

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.^{162 163 164} 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.¹⁶⁵ There were no rules, however, on the use or composition of any selling literature disseminated to the public.¹⁶⁶

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. & Gore, Forgan, Wm. R. Staats, Inc. The debentures were exchangeable for shares of the common stock of Norfolk & Western Ry. Co.¹⁶⁷ 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.

¹⁶² 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.

¹⁶³ Both offerings were made for the stated purpose of supplying funds for the Transportation Co.

¹⁶⁴ Pennco made a \$35 million private placement of collateral trust bonds in July, 1969. The proceeds were supplied to the parent company.

¹⁶⁵ 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.

¹⁶⁶ 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.

¹⁶⁷ 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 \$435,400,000.¹⁶⁸ 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.¹⁶⁹

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.¹⁷⁰

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 completed¹⁷¹ 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.¹⁷² Disclosure of the exchange might have alerted investors to the cash drain from the railroad to the real estate subsidiaries.

¹⁶⁸ 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
7.5 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

¹⁶⁸ See page 137 et seq.

¹⁷⁰ See page 104 et seq.

¹⁷¹ See page 142 et seq.

¹⁷² 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.¹⁷³ 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.¹⁷⁴ 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, 1971.¹⁷⁵

¹⁷³ The common stock of Pennsylvania Co. itself was pledged as security to the revolving credit.

¹⁷⁴ 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.

¹⁷⁵ A note written by Doescher dated Feb. 12, 1970 states: "Concept feasible, delay exercise of warrants until July 1, 1971. (Subsequent circular now delay registration statements until warrants become

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.¹⁷⁶ 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.¹⁷⁷ 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.¹⁷⁸

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.¹⁷⁹ 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

¹⁷⁶ From a memorandum of February 24, 1970 from Paul A. Downey of First Boston Corp. to Doescher:

"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 N.G.D. 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."

¹⁷⁷ Penn Central 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.

¹⁷⁸ From a letter of April 9, 1970 to Hans Muntinga, cf 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."

¹⁷⁹ Penn Central International, a Curaçao 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,¹⁸⁰ 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.¹⁸¹ 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.¹⁸² 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

¹⁸⁰ 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.

¹⁸¹ 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.

¹⁸² 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.¹⁸³

Doescher of First Boston then reviewed the International circular and, after speaking with a representative of Pierson, Heldring & 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

¹⁸³ 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, Pennel Co. ("Pennel"), 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.¹⁵⁴

(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

¹⁵⁴ 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.¹⁵⁵ 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

¹⁵⁵ Among those participating were: First Boston Corp. (Emil Patberg, Jr., chairman, Paul L. Miller, president, Charles C. Glavin, chairman of executive committee, N. Gregory Doescher, vice president); Gore 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 (Haus 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.¹⁵⁶ The railroad results included nonrailroad items, including the Bituminous sale.¹⁵⁷ 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.¹⁵⁸ 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

¹⁵⁶ 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.

¹⁵⁷ It appears that this sale, like the Wabash exchange, was entered into with a view toward lessening the losses in the first quarter.

¹⁵⁸ 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 Gloro 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 15.¹⁸⁹ 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 12.¹⁹⁰ The revised circular had been made necessary by a change in the terms of the offering.¹⁹¹ 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.¹⁹² It is unlikely that this additional circulation would be effective or even cause many brokers to read the circular.¹⁹³ The

¹⁸⁹ 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.

¹⁹⁰ The circulars were not distributed until May 16.

¹⁹¹ The revised circular was not filed with the ICC. The ICC had no rules relating to offering circulars or to their amendment.

¹⁹² Copies of the May 12 circular were sent to 3,375 NASD members whereas the April 27 circular had gone to 700 brokers.

¹⁹³ According to Doescher:

"Q. New 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.¹⁹⁴

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.

¹⁹⁴ Butcher & Sherrerd claimed that it had begun selling out selected accounts based in part on information

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?*¹⁹⁵ I am reluctant to use this because it will lead to more association of the financial results with the debenture issue.

¹⁹⁵ 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.¹⁹⁶

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.¹⁹⁷ 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 Glorc, 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 Glorc, Forgan upon the urging of Charles Hodge, a Glorc, Forgan partner.

¹⁹⁶ For convenience, unless otherwise indicated, references to Great Southwest include Macco Corp., which was merged into Great Southwest in March 1969.

¹⁹⁷ 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.¹⁹⁸

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.^{199 200}

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.^{201 202} 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

¹⁹⁸ See section on Penphil for Wynne's involvement at the time in an investment group including Hodge and Pennsylvania Railroad officers.

¹⁹⁹ Until the merger of Macco and Great Southwest in March 1969, Macco was a 100-percent subsidiary of Pennco.

²⁰⁰ 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.

²⁰¹ 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.

²⁰² 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,²⁰³ 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 * * *"²⁰⁴ 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.²⁰⁵

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.^{206, 207} 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.

²⁰³ Baker had been on the legal staff of Great Southwest and had advanced to general counsel and secretary prior to his Macco assignment.

²⁰⁴ Memo from Baker to Wynne Aug. 5, 1967.

²⁰⁵ Upon the acquisition of Macco by GSC in 1969, Baker replaced Wynne as chief executive officer of the combined companies.

²⁰⁶ 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."

²⁰⁷ 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 act

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.²⁰⁸ 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:

²⁰⁸ 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-firm 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."

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 Maeco, 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 Maeco and Great Southwest were counterparts to concealment efforts being made in other parts of the Penn Central system. Maeco 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 Maeco 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 Maeco 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 Maeco 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."²⁰⁰

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.²¹⁰ 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.²¹¹

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

²⁰⁰ 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."

²¹⁰ 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. 16, 1968.)

²¹¹ 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

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.²¹²

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.²¹³ 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.²¹⁴ Baker consulted law

²¹² This matter is more fully treated in the section of this report covering the role of the directors.

²¹³ Memorandum from Baker to Wynne Aug. 5, 1967.

²¹⁴ "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 1968²¹⁵ 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.²¹⁶ 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 33½ percent of the Texas park principal had been paid.²¹⁷ 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.²¹⁸ 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

²¹⁵ This was an intrastate offering and no SEC filing was made.

²¹⁶ These syndications were registered with the Commission.

²¹⁷ 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.

²¹⁸ 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 soared²¹⁹ and the growth in reported earnings helped to mask the losses of the railroad.²²⁰ 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.²²¹ 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.²²² 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"

²¹⁹ The price of Great Southwest shares increased as follows:

High bids:	
1964.....	2½
1965.....	4½
1966.....	4½
1967.....	4½
1968.....	13½
1969.....	41½

²²⁰ 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.

²²¹ 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."

²²² 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.^{223, 224} 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.

²²³ "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.)

²²⁴ William Dilliard, 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 \$4,600,000.²²⁵ These increases were attributed to the change from leasing to sales.²²⁶

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

²²⁵ 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

²²⁶ 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).²²⁷ 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.²²⁸ 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.²²⁹

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.²³⁰ Bevan's interest was not related to any prospect Penn

²²⁷ 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.

²²⁸ 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.

²²⁹ 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.

²³⁰ 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.²³¹ 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.

²³¹ 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.*²³² 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, Bevan 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

²³² 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.²³³ 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.²³⁴

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.²³⁵ 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 Caldwell²³⁶ 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.²³⁷ Based on 1968 results Wynne earned \$299,027, in additional compensation; Baker earned \$199,158 and Ray and Caldwell each earned \$99,675.²³⁸

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.

²³³ 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.

²³⁴ 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.

²³⁵ 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.

²³⁶ Wynne and Caldwell had previously been Macco employees under contract.

²³⁷ The contract period was from Jan. 1, 1968, to Dec. 31, 1972.

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.²³⁹ 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 1972.²⁴⁰ 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.²⁴¹

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.²⁴²

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.²⁴³

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

²³⁹ 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.

²⁴⁰ Base salaries were \$125,000, \$100,000, and \$75,000 for Wynne, Baker, and Ray respectively.

²⁴¹ Caldwell was to receive a base salary of \$55,000 plus compensation of 1 percent of the excess of Macco earnings only.

²⁴² Memorandum from Gerstnecker to Bevan, May 29, 1969.

²⁴³ 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.²⁴⁴ 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.²⁴⁵ 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.²⁴⁶ The origin of this proposed offering is not clear, but it appears to lie with Penn Central management.^{247 248} As Bevan told the stockholders, Pennco could recoup part of their investment and also create a larger market for the stock.²⁴⁹ The offer-

²⁴⁴ See page 127.

²⁴⁵ 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.

²⁴⁶ 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.

²⁴⁷ 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.

²⁴⁸ 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.

²⁴⁹ As Bevan spoke to the shareholders, GSC stock prices (high bids) were touching record levels: 1964—2½; 1965—4½; 1966—4¾; 1967—4¾; 1968—13¾; 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.^{250 251}

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 Glore 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.^{252 253} 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.

²⁵⁰ 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.

²⁵¹ In the last week of 1969, after GSC stock had been in constant decline, several members of Pennhill (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.

²⁵² 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.

²⁵³ 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.²⁵⁴ 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.²⁵⁵ 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:

	<i>Percent</i>
1966—\$2,990,000.....	6
1967—10,400,000.....	6½
1968—7,400,000.....	6½
1969—5,200,000.....	8½
(9 months)	

²⁵⁴ 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."

²⁵⁵ 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 1968	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.²⁵⁶ 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

²⁵⁶ The option was granted because GSC had found and evaluated Macco before its acquisition by Pennco.

its Macco warrants.²⁵⁷ 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.²⁵⁸ 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.²⁵⁹

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.²⁶⁰ 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,²⁶¹ 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

²⁵⁷ Glore Forgan's interest in Macco had been converted from shares to warrants in 1967.

²⁵⁸ 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.

²⁵⁹ 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.

²⁶⁰ The prospectus was not filed with or reviewed by the SEC.

²⁶¹ 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.²⁶² 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.²⁶³

The scheme appears to have been developed by Bevan and Wynne.²⁶⁴ 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

²⁶² 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.

²⁶³ 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.

²⁶⁴ 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.²⁶⁵ 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: ²⁶⁶

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.²⁶⁷

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

²⁶⁵ 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.

²⁶⁶ 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.

²⁶⁷ 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.²⁶⁸ 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

²⁶⁸ 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.²⁶⁹ 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.²⁷⁰ None of the loans were secured.

²⁶⁹ 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.

²⁷⁰ See table on p. 146.

It appears that these borrowings had been made in a desperate effort to meet GSC's tremendous cash needs.²⁷¹ 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.²⁷²

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. 13, 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 13, 1970	Overseas	Merban	2,000,000		Nov. 16, 1970
(l)	May 21, 1970	Overseas	Merban	2,000,000		Dec. 17, 1970

²⁷¹ 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.

²⁷² 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.²⁷³ 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.²⁷⁴ 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.²⁷⁵

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

²⁷³ Bevan and PC financial sources knew of the borrowings partly because they were borrowing from the same source.

²⁷⁴ Investors were additionally misled into believing the earnings represented cash income. Actually, a cash drain was occurring in the company.

²⁷⁵ 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."²⁷⁶

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 1970.²⁷⁷ Baker's views are contained in a memoran-

²⁷⁶ 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.

²⁷⁷ 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.²⁷⁸ Baker was concerned about the impact on GSC of a tightening of the rules:²⁷⁹

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.²⁸⁰ Later,²⁸¹ 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

²⁷⁸ From Baker to Bevan and Wynne, Feb. 3, 1970.

²⁷⁹ 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.

²⁸⁰ Baker apparently felt that unscrupulous real estate companies were bringing a crackdown on "reputable" companies such as GSC.

²⁸¹ 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.²⁸²

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.²⁸³

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.²⁸⁴

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.²⁸⁵

²⁸² Fletcher, *Cyclopedia of the Law of Private Corporations*; 1965 revised volume; vol. 3, p. 688 (§ 1079).

²⁸³ *Id.* p. 674 (§ 1070).

²⁸⁴ *Id.* p. 685 (§ 1072).

²⁸⁵ *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.²⁸⁶

The Penn Central outside directors maintain that they did not violate their obligations, including their obligations under the securities laws.²⁸⁷ 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.²⁸⁸ 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 Kirby²⁸⁹ 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

²⁸⁶ *Id.* p. 684 (§ 1072).

²⁸⁷ 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.

²⁸⁸ 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.

²⁸⁹ 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.^{290 291} 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 affairs²⁹² 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.²⁹³ 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 84.²⁹⁴ 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.²⁹⁵

²⁹⁰ 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.

²⁹¹ Even the finance committee received no additional written information.

²⁹² 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.

²⁹³ 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.

²⁹⁴ Adjusted for the premerger period.

²⁹⁵ 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, Gore, 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,

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.²⁹⁶ 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.

²⁹⁶ 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.²⁹⁷ 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.²⁹⁸ The directors, however, continued to accept the assurances of management that the company was under control.

²⁹⁷ 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.

²⁹⁸ 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.²⁹⁹ 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.³⁰⁰ 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.³⁰¹ 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

²⁹⁹ 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.

³⁰⁰ 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.

³⁰¹ One director presciently 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.³⁰² 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

³⁰² 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;³⁰³ that under the influence of Bevan, EJA was acquiring foreign airline interests and advancing funds to one Fidel Goetz among others;³⁰⁴ that Penphil (whose shareholders include Bevan and Hodge) had improper arrangements with EJA through Holiday International Tours which caused a waste of EJA funds;³⁰⁵ 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.³⁰⁶

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.³⁰⁷ 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.

³⁰³ 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."

³⁰⁴ 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."

³⁰⁵ 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."

³⁰⁶ The directors were not furnished with copies of the complaint. Apparently no director asked for a copy.

³⁰⁷ 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 Bevan³⁰⁸ 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 nowhere to come from.

Rauch concluded:

Dave must stay—what action can rectify appt. comiti [appointment on August 27th of committee to investigate EJA and Bevan].

³⁰⁸ Hanley was chairman of the board of Alleghany Ludlum and had caused Bevan to be named to the Alleghany Ludlum board in 1967.

Hanley conducted a telephone poll of most of the directors and explained Bevan's position on the matter of the investigation.³⁰⁹ 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.³¹¹ 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.³¹² 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.³¹³ 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.

³⁰⁹ Principally the Philadelphia area directors.

³¹⁰ 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.

³¹¹ Bevan was not present at the meeting.

³¹² 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."

³¹³ 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.³¹⁴ 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.³¹⁵ On September 18, 1969, when the \$10 million arrived in Liechtenstein, \$4 million was immediately transferred to another account, Vileda 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, 1969.³¹⁶

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.³¹⁷ These are set forth in greater detail in other sections.³¹⁸ In connection with keeping out \$200 million of commercial

³¹⁴ The history of this and related EJA matters is discussed at page 71.

³¹⁵ Rosenbaum is currently serving a prison sentence for defrauding the U.S. Government.

³¹⁶ 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, Gerstenecker 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.

³¹⁷ 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 Pemphil.

³¹⁸ 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 1970.³¹⁹ 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.³²⁰ 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.³²¹ Bevan and Saunders then discussed the position with Gorman.³²²

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.³²³ 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.³²⁴ 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

³¹⁹ 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.

³²⁰ See section on Public Offerings.

³²¹ 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.

³²² 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 Macco); he was a member of Penphil; he was involved in EJA. The directors knew nothing of Hodge's role in the hiring of Gorman.

³²³ 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.

³²⁴ 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.³²⁵ 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.³²⁶ 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.³²⁷ The insurance company then purchased 200,400 shares between August and December 1969 through Hodge's firm, Glore, Forgan & Co.³²⁸ 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

³²⁵ The other directors knew nothing of the role of Hodge in Gengras' coming to the board.

³²⁶ Gengras himself had a reputation for gaining control of and reorganizing companies.

³²⁷ 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.

³²⁸ 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.³²⁹ 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.³³⁰ As was indicated in the meeting, presenting the railroad

³²⁹ 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.

³³⁰ 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.³³¹ (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.³³² 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 1969.³³³ 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

³³¹ Day was apparently unaware that much of the nonrailroad earnings were paper earnings.

³³² If any comparability problem existed, an alternative presentation, with appropriate clarification, could have been supplied along with the standard format.

³³³ 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.³³⁴ 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.³³⁵

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.³³⁶

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.³³⁷ 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

³³⁴ 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.

³³⁵ See page 139.

³³⁶ 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.

³³⁷ 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.^{338 339} 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.³⁴⁰ 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.³⁴¹ 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

³³⁸ These proposed transactions are discussed in the section on Great Southwest Corp.

³³⁹ 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.

³⁴⁰ Odell had shortly before requested information on specific matters by letter.

³⁴¹ 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,³⁴² 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.³⁴³

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.³⁴⁴ In fact, Penn Central already dominated Great Southwest.³⁴⁵ 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 Arps³⁴⁶ 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 Wetzel, 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

³⁴² 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 \$23 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.

³⁴³ 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."

³⁴⁴ "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.)"

³⁴⁵ See section of this report on Great Southwest.

³⁴⁶ 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.³⁴⁷

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.³⁴⁸ 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.³⁴⁹ 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-

³⁴⁷ 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.

³⁴⁸ One director described this period as "The Valley of Frenzied Finance."

³⁴⁹ 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

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."³⁵⁰ 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.

³⁵⁰ 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.³⁵¹ 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.³⁵² 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-

³⁵¹ 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.

³⁵² 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 is 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.³⁵³ 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,³⁵⁴ 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.³⁵⁵

These generally optimistic statements on the part of management, as reflected in public speeches and press releases, continued throughout the summer.³⁵⁶ 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.

³⁵³ 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.

³⁵⁴ 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 1965. The improvement came in other areas.

³⁵⁵ 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.

³⁵⁶ 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 yearend 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.”³⁵⁷ 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.³⁵⁸ 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.³⁵⁹

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

³⁵⁷ Cole in his testimony characterized Saunders as “the most optimistic man I’ve ever known.”

³⁵⁸ 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.

³⁵⁹ At the shareholders meeting in May 1969, the operating problems were mentioned almost as an aside

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.³⁶⁰

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."³⁶¹ 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.³⁶²

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.³⁶³ 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.

³⁶⁰ Perlman had taken a similar position many months earlier on the necessity to get service problems resolved promptly.

³⁶¹ House Committee on Interstate & Foreign Commerce, November 12, 1969. [S. 315].

³⁶² Saunders' reaction to this situation, in response to a suggestion from Day that disclosure be more open, has been described previously. See page 165.

³⁶³ Actually, while Penn Central had significant losses on passenger business, this was not the area of most deterioration in the post-merger 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.³⁶⁴ 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.³⁶⁵ 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 Pencco 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.³⁶⁶

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

³⁶⁴ 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.

³⁶⁵ See further discussion on page 165.

³⁶⁶ 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.³⁶⁷ 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:³⁶⁸

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-

³⁶⁷ See p. 40.

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.³⁶⁰ 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.

³⁶⁰ 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 \$1½ 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 basically³⁷⁰ 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

³⁷⁰ There was a small difference in the company-only figures.

\$44 million in 1968,³⁷¹ 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.³⁷² 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 statement³⁷³ 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

³⁷¹ 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.

³⁷² 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.

³⁷³ 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

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 1967.³⁷⁴ 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.³⁷⁵ 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 agreements³⁷⁶ 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.

³⁷⁴ Saunders also cited this factor when a shareholder, attending the 1969 annual meeting, expressed concern about the level of 1968 railroad earnings.

³⁷⁵ Saunders gave the \$75 million figure at the annual shareholders meeting but at that time he did indicate that there were offsetting savings.

³⁷⁶ 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 represent a net expense.

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 1968.³⁷⁷

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.

³⁷⁷ 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 Feat, Marwick people felt that it was. The final memorandum ends with the words, "Everyone realized there is

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.³⁷⁸

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.³⁷⁹ 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.³⁸⁰

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,³⁸¹ 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.

³⁷⁸ It might be noted that the Board continued to declare dividends throughout this period.

³⁷⁹ The transaction was reported as ordinary income in Penn Central's statement although it was treated as an extraordinary item in GSC statements.

³⁸⁰ See discussion on page 178.

³⁸¹ 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,³⁸² 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,³⁸³ 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

³⁸² See page 178.

³⁸³ 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.³⁸⁴

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

³⁸⁴ 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.³⁵⁵

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 1968,³⁵⁶ 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

³⁵⁵ 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.

³⁵⁶ 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,³⁸⁷ basically because of the capital needs of the merger,³⁸⁸ 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.³⁸⁹ Again he thanked the commercial and investment bankers for their cooperation.³⁹⁰

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.³⁹¹ He did mention, however, that, after the sale of the \$100 million Pennco bond issue expected in a few days,³⁹² 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 capital³⁹³ 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

³⁸⁷ This was a perennial complaint, but he gave no indication that financing had been stretched to the limit.

³⁸⁸ This was very clearly not the major cause of the drain.

³⁸⁹ \$245 million in debt had been paid off during the same period.

³⁹⁰ 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.

³⁹¹ 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.

³⁹² 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.

³⁹³ 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,³⁹⁴ rather than as a current liability,³⁹⁵ 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.³⁹⁶ 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.³⁹⁷

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.³⁹⁸ 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

³⁹⁴ Penn Central broke this category down into long-term debt due within 1 year and long-term debt due after 1 year.

³⁹⁵ 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.

³⁹⁶ See exhibit IG-2 at end of this section.

³⁹⁷ 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.

³⁹⁸ 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

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.³⁹⁹ 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.⁴⁰⁰

This represented a marked deterioration in position over the prior year, although that was not stated.⁴⁰¹ 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.⁴⁰² 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.⁴⁰³

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

³⁹⁹ He repeated it however in his speech before the Financial Analysts Federation in October 1969.

⁴⁰⁰ 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.

⁴⁰¹ 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.

⁴⁰² Dividends far exceeded income of the Transportation Co. for both 1968 and 1969.

⁴⁰³ The letter was rife with what had to be deliberate overoptimism. It is included in its entirety as Exhibit 1G-3. This letter should be contrasted to the tone in other events occurring the same day—Day's letter to

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.⁴⁰⁴ 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

⁴⁰⁴ 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 our assets into cash" indicating that \$1.1 billion had been expanded on equipment by the

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 ⁴⁰⁵ 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

⁴⁰⁵ Management, hearing the report was underway and fearing an adverse report, had been working very hard with the analyst involved. An interesting incident took place in this connection. David Wilson, the counsel for Penn Central, called Dechert, Price and Rhoads, outside counsel, on January 3, the day the report was issued and 3 days after the Madison Square Garden transaction was consummated. Wilson asked whether Penn Central would have to make any statement about the profit recorded in MSG. Dechert's memorandum indicates that:

"I agree it has no duty to its own shareholders to do so, despite the magnitude of the transaction and the accuracy of the ERA statement against the background of the rather optimistic release by the Board" (probably his year-end statement issued on December 26, 1968).

Apparently, Penn Central felt that if they gave the information...

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: ⁴⁰⁶

(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."

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,⁴⁰⁷ 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

⁴⁰⁷ 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.⁴⁰⁸ 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.⁴⁰⁹ 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

⁴⁰⁸ 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.

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.⁴¹⁰ 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

⁴¹⁰ In another memorandum prepared at about the same time he warned that certain information could

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
COMPANY	Consolidated "Railroad system" \$ 13.4 1.9	Consolidated "Railroad system" \$ 23.6 2.1	Consolidated "Railroad system" \$ 15.7 30.4	Consolidated "Railroad system" \$ 18.0 1.20	Consolidated "Railroad system" \$ 60.3 (2.3)
ICC	Net railway operating income (2.9) Ordinary and net income 1.9	Net railway operating income 1.0 Ordinary and net income 2.1	Net railway operating income (9.1) Ordinary and net income (3.4)	Net railway operating income (21.9) Ordinary income 1/ Net income (41.2)	Net railway operating income (27.2) Ordinary income 1/ Net income (41.5)
GORHAM CHART (separate class)	Rail earnings (27.8) Net company earnings 1.0 Consolidated earnings 13.4	Rail earnings (20.9) Net company earnings 2.1 Consolidated earnings 23.6	Rail earnings (42.3) Net company earnings (3.2) Consolidated earnings 15.2	Rail earnings (54.4) Net company earnings (2.5) Consolidated earnings 36.9	Net railway operating income (27.2) Ordinary income 1/ Net income (41.5)
OFFERING CIRCULAR	Loss on railway operations (142.4) Earnings from railway operations (5.1)				
COMPANY	Consolidated "Parent railroad company" \$ 4.6 Net railway operating income (15.1)	Consolidated "Parent railroad company" \$ 7.9 Net railway operating income (7.5)	Consolidated "Parent railroad company" \$ 8.9 Net railway operating income (14.1)	Consolidated "Parent railroad company" \$ 11.7 Net railway operating income (9.0)	Consolidated "Parent railroad company" \$ 4.4 Net railway operating income (41.3)
ICC	Net railway operating income (20.3) Ordinary and net income (21.8)	Net railway operating income (1.5) Ordinary and net income (8.2)	Net railway operating income (14.1) Ordinary income (19.2) Net income (29.0)	Net railway operating income (25.4) Ordinary income (42.8) Net income (45.6)	Net railway operating income (67.8) Ordinary income (82.2) Net income (91.8)
GORHAM CHART (separate class)	Rail earnings (42.5) Net company earnings (12.8) Consolidated earnings 4.6	Rail earnings (42.2) Net company earnings (6.2) Consolidated earnings 21.9	Rail earnings (59.6) Net company earnings (19.2) Consolidated earnings (8.9)	Rail earnings (65.8) Net company earnings (16.1) Consolidated earnings (13.2)	Net railway operating income (67.8) Ordinary income (82.2) Net income (91.8)
OFFERING CIRCULAR	Loss on railway operations (101.6)				Loss on railway operations (113.2)

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.	GORHAM CHART - Figures from Internal company report prepared on July 15/68
ICC - Figures from reports filed on ICC Form 100 (Transportation Company - only figures)	OFFERING CIRCULAR - Figures from offering circular prepared on January 11/68 unless otherwise stated.

EXHIBIT IG-2

PENN CENTRAL CONSOLIDATED SOURCE & APPLICATION OF FUNDS/YEAR 1968 (in millions)

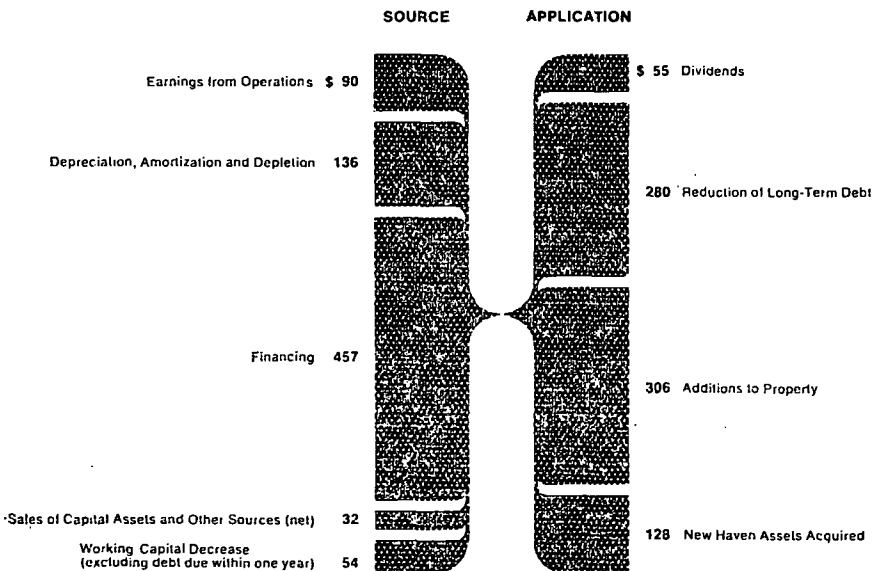


EXHIBIT IG-2—Continued

Penn Central Consolidated Source & 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)
TOTAL	\$772	TOTAL	\$772

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.

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. Propects 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.