become the parent of the railroad in October 1969. Management had hoped to delay registration of warrants until they became exercisable in the future. Penn Central had abandoned a planned public offering of Great Southwest stock in late 1969 because of the disclosure that would be required in a registration with the SEC. After doubts were raised about whether registration could be delayed, the warrants were dropped from the offering. The Pennco offering circular was under ICC jurisdiction and was not filed with the SEC.

A more serious problem developed as counsel for the underwriters began uncovering information about the railroad which indicated that it was heading for bankruptcy. Although the underwriters were going to be offering a security of Pennsylvania Co., which they thought could survive a bankruptcy of the railroad, they were aware that conditions which might so adversely affect the railroad would be important to potential investors in Pennco. They determined to obtain disclosure of these facts in the offering circular. Management initially resisted these efforts and a management official even attempted to have one of the underwriters' lawyers removed from the underwriting because of the questions he was raising as a result of the inquiry made into the company's financial condition.

Although the underwriters resisted these efforts and succeeded in getting significant disclosures in the circulars, no steps were taken to point out these disclosures in the public announcements about the offering or otherwise. Large numbers of the circulars were distributed to broker-dealers and institutional investors and copies were sent to financial publications. The underwriters were aware, however, that the offering would only be of interest to institutional investors and the adverse information in the circulars did not become generally circulated although some large institutional sellers in May 1970 had access to and read the offering circular.

Although it was unlikely from the outset that the offering could be completed, management was able to use its pendency as a part of its facade of the continuing viability of the company. The abandonment of the offering was not announced until May 28, 1970.

#### GREAT SOUTHWEST (I-E)

Great Southwest, a real estate development subsidiary, played a significant role in Penn Central's affairs. Great Southwest was touted as an example of the success of Penn Central's diversification program; Great Southwest's financial results contributed significantly to Penn Central's reported earnings; and the Great Southwest stock owned by Pennco was Pennco's major asset when valued at market prices. Penn Central, through Pennco, had acquired control of Great Southwest and Macco Corp., which later became a subsidiary of Great Southwest, in the early to mid-nineteen-sixties as a part of its diversification program. Macco quickly became a major problem because of its large cash drains which had to be met by cash advances from the railroad.

At about the time of the merger of the railroads, Great Southwest and Macco embarked on programs to drastically increase their reported earnings. The principal vehicle used was the "sale" of large properties for very large reported "profits" to syndicates of investors who were motivated to participate because of tax benefits. These transactions involved only small downpayments and principal payments deferred to future years. Typically there was no obligation that the investors continue making payments. These were essentially paper transactions which should not have been recorded as profit. These transactions were effected in furtherance of the Penn Central program of inflating reportable profits to offset losses in the railroad.

Senior Macco officials were under employment contracts which provided they would be paid a percentage of the profits reported.

Because of large profits being reported, Macco paid the officers hundreds of thousands of dollars in 1968. Penn Central management then renegotiated the contracts which resulted in the officers receiving a total of \$7 million to sign new contracts.

The real estate transactions described above were largely paper transactions and so the serious cash problem continued. In 1969 a public offering of Great Southwest stock was prepared to raise cash. The offering included a sale by Pennco of some of its holding of Great Southwest stock. Shortly before the offering was to be filed with the SEC, it was abandoned because of the disclosures which would have been required in the prospectus. It was feared that the disclosures would cause a sharp drop in the price of Great Southwest stock. This would have very seriously affected the value of Pennco's portfolio and Pennco itself was about to be used as a financing vehicle for the railroad.

By late 1969 Great Southwest was disintegrating. Changes in accounting guidelines and tax rulings were preventing further large tax oriented sales. The cash drain was worsening. In early 1970, Great Southwest, like Penn Central turned to foreign financing and borrowed approximately \$40 million in Swiss francs. The nature of Great Southwest's earnings and the problems being encountered were never disclosed to Great Southwest or Penn Central shareholders.

#### ROLE OF DIRECTORS (I-F)

Pennsylvania Railroad and New York Central directors were accustomed to a generally inactive role in company affairs. They never changed their view of their role. Both before and after the merger they relied on oral descriptions of company affairs. They failed to perceive the complexities of the merger or the fact that appropriate groundwork and planning had not been done. After the merger they claim to have been unaware of the magnitude of the fundamental operational problems or the critical financial situation until near the end. They did not receive or request written budgets or cash flow information which were essential to understanding the condition of the company or the performance of management. Only in late 1969 did they begin requesting such information and even then it was not made available in a form that was meaningful or useful.

On at least two occasions, the directors deliberately avoided confrontations with management on issues critical to testing the integrity of management and providing adequate disclosure to shareholders. On one occasion, in the summer of 1969, a law suit which claimed improper and unlawful conduct by David Bevan, chief financial officer of Penn Central, in connection with Executive Jet Aviation (effectively a subsidiary of Penn Central) and Penphil Co. (a private investment club) was brought to the directors' attention. As they were obligated to do, they authorized an investigation. When Bevan threatened to resign, however, they canceled the investigation even though the charges appeared to be well founded and later proved to be essentially correct. Without restraint Bevan continued to engage in questionable conduct including the diversion of \$4 million to undisclosed Liechtenstein interests. He also continued as the sole and important contact between Penn Central and the financial community to whom he repeatedly misrepresented the company's financial con-

dition. Even in the instance where a director was interested in inquiring into the affairs of a major subsidiary this initiative was not favorably received by his fellow directors. If such an inquiry had been made it would have uncovered the improprieties occurring in the subsidiary and the concomitant need to provide full and adequate disclosure of that entity's affairs. The directors permitted management to operate without any effective review or control and they remained uninformed throughout the whole period of important developments and activities.

#### DISCLOSURE (I-G)

The picture within Penn Central was bleak. The company's disclosure policy, however, is illustrated by a comment which other members of Penn Central management apparently made on a number of occasions—"Well, it looks like Saunders has his rose colored glasses on again." Stuart Saunders, Penn Central's chairman of the board, set the disclosure policy and made it clear that the others were expected to comply. Professional analysts spoke frequently of the "credibility gap" they discerned and of the difficulty of getting adequate and accurate information from the company.

The railroad picture was always presented by management in optimistic terms. There was a stress on the hopes and promises of the future, particularly those related to the merger, while the immediate problems were ignored. When put in a position where the immediate problems arising out of Penn Central's own limitations could not be ignored Penn Central grudgingly admitted their existence but would claim the situation had "turned the corner" and was on the upswing. Yet there was no real prospect of an effective turnaround. The basic industry problems remained, as did the financial and management limitations of Penn Central itself.

Most shareholders measure success in terms of earnings. Losses from railroad operations were running at the rate of \$150 to \$200 million per year, a rate which clearly could not be sustained for long. However, this figure was never presented to the shareholders and in other ways as well, the drain from railroad operations was downplayed. The earnings contribution of nonrail activities was emphasized. No mention was made, however, of the questionable accounting practices which had been utilized in recording many of these earnings and of various factors which seriously affected the quality of significant portions of the remaining earnings. In effect, the earnings figures being given to the public were not an accurate picture of the earning power of the corporation. Indeed, until 1970, the year of bankruptcy, the company on a consolidated basis was reporting profitable operations.

The immediate cause of the bankruptcy, and the most obvious reflection of the problems discussed earlier, was the cash drain and the inability of Penn Central to obtain additional financing. Disclosure to shareholders in these areas was marked primarily by silence, although on those occasions when Penn Central did reveal what financings it was doing, it stressed the flexibility and strength of its financing program rather than the desperation of the company's financial condition.

#### SALES OF SECURITIES BY INSTITUTIONS (II-A)

Many institutions held Penn Central stock, particularly as it approached its peak price in the summer of 1968. Most of these

institutional holdings were sold over the next 2 years as the price of the stock continued to decline.

The examination focused on several institutions where the timing of the sales and the possible access to inside information raised questions. These institutions were Chase Manhattan Bank, Morgan Guaranty Trust Co., Continental Illinois Bank & Trust Co., Investors Mutual Fund, and Alleghany Corp.

As we conducted our inquiry in this area we were faced with difficulties of proof. Regardless of such difficulties, it is important to note that in the case of at least two of the banks it is clearly established that they had inside information at the bank at the time of the sales. The banks deny, however, that this information was known to those making the decision to sell. This points up the real possibility of conflicting responsibilities and the need for procedures to prevent misuses of information reposed with a bank in a commercial banking relationship.

Our inquiry also raised questions where Penn Central and banking institutions shared common directors. One such director indicated that at times in a meeting of a committee of the bank's board he was called upon to speak about Penn Central in the presence of members of the bank's trust department. Although in this case the director stated that he provided no inside information, banks should not place common directors in such a position where they might easily disclose inside information.

#### INSIDER TRADING BY OFFICERS AND DIRECTORS (II-B)

From its extensive review of the trading of officers and directors of Penn Central Co. which took place between the merger and the bankruptcy, the staff found that a number of high corporate officials had made sizable sales during this period.

A detailed review was made of the transactions of 15 officers whose trading was deemed to raise the most serious questions as to whether it had been based on material inside information. The 15 officers, who prior to bankruptcy had sold about 70 percent of the stock they owned at the time of the merger, included officials of the finance and operating departments. These officers had apparent access to information concerning the state of Penn Central's affairs which was reaching the public only with a serious amount of distortion. This section of the report summarizes the staff's investigation of the trading of these officers, examining the timing and extent of these sales, and the reasons given for them by the officers.

As in other major companies, Penn Central had an elaborate option system for its key employees. Many of these officers exercised their options through the use of large bank loans. As this study shows, the presence of such loans can clearly distort the purposes of the option system by encouraging officers to sell when the market in the company's stock declines, even though material undisclosed information may exist at the time.

#### COMMERCIAL PAPER SALES: GOLDMAN, SACHS AND NATIONAL CREDIT OFFICE (III A AND B)

As the company's financial condition deteriorated, management relied more heavily on the sale of commercial paper as a means of

financing the losses being incurred. The company was not using commercial paper for short-term borrowing which is the customary use of commercial paper. Instead, conditions developed in a way which required that the full amount of commercial paper be continually rolled over as if it were long-term financing.

Goldman, Sachs & Co. was the sole dealer in Penn Central's commercial paper and at its peak there was as much as \$200 million of paper outstanding. While some of the buyers of this commercial paper were relatively sophisticated institutional investors, others were not. Only limited information was supplied to buyers of Penn Central paper. Even when Goldman, Sachs began receiving warnings of critical problems no additional information and no warnings were communicated to buyers. Goldman, Sachs maintains it was merely a dealer and not an underwriter and that it did not have duties of disclosure.

The sale of Penn Central's commercial paper was greatly facilitated by the receipt of a "prime" rating from the National Credit Office, the only national rating service of commercial paper. This rating was provided without adequate investigation of the company's financial condition. It is clear that NCO continued to provide the highest rating at a time when the facts did not support such a rating.

#### PENPHIL (IV)

Beginning in 1962, Bevan and Charles Hodge, an investment counselor to the Pennsylvania Railroad, formed a private investment club, Penphil Co. Its members included several other Penn Central financial department officers. The club made investments with funds borrowed from Chemical Bank. The bank made these funds available because Bevan was the chief financial officer of Penn Central and because the railroad had a substantial banking relationship with Chemical.

The investment club made investments in companies where the club had relationships which made inside information accessible to the club. From time to time, officers and directors of the companies in which investments were being made were invited to join the club.

## CHRONOLOGY OF EVENTS

1968

January 15: Supreme Court decision authorizing merger.  
February 1: Merger of Pennsylvania and New York Central railroads.  
March 30: Announcement of mailing of 1967 annual report to shareholders. Press release indicates merger proceeding smoother and more rapidly than anticipated.  
May 7: Annual shareholders meeting.  
June 21: Final of a series of drawdowns in early 1968 against the revolving credit. This brings the total to \$100 million.  
July 3: Odell writes to Saunders expressing concern about Macco.  
July: Butcher & Sherrerd releases report on Penn Central reducing 1968 earnings estimate. Because of firm's relationships to Penn Central, causes sharp decline in price of stock.  
July 15: Press release announcing no adverse changes in the company's affairs to justify the recent market action.  
July 17: Penn Central receives authority from ICC to sell commercial paper for the first time. Authorization for \$100 million.  
Summer: Service problems developing.  
September 5: Saunders speech to New York Society of Security Analysts—critical response.  
September 30: Washington Terminal Co. dividend-in-kind paid.  
October 9: Bevan memo reviewing critical cash situation and calling for cutback in capital expenditures.  
October 23: Third quarter earnings announcement. Consolidated earnings up. Company-only figures not given.  
November: Penn Central draws down a \$50 million Eurodollar loan.  
December 11: ICC approval of \$100 million revolving credit.  
December 26: Year-end statement issued by Saunders.  
December 31: Madison Square Garden transaction consummated.  
December: Sale of Bryant Ranch by Macco.  
December: Sale of Six Flags Over Georgia by Great Southwest.  
December 31: Acquisition of the New Haven Railroad.

1969

January 7: Bevan seeks financial advice from former chairman of First Boston Corp. and from consultant who was president of International Bank for Reconstruction and Development.  
January 23: Board approves plan to form holding company—announced to public.  
January: Penn Central claims this is peak for service problems.  
January: EJA withdraws application to acquire Johnson Flying Service.  
January: Penn Central discussions with Peat, Marwick and ICC relating to charging of mail handlers against the merger reserve.  
January 30: Preliminary earnings for 1968 announced. Results show consolidated earnings of \$90.3 million, up from 1967, and a parent company loss of \$2.8 million, down from a profit of \$11.5 million a year earlier.  
February 13: Penn Central issues release on results of diversified subsidiaries.  
February: Meeting with officers of First National City Bank concerning increase in revolving credit.  
February 20: Saunders' "turning the corner" claim set forth in release.  
March 1: Smucker replaced by Flannery in charge of operations.  
March 19: ICC authorizes increase in commercial paper from \$100 million to \$150 million.  
April: Flannery objects to budget cutbacks. Cites danger of affecting service.  
April 23: Penn Central announces first quarter consolidated earnings of \$4.6 million, down from \$13.4 million a year earlier. Parent lost \$12.8 million compared to a profit of \$1.0 million in 1968.  
May 12: ICC approves increase in revolving credit agreement from \$100 million to \$300 million, with \$50 million reserved to refund commercial paper.

(11)



June 4: Settlement of employment contracts with Great Southwest officers.  
 June: Sale of Six Flags Over Texas by Great Southwest.  
 June 13: Extraordinary joint finance—executive committee meeting to discuss the situation.  
 June 25: Board discusses possibility of omitting dividend, but ultimately decides to declare dividend with special meeting on August 27, to review payment.  
 July: \$35 million private placement of Pennco debentures.  
 July 28: Second quarter earnings announced. Consolidated earnings at \$21.9 million, down 7.5 percent. Railroad company lost \$8.2 million versus year earlier profit of \$2 million.  
 August 27: *Kunkel* suit discussed at meeting of Penn Central board. Investigation of EJA and Bevan approved. Bevan's subsequent threat of resignation causes cancellation of investigation.  
 September 18: Bevan diverts \$10 million of equipment loans to Leichtenstein account of Goetz in connection with EJA and other matters.  
 September 8-12: Bevan and Saunders discuss bleak financial condition and call for cutbacks on capital expenditures.  
 September: Saunders orders halt of retirement of properties until accounting authority received, thereby avoiding writeoffs against ordinary income.  
 September 23-24: Penn Central announces that Gorman named president, effective December 1. Saunders denies presidency offered to several others first.  
 September 24: O'Herron reads to board Bevan's statement on Kunkel, EJA and Penphil.  
 September 25-26: Saunders testifies before congressional committee on passenger legislation.  
 October 1: Holding company becomes effective.  
 October 20: Penn Central reports consolidated third quarter loss with 9-month earnings down substantially. Railroad lost \$19.2 million.  
 October 29: ICC approves increase in authorization to sell commercial paper from \$150 million to \$200 million.  
 October: Great Southwest offering called off because of disclosure problems.  
 November: Service deterioration noted.  
 November 7: Attorney representing Penn Central tells ICC that since merger company has failed to regain its competitiveness and remains financially shaky.  
 November 10: Odell invites all outside Penn Central directors to a dinner on November 25, to discuss financial and management problems.  
 November 12: Saunders testifies before congressional committee on passenger service losses in connection with pending legislation.  
 November 19: Saunders meets with Kirby in Alleghany offices re management problems.  
 November 26: Odell moves for dismissal of Bevan and Saunders.  
 November 29: Board of directors votes to omit fourth quarter dividend.  
 November-December: Commercial paper dealer evidences concern about financial condition of Penn Central.  
 December 1: Letter to shareholders concerning elimination of dividend.  
 December 1: Day's letter to Saunders suggesting better disclosure of railroad losses.  
 December 1: Saunders speech at staff luncheon concerning critical nature of service situation.  
 December 15: Saunders makes impossible demands for increased revenues and reduced expenses by yearend.  
 December 17: Pennco sells \$50 million debenture offerings—proceeds passed up to Transportation Co.  
 December: Writeoff of long haul passenger facilities.  
 December: Discussions concerning sale of Great Southwest stock to Great Southwest officers.  
 December-January: Bad winter weather. Later blamed for poor earnings.  
 December 31: Pennco accepts Great Southwest stock in exchange for previously created debt.

## 1970

January 22: Meeting on possible foreign financing leads later to Swiss franc loan.  
 January 27: Bevan and O'Herron approach First National City Bank about "bridge" loan in contemplation of \$100 million Pennco offering. First National City Bank asks for more security.  
 February: Discussions concerning \$20 million Eurodollar offering through Penn Central International.

- February 2: Initial contact with First Boston concerning Pennco \$100 million debenture offering.
- February 4: Penn Central announces 1969 earnings of \$4.4 million versus \$86.9 million a year earlier; railroad lost \$56.3 million versus \$5.1 million loss.
- February 5: Odell submits resignation letter to board.
- February 6: Bevan et al., meet with Gustave Levy and others from Goldman, Sachs to review commercial paper situation.
- February 12: Penn Central buys back \$10 million in notes from Goldman, Sachs inventory.
- February 13: ICC orders Alleghany to sell its Penn Central shares.
- February: "Bridge" loan arranged with Chemical Bank.
- March: Various evidences of concern with status of EJA.
- March 12: "Comfort letter" from Bevan to Peat, Marwick re: (1) EJA; (2) Madison Square Garden; (3) Lehigh Valley.
- March 12: Peat, Marwick signs opinion letter, qualified only for the failure by Penn Central to provide for deferred taxes.
- March 20: Counsel for underwriters questions possible major writeoff. Bevan denies it, but appears evasive.
- March 25: Pennco applies to ICC to sell \$100 million debenture offering—announced in press release.
- March: O'Herron tells commercial paper dealer first quarter losses will be "terrible."
- March 28: Bevan seeks removal of "troublesome" attorney from underwriting.
- March 30: Penn Central files with ICC for discontinuance of 34 East-West long-distance passenger trains.
- March 31: Meeting at Sullivan & Cromwell offices with senior officers of each of comanagers of \$100 million offering. Possible bankruptcy of Penn Central discussed.
- March 31: Wabash exchange transaction recorded.
- April 6: Decision made to drop warrants for \$100 million debenture offering.
- April 14: O'Herron tells commercial paper dealer that first quarter losses will be "staggering."
- April 14: Fred Kirby resigns as Penn Central director.
- April 22: Penn Central announces first quarter consolidated loss of \$17.2 million and Transportation Co. loss of \$62.7 million.
- April 27: Pennco \$100 million preliminary offering circular.
- April 28: Pennco announces proposed offering of \$100 million debenture. Proceeds will be passed up to the Transportation Co.
- April 30: Penn Central representatives, led by Saunders, meet with Volpe of DOT. Discuss possible assistance on equipment financing and passenger losses.
- May 4: Due diligence meeting with underwriters—indications that initial interest in issue is poor.
- May 8: O'Herron speaks with Volpe. Tells him situation more critical than revealed by management.
- May 5: Gorman calls for special finance committee meeting. Objects to various reporting practices.
- May 10: Saunders announces austerity program until Railpax program adopted. Capital spending cut.
- May 12: Annual meeting.
- May 13: Butcher & Sherrerd switches recommendation to "sell" after reviewing first quarter earnings.
- May 15: Standard & Poor's reduces Pennco rating from BBB to BB.
- May 15: Dun & Bradstreet (NCO) gives Penn Central's commercial paper a "Prime" rating.
- May 16: Revised offering circular issued, including information on commercial paper runoff. Underwriters indicate issue is expected to carry interest rate of 10½ percent.
- May 19: Saunders discusses Government guaranteed loan with Kennedy of Treasury.
- May 19: Penn Central spokesman announces he knows of no reason for the stock's decline.
- May 21: Bevan meets with representatives of Chemical Bank, New York Trust and First National City Bank.
- May 21: Penn Central notifies underwriters that it has decided not to go forward with the offering.
- May 21: Chemical Bank and First National City Bank representatives meet with Bevan. Bevan tells them of decision to postpone debenture offering and seek Government loan.

- May 23: Penn Central hits new low amid conjecture about financial difficulties. Butcher & Sherrerd who strongly recommended Penn Central in January is rumored to have liquidated its holdings.
- May 26: Bevan and others from Penn Central meet with representatives of Chemical Bank, First National City Bank, and counsel for the banks involved in the \$300 million revolving credit agreement to discuss Government guaranteed loan.
- May 26-27: Broad tape and WSJ announcement on commercial paper runoff.
- May 27: Finance committee meeting. Saunders tells Penn Central board that the debenture offering is being called off, that further issues of commercial paper will be halted and that substantial additional amounts of cash will be needed.
- May 28: Bevan and others meet with the 53 revolving credit banks about current status of Penn Central and negotiations with Government.
- May 28: Postponement of Pennco debenture offering announced to public. Alternative financing methods to be considered.
- June 1: National Credit Office withdraws "Prime" rating on Transportation Co.'s commercial paper.
- June 2: Announcement made that First National City Bank heads 73 banks applying for Government guarantee of \$200 million loan.
- June 8: Bevan, Saunders, and Perlman dismissed.
- June 10: Administrative support announced for \$200 million loan guarantee with a possible total of \$750 million.
- June 19: Administration withdraws loan guarantee support.
- June 21: Chapter 77 Bankruptcy reorganization filed.

## I-A. RAILROAD DIFFICULTIES: MERGER AND OPERATING PROBLEMS

### PREMERGER PERIOD: HISTORY

The concept of realining the various eastern roads into a small number of major systems to insure their continued economic viability, dated back many years. The poor railway industry conditions of the mid-fifties, however, gave the idea new impetus. It was under these circumstances that in 1957 James Symes, chairman of the Pennsylvania Railroad (PRR) and Robert Young of the New York Central Railroad (Central) first discussed a merger of these two roads. Alfred Perlman, president of the Central, objected when the matter was raised with him, particularly because his own view of a balanced Eastern realinement was not consistent with this merger. He agreed to further studies, but these were terminated when Young died a few months later.

Subsequently, the Norfolk & Western (N. & W.), which was a very strong road, became involved in plans to combine with certain smaller eastern lines. This would involve expansion into areas where they would threaten some of Central's major markets. Perlman looked around for another merger partner, and had his eye on the Baltimore & Ohio (B. & O.) and Chesapeake & Ohio (C. & O.). This three-road combination, he felt, would offer a balanced entity, able to effectively compete in the markets it served. However, the B. & O. and C. & O. decided to merge without the Central. It began to look like Central would be left out in the cold in the major realinements then occurring, and faced with a strengthened group of competitors. When PRR again raised the possibility of a merger with the Central and agreed to dispose of its interest in the N. & W., resolving one of Perlman's major objections to the merger, talks between the PRR and the Central resumed.

The merger discussions were often rocky. Much emphasis was placed on who would hold what management positions in the new company, as various parties maneuvered for good jobs for themselves and their associates. The situation was further complicated by personality conflicts and by the significant differences in philosophy and approach of the two roads. Blunt discussions took place, with representatives of each company expressing dissatisfaction with the management of the other company. Each felt its own officers should hold certain key positions. Ultimately, in compromise, it was decided that the PRR would name the chairman, who would be the chief executive officer, while the Central would name the president and chief operating officer. Both Perlman and Symes, who had been focuses of controversy, would be relegated to the position of vice-chairmen. After Stuart Saunders succeeded Symes as chairman of the PRR, however, he agreed to the naming of Perlman as president, in part because by this point there was no other logical candidate available.

## PREMERGER PERIOD: MERGER EXPECTATIONS

The formal application for approval of the merger was filed with the ICC in March 1962 and this was followed by lengthy hearings over the next 2 years. The thrust of the position presented by the two roads was clear. As stated by Symes in the merger hearings, the merger was necessary "to preserve and strengthen these railroads in the public interest and for the national defense, to arrest their physical deterioration of the last 15 years, and to avert possible bankruptcy." Perlman warned that if the two were not allowed to merge "their ability to compete \* \* \* will continue to decline to the point of ineffectiveness." Throughout their testimony, witnesses for the two roads stressed the poor earnings record, the resulting difficulties in attracting capital, and the detrimental effect of this on railroad operations and thus on service. The precarious position of the two roads was alluded to again and again.

Symes then described the solution to these problems. "In my opinion there are no two railroads in the country in better position than Pennsylvania and Central by reason of their location, duplicate facilities and services, and the similarity of traffic patterns to consolidate their operations and at the same time substantially increase efficiency and provide an improvement in service at a lower cost." Extensive testimony was given on how this would be accomplished through improvements in routes, consolidation of facilities and equipment, and other changes in physical operations. Projected merger savings of \$81 million per year were described.<sup>1</sup> A figure of \$75 million total was given for the required capital requirements, less disposals of \$45 million, leaving a net cost of \$30 million. Merger savings, it was stated, would provide badly needed capital.

The ICC in its opinions basically accepted these arguments. In the final ICC opinion it was stated:

We believe that with the approval of this merger many problems facing the applicants will be resolved to a considerable degree. Applicants have shown that their annual savings from the merger will exceed \$80 million after about 8 years \* \* \*. These large operating savings will go far toward compensating for the persistently low rates of return, and the increased earnings flowing from the merger should motivate the unified company to accelerate investments in transportation property and continually modernize plant and equipment. This in turn should enable the unified company to more fully develop and utilize the inherent advantages of railroad transportation in the territory served and provide more and better service, all to the ultimate benefit of the public. (327 I.C.C. 475, 501-02)

<sup>1</sup> This was the figure following a shakedown period of several years during which lesser savings would be available. An exhibit submitted during the hearings shows the following sums (in millions):

	Savings	Net savings
Years:		
1.....	\$6.7	\$3.4
2.....	26.6	14.0
3.....	51.3	33.7
4.....	67.2	43.4
5.....	81.6	68.8
6.....	81.6	74.1
7.....	81.6	77.9
8.....	81.6	78.4
9.....	81.6	81.1

Note: The difference between the 2 figures represents costs of joint facilities and employee protection agreements.

### The opinion further stated:

We do not mean to imply that merger is the magic touchstone of success—too many other elements are essential: research, progressive technology, salesmanship, alert management willing to face today's problem on a realistic basis, etc. But this merger will enable the applicants to more effectively handle the external pressures with which they must daily contend in fulfilling a large part of the requirements of the public convenience and necessity in transportation. The economies it makes possible can be converted into the greater return needed by the applicants to attract investment capital, to maintain and improve service essential in commerce and industry, to recapture diverted traffic and to avoid further loss of traffic to other carriers. (327 I.C.C. 519)

The position of the two companies has been presented in some detail in this section because of its disclosure implications. First, it illustrates management's comprehension of the basic problems facing these companies and its ability to describe them clearly when it was advantageous to do so. As conditions deteriorated in the postmerger period, it might be noted, no comparable effort was made. Secondly, the promised solutions led to high expectations on the part of the public. This was reinforced by frequent references in analytical and research material of the period. What was not made clear, however, was that, while the problems were understood, the proposed solution had not been thoroughly examined.

### PREMERGER PERIOD: PLANNING

No consideration was given in connection with this merger to the broad question of realignment of the Eastern roads or whether this was the best merger for the two roads. They were, in effect, the leftovers, after other combinations had been individually arranged. Furthermore, little consideration appears to have been given to the question of whether this particular merger would work at all. Certainly the combination of two already ailing and financially weak roads raises questions as to feasibility and in this situation the possibility also existed that the size and complexity of the merged company would preclude manageability. Although this latter possibility was lightly dismissed by both Perlman and Symes when raised in the merger hearings, the intermanagement squabbling already apparent at that time did not bode well for the future.

The basic source document used during the merger hearings, which purportedly reflected the economic justification for the merger, was a report which became known as the Patchell study. This was never intended to be used as an actual operating plan but represented a document assembled rather hastily by the staffs of the two roads for the specific purpose of having some sort of "plan" to present to the ICC. It dealt with such matters as which routes should be adopted, how terminals and other facilities should be consolidated and other matters of physical coordination and the projected savings related thereto. The study had a theoretical, rather than a practical, orientation, claiming to show what the merged company would look like, assuming that the very short past period used as the basis for the projection accurately reflected the companies as they then existed. As it developed, however, many of the assumptions on which this rather simplistic study was based were unrealistic. In a recent assessment of the situation the ICC reported:

The estimates, plans and predictions of railroad executives presented at the hearings before the Commission in the early 1960's appears to bear little relation to the savings, costs, investments and operational changes which Penn Central claims in its reports to have actually realized. We realize that conditions change; however, there appears so little correlation between the claims and the realities as to seriously question whether a realistic merger plan ever existed.

The conceptual weaknesses reflected in that report would, of course, also be present in the original decision to merge, which preceded the submission of the report. It should be noted too that the Patchell study was a critical document in the ICC's consideration as to the feasibility and advisability of the merger.

By the time ICC's approval was obtained, two decisions had been made which many people have suggested sealed the doom of the company. Neither had been contemplated at the time of the original proposal. First, in May 1964, the two roads reached an accord with labor, the Merger Protective Agreement, whereby they, in effect, bought the cooperation of the unions, which had been opposing the merger. The result of this agreement would be to cause the company to incur costs far above those anticipated in the Patchell report and thus limit the savings projected. The second factor was the decision of the ICC to force the New Haven Railroad on the Penn Central, adding still a third financially and operationally weak road to the group.

The hearing examiner's initial report recommending approval of the merger came down in 1965, with the ICC's decision issued on April 16, 1966. The merger now appeared imminent.

Saunders has described the Penn Central as the most complex merger in the history of the United States. Thorough planning was obviously essential. It was reported to the PRR board in late 1965 that:

For us these are uncharted seas and all of these tasks demand a considerable expenditure of time and forethought in anticipating problems to be encountered in doing a job which had never been done before on anything approaching this scale.

Yet from the beginning, it appears, this effort was doomed. The problems faced, most of which have been noted previously, were overwhelming. The complexity and the dispersed nature of the two roads made the task of combining their activities difficult under the best of circumstances. And these were not the best of circumstances. The facilities and equipment of both roads were seriously rundown. Major infusions of capital were needed but the cash situation was critical and no such funds were available. And the conflicts between the officers and staffs of the two companies which had first surfaced at the highest levels of management were now appearing at lower levels as well.

Shortly after announcement of the hearing examiner's initial report, Saunders and Perlman called a top level staff meeting announcing they had designated themselves as the merger steering committee, and that all merger plans to date, generally dating back several years, would be scrapped and a fresh start made. A merger coordinator was named for each company and intercompany committees were established in the various functional areas, to work jointly in developing plans. The theory, as reported to the PRR board, was as follows:

The aim is not to fit one organization into the mold of the other, but to take what is best of each, or formulate something new so that the merged company will be

superior to either of its components. To this end, the focus has been on the essential functions performed by each department. Once it is decided just what is to be done, the organizational structure best suited to the job will be adopted.

However, the sharp personality conflicts and fundamental differences in philosophy were in many instances seriously interfering with the planning effort. While the decision had been made to seek the "best method" in all circumstances, among those with differing philosophies, who was to decide what was the best method? As long as the two roads remained independent, one side was not in a position to impose its decisions on the other and the problem was increased by the fact that no one knew which "side" would hold various critical management positions after merger and would thus be in a position ultimately to make the decision. Even as between Saunders and Perlman, the only two officers named prior to merger, it was unclear at that point how the postmerger lines of power would operate. All in all, there was no one able to take effective control and give direction to what was obviously a very difficult situation. And so, critical preparatory work was not done. The later repercussions would be disastrous.

While the planning purportedly went as hoped in some areas, in others it definitely did not. Among the areas where there were serious deficiencies were: (1) operations, encompassing the running of the railroad itself; (2) marketing and sales; and (3) finance, which included accounting, financing and computer operations. Obviously, these three activities would be at the heart of Penn Central. The other activities would be peripheral.

Of all the functional departments, only the financial department refused to cooperate in the overall effort of the merger-planning group. The chief financial officers at both roads were strong personalities and the attitude of the two departments was apparently that one side or the other would survive in the merger and implement its own approach. Since no one knew who the boss would be until after the merger, basic problems were left unresolved. Some minimal effort was made within the financial departments to deal with the most obvious and immediate merger problems, but there was no genuine planning. The disagreements between the computer organizations were particularly acute.

In the marketing area the problem was somewhat similar. While they cooperated in the planning effort, there was a basic conflict in the marketing philosophy of the two companies, with two rather extreme positions represented, and the repercussions and uncertainties related to this situation continued long after the merger was consummated. Before the matter was resolved, almost the entire New York Central marketing organization had left Penn Central.

The combination of operations of the two railroads was, of course, the crux of the merger. As indicated earlier, the original Patchell report was not an adequate base for actually implementing the merger, and a group was assigned to work out an implementation plan. One person from each road was put in charge and they had a large full-time staff working on the combination. After extensive work, this group prepared a six-volume master operating report, which they planned to present to Saunders and Perlman at a meeting in November 1967, shortly before the merger.

The assigned task of the group was to provide for an orderly step-by-step transition from a two-railroad facility into a one-railroad



facility, and their report represented the culmination of 2½ years of effort. However, Perlman, apparently with support from Saunders, wanted rapid implementation of the merger so that merger savings might be achieved as rapidly as possible, while the merger-planning staff favored a somewhat slower approach in order to ease the problems of transition. Instructions were issued in early November to revise the sequence of construction projects contemplated by the master operating plan to accelerate savings in the first 2 or 3 years. And a few minutes before the plan was to be submitted at a meeting on November 28, Perlman ordered all copies marked "Preliminary". The marked copies were distributed at the meeting, then gathered up, and apparently permanently laid aside. As one individual closely involved with the situation assessed it:

We were in the same situation as if we had planned the invasion of Europe without having General Eisenhower named until D-Day . . . Here we have a plan which has never been said, "This is it, do it this way." The man who was going to run the railroad has not said, "This is what we're going to follow."

The future impact of this report can be judged by the fact that Perlman at the time of his testimony before the SEC staff apparently did not even recall its existence. Saunders recalled its existence, but claims never to have seen it (although it is clear from the testimony of others that he did). He indicated that this area was Perlman's responsibility as chief operating officer and that he knew there was a plan and assumed Perlman was following it, although he never asked, even after severe operating difficulties developed in the postmerger period.

The master operating plan was merely a plan for implementation. Little actual implementation was carried out in the premerger period, either in the preparation of physical facilities or in the education of employees for the changes which would be brought about.

It was understood before the merger that there would be chaos if employees were not adequately prepared when M-day arrived, yet minimal attention was directed to this problem. Some witnesses have claimed such training prior to merger was impractical; others suggested that more could have been done if more firm decisions had been made in the operations area prior to merger, so that there was a clearer idea of where the road was going and what had to be done.

Five years passed between formal application to the ICC and the final merger. During this period few of the projects necessary to physically combine the two roads were carried out and thus on merger date there were still basically two separate roads. To a considerable extent, the reluctance to invest money in merger projects was understandable, since the merger was not a certainty. Furthermore, money was scarce. On the other hand, there is evidence that certain modernization projects, in particular, would have been carried out earlier, on their own merits, as advantageous even if the merger did not ultimately go through, if the management of one road had been able to impose its decisions and philosophies on the other. Thus, even at the end there were projects in dispute, with the final determination dependent on who would be "boss" in the combined road.

#### POST-MERGER PERIOD: SERVICE PROBLEMS

With the fundamental problems which originally led to the merger proposal still extant, Penn Central was burdened with a new series of

problems arising out of the merger itself. As suggested in the earlier discussion, the merger was questionable in theory and poorly planned. Now it was poorly implemented and when things fell apart operationally, as they almost inevitably would, considering the circumstances, management proved itself incapable of straightening them out. As a result, the new company found itself faced with the double-barreled disaster of substantial losses of business and extra costs.

In attempting to understand the operating situation, the staff took extensive testimony from Penn Central personnel. The picture that emerges is one of confusion and chaos. Directly conflicting testimony was received on virtually every major point, strongly suggesting that no one really grasped what was going on. The lack of planning and the hostility personnel from the two roads felt towards each other interfered with the orderly flow of information, while major officers appeared to lack the capacity to assess the information that was being received.

The following discussion focuses on two major areas—the problems which arose in the physical operation of the Penn Central in the period after merger, and the financial effects and implications of these problems.

During the initial months following the February 1, 1968, merger, things were in a state of confusion at headquarters. Part of the top management group was located in New York and part in Philadelphia. Personal relationships were still in a fluid state and responsibilities were not clearly delineated. There had been serious conflicts between the two organizations during the premerger planning period and, with several years to fester, there was no reason to anticipate that the problems would be suddenly resolved because the companies were now merged. Many management-level people, who were unhappy at the decisions being made and the people they would have to work with, were leaving Penn Central, depleting the executive ranks.

Out in the field, for the first few months, physical integration of the two roads was limited because necessary connections had not been made. Thus, physically they were handled as two separate operations, as before the merger. However, they did operate now under one name, not retaining their separate identities in relationships with shippers and other railroads. This caused initial problems and when, in the summer of 1968, the first large-scale attempt was made to combine the roads physically, major service problems, far beyond those anticipated or planned for, developed. Management admits that at least by late summer the situation had reached alarming proportions, and over the ensuing months it got worse.

Perhaps the best way to summarize this complex area is to quote from documents prepared at the time by company personnel. One officer, in a speech given to a group of shippers in March 1969, described the situation as follows:<sup>2</sup>

This period of transition from two railroads to one harmonious system has not been easy. One of the reasons for our difficulty can be found in the size of the plant itself. While our lines paralleled each other in a number of areas and we shared many common points, the Pennsylvania and New York Central systems were not complementary. Our separate yards did not have the individual capacity to handle the combined business of the two railroads, and we have had to keep several yards in operation until combined facilities can be built.<sup>3</sup>

<sup>2</sup> It should be noted that both this document and the following one were prepared for the public and thus carefully worded to minimize the unfavorable aspects.

<sup>3</sup> According to the ICC, one major source of difficulty was that traffic from both roads was in fact directed into one facility, which lacked the capacity to handle both.

Our separate communications systems were not compatible and this complicated some of the service problems created by the merger. This situation has been aggravated by confusing routing symbols, particularly from off-line sources. For example, a car routed Penn Central-Cincinnati that should have gone to the former Central yard in Cincinnati often has ended up in the old Pennsylvania yard and frequently its waybill papers went astray as well. In addition, employees of the former Pennsylvania were not familiar with the properties and procedures of the former New York Central, and vice versa. A great deal of cross-pollination had to take place in the process of finding the most efficient way to handle traffic.

An internal memorandum prepared about the same time and intended for use by top-level management personnel as a basis for response to numerous press inquiries about the road's "lousy" freight service relates the following:

From the beginning of merger discussions it was recognized that it would be necessary to continue parallel operations over the lines of the two former railroads until terminals could be integrated, connections constructed, and yards expanded along principal routes. Before the merger was consummated, arrangements were made with our principal connecting carriers that blocking of traffic and interchange would continue as before merger, with gradual changes to be made as construction and operational arrangements were completed to permit integration on an orderly basis. For a while following merger, operations were maintained in accordance with this plan, and deterioration set in only when there was a relaxation in the preclassification and delivery arrangements at major gateways, such as St. Louis and Chicago. The problem was unintentionally compounded when shippers began to route their freight "PC" rather than via "PNYC(P)" or "PNYC(N)" thereby failing to direct their traffic to one or the other of the former railroads.

The principal effect of these changes was to create congestion and confusion at major gateways and to shift the classification functions of those terminals to internal yards, thus spreading the congestion eastward. This initial disruption triggered a number of collateral effects: It widened the margin for error by clerical personnel who were unfamiliar with stations and consignees to which they were routing traffic; it disrupted the cycling of locomotives and thereby produced sporadic power shortages; it placed an unmanageable tracing demand upon a data processing system already beset with the problems in incompatibility;<sup>4</sup> it caused separation of cars from billing as emergency steps were taken to clear congested yards; it prompted short-hauling of Penn Central, thereby increasing the switching burden at interchange points with other eastern carriers—and as these adversities snowballed one after another the speed and reliability of our service deteriorated steadily.

As suggested by the paragraphs quoted above, the immediate problems experienced by Penn Central could be traced in large part to the inexperience and lack of training of its personnel. When questioned about this, certain witnesses pointed out that new classification manuals, with revised routing, had been prepared for yard employees in the premerger period.<sup>5</sup> It is clear that little else had been done to meet problems of this nature. As the situation deteriorated, efforts were made to step up training and education, but the decline continued. Eventually, with the passage of time and still more strenuous educational efforts, some degree of control was obtained over the activities of yard and other field employees. However, internal documents show that substantial residual effects of these problems remained well into 1970.

Penn Central was also taking other steps to improve the chaotic situation. A crash program was instituted to increase compatibility of the two computer systems, so that the masses of misdirected cars

<sup>4</sup> As noted earlier the computer area was one where there had been strong conflicts in the premerger period, seriously limiting planning efforts.

<sup>5</sup> However, as one witness put it, if a yard clerk, who for 20 years had relied on his memory to correctly direct cars, suddenly had to go through a manual for each car that came along, he would soon have cars backed up all the way from Indianapolis to Kansas City.

could be located.<sup>6</sup> By mid-1969 there was apparently some improvement in this area. A program to engage the assistance of connecting lines and shippers in directing traffic to the yards which Penn Central had selected met with only very limited success. Former officers have indicated to the staff that it was unrealistic for the company to have expected shippers to uniformly follow their instructions to route traffic as "PNYC(P)" or "PNYC(N)." And there is testimony that some officers questioned, even before the merger, management's easy assumption that they had enough clout with the connecting lines to force them to send traffic to the yard which Penn Central had designated for that class of traffic, even though it might be cheaper or more convenient for the connecting line to use the other local Penn Central yard. In addition, just as the confusion and bottlenecks caused a snowballing effect within Penn Central, these factors may have also been a contributing factor with the connecting lines whose employees felt their carelessness would scarcely have an effect on the massive congestion that already existed in Penn Central's yards.

The problems were not limited to the shortcomings of field personnel. Despite the complexities involved, Perlman was operating on a very informal, ad hoc basis in running the railroad and implementing the merger. The Patchell plan was acknowledged to be unrealistic and Perlman himself had scuttled the master operating plan. Route and terminal selections which looked good on paper proved unfeasible in actual practice. And so something else would be tried, and then something else again, in the search for suitable solutions. Throughout this chaotic period, the merger acceleration program, which Saunders and Perlman had favored, continued, yielding new changes before the old ones had been adequately coped with.

Policy differences remained and the propensity of operating personnel to criticize the practices of those from the "other road" increased as the situation deteriorated. Perlman and David Smucker, executive vice president in charge of operations and a former PRR man, clashed frequently. Ex-Central personnel were strongly critical of the old PRR facilities, indicating they were completely out of date and that significant infusions of capital would be necessary if the Penn Central was ever to become a profitable road. The PRR group on the other hand claimed that Perlman was more interested in building railroad yards than he was in running a railroad, and there was skepticism concerning the savings being claimed on some of these projects. One focal area of dispute was the necessity of a new yard in Columbus, Ohio. This project was strongly supported by ex-Central employees while the PRR personnel felt it was unnecessary or extravagant. It became virtually a symbol in the continuing battle between the two groups and at one point the conflicts reached such a pitch that Basil Cole, Saunders' assistant, seeking an objective opinion, met to discuss the plan with an ex-Central operating man who was now with another road and thus felt to be somewhat removed from the battlelines.

In early 1969 Smucker was replaced as chief operating officer because of the unsatisfactory service record of the new company. This was done at Perlman's insistence but with Saunders' agreement. What Perlman did not know was that Saunders had also decided to replace Perlman. Smucker testified that during this period Saunders told him:

<sup>6</sup> The computer problem was also linked to inexperienced personnel, which resulted in errors in input.

I'll be rid of Perlman within ninety days; he's the worst enemy I've ever had in my life; he's cost me untold millions of dollars; I didn't want him in the first place and I'll get rid of him; you can have my word of it; I'll be rid of him in ninety days.

However, Saunders could not accomplish this task. Penn Central's condition by this point was well-recognized in the industry and although he tried, Saunders could not get any suitable railroad executive to take the job as top operating executive.

Management has indicated on several occasions that the service problems peaked in mid-January 1969 and that there was significant improvement thereafter. Saunders was apparently getting information to this effect from his operating and marketing people,<sup>7</sup> although it was of course in their own self-interest to make such claims. As Smucker put it:

[Perlman] was characterizing the operation as being very poorly handled and very badly done and at the moment I was no longer in charge of it, Mr. Perlman was characterizing the operation as having been vastly improved and the subject of compliments instead of complaints and this sort of thing.

Smucker, who was put on Saunders' staff after he was replaced as operating head, indicated that Saunders would ask him if these purported improvements were real and that Smucker would point out that there were still significant problems.

It would appear from the testimony taken that there was perhaps some success in overcoming the merger-related service problems after early 1969, although it is unclear how much of this represented real improvement and how much of it was simply an improvement in weather conditions.<sup>8</sup> At any rate it is clear that the pace of improvement was disappointing. One witness, who is currently a Penn Central officer, but was with connecting roads in 1968 and 1969, recalled only poor service throughout. Another officer, also new with the company, held a series of meetings with large shippers in April 1970, to get their comments on Penn Central's service. "We got an earful. We really did," he reported.

In about January of 1969, Penn Central had undertaken a major public relations program aimed at shippers. The reason was obvious. Penn Central was losing vast amounts of business from irate customers who were turning to other modes of transportation whenever possible. To prevent further diversion, to recapture lost business and to offset critical articles appearing in the press, Penn Central went on the offensive. This program included a series of press releases, noting improvements in facilities and equipment, and a number of visits by high level management with major shippers, in which the officers described what was being done to improve service and beseeched the customer to give Penn Central another chance. To some extent management apparently succeeded in this recapture program, although it was recognized that henceforth these customers would be very sensitive to inadequacies in service and, thus, the road's task would be doubly difficult. This doubtlessly meant increased costs.

Nonetheless, there remained numerous complaints from shippers and from connecting lines, whose own customers were complaining to them about Penn Central's inadequate service. When groups of shippers or traffic men from other roads gathered, the discussions

<sup>7</sup> Actually, according to notes taken in staff meetings he was getting information that the situation was improving even during the mid-December to mid-January peak.

<sup>8</sup> Winter weather regularly caused service problems.

would turn inevitably to Penn Central's poor service. And the company's complaint files were voluminous—although these files contained only the written complaints, while most were oral. A number of the letters were sarcastic. One writer indicated that fifteen years ago his business had been located on the New Haven line and the service was terrible. "We all know what happened to that railroad,"<sup>9</sup> he added. After a change in location to a spot on the Central line, service had improved but now, with the merger, it was worse than it had ever been on the New Haven and "I can only say that I hope your railroad survives." Another shipper suggested that the company put some of its dispatchers and car handlers into a boxcar headed for the west coast with just enough food to last the scheduled trip, indicating that they might well be more sympathetic to the shippers' problems upon their eventual arrival at the intended destination. Some complaints were more gentle, but still to the point. How could Penn Central hope to compete with those providing far superior service? some asked. One shipper noted that he had been sympathetic toward the road's problems in the past and often turned the other cheek, but his customers were unfortunately not so understanding and forgiving about the delays. Would management please consider the enclosed list of past deficiencies? he asked. Another customer suggested that while the road had explained his complaints of the prior winter away on the basis of winter weather, it was now summer and things were still bad.

Management became quickly aware of the physical aspects of the service problems. That information did not have to be generated internally—complaints from the outside told the story. An understanding of economic aspects however developed more slowly. In the first few months after merger, management had only a weak grasp of major segments of its cost and revenue situation. There was no prior history as a combined company to serve as a basis of comparison. Managers were in some areas unfamiliar with major sections of their operations, because of the addition of facilities of the other road, and therefore were not in a position to effectively control costs. Techniques which had formerly been used on the two roads for estimating revenues presented difficulties when the two roads were combined, making for distortions in the figures. While the calculations of actual revenues were amended in light of these problems, the forecasts were not, adding to the confusion. Reports from the field were being received in two formats depending on whether it was former Central or former PRR territory. Complaints by high level management about the unreliability of the profit figures, particularly in 1968, were frequent.

These problems were compounded by disputes between the staffs of the two roads as to the accounting system, which led to substantial delays in getting a combined system instituted. The PRR system, utilizing responsibility accounting, was ultimately adopted, but not without considerable confusion. One official complained in an October 1968 memorandum:

It is unfortunate that we are enmeshed in all of the problems of unifying the accounting at the same time as our need for cost control is so great. . . . [A] gap between the way the railroad is operationally organized and the way it is being accounted for leaves quite a few holes and quite an opportunity for passing the buck.

<sup>9</sup> It went bankrupt.

Perlman, who at the Central had used another accounting system, made no attempt to hide his dislike for the system adopted. This led to complaints by him that he was not being given the information he needed to do his job effectively, a claim which is disputed by other officers. He also indicated that he was disturbed and confused by the fact that the earnings figures as they were distributed to the public, did not agree in content with those which he was receiving internally.

About once a month Saunders held budget committee meetings with his top operating and financial officials to discuss current results. These were measured against established budgets or more frequently, as the pressure of events rendered the budgets of limited value, against a series of relatively short-term forecasts, concerning basically the current quarter.

One participant described these meetings as consisting principally of strongly worded exhortations to do better. As the initial postmerger confusion settled and the situation was clarified, Saunders was highly unhappy with company results, and demanded to know why. Many of the problems appeared to lie with lower than anticipated revenues,<sup>10</sup> which the marketing people attributed to poor service, a responsibility of the operating department. The operating people would respond by explaining the poor service on the basis of bad weather, lack of money to maintain equipment, slow orders because of poor track, and so forth, and so forth.<sup>11</sup> One witness summarized these budget committee discussions:

You could cut a record, and rather than have these meetings, just play this record over again, all of which [problems] were real. The fact of the matter was that the railroad was in a hell of a mess.

The financial situation continued to deteriorate. It was not merely a question of profits. The cash situation was critical, and the railroad losses were a drain. The exhortations grew stronger. The emphasis was on what *had to be done* rather than what *could be done*. Saunders demanded that operating officers cut costs, generally by a specific amount or percentage, which he had arbitrarily selected. Often these orders came very shortly before the end of a quarter, with instructions to cut  $x$  dollars, for example, before the end of the quarter.<sup>12</sup> High level operating personnel indicated that these instructions were generally completely unrealistic, especially in light of the very high ratio of costs which were fixed over the short term<sup>13</sup> and that in effect no attempt was made to comply with them fully, although

<sup>10</sup> This is a particularly damaging feature in the railroad industry with its high ratio of relatively fixed costs, since a high proportion of lost revenues work their way down to the profit.

The master operating plan had contained projections of ton miles, based on certain gross assumptions as to rates of growth, specifically growth of 2.9 percent and 2.6 percent from 1966. Instead, Penn Central's figure in 1969 was 8 percent below 1966, according to ICC calculations.

<sup>11</sup> The latter two items reflected a perennial lack of adequate maintenance and repair which had indeed by this point reached very serious proportions.

<sup>12</sup> As will be discussed later, this is part of a broader pattern of last minute attempts by management each quarter to find some way to report respectable earnings.

<sup>13</sup> No one denied the cost figures contained excessive items. The objections lay with the nature of the crash program being instituted to cut costs. Paul Gorman, who was hired principally on the basis of his reputation for cost control, indicated that the bulk of operating costs relate either to the labor factor or to repairs and maintenance. He felt that there was little room for improvement in the maintenance area, since the equipment and plant was already in poor condition. In the labor area efficiency was not good and there were many excess people on the payroll. However, under the labor agreements they had tenure for life and there was no way of getting rid of them except by buying them off, delaying the impact of any financial benefit.

some cuts were made.<sup>14</sup> To have made the cuts ordered would have destroyed service, they stated.<sup>15</sup>

Although the instructions to cut costs which were sent by the operating personnel into the field indicated that they were not to let such cuts interfere with service, this was more easily said than done. In November 1969, several memorandums appear in Penn Central's files indicating that service was deteriorating seriously and that complaints were increasing. Problems cited included late arrivals of trains, missed connections, cancellation of regular trains and switching services, delays in yards, car shortages, shortage of power, yard congestion, misclassification of cars, and other problems similar to those which had plagued the company in the immediate postmerger period. Some regional managers, it was noted in these memorandums, were publicly attributing the deterioration in service to the severe budget restrictions which had been ordered. Renewed instructions were issued that while costs were to be trimmed, the managers were not to let this interfere with service. There was concern expressed that inadequate service could lead to further loss of customers, who could not this time be wooed back.

On December 1, 1969, Paul Gorman became the president of Penn Central. Unable to find a railroad man to take over operating responsibility in what was obviously a failing situation, Saunders and the directors finally went outside the industry. Gorman, a cost-control expert who knew little about the railroad business when he arrived, was appalled by and completely unprepared for the situation in which he suddenly found himself.

In the latter part of December and early January there was severe winter weather which the company blamed for a considerable part of the very poor first quarter 1970 earnings. Again, the precise impact of such a factor cannot be gauged. While it perhaps did have some impact, a road operating in the Northeastern part of the United States which cannot financially withstand a poor winter is indeed in a precarious position. Furthermore, it should be noted that unusually bad weather was also used as an excuse the previous winter and that second quarter 1970 results were relatively no better than first quarter results.<sup>16</sup>

Meanwhile, as the financial condition of Penn Central degenerated, the railroad's capital expenditure program, which, because of financial limitations, had been inadequate to maintain equipment and facilities for many years, deteriorated still further. In mid-1969 orders went out to see what capital programs already under construction could be halted to conserve cash.<sup>17</sup> While a capital expenditure budget for 1970 was prepared, it was not even sent to the Board because of lack of funds.<sup>18</sup>

<sup>14</sup> Gorman related his initiation at his first budget committee meeting, 2 weeks after he had started with Penn Central. It was mid-December and Saunders was ordering a \$20,000,000 increase in revenues and \$10,000,000 reduction in expenses before the end of the quarter. Gorman, in amazement, asked him to repeat the statement, then announced it was not realistic, but that he would look into the matter and see what he could do. A few days later he reported back that he could cut \$100,000 or so, but that was all there would be. In his testimony before the SEC staff, Saunders did not recall making such statements and indicated that such orders would not be realistic, that there was "no way in the world" that this could be done. However, there are several witnesses who do recall this and other budget committee incidents clearly.

<sup>15</sup> By this point even some of the directors were expressing concern that the extreme cost cutting measures being contemplated would damage the road.

<sup>16</sup> The term "relatively" is used since the first quarter is generally the poorest quarter of the year because of seasonal factors.

<sup>17</sup> One immediate target suggested by the PRR people was the Columbus yard, but it was virtually finished by this time.

<sup>18</sup> This did not of course completely stop the flow of funds into capital projects but eliminated all but those immediately essential.



The events described in this section are illustrative of the problems that faced Penn Central. Here was the largest railroad in the United States, faced with what Saunders described as "the most complex merger in the history of this country." The company had three principal officers—Saunders, Perlman, and Bevan. Saunders had come from the N. & W., one of the most profitable railroads in the country, to head the PRR and later the Penn Central, with its multitudinous problems. He was a lawyer by profession, not an operating man. His special assistant characterized his special talent as problem solving but it is clear that he was unable to solve the biggest problem of them all, the railroad itself. His expertise did not lie in this area and he was unable to cope with such problems. His solutions lay with exhortations and completely unrealistic demands, not of much aid to the fundamental problems facing this faltering railroad. The second major officer was Perlman, who was an operating man with a respected reputation. He had salvaged several faltering roads. However, his ad hoc techniques and the very personal role he took in running the railroad proved inappropriate for the sprawling complex that was Penn Central, further contributing to the chaotic situation. Saunders' solution to this "problem" was to search for a replacement for Perlman. But, with the company's future so dismal, he could not find a topnotch operating man who would take the job. The third major officer was David Bevan, the chief financial officer, who had originally aspired to have Saunders' role as chairman of the PRR, prior to the merger. He was bypassed. Bevan had carved out his own little empire, focused on financing and diversification. His interests apparently lay principally in diversification, and he was ready to starve the railroad which he felt was unprofitable and held no promise. In the meantime he was off on frolics of his own, involving him personally in very questionable situations. In his areas he kept the information very much to himself, giving fuel to the claims of Saunders and Perlman that they were being provided with inadequate financial information.

With these three individuals, all pulling in opposite directions, it is not surprising that the outcome was chaos. Compounding the confusion was the imposition in the operating hierarchy of two former PRR officers in the positions immediately subordinate to Perlman. Each had no confidence in the ability of the other. Under these circumstances, it was not surprising that Saunders, the consummate optimist, faced with conflicting stories on the operating situation on nearly every point, chose to believe the most favorable. Yet, even Saunders seemed to recognize reality because, when faced by the SEC staff with blatant examples of his "overoptimism", he denied they happened, pointing out that the position attributed to him was unreasonable and unrealistic. Yet, it is clear that they did happen and that the same general attitudes were reflected in information being disseminated to the public.

## EARNINGS RECORD

### INTRODUCTION

The basis for the merger, as indicated earlier, was the promise of substantial operating savings from the combining of the two roads. While it was recognized that there would be some offsetting costs initially, the magnitude of the problems which would develop, and

the accompanying costs, was grossly underestimated. The result was a sharp plunge in the reported results from railroad operations.

#### MERGER SAVINGS AND COSTS

In response to an item on the Merger Performance and Status Report,<sup>19</sup> requiring the company to report to the ICC the net effect on revenues and net income of actions taken under the merger, Penn Central reported that it was "difficult to identify and evaluate merger related projects and activities separately from all other projects and activities of this company." Nonetheless they did make such calculations, showing savings of \$22½ million in 1968 and \$52 million in 1969. These figures were well above those predicted for the postmerger period in either the Patchell report or the master operating plan, fueling public statements that the merger was progressing well. The company did not, of course, purport to be operating under either of these plans, but under an ad hoc, accelerated schedule involving substantial extra costs. Furthermore, skepticism has been expressed as to the accuracy of the figures, since the interpretation of what constitutes a merger saving appears to leave a great deal of room for discretion and varying interpretation.

While there were certain merger-related charges which did not impact the income account—e.g., capital expenditures and costs which Penn Central got permission from the ICC to charge against a special reserve<sup>20</sup>—there were other items which did affect the current income figures. According to company calculations, these totaled \$75 million in 1968 and \$15 million in 1969. Calculations of such costs present the same problems of determination as do the savings figures, and it is clear that it is not feasible to obtain definitive figures suitable for public dissemination. Furthermore, it appears that Penn Central calculated the figures on a different basis in each of the 2 years to show the results which it desired to show. While it is clear that the effects of merger-related service problems caused the newly formed company to incur very substantial costs which had not been anticipated in the premerger period, only the 1968 figures attempted to take into account this element. In 1968, Penn Central, seeking to explain away disappointing earnings figures on the basis of allegedly temporary factors, included in its \$75 million figure, \$33 million in revenue losses due to service impairment, \$15 million in extra per diem costs<sup>21</sup> due to yard congestion, and \$15 million in overtime labor costs in excess of normal levels. While the problems continued in 1969, Penn Central's \$15 million cost figure included no adjustment for the three service impairment items described above. By year-end 1969, Penn Central was seeking a bright spot in the seemingly dreary railroad picture and wanted to show net merger savings, so low cost figures were advantageous and these items were ignored. Thus, in 1968 the calculations showed net merger costs of \$52 million charged to the income statement, while 1969 showed net savings of \$36 million. Clearly, there had been no improvement on that scale.

<sup>19</sup> Penn Central was required to submit such a report to the ICC annually for 5 years after merger.

<sup>20</sup> See discussion of merger reserve at p. 42.

<sup>21</sup> Per diem costs are charges which one railroad pays for the use of cars of another railroad.

## THE ICC STUDY

In assessing the conditions leading up to the failure of Penn Central, the staff of the ICC's Bureau of Accounts made a comparative evaluation and study of the income pattern of Penn Central and other large eastern roads, covering both the premerger and postmerger period. On the basis of this the Bureau concluded that the decline in railway operating performance of Penn Central in the postmerger period was the primary cause of the failure, attributing this to a rapid decline in both market share and absolute levels of freight volume, at a time when other comparable roads were showing increases.<sup>22</sup> A deterioration in operating ratios during this period, it was indicated, probably also in part reflects the decline in business. This decline, the ICC report stated, was almost certainly merger related.

## REPORTED EARNINGS

Penn Central's quarterly results from railway operations, as reported to the ICC,<sup>23</sup> for the last premerger year and the postmerger period are as follows:<sup>24</sup>

[In millions]

	1967	1968	1969	1970
<b>Operating revenue:</b>				
1st quarter.....	\$371	\$382	\$406	\$403
2d quarter.....	387	392	418	455
3d quarter.....	363	372	398	
4th quarter.....	389	370	430	
Annual.....	1,510	1,516	1,652	
<b>Operating expenses:</b>				
1st quarter.....	311	316	339	386
2d quarter.....	314	314	349	408
3d quarter.....	301	316	343	
4th quarter.....	307	322	383	
Annual.....	1,233	1,268	1,414	
<b>Net railway operating income:</b>				
1st quarter.....	(2.5)	(2.9)	(10.1)	(65.8)
2d quarter.....	9.0	7.1	(7.5)	(45.0)
3d quarter.....	(0.1)	(9.2)	(14.8)	
4th quarter.....	11.0	(21.9)	(35.5)	
Annual.....	17.5	(27.0)	(67.8)	

<sup>1</sup> Penn Central reported to the shareholders a loss of \$9 million.

Note: Losses shown in parentheses.

Source: ICC form R. & E.

These figures, while important as a reflection of the steady deterioration in operating performance, do not reflect the full extent of railroad losses, since the fixed charges are not included, and these involve very substantial amounts. An offering circular prepared for a proposed Pennsylvania Co. debenture offering in April 1970, gave the following Transportation Co. figures:

<sup>22</sup> See exhibit IA-1 at end of section. This chart, taken from the ICC Report, shows ordinary income, but the net operating income closely parallels it.

<sup>23</sup> As discussed later, the figures reported to the ICC and to the public were not always the same.

<sup>24</sup> Results include New Haven Railroad beginning Jan. 1, 1969.

[In millions]

	1967	1968	1969
Railway operating revenues.....	\$1,507	\$1,514	\$1,652
Railway operating expenses.....	1,236	1,268	1,387
Taxes, equipment, rents and other deductions.....	272	293	335
Loss before fixed charges.....	1	(47)	(70)
Fixed charges.....	85	95	123
Loss on railroad operations.....	(86)	(142)	(193)

Source: Pennco: Preliminary offering circular—Apr. 27, 1970.

Note: Losses shown in parentheses.

Figures prepared for internal management purposes and including only 1968 and 1969, show the following:

[In millions]

	1968	1969
Rail losses:		
1st quarter.....	\$27.8	\$42.0
2d quarter.....	20.9	44.2
3d quarter.....	42.2	59.6
4th quarter.....	54.4	45.0
Annual.....	145.3	190.8

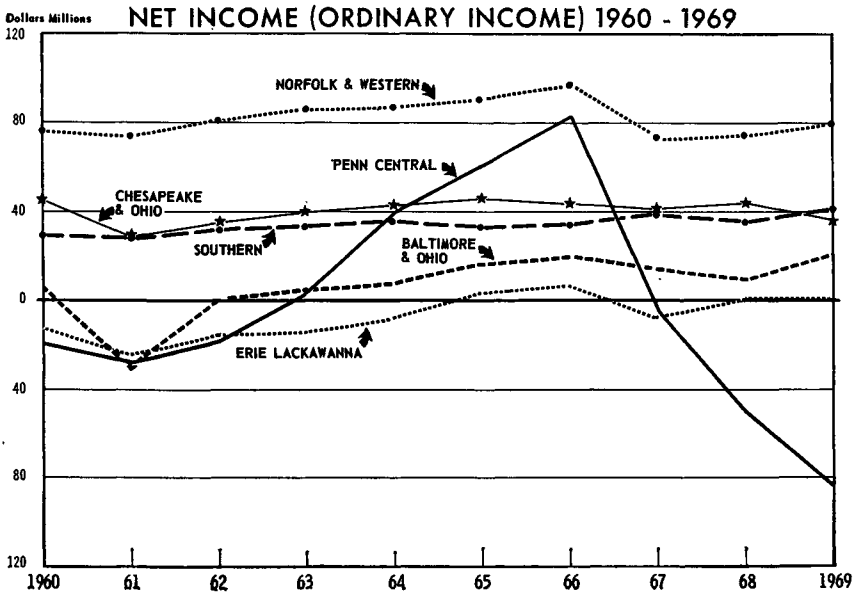
The loss for the first quarter of 1970, calculated on the same basis, was over \$100 million.

## SUMMARY

It appears that the underlying factor which sent Penn Central into reorganization was the gigantic losses it had to absorb on railroad operations. These losses reflected problems more deepseated than simply those brought about by the merger. There is, of course, no way of knowing whether the PRR and Central would have ultimately survived if there had been no merger.<sup>25</sup> It is clear, however, that in contrast to the expected benefits of the merger, it had instead the opposite effect, and that the immediate problems arising therefrom were a critical factor in the collapse of Penn Central in mid-1970.

<sup>25</sup> Perlman indicated he felt that the Central had the financial capacity to survive, absent the merger. Bevan testified that the merger probably accelerated the downfall of the PRR, although he had reservations about the long term viability of the railroad at any rate.

EXHIBIT AI-1



## I-B. INCOME MANAGEMENT

### THE MAXIMIZATION POLICY

As suggested in the last section, by background and experience Saunders was ill-prepared to handle the fundamental problems facing the Pennsylvania Railroad and later the Penn Central. Exhortations, without substance, proved inadequate. Saunders' reaction was to substitute improvement through accounting devices for the real improvements which were essential. His policy, he made clear to the other officers, was that, despite the vast array of problems facing the company, the earnings picture was to be presented in the best possible light. Basil Cole, a Penn Central vice president and special assistant to Saunders in the 1967-70 period, described the situation as follows:

... Relating that phrase [income maximization] to my experience working for Mr. Saunders, I think it means, it reflects, keeping the company on an even keel during times of adversity. He was not prepared to see the earnings of the company look any worse than they had to in days of declining business and increasing expenses, and when an opportunity occurred for producing income that would keep the earnings of Penn Central on as level as possible a basis, he tended to favor that course of action.

There was, of course, except possibly in 1965-66, nothing but periods of adversity for Penn Central, with the situation steadily deteriorating and no real prospect of a turnaround.

Perhaps management had hopes of some future improvement, but the shareholders and the public were entitled to be provided with the picture as it existed at the time, minus the impact of the temporary expedients being utilized to provide the illusion that the company was on an even keel when it was not.

Just as Saunders was not an operating man, his background was not in the financial area either. Therefore, while he established and encouraged the basic policy of maximizing the reported income, he had to rely on others for ideas, which he would then pursue. It became a group effort among the top echelons of management. As Cole suggested:

Everyone thought it was their job. Certainly in the real estate area—  
... Sam Hellenbrand would have thought it was his job. Ted Warner certainly thought it was his job to do what could be done in the tax field.

Warner also, he added, took over responsibility for searching the company's multitude of subsidiaries for income opportunities for the parent. William Cook, who was comptroller of Pennsylvania Railroad and later Penn Central, explained that in recommending one of his employees, Charles Hill, for a raise, he noted that Hill was extremely creative and had added millions annually to the Pennsylvania Railroad's reported net income. This comment was made because it was recognized that it would have a special appeal to Saunders. Cook also indicated that many of the accounting devices which might be used to increase earnings emanated from operating people who were not meeting the goals which Saunders had established

for them, and would come up with these proposals as a defensive measure. Saunders would be receptive to any such suggestion.

Various classes of devices fell within the maximization program, all directed toward improving apparent earnings.<sup>26</sup> In many instances they reflected the desperation of the circumstances facing Penn Central, and the importance attached to immediate earnings, since the benefits were clearly short term, with offsetting detriments of equal or greater scope in the future. One class of activity, sometimes referred to as "cannibalizing" the company's assets, involved the selling off of anything salable, both for earnings and for cash flow purposes. While this type of transaction hardly reflects a healthy situation, it does increase reported earnings, especially if the company limits the transactions to those which can be executed at a profit. Another practice involved the timing of certain items. Apparent improvements in reported earnings could be brought about by simply accelerating the recording of revenues in a particular quarter, while at the same time delaying the recording of expenses. This could be, and was, done legitimately in some cases where reportable transactions themselves were rushed through or delayed, but in many other instances such action simply reflected improper accounting practice. Another device employed by management was to stress the ordinary and recurring nature of various somewhat unusual income items, while seeking to label somewhat unusual expenses as nonrecurring.<sup>27</sup> The purpose was, of course, to show the maximum possible basic or normal earning power.<sup>28</sup> In all of these arrangements the imprint of what one witness described as Saunders' "preoccupation with the appearances of income" is clearly visible.

#### PRESSURES ON THE ACCOUNTING DEPARTMENT TO ALLOW THE REPORTING OF HIGHER INCOME

It is clear from the testimony of various witnesses, for example, Bevan, Cook, and Hill, that the accounting department was under pressure to do their part to assist management in reporting higher earnings. Hill, for example, testified as follows:

*Question. I got the impression that you were under a mandate to compute earnings to the greatest extent possible, is that correct?*

Answer. Unquestionably correct.

*Question. That mandate came from Saunders directly?*

Answer. From Saunders directly.

He later indicated that there was a continuing effort on the part of top management "to create the most favorable income at all times by the best favorable transactions".

The impact of such pressures was predictable. Wherever advantage could be taken either of some imprecision inherent in the figures or of some situation not specifically and precisely covered by the accounting literature, the effort was made to do so. In the former situation, where some imprecision was inherent in the figures, accounting department personnel appear to have pushed things as far as they

<sup>26</sup> As will be discussed in a later section on disclosure, the actions described here were part of an overall pattern of masking railroad operating losses.

<sup>27</sup> At times this was reflected in the financial statements themselves and at times in textual material contained in press releases and other information disseminated to the public.

<sup>28</sup> Generally, the value of a stock, at least for long-term investment purposes, is dependent on its future earning power, and current basic earnings levels are the starting point for an assessment of future levels.

dared, although the staff has not attempted to measure the precise impact. In the latter situation, where specific accounting precedents were lacking, several examples will be given below in which technicalities of form were stressed and the substance of the transaction was ignored. In effect, concepts established under generally accepted accounting principles were stretched to justify the treatment desired to the point where their application under the circumstances of this case may have been misleading.

Since the bankruptcy, Penn Central's prebankruptcy accounting practices have been widely criticized. Saunders was obviously very much aware of this and came in to testify with his defense prepared. Again and again in his testimony he referred to "generally accepted accounting principles." The almost incredible number of times he used this phrase suggests that this had been his all-consuming standard while he was running Penn Central, yet Cook suggested that it did not seem to him that Saunders was overly concerned with such principles. Cook stated that "if the accountants would go along with overstating it [reported income], that would not bother him [Saunders] particularly either".

Initially, Saunders in his testimony sought to create the impression that he was not an accountant and would almost blindly and without question accept anything accounting personnel proposed. Obviously, he was not qualified to discuss what was and was not acceptable under generally accepted accounting principles. However, while neither the Penn Central accounting staff nor the accounting profession can escape responsibility for their contributions to the events involved in this situation, it is clear that Saunders was not playing the passive role he sought to project. Indeed, by the conclusion of his testimony, Saunders was characterizing Cook as "overly cautious and highly straitlaced".<sup>29</sup> Cole testified that:

I think he [Saunders] felt many times that they [the accounting department] were unimaginative and wanted to slavishly follow through on a project for the sheer joy of making the entries.

Considering the extent to which the accounting department was willing to go to satisfy Saunders' recognized desires for the maximum possible reported income, the foregoing comments seem ironic. However, as indicated earlier, there was a barrage of suggestions from a variety of sources, and the accounting officers did resist certain of these. Both Cook and Hill indicated that Saunders sought to make his influence felt, and, even though they might ultimately prevail, they were constantly being called upon to defend their actions to him. Cook added that in these matters it was always helpful to have some outside support, for example, from the ICC accounting regulations or professional accounting literature in fending off these demands. As illustrated in subsequent sections, at times even this was not sufficient to convince Saunders, who then sought to apply his keen persuasive powers on representatives of these outside sources. And all this effort was being exerted to salvage the apparent earnings of a failing company.

<sup>29</sup> He added that, while he did not mind this in an accounting officer, he did not feel that Cook's word was gospel or that he could not be questioned.



## THE NOVEMBER CONFRONTATIONS

Typical of the intense pressures to which the accounting department was subjected in the interest of reporting higher profits are those described by Bevan in a diary which he kept in 1967 and 1968, assertedly for his own protection.<sup>30</sup> While Bevan's credibility on some subjects, as illustrated elsewhere in this report, is open to serious question and while he may have had his own personal reasons for keeping this permanent record of Saunders' improper activities at the same time that he was concealing so many of his own, the entries are supported by the testimony of Cook, who was comptroller during most of the period covered by the diary. The testimony of other witnesses also support this document, although on occasion they question the tone (rather than the substance) of some of the entries.

The most serious dispute between Saunders and the Penn Central accounting staff which is reflected in the diary involves a period in early November 1967.<sup>31</sup> Throughout the last half of 1967 it was known that there was a significant inventory deficit and increased requirements for reserves for injuries and for loss and damage. The accounting staff delayed booking these costs at Saunders' request that they wait until the fourth quarter when it was anticipated that earnings would be better. When earnings did not improve and Saunders then objected to loading everything into the fourth quarter, Bevan reported:

He [Saunders] said some people did not seem to realize we were going to merge with the New York Central and whether or not we were underaccrued by several millions of dollars at that time would never be known and would make no difference.

I explained as far as inventory deficit was concerned this shortage basically represented an understatement of earnings and had to be taken care of this year.

He then jumped on increased requirements for injuries to persons and loss and damage. He stated these were estimates at best and there was no reason to catch this up in the 4th quarter. I explained that we closed our books at the end of the year and that we had to have our reserves as proper as we knew how at that time. He then lost his temper and said I and nobody else would decide what we are going to charge in this connection. I remained silent and we moved on to other matters.

While Cook did not attend the meeting in question, one of his associates did and wrote a memorandum to Cook outlining the events of the meeting. He reported:

Mr. Saunders felt that it was not necessary to go into the merger fully accrued in these areas and he said that 1967 operating results did not have to reflect these adjustments unless he said so. He then said they should not.

In his own memorandum, Cook described the next event:

Late in the afternoon of November 7, Basil Cole came down to my office and stated that in addition to the items discussed at the Budget meeting, Mr. Saunders wanted to see what could be done to avoid the booking of the \$3 million inventory deficit in the fourth quarter of 1967. I explained to Mr. Cole that nothing could be done—that the inventory was taken at the end of June and that the results had been constantly reviewed by the auditors and other accounting personnel and that this item would have to be booked in 1967. He took the position that he did

<sup>30</sup> This diary has been reproduced in its entirety as exhibit IB-1. It will be quoted extensively in subsequent parts of this chapter.

<sup>31</sup> The diary ends in mid-1968 after Bevan lost responsibility over the accounting functions in the merged company. Bevan claims that the reason why he was downgraded at merger was because he would not play along with Saunders' schemes as described in the diary. Saunders claims it was because he had a constant problem with Bevan, finding it difficult to get needed financial information from him and never knowing whether the information obtained was the truth or only a partial truth.

not see where it would hurt anything to let this go until some time next year after merger and I explained the position that we certify to in the annual financial statements and that what he was suggesting was the same type of thing that occurred at Yale Express and Westec which was a criminal offense and that I would not be a party to it.

In preparation for a possible battle, he also asked Charles Hill, who was to later become his successor as Penn Central comptroller, to prepare for him a memorandum outlining the provisions of the Interstate Commerce Act relating to annual reports. The following provisions were quoted:

(1) The Commission is hereby authorized to require annual, periodic or special reports from carriers \* \* \* to prescribe the manner and form in which reports shall be made, and to require from such carriers, specific and full, true, and correct answers to all questions upon which the Commission may deem information to be necessary. \* \* \*

(2) Said annual reports shall contain all the required information \* \* \* and shall be made under oath and filed with the Commission. \* \* \*

\* \* \* \* \*

(7)(b) Any person who shall knowingly and wilfully make, cause to be made, or participate in the making of any false entry in any annual or other report required under this section to be filed \* \* \* or shall knowingly or wilfully file with the Commission any false report or other document, shall be deemed guilty of a misdemeanor and shall be subject, upon conviction in any court of the United States of competent jurisdiction, to a fine of not more than five thousand dollars or imprisonment for not more than two years, or both such fine and imprisonment: \* \* \* (Interstate Commerce Act, Part I—Section 20)

His continuing concern about the criminal implications is obvious in the final paragraph.

This information apparently proved useful, because Cook reported that 2 days later Cole was down again:

Cole made some further remarks about Mr. Saunders' desire to improve the fourth quarter results, particularly in the railroad, despite the fact that he thinks that revenues will be lower and operating costs higher than previously forecast and that he, Mr. Saunders, and Cole see nothing particularly wrong with under-accruing various items at this point in time which could conceivably be caught up some time in the future.

Cook was again forced to point out to Cole that they had to certify the correctness of the financial statements "and that any deliberate understatement of expenses in the manner suggested was a criminal offense." Further emphasizing Cook's great concern are two *Wall Street Journal* articles, dated November 9 and November 10, 1967, which he sent to Bevan. These articles deal with the Westec situation, then before the civil courts, and the passages marked referred to the overstatement of that company's earnings. It was obviously clear to the PRR accounting department what their own top management was trying to accomplish!

It was a period of tension within the accounting department. Cook went to see Bevan, who was his superior at the time, indicating that he was indignant and outraged and would resign if forced to do what was being suggested. Bevan indicates that Cook told him that he would fully support any statement by Bevan that "month after month we have been subjected to improper and undo [sic] influence as to accounting."<sup>32</sup> Meanwhile, Saunders called Bevan and asked him not to prepare any letters or memoranda about the accounting questions he had raised at the November 6 meeting. He said he wanted to sit down with

<sup>32</sup> Cook did not recall this particular discussion, but indicated that it was consistent with his feelings at the time.

Cook and Bevan to discuss the questions, stressing that everything possible had to be done to improve fourth-quarter earnings. Bevan speculated that one of the other officers had warned Saunders after the November 6 meeting that he was putting himself into an untenable position, and that, accordingly, Saunders did not want any permanent record made of this.

Cook and Bevan both agree that the accounting changes which Saunders was demanding were not carried through. The staff has not examined the voluminous underlying accounting records in question and cannot directly take issue with this position. It might be noted, however, that in connection with the 1968 audit, which was the first audit for the Penn Central (and the Pennsylvania Railroad <sup>33</sup>), very substantial retroactive increases were made in these reserve accounts. It should also be noted that, consistent with Penn Central's ever-present policy of reporting the maximum income possible, these major increases were offset by direct charges to retained income, rather than against the current income account.

Saunders claims not to recall any of the incidents in question surrounding the November budget meeting, although he generally denies the implication of the Bevan diary entry, quoted above, that he was trying to bury certain expenses until after the merger. Cole denies any independent recollection of the budget meeting but did seek to interpret notes that he took there which indicate "STS said, 'Why hit the fourth quarter with all these catchups. It won't make any difference after we merge.' " Since Cole was obviously directly involved in the events too, it is perhaps not surprising that he jumped to Saunders' defense, when questioned about these items. While it seems clear that what Saunders was trying to do was to get the accounting department to agree to "doctor" the books, the core of Cole's position seemed to be simply that Saunders would not do anything improper or deceptive. Initially Cole tried to avoid the obvious explanation of Saunders' comment by suggesting there was something in the merger and combining the books of the two roads which justified what Saunders was advocating. However, he could not suggest what that was or that he had any basis for that belief. While he admitted that Bevan's diary and his own notes were obviously referring to the same event, he claimed they were interpreting it differently. However, he could not explain his own interpretation. He next claimed he knew nothing about accounting,<sup>34</sup> although his own testimony showed he knew more than he was admitting. He suggested then it might be unnecessary or improper to accrue this item, even though the accounting department had said it was required. He even got to the point where he said that while he understood now that, if such an expense was not charged, income would be higher, he was not sure that he understood it then. That this very elementary concept would not be understood by an individual in Cole's position is very difficult to accept.

With respect to the events following the budget committee meeting, Saunders did not recall, but could not deny, the call to Bevan asking him not to reduce to writing the events of the meeting. His position as to the Cook-Cole meetings suggests that Cole was off on some frolic of his own, and that Saunders knew nothing about them. Cole on the

<sup>33</sup> The Pennsylvania Railroad had not had audited financial statements prior to that time.

<sup>34</sup> Cole is an attorney and is currently Penn Central's vice president—legal administration. During the time under discussion his title was assistant vice president, administration, and he reported directly to Saunders.

other hand dismisses the Cook meetings lightly, saying he does not deny they occurred and thinks they probably did, but that the tone is wrong, that if there had been a serious confrontation of the type described he would recall it. He attributes Cook's memoranda to the fact that someone (obviously referring to Bevan) had conditioned Cook's mind.

Actually, the events of the November period appear to be the culmination of a year of controversy. On March 22, 1967 Cook had written a memorandum marked "personal and confidential" to Bevan, objecting to "schemes being discussed to manipulate first-quarter earnings" and adding that "I think to enter into any of them would be a very serious mistake and would invite disaster. I do not condone them nor will I participate in them." The three schemes noted in particular in that memorandum were—

- (1) The reporting of earnings on real estate sales on the basis of date of agreement rather than date of settlement;
- (2) The cutting off of material transactions prior to the normal cut off period;
- (3) The spreading of storm costs throughout the year, rather than recording them in the period when they occurred.

Cook's memorandum went on to emphasize his point by indicating that this would invite "disaster from the ICC as well as severe criticism from the analysts and the public accounting fraternity," going on to document his arguments with provisions from the ICC regulations as well as accounting literature. The constant pressure being exerted by top management is illustrated by the fact that, a few months later, near the end of the next reporting quarter, Cook again had to repeat his objections in response to further suggestions that the booking of real estate sales be carried through on an accelerated basis. Cook was also disturbed by a suggestion made almost simultaneously by the vice president of coal and oil that the revenues that quarter be arbitrarily increased by certain amounts then in dispute between the Pennsylvania Railroad and another road, although there was a strong possibility they would have to be deleted some time in the future, stating that "as far as I am concerned this is placing a worthless asset on the books and creating imaginary income."

An interesting comment was made by Cook in connection with the March memorandum. He pointed out that the Pennsylvania Railroad would have in that quarter very significant "credits and other unusual income items," including sales of real estate and securities and prior year adjustments, and he suggested that the policies being proposed might well place in jeopardy these other items as well. And this was not the only situation where such a consideration entered into discussions on the proper accounting treatment for a particular item. In effect, management was being warned that if it got too greedy, the whole house of cards might collapse.

### THE "SPONGY" AREAS

Certain areas proved particularly troublesome to the accounting department because of the problems they presented in withstanding top management pressure. These generally involved areas which Hill described as "spongy." These were accounts where the final definitive figures would not be available until some time in the future, and thus

involved some element of judgment in recording them currently. The temptations in times of declining income were obvious and there were numerous suggestions that the company take advantage of the imprecision inherent in these figures, pending some improvement in operating results. Basically, this would be used as an income equalizing device. Saunders, perhaps sensing this was a toe-hold in his battle with accounting personnel who would be unable to confront him with hard facts and absolutes,<sup>35</sup> raised these matters at virtually every budget meeting. In effect, he was seeking to substitute his judgment, always on the side of higher earnings, for theirs. Nonetheless, as Hill put it, while there was some uncertainty inherent in these "spongy" areas, the flexibility was inherent in the accounting and not in the executive direction of the company. It was not merely a question of arbitrary judgment but of fact, and these items were subject to pre-established procedures of calculation. They could not properly be used to meet the needs of the moment, and there is evidence, both in the Bevan diary and in testimony, of resistance to Saunders' demands.

One problem area of this nature has already been mentioned—that surrounding various types of reserves. This was not merely a late-1967 problem but one which recurred again and again, both before and after merger. One witness noted that the concern of top management always seemed to be that these accounts reflected overprovision, thereby understating income, and that equal concern was not directed to the possibility of underprovision. Saunders' version, on the other hand, is that he was involved in "a couple of discussions from time to time about the size of our reserve for loss and damages and casualties" characterizing them as discussions on the appropriate level of reserves, whether they were too low or too high. He added, almost as an aside, that in a number of instances they were too small and had to be increased.

Another of these "spongy" areas on which Saunders concentrated involved freight revenues. The final revenue figures were not known for several months after the close of an accounting period<sup>36</sup> and certain elements would be handled temporarily through the clearing account. As indicated earlier, revenues regularly failed to meet Saunders' targets. Bevan recorded one incident in late August 1967 when Saunders indicated to him that the third quarter revenue forecasts were very poor and that an additional \$5 million of revenues had to be found. Bevan reported in his diary that "[a]lthough he did not come out and say so \* \* \* the implication was clear that he expected me to get this out of the clearing account regardless \* \* \* ." He also reported that another employee had been approached separately by Saunders on the matter. Bevan's description was as follows:

I asked Sass what that had to do with him since he has nothing to do with accounting but merely participates in forecasting. He said it was not clear to him. He did not have a chance to ask any questions as S.T.S. was talking at him but there seemed to be an implied suggestion that if revenues were not there we should mortgage our future and put \$5 million in anyway.

Cook recalled the Sass incident because, he related, everyone thought it was hilarious and used to kid Sass about where he was

<sup>35</sup> This had the further advantage of making it more difficult for outsiders (e.g., the ICC and the auditors) to uncover and question.

<sup>36</sup> Hill testified that the area of elasticity was perhaps \$2 to \$3 million and that even within that range, it was not arbitrary but based on various available data.

going to find \$5 million. Cook did agree that what Saunders apparently had in mind was taking it out of the clearing account and putting it back by understating future revenues, indicating that this was the only way to interpret the request.

Hill also testified that Saunders at least quarterly made demands for additional revenue. When asked how Saunders expected him to find it, he answered, "I have no idea, frankly. I assume by adjusting the book." He indicated that Saunders constantly and legitimately raised the issue with him that he, Hill, could not with absolute certainty document the revenue within 1, 2, maybe even 5 percent. Hill understood that Saunders by these comments was trying to tell Hill to increase the revenues. However, Hill testified that the 1 to 2 percent elasticity inherent in the figures could not be used legitimately to manipulate revenues within that 1 to 2 percent range.

Saunders describes these conversations as merely reflecting his concern that all revenues which could legitimately be recorded that quarter be recorded and that the accounting people went out and made sure they picked up everything possible. While it is clear that the types of effort he described were taking place, the situations described by others appear to extend well beyond Saunders' appraisal of them.

The operating people, who were under fire for performing poorly, were making their own revenue calculations and coming up with more favorable figures than those of the accounting people, thus fueling Saunders' desire for more income. Saunders admitted he recognized the bias in the operating department figures, indicating that that was the reason why he inevitably accepted without question the accounting figures. However, Hill describes one occasion in late 1969 which refutes this claim. The executive vice president for marketing gave Saunders a memorandum charging that the financial department figures were understating revenues by several million dollars:

Answer. Saunders confronted me with the memorandum and requested that I adjust to that level. We could not adjust to it. We had what we regarded as factual data. It went beyond the information available to the Vice-President of Marketing.

*Question. Did he [Saunders] tell you that he was going to be the one to make that decision and not you?*

Answer. That substance of words crept into the conversations but without result.

*Question. How did you withstand that pressure, then?*

Answer. By simply not making the changes in the account.<sup>37</sup>

This situation is illustrative of the environment in which the accounting department was forced to function.<sup>38</sup> Considering the nature and source of these pressures, it is not unreasonable to believe that such pressures had a significant impact on the recording of various items, encouraging the staff to push things as far as they felt they could hope to get away with.

Per diem charges<sup>39</sup> were another situation where full charges would not be known for some time and accruals were necessary. Bevan's diary describes two situations, one in mid-1967 and one in mid-1968, in which he claims that Saunders advocated deliberately understating per diem charges to increase income. In the second situation Bevan

<sup>37</sup> Saunders and Cole recall the meeting, but deny it went as far as Hill indicates.

<sup>38</sup> Saunders offered the same incident as an example of how he always followed accounting department policies.

<sup>39</sup> These are the charges which one railroad must pay for using the cars of another railroad.

indicates that, when Hill told Saunders it was probably already under-accrued, Saunders said that did not matter, "[i]t had been under-accrued before and it was not necessary to become a 'Christian' all at once." While Hill did not recall the incidents, he indicated, however, that they would be characteristic of the situation. Notes which Cole took at the budget meeting described also appear to support Bevan's comment.

Per diem costs were very high in 1967-69, a matter which concerned Saunders greatly. Operating people, in defense of their poor performance, would indicate that they thought per diem charges were being over-accrued by the accounting department and would come up with their own supporting figures. Cook testified that Saunders never directly told him to under-accrue the per diem account but it was suggested at budget committee meetings and Saunders was a party to the discussions. And Hill recalled that accounting personnel were being challenged at virtually every budget meeting that they were overproviding for per diem costs and being directed by Saunders to reevaluate the figures. Hill indicated that, indeed, they felt they were just barely at the correct level with a struggle to keep fully accrued. Cook characterized it as being a matter of Saunders believing his operating people (who were offering higher profits) rather than his accounting people.<sup>40</sup> Hill and Cole indicated that Saunders had a tendency to want to wait on these unfavorable items, until "we have a better feel" (that is, when operating conditions improved).

#### THE MERGER RESERVE

Another subject of controversy and pressure involved the merger reserve. In line with his past proclivities to advocate accounting treatments which would avoid charges against current income, Saunders took the position that all types of costs which could be considered merger-related should be charged off against a reserve established for that purpose.<sup>41</sup> Once again, while this would not result in any real savings, it would enable Penn Central to report higher earnings than if it was forced to treat these items as current expenses as they were incurred. In contrast to costs, merger savings would be allowed to flow through to increase reported earnings.

Before it could establish the reserve, Penn Central had to obtain ICC approval. Saunders was told by his staff that an all-inclusive, broad proposal had no possible chance of getting the required approval and, accordingly, such a proposal was never submitted. Indeed, Cook told him that even a much narrower plan the company was preparing would probably be turned down by the ICC's Bureau of Accounts and would have to be taken up with the Commission. Indicative of Saunders' keen interest in income maximization was the fact that upon being informed of this and before the accounting people dis-

<sup>40</sup> Saunders testified he always accepted his accounting department's judgment without question and when the staff pointed out that there was testimony from others which contradicted this, he characterized these incidents as discussions where he sought to understand what was going on.

<sup>41</sup> Saunders also took the position that the reserve should be established by a direct charge to retained earnings. While it was ultimately handled as an extraordinary charge in the 1967 income statement, it would appear that as a practical matter this change is of little significance.

cussed the matter with the ICC staff, Saunders himself took Cook down to discuss the matter privately with William Tucker, Chairman of the ICC.<sup>42</sup> No one was present from the Bureau of Accounts, although Tucker did eventually call in another Commissioner, John Bush, who had an accounting background. After some discussion it was decided to handle it through a normal presentation to the Bureau of Accounts. A meeting was held later with Mathew Paolo, Director of the Bureau, although the Pennsylvania Railroad did not inform him of their earlier meeting with the ICC chairman. After getting a staff denial on most of the request, the company then appealed through regular channels. When Cook came down for the appeal proceeding, Tucker, who was not one of the three Commissioners hearing the appeal, asked Cook to stop by afterwards and tell him how it went. Cook indicated to him that he thought it was favorably received. He got the impression that Tucker also was sympathetic to the road's position. Shortly afterwards, Pennsylvania Railroad was notified it had received virtually full approval of their request at the Commission level.

Upon approval, a \$275 million pool had been created against which currently incurred expenses could be charged.<sup>43</sup> The temptations for misuse this would present to a profit starved company were recognized by both the ICC staff and by Peat, Marwick, Mitchell & Co. (Penn Central's auditors) at the time the account was established. It was agreed it would have to be closely audited.<sup>44</sup>

As anticipated, almost immediately after the merger Saunders began to make suggestions that the use of the reserves be expanded. Saunders denies a statement in Bevan's diary of April 22, 1968 that Saunders

<sup>42</sup> Saunders did not specifically recall the incident, but agreed that it happened. His explanation of why Penn Central started at the top, so to speak, is as follows:

"A. This was something new for the Commission mainly as to whether there is any possibility of getting this done and they submitted papers to the Bureau of Accounts and if they don't go along, you have got a right to appeal it, that is what they said.

"Q. Why didn't you do that in the first place, why didn't you go right to the Bureau of Accounts?

"A. We wanted to find out if we had any chance of getting this thing.

"Q. Couldn't he have told you that, couldn't Mr. Paolo have told you that?

"A. Told us what?

"Q. Whether you had a chance of getting it through or not?

"A. It's just like a court proceeding, you can submit something to the Federal judge or court of first jurisdiction if you don't like their decision.

"Q. You don't start with the Supreme Court and ask them their views before you go down to the trial court, do you?

"A. Well—

"Q. That is what you did, isn't it?

"A. No, this is not a court.

"Q. You used the analogy.

"A. But you've got a right to appeal.

"Q. But you don't go to the Chief Justice first.

"A. Well, it's not uncommon to discuss matters of this sort with the Commissioners.

"Q. You did it on a number of occasions, didn't you?

"A. Well, on certain occasions, yes."

<sup>43</sup> The reserve had been established at a level which proved to be far in excess of the amount of charges authorized under the agreement permitting its establishment. While this is contrary to the pattern exhibited with the reserves discussed earlier, it should be noted that these earlier charges would have been against ordinary income, while the one-shot establishment of the merger reserve was treated as an extraordinary item.

<sup>44</sup> Peat, Marwick, for example, in an internal memorandum dated January, 1968 noted:

"It seems to us that the critical points will be reached in determining the actual amounts to be charged against the reserve, since the establishment of the reserves has been based on rather broad estimates at best. Charley Hill recognizes that he will be under pressure to use up whatever reserve is created and, knowing him, I am sure he will find a way to rationalize many borderline expenditures."

Another memorandum during this period contained a number of guidelines and concluded:

"While the foregoing admittedly are rather stringent, they would serve as the basis for restrained discussion and would bring about the necessary reorientation in thinking to prevent the reserve from being used as an earnings stabilizer in future years."



had been told at a budget meeting that Penn Central "could not hope to get away with" charging extra people against the account because it would be closely audited, and that he had tried to insist that all that Peat, Marwick and the ICC could do (if they learned of it) was to criticize the company, which did not bother him. Bevan was sufficiently concerned about the implications of this and other similar suggestions that in spite of the fact he no longer had accounting responsibility he discussed the matter with Edward Hanley, one of Penn Central's directors, in the summer of 1968. Hanley then met with Walter Hanson, senior partner of Peat, Marwick, in New York. Hanson assured him the account would be watched closely.

When the substance of Bevan's diary entry of April 22 was presented to Hill and to Cole they objected to the use of the term "get away with" but recalled that Saunders had on occasion made comments of similar import. Hill recounted that over the postmerger period, as earnings worsened, Saunders increasingly focused attention on what Hill described as an "expanded use concept" of the merger reserve, indicating a feeling that "in a general sense, the merger reserve ought to be a means of sheltering any unusual costs growing out of the merger." Hill further indicated that Saunders apparently looked upon the reserve as simply a bookkeeping device, and "at one time or another would have solicited a charge to the fullest extent of the reserve provision without regard to the nature of the agreement [with the ICC]." Saunders was clearly attempting to return to his original concept which he had been told could not generate ICC approval. In addition, Hill also stated that Saunders was constantly concerned that maximum use was not being made of the merger reserve and that he "was insistent in his own mind that we were not charging adequately to the reserve" so that Hill was constantly having to check the reserve to make sure that some legitimate cost was not getting by.

Hill claims that no charges except those permitted under the conditions established by the ICC were made against the merger reserve, to the best knowledge of the accounting department. However, there were two situations where Penn Central returned to the ICC for expansion of authority. In one of these instances again, Saunders was directly involved, seeking to make his influence felt to obtain desired goals. This case involved a group of mail and baggage handlers and a \$4.7 million charge. Initial indications were that both Peat, Marwick and the ICC staff were opposed to permitting this charge against the reserve. After meeting with Saunders, Hanson (of Peat, Marwick) apparently changed his mind, agreeing to abide by the ICC decision. And again Penn Central went directly to the ICC chairman. Hill, who had taken over from Cook as comptroller, and Tucker, who had left his position as chairman of the ICC to become a Penn Central vice president, met with Mrs. Virginia Mae Brown, the then current chairman. Once again, Penn Central succeeded in obtaining the

decision it wanted at the Commission level.<sup>45</sup> However, the SEC staff believes that \$4.7 million charge did not come within the original "merger reserve" criteria and should have been reflected as a period expense during the year ended December 31, 1968. (See further discussion at page 67.)

### OTHER DEVICES TO INCREASE RAILROAD EARNINGS

Management's attempts to improve railway earnings through exhortation were described previously, as was the unfortunate practice of skimping on maintenance to save current expenses (and cash). The suggestions for increasing revenues through use of the suspense account and for reducing expenses through delays in the booking of per diem charges, inventory losses, increases in reserves for damages, personal injuries and the like, has been noted, as has the plan to charge current costs against a reserve instead of against current operations. All of these actions were directed toward increasing reported earnings.

The last section was devoted principally to those situations where the accounting department was under pressure to do things which it was resisting. However, it agreed to and sometimes initiated schemes involved in other parts of the earnings management program.

Under railroad accounting, certain facilities are not depreciated but their costs (less scrap value) are charged to ordinary income when abandoned. It was up to Saunders to determine when a facility was considered abandoned, which gave him effective discretion to control expenses of this nature. He took advantage of this situation. In September 1969 Saunders issued instructions that, while he had approved the preliminary forms necessary for retirement of certain properties, none were to be made effective "until accounting authority is received which will avoid these losses from being charged to ordinary operations." Plans were underway for a Master Abandonment Program whereby at some point in the future, ICC authority would be sought to establish a reserve against which both past and future writeoffs could be made. In the meantime, the abandonments would pile up.<sup>46</sup>

<sup>45</sup> Another example of Saunders' keen interest in keeping every somewhat unusual expense item out of the calculation of ordinary income and his willingness to take steps personally to bring it about is a 1964 situation involving certain damage to equipment caused by heavy snowstorms that winter. Saunders wanted to charge it directly to retained earnings. He put a great deal of pressure on the accounting department, and when they resisted, he insisted that they take the matter to the ICC for approval. The Bureau of Accounts turned them down. Saunders then met with Walter Hanson of Peat, Marwick to seek his support, but Hanson, after some research, indicated that he was unable to do so. Saunders wrote back to Hanson stating his basic position:

"I am convinced that the business community benefits from financial reporting practices which are consistent in principle and which meet broad tests of acceptability. At the same time, it is highly important that investors and financial people obtain a correct picture of the effectiveness of management in conducting corporate affairs. It seems to me that the short-term disturbance to earnings produced by such events as the January snowstorm leads to misjudgment in evaluating our direction. The accounting profession and the business world would do well to look to a better solution to the problem of reporting period income."

This statement reflects the clearly "even keel" attitude.

A few months later, Saunders was still complaining about the situation asking Bevan "What are we doing to get the Commission to adopt a more realistic attitude in this regard?" Bevan in a reply memorandum stated:

"Practically every well-known accounting firm in the country is strongly in favor of putting, with very few exceptions, all charges through the current Income Account. We believe that as time goes on their influence in this respect on the ICC's position will be such that it will become increasingly difficult to get permission to charge various items to Retained Income. Furthermore, each year a greater percentage of the railroads of the country are having their books audited by C.P.A.'s who, in turn, will insist on this approach with the various railroads involved. Under the circumstances those roads that wish to handle numerous items through Retained Income are going to find themselves very much in the minority and very much in an almost untenable position.

"These are the facts of life as we see the situation at the present time."

Cook testified that the PRR did obtain permission to charge these storm-related costs over the full 1964 year and that it was his impression that this was because of Saunders' intervention, but this matter is unclear.

<sup>46</sup> One witness testified that from his trips around the system shortly after merger, it appeared that PRR had a lot of unused track, which it was apparently not taking out of service because it did not want to incur the service costs.

Also in 1969 Penn Central established a reserve for "Loss on Investment in Long-Haul Passenger Facilities" of \$126 million. The ICC disallowed the item for ICC reporting purposes, but the company included it in its reports to the public. The basis for ICC disapproval was that the properties were still in use and had not been abandoned. The company, on the other hand, claimed that there was a permanent impairment in value and wrote it off anyway.<sup>47</sup> This had the earnings advantage of lowering depreciation costs now and in future years (most of this property was depreciable).<sup>48</sup> And the reserve, labeled as an extraordinary item in the 1969 income statement, would be construed as such by the investment community, and thus its effect on reported income in 1969 would be discounted.

In this last situation, perhaps more disturbing than the transaction itself is the inconsistency with the prior item. Here, property still in use was nonetheless written off in order to save on current expenses, whereas in the last instance, property which was effectively abandoned was not written off, again to save on current expenses. The influence of the maximization policy is clear.

In 1969 Penn Central had another problem. It had been forced to absorb the New Haven Railroad. The New Haven had lost \$22 million in 1968 and had a consistent pattern of unprofitable operations, which Penn Central could ill afford to report considering its own disastrous performance.<sup>49</sup> Saunders suggested a reserve for operating losses be established, but was told that this was clearly impossible under generally accepted accounting principles. However, a treatment was found that reduced the earnings impact, at least over the short term. The state of New Haven's equipment was very poor, it was claimed, and it had to be rehabilitated. On this basis, a very high proportion of the total maintenance cost attributable to the road in 1969 was written off against a liability for rehabilitation cost<sup>50</sup> established as sort of negative goodwill in connection with the purchase of the New Haven properties.<sup>51</sup> As a result total maintenance costs in 1969 were very significantly lower than they had been in the prior year. Peat, Marwick, after initial objection to Penn Central's claim, finally relented and accepted the company's position. On the other hand, for purposes of reporting to the ICC, the company was forced to treat \$22 million of these charges as ordinary maintenance, not rehabilitation, and charge them against ordinary income. The result was a \$22 million difference in the profit figures reported to the ICC and to the public in 1969.

<sup>47</sup> The files of Peat, Marwick, discussing 1969 accounting problems, carry the following notation concerning this item:

"Two conflicting theories of accounting may be advanced with respect to the long-haul passenger service situation. On the one hand, there is ample precedent for writing down assets to their net realizable value; on the other hand, an argument can be made that to continue long-haul passenger service carries with it the obligation that the true costs of providing that service is rendered. We can see merits to both arguments, and, therefore believe we must respect Penn Central's position."

<sup>48</sup> The financial statements did carry a footnote reporting the difference between the treatment in the shareholder report and the ICC report, and the fact that the item had a \$4.5 million impact on depreciation in 1969.

<sup>49</sup> Hill testified that on the structuring of the New Haven transaction "I know I did a lot of head-scratching, trying to figure out a means to achieve the objectives that seem evident in Interstate Commerce Commission with the least possible burden on the Transportation Co."

Cole's budget meeting minutes indicate that at one meeting the suggestion was thrown out that the New Haven be assigned to the employees' pension fund! While this was not ultimately done, the idea was that the equity could be given away, while Penn Central continued to operate the road. This way it would not have to be included in Penn Central's results.

<sup>50</sup> It was contemplated that when the \$40 million sum thus reserved was exhausted further such expense might then be capitalized.

<sup>51</sup> When Penn Central's comptroller was asked if anyone in Penn Central ever expressed the opinion that this was nothing more than a reserve for future losses he replied that "there was a great deal of cynicism among people that did not understand the accounting principle involved \* \* \*"

Another consistently unprofitable railroad property was Lehigh Valley Railroad Co., a 97.3-percent owned subsidiary of Penn Central. Losses in 1968 and 1969 were \$5-\$6 million per year. However, despite the very high percentage of ownership, Lehigh Valley's results were not included in the consolidated statements, thereby permitting the parent to report a higher net income. The justification claimed was a fiction that the Lehigh Valley was being held only on a temporary basis.<sup>52</sup>

### NONRAILROAD OPERATIONS

The emphasis thus far has been on railroad activities. However, in the quest for income to meet management's earnings goals, nonrailway areas, particularly those related to real estate and investment activities, presented even greater opportunities.

The Penn Central complex includes over 170 separate companies.<sup>53</sup> The key entity is Penn Central Transportation Co. which has direct responsibility for operating the railroad, and also holds securities in various railroad and nonrailroad subsidiaries. The bulk of the non-railroad assets are held through the Pennsylvania Co. (Pennco), a 100-percent owned subsidiary of the Transportation Co., which functions principally as a holding company for the various investments it controls. Both Pennco and the Transportation Co., have numerous subsidiaries involved in railroading, real estate, and other endeavors.

Above the Transportation Co. on the organization chart is Penn Central Co., a parent holding company formed on October 1, 1969.<sup>54</sup> This company is basically a shell with virtually its sole asset being 100-percent of the stock of the Transportation Co. In requesting shareholder approval of this change in organization management told the shareholders that the holding company device was being adopted to simplify the diversification process and to reflect the importance of nonrailroad operations, getting away from the image of Penn Central as a railroad company. Basically, what was occurring was that the railroad's record was so dismal and its future so unappealing that the company wanted the public to forget it was a railroad. However, as indicated earlier, the dominant feature in the earnings picture of the Penn Central system was the very substantial losses being generated by the railroad system.

In assessing the impact of nonrail activities on Penn Central's income statements, two sets of figures should be considered. One consists of consolidated figures, those of Penn Central and its majority owned subsidiaries. The other represents figures of the principal operating entity<sup>55</sup> on an unconsolidated basis, hereinafter referred to as "company-only" or "Transportation Co."

The impact of the drain from railroad activities and the importance of nonrailway activities to the Penn Central organization is shown by the following table:

<sup>52</sup> See further discussion on page 64.

<sup>53</sup> A simplified chart, showing the major companies relevant to the discussions in this report, is included as exhibit 1B-2.

<sup>54</sup> Up until this date what is now the Transportation Co. was the top entity and carried the name Penn Central Co.

<sup>55</sup> The Transportation Co. and its predecessors.

[In millions]

	1966	1967	1968	1969
Company, only:				
Earnings (loss) from ordinary operations.....	\$85.1	\$9.1	(\$5.2)	(\$56.3)
Represented by:				
Profit (loss) on railway operations.....	3.4	(85.7)	(142.3)	(193.2)
Profit from nonrailway activities.....	81.7	94.8	137.1	136.9
Consolidated:				
Earnings from ordinary operations.....	147.4	68.5	87.8	4.4
Represented by:				
Profit (loss) on railway operations.....	3.4	(85.7)	(142.3)	(193.2)
Profit from nonrailway activities.....	144.0	154.2	230.1	197.6

Source: Pennco 1970 offering circular.

Some of the income from nonrailway operations<sup>56</sup> represented the results of routine activities but other portions clearly reflect the results of the maximization policy and Saunders' desire to conceal the earnings slide.

In the company-only statements, substantial income was derived from rental properties, principally New York real estate formerly held by the New York Central, from dividends and interest received from consolidated subsidiaries, from dividends and interest on other investments, from gains on sales of property and from tax allocation agreements negotiated with subsidiaries who benefited tax-wise from the railroad's losses. Because Penn Central had the power to control the timing of gains on sales of investments and properties, and dividends from controlled companies, these categories offered particularly attractive opportunities for programing reported earnings.

In the consolidated statements the major categories of nonrail income, without elimination of minority interest and without deduction of interest expense, were as follows:

## CONSOLIDATED EARNINGS

[In millions]

	1966	1967	1968	1969
Pipeline, net.....	\$13.8	\$15.4	\$16.6	\$15.5
Real estate rents, net.....	26.7	27.4	24.5	22.2
Real estate sales:				
Sales.....	61.4	113.4	175.8	186.4
Costs.....	45.2	76.9	104.8	104.0
Net.....	16.2	36.5	71.0	82.4
Dividend and interest on investments.....	40.1	34.8	46.2	39.1
Net gain on sale of investments.....	11.1	16.8	53.6	25.4
Total.....	107.9	130.9	211.9	184.6

Source: Assembled from information in 1970 Pennco offering circular.

In the mid-1960's PRR, knowing that it was going to be required by the ICC to dispose of its very substantial interests in the securities of the N & W and the Wabash Railroad, and dissatisfied with the results of its own railroad operations, embarked on a major diversification program. Pursuant to this program by 1965 it had acquired, through Pennco, controlling interests in Buckeye Pipeline Corp. and in three real estate development companies, Great Southwest Corp.,

<sup>56</sup> Certain railway-related activities of companies other than the Transportation Co. are included in the nonrailway figures.

Macco Corp., and Arvida Corp. Great Southwest acquired Macco from Pennco in 1969. The latter three companies greatly expanded the scope of Penn Central's real estate activities, as reflected in the consolidated statements. The Great Southwest-Macco operation proved a particularly useful device in the maximization program.

### REAL ESTATE ACTIVITIES

There was tremendous pressure on those responsible for the company's real estate activities to generate additional income. Whatever could be done within the Transportation Company and its railroad related subsidiaries to generate additional income and cash flow from disposition of property holdings was done. A great variety of avenues, involving a multitude of properties, was explored, although many of the proposed transactions were never consummated. At any rate, revenue potential in this area was limited.<sup>57</sup>

The real focus, however, came not in the parent but in Great Southwest-Macco. These operations are examined in considerable detail in a later portion of this report. Suffice it to say at this point that there were pressures exerted by Penn Central management which resulted in changes in the scope and methods of operations of these subsidiaries and provided a very sharp increase in income in 1967-69. Such changes so overextended Great Southwest that it nearly collapsed in 1970 and has survived only on the basis of a massive retrenchment in operations.

A considerable portion of the Great Southwest-Macco earnings was attributable to a limited number of very large transactions. Two transactions contributed approximately \$15.1 million to Penn Central's consolidated net earnings for the fourth quarter of 1968.<sup>58</sup> These purported sales, the Six Flags Over Georgia and Bryant Ranch transactions described in more detail later, involved premature recognitions of income and little immediate cash benefit to Great Southwest. In 1969 there was another similar transaction, involving the purported sale of Six Flags Over Texas (also discussed later), which resulted in an increase to Penn Central's consolidated net earnings of approximately \$24.4 million. The following schedule sets forth the estimated incremental effect of these three transactions on the financial statements of Great Southwest and Penn Central, respectively. It should be noted that the effect on Penn Central differs due to: (1) the inclusion of Great Southwest in the consolidated Federal income tax return of Penn Central; (2) the absence of taxes payable by Penn Central due to its tax losses and carryovers and the absence of deferred tax provisions; and (3) the minority interest in Great Southwest. The \$13,401,576 and \$18,358,003 figures represented approximately 67 and 53 percent of Great Southwest's reported consolidated net income for the years ended December 31, 1968 and 1969, respectively:

<sup>57</sup> The fact that many of the properties were heavily mortgaged further complicated the situation.

<sup>58</sup> The company-only statements of the Transportation Company were not affected, except to the extent of the increase, if any, in tax allocation agreement payments as a result of these transactions.

	Increase to net income (after tax provision) of GSC	Approximate in- crease to con- solidated net income (no tax effect) of Penn Central
1968:		
Six Flags Over Georgia.....	\$4, 813, 400	\$6, 370, 000
Bryant Ranch (less deferred portion).....	8, 588, 176	8, 730, 000
	13, 401, 576	15, 100, 000
1969:		
Six Flags Over Texas.....	17, 530, 170	22, 910, 000
Bryant Ranch (deferred portion).....	827, 833	1, 490, 000
	18, 358, 003	24, 400, 000

As a result of administrative proceedings commenced by the Commission on December 8, 1971, and as announced by the Commission on June 6, 1972, Great Southwest has agreed to file amendments to its Form 10-K annual reports for the years ended December 31, 1968 and 1969 which will *exclude* profits from the above three purported sales, i.e., Six Flags Over Georgia, Bryant Ranch, and Six Flags Over Texas. In substance, the Six Flags Over Georgia and Six Flags Over Texas transactions are to be treated as joint ventures with the purported purchasers, and the Bryant Ranch transaction is to be treated as an incomplete sale where income will be recognized only after all costs relating thereto have been recovered by Great Southwest.<sup>59</sup>

A sale in 1969, involving the Rancho California property, resulted in the booking of a large profit in the third quarter. Unlike the others, this was a cash sale and has not been challenged from an accounting standpoint. However, it cannot be considered, either in size or in type, as a routine Great Southwest transaction, a fact which has disclosure implications.

These real estate transactions, both in Great Southwest and in other sections of the Penn Central organization, played an important role in management's attempts to control quarterly earnings. Saunders' calls to the Great Southwest's management shortly before the end of each quarter, seeking income for Penn Central, were an integral part of his operating routine. On transactions within the parent company itself there were frequent pressures from top management to force transactions through before the close of a quarter for income statement purposes. Usually these related to accelerating the closing. However, on at least one occasion Bevan reported that Saunders had suggested that a wash sale should be arranged to get the profit if a transaction could not be pushed through before the end of the quarter.<sup>60</sup> In contrast, the next quarter, when income was again below expectations, Saunders inquired of the comptroller as to whether there was a way to avoid recording a loss on the sale of another building in that period.<sup>61</sup> Once again, management's propensity to control the earnings being reported to the public by speeding up the profits and delaying the losses and costs is clearly apparent.

<sup>59</sup> See Securities Exchange Act Release No. 9629 (1972).

<sup>60</sup> Bevan indicated that he had refused, and that at any rate it was never consummated as the potential buyer was not interested.

<sup>61</sup> Again he was told no, according to testimony.

## THE SEARCH FOR INVESTMENT INCOME

The same pattern is prevalent in the investments area. During this period of time an intensive effort was underway to find additional sources of cash and profit, and it appears that with a few exceptions (i.e., the four "diversified companies" acquired in the diversification program) virtually any company assets offering such benefits were on the block if a buyer could be found at a reasonable price. Unfortunately, however, the opportunities were limited. The two roads had been cannabilizing their assets for many years and the most saleable items were gone. The N&W stock was being sold as rapidly as possible, pursuant to an ICC order, described later in this section. This was generating both cash and profits (\$10.3 million in 1968 and \$13.6 million in 1969) and would continue to do so until 1974 when the supply would be exhausted. However, there were limitations on the capacity of the market to absorb the stock and furthermore many of the shares had been pledged or were for other reasons not readily available for sale.

As will be discussed in a subsequent section, attempts were made in the last half of 1969 to dispose of part of Pennco's holdings of Great Southwest and substantial profits would have been generated thereby, but these plans fell through, largely because of disclosure problems. Most of the other investments of Pennco and the Transportation Co. were closely held and lacked marketability, and were often unattractive as well. Efforts were made to dispose of them but they were for the most part unsuccessful. For example, in mid-1969 the sale of one subsidiary was being considered, but since virtually all of this subsidiary's operations were carried out on behalf of its parent, the Transportation Co., Peat, Marwick and Penn Central's own accountants vetoed the transaction. Because the subsidiary's basic means of support was, and would be, the obligation of the parent to use the subsidiary's equipment, the sale would have resulted in no economic advantage to the Transportation Co. Thus, management was told, it would be improper to record a "profit" on such a "sale" transaction.

While Penn Central was stymied in its efforts to sell sufficient assets to bring income up to the desired standards, the income account was buoyed by a series of paper transactions which reflected no real change in the company's position. For example, the subsidiaries were examined closely for possible dividends, and a series of "special dividends" was ordered by the parent. These were designed to draw into the parent's income statement any earnings which had been accumulating over a period of years. Obviously, any such dividends did not accurately reflect current earning power. Several such payments were arranged in 1969, and dividends from consolidated subsidiaries increased by \$25 million. The two largest items of increase were represented by a \$14.5 million dividend from New York Central Transport Co. and a \$4.8 million dividend from Strick Holding Co. The Strick transaction was basically noncash in nature.<sup>62</sup> In the case of New York Central Transport, Penn Central in effect loaned its subsidiary \$12 million to pay the dividend, since the subsidiary lacked the necessary funds, and after some accounting legerdemain, recorded the

<sup>62</sup> No cash payment was made, but debt owed by the parent to the subsidiary was reduced. And the earnings from which Strick paid the dividend were represented by values assigned to warrants in a newly formed company which had acquired Strick's major assets.



items as income.<sup>63</sup> There were also other similar intercompany dividends. While these transactions would be eliminated upon consolidation, they did help the Transportation Co.'s results, and considering that entity was where the major problem was buried, Penn Central apparently considered this better than nothing.

A device used extensively in 1968 to increase income was the repurchase, in the open market at a deep discount, of bonds of various companies in the Penn Central complex. The difference between the price paid and the par value was then recorded as a profit. The company recorded a profit of \$8.4 million in the Transportation Co. and \$9.8 million in the consolidated entity from this source in 1968, but found it virtually exhausted when suggestions were made in 1969 that this device be tapped again.<sup>64</sup> These transactions, particularly in light of Penn Central's need to finance the purchases through additional borrowing, apparently offered no real benefit to the company except the generating of paper earnings.

There were also a series of paper transactions involving in essence substitutions of similar securities which resulted in significant amounts being added to reported income in 1968 to 1970. Two such transactions contributed a total of \$32.7 million in 1968 to both consolidated and company-only earnings. The first involved a dividend-in-kind from Washington Terminal Co.,<sup>65</sup> a 50-percent owned subsidiary. This dividend was in the form of the securities of a newly formed company which Washington Terminal had received when it transferred to the new company a one-half undivided interest in Union Station in Washington, D.C. Union Station had been Washington Terminal's principal asset and an undivided one-half interest therein was the major asset of the new company as well. Penn Central controlled after receipt of the dividend, essentially the same underlying asset as it had had prior to that time, but it recorded income of \$11.7 million as a result. The second transaction was in the form of an exchange of securities with Madison Square Garden Corp. and contributed \$21 million to reported 1968 results.<sup>66</sup> The Transportation Co. exchanged its interests in two assets held jointly with Madison Square Garden Corp., and which constituted the bulk of that corporation's assets, for shares in Madison Square Garden Corp. itself. Again, following the consummation of the transaction Penn Central had basically the same interest as before, packaged in a slightly different form, but took advantage of the situation to record a large gain.

Other transactions of this nature also occurred.<sup>67</sup> In 1964 the ICC had issued an order requiring PRR and its affiliates to divest themselves of all of their extensive holdings of N&W stock by 1974.<sup>68</sup> In late 1965 PRR and Pennco entered into an agreement with the N&W, whereby Pennco, which held all of the PRR system's N&W shares, would exchange about one-third of these shares for 15-year N&W convertible debentures,<sup>69</sup> with the exchange to be

<sup>63</sup> See further discussion of this item on page 60.

<sup>64</sup> In 1967 and 1969 the Transportation Co. earned about \$500,000 from this source, while consolidated figures were \$700,000 and \$1,700,000 respectively.

<sup>65</sup> See further discussion on page 62.

<sup>66</sup> See further discussion on page 57.

<sup>67</sup> See also discussion concerning Wabash Railroad Co. stock on page 55.

<sup>68</sup> The PRR system at that point owned 2.4 million shares of N&W common, representing 32 percent of the total, and a majority of its voting preferred shares. The reason for allowing a 10-year period was to permit an orderly disposition and to provide certain tax advantages.

<sup>69</sup> Pennco was to receive \$104 million in 4½ percent debentures which were convertible only by holders other than PRR.

made in 10 installments. A gain of about \$80 million was recorded on PRR's consolidated books,<sup>70</sup> but instead of taking the entire amount into income that year, the company recorded it as deferred income. The deferred income was then to be recognized on a periodic annual basis over the life of the contract, 9½ years.<sup>71</sup> It might be noted that, whereas in the Madison Square Garden and Washington Terminal transactions it was contemplated that the securities received in exchange would continue to be held as an investment, the N&W debentures would, of necessity, be liquidated. Indeed, the securities received in 1966–68 were sold in 1967 and 1968. There were no sales in 1969.

Penn Central took the position that its investment activities were an integral part of its business and classified all income from this source as ordinary income. Such a claim apparently lies at the root of attempted justification of nondisclosure of many of the various transactions noted above. However, not only had the opportunities for conventional sales become severely restricted, but it would be difficult to sustain income of the type derived from such items as special dividends, repurchases of company bonds, and paper transactions like Madison Square Garden, and Washington Terminal.<sup>72</sup> The contrast between this and Penn Central's handling of what it considered to be unusual merger related expenses should be noted. In its presentation to the ICC on behalf of Penn Central, Peat, Marwick pointed out that the use of such a reserve would result in a more fair presentation of the results of the merged company by removing the impact of certain unusual expenses on the income statement. Furthermore, as to the \$75 million in merger-related costs which did impact the income statement in 1968, management took pains to point out to the shareholders that they were temporary in nature. No similar effort was made to clarify the nature of many of the investment transactions which were generating reported income.

While Penn Central's search for income potential among its investments was broad-ranging, it exhibited a pronounced reluctance toward writeoffs of investments. There was substantial evidence by the end of 1969 of permanent impairment in the value of the investments in Executive Jet Aviation Corp., Madison Square Garden Corp., and Lehigh Valley Railroad. However, formal recognition of this fact would require charges against the income statement, charges which Penn Central could ill afford to report.

Penn Central had invested \$22 million in Executive Jet Aviation. Most of this investment should have been written off in 1968 and 1969.

<sup>70</sup> Because of prior intercompany sales, the profit on Penneo's books was smaller—only \$59 million.

<sup>71</sup> While this may appear inconsistent with the Penn Central policy of taking everything into profit immediately and worrying about the future later, it might be noted that 1966 was an extraordinarily profitable year in the railroad industry, and thus there was not the pressure for additional earnings which was present in subsequent years. Furthermore, a gain of this size would certainly have been considered non-recurring and discounted by the public, whereas the smaller amortized gains could perhaps pass unnoticed. In this connection it might be noted that while in 1966 PRR made the decision to report the N&W exchange as an ordinary income item, in 1965 when it sold its interest in the Long Island Railroad at a substantial loss, it reported a "Provision for loss on sale of Long Island Railroad" as an extraordinary charge.

<sup>72</sup> Perhaps another indication of management's propensity to use artificial devices to increase income is this comment in early 1969 by Cole, in discussing plans to establish the holding company:

"I have taken a special interest in this project and have been trying to push it along, because I thought I foresaw the prospect of being able to generate net income by Railroad or Pennsylvania Company declaring dividends of low-book value assets which would then be taken in by the Parent at present market values, as in the case of the Washington Terminal dividend and the Madison Square Garden transaction. Alas, I have just learned that this is prohibited where the declaring corporation is more than 50 percent owned." Management never did find any additional transactions similar to the transactions alluded to, and 1969 investment income dropped accordingly.

Unfortunately, disclosure of the fiasco surrounding this situation <sup>73</sup> would have been embarrassing to management, in addition to its detrimental effect on earnings, and so no writedown was taken. The market value of the Madison Square Garden shares had dropped by more than 50 percent between the time Penn Central's investment in the project was in effect written up in connection with the previously described exchange of securities in late 1968, and the close of 1969. <sup>74</sup> Again, the investment was not written down. In the case of Lehigh Valley Railroad, as suggested earlier, that company should have been consolidated and not carried as an investment, but even as an investment, the earnings and financial history of the company clearly called for a writedown to realizable values. <sup>75</sup>

### EARLY 1970—THE LAST GASP

When Gorman came to Penn Central in late 1969, and began to familiarize himself with the company, he became concerned about an earnings pattern he discerned. In connection with his testimony he submitted a table of quarterly earnings results for 1969 and 1968, which has been attached as exhibit IB-3. This table, prepared by a Penn Central statistician early in 1970, presents in a readily comprehensible format not only the full loss on railroad operations, but also a chart of "significant items," including many, although not all of the items described in previous parts of this section—e.g., New Haven capitalization, merger reserve charges, the Washington Terminal dividend, the New York Central Transport dividend, the Madison Square Garden exchange, the three Great Southwest transactions and the profit on reacquisition of company bonds.

On the basis of the pattern exhibited, Gorman requested a special meeting of the finance committee of the board, which met in early May 1970. The minutes of that meeting record the proceedings as follows:

The President then stated that he was deeply concerned about a number of management practices, although there was no indication that they were illegal or had not been approved by outside counsel and outside auditors.

He did state, however, that he was disturbed by certain matters because in his view an item must not only be right but must look right to outside sources. He stated that he had followed this code for over 40 years and did not intend to change at this stage of his career and that he would like to discuss certain matters with the Committee to determine whether the practices would be continued in the future. He emphasized that his action did not imply criticism of the Chairman of the Board, the Chairman of the Finance Committee to the Finance Committee, but, nevertheless, what he was talking about was practices which he believed had been followed for some time in the past.

While not all the practices related to reported earnings, it was clear that this was the dominant theme. He specifically mentioned such matters as the "declaration of dividends by subsidiaries on a hit or miss basis to satisfy a current underrun", profits on transfers of investments between segments of the Penn Central organization, write-ups of investments such as Madison Square Garden with the holdings then locked in because of subsequent price declines, and unrealistic budgets. He also questioned certain other practices which he felt did not reflect a conservative approach to reporting earnings.

<sup>73</sup> See discussion on page 71.

<sup>74</sup> It has remained at lower levels since that time.

<sup>75</sup> See discussion on page 64.

Apparently it was in substantial part events in the first quarter of 1970 which alarmed Gorman. As noted earlier, the first quarter was operationally a disaster, with \$100 million in losses from railroad operations. This was unfortunate because, with a critical cash situation, Penn Central, through Pennco, was about to go into the public markets for financing. Some way had to be found to improve the apparent earnings picture if the issue was to succeed. Gorman objected to the two major devices adopted, however, to accomplish the goal.

In connection with the channeling of the proceeds of the proposed offering from Pennco to the Transportation Co., Pennco was to purchase from the Transportation Co. the stock of Clearfield Bituminous Coal Corp., a 100 percent-owned subsidiary.<sup>76</sup> The transfer was made at net asset value, and a profit of \$16.9 million was recorded on the Transportation Co. books. Gorman indicated he questioned booking paper profits such as this, even with full disclosure. He recognized these intracompany sales would be wiped out in the consolidated statements but asked the question "why do we bother with those kind of things?" The reason was clear—to dress up the Transportation Co. figures.

That transaction was dwarfed, however, by the other one, which involved not the Transportation Co. but the consolidated statements. Pennco owned virtually all of the common shares of Wabash Railroad Co. and pursuant to an ICC order dated 1964 had agreed with the N&W to exchange them for N&W shares. The date of the exchange was established as October 15, 1970. However, when it was recognized the first quarter profits would be very bad, hurried plans were made to accelerate the exchange to March 31, 1970. As a result, profits of \$51 million were booked as ordinary income in that quarter.<sup>77</sup> Gorman, who was in the hospital at the time, knew nothing about it until after the transaction was consummated and reported. He was irritated and reported to the finance committee that if he had known about it he would have dissented. This was a writeup of paper profits, with a flow through to earnings but no cash benefit, he stated, reflecting to the committee "a general feeling that where there is no cash involved why do you do things. And certainly we were in need of cash." Furthermore, he was particularly disturbed by the fact that the acceleration had cost Penn Central \$1.8 million in Wabash cash dividends,<sup>78</sup> which he felt he could certainly have used to repair freight cars which seriously needed repairing. It might be noted that Penn Central management had made a number of other expensive concessions to N&W as well, to gain the income acceleration.<sup>79</sup>

The impact of just these two transactions on reported earnings in the first quarter of 1970 was as follows:

<sup>76</sup> The carrying value on the Transportation Co. books was only \$82,000.

<sup>77</sup> The gain on Pennco's books was \$47 million.

<sup>78</sup> This reflects the difference between the dividends which Pennco received from the N&W shares in the interim period and those it would have received had it held the Wabash stock.

<sup>79</sup> It appears that under the terms of an escrow agreement in connection with a \$50 million debenture offering of Pennco, debenture holder approval was required before the terms of the exchange agreement could be amended. Such approval was not obtained.

	Company only	Consolidated
Reported loss.....	-\$62.7	-\$17.2
Increase loss by eliminating purported profits on:		
Sale of Clearfield Bituminous Coal.....	-17.2	
Exchange of Wabash RR. Stock.....		-51.0
Total loss as adjusted (in millions).....	-79.9	-68.2

It might be noted that there were also other devices discussed by Saunders and Bevan during the early 1970 period whose effect would have been to increase reported earnings. The accounting department suggested an upward revaluation of inventory, although this idea was dropped on Gorman's objection. The possibility of allocating part of the overhead and management costs of the Transportation Company to the holding company and the subsidiaries was brought up. Gorman said he had no objection but asked why *now*? Bevan instructed Hill to check with other railroads on amounts being accrued for 1970 wage increases, stating that it was important not to exceed what was necessary in this respect. And the old possibilities of expensing off the winter's heavy snow removal cost over the entire year and increasing use of the merger reserve were raised once again. Saunders also asked the appropriate people to look at the reserves for injuries, damages, and so forth, to see if a lower figure could be justified.

#### ACCOUNTING TREATMENT

The foregoing activities clearly illustrate the course of conduct being pursued by Penn Central's management. All manner of means were being employed to make the situation appear better than underlying circumstances warranted. Very significant portions of the reported earnings of this cash-starved company were noncash in nature. Moreover, the figures were replete with income derived not from routine, on-going investment and real estate activities but from forced liquidations of assets employed in these activities in order to meet the earnings and cash needs of the railroad. These assets were not available in unlimited supply, a fact clear to management long before Penn Central's final collapse. And the pressures applied by top management to alter cost and expense figures to meet management's desires in all probability had an impact, of unknown extent, on the reported figures.

At a minimum, the course of conduct illustrated above called for clear disclosure of the nature and effect of the policies management was following in this respect. Thus, under the circumstances of this case shareholders were entitled to be provided with the information necessary to permit them to fully and fairly assess the quality of the earnings being reported. Beyond this, however, it is clear that in a number of instances the recording of income or failure to record deductions from income involved the stretching of generally accepted accounting principles to the point where the total impression given may have been highly misleading. A few of the most significant situations are described in the following section.

## ACCOUNTING—MADISON SQUARE GARDEN CORPORATION

*Background.*—In connection with the construction of the new Madison Square Garden Center over Pennsylvania Station in New York City the then Pennsylvania Railroad Co. (PRR) acquired a 25 percent stock interest in Madison Square Garden Center, Inc. (Center). These shares were received as part of the lease arrangements for air rights over the station and were carried on PRR's books at \$1. The other 75 percent stock interest in Center was owned by Madison Square Garden Corp. (Garden). Center constructed the facility and after it was completed in early 1968, all of the revenue-producing activities and certain related assets of Garden, which had owned and operated the old facility, were transferred to Center.

As part of, and in connection with the construction of the new facility, a joint venture was entered into for construction and operation of a 29-story office building above the easterly third of Pennsylvania station in New York City. Participation in the venture was as follows:

	<i>Percent</i>
Pennsylvania Terminal Real Estate Corp. (PTRE) <sup>1</sup> -----	55
Two Pennsylvania Plaza, Inc. <sup>2</sup> -----	25
Tishman Plaza, Inc.-----	20
<b>Total</b> -----	<b>100</b>

<sup>1</sup> A corporation 100-percent owned by PRR directly or through one of its wholly owned subsidiaries.

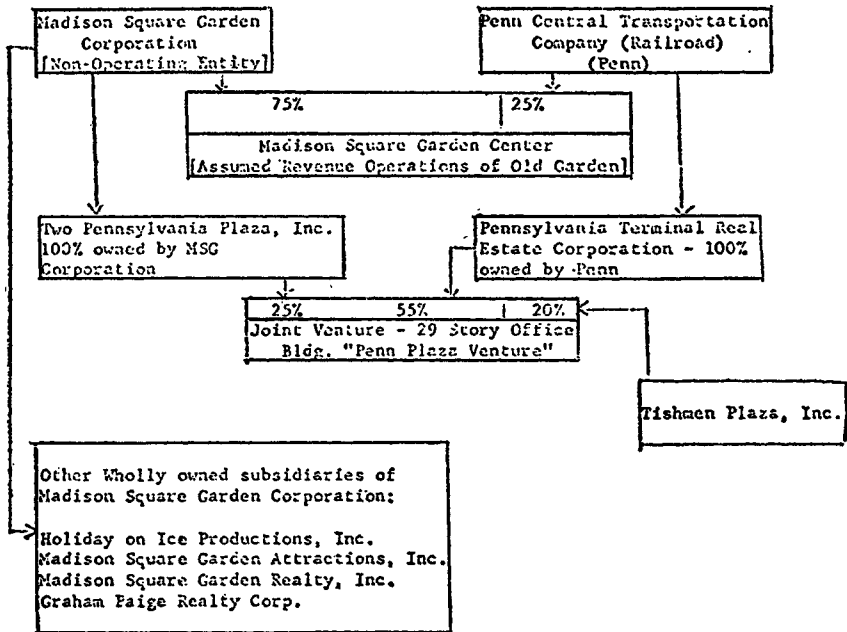
<sup>2</sup> A corporation 100-percent owned by Garden.

Under the terms of the joint venture, in exchange for an increased participation,<sup>80</sup> PTRE undertook to loan funds to cover costs of construction in excess of the construction loan and PRR, which owned all the stock of PTRE, agreed to furnish funds to PTRE for such purpose.

Just prior to December 31, 1968, the equity interests of Garden and Penn Central in Center and in the joint venture are illustrated by the following chart:

<sup>80</sup> The agreement, as originally structured, provided for a 25 percent interest to the PRR subsidiary and 75 percent to the Garden subsidiary. Because of difficulties in obtaining needed financing, this was later renegotiated, with PRR receiving an increased participation in return for an agreement to provide financing.

Equity Holdings Before Exchange of Stockholdings



Pursuant to an agreement dated December 18, 1968 Garden acquired as of December 31, 1968,<sup>81</sup> Penn Central's interests in Center and PTRE. In addition certain indebtedness owed Penn Central in connection with the office building project was forgiven. In exchange, Penn Central received 1,168,664 unregistered shares of Garden's common stock and 100,000 shares of Garden's participating preferred stock. Contingent upon approval of Garden's stockholders, it was agreed that the participating preferred would be exchanged for 1,151,000 shares of common. This approval was obtained on April 9, 1969 and the exchange made about 10 days later.<sup>82</sup>

In connection with the above, on December 18, 1968, Garden and Penn Central also entered into a stock purchase agreement whereby Penn Central agreed to purchase shares of Garden's common stock to furnish the financing necessary to complete the office building. This related directly to Penn Central's obligation under the joint venture agreement, as mentioned previously, to furnish funds to PTRE for that purpose.<sup>83</sup>

*Analysis of Changes in Equity Interest of Penn Central, as a Result of the Exchange.*—Penn Central indicated that the reason for the transaction was as follows:

The purpose of Penn Central in agreeing to the purchase and proposed purchase of Securities of the issuer was to concentrate and unify Penn Central's interests in

<sup>81</sup> This date was selected because of Penn Central's desire that the transaction be closed before the end of the year.

<sup>82</sup> The interim step was necessary because Garden did not have the authority to issue the full 2,300,000 shares in December 1968.

<sup>83</sup> Penn Central agreed to purchase up to 180,538 shares at \$11.078 per share. PTRE would request the advance needed. Penn Central would then purchase from Garden the shares required to provide that sum and Garden would advance the proceeds to PTRE.

the new Madison Square Garden Center and the office building at Two Pennsylvania Plaza through the ownership of a substantial equity interest in Madison Square which will be the beneficial owner and operator of those facilities. Thus, Penn Central as owner of the underlying properties will continue to receive fixed rentals from these facilities and will in addition have a significant single equity interest in the profit from their operation.<sup>84</sup>

Penn Central realized no cash from the transaction. It gave up a controlling 55-percent interest in the Penn Plaza venture, a 25-percent equity interest in Center and certain interest bearing indebtedness related to the Penn Plaza project. In return Penn Central received a 23-percent interest in the outstanding stock of Garden, which was increased soon thereafter to 25 percent through other purchases.<sup>85</sup> Garden at this point was essentially a holding company, whose major assets consisted of its interests in Center and the Penn Plaza venture. Penn Central retained its 25-percent interest in Center. Its interest in the office project was reduced from 55 percent to about 20 percent and it received a 25-percent interest in Garden's lesser subsidiaries,<sup>86</sup> which were all associated with the Garden project. Penn Central was not relieved of its contractual agreement to advance additional funds for the completion of the Penn Plaza venture and retained its rights to receive long-term rentals under the main lease of the air rights to be paid by Center.

In terms of recorded values on the books, Penn Central was giving up assets which had a stated value of \$4.7 million. It received shares which had an equity value on the books of Garden at May 31, 1969 of \$4.2 million.<sup>87</sup>

*Exchange Arrangement Recorded as Gain by Penn Central.*—Penn Central reported a gain of \$20,999,905 on this exchange as ordinary income in the year 1968. This was computed as follows:<sup>88</sup>

Received by Penn Central:

Shares of Garden common stock.....	1, 168, 664
Shares of Garden common stock which were represented by the convertible preferred.....	1, 151, 000
Total.....	2, 319, 664
Multiplied by per share market price of Garden stock.....	<sup>1</sup> \$11. 078
Total market value of shares received.....	25, 697, 238

Given up by Penn Central:

225 shares of Center.....	\$1
100 shares of PTRE.....	100
Indebtedness forgiven.....	4, 697, 232
Total given up.....	4, 697, 333
Net gain on exchange.....	20, 999, 905

<sup>1</sup> This was selected as the average market value per share at the time of negotiations and was the figure agreed to in the stock purchase agreement.

<sup>84</sup> Source: Item 4 of Schedule 13D, filed on Apr. 1, 1969.

<sup>85</sup> This increase was attributable mainly to purchases under the stock purchase agreement entered into in December 1968, which was previously described.

<sup>86</sup> Because of the early stage of operations the contribution to earnings is difficult to assess. However, of total investments and advances to subsidiaries of \$24,800,000 Garden's books, \$17,000,000 was invested in Center, \$6,500,000 in the office project, and \$1,300,000 in the lesser subsidiaries. The other significant asset on Garden's books was the old Garden facility which has been cleared and is currently being used as a parking lot.

<sup>87</sup> This figure represents a 25-percent interest, rather than a 23-percent interest in these assets.

<sup>88</sup> As abstracted from accounting workpaper included in the files of Peat, Marwick.



The impact on the 1968 financial statements was as follows:

	Consolidated	Company-only
Earnings (loss) from ordinary operations <sup>1</sup> .....	\$87,789,000.00	(\$5,155,000)
Earnings (loss) absent recognition of gain.....	66,789,095.00	(26,154,905)
Per share difference:		
As reported.....	3.80	
Absent recognition of gain.....	2.89	
Difference.....	.91	

<sup>1</sup> Figures are 1968 figures as restated in the 1969 annual report to shareholders. The 1968 report to shareholders had reported a profit of \$90,300,000 on a consolidated basis and a loss of \$2,800,000 for the Transportation Co. only.

This transaction accounted for slightly less than half of the net gain on sale of investments in the consolidated income statement and 60 percent of the net gain on sale of property and investments in the company-only statements.

*Conclusion.*—Serious questions are raised as to the recognition of gain on this transaction, since, in substance, this transaction reflected merely the substitution of an investment in one form for essentially the same investment in another form.

#### ACCOUNTING—TRUCKING COMPANY DIVIDENDS

*Background.*—Prior to the year 1969, as part of a plan to simplify the corporate structure of Penn Central, it was contemplated that certain trucking companies would be merged. It was considered at that time that the New York Central Transport Co., Penntruck Co., Inc., and Merchants Trucking Co. would merge into Pennsylvania Truck Lines Inc.<sup>89</sup>

An internal memorandum prepared by Penn Central's tax department proposed that a significant amount of the retained earnings of the nonsurviving corporations be paid out as a dividend prior to merger. The memorandum stated that the reason for the proposal was to create an annual savings of some \$60,000 in various State income and franchise taxes. As part of the proposal it was suggested that the amounts representing the dividends paid out be immediately loaned back to the paying corporations so that no actual transfer of cash or other assets would be involved. These loans would bear interest and be subordinated to the rights of creditors requiring that protection. The proposal as set forth by the tax department recommended the proposal subject to the absence of any objections from the operations and financial sections of management. It appears, however, that there were "financial objections" to the proposal as set forth by the tax department. On March 4, 1969, Cole advised Saunders:

Our financial people have been shying away from this however, because there is not sufficient cash to pay the dividend and they say that to execute it as a single transaction on an intracorporate "bookkeeping" basis might be regarded as a manipulation which would be misleading as to actual results.<sup>90</sup> An acceptable alternative might be to take the dividends on a gradual basis over a period of time.

<sup>89</sup> New York Central Transport, Pennsylvania Truck Lines, and American Contract Co. were 100 percent owned subsidiaries of the Transportation Company. Penntruck and Merchants Trucking were 100 percent owned subsidiaries of American Contract.

<sup>90</sup> Hill testified that some people within Penn Central thought that maybe "you could just make marks in a book" that would effect the dividend, but that he objected to taking the dividend income "unless something of value flowed between the parties."

*Special Dividend Income Recorded by the Transportation Company in 1969.*—New York Central Transport Co. declared the following dividends payable to the transportation company: <sup>91</sup>

Apr. 15, 1969.....	\$6, 000, 000
July 15, 1969.....	6, 000, 000
Dec. 31, 1969.....	2, 500, 000

Also in 1969, Merchants Trucking Co. and Penntruck Co., Inc. declared dividends of \$300,000 and \$1,700,000, respectively, to American Contract Co. This \$2 million in dividends declared to American Contract was the basis for the declaration of a dividend to the Transportation Company which included this amount.

As to the two \$6 million dividends outlined above, the Transportation Company instructed the Manufacturers Hanover Trust Co. to charge its account and credit the account of New York Central Transport Co., whose account was also carried at that bank. Simultaneously, New York Central Transport Co. instructed the Manufacturers Hanover Trust Co. to charge its account and credit the account of the Transportation Company. The instructions were followed. At the time Penn Central was allegedly loaning funds to New York Central Transport Co., Penn Central did not have the necessary funds in that bank to cover the amounts transferred.

While advances payable were substituted for equity belonging to the sole shareholder, the end result, in effect did not give the 100-percent stockholder entity anything more than it had before. Indeed, it was further provided that future dividend potential of the surviving entity in the trucking company merger was to be reduced by the amount of interest paid—at the prime rate—on the advances.

The form developed for the manner in which dividends would flow upstream to the railroad was regarded by management in the first instance as a manipulation. The interjection of Manufacturers Hanover Trust Co. was a facade designed to provide illusionary evidence of dividend payments by New York Central Transport of the Transportation Company and did not alter the substance of the transaction. <sup>92</sup>

Certainly, the situation appears to bear close analogies to the content of Accounting Series Release No. 95, which deals with real estate transactions:

In some of the transactions coming before us it appears from the attendant circumstances that the sale of property is a mere fiction designed to create the illusion of profit.

Circumstances such as the following tend to raise a question as the propriety of the current recognition of profit:

6. Simultaneous sale and repurchase by the same or affiliated parties.
7. Concurrent loans to purchasers.

As noted above, the dividends to American Contract by Merchants Trucking and Penntruck were passed on to the Transportation Co. as well. The Transportation Co. advanced to the two subsidiaries the \$300,000 and \$1,700,000 necessary to pay the dividends to American Contract. In practical effect the transactions were the same as in the case of New York Central Transport although the format differed slightly.

<sup>91</sup> New York Central Transport Co. reported net income of \$2,686,884 and \$4,202,098 for 1968 and 1969 respectively. Retained earnings, including 1969 results, amounted to \$14,755,632 at December 31, 1969 before, giving effect to the 1969 dividend.

<sup>92</sup> Indeed, Cole has testified that New York Central Transport is currently protesting the transaction and asking for cancellation of the debt incurred.

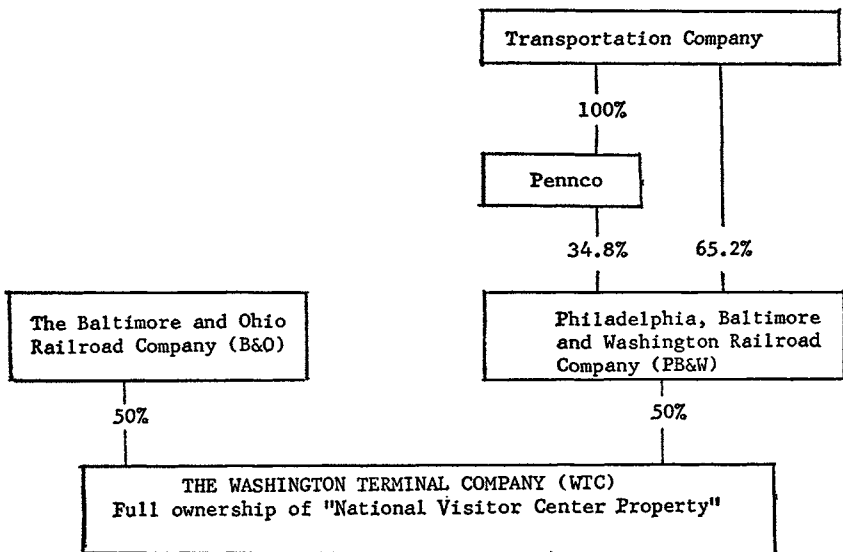
*Conclusion.*—The 1969 "company-only" (railroad) financial statements included the sum of \$66,324,000 as dividend and interest income. Of this amount, \$63,838,000 was from dividends of which \$14 million <sup>83</sup> discussed herein, or 22 percent, is included. The loss from ordinary operations of \$56,328,000, as shown in the 1969 operating statement, was understated by this \$14 million (25 percent of \$56,328,000).

In the opinion of the staff the appearance of dividend income in these transactions is without substance and there is no support under generally accepted accounting principles to include the results of these transactions as dividend income on the "parent company only" financial statements for the year 1969.

#### ACCOUNTING—WASHINGTON TERMINAL CO.

*Background.*—The Transportation Co. reported as dividend income in the year ended December 31, 1968, the receipt of a dividend-in-kind from a 50-percent owned company, the Washington Terminal Co. (WTC). The dividend-in-kind consisted of stock representing 100-percent ownership of a newly formed corporation holding an undivided one-half interest in certain real property and air rights relating to Union Station, Washington, D.C., and its proposed development into a National Visitor Center.

The voting control relationships of the respective entities as of September 13, 1968, just before the declaration of the purported dividend-in-kind by the Washington Terminal Co., were as follows:



<sup>83</sup> New York Central Transport Co.....	\$12,000,000
Merchants Trucking Co.....	300,000
Penntruck Co.....	1,700,000
Total.....	14,000,000

On September 13, 1968, the board of directors of WTC adopted a resolution with respect to the transfer of title to the National Visitor Center property to the owners of WTC. It was the intent to convey undivided one-half interests in the property to two companies to be formed by WTC. The dividend-in-kind would then be accomplished by conveying 100 percent of the common stock of one such company to B&O and 100 percent of the common stock of the other company to the Transportation Co.<sup>94</sup> This was accomplished on or about September 30, 1968, when 100 percent of the stock of Terminal Realty Penn Co. was transferred to the Transportation Co. as a dividend.

The deed by which WTC conveyed (to the newly formed corporation) the undivided one-half interest included the following reservation, among numerous others:

Subject to the continued right of use, possession, operation and maintenance of the Union Station Building, concourse concession areas and related areas presently used for commercial operation by The Washington Terminal Co., its lessees, concessionaires, licensees, passengers, officers, employees, contractors, invitees, and visitors during the period of alteration and construction of the Visitor Center parking facility and new passenger station contemplated by Public Law 90-264 and until the taking of full occupancy by the United States of America pursuant to a lease covering the property herein described.

The deed may have in form transferred legal title of the undivided one-half interest to the newly formed corporation. However, the right to control and use the property remained with WTC.

At the date of the declaration of the WTC dividend-in-kind, it was anticipated that an agreement would be entered into between the U.S. Government and the owners of the distributed property for the development of such property into a National Visitor Center. On December 18, 1968, such agreement was actually executed. The December 18, 1968, agreement provided that the National Park Service would lease the property for 25 years, *after the owners had made significant alterations and improvements, expected to take 2 to 3 years*. After the first year of the deferred 25-year-lease term, the Government had the option to acquire the altered and improved property for a reducing amount declining to zero at the end of the 25 years.

*Accounting Treatment.*—The Transportation Co. recorded and reflected the dividend-in-kind as dividend income in the amount of \$11.7 million,<sup>95</sup> the estimated fair value of its undivided one-half interest.<sup>96</sup> For the year ended December 31, 1968, this represented approximately 13 percent of Penn Central's consolidated net income, while elimination would increase the company-only loss from \$2.8 million to \$14.5 million.

*Conclusion.*—We question the propriety of the recognition by the Transportation Co. of income in the amount of \$11,700,000 in the form of a dividend-in-kind from WTC since in substance the position of the consolidated enterprise was unchanged with respect to the use, possession, operation, and maintenance of the subject property. Generally accepted accounting principles do not permit recording a transaction based on form when its substance is materially different.

The substance of the December 18, 1968, agreement was a promise

<sup>94</sup> Under a lease agreement, the Transportation Co. was entitled to all income of PB&W.

<sup>95</sup> The amount was originally recorded as \$13.5 million but was adjusted later in the year.

<sup>96</sup> WTC's net income for the years ended Dec. 31, 1967 and 1968 was approximately \$56,810 and \$1,401, respectively

on the part of the U.S. Government to purchase certain property *after* significant construction and alternations had been made to transform such property into a National Visitor Center. Recognition of income under such circumstances was inappropriate until the seller had substantially performed its obligations.

#### ACCOUNTING—LEHIGH VALLEY RAILROAD CO.

*Background.*—Prior to 1962 the then PRR, through subsidiaries, owned 44.4 percent of the outstanding shares of Lehigh Valley Railroad Co. As a result of an exchange offer, PRR on February 28, 1963, became the record or beneficial owner of 89.9 percent of the stock and this was increased to 97.3 percent in 1964.

The Lehigh Valley's position was considered in the PRR-New York Central merger hearings before the ICC. The hearing examiner found that the merger could be anticipated to have a detrimental effect on Lehigh Valley and that specific protective provisions should be provided. It would either have to find affiliation with the Norfolk & Western (N&W) or Chesapeake & Ohio/Baltimore & Ohio (C&O/B&O) systems or be merged into PRR. Until this matter was resolved PRR would be required to keep Lehigh Valley operational. The following conditions were imposed by the ICC in its decision dated April 6, 1966, approving the Penn Central merger:

1. Penn Central was required to propose negotiations and, if the offer were accepted, to negotiate in good faith and otherwise use its best efforts to obtain a place for Lehigh Valley in the C&O/B&O system.

2. After October 16, 1969, or upon the issuance of an ICC order denying the Erie-Lackawanna petition for inclusion in the N&W system, Penn Central was required to negotiate in good faith with the N&W with respect to the inclusion of Lehigh Valley within the N&W system.

3. Unless otherwise relieved by the ICC, Penn Central had to retain its holdings in Lehigh Valley and provide financial support to keep that road going for the next 10 years. If at the end of that time, it has not been taken into the N&W or the C&O/B&O systems, the Commission could, as part of the instant proceedings, require inclusion in the Penn Central system.

Neither the N&W nor the C&O/B&O had indicated any interest in acquiring Penn Central's interest in Lehigh Valley either at that time or subsequently.

Lehigh Valley was consistently a loss operation with total losses in 1960-69 of over \$40 million. In 1968 the net loss was \$6 million, while the 1969 figure was \$5.2 million, before an extraordinary charge of \$1.2 million.<sup>97</sup> Meanwhile, Penn Central was required during 1968 and 1969 to advance substantial sums to that company to keep it operational. Shortly after Penn Central filed for reorganization, Lehigh Valley followed suit.

*Accounting Treatment.*—Lehigh Valley was carried as an investment in Penn Central's consolidated financial statements in 1968 and 1969, at the following values:

<sup>97</sup> The company has been unable, by a large margin, to even operate within its depreciation.

## CONSOLIDATED INVESTMENTS AT COST OR LESS

	1968	1969
Unconsolidated subsidiary:		
Lehigh Valley Railroad Co.:		
Stock, 1,475,579 shares.....	\$23.0	\$23.0
Bonds.....	4.1	
Bonds, notes and advances.....		26.5
Total (in millions of dollars).....	<sup>1</sup> \$27.1	\$49.5

<sup>1</sup> The figures omit to state \$9,400,000 in advances to Lehigh Valley, which in 1968 had been included in the asset category of "Deferred charges and sundry assets", under the caption "Accounts doubtful of collection." In the 1969 statements which included comparative 1968 figures this \$9,400,000 was reclassified to the investment account.

No dividends were paid in either year.<sup>98</sup>

Despite Penn Central's 97.3 percent ownership, Lehigh Valley was not consolidated and accordingly its losses were not reflected in the consolidated results. The advantage to Penn Central was obvious, and was consistent with that company's policy of maximizing earnings. The reports included a footnote explaining the principles of consolidation and noting that Lehigh Valley, "which the Commission has required to be offered for inclusion in another system", had not been consolidated. Information as to its net assets and net loss were contained in another footnote.

*Analysis.*—Penn Central apparently relied on the requirement that it offer Lehigh Valley to C&O/B&O and then N&W as the basis for nonconsolidation, drawing its accounting support from the criteria included in Accounting Research Bulletin No. 51. The pertinent section of that bulletin reads as follows:

Consolidation policy:

2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over 50 percent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary; or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy).

In this instance, despite the merger conditions, it appears unlikely that control would be temporary. There were no contacts between Penn Central and C&O/B&O that related in any way to the acquisition of Lehigh Valley in the period from 1966–1969. It seems safe to presume that if Penn Central had thought there was any possibility of interest on the part of C&O/B&O, it would have explored the matter<sup>99</sup> but C&O/B&O was involved in its own merger plans at the time, plans which would clearly not have included Lehigh Valley.<sup>100</sup> Furthermore, even absent the merger factor, the company was not attractive. Both the senior vice-president and the chief counsel of C&O/B&O were emphatic in their testimony: at no time from 1965 to date would Lehigh Valley have had any strategic value to their road. Indeed, the C&O/B&O would have to be paid to take it, because of the obligations and liabilities involved. Its attitude toward that road was completely negative.

<sup>98</sup> No dividends had been paid since 1957.

<sup>99</sup> Not only was it required to do so under the terms of the merger, but it would certainly have jumped at the chance to get rid of this subsidiary.

<sup>100</sup> The Erie-Lackawanna Railroad offered in effect the same benefits as the Lehigh Valley, and was considered more attractive. N&W, which was the potential merger partner of C&O/B&O, absorbed the Erie-Lackawanna in early 1968.

In response to a staff inquiry to the N&W regarding its possible interest in Lehigh Valley, that road's vice president-finance replied:

To my knowledge, Penn Central never approached N&W management about a possible sale of Penn Central's interest in Lehigh Valley. For its part, N&W had no occasion to consider acquisition of Lehigh Valley in view of the mandatory order of the ICC requiring inclusion in N&W of Erie-Lackawanna, which like Lehigh Valley, affords access to the port of New York through Buffalo. Erie-Lackawanna was included in the N&W System on April 1, 1968.

Furthermore, Saunders himself testified that they wanted to sell Lehigh Valley and could find no one to buy it:

*Question. What was wrong with Lehigh Valley?*

Answer. It was killed by competitors. It was not really a good investment, I don't think, but I shouldn't pass judgment on that, but Lehigh Valley has never made any money. It may have way back in the Thirties, but in the last 20 years Lehigh Valley hasn't made a cent.

*Question. Well, why didn't you get rid of Ann Arbor or Lehigh?*

Answer. We tried to get rid of Lehigh Valley, we offered it to Norfolk and Western Railroad and to the C. & O. They wouldn't touch it, nobody would.

*Question. Well, wouldn't they take it out of [sic] of book value?*

Answer. They wouldn't give you a penny for it, that's my judgment. It's not worth anything.

*Conclusion.*—Penn Central knew or should have known that by the year 1968 it could no longer avoid consolidating Lehigh Valley. By this point, it was clear that neither the N&W, nor the C&O/B&O had any interest in acquiring it, and there was no indication of a feasible alternative. The implications of the ICC conditions with respect to Lehigh Valley in the Penn Central merger hearings were clear. The Lehigh Valley would be kept running and if no other solution were found, Penn Central would have to absorb it. The company could no longer rely on ARB No. 51 to avoid consolidating Lehigh Valley.<sup>101</sup>

Against this background it would appear that the company's consolidated income statements for 1968 and 1969 were overstated by the amounts of \$5.8 million and \$5.1 million (\$6.2 million after extraordinary charges) which represented 97.3 percent of the unaudited losses for Lehigh Valley for those years.

Even if it were deemed that Penn Central had an arguable position, supported by persuasive evidence, for not consolidating its 1968 and 1969 financial statements, the evidence clearly indicates the necessity of a write-down of this investment, at least by December 31, 1969. In this instance, the negative impact on the 1969 financial statements would be even greater than in the case of consolidation.

The stock was listed on Penn Central's books at a value of about \$15 per share, whereas the price range in 1969 was \$6¼-4.<sup>102</sup> In addition, beginning in 1968, Lehigh Valley required significant infusions of capital from Penn Central.<sup>103</sup> The operating history of Lehigh Valley for the decade prior to 1970 clearly indicated that the Penn Central could not expect repayment of advances<sup>104</sup> and any benefit from share ownership. All evidence points to a situation of permanent impairment in Penn Central's investment.

<sup>101</sup> It might be noted that the Wabash Railroad Co. was also an unconsolidated, majority owned company but, as discussed previously, in that case the temporary nature of the control was obvious. See page 55.

<sup>102</sup> The market was, of course, limited considering Penn Central's 97 percent ownership. The price might reflect this factor to some degree.

<sup>103</sup> Prior to that time, Lehigh Valley had relied largely on proceeds of the sale of capital scrap [largely second track that they took up] for additional capital.

<sup>104</sup> As noted previously, Penn Central itself initially classified the advances as "accounts doubtful of collection," although this was later reclassified into the investments category.

The audit workpapers of Peat, Marwick for 1969 illustrate their awareness of the problem. They stated, "Lehigh Valley—to be written down or reasons must be supplied."

As a result they obtained a representation letter from Bevan stating the following:

One of the roads to which the Lehigh Valley must be offered is the C&O and if the merger with the Norfolk & Western does not go through, the Lehigh Valley will have great strategic value to the C&O and we certainly should be able to come out well on our investment.

There are other alternatives we have in mind if this does not occur but it is too early and premature to determine to what extent, if any, an impairment may result in the investment.

As indicated earlier, it was clear by this point that C&O/B&O had no desire to acquire Lehigh Valley, a fact of which Penn Central must have been aware. There is no evidence of meaningful alternatives available at the time.<sup>105</sup> In late July 1970, Lehigh Valley entered into reorganization and Penn Central wrote off the unsecured portion of its investment, amounting to \$30.3 million.

#### ACCOUNTING—MERGER RESERVE: SEPARATION OF MAIL AND BAGGAGE HANDLERS

*Introduction.*—The consolidated financial statements included in Penn Central's 1967 annual report to shareholders contain the following note:

The Penn Central merger results in duplication or obsolescence of certain railroad properties, equipment, materials and supplies, and the requirement to rehire certain otherwise surplus furloughed employees, all of which are estimated to represent \$275,421,985 in costs and losses. An extraordinary charge for these items has been provided as a reduction of earnings in 1967. The effect on the balance sheet, at December 31, 1967 is:

##### Adjustment of assets:

Obsolescence of materials and supplies.....	\$6, 013, 000
Impairment in value of properties.....	125, 859, 313

Total.....	131, 872, 313
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##### Provisions for Liabilities:

Impairment in value of leased property.....	385, 461
Cost to demolish obsolete properties.....	26, 236, 211
Cost of recalled employees.....	116, 928, 000

Liabilities incurred upon merger.....	143, 549, 672
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Total costs and losses incurred upon merger.....	275, 421, 985
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In 1968 and 1969, charges of \$17,225,000 and \$7,216,000, respectively, were made to the provisions other than those for recalled employees. The charges to the merger loss provisions relating to recall of surplus furloughed employees totaled \$22,459,000 and \$15,250,000 for the 2 years, respectively.

There has been concern as to the propriety of creating a large "reserve for future losses" by means of an extraordinary charge to income. There are some circumstances where the creation of such a reserve is proper accounting and in this case there seems to be justification for its establishment. Under such conditions, the critical

<sup>105</sup> While shareholders equity was still \$67 million at the end of 1969, there is no indication that this figure had any meaningful relationship to liquidating value. Indeed the figure had been declining from year to year and was down from nearly \$100 million at the time when P.R.R. acquired control in 1963.



problem is to make sure that all charges against an appropriately established reserve are reasonable and proper.

*Background.*—A merger protective agreement dated January 1, 1964, entered into between the two railroads and the labor unions provided that, if the merger ultimately became effective, no one employed during the period from January 1, 1964, to the effective date of the merger would be terminated after January 1, 1964. A subsequent termination did not have to be merger related for the agreement to apply.

There were two separate classes of employees who were expected to be made surplus as a result of the merger. The first group numbered about 7,800 and were to be made surplus as a result of consolidations, coordinations, elimination of facilities, and so forth. It was made up of employees who were working as of February 1, 1968, and were to be subsequently made surplus. All wages relating to such 7,800 employees were to be charged to current operations—*none* charged to the liability reserve. The second group consisted of approximately 5,600 employees, furloughed prior to the merger, but who, due to the merger protective agreement, had to be recalled to service upon consummation of the merger and had to be employed and/or paid thereafter until they left through natural attrition. It was the railroads' position that the costs associated with the recall from furlough to idle or nonproductive work of these 5,600 employees was solely related to the merger.

The \$116,928,000 liability reserve established was to provide only for wages to be paid to these surplus furloughed employees and only if they were involved in idle-time or nonproductive assignments. It should be noted that this group of employees was not made surplus by any projects conducted after the merger but were already surplus prior to the consummation of the merger; the obligation to recall them to service came about solely as a result of the merger protective agreement and not from anything connected with the physical operation or consolidation of the merged railroads. In other words, if the merger would not have been consummated, the railroads would have had no obligation to recall such furloughed employees.

*Application to the ICC for Approval of the Charging of Separation Cost of Mail and Baggage Handlers.*—In 1968, as a result of curtailment of use of Penn Central's services by the U.S. Post Office Department, Penn Central incurred a cost of \$4,672,000 in separation payments to mail and baggage handlers made surplus by that curtailment. By letter to the ICC dated January 23, 1969, Penn Central argued that such costs should be charged to the "merger reserve" instead of being reflected as an operating expense for the year ended December 31, 1968. The primary reasons given in the letter were that such costs were directly the result of the labor agreements incident to merger,<sup>106</sup> they were unproductive of merger savings, and "... the reserve was adequate to provide for these charges since a number of employees entitled to reemployment upon merger and for whom reserve provision was made failed at their own volition to appear on the rolls of the company." Penn Central did not explain why such costs did not more closely resemble the type relating to the expected "protection" payments to the 7,800 employees referred to above than they did to those

<sup>106</sup> The separation payments were a way of "buying-out" of the guarantees established under the Merger Protective Agreement.

which had been provided for in the merger reserve. Hill, who was instrumental in obtaining the necessary ICC approval, claimed that the separation of mail and baggage handlers had been delayed as a result of a fire in the related facilities and that otherwise they would have been separated prior to the merger. However, when asked to provide documentary evidence of this, he furnished two memoranda, one prepared in December 1968 which does not refer to a fire, and one in January 1969, which makes only incidental reference to a fire.

The December 1968 memorandum, which was prepared by Hill, does, however, clearly indicate that in the absence of other authority, the severance costs would have to be recorded as charges against income in the year 1968. The memorandum further states that while it would appear likely that the ICC would grant authority for such a charge, it was unlikely that Peat, Marwick would accept it:

"The principal reason for rejection by independent accountants is that the costs arise as a result of decline in business under an agreement which the company was willing to adopt as a price for doing business on a merged basis. Under such circumstances, independent accountants would conclude the costs are expenses of the period and therefore chargeable against income without regard to any prior period provision of reserves."

Indeed, it is clear that in the railroad industry, contracts giving extensive protection to labor and entered into to "buy" the cooperation of labor are by no means unique to the merger situation, and related costs are typically considered as operating expenses.

The period in mid and late January was one of substantial activity by a Penn Central management bent on avoiding this charge against operations. On January 22, 1969, Hill and Tucker (a Penn Central vice president who had a short time earlier served as ICC Chairman) met with Mrs. Brown, the current ICC Chairman, and Commissioner Bush to discuss the propriety of the charge. About a week earlier Saunders had met with Walter Hanson, senior partner of Peat, Marwick for what he described as a general get-acquainted meeting. In a memorandum dated January 21, 1969, Cole advised Saunders that Hill had that day spent a considerable length of time with Peat, Marwick and that "... they didn't understand that Mr. Hanson had changed his position about the propriety of including mail handlers' separation pay." The following short memorandum, prepared by Cole, was given to Hill on the morning of January 22, 1969, the day of his meeting with the ICC:

Your interpretation of the Saunders-Hanson conversation about separation pay for mail handlers is correct. That is to say, PMM will not take exception to the charging of this expense to the Reserve if the ICC will approve that accounting.

By letter dated January 23, 1969, Peat, Marwick expressed its opinion to Penn Central that the \$4,672,000 "... costs would not constitute an appropriate charge against the reserve." However, Peat, Marwick then went on to state the following (emphasis added):

We understand that you intend to petition the Interstate Commerce Commission to review the facts concerning the separation of the mail and baggage handlers and to rule on the question of whether such separations are, in fact, merger-related. We have reviewed the letter addressed to the Commission by Mr. Saunders. *Under the circumstance, if the Commission in its judgment deems the separations to be merger-related and the costs incident thereto chargeable against the reserve, we would no longer have a basis for objection to a charge against the Merger Reserve for this purpose.*

Henry Quinn, the writer of the January 23, 1969, Peat, Marwick letter, testified that he may have been expressing his own personal opinion in such letter. He explained by saying that the Peat, Marwick staff had discussed the matter and several felt that the \$4,672,000 was an appropriate charge to the "merger reserve." He stated further that his opinion was not whether the charge was in accordance with generally accepted accounting principles but was whether the charge was in accordance with the criteria initially approved by the ICC. Accordingly, it was Peat, Marwick's position that if the ICC said that the \$4,672,000 charge was appropriate then Peat, Marwick would not object.

By letter dated January 29, 1969, the ICC notified Penn Central of its decision:

This will advise that a majority of Division 2<sup>107</sup> in conference today voted to grant the letter request filed January 23, 1969, for authority to charge an amount of \$4,672,000 expended during 1968 in connection with separation of mail and baggage handlers against the "merger reserve" established in 1967.

It should be noted that the ICC's letter did not address itself to the question of whether the charge met the criteria originally established; instead, it merely gave permission to charge the reserve. The decision was made by Division 2 without the benefit of a written Bureau of Accounts analysis and recommendation.

*Conclusion.*—With respect to the special charge relating to the termination of mail and baggage handlers, the facts expressed in Saunders' January 23, 1969 letter to the ICC clearly disclose that the \$4,672,000 charge did *not* relate to recalled surplus furloughed employees or appropriate substitutes. Such letter clearly indicates that the \$4,672,000 charge related to a curtailment of services *after* merger and that such curtailment was not merger related. The additional facts available to the staff clearly indicate that the curtailment was a non-merger related reduction in the demand for the railroad's services by the Post Office Department. The accounting rationale for setting up the original \$116,928,000 liability for the recall of surplus furloughed employees was that solely as a result of the effectiveness of the merger a liability had been created and the combined railroads had therefore suffered an expense (loss), unrelated to future operations, that had to be recognized. This accounting rationale does not apply to the facts leading to the \$4,672,000 in payments. The operative fact leading to such payments was the curtailment of services, not the mere fact of the effectiveness of the merger. The liability, and hence the expense, did not exist as of December 31, 1967 nor February 1, 1968. Nor was there a known contingent liability as of such dates.

The \$4,672,000 in separation payments incurred during 1968 as a result of the curtailment in services of mail and baggage handlers appears not to come within the letter or intent of the original "merger reserve" criteria. Accordingly, even though the ICC allowed it for ICC reporting purposes, such amount should have been reflected as a period expense during the year ended December 31, 1968 in Penn Central's annual report to shareholders.

<sup>107</sup> Division 2 is the three Commissioner panel responsible for hearing appeals in ICC accounting matters.

## ACCOUNTING—EXECUTIVE JET AVIATION

*Background.*—In 1965, as part of its diversification program, PRR, through a wholly owned subsidiary, American Contract Corp., acquired 655,960 shares of class B nonvoting common stock of Executive Jet Aviation, Inc. (EJA) at a cost of \$327,980 representing a 58-percent interest in the company's combined class A and class B shares outstanding. American Contract's largest investment in EJA, however, was in the form of loans and advances. Between 1964 and 1969, loans totaling \$21 million<sup>108</sup> were made by American Contract with funds provided to it initially by PRR, and later by Pennco.

EJA had been formed in 1964 as an air taxi operation, to furnish air transportation when and as needed to executives at a fixed rate per mile under a minimum usage contract. PRR looked upon its investment primarily as a way of entering the air transport and air cargo fields. In August 1966, EJA negotiated for the acquisition of Johnson Flying Service, Inc., whose principal asset was a permanent certificate as a supplemental air carrier, which it had received from the Civil Aeronautics Board. Shortly thereafter, EJA committed itself to purchase four large jet aircraft at a total cost of \$26 million. However, unless and until EJA received the required CAB approval for acquisition of Johnson Flying Service, EJA had no use for the aircraft since it lacked the authority to operate them.

In late 1966 EJA applied to the CAB for approval of its acquisition of Johnson Flying Service. After a lengthy hearing before a CAB trial examiner a decision to approve of EJA's acquisition was made, with the condition that PRR divest itself of control of EJA within 6 months. The divestiture was ordered because the examiner found that PRR was in control of EJA in violation of the provisions of the Federal Aviation Act, which requires CAB approval before any surface carrier can acquire control of an air carrier.<sup>109</sup> The CAB adopted the examiner's decision, with certain limited exceptions, in June 1967.

Subsequently, PRR and EJA prepared and submitted for approval to the CAB a financing and divestiture plan. In this connection, a preliminary registration statement was filed with the SEC, covering certain aspects of the proposed financing.<sup>110</sup> On December 22, 1967, the CAB held that the plan, which contemplated considerable continuing investments in EJA by PRR, did not meet the requirements the CAB had established. It indicated that complete liquidation of PRR's investment was required.

Meanwhile, the PRR was quietly continuing to advance moneys to EJA. And EJA itself was still thinking in terms of expansion. In the last half of 1967, it embarked on a "world operating rights" program designed to acquire controlling interests in various foreign supplemental air carriers. At the same time, Penn Central was also purportedly trying to find a buyer for its interest in EJA, although its desire to retain some sort of "buy-back" rights was making this more difficult. In mid-1968 U.S. Steel Corp. and Burlington Industries Inc.

<sup>108</sup> The advances were as follows:

Through 1966.....	\$13,864,877
1967.....	2,441,000
1968.....	2,714,000
1969.....	2,000,000
Total.....	21,019,877

<sup>109</sup> PRR had been aware of this problem earlier and taken steps to obscure its effective control.

<sup>110</sup> This was later withdrawn.

entered into a memorandum of understanding whereby they would purchase Penn Central's equity and debt interest in EJA, subject to EJA's receiving CAB approval to acquire Johnson Flying Service.<sup>111</sup> However, Burlington withdrew from the agreement in December 1968 and U.S. Steel followed. Other attempts by Penn Central to dispose of its interest in EJA proved unsuccessful.

In late 1968 the CAB hearings resumed to consider the steps being taken toward divestiture. EJA's surreptitious foreign air carrier acquisitions and the continuing control being exercised by Penn Central were brought to the attention of the Board by other supplemental air carriers. After the CAB began to inquire into its overseas activities, EJA, in January 1969, withdrew its application for permission to acquire Johnson Flying Service and filed a request that the proceeding be terminated. On June 4, 1969, the CAB instituted proceedings to determine whether EJA and Penn Central had violated provisions of the Federal Aviation Act. Subsequently, in October, the CAB issued a cease-and-desist order, to which Penn Central and EJA consented. In addition to levying substantial fines against both, the order directed EJA to divest itself of control of foreign air carriers and Penn Central to divest itself of control of EJA.<sup>112</sup>

*EJA's Operating and Financial Condition.*—Since starting its operations in 1965, EJA sustained continuing losses in its domestic<sup>113</sup> and foreign<sup>114</sup> operations. At the same time that these losses were draining the financial resources, substantial amounts of capital were required to meet the demands of the company's expansion program. With the assistance of senior financial officers of Penn Central, arrangements were made for outside financing, but this could be obtained only under terms requiring that the loans be secured by aircraft and that Penn Central agree to subordinate its interests in the assets of EJA. This meant a reduced security position for American Contract. In addition, Penn Central, despite its own difficult financial situation, was forced to agree to deferral of interest and debt payments from EJA as they became due. And by the end of 1967, the financial condition of EJA's foreign subsidiaries was so bad that in order to meet minimum capital requirements under Swiss law, EJA had to subordinate its interest in these subsidiaries to that of all other creditors.<sup>115</sup>

Early in 1969 Lybrand, Ross Bros. & Montgomery, EJA's auditors, informed their foreign correspondent, who audited EJA's foreign subsidiaries, that the subordination agreement might be open to attack in view of the parent's financial condition. Penn Central was informed that, because of this, before the foreign auditors would sign the auditors' report, they were insisting on a statement "that during the year 1969 the danger of EJA going into liquidation does not exist" or "that EJA Inc.'s parent [Penn Central] has agreed to subordination." The statement was to be signed either by EJA's auditors or by Penn Central or someone with power of attorney to sign for Penn Central.

The withdrawal of the application to acquire Johnson Flying Service in early 1969 effectively meant the end of EJA's grandiose

<sup>111</sup> If EJA was successful, Penn Central would realize a small profit; if it were liquidated, it would incur a small loss.

<sup>112</sup> The order directed Penn Central to place all debt and equity interests in EJA into an irrevocable liquidating trust and to divest all of its interest no later than Mar. 1, 1970.

<sup>113</sup> 1965 loss, \$932,000; 1966 loss, \$2,214,000; 1967 loss, \$869,000; 1968 loss, \$3,830,000; 1969 loss, \$4,101,000.

<sup>114</sup> 1965 profit, \$10,000; 1966 loss, \$747,000; 1967 loss, \$533,000; 1968 loss, \$489,000; 1969 loss, \$265,000.

<sup>115</sup> The companies had a very substantial equity deficit.

plans and further meant that the company had substantial equipment which it could not operate. EJA was forced to search for purchasers for the large jet aircraft and allied equipment it had acquired. The company was obviously in extremely serious difficulty, since this would undoubtedly result in additional severe losses, on top of the already unsatisfactory results. Indeed, because of this and other matters, Lybrand wrote to O. F. Lassiter, EJA's chairman in February 1969, outlining to him four major areas that would have to be resolved before they could complete their audit for 1968. No audited financial statements were issued for 1968 or 1969 until after Penn Central's bankruptcy. At that point the auditors disclaimed an opinion on the statements.<sup>116</sup>

In the summer of 1969, a former EJA officer, John Kunkel, filed suit alleging mismanagement by EJA's president and naming Penn Central, American Contract and Bevan, among others, as defendants. There appears to be considerable evidence that mismanagement and corporate waste were indeed adding to EJA's substantial operating losses. Even then, however, Penn Central did not insist on being provided with audited financial statements for this company in which it had a major investment.

As indicated earlier, Bevan and other top Penn Central financial officers had been instrumental in obtaining substantial loans for EJA, through Penn Central's banking connections. The largest loan was from First National City Bank and by late 1969 their concern at the situation in EJA was reflected in frequent conversations between bank officers and Bevan and Jonathan O'Herron, vice president-finance of Penn Central. One bank employee reported in an internal bank memorandum dated March 6, 1970 that EJA was "both insolvent and on the verge of bankruptcy" but that Penn Central did not want to take a loss that quarter on the investment. Internal Penn Central management concern during the same period was evidenced in a memorandum to Saunders, dated March 8, 1970, in which Cole reported:

But what about now? It should be clear by now that no one is willing to take our position and Mr. Bevan apparently admitted to you last week the probability of a loss in EJA some time this year in suggesting the Wabash gains be used as an offset. Indeed, if the rumors are true, EJA is not meeting its current fuel bills, one of the big New York banks is calling a \$2 million loan within the next 10 days and Lassiter has been diverting funds for some enterprise of his own.

In contrast, Bevan's stated position, as reflected in a "comfort letter" addressed to Peat, Marwick concerning the necessity for a writedown to be reflected in the 1969 statements, was as follows:

Pursuant to order of the Civil Aeronautics Board, we must dispose of our investment in Executive Jet Aviation by March 1, 1971. Consequently we are at this time carrying on negotiations with a number of interested parties with a view of disposing of our holding just as soon as practicable. It is a complicated situation and consequently negotiations as between interested parties vary widely. We anticipate that our holding will be disposed of in the relatively near future but only at that time will it be possible to evaluate intelligently the consideration to be received for our investment. It is almost certain that we will receive various types of securities in exchange for our stock.

<sup>116</sup> They stated that although the statements were prepared on a going-concern basis, continuing operations were contingent on resolution of the following matters:

- (1) Realization of assets and liquidation of liabilities connected with discontinued operations;
- (2) Stopping of losses of foreign subsidiaries;
- (3) Preventing default actions available to creditors; and
- (4) Stopping losses of domestic operations.

It might be noted also that EJA had a reported capital deficit of \$13,400,000 as of the end of 1969 and \$9,000,000 at the end of 1968.

This letter was dated March 12, 1970, a few days after the Cole and First National City Bank memoranda.

During the second quarter of 1970, American Contract finally wrote down its investment in EJA by \$16.2 million because of impairment in value. This action was taken after the bankruptcy, when the public impact of such a writedown was minimal.

*Conclusion.*—It is obvious that American Contract's investment in EJA was seriously impaired by the continued losses sustained since its formation. The inability of EJA to obtain financing from any independent source, the CAB's divestiture order, the withdrawal of the offer of U.S. Steel and Burlington to purchase Penn Central's interest, and the write-off by EJA of certain costs and equipment related to its anticipated operations as a supplemental air carrier made realization by Penn Central of its EJA investment extremely unlikely and reflected a permanent impairment in value. Based on all available evidence, it appears that the \$16 million writedown recorded in mid-1970 should have been recognized in 1968 and 1969.

*EJA addendum: The \$10 million Liechtenstein account*

As part of our review of the Executive Jet Aviation matter, we also inquired into the transfer of \$10 million by the Penn Central Transportation Co. to a Liechtenstein Account.

We encountered great difficulty in exploring the facts in this area. The key witness, Joseph Rosenbaum, a Washington attorney, declined to testify, asserting his rights under the fifth amendment. Other key witnesses are out of our jurisdiction and we were unable to question them or obtain records from them. Accordingly, the facts we have were obtained from the company's available documents and discussions with various persons who either have direct knowledge of the transactions or who have questioned others and have second-hand knowledge. The facts we have learned indicate the need for additional inquiry.

**1. THE COMPANY'S USE OF EUROPEAN FUNDS FOR THE FINANCING OF THE REHABILITATION OF EQUIPMENT**

In early 1969, the company found it almost impossible to find domestic sources of funds to be used for the rehabilitation of railroad equipment. Joseph Rosenbaum, a Washington attorney in practice with his brother, Francis Rosenbaum, had been involved in obtaining financing and possible acquisitions for the company since early 1968. The Rosenbaums had let it be known to the company's top management that they had foreign sources of available funds. One of these sources was Fidel Goetz, a German financier. A number of transactions resulted from this relationship.

The first effected by the Rosenbaums involved the obtaining of financing through a Rosenbaum family partnership, American Investors Co., for the purchase and lease of automobile racks used by the company in transporting automobiles. The second transaction involved a \$12 million equipment-rehabilitation loan from the Berliner Bank, Berlin, Germany, in mid 1969. Thereafter in August of 1969, the Rosenbaums again through the Berliner Bank arranged for another equipment loan of some \$10 million to be secured by a conditional sales

agreement between the company and American Contract Co., a wholly-owned subsidiary of the company. Funds were to be drawn down as "groups" of the equipment were completed and a schedule of equipment which had been rehabilitated was submitted to the lender.

## 2. THE CLOSING OF THE LOAN AGREEMENT AND THE DISBURSEMENT OF THE \$10 MILLION PROCEEDS

### (a) *The closing*

Prior to the completion of the transactions the parties met in Bevan's office in Philadelphia, Pa. on September 11, 1969. In attendance were, among others, David Bevan, William Gerstnecker and Robert Loder from the company, Joseph Rosenbaum and his brother Francis Rosenbaum, and John Young of the New York law firm of Cravath, Swaine & Moore. It is not clear who the Rosenbaums represented in these discussions.

During the morning the various documents were reviewed by the parties, and corrections made. Right after lunch, there was a meeting of the officers of American Contract Co. ("ACC"), the company's subsidiary, at which time the contract and related documents were ratified. One of the Rosenbaums then took the documents to Germany for the approval and signatures of the appropriate officials of the Berliner Bank. Among these documents was a letter signed by the president of ACC addressed to an entity known as First Financial Trust ("FFT") a Liechtenstein trust. The letter advised FFT that it (ACC) had directed the Berliner Bank to transfer the \$10 million proceeds of the loan to FFT's account. The letter instructed FFT to invest the funds for the benefit of Penn Central Transportation Co. and requested that the company be protected "insofar as possible against the possibility of revaluation of the Deutsche mark."

First Financial Trust prior to September 15, 1969, was a Goetz entity known as Finimobil Anstalt which had been a dormant "Liechtenstein trust." On September 15, 1969, its name was changed to First Financial Trust and Francis Rosenbaum and Joseph H. Rosenbaum were listed as the only individuals authorized to give instructions to the agents, Dr. Peter Marxer and Adolf Goop. The first act of First Financial Trust was to open a bank account with the "Bank in Liechtenstein."

### (b) *Transfer of the proceeds to the First Financial Trust account*

Although the Berliner Bank was directed to transfer the \$10 million to FFT's account with the bank in Liechtenstein, the Berliner Bank refused to do so because neither the company nor ACC had an account at the Bank in Liechtenstein.

This prompted the company to issue amended instructions providing for funds to be deposited with the Chemical Bank's correspondent bank in Germany, the Allgemeine Bankgesellschaft. At the same time these instructions were given, the Chemical Bank's correspondent bank was directed to transfer the \$10 million to FFT's account with the Bank in Liechtenstein.

### (c) *Transfer of \$4 million of the loan proceeds to Fidel Goetz*

In 1967, Fidel Goetz, a German financier, was introduced to the top management of the company by Charles Hodge of Gloré Forgan, Wm. R. Staats, Inc., who had also introduced Joseph Rosenbaum to the company. According to Bevan, when Goetz first met him,



Goetz expressed an interest in loaning money to American companies and investing funds in foreign airlines. Goetz was apparently aware of the company's interest in EJA, and of EJA's plan to acquire interests in foreign air carriers.

Goetz claims that during the latter part of 1967 and throughout 1968 he made various investments in foreign air carriers as a result of which he maintains he sustained losses of over \$4 million. It is further claimed that the interests were acquired by Goetz to assist EJA in its foreign air carrier program, and that Bevan had promised that he would be held harmless from any loss sustained in connection with these transactions. Bevan denies that he had any such arrangement with Goetz. Goetz claims that the moneys were due him as a result of losses he sustained when the company was forced by the CAB to curtail and divest itself of its overseas foreign air carrier program of EJA.

David Bevan testified that the suggestion for transferring the proceeds of the loan to the Goetz entity, FFT, originated with Gerstnecker, his assistant. Gerstnecker testified that the suggestion came from Joseph Rosenbaum, and that he advised Bevan of that fact. Bevan imposed no objection to placing the funds with Goetz because, according to what Bevan told Gerstnecker, Goetz had attempted to raise financing for the company and had "been involved in EJA matters."

On the same day, September 22, 1969, that the \$10 million proceeds were transferred from the company's account in the Chemical Bank to FFT's account in the bank in Liechtenstein, \$4 million was withdrawn, at the direction of the Rosenbaums, and deposited in an account for Vileda Anstalt, a Goetz entity. Dr. Marxer, a Liechtenstein attorney, and his partner, Adolf Goop, who were agents for FFT had been directed to so transfer the funds by the Rosenbaums who had stated in writing to Dr. Marxer that Vileda Anstalt was owed these moneys by the company. Dr. Marxer did not question this statement as Francis Rosenbaum had been introduced by Goetz as an attorney representing Penn Central Transportation Co.

*(d) The drawdown of \$6 million from FFT by the company*

The conditional sale agreement signed on September 12, 1969, specified that the rehabilitated equipment was to be completed in two groups, the first group involving some \$6 million and the second some \$4 million.

When the first group was completed on October 21, 1969, the \$6 million became available for use to the company's subsidiary, ACC. At or about that time Joseph Rosenbaum arranged to transfer that amount to the company's account at the Chemical Bank.

**3. THE COMPANY'S DELAY IN DRAWING DOWN THE \$4 MILLION ON DEPOSIT WITH FIRST FINANCIAL TRUST**

Some time in late 1969, the rehabilitation of the second group of equipment was completed, and the company would have been entitled to draw down the remaining \$4 million at that time. When inquiry was made of Bevan by other company employees, Bevan stated that it was not the right time to draw down the funds. It was indicated that the funds were to remain in Europe so that Goetz could use them as a compensating balance. These funds have never been recovered by the company.

#### 4. OTHER COMPANY FUNDS DIVERTED TO GOETZ BY THE ROSENBAUMS

This was not the first time that the Rosenbaums were instrumental in directing the company's funds to the use of Mr. Goetz. In May of 1968, the Rosenbaums received \$1,125,000 from the company as a "security deposit" which was to be "front money" to enable the Rosenbaums to develop "fresh" sources from which the company could borrow funds. But, in fact, these funds were transferred to Goetz' account, Finance Aktiengesellschaft, in the bank in Liechtenstein. These funds were returned to the company on August 6, 1968. On August 28, 1968, the Rosenbaums were instrumental in transferring \$675,000 to an account, Agencier Industrial Corp., in the bank in Liechtenstein. The funds were not returned to the company until July 21, 1969.

#### THE ROLE OF THE INDEPENDENT AUDITOR

The discussion of the accounting principles followed by Penn Central inevitably raises questions in regard to the role of Peat, Marwick, Mitchell & Co., the corporation's independent public accountants.

In the various individual accounting controversies discussed above, it appears that a variety of justifications were presented to the auditors supporting the accounting methods followed. The validity of a number of these justifications seems doubtful, and the depth of investigation by the auditors of company assertions was perhaps less than might have been expected under the circumstances.

The problem of distinguishing form from substance is a significant and difficult one, yet successful discrimination is essential if financial statements are to be meaningful to investors and creditors. A number of the specific problems above are of this nature. Independent auditors bear a heavy burden of public responsibility in reviewing transactions with such a distinction in mind. It is not clear that the auditors in this case gave sufficient consideration to the reality behind the various transactions.

In addition to the analysis of various individual transactions, the overall impression left by the financial statements is part of the responsibility of the public accountants. Statements cannot simply be the accumulation of data relating to individual transactions viewed in isolation. Questions can be raised as to whether a reasonable and dispassionate appraisal of the totality of Penn Central's operations could lead to the conclusion that the company was profitable in the year 1969. It is not apparent that such an appraisal of the total impression created was fully considered by the auditors.

#### EXHIBIT IB-1—DIARY OF DAVID C. BEVAN

For a variety of reasons, I have decided it is advisable to keep a diary regarding certain things.

1. About a month ago, at a Budget Meeting S. T. S. stated he thought we should deliberately underestimate our per diem charges until such time as we received a rate increase in order to help out in the income account. I ignored this statement and changed the subject to another area. After the meeting Tom Schaekel came up to me very much disturbed and shocked and asked me if S. T. S. meant this since I had specifically instructed him after we got out of some trouble when

the per diem was handled in the Operating Department that under no circumstances was there ever to be any juggling in this account. I told Schaeckel to ignore the entire thing and proceed in accordance with instructions and accrue per diem as accurately as possible regardless of anyone and I would stand back of him.

2. The same afternoon S. T. S. advised me that he had a talk with Bill Johnson of the Illinois Central and they might be interested in purchasing our interest in the Willet Co. and he wanted to push this sale through to get profit involved before end of quarter, if humanly possible. He said if this did not work out could we arrange a wash sale to get the profit anyway. I told him this was not possible but I would do everything I could to work out a sale if the Illinois Central was interested—it developed they were not.

*August 22, 1967*

1. Coming back this morning on the plane from New York, S. T. S. was reviewing the very poor forecast of earnings for the third quarter. After covering various expense items that might be involved, he said that we had to find an additional \$5 million of revenues. Although he did not come out and say so since I have nothing to do with revenue side of the picture, except from accounting, the implication was clear that he expected me to get this out of clearing account regardless, a matter in which he has expressed a great deal of interest.

2. I was informed by W. S. C. at home tonight that Basil Cole had been down to see him on instructions of S. T. S. to find out if there was any way we could avoid recording in the third-quarter accounting the loss on sale of Manor Building in Pittsburgh. W. S. C. replied in the negative.

*Wednesday, August 23, 1967*

Wednesday night, before dinner, at Seaview S. T. S. came up to me and said that he just wanted me to know that in his opinion the Financial Department was the best department in the Company and best managed and he greatly valued the warm friendship existing between us for many years.

*Friday, August 25, 1967*

Just before lunch today, Fred Sass said he had to see me immediately after lunch on an urgent matter. It develops that on Wednesday morning, before we left for Seaview, S. T. S. called him in and told him we had to find \$5 million of additional revenues in the third quarter.

I asked Sass what that had to do with him since he has nothing to do with accounting but merely participates in forecasting. He said it was not clear to him. He did not have a chance to ask any questions as S. T. S. was talking at him but there seemed to be an implied suggestion that if revenues were not there we should mortgage our future and put \$5 million in anyway.

I told Sass this was not very logical since he had nothing to do with accounting but he could review our present forecasts all he wanted to, but under no circumstances was he to come up with a revenue forecast on any other basis than the best combined judgment of the forecasting committee.

*Wednesday, August 30, 1967*

This morning at our Budget Meeting I advised S. T. S. that we had just received information with respect to taking inventory and there

is an indicated deficit in the inventory of \$4 million, that we still had to take inventory at Altoona and this would probably be on the plus side but not by any substantial amount. I went on to say that this deficit meant that our inventories were currently overstated by \$4 million and that our operating expenses for the year to date were understated by \$4 million through failure to charge out the missing inventory and, therefore, our profit picture was \$4 million worse than so far reported. This would have to be absorbed before the end of the year.

S. T. S. replied that we certainly could not afford to have a charge of this magnitude made against income and he advised D. E. S. to look into the situation immediately. I have no idea what he can produce other than if the figures mentioned should contain some error or errors. However, in view of the fact I was not sure whether the figures were firm or preliminary, I did not press the matter nor did D. E. S. ask what he was to look into.

Later both our Treasurer and Comptroller came to me disturbed by the implications involved and said that we just had to charge this out this year with which I agreed.

*Monday, November 6, 1967*

This morning we had quite a difficult budget meeting. Included in charges against the fourth quarter earnings we indicated a \$3 million deficit for inventory shortages and an increase in the requirements for injuries to persons and loss and damages of \$2.1 million.

For some months we have known of both of these and S. T. S. has been consistently advised these charges would have to be made. In each instance he has requested they be put off until the fourth quarter when earnings will be better and we will have the rate increase.

This morning he strenuously objected to what he termed loading everything against the fourth quarter. He said some people did not seem to realize we were going to merge with the New York Central and whether or not we were underaccrued by several millions of dollars at that time would never be known and would make no difference.

I explained as far as inventory deficit was concerned this shortage basically represented an understatement of earnings and had to be taken care of this year.

He then jumped on increased requirements for injuries to persons and loss and damage. He stated these were estimates at best and there was no reason to catch this up in the fourth quarter. I explained that we closed our books at the end of the year and that we had to have our reserves as proper as we knew how at that time. He then lost his temper and said I and nobody else would decide what we are going to charge in this connection. I remained silent and we moved on to other matters.

It is obvious there will be extreme pressure on everyone to cut these charges as contained in the attached memorandum of November 3 just as far as possible since he insisted at the close of the meeting that we had to have earnings in the fourth quarter of \$13 million and \$22 million for the year. We only had \$7.5 million for the first 9 months; it is not clear how we jump from the \$20 million to the \$22 million but I raised no question.

S. T. S. also complained bitterly over the fact that profit on sale of real estate in the third quarter on the UNJRR went to the UNJRR and could not be included in the account of PRR itself but only in the

consolidated statement and at the same time the capital gains tax had to be charged to PRR. He wanted to know who wrote the lease and wanted to see a copy of it. It was explained to him the lease was made over 100 years ago. He also said it was unfair the other stockholders should get a windfall with PRR paying all the tax. It was explained to him that one factor in the annual rental paid by the PRR is the income tax of UNJRR and that the tax is increased by gains and decreased by losses and in our consolidated return we get all the benefit of the gains and that the other stockholders of the UNJRR get no windfall since they are paid an agreed upon fixed rate of return out of the rental.

Messrs. Cook and Relyea were out of town and Messrs. Charlie Hill and Ed Hill substituted. Among those present were Sass, Funkhouser, Smucker, Large, Chaffee, Cole, and Greenough.

*Tuesday, November 7, 1967*

This morning W. S. C. came in to see me since he had heard about yesterday's budget meeting. He told me he would not be willing to sign any statements that underaccrued personal injuries reserve and as a matter of fact he said in all probability if we did not do this it would be picked up by examiners of the ICC who are in at the present time. I assured him I had no intention of asking him to do anything improper. I did ask him point blank however that if I ever made a statement that month after month we have been subject to improper and undo [sic] influence with respect to accounting whether he would consider this a correct statement and whether he would confirm it. He replied very positively in the affirmative.

*Thursday, November 9, 1967*

Yesterday I had a very unusual call from S. T. S. just before he was taking off for California.

He said that in his absence he did not want any letters written about the accounting questions he raised at the Budget Meeting on Monday, the 6th of November. I told him I did not understand what he meant about letters as I did not know why or who would be writing letters dealing with that subject. He then hesitated and said he really meant memorandums back and forth between officers. I had only written the attached to him but under the circumstances I said nothing about it and will not send it.

He said he wanted to sit down with W. S. C. and me on questions he raised which I said we would be glad to do. He went on to say we had to do everything possible to improve fourth quarter earnings since he was afraid revenues were not going to hold up. I said I understood that situation and shared his fears but the real problem was that the operating people were failing to meet the budget, particularly in the Western Region. He concurred in this and said he would talk to A. J. G.

The import of the whole conversation was that I had a feeling that possibly Funkhouser, although this is pure speculation, had advised him after the Budget meeting that his comments at the meeting had put him in a very untenable position and he was trying to prevent anything going on the record about it. I really think he had in mind the fact that the minutes might include some statement about it.

*[c. May 1, 1968]*

At the Budget Meeting on April 22, 1968, S. T. S. suggested that certain additional people be charged to the reserve account. Messrs.

Grant and McTiernan replied that we "could not hope to get away with it. This reserve account will be closely audited by our own CPAs and the ICC." S. T. S. tried to insist that all they could do in the last analysis would be to criticize us and this did not bother him. He dropped the matter for the time being.

On April 30, S.T.S. and I flew to Pittsburgh together. On the way out, S. T. S. said Mr. Perlman said I had been 100 percent cooperative with him and Perlman was very pleased. On the way back S. T. S. advised me he had talked to Dick Mellon, whom he stopped in to see on the same trip, and told him I was doing a fine job in every way.

*Monday, May 20, 1968*

I had a call from Charlie Hill advising me that Tom Meehan, Director, Auditing, was very upset and would probably quit and that he had a date at 10 a.m. with S. T. S. The news came as no surprise as I previously had a number of talks with him as he was very upset by the fact that Walter Grant had made him report to the Budget Manager, whereas before the merger he reported directly to W. S. Cook and me. Also, he had been given various warnings about not being aggressive in his auditing plus a number of other things that had a very bad cumulative effect on him.

As a result of these various conversations, prior to our board meeting in April I had a long talk with S. T. S., explained the situation to him, and told him if we were going to keep Meehan he would have to report to someone at a higher level and I had never known any place where the auditor reported at such a low level. This is particularly important in our case since Meehan has uncovered very substantial areas of fraud. S. T. S. agreed with me and stated he would have it handled through one or two of the Directors making a suggestion at board meeting. I thought it would come up in April or May but it never materialized.

On Monday, after receiving a call from Hill, I got ahold of Meehan and tried to calm him down. He said there had never been any problems as long as he had reported to W. S. Cook and me, but things were unsatisfactory now and he had gone too far to reverse himself and stay. He thought that by the way he had been deliberately undercut by his new superiors that he had lost his effectiveness and he thought our Auditing Department was disintegrating very rapidly.

Later in the day, Basil Cole on S. T. S. staff, advised me that S. T. S. had been unable to persuade Meehan to stay but had remarked if he had an opportunity to get into this earlier he was sure he could have persuaded him to stay.

*Tuesday, May 21, 1968—Budget Meeting*

As usual S.T.S. complained about the per diem account and how excessive it was. He then suggested that in order to improve earnings that we deliberately underaccrue it. When told by Charlie Hill that he thought it was probably already underaccrued, S. T. S. said that that did not make any difference. It had been underaccrued before and it was not necessary to become a "Christian" all at once.

*Wednesday, May 22, 1968*

Today, while W. R. G. and I were in New York, W. R. G. received an urgent call from Verlander stating that he had been instructed by McCrone, Treasurer in New York, to cancel a lease that the Financial Department had authorized by the Board of Directors in-

volving some racks for piggyback cars. McCrone also said that he should order some additional racks and pay for them in cash and not finance. He said these instructions had come from Walter Grant. On my advice W. R. G. advised Verlander to take no action until he had an opportunity to investigate what was going on.

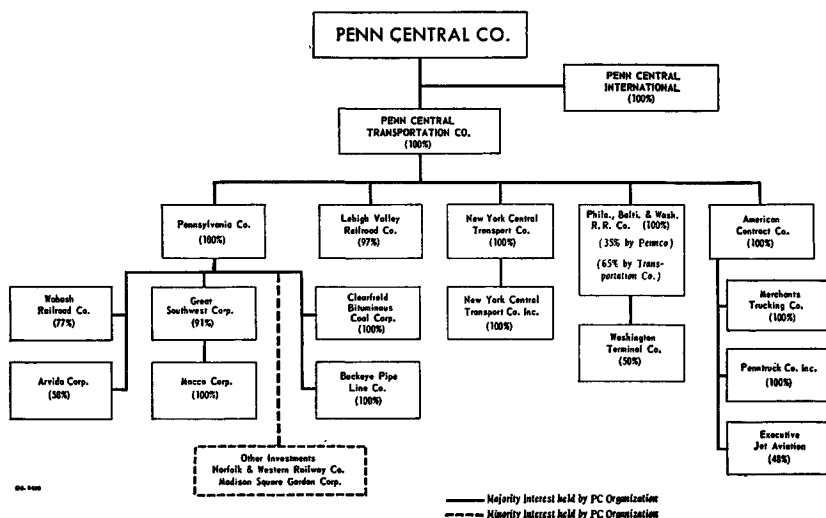
Thursday morning Walter Grant denied to W. R. G. that he told McCrone to have the lease canceled but still insisted that the racks should be bought for cash by Dispatch Shops, a subsidiary of the former N.Y.C. W. R. G. pointed out that we had a very serious cash situation and that these racks were ideal for investment credit financing and that he thought one way or another Dispatch Shops money should be conserved.

Late Wednesday afternoon I had a meeting with S. T. S. and informed him what had transpired up to that date re interference by Grant. All he said in reply was work it out yourself.

\* \* \* \* \*

Recently, when I received rumors that Bruce Relyea, Budget Manager of the Pennsylvania before the merger and now Assistant Budget Manager was planning to leave I called him in to talk to him to see if I could persuade him to stay in any way. He advised me that morale on the Pennsylvania side was very bad in the accounting budget area, that although he considered McTiernan, Budget Manager, a very bright person he thought he was not only lazy but only willing to take the course of least resistance. He said McTiernan was not interested in developing true cost throughout the railroad but was satisfied with something far less than what was potentially possible and desirable. He thought he would be wasting his time in staying. He also advised me that certain of the Regional Comptrollers, formerly of the Pennsylvania, were looking for jobs because they thought we were going to lapse into the former N.Y.C. bookkeeping approach rather than a modern scientific accounting approach that had prevailed on the Pennsylvania prior to the merger.

#### EXHIBIT 1B-2



## EXHIBIT 1B-3

## PENN CENTRAL—QUARTERLY RESULTS (PUBLICLY REPORTED ORDINARY INCOME)

[Dollars in millions]

	1968				1969			
	1st quarter	2d quarter	3d quarter	4th quarter	1st quarter	2d quarter	3d quarter	4th quarter
<b>TRANSPORTATION COMPANY</b>								
<b>Rail:</b>								
Revenues.....	\$382.2	\$392.1	\$372.1	\$369.3	\$406.0	\$417.9	\$398.4	\$429.7
Costs.....	387.1	388.9	388.6	397.6	420.3	431.5	423.9	439.2
Fixed charges.....	22.9	24.1	25.7	26.1	27.7	30.6	34.1	35.5
Rail earnings.....	(27.8)	(20.9)	(42.2)	(54.4)	(42.0)	(44.2)	(59.6)	(45.0)
<b>Real estate:</b>								
Operations.....	5.3	5.3	6.4	7.7	7.5	8.4	6.6	9.0
Sales.....	8.4	2.4	0.9	2.5	1.3	1.0	2.2	7.4
Real estate earnings.....	13.7	7.7	7.3	10.2	8.8	9.4	8.8	16.4
<b>Financial:</b>								
From subsidiaries:								
Dividends.....	10.9	7.6	7.9	11.0	14.8	19.0	19.3	10.1
Tax payments.....	2.0	3.9	7.3	6.0	4.2	6.1	10.7	.5
Total.....	12.9	11.5	15.2	17.0	19.0	25.1	30.0	10.6
Other dividends—Interest.....	1.1	2.6	14.6	(0.4)	1.1	1.0	1.6	1.8
Securities transactions.....	1.1	1.2	1.3	25.0	.3	.5	-----	.1
Financial earnings.....	15.1	15.3	31.1	41.6	20.4	26.6	31.6	12.5
Net company earnings.....	1.0	2.1	(3.8)	(2.6)	(12.8)	(8.2)	(19.2)	(16.1)
<b>SUBSIDIARIES NET CONTRIBUTIONS</b> .....	12.4	21.5	19.0	39.5	17.4	30.1	10.3	2.9
Consolidated earnings.....	13.4	23.6	15.2	36.9	4.6	21.9	(8.9)	(13.2)
<b>SIGNIFICANT ITEMS</b>								
<b>Transportation Company, rail:</b>								
New Haven losses.....	6.5	4.9	6.4	4.5	(1)	(1)	(1)	(1)
Passenger depreciation reversal.....	-----	-----	-----	-----	-----	-----	-----	4.5
New Haven capitalization.....	-----	-----	-----	-----	4.8	5.5	5.7	6.0
Per diem time/mileage.....	-----	-----	-----	-----	-----	-----	-----	6.5
Northeast corridor A/C 80 charges.....	1.9	3.1	1.4	(1.7)	.1	1.1	1.5	1.7
Merger reserve charges.....	.6	4.6	11.5	23.1	5.9	3.6	6.1	6.8
IBM program capitalization.....	-----	-----	-----	2.2	.5	.7	.8	.6
<b>Transportation Company, nonrail:</b>								
Sale:								
Albany Stations, New York.....	3.5	-----	-----	-----	-----	-----	-----	-----
Dover station yard, Boston.....	-----	-----	-----	-----	-----	-----	-----	4.0
<b>Special dividends:</b>								
Washington Terminal sale.....	-----	-----	13.5	(1.8)	-----	-----	-----	-----
N.Y.C. Transport.....	-----	-----	-----	1.0	6.0	6.0	-----	2.5
Merchants Despatch Transport.....	-----	-----	-----	1.5	-----	-----	4.0	-----
Despatch Shops.....	-----	-----	-----	-----	-----	1.0	-----	-----
Strick Holding.....	-----	-----	-----	-----	-----	-----	5.6	-----
Manor Real Estate.....	-----	-----	-----	-----	-----	-----	2.0	-----
Sale Madison Square Garden securities.....	-----	-----	-----	21.0	-----	-----	-----	-----
Profit-Company bonds reacquired.....	1.1	1.2	1.3	4.9	.3	.1	.1	-----
Total Transportation Co. significant items.....	13.6	13.8	34.1	54.7	17.6	18.0	25.8	32.6
<b>Subsidiaries:</b>								
Great Southwest—Sale:								
Bryant Ranch.....	-----	-----	-----	9.8	-----	-----	-----	-----
Atlanta & Irvine Sck.....	-----	-----	-----	6.7	-----	-----	-----	-----
Six Flags Over Texas.....	-----	-----	-----	-----	-----	17.5	-----	-----
P.L.E. Pennsylvania capital stock tax refund.....	-----	-----	1.0	-----	-----	-----	-----	-----
Manis Lke. Sup.—Pft. prop. liquid.....	-----	-----	1.0	-----	-----	-----	-----	-----
Manor Real Estate—Pft. Prop. sales.....	-----	2.0	-----	-----	-----	-----	-----	-----
Pennsylvania Co.—Gain on sale of N.&W. investment.....	2.4	2.3	2.4	12.6	5.9	5.2	8.1	3.6
Total subsidiaries' significant items.....	2.4	4.3	4.4	29.1	5.9	22.7	8.1	3.6
Grand total Significant items.....	16.0	18.1	38.5	83.8	23.5	40.7	33.9	36.2

Note: Transportation Company earnings also reflect Subsidiaries' significant items to the extent received as dividends and tax payment.

<sup>1</sup> Included in above results.



## I-C. FINANCES

### CASH FLOW VERSUS "EARNINGS"

The formal bankruptcy of the Penn Central finally occurred in June 1970 after the company was unable to obtain an immediate Government guarantee for a \$225 million loan. The company had simply run out of cash and ways of raising cash. To many reasonably informed investors this terminal cash crisis came as a surprise because Penn Central's earnings, while becoming progressively worse, had not seemed to indicate such a critical cash shortage.<sup>117</sup> The results for the transportation company only (the company containing the railroad) were poorer than the consolidated results, but they did not appear to be terminally critical, particularly considering the size of the company.<sup>117</sup>

The reported earnings, however bad, did not reflect the truly disastrous performance of the company, particularly with respect to the critical cash flows. The earnings were inflated by transactions and accounting practices which produced reported earnings but little or no cash.<sup>118</sup> Additionally, the earnings were presented in a format which tended to conceal the source and the trend of the losses.<sup>119</sup>

While the moderately adverse earnings figures were being presented to the public, a cash drain of staggering proportions was occurring in Penn Central. The following is a chart of the cash flow at Penn Central, including the railroad but excluding cash flows within individual subsidiaries:<sup>120</sup>

<sup>117</sup> For Penn Central's earnings see following table:

	Penn Central consolidated earnings <sup>1</sup>	Penn Central Transportation Co. only <sup>1</sup> (which includes railroad)
January-March 1970 .....	(\$17, 229, 000)	(\$62, 709, 000)
1969 .....	4, 388, 000	(56, 328, 000)
1968 .....	87, 689, 000	(5, 155, 000)
1967 .....	68, 519, 000	9, 085, 000
1966 .....	147, 394, 000	85, 156, 000
1965 .....	121, 872, 000	72, 422, 000
1964 .....	89, 453, 000	49, 890, 000

<sup>1</sup> Excluding extraordinary items.

<sup>118</sup> See Income Management section of this report for further explanation.

<sup>119</sup> Management has argued that accounting practices required for reporting to the ICC mandated this presentation. Even if ICC accounting were required for ICC regulation purposes, management was not prevented from supplying additional earnings information to the public.

<sup>120</sup> These figures do not include expenditures for equipment which is customarily financed by conditional sales agreements or equipment trust certificates which require little or no cash outlay by the company. Under these financings, the loans are directly secured by the equipment being acquired.

[In millions of dollars]

Date	Month's end cash balance	Month's cash deficit	Cumulative cash flow <sup>1</sup>	Cumulative debt repayment
February, 1968	42.4	(34.4)	(34.4)	7.8
March, 1968	31.9	(10.5)	(44.9)	14.6
April, 1968	30.3	(16.6)	(61.5)	19.4
May, 1968	30.4	(19.9)	(81.4)	22.7
June, 1968	43.7	(26.7)	(108.1)	25.0
July, 1968	28.0	(15.7)	(123.8)	28.5
August, 1968	42.0	(46.6)	(170.4)	31.7
September, 1968	39.9	(28.5)	(198.9)	40.1
October, 1968	38.4	(14.5)	(213.4)	44.4
November, 1968	47.3	(31.1)	(244.5)	49.6
December, 1968	46.3	(11.0)	(255.5)	98.2
January, 1969	26.1	(20.2)	(275.7)	103.5
February, 1969	35.1	(13.0)	(288.7)	114.1
March, 1969	55.3	(26.9)	(315.6)	122.6
April, 1969	29.6	(28.6)	(344.2)	127.9
May, 1969	86.5	(43.1)	(387.3)	132.7
June, 1969	47.2	(39.3)	(426.6)	142.0
July, 1969	44.3	(37.9)	(464.5)	147.7
August, 1969	38.4	(30.9)	(495.4)	154.6
September, 1969	39.6	(23.8)	(519.2)	163.3
October, 1969	36.2	(28.4)	(547.6)	166.6
November, 1969	39.7	(21.5)	(569.1)	171.5
December, 1969	58.7	(14.0)	(583.1)	178.9
January, 1970	28.9	(45.8)	(628.9)	183.7
February, 1970	36.8	(17.3)	(646.2)	193.9
March, 1970	31.9	(22.2)	(668.4)	202.7
April, 1970	46.4	(26.7)	(695.1)	205.5
May, 1970	65.5	(.9)	(696.0)	214.5
June, 1970	37.4	(28.1)	(724.1)	258.3

Cash drain met by borrowings; includes debt repayment.

The public was unaware of the magnitude of the cash drain. This cash drain was particularly important information about the condition of the company and the direction in which it was headed. The drain cut through the optimistic statements and the inflated earnings because it was a reality which could not be denied even by management. The cash drain also indicated at a very early date that Penn Central was a likely prospect for bankruptcy. Penn Central's ability to borrow was very limited despite its huge corporate size. It could not raise money through long-term debt because most of its property was already encumbered by debt and Penn Central's poor earnings would assure poor reception for long-term debt in the financial markets. Penn Central could meet its cash drain only by short-term borrowing or by a liquidation of assets and these two courses were restricted in their own right. There were few assets that could be liquidated. The real estate holdings in New York City, formerly owned by the New York Central, were heavily mortgaged and would not produce much cash upon sale. The other likely area for salable assets would be the Pennsylvania company, but many of these assets were pledged, and some, like Great Southwest Corp. and Macco Corp., were not what they appeared to be on the surface.

Faced with these problems and the poor image that would be created by trying to liquidate, Penn Central decided to use some of these assets indirectly by pledging them as collateral for short-term loans. The short-term borrowing had severe limitations, however. The money market was tight and interest rates were high even for a large "blue chip" such as Penn Central. Then, too, the pledging of assets in connection with borrowings, such as the revolving credit,

quickly narrowed any future possibility for financing while the use of unsecured financing such as the commercial paper put out by the Transportation Co. exposed the railroad to an immediate runoff if adverse information about the company became public. Penn Central very quickly painted itself into a corner from which there was no escape short of a very dramatic and immediate reversal in the direction of the railroad earnings. Indeed, such a reversal would be needed simply to meet the interest charges. As described elsewhere, there existed fundamental problems in the merger and in management's ability which precluded such a reversal. The cash drain then, and not the publicly reported earnings, foretold the destination of the merged railroads.

#### SOME CAUSES OF THE CASH LOSS

Given the apparent differences between stated losses in the financial reports and the actual cash losses a question arises about where the cash went. The following are some of the major areas of cash loss. These descriptions are merely illustrative of some causes of the cash drain and of the efforts of management to conceal the true magnitude and extent of the losses.

#### OPERATIONS LOSSES

The principal cash drain was from the operations of the railroad. Losses had been experienced in the premerger period. After the merger these losses turned abruptly worse. The deteriorating condition of the railroad operations was masked because the financial results included income, much of it noncash income, from other sources. When the rail losses are set apart, the deterioration of the rail operations is apparent:

##### *(Loss) on rail operations*

January to March 1970- (\$101, 600, 000)	1966-----	2, 559, 000
1969----- (193, 215, 000)	1965-----	(548, 000)
1968----- (142, 367, 000)	1964-----	(15, 636, 000)
1967----- (85, 747, 000)		

The causes and the course of the deterioration of the railroad are described elsewhere in this report. It is sufficient to note here that traffic volume decreased while costs soared, mainly because of enormous and continuing drains brought on by the chaotic operation of the merged railroad.

It should be noted that most of the cash drain in railroad operations was a drain from the day-to-day operation of the railroad and not, as management implied in its public statements, expenses associated with improving the road's facilities. The growing cash outflow, therefore, did not principally represent expenditures being incurred for the development of a better railroad in the future; it represented drains

caused by the poor operations of the railroad. In fact, while capital needs were very great in the postmerger period, the funds available were limited and expenditures were fairly constant.<sup>121</sup>

Management also indicated repeatedly that the railroad's poor performance was caused by losses on passenger service. While losses from passenger service were growing<sup>122</sup> and did contribute to the cash drain, management cited the passenger losses in ways which tended to shift attention from the overall losses of the railroad to the losses from passenger service. This accomplished two management goals. First, it made the railroad's problems appear to be the fault of the Government and not the fault of management. Although the Government-mandated passenger service did cause losses, management was able to deflect criticism away from its own ineptness, which was the cause of most of Penn Central's losses.<sup>123</sup> The second effect of emphasizing passenger losses was to indicate that if and when the railroad was relieved of that burden by the Government, investors could expect the railroad to operate at a profit. On more than one occasion, management stated publicly that without the passenger service losses, the railroad would be operating in the black.<sup>124</sup> Such statements were inaccurate.

<sup>121</sup> Penn Central Transportation Co. (includes PRR, Central, and N.Y., N.H. & Hartford) capital expenditures for road and equipment 1964-70.

[Thousands of dollars]

	1964	1965	1966	1967	1968	1969	1970
Road.....	\$26,158	\$37,769	\$32,302	\$36,720	\$50,193	\$65,507	\$31,637
Equipment (excluding amount financed).....	45,631	31,679	35,097	19,350	19,835	5,998	16,073
Equipment (financed).....	80,549	186,546	148,982	81,092	76,382	80,042	13,620
Total.....	152,338	255,994	216,381	137,162	146,410	151,547	61,330

<sup>122</sup> Passenger results, 1964-1970:

	Solely related	Fully allocated
1964:		
New York Central.....	\$7,887,396	(\$21,951,885)
Pennsylvania Railroad.....	(2,451,494)	(32,401,279)
New Haven.....	11,820,339	(22,328,852)
1965:		
New York Central.....	5,577,655	(16,176,207)
Pennsylvania Railroad.....	(11,761,570)	(41,768,640)
New Haven.....	12,971,536	(9,855,825)
1966:		
New York Central.....	4,965,956	(16,023,304)
Pennsylvania Railroad.....	(15,603,156)	(45,381,349)
New Haven.....	14,332,014	(8,698,552)
1967:		
New York Central.....	(7,110,130)	(27,129,186)
Pennsylvania Railroad.....	(27,068,253)	(58,227,416)
New Haven.....	13,153,531	(10,281,467)
1968:		
Penn Central Transportation Co.....	(44,806,196)	(100,237,980)
New Haven.....	11,603,908	(12,553,243)
1969:		
Penn Central Transportation Co.....	(45,811,445)	(104,764,219)
1970:		
Penn Central Transportation Co.....	(73,853,718)	(132,482,305)

<sup>123</sup> Indeed, when questioned by the staff, many of the directors still cited the passenger losses as the principal cause of Penn Central's financial difficulties. The directors, however, were unable to identify the magnitude of the losses or their relation to overall losses.

<sup>124</sup> An example from Dec. 1, 1969, letter to shareholders explaining the cancellation of the dividend:

"In this same period [first 9 months of 1969], our railroad had a passenger deficit of \$73,000,000 on the basis of fully allocated costs or approximately \$47,000,000 in direct costs. But for this, the railroad would have been in the black." [The loss from rail operations exceeded \$193,000,000 for all of 1969.]

Management used two devices to achieve its goals in setting forth passenger service losses. First, it tended to emphasize the "fully allocated" losses rather than the lower "solely related" costs or the "avoidable" costs. The fully allocated costs include costs shared with freight service. Many of these costs would continue even if passenger service were abandoned. Solely related costs are the costs assigned by accounting to running the passenger service. Avoidable costs are costs which would be avoided by the discontinuance of passenger service.<sup>125</sup> When used in the context of savings that might be achieved by relief from passenger service, the fully allocated figures conveyed an inaccurate picture. The second device used by management was to avoid comparing passenger losses with overall railroad operation losses.<sup>126</sup> Such a comparison would have shown that the direct losses on passenger service were only a relatively minor portion of the overall operations losses.<sup>127</sup> These were losses which would still be incurred even if Penn Central was relieved of all passenger service and they were losses largely related to mismanagement and not Government fiat.

#### DIVIDENDS

The Penn Central continued to pay dividends until the fourth quarter of 1969.<sup>128</sup> Prior to the abandonment of the dividend Penn Central had been paying dividends of \$.60 per share each quarter.<sup>129</sup> Although the company had sufficient retained earnings from previous periods (in excess of \$500 million) to support a dividend under applicable legal standards, the serious cash drain caused by the performance of the railroad was substantially aggravated by the payment of the cash dividend:

<sup>125</sup> Avoidable costs were only computed when Penn Central petitioned for abandonment of a passenger service.

<sup>126</sup> See pp. 86 and 87 for loss figures.

<sup>127</sup> The rise in passenger service losses themselves was probably caused in part by the same problems affecting freight losses.

<sup>128</sup> For a description of the decision to abandon the dividend see the section of this report on the role of the directors.

<sup>129</sup> Dividend record of Penn Central and predecessors:

Year	Penn Central		PRR		NYC	
	Rate	Annual total <sup>1</sup>	Rate	Annual total <sup>1</sup>	Rate	Annual total <sup>1</sup>
1959-61.....	\$0.25					
1962.....	.25					
1963.....	.50					
1964.....	1.25	\$28,974	\$1.25	\$17,176	\$1.775	\$11,798
1965.....	2.00	45,386	2.00	27,661	2.60	17,725
1966.....	2.30	53,646	2.30	31,985	3.15	21,661
1967.....	2.40	56,051	2.40	33,493	3.12	21,558
1968.....	2.40	56,400				
1969.....	2.40	43,396				

<sup>1</sup> Annual totals in thousands of dollars.

[Thousands of dollars]

	Consolidated earnings (loss) <sup>1 2</sup>	Transportation Co. earnings <sup>1 2</sup>	Loss from railroad operations	Additional net borrowings, cash loss	Cash dividend paid
1968.....	\$87,789	(\$5,155)	(\$142,367)	(\$172,200)	\$55,400
1969.....	4,388	(56,328)	(193,215)	(273,000)	43,396

<sup>1</sup> Before extraordinary items.<sup>2</sup> The reported earnings are not equivalent to cash earnings. Income maximization section of this report describes a number of transactions which resulted in reported earnings without producing cash.

Because there had been no inflows of cash to support the dividend since some time before the merger, money had to be borrowed at the high interest rates to make the payments. The increases in dividends leading up to the merger were unwarranted, the continuation of the high dividend rate after the merger was reckless. At a time when urgently needed road capital items were being denied to those responsible for the operation of the company, money was being borrowed at high interest rates to pay dividends, including those paid to Saunders and other officers.

The principal purpose of the continuation of the dividend was the desire to project an image of optimism and soundness. The image was deceptive to investors, many of whom held this "blue chip" stock for its long history of dividend payments. The deception struck most directly at those who invested in Penn Central for its dividends. These investors were suddenly faced with no dividend at all and realization that the company's condition was much worse than they had been led to believe (with a commensurate decline in the price of the stock).

#### INTEREST COSTS

Interest rates were rising in the post merger period. Of more importance than the rise in rates, however, was the tremendous increase in borrowings needed to meet the cash drain. On a consolidated basis the interest on debt was as follows:

1965.....	\$80,723,000
1966.....	86,229,000
1967.....	90,771,000
1968.....	102,206,000
1969.....	137,018,000

The additional borrowing by the Penn Central from merger date through the end of 1969 (after deducting debt repayment) was \$405 million. The interest costs of these additional borrowings was in excess of \$40 million at an annual rate by the end of 1969.<sup>130</sup> These interest payments were, of course, cash payments. It can be said that the additional borrowings were the prime cause of the rise in the interest burden during the postmerger period, because the borrowings in this period were made at interest rates at or above the prime rate<sup>131</sup> while the interest burden on most of the existing long-term debt was at fixed lower interest rates from earlier periods.

<sup>130</sup> The company was required to keep compensating balances of between 15 and 20 percent of funds borrowed, thereby effectively increasing the interest rate.<sup>131</sup> Some investors may have believed that the short-term debt was being increased to avoid rolling over long-term debt at the prevailing high interest rates. In fact, most of the borrowing was being consumed by operations losses.

CASH RELATIONSHIP OF PENN CENTRAL TO GREAT SOUTHWEST, MACCO  
AND EXECUTIVE JET AVIATION

A principal example of the concealment of the real cash losses of the company under the camouflage of reported earnings is the performance of Great Southwest Corp. (GSC) and Macco. These subsidiaries were the source of profitable diversification according to repeated statements by management. Management also repeatedly stated or implied that these companies supplied cash to the railroad. During the years when the railroad was suffering a staggering decline, Great Southwest and Macco were reporting the following soaring earnings.<sup>132</sup>

1967.....	\$11, 408, 000
1968.....	32, 961, 000
1969.....	51, 543, 000

Although the earnings were reported in Penn Central's consolidated results, with a minor exception none of these earnings were received by the company in cash.<sup>133</sup> Adding further injury, the railroad actually passed approximately \$32 million in cash down to GSC (excluding the initial investment) from 1966 through 1969. The flow stopped during 1969 apparently because the railroad had finally run out of money itself.<sup>134</sup>

Pennco, the railroad subsidiary which owned Great Southwest and Macco, however, did pay dividends to the railroad.<sup>135</sup> The funds for these payments came chiefly from Pennco's holdings of Norfolk and Western stock and Wabash stock and not from the real estate subsidiaries. This source of cash was being diminished however, as the company sold off these holdings:

WABASH AND NORFOLK & WESTERN DIVIDENDS RECEIVED BY PENNCO

[Thousands of dollars]

	1965	1966	1967	1968	1969
Wabash.....	\$14, 463	\$12, 327	\$9, 758	\$8, 970	\$8, 941
Norfolk & Western.....	15, 555	15, 188	13, 783	12, 783	10, 836

In general, management misrepresented the role of the real estate subsidiaries, particularly as to cash contributions. The principal cash contribution was from the long-standing investments such as the Wabash and the Norfolk and Western dividends. The much-touted diversification into real estate was unproductive. Only Buckeye paid a significant dividend and that dividend of \$6 million a year was

<sup>132</sup> Before Federal and State income taxes. GSC paid no Federal taxes because of the railroad's tax loss shelter. Under a tax allocation agreement GSC was obligated to pay to the Transportation Co. 95 percent of the Federal taxes which would have been paid without the tax shelter. GSC never paid the Transportation Co. any cash under that agreement.

<sup>133</sup> GSC paid Pennco dividends of approximately \$1,000,000 in 1968 and \$2,900,000 in 1969. However, during that time substantially greater amounts of cash were being passed down to GSC and a total cash debt exceeding \$20,000,000 was "forgiven" in late 1969 through the acceptance of GSC stock. During this time GSC was itself suffering financing difficulties which made the payment of a dividend a questionable practice (during late 1969 and early 1970 GSC borrowed over \$40,000,000 in Swiss francs at high interest rates).

<sup>134</sup> For details of the relationship between Penn Central and GSC, see section of this report on Great Southwest Corp.

<sup>135</sup> Pennco dividends to Transportation Co.:

1965.....	\$23, 000, 000
1966.....	24, 000, 000
1967.....	25, 500, 000
1968.....	24, 000, 000
1969.....	24, 000, 000

simply a 6 percent return on the initial investment of approximately \$100 million. From the other diversification subsidiaries (Arvida, Great Southwest and Macco) no significant cash return on the investment was received and, in the case of Macco and Great Southwest, substantial cash advances were passed down after the initial investment. Worse than the poor performance of the diversification program was the use of the program to pass inflated earnings to the parent and the associated touting of the "performance" of the subsidiaries and the "value" of the holdings of the stock of these subsidiaries in Pennco's portfolio.

Executive Jet Aviation is another example of a concealed cash drain that is more significant in its concealment than in the actual amount lost. Penn Central lost over \$31 million in cash from the initial investment to the end of 1969. This may be only a relatively small part of the overall corporate cash drain, but as with the real estate subsidiary investments, the element of deception practiced by management compounded the injury caused by the actual cash loss. The initial investments were made to give Penn Central a foothold in the air cargo business.<sup>136</sup> This investment was made with the full knowledge that Civil Aeronautics Board rulings prohibited rail carriers from owning air cargo operations. When the CAB discovered the situation and ordered divestiture, Penn Central continued to invest money in EJA, much of which was squandered by EJA management.<sup>137</sup> Finally, \$10 million intended for equipment purchases was diverted to Liechtenstein to cover up EJA's European activities.<sup>138</sup> Penn Central management engaged in deception to keep the EJA losses confidential, in part to avoid a formal bankruptcy of EJA which would have affected Penn Central's financial statements. The deception was so diligent that even Paul Gorman, the president of Penn Central, who had been charged with investigating EJA affairs, did not realize the extent of the losses until after bankruptcy.

## MANAGEMENT'S VANTAGE POINT

### (1) CASH SITUATION AT TIME OF MERGER (FEBRUARY 1968)

Penn Central's cash crisis was well known to management. Management knew, in fact, that the financial situation was perilous prior to the merger. In 1968 the situation quickly became critical and by 1969 the company was drawing on its last available credit. The crisis, however, was concealed from investors. This and the next section describe the declining financial condition of Penn Central and management's knowledge of that crisis.

Railroads traditionally have operated on narrow cash balances. This situation had existed at both the Pennsylvania Railroad and the New York Central Railroad prior to the merger in 1968. At the time of the merger both railroads were cash short, with the Pennsylvania Railroad being acutely short of cash. In an early memorandum of November 10, 1966, to Bevan's immediate subordinate, William Gerstnecker, John Shaffer, the Pennsylvania Railroad treasurer,

<sup>136</sup> Saunders felt that air cargo service would do to rail freight what air passenger service did to the rail passenger business. Whether Saunders was right or wrong on that point, he could not have done worse than in selecting EJA as the countermeasure to the presumed threat.

<sup>137</sup> See further discussion at page 71.

<sup>138</sup> See further discussion at page 74.



indicated that the cash loss for 1967 would be \$50 million. He stated: "this preliminary forecast definitely indicates that we will be in a cash bind by the end of the first quarter of the next year and something will have to be done to generate cash."

By 1967 the cash situation had further deteriorated. The situation was complicated by the merger agreement with the New York Central which had placed a ceiling on additional borrowings. In a September 8, 1967 memorandum to Gerstnecker, Shaffer pointed out that net working cash at the end of August was at least \$57 million less than it was at the end of August 1966, but that this figure could be viewed as \$88 million if a number of unusual transactions were included.

At the same time, Bevan was alerting Saunders to the deteriorating state of affairs. In a memorandum to Saunders of September 8, 1967, Bevan warned: "Because of our present extremely low cash position it is imperative that we plan carefully for the balance of the year and for 1968 \* \* \*" The memorandum indicates that even after the receipt of \$18 million from the sale of N. & W. debentures "it is still estimated that the cash balance at the end of December will be only \$6 million compared with \$40 and \$45 million which is required for operations and compensating balances in banks where we have outstanding loans." The memorandum goes on to discuss necessary financings and the possible need to obtain New York Central permission again to increase its debt limit under the merger agreement:

As a matter of fact, we cannot get through October and November of 1967 when our cash is reduced by the end of those months to \$13 million and \$6 million, respectively. On top of this, based on present estimates and historical results, we are faced with a decline in cash between the end of this year and the end of the first quarter of 1968 of \$25 million.

Under all the circumstances it is essential for us to raise as early as possible this fall somewhere between \$35 million and \$50 million with the hope that this will carry us through next year until at least the end of May. We do not have any assets of a substantial nature which can be liquidated to supply our cash needs and, therefore, we must resort to the issuance and sale of debt and our medium would probably have to be an issue of debenture bonds by Pennsylvania company \* \* \*

Unless we do the latter, we have no alternative but request the New York Central to approve an increase in our debt limitation.

\* \* \* \* \*

I have been postponing this inevitable conclusion with the hope that increased rates and business would improve our position but our current and prospective cash position leads me to the conclusion that we cannot delay any longer.

By early November the railroad was considering requesting an increase of \$75 million in the debt allowable under the merger agreement with the New York Central. By mid-November of 1967, however, when it became apparent that the merger might take place as early as January 1, 1968, the Pennsylvania Railroad began rethinking its financing needs since it would have to survive only until January under the existing debt ceiling. The revised plans called for a "floater debenture" on Norfolk & Western stock owned by Pennco to produce over \$8 million; a drawdown under a revolving credit agreement of approximately \$10 million; and a sale to banks of dividends from the N. & W. stock expected to produce another \$10 million after the beginning of 1968.

## (2) THE IMMEDIATE CRISIS (MID TO END 1968)

As described above, the cash situation of the merged railroad at the time of merger was bleak. In the postmerger period chaotic operations and the resulting deterioration of service quickly put an additional strain on the cash situation. The Penn Central, however, managed to paint an almost flattering picture of its financial posture. In a news release dated August 7, 1968, the Penn Central reported on the sales of commercial paper and on its overall financing program. With reference to the \$100 million of commercial paper that had been authorized by the Interstate Commerce Commission on July 29, 1968, the release stated:

"We have been informed by Goldman Sachs & Co., our commercial paper dealer, that the paper has been well received in the financial market," Mr. Bevan said. He pointed out that the use of this method of financing is virtually new in the railroad industry but it can provide great flexibility in meeting short-term requirements.

The release went on to describe the issuance of commercial paper as the first phase of a three-phase program designed to give Penn Central "more modern methods of financing." The second phase was to be \$100 million in revolving credit to replace outstanding bank loans. The third phase involved a long-term blanket mortgage which was expected to become the major long-term debt vehicle for the Penn Central:

"Substantial progress has been made on this work," Mr. Bevan said. "When this program is completed, we will have all the tools necessary with which to meet both long- and short-term requirements, as circumstances dictate, with the greatest possible flexibility."

The picture painted in a memorandum from Bevan to Saunders on July 25, 1968, a couple of weeks earlier is starkly different from that presented to the public. Bevan complained about the absence of an income budget for 1968 and about a recent reduction in the revenue forecast, both of which made planning difficult. He indicated, however, that the situation had become "sufficiently critical" to have forced them to make some estimates. The memorandum indicates that by the end of the year: (1) the \$100 million revolving credit would be exhausted; (2) the \$100 million in commercial paper would be exhausted; and (3) there would be still a need for \$125 million to \$150 million of additional financing.<sup>139</sup>

In an October 9, 1968, memorandum to Saunders & Perlman, labeled "Personal and Confidential," Bevan reported on progress being made to close the \$150 million cash deficit projected for 1968. This included a reduction of capital expenditures by \$22 million and a proposed \$50 million Eurodollar loan. The total reduction was \$98 million. Bevan

<sup>139</sup> The memorandum reads in part:

"In the absence of an income budget for the year 1968, we have not been able to make a detailed cash flow estimate for the year. However, with two recent major cuts in revenue forecast and the possibility of a steel strike, the situation has become sufficiently critical so that we have felt impelled to make the best estimate possible under the circumstances.

"In connection with the revenue reductions, we are advised of a reduction of \$15 million made by the Revenue Forecast Committee on July 12 and an additional \$4 million reduction on July 16. This difficult situation has been further compounded by the not unexpected request from the New Haven for additional \$5 million on August 1 \* \* \* We are preparing further more detailed estimates based on the information presently available, but it now appears that at the end of this year we will have exhausted the \$100 million revolving credit and the \$100 million commercial paper program and that we will still have a need for somewhere, depending on future circumstances, between \$125 million and \$150 million. This is without giving further effect to what would be required in the event of a steel strike. When this is coupled with the fact that we almost invariably lose cash for the first 3 months of the year, I believe it is necessary for us to take all possible steps at this time to conserve cash and work toward a very minimum capital budget for 1969."

then made specific attacks on road capital expenditures including expenditures for yard improvements. He stated:

There are certain other items that cannot definitely be identified specifically as yard expenditures, but it seems likely that during the balance of the year capital expenditures for yards alone total about \$10 million. On the basis of the sketchy income budget recently submitted for 1969 it would appear that there is going to be very little cash available except for commitments already made. It seems highly improbable that amounts such as \$26 million for Columbus yard are going to be available for some time to come. It therefore raises the question as to whether or not future expenditures of this type during the remainder of 1968 are justified.

I strongly recommend that the yard program be reviewed at once and that the balance of the unexpended money for this year also be reviewed in an effort to bring our cash in line at least up to January 2. From that point on it is quite inevitable that we are going to have extremely serious problems and that every effort must be made to establish a positive cash flow quickly as possible.

Despite the addition of the Eurodollar loans, the cash situation did not sufficiently improve. The Treasurer's report on November 26, 1968, indicates that the projected cash loss for 1968 would be \$273 million which would be met by \$253 million in borrowings, including \$103 million in bank loans, \$100 million in commercial paper and \$50 million from the Eurodollar borrowing. The gap remaining was \$20 million to which was added the need for \$24 million additional cash in bank balances leaving additional cash required at \$44 million for 1968.

### (3) THE CRISIS GROWS (END 1968-FALL 1969)

The following year did not promise any relief from the continuing cash demands. A cash forecast dated January 23, 1969, to Bevan from Schaffer indicated that the cash figures for 1969 would go from a \$46 million positive balance on December 31, 1968, to a deficit of \$104 million in December of 1969. Schaffer concluded his presentation of figures with the statement that "Although this forecast is very tentative at this time, I believe it to be a good indication of the cash problems facing us in 1969."

By February of 1969 it was clear that major increases in financing would be necessary simply to keep the company afloat. A memorandum from Schaffer to Bevan on February 25, 1969, indicated that the company was in a cramped financial position and that there were heavy needs ahead. The memorandum indicated that the source and application of funds statement showed an anticipated source deficit of \$157 million for 1969.

By the latter part of 1968 and early 1969 it had become unmistakably apparent to management that the financial problems were extremely critical. It had been hoped that the merger would lessen the cash drains which had been experienced on the PRR. Yet, in this postmerger period, cash was actually flowing out at a much greater rate and there appeared to be no prospect of a reversal. Financing means were limited. The market for long-term railroad debt was bleak and for Penn Central it was nonexistent. Short-term debt was limited by the likelihood that lenders would discover the cash drain. There were not many salable assets, or at least not many assets that could be sold without alarming lenders or shareholders. In addition, many of the assets were covered by pledges, mortgages or other restrictions.

A particular problem at that time was the limit on bank borrowings and the problems of the additional restrictions that such borrowings would impose. Gerstnecker was aware that borrowing limits were being reached:

*Question. Were you involved in discussions to increase the revolving credit to \$300 million?*

Answer. Yes.

*Question. Did you believe at that time it would be possible to borrow any additional amounts [from] banks of the revolving [credit group] above the \$300 million?*

Answer. I think the reverse. When I told Mr. Saunders of my reason for leaving, I [told him] I would not take part in borrowing any more money than that. I thought we had reached the limit of our credit.

Gerstnecker's concerns were shared by Bevan. Bevan consulted George Woods, formerly chairman of First Boston Corp. and, at that time, a recently retired President of the International Bank for Reconstruction and Development. From the testimony of Gerstnecker:

*Question. Did Mr. Bevan fully perceive the increased bind the company was getting into in terms of its borrowings; that is, you were coming to a finite limit, and also the restrictions and burden of interest were becoming more and more complicated?*

Answer. Yes.

*Question. Did he express fears [to] you in discussion with you?*

Answer. Yes.

*Question. Was this [in] any particular context? For instance did you ever have a session where you sat down and discussed this?*

Answer. Yes; I had a session with George Woods, who is Chairman of the World Bank, I guess, or Monetary Fund or something, and who had previously been the head of First Boston. And Mr. Bevan took me with him, after saying he had gotten Mr. Saunders' approval to go talk with George Woods, and he told George Woods of his concerns and wondered if he had any suggestions as to why it might be—as to what might be done, and my understanding is, and my recollection is, although I'm not positive of it, that as a result of that discussion George Woods talked to Mr. Saunders and indicated to Mr. Saunders that the \$300 million was the limit and should be the last borrowing that the company could make unless the cash flow or the operations could be turned around.<sup>140</sup>

Knowledge of the financing problems at that time was not limited to top management. From Gerstnecker's testimony:

*Question. Was this a common open concern among people in the finance department what the limit would be?*

Answer. Yes.

*Question. Was that ever discussed at the budget committee meetings, [attended by operating officers as well as finance officers] particularly in the context "We're coming to some limit and we're getting blocked in by restrictions," and things of that sort?*

Answer. I don't recall there was. There were discussions at the budget committee where we would have before us one of Mr. Shaffer's forecasts of cash loss in which it would say "Here is another \$40 million loss, and we can't put up with this, we just can't lose a million dollars a day as we are doing," but there never was a sophisticated type of discussion that I recall.

On February 10, 1969, Bevan and Gerstnecker met with Patrick Bowditch<sup>141</sup> and another officer of First National City Bank to discuss increasing the revolving credit from \$100 million to \$300 million. The reasons given for the request for the additional loan were that the merger of the railroad was taking longer than anticipated and that estimates indicated a cash loss during 1969 with earnings not expected until late 1969 at the earliest. Another reason was the difficulties in issuing the new blanket mortgage. Bowditch suggested that a meeting of all banks be held in which Penn Central would indicate detailed lists of debt maturities by year for the years 1969 through

<sup>140</sup> Bevan first spoke with Woods on Jan. 7, 1969. Woods advised Bevan on efforts to increase the revolving credit to \$300 million. In May, Bevan sent Woods an unsolicited payment of \$25,000. Woods continued in an informal advisory capacity until the bankruptcy.

<sup>141</sup> A First National City president and the officer servicing the Penn Central commercial account.

1975 along with other information. The information was never supplied.

On February 28, 1969, William Mapel, Bowditch's superior, wrote a memorandum describing his understanding with Bevan and Gerstnecker on the increase in the revolving credit to \$300 million. Mapel felt that the loan was on sound footing. He noted in his memo.

With respect to the credit itself it has been upgraded through a tighter amortization schedule, a negative pledge on railroad properties which presently have a debt capacity of about \$200 [mm] and a negative pledge with the right to secure at our option outstandings through a pledge of Pennsylvania Company's stock. The latter was volunteered to me by Bevan without the knowledge of Gerstnecker, who told me to suggest this to Gerstnecker with the full knowledge that he would approve it. It is very important, however, that the nature of this deal with Bevan at no time be discussed with anyone else in the company. \* \* \* I feel that we have negotiated a very satisfactory deal with the company, and I have every confidence that it will live up to its commitment on balances. Furthermore, it is their firm intention to sell the blanket bond issue as soon as possible, and at that time they expect to use the proceeds to repay the banks.<sup>142</sup>

During this same period Bevan was negotiating for the issuance of additional commercial paper. On March 19, 1969, the ICC authorized the issuance of an additional \$50 million of commercial paper, bringing the total to \$150 million. This paper was quickly marketed. The Pennsylvania Co. was also being used during this time as a financing vehicle. In July 1969, \$35 million of Pennsylvania Co. debentures were privately placed and an additional \$40 million of Pennsylvania Co. preferred stock was to have been issued. The latter financing was, however, never effected.

A report prepared by the treasurer's office, dated, May 20, 1969, showed an anticipated year-end cash deficit of \$130 million which, when measured against a cash balance of \$46 million at the yearend 1968, indicated a cash deficit of \$167 million for 1969. The treasurer's report also indicated the uses of the first \$100 million to be drawn down under the \$200-million increase in the revolving credit. This included \$35 million for compensating balances, \$25 million for vouchers released and \$30 million to pay off temporary loans from banks, leaving a balance of working cash of \$10 million. This, plus the \$35 million to be received from the Pennsylvania Co. would provide sufficient cash to the end of June. Additional cash would be needed to meet debts occurring on the first day of July. The \$100 million of revolving credit was drawn down on May 27, 1969.

The cash situation continued to deteriorate. As of June 10, 1969, the treasurer estimated that yearend cash balances would be only \$37 million even after inclusion of the additional \$100 million drawdown under the revolving credit, the additional \$50 million commercial paper, and the additional \$35 million through Pennsylvania Co. preferred stock. The railroad was reaching a final crisis in its financings. In a memorandum of June 20, 1969, to Gerstnecker, Schaffer indicated that even drawing down an additional \$50 million under the revolving credit in August (bringing the total drawdowns to \$250 million) and raising \$75 million through Pennco borrowings, the company would still end the year with a balance of only \$37 million. Because of required bank balances, this meant that an additional \$63 million of

<sup>142</sup> It should be noted that our investigation has uncovered no indication of any activity with relation to the blanket mortgage after some initial activity in the early fall of 1968. The market for such an issue was poor, formidable legal and mechanical problems existed, and investors would not purchase such bonds from a company with the negative cash flow being experienced by Penn Central.

borrowings would be needed by the end of the year. This program allowed for a strict road capital program not exceeding \$50 million for 1969.

By this time it had become apparent that the additional financings themselves were producing serious cash burdens on the railroad. In addition to the need to keep extensive compensating balances against the bank loans as required by banking practice, the interest payments were becoming large. With \$250 million of revolving credit and \$150 million of commercial paper and with the Pennsylvania Co. borrowings, the interest costs were approaching a rate of \$50 million a year.

In September of 1969 Bevan met with First National City Bank officials to obtain their approval of an increase in commercial paper by \$50 million to a total of \$200 million. Under the terms of the revolving credit agreement, the debt of the railroad outside of the revolving credit could not exceed \$150 million which was the existing amount of commercial paper. The railroad had drawn down an additional \$25 million on the revolving credit on August 18, 1969, and was drawing down an additional \$25 million on September 3, 1969, bringing the total to \$250 million. Bevan pointed out that he could draw down the last \$50 million of the revolving credit and leave the commercial paper at \$150 million, but that he would prefer to obtain the last \$50 million by commercial paper. He agreed not to draw down the last \$50 million of revolving credit until commercial paper had been paid off in an amount equal to the final revolving credit draw-down. First National City Bank obtained the approval of other banks for this change in the agreement. The effect was to decrease the backup lines for the commercial paper while allowing Penn Central to increase its borrowings. Prior to this time the \$150 million of commercial paper had been backed by a \$50 million bank line and the last \$50 million of the revolving credit, providing a 66⅔ percent coverage. With the commercial paper increased to \$200 million the backup was reduced to only 50 percent. Prior to an attempt to get additional security in early 1970, it appears that the banks, through their agent First National City Bank, never seriously doubted the financial ability of Penn Central to pay off its loans. They continued to rely on the issuance of a blanket mortgage bond and on the earnings of the real estate subsidiaries in addition to a hoped-for turnabout in the performance of the railroad.

On September 8, 1969, Saunders wrote to Bevan asking for a program to meet capital needs for the next year and for the 2 years thereafter. Bevan responded with a memorandum to Saunders on September 10, 1969, in which he pointed out the continuing financing strains from the operations of the railroad. In light of the cash situation, Bevan observed:

Therefore, in my judgment, extraordinary efforts must be made to preserve every dollar possible. We will be coming up with additional suggestions in this regard shortly, but I think an immediate stop must be put on capital expenditures.<sup>143</sup>

\* \* \* \* \*

In view of the current cash situation, it seems to me that every project should be stopped immediately until each one can be analyzed individually to see whether or not it is absolutely necessary that it be progressed at this time or done at all this year.

\* \* \* \* \*

<sup>143</sup> It should be noted that capital expenditures were not greatly larger than they had been in the pre-merger period. See the descriptions in the earlier portions of this section. Bevan's request reflected the degree of the cash shortage and not unreasonably large capital expenditures.

I realize that there are problems incident to labor and overhead involved in stopping these projects but I think that a very complete analysis should be made immediately so that every possible cent of cash will be saved and I am particularly interested in what can be saved in the next 30 days. Where we have outside contractors obviously holding up the work or postponement of the work is easier than where we are doing it with our own labor.

I requested an intensive program to reduce accounts receivables but because of the nature of the program I am not optimistic of a material gain this year, although it could bear some near-term results. I do think, however, that a very drastic cut in inventories should be instituted immediately even to the extent of selling in the open market any excess items we may have on hand.

Saunders responded on September 12, 1969, in a letter to Bevan in which Saunders described efforts he had made to convey Bevan's requests:

With regard to your letter of September 10, I enclose a copy of [a] letter which I have written to Mr. Perlman today with copy to Mr. Flannery. I have also talked with them personally about this and impressed upon them the necessity of immediate action.

I have also talked with Malcolm Richards with regard to curtailing at every possible point and making no further purchases, except where absolutely necessary, until our situation improves.

At the budget meeting this morning, I asked Mr. O'Herron and Mr. Hill to work with Peat, Marwick on a study of our billing and accounts receivable situation to the end that recommendations can be brought forward for improvement.

On October 29, 1969 the Penn Central received ICC authority to issue an additional \$50 million of commercial paper, bringing the total to \$200 million. At this point the company had effectively exhausted all loans and all commercial paper possibilities. Most banks were at or near their legal or practical lending limits and were looking towards a paydown of these loans rather than increases. Goldman, Sachs, Penn Central's commercial paper dealer, was already indicating to management that it was difficult to keep out the \$200 million and that any adverse information might cause a run on the commercial paper.

It was also in October of 1969 that Penn Central learned that it would not be possible to market Great Southwest stock (which would have included a Pennsylvania Co. secondary offering). This offering would have produced approximately \$45 million for the Penn Central complex. As indicated elsewhere in this report the idea of the Great Southwest offering apparently originated with the Penn Central management. The cash needs of Great Southwest, however, were enormous and pressing and Pennsylvania Co. was no longer capable of supplying it with cash. The desperate financial activities in late 1969 and early 1970 by Great Southwest are detailed elsewhere in this report, including a last minute effort in 1969 to have the three principal officers of Great Southwest purchase \$40 million worth of Great Southwest stock as a substitute for sales to the public or to private investors.

#### (4) THE LAST EFFORTS (FALL 1969-JUNE 1970)

By October 1969 the prospects for improvement were bleak. A cash estimate from the financial department on a receipts and disbursements basis dated October 9, 1969, indicated a cash deficit of \$338 million for 1970. In November of 1969 Penn Central's commercial paper dealer began becoming more concerned about the condition of Penn Central.<sup>144</sup> The desperate condition of the railroad would first

<sup>144</sup> For a detailed treatment of commercial paper sales and the role of Goldman, Sachs, see section III-A.

affect commercial paper because there was a continuing need to resell the short-term paper as it became due and because it was an unsecured financing. Robert T. Wilson, the head of the Goldman, Sachs commercial paper department, spoke with Jonathan O'Herron, who had replaced Gerstnecker, on November 10, 1969, and indicated that a New York Times article which quoted Penn Central's counsel as having told the ICC that the Penn Central is having a rough time with the merger could be harmful to the sale of commercial paper. Wilson suggested an additional \$50 million of standby bank lines. On December 1, 1969, Wilson called O'Herron to indicate that with \$200 million worth of commercial paper outstanding the adverse information concerning Penn Central would require that \$15 million of the \$50 million standby bank lines be converted to "swing" lines which could be drawn down on very short notice in case of difficulties in reselling the paper as it became due. Wilson again made reference to the level of backup bank lines. At a meeting on December 9 between George Van Cleave of Goldman, Sachs and members of the finance department of Penn Central (not including O'Herron, who was out of town), Van Cleave pointed out that Goldman, Sachs was currently holding \$16 million of Penn Central notes in inventory, the largest position in Penn Central notes that they ever had. Goldman, Sachs suggested additional bank lines on a swing line basis to enable Goldman, Sachs to reduce its inventory. Goldman, Sachs cited "their now being at the \$200 million level, a tight market and adverse publicity" as figuring in its desire to reduce inventory.

As the bank lines and the commercial paper reached their limits, the Pennsylvania Co. became the last remaining vehicle for additional financing. The Pennsylvania Co. made a \$35 million private placement of collateral trust bonds in the summer of 1969 and then issued \$50 million in debentures in December 1969 in a public offering.<sup>145</sup> The proceeds of both sales were supplied to the Transportation Co. Each step of additional financing, however, restricted the range of options to the company. The stock of Pennsylvania Co. had been pledged to the revolving credit. Both the \$35 million trust bonds and the \$50 million debenture offering in December would have precedence for security purposes over any subsequent financings. This would make potential additional lenders on Pennco's credit more cautious. In addition, the principal asset of the Pennsylvania Co., the stock of the Great Southwest Corp., was very rapidly declining in price. It was clear to the Penn Central management that there was little hope of reversing this decline in the value of Great Southwest stock because the earnings of Great Southwest had been paper earnings and a Great Southwest stock issuance had already been canceled for fear of the impact on the market price from the disclosure of adverse information.

On January 27, 1970 Bevan and O'Herron once again approached officials of First National Bank for additional funds. Bevan indicated that Penn Central would have to raise \$165 million to cover capital expenditures and operating losses and to replenish working capital in 1970 despite a projected decrease in capital expenditures to \$150

<sup>145</sup> These debentures were convertible into Norfolk and Western which gave the issue value aside from the assets of Penn Central. The sale can be looked on as a liquidating of some of Pennco's most valuable assets.



million from the \$350 million for each of the preceding 2 years.<sup>146</sup> Bevan asked the First National City Bank to act as a lead bank on a \$50 million "bridge" loan to the Pennsylvania Co. to be repaid upon the sale of \$100 million of debentures by the Pennsylvania Co. Bevan also indicated that the company was discussing a \$15 million to \$30 million long-term European financing and \$20 million to \$40 million in commercial paper in European currencies, all of which was to be debt of the holding company.

Since banks normally have limited control over their outstanding loans except when the loans are in default or when other restrictive provisions become activated by circumstances, the First National City Bank decided to use this request for an additional loan to try to strengthen the security position of the \$300 million revolving credit. A January 29, 1970 internal bank memorandum by Bowditch observed that the \$165 million additional borrowings for 1970 anticipated a loss in the operations of the railroad of about the same size as that in 1969. He stated:

It is not possible for us to judge how long this cash drain will continue. Therefore, it appears necessary that we regularize through security and covenants our [loans].

\* \* \* \* \*

This is a condition precedent to our considering a new \$50 million loan (our share \$10 million-\$15 million) to the Pennsylvania Co. If Bevan is unwilling to do this, I feel we must decline additional advances and proceed to foreclose on our EJA equipment.<sup>147</sup> Our primary effort, however, should be to improve our present credit exposure.<sup>148</sup>

The First National City Bank informed Penn Central that it wanted a dollar limit on the amount to be borrowed by the Pennsylvania Co.; a secondary pledge of the Pennsylvania Co. stock on the existing \$50 million Eurodollar loan and on a \$30,400,000 working capital loan; a negative pledge with the right to take security on the proposed \$50 million bridge loan; and other changes in the credit covenants to restrict Penn Central. This was communicated to an officer in the Penn Central finance department on February 9, 1970. A First National memorandum also indicates that Morgan Guaranty had indicated to First National that it would not participate in the bridge loan without security.<sup>149</sup>

Bevan was not daunted in his efforts to avoid any further restrictions. He turned to the Chemical Bank which agreed to act as the lead bank in the unsecured \$50 million bridge loan to Pennsylvania Co. At that time, the Chemical Bank had a participation in the \$300 million revolving credit line and thus Chemical deprived itself of additional security on that loan as well as foregoing security on the additional loan. Although the First National City Bank shortly learned of the Chemical loan and although Chemical was aware of the absence of First National from the \$50 million group of banks, neither bank spoke to the other about this loan or about the loss of the opportunity to obtain additional security on the revolving credit.

<sup>146</sup> Bevan's figures on capital expenditures for 1968 and 1969 appear to be greatly exaggerated even when equipment financing is included.

<sup>147</sup> EJA had loans from First National City Bank which were in default. It avoided foreclosure, however upon Bevan's guarantee in the spring of 1970 that the railroad would make good any losses to First National. The bank was aware that EJA was bankrupt and that foreclosure would require an embarrassing writeoff, in Penn Central's first quarter.

<sup>148</sup> First National Bank internal memorandum by Bowditch 1-29-70.

<sup>149</sup> Penn Central directors Perkins and Dorrance were also directors of Morgan Guaranty but both deny any involvement in relations between Penn Central and Morgan Guaranty.

While Bevan was sidestepping a confrontation with Penn Central's banks he was beginning to feel increasing concern and pressure from Goldman, Sachs, its commercial paper dealer. On February 5, 1970, upon the announcement of the 1969 loss of \$56 million for the Transportation Co., Wilson contacted O'Herron. Wilson asked about the cash picture for the first 6 months of 1970 and O'Herron indicated that "it is very tight." Wilson told him that it was Goldman, Sachs' judgment "that this news [the 1969 loss] would have an adverse effect on their sale of c/p and we may not be able to keep out \$200 mm of their notes."<sup>150</sup> Wilson emphasized again the need for an additional \$100 million in standby lines to back up the commercial paper. O'Herron stated that he did not think it would be possible to get an additional \$100 million in standby lines. Wilson indicated that procedures would probably have to be set up so that Goldman, Sachs would not have to inventory the \$15 million of notes it was carrying (thereby diminishing the direct risk to Goldman, Sachs). On the next day, February 6, 1970, Gustave Levy, Goldman, Sachs' senior partner, and Wilson met with Bevan, O'Herron and Robert Loder of Penn Central to review the threats to the commercial paper situation. Bevan succeeded in explaining away the 1969 performance and in projecting an optimistic 1970, including having the railroad break even in the fourth quarter of the year. Goldman, Sachs again asked for an additional \$100 million in backup lines, suggesting the use of Eurodollar backup lines. They also requested provisions to make the existing backup lines more readily available, including availability to reduce Goldman, Sachs' inventory from \$15 million to no more than \$5 million. On February 12, 1970, Penn Central bought back \$10 million in notes that were in Goldman, Sachs' inventory. Penn Central never obtained additional backup lines.

As the lines of credit with domestic banks began running out for the company, it began looking toward Europe. In the fall of 1969, Penn Central engaged in some equipment financing through a German bank, with the assistance of Joseph Rosenbaum. At a later time, portions of this borrowing disappeared, apparently having been diverted to the European associates of Executive Jet Aviation.<sup>151</sup> Penn Central was looking for additional foreign financing, particularly general corporate financing. William Strub of Pressprich & Co. arranged through Joseph Rosenbaum to have Penn Central officials meet with officials of the Dresdner Bank of Germany. This meeting took place on November 19, 1969, in the Penn Central's New York offices. Bevan was present at this meeting. A subsequent meeting took place on January 22, 1970, again in Penn Central's New York offices. This meeting was attended by Bevan, O'Herron, Charles Hodge, Joseph Rosenbaum, and Strub, among others. A representative of the Dresdner Bank indicated that German Government restrictions would make a public deutschmark offering unlikely, but that the bank would like to do a Eurodollar offering in the amount of about \$20 million. This information did not satisfy Penn Central which wanted quick action and preferred much larger amounts than Dresdner could supply. After the Dresdner officials left, Strub indicated that he might be able to arrange a short-term Eurodollar financing of \$15 to \$20 million.

<sup>150</sup> Goldman, Sachs internal memorandum by Wilson Feb. 5, 1970.

<sup>151</sup> This matter has been previously discussed at p. 74.

Strub was authorized to proceed and he then contacted Ufitec, a group of European lenders based in Switzerland.<sup>152</sup> O'Herron instructed Strub that the borrowing would be made through the holding company, which had no debt or restrictions. Ufitec advised Penn Central to set up a subsidiary in Curacao for tax purposes. On February 2, Ufitec indicated that it would be able to lend 50 million Swiss francs. On February 5, Strub called Joseph Rosenbaum from Switzerland to tell him that Ufitec could raise up to 150 million Swiss francs. He received word from Rosenbaum that Penn Central would take 120 million Swiss francs (approximately \$30 million) at 10.5 percent. Meanwhile, Hans Muntinga of the European underwriting firm of Pierson, Heldring & Pierson called Strub on February 10, 1970, to say that he wanted to do a Eurodollar financing for Penn Central. Muntinga had heard of Penn Central's interest in European financing because the Penn Central International subsidiary in Curacao was being managed by an affiliate of Pierson, Heldring & Pierson. O'Herron met with Muntinga in mid-February 1970 and they discussed a \$20 million offering. The offering was to have been done in conjunction with First Boston Corp. The holding company, Penn Central Co., would have been the issuer (debt restrictions may have prohibited such borrowings through the railroad).<sup>153</sup>

After the first Ufitec offering was completed, Strub was asked by Ufitec to see if Penn Central would take an additional 35 million Swiss francs. This loan was completed in early March. On April 22 and 23 an additional 100 million Swiss francs were placed.<sup>154</sup> In all these financings, Pressprich and Rosenbaum split the finder's fee. These Swiss loans were first disclosed in the offering circular for the proposed \$100 million Pennco debenture offering. The European short-term money markets were Penn Central's last resource. Because it could be done through the holding company it avoided the restrictions under the revolving credit and other agreements. No security was required (none was available) and the European lenders were relatively unsophisticated about Penn Central.

After the \$50 million Pennco debenture offering, which presented few investment problems because the debentures were convertible into Norfolk & Western shares, Penn Central had little or no financing ability left. The company had found accommodating Swiss lenders (at high rates) and did manage to play Chemical Bank off against First National on the bridge loan, but the commercial paper borrowings were threatening to come apart. The situation was clearly terminal. The Pennsylvania Co. \$100 million debenture offering was the last hope for even temporary financial survival. The proposed Pennco offering was fraught with difficulties and doomed from the outset. The proposal of such an offering, however, did give management an opportunity to maneuver a while longer. The difficulties with the debenture offering and the discoveries being made by counsel for the

<sup>152</sup> Ufitec was already involved in some loans to Great Southwest. In the loans to GSC and Penn Central, Ufitec apparently felt it was lending to a blue chip company. The loans, however, were made at high interest rates.

<sup>153</sup> This financing was seriously considered, but was postponed pending developments with the troublesome \$100,000,000 Pennco debenture. Both issues would have been offered publicly and presented disclosure problems.

<sup>154</sup> In U.S. dollars, Penn Central International borrowed the following amounts from Ufitec:

Feb. 24, 1972	\$27,900,000
Mar. 12, 1972	8,100,000
Apr. 22, 1972	11,600,000
Apr. 23, 1972	11,600,000

underwriters are very significant. Because of its importance the offering is treated separately in the next section. The two sections must be read together, however, for a full description of the financial affairs of the company during this period.

By April 22, the final phase of the slide to bankruptcy began. On that day the company announced disastrous first quarter results, including a \$63 million loss in the Transportation Co. The announcement sealed the fate of the debenture offering and started a run on the commercial paper. Goldman, Sachs redoubled its sales efforts but could resell little of the paper coming due. Because most of Penn Central's paper was of short duration, the runoff was rapid as sizable amounts of the unsaleable paper matured. Part of the \$50 million standby line had already been drawn down to reduce Goldman, Sachs' inventory. By the end of April, \$37 million of the backup line had been drawn down. A few banks balked on their commitments and by May 11, 1970, the final drawdown of the \$46.5 million available took place. Now only the last \$50 million of the \$300 million revolving credit remained to pay off approximately \$150 million of commercial paper which was by then virtually unsaleable.

Under the terms of the credit agreement Bevan could draw down the last \$50 million as the commercial paper was reduced but the revolving credit bankers would want some explanations about what was happening to determine whether the provisions of the agreement had been met. Also, alerted by O'Herron's warnings that things were worse than Saunders or Bevan had admitted, Secretary Volpe had arranged for Saunders to see Treasury Secretary Kennedy over the weekend of May 9 and 10 at Hot Springs, Va., about emergency Government assistance. In public statements Bevan and Saunders continued to assure the public that the ship was still on course.

By May 21, 1970, Penn Central could no longer avoid drawing down the last \$50 million of the revolving credit. Bevan invited First National City Bank and Chemical Bank to a meeting in his New York office in the late morning. He told them that the debenture offering had been abandoned and that Penn Central was drawing down the last \$50 million of the revolving credit. He also asked them to join in an additional loan that would be guaranteed by the Government. This was the first knowledge the banks had that a terminal crisis existed. They told Bevan that they would hold up further drawdowns until the other banks could be informed and could indicate their approval because First National and Chemical feared they might be held liable for letting a drawdown occur under the circumstances. The bankers left to consult with their lawyers.<sup>155</sup>

Bevan then summoned the managing underwriters to a late afternoon meeting in his office.<sup>156</sup> It had been pretty well understood that the offering would not be completed.<sup>157</sup> Bevan now told them that the offering had been terminated but that they should keep this information confidential because of confidential negotiations taking place with the Government.

On Monday, May 25, management again met in Washington with Government officials including Secretary Kennedy, Peter Flanigan,

<sup>155</sup> Further detail on matters relating to the banks is given in section II-A dealing with sales of Penn Central stock by banks who were in the lending group.

<sup>156</sup> Representatives of Salomon Bros. and Glorie, Forgan were present. First Boston was unable to attend that meeting. It received the information the next morning.

<sup>157</sup> See section on Public Offerings.

and Arthur Burns. On Tuesday, management met again with First National and Chemical in New York. The bankers had decided that a meeting of all the bankers should be held at which time Bevan could explain the situation and prospects. Invitations were issued to all creditor banks for a meeting at First National on the morning of May 28.

On the 27th, management asked the Penn Central directors for what was, in effect, unlimited authority to pledge assets and to enter into financing agreements. When a few directors balked, management reluctantly told them what was taking place with the bankers and the Government. The board gave the requested authority.

The Wall Street Journal on May 27, 1970, contained an article highlighting the commercial paper runoff which was disclosed in a textual portion of the revised Pennco prospectus dated May 12, 1970. This appears to be the first revelation in the press of the financial crisis. Copies of both circulars had been distributed to the press but the format of the prospectus did not highlight the significant problem. A Wall Street Journal writer had attempted to learn about the commercial paper problem from Penn Central and from Goldman, Sachs on May 13, before the revised circular with the commercial paper runoff information was issued. Penn Central and Goldman Sachs had both refused to comment.<sup>158</sup>

At a meeting with the bankers on May 28, Bevan made some explanation of Penn Central's problems and announced the abandonment of the debenture offering. He also asked the banks to join in a Government-guaranteed loan. After the meeting, a steering group of banks was formed and representatives of First National City Bank flew to Washington to talk with Government officials. Early in the afternoon of May 28, Penn Central issued a release announcing the "postponement" of the debenture sale and indicating that the company was "working on alternate methods of financing."

Penn Central was now solely dependent on the Government loan. The success of this undertaking was largely a matter of the negotiation of terms between the bankers and the Government. One of these terms was the removal of Bevan and Saunders. The removal was accomplished on June 8. A major problem was the priority of security. The banks wanted to keep their existing security. In negotiations with the Government, flexibility to the extent of some sharing was possible. However, Congressman Patman, who was not involved in the negotiations but whose approval of additional lending legislation was needed, wanted the Government to have first priority. Finally on June 19 the Government withdrew the proposed guarantee and on June 21, 1970, the Penn Central Transportation Co. filed a petition for reorganization.

## POSTSCRIPT

### A CASE STUDY OF MANAGEMENT INDIFFERENCE TO OBLIGATIONS TO THE INVESTORS: DILUTION AFFECTING PENNCO PREFERRED SHAREHOLDERS

Throughout Penn Central's decline, management demonstrated indifference to its obligations to provide shareholders with adequate and accurate information about Penn Central's affairs and about the

<sup>158</sup> The question of selective disclosure through the prospectus is discussed in the next section on Public Offerings.

conduct of management. A relatively minor, but clearly delineated, obligation provides an example of that indifference. It also demonstrates that Penn Central's financial problems and restrictions were such that even minor financial demands were more than Penn Central cared to acknowledge. This particular example is the dilution of the value of stock of the Norfolk & Western Railway Co. (N. & W.) into which Pennco preferred stock was convertible. Under the terms of the preferred stock agreement, Pennco was obligated to increase the exchange rate whenever a dilution occurred in N. & W. stock. Penn Central senior management failed to follow the terms of the agreement, despite repeated warnings from subordinates that management was failing in its obligations.<sup>159</sup>

*Background.*—On July 24, 1964, pursuant to a merger agreement with Buckeye Pipe Line Co., Pennco, a wholly owned subsidiary of Penn Central Transportation Co., issued 699,123 shares of preferred stock convertible into N.&W. stock at any time after July 1, 1967. The optional redemption price was \$137, subject to adjustments if additional shares of N.&W. common stock (other than shares issued for reasons stated in the agreement) were issued at anytime after February 6, 1964. Pursuant to proceedings relating to the merger of N.&W. and the New York, Chicago & St. Louis Railroad Co. (the "Nickel Plate"), the ICC required N. & W. to acquire the Delaware & Hudson Railroad (D. & H.) and the Erie Lackawanna Railway (ELR). N. & W. organized Dereco under the laws of Delaware as a holding company to acquire the D. & H. and the ELR. N. & W. issued to Dereco 412,627 shares of its \$25 par value common stock to effect the D. & H. acquisition. N. & W. also issued to Dereco a right for it to require the issuance of not exceeding 821,280 shares of N. & W. common stock to Dereco in exchange for Dereco preferred stock issued to acquire ELR. The question whether the issuance of additional N. & W. shares had caused a dilution which required Pennco to place in escrow more N. & W. shares to be available in case of conversion by its preferred shareholders was considered at Penn Central with the knowledge that the Pennco preferred agreement specifically required prompt notice to shareholders in the event of any dilution.<sup>160</sup>

*Action by the Pennsylvania Co.:*

On December 27, 1968, Hill (Comptroller of Penn Central Co.) wrote a confidential memo to David Wilson of the legal staff of Penn Central stating that "[w]e have interpreted the N. & W. issue of stock rights for Dereco (Erie-Lackawanna) and their issue of common stock for Dereco (Delaware & Hudson) to cause price adjustment under our [Pennco] preferred requirements." He went on to say he felt the adjustment would result in a reduction in the redemption price from \$137 to \$130 per share or a loss to Pennco of over \$3,500,000. Because Pennco's holdings of N. & W. stock were pledged or otherwise restricted, Pennco would probably have had to purchase the stock on the open market to satisfy the escrow requirements. Hill asked Wilson to review the 1964 agreement "to determine if our interpretations are legally correct, and whether there are loopholes we might beneficially apply."

<sup>159</sup> On June 6, 1972, the board of directors of Pennco announced that the exchange ratio for the convertible preferred was being adjusted to reflect the 1968 issuances of N. & W. stock. Their knowledge of the existence of this problem arose out of inquiries made by the staff in the course of the investigation.

<sup>160</sup> Penn Central officers handled the matter because Pennco did not have its own officers except for purposes of formal actions.

On January 6, 1969, Wilson replied to Hill pointing out "that the terms contemplate that the optional redemption price must 'immediately' be adjusted whenever N. & W. issued any additional shares of stock other than so-called "excluded shares." "It is furthermore required that upon any such required immediate adjustment the corporation is obligated 'forthwith' to file a formal statement of the adjustment with the escrow agent and give prompt written notice by mail to all holders of record of the preferred stock. It would appear that Pennsylvania Co. is rather seriously in default in these obligations."

On January 15, 1969, Wilson wrote to David F. Anderson of the law firm of Potter, Anderson & Corroon of Wilmington, Del., the general counsel of Pennco, stating that he felt that the optional redemption price should be adjusted and asking Anderson for his thoughts. On January 20, 1969, Anderson replied to Wilson stating that he agreed with him, "[h]owever, I do not have an expertise in interpreting this provision of the merger agreement, and your judgment is as good as mine."

On January 22, 1969, C. L. Rugart, Jr., the secretary-treasurer and comptroller of Pennco, sent a memorandum to Gerstnecker who at the time was a financial officer of Penn Central but was neither an officer nor director of Pennco. The memorandum stated that Chemical Bank was holding 39 shares for conversion and that other preferred holders were considering converting. Advice was requested concerning revision of the conversion ratio. Rugart also cited the provision which states that if N. & W. takes any action with respect to its capital stock which is not adequately covered by the express provisions on dilution and which might materially dilute the right of any holder of preferred stock, the board of directors of Pennco must appoint a firm of independent certified public accountants to get an opinion as to the adjustment.

During the latter part of January, Wilson, at the suggestion of Gerstnecker, forwarded to Robert Rosenman of the law firm of Cravath, Swaine & Moore, documents relating to the several transactions. Rosenman was asked to form tentative conclusions to be given informally. Sometime prior to February 18, 1969, Wilson and Rosenman conversed. On February 18, 1969, Wilson wrote a memorandum to Gerstnecker stating that the preliminary view of the Cravath firm was that the transactions did constitute the events of dilution requiring an alteration of the conversion ratio and the deposit of additional N. & W. stock with the escrow agent. The memorandum stated that Wilson had told Rosenman that Gerstnecker felt no dilution had occurred. In response, Rosenman had indicated that a change in their preliminary opinion would require additional facts, assuming that such facts existed. The memorandum closed with a request to Gerstnecker to consider the urgency of the situation.

On April 3, 1969, Wilson wrote separate memorandums to Rugart, Edward Kaier, general counsel of Penn Central, and Cole, assistant to Saunders. In the memoranda Wilson indicated that nothing had been done since his February 18, 1969, memorandum and that while he realized that Gerstnecker did not agree with his opinion Wilson felt that very serious consequences could result if the company continued to be derelict in its duties to the stockholders. Cole testified that he recalled receiving Wilson's memorandum and having had some discussions with Wilson on the matter. Cole also stated that he

never discussed the area of dilution with Saunders and that he was not aware of whether Saunders was familiar with the area of not.

On May 5, 1969, Wilson wrote a memorandum to the files concerning a conversation with Rugart on May 1, 1969, in which Wilson was informed that Chemical Bank had asked what the reason was for the delay in converting 39 shares. Wilson told Rugart that he could approve only two courses of action: either (1) convert and inform the stockholder that a change in ratio was being worked out; or (2) convert without giving the shareholder any notice, and send the additional shares in a week to ten days. Wilson stated that he could not approve any course of action which complied with the redemption request on the old basis without any intention to get in touch with the stockholder in the future or to take any required action to change the ratio. On May 5, 1969, Wilson was informed that the alternative adopted was the one he had not approved of. Wilson was involved in no further communication until after the bankruptcy.

In testimony Gerstnecker stated that he was aware that there was a question of dilution, and that he and Bevan had conferred about the matter. He recalled that both Wilson and Taylor had indicated to him that a dilution had occurred, but that he had felt that the question was one that should be resolved by the legal department.<sup>161</sup> He also stated that he did not attempt to interpret the sections of 1964 agreement or to indicate his views concerning the intent of the agreement but that he was aware that Cravath, Swaine & Moore had indicated that dilution had occurred and that there was no reason for him to think that there was not a dilution. He stated that if he or Bevan had been told of the need for action, some action would have been taken. Gerstnecker, however, acknowledged having received and read Wilson's memorandum which emphasized the duty specified in the agreement to notify shareholders immediately. Despite this requirement of immediate action, nothing was done during the period of a year and a half until the bankruptcy. The matter was never brought to the attention of the Pennco board.

It is clear that Bevan and Gerstnecker knew that dilution had occurred and knew that Pennco had an obligation immediately to notify shareholders upon such occurrence. Their failure even to raise the issue with the board or to take any of the required steps such as notifying the shareholders resulted from their unwillingness to have to face the problem of finding N. & W. shares. All of Pennco's N. & W. stock had been pledged or escrowed or otherwise restricted. Pennco probably would have been required to purchase the N. & W. stock in the market for cash and management was unwilling to face another cash drain in light of the other financial problems being encountered. Their failure to resolve the problem also contributed to the inaccuracy of statements concerning Pennco's assets. Although the amount of money involved was relatively small, management refused to take even minimal steps to meet its obligations to shareholders.

<sup>161</sup> His recollection differs from that of Taylor. Taylor recalled that he was summoned by Gerstnecker and Bevan and told that they were of the opinion that no dilution had occurred despite the opinion of Wilson and others. Taylor stated that with this in mind he looked into the matter and concurred. He did not put his views in writing and never spoke with Wilson despite his possession of Wilson's memorandums and despite the fact that Wilson's office was next to his.



## I-D. PUBLIC OFFERINGS

### INTRODUCTION

The only public offerings by the Penn Central following the merger of the two railroads were a \$50 million Pennco debenture issue in December 1969 and a \$100 million Pennco debenture offering in the spring of 1970.<sup>162 163 164</sup> The latter offering was never sold. There was no requirement that the offerings be registered with the Securities and Exchange Commission because the issuing company, Pennco, was under the jurisdiction of the Interstate Commerce Commission. The Interstate Commerce Commission rules require that companies under its jurisdiction make applications to the ICC for permission to increase their debt obligations. The purpose is to determine whether an increase in debt is justified in the public interest.<sup>165</sup> There were no rules, however, on the use or composition of any selling literature disseminated to the public.<sup>166</sup>

Normally, companies under ICC jurisdiction prepare and distribute an offering circular in the general format of a prospectus for a registered offering because the civil liability provisions of the Federal securities laws concerning disclosure apply to selling literature used by these companies. Despite the absence of a requirement that offerings be filed with, and subject to review by, the SEC the threat of civil liability forces issuers and underwriters to be cautious in their use of sales literature.

### FIFTY MILLION DOLLAR DEBENTURE OFFERING

The \$50 million Pennco debenture offering was made on December 16, 1969. The underwriters were First Boston Corp. & Glore, Forgan, Wm. R. Staats, Inc. The debentures were exchangeable for shares of the common stock of Norfolk & Western Ry. Co.<sup>167</sup> The N. & W. shares owned by Pennco had been its most valuable asset both in underlying value and production of cash income. Because of the exchange feature, these debentures kept their value even after the bankruptcy of the railroad. The underwriters have cited this exchange value as one of the reasons why the circular contains no information about the Transportation Co. or the holding company. The information in the circular is limited to the Pennsylvania Co. and Norfolk & Western.

<sup>162</sup> The Transportation Co. did issue commercial paper which was made available to public investors but no offering circular was used or was required by the ICC.

<sup>163</sup> Both offerings were made for the stated purpose of supplying funds for the Transportation Co.

<sup>164</sup> Pennco made a \$35 million private placement of collateral trust bonds in July, 1969. The proceeds were supplied to the parent company.

<sup>165</sup> The Penn Central had to seek and obtain ICC approval to increase debt under the revolving credit agreement and the commercial paper authorization as well as for these public offerings.

<sup>166</sup> The Federal securities laws require issuers (except exempted issuers, such as those regulated by the ICC) to file with the Securities and Exchange Commission a registration statement containing specific types of information. There are additional rules governing the distribution of selling literature to the public.

<sup>167</sup> Exchangeable from Nov. 1, 1970, to Apr. 15, 1979, at the rate of 12.2 shares of N. & W. for each \$1,000 debenture (i.e. at a price of \$81.97 per share of N. & W.).

Despite the fact that investors have been protected by the exchangeability provision, the circular presents a misleading picture of Pennco, particularly in connection with Great Southwest. The assets are described in the introduction as constituting \$922 million in market value on December 10, 1969. Of this \$922 million the Great Southwest stock comprised \$435,400,000.<sup>168</sup> The market value of Pennco's GSC holding was as large as it was because of failure to disclose the true state of affairs at GSC. The overvaluation was known to Glore, Forgan because it had been the designated underwriter on a GSC offering in October 1969, which had to be abandoned because of the adverse disclosure that would have been required.<sup>169</sup>

The circular contained other failures to fully disclose the affairs of Pennco. The apparent dilution of N. & W. stock which had occurred in 1968 was described at the end of the previous section of this report.<sup>170</sup>

This would require Pennco to free N. & W. stock from pledge or to purchase more on the open market. No mention of this additional burden was made in the circular and Pennco never informed the Pennco preferred shareholders of this apparent dilution.

The circular mentions a proposed sale of 2 million shares of Pennco's GSC stock to three senior officers of GSC for \$20 million in cash and \$16 million in notes. This was a frivolous proposal which was never completed<sup>171</sup> and created a false impression as to the possible receipt of cash and as to the value of GSC stock. The circular failed to disclose a simultaneous proposal, which was actually carried out, to have Pennco accept GSC stock from GSC in exchange for the cancellation of a debt exceeding \$20 million owed by GSC to Pennco, principally for cash advances which had been made to GSC by Pennco.<sup>172</sup> Disclosure of the exchange might have alerted investors to the cash drain from the railroad to the real estate subsidiaries.

<sup>168</sup> Almost all of Pennco's assets were stocks and bonds. The following is a list of stocks and bonds owned by Pennco at Dec. 10, 1969: (From the Pennco circular, footnotes omitted, p. 7.)

[Dollar amounts in millions]

Security	Shares	Book value	Estimated market value
Arvida Corp, common stock.....	3,529,277	\$22.0	\$41.5
Buckeye Pipe Line Co., common stock.....	14,000	100.3	101.8
Detroit, Toledo & Ironton Railroad Co., capital stock.....	245,329	25.9	40.7
Great Southwest Corp., common stock.....	22,347,240	59.1	435.4
Great Southwest Corp.:			
6 percent cumulative preferred stock, series A.....	3,500,000	3.5	2.3
7 percent cumulative preferred stock, series B.....	3,650,000	.5	2.8
7.6 percent cumulative preferred stock, series C.....	16,410,980	2.4	13.8
Norfolk & Western Railway Co.:			
Common stock.....	1,204,105	67.5	91.8
Common stock with exchange rights.....	400,000	52.0	31.2
Philadelphia, Baltimore & Washington Railroad Co., capital stock.....	277,259	37.2	34.4
Wabash Railroad Co.:			
Common stock.....	595,255	7.3	51.1
4½ percent preferred stock.....	101,836	3.8	6.0
Other.....		92.5	69.2
Total.....		474.0	922.0

<sup>169</sup> See page 137 et seq.

<sup>170</sup> See page 104 et seq.

<sup>171</sup> See page 142 et seq.

<sup>172</sup> See section I-E of this report on Great Southwest for details.

Penn Central avoided disclosing these and other adverse facts about the railroad, Pennco, or GSC in the \$50 million circular. As described below, it was not quite so fortunate in the next public offering.

### ONE HUNDRED MILLION DOLLAR DEBENTURE OFFERING

In 1970, the last vehicle that might be used for an attempt at a major financing was the Pennsylvania Co. The Pennsylvania Co. itself had inherent drawbacks as a financing vehicle at this time and the drawbacks were becoming ever more serious. Debt instruments, including that \$50 million December 1969 debenture offering, contained covenants restricting the amount of debt that could be incurred by the Pennsylvania Co. in relation to the assets.<sup>173</sup> The borrowings of Pennco had already increased by \$85 million in 1969. At the same time the market price of Great Southwest shares, Pennco's principal asset in terms of market price, was steadily declining in late 1969 and early 1970. Penn Central management realized that the decline would continue as the deteriorating condition of Great Southwest was gradually being perceived by investors. The Penn Central, however, had no choice about using Pennco as a financing vehicle because money was needed and there were no other means of obtaining that money.

On February 2, 1970, O'Herron called N. Gregory Doescher of First Boston Corp. to inquire about the possibility of a debenture issue for Pennsylvania Co. which would include warrants for Penn Central Co. stock and Great Southwest stock owned by Pennsylvania Co. The fact that this proposal was coming less than 2 months after Pennco had completed a similar offering was a clear indication of the serious cash drain and the limited financing possibilities. Despite this warning, the underwriters began preparations for the offering.

### WARRANTS FOR GREAT SOUTHWEST AND PENN CENTRAL STOCK

One complication was encountered immediately. Penn Central management had proposed the use of Great Southwest warrants despite the fact that Great Southwest had been forced to abandon a public offering in late 1969 because of the adverse disclosure which would have been required in a registration statement. Glore Forgan, which had been the proposed manager of the abandoned Great Southwest offering, knew of the reasons for the abandonment. First Boston, the lead manager on the Pennco offerings, did not know about the abandoned Great Southwest offering.<sup>174</sup> Doescher realized, however, that the GSC warrants and the holding company warrants were needed as "sweeteners" because of the prevailing high interest rate and the fact that the Pennsylvania Co. debentures would be less than premium grade. Doescher understood that these factors might have required an interest rate so high that it would be self-defeating in that investors would be frightened away by an offering that had to pay such high rates.

Penn Central had hoped to avoid the disclosure problems by delaying registration of the warrants until their exercise date on July 1, 1971.<sup>175</sup>

<sup>173</sup> The common stock of Pennsylvania Co. itself was pledged as security to the revolving credit.

<sup>174</sup> First Boston and Glore Forgan were the original comanagers of the \$100,000,000 Pennco debenture as they had been on the \$50,000,000 offering. Salomon Bros. was added at the request of Penn Central.

<sup>175</sup> A note written by Doescher dated Feb. 12, 1970 states: "Concept feasible, delay exercise of warrants until July 1, 1971; [debenture] circular now; delay registration statements until warrants become exercisable."

For their own reasons Great Southwest and its outside counsel, George Davis, were not happy about that approach. Even if registration could be delayed, Great Southwest would have a commitment to future registration hanging over it. At that time Great Southwest's affairs were deteriorating. This made the prospect of even a future registration unattractive. Glore Forgan shared Great Southwest's concerns. In a February 20, 1970, memorandum of a telephone call between David Wilson, Penn Central house counsel, and Davis, Wilson wrote:

According to Davis, General Hodge and Jack Harned of Glore Forgan, either severally or jointly, suggested to Davis that he call me with the proposal that Davis and I try to sit down with Mr. Bevan at a very early date and persuade him not to market any part of a GSC common stock offering at this time. In talking with Davis, I gathered that at least Harned (if not Hodge) was present at the general meeting in New York on Wednesday, February 18. After some discussion neither Davis nor I could understand why the Glore Forgan people did not take that occasion to explain the big problems to Mr. Bevan.

Discussions about the problems involved First Boston and their counsel as well as Great Southwest, Penn Central and Glore Forgan officials. First Boston was supplied with a copy of the draft prospectus for the abandoned Great Southwest offering.<sup>176</sup> Sullivan & Cromwell, counsel to the underwriters, began having reservations about whether registration could be legally delayed. In early March, Sullivan & Cromwell suggested that the underwriters seek a "no-action" letter from the SEC.<sup>177</sup> The matter of the registration of the warrants became secondary in late March as the underwriters became increasingly alarmed about the debenture offering itself and serious disclosure problems. Apparently these revelations eliminated the possibility that the sale of the Great Southwest and the holding company stock would be allowed without registration. The disclosure that would have been required would have compounded the disclosure difficulties. The warrants were abandoned in early April.<sup>178</sup>

#### DISCOVERY BY UNDERWRITERS OF PENN CENTRAL'S CRITICAL PROBLEMS

Penn Central had decided to have a simultaneous offering in Europe of \$20 million in debentures of Penn Central International Corp., a newly formed subsidiary of Penn Central Co.<sup>179</sup> Therefore two circulars were being prepared simultaneously: the Pennco debenture circular and the Penn Central International circular. First Boston and Pierson, Heldring & Pierson of Amsterdam were the underwriters

<sup>176</sup> From a memorandum of February 24, 1970 from Paul A. Downey of First Boston Corp. to Doeschner:

"Jack Harned called today to say that lawyers from Great Southwest and the railroad got together with Jack Arning Monday to discuss the problems of SEC vs. ICC registration. They will meet again on Wednesday and will determine at that time what route is to be taken. Harned sent a copy of the Great Southwest red herring to NGD, which I have intercepted. The next move is still up to the company and there is nothing we can do for the immediate future except familiarize ourselves with Great Southwest."

<sup>177</sup> Counsel indicated to the staff that statements in Louis Loss' Treatise on the securities laws raised a question about the legality of offering the warrants without registration.

<sup>178</sup> From a letter of April 9, 1970 to Hans Muntinga, of Pierson, Heldring & Pierson of Amsterdam, underwriters for the proposed debenture offering of Penn Central International Corp., from William Williams of Sullivan & Cromwell:

"On Monday afternoon Dave Bevan met with representatives of First Boston, Glore Forgan and Salomon Bros. and proposed that the Penn Central and Great Southwest warrants be eliminated from the Pennco \$100,000,000 offering. Fred Smith of First Boston believes that one of Bevan's motives was to avoid the disclosures with respect to Penn Central and the Railroad which he knew, from our draft introduction, we would have required. I think this also enabled Bevan to avoid some rather difficult problems he was encountering with Great Southwest's management and counsel and in getting the Penn Central Common stock into Pennco's hands on a basis satisfactory to all concerned."

<sup>179</sup> Penn Central International, a Curacao subsidiary of the holding company, had been formed for purposes of making short-term Swiss franc borrowings. The holding company and its subsidiaries were used because the debt restrictions of lending agreements did not apply to it. See page 101 et seq. for details of efforts to obtain foreign borrowings during this period.

on the International offering. The format of the International offering circular was focused more on the holding company and the railroad than was the Pennco circular.

The preparation of the circulars proceeded routinely, except for the warrant question, until mid-March. At that time, the underwriters began receiving materials, including financial statements, from Penn Central. The underwriters' counsel had indicated that the preparation of financial information should take the SEC standards into consideration even though the circulars would not be filed with the SEC. Counsel had also asked for cash flow information. The information began to alarm the underwriters and counsel for the underwriters. They were also concerned about whether the company was making full disclosure to them. On March 18 Bevan and O'Herron met with the underwriting group working on the domestic issue. Bevan stated that budget projections showed break-even results in third quarter of 1970 and a profit in fourth quarter. The statement was not based on fact. The railroad had already lost as much as was projected for all of 1970 and there was no indication of a reversal. The underwriters knew or should have known that these projections were not founded on fact because Penn Central did not have established forecasts or budgets. From the testimony of Doescher:

*Question. Do you remember exploring the budgets of the Transportation Company for 1970 and subsequent years in connection with preparing the circular?*

Answer. I remember trying to.

*Question. You weren't able to do that?*

Answer. As I recall, they did not have budgets, much to our surprise.

*Question. Is that unusual for a large company like that not to have budgets?*

Answer. Yes.

*Question. Did they give any explanation for not having them?*

Answer. The explanation was that they were in a situation that was simply impossible to forecast.

*Question. What was the factor that created the impossibility to forecast; the factor or factors, as they explained it?*

Answer. The size of the railroad and the lack of financial controls and then I should say that [at the March 18 meeting] Mr. Bevan went on to give his own description, his own forecast of the railroad for 1970 which I have testified previously on.

*Question. Did he indicate how he was able to make such a forecast if the company itself could not pull together the necessary information?*

Answer. Well, he wasn't necessarily separating himself from the company; he was saying that, "No, we don't have detailed financial forecasts, but my own forecast would be along these lines."

Two days later on Friday, March 20, despite the warning signs, the senior First Boston officials decided the domestic issue did not present serious problems and that although they were "uncomfortable" about the international issue, they would go along because of its small size.

At the same time that the underwriters were being appeased by Bevan, William Williams, counsel to the underwriters on the international issue, was becoming increasingly concerned about what he was seeing. He was particularly concerned about the cash situation at Penn Central. In light of the excess of current liabilities, debt due within 5 years and the growing losses, Williams concluded that "there was a risk, perhaps a significant risk, that some time within the next

1 or 2 years that the railroad could end up in bankruptcy whether they obtained \$120 million or not." On March 19 Williams spoke with John Arning, counsel to the underwriters on the domestic offering,<sup>180</sup> and then with the working group members representing the underwriters on the international offering. He told the working group members to bring to the attention of the senior underwriting representatives the adverse information that was being uncovered.

The following day, Williams and other members of the International offering working group were in Philadelphia for a regular session on the circular. As a routine question in light of large writeoffs in 1969 the underwriters asked the Penn Central representatives whether any additional writeoffs were contemplated for 1970. The comptroller, Hill, stated that a major writeoff of track was being contemplated. Hill produced a book describing the writeoff plans. He also submitted a draft of the 1969 annual report to shareholders which was to be issued shortly and which contained the following statement:

*Redesign of System Trackage.*—We have launched a project to streamline our railroad by eliminating 5,800 miles of surplus track from our total of 40,000 miles. This could bring benefits of \$90 million of equivalent capital and save \$9 million annually in operating expenses.

Efficiency of our remaining plant will be enhanced through disposition of these unneeded freight facilities, seldom-used branch lines, excess yard trackage, and duplicate lines.

Williams indicated that the writeoff against earnings that would result should be disclosed in the circulars and that a press release should be issued no later than the issuance of the circular if such a writeoff was imminent.<sup>181</sup> E. K. Taylor, Penn Central's house counsel who was working on the offering, then suggested that this be taken up with Bevan. After Hill had briefed Bevan, the working group was called to Bevan's office. Bevan was annoyed about this question of disclosure. He stated that much of any writeoff would be covered by the merger reserve and would not have to be reflected in earnings. He said the abandonment plan was subject to constant change. When asked why the abandonment was mentioned in the annual report he said he did not know of it and considered such reference to be stupid.<sup>182</sup> He left the room to consult with Saunders and returned to assure the working group that there were no plans for abandonment "in the foreseeable future." Williams pressed Bevan on the meaning of "foreseeable future." Bevan finally indicated that it would not take place in 1970. Hill agreed with Bevan. Williams was troubled by the inconsistency of the earlier position of Hill and Bevan's position. Williams was also troubled by Bevan's evasiveness:

*Question. Did you get the impression that Mr. Bevan's answers to your questions were evasive?*

Witness WILLIAMS. Can I let the record speak for itself?

*Question. Well, I'm asking you for an impression, or what was your impression, in your efforts to obtain his answer?*

Witness WILLIAMS. My impression was that on the subject he was being evasive

<sup>180</sup> Although the international offering and the domestic offering were being coordinated, separate working groups were working on the offerings. William Williams was counsel to the international group and John Arning was counsel to the domestic group.

<sup>181</sup> Williams was not taking the position that such a writeoff necessarily would be viewed adversely by investors, but only that it was something they should know of.

<sup>182</sup> This was typical of Penn Central disclosure. The annual report stressed the benefits and their immediacy. Disclosure of any adverse impact on the earnings, however, was ignored.

*Question. Did you consider the possibility that perhaps a writeoff had been contemplated by the Transportation Co., but that Mr. Bevan was now taking the position that it was not contemplated so as to avoid a damaging disclosure in the proposed offering circular?*

Witness WILLIAMS. Yes, I considered that.

*Mr. Cooper. You considered that as a possibility?*

Witness WILLIAMS. Yes.

Williams was receiving an introduction to the Penn Central standard of disclosure.

Arning was out of the country from March 21 to April 4 during which time Williams covered the work on both the Pennco and the International offering. On March 23, Williams informed Arthur Dean, senior partner of Sullivan & Cromwell, about what he had told the junior members working on the International offering, including the possibility of bankruptcy of the railroad. Dean advised him to be sure the senior underwriting officers were aware of the problem. Williams then contacted the senior members to say that Sullivan & Cromwell would not go along with the International offering unless the underwriters were fully aware of the facts.<sup>183</sup>

Doescher of First Boston then reviewed the International circular and, after speaking with a representative of Pierson, Holding & Pierson, decided to recommend postponing the International offering because the "disclosures are very severe and [the underwriters] did not want to be in a position of appearing to sell something abroad which could not be sold at home" according to a note made by Doescher. On the 24th and 26th, further conferences involving the underwriters, counsel, accountants, and officers of Penn Central took place. At about this time, Dean decided to call a meeting of the top officers of each of the underwriters to make certain that they understood the facts. The meeting was set for March 31. This was acknowledged to be an extraordinary meeting which resulted in part from Williams' growing concern that "someday this whole thing would blow up, and I wanted to make sure that the firm was focusing on it at the stage where we could do something about it, focusing on it at the highest levels \* \* \*."

Bevan was growing increasingly concerned for his own reasons. Every probe was uncovering embarrassing information that was contradicting his representations, which he knew were false. On March 27 Dean met with Bevan at Bevan's request. Bevan criticized Williams and asked that Williams be removed. In response, Dean noted that Williams belonged to a younger generation and that certain duties were imposed by a case known as *BarChris*. (*Escott v. BarChris Construction Corp.* relates to the liability of parties to a registration statement when inadequate investigation is done). Dean declined Bevan's request to remove Williams. Williams was then called into the meeting.

In response to a question from Williams about income budgets, Bevan stated again that the company would lose no more in 1970 than in 1969 although he admitted that first quarter losses were considerably greater than first quarter losses in 1969. Bevan also stated that there were assets that could be sold. When Williams referred to the

<sup>183</sup> The International underwriting presented particular problems because its only asset, indirectly, was the railroad and the offering would require extensive disclosure about the railroad.

negative pledge in the revolving credit agreement, Bevan said he was negotiating with First National City Bank to get a release of the assets. In fact, however, First National had been foiled only a short time before in efforts to get additional security on the outstanding loans and certainly would not be inclined to weaken its secured position.

On March 28, 1970 Williams prepared a memorandum to Dean outlining some of his concerns about the company. The memorandum was to be distributed to the underwriters at the March 31 meeting. Summarized below are a number of observations which Williams made in this memorandum:

(1) Williams noted that "substantially all Railroad's system lines are mortgaged or otherwise encumbered. A significant portion of its investments is pledged as security for Railroad's long-term and short-term indebtedness. In particular, in April 1969 Railroad entered into a Credit Agreement ("Credit Agreement") pursuant to which it pledged all of Pennco's common stock to First National City Bank, as Agent for some 48 banks. Indebtedness outstanding under the Credit Agreement may be accelerated and the pledge may be foreclosed in the event that, among other things, any obligation of Railroad, Pennco, Pennndel Co. ("Pennndel"), The Pittsburgh and Lake Erie Railroad Co. ("P & LE") or the Pittsburgh, Fort Wayne and Chicago Railway Co. ("Fort Wayne") for the payment of borrowed money, the deferred purchase price of property or the rental, charter or hire of rolling stock is not paid when due or is declared due and payable prior to stated maturity by reason of default or violation of the terms thereof. In addition a major portion of the properties of Railroad's subsidiaries other than Pennco is mortgaged or pledged to secure their indebtedness, and Railroad's right to mortgage or pledge certain of its unencumbered assets and the stock and assets of certain unencumbered subsidiaries is restricted.

(2) Williams noted that "Pennco has been used as a vehicle to finance Railroad's operations through the issuance of debt and preferred stock, the proceeds of which are used either to make loans to Railroad or acquire assets from Railroad."

\* \* \* \* \*

In connection with its financing activities Pennco has pledged a substantial portion of its investments as security for its long-term indebtedness and is committed to give up a substantial portion of its investments upon exercise of exchange rights by holders of its long-term indebtedness, and preferred stock. In addition, Pennco is obligated to deliver a portion of the N & W common stock held by it to N & W exchange for N & W debt, and Penn Central is committed beginning in 1975 to deliver N & W common stock upon exercise of exchange rights by holders of the preference stock which Penn Central issued to acquire Southwestern and Royal. (In fact, the total claims on N & W common stock by way of pledge and exchange rights exceed the amount of N & W common stock available to Penn Central without going into the open market.)

(3) If the railroad complied with the SEC line of business disclosure requirements, the losses on railroad operations would be shown as being extremely large.<sup>184</sup>

(4) Penn Central's earnings prospects were uncertain at best despite Bevan's assurances.

(5) On the weekend of March 21-22, Penn Central set out to accelerate an exchange of Wabash stock for Norfolk and Western stock which would produce a paper profit of \$40 million-45 million in the first quarter.

(6) Penn Central had arranged financings through Francis and Joseph Rosenbaum and Francis was a convicted defrauder of the U.S. Government.

On March 30, at Williams' request, First Boston contacted the First National City Bank to review the credit position of the company. First National City Bank informed the underwriters that the railroad could be in trouble if there was not a turnaround, that First National had turned down Bevan's request for the \$50 million bridge loan which later was made by a group of banks led by Chemical Bank, and that Executive Jet Aviation was in default of some obligations to the

<sup>184</sup> Williams also noted that the domestic offering with the warrants "was structured in this way because Penn Central wished to avoid registration under the Securities Act of 1933 at this time."



bank. First National indicated it knew of no other defaults. The underwriters made no attempt to contact Chemical Bank or the commercial paper dealer, Goldman, Sachs.

Counsel for the underwriters called a meeting for the purpose of considering the serious questions being raised about the underwriting. The meeting took place on March 31, 1970, at 2:30 p.m., in the offices of Sullivan & Cromwell. Attending along with Dean and Williams of Sullivan & Cromwell were the leaders of the investment firms participating in the underwriting.<sup>185</sup> The March 28 memorandum was distributed. Of particular concern was the threat to Penn Central's viability:

The subject of what would happen in the event of a bankruptcy in the railroad was discussed. We [counsel] read them the relevant provisions of Section 77 of the Bankruptcy Act.

We were asked whether, as a legal matter, Pennsylvania Co. would withstand the bankruptcy of the railroad, and we expressed the view that it would.

This danger most directly threatened the international offering and it was decided that the offering would be postponed. It was next concluded that the underwriters would be willing to state in the prospectus that the warrants for Penn Central Co. stock were worthless. After further discussion it was agreed that they would proceed with the underwriting with the understanding that Sullivan & Cromwell would include any disclosures needed to protect the underwriters from liability. No consideration was given at this time or any other time to asking or requiring the company to make any public statement about the seriousness of the problems.

The underwriters were running some risk but they were apparently unwilling to be known in the financial community as the cause of the collapse of the Penn Central by any move to withdraw. A minute from the Salomon underwriting committee meeting of April 2, 1970, reflects the conclusion of the underwriters:

*Pennsylvania Company offering.*—John Gutfreund stated that we had a moral obligation to do the issue if we get adequate opinion of the Company's counsel. He stated that we will have to be very careful because of the Company's cash problems and large amounts of pledged assets.

As a result of the March 31 conference Penn Central was called upon to supply a number of items of information for review for possible inclusion in the circular. One of the individuals working on the underwriting indicated Penn Central had some difficulty in producing this information and some information such as cash forecasts was never produced. It was this individual's view that Penn Central was simply incapable of producing some of this information although it is almost unheard of for such information to be unavailable in companies of that size.

A major hurdle to the offering was encountered on April 22 when Penn Central released its first-quarter results. The results were extremely poor and tended to confirm the downward plunge of the company. The results should have been a further warning to the underwriters that they were not being told the whole truth by Bevan

<sup>185</sup> Among those participating were: First Boston Corp. (Emil Pattberg, Jr., chairman, Paul L. Miller, president, Charles C. Glavin, chairman of executive committee, N. Gregory Doescher, vice president); Glorie Forgan, Wm. R. Staats, Inc. (J. Russell Forgan, chairman, John C. Harned, senior vice president); Salomon Bros. & Hutzler (John H. Gutfreund, partner in charge of syndicate department); Pierson, Hending & Pierson (Hans Muntinga, the Amsterdam firm's senior representative on this underwriting).

and that the underwriters were contributing to the facade that Penn Central was trying to maintain. The loss was greater than Bevan had indicated in the March 18 meeting with the underwriters. From Doescher's testimony:

The actual loss was somewhat in excess of what he had represented to us. I recall having been surprised at the amount of the actual loss for the first quarter, but on the other hand I don't attribute that to any particular motivation on his part. My recollection of that meeting that we had with Bevan and O'Herron on the 18th was that they dealt with us just as honestly as they possibly could in terms of what they knew on the 18th.

In fact, on March 18 Penn Central management knew almost the precise magnitude of the loss that would be recorded in the first quarter.

In the April 22 release, Penn Central management attempted to play down the losses, which were lessened on the consolidated level by the \$51 million profit on the acceleration of the Wabash exchange and on the Transportation Company level by the \$16,900,000 profit on the sale of Clearfield Bituminous Coal to Pennco. The sale of Bituminous was a means of getting cash from Pennco in connection with proposed debenture offering. The release implied that the losses were a result of temporary difficulties such as bad weather and strikes. The release also referred to "railroad" losses of \$62,709,000 in the first quarter. In fact, the railroad's operations had lost over \$100 million.<sup>186</sup> The railroad results included nonrailroad items, including the Bituminous sale.<sup>187</sup> Although "railroad" may be used merely as a term of convenience, it has particular significance in a release of this kind.

The railroad operations were the heart of the company and seriously adverse performance directly threatened the survival of the enterprise.<sup>188</sup> The significance of the railroad losses was a cause of their being set out for the first time in the offering circular. They were not set out in the release, however, even though it was reviewed by counsel for the underwriters shortly before its issuance. To Doescher the problem was solved by financial statements attached to the release:

In my very recent testimony I went through my thought processes as far as this press release was concerned and they were to the effect that, taken alone, I would have considered this second paragraph misleading [the second paragraph showed the Transportation Company loss], however, as I have indicated before, my concern was allayed because the financial statements were attached to the press release and taken in the context of those financial statements, I don't believe this second paragraph was misleading. And after all, a net loss is reported by the accountants as a net loss.

It is the textual information which is used by the news media. Further, even an informed analyst would not have been able to fix the loss from rail operations from the statistical information.

On April 24, 1970, the underwriters met with Bevan and O'Herron. The underwriters had already assumed that the Standard & Poor's rating would be downgraded from BBB to BB (BBB is the lowest

<sup>186</sup> The release had a two page statistical presentation attached to the text. A reader could not tell what the losses were even from this table unless he knew how to rearrange certain of the figures. The text, of course, was the principal source for news media. Shareholders did not receive quarterly reports from Penn Central.

<sup>187</sup> It appears that this sale, like the Wabash exchange, was entered into with a view toward lessening the losses in the first quarter.

<sup>188</sup> Howard Butcher III, a former Penn Central director whose customer accounts represented the largest block of Penn Central stock, stated that he started selling off Penn Central when he learned from the offering circular for the first time that the railroad was losing so much money.

rated security of investment grade). The underwriters were attempting to establish a price for the offering. In light of Bevan's objections to their rating assumption they decided not to set a price. According to Doescher:

So, it is perfectly natural in that kind of a situation, to avoid the price question. What you decide is whether or not you're going to go ahead. Mr. Bevan, or the Penn Central Transportation Co., at that particular point in time was not in a position to be fussy about price. The question was: Could we sell the issue. And now let me explain that, what our position was. We weren't virtually certain that we could sell the issue knowing everything that we knew as of April 24 and particularly taking into consideration the bond market. But this was an old and valued client, particularly of First Boston and Glore Forgan, and a name of great reputation. We were dealing with people of high stature in the business community and finally, it was a matter of cash, it was a *pro bono publico* matter that we do everything possible, to see that the railroad obtain its \$100 million. And, therefore, you find yourself in a position where you are not really in a position to say that—you don't want to be in a position of saying you can't sell the issue, because who knows. There is a saying in the financial community that anything could be sold at a price.

On April 27, the application to the ICC for the offering was filed. On April 28, First Boston, using a standard mailing list, sent approximately 1,300 copies of the circular to members of the selling group, selected institutions, and certain publications. On April 30 Doescher conducted a meeting with the sales department of First Boston to explain the issue. The offering was directed at institutional buyers as is customary for railroad debentures. The reactions to the offering were not good. According to Doescher: "[D]uring this period of time, there was—we were not getting any reaction from the standpoint of the market. The issue was not taking hold." The institutional market was effectively eliminated by the downgrading of Pennco's rating from BBB to BB on May 15.<sup>189</sup> Despite the rating Bevan told the press that "We have every intention of going ahead with the financing as planned. The precise date of the offering is being determined and will be announced shortly."

Following the announcement of the first quarter loss a runoff of commercial paper had begun. This was disclosed in a statement in the text of a revised circular dated May 12.<sup>190</sup> The revised circular had been made necessary by a change in the terms of the offering.<sup>191</sup> The debentures had been made redeemable at the holder's option in 5 years. The revised circular was sent to those receiving the original circular and also to all members of the National Association of Securities Dealers.<sup>192</sup> It is unlikely that this additional circulation would be effective or even cause many brokers to read the circular.<sup>193</sup> The

<sup>189</sup> Bevan had learned of Standard & Poor's decision prior to the announcement and had arranged a meeting in an attempt to have the decision reversed.

<sup>190</sup> The circulars were not distributed until May 16.

<sup>191</sup> The revised circular was not filed with the ICC. The ICC had no rules relating to offering circulars or to their amendment.

<sup>192</sup> Copies of the May 12 circular were sent to 3,375 NASD members whereas the April 27 circular had gone to 700 brokers.

<sup>193</sup> According to Doescher:

"Q. Now would you be able to make any estimate with respect to how many of these broker-dealers [who received the circulars] actually do attempt to market this type of an offering? \* \* \*

"A. This type of an offering or any offering circular to the whole NASD, it will only be a very small—I don't think it would be any different than it would be with respect to any offering, I don't think that there is any difference between this particular offering and any other offering where we circulate to the dealers who are on the NASD list, and of the 3,300 dealers, that would be a relatively small proportion of the 3,300 who actually reacted to the—

"Q. In terms of numbers, just a rough estimate, would it be 50 brokers, 500 brokers, do you have any estimate along that line that might actually make an affirmative effort to sell an underwriting such as this?

"A. Beyond the list of underwriters [the] selling group might consist of 12 or 50 other NASD members."

underwriters learned during this time that Butcher & Sherrerd was withdrawing from the underwriting.<sup>194</sup>

On May 15, the terms were set at 10½ percent interest with a selling concession of 1¼ percent and a closing date of June 2. By this time the underwriters were able to conclude that the debenture offering would not be completed. As Doescher explained:

*Question. Did you say anything to Mr. Reimer [of First Boston]?*

Answer. No. I was beginning to take a rather relaxed attitude about this issue at this point in time.

*Question. For what reason?*

Answer. Well, we had floated our price ideas on Friday, the 15th and it did not appear to have any material effect on increasing the interest in the issue.

In the late afternoon of May 21 the underwriters were invited to Penn Central's New York office. Representatives of Glore, Forgan, and Salomon Bros., attended. The underwriters were told that Pennsylvania Co. had decided not to go forward with the offering. First Boston was notified the morning of the 22d about the cancellation of the offering. The three underwriters then met at First Boston's office on the morning of the 22d: "I [Doescher] recall that at the meeting, it was a general reaction, it was relief that we were off the hook, so to speak, as far as the issue was concerned." The underwriters agreed that their selling effort was to be concluded at that point and that they were not going to announce the conclusion of the offering until the company had an alternative plan worked out, probably involving a Government loan. From Doescher's testimony:

Answer. What we discussed in the meeting of the 22d was that we were going to conclude our selling effort as at that point in time. And also that we were not going to officially withdraw the issue until we were notified by the railroad that the issue would be withdrawn.

*Question. What was the reason that you were not going to notify—that you were not going to publicize the fact that the issue was withdrawn until it was withdrawn by the company?*

Answer. The reason was that it would have caused the company problems as far as the banks and rest of the financial community was concerned. In other words, what the company wanted to do was to be able to say they had the loan from the Government at the same time that they announced the withdrawal of our issue. Had we announced the withdrawal of our issue and no other alternative had been presented, that would have, in itself, collapsed the house of cards.

The announcement of the cancellation was made on May 28 and appeared on the Dow Jones broad tape at 1:22 p.m.

The handling of the Pennco offering is another example of management's attempts to create a facade to conceal adverse information. Throughout the entire spring and early summer of 1970 it was the Pennco debenture offering which enabled Penn Central to maintain a claim of solvency. In fact it was doubtful that the offering could be completed. The very fact that the offering was proposed almost immediately after the completion of a similar offering indicated the accelerating pace of Penn Central's cash drain and the unavailability of other means of financings. At the same time, Pennco was deteriorating as a financing vehicle: Its Great Southwest stock was declining in value; its N. & W. stock was pledged or escrowed; there were restrictions on selling or encumbering its rail holdings; and all of Pennco's common stock was pledged to the revolving credit lenders.

<sup>194</sup> Butcher & Sherrerd claimed that it had begun selling out selected accounts based in part on information learned from the circular.

Bevan knew of these problems and of the declining condition of Penn Central but he was prepared to explain away the problems to maintain the facade. The underwriters came to realize some of the fundamental problems. They also knew or should have known that Bevan could not be relied upon. Their reaction was to avoid a confrontation which would publicly have raised questions about Penn Central or the statements or actions of its management. They decided to protect themselves by avoiding direct liability to potential purchasers of the Pennco bonds although it is likely that they never expected to have to underwrite the bonds.

While the underwriters and their counsel resisted the distribution of an offering circular that did not contain what they believed to be adequate disclosure, the placing of the entire focus of disclosure on the offering circular does not appear to have been the appropriate way to make disclosure of the rapidly deteriorating financial condition. A more direct method should have been employed. Moreover, inclusion of disclosures in the circulars which were distributed to broker-dealers and institutional investors resulted in their having advance information concerning the company which in certain instances was used to their advantage and to the detriment of the uninformed members of the investing public.

An offering circular, particularly one principally of interest only to institutional investors, does not appear to be the appropriate way to make disclosure when the circular contains very significant information not previously public. A public statement should be made about the significant nonpublic information at the time the circular is distributed. No reference to adverse disclosures was contained in the April 28, 1970, news release announcing the application being filed with the ICC.

The limitation of the disclosures to the offering circular assisted Penn Central management in maintaining an appearance of solvency. Management not only avoided broad disclosure of what the underwriters were learning, but it was even willing to use existence of the debenture offering as a device to screen Penn Central from inquiries. In a letter of April 22, 1970, to Saunders, William Lashley, the public relations officer, made this suggestion:

With reference to my note about the strong possibility of requests for interviews with you, Mr. Gorman and Mr. Bevan and perhaps other company officials in the wake of our news release today [on first quarter results], I recommend the following procedure. My department should tell callers that we cannot arrange interviews but if we are given direct questions, my department will attempt to get the answers. *If this procedure does not satisfy some of the more insistent requests, do you have any objection to our saying that we are considered to be "in registration" at this time and are not free to talk?*<sup>195</sup> I am reluctant to use this because it will lead to more association of the financial results with the debenture issue.

<sup>195</sup> Emphasis added.

## I-E. GREAT SOUTHWEST CORP.

### INTRODUCTION

Although Great Southwest Corp. (GSC) was only one out of a number of subsidiaries in the Penn Central complex, it played a major role in the affairs of Penn Central, including the efforts of Penn Central management to conceal the railroad debacle.<sup>196</sup>

First, Great Southwest was the keystone of the railroad's diversification effort. It was this diversification which was supposed to make Penn Central a growth conglomerate. This prospect and the expected railroad improvements were the principal factors accounting for the soaring price of Penn Central stock in the premerger and immediate postmerger period. Second, the soaring earnings of Great Southwest in 1968 and 1969 helped conceal the railroad losses. Third, the market value of Great Southwest stock was important to the Pennco portfolio which, in turn, was important to Penn Central because Pennco was used both as security for railroad loans and as a financing vehicle in its own right. At one point, the value of Pennco's holdings of Great Southwest based on the quoted market price of Great Southwest shares was approximately \$1 billion. Even late in 1969 when Pennco was used as a public financial vehicle, the Great Southwest stock constituted approximately one-half of Pennco's portfolio market value.<sup>197</sup> Fourth, the public was given the impression that Great Southwest was contributing cash to the railroad, particularly in light of its soaring earnings. In reality, no cash except nominal dividends in 1968 and 1969 was coming up and instead substantial cash was being passed down to Great Southwest. The history of Great Southwest illustrates particularly well the deceptions practiced by management and the complex relationships among the different elements in Penn Central.

### GREAT SOUTHWEST CORP.

Great Southwest Corp. was formed in late 1956 by Angus Wynne, Jr., to develop the Waggoner Ranch, lying between Dallas and Fort Worth, into an industrial park. Wynne and his uncle, Toddie Lee Wynne, contributed \$4,500,000. New York interests, composed principally of Rockefeller Center, Inc., contributed the same amount. A group of Dallas investors contributed a lesser amount. Wynne became the president and chief executive officer. A public offering of Great Southwest stock was underwritten in 1960 by Glore, Forgan & Co. Part of the proceeds were used to underwrite the development of an amusement park within the industrial park. The park, Six Flags Over Texas, was built for the purpose of generating cash needed to carry the undeveloped land and to pay development costs. The Pennsylvania Railroad made its initial modest investment in Great Southwest when its pension fund purchased an unsold portion of this public offering from Glore, Forgan upon the urging of Charles Hodge, a Glore, Forgan partner.

<sup>196</sup> For convenience, unless otherwise indicated, references to Great Southwest include Macco Corp., which was merged into Great Southwest in March 1969.

<sup>197</sup> As will be seen, the market price was greatly inflated as was known by management.

In 1964 Angus Wynne undertook to head a Texas pavilion at the New York World's Fair. Wynne's involvement in the Texas pavilion forced him into personal bankruptcy. The 90,000 shares of GSC stock he owned had been pledged against loans for the pavilion. When he was unable to pay these loans his stock was sold. Wynne's return to Great Southwest was further complicated because he was no longer on good terms with his uncle who had opposed his involvement in the Texas pavilion. To resolve disharmony within Great Southwest, Wynne prevailed on his uncle and the Rockefeller interests to sell their holdings to a third party. Wynne then asked Hodge to find a buyer.

While this was taking place Pennsylvania Co. was beginning its diversification efforts, funded to a large extent by moneys received and to be received from the disposition of Norfolk & Western stock as required by the ICC. Hodge presented the Great Southwest investment to the Pennsylvania Railroad and both Bevan and Saunders visited the Great Southwest properties. The railroad, through its subsidiary, Pennsylvania Co., then acquired over 50 percent of Great Southwest stock. Wynne agreed to remain with the company as chief executive.<sup>198</sup>

In discussions between Wynne and Bevan, a mutually agreeable policy of expansion was undertaken. The management of the railroad wanted further real estate diversification and Wynne wanted to build a chain of amusement parks and to pursue industrial development in other parts of the country. In furtherance of this policy, Wynne began searching for land for development in California through a new Great Southwest subsidiary, Great Southwest Pacific. While Wynne was looking for individual parcels of land William R. Staats & Co. (then being merged into Gloré Forgan) brought Macco Corp. to GSC's attention. Macco had substantial undeveloped real estate holdings and also had an established business of single-family dwelling construction. Wynne had a high regard for the management of Macco. On his advice and following a detailed inspection of the Macco properties by Saunders and Bevan, the Pennsylvania Co. in 1965 purchased all of the company's stock for \$39 million.<sup>199 200</sup>

The investment in Macco soon proved to be a bane rather than a boon. Macco experienced a serious cash drain, which by 1967 required advances of over \$7 million a year from Pennco.<sup>201 202</sup> Residential sales were lagging and the idle holdings of undeveloped real estate resulted in heavy carrying costs.

In mid-1967 Robert C. Baker, who was then general counsel and secretary of Great Southwest, was selected by Bevan and Wynne to analyze Macco's problems with a view to his taking charge of Macco. Although Baker lacked management or real estate development

<sup>198</sup> See section on Penphil for Wynne's involvement at the time in an investment group including Hodge and Pennsylvania Railroad officers.

<sup>199</sup> Until the merger of Macco and Great Southwest in March 1969, Macco was a 100-percent subsidiary of Pennco.

<sup>200</sup> For its active part in the evaluation, development, and negotiation of acquisition of Macco, GSC was given an option to acquire 80 percent of the common stock of Macco from Pennco in exchange for 800,000 shares of GSC. The option was exercisable within 180 days of the date on which Macco repaid the \$39,000,000 advanced by Pennco to acquire Macco or redeemed preferred stock held by Pennco in substitution of the \$39,000,000 indebtedness.

<sup>201</sup> The railroad itself had a pressing need for cash at this time and it looked to Pennco also as a source of cash. The drain to Macco and Great Southwest accelerated until the bankruptcy of the railroad although the railroad was unable to supply funds after 1969.

<sup>202</sup> The treasurer and comptroller of Macco, Roy C. Fredrickson, reminded the Macco board of the problem: "In the course of his [financial] report [to the board], Mr. Fredrickson made particular reference to the efforts that were being made by the management to minimize the extent of borrowings needed from Pennsylvania Co. in order to meet the company's cash requirements" (Macco Realty Board Meeting Feb. 22, 1967).

experience,<sup>203</sup> he gave indications of being an imaginative and expansive executive. He began sending Wynne memorandums outlining problems and suggesting ambitious solutions to Macco's problems. Baker suggested elaborate administrative procedures (which later were to balloon into extremely costly but largely unproductive overhead). He also proposed various methods of restructuring Macco's operations including "\* \* \* deals whereby Macco receives prepaid interest. This type of transaction can be worked whether it involved Macco land or not \* \* \*." <sup>204</sup> The inventive schemes of Baker were to prove highly valuable in the short run to Penn Central although the long-run consequences to Macco and Great Southwest were less attractive.

In late 1967 he became vice president of finance of Macco and on January 1, 1968, president. Baker, in turn, recruited William Ray, who had been a bank official in California involved in real estate mortgage matters, as Macco's chief financial officer. During this time Great Southwest Corp. had begun development of an industrial park in Atlanta, Ga., imitating the Texas development. These were funded internally. During this time, Wynne remained the chief executive officer of both Great Southwest and Macco.<sup>205</sup>

#### GREAT SOUTHWEST AND PENN CENTRAL

Prior to Baker's arrival at Macco, the performance of the railroad's diversification program had been modest at best and Macco, as noted above, was incurring serious cash losses. Baker's arrival led to a significant change in the "performance" of Macco and later GSC. This change resulted from the coincidence of three factors. First, Baker himself was ambitious and was well aware of Bevan's desire for greater reportable earnings performance. Indeed, it was Baker's understanding that Bevan played a role in his being sent to Macco in 1967.<sup>206, 207</sup> Secondly, at about the same time, the need for greater reportable earnings from Macco and Great Southwest was increasing as the performance of the Pennsylvania Railroad began deteriorating rapidly. This trend was to be drastically accelerated a short time later when the Pennsylvania merged with the New York Central. Thirdly, under an employment contract which he entered into in 1968, Baker stood to receive a percentage of profits from transactions he devised.

It was not surprising that the Pennsylvania Railroad was able to make its desires known to the managements of Macco and Great Southwest. Before and after Baker was sent to Macco, Bevan played an active role in the companies through which the Pennsylvania had attempted to diversify. As a father to the diversification efforts, he became deeply involved both inside and outside of the board meetings in the affairs of Macco and Great Southwest.

<sup>203</sup> Baker had been on the legal staff of Great Southwest and had advanced to general counsel and secretary prior to his Macco assignment.

<sup>204</sup> Memo from Baker to Wynne Aug. 5, 1967.

<sup>205</sup> Upon the acquisition of Macco by GSC in 1969, Baker replaced Wynne as chief executive officer of the combined companies.

<sup>206</sup> From Baker's testimony:

"Q. To your knowledge, did Mr. Bevan have any role in your being transferred from Great Southwest to Macco?"

"A. Macco was, in 1967, not meeting its projections as to either income or cash. I was sent out to Macco at Mr. Wynne's direction, I assume at Mr. Bevan's request, in order to, as it was put to me, to try to get a handle on what exactly was going on and what needed to be done."

<sup>207</sup> From Bevan's testimony:

"Q. What was the chief quality that Mr. Baker had? That you looked for to help the situation?"  
 "A. He was—he understood legal matters, he was imaginative and creative, he had a great ability to set up tax-oriented deals which operated in Southern California with the film industry, wealthy people—he was good on that type of thing."



### From Baker's testimony on Macco:

*"Question. Did Mr. Bevan take an active role in the reorganization of Macco?"*

"Answer. I don't quite know how to answer the term 'active role'. He was on the board of directors of Macco and was responsible for Macco. Kept himself very much advised as to what was going on. He didn't actually go out and hire the people or fire them, as the case may be.

*"Question. Did you or to your knowledge did someone else report to him periodically what was taking place, what changes were being made?"*

"Answer. Yes.

*"Question. Did he ever make any suggestions or changes himself in the plan submitted to him?"*

"Answer. He was, you know, active as the one the company ultimately reported to and would take part in reasonably long director meetings where the company's prospects and plans were rather fully laid out and, you know, of course he made certain contributions to those meetings.

*"Question. Were these meetings other than the board meetings, you mean?"*

"Answer. Well, in many cases they were board meetings and in other cases they were just monthly kind of meetings that would take place, wherever the place he would designate. The company was a wholly owned subsidiary of the railroad or the Pennsylvania Company. So, the company would be rather detailed, not rather detailed, but completely detailed in terms of its projections and staffing requirements and proposed acquisitions and proposed sales."

Almost every other Penn Central officer in the financial, accounting, and related departments became involved in the affairs of Macco and Great Southwest.

### From Baker's testimony:

At some point in time it seemed like all the administrative people of the railroad came down to look over and make suggestions as to what was happening in the subsidiaries. But, principally, we were involved with Mr. Bevan himself, and Mr. Dermond, William Gerstnecker, William Cook, who was comptroller, and . . . Charles Hill, who was his assistant and then later became comptroller, various people on the comptroller's staff, which was a fellow by the name of Dawson and Mr. Warner was in charge of taxes back there and he had an assistant by the name of Antoine, and there was a vice president in charge of administration, I think that was his title and his name was Fox. Then, there were other people such as Robert Loder, and there may well be others that I have omitted.

The Penn Central accounting department which was responsible for producing the consolidated figures for the consolidated financial statements, required monthly and quarterly reports from Macco and Great Southwest.<sup>208</sup> The earnings projections were also continuously reviewed and discussed with the management of Macco and Great Southwest by Penn Central employees. These reviews and discussions made clear to Great Southwest officials that the railroad needed greater reportable earnings and that the need was always increasing.

### From Baker's testimony:

<sup>208</sup> Peat, Marwick, Mitchell & Co. were the auditors for Macco and Great Southwest as well as for Penn Central. At times the Philadelphia office of Peat, Marwick became involved in disagreements about booking profits for Great Southwest, particularly in light of the policies of maximization of reported income practiced by Penn Central. On the afternoon of July 25, 1969, after a morning consultation with Saunders, Charles Hill, the Penn Central comptroller Henry Quinn, the engagement partner on the Penn Central account flew to California to consider certain transactions which might result in higher reported earnings for the first half financial statements. The following is Baker's description of this event:

"In 1969 we had a couple of instances which gave rise to my statement which is rather general, as to the possibility that the railroad might do something or attempt to do something which would seek treatment of the transaction more favorable to their specific needs at the time than to the company.

"The first such instance arose in 1969 when, after the half-year profits were over or after the half year was over, Charlie Hill and Mike Quinn made a midnight ride out to Macco to see if there was possibly another \$300,000 of earnings, as I recall the number, and attempted to review rather specifically the various accounting treatments of the transactions in order to see if a few more dollars of profit could not be received from those transactions, and I took great offense to that because we felt like in this case we attempted to arrive at the best accounting treatment or the proper accounting treatment on the transactions.

"There's always an area of judgment in connection with transactions as to allocation of bases and, you know, the many and varied other things.

"We didn't feel that kind of pressure on the auditors was proper."

The questionable items were apparently not included as income. Quinn recalled a trip, but said that he was attempting to resist Great Southwest efforts to record certain transactions as income.

Answer. We made our own projections. Mr. Bevan and the financial staff worked with us in reviewing those initial projections and they monitored our performance under the projections. We were encouraged to push the companies forward as fast as they could reasonably go.

*Question. Did this indication by Penn Central as to earnings, profits, goals, become more intense as time went on, that is, were the goals raised individually [should read significantly]?*

Answer. Your question assumes an answer to the previous question which wasn't there.

I think I said they never did set our goals for us. They became increasingly more interested in profits, it seemed to me as time went on. I am trying to answer your question, but they did not set specific goals for the company. From the outset, Penn Central indicated they wished to maximize their returns on the investment and I don't recall what percentage number they used.

But, in each case the subsidiary companies would present a pro forma or projections of the coming fiscal year end and that would be gone over by Mr. Bevan and his staff and there would be various consultations relative to those pro formas for the coming year, and the Great Southwest was encouraged, as was Macco, to attempt to increase profits and increase the cash results.

*Question. Did you ever discuss these budgets [of Great Southwest] with anyone at Penn Central before they were presented to the Great Southwest board?*

Answer. Yes.

*Question. And with whom did you discuss it?*

Answer. Primarily with Gerstnecker and Bevan. There was a man in their department named Earl [Dermond] who had occasion to review the budgets \* \* \*

*Question. Did they ever discuss the profit performance?*

Answer. Oh, yes.

*Question. Was this just in terms of how much it was?*

Answer. How much and, "how much can you increase it," yes.

*Question. Were the Penn Central officials satisfied with the profit level that was in the budget that they were given for review?*

Answer. Well, I don't know how satisfied they were. They should have been; but there was always a demand for more—at least a desire for more.

Not necessarily a demand.

Penn Central's interest in the reporting of profits by Great Southwest was more than the simple pursuit of "performance." Penn sought desperately to conceal the disastrous performance of the railroad. The profit maximization schemes in Macco and Great Southwest were counterparts to concealment efforts being made in other parts of the Penn Central system. Macco and Great Southwest management, particularly under Baker, knew what Penn Central management wanted and it acted to meet those wants. It should be noted that the booming "earnings" performance of Macco in Great Southwest not only helped conceal the railroad losses in the consolidated financial reports but it also gave the false impression that the railroad's diversification program was enormously successful in itself. Finally, the resulting explosion of the value of GSC stock made Pennco's assets balloon in value which aided the railroad in obtaining financing from banks (to whom Pennco's stock was pledged) and in making sales of Pennco securities.

The intensity of Penn Central's desires for more profits from Macco and Great Southwest increased as the fortunes of the railroad declined and its losses and financing needs increased. Indeed, after the merger of the railroads even Saunders, who had little involvement in the affairs of Macco and Great Southwest, became directly involved in seeking greater profits from the subsidiaries. He began calling Wynne and Baker at the end of each quarterly reporting period asking what the profits were going to be and demanding that they be increased.

At one point, after the end of the second quarter in 1969, Saunders sent Hill (the Penn Central comptroller) and Quinn (a Peat, Marwick partner in Philadelphia) to find additional earnings to be included in the second quarter report. From Baker's testimony:

*Question. Did either Mr. Hill or Mr. Quinn ever indicate that they were making this examination at the behest of anyone at Penn Central; that is, any member of the senior management?*

*Answer. Mr. Saunders was the one that was always calling right at the end of the quarter and screaming for a few more hundred thousand dollars profit and Mr. Hill worked for Mr. Saunders.*

\* \* \* \* \*

Mr. Saunders would call and say, "Can't you close this deal or Can't you do something here? And sometimes we could. Sometimes there was a piece of property we could sell."<sup>209</sup>

Amid this constant interaction between Great Southwest and Penn Central, one element of the Penn Central organization remained, at its own choosing, largely uninvolved in the events taking place. The directors of Penn Central received periodic reports from Bevan that the earnings were soaring and would continue to soar. Only one director, Robert Odell, showed concern. Odell was himself involved in California real estate. In July 1968 he wrote to Saunders to warn him of problems Macco could face and to counsel caution.<sup>210</sup> When Odell later demanded that the board be furnished with information on Great Southwest activities, management refused Odell's demands by informing the other directors that Odell had a conflict of interest because his own firm was involved in west coast real estate. Management also obtained an opinion from Dechert, Price and Rhoads, a Philadelphia law firm, stating that the directors would expose themselves to liability if they became too involved in Great Southwest's affairs. This opinion was circulated to the directors.<sup>211</sup>

At the December 17, 1969, board meeting of the Transportation Co. management attempted to reassure the directors about Great Southwest by having Great Southwest officers make a presentation to the board. This presentation has generally been described by witnesses as a "slide show" of California and Texas properties. No

<sup>209</sup> Wynne also received these quarterly calls:

"Q. Did Mr. Saunders participate in many of those discussions about the—[budget]?"

"A. Yes, every quarter.

"Q. Would this have been in the context of the board meetings?"

"A. No.

"Q. In what context would it be?"

"A. How much are you going to be able to increase your earnings primarily.

"Q. Was this a personal meeting?"

"A. Primarily, a telephone call.

"Q. Would he call you?"

"A. Yes."

<sup>210</sup> In a letter of July 3, 1968 to Saunders, Odell wrote:

"DEAR STUART: I am apprehensive about the Macco operations and fear there may be some unpleasant surprises later on. Unconfirmed rumors concerning Macco are quite unfavorable. Large investments in undeveloped land are very speculative in any market, and especially under present and foreseeable money conditions. Interest charges and taxes usually double the cost in about 5 years without development and planning, which is always very costly.

"I am for whatever is good for Penn Central, Pennsylvania Co. and Stuart Saunders.

"However, there is so much chance for bad judgment and manipulation in land development projects, I feel they should be most carefully watched." (Letter from Odell to Saunders July 3, 1968.)

Odell was concerned that Saunders would be caught unaware. Unknown to Odell, Saunders was directly involved himself in Macco through the extension of his insistence on maximization of reported profits to Macco management. Saunders nevertheless reassured Odell of Penn Central's review:

"Without overdoing it, I think it is safe to say that there is almost daily communication between officers of the Penn Central and these companies and finally, which I presume you realize, immediately after we acquired Macco, Peat, Marwick, Mitchell and Co. were engaged as certified public accountants for them and we have had audited statements every year thereafter. I might also say that I, of course, follow the activities of Macco closely as well as that of all of our other subsidiaries." (Letter from Saunders to Odell, Aug. 15, 1968.)

<sup>211</sup> Skadden, Arps, Meagher & Flom, a law firm working for the board's conflict of interest committee, concluded that the directors did have an obligation to become involved, but this view was not made known to most of the directors.

significant information about Great Southwest's condition or affairs was presented. This was Odell's last board meeting. After repeated attempts to get more information on Great Southwest and to get management changes, including the replacement of Bevan and Saunders, Odell resigned. Penn Central directors have stated that they were unaware of most of the significant events in Great Southwest. After Odell left the board, the directors ceased further inquiry into the matter.<sup>212</sup>

#### PROFIT MAXIMIZATION THROUGH SALES OF BRYANT RANCH, SIX FLAGS OVER GEORGIA, SIX FLAGS OVER TEXAS, AND OTHER SALES

As early as August 1967, in a memorandum to Wynne analyzing Macco's situation, Baker had raised the suggestion that Macco engage in "bulk" land sales, including prepaid interest arrangements.<sup>213</sup> He went even further and stated that the prepaid interest transactions could be effected even without using Macco land. These tax oriented transactions were to boost the earnings of Great Southwest and Macco by several hundred percent over the next 2 years. These increases, in turn, were loudly broadcast to the public as a demonstration of the miraculous performance of Great Southwest and the great benefits being received by the railroad from its diversification (while masking some of the railroad's growing losses). The miracle was made of paper and the condition of Great Southwest was in fact declining rather than soaring. The principal transactions contributing to the miracle were the sales of Bryant Ranch, Six Flags Over Georgia and Six Flags Over Texas. There were other profit maximization efforts as well.

Bryant Ranch was sold by Macco for \$31 million in December 1968. The sale produced a profit of \$9,925,780 for Macco. The syndicated group of approximately 400 investors (seeking tax shelters) paid \$6,039,000 in cash. Six hundred thousand dollars of this amount was a down payment on the principal (leaving a balance of \$30,400,000). The rest was prepaid interest (tax deductible by the individual investors). No principal payments were due until 1984. The only obligation of the investors during the years 1969 to 1983 was a yearly payment of \$1 million in interest payments (which were tax deductible to the investors). The interest at the 7-percent rate shown on the face of the note would have been \$2,128,000 but any excess over \$1 million was not payable until 1984. The investors had no personal obligation under California law to make any payments after making the initial cash investment. Macco, however, had an obligation to make recreational improvements estimated to cost \$2 million but which eventually cost \$5,500,000. Macco had a further obligation to develop lots for all 400 investors and to build an access highway at an estimated cost of \$4 million. Macco was further obligated to pay other cost of developing the entire property.

Baker has stated that it was he who first proposed the Bryant Ranch tax oriented syndication. He was vague, however, about how he first learned of this kind of real estate transaction.<sup>214</sup> Baker consulted law

<sup>212</sup> This matter is more fully treated in the section of this report covering the role of the directors.

<sup>213</sup> Memorandum from Baker to Wynne Aug. 5, 1967.

<sup>214</sup> "Q. How did you first become aware of that procedure?

"A. What do you mean?

"Q. About the prepaid interest type of transaction?

"A. I really don't know. I mean, anybody who is in the investment, you know, actively in the real estate business, you know, becomes aware of the various types of sales that are taking place and the terms. It is just a part of being involved in the active business community."

firms on the structuring of these tax transactions including a firm which had a connection with Property Research, an organization that eventually syndicated Bryant Ranch and the two amusement parks.

Macco at first attempted to syndicate the property through its own resources. By early 1968 a plan was formulated for the syndications and possible investors were being sought. A prospectus was prepared in the summer of 1968<sup>215</sup> and investors were given tours of the property. By September it was apparent that Macco would be unable to obtain a sufficient number of investors on its own and Property Research was brought into the planning. Wayne Hughes of Property Research headed the project for that firm. By the end of 1968, 15 percent of the syndicated interests remained unsold. The transaction was closed, however, before the end of the year and Macco deferred accounting for the 15-percent unsold portion until 1969.

The two amusement parks owned by Great Southwest Corp. were sold through tax-oriented syndications in 1968 and 1969 (Six Flags Over Georgia in December 1968; Six Flags Over Texas in June 1969). Limited partnerships were syndicated to investors.<sup>216</sup> The limited partnership contributed the parks to a second limited partnership. A subsidiary of Great Southwest was the general partner and had sole and exclusive control of the operation of the parks.

The Georgia park was sold for \$22,980,157 with a downpayment of \$1,500,000 and prepaid interest of \$1,450,000. Annual interest payments were \$1,249,500 through 1974 and \$759,500 thereafter until 2004. Principal payments of \$700,000 yearly were to begin in 1974 and continue until 2004. The Texas park was sold for \$40 million with a down payment of \$1,500,000 and prepaid interest of \$3,932,670. Interest payments were \$1,221,354 yearly and principal payments were \$1,094,331 starting in 1971, and continuing until 2005.

In neither transaction were the investors personally liable for the remaining obligations of the contract. Ninety percent of park earnings were obligated to meeting interest and principal payments until 50 percent of the Georgia park principal or 33% percent of the Texas park principal had been paid.<sup>217</sup> The amusement parks had been generating cash and the syndications caused only a minor decrease in cash flow (the cash was returning through interest and principal payments). The sale generated profits which were subject to tax but this did not directly affect Great Southwest because of the tax loss shelter of Penn Central. Payment obligations were incurred, however, because the tax allocation agreement with the Transportation Co. required GSC to pay Transportation for 95 percent of the tax savings realized from the shelter.

These syndications were not sales of property but, were, rather, sales of tax and other benefits in exchange for immediate reported profits and some immediate cash. Even the inflated profits could not continue, however, since GSC had used the best syndication vehicles in these initial syndications.<sup>218</sup> These profits were, in turn, repeatedly and falsely represented to GSC and Penn Central shareholders and to the investing public as reflecting enormous and sustained growth. The

<sup>215</sup> This was an intrastate offering and no SEC filing was made.

<sup>216</sup> These syndications were registered with the Commission.

<sup>217</sup> There are other details of the transactions which tend to indicate that GSC continued to be, in practical effect, owner and that GSC gave up certain benefits in order to book a profit.

<sup>218</sup> In early 1970 Baker proposed the purchase of property for the purpose of syndicating it at great profit. Great Southwest management was unable to explain how this could have been achieved and no such sales could be effected.

price of GSC shares soared<sup>219</sup> and the growth in reported earnings helped to mask the losses of the railroad.<sup>220</sup> The price rise for Great Southwest stock was itself an important benefit for Penn Central because Pennco owned approximately 25 million shares of GSC. Each additional point on the price meant an increase of \$25 million in Pennco's portfolio (at \$40 a share, GSC's peak price, the holdings equalled \$1 billion). Pennco was used to borrow \$85 million in 1969 and was the vehicle for the abandoned \$100 million debenture offering in 1970. The Pennco common stock was security for the \$300 million revolving credit of the Transportation Co. Bevan repeatedly emphasized Pennco's portfolio (of which GSC was the principal asset) to lenders and to the public.

Penn Central officers and employees were continuously aware of, and were consulted about these transactions.<sup>221</sup> As stated above, Penn Central officers continuously reviewed forecasts and discussed those forecasts with GSC officials. In addition, the cash flow impact of major transactions was discussed in detail by Penn Central employees in Philadelphia.

The managements of Great Southwest and Penn Central were not satisfied with recording profits from the sales of the amusement parks. After the sale of the \$50 million of Pennco debentures in 1969 but before the end of the calendar year, Great Southwest and its accountants decided on a change in the reporting of the income from the sale of Six Flags Over Georgia and Six Flags Over Texas. The sale of Six Flags Over Georgia in 1968 had been carried as extraordinary income.<sup>222</sup> The sale of Six Flags Over Texas in June of 1969 had also been reported as extraordinary income in interim financial statements. Before the close of the 1969 year, the reporting was changed to show the sales as ordinary income. The ostensible reason for the change to ordinary income was that Great Southwest had changed its business and had become engaged in the building and selling of amusement parks rather than in the building and ownership of amusement parks. At this time in late 1969 Great Southwest had begun construction of an amusement park in St. Louis to be called Six Flags Over Mid-America. This park was scheduled to open in the spring of 1971.

No other parks were being built or were in any planning stage. There had earlier been plans to develop a park near San Francisco but that plan was abandoned early in 1969 when local opposition developed. When asked to explain how Great Southwest could determine that it had changed its course of business the company officers made vague references to their hopes or aspirations. They also referred to "studies"

<sup>219</sup> The price of Great Southwest shares increased as follows:

<i>High bids:</i>	
1964.....	2½¢
1965.....	4½¢
1966.....	4½¢
1967.....	4½¢
1968.....	13½¢
1969.....	41½¢

<sup>220</sup> The amount of disclosure about these transactions varied from detailed recitations in the syndication prospectuses (which were not given to GSC or PC shareholders) to conscious and explicit misrepresentation by Penn Central officials.

<sup>221</sup> From Baker's testimony:

"Q. Do you recall every describing these prepaid interest transactions with Mr. Bevan or anyone else at the Penn Central?

"A. We discussed them at great length with the people at Penn Central.

"Q. Who conducted these discussions, yourself principally or were there other people?

"A. Well, there were a variety of people involved in the discussions. I had them with Mr. Bevan and Mr. Wynne. There were various people on the Penn Central staff that were involved."

<sup>222</sup> The sale of Bryant Ranch also had been carried as extraordinary income in 1968.

that had been done. These studies were done principally by Economic Research Associates. Booklets supplied by Great Southwest for staff inspection show only two studies done at the behest of Great Southwest: one for a park in Virginia and the other for one near Toronto. The Virginia feasibility study was not done until March 1970, and the study for the park in Toronto was couched in terms of financing the park for ownership by GSC, not for selling the park. Both studies were limited to preliminary feasibility studies and in no way indicate any consideration of going forward with such parks.

Considering the magnitude of the change in the reporting of income involved in switching from extraordinary to ordinary income it appears that only superficial consideration was given by the company or its accountants to the validity of such a change. In 1969 alone, the profit from Six Flags Over Texas accounted for \$27.6 million out of the \$51.5 million profit booked for that year by Great Southwest. As indicated by the construction program of Six Flags Over Mid-America no income from the sale of an amusement park could have been booked in 1970. All of the Great Southwest witnesses were unable to recall any review by the Peat, Marwick officials of the plans Great Southwest had for the future development and sale of parks.

#### SOME OTHER METHODS OF PROFIT MAXIMIZATION

The principal surge in the income of Great Southwest in 1968 and 1969 resulted from the syndication sales of assets including Bryant Ranch, Six Flags Over Texas and Six Flags Over Georgia. Profits were also being maximized by the acceleration of sales of developed real estate located in the industrial parks. This activity began in 1968 and, like the syndications, was linked to Penn Central's desire to be able to record greater profits from its subsidiaries to mask the severe losses from the operation of the merged railroads.

In its industrial parks in Texas and Georgia, Great Southwest prepared raw land for use by industrial and commercial firms. A portion of this land was immediately sold to produce cash for further development. Another portion was leased in order to provide a permanent flow of income. This was part of a longstanding program at Great Southwest.<sup>223, 224</sup> Following the merger of Macco and Great Southwest in March of 1969, which elevated Baker and Ray to control, a decisive change in industrial real estate policy took place. Emphasis was on selling land rather than on a balanced program. This resulted in a surge in reported profits, since in earlier periods only a portion of the developed land was sold. It also reduced the ratio of leased property in Great Southwest's portfolio which would have an adverse effect on long-term prospects. In fact, it was a trade off of long-term benefits for short-term profits.

<sup>223</sup> "But you have to weigh all those reasons, when you make a sale, as to whether you want the profit or you want to keep that annual income. We had been working for a long time to get our lease income up to a million dollars a year in Great Southwest Industrial District, Mark I, and we had." (From Wynne's testimony.)

<sup>224</sup> William Dillard, a Great Southwest officer who had responsibility for all industrial park development prior to March, 1969 described the policy:

"One thing here was that the goals and objectives of the company were different at the time [a couple of years prior to March 1969] In other words, they [Great Southwest] were not trying to sell as much land as they could possibly sell. The idea was to develop land, build buildings, lease the buildings; build up an investment portfolio that would produce investment income, pay off the mortgages, so down the road the mortgages were paid off. The revenue would carry the overhead of the company. So you make—when you take a leasing route, your profits—stated profits are much less than if you take an outright sales route.

"Q. What was the, say, percentage ratio between leasing and sales during that time?

"A. I'd say about fifty—I believe about fifty-fifty. In the early years, in order to get the property started, we had to sell land to users and people called investor-builders, to make it attractive and all."

The industrial park profits from land sales increased from approximately \$2 million in 1968 to \$3,700,000 in 1969 and the profit goal in 1970 was \$4,600,000.<sup>225</sup> These increases were attributed to the change from leasing to sales.<sup>226</sup>

There was also constant pressure on the sales manager of the industrial parks to produce maximum profits by accelerating the sales of specific projects into an earlier reporting period according to William Dilliard, a Great Southwest official in charge of industrial park development:

*Question. Did you ever learn, say that Penn Central had wanted Great Southwest to perform better in any particular quarter and that therefore was the cause of . . .*

*Answer. This was my understanding. I had heard that that was the case.*

*Question. Now, how did you hear that? Was it just a rumor, or did somebody tell you?*

*Answer. Well, usually my superior would ask me, could I make more profit or push it into this thing, and I would imagine that they would say, well, the owners of the Penn Central, or the boss wants us to do better.*

*Question. Is that what they would tell you?*

*Answer. Yes, I believe so. That's the way I recall it.*

*Question. Can you recall any specific individual . . .*

*Answer. . . . I would hear through William Ray or Hans Zwyter [an assistant of Ray] or one of his assistants that if we needed to get pushed up or try to come in with higher profits for that period of time, could I do it.*

An increased rate of sales, of course, is not improper conduct. Where, however, projects are taken from future dates for the purpose of boosting profits in a particular quarter, a false impression of increasing activity and profit can be given. It appears that this was the case with many of GSC's transactions. It is clear that the desires of Penn Central management for more income were well known at all levels in Great Southwest and that these syndications and accelerations were undertaken to book increased profits without full disclosure of the purpose or long range impact of this conduct.

### TAX ALLOCATION AGREEMENT

Among Penn Central's "assets" was an enormous tax loss carry-forward. Both the Pennsylvania and the New York Central had extensive periods of losses and the performance of the merged railroad added vastly to the losses. Because of this loss carry-forward Penn Central and its consolidated subsidiaries, including Great Southwest, paid no Federal taxes.

Prior to the merger of the New York Central and the Pennsylvania railroads, several of the New York Central's subsidiaries had entered into tax allocation agreements with that railroad. These tax allocation agreements sought to obtain for the parent company a portion of the

<sup>225</sup> Total profits from industrial park operations (including Texas and Georgia and including buildings):

1964.....	\$748,947
1965.....	1,304,413
1966.....	2,192,730
1967.....	2,358,792
1968.....	6,623,263
1969 (6 months).....	3,651,389

<sup>226</sup> From Dilliard's testimony:

"Q. Is that difference in the profits primarily from this change to sales?

"A. I would think so, yes.

"Q. You're doing essentially the same developing at the same rate, is that correct?

"A. Yes, that's right. And we began to sell more properties than we sold before. . . .

"Q. But it wasn't because the whole tempo of the development was increasing was it?

"A. No, I think a lot of it had to do with the change in policy."



tax savings enjoyed by the subsidiary because of the tax losses of the parent. Typically, the agreements required that the subsidiaries pay the parent a percentage of the tax saving. These agreements were entered into only with subsidiaries which had minority shareholder interests because only the minority interest portion of the tax savings was not recovered by the parent. The cases on such agreements indicate that tax allocation agreements are legal when they fairly adjust the benefits between the parent and the subsidiary. The question of fairness is not always easily resolved.

On October 28, 1968, at the insistence of the Penn Central officials Great Southwest entered into a tax allocation agreement with Penn Central (the Transportation Company after October 1, 1969).<sup>227</sup> Under the agreement Great Southwest was obligated to pay to Penn Central 95 percent of the taxes it would pay if it were filing separately. Tax allocation agreements are not uncommon between subsidiaries and their parents. The relationship between Great Southwest and Penn Central was uncommon, however. Great Southwest had undertaken rapidly to expand reportable earnings for the purpose, to a large extent, of helping to cover Penn Central's railroad losses. Under Penn Central's tax shelter, the booking of these profits had no adverse tax consequence. Under the tax allocation agreement, however, Great Southwest was in approximately the same position it would have been if it had to pay taxes. In such a situation, Great Southwest would normally have avoided transactions such as the sales of the amusement parks which created large tax liabilities, at least in accounting terms.<sup>228</sup> Great Southwest could have deferred taxes or utilized tax shelters if it were not for Penn Central's need for earnings and "performance" from Great Southwest.<sup>229</sup>

As a solution to this problem, Great Southwest almost from the beginning sought to have Penn Central eliminate the tax allocation agreement so that Great Southwest would not have to incur large tax liabilities while pursuing the maximization of reportable profit.

Bevan, however, remained adamant about the continuation of the agreement.<sup>230</sup> Bevan's interest was not related to any prospect Penn

<sup>227</sup> At the time, Great Southwest was attempting to conclude the syndicated sales of Bryant Ranch and Six Flags Over Georgia. Penn Central management had participated in evaluating, and was aware of, these pending transactions.

<sup>228</sup> Neither the agreement nor the tax rules require payment of taxes at the time the profit is booked; payment is made only as the profit is actually received. Great Southwest was required however to make an accounting provision for the total expected liability.

<sup>229</sup> From Wynne's testimony:

"Q. Did you ever discuss with Mr. Bevan whether, if it weren't for the interest of Penn Central in Great Southwest, that Great Southwest might have done things differently that wouldn't have incurred as much taxes?

A. Oh, yes.

Q. Do you have that view, yourself? Apparently, it was expressed by a view that Mr. Baker had made.

A. Oh, yes. Certainly. As a matter of fact, if we had been operating without the tax shelter, there are a number of things that we could have done to obviate taxes that we did not do. And this was pointed out to him from time to time.

I can't give you a concrete example of what I'm talking about now, but it would have been the sale and/or lease of real estate rather than sale, and realizing a profit taken over a period of time rather than all at once.

From Baker's testimony:

A. It seemed unfair to us to have to pay for a tax effect [through the allocation agreement] when we, meaning the Great Southwest Corp., had no control over its own tax return.

Q. What do you mean by that?

A. Just what I said. We were filing a consolidated return and if we were not to be provided with a parent tax shelter, then, we should have had the opportunity to create our own to such an extent that such creation made good business sense.

<sup>230</sup> The Transportation Co. (company only) received an additional, if relatively small, boost in income through the reportable profit maximization efforts of Great Southwest. The profits of Great Southwest were included in the results of Penn Central (consolidated). Because of the tax allocation agreement, however, the Transportation Co. (company only) was able to record amounts due under the tax agreement as income.

Central might have had of receiving cash from Great Southwest. It is doubtful whether Penn Central ever expected to receive payment from Great Southwest under the tax allocation agreement.<sup>231</sup> Indeed, the cash drain at Great Southwest was large and growing larger constantly and Pennco itself was supplying substantial amounts of cash to meet Great Southwest's needs.

By September 1969, Great Southwest management had decided to make another attempt to persuade Bevan to cancel the tax allocation agreement with Great Southwest. Baker worked with Byron Williams, a Great Southwest lawyer, in preparing a memorandum to be used as a basis for discussing cancellation of the agreement with Penn Central officials. The memorandum was written from Baker to Bevan and dated September 12, 1969. This memorandum was shown to and discussed with Wynne. It was then used in a meeting a short time later in Bevan's office. The bulk of the memorandum is in the general form of a brief on the cases governing tax allocation agreements between parents and subsidiaries. The principal rule governing such agreements, the memorandum asserts, is that both parties be treated fairly. A description of benefits to be received by Penn Central shareholders upon termination of the agreement is discussed in the context of the stated rule.

The memorandum concludes with an indirect threat presented in the guise of a further discussion of the fairness of the arrangement between the parent and the subsidiary. The threat also reveals Great Southwest's true motivation for accelerating the pace of recorded profits: to make Penn Central look better even at the possible expense of the interests of minority shareholders of Great Southwest.

Set forth below are the relevant portions of the memorandum. The memorandum is quoted extensively because it sets forth the entire matter of the relation of GSC's earnings to Penn Central desires.

The next factor bearing upon whether our execution of this agreement is a reasonable exercise of business judgment, and whether same is fair and just to the minority shareholders, is again illustrated by a passage from the Sullivan & Cromwell Opinion which directly quotes an observation by the court in the *Case* suit, noting that a majority shareholder is required not to "use its power to gain undue advantage at the expense of the minority \* \* \* and to follow a course of fair dealings toward minority shareholders in the way it [manages] the corporation's business." I am confident that you realize I personally am not about to criticize Penn Central's management of GSC, vis-a-vis the minority shareholder or otherwise, to accuse it of being unfair to us or them, or to accuse it of trying to take any undue advantage. However, issues such as these do get examined in the context of assertions that can be made by a disgruntled minority shareholder, possibly in a shareholder's derivative action, and, as always in such situations, with the benefit of 20/20 hindsight.

<sup>231</sup> From Baker's testimony:

Q. What cash impact did the allocation agreement have on Great Southwest?

A. It would have a substantial cash impact, if we had ever made any cash payments under it.

Q. Was this a concern to Great Southwest management?

A. It certainly was.

Q. Was this mentioned or brought up in discussions with the Penn Central officials?

A. Very much so.

Q. What was their response to you concerning this?

A. Well, they said that we will work out something when the time comes.

Q. Do you know what the officers meant when they said, the Penn Central officers, when they said, we will work something out when the time comes?

A. No. Please let me—I don't mean to make that statement as, you know, this is exactly what they said in response to our question about what happens when we have to make payments. It was just something that was pushed off into the future by the Penn Central Company.

The amounts first payable under the agreement were "forgiven" on the last day of 1969 in an exchange of newly issued Great Southwest stock for debt owed by Great Southwest to Pennco. See page 143 for further description of the exchange.

Any such litigation would presumably be predicated upon an assertion by such a shareholder that the alleged 5 percent tax saving afforded GSC by filing consolidated Federal income tax returns with the Penn Central group, and utilizing the group's tax loss carryovers, is more than offset by the tax liability incurred by GSC in failing to avail itself of all possible tax savings in an effort to produce needed profits for its controlling shareholder. In any such suit, I would certainly testify that I have always been advised by officers of the Penn Central that I had a duty to avail myself of all tax minimizing devices possible, and that I have certainly never been coerced to produce profits at the expense of tax savings. However, and by the same token, I would have to admit under oath that GSC has always had, and we certainly value, an excellent day-to-day working relationship with our Penn Central parent, take great pride in our contributions to its earnings, and consistently make every effort possible to increase that contribution. While such evidence should conclusively show that the Penn Central has never forced GSC, through its majority control, to produce profits against the best interests of the subsidiary's minority shareholders, I can nevertheless foresee a judge and/or jury concluding (with that famous 20/20 hindsight) that we, as officers and directors of GSC, had been guilty of a conflict of interest between our majority and minority shareholders, to the detriment of the minority. A perfect example of a transaction which might give rise to such a conclusion is the sale of the Georgia and Texas amusement parks. Although both sales made excellent sense, for all the reasons previously advanced to you, and while I have no reservations about their economic validity, *a disgruntled minority shareholder could nevertheless easily argue that GSC, at the direct instance of the Penn Central, sold two of its substantial and profitable assets solely to produce substantial profits for its majority shareholders within given financial periods.*<sup>232</sup> In making the sales, and as a necessary consideration to the investing syndicates for achievement of such substantial profits, GSC gave up all depreciation which had theretofore been available to offset the income from such profitable and productive assets. Therefore, and again with the benefit of 20/20 hindsight a group of minority shareholders could well argue that, not only was GSC's income from such assets reduced, but there was no longer available any depreciation whatsoever to offset such income; the result being that every dollar of the substantial tax savings that would otherwise be lost to the Internal Revenue Service by GSC (on a separate return basis), now amounts to a loss of 95 cents to Penn Central, at least in the form of an account payable (on a consolidated return basis), as a result of the tax allocation agreement. (Without even considering the large tax liability generated by the sales themselves.)

The threat is only thinly veiled and its presentation brought a hostile response from Bevan. Was Baker prepared to say that these transactions were done by Baker to please Penn Central at the expense of Great Southwest minority shareholders, Beven inquired. Baker was, of course, not willing to make such a statement. Bevan's point was clear: if Penn Central had harmed minority shareholders of GSC, so had the management of GSC.

Baker also noted in his memorandum that Pennco was only hurting Great Southwest by burdening it with a debt to Pennco and that, in any event, Pennco could not reasonably expect to have Great Southwest pay the debt:

As I noted earlier, if called upon immediately to pay its full account payable to Penn Central, arising from the tax allocation agreement, GSC would be unable to do so, because it just does not have the cash. By the same token, we are expected to independently finance our own operations insofar as possible, but, at the same time, our ability to do so is lessened by the fact that our balance sheet must show this resulting substantial account payable to our Penn Central parent. Again theretofore, I personally question whether, in the exercise of reasonable business judgment this is proper utilization of group financial resources.

Baker concluded the memorandum with the observation that proposed tax law changes would make Great Southwest's position even more difficult under the tax agreement. One change, a then recent

<sup>232</sup> Emphasis added.

change in deduction of prepaid interest, was seen as bearing on Great Southwest's way of doing business:

While it cannot be termed new tax legislation, the recent change in the IRS ruling on deduction of prepaid interest has already adversely affected GSC's ability to make and consummate certain profitable real estate transactions, both as vendor and vendee.

The "certain profitable real estate transactions" included the large syndication sales that accounted for most of the spectacular rise in Great Southwest's earnings. The difficulty in completing further deals of that sort would not have any relation to the tax agreement but it would affect Great Southwest's ability to continue its growth rate in earnings.<sup>233</sup> It appears that the reference to this difficulty appears principally to inform Bevan that Great Southwest management could not hope to repeat past performances regardless of the pressure from Penn Central. Indeed, despite continuing pressure and frantic efforts by Baker, Great Southwest was not able to find other deals.<sup>234</sup>

The tax agreement was not cancelled but Great Southwest was never required to pay any cash. On the last day of 1969, Pennco accepted GSC stock in exchange for debt arising out of the agreement and for debt existing from previous cash advances from Pennco to GSC. The tax agreement did not affect activities because Great Southwest had already sold its principal assets and the changes in the tax ruling made these and other schemes more difficult to complete. At this point Great Southwest was well on its way to generating its own tax losses.

#### OFFICER EMPLOYMENT CONTRACTS

When Macco was acquired by Pennco, the principal officers were required to enter into employment contracts providing for their exclusive employment and for additional compensation when Macco's earnings exceeded certain amounts.<sup>235</sup> The terms for compensation were based on the performance levels of Macco which were projected at the time of Pennco's acquisition of the company. No employment contracts existed for Great Southwest officers.

By the late spring of 1968, many of the original officers of Macco had left. They had been replaced by Baker and his appointees. At the request of Penn Central, Baker, Ray, Wynne, and Caldwell<sup>236</sup> executed employment contracts on June 3, 1968. The contracts provided that Wynne would receive as additional compensation over and above his regular salary, 3 percent of the net income before taxes in excess of \$10 million; Baker would receive 2 percent of such an amount and Ray and Caldwell would receive 1 percent.<sup>237</sup> Based on 1968 results Wynne earned \$299,027, in additional compensation; Baker earned \$199,158 and Ray and Caldwell each earned \$99,675.<sup>238</sup>

In the years preceding 1968, there appeared to be little likelihood that the employment contracts would require any payments. The results for Macco and Great Southwest even when combined were well below the \$10 million threshold.

<sup>233</sup> In October 1969, GSC had to abandon a proposed public offering because, among other things, it would have had to disclose that tax changes made it unlikely that its profits could continue.

<sup>234</sup> The last such deal was Six Flags Over Texas which was sold at the end of the second quarter in 1969. This sale coincided with the highest price for Great Southwest stock (40). From that point the value steadily declined to 16 at year end and to 5 at the bankruptcy of the railroad.

<sup>235</sup> Wynne was to receive 3 percent of earnings in excess of \$10 million and four other officers would each receive 1 percent of such earnings. Wynne was an officer of both Macco and Great Southwest.

<sup>236</sup> Wynne and Caldwell had previously been Macco employees under contract.

<sup>237</sup> The contract period was from Jan. 1, 1968, to Dec. 31, 1972.

<sup>238</sup> These sums were in addition to basic compensation of \$25,000, \$60,000, and \$55,000, respectively.

1964.....	\$928, 857
1965.....	1, 918, 974
1966.....	4, 731, 631
1967.....	6, 711, 616
1968.....	25, 426, 215

Baker and Ray have stated that they were reluctant about entering into these contracts because they disliked the requirement of exclusive employment for the duration of the contract. However, at the time they entered into the contract, the idea of syndication was well developed and much planning had been completed. They would have known of the benefits they could reap through syndications. It appears that Bevan had determined that the bonuses would be worth the price in the encouragement they would give Baker and Ray to push for profit maximization.

The size of the remuneration being received by the officers for 1968 alarmed Saunders when he learned of it. He was particularly concerned by the possible reactions of Penn Central directors if they were to learn of this generous remuneration.<sup>239</sup> Gerstnecker was assigned the task of negotiating a new employment contract. New contracts were entered into on June 4, 1969. In settlement of the previous contracts Wynne was paid \$3 million in cash. Baker was to be paid \$2 million over 10 years and Ray and Caldwell were to receive \$1 million each over 10 years. The new contracts provided additional compensation for Wynne, Baker and Ray of 3, 2, and 1 percent of earnings of the combined Macco and Great Southwest entity in excess of \$35 million in 1969; \$40 million in 1970; \$45 million in 1971 and \$50 million in 1972.<sup>240</sup> The contracts were to expire on December 31, 1972. The additional yearly compensation was limited to \$125,000 for Wynne; \$100,000 for Baker and \$75,000 for Ray.<sup>241</sup>

Disclosure about the agreements was a concern shared by Saunders and others at Penn Central. Great Southwest itself could look forward to disclosure in a prospectus for a public offering then being planned. Gerstnecker informed Bevan that the settlement as worked out would avoid the more damaging aspects of disclosure:

If approved by the Board of Great Southwest, it [the termination and new agreement] will, of course, become an accomplished fact and can and will be discussed in only general terms in any future prospectus with the settlement agreements being only a historical fact which will have resulted from the merger of two companies and the new contracts having a ceiling on compensation to the extent of no more than twice of their base salary.<sup>242</sup>

Saunders was also concerned with whether the new agreements would insure the continued performance of the GSC management:

I understand Mr. Gerstnecker believes, and I gather you also agree, that the new settlement and agreement will provide sufficient incentive for these officers to maximize earnings.<sup>243</sup>

As with many of Penn Central affairs in these years, attempts to conceal one aspect of the activities created a chain reaction which itself had to be covered over as best as possible. With the employment contracts, the initial incentive payments exceeded propriety when

<sup>239</sup> The Penn Central directors were unaware of the compensation being paid or the amount paid for renegotiation. Most of the directors admitted to surprise or shock when informed of the magnitude of the compensation and settlement.

<sup>240</sup> Base salaries were \$125,000, \$100,000, and \$75,000 for Wynne, Baker, and Ray respectively.

<sup>241</sup> Caldwell was to receive a base salary of \$55,000 plus compensation of 1 percent of the excess of Macco earnings only.

<sup>242</sup> Memorandum from Gerstnecker to Bevan, May 29, 1969.

<sup>243</sup> Memorandum from Saunders to Bevan, June 2, 1969.

Great Southwest and Macco engaged in schemes to maximize reported earnings. Costly settlements then were entered into to limit the exorbitant compensation. The terms were described in the April 22, 1970, Great Southwest proxy, but as Gerstnecker observed, Great Southwest was able to describe it in terms that were historical and whose impact was unclear to one who did not know of the full circumstances or the true nature of the earnings on which the compensation was based. In fact, the settlement was made necessary because of the Macco "earnings" surge which was caused principally by the Bryant Ranch transaction.<sup>244</sup> Macco never repeated such a sale so it can be said that Macco paid the principal officers \$7 million for producing a booked profit of \$10 million.<sup>245</sup> Penn Central shareholders were not informed of this cost of producing the Macco "profit" and the Penn Central directors remained ignorant of the matter.

#### ABANDONMENT OF PROPOSED OFFERING OF GREAT SOUTHWEST STOCK

By the late spring of 1969 plans were being made for a public offering of Great Southwest stock. At the annual shareholders meeting in Philadelphia on May 13, 1969, Bevan told the Penn Central shareholders:

In this connection, and I think this is important, we anticipate in all probability selling a relatively small portion of our Great Southwest stock this year. This will allow us to recoup a part of our investment, but what is probably more important, it will also create a floating supply of Great Southwest common stock and a good market for that company's stock. At the same time it will enable Great Southwest to finance its future needs through the use of convertible issues or through the sale of stock in the market, thereby again enhancing its potential and ability to grow in the future.

At a board of directors meeting of Great Southwest Corp. on June 4, 1969, the directors approved the preparation of a draft of a registration statement under the Securities Act of 1933, in connection with a proposed issuance of 1 million shares of preferred stock and an additional offering by "certain shareholders [in reality Pennco] of shares of common stock of the corporation held by them."

By October 1969 the offering had taken the form of a sale of 700,000 shares of GSC cumulative preferred stock for \$35 million together with a secondary offering by Pennco of 500,000 shares of Great Southwest stock from its holdings.<sup>246</sup> The origin of this proposed offering is not clear, but it appears to lie with Penn Central management.<sup>247 248</sup> As Bevan told the stockholders, Pennco could recoup part of their investment and also create a larger market for the stock.<sup>249</sup> The offer-

<sup>244</sup> See page 127.

<sup>245</sup> The formula used by Penn Central management was purportedly based on projected increasing profits through the years of the contract. Penn Central management, however, was aware of the kind of transportation that had produced the "earnings" surge and must have known that there was no hope of continuing the charade, particularly in light of Great Southwest's critical cash problems.

<sup>246</sup> It appears that the offering was delayed in part by possible problems under Sec. 16 of the Exchange Act because of other recent transactions in GSC stock by Pennco.

<sup>247</sup> Most of the parties to the offering gave vague answers about the origin and demise of the offering despite the extensive work done and the sudden termination.

<sup>248</sup> From Baker's testimony:

A. This was something that the railroad specifically wanted done in terms of this offering. I don't think anybody at Great Southwest was very much in favor of this kind of offering, because of the difficulties it presented to us management-wise.

Q. Who at Penn Central was the individual or who were the individuals?

A. Mr. Bevan was the only one we reported to.

<sup>249</sup> As Bevan spoke to the shareholders, GSC stock prices (high bids) were touching record levels:

1964—2½; 1965—4½; 1966—4½; 1967—4½; 1968—13½; Jan. 2, 1969—13.7; May 13, 1969—40.25 (record high bid); May 19, 1969—33.25; Dec. 31, 1969—16.

Adjusted to take into account a 10 for 1 split on Apr. 11, 1969.

ing of cumulative preferred would, of course, produce badly needed cash for Great Southwest. This motivation would grow greater later in 1969 when the railroad itself increasingly began to rely on Pennco to meet the railroad's desperate cash needs. There was one major obstacle to satisfying the desires of Pennco and Great Southwest: the offering would have to be made by means of a prospectus which met the disclosure requirement of the Securities Act.

In light of the way the affairs of the company were being conducted by the managements of Penn Central and Great Southwest, it was inevitable that the price of full disclosure would be very great. Indeed, it would appear that from the beginning the price would have been more than Penn Central or Great Southwest could pay. Full disclosure about the affairs of Great Southwest would certainly cause a drop in the market price of Great Southwest stock. Pennco's most valuable asset in mid-1969 was its approximately 25 million shares of Great Southwest stock (when valued at market price). Pennco, in turn, was about to be used as a financing vehicle for the railroad. Every drop of one point in the price of Great Southwest decreased the value of Pennco's portfolio by \$25 million and such a market decline would clearly threaten the ability of the railroad to use Pennco as its last source of cash.<sup>250 251</sup>

By the end of September, a draft prospectus was in existence and was being reviewed by Penn Central counsel. The offering was almost ready for filing of a registration statement with the Commission. Wynne told the Great Southwest directors on September 23, 1969, that the company planned to file the registration statement within the next 10 days. A draft prospectus bears a proof date of October 13, 1969. This was the last draft that was printed. At this time John Harned of Gloré Forgan, the underwriters for the proposed issuance, was in Dallas for the final arrangements. Harned, who had been involved in the initial planning in the summer, was becoming increasingly concerned about the kind of disclosure that would have to be made. Most of Great Southwest's earnings had come from the selling off of their principal saleable assets and there was considerable doubt as to whether this activity could be continued.<sup>252 253</sup> Harned was particularly concerned about the impact that disclosure would have on the market price of Great Southwest stock:

I had analyzed the company in great detail of the Great Southwest, in great detail, and I had come to the conclusion if the company were to make full disclosures of the business as it was then operated, then, in my judgment the more sophisticated community would tend to discount the earning power they had and there would be a serious selloff of the stock in the company.

<sup>250</sup> The market value of Pennco's portfolio was also important in connection with existing financings. In connection with certain borrowings the lenders had been assured through debt coverage provisions that Pennco's assets would not drop below a certain percentage of the outstanding debt. A serious decline in the market price of Great Southwest stock could create difficulties under these coverage provisions.

<sup>251</sup> In the last week of 1969, after GSC stock had been in constant decline, several members of Penphil (including the two officers in Penn Central's Securities Department) began buying GSC stock. Their purchases constituted most of the buy side that week and it is possible that this was an effort to hold up the price of GSC as of the last day of the year against a time when Penn Central might need to cite Pennco's portfolio market value as of year end. The buyers denied any such effort.

<sup>252</sup> The sale of Six Flags Over Texas in June 1969, was the last major sale that GSC was able to make despite what GSC management admits were feverish efforts to devise further sales of property.

<sup>253</sup> There were other activities which presented disclosure problems, but the dubious nature of most of GSC's earnings was a decisive problem of disclosure for GSC.

Harned calculated the consequences to Pennco of a selloff as follows:

	Value of Pennco holding	Loss to Pennco
Price:		
20.....	\$488,980,000	
15.....	366,735,000	\$122,245,000
10.....	244,490,000	244,490,000

Harned estimated that there would be a sell-off to between 10 and 15. Thus Pennco faced an asset loss at market value of up to a quarter of a billion dollars. This would occur at a time when Pennco was planning a public financing and while all the common stock of Pennco was pledged on a \$300 million revolving credit line.

Harned and other members of the group working on the prospectus were at the Dallas home of George Davis, GSC's outside counsel, for an evening work session, when Harned expressed his feeling that the offering should not be made. After some discussion, Harned then flew to California to tell Baker of his conclusions. Baker acquiesced.<sup>254</sup> Harned then returned to New York where he told O'Herron about the disclosure problems and the effect this disclosure would have on the price of the stock. By this time, Harned had obtained the concurrence of other senior Glore Forgan officials in his recommendation.<sup>255</sup> The offering was dropped and no further information was put forth by Great Southwest or Penn Central on this sudden demise or the reasons behind it. Harned's forecast of a sell-off was accurate, although the period of the sell-off was extended because accurate information merely seeped into the marketplace. By year end the price was 16; by the end of March it was 14 and at the end of May it was six. It is clear that the managements of Great Southwest and Penn Central realized that the true nature of Great Southwest's earnings, activities, and prospects were shockingly less than what was being actively represented to the investing public. For management the registration statement was the moment of truth. The managements avoided that moment, and continued a calculated course of deception.

In addition to information concerning the inflated and short-lived earnings, the prospectus would have contained a considerable amount of additional adverse information. The draft prospectus disclosed the extent of the railroad's cash contribution, through Pennco. This cash was needed to meet the severe cash drain at Great Southwest. Loans from Pennco to GSC and Macco were:

	Percent
1966—\$2,990,000.....	6
1967—10,400,000.....	6½
1968—7,400,000.....	6½
1969—5,200,000.....	8½
(9 months)	

<sup>254</sup> Davis and members of GSC management tended to be vague on the reasons for the abandonment of the offering. They indicated that the principal reason was that the offering was "premature."

<sup>255</sup> Charles Hodge, a partner of Glore Forgan and a director of GSC, was not available for consultation during this period.



The company received additional cash through purchase of securities by the parent:

Date	Purchaser	Security	Amount
Since 1966.....	PCTC Pension Fund.....	Unsecured note.....	\$2,500,000
July 15, 1966.....	Pennco.....	3,500,000 shares series A 6 percent cumulative preferred.	3,500,000
Oct. 9, 1967.....	PCTC.....	500,000 shares series A senior 6½ percent cumulative preferred.	500,000
Do.....	PCTC Pension Fund.....	2,000,000 shares of series A senior 6½ percent cumulative preferred.	2,000,000
Do.....	Buckeye Pipeline Annuity Plan.	250,000 shares series A senior 6½ percent cumulative preferred.	250,000
Do.....	Penn Central Employees Mutual Savings Association.	do.....	250,000

The prospectus hinted that the flow of cash from the railroad might not continue indefinitely:

To the extent that it has been unable to obtain outside financing, the company in the past has obtained funds from Pennsylvania Co. and its affiliates. The company may not be able to obtain similar loans in the future and accordingly, will be required to obtain all its financing from lenders not affiliated with the company.

The prospectus also indicated that GSC faced \$80 million of scheduled debt payment in 1970 and that 52 percent of GSC's stated assets were receivables, almost all of which were from bulk land sales.

The prospectus also outlined the option which GSC had to acquire Macco and the benefits which accrued to Pennco when GSC acquired Macco in 1969 through negotiation with Pennco and not through the option.<sup>256</sup> Pennco received \$274 million worth of GSC securities in exchange for Macco. If GSC could have exercised its option, it could have obtained 99 percent of voting control of Macco for \$61 million according to calculations in the draft prospectus. The terms of the option provided that it could be exercised after Macco repaid to Pennco the original purchase price (\$39 million). The prospectus stated that the option had not been exercised because (1) GSC or Macco might not have been able to obtain the financing; (2) that GSC could not have compelled Macco to repay the Pennco debt; and (3) that Macco could not have required Pennco to accept repayment (the debt had been converted to preferred stock.)

In connection with the acquisition of Macco by GSC in 1969, as just described, Glore Forgan received 641,450 shares of GSC (valued at \$11,500,000 on March 21, 1969 market price). This, too, appears to have been a favorable adjustment of earlier agreements, according to the draft prospectus. When Macco was acquired by Pennco, in 1965, Glore Forgan received 10,000 shares of Macco (10 percent of the outstanding common stock) for \$10,000. At the same time, Glore Forgan gave GSC an option to purchase the 10,000 Macco shares for 100,000 GSC shares after Macco had repaid Pennco the \$39 million which had been advanced to permit the original acquisition. In the 1969 agreement which joined GSC and Macco it was stated that GSC released its option to purchase Macco shares from Glore Forgan in exchange for Glore Forgan voting its Macco stock in favor of the merger. In negotiation, Glore Forgan received 641,450 shares of GSC in exchange for

<sup>256</sup> The option was granted because GSC had found and evaluated Macco before its acquisition by Pennco.

its Macco warrants.<sup>257</sup> According to the description in the draft prospectus, if GSC had been able to exercise the original option it would have paid Glore Forgan only 100,000 shares (valued at \$1,500,000) rather than 641,450 shares (valued at \$11,500,000). Approximately 600,000 of the shares received by Glore Forgan, were distributed to Glore Forgan officers.

The prospectus also reveals that after GSC's annual report for 1968 was issued, but prior to filing tax returns, GSC changed its income reporting so that earnings previously reported on the installment basis were reported as 1968 taxable income.<sup>258</sup> Net earnings for 1968 were increased \$7,036,508 above the previously reported amounts. This information appears as a footnote to the financial statements. It appears that this change in reporting was expressly undertaken to permit higher earnings reports to prospective investors.<sup>259</sup>

The draft prospectus also provides some information on individual development projects. A careful reading informs the reader that GSC had obligated itself for substantial development costs and that some land had serious hindrances to development.

The prospectus itself, as it appears in draft form, would not have disclosed the true condition of GSC, including Penn Central's dominant role and the plan of maximizing reportable earnings, but it gives hints of problems at Great Southwest.<sup>260</sup> GSC and Pennco could not have afforded to tell even what was in the draft prospectus. GSC and Pennco failed to disclose the abundance of adverse information known at that time. The cancellation of the offering is a clear demonstration of the knowing and willing concealment of adverse information by Penn Central and Great Southwest.

#### FAILURE OF ALTERNATIVE EFFORTS TO SELL GREAT SOUTHWEST STOCK

The forced cancellation of the proposed public offering put pressure on Great Southwest and Pennco. Great Southwest had an urgent need for cash and Pennco needed reportable profits. The first alternative effort was a private placement by Great Southwest. GSC officials talked with several prospective buyers, including Bethlehem Steel Corp., but it was unable to find any buyers. Great Southwest's financial plight worsened.

Pennco still sought desperately to record gains for the sale of some of its Great Southwest stock. Such a sale was needed to boost the reported profits of Pennco, which had become the prime financing vehicle,<sup>261</sup> and to boost the profits in the consolidated reports. It would also create the illusion for potential GSC investors that Great Southwest stock was desirable. The only avenue that could be found was a sale to the principal officers of GSC, Wynne, Baker and Ray. These officers were to purchase 1 million shares from Great Southwest for

<sup>257</sup> Glore Forgan's interest in Macco had been converted from shares to warrants in 1967.

<sup>258</sup> Macco was not covered by the tax allocation agreement in 1968 and did not deduct taxes from earnings because of the parent's loss carry-forward.

<sup>259</sup> Memorandum from Bevan to Saunders, Sept. 11, 1969:

With respect to your memorandum of September 10 about the tax elections of Macco:

Messrs. Warner, Hill, Wilson, and myself met this afternoon and are unanimously of the opinion that we should go along with the Macco management's recommendation. This will add almost \$0.50 a share to the reported earnings for last year, and merely on a basis of 10 times earnings will add \$5 a share to the value of any stock sold, and if it goes to 20 times earnings it would add \$10 a share. Our capital gains [from Pennco's participation in the sale of GSC stock] would be enhanced by this amount.

<sup>260</sup> The prospectus was not filed with or reviewed by the SEC.

<sup>261</sup> A proposed sale of GSC stock to GSC officers was mentioned in the Dec. 16, 1969, circular for the \$50,000,000 Pennco debenture offering.

approximately \$20 million. A refinement of the proposal called for the purchase of an additional million shares. Despite much activity, the scheme was not promising. Neither Baker, Ray nor Wynne had the resources to make this purchase.<sup>262</sup> Even if resources could have been made available, it is doubtful that Baker and Ray ever would have committed themselves to such a dubious investment under terms making them personally liable for the purchase price.<sup>263</sup>

The scheme appears to have been developed by Bevan and Wynne.<sup>264</sup> Wynne had helped found GSC and had lost his stock in his personal bankruptcy in 1964. Since that time he had been making purchases of the stock. Wynne apparently sought financing from several companies and individuals of his acquaintance but was unsuccessful.

At Penn Central, approval for the sale had been obtained from the Pennsylvania Co. board and the Transportation Co. board had been informed of the proposed sale. A considerable amount of planning for the transaction had been done by the Penn Central staff and an opinion letter as to a fair price for this non-arms-length transaction had been obtained from Salomon Bros. The existence of the proposed sale was reported in the \$50 million Pennco debenture offering circular. The timing was important because Penn Central wanted the transaction completed for reporting in 1969's results. O'Herron described the program on the sale in a memorandum to Bevan on December 24, 1969:

3. The irrevocable note must be signed and dated prior to December 31 and the stock certificates delivered to Messrs. Wynne, Baker, and Ray in exchange for the note prior to the year end.

4. The note should be paid a few days before the date in January at which time Penn Central's earnings for the year are released. Therefore, for purposes of discussion we have set January 20 as the maturity date for the note. Assuming the note is paid on January 20, the profit and the transaction can be reflected in 1969 earnings.

5. PMM takes the position that in order to reflect the profit in 1969, the stock certificates must be delivered to Messrs. Wynne, Baker, and Ray without any strings attached. For example, a profit could not be booked if the profit was placed in escrow together with the irrevocable note.

The push for the completion of this scheme, which was never more than fantasy, reflects the desperation of Penn Central to generate reportable profits and to salvage some demonstration that Great Southwest stock had some value. From a touted "billion dollar" asset Great Southwest stock had become something that first could not be sold publicly without making matters worse through disclosure; that later could not be sold privately; and that, finally, could not be sold to its own management.

Bevan made one other attempt to utilize Pennco's Great Southwest stock in financing. The \$100 million Pennco debenture offer in 1970 was originally to have warrants attached for the stock of GSC and the stock of the holding company, Penn Central Co. Bevan attempted to

<sup>262</sup> From testimony of Wynne:

A. I can't envision myself raising any \$20,000,000, and I know that the other two people didn't have any money so that seems like a rather far-fetched idea to me.

<sup>263</sup> From testimony of Ray:

Q. Would you have been willing to buy this stock, aside from any direct or indirect pressures that might have been put on you, if financing could have been obtained?

A. No, I thought it was goofy.

Q. Do you know whether Mr. Baker or Mr. Wynne shared your views on this?

A. I think Mr. Baker did.

<sup>264</sup> Wynne testified that he had difficulty even recalling whether such a proposal had been made even after being shown a memorandum of a telephone conversation on the subject naming him as one of the participants in the conversation. Bevan testified that it was Wynne's idea.

use the GSC stock in this way based on the assumption that no registration with the Securities Exchange Commission would be required at the time of issuance, since the warrants would not be exercisable for 2 years. This plan shortly ran into difficulties. The initial difficulties were presented by counsel for the underwriters and by George Davis, the outside counsel for Great Southwest Corp. Davis was of the opinion that the issuance of these warrants would require immediate registration.<sup>265</sup> Davis spoke with David Wilson, Penn Central's in-house securities counsel on February 20, 1970, and asked Wilson to intercede with Bevan to explain the problems of the issuance of these warrants to Bevan. At that time Davis raised the same problems that he had when the October 1969 issue was abandoned; namely, the disclosures about the condition and activities of Great Southwest Corp. In a memorandum of the February 20, 1970, telephone conversation, Wilson stated:<sup>266</sup>

According to Davis, General Hodge and Jack Harned of Glore, Forgan, either severally or jointly, suggested to Davis that he call me with the proposal that Davis and I try to sit down with Mr. Bevan at a very early date and persuade him not to market any part of a GSC common stock offering at this time. I then proceeded to carry out the request of O'Herron and asked Davis what he planned to advise the board and management of GSC about the advisability of full disclosure of that company's affairs at this time. He replied very briefly that he would advise them to the same effect as he did last year when he persuaded them to abandon then current plans to register a GSC common stock offering. Among the reasons for his negative advice were (1) the current absence of any real cash earnings by GSC, (2) the tentative, conditional and rather silly nature of a lot of pending GSC transactions which would not have to be so described after 1 or 2 years from now, (3) some fairly questionable features about inside interests in GSC, its mergers, and so forth, which might not have to be explained in the future, (4) the inevitably depressing effect of these disclosures on GSC stock prices, and (5) considerations of a similar nature.

In subsequent meetings with the underwriters, principally First Boston Corp., the need for immediate registration was not agreed with by all parties. Davis testified that at one point he stated he would seek an injunction to prevent Pennsylvania Co. from issuing the warrants without registration. The underwriters were becoming gradually concerned about this and other disclosure problems and were considering the possibility of seeking a "no action" letter from Securities and Exchange Commission about the need to register these warrants. Finally it became understood among the parties that registration would be required. The plan for having warrants was then abandoned.<sup>267</sup>

#### EXCHANGE OF GREAT SOUTHWEST STOCK FOR DEBT OWED TO PENNSYLVANIA CO.

By December 1969, Great Southwest's debt to Pennco arising out of cash advances and obligations under the tax allocation was \$25,210,977. This presented several problems to Penn Central and Great Southwest. GSC did not have the cash needed to pay the debt and, indeed, had a desperate need for additional cash. Not only was GSC unable to pay the debt, but its own financing efforts might be hurt by having this debt obligation on its balance sheet. For Pennco, the matter could be

<sup>265</sup> Aside from the interpretation of the legal provision, Davis was aware of the serious disclosure problems and was concerned about having a fixed commitment to register even at a future date.

<sup>266</sup> Davis testified that he was unable to recall discussions with Wilson on this matter. Wilson's memorandum appears to be an accurate presentation, however based on the circumstances and other testimony.

<sup>267</sup> For further information on the warrants and other disclosure problems with the Pennco offering see the section of this report on public offerings.

embarrassing because it reflected the cash drain to GSC and GSC's inability to pay. An exchange of the debt for newly issued GSC stock was effected on December 31, 1969, after hectic preparations. The exchange price was \$18 per share for 1,400,609 shares. The sales price exceeded the market price on December 31, 1969.

At the time the exchange occurred, Pennco had warrants to purchase 2,102,110 shares of stock for \$2.17 per share. Management was unable to explain why these warrants were not exercised before the purchase of shares for \$18. It appears that the sole purpose of the exchange was to conceal the cash losses of Great Southwest.

In a January 21, 1970, release by the Penn Central the exchange was pictured as a result of an orderly growth plan. The release quotes Bevan as saying:

... the projection of future growth for Great Southwest justified an increase in that company's total capital and the exchange of debt for stock was the first phase of a long term financing program.

The release failed to disclose that Pennco had been trying without success to sell Great Southwest stock to third parties for cash. Also, Great Southwest did not have an established long term financing program. It had begun borrowing very large amounts of unsecured short term funds from European lenders at high interest rates and had discussed the possibility of long term European loans. These loans, however, depended upon the continued appearance of sound financial health of Penn Central to whom the lenders looked for security. The transaction and release are misleading because they convey the impression that the exchange was motivated by positive factors whereas it really resulted from the inability of GSC to repay the moneys advanced to meet its continuous and serious cash drain.

#### GREAT SOUTHWEST FINANCING AFTER ABANDONMENT OF THE PUBLIC OFFERING

As Penn Central's cash problems grew more critical in 1969, it became less able to continue supplying cash to Great Southwest. At the same time, Great Southwest's needs were increasing rapidly. The corporate overhead had ballooned; carrying and development costs were increasing; debt was coming due; and some planned acquisitions required cash. Great Southwest's "earnings" boom of 1968 and 1969 did not produce cash equivalent to the magnitude of the reported "earnings."

Great Southwest could not easily obtain money. Ray had limited financing experience and the banks where GSC traditionally had entree had reached the limit of their lending authority. Great Southwest's traditional bankers would not accede to Ray's demands that they free assets by changing the loans to an unsecured basis.<sup>268</sup> This was part of a master plan of Ray's to have one subsidiary of GSC borrow money on an unsecured basis for the purpose of supplying all

<sup>268</sup> With Wynne along, Ray approached First National Bank of Dallas and Republic National Bank in Fort Worth. Both had an officer on GSC's board and had provided the principal bank lines. Ray wanted the banks to release the collateral. His demands created increasing hostility between GSC and its bankers.

the financing needs of other subsidiaries. It also reflects the scarcity of pledgeable assets. Some had counseled Ray to develop a secured line of credit with a group of banks.

The requirement of security presented problems to Ray, however, and when he was unable to come up with immediate financing, he turned to Provident Bank in Philadelphia.

Provident was more closely linked to Penn Central and its management than any other bank in the country.<sup>269</sup> By December 1969, GSC had already borrowed \$3 million from Provident. At that time, Ray obtained an additional \$5 million for 90 days by personally contacting William Gerstnecker (formerly Bevan's assistant), at that time, head of a Provident subsidiary and still a GSC director. Ray found that this kind of banking was not complicated as negotiation with banks where GSC's entree was more limited.

From Ray's testimony:

It was certainly not time-consuming. They were very accommodating about the whole thing. There was a call from New York and I went over there and effected the transaction in a very short period of time.

The Provident loan was only a stopgap measure. Ray was also talking with other Penn Central bankers. According to Ray, Chase Manhattan Bank agreed to provide a line of credit from which it retreated when Penn Central's problems started becoming evident to the bankers. In any event, Chase's foreign department provided Ray with introductions in Europe and Ray hired a Chase employee, James Himoff, to help raise money. Ray had no experience in foreign borrowing.

GSC's foreign borrowing actually did not come from contacts supplied by the New York banks. Ray had met Albert Gareh through a promoter in San Diego who had walked in the door at GSC. Gareh headed a New York firm, Pan American Credit Corp., which acted as a broker for foreign lenders. Ray called Gareh in Paris to ask for his help. Ray then flew to Switzerland and, through Gareh, met officials of UFITEC, a group of Swiss lenders, including Messrs. Vander Muhl, Swek, and Zilka. On December 19, 1969, GSC borrowed \$2,676,295 in Swiss francs from UFITEC on a 1-year unsecured note as introductory borrowing. GSC then established a foreign subsidiary, Great Southwest Overseas Financial Corp., in Curacao for tax purposes to handle additional borrowings. Most of the loans from UFITEC had maturities of 1 year. In April, GSC began borrowing from another company with European sources, Merban Corp. These negotiations were handled principally by Himoff and the maturities were 6 months at 1½ percent above the Eurodollar rate. In all, GSC borrowed over \$43 million in approximately 5 months before news of Penn Central's problems halted the flow of funds.<sup>270</sup> None of the loans were secured.

<sup>269</sup> Bevan and other Penn Central officers were on Provident's board and its loans to PC and related entities of \$20,023,479 on Feb. 1, 1970, exceeded the bank's legal lending limit of \$9,200,000. The bank maintains that the limit applies to each subsidiary separately. In any event, the loans to PC exceeded 20 percent of the bank's net assets.

<sup>270</sup> See table on p. 146.

It appears that these borrowings had been made in a desperate effort to meet GSC's tremendous cash needs.<sup>271</sup> The company was unable to expand U.S. bank lines because of antagonism between Ray and the bankers and because the company had few assets free for pledging. The cost for running the complex set up by Baker and Ray was soaring and development costs under contracts had to be met. Ray was even considering an attempt to raise cash in Asian money markets.

Ray has maintained that he had tentative commitments for medium- and long-term foreign borrowings from reputable lenders to replace the short-term borrowing. It is unclear whether these loans could ever have been completed. It seems clear, however, that the loans could only be made under the umbrella of a healthy Penn Central because the lenders looked to Penn Central to back up the loans. From Ray's testimony:

*Question. Did anyone from the Bank of Brussels or any of the other banks indicate that they thought the association with Penn Central would make it easier for them to place the Great Southwest notes in Europe?*

*Answer.* Not specifically with the Banque de Brussels. But that conversation did come up on a number of occasions, initially, during my first efforts there. Actually, the European banking community at that time, less so today, but at that time were extremely name-conscious, and they were very impressed by the size of the railroad and by the fact it was a company that had been in existence for a long time, even though there was no direct liability or direct connection with respect to the borrowing by the railroad. And I initially saw it and to take advantage of that, because it was helpful to the company in terms of its identification, and I did so myself without the knowledge that the railroad was about to run into some tough railroading times, and I had it somewhat backfire later on, in that I mean it would have had the same result anyhow, I am sure, but, basically, the only thing I did in that regard, I took copies of the Penn Central statements and I put those in a package of material that I gave out and on the first trip when I particularly gave out nothing, I would simply lay a copy of the railroad annual report on the table and a copy of the Great Southwest annual report on the table, and I didn't leave anything or didn't ask for anything.

Great Southwest was clearly borrowing on Penn Central's reputation in Europe as a blue-chip investment.<sup>272</sup>

The borrowings were authorized by the GSC board. At the December 2, 1969 board meeting, Ray obtained approval to borrow \$20

Footnote 270—Continued

	Date of loan	Borrower	Lender	Face amount of notes		Due date
(a)	Dec. 19, 1969	Macco.....	Panamerican.....	11,000,000	S.F.	Dec. 17, 1970
(b)	Dec. 19, 1969	Macco.....	UFITEC.....	2,000,000	S.F.	Dec. 17, 1970
(c)	Jan. 15, 1970	Overseas.....	Panamerican.....	51,000,000	S.F.	Jan. 8, 1971
(d)	Feb. 19, 1970	Overseas.....	UFITEC.....	11,000,000	S.F.	Feb. 15, 1971
(e)	Feb. 19, 1970	Overseas.....	UFITEC.....	7,000,000	S.F.	Aug. 18, 1970
(f)	Mar. 4, 1970	Overseas.....	UFITEC.....	7,000,000	S.F.	Mar. 2, 1971
(g)	Mar. 4, 1970	Overseas.....	UFITEC.....	3,000,000	S.F.	Sept. 4, 1970
(h)	Apr. 10, 1970	Overseas.....	Merban.....	10,500,000		Oct. 14, 1970
(i)	May 4, 1970	Overseas.....	Merban.....	5,250,000		Nov. 4, 1970
(j)	May 12, 1970	Overseas.....	Merban.....	5,250,000		Nov. 11, 1970
(k)	May 18, 1970	Overseas.....	Merban.....	2,000,000		Nov. 16, 1970
(l)	May 21, 1970	Overseas.....	Merban.....	2,000,000		Dec. 17, 1970

<sup>271</sup> Some of the money was used to repay the banks which were growing hostile to Ray; some was used for acquisitions, including a bankrupt computer company; the rest disappeared into the company's general accounts.

<sup>272</sup> Ironically, Penn Central itself had turned to this market of last resort for the company and had placed approximately \$60 million in short-term notes with UFITEC. American investors knew little of the true crisis at Penn Central in the spring of 1970; foreign investors knew less. Great Southwest was also in critical condition but it is unlikely that foreign investors even considered GSC's condition.

million from foreign lenders. At the next meeting, on February 26, 1970, the authorization was increased to \$50 million and at the following meeting on April 29, 1970, the authorization was increased to \$200 million. It appears, however, that few people at GSC or Penn Central realized what Ray was doing.<sup>273</sup> One GSC director who was asked about his knowledge of the sums borrowed stated that he was unaware that any loans had been made under the authorization. At one point Hodge indicated that some restriction should be put on the terms of the loans which were authorized but such restrictions were not adopted by the board. The board did require, however, the approval of the executive committee on loans under the final \$150 million authorization.

Great Southwest was caught in a financial squeeze which had become critical after the abandonment of the public offering. The cash drain which had always existed became even worse. Baker's activities had produced an impressively large operation to support soaring earnings, but the cost in terms of cash was enormous. At the same time Penn Central's inevitable financial crisis was shutting off the faucet at that source. Great Southwest was blocked from domestic borrowing because GSC could not produce security. After drawing on Penn Central's domestic bank of last resort, Provident Bank, Ray had turned to Europe. There his inexperience was matched by the Europeans' lack of knowledge of the condition of Penn Central or Great Southwest. Nowhere was even a hint of this financial crisis given to GSC investors. Instead the investors were fed a steady diet of puffing. In a report to shareholders in early 1970 GSC boasted, almost wryly, of its financing abilities:

The primary task of the finance division is to provide financing for the various divisions. Because of this unique approach to finance, the division has been able to develop a staff of specialists in the areas GSC is involved in. This expertise allows the finance division to take advantage of unique opportunities in the ever-changing financial community.

#### FUTILE ATTEMPTS AT AN EARNINGS ENCORE—1970

The proposed public offering had been abandoned partly because of Harned's concern that investors would ask what GSC could do for an encore. Many investors had undoubtedly gotten the impression that the earnings boom in 1968 and 1969 represented a trend. In fact, GSC had sold off its principal saleable assets.<sup>274</sup> Baker was faced with an impossible task. He knew that Penn Central wanted more reportable earnings, not less. Baker obliged. At a presentation to the Transportation Co. board meeting on December 17, 1969, Baker predicted earnings for 1970 of \$63 million.<sup>275</sup>

Baker was faced with several problems, however, since GSC had syndicated its only two amusement parks, which were the easiest syndication vehicles. Of equal difficulty were the tax changes and the growing concern of the accounting profession. The Internal Revenue

<sup>273</sup> Bevan and PC financial sources knew of the borrowings partly because they were borrowing from the same source.

<sup>274</sup> Investors were additionally misled into believing the earnings represented cash income. Actually, a cash drain was occurring in the company.

<sup>275</sup> The presentation was PC management's response to Odell's objections that PC board members were not being adequately informed of GSC activities.



Service was shortening the period which could be covered by prepaid interest. At the same time, the accounting profession was increasingly coming under attack for allowing earnings from sales of real estate to be taken in the first year where there is only a small downpayment and some question about the purchaser's willingness and ability to make full payment. Baker struggled to prevent tightening of the accounting treatment.

On December 23, 1969, Penn Central's comptroller Charles Hill, sent Baker a memorandum on proposed guidelines for accounting treatment for real estate transactions. The memorandum had been prepared by Peat, Marwick for discussion with Penn Central. The threat to GSC because of tighter was apparent to Hill:

The guidelines, if ultimately adopted, will represent the basis for recognizing income among the companies affiliated with Penn Central. Therefore they warrant searching consideration by you and your accounting staff. We expect to respond to Peat, Marwick with comments and suggestions on their guidelines by mid-January. With this target, we would appreciate your evaluation of the Peat, Marwick proposals and your suggestions for making them wholly acceptable from your point of view.

The Peat, Marwick memorandum noted that the American Institute of Certified Public Accounts had not addressed itself directly to real estate transactions but it cited APB Opinion No. 10:

Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured.

The memorandum further noted that:

The Securities and Exchange Commission, on the other hand, has shown a somewhat greater concern with respect to income recognition and in 1962 issued ASR No. 95, entitled "Accounting for Real Estate Transactions Where Circumstances Indicate That Profits Were Not Earned at the Time the Transactions Were Recorded."<sup>276</sup>

In the case of raw land sales, the memorandum concluded that where there is no effective recourse against nonpayment (for example, because of insufficient assets of buyer or State law—as in California) a downpayment of at least 10 percent and certain substantial payments in the first 5 years must be made.

A meeting among Penn Central and GSC officers was held at GSC in early February 1970.<sup>277</sup> Baker's views are contained in a memoran-

<sup>276</sup> The memorandum went on to quote from the SEC release:

With respect to when it would be inappropriate to recognize profits on real estate sale the release states that:

Circumstances such as the following tend to raise a question as to the propriety of current recognition of profit:

1. Evidence of financial weakness of the purchaser.
2. Substantial uncertainty as to amount of costs and expenses to be incurred.
3. Substantial uncertainty as to amount of proceeds to be realized because of form of consideration or method of settlement, for example, nonrecourse notes, noninterest bearing notes, purchaser's stock, and notes with optional settlement provisions, all of indeterminable value.
4. Retention of effective control of the property by the seller.
5. Limitations and restrictions on the purchaser's profits and on the development or disposition of the property.
6. Simultaneous sale and repurchase by the same or affiliated interests.
7. Concurrent loans to purchasers.
8. Small or no downpayment.
9. Simultaneous sale and leaseback of property.

Any such circumstances, taken alone, might not preclude the recognition of profit in appropriate amount. However, the degree of uncertainty may be accentuated by the presence of a combination of the foregoing factors.

<sup>277</sup> Attended by Bevan, O'Herron, Hill, Wynne, and Baker. The meeting dealt with Baker's concerns about the involvement of PC accountants and Peat, Marwick's Philadelphia officers in GSC's affairs as well as with the real estate guidelines.

dum he prepared for that meeting.<sup>278</sup> Baker was concerned about the impact on GSC of a tightening of the rules:<sup>279</sup>

An example of this [the importance of proposed accounting changes] is a lead article appearing in the February 2, 1970, issue of Barron's entitled "Castles of Sand." An expert questions the accounting practices of land development companies. Great Southwest is listed by the article as a major land development company, thereby purporting to place us in the group practicing the "questionable accounting practices." Yet, the entire thrust of the article is an attack on the development companies engaged in the sale of recreational lots to the public. However, the article is an example of the confused manner in which the accounting profession and the SEC may be focusing on the problems of real estate accounting practices. For the most part, such focus fails to take into account the variety of business and transactions which make up the field of real estate. In order to properly focus on real estate accounting practices, the real estate business must be looked at by accountants who have the necessary business knowledge of real estate or who have received sufficient input so as to know whereof they speak.

For longer range matters Baker proposed an aggressive posture to cut off SEC or AICPA rules which might curtail GSC activities.<sup>280</sup> Later,<sup>281</sup> Baker and GSC and Penn Central officers met with several Peat, Marwick officials at GSC's Cote de Coza resort in California to discuss the guidelines. As described by Baker, the meeting was an attempt to aid Peat, Marwick in considering problems and did not involve discussions of specific transactions. It was, Baker stated, a "scholarly" sort of discussion.

Aside from the accounting problems, Baker was having difficulty in setting up sufficient deals to even approach his earnings projections. He stated that he was so busy trying to arrange deals that he did not have adequate time to oversee the company's operations. Baker informed the GSC board that he had a number of transactions under way. They included syndications of various properties including the Movieland Wax Museum, Starr Ranch, and River Lakes Ranch. Of these properties only the River Lakes Ranch was then owned by Great Southwest Corp. Baker planned to do a syndication for a sales price of \$12 million and a pretax profit of \$7 million. Property Research was to be the underwriter and Great Southwest was to develop the properties in order to "generate sufficient cash flow to pay the promissory notes received upon the sale."

Great Southwest intended to purchase the Starr Ranch and then syndicate it in an intrastate offering. According to GSC's projections, the sales price would have been \$28 million and pretax profit would have been \$13 million. Neither the Movieland Wax Museum nor the Starr Ranch was purchased. Apparently Great Southwest was changing its activities. It was going beyond the mere syndication of properties already owned and developed, and was, instead, planning to move into the area of acting as broker in syndicating property. None of the company's officials could explain how GSC had been expecting

<sup>278</sup> From Baker to Bevan and Wynne, Feb. 3, 1970.

<sup>279</sup> He also felt GSC and the real estate industry was misunderstood:

We cannot permit P.M. & M., in the absence of rulings by the profession as a whole or the SEC, to attempt anticipated changes in accounting practice to our detriment or to retroactively apply its newly formulated guidelines to the transactions which have already been consummated in 1970. Nor can we afford to delay our sales, marketing and syndication efforts in 1970 while we wait for P.M. & M. to formulate its guidelines for 1970. Therefore, we are faced with two problems. They are:

(a) The immediate problem of the 1970 transactions; and (b) the new rules and guidelines which may be established by the accounting profession and the SEC.

<sup>280</sup> Baker apparently felt that unscrupulous real estate companies were bringing a crackdown on "reputable" companies such as GSC.

<sup>281</sup> Apparently on March 20 and 21, 1970.

to make such enormous profits from this real estate brokerage business. None of these transactions was ever completed. They do, however, mark the last gasps of the attempts to inflate reported earnings.

Baker was not going to produce an encore to the sale of Bryant Ranch and the two amusement parks. For Penn Central, there would be no paper profits to conceal the railroad losses. Even allowing for fluctuations in real estate company earnings, a quote from the GSC minutes of April 29, 1970, tells the story:

The next order of business to come before the meeting was a discussion of the corporation's anticipated pretax profit for the year for 1970. In this connection, Mr. Bevan asked what the profit was anticipated to be as of June 30, 1970. Mr. Baker replied that the anticipated pretax profit was somewhere between \$2 million and \$28 million depending upon whether or not certain large transactions were closed by June 30.

By mid-1969 the reality of GSC's enormous problems were evident. Enormous and growing cash losses were coupled with the loss of PC as a supplier of funds and the inability to produce even paper profits on transactions. Yet investors were never given a cautionary note (the prospectus for the abandoned offering would have helped). Indeed, the inflated claims about GSC's prospects in the spring of 1970 continued to mislead investors. The February 27, 1970, news release on 1969 earnings is headed "Great Southwest Corporation Announces Record 1969 Earnings" and begins:

Great Southwest Corp., a national land and environment developer, announced record earnings for 1969 reflecting the company's continued success since Macco Corp. merged with GSC in March last year.

The release was approved by the board of directors. A report to shareholders in 1970 begins:

For Great Southwest Corp. 1969 was a year of merger and expansion. The company established itself as one of the most profitable real estate developers in the Nation. And our merger with Macco Corp. in March provided a solid foundation for company growth and increased profits in the years ahead. (GSC progress report 1969.)

## I-F. ROLE OF DIRECTORS

### INTRODUCTION: RESPONSIBILITIES AND FUNDAMENTAL PROBLEMS

In light of the critically adverse developments, the lack of adequate disclosure and the dubious conduct of senior management as described in the other sections of this report, a question arises as to the role of the directors. It should first be noted that it is generally agreed that directors are not responsible for directing the day-to-day operations of the company and they are not insurers of the performance of management. It should also be noted that outside directors are undoubtedly at some disadvantage in terms of monitoring and appropriately directing a company and its management. Most directors have other demanding full-time jobs so that the time and energy that can be devoted to a company's affairs is limited. Directors often must rely on the company staff officers for information and evaluation. Directors rarely have their own staffs to assist them and they usually receive only relatively modest stipends for being on the board.

Outside directors are, however, ultimately responsible to the shareholders of the company for the proper monitoring of a company's affairs. Among the roles of directors are the selection of competent management and review of the performance and integrity of management including compliance with laws applicable to the corporation. As a practical matter, shareholders can rely only on the outside directors to oversee management and to take corrective action when management abuses its authority. The role of directors in the scheme of corporate affairs is reflected in some of the general legal principles relating to the liabilities of directors:

*Selection of officers.*—There is no question but that the directors may be personally liable where their appointee is untrustworthy or incompetent, and the directors were negligent in making the appointment.<sup>282</sup>

*Oversight of officers.*—All the courts doubtless agree that the responsibility of a board of directors, or of an individual director, does not end with the appointment of honest and capable men to be executive officers, and that ordinary care on the part of directors requires reasonable oversight and supervision.<sup>283</sup>

In other words, a director cannot escape liability merely by picking out able and apparently trustworthy men to act as president, general manager, and then paying no attention to the acts of such executive officer or officers or to the corporate business.<sup>284</sup>

*Being put on notice.*—Of course, if a director acquires knowledge which tends to raise a suspicion against executive officers or agents, in connection with their positions, he must follow it up or inform the other directors.<sup>285</sup>

<sup>282</sup> Fletcher, *Cyclopedia of the Law of Private Corporations*; 1965 revised volume; vol. 3, p. 688 (§ 1079).

<sup>283</sup> *Id.* p. 674 (§ 1070).

<sup>284</sup> *Id.* p. 685 (§ 1072).

<sup>285</sup> *Id.* p. 687 (§ 1078).

Of course, if negligent or wrongful acts of officers are merely isolated acts then it might well be that the directors would not be chargeable with notice thereof, but if the wrongful acts are part of a system which has long been practiced by the wrongdoer, the presumption is that the directors, ordinarily, would have discovered the wrongdoing if they had been reasonably diligent.<sup>286</sup>

The Penn Central outside directors maintain that they did not violate their obligations, including their obligations under the securities laws.<sup>287</sup> They maintain that they were faced with a difficult situation caused to a large extent by forces outside of the control of management or the board. They cite specifically inadequate tariffs, passenger service losses, inability to abandon lines, and the over-employment of labor. The directors claim that they took what measures that they reasonably could under difficult circumstances. They also emphasize that they received no personal gain from any nondisclosure and that some directors suffered significant losses on their Penn Central holdings. They further maintain that they had no knowing participation and they did not aid or abet any nondisclosure of material facts. It was their belief that all of the company's difficulties were repeatedly made known to the public through statements to Congress, the ICC, and the public.

It appears, however, based on the information in this and other sections that the Penn Central board failed in its obligations. In particular, it failed to see to the integrity of management and it failed to see to the compliance by management with the laws governing the company, including the provisions of the Federal securities laws.

The failure of the Penn Central board to effectively monitor management arose from several circumstances. One circumstance was the change in the complexity of corporate matters as a result of the merger and the diversification efforts. The directors of the Pennsylvania Railroad in particular had served on a company with a long and conservative financial and operating history. The railroad performed basic functions in a largely unchanging way.<sup>288</sup> In such a situation, a board seat was more a matter of business honor than an active business responsibility. On the New York Central, generally a more dynamic railroad, the majority of directors were overshadowed by the active ownership interest of Robert Young and Allen and Fred Kirby<sup>289</sup> and the active management of Alfred Perlman. Under these conditions, the boards tended to miss the management and financial complexity of the proposed merger. Even after the merger, the directors only slowly awakened to what was happening.

Another circumstance limiting the effectiveness of the board was the limited amount of information it sought or received. In the merged company, directors were furnished only with (1) a voluminous

<sup>286</sup> *Id.* p. 684 (§ 1072).

<sup>287</sup> In the course of its investigation, the staff took the testimony of almost every director who was on the board at anytime during the period from the merger to the reorganization. The experience of every director was not identical, of course. For purposes of clarity, however, this portion of the report will describe many of the activities of directors in the context of the board as a whole. Some reference is made to individual directors where such reference is necessary to explain particular developments.

<sup>288</sup> For example, until the merger, almost the sole financing vehicle was an uncomplicated and conservative conditional sales agreement for equipment. After the merger, commercial paper and Swiss francs were used.

<sup>289</sup> Alleghany Corp. acquired control of the New York Central in 1954. Robert Young was chairman and Allen Kirby was president of Alleghany. Young died in 1958 and Kirby became chairman of Alleghany. From 1961 to 1963 the Murchison brothers struggled with Kirby for control of Alleghany. Kirby, who finally retained control, retired in 1967. His son, Fred Kirby, replaced him. Alleghany's control was diluted in 1966 through an exchange offer of its New York Central stock for Alleghany Corp. stock.

docket of routine capital expenditure authorizations for numerous individual transactions, (2) a treasurer's report giving the current cash balances, and (3) a sheet listing revenues and expenses for the railroad for the period between the board meetings.<sup>290</sup> <sup>291</sup> The directors had no cash or income forecasts or budgets; they had no guidelines to measure performance; they had no capital budgets; they had no information describing the earnings or cash performance of the subsidiaries. For all this vital information, they were forced to rely on oral presentations by management.

The board meetings were largely formal affairs<sup>292</sup> which were not conducive to discussion or interrogation of management. Some of the directors had little opportunity to consult with other directors outside of the environment of the board meetings.<sup>293</sup> In extreme cases, directors were isolated from the company or other directors. Otto Frenzel, located in Indianapolis, spoke with other directors only at board meetings, which, as indicated, allowed only limited communication. Seymour Knox, who was in Latin America and in North Carolina much of the time from September 1969 to May 1970, attended only one board meeting during this extremely critical period.

The board failed in two principal ways. It failed to establish procedures, including a flow of adequate financial information, to permit the board to understand what was happening and to enable it to exercise some control over the conduct of the senior officers. Secondly, the board failed to respond to specific warnings about the true condition of the company and about the questionable conduct of the most important officers. As a result, the investors were deprived of adequate and accurate information about the condition of the company.

### PREMERGER PERIOD

The staff's investigation principally covered the period between the merger and the reorganization because in this period the decline in the affairs of the company was most significant and disclosure was most critical. Nevertheless, an examination of developments leading up to the merger is appropriate, particularly in connection with the role of the directors. During the period from 1963 to July 1968, the price of Penn Central stock rose from around 20 to a high of 84.<sup>294</sup> The principal cause of the rise was the prospects for the merged company. Numerous financial analysts were repeating the projections of management: the merger would vastly improve the performance of the railroads and the real estate diversification of the Pennsylvania Railroad would provide a bountiful growth factor. Neither prospect was founded on fact. This would have been revealed by a more intensive review of the prospects for the merger.<sup>295</sup>

<sup>290</sup> In late 1969 and early 1970, as directors became more concerned, the flow of information increased slightly but events had so vastly changed that the information was equally useless.

<sup>291</sup> Even the finance committee received no additional written information.

<sup>292</sup> The board of the merged company had 25 directors. These were joined at board meetings by numerous officers. Some directors testified that the size and the arrangement of the meetings effectively limited discussion between management and the directors.

<sup>293</sup> Directors associated with Alleghany Corp. did have a common connection. Kirby, Taylor, Rabe, Hunt, and Routh were all Alleghany directors. The Alleghany directors still on the board in the Spring of 1970 resigned following an ICC ruling on Alleghany's acquisition of Jones Motor Co.

<sup>294</sup> Adjusted for the premerger period.

<sup>295</sup> The directors state that the planning of that merger and its implementation were the responsibility of management. The directors also noted that the merger proposal was reviewed by the ICC and was litigated in the courts over several years. Governmental approval was obtained, however, on representations made by the railroads. In addition, management tended to encourage investor optimism and to minimize the very serious risks which they knew existed.

As described in the beginning of this report, the proposal of a merger between the PRR and the Central was dropped after the death of Robert Young in 1957. Later, following mergers among the other Eastern roads, Perlman became concerned that the Central would be isolated. When this concern arose in late 1961, the idea of merger between the PRR and the Central was revived and negotiating committees of the boards of both railroads were formed. Isaac Grainger chaired the Central committee consisting of himself, Seymour Knox, and R. Walter Graham, Jr. The PRR committee was chaired by Richard K. Mellon and consisted of Mellon, Jared Ingersoll, and Phillip R. Clark. The responsibility of the committee was limited to setting the general terms of the merger including the exchange rate, the composition of the board, and the staffing of the several top management positions.

The negotiating committees began their work in November 1961. It was necessary for the railroads to complete an arrangement within several months because other mergers were before the ICC and the Central had to determine its position before the hearings began. The committees each selected an investment banking house to set the exchange rate. The Central selected Morgan Stanley & Co. and the PRR chose First Boston Corp. These two selected the third, Glore, Forgan & Co. The principal problem facing the negotiating committees was the selection of the top officers. The Central directors felt strongly that Perlman should have responsibility for the operations in light of his performance on the Central. James Symes, chairman of the PRR, wanted to be chief executive officer despite his planned retirement in August 1962. Greenough of the PRR was expected to be Symes' replacement and so the PRR directors wanted Greenough as well as Symes to have a high position in the merged company. An impasse developed. On December 27, 1961, Grainger, Symes, and Perlman met to consider the selection of top management. Upon being pressed about problems in the selection of management Symes said that frankly the PRR directors were having difficulty accepting Perlman. The Central directors, however, were desirous of having Perlman as chief operating officer because of his performance on the Central. A caustic discussion followed during which Symes and Perlman bluntly stated their dissatisfaction with the other's management of his road. To resolve the basic dispute, it was finally proposed that Symes and Perlman would become inactive vice chairmen of the board and that the PRR would name a chief executive officer and the Central would name a president. The merger agreement was signed, and the merger began its course through the ICC and the courts.

The road to final approval was not wholly harmonious between the two railroads, and Perlman occasionally expressed the belief that the negotiating committee had given away too much and that perhaps an alternative merger was possible. Meanwhile Saunders had replaced Symes as chairman of the PRR on October 1, 1963. Saunders was formerly head of the N. & W. and was named chairman of the PRR when the railroad was unable to choose one of its own officers (including Greenough and Bevan) for the position. While discussing merger matters with Saunders in March 1965, Grainger broached the suggestion that the merger agreement be changed so that Perlman could be made president. Saunders, who was not an operating officer himself, agreed.

The negotiating committees became inactive after the signing of the agreement in 1962 and, except for isolated instances, neither that committee nor the board was directly involved in any other matters relating to the merger. The only information about the progress of the merger which the board received was oral reports from management at board meetings. Other than what was given in the oral presentations, the board did not review the savings or costs which were being forecast and they never reviewed the kind of planning being done.

As explained elsewhere in this report, the merger planning was inadequate and fundamentally flawed. The Patchell report which was presented to the ICC was not a plan for the merger nor was it intended to be. It had not attempted to set out savings or costs that would result from the actual operations of the merged railroad. Instead it was a vehicle for presenting some cost and savings figures to gain approval of the merger. The planning for some of the departments, other than the operations department was valueless. The departments of the respective roads did not cooperate and a lot of the planning did not take place until the department heads were named at the time of the merger. In the area of rail operations, where a detailed plan was formulated, the plan was ignored. Apparently no detailed plan was in effect on merger day. Little or no training was given yard crews or connecting lines and shippers.

None of the directors who testified was aware of these problems. The directors were under the impression that all necessary planning had been done and that the merger was being carried out pursuant to this planning. Most of the directors never did learn of the lack of meaningful planning or the relation of poor planning to the chaos which occurred upon the merger of the railroads. They were also unaware that the cost and savings forecasts were not accurate. The directors have emphasized that governmental bodies reviewed the merger and that only management could be expected to be familiar with the details of the planning. It would seem reasonable, however, for the directors to have informed themselves about the underlying theories and the actual planning. According to the testimony of directors, however, no director expressed any concern or reservations about the merger during the premerger period and the board never attempted to verify the representations of management about planning progress or expected savings and costs. Neither board had a committee established for the purpose of reviewing or monitoring the feasibility of, or planning for, the merger.<sup>296</sup> The merger of the Central and the PRR was probably one of the most complex and difficult mergers in corporate history and yet it appears that the directors did not make significant efforts to analyze it or evaluate it.

<sup>296</sup> A committee of the board did review one merger related item. Under the terms of the merger agreement, the Central and the PRR were limited to \$100 million in additional debt. In March of 1966, the NYC board considered a PRR request to increase their indebtedness above the ceiling. The PRR explained that the debt increase arose out of the acquisition of Great Southwest, Macco, Buckeye, and Arvida. The Central board formed a committee consisting of Grainger, Graham, and Odell to examine the request. Upon the recommendation of the committee, the board approved the increase. The approval recommendation, however, contained some reservations about the real estate investment (these had been raised by Odell):

Independent opinions were exceedingly favorable for the Buckeye property and for the most part favorable for the real estate acquisitions. However, questions were raised over short-term prospects for the Arvida properties, and there were negative views expressed in connection with the California properties. Therefore, the committee cannot give a definitive appraisal of the overall diversification program of the PRR. While there is a feeling that real estate investments at this time would not be the committee's choice, nevertheless, it has confidence in the judgment of its partner in the merger. (Memorandum from Graham, Odell, and Grainger to Central board May 2, 1966).



## POST-MERGER PERIOD

The merger got off to a bad start.<sup>297</sup> For the first 6 months the directors generally were unaware of the existence of fundamental problems. They were aware, of course, that mergers do not always proceed with complete smoothness but the directors assumed that all requisite planning and preparations had been done and that the merger was being successfully implemented.

By the summer of 1968 management was admitting to the directors that merger difficulties were being encountered. Computer difficulties were cited as a principal cause of operating problems. At this time the directors were relying solely on the oral presentations of management and reports from the news media. They had no written income budget information which would enable them to judge the progress of the merger or to judge the effectiveness of management. They had no written cash flow budgets to see the rate of the cash drain. Some of the directors, however, did begin getting some independent reports on the disastrous performance of the merged railroad. They began getting complaints from shippers, including complaints from their own shipping departments. Many of the complaints were sharply worded and described extremely poor service.<sup>298</sup> The directors, however, continued to accept the assurances of management that the company was under control.

<sup>297</sup> Some of the directors, like management, cited the short notice they had of the final governmental approval as a major cause of difficulty. They indicated that the roads could not commit themselves to capital expenditures until they were certain that a merger would occur. The Central's management apparently had begun at least some capital items prior to the merger. The PRR, as noted in the section on finance, was desperately short of cash and could not have afforded capital items even if they were willing to commit themselves. Neither the directors nor management considered entering into a mere formal corporate merger before making any attempt to combine the operations of the two roads so that the necessary training, organization and capital investment for the orderly functioning of the merged road could be made. Saunders did emphasize the need to obtain immediate savings through an immediate operational merger. It would seem, however, that merging slowly and well would produce more savings than merging quickly and poorly. If the short notice of final approval threatened any difficulties, the merger could have been delayed until the operating preconditions had been satisfied.

<sup>298</sup> Illustrative of the complaints being received orally and in writing by directors are the following complaints received by a director located in the western region of the railroad:

(a) "We are getting more complaints on our service to Indianapolis at this time from various customers, brokers and our own sales people than I can ever remember. Most of it is traceable to our inability to get cars and to get delivery of the cars to the customers after they are loaded. It has reached the point where I dread to see any of our sales people as I know they are immediately going to start complaining to me what lousy service they are getting from our master warehouse. Frankly, we would like very much to materially increase our rail shipments and would certainly do so if the car or service problem could be solved . . . I do not think we would look with favor on any location served exclusively by the Penn Central . . . We are big rail shippers and could very easily be much, much bigger. But frankly we don't know where to turn. . . ." (Letter of Nov. 12, 1968, from an Executive Vice President of a major food processing company.)

(b) "Apparently, neither company has been successful in promptly getting cars in or out of Indianapolis under the Penn Central operation. Along these same lines, numerous meetings have been held with area sales representatives and other Penn Central personnel relating to fantastic demurrage and detention bills resulting from improper placement of cars on the siding, lack of written notice of constructive placement, poor communication and problematical service. (Feb. 27, 1969 letter.) We sincerely appreciate your interest in this problem and your willingness as our banker and a Director of Penn Central to see that this information is brought to the attention of the right people at Penn Central for correction."

"As I explained, customers of ours, such as Morton Foods, Campbell Soup, Kraft, etc., ship products for storage and distribution to our subsidiary. . . . These are long hauls for the railroad and represent considerable volume. We are in danger of losing many of these important customers because they find it almost impossible to get good service from Penn Central in shipping to our plant in Indianapolis. This poor service is jeopardizing new business for the same reasons. Morton, for example, complains that it is taking them from 14 to 17 days to ship by rail from their manufacturing plant in Virginia to Indianapolis. Naturally, they cannot stand this situation." (Feb. 27, 1969, follow-up letter to above.)

(c) "I dislike very much to find it necessary to bring a matter of this type to your attention, but it does seem to me that unless I go higher than the local people there is no prospect of getting these industries serviced by rail. I am also willing to go on record that our dealings with Penn Central have been poor for sometime, but they are much worse since the merger, and I do not feel that Penn Central can service its shipping customers and that there is a total breakdown in the management responsibilities on a local level." (Apr. 7, 1969, letter.)

As the operational problems persisted and associated costs rose, the strain on the railroad's finances grew worse. By the fall of 1968 it was apparent to management that the cash drain caused by the operations debacle could not be absorbed for long. The drains were enormous and Penn Central had only limited access to cash. The directors have testified that while they were aware of some difficulties they were unaware of the extreme seriousness of the operational and cash problems at that time. It appears, however, that a more critical examination of management's statements would have uncovered the enormity of the problems and the urgent need for corrective action. Even if corrective action would have been difficult or impossible (perhaps because of fundamental weakness of the merger) the investors could have been warned of the magnitude of the misadventure.<sup>299</sup> Instead they continued to receive optimistic projections.

### FINANCIAL PROBLEMS AND A FIRST CHALLENGE TO DIVIDEND POLICY

The seriousness of Penn Central's plight should have been evident since the board was required to authorize the revolving credit and commercial paper borrowings. The use of commercial paper in particular should have caused alarm because the use of such paper was almost unheard of in railroading.<sup>300</sup> The directors have stated that these borrowings appeared reasonable to them because of the prevailing high interest rates. The use of short-term debt as a substitute for long-term debt may be justified as a temporary measure when it is decided not to roll over long-term debt at high rates or where long-term capital investments are being made. In Penn Central's case, however, the enormous amounts of short-term, high interest, borrowings were going principally to meet current operating losses. The significance of borrowing to meet staggering operating losses is that no company can long survive such a condition, regardless of the level of prevailing interest rates.

Most directors did not begin becoming concerned about the conditions of the company or its finances until the spring of 1969 when management sought and obtained authority from the directors to further increase the revolving credit and commercial paper.<sup>301</sup> By mid-1969 the directors had approved an increase of approximately \$500 million in short-term debt since the merger. Most of this was needed to meet operating losses and dividends.

During this time Penn Central routinely continued to pay dividends at the premerger rate. According to the testimony of the directors, no director expressed any reservation about paying the dividends prior to the events described below. During this time the company had to

<sup>299</sup> In the summer of 1968 the price of Penn Central stock had reached a record high level and numerous officers were selling stock acquired under option prices, which at that time were only one-fourth of the market price prevailing at that time. Under these option stock sales some officers individually made hundreds of thousands of dollars.

<sup>300</sup> The Chesapeake and Ohio, through a financial affiliate, had been the only other railroad to ever sell commercial paper. Commercial paper is usually used by companies with seasonal cash needs or by companies which routinely have sizable short-term borrowings. Railroads, however, usually have large cash flows and are more likely to have need of long-term borrowings.

<sup>301</sup> One director presently noted at this time that management's request for more locomotives indicated some fundamental problems because one of the major premises of the merger was that it would require fewer, not more, items of equipment.

borrow at high interest rates to pay the dividends. At the June 24, 1969 meeting the directors were faced with approving, as customary in prior years, a dividend for the third quarter. The board customarily did not meet in July and August when the dividend for the third quarter would otherwise come up for consideration. Saunders realized that there might be reluctance in this year to declare a dividend so far in advance. He inquired of the legal department about the disclosure that would have to be made if the dividend decision were postponed until a special August meeting. He was told that the postponement of the decision would have to be disclosed. This would have an adverse impact on the investing public, and he dropped the idea.

At the June meeting, several of the directors began questioning the payments of a dividend so far in advance of the third quarter results. The same problem of disclosure that had troubled Saunders earlier arose again. From the testimony of one director, Franklin Lunding:

*Question. Was this discussed at all at the June [board] meeting, the consequences that might happen if you delayed the decision [on the declaration of the dividend] until August?*

*Answer. It had been customary to declare the dividend at this meeting. If you didn't declare it at this meeting, then all kinds of questions would arise, I would judge.*

*Question. Well, can you recall whether this problem was discussed at the June meeting, that if the decision were formally delayed until August, that this would raise questions in the financial community.*

*Answer. I am not sure, but my impression is yes, this was raised by either Bevan or Saunders.*

The objections of the few directors were answered by having the board declare a dividend payable September 26, 1969 with the understanding that a special August meeting would be held so that the matter could be reconsidered if necessary. According to Stewart Rauch, a director:

It was June that the third quarter [dividend was declared] payable in September. It [the question of whether a dividend should be paid] was under discussion and it was concluded that further consideration should be given to it, so that the board was called in August for that purpose.

The dividend was then declared at the June meeting and was reported in the press. At the August meeting no objection was raised to the payment of the dividend even though Bevan indicated at that time that the cash drain for the year would be \$295 million and that he had no idea where the \$300 million needed for next year would come from. The dividend was finally dropped at the November 26, 1969 board meeting when the fourth quarter dividend came up.

#### INVESTIGATION OF BEVAN ABANDONED

The August 26, 1969 board meeting became an important meeting for reasons other than dividend policy. At that meeting it was disclosed that a suit had been brought by a shareholder and former officer of Executive Jet Aviation, John Kunkel.<sup>302</sup> The suit named EJA, Penn Central, American Contract Co., Glore, Forgan & Co., O. F. Lassiter (president of EJA), Charles Hodge, and David Bevan as defendants. Kunkel alleged, among other things, that Penn Central

<sup>302</sup> There were no public shareholders of EJA. Several insiders held stock and Penn Central had by far the largest investment.

dominated EJA through Bevan and Hodge;<sup>303</sup> that under the influence of Bevan, EJA was acquiring foreign airline interests and advancing funds to one Fidel Goetz among others;<sup>304</sup> that Penphil (whose shareholders include Bevan and Hodge) had improper arrangements with EJA through Holiday International Tours which caused a waste of EJA funds;<sup>305</sup> that operational losses were in excess of \$9,500,000 and that indebtedness to Penn Central exceeded \$19,500,000. The complaint also alleged a waste of corporate funds on the personal pleasures of Lassiter and others. Kunkel was in a position to know of these matters. He was formerly the treasurer and the chief financial officer of EJA.<sup>306</sup>

The directors had not been successful in insuring the competency of management or the company's compliance with laws. Now they were confronted with a direct challenge to the integrity of the company's chief financial officer. The allegations made by Kunkel were basically true. The directors had ample reason to be sensitive to any allegations of impropriety in connection with the affairs of EJA. The directors had been aware for some time that the Civil Aeronautics Board considered Penn Central's involvement in EJA to be illegal.<sup>307</sup> They also knew that sizeable amounts of money had been advanced to EJA and the Penn Central had received no return on the money. Up to this point they had relied on Bevan for information about EJA. The fact that Bevan was being sued was of such significance in light of all the circumstances that an independent inquiry by the board was certainly called for.

<sup>303</sup> From Kunkel complaint:

"6. Continuously up to the filing of this action defendant Penn-Central Railroad, dominated and controlled the election of the board of directors and officers and the management and business policies of EJA, Inc. through the American Contract Co., Gloré Forgan, Wm. R. Staats, Inc., Charles J. Hodge, and David C. Bevan. Disregarding the corporate well-being of EJA, Inc. and the rights of the minority shareholders the defendants entered into an illegal conspiracy to enable the Penn-Central Railroad to dominate the world air transportation market."

<sup>304</sup> From Kunkel complaint:

"He (Lassiter) directed EJA, Inc. on a course of action designed to gain control of and acquire foreign air carriers with funds supplied through various means of financial subterfuge by the Penn-Central Railroad and Gloré Forgan, Wm. R. Staats, Inc. in violation of the rules and regulations of the Civil Aeronautics Board and the laws of the United States . . . This agreement (on European operations) was consummated without the approval or concurrence of the board of directors, the management, or the shareholders of EJA except the coconspirators named herein. Financial reports later obtained by the treasurer of EJA showed a loss of approximately \$72,000 for Transavia in the first 3 months of 1968 and accumulated losses of nearly \$500,000 as of May 31, 1968. To finance this and other similar conspiratorial transactions the Penn-Central Railroad caused \$500,000 to be made available to EJA, to be placed in the bank (sic) of America and had one Fidel Goetz loan EJA \$650,000 for which Mr. Goetz received interest and a warrant for 40,000 shares of EJA. Mr. Goetz is a German textile magnate and the controlling stockholder in Sudwestflug, a German supplemental carrier."

"Subsequent to the agreement of February 1968 EJA leased a Boeing 707 to Transavia and is presently owed in excess of \$1 million by Transavia for the use of this airplane and attempts to collect this bill or to have the airplane returned to EJA have not been successful."

<sup>305</sup> From Kunkel complaint:

"During the month of February 1968 the coconspirators embarked upon a plan whereby EJA would control and operate International Air Bahamas and absorb all losses therefrom while the conspirators would personally benefit from a wholesale tour agency known as Holiday International Tours which had been hired as general sales agent for International Air Bahamas. Holiday International Tours was financed and controlled by an investment company called Penphil which had a list of stockbrokers including O. F. Lassiter, Charles J. Hodge, and David C. Bevan, in fact half of Penphil's shareholders are either present or retired employees of the Penn Central Railroad or Gloré Forgan, Wm. R. Staats, Inc. The conspirators charged EJA, Inc. with large sums of money for plush and elaborate entertainment expenses and ballyhoo far beyond any reasonable corporate expenditures for promotional purposes. International Air Bahamas is presently indebted (sic) to EJA, Inc. in excess of \$1,500,000 in back lease payments, maintenance costs and air crews for Boeing 707 furnished by EJA, Inc. and every attempt by the former treasurer of EJA, Inc. to (collect) this account was hampered and stopped by O. F. Lassiter for reasons unknown. This indebtedness grows monthly while EJA, Inc. goes further in debt to Penn-Central Railroad to finance this operation."

<sup>306</sup> The directors were not furnished with copies of the complaint. Apparently no director asked for a copy.

<sup>307</sup> The directors also admitted their growing concern about Bevan's inability to sell EJA as required by the CAB. Bevan had repeatedly assured the board that EJA would shortly be sold. At the time of this meeting previously reported efforts to sell to U.S. Steel and Burlington Industries had failed. Penn Central was also being fined \$65,000 by the CAB for its continuing involvement with EJA.

The directors state that they had relied in good faith on the opinion of counsel that the investment was legal.

The directors in fact realized the significance of the matter. During an executive session which was called to discuss Bevan's appointment to the board, Stewart Rauch questioned whether Bevan's appointment should be delayed until an inquiry of the EJA matter could be made. The directors finally decided to proceed with the appointment of Bevan to the board, but to authorize an investigation into the charges. Although Rauch wanted a wholly outside group to conduct the investigation it was decided, apparently at the suggestion of Thomas Perkins, who was a member of the conflicts committee, that the conflicts committee of the board would conduct the investigation. Bevan was out of the board room when this discussion took place.

After the meeting adjourned, Saunders informed Bevan of the board's decision on the investigation. Bevan became angered. He stated that he would consider an investigation to be a vote of no confidence and that he would resign. This alarmed Saunders and the directors who learned of it. Edward Hanley, the chairman of the conflicts committee and a friend of Bevan<sup>308</sup> decided that the resignation of Bevan would be extremely harmful to Penn Central because of the financial crisis being experienced by the company. Penn Central could not afford to lose its chief financial officer, especially one who seemed so adroit at raising cash. Despite Saunders' general animosity toward Bevan, he was aware of Bevan's importance at that critical time. Saunders called John Seabrook to warn about Bevan's threatened resignation:

*Question. Did Mr. Saunders indicate that he wanted to keep Bevan?*

*Answer. He sure did. He surely did.*

*Question. Had you understood that there was any animosity between Mr. Bevan and Mr. Saunders?*

*Answer. Yes. I didn't think they were fond of each other at all.*

*Question. Well did you see any reason why this was not a good time for Mr. Saunders to accept Mr. Bevan's resignation?*

*Answer. Well, keep in mind that timing, August was 2 months before we passed the cash dividend and he regarded Bevan as a wizard at raising cash and so I think he didn't want to lose his services at the time.*

Rauch was prevailed upon by Saunders to call Bevan and mollify him. Rauch called Bevan on September 3. It was an awkward call because Rauch had raised the question of what was happening in EJA and it was Rauch who had suggested postponing a salary increase for Bevan until the EJA matter could be examined. Bevan rebuked Rauch and emphasized that the company was in serious financial difficulties, with the implication that he was indispensable. Rauch's notes reflect that Bevan spoke of:

Cash drain of \$295 [million through 1970] 5 minutes on that.

Near miracle to save company next year \$200-\$300 million in equipment no where to come from.

Rauch concluded:

Dave must stay—what action can rectify appt. comti [appointment on August 27th of committee to investigate EJA and Bevan].

<sup>308</sup> Hanley was chairman of the board of Allegheny Ludlum and had caused Bevan to be named to the Allegheny Ludlum board in 1967.

Hanley conducted a telephone poll of most of the directors and <sup>309</sup> explained Bevan's position on the matter of the investigation. <sup>310</sup> The directors agreed that they could not afford to let Bevan go at that critical time. Hanley worked out a compromise. First, reference to the authorization of the investigation would be deleted from the minutes. Second, Bevan would prepare a statement explaining the EJA and Penphil matters and this statement would be presented to the board. Such a statement was prepared by Bevan and reviewed by Hanley. At the next board meeting on September 24, 1969, the statement was read by O'Herron. <sup>311</sup> The statement dealt with the foreign investments of EJA and made them appear to be minor and to be a result of a misunderstanding. The report mentioned Penphil briefly and identified only Bevan as a shareholder. <sup>312</sup> The report did not discuss the other allegations of the complaints, including the wasting of corporate assets. The statement was so innocuous that the directors could not recall the mention of Penphil in the report. If the board had not abandoned its intention of conducting an investigation or if the directors had merely read the complaint the unacceptable conduct of Bevan would have been apparent.

The directors explain that the reason for abandoning the inquiry was their concern because of Bevan's importance and the lack of a suitable replacement that he could not be permitted to resign. <sup>313</sup> It was an admission that the directors realized Penn Central's financial condition was critical. The public did not know this. Indeed the directors had avoided the dividend issue at the very meeting at which the suit was brought up. The shareholders were disserved doubly: (1) Bevan's activities were not uncovered and he was not removed; and (2) the financial debacle was kept from investors for a further period.

<sup>309</sup> Principally the Philadelphia area directors.

<sup>310</sup> Q. Was this matter (of the Kunkel allegation) taken under advisement by the Conflict of Interest Committee, at that time?

A. No, it was not. My recollection of what happened was that Tom Perkins said that he thought an investigation should be made of Executive Jet and Bevan took this to be a vote of no confidence.

Q. What happened?

A. Well, I think that Dave submitted a resignation.

Q. To the board?

A. To Saunders.

Q. How did you learn of that?

A. I think I learned about it from Bevan.

Q. Did anyone else know of this, to your knowledge? That is, did any of the other directors indicate that they had knowledge of the resignation?

A. Well, if they didn't then they did subsequently because I didn't think we should permit Bevan to resign from his job at Penn Central at that time, for sure.

Q. And was this discussed before the board, as a whole, then as to how they came to know it?

A. Well, I did a lot of telephoning on it.

Q. Did you talk to everybody on the board?

A. I don't think I talked to everybody, but I talked to most everybody. I know I talked to all of the people on the board who were from the Pennsylvania Railroad, so I know I talked to a lot of them. And, I talked to others. I know I talked to Del Marting, who was recently on the board. Finally, I wound up talking to Stewart Rauch.

Q. Would it be fair to say that the main reason for your not going ahead with the investigation of EJA at this period—sometime between August and September of 1969—was the fact that the financial condition or the financing status of Penn Central was in such a condition that the resignation of its chief financial officer would have made its financial condition or status even more precarious than it was?

A. I think so. We were getting into this. We weren't full-scale bankrupt at that moment, but were headed that way awful fast.

<sup>311</sup> Bevan was not present at the meeting.

<sup>312</sup> The complaint identifies Lassiter, Hodge, and Bevan as Penphil shareholders and states: "In fact half of Penphil's shareholders are either present or retired employees of Penn Central R.R. or Gloré Forgan, Wm. R. Staats, Inc."

<sup>313</sup> The directors stress the dilemma they faced. They believed that Bevan could not be replaced at that time without serious harm to the company and yet they were troubled by the charges concerning EJA. It should be noted, however, that the board did not attempt to place any constraints on Bevan and he was only replaced in June 1970 at the insistence of banks and the Government.

An immediate consequence to the directors' backing down under Bevan's threats was that Bevan could continue wasting corporate assets in the EJA activities and could continue to conceal the need to write off Penn Central's entire investment in EJA in light of the effective bankruptcy of the company.<sup>314</sup> Bevan had arranged for Fidel Goetz, a European investor mentioned in the Kunkel suit, to financially support EJA's "world operating rights program" in Europe. When EJA was forced to withdraw its application to acquire Johnson Flying Service, a supplemental carrier which was to be Penn Central's avenue to the air cargo business, the European plan collapsed. Goetz had advanced funds for this project and demanded compensation. In August of 1969 the Transportation Co., through American Contract Co., a subsidiary, was obtaining a \$10 million equipment rehabilitation loan from Berliner Bank in Germany. As part of a scheme to reimburse Goetz for his EJA losses and for other reasons, Bevan arranged to have the \$10 million transferred to First Financial Trust, an account set up in Liechtenstein by Goetz and Francis Rosenbaum.<sup>315</sup> On September 18, 1969, when the \$10 million arrived in Liechtenstein, \$4 million was immediately transferred to another account, Vilede Anstalt, controlled solely by Goetz. The \$4 million was never recovered. This diversion of funds, which occurred just as the directors were backing away from their investigation, was not mentioned by Bevan in his memorandum to the board of September 24, 1969.<sup>316</sup>

The consequences of Bevan's successful intimidation of the board and the board's knowing and willing refusal to examine direct and accurate challenges to his integrity were far more serious than the continuation of the EJA scandal. Bevan was the sole representative of Penn Central in dealing with lenders. He had responsibility for billions of dollars of financings. He was actively involved in raising several hundred million additional dollars during the period after August 1969. While engaged in this activity he made misleading statements to lenders.<sup>317</sup> These are set forth in greater detail in other sections.<sup>318</sup> In connection with keeping out \$200 million of commercial

<sup>314</sup> The history of this and related EJA matters is discussed at page 71.

<sup>315</sup> Rosenbaum is currently serving a prison sentence for defrauding the U.S. Government.

<sup>316</sup> The loss was not discovered until after the bankruptcy. The board apparently had continuing aversion to facing reality. When the EJA problem was again raised by a lawyer in Florida in early 1970, the conflicts committee referred the matter to Gorman for investigation (partly because there appeared to be a possible conflict on the part of the committee's counsel, Skadden, Arps, which represented Pan American, an intervenor in the EJA action before the CAB). Gorman's investigation was carried out under the supervision of Dechert, Price & Rhoades. As in other matters which that firm handled for Penn Central, its conclusions did not challenge company practices. It appears that Dechert did not talk to Bevan, Gerstnecker or EJA officers, and did not know of the diversion of \$4 million to Goetz even though they specifically did conclude that the company's officers did know they were violating the law through the foreign investments. Gorman then reported to Hanley by letter on May 28, 1970:

\* \* \* "During the course of the investigation, there was concern, of course, over the recitals in the CAB's consent order of possible knowing violations of aviation law by company officers. These related to EJA's dealing with foreign interests. Nothing brought out by this investigation persuades me that our people knew that EJA was doing more than having preliminary negotiations subject to CAB approval. \* \* \*

\* \* \* "The important thing now is to devote the company's efforts to salvaging as much of the investment as possible under present circumstances. [EJA was in fact effectively bankrupt and should have been written off Penn Central's books] \* \* \*

In fact, no independent investigation of EJA was ever made by the directors. Even a superficial investigation would have uncovered the conduct, the deception and the wasting of assets involving among others, the chief financial officer of Penn Central.

<sup>317</sup> Bevan asserted that he was doing what he could to keep the company going. While his motivation may be unclear (he had bailed out on much of his stock holdings in early 1969 when he could see the crisis which the company was in), he must have realized that his departure would expose him to liability for the activities which his successor might uncover, including EJA and Penphil.

<sup>318</sup> See in particular, Finance, Underwriting, Great Southwest.

paper, Bevan repeatedly made misstatements to the commercial paper dealer. Purchasers were continually buying this unsecured debt until May of 1970.<sup>319</sup> Bevan also made misleading statements to bankers to induce them to lend an additional \$50 million to Pennco. Bevan attempted to have an underwriter's lawyer who was becoming suspicious removed from an underwriting.<sup>320</sup> The board never asked about his dealings and they had not established any procedures for limiting Bevan's power or for monitoring his activities and representations.

#### FALL, 1969: GORMAN/GENGRAS—A BEGINNING REQUEST FOR INFORMATION

As reflected in their deference to Bevan following the August 1969 board meeting, the directors were aware by the fall of 1969 of the serious financial condition of the company. They were also generally aware that the railroad operations were experiencing continuing and serious difficulties which were causing large losses. They were unaware of the precise extent or cause of the financial or operational problems because that information was not being supplied to the board. The directors hoped for some kind of turnaround and cited the employment of Paul Gorman, which the board approved at the August meeting.

*Gorman.*—None of the directors could comment authoritatively on Gorman's hiring because the directors were not kept informed of the search. Saunders conducted the search and negotiated with Gorman on his own. The directors were not consulted during the search and no directors' committee was formed. Gorman was first approached about the job by Charles Hodge who knew of Gorman as a member of a country club of which Hodge was also a member.<sup>321</sup> Bevan and Saunders then discussed the position with Gorman.<sup>322</sup>

The hiring of Gorman was not a solution to Penn Central's problems. Without challenging Gorman's reputation as a cost controller, it can be said that in light of all the circumstances his hiring was an indication of Penn Central's dire condition. Gorman was Saunders' choice only after he had tried and failed to get any major railroad executive to take the job.<sup>323</sup> Despite the staggering crisis at Penn Central, Gorman's employment was not to begin until December 1, 1969, more than 3 months after he was hired.<sup>324</sup> Although he had no railroad experience he made no effort, aside from reading some annual reports, to inform himself about the railroad industry or about Penn Central. When he arrived he received some surprises. He had assumed that he would

<sup>319</sup> Commercial paper purchasers lost \$83 million. Despite misrepresentations by Bevan, the commercial paper dealers had ample warning of Penn Central's problems and should have taken appropriate action. See the section of this report on the sale of commercial paper.

<sup>320</sup> See section on Public Offerings.

<sup>321</sup> The directors cite the arrival of Gorman as an example of the efforts to secure competent management after they discovered the problems plaguing the railroad. The directors, however, played virtually no role in selecting Gorman or even in deciding whether a new president was needed. Saunders presented the whole matter as an accomplished fact.

<sup>322</sup> In fact, Hodge first approached Gorman at the country club. Hodge was not a director of Penn Central but he was influential; he was involved in the diversification efforts (particularly with GSC and Maccos); he was a member of Penphil; he was involved in EJA. The directors knew nothing of Hodge's role in the hiring of Gorman.

<sup>323</sup> The directors acknowledge that they knew this to be the case. They still felt that Gorman would be the right man. This view would appear to be a result of wishful thinking and lack of an understanding of the fundamental problems.

<sup>324</sup> One month was spent on vacation.



have control of accounting, but he found that Bevan had been given responsibility for accounting. Control over accounting would seem to be of particular significance to cost cutting activities. He also shortly learned that Saunders' management approach tended to be arbitrary and unrelated to reality. He also began learning of dubious accounting practices. This led to his calling a finance committee meeting on May 5, 1970 (described elsewhere), at which he confided his growing concerns about management and accounting practices at Penn Central.

*Gengras.*—During the time Saunders was involved in a search for a new president he acquired a new director, Clayton Gengras, again with the aid of Charles Hodge.<sup>325</sup> Gengras was the chief officer of the Security Insurance Co. of Hartford. The insurance company had begun making moderate purchases of Penn Central stock in 1965. In the early summer of 1969 Gengras learned through investment counsel to Security that Hodge was trying to interest a number of investors in Penn Central with a view to reorganizing the company.<sup>326</sup> At Hodge's invitation Gengras met with Hodge, Saunders, and Bevan in Hodge's office in New York. Hodge made a presentation in which he outlined a plan to have the soon-to-be-formed holding company controlled by new, more active directors than those on the railroad board. Saunders supported Hodge's presentation.<sup>327</sup> The insurance company then purchased 200,400 shares between August and December 1969 through Hodge's firm, Glore, Forgan & Co.<sup>328</sup> Gengras was then nominated to the holding company board by Saunders. Gengras was later added to the Transportation Company board after one of the directors remarked to Saunders about the peculiarity of having Gengras on only the holding company board. None of the other directors knew anything about the circumstances of Gengras' acquisition of stock. They testified that they assumed Saunders was naming him to the board because he happened to own a large block of stock.

*Information.*—In the fall of 1969, some of the directors were becoming concerned about the lack of information. At the same time, Robert Odell began raising questions about GSC openly in the board meetings. Under this growing restlessness Saunders asked the directors for suggestions on the presentation of information to the board. Louis Cabot and William Day responded in writing.

Cabot was a new member who had attended his first meeting in May 1969. His freshness to Penn Central as well as his experience with boards of his own companies may have assisted him in cataloging with some precision the information that had long been missing:

I believe directors should not be the managers of a business, but they should insure the excellency of its management by appraising the management's performance. To do this they have to measure that performance against agreed upon yardsticks.

So my first suggestion is that it would be most useful to the directors to have management tell us in quantitative terms what it is trying to accomplish. For Penn Central this is, of course, a complicated combination of a number of things. Even if you yourself have a clear picture of these objectives, it is most difficult for your directors to have one unless a careful job is done of painting a clear one

<sup>325</sup> The other directors knew nothing of the role of Hodge in Gengras' coming to the board.

<sup>326</sup> Gengras himself had a reputation for gaining control of and reorganizing companies.

<sup>327</sup> This description is based on Gengras' recollection. Hodge refused to testify on fifth amendment grounds. Bevan and Saunders were vague. Saunders admits to the meeting with Gengras in Hodge's office, but he denies having initiated a program of obtaining new directors.

<sup>328</sup> The stock, which was purchased for \$8,127,207.71, was held by Security through the bankruptcy of the railroad.

for us. The more complicated it is, the more valuable it can be to help the directors separate the important from the unimportant; and the more surely they should not get involved in details.

My second suggestion is that the directors be given, perhaps annually, an opportunity to review objectives with the management, and endorse them. I refer to both long-term direction type objectives and short-term targets. This is the only way we can give any input at all as directors without being in the position of second guessing after the facts. Furthermore, it can give management some assurance that the board supports what it is trying to do.

My third suggestion is that the directors be told periodically how actual results are working out as against the short term targets. Where are their shortfalls? What were the reasons? Were they some things not foreseen and beyond our control, or were they Penn Central shortcomings that need more attention.

To take a specific example, how does the \$40 million we have lost in transportation so far this year compare with what it should have been? Did the directors know what anyone thought we would earn or lose? And on the basis of that expectation did they agree with what management was planning to do; that is, capital investment, cost cutting, services added or abandoned, organization changes? Why did we miss? It's not very helpful to be told the railroad business is terrible. What didn't work the way we could have expected? The economy? Unusually high strike activity? An unexpected action by the ICC? Furthermore, if these kinds of losses are unacceptable, which I presume is the case, what shall we do different to reverse them? How and when can we tell whether the changes are working?

I do not think directors should know about every real estate deal, but I do think they should know what we are trying to accomplish. Are we trying to use up tax credits, or make large capital gains, or add to current earnings by a steady stream of profitable small trades, or what? How are we doing? How much capital should we devote to real estate? And what do we think lies ahead?

I am more concerned about our overall finances. How much longer are we going to invest vastly more than our cash flow? Are we trying to borrow all the money we possibly can or is there a prudent limit? If so, what is it? Are our plans consistent with it?

I think I can defend myself as having been diligent as a director if I have the opportunity to participate in and vote on such issues as I have listed. If not, I don't think I can. I certainly cannot merely by listening to a long list of railroad capital expenditures once a month. (Cabot letter to Saunders Oct. 28, 1969).

In reply, Saunders assured Cabot that his letter would receive careful consideration but he went on to give his opinion that much that Cabot saw as necessary was already being supplied in the reports given by Bevan, Perlman, and himself. The information, in fact, was not supplied and was not requested by anyone other than Cabot, and, to some extent, by Odell.

William Day also wrote to Saunders but his views were more toward the picture being presented to the Government and the public who were responsible, according to Day, for the railroad's problems:

The other evening I sat beside Harold Geneen of I.T.T. and had an interesting talk with him about the outlook for conglomerates and his general philosophy regarding the course of American business. He said he thought that Penn Central was making a great mistake in not "exposing the railroad in all its nakedness to the public" so that the public and, in particular, legislators would realize what a poor performance, under present ratemaking practices, the railroads are experiencing.<sup>329</sup> I mentioned Hal's comments to Jack Seabrook before the meeting and I think this is what prompted his comment.

It seems to me there is a great deal of merit in this suggestion. I realize that we must present the consolidated picture to Penn Central stockholders but we have been tending to cover up the poor results from the railroad operation rather than exposing them.<sup>330</sup> As was indicated in the meeting, presenting the railroad

<sup>329</sup> Penn Central's problems were much deeper than ratemaking; in fact Penn Central had difficulty in getting other roads to apply for the rate increases of the size wanted by Penn Central.

<sup>330</sup> The disclosure of the losses from the rail operations was never made public until the counsel for the underwriters put it in the \$100 million Pennco debenture offering circular in April 1970.

operation by itself would require a number of adjustments but I really feel this should be done. We just cannot go on forever having the profits of other operations almost completely absorbed by losses in railroad operations.<sup>331</sup> (Day letter to Saunders Dec. 1, 1969.)

With this reply, Saunders attached the published third-quarter income statement which, he stated, showed the separate railroad losses. Unless the reader knew how the figures were assembled, and could thus rearrange the figures, the statements did not show the losses on railroad operations. Saunders, however, did touch on the real reason for not providing full disclosure:

I recognize that there is merit in "exposing the railroad in all its nakedness to the public." On the other hand, if we go much further than other railroads go in this regard, our figures are not comparable.<sup>332</sup> Moreover, I think our picture is bleak enough to achieve most of the results that we need from the point of view of legislation and regulatory agencies. If we go too far in this regard, we also get ourselves in greater trouble so far as our financing is concerned. I am, however, in complete accord with you that the Board should have all these facts.

Penn Central had already overextended itself on financing and Saunders was aware that full disclosure would shut off further financing and probably begin a run on commercial paper. It probably also would have led to the removal of senior management.

Each of these letters reflects the views of two different types of Penn Central directors. Cabot was a new director concerned about what he was learning and what information he needed to function as a director. Day was a director of long standing from the Philadelphia area. He tended to view a director's responsibility to be solely that of backing management rather than representing the interests of shareholders; consequently his letter reflects problems he felt management was having with the government rather than his concern about disclosure to shareholders. Directors with Day's outlook far outnumbered directors with Cabot's outlook.

#### ROBERT ODELL ON GREAT SOUTHWEST AND MANAGEMENT

The unwillingness of the directors to see to adequate disclosure or to the integrity of management is demonstrated again in issues raised by Robert Odell in late fall 1969.<sup>333</sup> Odell had expressed reservations about the real estate subsidiaries when the matter came up before the New York Central board in 1966 in connection with the increase in Pennsylvania Railroad's debt ceiling. As described in the section of this report on Great Southwest, Odell had also written to Saunders in 1968 about his concern. He was right in his earlier expressions of concern and he was right in late 1969 when he voiced his concerns at several board meetings. At the October board meeting an executive session (excluding officers who were not also directors) was held at Odell's request. At that session he expressed his concerns about the real estate subsidiaries.

The Penn Central management sought to undermine his position by emphasizing that Odell had a conflict because he had a California real estate company of his own. Many of the directors, principally

<sup>331</sup> Day was apparently unaware that much of the nonrailroad earnings were paper earnings.

<sup>332</sup> If any comparability problem existed, an alternative presentation, with appropriate clarification, could have been supplied along with the standard format.

<sup>333</sup> Odell had not been able to attend the August and September board meetings and never learned of the proposed investigation of EJA and Bevan.

those in the Philadelphia area, accepted this argument and even cited it to the staff during its investigation. The directors apparently ignored the fact that Odell's knowledge of real estate development, particularly in California, might lend credence to his concerns.<sup>334</sup> The directors also ignored the simple solution to any conflict problem of conducting an inquiry into the affairs of the real estate subsidiaries in such a way that Odell would be excluded from access to inside information.

It is important to note that at the time Odell was pressing his concerns before the board the directors were unaware of the enormous problems in Great Southwest. The directors had been puzzled about the Six Flags Over Georgia amusement park sale in 1968 and Saunders had sent a reassuring, if misleading, letter to the directors. The directors admitted that even after they read the letter they were still unable to understand the transaction. In addition, by the fall of 1969 the price of Great Southwest stock, about which Bevan had earlier boasted, was plunging. Further, despite the supposed enormous "earnings" contribution of Great Southwest, the Pennco board in December 1969 approved a "forgiveness" of a \$25,000,000 debt owed Pennco by Great Southwest through the exchange of Great Southwest stock for the debt. The debt represented cash advances from the railroad to GSC to meet the continuing cash losses in the subsidiaries.<sup>335</sup>

Many of Great Southwest's problems were of vital interest to the parent company. These interests included the earnings (which appeared in the parent's consolidated results), the cash flow from the parent down to the subsidiaries, and the value of Great Southwest stock in Pennco's portfolio. Further, the Penn Central management dominated the affairs of Great Southwest. This raised the question of the obligation of the directors of the parent to see that the dominance was not adverse to the interest of the minority shareholders. The directors failed to make even minimal inquiries into Great Southwest when the matter was forcefully and repeatedly brought to their attention by Odell and by circumstances.<sup>336</sup>

When Odell encountered opposition from management at the board meetings he decided to invite the nonmanagement directors to a dinner meeting on November 25, 1969, the evening preceding the scheduled board meeting. The invitation prompted communication between Saunders and several directors and among several directors, principally those living in the Philadelphia area.<sup>337</sup> Saunders and the directors who rejected the invitation deny that they were attempting to prevent Odell from having such a meeting, but it appears from the pattern of communication and the pattern of rejections that an effort was made by management and directors favorable to management to prevent

<sup>334</sup> A director who was asked whether he had attempted to learn from Odell what information he had about the real estate subsidiaries stated that such an inquiry would be meaningless because of Odell's possible conflict of interest.

<sup>335</sup> See page 139.

<sup>336</sup> During testimony, many of the directors even in hindsight viewed Odell as an annoyance. One director, when asked what was done about the questions raised by Odell after he left the board replied that the problems ceased. When further questioned about how he knew the problems had ceased, he replied that Odell had left the board. It became apparent that the problems as seen by the director was not GSC but rather Odell himself.

<sup>337</sup> The Alleghany contingent and some others, principally those not living in the Philadelphia area, were inclined to accept the invitation but Odell canceled the meeting when he learned of the number of rejections.

Odell's meeting from taking place. At the board meeting on November 26, Odell read a prepared statement and then moved to have Saunders and Beven effectively removed from control and to have Perlman placed in control. The motion was not seconded.

On December 17, 1969, a Pennco board meeting was called by Saunders to obtain board approval for the exchange of GSC stock for debt owed by GSC to Pennco and to approve a sale of 2 million shares of stock to the three principal officers of Great Southwest.<sup>338 339</sup> At the Transportation Company board meeting on December 17, 1969, Great Southwest officers made a presentation to the board, apparently as part of an attempt by management to undercut Odell. The presentation consisted principally of slide photographs of the Great Southwest real estate. No solid information on Great Southwest conditions or problems was presented. No detailed information about the properties was supplied, nor was information on cash flows or costs presented. Directors favorable to management testified that they were satisfied by the presentation of the Great Southwest officials. Others characterized it as a "slide show" and a "dog and pony show." Odell asked for more information.<sup>340</sup> Bevan told the board that Great Southwest had an independent board. He neglected to say, however, that Penn Central management dominated Great Southwest. Saunders then assured Odell that procedures for reviewing the activities of the subsidiaries would be recommended to the board.

On January 8, 1970, Odell wrote to the Pennco board about a recent newspaper report that Great Southwest had acquired I.C. Deal Co. for approximately 1 million shares of GSC stock. Odell stated that this was yet another demonstration of Great Southwest activities taking place without Penn Central knowledge. He stated that the Pennco board should consider and investigate transactions of this magnitude before they were entered into by GSC. Apparently management saw this letter as an opportunity to undermine Odell. They could try to say that Odell was not interested in investigating Great Southwest and its transactions but that he really wanted Pennco to operate Great Southwest. Penn Central management then met with members of the law firm of Dechert, Price & Rhoads, frequently used by Penn Central.<sup>341</sup> Management indicated that problems they were having with Odell and indicated that he was something of a "troublemaker".

Odell's long-standing objections were that Pennco should take a closer look at Great Southwest's activities including its management and its major transactions. Penn Central management knew that such examination would prove extremely embarrassing. Some of Great Southwest's earnings, which contributed to Penn Central's results, were inflated earnings which did not present an accurate picture of the performance of Great Southwest. They also knew that in terms of cash the railroad was supporting Great Southwest, contrary to the understanding of the public and the Pennco directors. There were a number of other embarrassing facts about Great Southwest including

<sup>338</sup> These proposed transactions are discussed in the section on Great Southwest Corp.

<sup>339</sup> Gorman had refused Saunders' invitation to join the Pennco board at that time because he had doubts about the reasons behind, and the propriety of, these proposed transactions and did not want to have to pass on them.

<sup>340</sup> Odell had shortly before requested information on specific matters by letter.

<sup>341</sup> Dechert was at that time involved in other matters relating to Great Southwest. They were supplying legal advice to the Pennco board on the proposed sale of 2 million Great Southwest shares to Great Southwest officers and on the exchange of stock for debt. The Dechert firm later prepared the bankruptcy petition in June 1970.

the payment of \$7 million to four Great Southwest employees to renegotiate their employment contracts. Penn Central management and Dechert, however, decided to treat Odell's request as though he wanted the Pennco board to operate Great Southwest. Where Odell in his January 8, 1970 letter spoke of investigation and consideration of major transactions of the size of the I.C. Deal Co. acquisition,<sup>342</sup> Dechert's opinion referred to a question of prior review of "all material transactions" and of "formal action" to be taken by the Pennco board on all of such transactions.<sup>343</sup>

The Dechert opinion went beyond the issue of "formal action" on "all material transactions," however, and referred to the role of Great Southwest's "independent board and the independent management to establish policies and manage its business" and to the dangers of violating Federal securities laws in having Great Southwest furnish "inside" information to the Pennco board.<sup>344</sup> In fact, Penn Central already dominated Great Southwest.<sup>345</sup> Further, Penn Central already possessed an abundance of vital adverse "inside information" which neither it nor Great Southwest had shared with minority shareholders.

Dechert's opinion did not go unchallenged. Hanley told Leslie Arps<sup>346</sup> in mid-January that Saunders had said that the Dechert firm would give an opinion that Odell's request would violate the securities laws because Great Southwest would be giving Pennco inside information. Arps spoke with Carroll Wetzels, the Dechert partner who wrote the opinion, and stated his opinion that Pennco had an obligation to be informed of Great Southwest's affairs, particularly since Great Southwest's earnings were consolidated with Penn Central's. Arps stated that the securities laws do not prohibit a majority shareholder from having inside information but only from abusing it. Arps also responded to Dechert's warning that if Pennco got involved in Great Southwest affairs the board would be held liable

<sup>342</sup> From Odell's letter of January 8, 1970 to the Pennco board:

SAN FRANCISCO, CALIF., January 8, 1970.

Again I am distressed to learn from newspaper reports that Great Southwest Corporation has apparently made a commitment valued at between \$17 million and \$26 million without prior approval of the parent company.

In my opinion this is absolutely wrong in every respect and places all Directors of the Pennsylvania Co. in jeopardy.

Over and above legal aspects, transactions of this size should have careful prior consideration and investigation by the directors before any commitment is made.

Prior to consideration, back-up information should be furnished to each director embracing complete financial statements, independent appraisals and forecasts from a recognized firm of management consultants with complete detail concerning ownership and management of the company proposed to be acquired.

<sup>343</sup> From the Dechert opinion of January 21, 1970 addressed to the Pennco directors:

"We have been asked whether in our opinion it would be proper for Pennsylvania Co. to attempt to require Great Southwest Corp. to advise Pennsylvania Co. of all material transactions contemplated by Great Southwest before commitments are made so that prior consideration and investigation of the transactions might be undertaken by Pennsylvania Co.'s board and formal action taken with respect thereto by the board.

"Pennsylvania Co. owns more than 90 percent of the voting shares of Great Southwest and the remaining shares are publicly held. A majority of the directors of Great Southwest have no affiliation with Pennsylvania Co. other than in their capacity as Great Southwest directors.

"The procedure described above is not required by the laws of any applicable jurisdiction and in our opinion would not be proper, except with respect to transactions required by law to be approved by the shareholders of Great Southwest or with respect to which Great Southwest deems it desirable to have shareholder approval."

<sup>344</sup> "The role of Pennsylvania Co. as a shareholder of Great Southwest is to seek the election to the board of Great Southwest of qualified persons who will prudently direct its affairs and elect competent officers to operate its business. Its role is not to interject itself in the business affairs of Great Southwest. Great Southwest is a publicly-owned corporation with an independent board and independent management to establish policies and manage its business. Diverse ownership imposes on Great Southwest the duty under the federal securities laws not to disclose so-called "inside information" which is not available to the public generally. Moreover an attempt by the board of Pennsylvania Co. to exercise a management role as to Great Southwest might well result in imposing liability on Pennsylvania Co. for Great Southwest obligations. (Dechert opinion letter Jan. 21, 1970.)"

<sup>345</sup> See section of this report on Great Southwest.

<sup>346</sup> Of the Skadden, Arps, Meagher & Flom law firm, counsel to the conflicts committee.

for Great Southwest's obligations because of the existing relationship between the companies. Neither firm, apparently, knew of the state of affairs of Great Southwest or of the true relation between Great Southwest and Penn Central but Arps' position was certainly closer to reality. Dechert apparently had written an opinion tailored to the tactics of Penn Central management and had made no inquiry into the facts. Saunders knew of both opinions but communicated only the Dechert opinion to the directors. The other directors paid little attention to the whole matter, particularly because Odell was "solving" the problem for them by leaving.<sup>347</sup>

### THE FINAL MONTHS

If the directors had demanded adequate information, they would have known from the beginning that Penn Central was suffering serious operational and financial problems. It is probable that they would also have discovered the devices by which management sought to conceal the facts from shareholders and the public. Through late 1968 and early 1969, the problems became sufficiently critical that the directors were forced to note their existence although the directors were still able to avoid a confrontation with management. In the summer and fall of 1969 the situation deteriorated further. The directors were aware of the seriousness of the situation as is indicated by their reaction to Bevan's threatened resignation.

By the winter of 1969-70 and early spring of 1970 the directors knew that the situation was grave. Ironically, they were less informed about current developments than they had been earlier because the pace of events was accelerating even faster and the web of deception was becoming exceedingly intricate.<sup>348</sup> Some directors still nourished the ephemeral hope that a revival would occur under Gorman, but Gorman himself was learning some rude lessons about the company's affairs.<sup>349</sup> Some directors indicated that the bad weather in late December and early January made things look worse than they were at that time. This appears to be a thin thread of explanation because even though the bad weather increased the difficulties for a brief period, the decline quickly resumed its normal worsening rate after the bad weather passed.

During this time the management, the directors, and the company began to disintegrate. Some directors talked privately with manage-

<sup>347</sup> In a letter to Bevan on Feb. 5, 1970, copies of which were circulated to all directors along with his resignation letter, Odell expressed his views on the origin of the Dechert opinion:

I thoroughly disagree with the opinion of Dechert, Price & Rhoads, which is obviously "tailor-made," and the attitude of the Pennsylvania Co.'s board of directors and management in respect to the Great Southwest Corp., as expressed in your letter of Jan. 22.

Any time a company or an individual has an investment of over 80 percent in a company or a venture, they are entitled to know and should know in detail the policies that are being pursued and should have an intimate knowledge of the company's operations and investments. This does not imply that the directors should act as the management but that they should always be in a position to guide the management if they so desire.

Great Southwest Corp. and Arvida Corp. are highly speculative and are exposed to possible large losses.

As a stockholder, I will be pleasantly surprised by these operations not becoming a disaster and further that the Penn Central and its subsidiaries under present management does not end up in receivership.

<sup>348</sup> One director described this period as "The Valley of Frenzied Finance."

<sup>349</sup> Because of his growing concern about what he was learning, he called a meeting of the finance committee which eventually met on May 5, 1970. Among other things he told the committee was that an analysis of earnings of the past 2 years showed that earnings suspiciously ballooned at the ending month of each quarter. According to testimony given by the directors this was the first time they had heard of the practice of inflating earnings or of possible improper accounting activities. Most of the directors who were not at this meeting testified that they were never aware of any questioning of the company's accounting practices.

ment about individual concerns or suggested solutions. No organized activity occurred. Management continued to hide the worst developments from the shareholders, although there was a decrease in the public expressions of optimism. Bevan continued to deal with bankers, the commercial paper dealer, the underwriters, and foreign lenders while concealing Penn Central's desperate condition. The directors were unaware of, and made no inquiries about, Bevan's dealings. They made no effort to inquire about what he was telling lenders but simply gave blanket approval to his activities. The directors did not know of the concern being expressed by the commercial paper dealer about First National City Bank's attempt to get more security on the revolving credit agreement or about the disclosure problems being uncovered by the counsel for the underwriters.

The directors were aware of some of the earlier discussions with the ICC and the Department of Transportation on passenger losses and equipment financing. Gengras, in fact, assisted Penn Central management in bringing Penn Central's request for assistance to the attention of Secretary Volpe. The first meeting was on March 12, 1970, in Secretary Volpe's office. Penn Central asked the DOT for help on (1) passenger service, (2) track abandonment, (3) State taxes, (4) permission to diversify into other modes of transportation, and (5) freight rate increases. At a second meeting on April 30, 1970, Penn Central supplied some 1970 forecasts. The company pointed out that even though it had been skimping on equipment and road capital, it had reached its borrowing capacity. Saunders suggested legislation which would provide loan assistance on equipment. The DOT, however, suggested that this might jeopardize pending passenger assistance legislation. The DOT asked for information about the company's cash losses.

The discussion still had not gotten to the question of an immediate crisis even though Penn Central knew at the time of the April 30 meeting that there was a runoff of commercial paper and that the prospects for selling the \$100 million Pennco debenture were practically nonexistent. O'Herron was more of a realist than his superiors and he persuaded them to send a memorandum to Volpe explaining the true crisis. Consistent with their form, Bevan and Saunders substantially diluted the memorandum but O'Herron got permission to carry it to Secretary Volpe in Washington. O'Herron made the trip on Friday, May 8 and located Volpe at his home. O'Herron warned Secretary Volpe that the condition of Penn Central was more critical than Saunders was admitting and that the debenture offering would probably never be sold. Secretary Volpe called Secretary of the Treasury Kennedy and arranged for a weekend meeting between Kennedy and Saunders at Hot Springs, Va., where a business conference was taking place. On May 19 Saunders, Bevan, O'Herron and Randolph Guthrie met Secretary Kennedy for discussions about an emergency loan. On May 21, 1970, Bevan officially informed the managing underwriters that the debenture offering had been abandoned. He conveyed the same information to First National City Bank and Chemical Bank on that day. On May 25 the Penn Central officials met with Secretary Kennedy.

The regularly scheduled board meeting was held on May 27. None of the directors knew about the May meetings with Government officials, and, consistent with their form, Bevan and Saunders sought



approval of the board to pledge all the company's assets after telling the directors only that the debenture issue had been canceled. Several directors were not willing to go quite this far without some explanation. Saunders and Bevan finally relented and stated that they had been in contact with Government officials about a guaranteed loan and that Penn Central was facing a terminal crisis. The board then gave its approval. Extensive negotiations with bankers and the Government followed. Finally, on June 8, 1970, under pressure from the banks and the Government, the directors removed Saunders and Bevan.

Throughout the entire Penn Central debacle, including the loss of many hundreds of millions of dollars by shareholders, the board had done nothing. It gave the management, principally Bevan and Saunders, almost unlimited freedom to do as they wished. The board repeatedly failed to act despite direct and clear warnings. It is not necessary to say whether the bankruptcy of the Penn Central was caused by mismanagement and malfeasance. We can say, however, that during the decline of Penn Central its management acted improperly and engaged in conduct designed to deceive shareholders, and that the directors apparently made no effort to uncover or control this misconduct.

## I-G. DISCLOSURE

### GENERAL

The fact that Penn Central was experiencing difficulties did not come as a surprise to shareholders but the severity of the difficulties did. There had been problems in the railroad industry for years and it was recognized by most knowledgeable persons that the problems were more severe among eastern roads than among some other classes. Financial results and operational trends were there to be seen, despite management attempts to cover them up. However, these trends had been present for many years and there was no particular signal that Penn Central was now reaching the end of the road. Certainly, nothing the company and its officials said in their public statements would indicate it. Indeed, steps were being taken which were clearly designed to conceal from the public just how desperate the situation was.

The adequacy of disclosure depends principally on the fairness of the overall picture being presented to shareholders. Shortly after bankruptcy, one of the trustees noted in testimony before a Senate committee, "I don't mean to be pious but if you think of it in terms of technical accuracy of what is said, that is one thing. If you think in terms of what was reasonably conveyed, that is another. On the basis of the second, I think there is a real question about the accuracy of the picture that was conveyed."<sup>350</sup> It is clearly the latter standard which is the one applicable under the antifraud provisions of the Federal securities laws. In this connection, the size and complexity of the Penn Central organization, which was compounded by the widely varying nature of the different segments of its business, should be considered. The fact that relevant information is buried somewhere in the data and statements made to the public is not sufficient. It must be presented in a manner designed to reasonably inform the average shareholder of the significant events, figures and trends. See, for example, *Robinson v. Penn Central Co.*, (CCH Fed. Sec. L. Rep. ¶ 93,334 ED Pa. 1971) where the court makes it clear that this is the standard to be applied, further noting that significant facts and possible consequences must be highlighted and "conclusory statements and bare facts without a disclosure of the key issues" needed for intelligent decision are not sufficient. Furthermore, the concern is not with what the sophisticated analyst could ultimately discern from reported information but what is understood by the reasonable shareholder.

### RAILROAD OPERATIONS: THE MERGER

The merger of the Pennsylvania and New York Central railroads was repeatedly held out, both before and after the merger, as a strongly positive factor for the future, despite internal misgivings. The position was publicly held by Penn Central until the end, in mid-1970.

<sup>350</sup> Hearings on S. 4011, S. 4014, and S. 4016 before the Committee on Commerce, 91st Cong., second sess., part 3, at 681 (1970).

Certainly the industry had basic problems, but public attention was distracted from these by the expectations the merger had bred.

Statements made by management in the early months of 1968 were highly optimistic, although the company indicated that railroad earnings were down sharply in 1967 due to industrywide problems.<sup>351</sup> The letter to shareholders included in the 1967 annual report began: "Consummation of the Penn Central merger on February 1, 1968, began an exciting chapter in the annals of American business." After other remarks, the letter continued:

As a transportation system, we are modernizing our properties and making technological advances which will improve our service and efficiency.

Although we are just getting started, the transition and progress of our merger has been smoother and more rapid than we had anticipated. Sound and comprehensive planning while we awaited consummation enabled us to evolve a close working relationship between the two companies.

A remarkable spirit of cooperation and enthusiasm is manifest throughout our new organization. We are confident that we have a talented, experienced, and well-qualified management team for the years ahead, and we consider this a very important asset.

One of the great strengths of Penn Central lies in the fact that we are uncommitted to traditional approaches. We are adopting the best practices and procedures of each of the former companies.

We start with a foundation of solid achievement on which to build. Since 1961, Penn Central has had the largest capital expenditure program in the railroad industry for acquiring new freight cars and locomotives and upgrading facilities.

Penn Central is in the forefront of the rail industry in adapting computer technology to virtually every phase of the railroad business. We will stress innovation in transportation techniques, marketing concepts, and scientific research.

It is clear with hindsight that the optimistic picture being painted in the paragraphs quoted above was not justified. Management could not be, and obviously was not, unaware of the very severe personnel problems extending through the top levels of management and the compromises this had occasioned. While perhaps hopeful of an eventual resolution of these problems, it was improper to make assertions as to a "remarkable spirit of cooperation and enthusiasm." The departure of key personnel in the "talented, experienced, and well-qualified management team" had already been announced, while claims of selecting the best practices and procedures, uncommitted to traditional approaches should be considered in the context of the prior discussion on premerger planning. Likewise the extent of "sound and comprehensive planning" should also be assessed in light of that discussion.

Virtually every sentence of the paragraphs quoted was misleading. The statements as to modernization, technological progress and the capital expenditure program since 1961, suggest an up-to-date modern plant which clearly did not exist, a fact which management had been swift to point out in the ICC merger hearings, where the witnesses bemoaned the sorry state of the road's capital plant and equipment. Their state at merger date has been characterized as only "fair" or "poor" by witnesses in a position to know.<sup>352</sup> In light of the problems which developed subsequently with computer operations, and the lack of premerger consensus in that area, the reference to computer tech-

<sup>351</sup> Penn Central never completely eliminated mention of industry problems. Such factors were already known to the public anyway and furthermore, did not reflect on the ability of management. In addition they were necessary to explain to shareholders the reasons for any earnings decline which did show up on the financial statements.

<sup>352</sup> Several former Central employees testified that upon visiting former PRR properties right after merger they were appalled—that they knew it was bad but had not expected it to be this bad.

nology appears absurd. It is only in the statement that "the transition and progress of our merger has been smoother and more rapid than we had anticipated," that it is conceivable that management may have been merely myopic. It was very early and the ensuing problems, although predictable, had apparently not fully developed by that point. However, management might have noted for the benefit of shareholders that no significant attempt had yet been made to integrate the operations of the two roads and that the "sound and comprehensive planning" for this event had been scuttled in favor of an accelerated, ad hoc approach.

The letter to shareholders was dated March 15, 1968. Basically the same position was taken by management at the annual shareholders meeting held in May and similar claims were set forth in various speeches made by management during this period.<sup>353</sup> Claims were made on several occasions that the improved earnings in the first quarter of 1968 were an indication of the company's progress in realizing the projected merger efficiencies and economies,<sup>354</sup> although the staff found no evidence on which to predicate such a position. Indeed, as noted earlier, internal confusion within Penn Central at this point in time was such that it seems apparent that no one was in a position to assess much of anything.<sup>355</sup>

These generally optimistic statements on the part of management, as reflected in public speeches and press releases, continued throughout the summer.<sup>356</sup> For example, in a speech given to the New York Security Analysts' group in September 1968, Saunders made very optimistic statements as to merger benefits. They would be a great deal larger than projected and would be realized sooner than anticipated, he indicated. Implementation of the merger was ahead of schedule, with excellent progress in completing connections and consolidation of facilities, it was claimed, and the company was attaining faster schedules, more efficient yarding and operational savings through use of optimum routes. Without attempting to directly refute these claims, it is clear that at best they presented only part of the story. Regardless of what the future might eventually bring (and this was highly problematical), Penn Central was at this moment faced with severe operating problems, the very real results of its attempts at merger acceleration. The high hopes were mentioned, the immediate problems were not.

Saunders' speech also reiterated the party line that the thorough premerger planning would yield handsome returns, that there was a fine esprit de corps with no major personnel problems, and the presentation included strong praise of the equipment fleets of the two roads.

<sup>353</sup> On some of these occasions overall industry problems were mentioned and on other occasions they were not, but the overall picture presented was decidedly one of optimism.

<sup>354</sup> According to reports filed with the ICC the net railway operating deficit for the combined road showed small increase between the first quarter of 1967 and 1968. The improvement came in other areas.

<sup>355</sup> Actually, since merger implementation was not really started until the third quarter, this appears to be one of many instances where management was jumping the gun, and reporting things as it wished them to be rather than as they actually were.

<sup>356</sup> In a speech to the Investment Analysts Society and the Transportation Securities Club in Chicago on April 16, 1968, Bevan painted a somewhat less optimistic picture of Penn Central's outlook, reflecting the low rates of return on railroad assets and the fact that merger benefits would not come immediately. The low working capital and cash position was also alluded to.

In a memorandum to Bevan dated April 19, 1968 Saunders indicated that in speeches and interviews with security analysts all officers should "adhere to a common theme" in discussing the merger and its prospects, as well as earnings and any related matters. Henceforth, Saunders stated, all officers must obtain his approval of the text of major speeches on this subject.

On May 29, 1968 Bevan made a presentation before the Pittsburgh Society of Financial Analysts. It was much more optimistic than his previous speech. He testified that that speech was scheduled before he received the memorandum from Saunders and therefore he went through with it, but that he made no more speeches thereafter except at the annual meetings, because he would not comply with Saunders' directive.

This was while Perlman was fighting for additional capital expenditures to improve what he was indicating was the highly unsatisfactory condition of the facilities, track and equipment. Saunders, in his speech also commented on the tremendous savings available in per diem costs, although at the end of that year he attributed \$15 million in extra per diem costs to the merger service problems which had already developed and the record in this area remained poor through 1969. In the passenger area, it was stated that losses on these operations were a deplorable drain on earnings but presented a "great opportunity in improving earnings and this could be a real asset over a long period of time." Since the passenger loss area was the one which the company most persistently pointed to as a source of problems, this may well have been one of the occasions where Penn Central officers were commenting among themselves on Saunders' rose-colored glasses.

In a year-end statement, released to the public, management presented the railroad situation as follows:

It will take several more years to integrate our railroad system completely and benefits in terms of savings, service and growth will accumulate as this work progresses. We expect in 1969 to reap greater benefits of merger than we did in 1968.

During the 11 months of 1968 in which we have been a newly merged company, Penn Central has made great progress in the formidable task of physically combining properties and molding two formerly separate managements into a single cohesive organization.

In physically integrating our railroad system, we are ahead of schedule with our program of consolidating yards and terminals, interchange and connecting points, and shops and maintenance facilities. . . .

These and other projects encourage us to anticipate a gain in income from rail operations in 1969. We are aiming for an increase in freight revenues reflecting strong trends in the national economy. . . .

We will continue to make capital improvements during 1969 in order to provide better service and more efficient operations.

The tone was changing subtly, the enthusiasm moderating somewhat. However, no mention was made of the service problems which, according to later management claims, peaked at about this time, costing the company \$65 million in lost revenue, overtime and extra per diem costs in 1968.

Actually, by the time of the year-end statement it was well recognized that there were severe operating problems on the Penn Central, this being perhaps the dominant subject of conversation in the railroad industry. Considerable management attention was directed, somewhat unsuccessfully, to diverting the press from writing about these difficulties. In mid-January, 1969, Perlman acknowledged the problems in a speech to the Atlantic States Shippers Advisory Board, admitting, in something of an understatement, "Quite candidly, our service is not as efficient as we desired it to be at this point of merged operations." He then went on to discuss in some detail various steps Penn Central was taking to improve the situation. In a speech to the New York Traffic Club on February 20, and included in a company press release, Saunders stated "We are eliminating much of the confusion and misrouting which occurred in recent months. Our operating department now has a much firmer grip on these problems and I believe that our service difficulties have bottomed out. Yes, I am satisfied, we have turned the corner and this has become more evident to us in terms of

the marked upturn in our business in recent weeks.”<sup>357</sup> He also indicated that “the earning potential of our railroad system has turned the corner and is heading for a much better showing.” While management purportedly took months to recognize the service problem, or rather to admit it recognized it, it recognized the purported improvement almost immediately! Management was unable to show the staff any reasonable justification for these “turning the corner” claims, in light of the uncertainty of the conditions at the time and the very short time period on which the claimed improvement was based.<sup>358</sup> As noted in the section on operations, certainly the accuracy of its prior predictions had given management no basis for confidence in its ability to predict accurately in this area and subsequent experience also bore this out. It is clear that, at best, management did not have a sufficiently accurate picture of what was going on in the company to be making any positive predictions for public consumption. Its statements have to be classified as merely wishful thinking, not an adequate basis for the statements made.

In a release in January 1969, announcing preliminary 1968 results, management failed to mention directly the existence of the merger related service problems. However, the problems were specifically alluded to in the shareholder letter contained in the 1968 annual report. “We have encountered a number of operating problems in combining road operations and consolidating facilities. Some of these problems are still unresolved but we have turned the corner and the worst is behind us.” However, statements concerning the favorable progress in 1968 in implementing the merger which came immediately before the quoted statement, and optimistic statements at the close of the letter as to future prospects for improved service and savings were obviously designed to downgrade the impact of such disclosures.<sup>359</sup>

The same generally optimistic theme was played again throughout the ensuing months. Heavy merger start-up costs were continuing but, it was claimed, the company was now realizing significant benefits and giving better service than before the merger. The company was regaining business lost because of service problems and this would continue. Even if this were technically true, and that is open to serious question, it gave an impression of overall strength and potential in railroad operations not justified by the record. Any improvement was minimal when contrasted with the overwhelming problems faced. No mention was being made of the arbitrary budget cuts being imposed on the operating departments, which it could be foreseen would adversely affect service even further.

At a staff luncheon on December 1, 1969, Saunders spoke of the need to revitalize the company. He stated:

We are at a critical point in the history of our company. We face an urgent need to produce merger benefits of increasing quantity and quality. We must make money on this railroad, and in the process improve our service, lower our costs, and enlarge our volume of profitable traffic.

It is entirely possible that the next 6 months will be the most critical in the history of our railroad. Frankly, our customers are apprehensive about whether

<sup>357</sup> Cole in his testimony characterized Saunders as “the most optimistic man I’ve ever known.”

<sup>358</sup> One security analyst, in a report dated January 2, 1969, indicated that management had told him in October that while they recognized that service had been atrocious, by virtue of educational efforts and heavy capital expenditures for improvements, service had already at that early point begun to improve.

<sup>359</sup> At the shareholders meeting in May 1969, the operating problems were mentioned almost as an aside in the midst of an extremely favorable picture of merger progress and potential.

or not Penn Central can meet the test of adequate service during the winter months. If we do not, it is certain that we will have wholesale diversion of business which we could probably never regain.<sup>360</sup>

As you know, we are being given a second chance by a number of shippers who were extremely dissatisfied with our service last winter. If we fail them again we cannot expect to get another chance.

No indication of this and of the recurrence of service problems on the railroad was mentioned in public releases at that time.

Subsequent to the filing for reorganization, when asked why Penn Central had not pointed out its problems sooner, Saunders pointed to testimony he gave in connection with passenger aid legislation (which eventually led to Amtrak) being discussed before Congress in November 1969. He stated then that "our problem cannot wait another year or even another few months. The house is on fire and we cannot sit around and talk about the best way to put it out while it burns completely down."<sup>361</sup> This comment, taken in isolation, might indeed appear to be an indication of impending collapse. However, taken in the context of other circumstances, it is merely illustrative of one side of a dichotomy facing management. Management fully understood the immediate desperation of the circumstances. It could not survive without outside help. They sought it on one hand by telling the Government how critical the situation was. But they also needed help from the financial community and could not afford to alarm this element.<sup>362</sup>

Penn Central was forced to walk a tightrope. Congress was told the situation was bleak, but management stressed the problem as industrywide without focusing on Penn Central.<sup>363</sup> Furthermore, it was recognized that the presentation was being made from an advocate's point of view, further minimizing the impact. And this was nothing new. Saunders in his testimony quoted from an ICC study made 10 years earlier in which it was concluded that the financial loss on passenger business was large and growing, and that it endangered the welfare of the industry. And at the 1969 shareholders meeting, in response to a question from the floor as to whether Penn Central could continue to absorb the passenger loss, or indeed the overall railroad problem, Saunders brushed this off by saying that the same situation existed in each of the last 10 years except 1966. "This is nothing—people act as though this had never happened before."

Three weeks before his Congressional testimony, Saunders had told a group of security analysts:

I believe too many people have a negative attitude toward the railroads. They are ready to write us off. They claim that we are much more interested in diversifying ourselves out of the railroad industry than in making it a success. Such notions are, in my opinion, untrue and give a distorted picture of our potentialities.

No one can doubt that our industry, and this includes Penn Central, is faced with innumerable problems. I am not prepared to believe, however, that they are insoluble. On the contrary I think that they are soluble, but not today or tomorrow. It will take time, perhaps several years, but it could take place much sooner with cooperation from the Government authorities and the railway labor leaders. And there are already signs of real improvement in both areas. This, in fact, is one of the most encouraging developments in our industry.

<sup>360</sup> Perlman had taken a similar position many months earlier on the necessity to get service problems resolved promptly.

<sup>361</sup> House Committee on Interstate & Foreign Commerce, November 12, 1969, [S. 315].

<sup>362</sup> Saunders' reaction to this situation, in response to a suggestion from Day that disclosure be more open, has been described previously. See page 165.

<sup>363</sup> Actually, while Penn Central had significant losses on passenger business, this was not the area of greatest deterioration in the postmerger period.

In an article on Saunders appearing in *Nation's Business* in January 1970, William Lashley, Penn Central's vice president of public relations, pointed out that American railroads, largely because of mergers, were in far better financial condition than in many years. Five months later, after extended efforts to stave off bankruptcy, Penn Central filed for reorganization. And despite the months and years of optimistic statements emanating from Saunders' office, he now began to characterize the prebankruptcy situation as basically unmanageable.

### EARNINGS

The steps being pursued to minimize apparent earnings problems and the necessity of full disclosure of the course of conduct adopted have been described previously in the section on income management. Yet disclosure both as to the overall picture and as to the material individual items incorporated in the course of conduct was negligible. As with the operational situation just discussed, the picture was one of deliberate overoptimism. The pattern was reflected not only in an overstatement of earnings, but in deficiencies in other disclosures as well. These deficiencies encompassed the manner of presentation, as well as the content and emphasis, of information which was provided, and the omission of significant information required to adequately inform the investing public. Indeed, the situation was such, according to testimony from the former Penn Central comptroller, that there were some quarterly earnings releases to which he would not have put his name.

### RAILROAD EARNINGS

Since the focus of Penn Central's earnings problems lay in the railroad area, it was essential that results in this area be made clear to shareholders, investors, and the public. Instead, the manner in which operating results were presented served to conceal the problem. Railroad operations were clearly deemphasized, and never presented in a form in which their full impact was shown. Consolidated results were emphasized and for a period, over the objection of the press, analysts, etc., were the only figures presented. Even Transportation Co. results, on an unconsolidated basis, contained very substantial amounts of nonrailroad income and expenses, which greatly improved the company's apparent results. This factor was further confused by the company's practice of referring to Transportation Co. results by such descriptions as "railroad system" or "parent railroad company" in quarterly earnings releases and similar situations.

The figures showing the full loss in the Transportation Co.'s rail operations were available for internal management purposes. Rail industry security analysts also make a practice of computing such figures, further emphasizing their significance in assessing company results. Saunders' testimony indicates that he fully recognized the dominant importance that professional analysts attached to the railroad-only aspects of the total earnings picture. Furthermore, the underwriters in preparing the offering circular for the \$100 million Pennco debenture offering insisted on recasting the reported figures to focus on the unsatisfactory status of the rail activities. This form of presentation was particularly critical, they felt, in light of the rapidly



deteriorating trend in this area.<sup>364</sup> The suggestion by Day to Saunders in December 1969 that "we have been tending to cover up poor results from railroad operation rather than exposing them \* \* \* presenting the railroad operation by itself would require a number of adjustments but I really feel this should be done," reflected his concern that the Government, rather than the shareholders, be made aware of the existing situation.<sup>365</sup> Nonetheless, it illustrates once more the critical nature of this information.

The reported income figures over the postmerger period have been included in exhibit IG-1, which indicates consolidated figures, Transportation Company figures, net railway operating income figures, and the full loss on railway operations. The emphasis in press releases was on the consolidated figures. In no instance was the loss on railway operations clearly labeled, although in some cases the net railway operating income, which did not include such factors as fixed charges, was given. The "loss on railway operations" figures were not given to the public until 1970, when they were included in the Pennco offering circular. However, they have been included herein for comparative purposes. It is suggested that the reader review the annual reports of 1967, 1968, and 1969 in light of the results from railroad operations given in the chart.<sup>366</sup>

While not indicating the full extent of the drain from railroad activities, management did attribute the somewhat lower reported earnings in 1968 and 1969 to poor rail results. However, they took pains to suggest that future results would be better. "We regard our railroad as the asset which has the greatest potential," Saunders stated in late 1969. Predictions as to earnings, even those for the next quarter, were consistently overoptimistic. The merger savings potential was constantly alluded to. Even where problems were admitted, they were couched in optimism. The situation was particularly misleading during the later periods where, while citing the potential for longer term improvements, the company's immediate solvency was at stake. Future improvements were hardly relevant if the company could not survive that long.

#### NONRAILROAD EARNINGS

Concealment of the full impact of railroad losses was aided by the policies pursued in the nonrailroad area. As noted, the railroad losses and total reported earnings, whether on a company-only or a consolidated basis, were two very different figures. Helped along by the various investment and real estate transactions described previously, Penn Central thus managed to show profits, or at least reduced losses, despite the rapid deterioration in the railroad. If these represented regular cash earnings which could be maintained over subsequent years to offset the inevitable rail losses, it was one thing. But, to paraphrase a remark attributed to Saunders as early as 1967, the attitude seemed to be that if no other avenue was available, the

<sup>364</sup> Under current SEC rules, adopted in 1970, there is a requirement that total sales and revenues together with income or loss before taxes and extraordinary items be reported for each line of business which provides 10 percent or more of either the revenues or the income reported. This rule was proposed and published for comment in September, 1969.

<sup>365</sup> See further discussion on page 165.

<sup>366</sup> See exhibit IG-1 at end of this section. It should be noted that the calculation of railroad-only earnings, at least on a rough basis, was not difficult since it involved merely a rearrangement of figures already provided in the company-only statement. However, the reader had first to recognize the relevancy of the figures and what to base the calculations on.

company should mortgage its future, and take the income now.<sup>367</sup> This is clearly what was happening in many instances in Penn Central in 1968 and 1969, as earnings were manufactured under the needs and circumstances of the moment. To make the situation still more serious, despite Penn Central's voracious appetite for cash, many of these transactions generated paper, not cash, earnings.

Such factors, if brought to the shareholders' attention, would certainly raise concern. The question becomes whether this was in fact done, an issue which involves not only what information was and was not provided, but whether the information which was given was sufficient. The complexity of the Penn Central operation is relevant in this context. Illustrative of the problems entailed is a comment contained in a letter from one of Penn Central's directors to Saunders in late 1969, complaining about the quality of the information being provided to that body:<sup>368</sup>

Even if you yourself have a clear picture of these objectives, it is most difficult for your directors to have one unless a careful job is done of painting a clear one for us.

Cole, noting that the writer seemed to have put his finger on the problem, commented to Saunders:

This is a valuable reminder. Being immersed in these matters, it is easy to forget that people outside of management may not understand where the various items covered in the reports fit into the overall picture.

However, considering the overall pattern of conduct by the management group, as illustrated throughout this report, it is clear that management did not "forget" the complexity involved, it "used" it. And obviously the shareholders were in a far poorer position to demand information than were the directors.

Some information was provided; e.g. the financial statements themselves and limited descriptive data related thereto. However, it was left up to the investor to attempt to figure out from the melange of information given, just what these earnings consisted of. This was difficult to do. Even the limited information which was provided was scattered throughout the reports in such a way that it was a real challenge, even for the expert, to put it together. Under these circumstances, and with management continually extolling to shareholders the benefits of diversification, it is easy to see that investors would be misled. Indeed, considering the complexities of the situation, even a complete list of all the questionable items entering into the earnings picture would not constitute full disclosure unless the presentation was structured in such a way as to make the pattern evident. And in the actual situation, not only was the overall picture not drawn by management for the investor or shareholder, but he was not even given many of the pieces. The following discussion of the various releases and statements concerning earnings will focus principally on these individual pieces.

#### DISCLOSURES RELATING TO 1968 EARNINGS

The improvement in earnings in the first quarter of 1968 which was attributed by Penn Central to merger benefits has already been mentioned. A 17-percent increase in consolidated income and a 15-

<sup>367</sup> See p. 40.

<sup>368</sup> See further discussion on p. 164:

percent increase in earnings for the "railroad system" was reported.

The first full quarter after the merger was the second quarter of 1968. Penn Central reported a 15-percent increase over the earlier period. This reflected, it was stated, the continuing benefits of the diversification program with a 57-percent increase in net income from sources other than railroad operations. "The true index of Penn Central's profitability is in the consolidated figure and not those of the railroad alone," and thus in the future, only consolidated earnings would be reported, the company indicated in its press release. For this period, however, earnings of the "railroad system" were still reported. The figure given was profit of \$2.1 million. It was not disclosed that the railroad had lost \$20 million and the difference was derived from real estate and investment activities of the Transportation Co.<sup>369</sup> The release closes with the statement that Penn Central anticipated that earnings for the rest of 1968 would surpass 1967 results, a reference apparently to rail results, although this is somewhat unclear.

When third quarter results were announced, they did show an increase over the 1967 period, an increase of 48.6 percent. Reported earnings were \$15.2 million, compared with \$10.2 million reported for the prior year. Once again it was noted that this reflected the continuing advantages of the diversification program. Actually, however, it reflected the one-shot advantage of the Washington Terminal dividend. While the release did disclose that the earnings figure included a "non-recurring dividend of \$13.5 million from a company in which Penn Central has a half-interest," shareholders were assured that there were substantial nonrecurring items of net income in practically every quarter. An alert shareholder would have perhaps discerned that Penn Central had very little profit except for that dividend, although there was nothing from which he could deduce its noncash nature. And as indicated earlier, there is a real question as to whether this was properly booked as income.

True to its word, Penn Central did not report railroad earnings for the third quarter, although a reference to the fact that results of the railroad system had been adversely affected by several factors would give some indication of possible problems. In fact, net railway operating income was down sharply and the loss on rail operations, including fixed charges, was over \$40 million. Saunders, while not giving these figures, did indicate that he felt the third quarter marked the low point in railroad business for the year.

The company's decision not to release company-only results had repercussions. A memorandum from the public relations department to Saunders on November 4, 1968, noted the following:

Attached is the only newspaper account we have seen to date on our figures reported to the ICC. I understand that many brokerage firms, however, get Xerox copies of our R&E and IBS statements from a service in Washington which gathers this information as soon as it is filed with the ICC.

In view of this, I suggest that we reappraise our decision not to report railroad system earnings when we report our consolidated earnings quarterly. Not reporting them has irritated both newsmen and security analysts. Their reaction is to probe deeper into railroad figures than they would ordinarily if we give them highlights of the railroad picture along with our consolidated earnings.

If you decided to reinstate giving railroad earnings, it could be announced at our November 21 meeting. I am sure that this announcement would be greeted with great enthusiasm.

<sup>369</sup> The term "Transportation Co." is being applied to the Company-only operations of Penn Central throughout the postmerger period, although the name was not adopted until late in the period.

And the policy was thereafter reversed. It had been a failure. Rather than deemphasizing railroad losses, as management desired, it had merely served to emphasize them.

On January 30, 1969, Penn Central reported consolidated earnings of \$90 million for the full year 1968, a 27-percent increase over 1967, and fourth quarter earnings of \$38 million, up 32 percent. The release indicated that the growth came through the diversified holdings and from certain nonrailroad transactions, mentioning in particular Madison Square Garden and Washington Terminal. No indication, however, was given as to the size and type of these two transactions. The Bryant Ranch and Six Flags Over Georgia transactions of Great Southwest were not mentioned.

Analyzing first the fourth quarter figures, if the effect of the \$36.1 million in paper profits recorded on the Madison Square Garden and Great Southwest transactions were eliminated, the profit would be virtually wiped out, and, for reasons stated earlier, the staff believes that these were improperly booked as income. Likewise, elimination of the Madison Square Garden profit would have turned a \$2 million loss of the Transportation Co. in that quarter into a \$23 million loss. Furthermore, had it not been for a \$5 million profit on the reacquisition of company bonds the Transportation Co. loss would have been larger. A \$12½ million profit of Pennco's disposition of N. & W. securities further improved results that quarter, although this item, unlike the others, was in part a cash transaction. Nonetheless, considering the nature, size and impact of these transactions, disclosure was called for, although none was made.

From the foregoing discussion, it is clear that Penn Central on a consolidated basis earned virtually nothing in the second half of 1968 and on an unconsolidated basis had a large loss. A profit had been recorded in the first half of the year, and on a full year basis, after elimination of improper items, some profit, although only a fraction of the original amount, still existed. However, in appraising these earnings, the various items described previously in the discussion relating to Penn Central's course of conduct should be considered. This includes in particular the charging of the mail handlers to the merger reserve, the failure to write off Executive Jet or consolidate Lehigh Valley, and the \$10 million in profits generated from repurchase of company bonds.

The 1968 Penn Central report to shareholders, mailed in late March 1969, contained basically<sup>370</sup> the same earnings figures as did the January release, and with the same limitations. The letter to shareholders included in that report stressed the positive, beginning with an announcement of the 27-percent increase in consolidated earnings, which "underscores the importance of our diversification program." Saunders and Perlman, who signed the letter, further stated:

We hope this Annual Report will help our stockholders to understand more thoroughly the diversified nature of the new Penn Central. Our company has grown from traditional railroad operations, which utilize about half of our total assets, into a broadly based organization with increased earning power.

They further went on to note that the four companies involved in the diversification program of the mid-1960's had doubled their contribution to Penn Central's net income, from \$22 million in 1967 to

<sup>370</sup> There was a small difference in the company-only figures.

\$44 million in 1968,<sup>371</sup> and that a holding company would be formed during 1969 to facilitate further diversification. An extensive section on the system's real estate activities, later in the report, gave an impression of dynamism and sharp growth in this area.

The report to shareholders, unlike the preliminary release, contained complete financial statements and related textual material as well. While disclosure will not cure improper accounting practices, there was no mention of many of the major transactions which had impacted reported income. The sale of N. & W. shares by Pennco at a profit of \$10.3 million was noted, although no mention was made of the profit on repurchase of company bonds. Shareholders were told of the N. & W. stock-for-debenture exchange and the Madison Square Garden exchange but no indication was given that large profits had been recorded thereon, and obviously the bare acknowledgement of the existence of these transactions, without more, is of little assistance to the shareholder who is attempting to understand the situation. The Washington Terminal dividend was not even mentioned.<sup>372</sup> While fantastic rates of earnings growth were cited for Macco and Great Southwest, the increasing risk reflected in that growth was not alluded to. Neither were the substantial profits claimed to have been generated on the Bryant Ranch and Six Flags Over Georgia transactions described, although these two transactions accounted for much of the reported growth in 1968. Clearly, the ability of these two companies to sustain this rate of growth (140 percent in one year), or indeed this level of earnings was open to serious question in light of the source of the earnings and the nature of the transactions. Even independent of the question of the acceptability of such practices under generally accepted accounting principles, in all fairness the shareholders should have been apprised of the quality of the earnings and the risks involved. Instead, management merely extolled to them the benefits of diversification.

There were other deficiencies in disclosure. Information as to the losses being incurred by Lehigh Valley was included in a footnote to the financial statement<sup>373</sup> but there was not reference anywhere in the report to the EJA problems, although by this time the application to acquire Johnson Flying Service had been withdrawn. The charges

<sup>371</sup> Penn Central on Feb. 13, 1969 had issued a special press release outlining the results of these four companies, further indicating the emphasis the company was putting on this aspect of its operations.

<sup>372</sup> As noted earlier, B. & O. and Penn Central each owned 50 percent of WTC and received similar dividends. Compare the extent of disclosures in the two companies.

B. & O.—The following language was included as a note to the financial statements in B. & O.'s 1968 annual report to shareholders:

During 1968 the company received a dividend in property from a 50-percent owned affiliate, the Washington Terminal Co. The dividend has been recorded at \$3.1 million which is considered to be fair value after allowance for contingencies which exist as to the proposed development and lease of the property as a visitor center under an agreement with the U.S. Government for a period of 25 years with an option to purchase. The approximate present value of the net cash flow that would be realized upon the completion of the proposed development (after consideration of interest and income taxes at current rates but before any allowance for contingencies) is \$5 million at December 31, 1968.

Substantially the same language was included as a note to the 1968 financial statements of the Chesapeake & Ohio Railway Co., owner of approximately 93 percent of B. & O. at the end of 1968.

Penn Central.—The following language was included in Penn Central's 1968 annual report to shareholders:

An agreement was signed with the U.S. Department of the Interior to convert Washington Union Station into a National Visitors Center within the next 3 years. This property was held by Washington Terminal Co., a 50-percent owned subsidiary. A new modern railroad passenger station will be built beneath a 4,000-car garage adjacent to the Center.

The above language does not indicate that any income was recognized upon signing the agreement nor does it mention the WTC dividend-in-kind. It might be noted that Penn Central recorded the dividend at \$11.7 million.

<sup>373</sup> Footnotes to the December 31, 1968 financial statements disclose:

*Principles of Consolidation.*—The consolidated financial statements include the accounts of the company and its majority-owned subsidiaries, except the Wabash Railroad Co., the divestment of which is arranged as ordered by the Interstate Commerce Commission, and the Lehigh Valley Railroad Co., which the Commission has required to be offered for inclusion in another railroad system.

*Lehigh Valley.*—Based on unaudited financial statements, the equity in the net assets of Lehigh Valley at December 31, 1968 was \$73,232,000. Lehigh Valley reported a net loss for the year 1968 of \$5,969,000 and no dividends were paid.

against the merger reserve were referred to in another footnote to the financial statements, but the company was silent on other elements pertaining to the course of conduct being pursued to maximize income.

Thus far the focus of discussion on 1968 results has been on certain nonrailroad items. However, Penn Central lost \$140 million on railroad operations in 1968 after fixed charges. Of this, \$54 million was in the final quarter and \$100 million in the last half. These figures were not given. Instead, in its 1968 annual report Penn Central emphasized the loss of \$2.8 million from the "parent railroad company," without noting the impact of nonrailroad items on this figure.

While the full extent of the loss was not made clear, it was indicated in the 1968 annual report that railroad earnings were down. Various reasons were cited, most of them the industry wide problems which had been listed in the prior year's report as well. Only the merger-related costs were new. The shareholder letter in the 1968 report stated that Penn Central had been burdened with \$75 million (\$3.25 per share) in merger start-up costs and losses, many nonrecurring, and that without these "unusual expenses" railroad results for 1968 were better than for 1967.<sup>374</sup> In the release announcing the preliminary earnings figures, no merger start-up cost figure had been given but it was admitted there were "heavy nonrecurring expenses incurred in the initial phase of unifying the two separate railroads." These expenses would, however, it was indicated, help produce increased efficiencies and earnings as merger implementation progressed.

These claims are misleading in several respects. First, as indicated earlier, the merger-related cost figure could not be quantified with sufficient accuracy to justify its public dissemination. Furthermore, the company's own schedule indicated that calculated expenses of \$75 million were offset by purported savings of \$22 million, so that the comparison of 1967 and 1968 results was inaccurate.<sup>375</sup> In addition the suggestion that these merger related expenses would help produce increased efficiency and earnings is not justified, considering the nature of the majority of the expenses which consisted of costs under the labor protection agreements<sup>376</sup> and lost business, overtime and per diem costs related to the service problems. Finally, there was no mention of the fact that a very large proportion of this \$75 million figure was attributable not to anything inherent in the "carefully planned" merger, alluded to in the shareholder letter, but to costs associated with the unanticipated merger-related service disruption (i.e., management misjudgment). Indeed, the frequent references in company releases and speeches by Penn Central executives to the smooth progress of the merger and the fact that physical integration was well ahead of schedule leave the opposite impression.

#### DISCLOSURES RELATING TO 1969 EARNINGS

Following the events of the last half of 1968 which greatly overstated income, management was hard pressed to come up with an encore when rail earnings remained depressed in 1969. It was only partially successful.

<sup>374</sup> Saunders also cited this factor when a shareholder, attending the 1969 annual meeting, expressed concern about the level of 1968 railroad earnings.

<sup>375</sup> Saunders gave the \$75 million figure at the annual shareholders meeting but at that time he did indicate that there were offsetting savings.

<sup>376</sup> At the 1969 shareholders meeting Saunders alluded to a \$35,000,000 figure for severance pay, moving expenses, etc. This was mentioned in conjunction with the \$75,000,000 figure, although the bulk of these labor related expenses had been charged off against the reserve and did not appear in the \$75,000,000 figure. This again illustrates management's inclination to use ambiguous comparisons to suit its purposes.

As noted earlier, even before the 1968 report to shareholders had been distributed, management was indicating that the earning potential of the railroad had turned the corner and was heading for a much better showing. The press release announcing the mailing of the 1968 report to shareholders began, "A bright outlook for Penn Central and its railroad operations was forecast for 1969 in the company's annual report." The same generally optimistic theme was played again a few days later in the release announcing first quarter 1969 earnings. Consolidated earnings were down from \$13.4 million to \$4.6 million, although the company hastened to add that the New Haven, which was included in 1969 figures but not 1968 figures, had lost \$6.5 million in 1968.<sup>377</sup>

At this point Penn Central began to include the railway operating income figures in its quarterly results, which represented improved disclosure but still did not reflect full losses after fixed charges. A first quarter loss of \$10 million was reported, while the full loss was \$42 million. In reporting this loss, management mentioned the same problems as it had indicated impacted 1968 earnings but left a clear impression of confidence in the future via merger savings, regained business, and so forth. The company, it was stated, had elected to absorb heavy nonrecurring initial costs to more quickly achieve the recurring benefits of merger. One analyst examined first quarter results shortly after they were announced, labeling them "in typical Penn Central style quite incomplete and lacking in necessary detail," but noting a further deterioration in net railway operating income after fixed charges. His prediction of a \$200 million loss for 1969 in this category was indeed close to the final figure of \$193 million reported for the year. This was \$50 million poorer than in 1968.

On top of the improvement in railroad earnings that management was projecting for the rest of 1969, the April release noted that the Arvida-Great Southwest-Macco-Buckeye group was still going strong, with a 92% increase in first quarter earnings over the like 1968 period. A new format was introduced for the consolidated statements, "designed to portray more accurately the diversified nature of the Company." The revenues and costs were each broken down into three major categories-transportation, real estate and financial operations. This helped, since before that time the quarterly releases had not included the financial statements but only selected figures. Now all the investor had to do was to figure out what was going on within the various categories, but the data to do this was not provided.

It may be noted that this quarter, the first in 1969, was a relatively "clean" quarter, as far as unusual transactions were concerned. On the other hand, without the benefit of profits of this nature, the company was able to record only a nominal profit on the consolidated statements. The company-only income statement, which showed a loss of \$12.8 million (compared to a \$1 million profit in 1969), was helped along in this quarter by the first of the two \$6 million "special dividends" from New York Central Transport.

<sup>377</sup> Memoranda in the files of outside counsel reflect a suggestion by house counsel for Penn Central that shareholders be told in connection with the \$6.5 million figure that:

"\* \* \* comparisons between operations of the New Haven by the trustees [and current year results] are impractical because the purchase resulted in a new basis of accounting."

In the final version this was watered down to:

"The New Haven reported a loss of \$6,500,000 as it was then structured and operated in bankruptcy." The memoranda reflect that outside counsel "did not think that this was fully adequate" but that Peat, Marwick people felt that it was. The final memorandum ends with the words, "Everyone realized there is some risk here."

Consolidated earnings of \$21.9 million for the second quarter of 1969 were down only slightly from those of a year earlier. All of this profit was accounted for by the sale of Six Flags Over Texas which had been improperly reported as income. Thus, for the fourth straight quarter, if reporting on a proper basis, Penn Central would have had little or no consolidated income.<sup>378</sup>

In its second quarter earnings release, Penn Central reported the profit of \$21.9 million. It was stated that the Arvida-Great Southwest-Macco-Buckeye group had contributed \$29.1 million to earnings, an increase of \$20.8 million over the like 1968 period and that the parent railroad company had lost \$8.2 million, down from a 1968 profit of \$2 million. Management disclosed that the \$29.1 million from the diversified subsidiaries included the sale of Six Flags Over Texas, but no amount was given, either in the text or in the attached income statement.<sup>379</sup> And again, Penn Central sought to downplay the small decline in consolidated earnings by suggesting that the New Haven had lost \$5 million in 1968 so the results were not strictly comparable.

Management did not make a similar effort to point out other relevant items that quarter. It was not disclosed that the \$8.2 million Transportation Co. loss would have been larger were it not for another parent-financed \$6 million special dividend from New York Central Transport. And, while the attached financial statements of the Transportation Co. showed a net railway operating loss of \$7.5 million, the full railroad loss of \$44.2 million was never mentioned. Possible investor concern was further alleviated by the statement that heavy costs were still being undertaken to expedite unification, combined with the assurance that the merged system was now realizing benefits from merger projects and that service was better than it had been premerger. Internally, the financial situation was critical and the dividend in doubt, a factor which management was consciously concealing from the public.<sup>380</sup>

By the third quarter, Penn Central could hold off consolidated losses no longer. The reported loss for the quarter was \$8.9 million, although the company was quick to point out that there was a \$17.6 million profit for the 9-month period. The third quarter figure reflected a \$24 million decline in profit from the year earlier period. While it would be possible for the investor to calculate the figure himself from the data provided,<sup>381</sup> the company certainly did not point out this feature.

The emphasis in the third quarter earnings release was on railroad operations, which had been poor. The usual list of factors, plus a \$5 million impact from "unusual occurrences," were cited as the reasons. However, "much better results" were predicted for the fourth quarter. The relevant figures given included a \$19.2 million loss for the "parent railroad company" and a net railway operating loss of \$14.8 million. The full loss on rail operations, after fixed charges, was almost \$60 million, but this was not stated. Neither did the company point out that the results for the parent railroad company were inflated by nearly \$12 million in "special dividends" drawn up from subsidiaries.

<sup>378</sup> It might be noted that the Board continued to declare dividends throughout this period.

<sup>379</sup> The transaction was reported as ordinary income in Penn Central's statement although it was treated as an extraordinary item in GSC statements.

<sup>380</sup> See discussion on page 178.

<sup>381</sup> The Washington Terminal dividend had entered into the 1968 results.



In the release, Penn Central devoted little attention to nonrailroad subsidiaries, although Saunders' "good news behind the bad news" speech to the Baltimore Security Analysts,<sup>382</sup> which was summarized in an attachment to the release, did push the diversification program in optimistic terms. And in the release itself, although giving no earnings figures for the subsidiaries, Saunders did note that fixed charges had risen in the Arvida-GSC (Macco)-Buckeye group, because of the financing of facilities, which would, however, in the future produce higher earnings. It was also stated that real estate revenues, which had increased sharply, included the sale of Rancho California, and the reader could perhaps surmise that the transaction was being mentioned because of its size. However, no sales or profit figures were given,<sup>383</sup> and the reference by itself was certainly not very informative. As suggested earlier, this was not the routine, everyday type of transaction and disclosure to that effect was called for.

By this period, it should be recalled, Penn Central's interest in its diversified subsidiaries had become concentrated on the immediate earnings they could be made to produce. And within Penn Central, management was engaged in an almost desperate search for income and cash. None of this comes through in the sterile statements being furnished to the public concerning earnings.

By the close of the fourth quarter it was clear that the battle to sustain 1969 earnings had been lost. The consolidated profits for the year had evaporated, with a \$13.2 million loss in the fourth quarter. This represented a \$50 million decline over the fourth quarter of 1968, although this was not emphasized in the body of the earnings release where management had always been quick to point to favorable earnings progress. The various devices which had been used to increase earnings in late 1968 were now apparently catching up with management in the form of unfavorable earnings comparisons. There were no substitutes available for the 1969 period.

The fourth quarter earnings figures issued to the public on February 4, 1970, showed a net railway operating loss of \$9 million for the quarter. This compared with a \$35 million loss reported to the ICC. The shareholders were not told of this difference, which was based primarily on the capitalization of the New Haven repair costs and the depreciation savings on the long-haul passenger facility write off. Neither was it pointed out to them that \$35 million in fixed charges should be added to the loss figures given, to get an accurate picture of the full railway losses that quarter. On the other hand they were told such things as the fact that quarterly results had been adversely affected by a \$6 million extra charge in accruals for loss and damage claims and by abnormally high snow removal costs. The suggestion was that these were nonrecurring.

Penn Central did manage to show a nominal \$4.4 million profit on a consolidated basis for the year 1969, down sharply from 1968 but hardly a harbinger of the impending disaster. The "principal railroad subsidiary" reported a net loss of \$56 million, compared with a much smaller loss in 1968. A loss of this size is obviously not a plus factor, but a \$56 million loss certainly sounds better than a \$193 million loss. The latter was the full loss on the Transportation Company's railroad activities. And even that was understated if the

<sup>382</sup> See page 178.

<sup>383</sup> GSC had reported the sales figure earlier in the quarter, however.

ICC approach to the New Haven repair costs and the long haul writeoff was adopted. While these two items were noted in the footnotes to the 1969 financial statements, no effort was made to clarify for shareholders the complete loss on rail operations. This was true even though by the time the report to shareholders was issued, the company was on the verge of collapse because of still further deterioration in this factor in the first quarter of 1970.

It might also be noted that any one of a number of factors could have turned Penn Central's meager 1969 consolidated profits into a loss. Elimination of the Six Flags Over Texas transaction, for example, would have resulted in a sharp loss. Reclassification of the gain reported on Penn Central's N. & W. investment as extraordinary income would have had a similar impact. Consideration should also be given to what the effect would have been of the consolidation or write-down of Lehigh Valley, the write down of Executive Jet or Madison Square Garden, the expensing of the New Haven repair costs, or the effects of a multitude of other possibilities discussed in an earlier part of this report whereby management took the route of maximizing income. No hint that such a policy was being followed was given to shareholders who were expected to blindly accept what was being handed to them by management.

Actually, while the figures given in the February 1970 release dealing with 1969 earnings were poor, the text itself was remarkably optimistic, or at least very bland, considering the problems then extant. The 1969 annual report sent out a few weeks later was somewhat more realistic. By this point of course the dividend had been eliminated, so the chairman's opening statement in the shareholder's letter accompanying the 1969 annual report could have come as a surprise to no one, "The year 1969 was a very difficult one for Penn Central. Our problems were principally centered in the transportation company and some of them were beyond our control." It might be noted that by this point management knew the first quarter 1970 results were a disaster.

Obviously, no shareholder would be overjoyed by the 1969 decline in earnings, especially after elimination of the dividend. Some explanation was clearly required. Saunders, in the letter to shareholders, went on to list and describe seven problems—inflation, delays in securing rate increases, economic slowdown, passenger deficits, merger startup costs, abnormal weather conditions, and strikes, although he admitted that even under optimum conditions, the company might not have been able to overcome the effect of these problems. He then outlined steps management was taking to improve the situation. The picture thus painted was one of a management aggressively moving to deal with a series of problems, most of which had been listed as excuses for poor 1967 and 1968 earnings as well. While management was in all likelihood attempting to improve the situation, no indication was given of the desperateness of the circumstances.

The discussion thus far has dealt principally with railroad operations. However, management in its statements regarding 1969 earnings results pointed out that the Great Southwest-Arvida-Buckeye group had increased its contribution to consolidated earnings to \$53 million, 21 percent over the 1968 level. A very careful reading of the report to shareholders would further show that the growth came entirely in Great Southwest. As described earlier, this company's ability to sustain

that rate of growth was in serious question in light of the nature of the earnings being reported and the efforts being made to generate immediate earnings at the expense of future operations. The then recent action in calling off Great Southwest's proposed public issue because of the feared effect of forced disclosure of such factors certainly brings into clear focus their critical importance. Instead of warning the shareholders about this, Saunders, in his annual letter told them:

The impressive performance of our real estate subsidiaries is described in this report. Income of \$137 million—derived from real estate operations, investments, and tax payments from subsidiaries was used to support our railroad operations during the past year.

These assets have proved invaluable to us and we are confident of their continued success. Their health and strength will enable us to use them in our financing program for 1970.

While "renewed emphasis was given to diversification through growth of [Great Southwest] in order to broaden the company's base of earnings," no information was given whereby the investor could judge the quality of that subsidiary's overstated earnings.<sup>384</sup>

#### DISCLOSURES RELATING TO 1970 EARNINGS

Announcement of earnings for the first quarter of 1970 came on April 22, 1970, amidst preparation for the \$100 million debenture offering. While the disclosure requirements on the part of the company were not increased because there was an impending offer, it seems apparent that the liabilities that could arise from the offering, affecting not only the company but others involved in the underwriting process, had an impact on the degree of disclosure made.

The Wabash exchange involving a \$51 million profit and the Clearfield Bituminous Coal intercompany profit of \$17.2 million were both of such a size and impact on the disastrous first quarter results that they could not safely be ignored. While in the initial drafts of the release announcing the earnings for the period disclosure as to the items was buried near the end of the release, it was eventually pushed up to the front at the insistence of attorneys for the company and the underwriters. However, disclosure as to the Wabash exchange did not extend so far as to indicate the manufactured nature of that \$51 million gain, involving as it did acceleration of a transaction which was to have occurred later in 1970, nor did it encompass information as to the very significant benefits Penn Central had given up to enable it to thus paint the first quarter earnings picture. Likewise, the disclosure that the Transportation Co. statements included an intercorporate profit of \$17 million represented improved disclosure. However, that improvement did not extend so far as to indicate that the loss on railway operations was \$100 million that quarter, although

<sup>384</sup> In contrast, at the underwriters' insistence, the following was included in the offering circular for the \$100 million debenture offering:

"Great Southwest records sales of land and buildings in the year of sale and generally takes the full sales price into income even though in many instances a substantial portion of the sales price is payable over an extended period of time and may not include personal liability of the purchaser so that the collection of the total purchase price may be dependent upon successful development of the property. A substantial portion of Great Southwest's real estate sales in 1968 and 1969 are in this category and were made to a limited number of individuals. The Tax Reform Act of 1969 and other recent tax rulings have made investments in properties of this type less attractive to individuals. For this and other reasons, including general economic conditions and the difficulty in obtaining mortgage financing, there can be no assurance that such sales will continue.

"In the past Great Southwest has been able to make substantial real estate sales by accepting the prepayment of several years' interest. However, by reason of a November 1968 release of the Internal Revenue Service limiting the deductibility of prepaid interest, the number of prepaid interest transactions may decrease substantially, and Great Southwest's sales may be adversely affected thereby."

this class of figure was, at the underwriters insistence, being included in the offering circular then under preparation. Obviously, a \$62 million figure, the net Transportation Co. result, was bad enough—\$100 million would suggest that the entire amount Pennco was then trying to borrow for the railroad's use could be wiped out in just one quarter!

### CASH FLOW AND FINANCING

Penn Central's voracious appetite for cash was described in an earlier section. As noted therein, this necessitated huge amounts of external financing. When the company's ability to borrow ran out, it was forced into bankruptcy. Neither of these two elements, the current cash drain combined with the reasons for it, and the company's ability to continue to finance these drains, was presented to the shareholders in any meaningful way, although by this point it must have been clear to management that these were perhaps the most immediately critical factors for investor consideration.

Realistically, shareholder reliance on management to warn them of impending financial disaster in a situation such as that confronting Penn Central is necessarily great. There are many intangibles involved, and management's knowledge and ability to put the pieces together obviously far surpasses that of the average investor. Financial statements alone cannot be counted on to do the job, and most certainly not the financial statements containing the limitations present in this case. Thus, the public was clearly dependent on the willingness of Penn Central officers to provide them with a realistic appraisal of the situation, and management was not "willing." The issue here, however, involves not merely good will or free choice on the part of management, but involves obligations imposed under the Federal securities laws.

During the merger hearings of the early 1960's, Bevan, Symes, and others had discussed in considerable detail the difficult financial situation facing the two roads. Railroad operations, they pointed out, were consuming huge amounts of cash. On the other hand, because of the poor earnings record, the securities of most railroads had a very poor reputation and it was difficult to find sources of financing. As a consequence they had often been forced to rely on types inappropriate to their needs—for example, short-term sources to meet long-term needs. Bevan decried the weakened working capital position, which he suggested, reflected a reduced ability to withstand bankruptcy. Symes described some of the repercussions of the earnings and cash situation including deferral of necessary capital expenditures and maintenance, liquidation of assets, and shrinkage of plant and equipment.

The merger finally came in 1968 and, with it, glowing public statements about plans for financing devices which would be employed. At the 1968 annual meeting Bevan reported, "We on the financial side are taking such steps as we deem necessary to meet the challenge of a new and dynamic company by revamping its corporate structure to provide management with the most modern tools available to meet future capital requirements, which we know are going to be large." Thus, the public was conditioned to view with favor, rather than alarm, the very substantial financing which it was recognized the future would bring. Bevan noted plans for the issuance of debentures, preferred stock, and some time in the future the possibility of a blanket mortgage. Suddenly, the avenues for financing seemed very broad, in

contrast to the bleak picture painted in the merger hearings. Yet realistically, the possibilities of implementing such grandiose plans, although mentioned throughout the 1968 period, were remote.

The most specific plans alluded to involved the revolving credit and commercial paper. These programs, in fact served as the major post-merger financing devices. Purported advantages in the use of these devices were pointed out. At the 1968 annual meeting Bevan noted that "they should provide the flexibility with which to meet suddenly arising problems quickly." An August 1968 press release referred to the flexibility of commercial paper and the lower interest costs it offered in the present market. No mention was made of the risks involved in using short-term capital to meet what were essentially, at best, long-term needs.<sup>385</sup>

In his speech to the New York Society of Security Analysts on September 5, 1968, Saunders presented basically the same favorable picture concerning the financing outlook. Yet, just a week earlier Bevan had written him a memorandum describing the critical cash situation at the time of the merger, and saying that the difficulties in overcoming this problem had been compounded by a \$48 million deficit on railroad operations in the first 6 months of 1968,<sup>386</sup> and a cash loss of \$131 million in the first 8 months of the year. "This drastic cash drain is going to have a very serious effect, not only this year, but certainly through 1969." The entire commercial paper and revolving credit lines would be absorbed and Penn Central would require another \$125 to \$150 million before the end of 1968, Bevan had indicated.

The first words in the 1968 annual report to shareholders were: "The cover sculpture symbolizes Penn Central as a strong and dynamic company, supported by the many different elements that comprise its diverse interests." No mention of financing, positive or negative, was made.

At the 1969 shareholders meeting, Bevan was again assigned to make the financial presentation. He boasted of the company's ability to raise substantial amounts of money required by the merger, \$450 million to date, despite a difficult financial market. Commercial paper outstanding had reached \$150 million—market acceptance was "uniformly good" and the company had no difficulty in disposing of the paper, he reported. The company had just asked the ICC to approve an increase from \$100 million to \$300 million in the revolving credit plan. The use of short-term maturities was "extremely advantageous" because they could be refinanced later on a long-term basis at lower rates than available in the present market. He expressed publicly the company's "appreciation and deep gratitude" to its banks for their vote of confidence and cooperation at a time when the market for money was very tight. He also noted that Penn Central was now going into the Eurodollar market for the first time, speaking also of this in glowing terms. This was mid-May and, internally, the financial problems were a matter of great concern. Yet the public was left with

<sup>385</sup> In a discussion with a railroad analyst in June 1968, Bevan suggested the blanket mortgage as an offset to the short-term debt currently being floated, because of the danger of overextending in short-term securities. This danger was not, however, expressed to the public. Actually, the short-term/long-term distinction is generally drawn between funds put into such items as inventories or accounts receivable, which will be liquidated within a short period, and those invested in plant or equipment where the funds for repayment are generated over a long period of time. The situation here, where the money is going to dividends and operating losses, which themselves will never generate a return, obviously presents a particular problem.

<sup>386</sup> This was an instance where, for internal purposes, management was using the full railroad loss, rather than the far more favorable figures being given to the public.

the impression that banks and the institutions which bought commercial paper thought very highly of Penn Central. The poor reputation noted in the merger hearings seems to have evaporated. The deception being practiced on these lenders who purportedly looked with favor on the company, and the huge amounts of the borrowed funds going into nonproductive uses were decidedly not items which management was endeavoring to point out to its shareholders.

The 1969 annual report was sent to the shareholders in March 1970. Perhaps reflecting an attitude that if you can't say something good, don't say anything, there was no reference in the textual material to the financing situation.

By the shareholders meeting in May 1970, Bevan's enthusiasm had blunted somewhat. He noted that the cash position was tight,<sup>387</sup> basically because of the capital needs of the merger,<sup>388</sup> he suggested, and the company was reviewing all expenditures very carefully. However, the arranging of \$935 million in financing over the past 2 years was an "outstanding accomplishment" considering the tight state of the money market.<sup>389</sup> Again he thanked the commercial and investment bankers for their cooperation.<sup>390</sup>

Bevan admitted that the big increase in debt had increased base and fixed charges markedly:

On the other hand, a substantial proportion of this debt is short or medium term in nature. Therefore, when market conditions change . . . we should be in a position to lengthen our maturities and reduce our fixed charges accordingly. We will not be locked into high cost debt for a long period of time for this portion of our indebtedness.

He did not indicate that by this point the runoff of short-term commercial paper, which immediately preceded and contributed to the final collapse, was in full swing.<sup>391</sup> He did mention, however, that, after the sale of the \$100 million Pennco bond issue expected in a few days,<sup>392</sup> the major portion of the 1970 estimated financing requirements would be met. A shareholder present at the meeting commented that some Wall Street houses were saying that Penn Central would need another \$100 million after that and wondered whether the company had the borrowing power. Saunders indicated that he did not think anyone could answer at this time the question of whether Penn Central would need more money. There was no mention that approaches had already been made to the Federal Government for emergency assistance.

The foregoing statement was clearly misleading with respect to the developing financial crisis. Investors were also given very little other information to direct their attention to this situation. Bevan had earlier stressed the importance of working capital<sup>393</sup> as an indicator of financial health. He had also stated in the merger hearings:

In the case of the railroads debt due within one year is not included in current liabilities, although it is now reported as a separate item in ICC reports. This is

<sup>387</sup> This was a perennial complaint, but he gave no indication that financing had been stretched to the limit.

<sup>388</sup> This was very clearly not the major cause of the drain.

<sup>389</sup> \$245 million in debt had been paid off during the same period.

<sup>390</sup> He neglected to mention the difficulties the Penn Central organization had faced recently in obtaining financing, the exhaustion of the borrowing capacity of the Transportation Co. and the necessity to now finance indirectly through such subsidiaries as Pennco and Penn Central International, operations which would obviously also have their borrowing limits.

<sup>391</sup> The revised offering circular, dated the same day, did make such a disclosure. The underwriters were writing the one presentation; Bevan was writing the other.

<sup>392</sup> By this point (May 12) it was problematical whether the issue could be marketed. It was only 9 days later that Bevan met with the bankers to tell them the issue could not be floated.

<sup>393</sup> Working capital equals current assets less current liabilities.

contrary to standard accounting procedure and the practice in other industries, and in my judgment gives a completely false picture, since obviously there is no difference between one type of liability and another if both have to be paid in the same period of time.

However, in the annual report to shareholders Penn Central continued to classify it as long-term debt,<sup>394</sup> rather than as a current liability,<sup>395</sup> thereby improving reported working capital.

Perhaps even more important than the working capital situation was the rapid exhaustion of the sources of credit available to Penn Central. The public statements previously described definitely showed the positive side, with no indication the limit was fast approaching, although this matter was obviously of concern internally. Each annual report included, in a graphic form, a statement of source and application of funds for the year, but the information contained therein was so general as to be virtually useless.<sup>396</sup> For example, no indication was given as to the level of noncash earnings. Considering the admitted importance of the maturity schedule, and the heavy reliance on relatively short-term debt in situations where long-term financing was called for, an item in the source and application of funds labelled "financing" is not very informative, and this is doubly true in a company like Penn Central where such diverse activities as railroad operations and real estate development and sales are being combined. Actually the company did provide more meaningful figures for its own internal purposes, although these were not available to the general public.<sup>397</sup>

Other financial statements were scarcely more useful than the source and application of funds. As noted earlier, lenders had turned money over to Penn Central, without much inquiry into the company's ability to repay, because of the very great assets and equity of the firm. How was the average investor to measure such factors? While the accountants' report generally indicates the CPA firm's opinion as to whether the balance sheets and related statements of earnings and retained earnings "present fairly" the information contained therein, such statements do not reflect current economic values of the assets involved nor do they attempt to do so. Thus, at least insofar as the balance sheet is concerned, it appears to be of very limited value to the average investor in gauging the value of Penn Central as a going concern.<sup>398</sup> Further, if the investor is not knowledgeable about accounting practices he might even be misled by the information contained therein. This is particularly a danger in a railroad company where fixed assets loom large in the balance sheet.

The management of Penn Central clearly recognized the limitations in such figures, as reflected in their frequent complaints about the highly unsatisfactory rate of return being earned on railroad assets. Low rates of return mean low economic values on those assets. In

<sup>394</sup> Penn Central broke this category down into long-term debt due within 1 year and long-term debt due after 1 year.

<sup>395</sup> In the case of commercial paper, totaling nearly \$200 million by yearend 1969, even Goldman Sachs had to ask where that item appeared in the balance sheet. The answer was that roughly half was included in current liabilities and the remainder in long-term debt due in more than 1 year, although all was in fact due within 1 year.

<sup>396</sup> See exhibit IG-2 at end of this section.

<sup>397</sup> At the present time, the SEC requires detailed statements of source and application of funds under article 11A of Regulation S-X in registration statements and reports filed pursuant to the 1933 Act and the 1934 Act. Further, through the proxy rules (Rule 14a-3(b)(2) of the 1934 Act), the SEC also requires such information to be included in annual reports (Section 14A of the 1934 Act and Rule 14a-3(b)(2) thereunder,) to shareholders.

<sup>398</sup> At December 31, 1969, Penn Central's balance sheet showed shareholders' equity of \$2,800 million, while the market value of the outstanding stock was only \$700 million. At present prices, market value is \$120 million.

light of this, Saunders' suggestion at the 1969 shareholders meeting that, in the railroad, Penn Central held an asset which could not be replaced for less than \$15-\$20 billion (book value was perhaps \$3-\$3½ billion) was unconscionable.<sup>399</sup> This is an example of the situation described at the beginning of this section where the distinction was drawn between technical accuracy and what was reasonably conveyed. While it may perhaps be true that the asset could not be replaced for less than \$15-\$20 billion, the property clearly was not worth anything remotely resembling that figure and based on economic factors no one would replace it at such a cost.

Another difficulty which reflected on the financing area was that the company's assets were already heavily pledged. It is true that the company did indicate in the notes to the balance sheet in the 1969 annual report that:

Substantially all investments and properties included in the consolidated sheet and substantially all the properties of the transportation company, together with certain of its investments, principally Pennsylvania Co. . . . have been pledged as a security for loans or are otherwise restricted under indentures and loan agreements.<sup>400</sup>

This represented a marked deterioration in position over the prior year, although that was not stated.<sup>401</sup> Furthermore, the burying of this information in footnote 7 to the financial statements does not meet the requirements of a company which is on the verge of collapse, because of the inability to market further long-term debt, to fully disclose the imminent danger to its shareholders.

Considering Penn Central's financial predicament, it was misleading for management to continue to make dividend payments.<sup>402</sup> When the practice was finally stopped, although it was long overdue, management, in a letter to shareholders dated December 1, 1969, explaining the reasons, cited "the necessity to conserve cash in keeping with responsible management." The possibility of renewed dividend payments in 1970 was held out as a favorable trend in operating results. Thus, although dividends were stopped, the true nature of the crisis was still concealed. "Responsible management" was merely taking prudent and timely steps to conserve cash, it was suggested. No indication was given that the action was long overdue and the situation was critical.<sup>403</sup>

That letter also pointed out that Penn Central had spent nearly \$600 million for "merger connected capital projects" since the merger. Reports filed with the ICC show that merger related capital expenditures were \$43 million in 1968 and \$54 million in 1969, far short of the figure given above. This illustrated another difficulty the investor faced in assessing the financing situation. Huge sums were borrowed, it is true, but the investor had been led to expect this—he had been warned that capital expenditures would be abnormally high in the postmerger period, because of merger-related projects. These expenditures of course were to be temporary in nature. This theme was reinforced by postmerger statements about the very rapid progress being

<sup>399</sup> He repeated it however in his speech before the Financial Analysts Federation in October 1969.

<sup>400</sup> Generally accepted accounting principles clearly require such a disclosure, so the company was not going out of its way to make full disclosure in light of the perilous condition of the company. See also the Commission's Regulation S-X, Rule 3-19.

<sup>401</sup> The prior year's report did indicate that "substantial portions" of both categories of assets were restricted. Apparently, however, the final limit had not yet been reached.

<sup>402</sup> Dividends far exceeded income of the Transportation Co. for both 1968 and 1969.

<sup>403</sup> The letter was rife with what had to be deliberate overoptimism. It is included in its entirety as Exhibit IG-3. This letter should be contrasted to the tone in other events occurring the same day—Day's letter to Saunders (p. 165) and Saunders' luncheon meeting with the staff (p. 177).



made in physically implementing the merger. To state that merger-related capital expenditures were \$600 million was definitely misleading. This figure apparently included all capital expenditures, the bulk of which would be recurring in the future and were not temporary in nature. Many were nonrailroad. Further, the rate of capital expenditures in the postmerger period was in line with the expenditures in the immediate premerger period. And the statement in a special press release put out for year-end editions and dated December 19, 1969, to the effect that capital expenditures in 1970 would be substantially less than in 1969 and suggesting that this was because of a decline in merger costs and plans to improve equipment utilization is misleading. It is obvious that the real reason was simply lack of financing.

The favorable picture painted throughout the entire postmerger period of the state of the road's track, facilities, and equipment must also be considered misleading in tending to divert attention from financing problems.<sup>404</sup> If the truth were told, the condition of the plant and equipment was highly inadequate, causing serious service problems, and this was because the company could not provide the financing to do better.

Further indications of financial strength were also present. On January 21, 1970, Pennco announced it was acquiring additional shares of stock for the \$25 million owed to it by Great Southwest. This forgiveness of indebtedness would hardly appear to be the action of a company whose parent was deeply concerned about where it could obtain additional cash to keep operating.

### THE PROFESSIONAL ANALYST

It is very clear that the average shareholder could not be expected to make sense out of the information selectively provided to him by management. This is further emphasized by the fact that, as noted earlier, apparently the directors of the company, who had access to considerably more information than did the public, were unable themselves to piece together the then existing situation.

As indicated, the problem was apparently in part inadequate information and in part the complexity of the situation. While the professional analyst should not be the standard to which disclosure is directed, examination of what the professional is able to discern, and how, is enlightening. The fact that some astute analysts were able, using information from a variety of sources and reflecting an awareness that very significant information seemed to be lacking, to obtain a fairly reasonable assessment of the situation, militates against charges made by some persons that criticism levelled toward Penn Central involves an unjustifiable use of hindsight.

It is clear that over the postmerger period Penn Central developed a large "credibility gap" among significant members of the investment community. It is equally clear that management recognized the problem. On occasion it went on the offensive. For example, in late 1969 some deterioration was showing up in the company's earnings and

<sup>404</sup> This tendency appears to have been exacerbated by Penn Central's desires to convince the shipping public, through press releases, that its service was improving.

However, even before that time, on Sept. 5, 1968, Saunders told the New York Society of Security Analysts "one of our greatest accomplishments in preparation for our merger was the remarkable transformation of the equipment fleets of both railroads," indicating that \$1.1 billion had been expended on equipment by the two roads since merger proceedings were instituted.

operational figures, and rumors were spreading about Penn Central's condition.

Saunders, appearing before the Financial Analyst's Federation 1969 fall conference in October, opened his prepared speech as follows:

I don't know whether I should ask you to give me a medal for bravery or folly in appearing before this very influential group today. At least you should be grateful that our merger has provided you so much to write about in the past year and a half. Penn Central is enjoying the dubious honor of being probably the most talked about company in the railroad industry, if not the business world.

One phenomenal thing that our merger has achieved is that it has produced a host of experts on Penn Central many of whom seem to know far more about our business than anyone on our payroll.

He then moved on to discuss again the industry:

Speaking to a group of financial analysts at this time is a particularly challenging assignment for any railroad inasmuch as it seems obvious that members of your profession are not overly optimistic about our industry. But if I may say so, I fear that some of us in our concentration on figures and statistics sometimes tend to overlook and underestimate many good things which are taking place in our industry.

After some discussion, he went on to treat Penn Central individually, stressing the positive steps the company was taking to improve service, lower costs and increase profits. An article to the same effect, based on an interview with Saunders, entitled "Penn Central Sees a Light in the Tunnel," appeared in *Business Week* on November 22, 1969. He was quoted as saying that Penn Central's problems had been exaggerated out of all proportion on Wall Street and in the press, and that unfounded rumors were generating pressure on the stock. Four days after appearance of the article the directors voted to omit the payment of the fourth quarter dividend.

The credibility gap was very obvious by this point. However, investment community dismay at the situation had begun as early as September 1968 when Saunders gave a talk before the New York Society of Security Analysts. One analyst characterized the speech in a report as follows: "Management's recent presentation at the NYSSA was generally disappointing. While many of the known profit potentials were discussed, there was an abundance of vague, unsure and contradictory answers." *Forbes* magazine, indicating that the group was looking for answers for the sharp decline in the stock's price in the past 2 months, labelled Saunders' performance as a "letdown" in an article entitled "Weak Script" appearing in its October 1, 1968, issue. Other examples of analyst concern can also be cited. Rumors were circulating widely by the summer of 1969 about a likely elimination of the dividend, and by September even Equity Research Associates, which had distributed a favorable report on Penn Central in January <sup>405</sup> and continued to recommend the company through the year, indicated that "ERA hates to give up on this one but we have to for now. The 'explosive' potential we spoke of as recently as last week is still there and will one day be realized, but before that day

<sup>405</sup> Management, hearing the report was underway and fearing an adverse report, had been working very closely with the analyst involved. An interesting incident took place in this connection. David Wilson, in-house counsel for Penn Central, called Dechert, Price and Rhoads, outside counsel, on January 3, the day after the report was issued and 3 days after the Madison Square Garden transaction was consummated to inquire as to whether Penn Central would have to make any statement about the profit recorded in MSG. A memorandum indicates that:

"Dave and I agree it has no duty to its own shareholders to do so, despite the magnitude of the transaction because of the accuracy of the ERA statement against the background of the rather optimistic release by Mr. Saunders" (probably his year-end statement issued on December 28, 1968).

Apparently, Penn Central felt that if they gave the information to one analyst, they had met their disclosure obligation.

dawns we now believe the dividend will be cut or eliminated." An analyst from Spencer Trask in early August pointed to the substantial and increasing cash drain from operations as the most significant indication of the company's progress, suggesting that "reported earnings are a meaningless guide to the position of the company." Continuing deterioration in passenger and freight operations and the continued dividend payments were making necessary sales of prime real estate, extraordinary dividends and debt financing, he reported.

It is clear that if Penn Central management had been meeting its responsibilities to shareholders, it would have been alerting shareholders to these same factors.

Other professionals were also evidencing awareness of critical problems which were not being stressed to shareholders. After a visit with Perlman in August 1969, Morgan Guaranty Bank analysts came to the following conclusion:<sup>406</sup>

(1) Our earlier expectations of a rebound in rail operations by the second quarter failed to occur because of continuing merger costs. (2) We are increasingly concerned about the weak consolidated financial position in view of the fact that approximately 30 percent-40 percent of reported earnings are estimated to be of a noncash nature, resulting in a situation whereby the payment of common stock dividends might well be from bank lines or short-term commercial paper borrowings. (3) Our 1969 estimate of \$4.75 per share now implies that management might resort to additional nonrailroad sources to meet this objective and to raise additional working capital—in this regard management could well decide to sell more nonrailroad investments, that is, Great Southwest Corp., Norfolk and Western common stock, or a variety of other low cost assets. While such an occurrence would have been indicated to us early in the year, we feel the quality of these earnings will be substantially lessened, and more importantly such an occurrence would mark the second straight year of railroad deficits in excess of \$122 million. (4) The apparent lack of harmony in top and middle management is gradually being resolved, though we feel this is still somewhat of an inhibiting factor in achieving operational improvement and also in obtaining a successor to Mr. Perlman who will retire in October 1970. (5) Management in general continues to divulge little in the way of analytical information, thus leading to investor confusion as to the extent of Penn Central's overall problem and resources.

The contrasts between these impressions and the official company position, described earlier, should be noted.

Over the ensuing months, the analysts at Chase Manhattan Bank continued to view Penn Central with suspicion. A check with certain shippers in late 1969 indicated that there was still much dissatisfaction with service. After reviewing operating results for the fourth quarter of 1969, these analysts wrote that the credibility gap between management and the investment community seemed to be widening and contrasted the poor results with recent statements by management. They further commented on the "lack of meaningful published information and the reticence on the part of management to thoroughly discuss the now-sensitive area of railroad operations," indicating that this further complicated attempts to assess near term prospects and the status of certain recognized variables, such as business lost because of poor service, high per diem costs and merger costs and savings. In like vein, another analyst, this one from Black & Co., wrote in early 1970: "with the credibility gap existing in this railroad and, keeping in mind the many unique adjustments which this railroad has made and can continue to make, it is evident that the course of their earnings over the next several years cannot be accurately determined."

<sup>406</sup> These were the negative conclusions; there were some positive ones as well.

In another development at about the same time, an executive of Alleghany Corp., a large Penn Central shareholder, expressed concern about the trend he had discerned:

It is obvious that there is a timetable beyond which the situation can no longer continue, that is, railroad operating losses aggregating in excess of \$10 to \$15 million per month can only be sustained for a short period of time before insolvency inevitably results. It is for this reason that I wished to speak to Mr. Bevan concerning what unhocked assets or resources, if you will, are left to Penn Central to use as a source of funds to support inevitable continuing railroad deficit operations in 1970.

He further noted in the memorandum, which was addressed to Alleghany Corp.'s chief executive, a member of Penn Central's board, that it would be unfair and possibly dangerous from a director's point of view for Penn Central not to make full and clear disclosure of the railroad losses and its overall financial position in the 1969 annual report.

While the average shareholder would have neither the ability to put the information together nor the ready access to certain types of information relating to the company which could be gathered from various sources,<sup>407</sup> shareholders could often benefit from work done by the professionals, particularly if they were active customers or otherwise in a situation to command this knowledge. Thus, one, a well-known attendee at the meetings of various corporations, asked at the Penn Central annual meeting held 6 weeks before the company filed for reorganization:

It would be very reassuring to your stockholders, Mr. Chairman, in view also, of the comments of some Wall Street observers, if you would comment on the solvency of the Pennsylvania Railroad in light of the heavy deficit with which it is presently afflicted.

Saunders' response was analogous to that he gave at the September 1969 analysts' convention noted earlier in this section. He pointed to the company's large assets and equity. He admitted Penn Central could not continue to lose money as it had in 1969 for an indefinite period but added:

I do not want to make you think it is going to be easy. It is not. It is going to be a very difficult task, there are terrific challenges here; there are terrific potentialities; there are terrific assets; and it is certainly the intention of management not only to keep this company solvent, as you say, but to make it grow and prosper.

He then went on to point out that while there were bleak aspects, there were bright aspects also, which he proceeded to describe in some considerable detail.

The shareholder, apparently unconvinced, tried again:

Perhaps it would be helpful at this time if I asked the question in a slightly different way and that is: Can we keep out of bankruptcy without another freight increase?

She went on to suggest, as others had done earlier, a policy of full disclosure in order to gain more Government assistance—that the ICC should be told just how much the company needed the then pending rate increase. Saunders said he felt that he had already answered her concern, and he did not feel it was necessary to go as far as she was suggesting with the ICC since they were cognizant of the industry's

<sup>407</sup> For example, reports filed with the ICC and the American Association of Railroads, industry statistics, contacts with other professionals, with Penn Central management, with officials of other railroads, with shippers, and so forth.

problems and anxious to keep it strong and viable. The critical financial condition was never clearly revealed.

### SUMMARY AND CONCLUSIONS

It is doubtful that any knowledgeable investor bought stock in Penn Central or its predecessors in recent decades without recognizing that there was some risk involved that the company could go bankrupt at some future date.<sup>408</sup> The risk such investors should not have been expected to take, however, was the risk that they would not be given relevant information available to management to enable them to assess the fact that that day was fast approaching and finally was imminent. Even less should they have had to accept the risk that management was actively taking steps to conceal that information. Hope springs eternal, perhaps, and suggestions that there eventually might be a turnaround in industry problems, based largely on hoped for Government action, might ring a responsive chord in the investor, but if there was a significant danger that the company could not survive that long, the shareholder had the right to be so apprised. The feeling that, if the truth were known, investors or creditors could not be expected to furnish additional needed capital, is scarcely a valid excuse for such deception, although it appeared to be a major factor propelling management's lack of candor.<sup>409</sup> Neither can management be excused by the fact that their attempts at deception were partially recognized by a disbelieving corps of professionals and that to some extent this filtered through the market, as reflected in substantial declines in the price of the stock.

It is clear from the preceding discussion that, throughout the entire period from February 1, 1968, until June 1970, when top management and Penn Central parted company, the public was being fed misleading information on a virtually continuous basis. Disclosure was made only to the extent it was not feasible to do otherwise, because it could not be hidden. The tone presented to the public throughout 1968 was one of great optimism with respect to all aspects of the business—financing, earnings, operations, etc., an optimism clearly not justified by the facts. This picture was altered only when facts about the service problems became known anyway. The company then admitted the existence of these merger-related problems and their related earnings impact, but indicated repeatedly that the situation had turned the corner and things were definitely on the upswing. The rest of the picture was rosy. The diversification program was a success, and there was no indication given of any significant problems in the financing area. The policies in reporting earnings assured that the full impact of railroad losses would be hard to detect.

It was not until early 1970, when the end was near, that the rosiness was tempered. There was no mention yet of financing problems or the course of conduct being pursued in the earnings area. The company did give increased indication of problems in the critical railroad segment of the business, although management rejected internal suggestions that it might be in the economic interest of the company to lay these problems bare in their entirety. Losses were only partially disclosed and considerable emphasis was being put on steps being taken

<sup>408</sup> There were unsophisticated investors, however, who apparently viewed the company as a real blue chip, which had paid dividends for many years and was completely sound.

<sup>409</sup> Another major reason was probably the personal interest of management in keeping their jobs.

to remedy the situation—steps which could not realistically be expected to yield results in time to prevent disaster.

By this point, in early 1970, some people in the Penn Central organization were becoming concerned about potential liability if disclosure was not made. The focus was clearly not on what they should disclose to the public to fairly apprise them of the situation, but on what they were forced to disclose because the dangers of nondisclosure were just too great. Indeed, the fact that some disclosures, which should have been made many months before, were now finally being made, is a good indication of just how desperate the situation was, as people scrambled for some degree of protection for themselves. Collapse of the company would certainly bring this information out and require explanations for prior concealment. Nonetheless, it was still difficult to convince top management of the necessity, and there was constant conflict. O'Herron objected strongly to the initial draft of the 1969 annual report, indicating that it "essentially duplicates the same bland and relatively optimistic tone that was featured in previous years' reports," and that it did not convey the true character of 1969 results. "Let's tell the real story without all the nuances and details and establish a credibility which will be useful when things really do get better." Wilson, the legal department's SEC expert, raised cries of anguish at the two initial drafts of the report and announced he refused to take any responsibility for the material contained therein, further indicating that the courts had made it clear that material in an annual report could be viewed as evidence of a practice or intention on the part of management to mislead investors in violation of the antifraud provisions of the Federal securities laws.<sup>410</sup> He was also disturbed by certain disclosures concerning Great Southwest to be made in the Pennco offering circular, stating:

"If everything turns out OK for GSW and none of the plans and programs on which its earnings have been reported comes to grief, all this worrying does not matter. But management should recognize that they are taking a substantial business risk in attempting to shortcut disclosure in connection with operations such as GSW."

He again referred to court decisions dealing with such matters.

Other instances in this period of management's propensity not to disclose and contra-pressures to provide better disclosure could also be given. A First Boston representative, describing their experience in connection with the underwriting, testified as follows:

"And because the Penn Central needed this financing once we had established that we were going to obtain the necessary disclosures, we were in a position of some strength as far as negotiations over exactly what would be disclosed would be concerned. They sparred with us for awhile and finally we established the position that we were going to have an offering circular that we were satisfied with.

"The basis of the problem was that Penn Central was concerned that we would produce an offering circular that would not make a good selling document. They were concerned about producing a document that was a selling document and at this point we were beginning to be more interested in producing a document that was a disclosure document.

"So there was a basic difference of objective at this point in time. And consequently, information was not being volunteered. We would have to ask specific questions. We had to make sure we were asking the right questions."

The information contained in the 1970 debenture offering circular did represent a considerable improvement in disclosure. And, it

<sup>410</sup> In another memorandum prepared at about the same time he warned that certain information could seriously mislead the unsophisticated investor, even if the professional would catch the nuances, and that it should accordingly be adjusted.

might be noted, like the earlier aborted Great Southwest offering, when the truth was known, the issue would not sell.

## EXHIBIT IG-1

## PENN CENTRAL SCHEDULE OF REPORTED EARNINGS

EXHIBIT IG-1

	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER	FULL YEAR
<b>1968</b>	<b>COMPANY</b> Consolidated "Railroad system" \$ 13.4 Net railway operating income ( 7.9) Ordinary and net income 3.0  <b>GORMAN CHART (unpublished)</b> Rail earnings (27.8) Net company earnings 1.0 Consolidated earnings 13.4	<b>COMPANY</b> Consolidated "Railroad system" \$ 13.6 Net railway operating income 7.9 Ordinary and net income 2.1  <b>GORMAN CHART (unpublished)</b> Rail earnings (26.9) Net company earnings 2.1 Consolidated earnings 23.6	<b>COMPANY</b> Consolidated "Railroad system" \$ 15.2 Net railway operating income ( 9.1) Ordinary and net income ( 3.6)  <b>GORMAN CHART (unpublished)</b> Rail earnings (42.3) Net company earnings ( 3.8) Consolidated earnings 15.2	<b>COMPANY</b> Consolidated "Parent company" \$ 38.0 Net railway operating income (31.9) Ordinary income 1/ (12.9) Net income (41.2)  <b>GORMAN CHART (unpublished)</b> Rail earnings (54.4) Net company earnings ( 2.9) Consolidated earnings 36.9	<b>COMPANY</b> Consolidated "Parent railroad company" \$ 60.3 Net railway operating income ( 27.9) Ordinary income 1/ ( 23.9) Net income ( 41.9)  <b>OFFERING CIRCULAR</b> Loss on railway operations (142.4) Earnings from ordinary operations ( 5.1)
<b>1969</b>	<b>COMPANY</b> Consolidated "Parent railroad company" \$ 4.6 Net railway operating income (10.1) Ordinary and net income (12.8)  <b>GORMAN CHART (unpublished)</b> Rail earnings (42.0) Net company earnings (12.8) Consolidated earnings 4.6	<b>COMPANY</b> Consolidated "Parent railroad company" \$ 21.9 Net railway operating income ( 7.5) Ordinary and net income ( 8.2)  <b>GORMAN CHART (unpublished)</b> Rail earnings (44.2) Net company earnings 21.9 Consolidated earnings 21.9	<b>COMPANY</b> Consolidated "Parent railroad company" \$ 8.9 Net railway operating income (14.8) Ordinary income (18.2) Net income (28.9)  <b>GORMAN CHART (unpublished)</b> Rail earnings (19.6) Net company earnings ( 8.2) Consolidated earnings ( 8.9)	<b>COMPANY</b> Consolidated "Parent railroad company" \$13.2 Net railway operating income ( 9.0) Ordinary income (35.4) Ordinary income (42.6) Net income (41.4)  <b>GORMAN CHART (unpublished)</b> Rail earnings (45.0) Net company earnings (36.1) Consolidated earnings (13.2)	<b>COMPANY</b> Consolidated "Parent railroad company" 1/ \$ 4.4 Net railway operating income ( 41.3) Ordinary income ( 67.8) Ordinary income ( 42.8) Net income ( 91.6)  <b>OFFERING CIRCULAR</b> Loss on railway operations (103.2)
<b>1970</b>	<b>COMPANY</b> Consolidated "Parent railroad company" \$ ( 17.2) Net railway operating income ( 61.8) Ordinary income ( 83.9) Net income ( 66.6)  <b>OFFERING CIRCULAR</b> Loss on railway operations (181.6)				

NOTE: Figures in millions of dollars  
Figures in parentheses indicate losses

1/ Before prior period and extraordinary items.  
2/ This figure was included in the press release  
but not the report to shareholders.

## KEY

COMPANY - Figures from Penn Central annual reports and press releases  
GORMAN CHART - Figures from internal company report prepared in early 1970  
OFFERING CIRCULAR - Figures from offering circular prepared for Pennco \$100 million selective offering

## EXHIBIT IG-2

## PENN CENTRAL CONSOLIDATED SOURCE &amp; APPLICATION OF FUNDS/YEAR 1968 (in millions)

SOURCE	APPLICATION
Earnings from Operations \$ 90	\$ 55 Dividends
Depreciation, Amortization and Depletion 136	280 Reduction of Long-Term Debt
Financing 457	306 Additions to Property
Sales of Capital Assets and Other Sources (net) 32	128 New Haven Assets Acquired
Working Capital Decrease (excluding debt due within one year) 54	
<b>TOTAL \$769</b>	<b>TOTAL \$769</b>

## EXHIBIT IG-2—Continued

Penn Central Consolidated Source &amp; Application of Funds / Year 1969 (in millions)

Source		Application	
Earnings from Ordinary Operations	\$ 4	\$ 43	Dividends
Depreciation, Amortization and Depletion	133	302	Reduction of Long-Term Debt
Financing	635	257	Additions to Operating Property
		107	Investments—Securities and Properties (Net)
		36	Charges to Reserves and Other Items (Net)
		27	Working Capital Increase (Excluding Debt Due in One Year)
<b>TOTAL</b>	<b>\$772</b>	<b>TOTAL</b>	<b>\$772</b>

## EXHIBIT IG-3

PENN CENTRAL,  
December 1, 1969.

DEAR STOCKHOLDER: I am writing you regarding the action taken by the Board of Directors on dividends at its November 26 meeting, and to report to you on the current status of the Company, particularly our railroad operations.

The Board decided that the total dividend for 1969 would be the \$1.80 per share already paid, and to omit a payment for the fourth quarter. It will, however, give consideration during 1970 to dividend payments, either in cash or in stock or both.

This action was prompted by the necessity to conserve cash, in keeping with responsible management. Current indications are that railroad operating losses will show a favorable trend in the fourth quarter, but obviously the railroad strike which might occur this month would have an adverse impact on earnings for this period.

The following summary shows how your 1969 dividend compares with annual payments in recent years:

1968-----	\$2. 40	1964-----	\$1. 25
1967-----	2. 40	1963-----	. 50
1966-----	2. 30	1962-----	. 25
1965-----	2. 00	1961-58-----	. 25

On a consolidated basis, Penn Central earned \$17.6 million, or 73 cents a share for the first 9 months of this year.

In this same period, our railroad had a passenger deficit of \$73 million on the basis of fully allocated costs, or approximately \$47 million in direct costs. But for this, the railroad would have been in the black. Other important factors in our railroad deficit were exceptionally high costs (most of which are nonrecurring), of implementing the consolidation of the former Pennsylvania, New York Central, and New Haven Railroads into a single system, higher operating expenses incidental to the startup of the merger and inclusion (since January 1, 1969) of the New Haven, the impact of inflated costs of wages and supplies and the sharp increase in interest rates.

No compensating increases in freight rates were granted this year until November 18, when a 6 percent increase became effective. Penn Central will gain about \$7.5 million during this quarter from the increase, and about \$80 million on an annual basis, but we also face further inflationary wage demands for 1970. It will be necessary for the railroad industry to request an additional rate increase during the year.

Penn Central is making a determined effort to reduce costs and we are showing progress in this respect. Our executive payroll is the lowest of any major railroad as a percentage of total compensation.

With regard to total labor force, we now have approximately 7,500 less employees than we did at the highest level since our merger and inclusion of the New Haven. We are accelerating our early retirement program and have retired 541



officers and supervisory employees since the merger. We will retire 143 more by the end of the year, and every department is being asked to submit a list of candidates who will be eligible in the near future.

In the fourth quarter, we expect to cut our per diem payments (to other railroads for their freight cars on our lines) by about \$6.5 million, and we estimate that these costs will run some \$9 million less than for the last half of 1968.

In addition, a recent Supreme Court decision upholding a time-mileage formula for per diem payments is expected to become effective in the near future and should produce additional savings of \$16 million in 1970.

As you are aware, Penn Central is burdened with a far greater passenger service deficit than any other railroad, since we now operate more than a third of all the Nation's rail passenger service. We are continuing to develop public assistance plans for improving commuter service and cutting operating deficits in the Philadelphia, New York, New Jersey, and Boston areas.

Under terms of an agreement executed on November 25, Penn Central will sell for \$11.1 million its equipment and part of its right-of-way and will receive approximately \$4 million in annual rentals from the States of New York and Connecticut for its commuter line between New York City and New Haven. The two States and the Federal Government will spend \$80 million to acquire new equipment and modernize facilities.

Our railroad's new Metroliner trains are producing a 14-percent gain in overall passenger traffic between New York and Washington.

Penn Central has spent nearly \$600 million for merger-connected capital projects since the merger of the Pennsylvania and New York Central railroads in February 1968. The biggest single new facility for 1969, a \$26-million electronic classification yard at Columbus, Ohio, will be opened in December. Several other key yards have been expanded to accommodate heavier traffic.

The largest and most costly of our merger projects are now behind us. We have combined 32 major terminals and have made virtually all important rail connections. These new facilities are tools with which we can improve our efficiency and productivity in the years ahead.

Our new president, Paul A. Gorman, took office today. He was formerly president of Western Electric Company, an organization larger than Penn Central, and an executive vice president of American Telephone & Telegraph Company. Mr. Gorman, I am sure, will give fresh impetus to cost control and management efficiency programs. He is recognized as a leading expert in corporation management and we are fortunate to get him.

Our diversification program has been extremely successful since the former Pennsylvania Railroad initiated it in 1963. We have branched out in two directions—(1) development of our own railroad-related property and (2) acquisition of real estate properties in California, Texas, Florida, and Georgia, and a pipeline system in the Northeast.

We are expanding our wholly owned subsidiary, Buckeye Pipe Line Company, which now operates a 7,800-mile distribution network. Buckeye, together with our two real estate subsidiaries, Great Southwest Corporation and Arvida Corporation, contributed more than \$50 million to our consolidated income during the first 9 months of this year.

We are in the process of acquiring three companies which will add more than \$100 million to our revenues next year. Southwest Oil & Refining Company operates a 50,000-barrel-per-day refinery and Royal Petroleum Corporation wholesales fuel oil and operates a deepwater marine terminal in the New York City area.

Richardson Homes Corporation of Indiana, which is being acquired through Great Southwest, a Penn Central subsidiary, has built mobile homes for more than 25 years. Its 1969 sales volume will reach \$25 million. Richardson has plants in Indiana, North Carolina, Texas, and Florida, and is now planning to enter the modular home field, for the manufacture and distribution of prefabricated housing.

I would like to call your attention to legislation pending in Congress which will provide Federal aid for passenger-carrying railroads. We are seeking Federal assistance to cover deficits incurred in operating passenger trains which cannot pay their own way and to finance acquisition of modern passenger equipment.

Penn Central's best hope for real progress in curtailing its passenger deficit lies in this legislation. Prospects for its enactment are better than they have ever been. I urge you to write immediately to the Members of Congress whom you know or represent you asking them to approve this vitally essential measure. Favorable action by the 91st Congress will be in the public interest as well as your own.

Sincerely,

STUART T. SAUNDERS, *Chairman.*

## PART II

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### II-A. SALE OF PENN CENTRAL STOCK BY INSTITUTIONS

#### INTRODUCTION

During the optimistic period before and shortly after the merger, Penn Central stock was favored by many institutional investors including mutual funds and banks. As Penn Central's fortunes declined, most of these institutions sold their holdings. A number of these institutions had possible means of obtaining confidential information.

To explore the possibility of sales based on inside information, the staff sought the identity of these institutions through questionnaires sent to brokers, through reports to the Commission from registered investment companies, and through various other means. Where a pattern or relationship raised some question, further information was sought. Over 100 institutions were subpoenaed for the production of documents. This information was analyzed to determine whether trading on inside information had occurred.

The analysis of possible insider trading was made difficult by the existence of some public adverse information throughout the period. Although there was significant adverse information that was non-public, sellers were able to cite the public information as a reason for selling. The staff, therefore, paid particular attention to trading at significant times or where there was a significant relationship between the company and the seller. Affidavits or testimony were sought where unresolved questions existed.

As a result of the analysis, the inquiry focused on five institutions which sold stock at a critical period (late May and early June 1970) and which had, or may have had, a relationship to Penn Central: Chase Manhattan Bank, Morgan Guaranty Trust Co., Continental Illinois National Bank & Trust Co., Investors Mutual Fund and Alleghany Corp. The staff's findings on these institutions are described separately in this section.<sup>1</sup> Testimony was taken from officers and employees of these institutions. The witnesses denied that inside information was used in any way in the decision to sell Penn Central stock. In each case they cited public information or particular internal circumstances as the reason for the sales. It is clear, however, that the sales of the banks point up inherent conflicts of interest. As a lender to corporations, a bank is obviously entitled to nonpublic information. As a manager of trust accounts, a bank seeks out information to advance the interest of these accounts. It is clear, however, that no

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<sup>1</sup> Investors Mutual Fund and Alleghany are described together because of common control of Alleghany and Investors Diversified Services, Inc. (management company for Investors Mutual) and because of relationships in the timing of the sales.

confidential information gathered in a commercial banking capacity may be used to benefit the trust accounts. Banks have an affirmative duty to see that appropriate procedures are established to prevent any transmittal of information. In the case of these banks, Chase described certain procedures it had instituted to separate the functions, whereas Morgan, on the other hand, had no such meaningful procedures. Officers from both units routinely attended joint meetings, and, until almost the hour of Morgan's sales, one analyst served both the commercial and trust departments.

There is also a question of confidential information passing by way of interlocking directors. Stuart Saunders was a common director of Penn Central and Chase. Thomas Perkins and John Dorrance were common directors of Penn Central and Morgan. Although any conveyance of confidential information by this route was denied, on at least the Morgan board and its trust committee a common director spoke on Penn Central's affairs in the presence of trust officers. Interlocking directors should not be put in the position where they might disclose confidential information to bank trust officers.

Although at this point serious questions exist about whether sales were made on inside information, it should be noted that proof of insider trading is always difficult. The difficulty is increased where, as here, there is some public adverse information which might explain the trade. Unless direct testimony or documents can be obtained on the use of inside information it is difficult to sustain a charge of misuse of information.<sup>2</sup>

#### CHASE MANHATTAN BANK, N.A.

Chase Manhattan Bank, N.A., as one of the largest commercial banks in the United States, had extensive relationships with Penn Central, including among others, participation in various term loans to Penn Central by banking syndicates and an interlocking directorship in that Stuart Saunders, chairman of the board of Penn Central, was a member of the board of directors of Chase.

During the period of May 1-June 21, 1970, Chase sold 7,618 shares for its personal trust<sup>3</sup> accounts and 3,597 shares for its investment advisory<sup>4</sup> accounts. During the period May 6-June 21, 1970, Chase sold 543,500 shares<sup>5</sup> from its pension trust accounts.<sup>6</sup>

The activity in these various accounts at Chase may be illustrated by the following table:

TABLE I.—HOLDINGS OF PENN CENTRAL STOCK

Date	Pension	Personal Trust	Advisory	Total
Mar. 26, 1970.....	566, 320	40, 226	72, 673	629, 219
June 23, 1970.....	48, 000	32, 840	69, 061	149, 901

<sup>2</sup> Both of the commercial lending departments of Morgan and Continental had inside information at the time the trust department was selling Penn Central stock, but the parties to the decision to sell deny under oath that the trust department had access to the information.

<sup>3</sup> In personal trust accounts Chase usually did not have discretionary authority but rather was limited by the terms of the trust instrument and by the control exercised by the co-trustee(s).

<sup>4</sup> In investment advisory accounts Chase merely furnished advice with no authority to purchase or sell securities for the account.

<sup>5</sup> From figures made public by Chase. It should be noted that a staff review of the confirmation sheets submitted by Chase indicates a lesser total. However, we will assume that public statistics are correct.

<sup>6</sup> In almost all pension trust accounts, Chase acted as Manager, i.e., it had full discretionary authority to purchase or sell securities held by the Trust as it deemed appropriate.

Thus, holdings of Penn Central stock decreased by 529,318 shares or 78 percent.<sup>7</sup> The foregoing figures should be compared with the following table II, which indicates Chase's holdings at various dates prior to this period:

TABLE II.—HOLDINGS OF PENN CENTRAL STOCK

Date	Pension	Personal Trust	Advisory	Total
Mar. 21, 1968.....	743,060	46,996	132,857	922,913
Mar. 4, 1969.....	425,550	37,864	76,953	540,307
June 12, 1969.....	197,980	29,770	70,194	297,944
Nov. 19, 1970.....	592,725	38,548	73,026	704,299

Moreover, it should be noted that Chase as a bank subject to regulation by the Federal Reserve Board and subject to the restrictions of the Glass-Steagall Act did not own or trade any Penn Central stock for its own account.

As the foregoing statistics indicate, the overwhelmingly majority of sales by Chase of Penn Central stock were made for its pension accounts. The following table indicates also that these sales were clustered during the period May 6–June 10, 1970.

TABLE III

Date:	Number of shares sold	Date:	Number of shares sold
May 6.....	9,900	May 29.....	63,700
May 15.....	1,000	June 1.....	27,000
May 19.....	8,000	June 2.....	50,000
May 20.....	7,000	June 3.....	45,700
May 22.....	125,400	June 4.....	30,600
May 25.....	57,100	June 10.....	7,800
May 26.....	31,850		
May 27.....	39,700	Total.....	543,550
May 28.....	38,800		

Thus, during the period from May 22 to June 4, 1970, Chase sold from its managed pension accounts a total of 509,850 shares or approximately 94 percent of the total Penn Central sales made by Chase in the period May 1–June 21, 1970.

In order to examine the reasons why these transactions occurred, four employees of Chase were deposed. They were Paul T. Walker, Vice President, U.S. Department (commercial division of Chase); James M. Lane, executive vice president, Fiduciary Investment Department (trust division of Chase); Paul P. Lehr, financial analyst, Fiduciary Investment Department; and James S. Martin, vice president, Fiduciary Investment Department.

Walker was a vice president in the commercial division of Chase who had responsibility for the commercial and correspondent bank business in certain mid-Atlantic States. One of his accounts was the Penn Central complex.

Chase was a participant in various term loans and revolving credits made to Penn Central and was also a depository bank for Penn Central. However, Chase did not directly loan funds to Penn Central as Stuart Saunders was a member of the board of directors of Chase, and apparently a direct loan would constitute a conflict of interest.

<sup>7</sup> However, it should be noted that the apparent discrepancy between the amount held at Mar. 26, 1970, and the amount held at June 23, 1970, may be attributable to a number of factors, including purchases of Penn Central stock, and transfer of accounts holding Penn Central to or from Chase.

Walker normally represented Chase in its dealing with other banks relative to loans to Penn Central. Walker did not attend nor was he aware of the content of the May 21, 1970, meeting between David Bevan and First National City and Chemical banks, wherein Bevan discussed Penn Central's current financial condition, the postponement of the Pennsylvania Company's \$100 million debenture offering and Penn Central's intent to seek a \$225 million Government guaranteed loan.<sup>8</sup> Walker did attend the May 28, 1970, meeting of the banks regarding Penn Central.

Walker maintained that the only persons he ever talked with at Chase about Penn Central financial matters were other officers of the commercial department. Walker specifically denied talking with Mr. Lehr or Mr. Martin of the Fiduciary Investment Department of Chase about Penn Central. Moreover, although Chase was represented at the May 28, 1970, meeting and although it did receive the "Confidential Memorandum" dated May 22, 1970, regarding the financial condition of Penn Central, it was claimed such information was not given to the Fiduciary Investment Department.<sup>9</sup> Walker made reference to Chase's internal policy regarding communication between the commercial and trust divisions of Chase. This policy was stated by David Rockefeller in testimony to Congress as follows:

By executive letter, last revised under date of November 4, 1968, which was issued by the chairman of the board and the president of the bank, all personnel were instructed that there is to be no flow or incidental communication of inside information from the commercial departments or divisions of the bank to the investment department or the pension or personal trust divisions of the trust department.

Chase has erected a "Chinese wall" between its commercial and trust divisions with the intent that neither act with or for the other, and that although, organizationally, they are divisions of the same bank, they should be functionally independent.

Lane, as executive vice president, was in charge of the Fiduciary Investment Department of Chase. Lane was chairman of the investment policy committee which had the responsibility for determining broad investment policy and strategy. Lane was also chairman of the trust investment committees, which were four committees, one each for pension, personal trust, corporate trust, and discretionary investment management accounts.

The investment policy committee in addition to setting broad policy has final authority to accept or reject the specific market ratings of the Fiduciary Investment Department's research group. Thus the investment policy committee in setting broad investment guidelines and approving specific ratings of particular securities determines the parameters within which the individual portfolio managers may act, subject to any applicable restrictions in a trust instrument. However,

<sup>8</sup> Walker did receive a telephone call from Jonathan O'Herron at his home on Saturday night, May 23. O'Herron apologized to Walker about Penn Central's not having kept the banks adequately informed. Walker considered this to be an extraordinary call.

<sup>9</sup> In a letter dated Mar. 3, 1971, addressed to William Kuehnle, Roy C. Haberkern, Jr., Counsel to Chase states:

"After investigation, we have determined that the "confidential" memorandum dated May 22, 1970, concerning Penn Central Transportation Co. was received by one or both of two officers in the Commercial department of the Chase Manhattan Bank (National Association), Paul T. Walker and Peter E. Lengyel, both vice-presidents. It is their recollection that said memorandum was received from representatives of First National City Bank at a meeting held at First National City Bank on May 28, 1970, or shortly thereafter. We are further advised by Messrs. Walker and Lengyel that neither of them had any conversations with any officer or employee of the Fiduciary Investment Department of Chase with respect to said memorandum or with respect to any other subject involving either Penn Central Co. or any of its affiliates. As you know, the memorandum was not contained in the files of the Fiduciary Investment Department."

the immediate responsibility for managing the account is that of the portfolio managers. The other members of the investment policy committee are the senior officers of the various Fiduciary Investment Department divisions.

Lane discussed the various aspects of the internal Chase system for rating specific securities. Lane noted that the investment policy committee must approve a change in rating of a specific security before the change is made. With respect to the rating of Penn Central common stock, Lane stated that the research department submitted a proposed change in rating for Penn Central to the investment policy committee on May 22, 1970. The proposed change was to reduce the rating of Penn Central from "D3" to "D4", which in terms of the Chase rating system would be a reduction from a permissible sell to a recommended sell. The proposed change of rating consisted of a two-page memorandum which detailed the analyst's reasons for recommending the change.

This recommendation would be received by members of the investment policy committee and certain senior officers but not by all the portfolio managers.

The investment policy committee met on May 26, 1970, according to their usual schedule and approved the downgrading of the Penn Central rating. This change of rating and the analyst's detailed dissection of the Penn Central situation was, in accordance with customary procedure, then disseminated to all investment department personnel.

Lane noted that the effect of a change from a "D3" to a "D4" rating was that:

If the account manager does not sell, he has got to answer for his decision not to sell, in terms of the policy guidelines that have been given to him . . . He not only has the delegated authority to sell a 4, if he doesn't sell, he has a lot of explaining to do.

These investment policy guidelines applied to all accounts held by Chase, including nondiscretionary accounts. Also, this guideline would apply to Chase's investment advisory service.

Thus, as of May 26, 1970, by virtue of the action of the investment policy committee, Chase's Fiduciary Investment Department personnel were strongly advised to sell any Penn Central stock held by accounts they managed or advised.

In order to determine the evolution of this change of rating, the staff deposed the financial analyst who recommended the change and provided the reasoning therefor.

Paul P. Lehr was a financial analyst in the Fiduciary Investment Department of Chase. After approximately 1 year's experience in financial analysis and management training, he was assigned in April 1970 as the analyst for the surface transportation industries with which he had no previous experience. Lehr stated that he had:

. . . full investment responsibility. . . . I have the full scope of responsibility for my particular securities.

Lehr noted that he was prohibited by Chase's internal policy from talking with the commercial department of the bank. Lehr could speak to the technical research department which serviced both the trust and commercial departments. However, the technical research department was prohibited from discussing specific companies and was responsible solely for economic studies of an industry as a whole.

In executing his investment responsibilities with respect to railroads, Lehr utilized as his principal sources of information, brokerage research reports, Moody's Manuals, reports of the Interstate Commerce Commission, and reports of the American Association of Railroads, as well as any annual and quarterly reports maintained in Chase's research files. Additionally, Lehr would review any documents, e.g., prospectuses, relative to a public financing.

Lehr would receive a monthly computer printout of holdings of various Chase accounts of a particular security which would indicate any changes from the previous month's holdings.

In the ordinary course of his duties, Lehr was expected to prepare and disseminate to the Fiduciary Investment Department personnel an informal document known as a flash report which would inform them of any current information about a specific company which he deemed significant. These flash reports, and also information memoranda (merely a longer version of a flash report), would not be submitted to or approved by the investment policy committee, but merely by the director of research.

If a change in rating were to be made, an analyst such as Lehr would initiate the process. The next step would be a review by the research review committee.

However, Lehr stated that it was his normal procedure that before this rating review and change process was initiated and/or completed he would speak with the portfolio managers regarding a specific security. Lehr stated:

I try to talk to portfolio managers who I know have a large interest, whether it be in a number of shares or the importance within a single account.

With respect to Penn Central in particular, Lehr's first written document was a flash report dated May 13, 1970. Lehr, in describing the circumstances surrounding this flash report, stated that the predecessor surface transportation analyst had received a call from James Reynolds, an institutional salesman for Butcher & Sherrerd. Reynolds told the analyst that Butcher & Sherrerd was recommending a switch which Lehr interpreted as a change from a buy recommendation to a permissible sale recommendation.

After this call, Lehr was instructed to call the research director for Butcher & Sherrerd, a Ted Bromley, to find out what the main points were that he thought made Penn Central a switch in recommendation.

According to Lehr, this conversation took place on May 12 or May 13, 1970. Lehr stated that:

... everything Mr. Bromley discussed was either information available in the annual report of Penn Central [or] was just knowledge you gain by experience.

It is important to note that although this conversation took place on May 12 or 13 and although Bromley discussed the April 27 prospectus, the revised prospectus of May 12 was not discussed by Bromley and Lehr was unaware of it. In fact, according to Lehr the earliest he was aware of the May 12 revised prospectus would have been May 22, 1970.

After this conversation with Bromley, Lehr decided to make an extensive analysis of Penn Central. He spoke with Chase's research director and received his approval to make the analysis his first priority. He then proceeded to make an extensive analysis of data

provided by Moody's Transportation Manual and the April 27, 1970, prospectus for the \$100 million Pennsylvania Co. debenture offering.

Lehr had been aware of the first quarter loss of Penn Central but had not been alarmed, partially due to the fact that a loss was expected and due to his experience in the area. Consequently, he had not done anything more than note the loss and informally discuss it with his predecessor who shared his lack of alarm.

The flash report of May 13, 1970, was essentially a report of the conversation with Bromley, the fact that Butcher & Sherrerd was recommending a change and certain financial data which Lehr had obtained from various public sources. Lehr noted in the flash report that Butcher and Sherrerd was a firm which knew Penn Central well.

Lehr stated the importance of this was that:

I was putting this out to the portfolio managers in order to give them an idea that this isn't only Paul Lehr with 1 month's experience informing them that the situation deserves a scrutiny, but that here was a firm that knew Penn Central supposedly well as witnessed by their being bullish on the stock and writing this bullish report . . . here was a firm going out saying we are no longer recommending purchase.

After distributing the flash report, Lehr arranged to see Jonathan O'Herron, vice president of Penn Central, to try to obtain further information such as the sources and uses of funds. However, the meeting which took place on May 15, 1970, was aborted by O'Herron without any substantial discussion.

Lehr then resumed preparing his detailed analysis of Penn Central's financial condition. He tried to reach O'Herron by telephone repeatedly but was unsuccessful.

By May 22, Lehr's recommendation for a change in rating of Penn Central stock had been prepared. Lehr also spoke with portfolio managers, including James Martin, about Penn Central during the week of May 18-22, 1970. Lehr discussed Penn Central's financial situation, both present and projected, and his proposed change in rating. Lehr spoke with portfolio managers in the pension, personal trust, and investment advisory areas.

Although the portfolio managers did not receive Lehr's memorandum of May 22, he had orally conveyed the substance of same to a large number of them prior to May 22.

Lehr did not recall whether the research review group approved the change in rating on Friday, May 22, or Monday, May 25, but in any event the investment policy committee did in fact approve the change in rating on Tuesday, May 26. The information regarding the change in rating would have been disseminated to all Fiduciary Investment Department personnel by Wednesday, May 27. However, the portfolio managers had begun selling during the week of May 18-22.

Lehr stated that he and Louis J. Kleinrock of the research group met with Burt Habgood, vice president in charge of the Pension Trust Department. Lehr spoke with Habgood and with Martin, who was also present at the meeting, about the substance of the May 22 memorandum regarding Penn Central.

However, Lehr could not recall exactly when the meeting occurred but felt that it probably was the week of May 25 or later. This fixing of the time of the meeting was due to the fact that Lehr recalled that Martin stated that he had sold out most of his position in Penn Central, which according to Lehr would have May 26 at the earliest.



Lehr stated that purpose of the meeting was to provide Habgood and his department with the analyst's latest information and judgment about Penn Central and to inquire whether holdings of Penn Central had been reduced to an extent commensurate with the risk.

Lehr spoke with Don Berry, vice president in charge of the Personal Trust and Investment Advisory Departments the day following his meeting with Habgood. Essentially, this conversation covered the same points Lehr had previously discussed with Habgood.

Lehr's conversation with Berry occurred at the request of Kleinrock who felt that both areas of the Fiduciary Investment Department should be equally informed.

After this meeting and conversation, Lehr issued a flash report dated May 29, 1970, which essentially announced the cancellation of the \$100 million debenture offering.

After these events and prior to the reorganization, Lehr did not issue any other written reports about Penn Central and his involvement, if any, would have been limited to discussions with the portfolio managers about Penn Central.

Martin had four portfolio managers reporting directly to him as well as personally managing certain pension accounts. Martin was one of two officers who had responsibility for supervision of the pension trust portfolio managers, subject to the supervision of the head of the Pension Trust Department, Habgood.

Martin stated that his:

... primary responsibility is the accounts which are directly assigned to me, which are 13 in number. Secondly, I have responsibility for the administration of the division of which I am head.

Additionally, Martin was a member of the pension trust investment committee.

Martin recalled that he had met with Lehr, Kleinrock, and Habgood regarding Penn Central, but he could not remember the date of the meeting. However, he did indicate that it probably was prior to May 26 when the change in rating of Penn Central was officially made.

Martin stated that at the meeting they discussed:

What course of action we should be taking with respect to Penn Central stock that we held, and we really debated as to whether or not the stock should be sold and should be sold across the board within the pension department.

Martin noted that the information discussed at the meeting was based upon the first quarter report of Penn Central and the first offering circular for the \$100 million debenture offering.

Martin recalled that they did discuss at the meeting that Lehr was recommending a change in the rating of Penn Central stock.

Although Martin could not recall the precise date of the meeting he was certain that it occurred before he began selling Penn Central stock on May 22. His recollection differs from Lehr on this point. Martin's memory appears more accurate since Lehr remembers being told to convey information to the head of the personal trust department after the meeting with Martin. That sequence appears more consistent with conveying information than with checking on the progress of sales.

Martin noted further that he did not see the revised offering circular until after he had begun to sell Penn Central stock.

In discussing the management of his accounts, Martin noted that he had in the spring of 1969 sold substantially all of the shares of

Penn Central in these accounts at above \$50 a share and then in November or December 1969 he bought approximately 250,000 shares at about \$25 a share.

With respect to the sales of Penn Central stock commencing on May 22, 1970, Martin stated that his order to his trading desk was at a "level indication", which he explained as sales within a reasonable range of a specific price but not a limit price. Martin stated that he gave the trading desk:

An amount of shares to work with at the outset rather than specific orders with respect to specific amounts. . . . As I recall when the orders were first entered the stock was in the 12 area and we used that as a level. The implication there is roughly within half a point of that in that kind of situation.

According to Martin all sales made for his accounts were within the range of 11½ to 13. These sales occurred during the period May 22-June 1 and during this entire period Martin had an outstanding order to sell.

Martin stated that "6 or 7" of the 13 accounts he managed held Penn Central stock in May, 1970, and that he placed oral orders with his trading desk to sell 100,000 shares beginning on May 22, 1970.

At the time of placing his initial order to sell on May 22, Martin indicated to the trading desk the approximate amount of his holdings of Penn Central but did not tell them that he wanted to sell all his holdings. Martin stated that:

I would have indicated to them the 100,000 shares and that there possibly was another hundred behind it. The decision I made at that time was not one to sell all the stock I had as far as I could sell it. It was to begin moving out of the stock, particularly in those accounts where it represented significant exposure. There was at that time the possibility that some of the stock would have been retained

Martin stated that he would not have sold all his holdings on May 22 if such a sale were possible:

I didn't feel at that time that it was that critical a matter to move all the stock as fast as I could. I felt that if it was a stock I wanted to be out of I was willing to take a period of time to do it. I didn't think I was in any imminent danger of losing all my money. There was a great deal of interest in the stock at the time. By moving more slowly and without putting undue pressure on the market it was likely I could get a better price overall.

The trading desk was able to unload a major part of this 100,000-share order on May 22. Martin continued to give orders for the sale of Penn Central until June 1 when his accounts were sold out.

Martin stated that he did not know at the time he placed the order whether the trades would be made that day or for which specific accounts he would be selling. At the time Martin placed the initial order to sell he had a specific order of his accounts that he wished to sell out first. Martin listed the specific accounts he sold out first and reiterated his reasons for selling out these specific accounts. Martin stated that his:

. . . interest was to allocate to those accounts in whom-in which it represented a material position, which were, in my view, at least more conservative in terms of their investment approach.

Further Martin noted that:

The allocation was made to those accounts first which I felt either had the greatest exposure in the stock in terms of percentage holding or to those accounts which I felt could assume the least risk by their nature.

Normally the allocation would have been made on a pro rata basis for all accounts selling Penn Central by the trading desk on the basis of order tickets submitted by the portfolio managers.

Martin noted that his decision to sell Penn Central was known by his fellow portfolio managers and also that the Penn Central situation had been extensively discussed by them. He also noted that only one other individual portfolio manager in his division held Penn Central stock. This was a Michael Hoben, whose account which held approximately 7,500 shares was sold by him on May 19 and May 21.

Although Martin was unaware of the reasons why Hoben sold, Chase has represented that Hoben sold on the basis of the May 13 "flash report" and his conversations with Lehr.<sup>10</sup>

Chase had a possible avenue for the transmission of inside information aside from the commercial lending department. James O'Brien, who was a partner at Salomon Brothers and who was involved in the Pennco debenture offering that was aborted on May 28, 1970, attended the May 21, 1970, meeting in Bevan's office. At that meeting, the underwriters were told the offering was being abandoned and that a government loan was being sought. O'Brien was formerly head of the Chase trust department. He knew all the individuals involved in the decision to sell Penn Central stock and in the normal course of business spoke with them about transactions in which Salomon was acting as broker. O'Brien testified that he did not recall the information disclosed at the May 21 meeting but that he is certain he never discussed Penn Central or its securities with Chase officers.

#### SUMMARY

It would appear that the commercial department of Chase would and did as a customary part of its loan arrangements have certain inside information about the financial condition of the borrower, Penn Central. However, Chase has claimed that, pursuant to its written internal policy, such confidential information was not communicated to its trust department and that the sales of Penn Central stock by Chase Manhattan Bank in May and June of 1970 were not occasioned by the receipt and use of inside information but rather were caused by an internal analysis of Penn Central which resulted in a downgrading of its rating to a point where it became an almost mandatory "sell" situation.

#### MORGAN GUARANTY TRUST COMPANY OF NEW YORK

Morgan Guaranty Trust Company of New York (MGT), a wholly-owned subsidiary of J. P. Morgan & Co., Inc., was the largest single shareholder of Penn Central (PC) at the end of 1968 with 849,275 shares held in nominee name for its trust accounts. This represented 3.4 percent of the total PC shares outstanding. By December 31, 1969, MGT had increased its holdings to 1,173,078 shares of PC stock. In 1970, prior to May 28, 1970, MGT sold 208,287 shares of PC stock, but continued to hold 847,308 shares in pension trusts administered by the trust department. But between May 29, 1970, and the filing for bankruptcy by PC on June 21, 1970, MGT sold 371,000 shares held for the pension accounts. The basis for these sales in May-June,

<sup>10</sup> Letter of Howard A. Scribner, Jr., vice-president, Chase Manhattan Bank, N.A., dated May 5, 1972.

1970 was a trust department decision to sell PC held in all pension accounts.

MGT also provided a significant amount of banking services for PC with \$35 million in various commercial debt obligations, and it also was part of a consortium of banks meeting at the end of May, 1970 to seek methods for additional financing for PC. Furthermore, MGT was the sole issuing agent<sup>11</sup> of PC commercial paper and two of MGT's directors were also directors of PC.

Taken as a whole these factors raise questions on possible use of inside information obtained as the basis for the trust department's sales of PC stock just prior to PC's bankruptcy.

#### INTERLOCKING DIRECTORS

There were two interlocking directorships between MGT and PC. John T. Dorrance, Jr., a director of both Penn Central Co. and Penn Central Transportation Co., was a director of both J. P. Morgan & Co., Inc. and MGT in early 1970. He also was chairman of the board of the Campbell Soup Co. and served on the boards of John Wanamaker (Philadelphia) and the Penn Mutual Life Insurance Co. The other interlock, Thomas L. Perkins, an attorney with the New York law firm of Perkins, Daniels and McCormack, served also on the boards of American Cyanamid, Duke Power, Discount Corp. of New York and General Motors Corp.

Dorrance was the senior MGT director, having joined the board of Guaranty Trust Co. in the mid-1950's, but not until about 10 years later, after the PC merger, did he become a PC director at the invitation of Stuart Saunders. Several companies Dorrance was affiliated with had investment accounts managed by MGT, but none of the accounts had any transactions in PC securities. Although Dorrance was aware of MGT's participation in First National City Bank's (FNCB) \$300 million revolving credit arrangement with PC, he testified that he was not aware of the MGT holdings of PC securities, of the FNCB meeting, of the decision to sell PC stock on May 29, or of the sales by MGT in May or June 1970. Dorrance attended the May 27 PC board meeting when the PC directors were informed that the debenture offering was to be postponed, and the June 8, 1970, meeting when certain PC officers were replaced.

Perkins, who served on the finance committee of the PC board, was quite familiar with PC's financial condition. Like Dorrance, Perkins had served as a MGT director before becoming a director of New York Central prior to the merger with the Pennsylvania Railroad. Perkins was aware of the significant PC holdings by MGT in early 1969 when, as a director of Discount Corp. of New York, he learned that MGT had purchased PC for Discount's pension plan. Upon inquiring, he learned that MGT's trust department was optimistic about PC's future, and he informed the trust department that he didn't care how they felt about PC, he didn't want any more PC purchased for the Discount pension fund. However, Perkins stated that he was not aware of the sales by MGT of PC in May or June and did not talk to anyone at MGT during May or June about PC, except for his discussions with John M. Meyer, chairman of the board of MGT,

<sup>11</sup> The issuing agent processes the physical issuance of the notes and receives and disburses the cash involved. The issuing agent is to be distinguished from the commercial paper dealer, Goldman, Sachs in this case, who has responsibility for marketing the paper.

about Perkins' resignation from the PC board of directors. Perkins testified that it was the practice for MGT directors to periodically attend trust committee meetings at MGT to discuss other companies which they also served as directors, although no information of a confidential nature was given the trust committee. In a May 3, 1972, letter, MGT's counsel stated:

With respect to meetings of the full Trust Committee, we are advised that it was not the practice at any of these meetings to discuss affairs of a particular company of which one of the members of the Trust Committee was a director, but rather the general industry being presented for review.

More specifically with respect to Mr. Perkins we are advised that he did not attend any meeting of Morgan Guaranty's Trust Committee during the period of May 1, 1970, through the bankruptcy of Penn Central. We are further advised that there was no discussion of Penn Central or the railroad industry in any meeting of the full Trust Committee held during this period.

#### COMMERCIAL DEPARTMENT

Kenneth E. MacWilliams, vice president of MGT, assumed client responsibility for Penn Central in April of 1970. MacWilliams reported that his duties regarding a particular client were to be aware of the client's financial needs and to participate in the extension of credit when it is necessary. Before credit is extended by MGT two members of the credit policy committee must approve any loan involving \$5 million or more, or any loan with a maturity date of over 1 year. Any officer can commit the bank up to these limits without committee approval.

In February 1970, MGT declined to participate in a \$50 million bridge loan to the Pennsylvania Co. for additional cash needs.<sup>12</sup> The loan was to have been unsecured, and was to have been repaid out of the proposed \$100 million Pennco debenture offering.

On May 6, 1970, Jonathan O'Herron, vice president of finance of Penn Central, met with representatives of the MGT's banking division to discuss Penn Central's financial condition and to make a preliminary inquiry as to MGT's potential participation in a 60-day bridge loan of \$20 million. Apparently MGT declined to participate in this loan for the same reasons it declined participation in the \$50 million loan in February.

The major loan to Penn Central by MGT was a \$25 million participation in the \$300 million revolving credit loan which was secured by Pennsylvania Co. stock. At the beginning of May 1970, MGT had extended \$20,833,333 out of its \$25 million participation; \$4,166,667 remained available for Penn Central prior to the bankruptcy.

On May 25, 1970, MacWilliams was informed by FNCB of a meeting to be held involving the revolving credit loan to Penn Central because Penn Central had estimated it needed a new loan of approximately \$225 million if the debenture issue had to be postponed. Approximately \$100 million of this amount was to be used to repay commercial paper, the balance was to go for operating losses. MacWilliams was also told that Saunders, Bevan, and O'Herron of Penn Central were in Washington with Treasury Secretary Kennedy and White House Special Counsel Flanigan to try to obtain a Government guarantee on the new debt.

<sup>12</sup> A bridge loan is a loan to bridge the creditor over until a pending public financing is completed. In this instance the loan was to be repaid from the proceeds of the \$100 million debenture offering.

A memorandum of these conversations was sent to Dewitt Peterkin, president of the bank, Stuart Cragin, chairman of the credit policy committee, and Frank Sandstrom, senior vice president because of the importance MacWilliams had placed on the telephone call. MacWilliams testified he did not talk to anyone in the trust and investment division or the research department during the time between the telephone calls and the FNCB meeting on May 28 and to his knowledge neither did his immediate superiors.

The FNCB meeting took place at mid-morning on May 28, 1970. MacWilliams and G. Kenneth Crowther, both bank officers, and Bruce W. Nichols of MGT's counsel, Davis Polk & Wardwell, represented MGT. Upon returning from the FNCB meeting, MacWilliams wrote a confidential memorandum dated May 28, 1970, to the credit department files reporting the events that had occurred. This memorandum contained a good deal of information about the financial and operational condition of Penn Central which at that time had not been publicly disclosed. It specifically referred to the existence of the negotiations regarding the Government guaranteed loan, the postponement of the \$100 million debenture offering, and the serious financial condition of Penn Central.

Copies of this memorandum were directed to Meyer, Cragin, and Peterkin in addition to the normal distribution in the credit department. MacWilliams testified that he did not talk to anyone in the trust and investment division concerning Penn Central on May 28 or May 29 nor was he aware of any events involving Penn Central that occurred at the bank on May 29, for example, the global order directing sales of Penn Central stock in all pension accounts.<sup>13</sup> Crowther testified that he could not recall specifically speaking to anyone at MGT upon returning to the bank after the FNCB meeting but someone, such as chairman Meyer, might have contacted him to find out what happened. Crowther and MacWilliams were cautioned to say nothing concerning the meeting.

#### THE TRUST AND INVESTMENT DEPARTMENT

The trust and investment department administers investments in connection with basically three types of accounts: personal trust accounts; investment advisory accounts; and pension accounts. For the personal trust and investment advisory accounts, the bank normally shares the investment responsibility with a cotrustee, while in the case of most pension accounts, the bank has sole investment responsibility. An advisor is responsible for the investment decisions for the account, but he is guided by two committees within the trust department: the committee on trust matters and the common stock committee.

The internal committee on trust matters meets twice each week to review accounts, to consider recommendations presented by the officers of the trust and investment department and to formally ratify actions taken between regular committee meetings. The investment officers base their recommendations to the committee on trust matters on conclusions of the common stock committee (a committee of eight officers of the investment department), on information received from the research department, the economics department, and on previous

<sup>13</sup> See pp. 85 ff.

decisions of the committee on trust matters. The total committee on trust matters usually meets twice a month prior to meetings of the board of directors or executive committee of the bank. These meetings are limited to consideration of general investment policies and no discussions are held regarding individual accounts or approval or disapproval of specific investments.

The common stock committee considers both individual securities and industries. Although there is no rating system for individual securities the common stock committee recommends by categories a particular issue as a "fielder's choice" to sell, or a "fielder's choice" to buy or to hold. When the common stock committee determines that a particular security falls within one of these categories, each account manager considers the recommendation in relation to the circumstances of the individual account, for example, the tax effect, the client's wishes, the company trustee's instructions and such. A recommendation is not a mandatory instruction for the account manager, but the manager must satisfy the committee on trust matters that acting in a contrary fashion to the recommendation of the common stock committee is best for a particular account in light of all the circumstances.

MGT had purchased most of the Penn Central shares held in its various trust accounts just prior to the Pennsylvania Railroad and New York Central merger. Nearly 900,000 shares of Penn Central were acquired in 1966 when the yearly high was 73 and the low was 40. The stock was purchased primarily because of the savings expected to result from their merger. MGT's research department had determined the PC would earn \$5 per share during a good economic year and the merger should increase PC's earnings an additional \$5 per share from cost savings. Other reasons included the high book value of Penn Central as compared with the then current price of PC stock, and the tax shelter which would result from the peculiarities of railroad accounting. No shares were acquired after 1969.

The following table shows shares held by MGT in various accounts at the end of 1969 and at the time of the May 28, 1970, meeting of banks:

	Dec. 31, 1969	May 28, 1970	Sales
Personal trust.....	49,329	<sup>1</sup> 15,308	31,692
Investment advisory.....	173,613	<sup>1</sup> 42,770	129,843
Pension.....	950,136	<sup>1</sup> 847,308	46,754
Total.....	1,173,078	<sup>1</sup> 905,386	208,289

<sup>1</sup> Besides sales, certain shares were delivered to clients by the bank for various reasons.

Between December 31, 1969, and May 28, 1970,<sup>14</sup> MGT sold 64 percent of Penn Central securities in the personal trust accounts, 75 percent of the Penn Central stock in the investment advisory accounts and 5 percent of the Penn Central stock held in the pension accounts. Included in the pension sales was the sale on May 19 of the entire position of 7,600 shares held for the Morgan Guaranty Trust Co. of New York and Affiliated Companies Retirement Plan for the U.S.

<sup>14</sup> Between May 25 and May 28, MGT sold 7,000 shares of Penn Central. May 28 was chosen for analysis of Penn Central trading because it was the day of the FNCB meeting when confidential information concerning Penn Central came from Bevan.

Employees. This sale was represented as necessary to provide the funds necessary to pay for a recent purchase of Federal National Mortgage notes, because the fund is a static fund and most purchases must therefore be offset by a sale of other securities in the fund.

The common stock committee considered Penn Central on January 21, 1970, and again on May 19, 1970. A report by the research department, distributed prior to the January meeting, contained the following information:

It now appears that the railroad operating deficit for the fourth quarter of 1969 will equal or exceed the \$47 million loss reported for both the third quarter of last year and the fourth quarter of 1968. The credibility gap between management and the investment community seems to be widening, since these anticipated results are in direct contrast to the recent remarks of Mr. Saunders. In a letter to stockholders on December 1, it was stated that the merger was progressing satisfactorily and that railroad operating losses will show a favorable trend in the fourth quarter. Our estimated final quarter results would put the operating deficit for the year at about \$170 million, compared with \$122 million for 1968 (\$153 million including the New Haven). No special transactions by the railroad or real estate subsidiaries took place during the fourth quarter. Thus, consolidated earnings for the year 1969 could be as low as \$0.50 per share, compared with the \$3.91 reported for 1968.

The lack of meaningful published information and the reticence on the part of management to thoroughly discuss the now-sensitive area of railroad operations makes us more uncertain about the near-term prospects for Penn Central than at any time in the recent past. Heretofore, our conclusions have been based on an analysis of management's documentation of the swing variables—i.e., severance and overtime, abnormally high per diem charges, and the attainment of merger savings. Despite the recent rate increase and management's statements that merger costs were being reduced and that merger savings in the fourth quarter were running at an annual rate of \$34 million, it is quite evident that the net benefits are being lost to yet to be defined areas.

The common stock committee at the January 21 meeting categorized Penn Central common stock as a fielder's choice to sell.

A report prepared for the May 19, 1970, meeting concluded that:

Penn Central does control nearly \$7 billion of assets on which it should be able to earn a reasonable return, but we do not think it will happen in 1970. Because of the poor first quarter results, we are reducing our earnings estimated for this year to \$1.00 per share, from the previous \$2.00. However, we do not have much confidence in our estimate, because of the many variables involved and management's continued credibility gap.

The research analyst who prepared these reports, John C. Holschuh, did not recall speaking to anyone at Penn Central, other analysts, or anyone at MGT. The common stock committee at the May 19, 1970, meeting continued Penn Central stock as a fielder's choice to sell.

MGT normally exercises sole investment discretion for pension accounts; thus transactions in these accounts differ slightly from the procedures for effecting transactions in personal trust and advisory accounts. Each pension account is reviewed quarterly by the committee on trust matters, but most of the activity occurs between the formal review and is approved by the officer in charge of the pension account managers and later ratified by the committee on trust matters.

A global order is used to designate a security to be bought or sold for all pension accounts managed by MGT. In the case of a global order to sell, all shares held by the pension accounts are sold at the best price obtainable with allocation of specific sales to individual accounts done on an equal basis, each account receiving a daily average price for the shares sold. A global order thus, in effect, preempts the opinions of all individual account managers and it does not take into consideration the individual circumstances of each pension account.



On May 29, the day after the FNCB meeting, Samuel R. Callaway, executive vice president and head of the trust department, Harrison V. Smith, senior vice president, and Carl E. Hathaway, senior vice president met in the morning and decided to place a global order to sell all the Penn Central shares held by the pension accounts. All three men met shortly after arriving at work and discussed what they felt was the serious financial condition of Penn Central. While Callaway and Hathaway could not recall the specific details of the meeting, Smith testified:

*Question. Then after you arrived at the bank on the morning of the 29th, you met with Mr. Callaway and Mr. Hathaway?*

*Answer.* That's right. And we decided despite the decline in the price in the stock, it should be sold for pensions on a global basis, and Hathaway implemented that decision.

*Question. Now was this meeting the first thing in the morning, do you recall?*

*Answer.* I don't recall exactly. It was probably sometime after our routine 9:15 meeting of the entire department, so I would place it at half past nine or 10 o'clock, something like that.

*Question. Do you recall where you met?*

*Answer.* Somewhere on the fourth floor, but I can't recall whether it was Mr. Callaway's office or in the space outside of it where the rest of us sit.

*Question. How long did this meeting last?*

*Answer.* I believe it lasted 2 or 3 minutes at the most.

The decision was reached without contacting the research department at MGT because all three felt they knew enough to make an informed investment decision. The sale was not discussed at the routine staff meeting that morning, but according to Hathaway such a sale would not normally be discussed at the staff meeting.

The decision to sell was based primarily on the disclosure in the May 29, 1970 Wall Street Journal of the postponement of the debenture offering. Smith testified concerning the significance of the postponed offering:

*Question. And there was a very real feeling, then by those making this investment decision for the bank, that if Penn Central could have gotten the \$100 million they possibly might have been able to survive?*

*Answer.* It might have given them enough breathing space to bring some order into the operation of the railroad, and salvage something from the situation.

*Question. In view of the fact the debenture had its rating lowered to Double B, and in view of the fact that the interest rate was set at 10½ percent, could it not have been fairly anticipated at this time that this offering would not go through? Did it come as any surprise to you, Mr. Smith, that the debenture offering was postponed?*

*Answer.* Yes, I was surprised that it had gone this far, and it would have been more usual if First Boston, who are the principal investment bankers involved in a situation like this had said early on there is no point in this. And they had gone so far as to schedule the issue for early in June. So it was surprising to us that they couldn't sell it. Because, of course, that was the situation that caused the postponement of the offering was that they didn't have the buyers.

*Question. Did you attach importance to the fact that they had gone so far and did this have any effect on your investment decision on the morning of the 29th?*

*Answer.* I can't remember any discussion along those lines. The significance of it was that when the offering was scheduled in May, the underwriters felt there was a possibility or they wouldn't have done so. By the time May 29 came along the sentiment had deteriorated so that it was no longer possible to do so.

In arriving at the decision to sell Penn Central, all three men testified that they did not contact anyone else either at Morgan Guaranty Trust or outside the bank concerning Penn Central. Smith and Hathaway testified that they were not then aware of the negotiations concerning the government guaranteed loan or the meeting the previous day at FNCB attended by representatives of Morgan Guaranty Trust.

After the decision to sell was made, Hathaway placed by telephone a global order to sell approximately 800,000 shares of Penn Central with the trading desk at Morgan Guaranty Trust <sup>15</sup> with no specific instructions concerning the price, the timing of the sales or the manner in which the stock was to be sold. Standard procedure at Morgan Guaranty Trust is to sell as much as possible at the best price obtainable without affecting the market.

Between the institution of the global order and the bankruptcy petition, Morgan Guaranty Trust sold 371,000 of the 847,308 shares held for the pension accounts on March 29. In the personal trust accounts, only 4,102 shares out of 15,308 were sold during this period, and 29,660 shares in advisory accounts were sold out of 42,770 shares. In all, sales due to the global order represented 92 percent of all the Penn Central sales during the period between May 29 and June 19.

The table on the next page shows the sales by Morgan Guaranty Trust during the period:

Date	Shares		MGT sales as a percentage of exchange volume
	Sales	Exchange volume	
May 29 .....	45,930	212,545	21.6
June:			
1 .....	32,000	117,008	27.3
2 .....	25,900	151,921	17.0
3 .....	24,435	119,478	20.4
4 .....	42,300	126,771	33.3
5 .....	41,000	113,410	36.1
8 .....	0	48,595	0
9 .....	96,450	253,804	38.0
10 .....	52,087	258,515	20.1
11 .....	30,775	117,413	26.2
12 .....	360	399,457	.09
15 .....	0	151,746	0
16 .....	425	114,957	.3
17 .....	200	113,086	.1
18 .....	11,600	88,783	13.0
19 .....	0	77,786	0

The majority of the sales were placed through Dean Witter, but on two occasions sales were executed through Eastman Dillon, Union Securities & Co.

The orders for sales were normally given to Dean Witter to sell "at market" in 5,000 and 10,000 lots. When a particular lot was sold, the trader would give Dean Witter another order and vary the instructions as to whether it was to be a limit order or a market order. Ronald C. Ivory, the trader, testified that he tries to sell about one-third of the volume when attempting to liquidate a large position because he has found this to be the best procedure to follow so as not to depress the market price of the security. Furthermore, he would not try to sell a position as large as the Penn Central holdings in several block transactions because a broker positioning a block would compete in the marketplace with Morgan Guaranty Trust when it unloaded the block subsequently.

As the table reflecting the trades by Morgan Guaranty Trust reveals, roughly half of the global order was sold between May 29 and June 11. The only day Morgan Guaranty Trust did not trade was on June 8. Ivory testified that he was instructed not to sell any shares of Penn

<sup>15</sup> The exact amount to be sold was later determined after checking the bank's records.

Central on that date by his immediate superior, who gave no reason for the instructions. Apparently Meyer had ordered the trading stopped. In a memorandum supplied by counsel, the reasons for not trading on June 8 are set forth:

EVENTS LEADING TO DECISION TO SUSPEND SELLING OF PENN CENTRAL STOCK  
ON JUNE 8, 1970

On Saturday and Sunday, June 6 and June 7, 1970, a series of meetings were held at the Federal Reserve Bank in New York City which were attended by representatives of the U.S. Department of Commerce, counsel for the U.S. Department of Transportation, officers of the Federal Reserve Bank of New York, representatives of three New York banks (Morgan Guaranty, First National City, and Chemical), and representatives of First National Bank of Chicago and Mellon National Bank & Trust Co. In attendance from Morgan Guaranty were John M. Meyer, Jr., Chairman of the Board, and Kenneth E. MacWilliams, a Vice President, who were accompanied by Bruce Nichols of Davis Polk & Wardwell, counsel for Morgan Guaranty.

During the course of these meetings, several statements were made which led Mr. Nichols to conclude that at some time on Monday, June 8, a Board of Directors meeting of the Penn Central Company would be held at which important top-management changes might be made, changes which would be of such an unusual nature as clearly to indicate that Penn Central was in the gravest financial difficulty.

No one from the Trust and Investment Division of Morgan Guaranty was in attendance at any of the meetings over this weekend, and neither Mr. Meyer, Mr. MacWilliams, nor Mr. Nichols informed any member of the trust and investment division of what had occurred. Nonetheless, Mr. Nichols was concerned that, because of the quasi-public nature of these meetings, which he felt might attract attention by reason of their being held on Saturday and Sunday at the Federal Reserve Bank with so many prominent persons in attendance, information as to the possible impending management change might leak out and come to the attention of someone in the Trust and Investment Division from some other source. He was further concerned that if sales were made on June 8, someone might later contend that information relating to such change had come to them from Mr. Meyer or Mr. MacWilliams. Under these circumstances, he felt that the safest thing to do was to advise the Trust and Investment Division not to make any trades in Penn Central on June 8.

On the afternoon of June 8, the news of the management shakeup was publicly announced and this news was prominently featured in the New York Times and the Wall Street Journal on June 9. In view of the public disclosure of this information, it was felt that there was no longer any reason to refrain from making sales under the global order and the Trust and Investment Division was so advised before the opening of trading on June 9.

After resuming trading on June 9, Morgan Guaranty Trust all but ceased selling PC in significant amounts on June 12 until after the bankruptcy petition. By June 21, 44 percent of the shares under the global order had been sold.<sup>16</sup> Hathaway testified that a hold was placed on the sales because the market price of Penn Central had fallen approximately 25 percent from the time the global order was placed, and because he believed that the Federal Government would not permit a company the size of Penn Central to fail. It was Hathaway's responsibility to obtain the best price possible once the decision to sell was made and he felt the price of PC would regain some of the 25 percent decline.

Although Penn Central was discussed at the corporate office meeting on June 10, the discussion did not involve the sales of Penn Central other than the change in Penn Central management on June 8. Meyer did not attend the meeting and although Callaway was present at the

<sup>16</sup> Practically all the remaining 468,500 shares of Penn Central held for the pension accounts were sold between June 25 and June 30. Morgan Guaranty Trust sold the rest of Penn Central for the pension accounts after the bankruptcy petition because it felt there would be nothing left for the shareholders in any type of eventual liquidation. Selling was not immediately resumed because the initial news of the bankruptcy petition depressed the price of Penn Central. After several days the price of Penn Central rose somewhat and Morgan Guaranty Trust liquidated its holdings.

meeting, he stated that no one instructed him to cease selling Penn Central.

By June 19, Morgan Guaranty Trust had sold 57 percent of the total Penn Central shares held for the various trust accounts at the beginning of 1970. Specifically, 77 percent of the shares held in the personal trust accounts, 92 percent of the investment advisory holdings, and 50 percent of the pension shares had been sold. In the accounts for which Morgan Guaranty Trust exercised sole investment discretion 50 percent of the shares had been sold. Eighty-nine percent of the shares had been sold in the accounts in which Morgan Guaranty Trust shared the investment responsibility with a cotrustee.

The allocation of the sales under the global order to particular pension accounts was done in a manner so as to affect each account equally. The percentages of Penn Central held in each pension account were substantially identical on May 29 and June 19.

At the time of the filing of the bankruptcy petition, there were 19 personal trust accounts and nine advisory accounts which still held Penn Central. Documents submitted by Morgan Guaranty Trust indicate that the appropriate party for each such account had been contacted by his adviser before June 19 with the recommendation to sell Penn Central, but the person sharing the investment responsibility declined to sell Penn Central at the time. Smith testified concerning the decision to place the global order and the effect of this decision on the nonpension accounts:

*Question. Now, during the discussions which occurred at this very brief meeting [when the global order was placed] was any thought given to the accounts still holding Penn Central which would not have been involved in the global order?*

*Answer. I don't recall any discussion of those accounts, however, entering the global order did change the situation for the nonpension accounts, because it meant that there was unanimity among the trust committee members, who were in the trust investment division, that it should be sold. And I am satisfied that John McGinnis and Harry Barbee, who are in charge of the nonpension side, put additional pressure on the investment advisors who report to them, to try to get their clients to sell the stock.*

The nonpension side had been selling the stock for months, and as I mentioned earlier, they sold 70 percent, roughly, of what they had . . . we were down to what seemed to be a hard core of accounts. It was difficult to move the stock out because of the attitude of the client or cotrustee. In addition, I was going to say, there is a certain amount of latitude, even under these circumstances, allowed to the investment manager in charge of specific accounts, the interpretation of instructions, such as fielder's choice to sell, and some of the investment advisors on the nonpension side were not so eager to sell the stock as some others.

And while I am sure they had all contacted their clients as they had been instructed to, I don't know how forcefully they had to put it, but in any case, after the global order was entered on the pension side, and McGinnis and Barbee had put additional pressure on all the investment advisors to go back to their accounts and see what they could do to get it out.

Smith stated that it was unlikely that each nonpension account cotrustee or beneficiary was told that Morgan Guaranty Trust had placed a global order for the pension accounts but that increased emphasis was put on obtaining the approval of the cotrustees to sell Penn Central.

Since the bankruptcy petition, 27 of the 28 trust accounts have sold their Penn Central holdings. Most of the accounts liquidated their positions in June and July after filing of the bankruptcy petition; several held their Penn Central securities until October, 1970.

MGT POLICY OF SEPARATION OF TRUST AND COMMERCIAL  
DEPARTMENTS

Morgan Guaranty Trust has an established policy regarding the treatment of confidential information obtained by its representatives in the normal course of their duties. The bank's general rules and regulations prohibit the improper use of such information. Rule 1 concerning confidential information states in part:

In the case of confidential information received from a customer, disclosure within the company must not extend beyond those persons who need to know the information in order to serve the particular customer from whom the information was received. In the case of confidential information of other types [including but not limited to such matters as customer identification, balances other account information, security trading activity and investment programs] disclosure must not extend beyond those persons within the Company who require such information for the efficient performance of their duties.

In addition to the general rule, Morgan Guaranty Trust has circulated memoranda concerning special responsibilities to both the general banking division and the trust department.

The memorandum to the general banking division, which was first issued on November 8, 1968, specifically prohibits the transmitting or providing confidential information obtained from a client of the banking division to anyone making an investment decision for Morgan Guaranty Trust. Procedures adopted to implement this policy include a prohibition against transmitting trip reports or conversations with clients to the trust department and the research department, and the denial of access to the banking department files to the trust department. In addition, a memorandum to the trust department originally circulated in September 1968, requires each member of the trust department to clearly identify himself as requesting information from an investment standpoint and not from a commercial banking standpoint.

Before May 27, 1970, the corporate research department at Morgan Guaranty Trust served both the banking division and the trust department. The research department was divided at the end of May to serve the trust department and the remainder of corporate research was moved to the banking division to serve that division exclusively. This separation was represented as designed to ease the administrative burden and to remove the problems caused by having one research department serve two entities. Smith also conceded that another purpose was served:

Answer. \* \* \* Of course, I am also aware that while the research and corporate research personnel had seemed to be able to handle problems of potential conflicts of interest arising from their working for more than one part satisfactorily, it put us in the position that somebody might say that this was a hole in the wall that existed between us [the Trust Department] and the commercial bank.

The timing of the division of the research department, it was testified, has nothing to do with Penn Central.

Holschuh was a vice president of Morgan Guaranty Trust, and its analyst in charge of railroads. During April and May of 1970, he met with officers of both the banking division and the trust department concerning Penn Central. Holschuh met with MacWilliams of the banking division on several occasions. During the course of these meetings, Holschuh briefed MacWilliams on the operational history and organizational structure of Penn Central, but Holschuh stated

that MacWilliams did not tell him anything about Penn Central. Holschuh further testified that he never was aware of the size of loans to Penn Central by Morgan Guaranty Trust nor was he aware of any banking arrangements between Penn Central and Morgan Guaranty Trust and that MacWilliams never sent any information to Holschuh about Penn Central. On May 27, the day before the FNCB meeting, Holschuh was transferred permanently to the banking division and assigned to do statistical studies on Penn Central to assist Morgan Guaranty Trust in evaluating its loans in light of Penn Central's financial condition. He did not, however, learn of the sale of the pension shares or the trades of Penn Central during May and June until some 2 years later.

#### SUMMARY

Admittedly the commercial department of Morgan Guaranty Trust Co. was in possession of nonpublic information regarding the financial condition and future viability of Penn Central prior to the global order sales by the trust department on May 29, 1970. However, Morgan Guaranty Trust personnel stated that such information was not passed to the trust department and that the global order and the subsequent sales were based upon information which was available from the news media.

#### CONTINENTAL ILLINOIS NATIONAL BANK & TRUST CO.

Continental Illinois National Bank & Trust Co. of Chicago, Ill. (CINB) was involved with Penn Central both by virtue of loans extended to Penn Central and its subsidiaries and by its holdings of common stock of Penn Central in trust accounts managed or advised by its trust department. As of June 1, 1970, the commercial department of CINB held outstanding debt of approximately \$24 million of Penn Central and its subsidiaries and during early June it became a member of a 10-bank steering committee which was participating in a plan to secure a federally guaranteed loan to Penn Central. CINB's trust department held for various pension and profit sharing trusts, personal trusts, and agency trusts approximately 422,000 shares of Penn Central common stock as of June 11, 1970. The overwhelming proportion of CINB's holdings of Penn Central stock were sold between June 12, 1970, and June 19, 1970, at which time the commercial department was receiving information regarding the financial situation of Penn Central and the status of negotiations for the Government guaranteed loan. That the bank was the recipient of significant nonpublic information which would reflect on the value of Penn Central securities while the trust department was engaged in a program of selling Penn Central securities raises questions as to whether such information was passed on to the trust department forming the basis for sales of Penn Central stock.

#### COMMERCIAL DEPARTMENT

CINB's commercial department for a number of years prior to 1970 had participated in various lending arrangements to Penn Central and its subsidiaries. In June 1970, CINB held outstanding loans to Penn Central and its subsidiaries of approximately \$24 million comprised of the following: (1) a \$15-million participation in a \$300

million revolving credit loan which was secured by 100 percent of the common stock of the Pennsylvania Co.; (2) a \$4 million participation in a \$50 million unsecured revolving Eurodollar commitment; (3) \$3,898,000 of direct equipment lease financing arrangements; (4) \$735,000 of equipment financing comprised of conditional sales contracts; and (5) a \$140,000 equipment financing comprising a conditional sales contract to the Indiana Harbor Belt Railway Co.

Thus, CINB with \$19 million of outstanding loans was the ninth largest lender to Penn Central excluding direct equipment loans and a Swiss franc loan.<sup>17</sup>

CINB first became involved in attempts to raise additional emergency financing for Penn Central when it was invited to a May 28, 1970 meeting called by First National City Bank and Penn Central. Although the invitation was extended to a senior officer of CINB's main office in Chicago, Donald Myers from the New York City office attended. Myers had not been previously involved in loan arrangements with Penn Central, but he attended the meeting because Gerald Mast, the officer most closely associated with Penn Central, was only just returning to a partial work schedule after an illness. Myers, the only CINB representative to attend the May 28, 1970, meeting, was generally unfamiliar with the particulars of Penn Central financial affairs.

At the May 28 meeting, David Bevan, chief financial officer of Penn Central, outlined the causes of the liquidity crisis as the result of merger problems, namely an inability to keep refinancing its commercial paper in quantities greater than repayments due on maturity dates and Standard & Poor's downgrading of the Pennsylvania Co. debenture offering to a double "B" rating. Bevan stated that Penn Central required an aggregate of \$263 million of cash in 1970 primarily to meet maturing debt obligations including \$100 million of commercial paper, and to underwrite anticipated losses. Bevan proposed that the necessary funds could be raised by a \$225 million bank loan guaranteed by the Federal Government, a \$25 million increase of an existing \$50 million loan to the Pennsylvania Co. and \$13 million from Penn Central's continued sales of real estate or cutbacks in compensating bank balances. With regard to future prospects, Bevan expressed the view that the diversification program of Penn Central should produce increased profits in coming years and that he anticipated that railroad operations could break even in 1971. Following this general meeting, First National City Bank and Chemical Bank were to meet with Bevan to structure a banking lending committee to work out the details of bank participation in the refinancing program.

<sup>17</sup> The 10 largest lending banks based upon composite bank loans excluding direct equipment loans and a Swiss franc loan were:

	<i>Million</i>
First National City Bank.....	\$63.2
Manufacturers Hanover.....	40.0
Chase Manhattan Bank.....	34.2
Chemical Bank.....	31.2
Irving Trust Co.....	30.0
First National Bank of Chicago.....	28.0
Morgan Guaranty Trust Co.....	25.8
Mellon Bank.....	22.0
CINB.....	19.0
Bankers Trust.....	15.0
Subtotal.....	308.4
Total of all participating banks.....	494.0

At the next meeting of banks on June 3, 1970, called by First National City Bank for the 10 largest bank lenders to Penn Central,<sup>18</sup> interim developments were reviewed including the June 2 application for the \$225-million loan, the rejection by the various banks of the proposed \$25-million increase in the Pennsylvania Co.'s revolving credit, and the drawing down by Penn Central of the remaining \$33 million of a \$300 million revolving bank credit arrangement. Also discussed at this meeting were plans to secure the \$225-million loan and a proposed interim measure consisting of the 10 participating banks each providing \$5 million as a forerunner of the Government guaranteed loan. Six of the banks attending the meeting had previously agreed to their ratable share; Chase, Irving Trust, Morgan and CINB were still uncommitted. The loan policy committee of CINB on June 5 reviewed the Penn Central liquidity crisis and the plans for refinancing, and approved the bank's \$5 million participation "If a proper spread of collateral could be arrived at to improve our present position." (All CINB loans were secured except for the \$4 million Eurodollar loan.)

The next meeting of participating banks was held on June 10 at the Federal Reserve Bank of New York at which three representatives of CINB attended. Paul Gorman, chairman of Penn Central,<sup>19</sup> made a presentation of Penn Central's financial and operational plans while a representative of First National City Bank reported that the 10-bank steering committee had reached general agreement on the \$225-million loan, with each bank taking a prorata share, and on a moratorium on present debt. The final speaker was Paul Volcker, Under-Secretary of the Treasury, who reviewed the administration's intentions to utilize the Defense Production Act to guarantee the loan with a maturity to October 31, 1971, at which time new legislation was anticipated to provide financing for Penn Central and other railroads.

In between these meetings, CINB personnel involved in the negotiations for the loan to Penn Central kept contact with the primary banks involved and kept officials at the Chicago office appraised of developments of the plans for the Government loan. However, each of the witnesses from the commercial department and the trust department denied that there was any contact or flow of information between these departments. The first time that CINB apparently became aware that the Government was not going to support the loans was on June 19.

#### TRUST DEPARTMENT

The trust department of CINB is divided into three groups by general classification of types of accounts managed or advised, namely employee pension or profit-sharing trust, personal trust, and agency trust. Account advisers have responsibility for the investments in specified accounts. Their discretion regarding investment decisions, however, is guided by the trust department's stock selection committee (SSC) which has the responsibility for conveying to the portfolio managers information given out by security analysts from the trust department and from outside brokerage firms, and making recommendations for the purchase and sale of securities. The SSC transmits

<sup>18</sup> See list of banks in previous footnote on page 223.

<sup>19</sup> Stuart Saunders, chairman of Penn Central and David Bevan, chief financial officer, had resigned on June 9, 1970.



its recommendations to account advisers by weekly "buy" and "source of funds" lists. Changes in these lists are brought to the attention of the advisers by flash memoranda (so named because of the word flash imprinted on them), which are intended to denote matters which should be given immediate attention.

Although the scope of authority of an account adviser to authorize a purchase or sale does not appear to be formalized in the trust department, generally he can buy securities from the buy list and sell securities from the source of funds list by virtue of the SSC recommendation. In other situations, he must obtain the approval of a superior. The group head of the personal trust group, however, indicated that it was his policy to allow account advisers latitude to trade broader than that contained solely to the buy or source of funds list. This position is relevant to the Penn Central situation in that several account advisers within this group authorized sales of Penn Central stock on June 11, 1970, that is, prior to the issuance of a June 12 flash memorandum of the SSC which for the first time recommended the sale of Penn Central.<sup>20</sup>

Whereas the SSC concentrates on recommendations for specific securities, the trust investment committee (TIC), to which the SSC is responsible, promulgates policy guidelines based upon economic and industry analysis and establishes such priorities as the percentage of investments which should be in equity versus debt securities and the percentage of overall investments by industry groups. Normally the TIC is not involved with investment decisions concerning individual securities, but where a recommendation of the SSC relates to a major holding of the department the TIC's approval is solicited by the SSC.

In 1969 and 1970, personnel in the trust department were aware of the deteriorating financial condition of Penn Central. The predominant source of their information was apparently articles in the financial press including the Wall Street Journal, the newspaper which witnesses uniformly identified as a daily source of information. However, except for a short page and a half report of the trust department analyst relating a visit in January 1970 with Stuart Saunders, chairman of Penn Central, it does not appear that any in-depth analysis was performed. Sometime in early 1970, the analyst responsible for transportation securities was reassigned to an area outside the trust department and his responsibilities were transferred to another analyst, Samuel Sylvester. Except for an analysis in May 1970 of the financial impact of the Railway Passenger Act legislation, Sylvester was not involved in any analysis of Penn Central until after the bankruptcy. The SSC had placed Penn Central as a "hold" security in September 1969, but as events indicated the deteriorating condition of Penn Central, this status was not altered nor did the SSC or anyone else cause any in-depth analysis to be performed. When asked who was responsible for investment analysis of Penn Central, personnel from the trust department indicated that Sylvester had that responsibility, but in explaining why he had in fact not performed such analysis, Sylvester indicated that he concentrated during the first half of 1970 on an analysis of the airlines industry.

In certain individual situations the sale of Penn Central stock was recommended even though the overall trust department position was

<sup>20</sup> None of the three account advisers who wrote sales order slips on June 11, 1970, could recall the circumstances surrounding the preparation of these slips.

a continued "hold" on Penn Central securities. At an initial meeting on April 20, 1970, after the opening of an account for a church organization, members of the trust department indicated that Penn Central was "under consideration" as a sale candidate. Subsequently, on May 15, 1970, 7,000 shares of Penn Central common stock were sold from this account. In another account, CIIT Equity Fund, CINB's pool-type common stock fund for smaller employee benefit trusts, CINB, on May 19, 1970, sold 20,000 shares out of a position of 60,000 shares of Penn Central held by that account. These sales were made to raise funds to meet the anticipated withdrawal of one of the larger participants in the CIIT Equity Fund. Other than these two instances, it does not appear that any substantial sales were made of Penn Central securities in accounts managed by CINB's trust department.

As of June 11, 1970, CINB held 422,337<sup>21</sup> shares of Penn Central stock for accounts managed and advised by its trust department, as follows:

	<i>Number of shares</i>
Personal trusts.....	54, 920
Pension trusts.....	206, 485
Profit-sharing trusts.....	11, 000
Investment agency.....	27, 817
Managing agency.....	2, 615
Pension—agency.....	17, 800
Profit-sharing agency.....	36, 700
Other fiduciary (pooled funds, other).....	65, 000
<b>Total.....</b>	<b>422, 337</b>

Specifically relating to Penn Central, the members of the SSC were concerned about Penn Central for some time, but did not issue a sell recommendation until the morning of June 12, 1970, at which time they issued a flash memorandum which concluded regarding Penn Central:

[The SSC] recommends the sale of the common stock in all accounts.

Commentary: Recent events indicate that the likelihood of returning to a profitable basis appear quite distant at this point in time. Despite the possibility of government aid in securing additional financing, the basic operational problems of the railroad company will still remain and it is doubtful that substantial losses can be avoided for the foreseeable future.

Personnel from the SSC and TIC, including Thomas Larocca, chairman of SSC, Joseph Alaimo, member of SSC, and Philip J. Dambach, chairman of TIC and head of the trust department, were unable to recall precisely the sequence of events which led to the issuance of the June 12 "flash memorandum." Generally, these and other witnesses were able to recall some of the information reported in the press relating to the financial condition of Penn Central, including the omission of dividends, quarterly earnings reports, the cancellation of the proposed \$100 million debenture offering of the Pennsylvania Co., the maturation of Penn Central commercial paper at a rate faster than it could be refinanced, and the resignations of Stuart Saunders, David Bevan, and Alfred Perlman. However, other than representing that these events evidenced to them a deterioration of Penn Central financially, they could not relate specific discussions among the members of the SCC, the TIC, or with other

<sup>21</sup> These figures were supplied by CINB with a caveat that "despite the apparent specificity of the figures, complete accuracy cannot be guaranteed."

members of the trust department other than the fact that they were certain that Penn Central had been discussed.

The SSC concluded that Penn Central securities should be sold some time prior to June 12, but whether this was a few days prior or a week or more prior was not specifically recalled by any of the witnesses. In any case, at least by June 10, 1970, at the regular meeting of TIC, the SSC communicated its view to the TIC that it wanted to issue a sell recommendation. The SSC sought the concurrence of the TIC because of the substantial holdings of Penn Central by trust department accounts. The TIC continued to believe that Penn Central stock should not be sold, but again witnesses did not recall the specific views of individual members of the TIC. Apparently, Dambach, as the head of the trust department and chairman of the TIC, was the last to be converted to the view that Penn Central should be sold. Dambach believed that because the Federal Government had been so instrumental in the merger of the Pennsylvania Railroad and the New York Central Railroad the Federal Government would come to the aid of the distressed Penn Central and not allow it to go bankrupt.

On the morning of June 12, 1970, Larocca reiterated his concern to Dambach that Penn Central should be sold. Dambach finally agreed apparently because of a news item in that day's papers which indicated that there was congressional opposition of a Government guaranteed loan to Penn Centra'. With Dambach's decision thus changed, Larocca relayed this to Alaimo who then contacted a trader for the trust department with instructions to execute a 100,000 share block trade. A "flash memorandum" was then drafted by an analyst and circulated throughout the trust department.

The initial trade after the decision to sell Penn Central was consummated through Salomon Bros., which sold shares in the market down to \$10 per share and positioned the remaining 45,000 shares. The average price per share for the block was \$10.18975. Alaimo testified that he contacted the group head of pension and profit sharings trusts so that he could have the advisors execute sale authorizations and allocate the trade among the accounts in this department. This department was chosen because it had the largest proportion of Penn Central common stock. Of this initial trade, 3,200 shares were allocated to profit sharing trusts, including 2,000 shares for the Continental Illinois Employees Profit Sharing Trust, and the remainder for various pension trusts including 6,800 shares for Continental Illinois Employee Pension Plan Trusts. Later trades on June 12 and in the following week were executed at prices slightly higher than the \$10 for the initial block trade. The distribution of sales among the various accounts administered by the trust department is set forth in the following table:

Trade date	Pension trusts	Profit-sharing trusts	Personal trusts	Other	Total
June 11.....			1,000	600	1,600
June 12.....	103,500	4,100	2,000	14,100	123,700
June 15.....	46,800	6,100	6,500	2,700	62,100
June 16.....	27,700	8,600	1,600	1,400	39,300
June 17.....	42,100	2,300	600	4,800	49,800
June 18.....	24,600	900		1,000	26,500
June 19.....	23,500		200	2,200	25,900
Total.....	268,200	22,000	11,900	26,800	328,900

Except for the 100,000 share trade on June 12 initiated by Alaimo as director of portfolios, sales were made upon the initiative of individual account advisors.

An advisory service offered by the bank recommended by a letter dated June 16, 1970, that its clients sell Penn Central and invest the proceeds in Howard Johnson securities. CINB also contacted other accounts over which it did not have discretionary authority in the usual manner by telephone.

#### SUMMARY

Although the commercial department of Continental Illinois National Bank and Trust Co. possessed nonpublic information concerning Penn Central's financial problems by virtue of its role as one of the banks attempting to secure emergency financing for Penn Central, personnel of the commercial and trust departments denied that such information was passed to the trust department. Rather, CINB maintained that the sales of Penn Central common stock between June 12 and June 19, 1972, were based upon publicly available information.

#### ALLEGHANY CORP. AND INVESTORS DIVERSIFIED SERVICES, INC.

Alleghany Corp. (Alleghany), a public corporation whose predominant business activity is investing in corporate securities, and Investors Mutual Fund, Inc. (IM), a mutual fund managed by Investors Diversified Services, Inc. (IDS), were included in this investigation because both sold substantial quantities of Penn Central common stock on May 27, 1970, a day prior to the announcement of the cancellation of the Pennsylvania Co. \$100 million debenture offering.<sup>22</sup> Because until a few months prior to this, three Alleghany directors had served as Penn Central directors, and because Alleghany controls IDS, the sale of a combined total of 212,000 shares of Penn Central common stock by Alleghany and IM raises questions as to whether these sales were prompted by knowledge of adverse nonpublic information and whether there was coordination in the sales of Penn Central stock by these affiliated entities.

#### ALLEGHANY CORP.

##### *Background*

Traditionally, Alleghany's principal business has been investing in corporate securities with particular emphasis, other than its investment in IDS, on the railroad industry. For instance, as of December 31, 1967, approximately 21.7 percent of Alleghany's assets of \$187,794,396 was invested in railroad securities and approximately 58.8 percent of its assets were comprised of noncarrier securities including 40.7 percent of its assets invested in the capital stock of IDS.<sup>23</sup> Even though the nature of Alleghany's business was somewhat altered in 1970 by the acquisition of the operating rights and licenses of a motor carrier (the Jones Motor Co.), as of December 31, 1970 investments in securities were \$127,178,072 as compared to total assets of \$176,465,-

<sup>22</sup> On May 27, 1970 the Penn Central board of directors was informed that the proposed debenture offering, was to be canceled. This information was not publicly released until May 28.

<sup>23</sup> See Alleghany Corp.'s 1967 annual report.

216. In that year, securities transactions accounted for net profits of \$1,800,753 and net income exclusive of securities transactions was \$1,943,143.<sup>24</sup>

In 1954 and early 1955, Alleghany purchased 384,100 shares of New York Central Railroad (Central) stock. It increased its holdings by purchasing 600,000 shares of Central stock between 1955 and 1959 (200,000 shares were also acquired at the same time by Allan P. Kirby, Sr.). By 1966 Alleghany owned 984,000 shares of Central (15 percent of the total outstanding voting shares) and Allan P. Kirby, Sr., chairman of Alleghany at the time, owned 300,100 shares of Central or approximately 4.5 percent of the total outstanding. Seven of the 10 Central directors were members of Alleghany's board of directors, and, in addition, three of the five members of the executive committee of Central had joint affiliations with Alleghany.

On March 28, 1966, after the approval of the merger between the Pennsylvania Railroad Co. and Central, but prior to the actual consummation of the merger, Alleghany offered the Central securities in its portfolio to Alleghany shareholders in exchange for their Alleghany securities.<sup>25</sup> As a result of this offer 833,181 shares of Central common stock were exchanged so that Alleghany continued to hold 150,919 shares of Central stock. The reasons for the exchange offer as stated in the offering circular were the inadvisability of maintaining a substantial portion of its portfolio in stock of a corporation Alleghany would not control; the ability to liquidate the Central holdings without incurring a substantial capital gains tax; the changing nature of Alleghany's portfolio from that of a railroad holding company to a more diversified portfolio. Although not so stated, another reason was that the Kirby family control of Alleghany would be ultimately increased.<sup>26</sup>

After the Penn Central merger, Alleghany owned 196,195 shares of Penn Central common stock representing .85 percent of the total outstanding and Allan P. Kirby, Sr., owned 390,130 shares of Penn Central common stock or 1.69 percent of the total outstanding shares. Although Alleghany and the Kirby family might not be considered in control of Penn Central, they had a substantial interest in its affairs as evidenced by the fact that five of Penn Central's 22 directors were also Alleghany directors: James S. Hunt, Fred M. Kirby, William G. Rabe, Carlos Routh, and Daniel E. Taylor.

This close relationship was obvious on its face and admitted by Fred M. Kirby at an Alleghany shareholders meeting on April 26, 1968, when he stated in response to a shareholder question: "We have incidentally very fine representation on the Penn Central Board and are very close to that situation and feel that we're in a very good position to appraise the desirability of it as a continuing investment."<sup>27</sup>

<sup>24</sup> From the above figures, it is readily apparent that more than 40 percent of Alleghany's assets are investment securities, thus placing the company within the definition of an investment company under Section 3(a)(3) of the Investment Company Act of 1940. However, Alleghany was exempted by the Commission from regulation as an investment company in 1945 and again in 1970 by reason that Alleghany was subject to regulation by the Interstate Commerce Commission and thus exclude 1 from the Commission's jurisdiction as provided in Section 3(b)(7) of the Investment Company Act of 1940.

<sup>25</sup> Allan P. Kirby, Sr. did not include his Central shares in the offer nor did the Kirby family interests exchange any of their Alleghany securities.

<sup>26</sup> Whereas on February 28, 1966, Allan P. Kirby Sr. owned 40.4 percent of the common stock of Alleghany, on April 15, 1966 after the exchange offer he was the beneficial owner of 55.36 percent of the Alleghany common stock. Notice of annual meeting to shareholders of Alleghany, April 19, 1966.

<sup>27</sup> Fred M. Kirby became chairman of Alleghany in 1967 after his father, Allan P. Kirby, Sr., suffered a severe stroke. F. M. Kirby and Allan P. Kirby, Jr., were appointed guardians of their father's property also in 1967.

*Unheeded investment advice*

Information and documents received by Penn Central directors at board meetings did not permit sufficient time for thorough analysis by them. F. M. Kirby frequently relied upon John J. Burns, vice president of finance for Alleghany, for his analysis of the financial condition of Penn Central. Although Burns was not a rail expert as such, his background in motor carriers and his responsibilities at Alleghany for investment analysis of present and potential holdings included expanding his knowledge of railroads.

Beginning sometime in the spring of 1969 and continuing into 1970 Burns was formulating the belief that Alleghany should sell its Penn Central stock because of the operational and financial problems. The earliest evidence of the crystalization of Burns' growing belief that Alleghany should sell its Penn Central holdings is found in a March 11, 1969, memorandum to F. M. Kirby in which Burns stated that he regretted not having strongly recommended sale at a higher price and that he had "not firmly made up my mind but feel the odds favor a sell rather than a hold some time soon." The subject of selling Alleghany's Penn Central stock was presented at Alleghany's March 1969 board of directors meeting at which time Burns outlined the "pros" and "cons" of a sale. The minutes of that meeting reflect that counsel to Alleghany pointed out that substantial legal problems existed in that prior to a sale, Alleghany might have to announce its intention to sell, followed by a waiting period before the sale. The sense of the directors was to not dispose of the Penn Central holdings at that time.

Following the April 23, 1969, Penn Central board of directors meeting F. M. Kirby forwarded to Burns Penn Central's consolidated income statements for the first quarter of 1969 and an income statement for the parent railroad company. Kirby in an attached note to those statements said:

Directors impressed today with MGT position that Penn Central foul-up has been largely corrected. Will not show up in earnings for some time unless unexpected surge of volume develops.

I believe the attached figures, entrusted to you in confidence, contradict Wall Street assumptions.

In a reply memo Burns, using these first quarter figures, calculated the net railway operating income after fixed charges as a \$20 million loss in the first quarter of 1968 and a \$36 million loss in the first quarter of 1969. Annualizing these figures, losses would have been \$80 million in 1968 versus \$144 million in 1969. However, Burns pointed out that losses in 1968 were actually \$150 million. Thus apparently \$130 million of losses were attributable to the last three quarters of that year. Accordingly, with first quarter 1969 showing no turnaround, losses were predicted by Burns to be close to \$200 million for 1969. In concluding this memorandum Burns referred to the legal problems of a sale by stating:

Since we have apparently no choice but to hold on to Penn Central for the time being, this memo is somewhat unnecessary, nonetheless, I did feel constrained to briefly comment on the confidential figures which you gave me.

In July 1969 Burns had reached the conclusion that Alleghany's holdings should be liquidated, but again this necessitated overcoming the legal problems which counsel had previously presented. Burns again wrote a memo to Kirby with a new approach of securing a

private placement of Alleghany's Penn Central stock as well as the IDS and Kirby family Penn Central shares:

For various reasons I have been interested in seeing Alleghany Corporation dispose of its investment in Penn Central. In conversation with John Tobin it has developed that one feasible way for a sale of our holding to be effectively accomplished in a manner that would minimize the possibilities of any successful litigation, would be for Alleghany, the Kirby family and IDS to sell all of their shares, preferably at the same time, to a group who could be considered sophisticated institutional-type buyers.

I have determined that IDS has partially completed a selling program of its IDS shares, and that they would be interested in participating if a block transaction was to be accomplished to the extent of all of their remaining 440,000 shares.

Counting our shares, the Kirby family shares and IDS shares, we would need to sell approximately 1,136,000 shares of Penn Central to dispose of all of the stock. If such a sale is to be contemplated, timing is of prime importance. At the present time, I understand that since Penn Central stock is an "exempt security" (because of its ICC status). A sale of Alleghany and the family's stock would not require either an investment letter of a registration statement. However, once the Penn Central shares are turned in for the new holding company shares (probably later this summer) the new shares will have lost their "exempt" status and will have to be sold on either an investment letter or a "registration" basis. This could possibly make a sale both awkward and expensive.

Therefore, timing is very important.

In order to accomplish a major sale such as this, I feel the cooperation of the railroad's management will be almost essential. Since we cannot induce buyers ourselves (for obvious legal reason), large institutional purchasers would probably be most easily found by an enthusiastic management who should have a real interest in seeing a large block of the company's stock successfully placed in good hands.

Accordingly, I would like to discuss this matter with Mr. Saunders at once,<sup>28</sup> assuming that you and the family are seriously interested in a sale at this time and under these circumstances. If you are not interested on behalf of your family holdings, I would like to see if another way can be found to enable us to sell our shares in a manner which would minimize potential legal problems.

Comments would be appreciated.

This view that a sale of their Penn Central stock should be made was presented by Burns again in a July 15, 1969, memorandum to F. M. Kirby reviewing the status of Alleghany's investment portfolio:

You know my opinion of this one (Penn Central). I feel the sooner we get out the better, even at these prices, since in my opinion, the company with its current inept management and large, uneconomical, ungainly, high cost, rail system will be particularly vulnerable to the impending labor squeeze I see forthcoming in the early 1970's. If we must maintain a railroad investment of some kind, it would not be this one, in my opinion.

Burns continued to press his method of selling the Penn Central holdings to a sophisticated investor or financial institution especially because when the Penn Central holding company would be created it would fall within jurisdiction of the Securities and Exchange Commission rather than the Interstate Commerce Commission. A Burns memorandum of September 25, 1969, to Kirby presents this view:

According to the attached announcement<sup>29</sup> our Penn Central shares (now representing shares in a carrier corporation) will be automatically exchanged for noncarrier holding company shares on October 1. I feel that this plan is detrimental to Alleghany Corporation since, according to counsel, once our Penn Central shares no longer represent shares in an "ICC regulated carrier corporation" they will either have to be registered, or an investment letter will have to be obtained, if and when sale is to be effectuated. As I understand it, *right now*, assuming resolution of various other problems, we could sell our Penn Central shares to a knowledgeable buyer without either a registration statement or an investment letter.

<sup>28</sup> In his testimony before the staff on Apr. 29, 1971, Burns stated he at no time met with Saunders.

<sup>29</sup> News article in Wall Street Journal, Sept. 25, 1969.

I do not know what we can do about this situation but it appears to me that this "automatic" exchange of Penn Central railroad shares for Penn Central holding company shares without any vote or registered exchange offer to shareholders is unfair to stockholders, such as Alleghany Corporation.

In furtherance of his view that Alleghany should sell its Penn Central stock, Burns discussed in October 1969, such a sale during the course of a general conversation on the condition of Penn Central with E. Clayton Gengras, chairman of the board of Security Corp. of New Haven, Conn.,<sup>30</sup> Burns thought perhaps Gengras might be interested in purchasing Alleghany's stock, but again this approach was not followed up. A number of other memoranda in 1969 and 1970 to Kirby continued to emphasize the poor condition of Penn Central and that the Alleghany holdings should be sold.<sup>31</sup>

*Events leading to sale of Penn Central common stock*

At the same time that Burns was recommending sale of Alleghany's Penn Central shares, Alleghany in April 1969, had filed an application with the ICC for authority to acquire control of Jones Motor Co. and its subsidiary so as to be able to have the operating rights to act as a motor carrier.<sup>32</sup> During the course of the hearings before the ICC on this matter it became apparent that Alleghany would probably be required to divest itself of any other interests in an ICC-regulated carrier. At various times Burns had suggested that to improve its position with the ICC, Alleghany should sell its Penn Central shares.

By order of January 27, 1970, the ICC granted Alleghany's application to acquire the operating rights and properties of Jones Motor Co., but because of the close relationship between Alleghany and Penn Central, Alleghany was directed to place its Penn Central securities in a trust and within 5 years sell them, and also to terminate all joint director affiliations between Penn Central and Alleghany. Although the Penn Central shares owned by Allan P. Kirby, Sr. did not have to be sold, they also were directed to be placed in a voting trusteeship.

Joint directorships were terminated by Daniel E. Taylor resigning from the Alleghany board in March 1970, and F. M. Kirby and Carlos J. Routh resigning from the Penn Central board in March 1970. Those Alleghany directors serving on boards of Penn Central subsidiaries likewise resigned from those positions.

The trusteeship of Alleghany's shares was placed with Irving Trust Co. by an initial agreement of March 26, 1970. Various amendments were made to the trusteeship agreement with the final agreement executed on April 27, 1970. Basically the trusteeship provided for initiative for sales to rest with Alleghany at the early stage of trusteeship, with consultation with the trustee.<sup>33</sup>

Apparently the decision by Alleghany to sell its Penn Central shares was made shortly before the May 15, 1970, Alleghany board of directors meeting. The minutes of that meeting reflect that the sale of Penn Central Co. capital stock was discussed at length and Burns stated that, "it was management's intention, if given suitable market conditions, to dispose of this investment."

<sup>30</sup> Gengras in December 1969 became a director of Penn Central.

<sup>31</sup> One memorandum of Apr. 16, 1970 from Burns to F. M. Kirby summarized a meeting with David Bevan, chief financial officer of Penn Central, in which Bevan "did not seem shocked at my suggestion of the possibility of future insolvency if current trends continue much longer."

<sup>32</sup> Alleghany made a successful tender offer for Jones Motor Co. shares in 1968.

<sup>33</sup> This was set forth in a plan for accomplishing the disposition of Penn Central shares owned by Alleghany and held in trust by Irving Trust Co. which was drafted on May 26, and submitted to Alleghany on May 27, 1970.



That Alleghany was interested in selling its Penn Central stock was communicated to an institutional sales representative, John Shepherd, who handled Alleghany's account at Goldman, Sachs. Although the time has not been precisely fixed, Burns told Shepherd in February or March 1970 that Alleghany would be in a position to sell its Penn Central stock. However, no action was taken either by Goldman, Sachs or by Alleghany to sell the Penn Central stock.<sup>34</sup>

On the evening of May 26, 1970, at a dinner hosted by Shepherd for his clients, Burns had occasion to discuss Penn Central with the head block trader of Goldman, Sachs; Robert Mnuchin. Burns recounted the discussion with Mnuchin on the evening of May 26 and the sale on May 27 as follows:

During the course of the evening, he mentioned to me he knew I had been listed by Jack (John Shepherd, an institutional sales representative for Goldman, Sachs) as a possible seller of Penn Central,<sup>35</sup> which I had been, and that in his opinion, the market was active in Penn Central and that he might be able to make me a good bid if I was still interested in selling and I asked him why and as I recall his answer was: there are plenty of buyers in Penn Central and I think it is a good trading stock right now.

So before the evening was over, I asked Mr. Mnuchin to give me a call the next day, which was the 27th and if he had a bid to make, possibly I would entertain it. I went home that night. The next day Goldman, Sachs phoned, Jack Shepherd did call, put Bob Mnuchin on the phone, and gave me the opening in Penn Central, and said I can give you a bid for approximately 200,000 shares at somewhere—at a discount, would you be interested in entertaining a bid?

Now, this was the first time anybody had told me that, (A) I could sell this much stock, and, (B) in effect, put up or shut up. My recollection is that I went in and had a general discussion with one of my associates—a discussion which lasted about an hour concerning the state of the market, the decline in the stock on the one hand and our pessimistic feeling concerning the losses for this year of the railroad and [sic] the other, that we thought it would be a good idea to sell half of our position, about half of our position.

I then went back, call Mr. Mnuchin directly and asked what he was prepared to do on 96,000 shares—roughly 96,000. Maybe exactly 96,000, and after checking the market, as I recall, he came back and said that—I am not sure of the exact figure, so you will have to forgive my inaccuracy, the last sale was  $13\frac{3}{4}$ , that he would like to make a position bid on or around  $13\frac{1}{4}$  and that he would give me the benefit of any sales that he was able to get off in brining the stock down to the  $13\frac{1}{4}$  level where he would be the buyer and I would be the seller and the block would cross.

I believe we negotiated a little, he might have given me a bid and I got him up to  $13\frac{1}{4}$ , he might have given me  $13\frac{1}{8}$  and I got him up to  $13\frac{3}{8}$ . I am not sure of the facts. I told him that would be acceptable, but I had to speak to the Irving Trust Company who was the record holder of the stock (trustee for Alleghany's Penn Central stock).

I called Mr. McCabe and spoke with him and in line with our trust agreement, I was recommending a sale at this particular time and Goldman, Sachs and Company had made us a bid and that I would recommend that he go along and accept the bid on behalf of us as beneficial owner.

He said he thought that was all right. I then called Mr. Mnuchin and asked him to get in touch with Mr. McCabe or one of his assistants directly. The trade was consummated somewhere around 12:00. The stock closed that day higher and there was quite a bit of buying.

Those are the circumstances under which I accomplished that trade.

The sale of 96,000 shares of Penn Central was executed by Goldman, Sachs at  $\$13\frac{1}{4}$  per share for 70,000 shares, with the remainder sold in the market at prices ranging from  $\$13\frac{1}{4}$  to  $\$13\frac{3}{8}$  per share. The balance of Alleghany's 100,000 shares of Penn Central were sold in

<sup>34</sup> Goldman, Sachs was a dealer in Penn Central's commercial paper and was in frequent communication with Penn Central during this period, especially in late May.

<sup>35</sup> Mnuchin's recollection somewhat differs in this regard as he believed Burns initiated the conversation about selling Penn Central, although Mnuchin did not specifically recollect who initiated the discussion on Penn Central.

January 1971, and the Kirby family holdings of Penn Central were disposed of on September 22, 1970.

#### INVESTORS MUTUAL FUND, INC.

Investors Diversified Services, Inc. provides, among its other lines of business, advisory and distribution services for six open-end mutual funds with assets as of September 30, 1971, of approximately \$6.6 billion. Three of these funds, Investors Mutual Fund (IM), Variable Payment Fund (VP), and Investors Stock Fund (IS) sold common stock of Penn Central in 1969 and 1970. In September 1968, Penn Central common stock owned by IDS-managed funds totaled 1,020,000 shares divided as follows between the funds: Investors Mutual—500,000 shares; Variable Payment—200,000 shares; and Investors Stock—320,000 shares. These positions had been accumulated over a period of time commencing in 1967. The following table shows the holdings of Penn Central of the three funds, beginning on January 1, 1968, and showing subsequent purchases and sales.

PURCHASES AND SALES OF PENN CENTRAL COMMON STOCK BY MUTUAL FUNDS MANAGED BY INVESTORS  
DIVERSIFIED SERVICES

	Holdings on Jan. 1, 1968	Purchases	Sales—			
		Jan. 1, 1968 to Aug. 26, 1968	Mar. 27, 1969 to July 17, 1969	Oct. 8, 1969 to Oct. 16, 1969	Jan. 19, 1970 to Mar. 26, 1970	May 6, 1970 to May 27, 1970
Investors Mutual.....	88,700	411,300	108,100	45,600	103,100	243,200
Investors Stock.....	245,000	75,000	320,000	0	0	0
Investors Variable Payment.....	200,000	0	200,000	0	0	0

#### *Events surrounding sales by IM*

Whereas IS and VP began to sell their Penn Central stock in March and April 1969, respectively, and had completely sold out their holdings in May 1969, IM continued to hold all of its Penn Central shares in its portfolio until June 13, 1969, when the investment committee of IM authorized the sale of 100,000 shares of Penn Central from its holdings of 500,000 shares. Such an authorization permits the fund's portfolio manager to sell the stock at his discretion. This authorized sale of 100,000 shares was completed on July 8, 1969, and the sale of an additional 100,000 shares was authorized on July 9, 1969, by IM's investment committee. After the sale of the initial authorization was completed, sales of Penn Central stock were intermittent during the remainder of 1969 and until May 1970.

It is apparent that the portfolio managers of IS and VP were more strongly convinced that Penn Central stock should be sold than was the portfolio manager of IM. Harold A. Schwind, portfolio manager of IM with responsibility for Penn Central, commented on the long period of time it took to sell the Penn Central stock:

Answer. I think the most important reason was I didn't feel that I had enough information and a strong enough feel of the situation to warrant holding it. It sounds like reviewing the problem from a little different focus, but at no time did I have hard, fast, specific reasons for selling it. If I had, I think I would have sold it quickly.

One of the unusual things about the sale of this stock is it took us 11 months to sell it. I can't remember ever taking that long to sell anything before.

*Question. What was the most important reason for your not selling it quickly?*

Answer. I guess I was never sure that I was making the right decision. In fact, when we sold the final block of the stock in May, there was no feeling of elation because I wasn't sure I was doing the right thing.

After the additional authorization to sell 100,000 shares of Penn Central was made on July 9, 1969, only 8,100 shares were sold before IM ceased selling. The reason for this is associated with a conversation between Stuart F. Silloway, president of IDS, and Jack L. Nienaber, vice president of IDS. Nienaber recalled the conversation:

He (Silloway) noted that we were selling additional Penn Central Stock. \* \* \* And he urged that we take another look and not sell it, because he thought there were good reasons on the basis of conversations he had with people he considered well informed who felt the company, if you will, had a very real chance to turn around.

This information was relayed to the portfolio manager of IM, Harold A. Schwind:

My superior, Mr. Nienaber, came to me one morning—it was early in the day—and related a conversation he had just had with Mr. Stuart Silloway, the president of IDS, and Mr. Silloway had told him that he had a contact—some acquaintance or broker, some contact—that was never identified to me—who apparently was aware that we were selling Penn Central and felt that we were making a mistake and would like to tell us more about the situation and the attractiveness of the stock.

We discussed it, Mr. Nienaber and I, and felt that under the circumstances we had better put a hold on the stock and stop selling it.

Silloway's well informed source was Fred M. Kirby, chairman of IDS and Alleghany Corp. and a director of Penn Central. Silloway's version of the conversation with Kirby was similar to Nienaber's in that as he recalled the conversation:

He (Kirby) expressed a point of view that, well, maybe there will be some improvement that you will see. Perhaps there will be something; maybe the thing is not as bad as you think it is—nothing tangible or nothing specific.

Later in his testimony Silloway restated Kirby's view as more of a hope some progress would be made by Penn Central in its operations.

This information was apparently of sufficient import that IM made no sales of Penn Central until October 1969. As Schwind stated, he decided to sell Penn Central again because:

Well, nothing was ever heard back from Mr. Silloway or Mr. Nienaber with regard to the original comment of talking to some contact with regard to Penn Central. \* \* \* I didn't really consult with anyone about resuming of the sale. I believe—I'm sure I mentioned it to Mr. Nienaber. So we just simply opened up the balance of the stock and began to sell.

After the authorization for sale was again approved in October 1969, sales were sporadic: between October 8-16, 1969, IM sold 45,600 shares and between January 1, and March 26, 1970, 103,100 shares were sold. The hiatus from selling in November-December 1969 was not explained by any of the witnesses, other than being based on indecision.

However, another contact this time with Charles Hodge, chief investment adviser to Penn Central and a partner of Gloré Forgan, William R. Staats, may have resulted in this cessation from selling. Silloway called Hodge after seeking guidance from a friend in Philadelphia as to the name of someone who "really knew Penn Central inside and out \* \* \* somebody who had done a lot of work and had access perhaps to people within management who would help them put infor-

mation together." Silloway was supplied the name of Hodge as one who could provide such information. Silloway then called Hodge in late September or early October of 1969, but was unable to obtain answers to his specific questions on operating expense trends of Penn Central other than that Hodge had confidence in the Penn Central situation and was going to recommend the stock to some people who hopefully would purchase substantial amounts of the stock and that then he would be an influence in changing the management.

The lack of sales in April 1970 was explained as caused by an oversight by the portfolio manager in that the authorization for sale of the remaining portion of Penn Central lapsed 6 months after the September 1969 authorization. A new authorization was obtained on May 5, 1970, to sell IM's remaining position of 243,200 shares of Penn Central. When sales commenced on May 6 again there was little urgency in the disposition of the Penn Central stock.

John P. Vervoort, president of IDS securities and the trader of Penn Central for IM, commented on this lack of aggressive selling.

Answer. I do not recall specifically the instructions. However, if I look at the sales as they occurred none of them indicate to me that there had been any urgency, if you wish, or guidance or expression of opinion that this stock should be sold in a very definite manner. None of these trades are of any relative size with the exception being the 27th of May. So I cannot recall any precise instructions.

*Question. Can you recall any instructions whatsoever, precise or imprecise?*

Answer. I do vaguely recall a number of times having had participating instruction. When, precisely they were, I do not recall.

*Question. Could you describe what these participating instructions were?*

Answer. Participating instructions are generally construed as meaning to participate in the floor activity on a stock and we generally think in terms of 20,000 and 25,000 shares. Anywhere between that.

Participating sales were accomplished in this situation by a continuing order at the brokerage firm of Mitchum, Jones & Templeton to sell as many shares as possible within a specified price range. At the conclusion of the day, the Mitchum firm would notify Vervoort of sales executed on its behalf that day. Even on days which resulted in the sale of significant amounts of Penn Central stock, a number of smaller trades contributed to the larger total.

#### INVESTORS MUTUAL SALES IN MAY 1970

Date and number of shares in trade	Price	Date and number of shares in trade	Price
May 6:		May 19—Continued	
6,000.....	18	2,100.....	14½
900.....	18¼	300.....	14½
May 7:		400.....	14¼
2,000.....	18½	7,400.....	14½
2,000.....	18½	12,100.....	14
2,000.....	18½	May 21:	
May 8:		400.....	13½
200.....	18¾	5,000.....	13
1,800.....	18½	8,000.....	13
33,000.....	15	May 26:	
May 14:		2,000.....	13¾
1,000.....	15½	May 27:	
May 15:		2,000.....	13¾
2,000.....	15¾	2,000.....	13¾
500.....	15¾	2,000.....	13¾
May 19:		200.....	14½
1,000.....	15	1 1,000.....	13¾
2,000.....	14	1 400.....	13¾
32,100.....	14	1 2,100.....	13¼
600.....	14½	1 25,000.....	13
2,100.....	14½	1 81,600.....	13

\* Trade was for 110,100 with 81,600 positioned by Shields & Co., after trades available at higher prices were executed.

The sale of 110,100 shares through Shields & Co., was a variation from the previous pattern of selling small pieces of IM's Penn Central holdings. From the testimony of a number of witnesses at IDS, the change in selling pattern occurred because of a comment from the IDS analyst of Penn Central to the trader. Apparently at some time during the lunch hour, Richard Warden, the rail analyst for IDS, entered the trading room seeking the trader for Penn Central to discover how much PC stock IM continued to hold. Previously Warden had without success looked for Nienaber and Schwind for this information so he sought out the trader. Warden told the trader: "that I was concerned that this was a possible bankruptcy, and I felt that the stock should be sold." The trader then contacted Shields & Co. for a block bid and thereafter Mitchum, Jones & Templeton to find out how much had been sold that day on the participating sale instructions. Upon learning that 6,200 shares had been sold, the remaining order was canceled. Vervoort stated his reasons for the decision to sell:

My decision to sell that stock on that day was based upon a long period of selling this stock, passing a number of opportunities to have sold stock before, to have seen the price deteriorate constantly over a rather long period of time, having been involved in the wrong decision to purchase part of that stock, to the remark that Mr. Warden made, to the fact that the portfolio managers, Mr. Hal Schwind and Mr Nienaber were not available. I was just sick and tired of this stock and I was sick and tired of the indecisiveness. I probably felt guilty about having been involved in the suggestion that the stock be bought much earlier at much higher prices, that this was—it just reached the peak, if you wish at that time on that day or a combination of all these factors as the trend of the stock indicated that this thing could slip down further and I just took this opportunity to once and for all get it off the books.

To be done with a decision that had been made much earlier but had never been fully executed.

Vervoort had had this feeling of indecisiveness for a number of months, but characterized Warden's comment as the excuse needed to then act decisively. Warden's comment concerning the possible bankruptcy of Penn Central resulted from being told of a report over the Dow Jones on May 26, and an article in the Wall Street Journal on May 27, that Penn Central's commercial paper was maturing faster than it was being sold. While this information was contained in a prospectus dated May 12, 1970, issued by the Pennsylvania Co., Warden testified he did not recall whether in fact he had seen the prospectus and did not learn of the information concerning PC's commercial paper until May 27.

Thus Vervoort made a definite change to clear out the position by diverting from the prior pattern of selling.<sup>36</sup> Schwind stated that the trader's cancellation of the sales order at Mitchum Jones and the solicitation of a block bid at a discount from the current market price would be somewhat inconsistent with the instructions the trader had and that it is a customary practice for a trader soliciting a discount bid to first talk with the portfolio manager. However, Schwind also characterized a discount of three-fourths of a point as not clearly excessive but in a "gray area" in which the trader could in his discretion make such a decision. Nienaber also stated that the trader's action was within the limits of his discretion.

<sup>36</sup> A telephone call was made from the Goldman, Sachs trading room to IDS shortly before IDS's sale of Penn Central, but who made or received the call and the substance of the conversation is not known. Mnuchin from Goldman, Sachs testified that this commercial call could have been made because the direct line had broken down.

*Additional circumstances relating to IM's May 27 sale of Penn Central*

At the initial stages of the investigation of the circumstances relating to sales by both Alleghany and IM of substantial quantities of Penn Central stock on May 27, 1970, coordination between sales was believed to be possibly linked to several telephone calls recorded on telephone toll slips of Alleghany to various personnel at IDS. A certain number of telephone calls should certainly be expected because of the close affiliation between Alleghany and IDS, but most likely such calls would be to management personnel at the higher corporate levels of IDS due to Alleghany's interest in overall corporate policy of IDS. Indeed, this was primarily the situation in that calls normally made were to such individuals as the vice president for public relations, the comptroller, vice president for law, et cetera. However, calls were made on May 25, 26, and 27 which did not follow the prior pattern of calls from Alleghany to IDS.

On May 25, 1970, a call was made to the telephone number of Thomas R. Reeves, vice president for investments, which lasted for 19 minutes. A few minutes after the conclusion of that conversation, a call was made to the telephone number of Robert B. Johnson, vice president—investment research which lasted for 34 minutes. The next day, May 26, at 10:11 a.m. (New York City time), which would be 9:11 a.m. Minneapolis time, Johnson of IDS apparently conversed with someone from Alleghany for 15 minutes. On May 27, the day of the trading by Alleghany and IDS, Silloway's secretary received a call at 11:15 a.m. which lasted for 2 minutes.

The obvious question is what was the purpose of these calls? A reason for focusing on these calls is that neither Reeves nor Johnson had received direct phone calls from Alleghany for the year prior to May 1970. In addition, Silloway received only one phone call from Alleghany on his direct number during the year prior to May 1970. It is possible that these calls bear no relationship to the trading in Penn Central but the suspicions exist in that after Alleghany had placed its order to sell then IDS may have been given the green light for it to sell. Counsel for Alleghany stated that "we are unable to determine who placed these calls but Mr. Burns does not recall making any of them."

From affidavits of Thomas R. Reeves and Robert B. Johnson, it does not appear that either person was the recipient of these calls from Alleghany on those dates. Reeves was in New York City on May 25 through May 27 and stated that it was his practice to use Alleghany's office to keep contact with his office in Minneapolis. In addition, Johnson was not in his office on May 25, but was playing in a golf tournament which was verified to the best of their recollection by three other persons. Both Reeves and Johnson denied discussing Penn Central with anyone on May 25 through May 27.

Other coordination could have existed due to an IDS executive committee meeting on May 26 at Alleghany's office attended by Kirby and Silloway. However no, evidence was uncovered that Penn Central was discussed either informally or formally and furthermore, both these persons denied any conversations occurring on that date or at any other time, other than previously described in this section.

## SUMMARY

Officers and employees of Alleghany Corp., Investors Mutual Fund, Inc. and Investors Diversified Services, Inc. asserted that the sales on May 27, 1970, of Penn Central stock were made independently without any communication between these entities and that none of the sales was made on the basis of material nonpublic information.

## II-B. TRADING BY OFFICERS AND DIRECTORS

### INTRODUCTION

Between the time of the formation of Penn Central Transportation Co. in February 1968 and the June 1970 bankruptcy, as management deliberately and increasingly glazed its public reports with distorted optimism, many members of management succeeded in selling many shares of Penn Central stock.<sup>37</sup> This section of the report deals with the detailed inquiry the staff has made into the sales of Penn Central officers and directors after the merger.<sup>38</sup>

The securities laws, in particular rule 10b-5 of the Securities Exchange Act of 1934, prohibit stock transactions based on material inside information which has not been disclosed to all parties in the transaction or to the public in general. Therefore, any officer aware that the company's prospects were significantly more dismal than the public had been led to believe would have been precluded from trading in Penn Central shares while the disclosure gap existed, even though such officer's unwillingness or inability to correct the disclosure gap could have had the effect of locking him in to his investment.

Other sections of the report analyze in depth the areas in with the Penn Central disclosure gap existed, and the widening of that gap with the passage of time and the decline of the company. This section, which examines the timing and extent of officers' sales, the reasons given for them, and the position of the officers in the corporate structure, is intended to be read in conjunction with the full report in determining whether any officer trading was done on the basis of material inside information.<sup>39</sup> The reader's attention is also called to the chronology of events which accompanies the disclosure report, and which should also used to shed light on the possible culpability of various officers for their sales. Finally, even though very difficult to assess, the existence of rumors should not be discounted. Considering the broad and fundamental nature of the problems facing Penn Central, their impact may well have been widespread and significant.

During the course of this investigation, the trading of over 80 officers and directors was reviewed, including officers and directors who left prior to the bankruptcy and/or joined the company post merger. A large amount of documents of such trading and the reasons for it were submitted and reviewed, and in certain cases outside confirmations of various events were obtained. Any major trading which occurred after the merger was questioned in testimony or through the use of affidavits. The staff found that virtually no outside directors,

<sup>37</sup> The 15 officers whose trading is summarized in this report held, at the time of the bankruptcy or of their departure from the company prior to bankruptcy, only about 30 percent of the total amount of Penn Central stock they had owned at the time of the merger. (This figure excludes thrift plan distributions).

<sup>38</sup> The term "officer" in this report means anyone with the title of president, vice president, treasurer, secretary, comptroller of Penn Central Transportation Co. or of Penn Central Co.

<sup>39</sup> Although the news coming out of the company was, in retrospect, optimistic to the point of absurdity it was, even in its watered-down form, mostly bearish. Some officers' trading occurred at times when specific items of bad news were known within the company, but had not reached the public in any form, such as, for example, earnings reports. Where there appears to be a connection between an officer's sale and such specific information, it is discussed below as part of the summary of the officer's trading.



most of whom owned only minimal amounts of Penn Central stock, had made significant sales for their own accounts during the post-merger period.<sup>40</sup>

The investigation revealed that, although the trading carried on by many officers raised few questions concerning its propriety under the securities laws, the conduct of a significant number of officers demanded serious consideration in this regard. The staff has selected from these questionable trades those which appear to raise the most serious questions under the securities laws, and has summarized them in this report.

Many factors complicated this retrospective study.<sup>41</sup> The price of Penn Central stock slid ineluctably from a high of 86½ in July 1968, to a low of 10 in June 1970, just prior to the June 21 reorganization announcement. The 2-year performance of the stock makes it very possible that some officer sales were legitimately made simply on the basis of public adverse information. On the other hand, it must be remembered that there were many investors not bailing out during this period. Indeed the optimism or thoughtlessness of a number of major outside investors found them with large amounts of Penn Central stock in the spring of 1970, the sales of which are dealt with in the previous section of this report.

Apart from insider trading questions, it should be noted that the extent of the bail-out by officers during the steady price decline of the stock is somewhat inconsistent with the concepts underlying the option system, whose supposed purpose of generating and rewarding corporate loyalty was lost in the shuffle as officers bailed out of Penn Central stock to protect their investments and realize their paper profits. Over the years, some Penn Central officers had built fortunes based on the company's large option grants.<sup>42</sup> Although the officers had been allowed to profit from these grants on the theory that they, as key employees, were contributing to the betterment of the company, including the rise in price of the company's stock, many of them felt no compunction against bailing out in the down market, thus providing themselves with extra compensation due to the company's good fortunes and evading penalization for any adverse happenings.

Further, the staff found that certain banks (some with Penn Central connections) had made a number of large, long-term, unsecured loans to high Penn Central officials, mostly in connection with their exercise of Penn Central stock options, and mostly at the very favorable terms of one-half to 1 percent above the prime rate. Even though these were unsecured loans, many Penn Central officers appeared to

<sup>40</sup> This section is limited to examining officers' and directors' personal holdings of Penn Central common stock.

Sales by directors were as follows:

1. William L. Day\* sold 450 of his 1,000 shares in 1968 and 1969, but purchased 450 shares in Nov. 1969, leaving him with the same balance of 1,000 shares at his resignation from the board on June 21, 1970, as at the time of the merger.

2. R. W. Graham\* sold 3,568 of 83,708 shares owned by him in Nov. 1969, repurchasing 3,890 shares in March 1970. Graham maintained his investment in this large amount of Penn Central stock until after the bankruptcy.

3. Edward J. Hanley,\* who owned 200 shares during this period, reported that his wife sold 300 of 800 shares which she owned in Dec. 1969. Hanley, who was the chairman of the Conflict of Interest Committee, stated through his attorneys that the 300 shares had been sold "in order to establish a tax loss to off-set taxable gain on other securities which Mr. Hanley had sold."

\*Day and Graham, directors of Penn Central Transportation Co., were both elected to the board of Penn Central Co., on June 18, 1970. Hanley was on the board of Penn Central from its formation.

<sup>41</sup> Not the least of these complications was that in October, 1969, when the Penn Central Co. was formed, the Penn Central Transportation Co. became a wholly owned subsidiary, and only vice presidents of Penn Central Co. reported their purchases and sales to the Commission under section 16 of the 1934 act.

<sup>42</sup> Although, prior to the merger, the New York Central had also had a generous option plan, Penn Central's officer compensation program, including options, was far more extensive.

have irrevocably associated them with their stock purchases, using the proceeds from Penn Central stock sales to pay off the loans. Obviously, the presence of these loans, which enabled officers, with no cash outlay of their own and at the most favorable terms possible, to benefit from a price rise in Penn Central stock, also acted to encourage officers to sell in a down market to protect their investments.

A stunning example of such a bail-out is that conducted by David Bevan, who was at the vortex of Penn Central's machinations, and who sold 15,000 shares of Penn Central stock in the first half of 1969 at prices ranging between \$50 and \$66, paying off a \$650,000 stock option loan and managing to keep his personal fortune virtually intact. In contrast to this was the trading, or lack thereof, of Stuart Saunders, who has made no sales since 1967, even though his 45,000-share block of stock represented almost his whole fortune, and large loans he had made to purchase the stock remain outstanding. Of course, Saunders was virtually locked in to his no-sale position both because of the potential liability which his insider knowledge would have caused for him, and the possible harm to the fortunes of the company which such a vote of no-confidence by him could have engendered.<sup>43</sup>

The heaviest concentrations of officer selling occurred in June and July 1969, a time when the accumulation of Penn Central's major problems in the areas of operations, earnings, and finance culminated with a discussion at the June 25 meeting of the board of directors as to whether Penn Central should withhold its time-honored quarterly dividend from its shareholders.<sup>44</sup> Between June and July 1969, Bevan chose to make the last sale (2,300 shares) of his program of sales which halved his ownership of Penn Central stock; three other officers sold over 50 percent of their holdings—Roberts (2,000 shares), Haslett (3,000 shares), and Smucker (3,600 shares); and two more officers virtually liquidated their Penn Central investment—Flannery (236 shares—100 percent) and Knight (3,950 of 3,957 shares). The circumstances surrounding these sales, including each officer's reasons for them, are discussed below as part of the summary of each officer's trading.

All officers who were questioned denied that any of their sales had been made on the basis of material inside information. It appears that few officers were concerned that the public might be deluded about corporate affairs, and that the possibility that there might be inadequate disclosure had figured very little, or not at all, in their trading. Thus could a high financial officer try to explain his sale in February 1970, by stating blandly that he had merely waited until after the 1969 financial figures had been disseminated.<sup>45</sup>

Many of the explanations most commonly given by officers concerning their postmerger trading in Penn Central stock appear, under examination, to lack the sense of urgency reasonably required to cause an officer to make a forced sale. The most obvious example of this was the claim that some sales were made to pay off loans, when in fact the idea to pay off the loan had originated with the officer, and not the bank, or when the officer made a choice to sell Penn Central

<sup>43</sup> It is interesting to note, however, that neither of these reasons stopped Bevan. (See below for a full discussion of Bevan's sales).

<sup>44</sup> This discussion concerned the third quarter of 1969 dividend, which was ultimately declared. The fourth quarter dividend was the first one not declared.

<sup>45</sup> Another officer, when queried concerning his trading, claimed the subject of insider trading had not entered his mind.

stock over other liquid assets. Likewise, the claims of some officers that they sold because they sought to diversify their assets, either for general purposes or in contemplation of retirement, lose credence when the officer is at a loss to explain how his interest in diversification happened to come to him at a specific time, particularly when such officer's financial situation and dependence on Penn Central stock had remained stable for a number of years preceding his sale. Trading based on a well-established window pattern of purchases and sales does serve to show a lessened reliance on inside information, although it cannot be assumed that such patterns excuse all insider sales.

The company and the board of directors had seen to it that all officers had been clearly informed of the prohibitions against insider trading. In October 1969 a "Penn Central Manual on Insider Securities Trading" was widely circulated at and below the top management level, and in December 1968, and March 1970, memoranda sent out discussing the company's disclosure policy emphasized the duty of insiders to refrain from trading prior to full public disclosure of important corporate news.

Penn Central did a very poor job of watching over the trading of its officers. Saunders claimed that he had turned over all corporate responsibilities in this area to the Conflict of Interest Committee when it was formed in 1968. The Conflicts Committee considered that it had discharged its duties in this area with the publication of various reports, memoranda and manuals prepared by the law firm it had hired.<sup>46</sup> Although the 1969 Insider Trading Manual and the 1970 disclosure memo refer to procedures to be carried out through the office of general counsel in connection with undisclosed material information, no one, including the Conflicts Committee, the president and office of general counsel, paid the slightest attention to implementing the proposed procedures.

Over the years, many officers had been in the habit of consulting D. L. Wilson of the office of general counsel concerning the propriety of their trading under the short-swing trading prohibitions of the 1934 act. As the company drew closer to bankruptcy, a few prospective traders also broached the subject of insider trading. Without, apparently, a deep analysis of the subject, Wilson raised no major objections to these sales, with the exception of discussions he held with Saunders concerning the possibility of his selling at this time.

The secretary's office, under the direction of Secretary Bayard Roberts, prepared and relayed to the Commission the form 4 reports of officer and director trading. According to Roberts, preparation of these reports was a purely bookkeeping function, and the reports were not subjected to any sort of review. When Penn Central Transportation Co. officers stopped filing form 4 reports in October 1969, no one at any level of the company had any thoughts concerning monitoring

<sup>46</sup> The 1969 manual and the 1970 memo had been prepared by an outside law firm at the direction of the Conflict of Interest Committee. Although sent out with the knowledge of this committee, the 1968 memo had been prepared by the legal department at Saunders' instigation. The Conflict of Interest Committee, which had been set up in September 1968, sent, in early 1969, an extensive questionnaire to officers and directors of the company and its subsidiaries seeking information concerning officers' trading and possible conflicts of interest. The committee's report on the questionnaires noted that officers had made substantial sales in 1968, but found no evidence of improper motives. The questionnaires also uncovered some potential short-swing trading violations which were referred to the company for action. The committee delved no further into the subject of officers' trading in general following the questionnaires, and although it did entertain the idea of urging that further questionnaires be sent out on a periodic basis, this suggestion was shelved within the committee and had not been acted on by the time of the bankruptcy.

the further trading of even those officers whose trading was no longer the subject of public scrutiny.<sup>47</sup>

One caveat must be given concerning the individual trading reports: Although the numbers have been checked and rechecked for accuracy, many times the purchases and sales discussed will not balance out to the numbers given. This is because, for reasons of clarity, only major transactions have been signaled. Gifts and charitable donations have, in general, been omitted.<sup>48</sup> Most officers were members of Penn Central's thrift plan, contributing up to 5 percent of their income to make regular purchases of stock at half-price. The major distribution of these shares came after bankruptcy (or after prebankruptcy retirement), but some small distributions were made on an annual basis and have been figured into an officer's total holdings, although not recorded as separate purchases.

### OFFICERS—FINANCE

The finance department, run very much as a separate entity by David Bevan, dealt on a daily basis with the company's problems in obtaining cash and the enormous demands for cash made by the subsidiaries as well as the parent company.

It should be noted that the sales of the four men discussed in this section, all top finance department officers, pursue a remarkably similar pattern in that each of the four stated that his sales had been made to pay off bank loans whose need to be paid off at the time was questionable, to say the least. Three of these officers, Bevan, Gerstenecker, and Haslett, who all took part in the Penphil venture, all made their major sales during the beginning of 1969.

#### DAVID C. BEVAN

	Purchases	Sales	Balance
Feb. 1, 1968			30,404
Mar. 11, 1968	3,600		33,904
Jan. 6, 1969		3,000	30,718
Mar. 11, 1969		3,000	27,546
Apr. 9, 1969		3,000	24,546
May 6, 1969		3,000	21,546
May 27, 1969		700	20,846
June 25, 1969		2,300	18,546
June 19, 1970		4,900	13,246
June 24, 1970		5,100	8,146
July 3, 1970		8,146	

There is no doubt that David Bevan was the key financial officer at Penn Central, responsible for initiating or effecting all financial machinations of the postmerger period. He held the title of chairman of the finance committee throughout this period, and also served on the board of directors except for the period between February 1968 and the fall of 1969. He was one of the three top officers abruptly severed from the company following the dramatic June 8, 1970 meeting of the board of directors.

<sup>47</sup> In October 1969, Saunders asked Cole for a list of officers' stock sales. Cole had the secretary's office prepare the list, and forwarded it to Saunders. When shown a copy of the list, Cole, Roberts, and Saunders all claimed they had forgotten about it, and could not remember why Saunders had asked for it or what he did with it.

<sup>48</sup> Family gifts which remained under the control of the donating officer are counted as part of his Penn Central holdings.

Bevan liquidated his substantial holdings of Penn Central stock in two separate series of transactions. The first occurred between December 1968 and June 1969 when he ceased his program of buying Penn Central shares and sold almost half his holdings of Penn Central stock.<sup>49</sup> The final sell-out occurred between June and August 1970. Between 1964 and 1968, Bevan had acquired a sizable amount of shares by exercising options at 21 and 24½.

By the end of 1968, he had acquired 34,400 shares of stock pursuant to these options, and he had outstanding with Mellon National Bank and Trust Co. an unsecured loan in excess of \$650,000 which he had used to purchase these shares. Between January and June 1969 Bevan sold 15,000 shares of Penn Central stock in six separate transactions.<sup>50</sup> The explanation that Bevan presented concerning the 1969 sales was that he had liquidated his \$650,000 loan at the insistence of Mellon Bank, and that in any case he had planned as early as 1965 to sell Penn Central stock to liquidate his outstanding loans by 1970. As complete evidence of this, Bevan pointed to a December 1968 letter from Spencer R. Hackett, Mellon Bank vice-president, suggesting that Bevan consider making gradual periodic reductions on his loan, and Bevan's January response agreeing with the suggestion.<sup>51</sup> Bevan claimed that in 1965 he had notified both the Mellon Bank and the Chemical Bank that he intended to pay off his loans within 5 years from the sale of Penn Central stock.<sup>52</sup>

Whatever Bevan's reasons for the 1969 sales, they were not caused by any pressure from Mellon Bank. According to Hackett's sworn statement, Bevan called Hackett in December, 1968, to ask for the letter from Mellon Bank requesting a pay-down. The only reason Hackett wrote the December, 1968, letter was to comply with this request; prior to Bevan's phone call, Hackett had had no thought of asking Bevan to reduce the loan.<sup>53</sup> Bevan, however, denied categorically under oath that he had initiated the Mellon pay-down request.<sup>54</sup>

<sup>49</sup> Bevan left unexercised 3,600 option shares available to him at 24½.

<sup>50</sup> A reasonable guess as to why Bevan held on to the balance of his stock would be that Bevan, as chief financial officer of the company, was reluctant to make such a public show of no-confidence in the company, since he reported his stock transactions to the Commission on form 4's. It also appears that the company was very conscious of sales by officers and directors during this period. In its April 1970 proxy statement it listed, as required by proxy rules, sales of option shares made between 1968 and 1970 by Saunders (4,000) Perlman (9,230), Bevan (16,000) and eight other officers (29,411). Then it added a footnote to this breakdown which stated: "The sales by Messrs. Saunders and Perlman were made prior to February 1, 1968, the effective date of the Pennsylvania New York Central merger. Prior to the same date, Mr. Bevan sold 1,000 shares and other officers as a group sold 17,752 shares."

<sup>51</sup> Bevan's letter to Hackett, dated January 8, 1969, reads in part, as follows: Thank you very much for your letter of December 24, and I understand perfectly the spirit in which it was written. You are quite right that my loan has been on the books for quite a period of time. Do not feel guilty about this. As I explained to you and John Mayer, I do not think anyone in top management should be a quick-buck artist. There is a limit to everything and the bank has been very good to me.

Your letter also made me stop and reassess my whole position. I have been so busy that I had not really stopped and considered what I had in the way of stock options. In December, I completed earning an additional 3,600 and on February 1 I will have earned an additional 10,000 and as of February 1, 1970, there will be another 10,000 for a total of 23,600 shares that has to be financed. Therefore, I agree with you that it behooves me to gradually reduce my outstanding loan.

<sup>52</sup> A letter to Chemical Bank indicating this was submitted as an exhibit. No such letter to Mellon Bank has been located.

<sup>53</sup> Hackett stated that Bevan gave no reason for the request, and Hackett did not ask for one, as "I did not consider this my affair or that of the Bank." In a further letter, dated January 9, 1969, Hackett took pains to assure Bevan that he was prepared to authorize further loans on his behalf.

<sup>54</sup> Q. Did you ask Mr. Hackett to write the letter to you?

A. No.

Mr. GERMAN (attorney for Bevan). I didn't hear the question.

Q. The question was, Did you ask Mr. Hackett to write the letter to you?

A. No. I don't like the implication. The answer is no.

Q. Do you remember making a phone call to Mr. Hackett at any time in December of 1968 concerning your personal loan?

A. Concerning my personal loan, no.

Q. Information has been given to us that such a phone call was made and such a request was made. Do you remember anything about a phone call of that kind?

A. No. I don't recall any unless you indicated before maybe he said he was writing such a letter or that I should do it. He may have warned me that it was coming or something of that sort, but my answer still

The proceeds of Bevan's 1969 sales came to about \$835,000, most of which was used in liquidating the Mellon loan (which exceeded \$661,000 in December, 1968) and to reduce the Chemical loan by about \$114,000, leaving an outstanding loan balance at Chemical of about \$16,000.<sup>55</sup> Both of these loans had been outstanding in significant amounts since 1965.<sup>56</sup> Bevan's considerable reduction of his debts during this period appears, however, not to have been the cause of his 1969 sales, but simply the end result of a decision he made independently that the first half of 1969 was a propitious time to reduce his substantial financial reliance on Penn Central stock.<sup>57</sup>

Bevan made no further sales of Penn Central stock until after his June 8, 1970, dismissal. Between June and August 1970, Bevan sold all of his remaining shares of Penn Central stock, including 3,370 shares from the thrift plan which were distributed to him on August 3, 1970. His first sale was made on June 19, 1970, the last trading day prior to the Penn Central bankruptcy. On this day, pursuant to an order entered with his broker at Yarnall, Biddle & Co., on June 18, Bevan sold 4,900 shares at 11½ in a limit order transaction.<sup>58</sup> On June 24, Bevan's broker entered and executed a further limit order to sell 5,100 shares at 8.<sup>59</sup> At that time, Bevan still maintained his office at company headquarters "trying to get things straightened out for the railroad. \* \* \*" He had decided on June 8, the day of his dismissal by the board of directors, to sell all of his Penn Central shares.<sup>60</sup>

stands that I would have no recollection of it. I did say he may have called me to tell me it was coming or called me afterwards and expressed a hope that it didn't annoy me or anything, but I haven't any recollection of it.

Q. Are you certain then that you yourself did not initiate a call to Mr. Hackett in connection with your loan?

A. I have no recollection of it. If anything had happened, if there was such a phone call, he may have called me, and I may have said, well, then put it in writing.

Q. No; but I am asking you if you are reasonably certain that you never initiated any such call?

A. I am as certain as I can be.

Q. So I take it that means that you are virtually certain?

A. I am virtually certain.

Q. So that you did not about that time initiate a call to Mr. Hackett or to anybody else at the Mellon Bank indicating to them that you would like them to write you a letter requesting that the loan be reduced?

A. I can't even—well, a bank of the quality and character of Mellon, they wouldn't connive with anybody anyway. I don't understand it really at all. This ties in with the whole record. It does tie in completely. I don't recall, but the most I could say is that if they asked me verbally to do it I may have asked them to put it in writing, but I don't recall that.

Now, I may have called Hackett to say, "Merry Christmas." I call a lot of our banks. It is a matter of custom, where we had relations, and maybe he brought it up at that time, I don't know. I don't recall. I am trying to reconcile with you, but, no, this would be always true when Pixley was there. I didn't know Hackett as well. Either he would call me or I would call him either before Christmas or New Years just as a matter of courtesy between us, and that happened with a whole number of banks.

Q. But it is your testimony that at this time late in 1968 the suggestion that you did not suggest in any way—

A. I didn't initiate reduction of the loan.

<sup>55</sup> Bevan claimed the proceeds were used to pay the Mellon Bank loan and capital gains taxes.

<sup>56</sup> During this time, Bevan had a third significant loan outstanding, with Provident National Bank, which was increased rather than paid down between 1968 and 1969.

<sup>57</sup> As of December, 1967 Penn Central stock, at its market value at the time, comprised about two-thirds of Bevan's total assets. By the end of 1969, Penn Central stock, selling at less than half of its 1967 price, equaled about one-fourth of his total assets. Bevan's net worth both in December, 1967, and December, 1969 hovered around \$2 million.

<sup>58</sup> This was also the last day the thrift plan made its regular daily purchase. On this day Goldman, Sachs purchased 2,800 shares for the thrift plan at 11½, the market high of the day.

<sup>59</sup> On June 22 and 23, trading in Penn Central stock had been suspended, except for one large trade each day which took place at the closing bell.

<sup>60</sup> Q. When did you decide to sell at this time?

A. As fast as I thought that I was allowed to after June 8th.

Q. When did you reach that decision?

A. June 8. I wanted to make a complete severance.

Q. Can you tell us why you waited until June 18 to send in the first order, or why you decided on June 18 to send in the first order?

A. I suppose it was to allow a reasonable length of time after I got out. I think—I am not sure of this—I think that I waited until it was announced that the Government was going to make the guaranteed loan. I didn't know about whether it was going to be made or not when I left. I thought it was going to be made, but that might have been interpreted [as] insider information, but I wasn't sure. I was optimistic about it. I think I waited until they announced they were going to make it, and then it was changed when they reversed themselves. But that is again recollection.

## WILLIAM R. GERSTNECKER

	Purchases	Sales	Balance
Feb. 1, 1968.....			6,206
Jan. 8, 1969.....		1,000	5,275
Jan. 9, 1969.....		1,000	4,275
Jan. 29, 1969.....		1,000	3,275
Jan. 30, 1969.....		1,000	2,275
May 26, 1969.....		1,000	1,275
Nov. 28, 1969.....	1,400		2,675

Gerstnecker was vice president—corporate (finance) from the time of the merger until August 1969 when he retired to become the vice chairman of Provident National Bank. In this capacity, he functioned primarily as right-hand man to Bevan and was privy to all information on the company's finance problems.

Gerstnecker owned 6,206 shares in February 1968, including 100 shares held in his wife's name. The bulk of these shares had been acquired through an option purchase in 1964, and though he had made some purchases and sales between 1964 and the time of the merger, he had maintained an ownership of between 4,700 and 6,900 shares during that period. In January 1969, Gerstnecker sold 4,000 shares in four 1,000-share transactions, and he sold an additional 1,000 shares in May 1969, leaving him with a balance of 1,275 shares. On November 28, 1969, he made his final option exercise, purchasing 1,400 Penn Central shares at  $24\frac{1}{2}$ .

Gerstnecker determined at the end of 1968 to resign from Penn Central after July 1969, and go with the Provident National Bank. He testified that his four January sales were for the purpose of liquidating a large loan outstanding at Provident, so that it would not be outstanding when he moved over to Provident, and to purchase 1,000 shares of Provident stock. The Provident loan had been outstanding since March 1964, and totaled during most of that time approximately \$155,000. Although Gerstnecker had made the sales in January, he did not pay off the loan immediately, but reduced it between February and July 1969. He purchased the 1,000 Provident shares in August 1969 at a price of \$24,750. The price of these shares plus the loan total about \$175,000. Even though this amount was less than the \$272,000 proceeds of the January sales, Gerstnecker could not recall what uses he made of the balance of the proceeds. Gerstnecker claimed that his May 26 sale, which grossed \$55,500, was to finance his planned final option exercise 6 months later, which in fact did take place just 6 months later, commanding a total purchase price of \$34,300. Again, Gerstnecker could not recall the uses to which he put the balance of the proceeds.

After further questioning, Gerstnecker also stated that the January sales may have been made due to a desire for diversification of his assets, since he was contemplating changing jobs. He did not elaborate, however, on why a prospective job change would necessarily prompt such diversification. Neither could he point to any reason for having decided to make the sales in January—even after it was called to his attention that his claimed uses of the proceeds, paying off the loan and purchasing the Provident stock, occurred between February and August, Gerstnecker simply indicated that he decided to make the sales following his decision to join Provident.

Two other factors should be noted in connection with Gerstnecker's January sales. First, David Bevan began reducing his holdings in January 1969, and, although Gerstnecker disclaimed knowledge of these sales at the time they were being made, his position as Bevan's assistant makes the timing of these sales appear to be more than coincidental. Second, all of Gerstnecker's transactions were reported on form 4 as of the trade date, as required by form 4, with the exception of two trades, which were reported as of settlement date rather than trade date. These were the last two of his four January 1969 sales, in which he sold 1,000 shares each on January 29 and 30. On those 2 days the Penn Central market price peaked—the Penn Central market price had been rising for about 2 weeks—and Gerstnecker sold his shares at 71–71½. The next day, January 31, the market fell 2 points, and the price of the stock resumed its steady decline which had begun in the last half of 1968.<sup>61</sup> Although Gerstnecker claimed he did not remember directing the reporting of these trades as of settlement date, it is clear that it was a conscious departure from his reporting practice,<sup>62</sup> and his representation to the Commission that the trades occurred on February 5 and 6 rather than at the end of January also made it appear in the published trading summary that his trading had taken place after the publication of Penn Central's financial report.

## ROBERT HASLETT

Purchases	Sales	Balance
Feb. 1, 1968 .....		5,425
July 15, 1969 .....	3,000	2,402

From the time of the merger until after the bankruptcy, Haslett served as vice president—investments of Penn Central. As such he reported directly to and worked closely with David Bevan. Haslett owned 5,425 shares at the time of the merger. Five thousand of these shares had been purchased pursuant to options in 1964 and 1967; the balance was acquired from the thrift plan.

Haslett had made no sales of Penn Central stock since he began acquiring it in 1964. On July 15, 1969, he made his only prebankruptcy sale, selling 3,000 shares, and thereby reducing his Penn Central holdings to 2,402 shares. Haslett had no other transactions in Penn Central stock prior to the bankruptcy, and he allowed the substantial number of options at 24½ which had been available to him since December 1967 to expire.

When Haslett had exercised his options in 1964 and 1967, he had taken out unsecured loans for the full amount of the exercise price from Girard Bank, amounting to \$63,000 in 1964, and \$50,000 in 1967. From 1964 on, Haslett consistently maintained the loan at its original balance, and paid only the interest as it became due in quarterly installments. The balance of \$113,000, therefore, was

<sup>61</sup> The market rise had been in response to Saunders' January 10 announcement of the proposed formation of the holding company. On January 30 Penn Central published preliminary figures for 1968, which, although registering an increase on a consolidated basis, indicated that the parent company had lost \$2 million, down from a profit of \$11 million in 1967.

<sup>62</sup> Gerstnecker's secretary apparently coordinated the filing of Gerstnecker's reports with the secretary's office at Penn Central. (Gerstnecker, of course, signed the form 4's which were submitted to the Commission). The documents submitted by Gerstnecker in connection with his trading contain a copy of the letter transmitting the certificate for the 2,000 shares to his broker. Handwritten on the bottom of this copy, in what appears to be his secretary's writing, is the notation, "Use settlement dates, Feb. 5 and 6, in reporting sale."



maintained from December 1967, until July 1969, when Haslett paid off the loan in full. Haslett stated that his July 1969 sale of 3,000 Penn Central shares, which grossed him about \$130,000, was for the purpose of paying off the \$113,000 loan, which was in fact paid off July 23.<sup>63</sup> The bank had not requested that the loan be paid off or reduced, and Haslett could not pinpoint why he chose July 15, 1969, as the time to sell stock to pay off a loan which had been outstanding, in part, since 1964: "I sold the stock because it was acting poorly. I had a large bank loan, and I sold enough stock to pay off my bank loan, and sold no more stock, kept the balance."

## JONATHAN O'HERRON

	Purchases	Sales	Balance
Feb. 1, 1968.....			5,833
Apr. 23, 1968.....		100	5,733
Apr. 26, 1968.....		1,000	4,733
Apr. 29, 1968.....		1,000	3,733
May 27, 1968.....	1,842		5,575
Nov. 7, 1968.....		2,000	3,575
Nov. 8, 1968.....		1,000	2,575
Feb. 9, 1970.....		500	2,075

O'Herron, who had worked for Penn Central's Buckeye subsidiary for a number of years before he was brought to Penn Central to be groomed as Bevan's successor, became Penn Central's vice-president—finance in September 1969, following a 2-month stint in charge of accounting. He replaced Bevan upon his departure in June 1970. At the time he joined Penn Central in July 1969, O'Herron reported an ownership in Penn Central stock of 2,575 shares (including shares held in the names of his wife and children). Prior to joining Penn Central he had received, through his employment at Buckeye, Penn Central option grants of about 9,000 shares, all of which had been exercised and most of which had been sold by 1968. After joining Penn Central O'Herron's only sale prior to bankruptcy was the sale of 500 shares on February 9, 1970.

O'Herron stated that he made this sale, which grossed about \$13,000, to liquidate an outstanding (unsecured) bank loan of \$12,000 which he had taken out for income tax purposes in April 1969, and which he had told the banker granting it that he would liquidate prior to the end of 1969. Although at the time of the sale O'Herron had a number of other equity securities he could have sold to obtain funds for the loan, O'Herron could only answer, when asked why it was Penn Central stock he chose to see, that it had stopped paying dividends. O'Herron stated that the February sale was purposely timed to follow the dissemination of the 1969 preliminary financial figures by a number of days. By February 1970, O'Herron was deeply involved in the preparation of both United States and foreign public offerings, and he was taking part in the negotiations for private Swiss franc financings and for stand-by bank loans to tide Penn Central over prior to the \$100 million Pennco offering. On February 5, 1970, a few days before his sale, he had been informed by a representative of Goldman, Sachs that they would no longer "roll-over" the Penn Central commercial paper as it became due.

<sup>63</sup> From about 1964 to 1970 Haslett had another, secured, loan outstanding at Girard Bank in the amount of \$35,000.

## OFFICERS—REAL ESTATE AND TAXES

Both of the officers discussed in this section are tax specialists, although one looked after the postmerger real estate transactions and one for a time was also titular head of the accounting department. Both of them attended the budget committee meetings, Saunders' monthly policy meetings.

S. H. HELLENBRAND

	Purchases	Sales	Balance
Feb. 1, 1968.....			2,844
Feb. 14, 1968.....	1,023		3,867
Sept. 3, 1968.....		1,000	2,867
Sept. 4, 1968.....		1,000	1,867
Sept. 5, 1968.....		500	1,367
Sept. 16, 1968.....		700	667
Sept. 17, 1968.....		300	367

Originally a New York Central officer, Hellenbrand became a Penn Central vice president, taking charge of industrial development and real estate following the merger. In March 1970, with the retirement of T. K. Warner, Hellenbrand also headed the tax department. In February 1968, following the exercise of all available options, Hellenbrand owned 3,867 Penn Central shares. In September 1968, Hellenbrand sold 3,500 shares, reducing his holdings to only 367 shares. Although further options became available to him at attractive prices at the end of 1968, Hellenbrand effected no further Penn Central stock transactions, aside from his thrift plan participation, until after the bankruptcy.

Hellenbrand claimed that his buying and selling followed no specifically laid out program, even though in 1965 and 1966 he had exercised options and 6 months later each time sold at least as many shares as he had acquired. In his testimony, Hellenbrand could point to no specific reasons for his 1968 sales:

As I said, I recall among the reasons was a desire to pay down the loan which I had outstanding in the bank, and of all the reasons which go into the operation of the human mind to buy or sell something \* \* \*. I do not know that there was anything more specific than the conclusion that I felt it was a wise thing for me to do at the time.<sup>64</sup>

It is likely that Hellenbrand knew at the time of his 1968 sales of the dubious tax-oriented transactions management was then planning for the Great Southwest-Macco subsidiaries to conceal the disastrous condition of the railroad. Hellenbrand also was aware at that time that the so-called Park Avenue properties were not, as they had been advertised to be, a liquid investment which the railroad could sell for cash, due to the formidable obstacles raised by heavy mortgages and minority interests.

<sup>64</sup> The loans to which Hellenbrand referred were loans obtained in connection with the exercise of the stock options. In September 1968 however, Hellenbrand had only \$33,000 outstanding on his loans, while the proceeds from his September sales equaled \$228,000.

T. K. WARNER, JR.

	Purchases	Sales	Balance
Feb. 1, 1968			4,888
Mar. 20, 1968		100	4,788
Mar. 25, 1968		100	4,688
Mar. 29, 1968		100	4,588
Apr. 2, 1968		500	4,088
Apr. 5, 1968		300	3,788
May 9, 1968		200	3,588
May 21, 1968		200	3,388
July 9, 1968		100	3,288
Mar. 6, 1969	1,200		4,480
Sept. 8, 1969		2,000	2,380
Sept. 11, 1969		2,000	380
Dec. 19, 1969		100	240
June 12, 1970		200	96

From the time of the merger until July 1969, Warner served as vice president in charge of tax matters (from November 1968 to July 1969 his title was vice president—accounting and taxes). In this capacity he functioned independently of the finance department.<sup>65</sup> In July 1969 when Jonathan O'Herron was brought in, the accounting department was moved from the control of Warner and given to O'Herron. At that time Warner was made vice president—corporate administration, and he kept this title until his official retirement in May 1970. Warner looked upon this job change as being kicked upstairs to make room for O'Herron and as early as June 1969, he began to consider retirement.<sup>66</sup> Nonetheless, between July 1969 and his retirement in May 1970, Warner was in charge of the department of corporate analysis and cost and profit analysis as well as taxes.

Between 1964 and 1969, Warner had made purchases and sales of significant amounts of shares each year (in 1967 and 1968, he sold a significant number of shares but made no purchases). From 1965 on, however, the amount of shares he owned was never less than 3,000 shares. On March 6, 1969, he made his final option exercise, purchasing 1,200 shares at \$24.50 per share. At this time he borrowed \$50,000 from a bank, using \$29,400 of the borrowed money to exercise his option. Following the exercise of this option, he owned 4,480 shares. On September 8 and 11, 1969 he sold 2,000 shares of stock each day, and on December 19, 1969, he sold an additional 100 shares. These sales, along with gifts he made during 1969, reduced his ownership to a total of 240 shares at the end of 1969.

On May 1, 1970, Warner officially retired from the company. It should be noted, however, that he sold 200 of the 296 shares he owned at the time of his retirement on June 12, 1970, just prior to the bankruptcy.

Warner's reasons for the 4,000 share sale he made in September 1969 were very unclear. First he mentioned that by selling in September, he would have been able (under the 6-month rule) to buy further option shares in March.<sup>67</sup> The only options available to Warner

<sup>65</sup> He was, however, close enough to Bevan to be the only nonfinance officer chosen to participate in the Penphil venture.

<sup>66</sup> Warner claimed that the reason his retirement was delayed some months was that Saunders had asked him to remain.

<sup>67</sup> Warner's testimony reads as follows:

"There were several factors, one of which is that under the stock option plan, when you terminate service you can continue to exercise your stock option for 3 months thereafter. I had also already planned to leave, therefore, when the 6 months expired on the 1969 exercise, sometime in February, by selling in September I can buy 6 months later.

"I was then planning to leave December 31, so I could purchase stock through March 31 under the terms of the plan."

were at 57%, and by September 1969, Penn Central had sold down below 41. Reminded of this, and asked if he had expected the stock to have climbed above 57% by March, Warner stated that diversification in anticipation of retirement<sup>68</sup> rather than a prospective option purchase had been the major reason for his sales.<sup>69</sup> According to his recollection, Penn Central stock represented over 25 percent of his investment portfolio in 1969. Warner did not elaborate on why he chose to diversify by virtually eliminating Penn Central stock from his investment portfolio nor did he indicate why he decided to pursue this diversification policy in September 1969. Warner invested the proceeds of the sales in other securities.

Warner's involvement in tax matters exposed him to much of the covered-over activities of the Great Southwest-Macco group. By late 1969, he was deeply involved in the program of maximizing earnings through tax aspects and through exploration of the subsidiaries for possible opportunities to bring up earnings to the parent company. Indeed, at the very time he was selling on September 9 and 11, 1969, he was involved in a tax accounting change for Macco that would increase Macco's 1968 earnings. Warner knew that such actions were important to continuing the Macco-Great Southwest facade for the public offering of Great Southwest stock then being readied.<sup>70</sup> In a followup of earlier discussions Warner wrote to Saunders on September 10, 1969:

This relates to the 1968 tax elections of the Macco group which will be included in the Penn Central consolidated Federal income tax return which must be filed on Monday, September 15. Last evening I was informed by Peat Marwick & Mitchell (Philadelphia) that the Macco people were sending us tax return material for their group in which they were increasing taxable income from \$1 million to \$27 million. We have not yet received the Macco papers, but a letter on a related subject confirms the P.M. & M. statement. The public accountants report that the new elections will result in a change in Macco's (but not our consolidated) book net income eliminating \$13 million of deferred taxes and increasing its book net income by that \$13 million. This is important in preparing the SEC financial statements for the sale of Great Southwest stock.

The next day (on which Warner was selling a second 2,000 shares) Warner met with others to review the matter. Bevan reported to Saunders in a memo on that day:

Messrs. Warner, Hill, Wilson and myself met this afternoon and are unanimously of the opinion that we should go along with the Macco management's recommendation. This will add almost 50 cents a share to the reported earnings for last year, and merely on a basis of 10 times earnings will add \$5 a share to the value of any stock sold, and if it goes to 20 times earnings it would add \$10 a share. Our capital gains would be enhanced by this amount.

It should be noted the overwhelming portion of Macco's profit that year was in the Bryant Ranch transaction which produced little cash but obligated Macco to heavy expenditure commitments.

#### OFFICERS—OPERATIONS AND LABOR

All of the top operating people dealt with Penn Central's major service problems, which peaked at the beginning of 1969. They also

<sup>68</sup> At no time, however, had Warner planned to retire without seeking other employment, and by December 1969 he was discussing employment with a law firm.

<sup>69</sup> Q. Did you expect the price of the stock to go beyond \$57 within the 6 months before your retirement, or up to your retirement, in the 3 months after?

A. I just never knew that much, understanding why stocks went up and down, so that I think one ought to try remain flexible. But I want to add, I am not sure that was any more than another straw. I wouldn't be surprised that my leaving was not the main thing.

<sup>70</sup> See Great Southwest section of this report.

experienced first-hand the crippling budget restrictions which the finance department placed on the operating departments beginning in mid-1969, and which magnified the operating problems which increased again during the 1969-70 winter.

With the exception of Messrs. Funkhouser and Sullivan, all of these operating officers attended the budget committee meetings, and must have been fully aware from those meetings of the company's "profit maximization" policies, and of the contrast between Saunders' private dissatisfaction with the company's performance and his soothing public pronouncements on the subject.<sup>71</sup> Further, dealing on a day-to-day basis with budget restrictions and endless pressure to produce more revenues brought home to these officers the realities of the company's cash lag, and of the workings of "profit maximization". Apart from company rumors, however, the operating people may have had only the same knowledge as the public concerning the dealings between Penn Central and its subsidiaries, since these nonrailroad activities were dealt with only in summary fashion at the budget committee meetings.

## ROBERT G. FLANNERY

	Purchases	Sales	Balance
Feb. 1, 1968			511
June 12, 1968	325		836
Mar. 17, 1969		300	536
May 12, 1969		100	436
May 13, 1969		200	236
July 2, 1969		200	36
July 3, 1969		36	

A former New York Central officer, Flannery served as vice president—systems development from the time of the merger until February 1969, when he was named vice president—operations. He remained with the company until after the bankruptcy.

In June 1968, following a purchase of 325 option shares, Flannery owned 836 Penn Central shares.<sup>72</sup> In 1969, he totally liquidated his holdings in a series of five transactions between March and August. Named to replace Smucker due to the winter 1969 operating crisis, Flannery began liquidating his shares about 1 month after he took charge of the operations department. Flannery claimed the proceeds were used to purchase a house, on which he placed a down payment on April 19, 1969, and which was completed in 1970. According to Flannery's reckoning, he had invested a total of \$143,000 in the house by the time it was completed, including a \$65,000 mortgage, and also (it appears) approximately \$47,000 in cash netted from the sale of his previous house. The total gross proceeds of Flannery's Penn Central sales, \$44,000, would have more than made up the cash difference needed to reach \$143,000, but Flannery claimed that, along with his Penn Central shares, he liquidated his stock holdings in other companies in May and September, 1969, to raise money for his house. Flannery did not sell his house in New York until August 1969. He claimed that

<sup>71</sup> It should be noted that after problems arising from possible leaks of information to the brokerage firm of Butcher & Sherrerd in mid-1968, Penn Central attempted to restrict the internal dissemination of financial information by sending the various officers only that information of particular interest to them prior to the budget meetings. However, the full scope of the information was discussed during the meeting and so the various officers would emerge with a fairly complete, general picture of what was occurring within the company.

<sup>72</sup> Under a New York Central stock purchase plan, Flannery had contracted to buy an additional 130 shares in 1967. As allowed by the contract provisions, however, Flannery rescinded the sale within a 3-year period.

at the time he committed himself to buy the house in Philadelphia, he did not know what price he would get for his New York property. He had paid \$63,500 for the New York house "And was quite fortunate for selling same for \$89,000 which was far more than I expected." Except for the first Penn Central sale in March 1969, the proceeds of which were used as the down payment on the house in April, Flannery was unable to relate the timing of any Penn Central sales to a specific need for cash:

You also asked me to clarify my purchase of a house in Philadelphia as related to my savings account bank statement for the year 1969. You will note that on February 18, 1969, my account was down to \$968.88. I sold 300 shares of Penn Central stock March 17, 1969, and deposited same in the account. A large part of this was withdrawn in April in order to make the downpayment on the purchase of my new home, copy of purchase agreement you have in your file. You are also aware of the fact that I had made quite a commitment in purchasing this home prior to disposing of my home in Hartsdale, N. Y. Also, the committed amount of \$120,000-plus was just for the bare minimum of a house. As stated to you, I eventually ended up with \$143,000 invested and the difference between the original commitment and the final amount was for drapes, carpeting, landscaping, and so on. In fact, we paid several contractors direct for the installation of better fixtures such as kitchen appliances, bathroom fixtures, electrical outlets, and so on, which was over and above the committed price to the contractor. With this commitment, you will note I also sold Penn Central stock in May and July and other stock in September in order that I could properly plan and know definitely how many commitments to make in further improving the house.

A. PAUL FUNKHOUSER

	Purchases	Sales	Balance
Feb. 1, 1968.....			5,001
June 24, 1968.....		1,900	3,101
Dec. 26, 1968.....	1,900		5,001
Jan. 26, 1970.....		100	4,949
May 27, 1970.....		4,500	504

Funkhouser was a close associate of Saunders, having worked for him at Norfolk & Western. From the time of the merger until March 1970, he was vice president in charge of coal and ore traffic. In March 1970, in response to the gravity of Penn Central's passenger service problems, he was made senior vice president—passenger service.

Funkhouser's last option exercise was in December 1968, giving him ownership at that time of a total of 4,900 shares, all acquired through options, plus 101 shares held by his family. Prior to the merger, Funkhouser had acquired his stockholdings between 1964 and 1968 by exercising options using borrowed funds, and selling a portion of the purchased shares after 6 months to pay off the loan. The December 1968, purchase was not made with loaned funds, and it marked the beginning of a holding period unbroken until 1970. On January 26, 1970, there was a sale of 100 shares he had given to his wife in 1967. On May 27, 1970, Funkhouser sold 4,500 shares, representing the major portion of his Penn Central holdings.

Funkhouser testified that the January 1970 sale of 100 shares was pursuant to his wife's decision to sell since she did not want to hold the stock because they passed the dividend. The public announcement that the fourth quarter dividend would not be declared had been made in November 1969. Funkhouser could not recall why she did not reach this decision until January.

The May 27 trade had its origin in an April 28, 1970, limit order to sell 4,000 shares at  $20\frac{1}{4}$  which Funkhouser changed on the morning of May 27 to a market order to sell 4,500 shares. Funkhouser explained that he decided to sell his shares after the April 22 publication of Penn Central's first quarter earnings, which made him decide that the company would not be able to resume paying dividends in the foreseeable future. Based on this decision, he placed his  $20\frac{1}{4}$  limit order on April 28, anticipating that the market in Penn Central stock (which had closed at  $17\frac{7}{8}$  on April 27) would recover sufficiently to allow execution of the order. The limit of  $20\frac{1}{4}$  had been chosen because Funkhouser had arbitrarily set himself the goal at that time of realizing \$80,000 in liquidating his Penn Central investment. The price of the stock did not recover, however, and Funkhouser explained his decision to change his order to a sale of 4,500 shares at market as follows:

\* \* \* there was an announcement on May 15 that the credit rating of the Pennsylvania Co. had been downgraded. And I determined that the stock, after that, probably wouldn't get back up into the 20's—and I executed a market order on May 27. Now my reason for selling was basically because I wanted some return on my investment. I did not not know the company was going bankrupt nor did I—and I full[y] expected it to be turned around at that time. But I knew that we were having tremendous earnings problems—that is, in brief, my reason for selling.

Funkhouser decided to sell his shares at market on the afternoon of May 26. That afternoon he consulted both Wilson and Roberts concerning his proposed trade, specifically asking each one if he knew of any inside information why I should not sell my shares. Both men told him that they knew of no reason why such a sale should not be made. Funkhouser entered the market order the next morning, prior to the opening of exchange trading.

Funkhouser claimed that by 1969 he was counting on the substantial cash dividends which his sizable Penn Central holdings had been yielding.<sup>73</sup>

When he sold, he deposited the proceeds in a savings bank until August, when he reinvested the money in bonds:

*Q. The question is, "When you made the sale in May, did you do it with any specific investment in mind, or was it simply because you were dissatisfied with the Penn Central's dividend policy at this point?"*

A. I did not sell with any specific investment in mind. My motivating force was to obtain some return on that investment. Normally I would have invested probably in some security soon after that on the advice of my wife, but I don't know particularly why I didn't; but we went into reorganization and I had the money in savings. I

<sup>73</sup> At that time, these shares represented about one-third of his equity investments, the other two-thirds of which had been chosen for appreciation rather than dividend return:

*Q. Did you contemplate, when you discovered that this investment was not going to bring in dividends, making any changes in any of the other investments which you were holding which were not bringing in dividends so that that money would give you a return on your money?*

A. I don't recall doing that. The securities other than my Norfolk & Western for the most part were being handled by Bonsal White and it was, for the most part, an effort to seek appreciation rather than income. And I had at that time, I think, substantial gains which, had I sold, would have resulted in considerable tax, although I suppose it could have been offset against the Penn Central loss. But these securities were under—well, as a matter of fact I think I did take some gains that offset that loss. In hindsight I may have made some changes.

But I would say this to you: The securities that Bonsal White was handling for me, the goals were more appreciation than income. And I don't recall selling those stocks to seek more income. If I did sell—and I think I may have sold some—it would have been to offset by taking the loss, and probably they went back into the area of seeking appreciation under his guidance.

*Q. Well would you say then that you did not have appreciation in mind when you invested in Penn Central stock?*

A. I did not have appreciation in mind?

*Q. Well did you, or did you not?*

A. Yes; I would say that appreciation was a factor. I was hoping to acquire as much of the stock as I could, seeking both appreciation and income.

was drawing interest on the savings account, and then I decided to put the money in tax-free bonds. My return on the tax-free bonds would have been, I think, somewhere around 5 percent and 6 percent, taking into consideration the taxes.

## HENRY W. LARGE

	Purchases	Sales	Balance
Feb. 1, 1968			4,604
July 8, 1968		1,000	3,554
Feb. 18, 1969		300	3,254
June 10, 1969		200	3,054
Sept. 17, 1969		200	2,854

Large served as executive vice president—sales and marketing from February 1968 until his retirement on June 1, 1970. A career employee, he reported directly to the president. At the time of the merger, Large owned 4,604 shares, most of which had been acquired from options. Following the merger, he exercised no further options, even though by December 1968, he was eligible to purchase 1,600 further option shares at 24%.

Large explained that his July 1968 sale, the proceeds of which were \$85,000, was made in order to pay off a stock option loan of \$58,400 and an income tax loan of \$15,000, and to provide cash for anticipated capital gains taxes. Bank records show the two loans paid off as of July 17, 1968. Large claimed that each of his three 1969 sales were made to meet income tax payments; the proceeds of the sales, which were \$18,336, \$10,450, and \$8,053, respectively, were used for tax payments of \$18,000, \$7,000, and \$7,000.

Large insisted that he only sold what he felt he had to sell of his shares, although he did not indicate whether this involved a choice between Penn Central shares and any other liquid assets he may have had.

## A. E. PERLMAN

	Purchases	Sales	Balance
Feb. 1, 1968			2,860
Apr. 1, 1970		500	1,400

Note: Between 1968 and 1969, 960 shares had been donated as gifts.

Perlman was the president of Penn Central from the time of the merger until December 1969, when Saunders brought in Paul Gorman to be president. Insisting that the conditions of his employment contract be adhered to, Perlman became vice-chairman of the board at that time, retaining this position until his June 8, 1970, removal by the board.

Prior to the February 1968 merger, Perlman had exercised options for 34,000 shares which were the total number of options granted to him (these grants had been made before 1964) and had sold 32,890 of these shares. As of February 1968, Perlman reported his ownership of stock at 2,860 shares. His only transactions in 1968 and 1969 were disposing of 960 shares as gifts. On April 1, 1970, he sold 500 shares and held the remaining balance of 1,400 shares until after the bankruptcy.



Perlman claimed that his 500 share sale resulted from turning over his portfolio to Lionel D. Edie & Co., Inc. (an investment adviser). Edie made its first appraisal of Perlman's portfolio in January 1970. As a general policy, Edie was against buying railroad stocks at that time, and favored the sale of its customers' current railroad stock holdings. Although Perlman had given Edie complete discretion over his account, Edie checked with Perlman as a matter of practice before making a trade. When told of Edie's plans to dispose of all of his Penn Central stock, Perlman stated he vetoed the idea because he believed that as a director of Penn Central he should remain a substantial holder of the company's stock. He said he told Edie it could only sell up to 500 shares which in his view would still leave him a substantial holder of Penn Central stock. Perlman claimed he characteristically followed Edie's recommendations concerning his holdings, and noted within 2 years of acquiring Perlman's portfolio, Edie had replaced all stock originally held. Perlman stated that at no time did he discuss the merits of Penn Central with Edie representatives, and insisted the 500 shares trade was made solely on the basis of the general Edie recommendation.

Perlman's sale is included in this report because it came so close to bankruptcy that he obviously had adverse information which was not available to the public at the time of his sale. He knew, to an extent that the public did not, that Penn Central was a sick company. He had complained about money being diverted to real estate operations, and of lack of funds for the railroad. He was unhappy with the way the company was being managed and knew of all the operating difficulties. He knew of the internal pressures to generate additional earnings and sitting through budget meetings must have had a good idea of some of the artificial techniques being used to accomplish this purpose. On the other hand, for at least 6 months prior to his sale, since the decision was made to replace him as president, he had been effectively isolated from regular sources of information within the company. His awareness, if any, of the critical new problems which were then developing would most likely have come from secondary sources.

## DAVID E. SMUCKER

	Purchases	Sales	Balance
Feb. 1, 1968.....			12,600
July 8, 1968.....		9,000	3,600
Feb. 21, 1969.....	2,200		5,800
July 2, 1969.....		2,200	3,600
July 3, 1969.....		1,400	2,200
Feb. 25, 1970.....		1,600	40
Apr. 10, 1970.....	2,067		12,107
Apr. 20, 1970.....		2,000	107

<sup>1</sup> Thrift plan distribution following Smucker's retirement.

Smucker was executive vice president in charge of operations until February 1969. At that time, with Penn Central's operations in a disastrous state, he was replaced by Flannery at the insistence of Perlman, and made executive vice president—office of the chairman until his March 1970 retirement. At the time of the merger, Smucker held 12,600 shares, which he had acquired through options. He sold

9,000 shares in July 1968, hitting the market near its all time high at about 85. In February 1969, he made his final option exercise of 2,200 shares. He sold 3,600 shares in July 1969, and 1,600 in February 1970, and made gifts to his family, leaving him with a balance of 40 shares at his retirement on March 1, 1970. Following his retirement, he sold 2,000 of the 2,067 thrift plan shares distributed to him immediately upon receiving them in April 1970.

It appears that about \$83,000 of the proceeds of the July 1968, sale was used to pay off loans Smucker had taken out in connection with the exercise of his options in 1967. Smucker stated that the sale had been planned at that time to obtain funds to exercise options when they vested in December 1968, and for capital gains taxes. At this time, according to Smucker, he was expecting to exercise in December not only his remaining options at  $24\frac{1}{2}$ , but also up to half of his recently granted option to purchase 12,000 shares at 57%.<sup>74</sup> When Smucker exercised his options in early 1969, however, Penn Central stock was down to selling in the low 60's and the options at 57% had lost their attractiveness to him, so he exercised only the options remaining to him at  $24\frac{1}{2}$ .

The only reason Smucker gave for his 1969 and 1970 sales was that he had decided to retire. Smucker's official termination date was in March 1970, and he claims that he actually left the company in December 1969. By July 1969, however, he had been relieved of responsibility for operations and was contemplating retirement:

Yeah, by July of 1969 I had decided to retire. Mr. Saunders' 90 days had elapsed and I decided to retire. And I was sitting there holding 3,600 shares of stock, and we had been told by the legal department and by the financial department that if we've got any questions relative to purchases or sales of the company's stock to talk to Dave Wilson or Ted Warner or both. So I got Dave Wilson up to my office, and I said, here I'm sitting, oh, buddy with 3,600 shares of stock that I have owned since December of 1967; and I unfortunately exercised an option to buy 2,200 shares last February. How long do I have to hold this.

According to Smucker's testimony, he decided following the consultation to sell his stock, even though it was less than 6 months since he had made his last purchase in reliance on Wilson's advice that recovery of profits would not be possible under section 16 of the 1934 act.

The gifts of 560 shares to Smucker's daughter and her family were also prompted by Smucker's review of his financial affairs in contemplation of his retirement.<sup>75</sup> Smucker explained that the balance of 1,600 shares was not sold until February 25, 1970, because he had placed a limit order to sell them at 45 on August 27 which he remained hopeful of executing until February, when the stock had slid to 25.

Although Smucker's 1969 sales were made following his removal from operating responsibility, he had continued to work for Penn Central in Saunders' office and, as evidenced by various memoranda he wrote, he was very much aware that the operating situation was still critical. As an operating officer he recalled being "bumped over the head to get the expenses down and see if you can't find or sell some scrap or do something to get the income up."

<sup>74</sup> The June 1968, sale grossed about \$765,000. Figuring the cost of these options at about \$400,000 leaves a balance of proceeds, after payment of the loans, of about \$280,000.

<sup>75</sup> These shares were subsequently sold, but Smucker claimed that he had refused to advise the donees as to when they should sell and in fact did not know when the sales occurred.

JAMES R. SULLIVAN

	Purchases	Sales	Balance
Feb. 1, 1968.....			2,730
Feb. 29, 1968.....	250		2,980
June 4, 1968.....	325		3,315
Jan. 20, 1969.....		500	2,815
Mar. 13, 1970.....		2,300	515

A former New York Central operating official, Sullivan served as vice president (marketing) of Penn Central from the time of the merger until after the bankruptcy. Sullivan, who was subordinate to Large (later replaced by E.G. Kreyling) and who did not attend the budget committee meetings, would have learned only indirectly of Penn Central's financial and diversification problems. He was, however, clearly aware of all of the problems in the railroad end of the business. He had been in favor of a slower approach toward integration of the two roads, feeling that the acceleration plan was a mistake. When operating problems developed, as head of marketing he was very familiar with the barrage of customer complaints which arose. He knew Penn Central was losing business because of these problems, and from his testimony it is clear that he was acutely aware of the conflicts between former New York Central and former Pennsylvania Railroad employees, and the impact this was having on the orderly functioning of the department.

Sullivan claimed that his 1969 and 1970 sales were made on the basis of his broker's advice to diversify his portfolio. In 1965, he had opened an account at Merrill Lynch, Pierce, Fenner & Smith, and from his testimony, it appears that from the time of opening the account his broker, Edward W. Kann, had discussed with Sullivan the advantages of diversification. Ignoring his advice, however, Sullivan had steadily increased his investment in Penn Central shares (which were, of course, New York Central shares prior to February 1968) by exercising his options, so that by December 1968, Penn Central represented about 75 percent of the value of his equity holdings. Sullivan emphasized that his broker's recommendation was not merely diversifying away from reliance on one stock, but also diversifying from equity into debt investments, due to the general stock market decline. Although he did make substantial bond purchases with the proceeds of his Penn Central stock sales, Sullivan also made substantial equity purchases in 1969 and 1970, and sold few or none of the other equity stocks he owned, indicating that his "diversification program" was, in fact, solely away from Penn Central, and not from equity stocks in general.

Sullivan's January 1969 sale was made to buy \$30,000 worth of 1-year municipal bonds. ("\* \* \* I am a little hard to convince sometimes, it takes a little while, and when we made this move, we went with a relatively small excursions [sic] in the city of Goshen bonds.") Apparently, Sullivan's broker had called in January to recommend the Goshen purchase, but Sullivan could not recall why he chose January 1969 as the first time to take his broker's diversification advice seriously.

Later in 1969, Sullivan made further equity purchases and listened to periodic suggestions from his broker to diversify into more bonds, but he sold no Penn Central (and bought no debt securities) until

March 1970. Sullivan could give absolutely no reason why it was March of 1970 when the diversification urge hit him again.<sup>76</sup>

This time, at the time of the sale Sullivan and his broker did not have a crystal clear idea of what they would do with the proceeds:

We had discussions, I had had discussions with Kann about a number of things that he had suggested in the way of diversification and we concluded that this activity would require approximately that much money, so we proceeded accordingly.

Sullivan's March 13 sale of 2,300 shares (reducing his Penn Central holdings to 515 shares) grossed about \$56,000. About \$40,500 of this was invested immediately in long-term bonds, and \$7,000 went to purchase shares (equity) in Maui Land & Pineapple Co. In August, a further \$10,000 was invested in more bonds. (Sullivan stated that at the time of his sale his broker had indicated "That he would probably have something else at hand within a very short time," and that he was surprised, but not disturbed, by the 5-month delay.)<sup>77</sup>

When questioned concerning the amount of shares he chose to sell in March 1970, Sullivan responded as follows:

*Question. Can you tell us in March of 1970 whether you considered selling that remaining 500 shares or why did you decide to keep it?*

Answer. No, I thought it was all right to leave it where it was and if I had been disturbed about the thing, I would have throttled the thrift plan, but the idea never occurred to me so we just let it go right along.

*Question. Did it occur to you that in March of 1970, you were liquidating the major part of your holdings in the stock for the first time in a number of years?*

Answer. I don't know that it occurred to me in that context, what I was [thinking] about was the advice of my counselor on the business of debt securities and the outlook as he saw it and as I seemed to feel it was of the market, that stocks were going to, in general—the stock outlook was not promising.

Sullivan knew of and dealt with the operating problems the company experienced during the 1969–70 winter. Claiming that the appointments of Flannery and Kreyling to key operating posts had made him optimistic about the future of Penn Central, Sullivan discounted the idea that his trading was in anticipation of the tremendous first-quarter loss which those operating problems had caused. He also claimed that in making his sales he didn't even think about "the results of the first quarter or anything like that:"

*Question. Was there any particular price consideration in March of 1970 when you decided to actually follow Mr. Kann's advice apart from the 500 shares you sold in 1970 and sold the bulk of your Penn Central holdings? Was there any consideration that you gave to the price that Penn Central was selling at that time?*

Answer. Not especially, of course we were anticipating, with the things that we talked about at some length here, that the Penn Central might very well regain its position, so it was a question to stay with that or to diversify as Kann had recommended, so we decided to diversify rather than sell it all. If I had any real serious concern about the thing, the sensible thing would have been to just eliminate it all, but I stayed with the thrift plan or 600 whatever shares that are there.

*Question. Can you say that at the time you sold, you did expect the price of the stock to turn around eventually?*

<sup>76</sup> Q. Can you recall for us what went on to generate your decision to sell 2,300 shares of stock on March 13, 1970?

A. Yes; as I have indicated to you, I had these continuing discussions with Kann and our experience with the Goshen bond thing seemed to go all right so it seemed to me that in the light of Kann's continued reminders on this subject and my feeling that his judgment was sound, that this was the thing to do.

Q. Why was it the thing to do so on March 13, 1970?

A. That just happened to be the date that we decided to move off with it, just as January 20, 1969, was the date we decided to move off with the sale of the 500 originally.

<sup>77</sup> In the month prior to Mr. Sullivan's 1970 sale, his 1969 investment of municipal bonds matured. About 80 percent of the funds from the maturing bonds plus the 1970 Penn Central stock sale was invested in debt securities and about 20 percent was invested in equity securities.

Answer. Yes; I thought it might very well do so.

*Question. Was that in the near future or distant future?*

Answer. I would think in the longer haul because of the problems we have just been talking about.

*Question. As far as the shorter haul, at that time as I understand it, well, the first quarter earnings had not been calculated because the first quarter had not been closed.*

Answer. That's true.

*Question. Did you expect the stock was going to decline significantly before it possibly turned around?*

Answer. To be perfectly candid, I didn't give any special consideration to that at all, as to what it was liable to do in the near future or the results of the first quarter or anything like that. I didn't even think about it. I was concerned with finally moving in the direction that Kann suggested that we ought to move and we would still retain a quite substantial position in Penn Central, so as the turn around occurred, we still have a fairly substantial equity and of course, we had these other options.

*Question. When you say finally, this is over a year after Mr. Kann had first suggested it.*

Answer. Yes.

*Question. And I would simply like to ask you one more time why you chose this particular period of time to put this program into effect in a major way.*

Answer. Well, simply because I became convinced that this was the right thing to do.

GUY W. KNIGHT

	Purchases	Sales	Balance
Feb. 1, 1968.....			4,281
June 20, 1968.....		1,750	2,531
July 15, 1968.....		73	12,458
Dec. 20, 1968.....	1,600		4,047
July 3, 1969.....		3,950	97
Sept. 4, 1969.....		90	17

<sup>1</sup> Sales made for account of children.

Knight was a senior vice-president in charge of personnel and labor relations from the time of the merger until his October 1969 retirement. While not directly connected with the operations of the company, and not a participant in the budget committee meetings, Knight's position in charge of labor relations brought him into close working contact with Penn Central's operating people. He sold virtually every Penn Central share he owned at the beginning of July, the same time numerous operating officials had chosen to liquidate their holdings.

At the time of the merger, Knight owned 4,281 Penn Central shares. In June 1968, he sold 1,750 shares. In December 1968, he exercised an option for 1,600 shares. On July 3, 1969, along with a number of other officers selling at this time, Knight liquidated his Penn Central holdings, selling 3,950 of his balance at that time of 3,957 shares.<sup>78</sup>

Since 1965, Knight had an established "window" pattern of exercising options and making substantial sales at 6-month intervals, and his 1968 and 1969 transactions fall within this 6-month pattern. Even with these sales, however, he had maintained a balance of at least 1,000 shares from August 1965 until the time of the July 1969 liquidation.

Asserting his rights under the fifth amendment, Knight refused to supply any information relative to his Penn Central trading or any other Penn Central related activities.

<sup>78</sup> In July 1968 and September 1969 Knight made sales on behalf of his children of 73 and 90 shares, respectively.

## GENERAL CORPORATE OFFICERS

The two officers discussed in this section, although possessing no expertise concerning the operational and financial aspects of the company, had constant, day-to-day access to top management in pursuing their duties as head of public relations and corporate secretary.

## WILLIAM A. LASHLEY

	Purchases	Sales	Balance
Feb. 1, 1968.....			3 000
Mar. 30, 1970.....		500	2,507
Apr. 15, 1970.....		500	2,007
May 22, 1970.....		1,000	1,007

Lashley was vice-president in charge of public relations and advertising until after the bankruptcy. Reporting directly to Saunders, he had virtually complete access to all company officers, and his office was responsible for drafting almost every public statement issued by the company. Having worked for Saunders for many years,<sup>79</sup> Lashley knew almost reflexively that the public relations department was expected to stress—or manufacture—something hopeful out of the bleakest announcement. It is likely he knew of every significant development in the company, and it appears that he knowingly and actively participated in management's attempts to conceal adverse information about the company.

Lashley steadily exercised his 1964 option to purchase Penn Central shares at \$28 per share until the end of 1967, so that, by the time of the merger, he owned 3,000 shares. Sixteen hundred of these shares were owned jointly with his wife, who had put up the purchase price for some of them. Lashley made a 500-share sale of Penn Central stock on March 30, and again on April 15, 1970, in response to bank pressure to pay down the loan for which these shares were collateral. Although Lashley claims that his Penn Central sales were made solely because of the bank's demands, it is significant to note that at the same time he was making Penn Central sales to reduce this outstanding debt he was resisting pressure from another bank to sell out 300 shares of Norfolk and Western stock securing another loan which was also undercollateralized.<sup>80</sup>

The sales point up the difference in regard which Mr. Lashley had for Penn Central stock as opposed to Norfolk and Western stock at the time, because the proceeds of the sale of Penn Central shares went to reduce an 8-percent loan with a bank with which Lashley felt he had a good relationship,<sup>81</sup> while, in contrast, Lashley was simultaneously maneuvering to avoid selling his Norfolk and Western stock to pay off an 8¾-percent loan with another bank (Lincoln Bank) with which

<sup>79</sup> Lashley had previously worked for Saunders at Norfolk and Western.

<sup>80</sup> Lashley claimed that he had no inside information at the time of his sales, but that "I had hesitation to sell because I was a corporate officer and might be accused of having inside information." Prior to his sales, Lashley consulted with Wilson and Saunders about his sales. Saunders was consulted because, "I felt badly about it, about the situation, and told him that my personal finances were such that I was going to have to sell some of the stock. I knew he wasn't selling any of his". According to Saunders, he advised against the sale and told Lashley to consult the legal department. Lashley claimed he consulted with Wilson because he believed the circulated guidelines had advised him to. "Dave Wilson, as I recall, said, 'Well, if you have to you have to, but make sure you report the sales to the SEC.'"

<sup>81</sup> The Penn Central stock-secured loan had always been maintained at prime rate and, aware of this beneficial rate, Lashley has to date maintained the loan in its reduced form.

he felt his relationship had become acrimonious. As Lashley's relationship with this second bank deteriorated, Lashley, "pretty upset and angry at the Lincoln Bank for their constant harangues," transferred the loan to the Provident National Bank. When Lashley was asked why he did not feel compelled to sell his Norfolk and Western stock to reduce that loan at the same time he sold his Penn Central stock, Lashley responded, "Because I wanted to hold on to it. I regarded Norfolk and Western stock as a good investment, particularly from the standpoint of dividend. They were paying, I think, about \$6 a share."

At the time of his sales on March 30, and April 15, 1970, Lashley knew that the first quarter results would be much worse than expected. Before the March 25, 1970 announcement of the filing of the debenture application with the Interstate Commerce Commission, Lashley was involved in Penn Central discussions about disclosing the fact that Penn Central's first quarter results would be worse than expected.<sup>82</sup> Ultimately, Penn Central decided not to make such a disclosure.<sup>83</sup>

At the same time that Lashley was arranging the loan with Provident to retain his Norfolk & Western stock, he made a further major sale of Penn Central stock, selling 1,000 shares on May 22, 1970. This was part of the 1,600 shares purchased with his wife's funds and held in their joint names.<sup>84</sup> Lashley regarded this stock as belonging to his wife, and it had not been pledged in connection with any of his loans. Lashley claimed that the May sale was made at the insistence of his wife, who was "terribly worried about the loss of, the complete loss of her investment, and I sold at her request in order to salvage what we could of her investment."

Although Lashley claimed his wife did not seriously request him to sell stock "before about April or May," he could not recall precisely when the request began:

. . . she started making the request when I was telling her about my difficulties with the banks and more loans. And she said "Why don't we just get rid of all of it and sell out of Penn Central completely?" And I said "I didn't want to do that, that I was hoping the stock would come back and hold on as much as I could." But she was very concerned about it so at her request I made those two sales.

When asked why he chose May 22 as the day finally to comply in part with his wife's directives Lashley answered as follows:

<sup>82</sup> Penn Central officials believed that Chrysler Corp. had disclosed its anticipated bad first quarter while announcing a securities offering. Lashley contacted Chrysler and reported as follows:

"Attached are copies of the news releases which Chrysler Corp. issued in connection with their public offering of sinking fund debentures in February.

"You will note that neither the preliminary announcement on January 27 nor the release of February 20, which was on Friday and therefore did not appear in the Wall Street Journal until Monday, February 23, mentions the prospects for the first quarter in the release itself. However, a prospectus was attached to each of the releases.

"Also, I suspect that Chrysler deliberately selected a Friday to put out the release in hopes that it would not attract any great attention. I am certain they were somewhat upset by the full story in the Wall Street Journal on February 23." (Memo from Lashley to O'Herron & Hill Mar. 20, 1970.)

<sup>83</sup> But Lashley realized disclosure would come sometime:

"Although we have not yet received clippings, I am enclosing accounts of the Pennsylvania Co. application to the ICC to authorize \$100 million of securities as they appeared in the Wall Street Journal, New York Times and Washington Star today.

"Because of the heavy amount of financial news resulting from the lower interest rate and spurt in the stock market, neither the Wall Street Journal or New York Times had much space to go into details about the securities involved, although they called us for information and we had to give it to them because it was in the application filed with the ICC.

"Our friend Steve Aug of the Washington Star, however, went into more details.

"I expect that many more details of the transaction, together with the statements we will have to make about the first quarter, will come out much more prominently when we offer the debentures for sale." (Memo from Lashley to Bevan Mar. 26, 1970.)

<sup>84</sup> The remaining 600 shares were sold on June 29. Lashley turned the proceeds of the sale of all 1,600 shares over to his wife.

I think it was shortly—I think we talked it over the previous night and I came in and made the decision during the morning to—I think it was in the morning—to sell the stock.

Lashley must have been well aware by the last half of May 1970 that the debenture offer had been canceled and that senior management was meeting with Government officials about a guarantee. As head of the public relations department, Lashley admitted receiving queries concerning the financing during the month of May, but claimed he referred the calls to Jonathan O'Herron. Although disclaiming knowledge of inside information at the time of the sale, he did admit in response to repeated questioning that he had spoken with O'Herron concerning the status of the financing at some time during this period.

## BAYARD ROBERTS

	Purchases	Sales	Balance
Feb. 1, 1968.....			5,731
Mar. 21, 1968.....		1,800	3,931
June 11, 1969.....		1,000	2,931
June 29, 1969.....		700	2,231
July 3, 1969.....		300	1,931
Jan. 8, 1970.....		200	1,731

Between merger and bankruptcy, Roberts served as secretary of the company. This position afforded him access to vital corporate information, as he took minutes of the board of directors meetings, and the meetings of the board's finance committee. He did not, however, attend the budget committee meetings on a regular basis, and it does not appear that he worked closely with the finance department. At the time of the merger, Roberts owned 5,731 shares, acquired through the exercise of options. His only post-merger acquisition of shares was the inheritance of 59 shares from his father's estate. In March 1968, he sold 1,800 shares, applying most of the proceeds to liquidate a loan incurred in exercising his options in 1966. By mid-1969 he owned over 3,900 shares, with no large loans left outstanding. In June and July 1969, he sold 2,000 shares, and he sold an additional 200 shares in January 1970, leaving him with a balance, through the time of the bankruptcy, of 1,731 shares.

Roberts stated that he had opened an account with Drexel Harriman Ripley in early 1969 at the time of the settlement of his father's estate, and looked to that firm for investment guidance from that time on. He claimed that Drexel was recommending in general the sale of Penn Central stock at that time and that Roberts, determining that his financial position was too heavily reliant on Penn Central, decided to sell half of his Penn Central holdings, retaining half his shares out of an "obligation to hold on" based on his status as a Penn Central officer.<sup>85</sup> Roberts also testified that he had been contemplating diversifying his assets since prior to 1964, when he began exercising his options. As to why he chose June 1969, as the time to put his 5-year-old diversification plan into effect, Roberts offered the following explanation:

Well, the decision to sell was made before I even opened up the account actually. Just a question of when. Actually, I didn't want to sell before I had the account with Drexel because I didn't know what I would do with the proceeds and I wanted some advice on that. So after the account was opened then I gave some

<sup>85</sup> Penn Central stock equaled about half the value of Roberts' investments in 1969.



serious thought as to the timing of the sale. And we were then coming in toward the annual meeting and proxy material was going out and the annual meeting was coming along and so I said, well, let us wait until that is all over and then I will sell my stock. And that is about the way it worked out. The annual meeting was the Tuesday before the second Wednesday of May and I sold it about a month later.

On June 10 or 11 Roberts placed an order with Drexel to sell 2,000 shares. Drexel sold 1,000 shares at  $51\frac{3}{4}$ -52 on June 11 and on June 24, 700 shares were sold at  $49\frac{3}{4}$ . Noticing that his whole order had not been executed, Roberts got in touch with Drexel at the end of June, requesting that the final 300 shares be sold. Roberts claimed he called because he was anxious to complete the sale in order to enable him to exercise his options 6 months hence—he had outstanding an unexercised option of 1,000 shares at  $24\frac{1}{2}$ .<sup>86</sup>

Pursuant to his diversification program, Roberts reinvested all of the proceeds of the 2,000-share sale at Bruce's direction in various equity securities. His January 1970, 200-share sale was made to pay part of the capital gains tax on the major sale:

As you can see from the record I had a substantial capital gain on the sale of the 2,000 shares of Penn Central stock which I was able to offset by the sale of other securities where I took a loss but I couldn't offset it all and I therefore had to raise some more money to cover the tax on the capital gain. I was about to go away on vacation toward the end of January. The entire market was sliding off at that point and I wanted to go away with a free mind so I decided to sell some more stock, Penn Central stock, to raise the cash so I'd have it available at the time of the April tax return.

According to the testimony of D. L. Wilson of the office of general counsel, Roberts had learned in the first 2 weeks of June 1969, that Saunders was thinking of taking the unusual step of proposing that the board of directors delay consideration of the third quarter dividend until a special August board meeting, bypassing the traditional June board meeting. Roberts consulted Wilson on Saunders' behalf about this in mid-June.<sup>87</sup>

<sup>86</sup> A letter dated June 30, 1969, to Roberts from Richard Bruce, his investment adviser at Drexel, appears to confirm Roberts' statement. The second paragraph states:

"As you directed, I have entered orders to sell 200 Penn Central at  $50\frac{1}{4}$  and 100 at  $50\frac{1}{2}$ . I expect these orders will be executed in the next few days which will complete the program to sell your 2,000 shares and will leave you free to exercise your option on additional Penn Central shares 6 months hence."

The 300 shares were sold on July 3.

<sup>87</sup> Saunders eventually decided against this course of action, probably at least partly due to Wilson's recommendation that it be announced publicly.

## CHRONOLOGY OF OFFICER SALES DISCUSSED IN REPORT

	Sales	Balance
1968:		
February		
March	Roberts, 1,800	3,931
	Warner, 300	4,588
April	Warner, 800	3,788
May	Warner, 400	3,388
June	Funkhouser, 1,900	3,101
	Knight, 1,750	2,531
July	Knight, 73	2,458
	Large, 1,000	3,554
	Smucker, 9,000	3,600
	Warner, 100	3,288
August		
September	Hellenbrand, 3,500	367
October		
November		
December		
1969:		
January	Bevan, 3,000	30,718
	Gerstnecker, 4,000	2,275
	Sullivan, 500	2,815
February	Large, 300	3,254
March	Bevan, 3,000	27,546
	Flannery, 300	536
April	Bevan, 3,000	24,546
May	Bevan, 3,700	20,846
	Flannery, 300	1,236
	Gerstnecker, 1,000	1,275
June	Bevan, 2,300	18,546
	Large, 200	3,054
	Roberts, 1,700	2,257
July	Flannery, 236	0
	Haslett, 3,000	2,402
	Knight, 3,950	97
	Roberts, 300	1,957
	Smucker, 3,600	2,200
August		
September	Knight, 90	7
	Large, 200	2,854
	Warner, 4,000	380
October		
November		
December	Warner, 100	240
1970:		
January	Funkhouser, 100	4,949
	Roberts, 200	1,757
February	O'Herron, 500	2,075
	Smucker, 1,600	40
March	Lashley, 500	2,507
	Sullivan, 2,300	515
April	Lashley, 500	2,007
	Perlman, 500	1,400
	Smucker, 2,000	107
May	Funkhouser, 4,500	504
	Lashley, 1,000	1,007
June	Bevan, 4,900	13,246
(Prior to June 21, 1970)	Warner, 200	96



## PART III

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### III-A. THE SALE OF PENN CENTRAL TRANSPORTATION CO.'S COMMERCIAL PAPER BY GOLDMAN, SACHS & CO.

#### INTRODUCTION

On July 22, 1968, the Interstate Commerce Commission authorized Penn Central Transportation Co. (the Transportation Co. or the company) to commence selling commercial paper. By late 1969 the Transportation Co. had \$200 million in commercial paper outstanding. All sales were effected by Goldman, Sachs & Co. acting as dealer.

During the first half of 1970, the amount of the Transportation Co.'s commercial paper outstanding dropped from \$200 million to approximately \$82 million. This \$82 million in commercial paper was held by 72 customers who had purchased between November of 1969 and May of 1970. As commercial paper is universally believed to be a very low-risk security, these customers were shocked to learn, prior to the maturity date of their paper, that the Transportation Co. had filed a petition in bankruptcy. Penn Central has repaid none of this indebtedness, and there is little likelihood of repayment.<sup>1</sup>

While in this section the focus will be on the role of Goldman, Sachs in selling commercial paper, it should be noted that while the company's paper was being sold, the company and certain of its executives were making false and misleading statements to the public concerning the company's financial condition. These activities are being covered in other portions of the staff report.

Goldman, Sachs continued to sell the Transportation Co.'s commercial paper after they had received information about the financial condition of the Transportation Co. which should have raised serious questions as to the safety of an investment in the company's commercial paper, and Goldman, Sachs did not disclose such information to its customers. The information which Goldman, Sachs received should have put them on notice that a thorough examination of the financial condition of the Transportation Co. would seem appropriate in order that they, and through them, their customers would be apprised of the current position of the Transportation Co. Despite these warning signs, Goldman, Sachs made no meaningful investigation. Such an examination would have disclosed that the financial condition of the company was more serious than had been revealed to the public.

#### COMMERCIAL PAPER

##### CHARACTERISTICS OF COMMERCIAL PAPER

Commercial paper is a corporate, short-term promissory note. It is sold either directly by the issuer (borrower) to the purchaser (lender), or by the issuer to a dealer who resells to the purchaser.

<sup>1</sup> There are suits pending against Goldman, Sachs by almost all of the holders. Of these, \$20 million in claims have been settled for \$0.20 on the dollar.

The most noteworthy factor in the commercial paper market (at least until the Transportation Co. bankruptcy) was the common belief held by purchasers, to a degree not even found among those who invest only in the bluest of blue chip securities, that commercial paper was designed to be entirely riskproof. Because safety of principal so far and away transcended rate considerations, a very large number of purchasers of commercial paper did not shop for rates at all. Most looked upon commercial paper as the equal of U.S. Treasury notes or bank certificates of deposit (CD's) in terms of safety. Because of the short-term nature of the investment (average term is 90 days) it is extremely important that the notes are repaid at maturity and thus the liquidity of the company becomes a matter of vital concern to the customer.

The importance of safety to those who invest in commercial paper becomes apparent in a crisis. In the 30-day period following the Transportation Co. bankruptcy, the runoff in commercial paper is estimated to have reached \$3 billion. Only quick action by the Federal Reserve, which had been alerted to the approaching bankruptcy a day or two before, appears to have saved the day. On June 19, 1970, in anticipation of trouble, the Federal Reserve had agreed to let commercial banks borrow freely at its discount window. And on June 23, it voted to change its regulation Q, which limits what banks can pay for deposits, thus allowing them to buy money freely. And the banks borrowed heavily from the Federal Reserve in the weeks that followed—\$1.7 billion in just 1 week in mid-July. More than \$2 billion in bank money went to aid corporations in paying off maturing commercial paper. This rescue operation not only took some companies out of trouble, it also restored lender confidence in the commercial paper market. What could have blown into a major liquidity crisis vanished almost before it began.

A second most noteworthy factor is that those who purchase commercial paper are loaning funds to corporations which most often they know little about. Furthermore, the purchasers have no control over the use of the proceeds or any other of the borrowers' activities, as a lender normally does.

It is impossible to secure restrictive covenants limiting the commercial paper borrowers' freedom to raise additional debt or governing the use of proceeds. In addition, the purchaser who becomes dissatisfied with the issuer usually has no readily available market to which he can resell his paper before its maturity.<sup>2</sup>

The only information the purchaser can get, and in almost all cases does get, is either through the public media or through the dealer who is selling him the paper. In addition to their dealers' recommendations, most purchasers relied on the ratings given various commercial paper by the National Credit Office (NCO) as a basis for making an investment decision.

The problems of making informed investment decisions about commercial paper were aggravated by the rapid growth of the commercial paper market just prior to the company's bankruptcy on June 21, 1970. Witness the following:

<sup>2</sup> Paper which is purchased directly from the issuer, however, will usually be repurchased by the issuer at the purchaser's request. Some dealers also, subject to market conditions, maintain a limited secondary market in paper they handle.

- A. In 1960 there was \$4.5 billion in commercial paper outstanding:  
 On December 31, 1965, \$9 billion outstanding;  
 On December 31, 1967, \$16 billion outstanding;  
 On December 31, 1969, \$31.6 billion outstanding; and  
 On June 30, 1970, \$39.9 billion outstanding.

B. In December 1967, NCO was keeping tabs on 227 commercial paper issuers. By April 1, 1970, its list had increased to 615.

Much of the growth was directly related to the monetary squeeze in which U.S. industry found itself at the end of the 1960's. In December 1968, the Federal Reserve Bank imposed a ceiling on CD interest rates. The banks, expectedly, strenuously objected to regulation Q, as it is known, which had the effect of diverting funds from the banking system and into commercial paper and other money market instruments, but the banks themselves were contributing to the increase in commercial paper outstanding. Bank holding companies began to issue commercial paper, and the banks put hundreds of disappointed loan customers in the direction of commercial paper as a cure to corporate liquidity problems.

It appears that commercial paper will remain an important money market instrument. Some of the advantages are that the seller raises short-term cash at less cost than bank borrowings, the investor receives a higher rate of return than is otherwise possible through purchases of other short-term money market instruments, and commercial paper is also relatively easy to sell, as it requires no registration with the SEC. To make it possible for more institutions to issue commercial paper, legislation has been passed in Massachusetts and New York to enable savings banks to put their cash into commercial paper. Like Ohio, several other States have been authorized to purchase commercial paper. Recent legislative moves have authorized the New York State Teacher Pension Fund and the California General Funds to acquire commercial paper. On the other side of the coin, dealers are engaging in promotional activities to show small- and medium-sized companies the advantages of selling commercial paper.

#### APPLICABILITY OF FEDERAL SECURITIES LAWS TO COMMERCIAL PAPER

The rapid growth of the market for commercial paper has involved its increased use as a substitute for long-term financing. This has made it more important than ever to reconsider the adequacy of Federal securities law with respect to commercial paper. Almost all commercial paper is exempt from registration pursuant to section 3(a)(3) of the Securities Act of 1933.<sup>3</sup> Thus, commercial paper customers have not been furnished with all the current material information that would be required by a registration statement.

In the absence of registration requirements, there are no customary standards requiring disclosure of material information, to the extent the same is disclosed in a statutory prospectus, to purchasers. In many cases the information available to purchasers is limited and out of date. Furthermore, there is no investigation undertaken by the dealer which would even approximate that which is required of an

<sup>3</sup> Under Section 3(a)(3) of the Securities Act of 1933 commercial paper, if used for "current transactions" and having a maturity "not exceeding nine months," is an exempt security. In the case of the Transportation Company's paper, the Section 3(a)(6) exemption would apply to "Any security issued by a common or contract carrier, the issuance of which is subject to the provisions of Section 20a of the Interstate Commerce Act, as amended," without regard to whether it was used for current transactions or whether its maturity was more than nine months.

underwriter of a security offering registered with the Commission pursuant to the 1933 act.

In addition to the exemption from registration under the Securities Act of 1933, commercial paper maturing within 270 days also is exempt from all of the provisions of the Securities Exchange Act of 1934.<sup>4</sup> The sale of commercial paper is covered by the antifraud provisions of the Securities Act of 1933, sections 12 and 17.<sup>5</sup> Moreover, the Investment Advisers Act of 1940, is applicable to commercial paper.

## THE MARKET FOR COMMERCIAL PAPER

### COMMERCIAL PAPER DEALERS

Commercial paper sold through dealers—referred to as dealer paper as opposed to direct paper sold directly from borrower to lender—as of late has constituted approximately 40 percent of the commercial paper market—estimated to be \$40 billion. The seven major dealers are: Goldman, Sachs; A. G. Becker & Co.; Lehman Commercial Paper, Inc.; Salomon Brothers; the First Boston Corp.; Merrill, Lynch, Pierce, Fenner & Smith, Inc. and Eastman Dillon, Union Securities.

### ESTABLISHING THE COMMERCIAL PAPER RELATIONSHIP

Usually a commercial paper relationship will grow out of one of the aspects of the investment banking relationship that a dealer has with an issuer. Once the issuer decides that it wants to issue commercial paper, the dealer will want to determine whether the issuer is credit-worthy, i.e., able to repay the additional debt. The dealer will usually have a credit department or a credit analyst who is charged with the responsibility for making this determination.<sup>6</sup> With some dealers the recommendation of the credit department or analyst can be overridden by a partner or by the head of the commercial paper department. With others, the recommendation is final.

The dealer, having decided that the issuer is creditworthy, will usually then confer with the issuer to determine how much paper to issue based upon how much the issuer wishes to borrow and how much the dealer estimates can be marketed.

Next, the dealer and the issuer enter into an oral agreement whereby the dealer is to be the exclusive dealer to market a specific amount of commercial paper for a specific time. Normally, the dealer will buy from the issuer as principal and reoffer it to the public at a markup of from one-eighth to one-quarter of 1 percent. The dealer agrees to

<sup>4</sup> Under the Securities Exchange Act of 1934 commercial paper is not an "exempted security" as that term is defined in Section 3(a)(12), but is excluded from the definition of a security found in Section 3(a)(10): "The term 'security' means . . . but shall not include currency or any note, draft, bill of exchange, or bankers acceptance which has maturity at the time of issuance of not exceeding nine months. . . ."

Section 3(a)(10) of the '34 Act does not specifically require that in order to be excluded from the definition of what is a security, commercial paper must be used for "current transactions," as does Section 3(a)(3) of the '33 Act. However, see *Sanders v. John Nuveen & Co.*, CCH Fed. Sec. L. Rep. paragraph 93,517 (7th Cir. 1972), which used the "current transaction standard" in making its determination that paper of less than 270 day maturity was not exempt from the definition of a security under the '34 Act.

<sup>5</sup> The anti-fraud protection afforded by Sections 12(2) and 17 of the Securities Act of 1933 is expressly made applicable to securities exempted by Section 3. Section 12(a) provides a civil remedy to purchasers where securities are offered or sold by means of an untrue or misleading statements or omissions "(whether or not exempted by the provisions of Section 3 . . .)." Section 17(c) provides that:

"The exemptions provided in Section 3 shall not apply to the provisions of this section."

<sup>6</sup> The credit analyst considers various factors such as the potential issuer's net worth, its current debt structure, its position in its industry, etc., which affect the issuer's ability to repay the additional debt. Ordinarily this information is obtained primarily from public documents such as registration statements and filings with the Commission and annual reports.

assist in the technical tasks involved.<sup>7</sup> The issuer agrees to provide certain information at certain intervals and access to information of the nature provided to banks for line credit.

Since the dealer's compensation rarely varies from the one-eighth to one-quarter of 1 percent per annum spread, the primary sales points for a dealer are its financial capacity to purchase the paper and its marketing ability to sell the paper at a favorable rate.

#### THE PURCHASERS

Those who invest in commercial paper are predominantly institutions of various types. A small percentage in terms of dollar amount are purchased by individuals. In addition, banks will often purchase in the bank's name for individuals who each may own less than \$100,000. Most investors have only one thing in common: funds to invest for a short period of time with the smallest possible risk and the maximum return. Since treasury bills may not fit purchaser's maturity needs and both bank CD's and treasury bills have a lower interest rate, purchasers turn to commercial paper.

#### DIRECT PAPER V. DEALER PAPER

But why not direct paper instead of dealer paper? Direct paper has many advantages:

- A. usually the direct issuer is larger and more established;
- B. usually the direct issuer will repurchase the paper if the purchaser so requests prior to maturity; and
- C. usually it is easier to obtain the desired denominations and maturities.

However, direct paper typically offers a lower interest rate—by one-quarter percent—and most direct issuers do not have the same ability to reach purchasers as do the large commercial paper dealers, who more actively solicit purchasers.

A purchaser will usually select a particular dealer based upon one or more of the following factors: Prestige and reputation of the dealer; past relationships with the dealer; solicitation by the dealer; variety of paper offered by the dealer both as to type and maturity dates; and the quality of the paper offered by the dealer. Frequently, the purchaser will tell the dealer that it is only interested in NCO prime-rated paper.

#### REPURCHASES

Until recently, none of the dealers had a standing policy of repurchasing commercial paper prior to its maturity. Currently, a few dealers will under certain conditions repurchase the commercial paper of issuers which they handle. But a repurchase facility usually is not a condition of the original sale and is completely discretionary with the

<sup>7</sup> Those will usually include the following:

A. A determination by the issuer's counsel with assistance from dealer's counsel, if necessary, of the availability of the Section 3(a)(3) exemption which may require the granting of a no-action letter from the Division of Corporation Finance.

B. The selection of a New York City bank to act as the issuing and paying agent and an agreement reached with the bank to function as such.

C. Formal authorization from the board of directors of the issuer specifying the total amount to be issued and designating the officer(s) to execute the notes.

D. Selection of a format for the notes, printing, delivery of a minimum number of notes properly signed by the authorized officers to the bank. These notes have a provision for the issuing bank to complete such items as amount, maturity and payee.

E. The issuer obtains a rating from either NCO or Standard & Poor's, at its expense.



dealer. Infrequently, dealers will repurchase to preserve a good customer's relationship, although not as a condition of the original sale.

#### INFORMATION PROVIDED TO PURCHASERS AT THE TIME OF SALE

Because of the short-term nature of commercial paper and the way in which investments in commercial paper are made—there is a continuous turnover and a customer usually must choose from whatever commercial paper the dealer has available at the time which will meet the customer's maturity requirements—the usual purchaser does very little investigation or analysis of the investment merits of commercial paper. He is not in a position to acquire information directly and must rely on what he can get from the dealer selling the paper, rating services and the public media.

The profit margin on commercial paper is very thin for dealers— $\frac{1}{8}$  to  $\frac{1}{4}$  percent spread—who must meet the expenses involved in soliciting and selling plus the cost of inventory. A major reason for dealers to bother with commercial paper is the hope that it will lead customers to use more profitable facilities such as stock or bond underwriting. The low-profit margin would act to discourage dealers from voluntarily undertaking the expense of a thorough examination of issuers' creditworthiness and/or a thorough gathering of information for purchasers.

Since the holder of commercial paper has the status of an unsecured general creditor, there is an additional necessity to have access to reliable and current information, for in the event of bankruptcy the chance to recoup an investment is relatively small.

The dealers frequently prepare a dealer memorandum which is a short descriptive analysis of the issuer.<sup>8</sup> These are provided either to all potential purchasers or to those purchasers whom the dealer feels might be specifically interested. Dealers update the memorandum at least annually, and more frequently if significant events or circumstances should require.

Most customers assume that once they have told a dealer about the type of issuer they are interested in investing in, the dealer will provide only paper that meets the customers' standards. Without regard as to whether they have any basis, a number of other presumptions are held by purchasers: that the dealer will only offer the paper of an issuer which it considers to be credit-worthy and without any substantial risk; that the dealer will inform the purchaser of any adverse information concerning the issuers; and that the dealer will repurchase the paper before maturity.

Although most customers are institutions, they range from highly sophisticated investment oriented institutions to unsophisticated institutions such as many college trust funds, small town banks, and small manufacturing companies. However, as we indicated above,

<sup>8</sup> The typical dealer memorandum consists of the following:

1. A description of the company: Its history and the nature and type of its business;
2. The latest year-end balance sheet;
3. Income statements for the preceding 5 years;
4. Bank credit arrangements including a list of the company's primary banks;
5. The company's NCO or S. & P. commercial paper rating; and
6. Interim earnings.

Additional data which may also be provided about the issuer includes the following:

1. Ratio of current assets to current liabilities;
2. Ratio of funded debt to net worth;
3. Market value of common stock;
4. Long-term debt ratings, if any, by Moody's and S. & P.; and
5. Capital expenditures: current and projected.

even the sophisticated institutions are not given all the information as would be required by the Securities Act of 1933. Also because of the short-term nature of the investment and the speed and the manner in which it is made, investors do very little investigation on their own either into the issuer or the investment merits of the security.

#### ACTIVITIES OF DEALERS SUBSEQUENT TO INITIAL OFFERING

Most dealers provide one form or another of continuing review of their issuers, although it is very limited. This usually involved checking with banks to see if adequate back-up lines are being maintained in addition to the status of any other relationships between the issuers and the banks.

Most firms which act as dealers in commercial paper have a trading department staffed by individuals whose primary, if not sole, responsibility is marketing commercial paper. Ordinarily this trading department is separate and distinct from other marketing activities of the firm. Commercial paper traders at most firms are responsible not only for marketing the paper but also for maintaining relationships with customers. The investors which the dealers solicit are a relatively small group of institutions who apparently utilize the services of all the dealers.

Most dealers maintain an inventory of commercial paper which is made up of unsold portions of issuer's commercial paper. Dealers are under substantial pressure to turn over their inventory as quickly as possible for the inventory, which can run as high as \$300 million, is financed through bank loans. Such financing may be expensive and difficult to find.

#### PENN CENTRAL TRANSPORTATION Co.'s COMMERCIAL PAPER

##### ESTABLISHMENT OF COMMERCIAL PAPER RELATIONSHIP WITH GOLDMAN, SACHS & CO.

The first serious discussions between the company and Goldman, Sachs concerning the issuance of commercial paper took place in early 1968. David C. Bevan, chief financial officer of the company at that time, had met Gustave Levy, managing partner of Goldman, Sachs, while the former was with New York Life in 1946. The acquaintance was continued throughout the time Bevan was with New York Life and during the time, from 1951 on, that Bevan was with the company. At a meeting in March 1968, and after subsequent discussions between Bevan, Levy and Wilson, the decision was made to issue commercial paper and utilize Goldman, Sachs. At this point, according to Robert G. Wilson, a partner in Goldman, Sachs and head of its commercial paper department, Goldman, Sachs followed its usual procedures for taking on a new issuer.<sup>9</sup>

Wilson could not, however, recall whether anyone other than Jack Vogel, head of the commercial paper department's credit department, was involved in determining the credit-worthiness of the company, nor could he or Vogel recall if there were any reports prepared relating to the company's credit-worthiness at this time,

<sup>9</sup> This included obtaining the necessary borrowing resolutions, signature cards, annual reports, a copy of the ICC order approving the sale, and financial data.

although Vogel stated that he personally did not prepare a written report.

While neither witness could recall the specific steps taken in the case of Penn Central, they did testify as to the normal procedures followed within the firm. The credit department, headed by Vogel, would have made, in the ordinary course of business, a preliminary decision on credit-worthiness,<sup>10</sup> and it would have been up to Wilson to make the final decision. The recommendation by Vogel is usually not made in writing, but a checklist is made as to information received. Usually no memorandum or written record is made of Wilson's conversations with Vogel or of Wilson's decision. Wilson stated that he has no particular standards or guidelines for making this decision but draws upon his own experience and looks at each company individually. Wilson noted that the credit department has informally established certain minimum standards or guidelines. However, he did add that there are some standards in this area:

You look for a history of earnings, you look for a ratio that shows a relatively strong working capital position. You want to know about the management of the company, its reputation, where the company stands in its field, this type of thing.

Wilson also stated that there was no particular ratio or standard applied to the level of outstandings but that he only relates borrowings in commercial paper to current assets and receivables and the level of inventories since the proceeds from the paper are to be used for current purposes.

Vogel's testimony fairly much paralleled Wilson's in terms of the absence of any standards or ratios that are applied to the factors which are considered. He did, however, expand somewhat on the role of the analyst:

\* \* \* He would review the company's financial statements, determine whether or not the company is, or has, an ongoing nature to it, whether its product line is of the type that would do more in the next few years, or 10 years, whether the company has a record of profitability, whether it has a reasonable chance to have a record of profitability in the future, whether other lenders, or other suppliers of funds have a favorable opinion of the company in its past, and in its present, and of its future \* \* \*.

As was mentioned earlier, Vogel could not recall having made a written report on the company prior to its being approved by Goldman, Sachs as an issuer, nor could he recall other than in a general way, what factors were considered at the time (summer of 1968). Wilson's testimony was the same.<sup>11</sup>

The Interstate Commerce Commission on July 22, 1968, gave the company authorization to issue \$100 million in commercial paper, and by August 5, 1968, sales were well underway.

Once the decision to carry a particular issuer has been made, the credit department normally undertakes to review the public media for information about the issuer. Once a year the issuer is asked for confirmation of existing lines of credit. As will be shown, if the standards described above had been applied in late 1969 or early 1970, Goldman, Sachs would not have continued to offer the company's paper for sale.

<sup>10</sup> According to Wilson and Vogel the determination of credit-worthiness involves looking into the prospective issuer's borrowing practices, its access to credit, the opinions of banks with whom the issuer maintains lines of credit, and reviewing its financial statements as found in the annual reports. At no time did Wilson or Vogel indicate that it was normal procedure for Goldman, Sachs to investigate the issuer as an underwriter would be in a typical registered public offering.

<sup>11</sup> Vogel testified that Goldman, Sachs takes on about one new issuer a week. These issuers must be investigated by his staff of four. In addition, this staff is also responsible for maintaining an on-going review of the approximately 250 issuers for whose paper Goldman, Sachs acts as dealer.

THE FLOW OF INFORMATION TO GOLDMAN, SACHS & CO. WHICH INDICATED THE DETERIORATING FINANCIAL CONDITION OF THE COMPANY

From September of 1969 through May of 1970, Goldman, Sachs was very actively engaged in selling the company's commercial paper. In fact, the amount outstanding was increased from \$150 million to \$200 million during late 1969. During this period Goldman, Sachs gained possession of material adverse information, some from public sources and some from nonpublic sources indicating a continuing deterioration of the financial condition of the transportation company. Goldman, Sachs did not communicate this information to its commercial paper customers, nor did it undertake a thorough investigation of the company. If Goldman, Sachs had heeded these warnings and undertaken a reevaluation of the company, it would have learned that its condition was substantially worse than had been publicly reported.

*Public information*

Based on information publicly available by November of 1969, a thorough reevaluation of the transportation company's financial condition would seem to have been appropriate. For example, the reported loss of the transportation company for the first 9 months of 1969 was \$40.2 million, or \$26.4 million more than in 1968. In late November an announcement was made that Penn Central was passing the dividend. In testimony before the ICC, outside counsel representing the company told the ICC that Penn Central was having a very difficult time effecting the merger (management was very upset by this statement). This matter, as well as a reference to the same effect by an independent expert a few days later, was reported in the news media.

The above information was available to Goldman, Sachs through the public media. However, this did not cause Goldman, Sachs to re-examine the financial condition of the company whose paper Goldman, Sachs was selling as prime rated commercial paper. In addition, thereafter, other public information came to their attention which indicated a serious worsening of the company's financial condition.

*Other information available to Goldman, Sachs concerning the general financial condition of Penn Central Transportation Co.*

Whether it was for these or other reasons, a memo written by Robert Wilson on September 3, 1969, indicates that there was some concern at this time about the company's financial situation. In the memo Wilson states that as " \* \* \* it has been a long time since we had gotten together to talk about the company," he had requested a meeting with the top officials in the company's finance division since, "We have a lot of questions to ask about the merger, cash flow, and their long term financing plans."

On September 19, 1969, Wilson and others in Goldman, Sachs met with Jonathan O'Herron, vice president-finance of the company. Among other things, O'Herron stated that the company would be in a very tight cash position in the first quarter of 1970. Because of this, he asked if Goldman, Sachs would sell as much commercial paper as possible through April or longer, and disclosed that the company had applied to the ICC for authorization to increase its outstanding commercial paper from \$150 million to \$200 million.

On October 22, O'Herron told Wilson that Penn Central would show a small loss in the third quarter, but he anticipated that the fourth quarter would be in the black with a good improvement.

On October 29, the ICC approved an increase in the amount of the company's commercial paper outstanding from \$150 to \$200 million. There were, however, a number of important disclosures in the ICC's order. In discussing approval of the issuance of this increased amount, the ICC stated:

Applicant feels that long-term financing at the present time is not feasible due to the tight-money situation. Although we are sympathetic to applicant's problem, short-term financing has traditionally been relied upon to finance short-term needs and is not normally regarded as a proper source for long-term financing of capital expenditures or for refinancing of maturing long-term debt. As of June 30, 1969, applicant had a deficit working capital situation which can be expected to worsen if reliance on short-term financing is increased. The exhaustion of short-term credit to refinance maturing long-term debt or to finance long-term capital expenditures could expose a carrier to a serious crisis in the event of an economic squeeze, at which time a carrier may require short-term financing for traditional use. We are, therefore, concerned about the use of short-term financing for long-term purposes and feel that where necessary it should be resorted to cautiously.

The order went on to state that on the whole the company was in a strong financial condition, and in view of the tight money market at that time and the fact that the company had indicated its intent to negotiate long-term financing as soon as possible, the ICC would approve the request for an increase in the outstanding commercial paper. In approving the increase, the ICC order noted:

According to the investment banking firm which usually handles applicants' commercial paper, unless market conditions change, there is a market for an additional \$50 million of applicant's notes.

Goldman, Sachs, however, never did explore in any depth the areas of inquiry which they indicated would be the subject of the September meeting. All of the information described above raised serious questions about the soundness of the Transportation Co. and the safety of investing in its commercial paper. The information indicated that the company was experiencing a liquidity crisis and that it might find it extremely difficult in the future to meet its cash needs, thus jeopardizing commercial paper holders. A thorough study of the subject would have disclosed how much more damaging the information about liquidity of the company and its ability to pay off commercial paper holders was. Although such a study would appear to have been in order at this time, Goldman, Sachs did not conduct any further investigation, and made no disclosure of the above information while continuing to actively promote the company's commercial paper. Customers were not told that the company expected to be in a tight cash position in the near future; were not told about the ICC order or the information about the deficit working capital situation or the fact that the company's commercial paper proceeds were being used for long-term financing.

*Requests by Goldman, Sachs that Penn Central increase the lines of credit backing up its commercial paper*

There was other information Goldman, Sachs was receiving in the latter part of 1969 and in early 1970 which indicated a deteriorating financial condition and raised questions concerning the liquidity of the company.

As early as September of 1969, Goldman, Sachs initiated a request that the company increase its back-up lines of credit<sup>12</sup> for its commercial paper. At the September 19, 1969, meeting described above, O'Herron had described how the railroad was currently borrowing \$250 million out of a total \$300 million revolving credit. He went on to state that the company intended to use the remaining \$50 million of the revolving credit lines plus \$50 million of outside lines of credit as back-up for the \$200 million in commercial paper. Wilson then asked O'Herron if it were possible to get an additional \$50 million in back-up lines. According to Wilson, O'Herron replied that it was, but he would prefer not to do so. O'Herron's account is: "I can't remember specifically whether I said I preferred not to, or said I didn't think I could." When asked why the company could not have increased its lines, O'Herron replied:

Because I think the Penn Central had already had a line of credit, some of which was used at that time, of \$300 million, and which was a pretty sizable amount of credit availability, for even a company of that size. So, the probability of increasing that was not very great in my opinion. So, I can't recall if I said "preferred not to," or "couldn't," I think they are both the same.

Wilson testified that Goldman, Sachs' concern was to convey to the company their feeling that customers were considering back-up line coverage as being more important because of the tight money market which prevailed in late 1969 and early 1970. Although it is his opinion that back-up lines were not a firm commitment to lend money, Wilson did state that back-up lines are important to customers as an indication of some willingness on the part of the banks to supply credit to back up their paper, especially in times of tight money. In fact, when asked what the average commercial paper investor looks to in determining whether an issuer will be able to make repayment, Wilson replied:

I think they look at all these things, I think they look at cash flow; I think they look at back-up lines; I think they would look at capacity to get lines, capacity to do financing, all these things.

There is conflicting evidence as to whether or not it was unusual for Goldman, Sachs to have been requesting more than 50 percent line coverage of the company at this time. In any case, Goldman, Sachs was to ask the company repeatedly for an increase in line coverage on into the first quarter of 1970 without success (eventually Goldman, Sachs even began asking for 100 percent coverage). The management of the company was very reluctant to ask the banks for more line credit. Although Goldman, Sachs never inquired too deeply into the reasons for the company's reluctance, it should have been apparent that the company had exhausted all credit.

According to Wilson's testimony cited above, the fact that the company only had 50 percent line coverage and the fact that it was unable to obtain more was information that investors would have considered important. The unwillingness and inability of the company to raise more than 50 percent of the coverage was never disclosed to customers. Furthermore, this information, just as the other available information described in the previous section, was a further indication of the financial problems of the company and should have caused Goldman, Sachs to investigate further. During the period in question,

<sup>12</sup> Back-up lines of credit represented varying degrees of commitments by banks to loan money to the company in the event that it should need it.

when a tight-money market existed, access to credit was even more important. Goldman, Sachs kept a close watch on the banks participating in credit lines to the company. By their own actions, Goldman, Sachs acknowledged the importance of the inability of the company to raise 100 percent coverage at this time. In fact, on February 5, 1970, O'Herron had told Wilson that the company could not raise any additional lines of credit. The inability of the company to obtain 100 percent backup lines, as with other relevant information, was not disclosed to customers.

*Publication of 1969 year-end earnings by Penn Central Transportation Company*

On February 5, 1970, the transportation company announced a \$56 million operating loss for 1969, which indicated a loss of \$16 million for the fourth quarter. This was contrary to the company's recent assurances that the fourth quarter would be in the black. In addition to this loss the company wrote off \$125 million in passenger equipment and facilities as an extraordinary item. On the same day Wilson called O'Herron to set up a meeting on the next day to discuss the loss. At the meeting, at which Levy and Wilson of Goldman, Sachs, and Bevan, O'Herron, and Robert Loder of the company were in attendance, Bevan attempted to explain the 1969 loss and the company's projected budget—another \$56 million loss—for 1970.

Bevan explained that they all had anticipated that the railroad would break even in the fourth quarter but that at the last moment their accountants had suggested certain writeoffs which changed the results. The 1970 official budget, according to him showed an estimated loss of \$56 million, and the railroad needed an additional \$170 million for capital improvements and equipment, causing the total cash requirement for 1970 to be \$226 million. Bevan then explained that this would be raised by trust certificates—\$70 million—a long-term financing through Pennsylvania Company—\$100 million—and a Euro-dollar loan—\$50 to \$75 million. Although the timing on these was uncertain, they intended to set up a \$50 million bridge loan in the near future. Bevan added that although the official budget showed a \$56million loss, the management target for the railroad shows a loss of zero to \$23 million for 1970.

This explanation of the manner in which the company was to continue operating appears to have completely answered whatever questions Goldman, Sachs had at this time about the financial situations of the railroad. Levy and Wilson asked no questions about any of the methods mentioned above, by which Bevan intended to raise the necessary funds for 1970. According to Levy no questions were asked because "as I said, I had complete confidence in Mr. Bevan's integrity; that he could do what he said he could do." Furthermore, Levy did not confer with anyone at Goldman, Sachs about Bevan's plans, or direct anyone at Goldman, Sachs to contact the company personnel to inquire into Bevan's statements or to request the railroad to supply Goldman, Sachs with any statements or figures about their budget situation or cash forecast because Levy had "complete confidence in Bevan and O'Herron."

In spite of the fact that the railroad had suffered a loss for 1969 and the fact that it was now having great difficulty raising additional lines of credit, Wilson stated, concerning Bevan's explanation of the

1969 loss and the 1970 projections, that, "We had no reason to doubt him at that time, and we were satisfied with the answers to the questions we asked in these areas." It appears, however, that very few questions were asked. According to Wilson's testimony, the elements which he considered as affecting the company's creditworthiness on February 6, were the fact that the Pennsylvania Company had over \$900 million in securities, the fact the railroad had large real estate holdings, and the magnitude of the railroad itself. All these assets, however, had never been evaluated by Goldman, Sachs to determine their actual worth, how encumbered or pledged they were, or whether those that were held by subsidiaries could be liquidated for the company's purposes. Vogel, head of the credit department, who was also at the meeting testified that at this time no reexamination of the company took place as a result of these events:

As a result of information obtained through these meetings we were reassured by the management—at least in our opinion—of the railroad—that the situation was one that was explainable, normal, and not of any problem. To that extent we accepted that reassurance.

So, as a result of the announcement of a \$56 million loss for 1969, Goldman, Sachs had sought the assurance of management that all was well, got that assurance and was apparently satisfied with same.

*The National Credit Office (NCO) continues prime rating after 1969 results announced*

On February 5, 1970, Allen Rogers of NCO called Jack Vogel of Goldman, Sachs to express concern over the sharply reduced earnings announced in the newspapers that day. Vogel told Rogers that Goldman, Sachs was continuing to sell the company's paper in spite of the sharply reduced earnings. Vogel also suggested that the company had a number of valuable properties and securities, and he was certain that something could be worked out should it ever become necessary. According to a memo written by Vogel, Rogers stated, "that as a result of my comments, he would continue to carry Penn Central Transportation Company as a prime name." According to a memorandum written by Wilson of a conversation with Levy, "I also explained Allen Rogers' conversation with Jack Vogel and that Allen's feeling was that as long as Goldman, Sachs was going to continue to handle the company's c/p (commercial paper) he would keep the prime rating." In fact, NCO continued the prime rating until June 1, 1970.

As will be more fully described below, customers relied heavily on the NCO prime rating as an independent opinion of the creditworthiness of commercial paper issuers. Goldman, Sachs also utilized the availability of the NCO ratings as a selling point to assure customers of the low risk involved in purchasing commercial paper. Specifically with regard to the company's commercial paper, Goldman, Sachs was aware that customers relied on the prime rating of the company's commercial paper, and Goldman, Sachs used the company's commercial rating of "prime" in selling it.

As a result of this conversation with Rogers, Goldman, Sachs became aware of facts which undermined the value of the prime rating given by NCO to the company's paper and the independent nature of that determination. Thus, from this point on it appears that NCO was not the thorough, independent rating service that Goldman, Sachs had represented to customers that it was. In addition,



from this point on, Goldman, Sachs was aware that the "prime" rating was based to a great extent on the fact that Goldman, Sachs was continuing to offer it. They also believed that the "prime" rating was based in part on Vogel's opinion that the company had sufficient properties and valuables—which fact Goldman, Sachs had never investigated—to liquidate if necessary. Furthermore, if they were looking to liquidation as a means of determining creditworthiness, the railroad clearly was no candidate for the "prime" rating.

Certainly investors involved in such short-term investments as commercial paper where liquidity is so vital would want to rely on liquidation of corporate assets as a means of payment. Also Rogers' apparent reliance on the simple statement of Vogel would indicate that NCO was not engaged in the kind of analysis required to make an independent determination to continue the prime rating. Nor had Goldman, Sachs done any kind of analysis which would substantiate these statements. In addition, Goldman, Sachs never disclosed to any customers any of these matters.

*Goldman, Sachs reduces its inventory of Penn Central paper*

Goldman, Sachs' analysis about the significance of the year-end results may be ascertained with greater reliability from the actions they took rather than from their statements. Thus, on the very same day they learned of the first quarter losses, they contacted the company and got a commitment from the company to buy back \$10 million of its commercial paper from Goldman, Sachs' inventory. Furthermore, Goldman, Sachs insisted that from then on, the company's paper be sold under a tap issue arrangement whereby Goldman, Sachs would no longer buy any paper from the company, but would ask the company to issue certain paper only after it had found a customer for the paper, an arrangement involving no risk for Goldman, Sachs. At the time the company went into bankruptcy, Goldman, Sachs held none of the company's paper.

The coincidence of the timing of the reduction of inventory and the tap issue arrangement with the announcement of year-end results would appear to indicate that Goldman, Sachs' concern with the company made them more unwilling to risk their assets. In their testimony, Goldman, Sachs' people have admitted that one of the primary reasons for this action was the feeling that the yearend results would make the company's commercial paper much less marketable. Accordingly, they wanted to reduce their inventory. Most customers believed that Goldman, Sachs maintained an inventory in all commercial paper which they offered for sale. Many who purchased the company's paper after February 5, 1970, looked to the fact that Goldman, Sachs had an inventory of the company's paper as assurance that Goldman, Sachs felt the paper to be credit worthy. Goldman, Sachs never informed its customers of its decision to reduce and eventually eliminate its inventory.

*Receipt of adverse information as to first quarter results*

On March 23, 1970, in a conversation with Wilson, O'Herron stated the first quarter's figures would look terrible.

Goldman, Sachs made no further inquiry as to how adverse the first quarter results would be or how this would affect commercial paper holders. They did not seek to examine records of the company with regard to first quarter results. If they had done so, they would

have discovered that internal documents of the company indicated a loss of \$60 million for the first quarter.

Goldman, Sachs continued to actively promote the sale of the company's commercial paper for the period of March 23 to April 14, when another discussion was held with the company's management concerning first quarter results. A total of \$17.3 million in commercial paper was sold to 18 customers during this time. None of these customers were told about these expected terrible results for the first quarter.

*On April 14, 1970, Goldman, Sachs learns that there will definitely be a loss for first quarter; public learns on April 22, 1970*

On April 14, 1970, O'Herron told Wilson that the losses for the first quarter would be "lousy," and, in fact, "staggering." O'Herron added that he did not see the turnaround in the railroad yet, and that the cash position is in very serious shape.

Based on these comments Wilson recommended to Levy that they stop offering the company's paper until the current situation could be clarified. A meeting with Bevan and O'Herron was scheduled for later in the day for that purpose.

At that meeting O'Herron apologized to Wilson for the casual nature of his remarks made earlier in the day. Bevan indicated that he could not tell exactly what the first quarter losses would be, but they would be substantially in excess of the \$12 to \$13 million lost in the first quarter of 1969. The losses, he explained, had resulted from a \$20 million reduction in anticipated revenues and larger expenses due to the most severe winter in the history of the railroad. Bevan stated that he did not anticipate that the losses for 1970 would be worse than those sustained in 1969. He further stated that the entire system had been put on a severe cost-cutting program by Gorman, the new president.

There was more discussion about what measures were being taken to improve conditions. Bevan stated that they expected to announce the final loss figure next Wednesday (April 22) and at the same time would file for the upcoming \$100 million public debt offering. Bevan then outlined the ways in which he intended to meet the forthcoming cash needs of the company. He described specific steps that could be taken should it become necessary. Included in these was a plan to sell some of the real estate. Wilson asked whether these properties had several layers of mortgages and Bevan answered affirmatively. Bevan added that their cash position has been the subject of an intensive hearing in the past 30 days before the full ICC and Transportation Secretary Volpe. Bevan and O'Herron asked them to continue to offer the company's commercial paper until they effected their \$100 million bond offering in early May.

Again based on a brief explanation by Bevan, Goldman, Sachs was assured that "there was no emergency at the Penn Central Transportation Co." At this meeting Bevan stated that the losses for all of 1970 would not be more than \$56 million. Eight days later, the company announced that it lost \$62.7 million in just the first quarter of 1970. Bevan outlined new contingency plans for liquidation of real estate, equipment, and securities. As in the past, few questions were asked (Wilson did ask if the real estate was encumbered and Bevan replied that it did have several layers of mortgages), and no steps were taken

to investigate Bevan's reassurances. The next day, Levy told O'Herron that Goldman, Sachs would continue to offer the company's paper.

Bevan's statements at this meeting bore no resemblance to the reality of the situation. The situation was much worse at this time for in addition to the magnitude of the anticipated losses, O'Herron indicated that a substantial part (\$51 million) of the income to be reported on a consolidated basis was to come from extraordinary and non-recurring sources. The actual consolidated losses were, therefore, actually greater than was reported for the first quarter.

During the time between this meeting and the time that the first quarter losses were announced to the public, Goldman, Sachs made one sale of \$300,000 of the company's commercial paper. This customer was told nothing of the first quarter results.

*Sales of Penn Central Transportation Co.'s commercial paper after announcement of first quarter results*

On April 22, 1970, the company announced the results of the first quarter. The parent, Penn Central Co., reported first-quarter consolidated losses of \$17.2 million (compared with net income of \$4.6 million for same period in previous year). The results included extraordinary income of \$51 million. Penn Central Transportation Co. reported a loss of \$62.7 million for the first quarter.

Goldman, Sachs continued to offer commercial paper to its customers and in the period April 22 to May 15 sold \$5 million to one customer, the American Express Co., on May 1, 1970. Goldman, Sachs witnesses have testified that on April 30, their salesmen were required henceforth to read from press releases announcing first quarter results.

There is some dispute as to what American Express was told. The Goldman, Sachs salesmen stated that they were told about the first quarter results. American Express testified that this was not the case. It had been reluctant to purchase the company's paper, but Jack Vogel, head of the credit department, told it that there were adequate assets to back up commercial paper in order to persuade it to change its mind about buying the company's paper. The paper purchased by American Express resulted from a buy-back by Goldman, Sachs from Mobil Oil and then a resissue to American Express. American Express claims that at this time Goldman, Sachs told it that there was no reason to be concerned about the ability of the company to meet the maturity of the paper.

By mid-May it was clearly impossible to sell any more of the company's paper and all further effort was terminated by mutual agreement between Goldman, Sachs and the company. One of the reasons for the company's bankruptcy was its inability to roll over its commercial paper, for the amount of redemptions which could not be rolled over totaled \$117 million for the first half of 1970.

**OTHER FINANCIAL RELATIONSHIPS BETWEEN GOLDMAN, SACHS  
AND THE TRANSPORTATION CO.**

In addition to the compensation received for the sale of commercial paper, there were many other areas of financial relationship with the company which were being developed around the time in question, which could have and did produce additional sources of revenue for Goldman, Sachs. On November 4, 1969, representatives of Goldman,

Sachs and the company met to discuss a \$350 million pension fund and a high performance contingent compensation fund in which Goldman, Sachs was "hopeful that we will be able to make a contribution."

On November 17, 1969, Goldman, Sachs was invited to participate as a syndicate member in the underwriting of a \$50 million Pennsylvania Co. debenture offering.

On December 9, 1969, in discussions with the company, Goldman, Sachs uncovered "some possible lease finance business."

On January 2, 1970, Canada Southern Railway Co., a subsidiary of the company, purchased commercial paper of another issuer from Goldman, Sachs (\$1.5 million). Also Mahoning Coal Railroad Co., a company subsidiary, purchased commercial paper of another issuer from Goldman, Sachs (\$1,300,000). On January 8, 1970, the Peoria and Eastern Railroad Co., a subsidiary of the company, purchased another issuer's commercial paper from Goldman, Sachs (\$250,000). This was the first time these subsidiaries had ever purchased commercial paper.

By February 12, 1970, the company and its subsidiaries had purchased over \$60 million of commercial paper from Goldman, Sachs in the last 7 weeks.<sup>13</sup>

On February 26, 1970, Robert Haslett of the company called Goldman, Sachs and stated that he would like Goldman, Sachs to start working with him on the company's thrift plan (they invest about \$250,000 each month). George Ross of Goldman, Sachs stated that he had every reason to believe that they can do substantial securities business with the company and that Levy should mention Goldman, Sachs' investment management services to Bevan. Goldman, Sachs did eventually handle the thrift plan for the company.

Around this time Levy indicated to Wilson that he should get in contact with Bevan, who stated that the company may have a blanket mortgage from which Goldman, Sachs may benefit, and that this could amount to as much as a billion dollar underwriting.

## METHODS EMPLOYED BY GOLDMAN, SACHS TO SELL THE COMPANY'S COMMERCIAL PAPER TO CUSTOMERS

### GENERAL REPRESENTATIONS MADE ABOUT COMMERCIAL PAPER

Since Goldman, Sachs is the oldest and largest dealer in commercial paper, most customers believed that Goldman, Sachs would offer them only commercial paper which met their requirements and which Goldman, Sachs felt was credit-worthy. This impression was created in large part by oral representations made by Goldman, Sachs personnel and by written materials (pamphlets and brochures) distributed by them which extolled Goldman, Sachs as the "largest," and "most important," commercial paper dealer. Further enhancing this image were representations made by Goldman, Sachs that commercial paper is the equivalent of Government securities in terms of safety, that Goldman, Sachs only offered the paper of the top companies; that it maintained a credit department to review commercial paper issuers, that it offered investment advice to purchasers; that it purchased the paper of "outstanding" companies for resale to investors; that it would provide financial information on issuers whose paper

<sup>13</sup> Most of these funds came from the proceeds of the \$50 million Penneo debenture offering in December 1969.

it was offering for sale; and that it only offered paper rated "prime" by NCO, an independent credit rating service.

Most customers had sufficient contact with Goldman, Sachs for the latter to become familiar with the nature of the customers' businesses. Furthermore, this familiarity enabled Goldman, Sachs to learn that most customers contemplated that there would be a minimum risk involved as the funds were almost always earmarked for some purpose in the near future. In almost all cases Goldman would assure the customer, when asked, that the purchase was suitable for his situation.

Initially Goldman, Sachs would often provide a customer with a book which contained the latest financial statements of the companies whose paper they offered for sale. After a customer had made a purchase, Goldman, Sachs would send a copy of the issuer's latest available financial figures which would update the information about the issuer which was contained in the book. The information Goldman, Sachs was sending customers about the company, even as late as the end of March of 1970, was the year-end financial statement for 1968.

Rarely would a customer investigate an issuer on its own. Most customers either just stated to Goldman, Sachs that they were relying on Goldman, Sachs to provide them with the "very best paper" or "NCO prime paper" or in a very few cases, gave Goldman, Sachs an "approved list."

Most customers would call Goldman, Sachs and ask what was available which would fit their maturity requirements, and the salesman would describe what was available. In a few cases a customer would ask questions about the financial or general condition of the issuer and would be given answers. The customer would then select a particular paper for purchase.

#### HOW THESE CUSTOMERS INVESTED IN THE COMPANY'S COMMERCIAL PAPER

In the sales of the Penn Central Transportation Co.'s commercial paper, most customers asked no questions and when some did, they were reassured that everything was fine. When questions were raised by customers concerning the company's increased losses, the salesmen usually replied that merger or other temporary problems were the cause, and with \$6.5 billion in assets there was nothing to be worried about. Frequently, the salesmen, through the beginning of April 1970, would cite to customers the company's 1968 results in answer to these questions. Some customers who still resisted were persuaded only after arguments by salesmen that, additionally, the high rate of return (in 1970 the company was offering the highest commercial paper paper rates), and the fact that the company's paper could be tailored to their needs, made it the best for their purposes. Furthermore, most customers at the time of purchase did not have any current financial information about Penn Central Transportation Co., or any of the information described in sections above which was in the possession of Goldman, Sachs, and Goldman, Sachs did not offer any of it prior to the sales. If the customer indicated to the salesman that he had heard something adverse about the company, the salesman would often firmly reply that the company was still "NCO prime" and there was no risk at all involved.

An example of the type of situation in which the customer placed complete reliance on Goldman, Sachs' recommendations is that of a textile manufacturer in Clinton, S.C. The relationship between the customer and Goldman, Sachs originated in 1960 at the time the customer was considering a merger. Goldman, Sachs was consulted to help prepare the rate of the exchange. Although this merger fell through, a subsequent merger attempt in 1964 in which Goldman, Sachs worked out the details (and for which they were paid a fee) was a success.

The two had intermittent contact through the sixties. Goldman, Sachs set up a revolving credit agreement for the customer to enable it to build another plant.<sup>14</sup>

In the fall of 1968, Goldman, Sachs assisted the customer in another merger. In the course of this merger, Goldman, Sachs was furnished with complete financial information on the customer.

In August of 1969, the customer had accumulated \$1 million in cash in anticipation of another merger (although it had drawn down \$4 million from the revolving line of credit). Since it would be months before the merger took place, the customer contacted the individual at Goldman, Sachs with whom it had been dealing and explained the situation. The individual recommended commercial paper. The customer reminded him of the limitation on commercial paper placed by the revolving credit agreement and stated that it would be relying on the recommendation of Goldman, Sachs and no one else. In fact, the customer's president gave instructions that the company was to buy whatever was recommended by Goldman, Sachs. In September of 1969, Goldman, Sachs by letter recommended certain commercial paper. The customer purchased it. When this paper matured in December, Goldman, Sachs recommended the company's paper. The customer bought it. When this matured in March of 1970, Goldman, Sachs recommended repurchasing the company's paper, which the customer did. This paper and an additional amount, which Goldman, Sachs had at the same time recommended to be placed in the company's paper, were not repaid because of the company's bankruptcy.

The treasurer of a small college in Pennsylvania described, in an affidavit, the circumstances surrounding the college's purchase of the company's paper on March 30, 1970, as follows:

At this point the availability of Penn Central was mentioned. I hesitated because the college already held \$400,000 in Penn Central. On asking for pertinent information from the latest financial report, I was informed the company reported consolidated revenues of \$2,251,716,000 compared with \$2,102,770,000 the previous year and preliminary earnings of \$4,388,000 versus \$86,961,000. At this point the problems of consolidation as a result of the merger were pointed out. I next questioned the current asset to current liability ratio, which was indicated at approximately one to one. When I indicated my concern over this, the representative reassured there was no need for concern since total assets exceeded 6½ billion. With some hesitancy I agreed to the purchase of 300M of Penn Central paper.

On April 3, 1970, I received the letter of confirmation and a copy of the financial data on Penn Central. I was dismayed to learn the information conveyed over the phone was as of December 31, 1968, and not December 31, 1969. This, coupled with reports in the newspapers of the increased financial plight of the company, prompted me to call our representative to attempt to sell the paper held by the college. I was informed our representative accepted another job and the college had been assigned a new representative. I do not know what efforts were taken by Goldman, Sachs & Co. to resell the paper, but in any event they were unsuccessful.

<sup>14</sup> A clause of this agreement limited the customer to investing "in securities issued by the United States, CD's of banks and prime commercial paper as determined by generally accepted banking practice."

## KINDS OF CUSTOMERS WHO PURCHASED THE COMPANY'S COMMERCIAL PAPER

The customers who purchased the company's paper during this period fall into diverse categories: Institutions sophisticated in securities analysis; companies primarily engaged in manufacturing; colleges and universities; small banks; and individuals purchasing through banks. The vast majority of the customers were institutions or corporations.

Almost all the customers did no investigation of the company before or after purchasing its paper from Goldman, Sachs for a number of reasons. First of all, most of the institutions and corporations were not sophisticated in terms of their ability to gather and analyze the necessary information. Secondly, they did not have access to the kind of information necessary to make a meaningful investment decision on Penn Central's commercial paper. In addition, the quickness with which the decision had to be made would have prevented them from undertaking such an analysis. And last, almost all of the customers were relying on Goldman, Sachs' recommendation, and on the NCO rating and on the general reputation of the company.

### SUMMARY

Between November of 1969 and May of 1970 Goldman, Sachs sold \$83 million of Penn Central Transportation Co.'s commercial paper which was not repaid because of the latter's bankruptcy. During this time they became aware of information which cast doubt on the safety of this commercial paper. Most of the nonpublic information described above was not disclosed to customers. The information they did disseminate was out of date.

Despite repeated warning signals, Goldman, Sachs initiated no in-depth analysis. If they had, they would have found matters to be much worse.

In addition, Goldman, Sachs failed to disclose that they had reduced and were eliminating their inventory of the company's paper, that NCO had been induced to maintain the prime rating and that the company's paper was meeting strong resistance from customers.

### GOLDMAN, SACHS' POSITION ON THE SALES OF THE COMPANY'S COMMERCIAL PAPER

Goldman, Sachs' views concerning its sales of the company's commercial paper may be summarized in the following way. First of all according to Goldman, Sachs, its commercial paper operations were not lucrative when compared to its other activities. (For example in 1969 Goldman, Sachs had outstanding an average of \$4.7 billion in commercial paper, but their net profits from these sales was only \$435,000.)

According to Goldman, Sachs, the customers were sophisticated investors who purchased commercial paper in \$100,000 denominations. Goldman, Sachs felt that these customers were capable of making their own investment decisions and did not have to rely on Goldman, Sachs' opinion. Goldman, Sachs viewed itself as merely a conduit of commercial paper which made no recommendations as to the quality of the paper or the credit-worthiness of the issuers. Goldman, Sachs

would merely inform the customers as to what paper was available, and the customer would decide which paper it wished to purchase.

Goldman, Sachs also maintained that in the company, which was the country's fourth largest corporation, there were always sufficient assets which could be liquidated should the need arise, which provided sufficient protection for commercial paper holders.

Goldman, Sachs did take certain steps to disseminate information to customers and at least on two occasions did call in the company's top management for an explanation of what was happening. In addition, customers, if they so desired, could have obtained some information on the company since as a publicly held corporation it was required to make public its financial condition.



### III-B. ROLE OF NATIONAL CREDIT OFFICE IN RATING THE COMMERCIAL PAPER OF PENN CENTRAL

The concealment of Penn Central's condition was aided by Goldman, Sachs as described in the preceding section. Another entity, the National Credit Office (NCO), also contributed to the misleading of investors. This section is concerned with the activities of NCO prior to June 21, 1970, the date of bankruptcy, with respect to the commercial paper issued by the Transportation Co. and sold by Goldman, Sachs.

National Credit Office is a wholly owned subsidiary of Dun & Bradstreet, Inc. (D. & B.) which until on or about August 23, 1971, functioned as a rating agency for commercial paper. On August 23, 1971, the commercial paper rating service of NCO was transferred to Moody's Investors Services, Inc., another wholly owned subsidiary of D. & B. which is a registered investment adviser.

NCO had been rating commercial paper since 1920 and prior to 1970 it was essentially the only national commercial paper rating service. NCO was never registered with the Commission as an investment adviser.

As a standard method of operation, NCO would enter into a subscription agreement with the prospective issuer of commercial paper wherein the issuer would agree to pay an annual fee to NCO for appraising commercial paper and pursuant to which NCO agreed to evaluate and assign one of the following classifications to subscriber's (i.e., the issuer's) commercial paper:

*Prime.*—Companies with a net worth or capital funds (net worth plus long-term subordinated loans) in excess of \$50 million, which also meet NCO requirements and credit judgment in all other respects.

In the cases of "captive" finance companies, net worth or capital funds in excess of \$15 million are required in addition to meeting NCO requirements and credit judgment in all other respects.

*Desirable.*—Companies with net worth or capital funds (net worth plus long-term subordinated loans) of \$25 million to \$50 million, which also meet NCO requirements and credit judgment in all other respects.

*Satisfactory.*—Companies with net worth or capital funds (net worth plus long-term subordinated loans) ranging from approximately \$10 million to \$25 million, which also meet NCO requirements and credit judgment in all other respects.

*Fair.*—Companies which do not meet a sufficient number of NCO's requirements for the three preceding classifications.

*No Rating.*—Companies which do not meet any NCO requirements for inclusion in the commercial paper market.

Additionally, the issuer agreed to "furnish promptly to NCO pertinent financial reports and other data normally provided line banks, in order that NCO may accurately appraise the commercial paper."

From the foregoing it would appear that NCO's function was to rate the desirability of specific commercial paper. It would also seem apparent that as Mr. Eugene Schenk, the president of NCO, has stated:

NCO is the agency on which virtually all prospective buyers rely for ratings in the commercial paper field. Through the years our authoritative appraisals have been of material assistance in making a market for these short-term notes.

The commercial paper market which NCO had been engaged in as the sole national rating agency had experienced phenomenal growth in the late 1960's, primarily due to the severely tight money markets of that period and the relative ease and privacy of raising short-term debt afforded by this market. As the market grew rapidly, NCO's rating responsibilities grew concomitantly as the following data illustrates: NCO rated the following number of issuers in the respective categories at the indicated date.

	Apr. 1, 1970	December 1969	December 1968	December 1967
Industrial.....	266	236	149	108
Public utilities.....	163	153	82	25
Finance.....	118	112	99	92
Banking.....	47	42		
Insurance.....	10	9	1	
Transportation.....	11	9	4	2
Total.....	615	563	335	227

Thus in a period of 27 months the number of commercial paper issuers rated by NCO had increased by 388 or 271 percent. Further, by June 1, 1970, this number had increased to 647 issuers.

Included in this group of 615 issuers were Penn Central, King Resources Co. and Four Seasons Nursing Centers of America, Inc. all of which received a "prime" or highest possible rating.<sup>1</sup>

The relationship between NCO and the Transportation Co. which began in July 1968 was the customary one, described previously, between an issuer of commercial paper and NCO. After the execution of the subscription agreement and presumably after a customary review by NCO, the Transportation Co. was assigned a "prime" rating. This rating was listed by NCO and disseminated to all subscribers to its rating service.

Additionally, certain subscribers could at their election receive special service from NCO which consisted of a more extensive analysis of the issuer. In the case of Penn Central this would consist of excerpts from the latest annual report and interim financial data, if any, published by the issuer. The only other information contained in this report to subscribers not also contained in the annual report or interim financial statements were the rating classification by NCO, the identity of the dealer handling the paper and condensed information regarding the bank lines of credit available to the issuer, names of the lead banks, and amount of available credit, if any, from such banks.

All of the foregoing information plus, in the case of Goldman, Sachs, more detailed and current financial data was also customarily available to the dealer in the paper who also provided similar information to its customers.

Furthermore, the data contained in these NCO releases, except for the specific items heretofore mentioned, does not differ in any ma-

<sup>1</sup> It is interesting to note that not only was NCO's estimation of the quality of the notes issued by King Resources and Four Seasons deficient, but also that certain of such notes of both entities had a stated maturity of more than 270 days which would not qualify same for the statutory definition of commercial paper and exemption from registration.

terial way from that which Penn Central itself publicly disclosed either in annual or quarterly reports or in press releases which it issued. Moreover, none of these releases contains information as of a date prior to such public release by Penn Central. In fact, most of the data contained in the NCO releases is a mere reprint of Penn Central press releases or excerpts from annual reports.

Preliminary to a specific examination of NCO activities in rating the Transportation Co.'s commercial paper it is necessary to examine the standard or customary operating procedures at NCO during this period.

On September 15, 1969, Rudolph G. Merker was assigned as vice president in charge of NCO's commercial paper rating service. Prior to the assignment of Merker, responsibility for operation of this department had been assigned to Allen Rogers (now deceased.) However, Rogers had only been physically present in NCO's office twice since January 1965, preferring, apparently because of illness, to do his work from his home. The other analysts employed by NCO were located in the Manhattan office and the number of these individuals varied from three to four during this period.

Merker had previously been employed by D & B as manager of the retail and wholesale division of NCO, which apparently is part of the traditional D & B retail credit reporting system. Merker had been employed by NCO for 42 years, primarily in the retail credit reporting area. Merker has no college education and is not a chartered financial analyst. Prior to becoming head of the commercial paper division of NCO, Merker had very limited experience in the commercial paper rating area.

Merker stated that he was to assume Rogers' supervisory responsibilities, but that he did not know why he in particular was selected for this position. The following colloquy is illustrative of the conditions prevalent at NCO during this period:

*Question. When you assumed your responsibilities, were you instructed or informed as to what these responsibilities would be specifically, and if so, by whom were you informed?*

Answer. No; it was not spelled out.

*Question. How were you aware of what your responsibilities and duties would be?*

Answer. Well, it was just that being a department head, I knew what the responsibilities of a department head had been at NCO.

*Question. At the time you assumed your responsibilities, did you have any conversation or meeting with Mr. Rogers to explain what he expected of you and what you expected of him?*

Answer. No; not along these lines; no.

*Question. How was it determined what responsibilities you would have and Mr. Rogers would have after you assumed your new position?*

Answer. Well, he was a consultant and he was guiding me in my new position as director of commercial paper.

*Question. At the time you assumed your responsibilities, were there any written policies or operations manual for the different responsibilities in NCO?*

Answer. No; nothing in writing.

*Question. How did you become familiar with your duties and the manner of discharging them?*

Answer. Just by working with them.

*Question. With whom?*

Answer. With the problems and the reports and inquiries, and the workload of the day; and guiding and calling Allen Rogers and having his long years of knowledge in the department.

It would seem apparent from the foregoing that NCO's commercial paper department was relatively disorganized and of scant importance

in the D. & B. corporate complex as the person selected to manage same is a veteran functionary of limited skills and experience in this area and as he received no training or ongoing guidance in the performance of these duties.

In any event, Merker was responsible for the daily activities of the commercial paper division subject to the overall supervision of Eugene Schenk, president of NCO. Merker described the daily activities of his department as essentially consisting of supervising the activities of a limited number of analysts—three or four during the period from September 1969 to June 1970—who reviewed files, interviewed prospective issuers and responded to inquiries from subscribers to NCO's rating services.

Merker indicated that the analysts in rating the commercial paper would consider the issuer's annual reports and general operating statements to determine the issuer's liquidity. The analyst would individually review the issuer and assign a rating. However, the same analyst would not necessarily continue to be responsible for the rating of a particular issuer or a specific group of issuers. Thus, this responsibility would be rotated among the various analysts depending upon their availability and workloads. Prior to March 1970 there was no individual responsibility, for as Merker states:

\* \* \* we didn't have this individual control. It was a case of taking the reports and writing them as they became due to be written but no accounts were assigned to any specific analyst.

It should be noted that the system of rotating responsibility for assigning and/or reviewing the rating of issuers necessarily resulted in varying degrees of familiarity and expertise about such issuers by the NCO analysts.

In the ordinary course of rating commercial paper the issuer would enter into a subscription agreement whereby the issuer would agree to provide NCO with information which would differ in no material way from that information provided by the issuer to its line banks. This information would normally consist of the company's annual fiscal report, quarterly reports, profit-and-loss statements and press releases.

It was normal procedure for NCO to agree with the issuer that a specified officer of the company would provide the aforementioned information to NCO and be available to answer inquiries from NCO.

Normally, NCO, after having had an opportunity to review the aforementioned material might have occasion to personally contact the financial officers of the issuer for purposes of clarification.

However, it should be noted that NCO would not ordinarily consider whether or not the issuer had conformed to any or all applicable regulatory requirements prior to the issuance of the paper. The reason for this was that NCO was concerned primarily, if not exclusively, with the financial condition of the prospective issuer rather than the regulatory environment in which it might operate.

Moreover, the information that NCO would normally obtain in order to issue or continue a rating would not differ in content, detail or timeliness from that which was publicly available except as Merker stated:

\* \* \* bank information, the individual bank lines from an individual bank for that particular issuing company, the amount outstanding in bank lines, amount owing, and the high and low in bank borrowings for a period of time, either three months or it could be 6 months.

Merker also indicated that this information would be provided in the ordinary course to NCO by the banks without the need for prior authorization by the issuing company. However, this bank checking, if it did occur, would be quite infrequent, not even as often as annually.

Merker summarized the NCO prime rating as follows:

The NCO prime rating for a commercial paper issuer is giving our opinion of the liquidity of the company in that the commercial paper notes in our opinion would be met at maturity.

The NCO prime rating would be assigned after a review by NCO analysts of the issuer's financial statements. However, in making these determinations NCO did not have any internal guidelines or standard which it required issuers to meet; that is, standards regarding liquidity ratios, asset/liabilities ratios, quick capital ratio, or any other type of objective statistical standard.

Further, NCO regarded "liquidity," "bank support" and "operating performance" as the most important factors in assigning a rating. While Merker never specifically defined what NCO considered liquidity to be, his understanding of liquidity would appear to be the ability of the issuer to repay any outstanding amount of commercial paper at maturity.

NCO regarded "operating performance" as relating to the profitability of the issuer's operations for a period of time and "bank support" as the lines of bank credit available to "support" commercial paper.

NCO regarded 100 percent bank line coverage as desirable but not required in all instances. The percentage of bank line credit could even be 50 percent depending upon the issuer. Moreover, these lines of credit were not required to be confirmed or revolving, but merely unconfirmed lines would suffice to meet this NCO requirement.

NCO considered other factors also in making its credit determination. In particular, NCO considered the issuer's working capital position indicative of the issuer's ability to repay the commercial paper notes at maturity.

NCO defined "working capital" as current assets less current liabilities, including that portion of long-term debt due within 1 year. A concomitant part of this analysis of "working capital" was an evaluation of the issuer's ability to meet its current debt through cash flow. However, this cash flow was defined by NCO to include not only cash generated through operations but also the ability to raise short-term debt capital. Moreover NCO did not require any minimum dollar amount of working capital.

Further it is important to note that NCO did not require that the issuer's current assets exceed its current liabilities, although commercial paper itself is a current liability. NCO would also consider the availability of other assets which might be utilized to collateralize loans or which might be available for sale, if necessary, to raise capital.

NCO did not, however, require that the issuer have any specific ratio of assets which would be unencumbered by mortgage or lien and available for such use. Moreover, apart from reviewing the balance sheet, NCO would not confirm the amount and types of assets available for collateralization or disposition by sale, either from the issuer or its banks.

NCO also considered the investments of the issuer in securities of subsidiaries, affiliates, and unrelated parties, account or trade receivables, and investments in equipment or inventory.

NCO would not however inquire whether there were any restrictions on such investments (e.g. "letter" stock) or whether such investments had been used as collateral for loans, nor would NCO determine whether such investments were marketable or at what price, if any, these were marketable. As NCO stated, it was concerned solely with "the mere existence" of such investments.

Although NCO did state that it would consider the collectability and terms of payment of receivables, as well as encumbrances on inventory or equipment, its information would be provided by the issuer and would not be confirmed with any other source, for example, equipment trustees.

A further element in the NCO analysis is an "examination" of the corporate complex if an issuer should be part of same, for example, Penn Central Transportation Co. and Penn Central Co. NCO would evaluate the corporate complex, even though in the present market the issuer of the paper is solely responsible for its repayment, and no subsidiary, parent or affiliate guarantees repayment of principal and/or interest.

It should be noted moreover that NCO at this time did not consider any debt ratings of the issuer's securities, by either Standard & Poor's or Moody's, even though Moody's, like NCO, was a subsidiary of Dun & Bradstreet.

While the foregoing discussion of NCO's mode of operation was gleaned from testimony taken from Messrs. Merker and Rogers it is illustrative to consider the following excerpts from a letter written on January 29, 1969 by Louis C. Ward, manager, commercial paper division of NCO to Steven Clarke of the St. Louis Office of Goldman, Sachs & Co.<sup>2</sup>

As mentioned in my telephone conversation with you last week, it is difficult to list each standard we use in evaluating the quality of commercial paper notes, due to the diverse industries on which we report.

Even factors which may appear intangible to others, may be of pertinence in our reaching a rating decision, as per the examples I gave you on the phone.

However, some of the major points we look at are the following:

- (a) We compare each issuer's various ratios against industry averages.
- (b) Judge progress at least over the previous 10 years.
- (c) Evaluate the company and its markets and the market's potential.
- (d) Make an appraisal of principal officers and their business experience.
- (e) Analyze the company's potential in future years.
- (f) Review bank support and periodically contact a sampling of the company's line banks, as deemed necessary.

After reviewing the above, and taking into consideration the company's capital funds position (at least \$25 million net worth of capital funds are requisite for "prime", \$5 million for "desirable", \$1.5 million for "satisfactory"), we then determine the classification.

Another requirement we have is direct contact and discussion with financial management of the company, at least once a year when they are in New York to see the banks.

Occasionally, a nationally known firm seeks to enter the market, but somehow does not measure up to our evaluation of a prime company. Recognizing the questionable acceptance by the market were we to rate it as less than prime, we endeavor to persuade it to delay its plans to issue, until the particular problem we feel it has is alleviated or corrected.

<sup>2</sup> It should be noted that Clarke attached a photocopy of this letter to a letter he wrote on January 21, 1970 to W. N. Fedderspeel, comptroller of the Granite City Steel Co. of Granite City, Ill., as part of an explanation of what NCO was and what services it performed.

If the company, or dealer, decides to issue, anyway, we either withhold a rating completely or rate it as less than prime.

We feel this approach is equitable to the company and provides a measure of safety for the investor.

NCO had a continuing and extensive relationship with the major commercial paper dealers. This relationship consisted primarily of ongoing contacts between NCO and the dealers relative to information and/or opinions about specific issuers handled by the dealers. The dealers utilized NCO ratings as a marketing tool in offering commercial paper to their customers since many customers, particularly nonfinancial institutions, were required by statute or resolutions of their boards of directors or trustees, to purchase only that commercial paper which was rated prime by NCO, then the only national commercial paper-rating service. Due to the importance of an NCO rating, preferably a prime rating, dealers would require their issuers to obtain (at the expense of the issuer) a rating from NCO.

The largest and most influential commercial paper dealer is Goldman, Sachs & Co., which started as a commercial paper dealer and later expanded into a full-line broker-dealer. Goldman, Sachs was a subscriber to NCO's rating services and its issuers, whenever possible, obtained an NCO rating. Goldman, Sachs, as a customary part of its marketing of commercial paper, would communicate, orally and in writing, the NCO rating of the issuers it handled.

NCO personnel, in particular Merker, were acquainted with and had frequent contacts with Goldman, Sachs.<sup>3</sup> This relationship with Goldman, Sachs did not differ in any material way from those maintained by NCO with other commercial dealers. It apparently consisted primarily of frequent telephone conversations between NCO and Goldman, Sachs and the receipt by NCO of Goldman, Sachs' information sheets about the issuers handled by that firm.

The information sheets referred to were prepared by Goldman, Sachs and distributed to their customers. These were a short precis of the issuer and, according to NCO, did not contain any more extensive information or any more current information than that which was publicly available. Further, Goldman, Sachs did not explicitly make any evaluation on these sheets of the credit-worthiness of their issuers.

During the period from September 15, 1969, to June 1970, Merker was primarily responsible for the rating of Penn Central's commercial paper.<sup>4</sup> He stated that the reason why he became directly responsible for the Transportation Co. rating was: "Well, I had concern, but I was not overly concerned about it, and I was watching it."

When asked to explain the reasons for his concern Merker replied:

The bottom line was on the downgrade, and the railroad company was losing money very definitely, and it was a case that had to be watched very closely.

However, it should be noted that during this period Merker could not recall any other issuers for which NCO had the same concern. While Merker stated that his assumption of responsibility for the Transportation Co. rating was coincident with his becoming head of the NCO rating service on September 15, 1969, the first indication of any activity by him in this area was on October 2, 1969.

<sup>3</sup> The individuals at Goldman, Sachs were Robert G. Wilson, partner in charge of the commercial paper department of Goldman, Sachs; George Van Cleave, Wilson's assistant; Jack Vogel, the chief credit analyst of the commercial paper department; and Walter Fekula, a credit analyst.

<sup>4</sup> It is significant to note that Merker could not recall any other issuer for which he had the primary responsibility of rating during this period.

Merker's concern was prompted by a telephone conversation with Rogers who discussed an unfavorable item about Penn Central appearing in the Robert Metz column in the New York Times of that day. After receiving this information Merker reviewed the June 30, 1969, data in Moody's Transportation Manual which disclosed declining profits on a consolidated basis and a loss for the Transportation Co. itself for the 6 months ended that day. On October 3, 1969, Merker spoke with Jack Vogel of Goldman, Sachs regarding Penn Central. Vogel stated that he was not concerned about the 6-month results nor the unfavorable items in the New York Times. With respect to this conversation with Vogel, Merker testified as follows:

*Question. Did you rely on Mr. Vogel's comments?*

*Answer. Yes; I did.*

*Question. Did you have any basis for relying on his comments?*

*Answer. He is a responsible man and well recognized in the commercial paper market.*

*Question. You were aware though, I assume, that at the time he was working for the dealer in Penn Central commercial paper and as such it would seem to me that he would tend to be as favorable as possible on the security. Did you take this into consideration?*

*Answer. I do not think that Jack would have misled me.*

*Question. Did you see any conflict of interest in his position in that he is handling and his organization is selling this particular issue and you are asking him for his opinion on paper which they are selling on a continuing basis?*

*Answer. No; I didn't see any conflict of interest, no.*

The reason for Vogel's lack of concern was the existence of bank lines of credit of \$300 million available to the Transportation Co. Merker, however, did not inquire as to what amounts were then available or what conditions, if any, were applicable to the availability of same.

After speaking with Vogel, Merker wrote to Jonathan O'Herron, Penn Central's vice president (finance) and asked for interim operations figures, a list of banks of Penn Central's and bank credit lines and the high and low borrowings and other short-term debt. Merker received the requested information from O'Herron in October 1969. Merker stated that in reviewing the Transportation Co. file: " \* \* \* I saw no need for action as far as the rating was concerned."

On October 28, 1969, NCO issued a release to its subscribers on the Transportation Co., which gave consolidated earnings and revenues for 9 months of 1969 which indicated a downward trend. NCO however, then stated:

From this office's point of view the commercial paper standing of this company is not affected because of the readily salable assets of the subject, if the need arose.

On October 29, 1969, NCO issued another release on Penn Central which stated in part:

Jonathan O'Herron vice president—finance, has advised that the company has available a \$100 million line of credit to support its commercial paper position.

At this same time Penn Central had approximately \$150 million in commercial paper outstanding.

On November 6, 1969, the ICC authorized Penn Central to issue another \$50 million in commercial paper, increasing the authorization to \$200 million. The ICC's concern with the use of short-term debt has already been described.<sup>5</sup> However, despite the fact that this

<sup>5</sup> See discussion at page 280.



concern was expressed in a public document, NCO never reviewed it and was unaware of the serious implications of the ICC statement.

On November 26, 1969, Penn Central announced that for the first time in its history it was suspending payment of quarterly dividends. This action was taken by Penn Central " \* \* \* to conserve cash and in keeping with responsible management." Apart from notifying its subscribers of this already public information, NCO did not take any action with respect to the company's rating.

In December 1969, Pennco for the second time in 6 months was used as a financing vehicle to raise money for the Transportation Co.<sup>6</sup> NCO took no action regarding a review of the Transportation Co. rating, even though these facts, evidencing lack of financing capability by the parent Transportation Co., were publicly stated in the offering circular for the debentures issued by Pennco at this time.

On February 4, 1970, Penn Central announced preliminary 1969 results on a consolidated and unconsolidated basis. On a consolidated basis Penn Central had earnings before extraordinary items of \$4.4 million in 1969 as compared with \$87 million in 1968. The Transportation Co. lost \$56.3 million, compared with only \$5.1 million a year earlier.

When asked what NCO did upon receipt of this information Merker replied: "We had discussed it among the analysts and decided to wait for the balance sheet of December 31, 1969."

According to Merker, NCO did nothing else about Penn Central at this time. However, on February 5, 1970, Allen Rogers of NCO spoke with Jack Vogel of Goldman, Sachs. According to Vogel their conversation was as follows:

Alan Rogers of NCO called me today to express concern over the sharply reduced earnings announced in the newspapers today. He asked if we were continuing to sell the company's notes and whether I felt that Penn Central had sufficient resources which could be converted to cash to pay down debt, if necessary. I said that Goldman, Sachs was continuing to sell the commercial paper notes of Penn Central Transportation Co. In answer to question No. 2, I suggested that the company has a number of valuable properties and securities, and that I was certain that something could be worked out should it ever become necessary. Alan said that as a result of my comments, he would continue to carry Penn Central Transportation Co. as a prime name.

In his testimony Rogers stated that he could not recall such a conversation, but he admitted that it was possible that NCO continued rating the Transportation Co. as prime as a result of Goldman, Sachs' confidence in it.

In March 1970 Penn Central released the audited 1969 results and a balance sheet as of December 31, 1969. This report confirmed in detail the preliminary results announced on February 4, 1970.

Upon receipt of this report NCO reviewed same. However, this report was reviewed by a committee of NCO personnel, namely Merker, Rogers, Dan Cahalane (a junior analyst), and Eugene Schenk. NCO did not, however, take any action whatsoever with respect to the Penn Central rating until April 23, 1970. On that day Merker wrote to O'Herron as follows:

We are presently reviewing our classification. Because of the very substantial losses recorded last year; and it is apparent that the operating performance for the first quarter of the current year was rather disappointing for the parent organization just reported a loss of \$17.2 million, we would appreciate your assistance in furnishing some additional information.

<sup>6</sup> See section on Finances in Part I of this report.

Mr. O'Herron, in the event that additional capital must be raised, what assets would be available for this purpose? Also, please tell us how the funds from the sale of commercial paper notes are being used.

This information, and any other comments that you care to make would be very helpful in our analysis.

Unfortunately for NCO, O'Herron never responded to this inquiry even though Merker sent a followup letter on May 18, 1970.

On April 22, 1970, Penn Central announced a first-quarter loss of \$17.229 million compared with consolidated net income of \$4.601 million for first quarter 1969. The Transportation Co. had a first quarter loss of \$62.7 million compared with a loss of \$12.8 million in 1969. And it was obvious that even these substantial losses were not reflective of the underlying situation since they included the impact of large reported profits on two transactions.<sup>7</sup>

During the period from April 23 to May 18, 1970, NCO discussed the Penn Central situation but did not ever consider lowering the company's rating from prime, nor did they take any further action. In fact, the primary topic of discussions during this period was the failure of Penn Central to reply to the letter of April 23.

Moreover, NCO was not aware that the last sale of the Transportation Co.'s commercial paper occurred on May 1, 1970; that Goldman, Sachs ceased to offer the company's commercial paper on May 20, 1970; and that as of April 23, 1970, Goldman, Sachs required its sales personnel to inform prospective customers of the Penn Central earnings announcement of April 22, 1970.

NCO was unaware that the May 12, 1970, offering circular for the Pennco \$100 million debenture offering contained the following statement at page 4:

At May 8, 1970, railroad had outstanding \$152.1 million of commercial paper pursuant to orders of the Interstate Commerce Commission authorizing up to \$200 million of such paper. To the extent that commercial paper outstanding has been less than \$200 million, railroad has borrowed under a \$50 million bank line of credit. As additional backing for its commercial paper railroad has available \$50 million under the credit agreement referred to under introduction. Between April 21, 1970 (the day preceding the announcement of the operating results of railroad for the 3 months ended March 31, 1970) and May 8, 1970, maturities and payments of commercial paper exceeded sales of commercial paper by \$41.3 million. Of the commercial paper outstanding at May 8, 1970, approximately \$75 million matures prior to June 30, 1970, and the balance at various dates to December 16, 1970.

Although this was a preliminary offering circular, it should have been available to NCO pursuant to their subscription agreement with Penn Central. NCO, however, did not become aware of the fact that the company's redemptions of commercial paper were exceeding sales until the appearance of a Wall Street Journal article on May 27, 1970.

On May 15, 1970, Standard & Poor's downgraded the bond rating of the Pennsylvania Company and its proposed \$100 million debenture offering. On May 18, 1970, Merker spoke with Jack Vogel of Goldman, Sachs. According to Vogel, Merker asked him if he still felt the same way about Penn Central in view of Standard & Poor's rating change. Vogel replied affirmatively and Merker accepted his explanation for the change.<sup>8</sup>

On May 28, 1970, Merker spoke with Jack Vogel about Penn Central. Vogel after stating that the Transportation Company had bank

<sup>7</sup> See discussion at page 54.

<sup>8</sup> Merker, however was unable to recall that the conversation took place and the content of same.

credit still available to redeem commercial paper, also suggested that Merker check the May 12th offering circular.

Merker did obtain a copy and on June 1, 1970, after internal discussions at NCO between Merker, Schenk & Rogers, Merker called O'Herron asking for more information. O'Herron declined to provide same and this, coupled with the fact that the \$100 million offering was aborted, prompted NCO to reserve Penn Central's rating pending further information. Effectively this meant that NCO while not refusing to rate the Transportation Company's commercial paper, was not assigning a rating for a limited period as well as downgrading it from prime.

After discussing this action with Vogel and O'Herron, NCO then issued a press release regarding this action. A mere 3 weeks later, Penn Central filed for reorganization.

## PART IV

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### IV. PENPHIL COMPANY (PENPHIL)

#### INTRODUCTION

Penphil, a private investment company whose stockholders include David Bevan (D. Bevan), other members of the Pennsylvania Railroad Co.'s (PRR) financial department, and officers of companies in which it made investments, purchased securities at a cost of over \$2.2 million between 1962 and 1968. Charles J. Hodge (Hodge) and D. Bevan controlled Penphil.

Penphil was closely related to the PRR. Most of the funds for Penphil's investments came from loans made by Chemical Bank. At the time these loans were made D. Bevan was the chief financial officer of the PRR (and later the Penn Central) which had substantial banking relationships with the Chemical Bank. D. Bevan was also in charge of the investments of the PRR and its employee funds. In nearly all instances, the PRR and its employee funds invested in companies in which Penphil was to make or had made investments.<sup>1</sup> The possible conflicts of interest arising from Penphil's investments were never disclosed to the PRR board of directors.

Penphil also engaged in the practice of inviting officers and directors of companies in which Penphil invested to become members of Penphil. This put Penphil in the position of having an avenue of access to information concerning the day-to-day operations of the companies.

In July 1962, D. Bevan and Hodge, a partner in Glore Forgan—who was to become instrumental in PRR's diversification program of the mid-1960's—organized Penphil for the purpose of buying and selling securities of companies about which Penphil had intimate knowledge because of close business relationships between Penphil shareholders and the companies.<sup>2</sup>

In connection with these purchases D. Bevan, Glore Forgan, and Hodge arranged for the Chemical Bank, New York, to extend a line of credit to Penphil. Because of D. Bevan's position at the PRR, the Chemical Bank was willing to make these loans to Penphil at the prime rate without compensating balances and with the securities purchased as the only collateral. Prior to 1966, the Chemical Bank loaned Penphil more than 95 percent of the cost of its investments in stocks, most of which were traded over-the-counter. Overall, the Chemical Bank, between 1962–1968, loaned Penphil over \$1.7 million to buy securities at a cost of more than \$2.2 million. The loan balance was at times as much as \$1.2 million.<sup>3</sup>

<sup>1</sup> In the latter parts of this section no distinction is drawn between the investments made by the company and by the employee funds. Both are referred to as PRR or Penn Central investments hereinafter, unless otherwise specified.

<sup>2</sup> A table giving background information on Penphil shareholders has been attached as Exhibit 1.

<sup>3</sup> See discussion *infra* at p. 307 *et seq.*

## SUMMARY OF TRANSACTIONS

In July 1962, Penphil made its first purchases of securities when, on the recommendation of Hodge, a Kaneb Pipe Line Co. (Kaneb) director and a member of its executive committee, Penphil bought Kaneb stock at a cost of \$115,925. The July purchases were made with knowledge of nonpublic information regarding a substantial increase in Kaneb's earnings during the first third of 1962 and earnings per share estimates for the year. Penphil purchased additional Kaneb stock at a cost of \$40,000 in February 1963. At that point Hodge had information about Kaneb's 10-year estimates of favorable revenues, earnings and cash flow. During 1962 and 1963, the PRR and various Penphil stockholders also purchased Kaneb stock. These purchases were made when each had nonpublic information concerning major pipeline expansion plans and significant increased earnings of the company. As of April 20, 1972, Penphil still held its shares and had an unrealized profit of \$926,000.

Penphil's next purchase was 10,000 shares of Great Southwest Corp.—GSC—common stock in July 1963. Hodge, a GSC director, had nonpublic information about a dramatic and unexpected improvement in GSC fiscal 1963 earnings which were expected to double 1962 earnings. In March 1964, D. Bevan personally purchased GSC shares while in possession of information not publicly available that the PRR was considering acquiring 80 percent of GSC's outstanding stock. In November and December 1965, Penphil, D. Bevan, and Hodge sold their shares of GSC to the PRR at substantial profits. Penphil's profit was \$212,500.

In August 1963, Penphil, on Hodge's recommendation, made purchases of the common stock of Tropical Gas Co., Inc. (Tropical) Hodge, also a Tropical director, was intimately aware of the company's affairs.

In May 1964, Penphil bought Continental Mortgage Investors (CMI) shares for \$196,800. Prior to this purchase Penphil had obtained significant confidential information from CMI's investment banker. This information came from a partner of that firm who was also a Penphil stockholder. This information concerned CMI's confidential plans for \$10 million of long-term debt financing and its cancellation of plans for further equity financing; both announcements, when publicly made, were expected to have the desired effect of removing the lid on the price of CMI stock. Penphil still holds these shares and as of June 2, 1971, had an unrealized profit of more than \$1 million.

From May 29 to June 2, 1967, nine Penphil stockholders and the PRR bought an aggregate of 5,539 shares of Symington Wayne Corp. (Symington Wayne). On June 27, 1967, Penphil bought 1,000 Symington Wayne shares. These purchases were made with knowledge of private merger discussions. Symington Wayne was conducting with two competing companies.

The terms being proposed were very favorable to Symington Wayne and its shareholders in that if either offer was accepted it would cause Symington Wayne shares to immediately increase in price. The subsequent public disclosure of these negotiations resulted in the stock selling at an immediate and substantial premium. By the end of January 1968, Penphil, seven of its stockholders and the RPR sold their Symington Wayne shares at substantial profits.

In late 1965, D. Bevan, Hodge, and Benjamin F. Sawin (Sawin) a Penphil stockholder and its bank expert, made plans for Penphil to invest in a chain of Florida banks. They determined to do this through initial investments in two banks in Boca Raton, Fla. controlled by Thomas F. Fleming, Jr. (Fleming). Penphil used personnel and assets of Arvida Corp. (Arvida) a newly acquired subsidiary of the PRR, to meet with and obtain an agreement from Fleming that he would arrange for stockholders of these banks to sell Penphil some of their bank stock which, at the time, was tightly held. At least Penphil's initial purchases of this bank stock were made at a time when some of its members were in possession of nonpublic information concerning significant business developments in the Boca Raton area and private plans of the bank to sell stock to its stockholders at \$6 below market. Penphil has an unrealized profit on these purchases of more than \$742,000.

Finally, in June 1968, Penphil bought 5,000 shares of National Homes Corp. (National) common stock on the recommendation of Lawrence M. Stevens, a Penphil stockholder who was the manager of the Philadelphia office of Hornblower and Weeks-Hemphill, Noyes. During that same month three Penphil stockholders bought an aggregate of 2,200 National shares. National is the only instance where it appears Penphil invested without having any inside relationship with the target company. It is significant that Hodge opposed this investment, saying that the stock should not be held blindly.

As a result of its investments Penphil has made a profit of \$226,895.51 from securities bought and sold, and, as of June 1971, had an unrealized gain of \$3,026,476.40 from securities held. Penphil has not had a loss on any of its investments with the single exception of a \$40,000 note which it purchased from Holiday International Tours. The latter investment was associated with the EJA situation discussed elsewhere in this report.

#### BACKGROUND—PENPHIL

In the summer of 1962, D. Bevan and Hodge were the principal organizers and promoters of Penphil, a closely held corporation which was designed to engage in the business of purchasing, holding, and selling securities for its own account. On July 19, 1962, the day after its first securities purchase, Penphil was incorporated in Pennsylvania by Thomas Bevan, an attorney who was David Bevan's brother. Prior to Penphil's incorporation, 13 personal friends of David Bevan and Charles Hodge were invited by them to be stockholders. All were substantial businessmen, many being officers or directors of publicly held companies. Immediately upon its incorporation, Penphil issued 3,000 shares of its common stock by selling 200 shares to each of the 13 friends as well as Charles Hodge and David Bevan for a total capitalization of \$15,000. It was planned that Penphil's capital structure would be thin with substantially all of the funds needed for its business to come from bank loans.

Between July 1962 and the present, Hodge and Bevan invited and arranged for 15 additional people to become shareholders of Penphil. Ten of these persons purchased their shares either directly from Penphil or from one of the original shareholders. Five persons became shareholders when a corporation of which they were stockholders, Florphil Co., was merged into Penphil. Florphil had been incorporated to give

these five shareholders an opportunity to participate in certain of Penphil's investments. This matter will be discussed subsequently.

The evidence indicates that Penphil's investment objective was to purchase securities of issuers about which it had a great deal of current material information. Although any Penphil stockholder could suggest possible investments, investment decisions were, in fact, made by a small number of Penphil stockholders who dominated the affairs of the company.

From its establishment in July 1962 until October 20, 1970, Penphil made investments in common stocks, notes, warrants, U.S. Treasury bills and commercial paper. The following is a list of all of Penphil's investments other than U.S. Treasury bills and commercial paper:

Trade date	Issuer	Shares purchased and (sold)	Cost or (proceeds)
July 18-23 1962.....	Kaneb Pipe Line Co.....	22,633	\$115,925.35
Feb. 1, 1963.....	do.....	5,000	40,000.00
July 18, 1963.....	Great Southwest Corp.....	10,000	165,000.00
Aug. 1-29, 1963.....	Tropical Gas Co.....	10,000	191,495.27
May 8, 1964.....	Continental Mortgage Investors.....	10,000	196,800.00
Dec. 7, 1965.....	Great Southwest Corp.....	(10,000)	(376,949.00)
Sept. 27, 1966-Jan. 6, 1967.....	First Bank & Trust Co. of Boca Raton, Fla.....	8,250	249,972.00
Jan. 12-Mar. 27, 1967.....	University National Bank of Boca Raton, Fla.....	4,733	62,640.00
June 27, 1967.....	Symington Wayne Corp.....	1,000	34,234.38
Nov. 2, 1967.....	Kaneb Pipe Line Co.....	<sup>2</sup> \$500,000	493,544.90
Do.....	do.....	17,653	7,653.00
Jan. 4, 1968.....	Symington Wayne Corp.....	(1,000)	(41,549.16)
Feb. 21, 1968.....	Holiday International Tours.....	51,000	25,000.00
June 5, 1968.....	National Homes Corp.....	5,000	74,101.53
June 21, 1968.....	Holiday International Tours.....	<sup>2</sup> \$40,000	40,000.00
July 26, 1968.....	First Bank & Trust Co. of Boca Raton, Fla.....	1,815	90,750.00
Aug. 21, 1968.....	Holiday International Tours.....	(51,000)	<sup>2</sup> (25,000.00)
Sept. 10, 1968.....	Kaneb Pipe Line Co.....	<sup>2</sup> (\$500,000)	(516,423.62)
Nov. 18, 1968-Jan. 13, 1970.....	First National Bank of Deerfield Beach, Fla.....	( <sup>2</sup> )	(12,886.11)
Oct. 20, 1970.....	U. S. Freight <sup>4</sup> .....	(8,900)	(198,345.74)
Do.....	National Homes Corp.....	(5,000)	(82,407.01)

<sup>1</sup> Warrants.

<sup>2</sup> Note.

<sup>3</sup> Advance.

<sup>4</sup> Penphil received 8,900 shares of United States Freight Co., in exchange for its 10,000 shares of Tropical Gas Co., Inc., upon Tropical's acquisition by United States Freight in October 1969.

As the result of purchases, sales, stock dividends and splits, Penphil's investment portfolio as of June 2, 1971, contained the following shares of common stock and warrants to purchase common stock:

Issuer:	Shares
Kaneb Services, Inc.....	<sup>1</sup> 30,488
Continental Mortgage Investors.....	60,000
First Bancshares of Florida, Inc.....	<sup>2</sup> 52,096
Kaneb Services, Inc., warrants.....	7,653

<sup>1</sup> Kaneb Services, Inc. is the successor of Kaneb Pipe Line Company.

<sup>2</sup> Penphil received shares of First Bancshares of Florida, Inc. (First Bancshares) in exchange for its shares of First Bank and Trust Co. of Boca Raton (First Bank) and University National Bank of Boca Raton (UNB). First Bancshares is a registered bank holding company which was formed on or about October 15, 1970 to hold the stock of First Bank, UNB, First Bank of Riviera Beach, and Citizens Bank of Palm Beach County.

Only a small portion of the money which Penphil invested in securities came from Penphil shareholders. Penphil shareholders invested only \$389,062, and \$209,000 of this amount was not invested until late 1969. Penphil's largest source of funds was a line of credit extended by the Chemical Bank. Such loans were made at the prime rate with no compensating balances required and were secured entirely by the securities which the loans were used to purchase.

## CHEMICAL BANK

The PRR had done banking business with the Chemical Bank since 1891 and its account with Chemical was one of the PRR's largest and one of the bank's oldest accounts. As of the latter part of December 1961, the PRR had more than \$22,718,000 in outstanding loans from the Chemical Bank and was maintaining a compensating balance of between \$4,543,000 and \$5,818,000.

The banking relationship between the Chemical Bank and the PRR was a close one, and as vice president—finance, D. Bevan was a key man in the relationship. Bevan had known William S. Renchard, president of the bank since at least 1946, when Bevan was with N.Y. Life Insurance Co. D. Bevan had a personal line of credit with Chemical at the prime rate since at least 1960.<sup>4</sup> Hodge's and Sawin's relationship to the Chemical Bank also appears to have been very close. Glore Forgan had a long standing banking relationship with the Chemical Bank. Since 1961, Hodge had a personal line of credit, which reached a loan balance of nearly \$950,000 by November 1968.<sup>5</sup> Sawin was president of an important Philadelphia bank and acquainted with Renchard.

During the week of July 16, 1962, D. Bevan telephoned Renchard to arrange financing for Penphil's purchase of Kaneb. Renchard's memorandum of this conversation is as follows:

To: Messrs. M. P. Chamberlain, C. A. McLeod.

From: Mr. W. S. Renchard.

David Bevan, financial vice president of the Pennsylvania Railroad Co., called me on the telephone today and said that he and a group of friends, totaling about 15, are planning to organize a corporation to purchase a substantial block of common stock of Kaneb Pipe Line Co. The group will include Charlie Hodge of Glore, Forgan & Co., Benjamin F. Sawin, president of Provident Tradesmens Bank & Trust Co., Messrs. Gerstnecker and Haslett of the Pennsylvania Railroad's financial staff and others.

They have in mind the purchase of a block of 25,000 shares of Kaneb stock at a price of somewhere between \$5 and \$6 a share. Mr. Bevan said he had made a thorough study of the outl \* \* \* company and thought this was a very desirable purchase. Apparently \* \* \* block is being sold for tax reasons. The group \* \* \* equity into \* \* \* could pay in \$7,500 additional \* \* \* months' \* \* \* amounts of money borrowed \* \* \* would like to set the loan up \* \* \* basis at the prime rate of interest. WSR told Mr. Bevan we would be glad to handle this accommodation for him and suggested that he have whoever is handling the mechanics get in touch with Mr. Chamberlain or, in his absence, Andy McLeod.

Frankly, the rate on the proposed loan is too low, but, in view of the size of the deal and the fact that it has such good friends connected with it, WSR felt it was preferable not to quibble with Mr. Bevan over the rate. He indicated that George Bartlett of Glore, Forgan & Co. would probably be the one to negotiate the purchase of the stock and very likely Charlie Hodge would be the one to work out the mechanics of the loan arrangement.<sup>6</sup>

Hodge, a managing partner of Glore Forgan, thereafter contacted C. A. McLeod, a Chemical Bank vice president, regarding the loan on the morning of July 23, 1962, and that day McLeod mailed Warren Bodman, another Penphil member, and a partner in Yarnall, Biddle & Co., a broker-dealer, the necessary corporate papers for the loan account to be opened by Penphil along with a demand note form and loan purpose statement form. Penphil completed its purchase of

<sup>4</sup> Prime rate loans for individuals are highly unusual.

<sup>5</sup> Staff Report of the Committee on Banking and Currency, House of Representatives on *The Penn Central Failure and the Role of Financial Institutions*, 92nd Cong., 1st Session, ("Patman Report"), p. 201.

<sup>6</sup> The memorandum is in poor condition and pieces of it are missing. Letters *italicized* are readings from fragmentary letters.



22,633 shares of Kaneb stock the next day, and Glore Forgan subsequently delivered the certificates to the Chemical Bank against payment.

Although the purpose of the initial Chemical Bank loan was to purchase shares of Kaneb stock, the effect was that Hodge and D. Bevan established for Penphil a line of credit with the Chemical Bank which was to provide it with a ready source of funds for its purchases of securities. From the time of this first loan through August of 1968, Penphil, when it wished to buy stock, would merely have T. Bevan contact the bank by telephone, advise the bank that stock was being purchased, that a loan of a specified amount would be required and that the certificates would be delivered against payment. The evidence shows that the bank would then mechanically and routinely pay for such stock upon delivery. During the period from July 1962 to at least February 1968, Penphil purchased, among other securities, 27,633 shares of Kaneb, 10,000 shares of GSC, 10,000 shares of Tropical, 10,000 shares of CMI, 10,065 shares of First Bank and 4,733 shares of UNB. All of these securities were traded in the over-the-counter market. In connection with the purchases of the Kaneb, GSC and Tropical stock, Glore Forgan was the executing broker-dealer and Hodge was the salesman. After each purchase Glore Forgan caused the stock to be delivered to the Chemical Bank against payment. As previously noted, Hodge, a partner of Glore Forgan, had participated in the arrangements whereby the Chemical Bank extended the credit for the purchase of these securities.<sup>7</sup> Similarly the CMI shares were purchases on credit extended by the Chemical Bank although the executing broker-dealer delivering the shares to the bank against payment was Hemphill, Noyes. At least the 1,815 shares of the Florida bank stock purchased on July 26, 1968, were delivered to the Chemical Bank as collateral by T. Bevan. Purchases of the rest of the First Bank and UNB shares by Penphil were largely made with proceeds from the sale of securities originally purchased with Chemical Bank loans.

The following chart reflects the dates and amounts of loans made by the Chemical Bank to Penphil to finance the purchase of securities.

<sup>7</sup> Regulation T of the Federal Reserve System establishes margin requirements on loans by a broker-dealer for the purchase of securities, and further prohibits him from arranging for loans by others on a basis more favorable than he himself could provide. It appears that the credit extended was not in accordance with the provisions of regulation T.

Loan Date	Loan Amount	Purchase Amount	Security
August 20, 1962	\$102,000.00	\$115,925.35	Kaneb common. <sup>1</sup>
February 8, 1963	40,000.00	40,000.00	Do. <sup>1</sup>
July 25, 1963	120,000.00	165,000.00	Great Southwest common. <sup>1</sup>
August 8, 1963	47,450.00	47,450.00	Tropical Gas common. <sup>1</sup>
August 14, 1963	25,012.30	25,012.50	Do. <sup>1</sup>
August 16, 1963	27,187.50	27,187.50	Do. <sup>1</sup>
August 26, 1963	30,026.25	30,026.25	Do. <sup>1</sup>
September 9, 1963	<sup>2</sup> 45,636.75	42,036.75	Do. <sup>1</sup>
September 11, 1963	8,057.52	8,057.52	Do. <sup>1</sup>
September 13, 1963	4,000.00	4,000.00	Do. <sup>1</sup>
September 20, 1963	3,749.95	3,749.95	Do. <sup>1</sup>
March 23, 1964	<sup>3</sup> 1,739.95		
May 25, 1964	196,800.00	196,800.00	CMI shares. <sup>1</sup>
December 29, 1965	<sup>2</sup> 379,000.00	372,433.33	U.S. Treasury Bill <sup>1 10</sup>
September 15, 1966	<sup>4</sup> 15,000.00		
June 29, 1967	10,000.00	34,234.38	Symington Wayne common.
October 17, 1967	<sup>5</sup> 40,000.00		
November 2, 1968	493,000.00	501,197.90	Kaneb \$500,000 debenture and warrants.
June 24, 1968	<sup>6</sup> 50,000.00	74,101.53	National Homes common.
June 25, 1968	40,000.00	40,000.00	International Air Bahamas and Holiday International Tours notes.
August 30, 1968	760,000.00	90,750.00	First Bank common. <sup>1</sup>
October 4, 1968	<sup>8</sup> 30,000.00		
Total	\$1,768,659.92		

<sup>1</sup> Delivered to Chemical Bank against payment and held by Chemical as collateral.

<sup>2</sup> The disposition of the additional funds is unknown.

<sup>3</sup> The purpose of this loan is unknown.

<sup>4</sup> Loan to pay estimated Federal tax.

<sup>5</sup> Funds used to purchase Penphil stock from the estate of Leslie Cassidy.

<sup>6</sup> Purpose of this loan is uncertain but it appears to be for the purpose of purchasing National Homes stock.

<sup>7</sup> With this loan, Penphil's loan balance reached its maximum figure, \$1,228,000.

<sup>8</sup> Money borrowed to be deposited in overdrawn bank account to pay interest due and to pay current bills.

<sup>9</sup> As of June 30, 1971, Penphil still had an outstanding loan balance of \$280,000.

<sup>10</sup> A series of short term investments were made on a "roll over" of these funds.

It was possible for Penphil to buy securities at a cost of more than \$2,200,000 because of the highly unusual and enviable relationship between the Chemical Bank and certain Penphil stockholders. This relationship enabled Penphil to borrow, at the prime rate and without compensating balances, 95 percent of the cost of the securities purchased before 1966 and 79.7 percent of Penphil's total investments.

## KANEB PIPE LINE CO.

### BACKGROUND

Kaneb Pipe Line Co.,<sup>8</sup> a Delaware corporation with its principal office in Houston, Tex., was organized in 1953, for the purpose of transporting petroleum products by pipeline in Kansas and Nebraska. As of December 31, 1961, the company had 885,385 shares of common stock outstanding. The stock traded in the over-the-counter market. As of December 31, 1961, the PRR and the following persons who became Penphil shareholders owned Kaneb stock:

	Shares
Fisher <sup>1</sup>	97,263
Hodge	7,954
D. Bevan	155
T. Bevan	100
Horner <sup>2</sup>	3,082
PRR	15,782

<sup>1</sup> As of December 31, 1961, Fisher was Kaneb's second largest stockholder with 97,263 shares. The Northwestern Mutual Life Insurance Co. was the largest shareholder with 99,189.

<sup>2</sup> Edwin Horner, an investment banker of Lynchburg, Va. was a friend of Hodge.

<sup>8</sup> The name was changed in 1971 to Kaneb Services, Inc.

Herbert Fisher (Fisher) was president of Kaneb and was also president of Pipe Line Technologists (Pipetech), a consulting firm which provided the management of Kaneb under contract and which had been a consultant to the PRR since the 1950's. Hodge had been a director of Kaneb and, along with Fisher, a member of its three man executive committee since the mid-1950's. Glore Forgan was Kaneb's investment banker.

#### KANEB'S BUSINESS OPERATIONS 1961-62

For 1961 Kaneb's net income of \$38,547 was down from \$505,815 in 1960 due to "generally depressed conditions . . . throughout the Midwest petroleum products market during 1961." However, on March 5, 1962, Fisher wrote the Kaneb directors, including Hodge, and reported that shipments of fuel oils in January and February were at record highs due to severely cold weather in the areas served by Kaneb. He also stated that "As a result revenues are up more than 20 percent and earnings are expected to more than double those for the first 2 months of 1961."

A report to the shareholders included in the 1961 annual report and dated March 15, 1962, and distributed about April 1, briefly mentioned that business during the first 2 months of 1962 was stronger than during the comparable period of 1961, but gave no figures and no indication of the magnitude of the improvement. A detailed report of first quarter earnings was presented at Kaneb's annual shareholders meeting on April 16, 1962, but since only two persons who were not part of management were present and no press release was issued no public dissemination of this information occurred. During the latter part of May 1962, Hodge was informed that Whatley estimated 1962 earnings per share would be 58 percent greater than in 1961. A public announcement of the significant information concerning the improvement in Kaneb's earnings was made during the last week of August 1962, when Kaneb's semi-annual report was mailed to shareholders.

At least by August 1961, and continuing into 1962 Kaneb was also privately considering several proposals for the expansion of the transmission of liquid propane to its main line system. Fisher believed that this expansion would have a significantly favorable effect on Kaneb's earnings.

#### KANEB STOCK PURCHASES DURING 1962 BY THE PRR AND PENPHIL STOCKHOLDERS

From February 1962 to June 1962, D. Bevan and Robert Haslett, who was director of investments of PRR and also a Penphil member, caused the PRR to buy in 10 transactions 9,642 Kaneb shares at prices ranging from \$6 to \$7 per share. These purchases increased the PRR's holdings to 25,424 shares, an increase of 61 percent. Each of these transactions was executed by Glore Forgan on an agency basis with Hodge as the salesman.<sup>9</sup>

<sup>9</sup> Included in these ten transactions was a purchase on February 9 and a purchase on April 18, the same days that Horner, a friend of Hodge and subsequently a Penphil stockholder, bought Kaneb stock. Although a great majority of Horner's previous and subsequent transactions were executed through another broker-dealer, the Kaneb shares were purchased through Glore Forgan. Whether Hodge recommended these purchases is presently unknown.

On July 18, 1962, the day before Penphil's incorporation, Hodge and D. Bevan caused Penphil to begin buying Kaneb stock by purchasing 3,000 shares at \$5 per share. On July 19, Penphil purchased an additional 19,033 shares and on July 23 another 600 shares at \$5 per share for a total of 22,633 shares at a cost of \$115,925.35. Of that amount \$102,000 was borrowed from the Chemical Bank. Glore Forgan was the executing broker-dealer on these transactions, and Hodge was the salesman. At or about this same time, D. Bevan bought 1,200 shares, T. Bevan purchased 300 shares, and Hodge's secretary, Martha Fonner, purchased 50 shares. As noted above, information concerning the improved earnings did not become a matter of public knowledge until the last week of August 1962.

1963—KANEB STOCK PURCHASED BY THE PRR, PENPHIL AND PENPHIL STOCKHOLDERS AND RELATED EVENTS

On November 15, 1962, Kaneb's board approved an expansion of its business in the transportation of liquid propane. This information was released to the press on January 7, 1963.

On December 10, 1962, in connection with the possible acquisition of Kaneb by another company, James Whatley, vice president of Kaneb, mailed to Hodge a preliminary worksheet outlining estimated earnings and cash flow for Kaneb over the next 10 years. These estimates, which projected substantial growth in revenues and earnings, were never made public.

Shortly thereafter, Glore Forgan, with Hodge as salesman, executed substantial purchases of Kaneb stock for Penphil and Penphil members. On January 2, 1963, 5 days before the press release regarding the propane expansion, D. Bevan purchased 500 shares at  $8\frac{1}{2}$  bringing his holdings to approximately 1,855 shares. On January 8, 1963, Fred Billups<sup>10</sup> purchased 1,000 shares at  $8\frac{1}{4}$  per share. On January 31, 1963, D. Bevan met with Fisher, Hodge, and William R. Gerstnecker, treasurer of PRR, for lunch. The stated purpose of the meeting was to discuss pipeline studies being undertaken for the PRR by Pipetech, but the possibility of Fisher joining Penphil was discussed. At this time Fisher strongly indicated his interest in becoming a Penphil stockholder.<sup>11</sup> The next day, February 1, Penphil purchased 5,000 shares of Kaneb at \$8 per share, increasing its Kaneb holdings to 27,633 shares. Penphil borrowed the entire purchase price from Chemical Bank.

In late November 1963, Fisher and Glore Forgan arranged for a placement of 17,900 unregistered Kaneb shares for the New York Life Insurance Co. Of these, 4,500 shares were purchased at  $10\frac{1}{8}$  by Penphil stockholders, as follows: Gerstnecker, 500; D. Bevan, 1,000; Haslett, 500; 500 by Paul Fox, another PRR vice president; and Hodge, 2,000. On December 6, Hodge bought an additional 200 shares.<sup>12</sup>

<sup>10</sup> Billups was president of Tropical Gas, a company of which Hodge was a director. He became a Penphil member on June 30, 1963 and Tropical Gas became another Penphil investment.

<sup>11</sup> On February 5, Fisher wrote to Gerstnecker requesting the names, business connections, et cetera of all members of Penphil. Fisher commented: "It appears that this substantial group of successful businessmen could do much towards putting some good deals together. If I am to join them, it is quite important that we become better acquainted. I am sure that we all have the same interest; namely to get into some good growth situations where we can recoup substantial capital gains."

<sup>12</sup> Other than the purchases by D. Bevan and Billups in early January 1963, there were only two purchases of Kaneb stock by Penphil shareholders prior to November 1963. On June 18, Hodge bought 200 shares and on October 11, bought 100.

As of December 31, 1963, Kaneb had issued and outstanding 972,503 shares of common stock of which Penphil owned 29,462 shares, Penphil shareholders owned 158,597 shares and the PRR owned 56,974 shares. These shares, totaling 244,059 constituted 25.1 percent of the issued and outstanding Kaneb stock.

KANEB STOCKHOLDINGS BY PENPHIL, PENPHIL STOCKHOLDERS AND  
THE PRR 1964-69

During 1964, Penphil's holdings of Kaneb increased by 2,026 as the result of stock dividends. Penphil stockholders as a group increased their holdings, primarily from stock dividends, by 9,956 shares and the PRR increased by 24,479 as the result of both purchases and stock dividends. As of December 31, 1964, Penphil owned 30,488 Kaneb shares, Penphil stockholders 168,193, and the PRR 81,453 shares. This constituted 26.9 percent of the issued and outstanding shares. From 1964 through 1969 Penphil and its stockholders changed their holdings very little.<sup>13</sup> However, the PRR increased its holdings by purchasing an additional 34,047 shares. As of December 31, 1969, Penphil still owned 30,488 shares; Penphil stockholders owned 167,297 shares and the PRR 115,500 shares, which constituted 23.5 percent of Kaneb's shares. As of the present time Penphil still owns these shares which had been purchased at a cost of \$155,925.35. The shares now have a market value of \$1,082,324, giving Penphil a \$926,398.65 paper profit.<sup>14</sup>

GREAT SOUTHWEST CORP.

BACKGROUND

Great Southwest Corp., whose principal office is in Arlington, Tex., was incorporated in Texas in 1956 for the purpose of owning, leasing, and developing real estate. As of June 30, 1963, GSC had 1,076,501 shares of common stock outstanding, which was traded over the counter. At that time Toddie Wynne (T. Wynne), chairman of the board and a director of GSC, his son, Toddie Wynne, Jr. (T. Wynne, Jr.), a director of GSC, and Angus Wynne, Jr. (A. Wynne), president, a director and chief executive officer of GSC, owned or controlled approximately 45 percent of the outstanding shares. Rockefeller Center, Inc., (RCI) owned 220,851 common shares of GSC or 20.48 percent of the outstanding shares.

From at least January 13, 1960, until October 1970 Hodge was a member of the GSC board of directors, and during the same period was a partner of Glore Forgan, GSC's investment banker.<sup>15</sup>

From its inception in 1956 through September 30, 1961, the end of GSC's fiscal year, the company sustained continued operating losses. For fiscal 1962, however, GSC achieved a consolidated net profit of \$565,246 representing earnings of 52 cents per share. This turnaround was due largely to the successful operation of Six Flags Over Texas (Six Flags), a division of GSC.

<sup>13</sup> On Nov. 2, 1967, Penphil purchased a \$500,000 face amount Kaneb 6½ percent subordinated note and 7,653 warrants for the purchase of an equal number of shares at \$30 per share. Penphil paid \$493,544.90 for the note and \$7,653 for the warrants. Chemical Bank loaned Penphil \$493,000 of the total price of \$501,197.90 at 5½ percent (later increased to 6 then 6½ percent). Penphil sold the note for \$516,423.62, including interest, on September 10, 1968, and as of June 2, 1971, Penphil still held the warrants.

<sup>14</sup> Calculated on the AMEX closing price on Apr. 20, 1972.

<sup>15</sup> In addition, Glore Forgan was the managing underwriter for public offerings of GSC common stock in 1960 and 1963.

## PENPHIL'S PURCHASE OF GSC STOCK

On June 4, 1963, GSC held a board of directors meeting attended by Hodge, among others. At this meeting it was reported that GSC was doing better than had previously been estimated and it was expected that net income for fiscal 1963 would double that of fiscal 1962. This dramatic increase in projected net income was due to better than expected net income of Six Flags and to profit from land sales.

On June 14, 1963, 10 days after this board meeting, Hodge wrote A. Wynne inviting him to become a Penphil stockholder. This letter confirmed an earlier oral discussion of the matter. The addition of A. Wynne as a Penphil stockholder gave Penphil direct access to the person who was conducting the day-to-day affairs of GSC. A Wynne accepted the invitation and in September 1963 sent his check in the amount of \$9,000 to D. Bevan.

On July 10, 1963, Haslett and Edward D. Meanor (a private investor), both Penphil stockholders, flew to Texas and met with A. Wynne to discuss GSC. On July 15, after returning from Texas, Haslett spoke with Hodge by telephone concerning the purchase of GSC stock by the PRR and on July 17 he went to New York City to meet with Hodge.

A Glore Forgan research report dated July 17, 1963, concluded that GSC's earnings per share for fiscal 1963 would at least double fiscal 1962 earnings. This report and the conclusion therein incorporated in large part the financial and operating information which had been disclosed and discussed at the board meeting on June 4, 1963.<sup>16</sup>

On July 18, 1963, Penphil purchased 10,000 shares of GSC at \$16.50 per share from Glore Forgan. Hodge was the registered representative who placed the order. The total cost of this purchase was \$165,000; this transaction was financed by a loan from the Chemical Bank in the amount of \$120,000 secured by the 10,000 GSC shares. These shares were delivered to the Chemical Bank against payment. On the same day the PRR purchased 4,000 shares of GSC at \$16.50 per share from Glore Forgan. Again Hodge was the registered representative. In connection with both of these purchases, the investment decisions were made by D. Bevan, Haslett, and Hodge.

No public release of the improvement in GSC's fiscal 1963 earnings was made until August 5, 1963. On that day the Wall Street Journal published an article based on an interview with A. Wynne in which Wynne stated that earnings for GSC for the fiscal year ending September 30, 1963 (fiscal 1963) were going to be within the range of from \$1.35 to \$1.50 per share: (actual fiscal 1963 earnings per share, published later, were \$1.44). Such earnings would be nearly three times GSC's earnings for fiscal 1963.

## THE PRR ACQUIRES GSC

In February 1964, as part of Glore Forgan's efforts to suggest certain areas of diversification for the PRR, Hodge recommended to D Bevan that the PRR acquire 80 percent of GSC's outstanding stock. In his letter Hodge noted that there was "a distinct possibility of acquiring in one fell swoop about 40 percent of the company"

<sup>16</sup> It is unclear whether this report was ever distributed by Glore Forgan to its customers, but it was not distributed for at least several days after July 17, 1963.

at a price between \$20 and \$22 per share. Hodge also informed D. Bevan that Glore Forgan owned 28,000 shares of GSC and that Mrs. Hodge was the owner of GSC convertible debentures in the face amount of \$84,000.

During the spring of 1964, D. Bevan, Gerstnecker, and other members of PRR's finance department considered the merits of Hodge's recommendation. While it was under consideration, D. Bevan, on March 19, 1964, purchased 150 shares of GSC from Glore Forgan at 18%; Hodge was the registered representative.

On June 24, 1964, D. Bevan and Stuart Saunders recommended, and PRR's board of directors approved, the purchase by Pennco of 518,439 shares of GSC (approximately 49 percent of GSC's outstanding stock) from RCI and the T. Wynne family at a price of \$22.50 per share. This purchase was closed on July 15, 1964, at a total cost to Pennco of \$11,924,097. Glore Forgan, agent for both the buyer and sellers, received a commission of 50 cents per share, totaling \$529,219.50. It was the PRR's intention to acquire 80 percent of GSC's outstanding stock.<sup>17</sup>

Almost immediately after the above purchase, Haslett, at D. Bevan's direction, began to purchase additional shares of GSC for Pennco in the open market. Between July 1964 and October 1966 Pennco purchased 320,986 GSC shares in 118 transactions.<sup>18</sup> This series of purchases commenced on or about July 22, 1964, with a purchase of 2,000 shares at \$20.75 per share. From that date to November 30, 1965, Pennco bought 280,795 shares of GSC stock. During the period July 1964 to July 1965 the price of GSC stock remained relatively stable, fluctuating between 18¾ to 22¾ per share. Near the end of July 1965, however, the price began to rise and by November 30, 1965, Pennco was paying \$39 per share for GSC stock.

On December 7, 1965, Penphil sold to Glore Forgan a 10,000 share block of GSC stock at \$37.75 per share. On that same day Glore Forgan marked up these 10,000 shares \$.43 per share and resold them to Pennco at a profit of \$4,300. Penphil originally purchased its 10,000 shares of GSC at a total of \$165,000. Upon the sale to Glore Forgan Penphil realized total proceeds of \$377,500 and a profit of \$212,500.

Between November 3 and December 8, 1965, Hodge sold, either through or to Glore Forgan, 1,900 GSC shares at prices ranging from \$37.75 to \$45 per share for a profit of \$30,721.14. Hodge had purchased these shares on April 20, 1965, at 21%. On December 21, 1965, D. Bevan sold 107 GSC shares to Glore Forgan at \$35 per share. The result of this sale was a profit of \$1,752.13 or 87.9 percent. At the time of the initial purchases Hodge and Bevan had material non-public information as to PRR's interest in the acquisition of at least 80 percent of GSC's outstanding stock.

Although Penphil's records contain no resolutions, discussions or explanations regarding its purchase and sale of GSC common stock, D. Bevan set forth an explanation of these transactions in a letter dated July 2, 1970, to Mr. Edward J. Hanley, a director of Penn Central and a member of Penn Central's "information, disclosure and conflict of interest committee."

<sup>17</sup> This intention was not publicly disclosed.

<sup>18</sup> Of the 118 transactions, 54 were executed by Glore Forgan, generally as principal.

DEAR ED: This is to confirm our verbal conversation.

At the time we bought a small amount of Great Southwest stock for our contingent compensation fund, Penphil bought another odd lot offering with the same idea in mind that it was an interesting speculation.

At that point, control of Great Southwest was tightly centered in the Rockefeller and Wynne families. No one had any possible way of knowing that at a later date a rift would occur in the Wynne family. However, this occurred in the following year and as a result Toddy Wynne, Angus Wynne's uncle, thereupon expressed a desire to dispose of the family's interest in Great Southwest. Since the understanding between the Rockefellers and the Wynnes was that they would act in consort, control of the company became available and it was offered to us through Glore Forgan and, of course, as you know we purchased controlling interest.

A few months later I expressed a desire that Penphil sell its Great Southwest stock so that we would be sure to avoid any future possible conflict of interest. My wishes were respected and the stock was sold at a price of \$38. All members of Penphil made a sacrifice in this connection as the price of \$38 compares with even today's very low price of approximately \$60 a share since the stock was later split 10 for 1. Actually at its highest the stock sold at \$430 a share which was just a little over a year ago.

Sincerely,

DAVID C. BEVAN.

This explanation, written at a time when D. Bevan and his associates were being investigated by the PCC committee for these transactions, inaccurately described the reasons for the transactions in the staff's view. Moreover, it conceals certain significant aspects of these transactions. Specifically, the odd-lot transaction referred to was, in fact, a 10,000-share purchase by Pennco; the "few months later" referred to was, in fact, a 17-month period. Also, the letter fails to disclose that Bevan was responsible for Pennco's open market purchases including a 10,000-share purchase on December 7, 1965; that Penphil purchased its 10,000 shares on December 7, 1965; that Penphil purchased its 10,000 shares of GSC stock at \$16.50 per share and received a profit of \$212,500 (a 130-percent profit) on the sale of such securities; and that in November and December 1965, at the time D. Bevan was causing Pennco to buy GSC stock on the open market, he and Hodge were selling GSC stock held personally by them to and through Glore Forgan at a substantial profit. It would appear that the actual reason for the sales by Penphil, D. Bevan, and Hodge in December 1965 may not have concerned a conflict of interest as D. Bevan stated, but may have been because they knew that Pennco had virtually completed its program of acquiring at least 80 percent of GSC's outstanding stock. Furthermore, the crucial moment insofar as a conflict of interest was concerned was when the PRR decided to acquire an 80 percent interest in GSC. At that time Penphil had a major investment in GSC stock which was not disclosed to the board of directors of the PRR.

Although Pennco continued to purchase GSC stock from December 1965 to October 1966, it had, by December of 1965, bought 281,000 of the 320,000 shares it was to purchase. At the present time, Pennco owns over 90 percent of GSC's outstanding stock. It has sustained an unrealized loss on its investment as of June 9, 1972, of more than \$42 million. This is in sharp contrast to the substantial benefits Penphil, D. Bevan, Hodge, and Glore Forgan gained through their transactions.



## TROPICAL GAS CO., INC.

## BACKGROUND

Tropical Gas Co., Inc., with principal offices in Coral Gables, Fla., was incorporated in Panama on April 14, 1954, for the purpose of selling and distributing liquified petroleum gas (LPG) and gas-consuming appliances. As of May 1962, Tropical and its subsidiaries sold LPG throughout the Caribbean and Central America. Tropical's wholly owned subsidiary, Southeastern Natural Gas Corp. (subsequently known as Tropigas Inc. of Florida), sold LPG and LPG appliances in the southern half of Florida.

During the period from 1962 through 1969 Frederick H. Billups (Billups) was Tropical's president and chairman of the board and Hodge was a director and vice president.<sup>19</sup> Tropical's 10-member board of directors also included Hobart Ramsey (Ramsey) and Alfonso Manero (Manero).<sup>20</sup> Billups, Hodge, and Ramsey were on Tropical's executive committee, of which Billups was chairman and Hodge was vice chairman.<sup>21</sup> Each of these persons became a Penphil stockholder.

During 1962, Tropical realized a net income of \$1,689,633 on net sales of \$14,146,872. At December 31, 1961, Tropical had approximately 950,000 shares issued and outstanding, which were traded in the over-the-counter market.

PURCHASES OF TROPICAL COMMON STOCK FROM 1962 THROUGH 1964  
BY PRR AND PENPHIL

Prior to May of 1962, under the direction of D. Bevan and Haslett, the PRR had purchased 2,300 Tropical shares and between May 1962 and May 1963, the PRR purchased 29,000 additional shares of Tropical stock through Yarnall, Biddle & Co. and Glore Forgan at prices declining from 25 to 20½ per share.<sup>22</sup>

By letter dated June 14, 1963, Hodge invited Billups and Ramsey to join Penphil. They accepted and became Penphil stockholders on June 30, 1963. The inclusion of Billups as a stockholder gave Penphil direct access to the person running the day-to-day affairs of Tropical. On July 3, the PRR bought 2,900 Tropical shares through Glore Forgan at \$18 per share.

Between August 1 and August 7, 1963, upon Hodge's recommendation, Penphil purchased 5,415 shares of Tropical common stock through Glore Forgan at prices ranging from \$18 to \$18½ per share.

From August 19, 1963, to August 29, 1963, Penphil purchased 4,585 more Tropical shares through Glore Forgan at prices ranging from \$19.75 to \$20 per share. As a result of these purchases, Penphil held a total of 10,000 shares of Tropical stock.

In January 1964 Tropical management, including Hodge, began considering the listing of Tropical common stock on the American Stock Exchange (ASE). Tropical's board of directors authorized an

<sup>19</sup> Hodge had been a Tropical director since 1954.

<sup>20</sup> Manero was a partner in Glore Forgan; Ramsey was a limited partner in that firm.

<sup>21</sup> On April 26, 1962, Comer J. Kimball was elected to Tropical's board of directors and executive committee. Kimball, who was chairman of the board of the First National Bank of Miami and Arvida Corp., played a role in the PRR acquisition of Arvida and in Penphil's acquisition of the stock of First Bank & Trust Co. of Boca Raton and the University National Bank of Boca Raton.

<sup>22</sup> The 2,300 purchased prior to May 1962 were bought for the compensation plan; the 29,000 were bought for the pension plan as were all shares purchased thereafter.

application for listing on February 21, 1964. This meeting was attended by Hodge, who from February 26 to 28, 1964, bought 1,000 shares of Tropical at \$20 $\frac{7}{8}$  to \$21 per share. At the time of Hodge's purchases, Tropical's intention to list its stock on the American Stock Exchange was nonpublic. On July 29, 1964, 1,130,298 shares of Tropical common were listed on the ASE.

D. Bevan became a director of Tropical in November 1964, on the invitation of Billups, and subsequently became a member of Tropical's executive committee.<sup>23</sup>

From June 23, 1965, to October 15, 1968, the PRR increased its holdings of Tropical stock by 56,000 shares bringing the PRR holdings to 90,400 shares. Most of the transactions in Tropical stock during this period were made through Glore Forgan.<sup>24</sup>

On October 23, 1969, stockholders of U.S. Freight Co. (U.S. Freight) and Tropical approved an agreement which called for the exchange of 0.89 shares of U.S. Freight stock for each share of Tropical. Tropical became a wholly owned subsidiary of U.S. Freight on January 9, 1970. As a result of this transaction, Penphil received 8,900 shares and the PRR received 79,566 shares of U.S. Freight in place of their Tropical holdings.

Billups died on May 12, 1970, and on May 27, 1970, Hodge was elected to fill Billups' positions as Chairman of Tropical's board of directors and director of U.S. Freight. Hodge continues to hold both of these positions. D. Bevan and Ramsey continue to be Tropical directors and, along with Hodge, are members of Tropical's executive committee.

On October 20, 1970, Penphil sold its 8,900 shares of U.S. Freight through Yarnall, Biddle & Co. at \$22.50 per share. The proceeds of \$198,345.74 from the trade represented a profit of \$6,850.47 for Penphil.

## CONTINENTAL MORTGAGE INVESTORS

### BACKGROUND

Continental Mortgage Investors, a Massachusetts real estate investment trust, was organized on November 29, 1961, for the purpose of investing in first mortgage construction and development loans and in FHA and VA insured mortgages. Its principal offices are located in Boston. Since CMI's inception, Mortgage Consultants, Inc. has administered the day-to-day operations of CMI and serves as the investment adviser and consultant to CMI's board of trustees.<sup>25</sup> As of March 31, 1964, there were 1,710,644 CMI shares of beneficial interest issued and outstanding. CMI shares were traded over the counter until April 14, 1965, when they were listed on the New York Stock Exchange.

<sup>23</sup> Bevan had been asked to become a Tropical director before but had declined because of alleged possible conflicts of interest while the PRR was looking into possible pipeline acquisitions.

<sup>24</sup> On October 2, 1968, Mapco Inc., an Oklahoma based producer and distributor of oil, natural gas, and liquid plant foods, announced that it planned to make a tender offer for Tropical stock with the objective of acquiring 80% of Tropical's stock. In addition, as of October 2, 1968, Tropical was planning a public offering of 230,000 shares of common stock. (A registration statement covering this offering was filed with the SEC on October 15, 1968). Between October 3, and October 15, 1968 Penn Central purchased 9,800 Tropical shares.

<sup>25</sup> At about the time of CMI's formation, D. Bevan was asked to become a member of CMI's board of trustees. Bevan says that he turned it down after consultation with attorneys in PRR's legal department because of possible conflicts of interest with real estate operations of the PRR and its subsidiaries.

## PENPHIL AND THE PRR BUY CMI SECURITIES

In 1963, CMI, with the assistance of Hemphill, Noyes & Co., its investment banker, began developing plans for the private placement of \$10 million long-term notes. The proceeds of these notes were to be used to replace part of CMI's outstanding short-term bank loans with lower cost, long-term borrowing. As of March 31, 1964, CMI short-term bank loans were approximately \$40 million.

On April 1, 1964, Lawrence M. Stevens (Stevens), the managing partner of the Philadelphia office of Hemphill, Noyes & Co., and a member of Penphil's investment committee, wrote a confidential memorandum to the other members of Penphil's investment committee, recommending that Penphil invest in CMI shares. In his memorandum Stevens wrote that Hemphill, Noyes & Co. was placing \$10 million of 4½ percent 20-year notes and 10,000 shares at \$15 per share, the proceeds of which would be used to pay off part of CMI's current bank debt. The memorandum stated:

Incidentally and confidentially, the company has a bank line of approximately \$20 million at the prime rate (4½ percent). These loans require a compensating balance, however, whereas present financing will permit 100 percent use of the funds derived. As far as the additional common stock is concerned, it would represent only quite minor dilution and would not, in my opinion, represent a material factor.

Following this financing the company plans to announce, as you may note on one of the enclosed sheets, that no further debt or equity financing is contemplated at the present time. A quite substantial portion of the \$10 million of notes and stock has been reserved for one of the large New York City companies. One other institution has indicated that it will take a substantial amount of notes and stock and, in addition to that, two or three other institutions have the proposal under consideration.

Dividend payments for the 1963 fiscal year were \$1.10. We expect dividend payments for the 1964 year will amount to \$1.35 per share. At a price of \$17¼ for the stock this would afford a yield of about 7.6 percent.

May I again reiterate that some portions of the enclosed are confidential in nature.

Attached to Stevens' memorandum were four pages taken from a confidential memorandum prepared by Julius Jensen, III, a partner of Hemphill, Noyes & Co., in the corporate finance department. (Jensen's memorandum). These four pages, on the first of which was written the word "confidential," first stated that CMI shares had been selling at an "artificially depressed" price between \$14½ and \$16 per share. According to Jensen, "numerous security analysts and investment advisers," believed that the artificially depressed price resulted from the request made to CMI stockholders that they authorize the issuance of up to 1,900,000 additional shares at a minimum price of \$15 per share; and that this request, and the stockholder approval, were thought to have created an expectation that a substantial equity offering was imminent and would result in an immediate dilution of stockholder equity.<sup>26</sup>

Jensen's memorandum then stated that to remove the "lid" on the market price of CMI shares, the trustees planned to announce that no further permanent debt or equity financing was contemplated after the proposed \$10 million debt financing was completed; that CMI's trustees also planned a broader distribution of information about CMI, since the SEC's limitation on communications during periods

<sup>26</sup> This was in spite of public announcements by CMI that no decision had been made regarding the time when additional shares would be issued.

of such financing would not apply;<sup>27</sup> and that these steps would cause CMI's price to rise to \$18½ to \$20 per share shortly after the proposed financing.

Based on projected earnings for the next 3 fiscal years, Jensen predicted that the market value of CMI stock would rise to \$25½ to \$30½ per share by the end of the next fiscal year, \$31½ to \$37 per share by the end of the second succeeding fiscal year, and \$36 to \$43 per share by the end of the third fiscal year.

On April 2, 1964, after receiving this information as a member of Penphil's investment committee, Francis A. Cannon,<sup>28</sup> purchased 500 CMI shares for his wife's account at \$17½ per share. By April 9, 1964, three investment committee members had recommended CMI as a proper speculation for Penphil.

By May 6, 1964, the PRR pension plan through D. Bevan and Hastlett, Morgan Guaranty Trust Co. of New York as Trustee for a pension trust, and First National City Bank as trustee for various pension trusts, had agreed to purchase \$11 million of CMI 4½ percent notes due May 1, 1984, and an aggregate of 110,000 shares at about \$15 per share.

Penphil purchased 10,000 CMI shares on May 8, 1964, from Hemphill, Noyes & Co. at \$19.68 per share, at total cost of \$196,800, all of which Penphil borrowed from the Chemical Bank. Hemphill, Noyes & Co. bought more than 4,500 of these shares from at least 40 other persons and delivered the 10,000 shares to the Chemical Bank against payment. At the time of these purchases there had been no public disclosure of the information contained in Stevens-Jensen confidential memorandum.

The placement of the CMI notes and shares with the three purchasers was concluded on May 20, 1964. The PRR bought \$1 million of the CMI notes and 10,000 of the CMI shares at a price of \$15.1648 per share. News of the placement, published in the Wall Street Journal on May 26, 1964, included the announcement the Stevens-Jensen memorandum had revealed, that CMI's management had "Come to the conclusion that the sale of the additional shares authorized, other than the 110,000 shares \* \* \* would be inadvisable under the circumstances and should not be undertaken."

After its purchase in the May 1964 placement, the PRR continued to make investments in CMI. By December 1967, the PRR and its subsidiary, the Buckeye Pipe Line, acquired an additional 27,500 CMI shares and \$2,025,000 in CMI notes.

In August 1968, CMI shares were split 3-for-1, giving Penn Central a total of 105,750 CMI shares and Penphil a total of 30,000 shares.<sup>29</sup> In March 1970, CMI shares were further split 2-for-1 with the result that Penn Central held 211,500 CMI shares and Penphil held 60,000 shares. The market price of CMI shares as of June 2, 1971 was \$21⅛, and the value of Penphil's CMI holdings was \$1,267,500, an unrealized profit of \$1,070,700 or more than 540 percent.

<sup>27</sup> Information released by CMI had been limited to quarterly and annual shareholder reports.

<sup>28</sup> Cannon was administrative vice president of First Boston Corp.

<sup>29</sup> On February 17, 1969, the PRR purchased a \$1,000,000 CMI 5 percent note due April 1, 1989.

## FLORIDA BANKS

PURCHASE OF FIRST BANK AND UNB STOCK BY PENPHIL AND ARVIDA'S  
PURCHASE OF FLEMING/BUTTS REAL ESTATE

D. Bevan and Hodge had been instrumental in Pennco's acquisition in mid-1965 of controlling interest in Arvida Corp., which was in the business of purchasing, developing and selling real estate, principally on the east and west coasts of Florida. By the close of 1965, D. Bevan, Hodge, Gerstnecker and A. Wynne Jr., all Penphil shareholders, were on Arvida's board.

As early as the fall of 1965, D. Bevan and Hodge were interested in purchasing on behalf of Penphil a substantial block of stock of banks in the Boca Raton area. They therefore requested Comer J. Kimball, Arvida's chairman,<sup>30</sup> to obtain information on the First Bank and Trust Co. of Boca Raton N.A. (First Bank), University National Bank (UNB), and Boca Raton National Bank, the three banks in Boca Raton. He forwarded information on the deposits, loans, and capitalization of the banks to Bevan and Hodge in late November 1965.<sup>31</sup> Early in 1966 Bevan and Hodge requested Sawin to have Kimball arrange for Sawin to meet Thomas Fleming Jr., chairman of the board and largest shareholder of First Bank and UNB, to discuss the possibility of investing in these banks. Such a meeting was held on February 17 in Boca Raton between Hodge, Sawin, and Fleming. In addition to the availability and price of First Bank and UNB stock, they also discussed the possibility that the group represented by Hodge and Swain would participate with Fleming in building up a chain of banks in appropriate places in Florida. These conversations, without Hodge, were continued on the 18th. On February 21, 1966, Swain wrote Fleming thanking him for the information he had made so readily available and advising him that D. Bevan, Hodge, and he had discussed an investment by the group of \$1 million to \$1.2 million. Because of the very thin market in UNB and First Bank stock, it was difficult to acquire such stock on the open market.

Shortly after Sawin's discussion with Fleming about the purchase of First Bank and UNB stock, Fleming advised D. Bevan that he and his wife's family owned certain real property in the Boca Raton area (Fleming/Butts property) that he wished to sell. On March 23, D. Bevan advised Arvida's executive committee concerning Fleming's desire to sell the Fleming/Butts property. At a meeting of Arvida's executive committee on May 12, 1966, attended by David Bevan Hodge, and Gerstnecker, Arvida was authorized to negotiate for the Fleming/Butts property. Thereafter, on May 19, 1966, Brown Whatley president of Arvida and of Stockton, Whatley, Davin & Co., a large real estate and mortgage banking company, which provided operating management for Arvida, wrote Fleming a letter of intent proposing that Arvida purchase an option on 3,020 acres for the price of \$3 million. Whatley concluded the letter by saying:

We would appreciate it if you would keep our interest in your property in confidence. In the event you are interested in our proposal, we would probably want to take the option in a nominee so that our identity would not be disclosed unless and until the option is exercised.

<sup>30</sup> He had also been a director of Tropical since 1962. Kimball was at the time chairman of the First National Bank of Miami.

<sup>31</sup> During the same period John Harner of Gloré Forgan sent to Bevan, at his request, information on certain other southern Florida banks.

During the negotiations on the Fleming/Butts property, Fleming openly expressed his desire for more of Arvida's banking business. At an Arvida board meeting the board authorized the transfer of one of Arvida's bank accounts to First Bank. On September 26, 1966, Fleming wrote D. Bevan that he and Whatley had successfully concluded negotiations regarding the sale of the Fleming/Butts property.

Pursuant to arrangements with Penphil, on September 27, the day after the negotiations to purchase the Fleming/Butts property were concluded, Morgan Zook, executive vice president of First Bank, opened a brokerage account at the Boca Raton office of Hayden Stone in Zook's name as nominee for Penphil. On that day, Zook purchased 100 shares of First Bank; on September 28 he purchased 150 shares and on October 3, 100 shares. These 350 shares were all purchased for Penphil at \$30 per share. Penphil's objective, to acquire a substantial block of First Bank stock, however, could not be achieved by purchasing stock in the open market because of the thin market.

At least as early as February 1966, Sawin had suggested to Fleming that First Bank and UNB have a new offering of their shares, the proceeds of which could be used to construct a new bank building. In August 1966, after a July bank examination, the Comptroller of the Currency advised First Bank that it needed additional capital because of its recent substantial growth. As a result, Fleming and the other bank directors began to discuss the possibility of a preemptive rights offering. On September 13, 1966, the board of directors of First Bank authorized, subject to stockholder approval, the issuance of 25,000 additional shares at \$24 per share. This information was disclosed to Sawin sometime prior to Penphil's purchases in September and October and before other First Bank stockholders were notified on October 5. Existing stockholders as of October 19, 1966, would receive rights to purchase these shares. As noted above, Penphil purchased 350 shares between September 27 and October 3, 1966. Thereafter, on December 9, Sawin wrote a memorandum to Hodge describing the rights offering and recommending that Penphil buy approximately \$200,000 of additional First Bank stock and approximately \$100,000 of UNB stock. Sawin asked for authority to proceed with the purchase of this stock. Copies of this memorandum were also sent to D. Bevan and members of Penphil's investment committee. Shortly thereafter, Hodge, on behalf of Penphil, authorized Sawin to purchase \$200,000 of First Bank stock. This rights offering was made in late December 1966. First Bank's directors received the lion's share of the rights offered and Fleming arranged for each director to sell a portion of his rights to Penphil at \$1.50 per right. Pursuant to this arrangement, Penphil purchased 30,848 rights between December 30, 1966, and January 6, 1967, exercised the rights and purchased 7,712 First Bank shares. The cost to Penphil of the rights and stock was \$231,360.<sup>32</sup> As of January 6, 1967, Penphil owned 8,250 First Bank shares (6.3 percent of the outstanding shares) for a total cost of \$249,972.

It should also be pointed out that during the spring of 1966, at the same time it was negotiating for the Fleming/Butts property, Arvida was also confidentially granting IBM an option to purchase approximately 500 acres of land located near the Fleming/Butts property

<sup>32</sup> This money came from the proceeds received from Penphil's sale of its GSC stock in December 1965. Penphil also exercised the 350 rights it already held as a First Bank stockholder, purchasing 88 shares. In addition, it purchased 200 shares from a First Bank director.

and on which IBM proposed to build a research and manufacturing facility. This agreement was known to only a few persons associated with Arvida and IBM. Arvida wanted to keep the agreement with IBM confidential until after IBM purchased the property and Arvida acquired an option to purchase the Fleming/Butts property. When Penphil purchased 350 shares of First Bank stock from September 27 to October 3, IBM had already confidentially exercised the option and planned to build a manufacturing and research facility in Boca Raton. The entrance of IBM into the area with its attendant favorable economic impact was almost certain to generate new banking business. Penphil also had, at the time it made these purchases, the nonpublic information that First Bank had authorized a rights offering to existing shareholders at \$6 below the current market price.

#### FLORPHIL

Florphil Co. was incorporated on January 13, 1967, in order to give Whatley, Joseph Davin, vice president of Arvida,<sup>33</sup> and three others not associated with Arvida,<sup>34</sup> an opportunity to participate in Penphil's investments in First Bank and UNB. Upon its incorporation Florphil issued 1,600 shares at \$30 per share to these five individuals. On the same day Florphil issued 8,250 shares to Penphil in exchange for 8,250 First Bank shares.

In early 1967, Penphil and Florphil began to purchase shares of UNB. On January 12, Penphil bought 328 shares and on January 30, bought 200 additional shares at \$20 per share and on March 6, 100 shares were purchased at \$21 per share. On February 8, 1967, UNB authorized an offering of 10,000 shares. Each UNB shareholder, as of February 8, received the right to purchase, at \$16 per share, one new share for each five shares owned. Penphil, the record owner of 528 shares, exercised its rights and bought 105 additional shares. On March 22, Florphil bought 8,500 rights at \$1 per right from existing shareholders, exercised the rights, and bought 1,700 shares at \$16 per share. On March 27, Penphil purchased 11,500 rights at \$1 per right, exercised the rights, and purchased 2,300 shares at \$16 per share. The purchase of these rights was arranged in much the same manner as with the First Bank rights in December 1966. By March 27, Penphil and Florphil owned 4,733 UNB shares at a total cost of \$98,340. UNB as of that date only had 60,000 shares issued and outstanding, 7.1 percent of which were owned by Florphil and Penphil.

On February 20, 1968, Penphil and Florphil merged, with each Florphil stockholder receiving 0.8181 Penphil shares for each Florphil share owned. The following chart reflects the unrealized profit to each individual Florphil shareholder which resulted from this transaction.

Name	Florphil shares	Cost of shares	Penphil shares received	Total net asset value	Unrealized profit
Harry Ortlip .....	500	\$15,000	409	\$19,795.60	\$4,795.60
Joseph David .....	200	6,000	163	7,889.20	1,889.20
Alfonso Manero .....	200	6,000	163	7,889.20	1,889.20
Brown Whatley .....	500	15,000	409	19,795.40	4,795.60
O. F. Lassiter .....	200	6,000	163	7,889.20	1,889.20

<sup>33</sup> Kimball, Arvida's chairman died in March 1966.

<sup>34</sup> O. F. Lassiter of Executive Jet Aviation, Alfonso Manero of Glore Forgan, and Harry F. Ortlip.

In August 1968 First Bank had another offering of its securities at which time Penphil bought 1,815 shares at \$50 per share for a total consideration of \$90,750.

#### FIRST BANCSHARES

Sometime prior to June of 1968 Fleming had been invited to become a Penphil stockholder and on January 6, 1969 did so by purchasing 2,285 Penphil shares at \$35 per share for a total cost of \$79,975.

In February 1969, First Bank declared a 100-percent stock dividend and Penphil received an additional 10,690 shares. UNB declared a 10-percent stock dividend and Penphil received an additional 135 UNB shares. Penphil, as of February 1969, owned 19,565 shares of First Bank and 4,668 UNB shares.

As already stated, by February 1966, Sawin had been discussing with Fleming a program whereby a substantial interest would be acquired in a number of banks in southern Florida. In addition to Penphil's investments in First Bank and UNB, various Penphil stockholders discussed with Fleming possible investments in other Florida banks during the period of 1966 through 1969. At about this time, a bank holding company became a technique employed to circumvent Florida's prohibition against branch banking. On September 19, 1969, Fleming issued a news release announcing a proposed new bank holding company which would exchange its shares for outstanding shares of First Bank, UNB, First National Bank & Trust Co. of Riviera Beach, and Citizens Bank of Palm Beach County. Fleming was to be chairman of the board of the holding company.

Pursuant to permission granted by the Federal Reserve Board on May 21, 1970, the holding company, First Bancshares, offered its shares of common stock; the exchanges of stock were declared effective as of October 15, 1970. As a result Penphil became the owner of 26,048 shares of First Bancshares stock. Penphil's shares, after a 2-to-1 stock split on March 1, 1971, doubled to 52,096, approximately 7 percent of First Bancshares outstanding stock. According to a summary of financial data prepared by Penphil, the market value of such stock as of June 2, 1971, was \$1,181,400 representing an unrealized profit over Penphil's cost (\$439,062) of \$742,338.<sup>35</sup>

#### SYMINGTON WAYNE CORP.

##### BACKGROUND

Symington Wayne Corp. was incorporated in Maryland in 1924 and maintained its principal office in Salisbury, Md. The company was primarily engaged in manufacturing gasoline pumps and other service station equipment, steel castings, and equipment used in the railroad industry and handtools. During the period 1967-68 Symington Wayne's stock was traded on the New York Stock Exchange and as of December 31, 1966, the company had issued and outstanding 1,956,278 shares of common stock. During the period 1958 through 1967, the company's net sales increased from approximately \$40 million to

<sup>35</sup> As already noted, Pennco acquired its controlling interest in Arvida for approximately \$20,400,000. The last installment fell due in July 1967, and it was necessary for Pennco to borrow \$3 million from the First National Bank of Miami to pay the balance owed. First Bank and UNB both participated in the loan in the amount of \$200,000 and \$50,000 respectively due July 27, 1969. During January 1969, D. Bevan, through Fleming, obtained an extension of the loan, including First Bank's and UNB's participation. First Bank's loan was paid off on July 10, 1969 and the rest of the loan was paid when due on December 31, 1969.



\$104 million and net income increased from approximately \$1,600,000 to \$4,500,000. Retained earnings as of December 31, 1967, were \$26,283,105. Hobart Ramsey, a Penphil stockholder and Glore Forgan partner, was also a member of the board of directors of Symington Wayne.

#### DRESSER'S TENDER OFFER

Sometime prior to April 27, 1967, Dresser Industries, Inc. (Dresser) purchased 140,000 shares of Symington Wayne stock. On April 27, John Lawrence, president and chairman of the board of Dresser, advised the Dresser board that these shares of Symington Wayne had been acquired and recommended that he explore with Symington Wayne an exchange of Dresser cumulative convertible preferred voting for the outstanding common stock of Symington Wayne.

On May 2, 1967, Lawrence contacted William H. Bateman, president and chairman of the executive committee, of Symington Wayne by telephone and a meeting was arranged for May 16, 1967, to discuss in detail Dresser's proposal. By letter to Bateman dated May 15, 1967, Lawrence set forth in some detail the proposal being made. At the meeting on May 16, Lawrence presented a document entitled *Opportunities Resulting From a Merger of Symington Wayne Corp. and Dresser Industries, Inc.* Bateman requested Paine, Webber, Jackson & Curtis, its investment bankers, to analyze the proposal and also discussed it with various officers and directors of Symington Wayne. Bateman concluded that the Dresser offer would "have to be sweetened considerably before it would be advantageous to our stockholders." Paine, Webber estimated the value of Dresser's offer to be \$36 per share or a premium of 6% over the then market price of Symington Wayne common stock. On May 24, 1967, a meeting of Symington Wayne's executive committee was held with Hobart Ramsey, a Penphil member since June 1963, present. The Dresser proposal was discussed. The members of the committee were unfavorably impressed and directed Bateman to communicate this to Dresser, which he did that day. The next day, Lawrence and the vice president, finance of Dresser met with Bateman and an attorney for Symington Wayne. At this meeting Lawrence improved Dresser's offer for Symington Wayne's stock by increasing the amount of the proposed dividend on the convertible preferred. On May 26, Dresser's new offer was communicated to the members of the executive committee, including Ramsey. Ramsey thereafter discussed these meetings with Hodge, whose office was next to Ramsey's at Glore Forgan.

#### PURCHASE BY PENPHIL STOCKHOLDERS AND THE PRR

On Monday, May 29, at least seven Penphil stockholders purchased 5,300 shares of Symington Wayne. Warren H. Bodman (Bodman), a general partner of Yarnall, Biddle & Co., a broker-dealer in securities, bought 100 shares at 33%. Other Penphil stockholders purchasing that day through Yarnall, Biddle & Co. were D. Bevan, 1,000 shares at 30%, 31, and 31%; T. Bevan, 100 shares at 33% and Vincent G. Kling, 500 shares at 32%, 32%, and 33. Hodge purchased 2,000 shares that day through Glore Forgan at prices ranging from 30% to 33½ per share.

D. Bevan and Haslett caused the PRR to purchase 1,000 shares at 33 and 33¼ per share through Yarnall, Biddle & Co. on May 29. In addition, Gerstnecker bought 100 shares and Haslett bought 500 shares through White, Weld & Co. on that day.

On June 1, 1967, Paul D. Fox purchased 100 shares through De-Haven & Townsend, Crouter, and Bodine, while on June 2, Ramsey bought 139 shares through Glore Forgan at 33⅞ and 34 per share.

Despite the fact that at least seven Penphil stockholders purchased Symington Wayne stock on May 29, and one other bought by the first of June, those questioned have denied discussing the matter with each other and denied knowledge of the Dresser proposal. None, however, has been able to give any substantial reason for purchasing these shares except "I must have thought it was a good investment."

#### MERGER DISCUSSIONS BETWEEN SYMINGTON WAYNE AND UNIVERSAL AMERICAN

On May 30, 1967, the Symington executive committee met and discussed the new Dresser offer and determined to make a counterproposal. It does not appear that such a counterproposal was made, however merger discussions between Symington Wayne and Universal American Corp. (Universal) were initiated by Bateman during June. On June 21, 1967, Bateman and a Symington Wayne attorney met with officials of Universal in New York City to discuss in detail a possible merger. As a result, Bateman wrote the board of directors on June 22, stating that the Dresser offer would mean approximately \$42 to \$43 per share to Symington Wayne's stockholders; however, Dresser would not commit itself in writing to continue Symington Wayne as a separate corporate entity. On the other hand, he pointed out that Universal's offer appeared more favorable because it would mean approximately \$53 per share to Symington Wayne stockholders and there was a much better chance that Symington Wayne would retain its identity even to the extent of having an equal number of members on the board.

On the morning of June 27, Bateman, the Symington Wayne attorney, Ramsey, and a Glore Forgan analyst, among others, again met with Universal officials to discuss the merger and arrived at an agreement in principle to merge the companies. It was further agreed that letters of intent would be exchanged subject to board approvals on June 28, 1967, and a joint announcement would be made on June 28, after the close of trading on the NYSE.

At 10:42 a.m. on June 27, Penphil purchased 1,000 shares of Symington Wayne at prices ranging from 33½ to 34 per share through Glore Forgan. Hodge was the registered representative on the trade, which was placed by T. Bevan. On the 28th, the boards ratified the merger agreement and a public announcement was made. On June 29, the PRR purchased 4,000 shares at prices ranging from 33½ to 34 per share through Glore Forgan. Hodge was again the registered representative.

#### DRESSER ACQUIRES SYMINGTON WAYNE

Subsequent to the merger agreement, Dresser countered on July 7 with a tender offer for Symington Wayne stock at \$40 per share.

Eventually this tactic was successful and Universal withdrew its merger proposal. In April 1968, Symington Wayne merged with Dresser.

#### SUMMARY

As previously noted at least seven Penphil stockholders purchased Symington Wayne shares on May 29, and two others purchased the stock on or before June 2, 1967. Penphil itself also purchased 1,000 shares on June 27. The following chart sets forth these purchases, the subsequent sales and the resulting profits:

## PURCHASES AND SALES OF SYMINGTON WAYNE

	Hodge	Bodman	Kling	D. Bevan	Haslett	T. Bevan	Gerstnecker	Fox	Ramsey	Penphil
Date of purchase.....	May 29, 1967	May 29, 1967	May 29, 1967	May 29, 1967	May 29, 1967	May 29, 1967	May 29, 1967	June 1, 1967	June 2, 1967	June 27, 1967
Number of shares.....	2,000	100	500	1,000	500	100	100	100	139	1,000
Total Cost.....	\$65,203.03	\$3,312.50	\$16,614.69	\$31,596.27	\$16,916.19	\$3,398.31	\$3,385.75	\$3,147.26	\$4,767.70	\$33,875.
Date of sale.....	Aug. 1, 1967	Oct. 16, 1967	Nov. 30, 1967	Dec. 20, 1967	Dec. 27, 1967	Jan. 4, 1968	(1)	Jan. 5, 1968	(1)	Jan. 4, 1968
Number of shares sold.....	2,000	1,000	500	1,000	500	100	-----	100	-----	1,000
Proceeds of sale.....	\$78,496.55	\$4,000.00	\$20,774.58	\$42,046.65	\$20,774.58	\$4,154.91	-----	\$4,167.15	-----	\$42,000.
Profit.....	\$13,293.52	\$687.50	\$4,159.89	\$10,450.38	\$3,858.39	\$756.60	-----	\$1,019.89	-----	\$8,125.

<sup>1</sup> It is not known at this time whether or not Gerstnecker or Ramsey have sold their shares.

In addition to the above purchases and sales, the PRR purchased and sold Symington Wayne stock during this same period:

Date	Purchases		Sales	
	Shares	Cost	Shares	Proceeds
May 29, 1967	1,000	\$33,480.65		
June 29, 1967	4,000	136,640.17		
Dec. 27, 1967			2,000	\$83,198.32
Jan. 2, 1968			2,000	83,695.70
Jan. 19, 1968			1,000	43,589.12
Total	5,000	169,940.82	5,000	210,483.14
Less cost				169,940.82
Profit				40,542.32

## NATIONAL HOMES CORP.

### BACKGROUND

National Homes Corp. is an Indiana corporation organized June 25, 1940, to engage in the manufacture and sale of prefabricated houses. By 1968, National had formed or acquired a number of subsidiaries which engaged in manufacturing prefabricated homes, operating subdivisions, manufacturing mobile homes, making construction loans to builder-dealers, and making mortgage loans to purchasers of homes. National's headquarters and main manufacturing facilities are located in Lafayette, Ind. As of December 31, 1967, National had 4,687,754 shares of common stock issued and outstanding and 1967 sales of \$53,900,072. National's common stock and warrants were listed on the Midwest Stock Exchange.

### INVESTMENTS BY PENPHIL, PENPHIL MEMBERS, AND THE PRR

Unlike most of Penphil's investments, there does not appear to have been any interlocking relationship between Penphil shareholders and National. Neither the PRR, Penphil nor Penphil stockholders owned shares of the stock of National prior to June 1968. During 1968, prior to August, National apparently did not engage in any unusual or extraordinary business transactions.

During June 1968, Penphil and certain Penphil stockholders purchased shares of National. On June 5, 1968, Penphil, on the recommendation of Stevens, bought 5,000 shares of National through Hornblower & Weeks, Hemphill, Noyes at prices ranging from \$14½ to \$14¾ at a total cost of \$74,101.52.<sup>36</sup> On the same day, D. Bevan purchased 1,000 shares through Hornblower & Weeks at \$14¾ per share.<sup>37</sup> Stevens was the registered representative on the trades through Hornblower & Weeks, Hemphill, Noyes. Due to an apparent oversight, Hodge was not consulted or advised of Penphil's purchase until the morning of June 7th. Although Hodge believed Penphil would

<sup>36</sup> Stevens is deceased. There is no record of the reasons for his recommendation of National Homes stock.

<sup>37</sup> D. Bevan sold his 1,000 shares on December 9 at \$34 per share for a profit of \$18,671.82.

probably make some money on this investment, he nevertheless disapproved.<sup>38</sup>

Penn Central purchased 9,700 shares of National stock on December 2, 1968, at \$28½, 5,200 of these shares were sold during September 1969, at prices ranging from \$18¾ to \$19¾. Penphil sold its 5,000 shares of National on October 20, 1970, at \$16¾ for a profit of \$9,035.98.

## EXHIBIT IV-1

### PENPHIL STOCKHOLDERS

#### *Original Penphil stockholders*

David Bevan did not hold any office with Penphil but was one of the persons who controlled its affairs. While a Penphil stockholder, D. Bevan was vice president, finance of the Pennsylvania Railroad Co. (PRR) and chairman of the finance committee of the PRR and its successor the Penn Central Company (PCC). In these positions D. Bevan had overall responsibility for investments in securities by the PRR, PCC and their subsidiaries, including investments for the plan for supplemental pensions (pension plan) and the contingent compensation plan (compensation plan).<sup>39</sup> During this period D. Bevan was a director and member of the executive committee of Great Southwest Corp., Kanab Pipe Line Co., Arvida Corp., and Tropical Gas Co., Inc.

Charles J. Hodge whose Penphil stock was held in his wife's name, was also one of the persons who controlled Penphil's affairs and was a member of Penphil's investment committee. He was a partner or officer of Glore Forgan & Co. and its successors, a broker-dealer and investment banking firm, during the period 1962-71. While a Penphil stockholder, Hodge was also a director and member of the executive committee of Kanab Pipe Line Co., the Great Southwest Corp., Tropical Gas Co., Inc., and Arvida Corporation.

Thomas Bevan the brother of David Bevan, was at various times between July 1962 and 1970 president, secretary, treasurer and a director of Penphil. As Penphil's secretary and treasurer until 1971, Bevan maintained all of Penphil's corporate books and records, including Penphil's checkbooks and financial records. Throughout Penphil's existence T. Bevan has been a partner of the Philadelphia law firm of Duane, Morris and Heckscher. Until 1971 he handled all of Penphil's legal work.

Lawrence Stevens, whose Penphil stock was held in his wife's name, was a member of Penphil's investment committee until his death in 1969. As a member of the investment committee, he participated in several of Penphil's investment decisions. Stevens was the managing partner of the Philadelphia office of Hemphill, Noyes & Co., a registered broker-dealer, and its successor, Hornblower & Weeks-Hemphill, Noyes & Co. during his association with Penphil.

<sup>38</sup> When Penphil made its investment in National Homes without the benefit of an inside position, Hodge stated in a letter dated June 7, 1968 to D. Bevan:

"I was notified after the fact this morning that Penphil has bought 5,000 shares of National Homes. Larry called me and explained it was an oversight that I was not notified, and this oversight is understandable and I am certainly not put out. However, I must go on record, while this will be a popular and fast moving stock I do not agree with the fundamental purpose nor do I agree with the management of the Price brothers who have not demonstrated any ability in this field. I am confident that stockmarketwise we will probably make some money in it, but would like to go on record that this is not one to hold blindly."

<sup>39</sup> The pension plan is a qualified pension plan for employees of the PRR, PCC and their subsidiaries earning more than the amount covered by the Railroad Retirement Act. The compensation plan is a deferred compensation plan for employees of the PRR and the PCC earning an annual salary of more than \$80 thousand.

Robert Haslett has been a member of Penphil's investment committee from the date it was formed until the present and for most of that period served as its chairman. During his association with Penphil he has held the positions of director of investments of the PRR and PCC and also vice president, investments of the PRR and PCC. In such positions he has made, under the supervision of Bevan, all investment decisions for the pension plan and the compensation plan.

Benjamin F. Sawin, although never an officer of Penphil, played a significant role in several of Penphil's investments. While a Penphil stockholder, Sawin was also president and later vice chairman of the board of directors of Provident National Bank of Philadelphia.

Francis A. Cannon was administrative vice president of the First Boston Corp., a registered broker-dealer.

Warren H. Bodman was a partner of Yarnall, Biddle & Co., a registered broker-dealer.

C. Carroll Seward was also a partner of Yarnall, Biddle & Co.

William R. Gerstnecker was treasurer of the Pennsylvania Railroad and later vice president—corporate of the Penn Central Co., a director of Arvida and Great Southwest and vice chairman, Provident National Bank.

Paul D. Fox was a vice president of the Pennsylvania Railroad and vice president—administration of the Penn Central Co.

Theodore K. Warner was vice president—taxation of the Pennsylvania Railroad and of the Penn Central Co.

F. B. Holmes was vice president of P. H. Glatfelter Co.

Edward D. Meanor managed his personal investments.

John K. Acuff was a partner of Brooke, Sheridan, Bogan & Co., Inc., a registered broker-dealer.

*Other persons who became Penphil stockholders subsequent to June 1962*

Herbert E. Fisher became a Penphil stockholder on or about June 30, 1963. Fisher was the president and chairman of the board of Kanab Pipe Line Co., Inc., a company in which Penphil invested in 1962.

Angus G. Wynne, Jr., became a Penphil stockholder in the summer of 1963. Wynne was the president and chairman of the board of Great Southwest Corp., a company in which Penphil invested in 1963.

Fred H. Billups became a Penphil stockholder on or about June 30, 1963. Billups was the president and chairman of the board of Tropical Gas Co., a company in which Penphil invested in 1963.

Edwin B. Horner became a Penphil shareholder in the summer of 1963. He was with the First Colony Life Insurance Co.

Samuel A. Breene became a Penphil shareholder in June 1967. He was a Pennsylvania attorney.

Thomas F. Fleming, Jr., became a Penphil stockholder in August 1968. Fleming was chairman of the board of First Bank & Trust Co. of Boca Raton (N.A.) and also of the University National Bank of Boca Raton, companies in which Penphil invested in 1966 and 1967.

Hobart Ramsey became a Penphil stockholder on June 30, 1963. While a member of Penphil's Investment Committee Ramsey participated in some of Penphil's investment decisions. During his association with Penphil, Ramsey was a limited partner of Glore Forgan and a director and member of the executive committee of Symington Wayne Corp., a company in which Penphil invested in 1968.

Brown L. Whatley became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was president and a director of Arvida Corp., a company acquired by the Pennsylvania Company in 1965, and president of Stockton, Whatley, Davin & Co., a large real estate and mortgage banking company which provided operating management for Arvida since 1961.

Joseph W. Davin became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was vice president and a director of Arvida and first vice president of Stockton, Whatley, Davin & Co.

Alfonso Manero became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was a partner of Glore Forgan & Co.

Olbert F. Lassiter became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was president of Executive Jet Aviation.

Harry F. Ortlip became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was president of his own company.

Cornelius A. Dorsey became a Penphil shareholder in August 1968. He was Haslett's assistant at Penn Central.





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## APPENDIXES

Appendix A—H.R. 12128.

Appendix B—S.E.C. comments on H.R. 12128.

Appendix C—I.C.C. comments on H.R. 12128.



## APPENDIX A

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92<sup>d</sup> CONGRESS  
1<sup>st</sup> Session

# H. R. 12128

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## IN THE HOUSE OF REPRESENTATIVES

DECEMBER 8, 1971

Mr. STAGGERS introduced the following bill; which was referred to the Committee on Interstate and Foreign Commerce

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## A BILL

To extend the protection provided by the Federal securities laws to persons investing in securities of carriers regulated by the Interstate Commerce Commission.

1     *Be it enacted by the Senate and House of Representa-*  
2     *tives of the United States of America in Congress assembled,*

3                   AMENDMENTS TO SECURITIES ACTS

4     SECTION 1. (a) (1) Section 3 (a) (6) of the Securities  
5     Act of 1933 is repealed.

6     (2) The second sentence of section 19 (a) of such Act  
7     is amended by striking out “; but insofar as they relate to any  
8     common carrier subject to the provisions of section 20 of the  
9     Interstate Commerce Act, as amended, the rules and regula-  
10    tions of the Commission with respect to accounts shall not be

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(335)

1 inconsistent with the requirements imposed by the Interstate  
2 Commerce Commission under authority of such section 20”.

3 (3) Section 214 of the Interstate Commerce Act is  
4 amended by striking out the second proviso.

5 (b) Section 13 (b) of the Securities Exchange Act of  
6 1934 is amended by striking out “, and in the case of carriers  
7 subject to the provisions of section 20 of the Interstate Com-  
8 merce Act” and all that follows in such subsection, and insert-  
9 ing in lieu thereof “(except that such rules and regulations  
10 of the Commission may be inconsistent with such require-  
11 ments to the extent that the Commission determines that the  
12 public interest or the protection of investors so requires).”

13 (c) Section 304 (a) (4) (A) of the Trust Indenture Act  
14 of 1939 is amended by striking out “(6),”.

15 (d) Section 3 (c) (7) of the Investment Company Act  
16 of 1940 is repealed.

17 **EFFECTIVE DATES**

18 SEC. 2. (a) The amendments made by subsections (a)  
19 and (c) of section 1 shall take effect on the sixtieth day after  
20 the date of enactment of this Act, but shall not apply with  
21 respect to any security which was bona fide offered to the  
22 public by the issuer or by or through an underwriter before  
23 such sixtieth day.

24 (b) The amendment made by subsection (b) of section  
25 1 shall not apply to any report by any person respecting a

## 3

1 fiscal year of such person which began before the date of  
2 enactment of this Act.

3 (c) The amendment made by subsection (d) of section  
4 1 shall take effect on the sixtieth day after the date of enact-  
5 ment of this Act.

## APPENDIX B



SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

BY SPECIAL MESSENGER

Honorable Harley O. Staggars  
Chairman, Committee on Interstate  
and Foreign Commerce  
House of Representatives  
2125 Rayburn House Office Building  
Washington, D. C. 20515

Re: H.R. 12128, 92nd Congress.

Dear Mr. Chairman:

In the absence of Chairman Casey, I am pleased to send you herewith three copies of a memorandum setting forth the Commission's views on H.R. 12128. This is in response to your request for a report on that bill.

We have just been advised by the Office of Management and Budget that there is no objection to the submission of this report from the standpoint of the Administration's Program.

Sincerely yours,

Hugh F. Owens  
Commissioner

Enclosures (3)

(338)

MEMORANDUM PREPARED BY THE SECURITIES AND EXCHANGE COMMISSION FOR THE  
HOUSE OF REPRESENTATIVES COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE  
WITH RESPECT TO H. R. 12128, 92ND CONGRESS

H.R. 12128 would amend Sections 3(a)(6) and 19(a) of the Securities Act of 1933 [15 U.S.C. 77c(a)(6), 77s(a)], Section 13(b) of the Securities Exchange Act of 1934 [15 U.S.C. 78m(b)], Section 304(a)(4)(A) of the Trust Indenture Act of 1939 [15 U.S.C. 77ddd(a)(4)(A)], Section 3(c)(7) of the Investment Company Act of 1940 [15 U.S.C. 80a-3(c)(7)], and also Section 214 of the Interstate Commerce Act which was added under Part II of that Act by Section 214 of the Motor Carrier Act of 1935 [49 U.S.C. 314].

The effect of these amendments would be the repeal of certain exemptions under the federal securities laws administered by the Securities and Exchange Commission which are now available in connection with the issuance of securities and the filing of reports by certain interstate carriers by rail and motor which are subject to the jurisdiction of the Interstate Commerce Commission. An analysis of each amendment is set forth below.

While the Commission has been aware for some time of the existence of a weak spot in disclosures to, and protection of, securities investors who may acquire securities issued by ICC-regulated carriers which are exempt under the above mentioned provisions of the federal securities laws, the dangers inherent in this situation became much more apparent during recent Congressional hearings relating to the bankruptcy of Penn Central Transportation Company.<sup>1/</sup> In the light of this background and for the reasons which are more fully described below, the Securities and Exchange Commission strongly supports enactment of H.R. 12128 in its present form.

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<sup>1/</sup> See Hearings before the Special Subcommittee on Investigations of the Committee on Interstate and Foreign Commerce, House of Representatives, 91st Cong. 2nd Sess., Sept. 24, 1970 "Penn Central Transportation Company: Adequacy of Investor Protection"; also Staff Study for the same Special Subcommittee, July 27, 1971 "Inadequacies of Protections for Investors in Penn Central and Other ICC-Regulated Companies" (Committee Print).



I. Repeal of Section 3(a)(6) of the Securities Act of 1933.

The Securities Act of 1933 (the "Securities Act"), commonly called the "Truth in Securities" law, has two basic objectives: (a) to provide investors with material financial and other information concerning securities offered for public sale in interstate commerce or through the mails; and (b) to prohibit misrepresentation, deceit and other fraudulent acts and practices in the sale of securities generally. Such information is made available through the requirement that a registration statement be filed with this Commission by the issuer or seller of the securities which must become effective before sales may be effected, and that a prospectus which must be filed as part of that registration statement and must contain the minimum disclosures specified by the Securities Act be furnished to prospective purchasers so that they may exercise an informed judgment on whether or not to invest in such securities. Civil remedies are provided by the Act to an investor who suffers a loss as a result of violations of the registration, disclosure or anti-fraud requirements of the Act by the issuer or seller of the securities, and such remedies may also be asserted against others who participated in the violations.

Section 3(a)(6) of the Securities Act exempts from the registration and prospectus requirements of the Act securities of common or contract carriers, the issuance of which is subject to the provisions of Section 20(a) of the Interstate Commerce Act, as amended [49 U.S.C. 20(a)]. The term "carrier, as defined for purposes of Section 20(a), includes virtually all companies which are engaged in interstate transportation as common or contract carriers by rail or motor.

One result of the exemption under Section 3(a)(6) of the Securities Act has thus been that investors in such carriers have not been afforded the protections provided through registration as envisioned under Section 5 of that Act. To this extent, such carriers have been in a class by themselves among industrial corporations. Only banks, savings and loan associations, and insurance companies have specific exemptions comparable to those granted to such carriers. Moreover, it should be noted that not all carriers enjoy the exemption under Section 3(a)(6), for example, air carriers while ostensibly not different from railroads or trucks in such respects, are subject to the requirements of the Securities Act in the same manner as other industrial corporations. Nevertheless, while subject to the federal securities laws, an air carrier is also subject to concurrent supervision by the Civil Aeronautics Board, without any special problems arising from such dual jurisdiction.<sup>2/</sup>

There is very little in the legislative history of Section 3(a)(6) to provide an explanation for vesting of sole jurisdiction over carriers in the Interstate Commerce Commission including jurisdiction over issuance of securities. However, there appears in a statement by the Honorable Huston Thompson, a former member of the Federal Trade Commission in which supervision of the Securities Act was originally vested, and one of the framers of H.R. 4314 and S. 875 (the original versions of this Act in both houses of the 73d Congress), the following explanation of the purpose underlying what was to become Section 3(a)(6):

We do not want to have railroad companies file their information with the Federal Trade Commission and then go ahead and have to file it also with the Interstate Commerce Commission. So we say that where they are covered by a division of the Federal Government that has supervision, then they shall file their information with that division, but not with the Federal Trade Commission.

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<sup>2/</sup> This is applicable also with respect to the concurrent jurisdiction by the SEC and Federal Power Commission over gas and electric public utility holding companies; see Subcommittee Staff Report, fn 1 supra, pg. (11).

But when it comes to advertising, anyone, no matter where they have filed other information, becomes responsive to the provisions of this bill, so far as advertising is concerned. 3/

The section of H.R. 4314 dealing with advertising, and referred to above, was section 8 of the bill. Those sections of the Securities Act into which the originally proposed section 8 has been incorporated, i.e. Sections 5(b)(1), 5(b)(2), 6(d), 10(a)(1), 10(a)(2), 10(c) and 10(d), related to the form and content, availability for inspection, and requirement of delivery of prospectuses covering securities proposed to be sold in interstate commerce. These sections do not, however, apply to carriers, by virtue of the Section 3(a)(6) exemption. A possible explanation for the decision, at the time the Securities Act was enacted into law, not to carry through the original intention to require compliance with the advertising provisions, may be found in a statement by R. V. Fletcher, General Counsel of the Association of Railway Executives during the same hearings:

Section 8 was one of the matters I wanted to touch on. I have not had time to do that. That is the section, of course, which deals with advertisements, so called, and various things which might be put in there, and it seems to me that this is another feature which will burden the carriers unnecessarily, and accomplish no useful purpose insofar as the carriers and those purchasing their securities are concerned. 4/

The most significant effect of the repeal of Section 3(a)(6) of the Securities Act would be to abolish the exemption now available to ICC-regulated carriers from the registration and prospectus requirements of Section 5 of that Act and as a result place the securities of companies now under the jurisdiction of ICC alone under the concurrent jurisdiction of both the ICC and this Commission. With enactment of this provision of H.R. 12128, ICC-

3/ Hearings, House Comm. on Interstate and For. Commerce on H.R. 4314, 73d Cong., 1st Sess. at 29-30 (Mar. 31, Apr. 1, 4, 5, 1933).

4/ Id. at 204.

regulated companies would be required to file registration statements and prospectuses with the SEC, and have them become effective prior to any public distribution of their securities, and in this connection would be required to comply with other applicable provisions of the Securities Act and the rules and regulations promulgated thereunder which relate to the registration process.

While this memorandum will not go into a detailed analysis of all the differences which exist in connection with issuance of securities by companies which are subject to ICC regulation and those which are subject to the Securities Act,<sup>5/</sup> there are several important areas where the requirements under the latter legislation do not appear to have counterparts which apply at present to ICC-regulated carriers but which would do so with the repeal of the exemption in Section 3(a)(6) of the Securities Act. Among these, for example, are (1) the prospectus delivery provisions in Section 5(b)(2) of the Securities Act which require the dissemination of a prospectus to underwriters, and dealers, as well as to actual or prospective investors, prior to or simultaneously with the delivery of a security for purposes of sale or delivery after sale; (2) the obligations of the issuer to amend or update the prospectus after a registration statement has become effective and prior to completion of the offering; (3) assurance by the underwriter, pursuant to SEC Rule 460 [17 CFR 230.460], that proper steps have been taken to secure adequate distribution of the preliminary prospectus a reasonable time in advance of the anticipated effective date of the registration statement; and (4) compliance by all dealers effecting transactions in the

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<sup>5/</sup> The SEC does not have expertise on ICC procedures or requirements of the Interstate Commerce Act such as might qualify it to go into a detailed discussion of all such differences. However, these have been set out in the Hearings and Subcommittee Staff Report noted in footnote 1 above.

registered securities, whether or not they are participating in the distribution of the securities, with SEC Rules 174 and 425A [17 CFR 230.174, 230.425a] regarding the prospectus delivery duties of those dealers in the after-market. These rules relate to the obligation of dealers, including underwriters no longer acting as underwriters, to deliver a prospectus in transactions involving any securities of the same class as those registered during the 40-day or 90-day period after the effective registration date as specified in Section 4(3) of the Securities Act (except where they can prove that such securities are not part of the issue so registered), and require a statement to that effect to appear on the cover of the prospectus. Moreover, SEC Rules 135, 137, 138, and 139 under the Securities Act [17 CFR 230.135, 230.137, 230.138 and 230.139] spell out certain prohibitions and restrictions with respect to statements that may be published or circulated regarding the registered securities in the absence of an accompanying statutory prospectus, and provide an additional degree of protection which would not appear to be provided for under the ICC requirements.

Repeal of Section 3(a)(6) of the Securities Act would subject secondary distributions of securities by the corporate parent of the carrier, or by persons controlling, controlled by or under common control with the carrier, to the same requirements as initial offerings by the issuer itself. At present, as pointed out in the Subcommittee Staff Study<sup>6/</sup> of the House Committee on Interstate and Foreign Commerce, the ICC does not have the statutory authority to regulate such distributions because they do not involve the issuance by a carrier of its own securities. Since such large scale offerings by "insiders" of a carrier may possess all of the dangers attendant upon a new offering of securities, to insulate such distributions from the investor protection

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<sup>6/</sup>(Sec fn 1, supra.)

provisions of the Securities Act would not seem to be in the public interest.

Information now contained in prospectuses filed by carriers with the ICC is not ordinarily examined by the staff of the SEC, and, therefore, is not commented on. However, there are certain important differences both in textual requirements and accounting procedures followed by these two agencies, as was brought out during the above-mentioned House Committee hearings. For example, SEC forms under the Securities Act call for more detailed disclosure of such items as management compensation, stock options, and material interests in certain transactions involving management and the issuer. The accounting differences are discussed more fully below under the heading dealing with the proposed amendments to Section 13(b) of the Securities Exchange Act of 1934.

Certain additional advantages would result from repeal of Section 3(a)(6). Foremost among these, from the standpoint of investor protection as well as assistance to issuers in complying with the Act, is the reviewing process employed by the SEC staff. This process of review is directed to all filings with the SEC, and the staff is able to draw on considerable expertise gained over a period of many years relating to investor protection to assure compliance with the disclosure and protective provisions of the Securities Act.

Moreover, repeal of this exemption would bring into play certain administrative procedures which are now available to the SEC in aid of its reviewing process, such as investigatory powers conferred by Section 20(a) of the Securities Act [15 U.S.C. 77t(a)], the injunctive powers of Section 20(b) [15 U.S.C. 77t(b)] whereby this Commission may ask a court to enjoin or restrain any person whenever it determines that such person is engaged or about to engage in any act or practice which constitutes or will constitute a violation of the Act, and the power conferred on the Commission under Section

8(b) [15 U.S.C. 77h(b)] to issue a "stop order" which will delay the effectiveness of a registration statement until all deficiencies are remedied or which can stop all sales under an effective registration statement where such deficiencies are discovered after the effective date thus making any sales thereafter illegal until the deficiencies are remedied and the "stop order" has been lifted. When compliance with the disclosure requirements of the Securities Act is not obtained, or when any of the provisions of the Act or the rules or regulations promulgated thereunder are wilfully violated, the penalty provisions of Section 24 may be invoked by the SEC [15 U.S.C. 77x] under which a court may impose fines up to \$5,000 or imprisonment up to five years or both upon conviction. Finally, the civil remedies provided by Sections 11 and 12(1) of the Act [15 U.S.C. 77k, 77l(1)] would be available to purchasers of such securities not sold in compliance with the Act, remedies which would be in addition to the civil anti-fraud remedies provided by Sections 12(2) and 17(a) of the Act [15 U.S.C. 77l(2), 77q(a)] and by Rule 10b-5 under the Securities Exchange Act of 1934 [17CFR 240.10b-5] which are already available to purchasers of securities of carriers subject to ICC jurisdiction. The benefits inherent in bringing a civil action under Sections 11 and 12(1) of the Securities Act, which have no counterpart under ICC legislation, are that affirmative responsibility for complete and truthful disclosure is placed on the various classes of persons participating in the sale or distribution of the securities, and as a general rule the defrauded investor is entitled to recover upon proof of the misstatement or omission of a material fact in a registration statement or prospectus without being required to establish reliance thereon or the defendant's knowledge or intent to deceive as was required at common law, or upon a showing of failure to register such securities with the SEC when such registration is required.

II. Striking Out the Last Clause of the Second Sentence  
of Section 19(a) of The Securities Act of 1933

Section 19(a) of the Securities Act provides that the Commission shall have authority to make, amend and rescind such rules and regulations as may be necessary to carry out the provisions of the Act, including those governing registration statements and prospectuses for various classes of securities and issuers, defining accounting, technical and trade terms used in the Act, and prescribing the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts, in appraisal or valuation of assets and liabilities, in determining depreciation and depletion, in differentiation of recurring and nonrecurring income and of investment and operating income, and in the preparation of consolidated balance sheets and income accounts of persons in a control relationship to the issuer. Such authority is qualified, however, by a final clause reading: "but insofar as they relate to any common carrier subject to the provisions of section 20 of the Interstate Commerce Act, as amended, the rules and regulations of the Commission with respect to accounts shall not be inconsistent with the requirements imposed by the Interstate Commerce Commission under authority of such section 20."

Section 1(a) of H.R. 12128 would strike out the above quoted language from Section 19(a) of the Securities Act. The effect of this amendment would be to extend to the SEC the same authority with respect to rules and regulations which it may adopt under Section 19(a) of the Securities Act for carriers whose securities are now issued under Section 20(a) of the Interstate Commerce Act as it now has for other issuers. Thus financial statements of such carriers would have to meet the same general requirements as those of other issuers now subject to the Securities Act.



Should Section 3(a)(6) of the Securities Act be repealed, the proposed amendment to Section 19(a) would be necessary in order that the full benefit and impact of the deletion of the Section 3(a)(6) exemption be achieved. Without such amendment, ICC-regulated carriers brought under the registration requirements of Section 5 of the Securities Act might be able to continue to utilize their own methods of presenting financial information which now vary materially from those required by the SEC for other issuers. (The shortcomings of these alternatives from an accounting standpoint are discussed in those portions of this memorandum which deal with the proposed amendments to Section 3(a)(6) of the Securities Act and Section 13(b) of the Securities Exchange Act of 1934.) The proposed amendment to Section 19(a) of the Securities Act, on the other hand, would insure uniformity of reporting under this Act and would enable the average investor to make a more meaningful comparison between competing investment opportunities. Moreover, in the opinion of this Commission, applying present SEC requirements to financial statements of such carriers would make more readily apparent the true financial condition of such carriers. The SEC requirement that financial statements be certified by an independent public accountant would strengthen investor confidence in such reports and thus also benefit the carriers in this respect.

### III. Amendment Of Section 214 Of The Interstate Commerce Act

Section 214 of the Interstate Commerce Act was added under Part II of that Act by Section 214 of the Motor Carrier Act of 1935. The second proviso in Section 214 states:

Provided further, That the exemption in section 3(a)(6) of the 'Securities Act,' is hereby amended to read as follows: '(6) any security issued by a common or contract carrier, the issuance of which is subject to the provisions of section 20(a) of the Interstate Commerce Act as amended;'

The effect of that addition was to extend the exemption under Section 3(a)(6) of the Securities Act to motor carriers which the 1935 Act brought under the jurisdiction of the ICC.

Section 1(a)(3) of H.R. 12128 would repeal this exemption for contract motor carriers and place such carriers on the same basis with respect to issuance of their securities for public sale as common carriers by rail under the proposed repeal of Section 3(a)(6) of the Securities Act.

This amendment to Section 214 of the Interstate Commerce Act would be necessary since the repeal of Section 3(a)(6) of the Securities Act with respect to rail carriers would otherwise create the anomalous situation of continuing the Securities Act exemption as to motor carriers while abolishing it as to rail carriers.

Since the reasons for repealing the exemption are the same as to both types of carriers and have been fully stated earlier, they are not repeated here.

#### IV. Amendment of Section 13(b) of The Securities Exchange Act

In addition to providing for registration with the Securities and Exchange Commission of securities exchanges, securities associations and broker-dealers, and for market surveillance and certain restrictions on trading and prohibitions against market manipulation and fraud, and for regulating proxy and tender offer solicitations, the Securities Exchange Act of 1934 extends on a continuing basis the disclosure doctrine of investor protection which was initiated with the Securities Act. Its requirements in this area apply to companies with securities traded on national securities exchanges, and to those with securities traded in the over-the-counter market which have total assets of more than one million dollars and whose shareholders of a class of equity security number 500 or more, all of which are required to be registered with the Securities and Exchange Commission under Section 12 of the Act. For purposes of this memorandum, only the financial reporting requirements and related provisions will be discussed as they constitute the primary continuing disclosure mechanisms of the Securities Exchange Act.

Section 13(a) of that Act requires every issuer subject to the registration requirements of Section 12 of the Act to file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security, (1) such information and documents as the Commission shall require to keep reasonably current the information and documents filed under Section 12 of the Act (with one minor exception not pertinent to this discussion), and (2) such annual reports, certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports as the Commission may prescribe.

Section 13(b) of the Securities Exchange Act authorizes the Commission to prescribe the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in differentiating between recurring and nonrecurring income and also between investment and operating income, and in the preparation (where the Commission deems it necessary or desirable) of separate and/or consolidated balance sheets or income accounts of any person in a control relationship with the issuer.

Section 13(b) contains two qualifications to such authorizations, the first of which states:

"... but in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter."

In essence, this qualification places the Commission in a subordinate position with respect to the prescription of the proper method of accounting to be used in reports filed with the Commission under the Securities Exchange Act when the companies in question are also under the jurisdiction of other laws of the United States prescribing proper methods of accounting for those companies. Specific examples of such companies would be those regulated by the Interstate Commerce Commission, the Federal Power Commission, the Civil Aeronautics Board, the Federal Communications Commission, the Federal Home Loan Bank Board, and the Board of Governors of the Federal Reserve System.

This limitation on the Commission's authority in this area is further defined with respect to ICC-regulated carriers by the second qualification in

Section 13(b) which states:

[...the rules and regulations of the Commission with respect to reports] ... ", in the case of carriers subject to the provisions of section 20 of the Interstate Commerce Act, as amended, or carriers required pursuant to any other Act of Congress to make reports of the same general character as those required under such section 20, shall permit such carriers to file with the Commission and the exchange duplicate copies of the reports and other documents filed with the Interstate Commerce Commission, or with the governmental authority administering such other Act of Congress, in lieu of the reports, information and documents required under this section and section 12 in respect of the same subject matter."

As a consequence of the language quoted immediately above, ICC-regulated carriers presently file with the SEC duplicate copies of reports which they have filed with the ICC in lieu of reports which would otherwise be required of them. As a result, such carriers are not required to file annual reports with the SEC on SEC Form 10-K, quarterly reports on SEC Form 10-Q, or occasional reports of material changes on SEC Form 8-K.

The substitute forms filed by such carriers do not parallel SEC forms in several important respects. For example, the financial statements included in ICC reports are not required to be prepared in accordance with generally accepted accounting principles, nor are they required to comply with the provisions of SEC's Regulation S-X [17 CFR Part 210] regarding the form and content of financial statements.<sup>7/</sup> Specifically, the ICC does not permit

7/ The ICC did adopt, on January 25, 1962, in Docket No. 33581, a statement that:

Carriers desiring to do so may prepare and publish financial statements in reports to stockholders and others, except in reports to this Commission, based on generally accepted accounting principles for which there is authoritative support, provided that any variance from this Commission's prescribed accounting rules contained in such statements is clearly disclosed in footnotes to the statements.

Thus, even though certain accounting practices followed by the SEC, which are based on generally accepted accounting principles, may differ from corresponding practices followed by the ICC, ICC-regulated companies now have the discretion to prepare reports for dissemination to shareholders either in accordance with the rules of the ICC or with generally accepted accounting principles. Reports which are required to be submitted to the ICC, however, must still be prepared in accordance with ICC rules.

financial statements to be prepared on a consolidated basis or the recording of equity in earnings of unconsolidated subsidiaries, nor does it require that the statements be certified by independent public accountants. The ICC forms do not permit carriers to record provisions for deferred income taxes in their accounts, nor do they follow the method prescribed by the Accounting Principles Board of the American Institute of Certified Public Accountants for reporting prior period adjustments. On the other hand, SEC forms do call for financial statements prepared in accordance with generally accepted accounting principles which require consolidation of subsidiaries, recording of equity in unconsolidated subsidiaries, provisions for deferred income taxes and adjustment of surplus for prior period adjustments, and they also require that the annual financial statements be certified by independent public accountants (with one exception for insurance companies not pertinent to the present discussion).

From a textual standpoint, the ICC forms are not required to contain itemized reports of security issuances during the year, grants of stock options, other corporate events which may affect security valuations, and management remuneration and bonuses; whereas all of these are required to be included in the usual SEC Form 10-K because they are essential for a meaningful analysis of the companies involved.<sup>8/</sup>

With respect to the Form 10-Q quarterly reports required by Sections 12 and 13 of the Securities Exchange Act, Rule 13a-13(c) promulgated under this

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<sup>8/</sup> The SEC, constrained by the statutory limitations of Section 13(b) of the Securities Exchange Act, has adopted certain rules affecting the reports of the above-mentioned carriers. In lieu of Form 10-K, carriers file on SEC Form 12-K which does make provision for disclosure of securities issuances during the last fiscal year but which also allows them to file as the major portion of the Form 12-K the carrier's annual report to the ICC.

Act [17 CFR 240.13a-13(c)] permits common carriers which submit financial statements to the ICC to file as exhibits to reports on this form copies of certain quarterly reports submitted to the ICC. While the ICC forms in this case provide more detail regarding revenue and expenses than is required by SEC Form 10-Q for other corporations, they lack some of the information which this Commission deems essential, such as per share data, capitalization data, and other financial data prepared on a consolidated basis.

Section 1(b) of H.R. 12128 would delete from Section 13(b) of the Securities Exchange Act all of the second qualification (quoted above on page 14) which specifically concerns ICC-regulated carriers; and would substitute for such deletion a parenthetical clause. The result of these changes would be that Section 13(b) would then read:

(b) The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer or any person under direct or indirect common control with the issuer; but in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter (except that such rules and regulations of the Commission may be inconsistent with such requirements to the extent that the Commission determines that the public interest or the protection of investors so requires). <sup>9/</sup>

The effect of the deletion alone would be to place ICC-regulated carriers on an equal footing with the companies whose methods of accounting are prescribed

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<sup>9/</sup> The parenthetical "except" clause, which we have underscored, is what would be added by Section 1(b) of H.R. 12128.

by the provisions of any federal law (other than the Securities Exchange Act) or by rules and regulations under such laws. The Commission's authority with respect to these carriers, in the context of periodic reports filed with the Commission, would remain in a subordinate position to the ICC and its rules and regulations regarding inconsistencies "in respect of the same subject matter." The one important exception to this generalization, however, would be provided by the parenthetical "except" clause to be inserted in Section 13(b). This clause would allow the Commission to require compliance with its own rules pertaining to proper accounting procedures in reports filed with it by ICC-regulated carriers, even if inconsistent with procedures called for by ICC rules, "to the extent that the Commission determines that the public interest or the protection of investors so requires." As a result, under the limited circumstances stated in that clause, ICC carriers would be subject to filing annual, quarterly, and periodic reports of changes in conformity with the requirements of SEC rules and regulations. This would eliminate the present inconsistencies as outlined above between reports of such carriers and those of issuers subject to the full reporting requirements under the Securities Exchange Act. Not only would the investor receive documents containing more information relevant to his investment objectives and purposes, but he would be provided with a uniformity of reporting not now available to him with respect to ICC-regulated carriers which would be more useful for making comparative analyses of companies of different industries.

In closing this discussion of the amendments to Section 13(b), one final point is noted. The insertion of the parenthetical "except" clause discussed above, coupled with the language left unchanged in Section 13(b), would appear to remove the present limitations on SEC authority to prescribe accounting



procedures as to any person who reports to any other agency whose laws, rules or regulations impose requirements as to methods of accounting which differ from those of the SEC in respect of the same subject matter when the Commission determines that the public interest or the protection of investors so requires. In other words, under the circumstances mentioned in the parenthetical "except" clause, the Commission would have the discretionary power to exercise pre-eminent authority over the proper accounting procedures to be used in reports required to be filed with it by companies subject not just to ICC jurisdiction, but also the jurisdiction of other agencies such as the FPC, CAB, FCC, and FHLBB. It should be noted, however, that such a grant of pre-eminent authority would merely parallel that already granted the Commission under the Securities Act of 1933 regarding the issuance of securities (with the exception of securities issuances by ICC-regulated carriers, an exception which the present bill would remove). Although the drafters of the proposed legislation may have intended the thrust of this amendment to be limited to ICC-regulated carriers, it thus appears that in fact it would have a much wider impact in terms of the Commission's relationship with other agencies in accounting and reporting areas.

Assuming that H. R. 12128 would enlarge the scope of the Commission's authority in this broader fashion, not just vis-a-vis ICC requirements, the Commission would favor this aspect of the bill because it would move the requirements of the Securities Exchange Act closer to those of the Securities Act of 1933, something for which the Commission has been striving for some time. It would also afford investors information as to not just ICC-regulated carriers, but all companies regulated by any other agency whose accounting and reporting requirements vary from those of this Commission, which would better compare with that which they presently receive from other publicly held companies.

V. Deletion of Reference to Section 3(a)(6) of the Securities Act  
Contained in Section 304(a)(4)(A) of the Trust Indenture Act of 1939

The Trust Indenture Act of 1939 (the "1939 Act") was enacted as a supplement to the Securities Act after studies by the SEC had revealed the frequency with which trust indentures failed to provide minimum protections for security holders and absolved so-called trustees from minimum obligations in the discharge of their trusts. This Act applies in general to bonds, notes, debentures and similar debt securities offered for public sale which are issued pursuant to trust indentures under which more than one million dollars of securities may be outstanding at any one time.

The 1939 Act requires that such debt securities may not be offered to the public, even though registered under the Securities Act, unless they are issued pursuant to a qualified trust indenture which conforms to the minimum requirements specified in the Act. It requires also that the trustee, or at least the principal one, be a domestic corporation with minimum combined capital and surplus; imposes high standards of conduct and responsibility on the trustee; requires that the indenture trustee be free of conflicting interests which might interfere with the faithful exercise of its duties in behalf of purchasers of the securities; precludes preferential collection of certain claims owing to the trustee by the issuer in the event of default; provides for the issuer's supplying evidence to the trustee of compliance with indenture terms and conditions such as those relating to release and substitution of mortgaged property, issuance of new securities, or satisfaction of the indenture; and provides for reports and notices by the trustee to security holders. Other provisions prohibit impairment of the security holders' right to sue individually for principal and interest except under certain circumstances, and require the maintenance of a list of security holders which may be used by them

to communicate with each other regarding their rights as security holders.

The provisions of Section 304(a)(4)(A) of the 1939 Act exempt from the indenture and trustee qualifications requirements of the Act those securities which are also exempt under certain provisions of the Securities Act. Included therein is a reference to securities which are exempt under the provisions of Section 3(a)(6) of the Securities Act. The effect of this exemption, therefore, is to exclude from the requirements and proscriptions of the 1939 Act all debt securities which are subject to ICC jurisdiction under Section 20(a) of the Interstate Commerce Act.

The amendment proposed under Section 1(c) of H.R. 12128 is necessary, therefore, to conform Section 304(a)(4)(A) of the 1939 Act to the Securities Act exemption as it would be amended by Section 1 of the bill. Moreover, the reasons supporting repeal of the exemption in Section 3(a)(6) of the Securities Act would apply equally to the repeal of the exemption under the 1939 Act. The importance of this change is supported by the fact that the 1939 Act deals not only with disclosure of the terms of an indenture, but also with the substantive nature of the relations between obligor, obligee and trustee. For example, where indentures are required to be qualified under the 1939 Act, the Act prohibits certain relationships or transactions between the trustee and the obligor or the underwriter for securities of the obligor in certain instances which arise from certain interlocking management or directorships, ownership of securities or claims against the obligor or collateral for outstanding obligations of the obligor which are in default; it restricts the right of the trustee, if it becomes a creditor of the issuer, to improve its position as creditor to the detriment of security holders; and requires certain periodic reports by the trustee to the security holders for whom he acts as trustee.

Indentures now filed with the ICC by such carriers are not required to contain the provisions specified in the 1939 Act, nor are trustees subject to the same proscriptions by virtue of any federal statute. Thus security holders of debt obligations of such carriers are not afforded the same protections as are purchasers of securities subject to the 1939 Act. Enactment of the bill with Section 1(c) would extend such requirements and proscriptions to those carriers and their indenture trustees and would provide substantive protections and consistency of treatment to debt securities issued by such carriers.

VI. Repeal of Section 3(c)(7) of The Investment Company Act of 1940

The Investment Company Act of 1940 (the "1940 Act") resulted from a study of the activities and abuses of investment companies and investment advisers which was conducted by the Securities and Exchange Commission pursuant to direction of Congress. Under this Act, the activities of companies engaged primarily in the business of investing, reinvesting, owning, holding and trading in securities and whose own securities are offered and sold to and held by the investing public, are subject to certain statutory prohibitions and to SEC regulation in accordance with prescribed standards deemed necessary to protect the interests of investors and the public. Such companies are required to register with the Commission, and to disclose their financial condition and investment policies so as to afford investors full and complete information about their activities.

The Act provides a comprehensive framework of regulation which, among other things, prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval, protects

against management self-dealing, embezzlement or abuse of trust, and provides specific controls to eliminate or to mitigate inequitable capital structures. The 1940 Act also provides other basic investor protections including a requirement that management contracts be submitted to shareholders for approval; a prohibition against underwriters, investment bankers or brokers constituting more than a minority of the investment company's board of directors; and requirements for safekeeping of its assets. It also bars persons guilty of security frauds from serving as officers and directors; forbids issuance of senior securities by such companies except under specified conditions and terms; prohibits pyramiding of such companies and cross-ownership of their securities; and provides specific controls designed to protect against unfair transactions between investment companies and their affiliates.

At present, Section 3(c)(7)<sup>10/</sup> of the 1940 Act as amended excludes from the definition of an investment company for purposes of this Act:

(7) Any company subject to regulation under the Interstate Commerce Act, or any company whose entire capital stock is owned or controlled by such a company; Provided, That the assets of the controlled company consist substantially of securities issued by companies which are subject to regulation under the Interstate Commerce Act.

In effect, Section 3(c)(7) establishes two criteria, with the satisfaction of either one being sufficient to remove a company from the regulatory ambit of the 1940 Act. The first excludes a company subject to regulation under the Interstate Commerce Act, and the second excludes its controlled companies the assets of which consist substantially of securities of issuers which are themselves subject to regulation under the Interstate Commerce Act.

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<sup>10/</sup> Present Section 3(c)(7) was originally enacted as Section 3(c)(9), but was redesignated as Section 3(c)(7) by the Investment Company Amendments Act of 1970 which became effective December 14, 1970 (§3(b), P.L. 91-547, 84 Stat. 1414).

Section 1(d) of H.R. 12128 would repeal Section 3(c)(7) of the 1940 Act which now excludes ICC-regulated companies from regulation by the SEC under the 1940 Act. The effect of such repeal would be to extend SEC jurisdiction over ICC-regulated companies, which would fall within the definition of an investment company under the Act but for such exemption, in the same manner as it now applies to other investment companies.

The protective framework of the 1940 Act reflects the concern for the national public interest which Congress found to be affected by investment companies which customarily invest and trade in securities issued by companies engaged in business in interstate commerce, and which may dominate and control or otherwise affect the policies and management of such companies. This public interest, historically sensitive to abuse or imbalance, is further affected adversely when investment companies engage directly or indirectly in the business of an interstate carrier subject to the Interstate Commerce Act, the policy of which is, inter alia, to foster sound economic conditions in transportation.

Within this context of critical public concern, it is anomalous that an investment company can free itself of the regulation Congress deemed necessary to protect the public against abuse, not by a policy of self-restraint, but rather, as described below, by expansion into an area in which it may detract from sound economic conditions in transportation. This dichotomy is made possible by the gap in federal regulation that arises from the juxtaposition of the 1940 Act and the Interstate Commerce Act. The House Subcommittee Staff Study <sup>11/</sup> dramatically documents the detriments to

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<sup>11/</sup> (See n. 1 above)

public investors flowing from the regulatory gap created by the Section 3(c)(7) exclusion in the 1940 Act.

The Commission has on a number of occasions in past years called to the attention of Congress that Section 3(c)(7) provides a means whereby a corporation which largely may be engaged in the business of investing, reinvesting, owning, holding and trading in securities can avoid regulation under the 1940 Act simply by acquiring, with a small fraction of its assets, a common carrier, or to some minor extent directly engaging in the business of an interstate carrier.<sup>12/</sup> This avoidance is possible in a variety of ways. First, a company may itself be a carrier subject to regulation by the ICC, but its carrier assets may represent only a small fraction of its total assets. Second, a parent company, by the simple expedient of controlling a single carrier becomes subject to regulation by the ICC and is thus excluded from the definition of an investment company even though such control is exercised by stock ownership representing an insignificant

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<sup>12/</sup> See Annual Reports of the Securities and Exchange Commission: 21st Report, pp. 101-102 (1955), 22nd Report, pp. 188-189 (1956), 23rd Report, p. 10 (1957), 25th Report, p. 11 (1959); Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives (86th Cong., 1st Sess. 1959) pp. 124, 132, 140-141, 397-416; Hearing before a Subcommittee of the Committee on Banking and Currency, United States Senate (86th Cong. 1st Sess. 1959) pp. 130-133, 518-634; Memorandum of the Division of Corporate Regulation entitled "Possible Dual Regulatory Status of Investment Company-Carriers" transmitted by the Commission to Chairman Staggers on October 30, 1969; Memoranda of the Division of Corporate Regulation concerning the Pennsylvania Company, dated July 14 and September 15, 1970 and transmitted by the Commission to Chairman Staggers; Memorandum of the Division of Corporate Regulation concerning Alleghany Corporation, transmitted by the Commission to Chairman Staggers on August 21, 1970. The latter three memoranda are printed in Hearings "Penn Central Transportation Company--Adequacy of Investor Protection," (see n. 1 above) pp. 30-43 and 218-236.

At the time of the foregoing reports, hearings and memoranda the present section 3(c)(7) was 3(c)(9). (See n. 10 above).

percentage of the parent's assets. Further, with regard to the controlled company, since the Act does not define the term "substantially," a controlled company which has more than 50 per cent of its assets in non-carrier securities and an even greater percentage of its income which is derived from such securities, might claim it was excluded from being an investment company on the theory that its assets consist substantially of securities issued by ICC regulated companies.

H.R. 12128 would eliminate these anomalies by repealing Section 3(c)(7) of the 1940 Act so that those companies currently relying on that exclusion would be subject to registration and regulation under the 1940 Act if they otherwise fall within the Act's definition of an investment company.

Section 3(a)(1) of the 1940 Act defines as an investment company any company which is primarily engaged, or holds itself out as being primarily engaged in the business of "investing, reinvesting, or trading in securities." To cover situations in which such primary engagement is not readily apparent because the company is either directly, or through controlled companies, engaged in an industrial or other business together with investing in securities, Section 3(a)(3) provides a statistical definition of an investment company to include a company if, among other things, more than 40 per cent of the company's assets consist of securities other than those of majority-owned subsidiaries.



Section 3(b)(2) of the 1940 Act provides a means whereby the Commission may declare by order upon application that a company, notwithstanding the quantitative definition of Section 3(a)(3), is nevertheless not an investment company. Thus a company which can demonstrate that it is primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities, either directly or through majority-owned subsidiaries or through controlled companies conducting similar types of businesses, can be relieved from registration and regulation under the 1940 Act. In determining whether a company is so primarily engaged the Commission has traditionally considered the company's historical development; its public representations of policy; the activities of its officers and directors; and, most important, the nature of its present assets and the sources of its present income.

Though the original purpose of Section 3(c)(7) was to avoid subjecting companies to dual regulation, we believe that any adverse affect of such regulation has been exaggerated. Investment company-carriers, in fact, fall within the policy and purpose of both the Investment Company Act and the Interstate Commerce Act. Although regulation under both Acts may be dual, it is not duplicative because each has a different purpose with its own point of focus and concern.

To the extent, however, that duplicative regulation may arise as a result of the repeal of Section 3(c)(7), the Committee might consider

an amendment to Section 6 of the 1940 Act to add a new subsection (f)<sup>13/</sup>  
to provide:

(f) If, with respect to the issue, sale, or guaranty of a security, or assumption of obligation or liability in respect of a security, the method of keeping accounts, the filing of reports, or the acquisition or disposition of any security, money, or other property, and with respect to any other subject matter, any person is subject both to a requirement of the Investment Company Act of 1940, as amended, or of a rule, regulation or order thereunder and to a requirement of the Interstate Commerce Act or of a rule, regulation, or order thereunder, the requirements of the Investment Company Act of 1940, as amended, shall apply to such person, and such person shall not be subject to the requirements of the Interstate Commerce Act, or of any rule, regulation, or order thereunder, with respect to the same subject matter unless the Securities and Exchange Commission has exempted such person from such requirement of the Investment Company Act of 1940, as amended, by rule, regulation or order, in which case the requirements of the Interstate Commerce Act shall apply to such person. <sup>14/</sup>

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<sup>13/</sup> This suggestion is patterned after Section 318 of the Federal Power Act which eliminates duplicative regulation with respect to transactions which might otherwise be subject to regulation by the Commission under the Public Utility Holding Company Act of 1935 and the Federal Power Commission under the Federal Power Act.

<sup>14/</sup> As a further safeguard against any unanticipated duplicative regulation which may arise, it may be appropriate, after experience is acquired, to adopt rules under the 1940 Act exempting normal and traditional transactions or practices from sections of the 1940 Act which prove to be unnecessarily burdensome, or which should be subject to ICC oversight rather than that of the S.E.C. Such rules could be adopted pursuant to Section 6(c) which states that the "Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

The Commission, as noted above, has long recognized the regulatory gap created by Section 3(c)(7) and strongly supports repeal of that section. <sup>15/</sup>

CONCLUSION

For the reasons set forth above, the Commission favors prompt enactment of H.R. 12128.

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<sup>15/</sup> The Commission has supported earlier bills on this subject including H.R. 2481 (86th Cong. 1st Sess. 1959). That bill was reported out by the Interstate and Foreign Commerce Committee, (H.R. Rep. No. 2178, 86th Cong. 1st Sess.), was passed by the House and transmitted to the Senate. No action was taken thereon by the Senate. S. 1181, the counterpart of the House bill, was introduced on February 26, 1959, but was never reported out of Committee.

February 22, 1972

## APPENDIX C



*Interstate Commerce Commission*  
Washington, D. C. 20423

Office of the Chairman

April 10, 1972

Honorable Harley O. Staggers  
Chairman  
Committee on Interstate and  
Foreign Commerce  
House of Representatives  
Washington, DC 20515

Dear Chairman Staggers:

The purpose of this letter is to set forth the requested comments of the Interstate Commerce Commission upon H.R. 12128 which seeks to amend the following existing statutes - the Securities Act of 1933, the Interstate Commerce Act, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939 and the Investment Company Act of 1940.

Section 1(a)(1) of H.R. 12128 would repeal section 3(a)(6) of the Securities Act of 1933 which currently provides:

Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

(6) Any security issued by a common carrier, the issuance of which is subject to the provisions of Section 20a of Title 49;

The appropriate conforming repeal of the second proviso of section 214 of the Interstate Commerce Act is contained in section 1(a)(3) of the proposed bill. The result of such repeals would be to subject securities of carriers to the dual jurisdiction of the Securities and Exchange Commission (SEC) and this Commission.

Section 1(a)(2) would amend the 1933 Act by striking out the language in section 19(a) which requires SEC's accounting requirements covering common carriers subject to section 20 of the Interstate Commerce Act to be consistent with those issued by this Commission.

(367)

Section 1(b) of the bill would amend the Securities Exchange Act of 1934 to authorize the SEC to issue rules and regulations covering carriers subject to section 20 of the Interstate Commerce Act which are inconsistent with those of this Commission's to the extent the SEC determines it is necessary to protect investors or the public interest.

The Trust Indenture Act of 1939 deals with the disclosure of the terms of an indenture and with the substantive relationship between obligors, obligees and trustees. Section 304(a)(4)(A) presently provides an exemption for those securities which are exempt from the Securities Act--including, of course, those of ICC regulated carriers. To bring the Trust Indenture Act into conformity with the aforementioned repeal of the carrier exemption in the Securities Act, section 1(c) of H.R. 12128 would delete the exemption.

Section 3(c)(7) of the Investment Company Act of 1940, as amended, currently excludes from the definition of an "investment company":

any company subject to regulation under the Interstate Commerce Act, or any company whose entire outstanding capital stock is owned or controlled by such a company: Provided, That the assets of the controlled company consist substantially of securities issued by companies which are subject to regulation under the Interstate Commerce Act.

Section 2 of H.R. 12128 would provide appropriate lead times for the effective date of the various changes in regulation provided for in section 1.

The 1970 hearings before the Special Subcommittee on Investigations chaired by you focused needed attention on the gap in the exercised regulatory jurisdiction of the SEC and this agency. For example, it was developed during the course of those hearings that carriers offering securities pursuant to

section 20a of the Interstate Commerce Act are not in all cases required to tender a prospectus to investors as is required under the Securities Act of 1933.

As a result of your Subcommittee's hearings and our own staff report completed in 1969 and published by your full Committee in 1970, the Commission on November 8, 1971, instituted Ex Parte No. 279, Securities Regulations-Public Offerings. The proposed rules and regulations set forth in Ex Parte No. 279 would require carriers desiring to issue securities totalling \$100,000 or more to 25 or more investors to file an "offering circular" similar to the registration statement and prospectus used by the Securities and Exchange Commission. The "circular" will contain information and procedures, which will adequately inform the investing public in their investigation and properly protect them in the purchase of carriers' securities. Financial data will be furnished in accordance with generally accepted accounting principles. A copy of the order and proposed regulations are enclosed. We believe that the anticipated results of this proceeding negate any need for the changes contemplated in sections 1(a)(1), (2), and (3) and 1(c) of H.R. 12128.

We also oppose the change proposed in section 1(b) of the bill which would permit the SEC to establish accounting requirements which carriers subject to ICC regulation would have to meet in filing financial data with the SEC.

Section 13(b) of the Securities Exchange Act of 1934 empowers the SEC to prescribe the form or forms in which the required information shall be set forth, and when and how it should be submitted. However, it further provides that:

. . . in the case of carriers subject to the provisions of section 20 of the Interstate Commerce Act. . . [it] shall permit such carriers to file. . . duplicate copies of the reports and other documents filed with the Interstate Commerce Commission.

Pursuant to those requirements, reports filed with the SEC by carriers subject to our jurisdiction need not follow generally accepted accounting principles but instead can be filed on the basis of our Uniform System of Accounts. This, according to the SEC, creates a gap in information.

As pointed out in our letter to the Subcommittee, dated November 25, 1970, our accounting regulations differ slightly from generally accepted accounting principles. However, we remain convinced that by following our "Uniform System of Accounts", carriers are actually required to submit more complete and uniform statements than would be required if they merely followed "generally accepted accounting principles". We fail to see how the enactment of this section of the bill is necessary to protect investors.

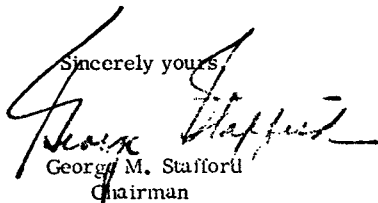
We support the change proposed in section 1(d) of the bill. The repeal of section 3(c)(7) of the Investment Company Act would subject companies now exempt from SEC regulation to the concurrent regulatory jurisdiction of that agency and this Commission. There are sound reasons for this. A carrier falling within the statutory definition of investment company may have a significant carrier operation which would warrant economic regulation by us to the same extent as any other carrier. A noncarrier holding company in control of two or more carriers which do not constitute a single system, and thus subject to our regulation under section 5(3) of the Interstate Commerce Act, may be extensively involved in transportation so that economic regulation by this Commission is similarly justified. Enactment of H.R. 11030 which expands our jurisdiction over holding companies would also include controls over their issuance of securities. We have the power, in any case, to decline jurisdiction when it appears that the company's involvement in transportation is relatively slight, and we conceive of no reason why we should pass on noncarrier operations and financing. Pursuant to dual jurisdiction, we would retain our full powers where such a company is a carrier, and, at the same time, be fully informed and be in a position to protect the carrier's interest. Concurrently, the SEC could exercise its jurisdiction and oversee the investor aspects. The overall protection of the carrier's and investor's interests far outweighs any additional burdens imposed upon the investment companies as a result of dual jurisdiction.

There is a matter not covered in the bill which warrants consideration, and that is the matter of secondary offerings. By statute our jurisdiction is restricted to situations where carriers are issuing securities. If someone other than a carrier makes a secondary offering of carrier securities, we have no authority to regulate that offering. We believe the Interstate Commerce Act or the Securities Act of 1933 should be appropriately amended so as to vest jurisdiction over such offerings in either this agency or the SEC.

In addition, although we have indicated that we do not favor the elimination of the carrier exemption by the repeal of section 3(a)(6) of the Securities Act of 1933, and related provisions, there is a matter that the Committee may want to consider if its decision is otherwise. This matter deals with a very unique form of security, the equipment trust certificate, and for the reasons outlined below, we are of the view that equipment trust certificates should be excepted from any general elimination of the carrier exemption. For one, these instruments are well-secured, low-risk forms of securities. The carrier usually puts up 20 percent of the purchase money, while the equipment itself stands as collateral for the other 80 percent. Secondly, while bids on these certificates are offered to the general public, it is invariably the case that these securities are purchased by sophisticated investing groups, such as syndicates of institutional investors. The successful bidder will designate a trustee who takes title to the equipment. Then, the trustee leases the equipment to the carrier, and when the indebtedness is satisfied through payment of the lease moneys, the trustee passes title to the carrier. It therefore seems that these certificates are marketed more in a manner like private placements, rather than public offerings.

Because of the nature of the instrument and the nature of the investor dealing in these instruments, it does not appear that the holders of these securities require the degree of protection such as is afforded the general public by the SEC. At the same time, one must consider the fact that since these certificates constitute a substantial part of carrier business, subjecting them to the full range of SEC regulation would place unwarranted burdens on carriers in terms of additional time and costs, all to little purpose in terms of public benefits. Accordingly, we feel that the processing of these securities should remain solely under the provisions of section 20a of the Interstate Commerce Act. If any future changes in the general marketing patterns for these securities, or a particular issue, indicates that the public needs further protection, our regulations to be promulgated in Ex Parte No. 279 could take such factors into account.

Sincerely yours,



George M. Stafford  
Chairman

Enclosure



SERVICE DATE

November 8, 1971

## NOTICE OF PROPOSED RULEMAKING AND ORDER

TITLE 49 - TRANSPORTATION  
 CHAPTER X - INTERSTATE COMMERCE COMMISSION  
 SUBCHAPTER E - PRACTICE AND PROCEDURE  
 PART 1115 - ISSUANCE OF SECURITIES, ASSUMPTION OF  
 OBLIGATIONS, AND FILING OF CERTIFICATES  
 AND REPORTS

At a General Session of the INTERSTATE COMMERCE COMMISSION, held at its office in Washington, D. C., on the 29th day of October, 1971.

EX PARTE NO. 279

## SECURITIES REGULATIONS - PUBLIC OFFERINGS

FORM OF OFFERING CIRCULAR REQUIRED FOR PUBLIC SALES  
 OF SECURITIES AUTHORIZED UNDER SECTION 20a OR 214  
 OF THE INTERSTATE COMMERCE ACT

Securities issued pursuant to Commission authority under section 20a or 214 of the Act are subject to "such terms and conditions as the Commission may deem necessary and appropriate in the premises..." (section 20a(3)). In those instances where carriers desire to issue securities to the public at large, it has been the standard practice of the Commission to require the applicant to sell such securities by prospectus or offering circular only, in the general form and manner prescribed by the Securities and Exchange Commission.

Currently, the volume of these public offerings has reached a sufficient number so that, in the interests of convenience and standardization, the Commission proposes to amend its form BF-6, Item 7, to set forth its required form and procedure in these matters. Our proposed new Item 7 is contained in appendix I attached to this Notice and Order.

The information required in the I.C.C. "prospectus", termed "Offering Circular of Security by Transportation Company," is essentially styled after the Securities and Exchange Commission S-1 form. Bold type statements with regard to I.C.C. jurisdiction will notify the public that the Securities and Exchange Commission does not have jurisdiction over the issue. Persons concerned with securities matters should carefully review the tendered regulation to note other departures from standard S.E.C. practices.

Anyone wishing to present their views and evidence, either in support of, or in opposition to, the action proposed in this order may do so by the submission of written data, views, or arguments.

Ex Parte No. 279

It is ordered, That a proceeding be, and it is hereby, instituted under the authority of the Interstate Commerce Act and the Administrative Procedure Act (60 Stat. 237, as amended; 5 U.S.C.A. § 553 and 559) for the purpose above described; that any views to be expressed by persons interested in this matter shall be filed with this Commission within 30 days of the publication of this order in the Federal Register; and that such views should specifically show any objection to these proposed regulations, with such responses to be presented on any item-by-item basis.

It is further ordered, That an original and 15 copies of such data, views, or arguments shall be filed with the Commission on or before December 11, 1971 and a copy thereof shall be served simultaneously upon each of the Commission's regional headquarters identified in appendix II of this notice and order. All statements will be a part of the record of this proceeding and will be available for public inspection at the offices of the Interstate Commerce Commission, 12th and Constitution Ave., N. W., Washington, D. C., during regular business hours.

It is further ordered, That notice to the general public or the matter here under consideration will be given by depositing a copy of this notice in the Office of the Secretary of this Commission, and in each of this Commission's regional headquarters identified in appendix II to this notice for public inspection and by filing a copy with the Director, Office of the Federal Register.

And it is further ordered, That these proposed regulations shall become effective 60 days from their publication in the Federal Register, unless otherwise ordered by this Commission.

By the Commission.

ROBERT L. OSWALD,  
Secretary.

(SEAL)

## APPENDIX I

## PROPOSED ITEM 7 OF FORM BF-6

Item 7. Contracts, underwritings, and other arrangements; public offerings.

(a) How and to whom, and by or through whom, it is proposed to issue the securities, with copies of all contracts, underwritings, and other arrangements made or proposed to be made in connection with the issue. The applicant must require the underwriter to undertake to provide copies of any required offering circular to prospective investors and persons directly solicited to invest their funds in the security.

(b) If applicant is effecting, causing to be effected, or has arranged for, the public offering of a transportation security, and said offer will be tendered to 25 or more prospective investors at a total price of not less than \$100,000, applicant must submit an offering circular for consideration by this Commission. Separate issuances made within one year will be considered as one issuance for the purposes of this paragraph.

## (1) General instructions:

(i) The financial representations contained in the offering circular should conform to generally-accepted principles of accounting. However, where there is a dissimilarity between a figure computed pursuant to generally-accepted accounting principles, and the figure produced under the Commission's Uniform System of Accounts, 49 CFR 1200-1219, the difference should be explained by footnoting the item under consideration. Any such footnote should be in language which adequately explains the reason for the difference to the ordinary investor.

(ii) A copy of any advertisement connected with the issue, such as "tombstone" or "red herring" advertisement, shall be attached to the application.

(iii) In the event the price of the security will not be determined by an existing market, or a formula relevant to market prices, as in the case of new issuances, the offering circular shall be made available to prospective investors, and likewise shall be furnished to those directly solicited to invest their funds in the security, when the order of the Commission authorizing the issuance of the securities becomes effective; but no sales or contracts to sell the securities, except to underwriters, may be made until 14 days, or as otherwise ordered, after the distribution of the authorized offering circular has taken place, this time period beginning from midnight of the day the distribution was initiated, including weekends and holidays. In all other cases, the same requirements as those in the above portion of this paragraph shall be applicable, except the waiting period will run for a period of three days, or as otherwise ordered by the Commission. Where an applicant elects to take the shorter three-day period, the reasons for the inapplicability of the fourteen-day period shall be specified.

(iv) The information presented in the offering circular should be presented in plain and concise language. Excessively verbose or complex descriptions may confuse the investor and should be avoided. Inapplicable items may be omitted and cross-references, unless otherwise indicated, may be employed.

(v) The offering circular shall contain an opinion of a Certified Public Accountant as to the financial representations contained therein.

(vi) For purposes of this form, and as a term of art limited in its application to these particular regulations, a "speculation" or "speculative security" is one where applicant has not had any substantial gross revenues or receipts from transportation or from the sale of services, or any substantial net income from any source, for any fiscal year ended the past 5 years, has not succeeded and does not intend to succeed such a concern, and does not have and does not intend to have any subsidiaries other than inactive subsidiaries with no more than nominal assets. If this offering is a speculation, an introductory statement shall be made in the offering circular summarizing the factors which make the offering a speculation and setting forth such matters as a comparison, in percentages, of the securities being offered to the public for cash and those issued or to be issued to promoters, directors, officers, controlling persons and underwriters for cash, property and services. Such applicants will follow the special instructions in the offering circular.

(vii) Attach to the offering circular, for the use of the Commission, a check list of the items required in the offering circular form. Identify the page(s) at which the item appears in the draft offering circular.

(2) Form and content of offering circular:

#### I. CAPTION AND DISTRIBUTION SPREAD

The outside front cover of the offering circular shall contain the information below in substantially the form indicated.

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#### OFFERING CIRCULAR OF SECURITY BY TRANSPORTATION COMPANY

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DISTRIBUTION OF THIS OFFERING CIRCULAR WAS INITIATED \_\_\_\_\_ (Date).  
INVESTORS MAY NOT BUY, NOR CONTRACT TO BUY THIS ISSUE UNTIL \_\_\_\_\_.  
(See General Instructions (11)).

(number of shares)

(name of issuer as it appears on securities)

(type of security; description)

THE ISSUANCE OF THESE SECURITIES HAS BEEN AUTHORIZED BY THE INTERSTATE COMMERCE COMMISSION WHICH DOES NOT PASS UPON THE INVESTMENT MERIT OF THESE SECURITIES NOR UPON THE ACCURACY OF THE INFORMATION THEREIN.

THIS OFFERING CIRCULAR IS AN INTEGRAL PART OF ISSUER'S APPLICATION UNDER SECTION 20(a) OR 214 OF THE INTERSTATE COMMERCE ACT. THIS ISSUE IS NOT SUBJECT TO THE JURISDICTION OF SECURITIES AND EXCHANGE COMMISSION.

	<u>Price to public</u>	<u>Underwriting discounts and commissions</u>	<u>Proceeds to registrant or other persons</u>
Per Unit _____	_____	_____	_____
Total _____	_____	_____	_____

Instructions. 1. Only commissions paid by the applicant or selling security holders in cash are to be included in the table. Commissions paid by other persons, and other considerations to the underwriters, shall be set forth following the table with a reference thereto in the second column of the table. Any finder's fee or similar payments shall be appropriately disclosed.

2. If the securities are to be offered at the market, or if the offering price is to be determined by a formula related to market prices, indicate the market involved and the market price as of the latest practicable date. Otherwise, the authorized offering circular must contain the sales price and commissions.

## II. PLAN OF DISTRIBUTION

(a) If the securities are to be offered through underwriters, give the names of the principal underwriters, and state the respective amounts underwritten. Identify each such underwriter having a material relationship to the issuer and state the nature of the relationship. State briefly the nature of the underwriters' obligation to take the securities.

Instruction. The description of the nature of the underwriters' obligation shall disclose whether the underwriters are, or will be, committed to take and to pay for all of the securities if any are taken, or whether it is merely an agency or "best efforts" arrangement under which the underwriters are required to take and pay for only such securities as they may sell to the public. Conditions precedent to the underwriters' taking the securities, including "market outs", need not be described except in the case of an agency or "best efforts" arrangement. All purchase agreements, underwriting agreements and agreements among underwriters must be submitted as part of the application.

(b) State briefly the discounts and commissions to be allowed or paid to dealers, including all cash, securities, contracts or other consideration to be received by any dealer in connection with the sale of the securities.

Instruction. If any dealers are to act in the capacity of sub-underwriters and are to be allowed or paid any additional discounts or commissions for acting in such capacity, a general statement to that effect will suffice without giving the additional amounts to be so paid.

(c) Outline briefly the plan of distribution of any securities to be applied which are to be offered otherwise than through underwriters.

#### III. USE OF PROCEEDS ACCRUING TO APPLICANT

State the principal purposes for which the net proceeds from the securities to be offered are intended to be used, and the approximate amount intended to be used for each such purpose.

Instructions. 1. Details of proposed expenditures need not be emphasized; for example, it is necessary to furnish only a brief outline of any program of construction or addition of equipment. If any material amount of other funds is to be used in conjunction with the proceeds, state the amount and sources of such other funds. If any material amount of the proceeds is to be used to acquire assets, otherwise than in the ordinary course of business, briefly describe the assets and give the names of the persons from whom they are to be acquired. State the cost of the assets to the registrant and the principle followed in determining such cost.

2. In the case of speculative securities, include a statement as to the use of the actual proceeds if they are not sufficient to accomplish all of the purposes set forth, whether or not the funds will be returned to subscribers in such case and, if not, the order of priority in which the proceeds will be used for the respective purposes.

## IV. SALES TO CURRENT HOLDERS

If any of the securities are to be offered for the account of security holders, name each such security holder and state the amount of securities of the class owned by him, the amount to be offered for his account and the percentage of the class (if one percent or more) to be owned by him after completion of the offering.

## V. CAPITAL STRUCTURE

Furnish the information called for by the following table, in substantially the tabular form indicated, as to each class of securities of the applicant and each class of securities, other than those owned by the applicant or its totally-held subsidiaries, of all subsidiaries whose financial statements are filed with the offering circular on either a consolidated or individual basis:

Title of class.	Amount authorized or to be authorized	Amount outstanding as of a specified date within 90 days	Amount to be outstanding if all securities being registered are sold
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Instructions. 1. Securities held by or for the account of the issuer thereof are not to be included in the amount outstanding, but the amount so held shall be stated in a note to the table.

2. Indebtedness evidenced by drafts, bills of exchange, bankers' acceptances or promissory notes may be set forth in a single aggregate amount under an appropriate caption such as "Sundry Indebtedness."

3. Applicant may, at its option, include in the table the capital share liability in dollars, as well as the amount, of each class of shares shown in the table, together with surplus attributed to each class of stock. Surplus shall be shown in the same manner as in the balance sheet of applicant, or in the consolidated balance sheet of the applicant and subsidiaries, if such a consolidated balance sheet is included in the offering circular.

## VI. SALES OTHER THAN FOR CASH

If any of the securities are to be offered otherwise than for cash, state briefly the general purposes of the distribution, the basis upon which the securities are to be offered, the amount of compensation and other expenses of distribution, and by whom they are to be borne.

Instruction. If the distribution is to be made pursuant to a plan of acquisition, reorganization, readjustment or succession, describe briefly the general effect of the plan and state when it became or is to become operative. If any of the securities are to be offered in exchange for securities of any other issuer, the offering circular shall contain a description of the exchange. State the relationship of the recipient of the securities to the company, including any promoter.

## VII. INFORMATION REGARDING ISSUER

State the year in which applicant was organized, its form of organization, and the name of the State or other jurisdiction under the laws of which it was organized, and each of the States under above laws it is authorized to operate.

List all the parents of applicant showing the basis of control and, as to each parent, the percentage of voting securities owned or other basis of control.

Briefly describe the parent's business activities, other than those of applicant. If applicant's parent is, in turn, controlled by another parent company, etc., describe that relationship.

Instructions. What is required is information that will describe any complex control situation to the prospective investor. And will inform him as to any proposed plans, such as acquisitions, sales, intercorporate transfers, dividend payments, spinoffs, etc., by the management of the parent corporation that will have a direct bearing on the financial well being of the carrier subsidiary in which the investor is being asked to invest.

Briefly describe the business actually done and intended to be done (not merely relating the powers authorized in the charter). The relative importance and size of various service and manufacturing endeavors should be furnished specifying those areas subject to regulation under the Interstate Commerce Act.

If the applicant and its subsidiaries are engaged in more than one line of business, state, for each of the applicant's last five fiscal years, the approximate amount or percentage of (i) total sales and revenues, and (ii) income (or loss) before income taxes and extraordinary losses, attributable to each line of business which during either of the last two fiscal years accounted for--

(A) 10 percent or more of total sales and revenues,

(B) 10 percent or more of income before income taxes and extraordinary items computed without deduction of loss resulting from operations of any line of business, or

(C) a loss which equalled or exceeded 10 percent of the amount of income specified in (B) above.



If it is impracticable to state the contribution to income (or loss) before income taxes and extraordinary items for any line of business, state the contribution thereof to the results of operations most closely approaching such income, together with a brief explanation of the reasons why it is not practicable to state the contribution to such income or loss.

Instructions. 1. If the number of lines of business for which information is required exceeds ten, the applicant may, at its option, furnish the required information only for the ten lines of business deemed most important to an understanding of overall operations. In such event, a statement to that effect shall be set forth.

2. In grouping products or services as lines of business, appropriate consideration shall be given to all relevant factors, including rates of profitability of operations, degrees of risk and opportunity for growth. The basis for grouping such products or services and any material changes between periods in such groupings shall be briefly described.

3. Where material amounts of products or services are regularly transferred from one line of business to another, the receiving and transferring lines may be considered a single line of business for the purpose of reporting the operating results thereof.

4. If the method of pricing intra-company transfers of products or services or the method of allocation of common or corporate costs materially affects the reported contribution to income of a line of business, such methods and any material changes between periods in such methods and the effect thereof shall be described briefly.

5. Information regarding sales or revenues or income (or loss) from different classes of products or services in operations regulated by Federal, State or municipal authorities may be limited to those classes of products or services required by any uniform system of accounts prescribed by such authorities.

#### VIII. DESCRIPTION OF PROPERTY

Briefly describe carrier revenue equipment, trackage, terminals, and other material tangible equipment and properties. Also describe trackage rights, certificates of public convenience and necessity, and other intangible operating authorities.

Separately describe other properties not used for providing transportation by applicant or its subsidiaries.

Instructions. Provide information which will fairly appraise the potential investor of the scope and potential of applicant's business. Detailed descriptions of the physical characteristics of tangible properties or reproductions of operating authorities are not required and should not be given. Maps, when instructive, should be employed.

## IX. BUSINESS CONDITIONS: REGULATION

Indicate briefly, to the extent material, the general competitive conditions applicant faces in its transportation services and, where applicable, in its non-transportation enterprises. Discuss any important changes in the technology or type of service applicant or its subsidiaries render to the public. Separate consideration should be given to different regions or modes.

List any material financial restrictions imposed upon applicant or its subsidiaries by the Interstate Commerce Commission to which it may be presently subject. Specify any such restrictions imposed in connection with this issue.

Reproduce the order of the Commission authorizing this issue.

## X. PENDING LEGAL PROCEEDINGS

Briefly describe any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the applicant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted and the principal parties thereto. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

**Instructions.** If the business ordinarily results in actions for negligence or other claims, no such action or claim need be described unless it departs from the normal kind of such actions. Any material bankruptcy, receivership, or similar proceeding with respect to the issuer or any of its significant subsidiaries shall be described. Any material proceedings to which any director, officer or affiliate of the applicant, or any associate of any such director, officer or security holder, is a party adverse to the applicant or any of its subsidiaries shall also be described.

## XI. STATEMENT OF INCOME AND EARNED SURPLUS

Furnish in comparative columnar form a statement of income for each of the last five fiscal years of the applicant and for any interim period between the end of the latest of such fiscal years and the date of the latest balance sheet furnished herein, and for the corresponding interim period of the preceding fiscal year. Include comparable data for any additional fiscal years necessary to keep the statement from being misleading. Where necessary, include information or explanation of material significance to investors in appraising the results shown, or refer to such information or explanation set forth elsewhere in the offering circular. An analysis of earned surplus shall be furnished for each period covered by an income statement, as a continuation thereof or elsewhere in the offering circular.

**Instructions.** 1. If common stock is to be offered, the statements shall be prepared to show earnings applicable to common stock. Per share earnings and dividends declared for each period of the statement shall also be included and the basis of computation stated.

2. If preferred stock is to be offered, there shall be shown the annual dividend requirements on such preferred stock. To the extent that an issue represents refinancing, only the additional dividend requirements shall be stated.

3. If debt securities are to be issued, the applicant shall show in tabular form for each fiscal year or other period the ratio of earnings to fixed charges. A pro forma ratio of earnings to fixed charges, adjusted to give effect to the issuance of the securities to be registered and any presently proposed issuance, retirement or redemption of securities, shall also be shown for the latest fiscal year or 12-month period.

4. Statements of income and earned surplus conforming to the foregoing may be furnished on a consolidated basis, but applicant must also present, for the most recent fiscal year, statements of income for each subsidiary (or appropriate groups of subsidiaries).

## XII. DESCRIPTION OF SECURITIES TO BE ISSUED

If capital stock is to be issued, state the title of the class and furnish the following information:

(a) Outline briefly (1) dividend rights; (2) voting rights; (3) liquidation rights; (4) pre-emptive rights; (5) conversion rights; (6) redemption provisions; (7) sinking fund provisions; and (8) liability to further calls or to assessment by the applicant.

(b) If the rights of holders of such stock may be modified otherwise than by a vote of a majority or more of the shares outstanding, voting as a class, so state and explain briefly.

(c) If preferred stock is to be issued, outline briefly any restriction on the repurchase or redemption of shares by the issuer while there is any arrearage in the payment of dividends or sinking fund installments. If there is no such restriction, so state.

Instructions. 1. This item requires only a brief summary of the provisions which are pertinent from an investment standpoint. A complete legal description of the provisions referred to is not required and should not be given. Do not set forth the provisions of the governing instruments verbatim; only a succinct resume is required.

2. If the rights evidenced by the securities are materially limited or qualified by the rights of any other class of securities, include such information regarding such other securities as will enable investors to understand the rights evidenced by the securities to be registered. No information need be given, however, as to any class of securities all of which will be redeemed and retired, provided appropriate steps to assure such redemption and retirement will be taken prior to or upon delivery of the securities to be issued.

3. If the securities described are to be offered pursuant to warrants or rights, state the amount of securities called for by such warrants or rights, the period during which and the price at which the warrants or rights are exercisable.

If debt securities are to be issued, outline briefly such of the following as are relevant:

(a) Provisions with respect to interest, conversion, maturity, redemption, amortization, sinking fund or retirement.

(b) Provisions with respect to the kind and priority of any lien securing the issue, together with a brief identification of the principal properties subject to such lien.

(c) Provisions with respect to the subordination of the rights of holders of the securities registered to other security holders or creditors of the registrant.

(d) Provisions restricting the declaration of dividends or requiring the maintenance of any ratio of assets, the creation or maintenance of reserves or the maintenance of properties.

(e) Provisions permitting or restricting the issuance of additional securities, the withdrawal of cash deposited against such issuance, the incurring of additional debt, the release or substitution of assets securing the issue, the modification of the terms of the security, and similar provisions.

Instructions. 1. In the case of secured debt, there should be stated (i) the approximate amount of unsecured property available for use against the issuance of bonds, as of the most recent practicable date, and (ii) whether the securities being issued are to be issued against such property, against the deposit of cash, or otherwise.

2. Provisions permitting the release of assets upon the deposit of equivalent funds or the pledge of equivalent property, the release of property no longer required in the business, obsolete property or property taken by eminent domain, the application of insurance moneys, and similar provisions, need not be described.

(f) The name of the trustee, if any, and the nature of any material relationship with the applicant or any of its affiliates; the percentage of securities of the class necessary to require the trustee to take action, and what indemnification the trustee may require before proceeding to enforce the lien.

(g) The general type of event which constitutes a default and whether or not any periodic evidence is required to be furnished as to the absence of default or as to compliance with the terms of the indenture.

Instruction. The instructions regarding capital stock, as pertinent, shall apply to debt securities.

If securities other than capital stock or debt are to be issued, outline briefly the rights evidenced thereby. If subscription warrants or rights are to be issued, state the title and amount of securities called for, the period during which and the price at which the warrants or rights are exercisable.

Instruction. The instructions regarding capital stock shall also apply to this item.

**XIII. DIRECTORS AND EXECUTIVE OFFICERS**

List the names of all directors and executive officers of the applicant and all persons chosen to become directors or executive officers. Indicate all positions and offices with the applicant held by each person named, and the principal occupations during the past five years of each executive officer and each person chosen to become an executive officer.

**Instructions.** 1. If any person chosen to become a director or executive officer has not consented to act as such, so state.

2. For the purpose of this item, the term "executive officer" means the president, vice president, secretary and treasurer, and any other officer who performs similar policymaking functions for the applicant.

**XIV. REMUNERATION OF DIRECTORS AND OFFICERS**

(a) Furnish the following information in substantially the tabular form indicated below as to all direct remuneration paid by the applicant and its subsidiaries during the applicant's last fiscal year to the following persons for services in all capacities:

(1) Each director, and each of the three highest paid officers, of the applicant whose aggregate direct remuneration exceeded \$30,000, naming each such person.

(2) All directors and officers of the applicant as a group, without naming them.

(A)	(B)	(C)
<u>Name of individual or identity of group</u>	<u>Capacities in which remuneration was received</u>	<u>Aggregate direct remuneration</u>

**Instructions.** 1. This item applies to any person who was a director or officer of the applicant at any time during the period specified. However, information need not be given for any portion of the period during which such person was not a director or officer of the applicant.

2. The information is to be given on an accrual basis if practicable. The tables required by this paragraph and paragraph (b) may be combined if the applicant so desires.

3. Do not include remuneration paid to a partnership in which any director or officer was a partner, but see item XVII.

4. If the applicant has not completed a full fiscal year since its organization or if it acquired or is to acquire the majority of its assets from a predecessor within the current fiscal year, the information shall be given for the current fiscal year, estimating future payments, if necessary. To the extent that such remuneration is to be computed upon the basis of a percentage of profits, it will suffice to state such percentage without estimating the amount of such profits to be paid.

5. If any part of the remuneration shown in response to this item was paid pursuant to a material bonus or profit-sharing plan, briefly describe the plan and the basis upon which directors or officers participate therein. See Instructions I to paragraph (b) for the meaning of the term plan.

(b) Furnish the following information, in substantially the tabular form indicated below, as to all pension or retirement benefits proposed to be paid under any existing plan in the event of retirement at normal retirement date, directly or indirectly, by the applicant or any of its subsidiaries to each director or officer named in answer to paragraph (a)(1) above:

(A)	(B)	(C)
<u>Name of Individual</u>	<u>Amounts set aside or accrued during applicant's last fiscal year</u>	<u>Estimated annual benefits upon retirement</u>

Instructions. 1. The term "plan" in this item includes all plans, contracts, authorizations or arrangements, whether or not set forth in any formal document.

2. Column (B) need not be answered with respect to amounts computed on an actuarial basis under any plan which provides for fixed benefits in the event of retirement at a specified age or after a specified number of years of service.

3. The information called for by Column(C) may be given in a table showing the annual benefits payable upon retirement to persons in specified salary classifications.

4. In the case of any plan (other than those specified in Instructions 2) where the amount set aside each year depends upon the amount of earnings of the applicant or its subsidiaries for such year or a prior year, or where it is otherwise impracticable to state the estimated annual benefits upon retirement, there shall be set forth, in lieu of the information called for by Column (C), the aggregate amount set aside or accrued to date, unless it is impracticable to do so, in which case there shall be stated the method of computing such benefits.

(c) Describe briefly all remuneration payments (other than payments reported under paragraph (a) or (b) of this item) proposed to be made in the future, directly or indirectly, by the applicant or any of its subsidiaries pursuant to any existing plan or arrangement to (i) each director or officer named in answer to paragraph (a)(1), naming each such person, and (ii) all directors and officers of the applicant as a group, without naming them.

Instruction. Information need not be included as to payments to be made for, or benefits to be received from, group life or accident insurance, group hospitalization or similar group payments or benefits. If it is impracticable to state the amount of remuneration payments proposed to be made, the aggregate amount set aside or accrued to date in respect of such payments should be stated, together with an explanation of the basis for future payments.

#### XV. OPTIONS TO PURCHASE SECURITIES

Furnish the following information as to options to purchase securities from the applicant or any of its subsidiaries, which are outstanding as of a specified date within 30 days prior to the date of filing.

(a) Describe the options, stating the material provisions including the consideration received and to be received for such options by the grantor thereof and the market value of the securities called for on the granting date.

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If, however, the options are "qualified stock options" or "restricted stock options" or options granted pursuant to a plan qualifying as an "employee stock purchase plan," as those terms are defined in Sections 422 through 424 of the Internal Revenue Code of 1954, as amended, only the following is required: (i) a statement to that effect, (ii), a brief description of the terms and conditions of the options or of the plan pursuant to which they were issued, and (iii) a statement of the provisions of the plan or options with respect to the relationship between the option price and the market price of the securities at the date when the options were granted, or with respect to the terms of any variable price option.

(b) State (i) the title and amount of securities called for by such options; (ii) the purchase prices of the securities called for and the expiration dates of such options; and (iii) the market value of the securities called for by such options as of the latest practicable date.

Instruction. In case a number of options are outstanding having different prices and expiration dates, the options may be grouped by prices and dates. If this produces more than five separate groups then there may be shown only the range of the expiration dates and the average purchase prices, i.e., the aggregate purchase price of all securities of the same class called for by all outstanding options to purchase securities of that class divided by the number of securities of such class so called for.

(c) Furnish separately the information called for by paragraph (b) above for all options held by (i) each director or officer named in answer to paragraph (a)(1) of item XIV naming each such person, and (ii) all directors and officers as a group without naming them.

Instructions. 1. The term "options" as used in this item includes all options, warrants and rights other than those issued to security holders as such on a pro rata basis.

2. The extension of options shall be deemed the granting of options within the meaning of this item.

3. Where the total market value of securities called for by all outstanding options as of the specified date referred to in this item does not exceed \$10,000 for any officer or director named in answer to paragraph (a)(1) of Item 17, or \$30,000 for all officers and directors as a group, or for all option holders as a group, this item need not be answered with respect to options held by such person or group.

XVI. PRINCIPAL HOLDERS OF SECURITIES.

Furnish the following information as of a specified date within 90 days prior to the date of filing in substantially the tabular form indicated:

(a) As to the voting securities of the applicant owned of record or beneficially by each person who owns of record, or is known by the applicant to own beneficially, more than 10 percent of any class of such securities. Show in Column (3) whether the securities are owned both of record and beneficially, of record only, or beneficially only, and show in Columns (4) and (5) the respective amounts and percentages owned in each such manner:

(1)	(2)	(3)	(4)	(5)
<u>Name and Address</u>	<u>Title of Class</u>	<u>Type of Ownership</u>	<u>Amount Owned</u>	<u>Percent of Class</u>

(b) As to each class of equity securities of the applicant or any of its parents or subsidiaries, other than directors' qualifying shares, beneficially owned directly or indirectly by all directors and officers of the applicant, as a group, without naming them.

(1)	(2)	(3)
<u>Title of Class</u>	<u>Amount Beneficially Owned</u>	<u>Percent of Class</u>

Instructions. 1. The percentages are to be calculated on the basis of the amount of outstanding securities, excluding securities held by or for the account of the issuer. In any case where the amount owned by directors and officers as a group is less than 1 percent of the class, the percent of the class owned by them may be omitted.

2. If the equity securities are being issued in connection with, or pursuant to, a plan of acquisition, reorganization, readjustment or succession, indicate, as far as practicable, the status to exist upon consummation of the plan on the basis of present holdings and commitments.

3. If any of the securities being issued are to be offered for the account of security holders, name each such security holder and state the amount of the securities owned by him, the amount to be offered for his account, and the amount to be owned after the offering.

4. If, to the knowledge of the applicant or any principal underwriter of the securities being issued, more than 10 percent of any class of voting securities of the applicant are held or are to be held subject to any voting trust or other similar agreement, state the title of such securities, the amount held or to be held and the duration of the agreement. Give the names and addresses of the voting trustees and outline briefly their voting rights and other powers under the agreement.



**XVII. INTEREST OF MANAGEMENT AND OTHERS IN CERTAIN TRANSACTIONS**

Describe briefly, and where practicable, state the approximate amount of any material interest, direct or indirect, of any of the following persons in any material transaction during the last three years, or in any material proposed transactions, to which the applicant, or a person in control of applicant as defined in Item VII or any of its subsidiaries was, or is to be, a party:

- (a) Any director or officer of the applicant;
- (b) Any security holder named in answer to XVI(a);
- (c) Any person listed in Item VII.
- (d) Any associate of any of the foregoing persons.

**Instructions.** 1. See Instruction 1 to Item XIV(a). Include the name of each person whose interest in any transaction is described and the nature of the relationship by reason of which such interest is required to be described. Where it is not practicable to state the approximate amount of the interest, the approximate amount involved in the transaction shall be indicated.

2. As to any transaction involving the purchase or sale of assets by or to the applicant or any subsidiary, otherwise than in the ordinary course of business, state the cost of the assets to the purchaser and the cost thereof to the seller if acquired by the seller within two years prior to the transaction.

3. This item does not apply to any interest arising from the ownership of securities of the applicant where the security holder receives no extra or special benefit not shared on a pro rata basis by all other holders of the same class

4. No information need be given in answer to this item as to any remuneration not received during the applicant's last fiscal year or as to any remuneration or other transaction disclosed in response to Items XIV or XV.

5. Information should be included as to any material underwriting discounts and commissions upon the sale of securities by the applicant where any of the specified persons was or is to be a principal underwriter or is a controlling person, or member, of a firm which was or is to be a principal underwriter. Information need not be given concerning ordinary management fees paid by underwriters to a managing underwriter pursuant to an agreement among underwriters the parties to which do not include the applicant or its subsidiaries.

6. No information need be given in answer to this item as to any transaction or any interest therein where:

(i) the rates or charges involved in the transaction are fixed by law or determined by competitive bids;

(ii) the interest of the specified persons in the transaction is solely that of a shareholder in another unaffiliated corporation which is a

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(iii) the transaction involves services as a bank depository of funds, transfer agent, registrar, trustee under a trust indenture, or other similar services;

(iv) the interest of the specified persons, including all periodic installments in the case of any lease or other agreement providing for periodic payments or installments, does not exceed \$30,000;

(v) the transaction does not involve remuneration for services, directly or indirectly, and (a) the interest of the specified persons arises from the ownership individually and in the aggregate of less than 10% of any class of equity securities of another corporation which is a party to the transaction, (b) the transaction is in the ordinary course of business of the applicant or its subsidiaries, and (c) the amount of such transaction or series of transactions is less than 10% of the total sales or purchases, as the case may be, of the applicant and its subsidiaries.

7. Information shall be furnished in answer to this item with respect to transactions not excluded above which involve remuneration, directly or indirectly, to any of the specified persons for services in any capacity unless the interest of such persons arises solely from the ownership individually and in the aggregate of less than 10% of any class of equity securities of another corporation furnishing the services to the applicant or its subsidiaries.

8. This item does not require the disclosure of any interest in any transaction unless such interest and transaction are material.

**XVIII. OTHER FINANCIAL STATEMENTS AND "BALANCE SHEETS" SCHEDULES.**

(a) There shall be furnished a balance sheet of the applicant and a consolidated balance sheet of the applicant and its subsidiaries as of a date within six months prior to the date of filing the application.

Instructions. The individual balance sheets of the applicant may be omitted if (i) consolidated balance sheets of the applicant and one or more of its subsidiaries are furnished, (ii) either one of the following conditions is met, and (iii) the Commission is advised as to the reasons for such omission:

(1) The applicant is primarily an operating company and all subsidiaries included in the consolidated balance sheets furnished are totally-held subsidiaries; or

(2) The applicant's total assets, exclusive of investments in and advances to the consolidated subsidiaries, constitute 85% or more of the total assets shown by the consolidated balance sheets filed and the applicant's total gross revenues for the period for which its profit and loss statements would be filed, exclusive of interest and dividends received from the consolidated subsidiaries, constitute 85% or more of the total gross revenue shown by the consolidated profit and loss statements filed.

(b) There shall be furnished for each majority-owned subsidiary of the applicant not included in the consolidated statements, the balance sheets which would be required if the subsidiary were itself an applicant. If the applicant owns, directly or indirectly, approximately 50% of the voting securities of any person and approximately 50% of the voting securities of such person is owned, directly or indirectly, by another single interest, there shall be filed for each such person the balance sheets which would be required if it were an applicant. The statements filed for each such person shall identify the other single interest. Where appropriate, group statements may be filed for such persons.

Instructions. 1. Insofar as practicable, these balance sheets shall be as of the same dates as those of the applicant.

2. There may be omitted all balance sheets of any one or more unconsolidated subsidiaries or fifty percent owned persons if all such subsidiaries and persons whose balance sheets are so omitted, considered in the aggregate as a single subsidiary, would not constitute a significant subsidiary.

(c) (1) There shall be filed for any business directly or indirectly acquired by the applicant after the date of the latest balance sheet filed pursuant to (a) above and for any business to be directly or indirectly acquired by the applicant, the financial statements which would be required if such business were an applicant.

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(2) The acquisition of securities shall be deemed to be the acquisition of a business if such securities give control of the business or combined with securities already held give such control.

(3) No financial statements need be filed, however, for any business acquired or to be acquired from a totally-held subsidiary. In addition, the statements of any one or more business may be omitted if such businesses, considered in the aggregate as a single subsidiary, would not constitute a significant subsidiary.

## APPENDIX II

## REGION 1

Regional Manager Robert L. Abare  
Interstate Commerce Commission  
John Fitzgerald Kennedy Building  
Government Center, Room 2211B  
Boston, Mass. 02203

## REGION 2

Regional Manager Fred E. Cochran  
Interstate Commerce Commission  
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1518 Walnut Street  
Philadelphia, Pa. 19102

## REGION 3

Regional Manager James B. Weber  
Interstate Commerce Commission  
1252 West Peachtree Street, N. W.  
Room 300  
Atlanta, Ga. 30309

## REGION 4

Regional Manager Charles W. Haas  
Interstate Commerce Commission  
Everett McKinley Dirksen Building  
Room 1086  
219 South Dearborn Street  
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## REGION 5

Regional Manager Harold M. Gregory  
Interstate Commerce Commission  
9A27 Fritz Garland Lanham  
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