THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY

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

AUGUST 1972

Printed for the use of the Committee on Interstate and Foreign Commerce

U.S. GOVERNMENT PRINTING OFFICE
81-938
WASHINGTON : 1972

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $1.50
On the occasion of the publication of the "Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations on the Financial Collapse of the Penn Central Company," I feel it appropriate that we take a comprehensive look at the Penn Central bankruptcy, its causes and its results, and the adequacy of the laws and regulatory agencies which administer those laws.

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

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

1. Elimination of exemptions for rail and motor carriers from the Federal securities laws.—The securities of carriers regulated by the Interstate Commerce Commission are generally exempt from the disclosure requirements of the Federal securities laws. Similar exemptions are not available for airline carriers regulated by the Civil Aeronautics Board; wire carriers regulated by the Federal Communications Commission or gas and electric carriers regulated by the Federal Power Commission. The intent of Congress in 1933 in creating the first of these exemptions for ICC regulated carriers was based on the assumption that the extensive regulation of rail securities then being
exercised by the ICC would be the best protection for investors. At that time the SEC did not exist and motor carrier securities were not regulated by the ICC. Thirty-nine years later, the SEC does exist and the reasons for exempting rail and motor carrier securities no longer seem valid.

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

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

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

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

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

4. Increased regulatory restrictions on dividend policy.—For a con-
cessors had maintained a policy of paying dividends out of borrowings rather than admit there were no real earnings. Stockholders were led to believe they were being paid dividends when in effect they were really receiving repayments of capital. It was this policy in particular which lulled the small investors into trusting in the safety of their investments.

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

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

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

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

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

The SEC report carefully documents the great conflict of interest situations in which the banking and financial institutions found themselves whenever they had dealings with the Penn Central. One bank with an interlocking director chose to make indirect loans “because a direct loan would constitute a conflict of interest.” In sum, any benefits from interlocking directorates seem clearly outweighed by the potential abuses which might flow from such relationships. An outright prohibition of interlocking directorates between public utility oriented companies and banking and financial institutions may be in the best interests of the public, the regulated companies and their financial
7. **Insulation of commercial banking functions from bank trust departments.**—The flow of information into a banking institution which is performing vital commercial banking functions must be of utmost confidentiality. A bank trust department is no more entitled to intrude upon the confidentiality of that banking relationship than any member of the general public.

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

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

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

**Harley O. Staggers,**

*Chairman, Special Subcommittee on Investigations,*

*Committee on Interstate and Foreign Commerce.*
LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION,

Hon. Harley O. Staggers,
Chairman, Special Subcommittee on Investigations, Committee on
Interstate and Foreign Commerce, House of Representatives,
Washington, D.C.

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

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

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

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

The first thing I would point out is that the securities laws contain exemptive provisions which permitted Penn Central and those involved in its financing and investments to operate free of several
important components of the regulatory and disclosure pattern which the Congress and the Commission have established under the securities laws.

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

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

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

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

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

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

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

The staff report shows that as both the operating and liquidity condition of Penn Central deteriorated, its management made increasingly strenuous efforts to make a bad situation look better by maximizing reported income. An elaborate and ingenious series of steps was concocted to create or accelerate income, frequently by rearranging holdings and disposing of assets, and to avoid or defer transactions which would require reporting of loss. Accounting personnel testified that they were constantly under intense pressure from top management to accrue revenue optimistically and underaccrue expenses, losses, and reserves, to realize gain by disposing of assets and
to charge losses to a merger reserve which would not take them through the income statement. Gains were reported on real estate transactions in which the realization of benefits to the company depended on operating results far into the future and in which there was little if any real change in the character or amount of assets owned by Penn Central. In this connection, the Commission has already taken administrative action to order correction of reported figures in the case of Penn Central's subsidiary, Great Southwest Corp.

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

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

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

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

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

Despite the absence of cash earnings, Penn Central continued to pay dividends at an annual rate of $56 million until November 1969. The company had to pay high interest for the dividend money and face high cash demands with no idea of where the needed cash would
tion on the part of management to make full public disclosure of the considerations and implications as well as the source of dividend payments.

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

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

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

The staff report shows how Penn Central, when unable to obtain needed financing in this country, turned to foreign markets for funds. This source of funds is an extremely important one, which we can lose if we permit a credibility gap to develop with respect to disclosure made by companies offering securities abroad. Consideration should be
financial condition and performance of U.S. corporations whether they are dealing in domestic or foreign markets.

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

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

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

Lastly, the report goes into the circumstances surrounding sales of Penn Central securities by management officials during this period in connection with the question whether sales by some individuals occurred while they were privy to material adverse inside information concerning the company. If this occurred, it might involve violations of existing law, and accordingly, I express no view at this time on the question. In addition, the report's analysis of the activities of a private investment fund composed primarily of principal corporate officials and their financial advisers raises questions of possible conflicts of interest and misuses of inside information and suggests the need for consideration of additional controls in this area.
The report represents the culmination of a lengthy and exhaustive inquiry by our staff. I hope it will be a catalyst for considering significant improvements and reforms in the securities field. In this letter of transmittal, I have tried to indicate some recent improvements in our rules which are relevant to the problems brought out by this report and to suggest other measures that should be considered.

Respectfully yours,

William J. Casey, Chairman.
<table>
<thead>
<tr>
<th>CONTENTS</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword.</td>
<td>III</td>
</tr>
<tr>
<td>Letter of transmittal.</td>
<td>VII</td>
</tr>
<tr>
<td>Introduction.</td>
<td>1</td>
</tr>
<tr>
<td>Summary.</td>
<td>3</td>
</tr>
<tr>
<td>Chronology of events.</td>
<td>11</td>
</tr>
<tr>
<td>Part I.</td>
<td></td>
</tr>
<tr>
<td>I-A. Railroad difficulties: Merger and operating problems.</td>
<td></td>
</tr>
<tr>
<td>Premerger period: History</td>
<td>15</td>
</tr>
<tr>
<td>Premerger period: Merger expectations.</td>
<td>15</td>
</tr>
<tr>
<td>Premerger period: Planning</td>
<td>16</td>
</tr>
<tr>
<td>Postmerger period: Service problems.</td>
<td>20</td>
</tr>
<tr>
<td>Earnings record.</td>
<td>28</td>
</tr>
<tr>
<td>Introduction.</td>
<td></td>
</tr>
<tr>
<td>Merger savings and costs.</td>
<td>29</td>
</tr>
<tr>
<td>The ICC study.</td>
<td>30</td>
</tr>
<tr>
<td>Reported earnings.</td>
<td>30</td>
</tr>
<tr>
<td>Summary.</td>
<td>31</td>
</tr>
<tr>
<td>I-B. Income management.</td>
<td>33</td>
</tr>
<tr>
<td>The maximization policy.</td>
<td>33</td>
</tr>
<tr>
<td>Pressures on the accounting department to allow the reporting of</td>
<td></td>
</tr>
<tr>
<td>higher income.</td>
<td>34</td>
</tr>
<tr>
<td>The November confrontations.</td>
<td>36</td>
</tr>
<tr>
<td>The “spongy” areas.</td>
<td>39</td>
</tr>
<tr>
<td>The merger reserve.</td>
<td>42</td>
</tr>
<tr>
<td>Other devices to increase railroad earnings.</td>
<td>45</td>
</tr>
<tr>
<td>Nonrailroad operations.</td>
<td>47</td>
</tr>
<tr>
<td>Real estate activities.</td>
<td>49</td>
</tr>
<tr>
<td>The search for investment income.</td>
<td>51</td>
</tr>
<tr>
<td>Early 1970—The last gasp.</td>
<td>54</td>
</tr>
<tr>
<td>Accounting treatment.</td>
<td>56</td>
</tr>
<tr>
<td>Madison Square Garden Corp.</td>
<td>57</td>
</tr>
<tr>
<td>Trucking company dividends.</td>
<td>60</td>
</tr>
<tr>
<td>Washington Terminal Co.</td>
<td>62</td>
</tr>
<tr>
<td>Lehigh Valley Railroad Co.</td>
<td>64</td>
</tr>
<tr>
<td>Merger reserve: Separation of mail and baggage handlers.</td>
<td>67</td>
</tr>
<tr>
<td>Executive Jet Aviation.</td>
<td>71</td>
</tr>
<tr>
<td>The $10 million Liechtenstein account.</td>
<td>74</td>
</tr>
<tr>
<td>The role of the independent auditor.</td>
<td>77</td>
</tr>
<tr>
<td>I-C. Finances.</td>
<td>84</td>
</tr>
<tr>
<td>Cash flow versus “earnings”.</td>
<td>84</td>
</tr>
<tr>
<td>Some causes of the cash loss.</td>
<td>86</td>
</tr>
<tr>
<td>Operations losses</td>
<td>86</td>
</tr>
<tr>
<td>Dividends</td>
<td>88</td>
</tr>
<tr>
<td>Interest costs.</td>
<td>89</td>
</tr>
<tr>
<td>Cash relationship.</td>
<td>90</td>
</tr>
<tr>
<td>Management’s vantage point.</td>
<td>91</td>
</tr>
<tr>
<td>(1) Cash situation at time of merger (Feb. 1968)</td>
<td>91</td>
</tr>
<tr>
<td>(2) Immediate crisis (mid to end 1968)</td>
<td>93</td>
</tr>
<tr>
<td>(3) Crisis grows (end 1968 to fall 1969)</td>
<td>94</td>
</tr>
<tr>
<td>(4) Last efforts (fall 1969—June 1970)</td>
<td>98</td>
</tr>
<tr>
<td>Postscript: A case study.</td>
<td>104</td>
</tr>
<tr>
<td>I-D. Public offerings.</td>
<td>108</td>
</tr>
<tr>
<td>Introduction.</td>
<td>108</td>
</tr>
<tr>
<td>Fifty million dollar debenture offering.</td>
<td>108</td>
</tr>
<tr>
<td>One hundred million dollar debenture offering.</td>
<td>110</td>
</tr>
<tr>
<td>Warrants for Great Southwest and Penn Central stock.</td>
<td>110</td>
</tr>
<tr>
<td>Discovery of underwriters of Penn Central’s critical problems.</td>
<td>111</td>
</tr>
<tr>
<td>(XV)</td>
<td></td>
</tr>
<tr>
<td>Part I—Continued</td>
<td>Page</td>
</tr>
<tr>
<td>-----------------</td>
<td>------</td>
</tr>
<tr>
<td>I-E. Great Southwest Corp</td>
<td>121</td>
</tr>
<tr>
<td>Introduction</td>
<td>121</td>
</tr>
<tr>
<td>Great Southwest Corp</td>
<td>121</td>
</tr>
<tr>
<td>Great Southwest and Penn Central</td>
<td>123</td>
</tr>
<tr>
<td>Profit maximization</td>
<td>127</td>
</tr>
<tr>
<td>Some other methods</td>
<td>130</td>
</tr>
<tr>
<td>Tax allocation agreement</td>
<td>131</td>
</tr>
<tr>
<td>Officer employment contracts</td>
<td>135</td>
</tr>
<tr>
<td>Abandonment of proposed offering of Great Southwest stock</td>
<td>137</td>
</tr>
<tr>
<td>Failure of alternative efforts to sell Great Southwest stock</td>
<td>141</td>
</tr>
<tr>
<td>Exchange of Great Southwest stock for debt owed to Pennco</td>
<td>143</td>
</tr>
<tr>
<td>Great Southwest financing after abandonment of the public offering</td>
<td>144</td>
</tr>
<tr>
<td>Futile attempts at an earnings encore—1970</td>
<td>147</td>
</tr>
<tr>
<td>I-F. Role of directors</td>
<td>151</td>
</tr>
<tr>
<td>Introduction: Responsibilities and fundamental problems</td>
<td>151</td>
</tr>
<tr>
<td>Premerger period</td>
<td>153</td>
</tr>
<tr>
<td>Postmerger period</td>
<td>156</td>
</tr>
<tr>
<td>Financial problems and a first challenge to dividend policy</td>
<td>157</td>
</tr>
<tr>
<td>Investigation of Bevan abandoned</td>
<td>158</td>
</tr>
<tr>
<td>Fall 1969: Gorman/Gengras—A beginning</td>
<td>163</td>
</tr>
<tr>
<td>Robert Odell on Great Southwest and management</td>
<td>166</td>
</tr>
<tr>
<td>The final months</td>
<td>170</td>
</tr>
<tr>
<td>I-G. Disclosure</td>
<td>173</td>
</tr>
<tr>
<td>General</td>
<td>173</td>
</tr>
<tr>
<td>Railroad operations: The merger</td>
<td>179</td>
</tr>
<tr>
<td>Earnings</td>
<td>179</td>
</tr>
<tr>
<td>Railroad earnings</td>
<td>179</td>
</tr>
<tr>
<td>Nonrailroad earnings</td>
<td>180</td>
</tr>
<tr>
<td>Disclosures relating to 1968 earnings</td>
<td>181</td>
</tr>
<tr>
<td>Disclosures relating to 1969 earnings</td>
<td>183</td>
</tr>
<tr>
<td>Disclosures relating to 1970 earnings</td>
<td>190</td>
</tr>
<tr>
<td>Cash flow and financing</td>
<td>191</td>
</tr>
<tr>
<td>The professional analyst</td>
<td>196</td>
</tr>
<tr>
<td>Summary and conclusions</td>
<td>200</td>
</tr>
<tr>
<td>Part II</td>
<td>203</td>
</tr>
<tr>
<td>II-A. Sale of Penn Central stock by institutions</td>
<td>207</td>
</tr>
<tr>
<td>Introduction</td>
<td>207</td>
</tr>
<tr>
<td>Chase Manhattan Bank, N.A.</td>
<td>207</td>
</tr>
<tr>
<td>Morgan Guaranty Trust Co.</td>
<td>214</td>
</tr>
<tr>
<td>Continental Illinois National Bank &amp; Trust Co.</td>
<td>225</td>
</tr>
<tr>
<td>Alleghany Corp. and Investors Diversified Services, Inc</td>
<td>231</td>
</tr>
<tr>
<td>II-B. Trading by officers and directors</td>
<td>243</td>
</tr>
<tr>
<td>Introduction</td>
<td>243</td>
</tr>
<tr>
<td>Officers—Finance</td>
<td>247</td>
</tr>
<tr>
<td>Officers—Real estate and taxes</td>
<td>253</td>
</tr>
<tr>
<td>Officers—Operations and labor</td>
<td>255</td>
</tr>
<tr>
<td>General corporate officers</td>
<td>265</td>
</tr>
<tr>
<td>Chronology of officer sales discussed in report</td>
<td>269</td>
</tr>
<tr>
<td>Part III</td>
<td>271</td>
</tr>
<tr>
<td>III-A. Sale of commercial paper</td>
<td>271</td>
</tr>
<tr>
<td>Introduction</td>
<td>271</td>
</tr>
<tr>
<td>Commercial paper</td>
<td>271</td>
</tr>
<tr>
<td>The market for commercial paper</td>
<td>274</td>
</tr>
<tr>
<td>Penn Central Transportation Co.'s commercial paper</td>
<td>277</td>
</tr>
<tr>
<td>Other financial relationships between Goldman, Sachs, and the Transportation Company</td>
<td>286</td>
</tr>
<tr>
<td>Methods employed by Goldman, Sachs to sell the Company's commercial paper to customers</td>
<td>287</td>
</tr>
<tr>
<td>Summary</td>
<td>290</td>
</tr>
<tr>
<td>Goldman, Sachs's position on the sales of the Company's commercial paper</td>
<td>290</td>
</tr>
<tr>
<td>III-B. Role of National Credit Office in rating the commercial paper of Penn Central</td>
<td>292</td>
</tr>
<tr>
<td>Part IV</td>
<td>Page</td>
</tr>
<tr>
<td>---------</td>
<td>------</td>
</tr>
<tr>
<td>Penphil Co</td>
<td>303</td>
</tr>
<tr>
<td>Introduction</td>
<td>303</td>
</tr>
<tr>
<td>Summary of transactions</td>
<td>304</td>
</tr>
<tr>
<td>Background—Penphil</td>
<td>305</td>
</tr>
<tr>
<td>Chemical Bank</td>
<td>307</td>
</tr>
<tr>
<td>Kaneb Pipe Line Co</td>
<td>309</td>
</tr>
<tr>
<td>Great Southwest Corp</td>
<td>312</td>
</tr>
<tr>
<td>Tropical Gas Co., Inc</td>
<td>316</td>
</tr>
<tr>
<td>Continental Mortgage Investors</td>
<td>317</td>
</tr>
<tr>
<td>Florida Banks</td>
<td>320</td>
</tr>
<tr>
<td>Symington Wayne Corp</td>
<td>323</td>
</tr>
<tr>
<td>National Homes Corp</td>
<td>328</td>
</tr>
</tbody>
</table>

Appendixes:

<table>
<thead>
<tr>
<th>Appendix</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix A—H.R. 12128</td>
<td>335</td>
</tr>
<tr>
<td>Appendix B—S.E.C. comments on H.R. 12128</td>
<td>338</td>
</tr>
<tr>
<td>Appendix C—I.C.C. comments on H.R. 12128</td>
<td>367</td>
</tr>
</tbody>
</table>
INTRODUCTION

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

SCOPE OF INVESTIGATION

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

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

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

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

Organization of Penn Central

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

RAILROAD DIFFICULTIES: MERGER AND OPERATIONS PROBLEMS (I–A)

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

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

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

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

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

FINANCES (I-C)

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

Much of the loss was caused by the deficits from rail operations. The payment of approximately $100 million in dividends in the post-merger period also contributed to the drain. The borrowings needed to meet the cash drain required large interest payments in this period of high interest rates. When the borrowings reached their peak, the interest alone on the additional borrowings was approaching $50
million a year. Cash was even needed to support Great Southwest, a real estate development subsidiary which management claimed was helping to support the railroad.

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

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

**Public Offerings (I-D)**

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

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

The offering quickly encountered difficulties related to the overall problems of Penn Central at that time. The offering in its originally announced form contained warrants for the stock of Great Southwest Corp. and of Penn Central Co., a holding company which had become the parent of the railroad in October 1969. Management had hoped to delay registration of warrants until they became exercisable in the future. Penn Central had abandoned a planned public offering of Great Southwest stock in late 1969 because of the disclosure that would be required in a registration with the SEC. After doubts were raised about whether registration could be delayed, the warrants were dropped from the offering. The Pennco offering circular was under ICC jurisdiction and filed with the SEC.
A more serious problem developed as counsel for the underwriters began uncovering information about the railroad which indicated that it was heading for bankruptcy. Although the underwriters were going to be offering a security of Pennsylvania Co., which they thought could survive a bankruptcy of the railroad, they were aware that conditions which might so adversely affect the railroad would be important to potential investors in Pennco. They determined to obtain disclosure of these facts in the offering circular. Management initially resisted these efforts and a management official even attempted to have one of the underwriters' lawyers removed from the underwriting because of the questions he was raising as a result of the inquiry made into the company's financial condition.

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

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

**Great Southwest (I-E)**

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

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

Senior Macco officials were under employment contracts which provided they would be paid a percentage of the profits reported.
Because of large profits being reported, Macco paid the officers hundreds of thousands of dollars in 1968. Penn Central management then renegotiated the contracts which resulted in the officers receiving a total of $7 million to sign new contracts.

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

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

ROLE OF DIRECTORS (I–F)

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

On at least two occasions, the directors deliberately avoided confrontations with management on issues critical to testing the integrity of management and providing adequate disclosure to shareholders. On one occasion, in the summer of 1969, a lawsuit which claimed improper and unlawful conduct by David Bevan, chief financial officer of Penn Central, in connection with Executive Jet Aviation (effectively a subsidiary of Penn Central) and Penphil Co. (a private investment club) was brought to the directors’ attention. As they were obligated to do, they authorized an investigation. When Bevan threatened to resign, however, they canceled the investigation even though the charges appeared to be well founded and later proved to be essentially correct. Without restraint Bevan continued to engage in questionable conduct including the diversion of $4 million to undisclosed Liechtenstein interests. He also continued as the sole and important contact between Penn Central and the financial community to whom he repeatedly misrepresented the company’s financial con-
dition. Even in the instance where a director was interested in inquiring into the affairs of a major subsidiary this initiative was not favorably received by his fellow directors. If such an inquiry had been made it would have uncovered the improprieties occurring in the subsidiary and the concomitant need to provide full and adequate disclosure of that entity's affairs. The directors permitted management to operate without any effective review or control and they remained uninformed throughout the whole period of important developments and activities.

Disclosure (I-G)

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

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

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

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

Sales of Securities by Institutions (II-A)

Many institutions held Penn Central stock, particularly as it approached its peak price in the summer of 1968. Most of these
institutional holdings were sold over the next 2 years as the price of the stock continued to decline.

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

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

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

INSIDER TRADING BY OFFICERS AND DIRECTORS (II–B)

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

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

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

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

As the company's financial condition deteriorated, management relied more heavily on the sale of commercial paper as a means of
financing the losses being incurred. The company was not using commercial paper for short-term borrowing which is the customary use of commercial paper. Instead, conditions developed in a way which required that the full amount of commercial paper be continually rolled over as if it were long-term financing.

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

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

**Penphil (IV)**

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

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

1968

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

1969

January 7: Bevan seeks financial advice from former chairman of First Boston Corp. and from consultant who was president of International Bank for Reconstruction and Development.
January 23: Board approves plan to form holding company—announced to public.
January: Penn Central claims this is peak for service problems.
January: EJA withdraws application to acquire Johnson Flying Service.
January: Penn Central discussions with Peat, Marwick and ICC relating to charging of mail handlers against the merger reserve.
January 30: Preliminary earnings for 1968 announced. Results show consolidated earnings of $90.3 million, up from 1967, and a parent company loss of $2.8 million, down from a profit of $11.5 million a year earlier.
February 13: Penn Central issues release on results of diversified subsidiaries.
February: Meeting with officers of First National City Bank concerning increase in revolving credit.
February 20: Saunders' "turning the corner" claim set forth in release.
March 1: Smucker replaced by Flannery in charge of operations.
March 19: ICC authorizes increase in commercial paper from $100 million to $150 million.
April: Flannery objects to budget cutbacks. Cites danger of affecting service.
April 23: Penn Central announces first-quarter consolidated earnings of $4.6 million, down from $13.4 million a year earlier. Parent lost $12.8 million compared to a profit of $1.0 million in 1968.
May 12: ICC approves increase in revolving credit agreement from $100 million to $300 million, with $50 million reserved to refund commercial paper.
June 4: Settlement of employment contracts with Great Southwest officers.
June: Sale of Six Flags Over Texas by Great Southwest.
June 13: Extraordinary joint finance—executive committee meeting to discuss the situation.
June 25: Board discusses possibility of omitting dividend, but ultimately decides to declare dividend with special meeting on August 27, to review payment. July: $35 million private placement of Pennco debentures.
July 28: Second quarter earnings announced. Consolidated earnings at $21.9 million, down 7.5 percent. Railroad company lost $8.2 million versus year earlier profit of $2 million.
August 27: Kunkel suit discussed at meeting of Penn Central board. Investigation of EJA and Bevan approved. Bevan's subsequent threat of resignation causes cancellation of investigation.
September 18: Bevan diverts $10 million of equipment loans to Leichtenstein account of Goetz in connection with EJA and other matters.
September 8-12: Bevan and Saunders discuss bleak financial condition and call for cutbacks on capital expenditures.
September: Saunders orders halt of retirement of properties until accounting authority received, thereby avoiding writeoffs against ordinary income.
September 23-24: Penn Central announces that Gorman named president, effective December 1. Saunders denies presidency offered to several others first.
September 24: O'Herron reads to board Bevan's statement on Kunkel, EJA and Penphil.
September 25-26: Saunders testifies before congressional committee on passenger legislation.
October 1: Holding company becomes effective.
October 20: Penn Central reports consolidated third quarter loss with 9-month earnings down substantially. Railroad lost $19.2 million.
October 29: ICC approves increase in authorization to sell commercial paper from $150 million to $200 million.
October: Great Southwest offering called off because of disclosure problems.
November: Service deterioration noted.
November 7: Attorney representing Penn Central tells ICC that since merger company has failed to regain its competitiveness and remains financially shaky.
November 10: Odell invites all outside Penn Central directors to a dinner on November 25, to discuss financial and management problems.
November 12: Saunders testifies before congressional committee on passenger service losses in connection with pending legislation.
November 19: Saunders meets with Kirby in Alleghany offices re management problems.
November 26: Odell moves for dismissal of Bevan and Saunders.
November 29: Board of directors votes to omit fourth quarter dividend.
November–December: Commercial paper dealer evidences concern about financial condition of Penn Central.
December 1: Letter to shareholders concerning elimination of dividend.
December 1: Day's letter to Saunders suggesting better disclosure of railroad losses.
December 1: Saunders speech at staff luncheon concerning critical nature of service situation.
December 15: Saunders makes impossible demands for increased revenues and reduced expenses by yearend.
December 17: Pennco sells $50 million debenture offerings—proceeds passed up to Transportation Co.
December: Writeoff of long haul passenger facilities.
December: Discussions concerning sale of Great Southwest stock to Great Southwest officers.
December-January: Bad winter weather. Later blamed for poor earnings.
December 31: Pennco accepts Great Southwest stock in exchange for previously created debt.

1970

January 22: Meeting on possible foreign financing leads later to Swiss franc loan.
January 27: Bevan and O'Herron approach First National City Bank about "bridge" loan in contemplation of $100 million Pennco offering. First National City Bank asks for more security.
February: Discussions concerning $20 million Eurodollar offering through Penn Central International.
February 2: Initial contact with First Boston concerning Pennco $100 million debenture offering.

February 4: Penn Central announces 1969 earnings of $4.4 million versus $86.9 million a year earlier; railroad lost $56.3 million versus $5.1 million loss.

February 5: Odell submits resignation letter to board.

February 6: Bevan et al., meet with Gustave Levy and others from Goldman, Sachs to review commercial paper situation.

February 12: Penn Central buys back $10 million in notes from Goldman, Sachs inventory.

February 13: ICC orders Alleghany to sell its Penn Central shares.

February: "Bridge" loan arranged with Chemical Bank.

March: Various evidences of concern with status of EJA.

March 12: "Comfort letter" from Bevan to Peat, Marwick re: (1) EJA; (2) Madison Square Garden; (3) Lehigh Valley.

March 12: Peat, Marwick signs opinion letter, qualified only for the failure by Penn Central to provide for deferred taxes.

March 12: "Comfort letter" from Bevan to Peat, Marwick re: (1) EJA; (2) Madison Square Garden; (3) Lehigh Valley.

March 20: Counsel for underwriters questions possible major writeoff. Bevan denies it, but appears evasive.

March 25: Pennco applies to ICC to sell $100 million debenture offering—announced in press release.

March: O'Herron tells commercial paper dealer first quarter losses will be "terrible."

March 28: Bevan seeks removal of "troublesome" attorney from underwriting.

March 30: Penn Central files with ICC for discontinuance of 34 East-West long-distance passenger trains.

March 31: Meeting at Sullivan & Cromwell offices with senior officers of each of co-managers of $100 million offering. Possible bankruptcy of Penn Central discussed.

March 31: Wabash exchange transaction recorded.

April 6: Decision made to drop warrants from $100 million debenture offering.

April 14: O'Herron tells commercial paper dealer that first quarter losses will be "staggering."

April 14: Fred Kirby resigns as Penn Central director.

April 22: Penn Central announces first quarter consolidated loss of $17.2 million and Transportation Co. loss of $62.7 million.

April 27: Pennco $100 million preliminary offering circular.

April 28: Pennco announces proposed offering of $100 million debenture. Proceeds will be passed up to the Transportation Co.

April 30: Penn Central representatives, led by Saunders, meet with Volpe of DOT. Discuss possible assistance on equipment financing and passenger losses.

May 4: Due diligence meeting with underwriters—indications that initial interest in issue is poor.

May 8: O'Herron speaks with Volpe. Tells him situation more critical than revealed by management.

May 5: Gorman calls for special finance committee meeting. Objects to various reporting practices.

May 10: Saunders announces austerity program until Railpax program adopted. Capital spending cut.

May 12: Annual meeting.

May 13: Butcher & Sherrerd switches recommendation to "sell" after reviewing first quarter earnings.

May 15: Standard & Poor's reduces Pennco rating from BBB to BB.

May 15: Dun & Bradstreet (NCO) gives Penn Central's commercial paper a "Prime" rating.

May 16: Revised offering circular issued, including information on commercial paper runoff. Underwriters indicate issue is expected to carry interest rate of 10% percent.

May 19: Saunders discusses Government guaranteed loan with Kennedy of Treasury.

May 19: Penn Central spokesman announces he knows of no reason for the stock's decline.


May 21: Penn Central notifies underwriters that it has decided not to go forward with the offering.

May 21: Chemical Bank and First National City Bank representatives meet with Bevan. Bevan tells them of decision to postpone debenture offering and seek Government loan.
May 23: Penn Central hits new low amid conjecture about financial difficulties. Butcher & Sherrerd who strongly recommended Penn Central in January is rumored to have liquidated its holdings.

May 26: Bevan and others from Penn Central meet with representatives of Chemical Bank, First National City Bank, and counsel for the banks involved in the $300 million revolving credit agreement to discuss Government guaranteed loan.

May 26-27: Broad tape and WSJ announcement on commercial paper runoff.

May 27: Finance committee meeting. Saunders tells Penn Central board that the debenture offering is being called-off, that further issues of commercial paper will be halted and that substantial additional amounts of cash will be needed.

May 28: Bevan and others meet with the 53 revolving credit banks about current status of Penn Central and negotiations with Government.

May 28: Postponement of Pennco debenture offering announced to public. Alternative financing methods to be considered.

June 1: National Credit Office withdraws “Prime” rating on Transportation Co.’s commercial paper.

June 2: Announcement made that First National City Bank heads 73 banks applying for Government guarantee of $200 million loan.

June 8: Bevan, Saunders, and Perlmutter dismissed.

June 10: Administrative support announced for $200 million loan guarantee with a possible total of $750 million.

June 19: Administration withdraws loan guarantee support.

June 21: Chapter 77 Bankruptcy reorganization filed.
I-A. RAILROAD DIFFICULTIES: MERGER AND OPERATING PROBLEMS

Premerger Period: History

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

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

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

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

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

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

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

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

<table>
<thead>
<tr>
<th>Years</th>
<th>Savings</th>
<th>Net savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>56.7</td>
<td>33.4</td>
</tr>
<tr>
<td>2</td>
<td>26.6</td>
<td>14.0</td>
</tr>
<tr>
<td>3</td>
<td>51.3</td>
<td>33.7</td>
</tr>
<tr>
<td>4</td>
<td>67.2</td>
<td>43.4</td>
</tr>
<tr>
<td>5</td>
<td>81.6</td>
<td>68.8</td>
</tr>
<tr>
<td>6</td>
<td>81.6</td>
<td>74.1</td>
</tr>
<tr>
<td>7</td>
<td>81.6</td>
<td>77.9</td>
</tr>
<tr>
<td>8</td>
<td>81.6</td>
<td>78.4</td>
</tr>
<tr>
<td>9</td>
<td>81.6</td>
<td>81.1</td>
</tr>
</tbody>
</table>

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

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

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

**Premerger Period: Planning**

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

The basic source document used during the merger hearings, which purportedly reflected the economic justification for the merger, was a report which became known as the Patchell study. This was never intended to be used as an actual operating plan but represented a document assembled rather hastily by the staffs of the two roads for the specific purpose of having some sort of "plan" to present to the ICC. It dealt with such matters as which routes should be adopted, how terminals and other facilities should be consolidated and other matters of physical coordination and the projected savings related thereto. The study had a theoretical, rather than a practical, orientation, claiming to show what the merged company would look like, assuming that the very short past period used as the basis for the projection accurately reflected the companies as they then existed. As it developed, however, many of the assumptions on which this rather simplistic study was based were unrealistic. In a recent assessment of the situation the ICC reported:
The estimates, plans and predictions of railroad executives presented at the hearings before the Commission in the early 1960's appears to bear little relation to the savings, costs, investments and operational changes which Penn Central claims in its reports to have actually realized. We realize that conditions change; however, there appears so little correlation between the claims and the realities as to seriously question whether a realistic merger plan ever existed.

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

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

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

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

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

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

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

The aim is not to fit one organization into the mold of the other, but to take what is best of each, or formulate something new so that the merged company will be
superior to either of its components. To this end, the focus has been on the essential functions performed by each department. Once it is decided just what is to be done, the organizational structure best suited to the job will be adopted.

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

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

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

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

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

The assigned task of the group was to provide for an orderly step-by-step transition from a two-railroad facility into a one-railroad
facility, and their report represented the culmination of 2\(\frac{1}{2}\) years of effort. However, Perlman, apparently with support from Saunders, wanted rapid implementation of the merger so that merger savings might be achieved as rapidly as possible, while the merger-planning staff favored a somewhat slower approach in order to ease the problems of transition. Instructions were issued in early November to revise the sequence of construction projects contemplated by the master operating plan to accelerate savings in the first 2 or 3 years. And a few minutes before the plan was to be submitted at a meeting on November 28, Perlman ordered all copies marked “Preliminary.” The marked copies were distributed at the meeting, then gathered up, and apparently permanently laid aside. As one individual closely involved with the situation assessed it:

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

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

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

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

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

**Post-Merger Period: Service Problems**

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

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

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

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

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

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

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

It should be noted that both this document and the following one were prepared for the public and thus carefully worded to minimize the unfavorable aspects. According to the ICC, one major source of difficulty was that traffic from both roads was in fact directed into one facility, which lacked the capacity to handle both.
Our separate communications systems were not compatible and this complicated some of the service problems created by the merger. This situation has been aggravated by confusing routing symbols, particularly from off-line sources. For example, a car routed Penn Central-Cincinnati that should have gone to the former Central yard in Cincinnati often has ended up in the old Pennsylvania yard and frequently its waybill papers went astray as well. In addition, employees of the former Pennsylvania were not familiar with the properties and procedures of the former New York Central, and vice versa. A great deal of cross-pollination had to take place in the process of finding the most efficient way to handle traffic.

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

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

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

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

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

---

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

5 However, as one witness put it, if a yard clerk, who for 20 years had relied on his memory to correctly direct cars, suddenly had to go through a manual for each car that came along, he would soon have cars backed up all the way from Indianapolis to Kansas City.
could be located. By mid-1969 there was apparently some improve-
ment in this area. A program to engage the assistance of connecting
lines and shippers in directing traffic to the yards which Penn Central
had selected met with only very limited success. Former officers have
indicated to the staff that it was unrealistic for the company to have
expected shippers to uniformly follow their instructions to route
traffic as “PNYC(P)” or “PNYC(N).” And there is testimony
that some officers questioned, even before the merger, management’s
easy assumption that they had enough clout with the connecting lines
to force them to send traffic to the yard which Penn Central had
designated for that class of traffic, even though it might be cheaper or
more convenient for the connecting line to use the other local Penn
Central yard. In addition, just as the confusion and bottlenecks
caused a snowballing effect within Penn Central, these factors may
have also been a contributing factor with the connecting lines whose
employees felt their carelessness would scarcely have an effect on the
massive congestion that already existed in Penn Central’s yards.

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

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

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

*The computer problem was also linked to inexperienced personnel, which resulted in
errors in input.*
I’ll be rid of Perlman within ninety days; he’s the worst enemy I’ve ever had in my life; he’s cost me untold millions of dollars; I didn’t want him in the first place and I’ll get rid of him; you can have my word of it; I’ll be rid of him in ninety days.

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

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

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

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

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

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

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

---

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

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

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

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

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

It went bankrupt.
Perlman, who at the Central had used another accounting system, made no attempt to hide his dislike for the system adopted. This led to complaints by him that he was not being given the information he needed to do his job effectively, a claim which is disputed by other officers. He also indicated that he was disturbed and confused by the fact that the earnings figures as they were distributed to the public, did not agree in content with those which he was receiving internally. About once a month Saunders held budget committee meetings with his top operating and financial officials to discuss current results. These were measured against established budgets or more frequently, as the pressure of events rendered the budgets of limited value, against a series of relatively short-term forecasts, concerning basically the current quarter.

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

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

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

10 This is a particularly damaging feature in the railroad industry with its high ratio of relatively fixed costs, since a high proportion of lost revenues work their way down to the profit.
11 The master operating plan had contained projections of ton miles, based on certain gross assumptions as to rates of growth, specifically growth of 2.9 percent and 2.6 percent from 1966. Instead, Penn Central's figure in 1969 was 8 percent below 1966, according to ICC calculations. The latter two items reflected a perennial lack of adequate maintenance and repair which had indeed by this point reached very serious proportions.
12 As will be discussed later, this is part of a broader pattern of last minute attempts by management each quarter to find some way to report respectable earnings.
13 No one denied the cost figures contained excessive items. The objections lay with the nature of the crash program being instituted to cut costs. Paul Gorman, who was hired principally on the basis of his reputation for cost control, indicated that the bulk of operating costs relate either to the labor factor or to repairs and maintenance. He felt that there was little room for improvement in the maintenance area, since the equipment and plant was already in poor condition. In the labor area efficiency was not good and there were many excess people on the payroll. However, under the labor agreements they had tenure for life and there was no way of getting rid of them except by buying them off, delaying the impact of any financial benefit.
some cuts were made.\textsuperscript{14} To have made the cuts ordered would have destroyed service, they stated.\textsuperscript{16}

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

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

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

Meanwhile, as the financial condition of Penn Central degenerated, the railroad's capital expenditure program, which, because of financial limitations, had been inadequate to maintain equipment and facilities for many years, deteriorated still further. In mid-1969 orders went out to see what capital programs already under construction could be halted to conserve cash.\textsuperscript{17} While a capital expenditure budget for 1970 was prepared, it was not even sent to the Board because of lack of funds.\textsuperscript{18}
The events described in this section are illustrative of the problems that faced Penn Central. Here was the largest railroad in the United States, faced with what Saunders described as “the most complex merger in the history of this country.” The company had three principal officers—Saunders, Perlman, and Bevan. Saunders had come from the N. & W., one of the most profitable railroads in the country, to head the PRR and later the Penn Central, with its multitudinous problems. He was a lawyer by profession, not an operating man. His special assistant characterized his special talent as problem solving but it is clear that he was unable to solve the biggest problem of them all, the railroad itself. His expertise did not lie in this area and he was unable to cope with such problems. His solutions lay with exhortations and completely unrealistic demands, not of much aid to the fundamental problems facing this faltering railroad. The second major officer was Perlman, who was an operating man with a respected reputation. He had salvaged several faltering roads. However, his ad hoc techniques and the very personal role he took in running the railroad proved inappropriate for the sprawling complex that was Penn Central, further contributing to the chaotic situation. Saunders’ solution to this “problem” was to search for a replacement for Perlman. But, with the company’s future so dismal, he could not find a topnotch operating man who would take the job. The third major officer was David Bevan, the chief financial officer, who had originally aspired to have Saunders’ role as chairman of the PRR, prior to the merger. He was bypassed. Bevan had carved out his own little empire, focused on financing and diversification. His interests apparently lay principally in diversification, and he was ready to starve the railroad which he felt was unprofitable and held no promise. In the meantime he was off on frolics of his own, involving him personally in very questionable situations. In his areas he kept the information very much to himself, giving fuel to the claims of Saunders and Perlman that they were being provided with inadequate financial information.

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

**Earnings Record**

**INTRODUCTION**

The basis for the merger, as indicated earlier, was the promise of substantial operating savings from the combining of the two roads. While it was recognized that there would be some offsetting costs
the accompanying costs, was grossly underestimated. The result was a sharp plunge in the reported results from railroad operations.

**MERGER SAVINGS AND COSTS**

In response to an item on the Merger Performance and Status Report, requiring the company to report to the ICC the net effect on revenues and net income of actions taken under the merger, Penn Central reported that it was “difficult to identify and evaluate merger related projects and activities separately from all other projects and activities of this company.” Nonetheless they did make such calculations, showing savings of $22.5 million in 1968 and $52 million in 1969. These figures were well above those predicted for the postmerger period in either the Patchell report or the master operating plan, fueling public statements that the merger was progressing well. The company did not, of course, purport to be operating under either of these plans, but under an ad hoc, accelerated schedule involving substantial extra costs. Furthermore, skepticism has been expressed as to the accuracy of the figures, since the interpretation of what constitutes a merger saving appears to leave a great deal of room for discretion and varying interpretation.

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

---

19 Penn Central was required to submit such a report to the ICC annually for 5 years after merger.
20 See discussion of merger reserve at p. 42.
21 Per diem costs are charges which one railroad pays for the use of cars of another railroad.
THE ICC STUDY

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

REPORTED EARNINGS

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

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating revenue:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st quarter</td>
<td>$371</td>
<td>$382</td>
<td>$406</td>
<td>$403</td>
</tr>
<tr>
<td>2nd quarter</td>
<td>387</td>
<td>392</td>
<td>418</td>
<td>455</td>
</tr>
<tr>
<td>3rd quarter</td>
<td>363</td>
<td>372</td>
<td>398</td>
<td></td>
</tr>
<tr>
<td>4th quarter</td>
<td>399</td>
<td>370</td>
<td>430</td>
<td></td>
</tr>
<tr>
<td>Annual</td>
<td>1,510</td>
<td>1,516</td>
<td>1,652</td>
<td></td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st quarter</td>
<td>311</td>
<td>316</td>
<td>339</td>
<td>386</td>
</tr>
<tr>
<td>2nd quarter</td>
<td>314</td>
<td>314</td>
<td>349</td>
<td>408</td>
</tr>
<tr>
<td>3rd quarter</td>
<td>301</td>
<td>316</td>
<td>343</td>
<td></td>
</tr>
<tr>
<td>4th quarter</td>
<td>307</td>
<td>322</td>
<td>383</td>
<td></td>
</tr>
<tr>
<td>Annual</td>
<td>1,233</td>
<td>1,268</td>
<td>1,414</td>
<td></td>
</tr>
<tr>
<td>Net railway operating income:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st quarter</td>
<td>(2.5)</td>
<td>(2.9)</td>
<td>(10.1)</td>
<td>(65.8)</td>
</tr>
<tr>
<td>2nd quarter</td>
<td>8.0</td>
<td>7.1</td>
<td>(7.5)</td>
<td>(45.0)</td>
</tr>
<tr>
<td>3rd quarter</td>
<td>(0.1)</td>
<td>(9.2)</td>
<td>(14.8)</td>
<td></td>
</tr>
<tr>
<td>4th quarter</td>
<td>11.0</td>
<td>(21.9)</td>
<td>(35.5)</td>
<td></td>
</tr>
<tr>
<td>Annual</td>
<td>17.5</td>
<td>(27.0)</td>
<td>(67.8)</td>
<td></td>
</tr>
</tbody>
</table>

1 Penn Central reported to the shareholders a loss of $9 million.

Note: Losses shown in parentheses.

Source: ICC form R.

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

---

See exhibit IA–1 at end of section. This chart, taken from the ICC Report, shows ordinary income, but the net operating income closely parallels it.

As discussed later, the figures reported to the ICC and to the public were not always the same.

Results include New Haven Railroad beginning Jan. 1, 1969.
<table>
<thead>
<tr>
<th>[In millions]</th>
<th>1967</th>
<th>1968</th>
<th>1969</th>
</tr>
</thead>
<tbody>
<tr>
<td>Railway operating revenues</td>
<td>$1,507</td>
<td>$1,514</td>
<td>$1,652</td>
</tr>
<tr>
<td>Railway operating expenses</td>
<td>1,236</td>
<td>1,268</td>
<td>1,387</td>
</tr>
<tr>
<td>Taxes, equipment, rents and other deductions</td>
<td>272</td>
<td>293</td>
<td>335</td>
</tr>
<tr>
<td>Loss before fixed charges</td>
<td>1</td>
<td>(47)</td>
<td>(70)</td>
</tr>
<tr>
<td>Fixed charges</td>
<td>85</td>
<td>95</td>
<td>123</td>
</tr>
<tr>
<td>Loss on railroad operations</td>
<td>(86)</td>
<td>(142)</td>
<td>(193)</td>
</tr>
</tbody>
</table>

Note: Losses shown in parentheses.

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

<table>
<thead>
<tr>
<th>[In millions]</th>
<th>1968</th>
<th>1969</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rail losses:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st quarter</td>
<td>$27.8</td>
<td>$42.0</td>
</tr>
<tr>
<td>2nd quarter</td>
<td>20.9</td>
<td>44.2</td>
</tr>
<tr>
<td>3rd quarter</td>
<td>42.2</td>
<td>39.6</td>
</tr>
<tr>
<td>4th quarter</td>
<td>54.4</td>
<td>45.0</td>
</tr>
<tr>
<td>Annual</td>
<td>145.3</td>
<td>190.8</td>
</tr>
</tbody>
</table>

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

**SUMMARY**

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

---

25 Perlman indicated he felt that the Central had the financial capacity to survive, absent the merger. Bevan testified that the merger probably accelerated the downfall of the PRR, although he had reservations about the long term viability of the railroad at any rate.
EXHIBIT AI-1

NET INCOME (ORDINARY INCOME) 1960 - 1969

Dollars Millions

1960 61 62 63 64 65 66 67 68 1969

NORFOLK & WESTERN
PENN CENTRAL
CHESAPEAKE & OHIO
SOUTHERN
Baltimore & Ohio
ERIE LACKAWANNA
I-B. INCOME MANAGEMENT

The Maximization Policy

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

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

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

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

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

Everyone thought it was their job. Certainly in the real estate area—

. . . Sam Hellenbrand would have thought it was his job. Ted Warner certainly thought it was his job to do what could be done in the tax field.

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

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

Pressures on the Accounting Department To Allow the Reporting Of Higher Income

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

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

**Answer.** Unquestionably correct.

**Question.** That mandate came from Saunders directly?

**Answer.** From Saunders directly.

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

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

---

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

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

28 Generally, the value of a stock, at least for long-term investment purposes, is dependent on its future earning power, and current basic earnings levels are the starting point for an assessment of future levels.
dared, although the staff has not attempted to measure the precise impact. In the latter situation, where specific accounting precedents were lacking, several examples will be given below in which technicalities of form were stressed and the substance of the transaction was ignored. In effect, concepts established under generally accepted accounting principles were stretched to justify the treatment desired to the point where their application under the circumstances of this case may have been misleading.

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

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

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

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

29 He added that, while he did not mind this in an accounting officer, he did not feel that Cook's word was gospel or that he could not be questioned.
Typical of the intense pressures to which the accounting department was subjected in the interest of reporting higher profits are those described by Bevan in a diary which he kept in 1967 and 1968, assertedly for his own protection. While Bevan’s credibility on some subjects, as illustrated elsewhere in this report, is open to serious question and while he may have had his own personal reasons for keeping this permanent record of Saunders’ improper activities at the same time that he was concealing so many of his own, the entries are supported by the testimony of Cook, who was comptroller during most of the period covered by the diary. The testimony of other witnesses also support this document, although on occasion they question the tone (rather than the substance) of some of the entries.

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

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

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

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

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

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

In his own memorandum, Cook described the next event:

Late in the afternoon of November 7, Basil Cole came down to my office and stated that in addition to the items discussed at the Budget meeting, Mr. Saunders wanted to see what could be done to avoid the booking of the $3 million inventory deficit in the fourth quarter of 1967. I explained to Mr. Cole that nothing could be done—that the inventory was taken at the end of June and that the results had been constantly reviewed by the auditors and other accounting personnel and that this item would have to be booked in 1967. He took the position that he did...
not see where it would hurt anything to let this go until some time next year after merger and I explained the position that we certify to in the annual financial statements and that what he was suggesting was the same type of thing that occurred at Yale Express and Westec which was a criminal offense and that I would not be a party to it.

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

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

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

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

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

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

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

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

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

32 Cook did not recall this particular discussion, but indicated that it was consistent with his feelings at the time.
Cook and Bevan to discuss the questions, stressing that everything possible had to be done to improve fourth-quarter earnings. Bevan speculated that one of the other officers had warned Saunders after the November 6 meeting that he was putting himself into an untenable position, and that, accordingly, Saunders did not want any permanent record made of this.

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

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

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

---

33 The Pennsylvania Railroad had not had audited financial statements prior to that time.
34 Cole is an attorney and is currently Penn Central’s vice president—legal administration. During the time under discussion his title was assistant vice president, administration, and he reported directly to Saunders.
other hand dismisses the Cook meetings lightly, saying he does not deny they occurred and thinks they probably did, but that the tone is wrong, that if there had been a serious confrontation of the type described he would recall it. He attributes Cook's memoranda to the fact that someone (obviously referring to Bevan) had conditioned Cook's mind.

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

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

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

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

The "Spongy" Areas

Certain areas proved particularly troublesome to the accounting department because of the problems they presented in withstanding top management pressure. These generally involved areas which Hill described as "spongy." These were accounts where the final definitive figures would not be available until some time in the future, and thus
involved some element of judgment in recording them currently. The temptations in times of declining income were obvious and there were numerous suggestions that the company take advantage of the imprecision inherent in these figures, pending some improvement in operating results. Basically, this would be used as an income equalizing device. Saunders, perhaps sensing this was a toe-hold in his battle with accounting personnel who would be unable to confront him with hard facts and absolutes, raised these matters at virtually every budget meeting. In effect, he was seeking to substitute his judgment, always on the side of higher earnings, for theirs. Nonetheless, as Hill put it, while there was some uncertainty inherent in these “spongy” areas, the flexibility was inherent in the accounting and not in the executive direction of the company. It was not merely a question of arbitrary judgment but of fact, and these items were subject to pre-established procedures of calculation. They could not properly be used to meet the needs of the moment, and there is evidence, both in the Bevan diary and in testimony, of resistance to Saunders’ demands.

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

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

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

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

---

35 This had the further advantage of making it more difficult for outsiders (e.g., the ICC and the auditors) to uncover and question.
36 Hill testified that the area of elasticity was perhaps $2 to $3 million and that even within that range, it was not arbitrary but based on various available data.
going to find $5 million. Cook did agree that what Saunders apparently had in mind was taking it out of the clearing account and putting it back by understating future revenues, indicating that this was the only way to interpret the request.

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

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

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

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

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

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

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

**Answer.** By simply not making the changes in the account. 37

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

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

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

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

39 These are the charges which one railroad must pay for using the cars of another railroad.
indicates that, when Hill told Saunders it was probably already under-accrued, Saunders said that did not matter, “[i]t had been under-accrued before and it was not necessary to become a ‘Christian’ all at once.” While Hill did not recall the incidents, he indicated, however, that they would be characteristic of the situation. Notes which Cole took at the budget meeting described also appear to support Bevan’s comment.

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

THE MERGER RESERVE

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

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

---

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

41 Saunders also took the position that the reserve should be established by a direct charge to retained earnings. While it was ultimately handled as an extraordinary charge in the 1967 income statement, it would appear that as a practical matter this change is of little significance.
cussed the matter with the ICC staff, Saunders himself took Cook down to discuss the matter privately with William Tucker, Chairman of the ICC.42 No one was present from the Bureau of Accounts, although Tucker did eventually call in another Commissioner, John Bush, who had an accounting background. After some discussion it was decided to handle it through a normal presentation to the Bureau of Accounts. A meeting was held later with Mathew Paolo, Director of the Bureau, although the Pennsylvania Railroad did not inform him of their earlier meeting with the ICC chairman. After getting a staff denial on most of the request, the company then appealed through regular channels. When Cook came down for the appeal proceeding, Tucker, who was not one of the three Commissioners hearing the appeal, asked Cook to stop by afterwards and tell him how it went. Cook indicated to him that he thought it was favorably received. He got the impression that Tucker also was sympathetic to the road’s position. Shortly afterwards, Pennsylvania Railroad was notified it had received virtually full approval of their request at the Commission level.

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

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

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

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

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

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

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

A. Told us what?

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

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

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

A. Well—

Q. That is what you did, isn’t it?

A. No, this is not a court.

Q. You used the analogy.

A. But you’ve got a right to appeal.

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

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

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

A. Well, on certain occasions, yes.”

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

44 Peat, Marwick, for example, in an internal memorandum dated January, 1968 noted:

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

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

“While the foregoing admittedly are rather stringent, they would serve as the basis for restrained discussion and would bring about the necessary reorientation in thinking to prevent the reserve from being used as an earnings stabilizer in future years.”
had been told at a budget meeting that Penn Central “could not hope to get away with” charging extra people against the account because it would be closely audited, and that he had tried to insist that all that Peat, Marwick and the ICC could do (if they learned of it) was to criticize the company, which did not bother him. Bevan was sufficiently concerned about the implications of this and other similar suggestions that in spite of the fact he no longer had accounting responsibility he discussed the matter with Edward Hanley, one of Penn Central’s directors, in the summer of 1968. Hanley then met with Walter Hanson, senior partner of Peat, Marwick, in New York. Hanson assured him the account would be watched closely.

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

Hill claims that no charges except those permitted under the conditions established by the ICC were made against the merger reserve, to the best knowledge of the accounting department. However, there were two situations where Penn Central returned to the ICC for expansion of authority. In one of these instances again, Saunders was directly involved, seeking to make his influence felt to obtain desired goals. This case involved a group of mail and baggage handlers and a $4.7 million charge. Initial indications were that both Peat, Marwick and the ICC staff were opposed to permitting this charge against the reserve. After meeting with Saunders, Hanson (of Peat, Marwick) apparently changed his mind, agreeing to abide by the ICC decision. And again Penn Central went directly to the ICC chairman. Hill, who had taken over from Cook as comptroller, and Tucker, who had left his position as chairman of the ICC to become a Penn Central vice president, met with Mrs. Virginia Mae Brown, the then current chairman. Once again, Penn Central succeeded in obtaining the
decision it wanted at the Commission level. However, the SEC staff believes that $4.7 million charge did not come within the original "merger reserve" criteria and should have been reflected as a period expense during the year ended December 31, 1968. (See further discussion at page 67.)

**OTHER DEVICES TO INCREASE RAILROAD EARNINGS**

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

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

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

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

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

This statement reflects the clearly “even keel” attitude.

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

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

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

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

One witness testified that from his trips around the system shortly after merger, it appeared that PRR had a lot of unused track, which it was apparently not taking out of service because it did not want to incur...
Also in 1969 Penn Central established a reserve for “Loss on Investment in Long-Haul Passenger Facilities” of $126 million. The ICC disallowed the item for ICC reporting purposes, but the company included it in its reports to the public. The basis for ICC disapproval was that the properties were still in use and had not been abandoned. The company, on the other hand, claimed that there was a permanent impairment in value and wrote it off anyway.\textsuperscript{47} This had the earnings advantage of lowering depreciation costs now and in future years (most of this property was depreciable).\textsuperscript{48} And the reserve, labeled as an extraordinary item in the 1969 income statement, would be construed as such by the investment community, and thus its effect on reported income in 1969 would be discounted.

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

In 1969 Penn Central had another problem. It had been forced to absorb the New Haven Railroad. The New Haven had lost $22 million in 1968 and had a consistent pattern of unprofitable operations, which Penn Central could ill afford to report considering its own disastrous performance.\textsuperscript{49} Saunders suggested a reserve for operating losses be established, but was told that this was clearly impossible under generally accepted accounting principles. However, a treatment was found that reduced the earnings impact, at least over the short term. The state of New Haven’s equipment was very poor, it was claimed, and it had to be rehabilitated. On this basis, a very high proportion of the total maintenance cost attributable to the road in 1969 was written off against a liability for rehabilitation cost,\textsuperscript{50} established as sort of negative goodwill in connection with the purchase of the New Haven properties.\textsuperscript{51} As a result total maintenance costs in 1969 were very significantly lower than they had been in the prior year.

Peat, Marwick, after initial objection to Penn Central’s claim, finally relented and accepted the company’s position. On the other hand, for purposes of reporting to the ICC, the company was forced to treat $22 million of these charges as ordinary maintenance, not rehabilitation, and charge them against ordinary income. The result was a $22 million difference in the profit figures reported to the ICC and to the public in 1969.

\textsuperscript{47} The files of Peat, Marwick, discussing 1969 accounting problems, carry the following notation concerning this item:

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

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

\textsuperscript{49} Hill testified that on the structuring of the New Haven transaction “I know I did a lot of head-scratching, trying to figure out a means to achieve the objectives that seem evident in Interstate Commerce Commission with the least possible burden on the Transportation Co.”

\textsuperscript{50} Cole’s budget meeting minutes indicate that at one meeting the suggestion was thrown out that the New Haven be assigned to the employees’ pension fund! While this was not ultimately done, the idea was that the equity could be given away, while Penn Central continued to operate the road. This way it would not have to be included in Penn Central’s results.

\textsuperscript{51} It was contemplated that when the $40 million sum thus reserved was exhausted further such expense might then be capitalized.

\textsuperscript{47} When Penn Central’s comptroller was asked if anyone in Penn Central ever expressed the opinion that this was nothing more than a reserve for future losses he replied that “there was a great deal of cynicism among people that did not understand the accounting principle involved.”
Another consistently unprofitable railroad property was Lehigh Valley Railroad Co., a 97.3-percent owned subsidiary of Penn Central. Losses in 1968 and 1969 were $5–$6 million per year. However, despite the very high percentage of ownership, Lehigh Valley's results were not included in the consolidated statements, thereby permitting the parent to report a higher net income. The justification claimed was a fiction that the Lehigh Valley was being held only on a temporary basis. 52

**Nonrailroad Operations**

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

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

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

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

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

---

52 See further discussion on page 64.
53 A simplified chart, showing the major companies relevant to the discussions in this report, is included as exhibit 1B-2.
54 Up until this date what is now the Transportation Co. was the top entity and carried the name Penn Central Co.
55 The Transportation Co. and its predecessors.
Some of the income from nonrailway operations represented the results of routine activities but other portions clearly reflect the results of the maximization policy and Saunders' desire to conceal the earnings slide.

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

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

<table>
<thead>
<tr>
<th>CONSOLIDATED EARNINGS</th>
</tr>
</thead>
<tbody>
<tr>
<td>[In millions]</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Pipeline, net</td>
</tr>
<tr>
<td>Real estate rents, net</td>
</tr>
<tr>
<td>Real estate sales:</td>
</tr>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>Costs</td>
</tr>
<tr>
<td>Net</td>
</tr>
<tr>
<td>Dividend and interest on investments</td>
</tr>
<tr>
<td>Net gain on sale of investments</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: Assembled from information in 1970 Pennco offering circular.

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

---

18 Certain railway-related activities of companies other than the Transportation Co. are included in the nonrailway figures.
Macco Corp., and Arvida Corp. Great Southwest acquired Macco from Pennco in 1969. The latter three companies greatly expanded the scope of Penn Central's real estate activities, as reflected in the consolidated statements. The Great Southwest-Macco operation proved a particularly useful device in the maximization program.

**REAL ESTATE ACTIVITIES**

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

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

A considerable portion of the Great Southwest-Macco earnings was attributable to a limited number of very large transactions. Two transactions contributed approximately $15.1 million to Penn Central's consolidated net earnings for the fourth quarter of 1968.⁵⁸ These purported sales, the Six Flags Over Georgia and Bryant Ranch transactions described in more detail later, involved premature recognitions of income and little immediate cash benefit to Great Southwest. In 1969 there was another similar transaction, involving the purported sale of Six Flags Over Texas (also discussed later), which resulted in an increase to Penn Central's consolidated net earnings of approximately $24.4 million. The following schedule sets forth the estimated incremental effect of these three transactions on the financial statements of Great Southwest and Penn Central, respectively. It should be noted that the effect on Penn Central differs due to: (1) the inclusion of Great Southwest in the consolidated Federal income tax return of Penn Central; (2) the absence of taxes payable by Penn Central due to its tax losses and carryovers and the absence of deferred tax provisions; and (3) the minority interest in Great Southwest. The $13,401,576 and $18,358,003 figures represented approximately 67 and 53 percent of Great Southwest's reported consolidated net income for the years ended December 31, 1968 and 1969, respectively:

---

⁵⁷ The fact that many of the properties were heavily mortgaged further complicated the situation.
⁵⁸ The company-only statements of the Transportation Company were not affected, except to the extent of the increase, if any, in tax allocation agreement payments as a result of these transactions.
1968:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Increase to net income (after tax provision) of GSC</th>
<th>Approximate increase to consolidated net income (no tax effect) of Penn Central</th>
</tr>
</thead>
<tbody>
<tr>
<td>Six Flags Over Georgia</td>
<td>$4,813,400</td>
<td>$6,370,000</td>
</tr>
<tr>
<td>Bryant Ranch (less deferred portion)</td>
<td>8,588,176</td>
<td>8,730,000</td>
</tr>
<tr>
<td></td>
<td>13,401,576</td>
<td>15,100,000</td>
</tr>
</tbody>
</table>

1969:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Increase to net income (after tax provision) of GSC</th>
<th>Approximate increase to consolidated net income (no tax effect) of Penn Central</th>
</tr>
</thead>
<tbody>
<tr>
<td>Six Flags Over Texas</td>
<td>17,530,170</td>
<td>22,910,000</td>
</tr>
<tr>
<td>Bryant Ranch (deferred portion)</td>
<td>827,833</td>
<td>1,490,000</td>
</tr>
<tr>
<td></td>
<td>18,358,003</td>
<td>24,400,000</td>
</tr>
</tbody>
</table>

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

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

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

Once again, management’s propensity to control the earnings being reported to the public by speeding up the profits and delaying the losses and costs is clearly apparent.

60 Bevan indicated that he had refused, and that at any rate it was never consummated as the potential buyer was not interested.
61 Again he was told no, according to testimony.
The Search For Investment Income

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

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

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

62 No cash payment was made, but debt owed by the parent to the subsidiary was reduced. And the earnings from which Strick paid the dividend were represented by values assigned to warrants in a newly formed company which had acquired Strick’s major assets.
items as income.\(^6^3\) There were also other similar intercompany dividends. While these transactions would be eliminated upon consolidation, they did help the Transportation Co.'s results, and considering that entity was where the major problem was buried, Penn Central apparently considered this better than nothing.

A device used extensively in 1968 to increase income was the repurchase, in the open market at a deep discount, of bonds of various companies in the Penn Central complex. The difference between the price paid and the par value was then recorded as a profit. The company recorded a profit of $8.4 million in the Transportation Co. and $9.8 million in the consolidated entity from this source in 1968, but found it virtually exhausted when suggestions were made in 1969 that this device be tapped again.\(^6^4\) These transactions, particularly in light of Penn Central's need to finance the purchases through additional borrowing, apparently offered no real benefit to the company except the generating of paper earnings.

There were also a series of paper transactions involving in essence substitutions of similar securities which resulted in significant amounts being added to reported income in 1968 to 1970. Two such transactions contributed a total of $32.7 million in 1968 to both consolidated and company-only earnings. The first involved a dividend-in-kind from Washington Terminal Co.,\(^6^5\) a 50-percent owned subsidiary. This dividend was in the form of the securities of a newly formed company which Washington Terminal had received when it transferred to the new company a one-half undivided interest in Union Station in Washington, D.C. Union Station had been Washington Terminal's principal asset and an undivided one-half interest therein was the major asset of the new company as well. Penn Central controlled after receipt of the dividend, essentially the same underlying asset as it had had prior to that time, but it recorded income of $11.7 million as a result. The second transaction was in the form of an exchange of securities with Madison Square Garden Corp. and contributed $21 million to reported 1968 results.\(^6^6\) The Transportation Co. exchanged its interests in two assets held jointly with Madison Square Garden Corp., and which constituted the bulk of that corporation's assets, for shares in Madison Square Garden Corp. itself. Again, following the consummation of the transaction Penn Central had basically the same interest as before, packaged in a slightly different form, but took advantage of the situation to record a large gain.

Other transactions of this nature also occurred.\(^6^7\) In 1964 the ICC had issued an order requiring PRR and its affiliates to divest themselves of all of their extensive holdings of N&W stock by 1974.\(^6^8\) In late 1965 PRR and Pennco entered into an agreement with the N&W, whereby Pennco, which held all of the PRR system's N&W shares, would exchange about one-third of these shares for 15-year N&W convertible debentures,\(^6^9\) with the exchange to be

---

\(^{63}\) See further discussion of this item on page 60.

\(^{64}\) In 1967 and 1969 the Transportation Co. earned about $500,000 from this source, while consolidated figures were $700,000 and $1,700,000 respectively.

\(^{65}\) See further discussion on page 62.

\(^{66}\) See further discussion on page 57.

\(^{67}\) See also discussion concerning Wabash Railroad Co. stock on page 55.

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

\(^{69}\) Pennco was to receive $104 million in 4\% percent debentures which were convertible only by holders other than PRR.
made in 10 installments. A gain of about $80 million was recorded on PRR's consolidated books, but instead of taking the entire amount into income that year, the company recorded it as deferred income. The deferred income was then to be recognized on a periodic annual basis over the life of the contract, 9 years. It might be noted that, whereas in the Madison Square Garden and Washington Terminal transactions it was contemplated that the securities received in exchange would continue to be held as an investment, the N&W debentures would, of necessity, be liquidated. Indeed, the securities received in 1966–68 were sold in 1967 and 1968. There were no sales in 1969.

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

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

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

Because of prior intercompany sales, the profit on Penno's books was smaller—only $59 million.

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

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

"I have taken a special interest in this project and have been trying to push it along, because I thought I foresaw the prospect of being able to generate net income by Railroad or Pennsylvania Company declaring dividends of low-book value assets which would then be taken in by the Parent at present market values, as in the case of the Washington Terminal dividend and the Madison Square Garden transaction. Alas, I have just learned that this is prohibited where the declaring corporation is more than 50 percent owned."

Management never did find any additional transactions similar to the transactions alluded to, and 1969 investment income dropped accordingly.
Unfortunately, disclosure of the fiasco surrounding this situation\textsuperscript{73} would have been embarrassing to management, in addition to its detrimental effect on earnings, and so no writedown was taken. The market value of the Madison Square Garden shares had dropped by more than 50 percent between the time Penn Central’s investment in the project was in effect written up in connection with the previously described exchange of securities in late 1968, and the close of 1969.\textsuperscript{74} Again, the investment was not written down. In the case of Lehigh Valley Railroad, as suggested earlier, that company should have been consolidated and not carried as an investment, but even as an investment, the earnings and financial history of the company clearly called for a writedown to realizable values.\textsuperscript{75}

**EARLY 1970—THE LAST GASP**

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

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

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

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

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

\textsuperscript{73} See discussion on page 71.
\textsuperscript{74} It has remained at lower levels since that time;
\textsuperscript{75} See discussion on page 64.
Apparently it was in substantial part events in the first quarter of 1970 which alarmed Gorman. As noted earlier, the first quarter was operationally a disaster, with $100 million in losses from railroad operations. This was unfortunate because, with a critical cash situation, Penn Central, through Pennco, was about to go into the public markets for financing. Some way had to be found to improve the apparent earnings picture if the issue was to succeed. Gorman objected to the two major devices adopted, however, to accomplish the goal.

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

That transaction was dwarfed, however, by the other one, which involved not the Transportation Co. but the consolidated statements. Pennco owned virtually all of the common shares of Wabash Railroad Co. and pursuant to an ICC order dated 1964 had agreed with the N&W to exchange them for N&W shares. The date of the exchange was established as October 15, 1970. However, when it was recognized the first quarter profits would be very bad, hurried plans were made to accelerate the exchange to March 31, 1970. As a result, profits of $51 million were booked as ordinary income in that quarter. Gorman, who was in the hospital at the time, knew nothing about it until after the transaction was consummated and reported. He was irritated and reported to the finance committee that if he had known about it he would have dissented. This was a writeup of paper profits, with a flow through to earnings but no cash benefit, he stated, reflecting to the committee "a general feeling that where there is no cash involved why do you do things. And certainly we were in need of cash."

Furthermore, he was particularly distressed by the fact that the acceleration had cost Penn Central $1.8 million in Wabash cash dividends, which he felt he could certainly have used to repair freight cars which seriously needed repairing. It might be noted that Penn Central management had made a number of other expensive concessions to N&W as well, to gain the income acceleration.

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

---

76 The carrying value on the Transportation Co. books was only $82,000.
77 The gain on Pennco's books was $47 million.
78 This reflects the difference between the dividends which Pennco received from the N&W shares in the interim period and those it would have received had it held the Wabash stock.
79 It appears that under the terms of an escrow agreement in connection with a $50 million debenture offering of Pennco, debenture holder approval was required before the terms of the exchange agreement could be amended. Such approval was not obtained.
It might be noted that there were also other devices discussed by Saunders and Bevan during the early 1970 period whose effect would have been to increase reported earnings. The accounting department suggested an upward revaluation of inventory, although this idea was dropped on Gorman’s objection. The possibility of allocating part of the overhead and management costs of the Transportation Company to the holding company and the subsidiaries was brought up. Gorman said he had no objection but asked why now? Bevan instructed Hill to check with other railroads on amounts being accrued for 1970 wage increases, stating that it was important not to exceed what was necessary in this respect. And the old possibilities of expensing off the winter’s heavy snow removal cost over the entire year and increasing use of the merger reserve were raised once again. Saunders also asked the appropriate people to look at the reserves for injuries, damages, and so forth, to see if a lower figure could be justified.

**ACCOUNTING TREATMENT**

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

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

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

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

<table>
<thead>
<tr>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pennsylvania Terminal Real Estate Corp. (PTRE)</td>
</tr>
<tr>
<td>Two Pennsylvania Plaza, Inc.</td>
</tr>
<tr>
<td>Tishman Plaza, Inc.</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

1 A corporation 100-percent owned by PRR directly or through one of its wholly owned subsidiaries.
2 A corporation 100-percent owned by Garden.

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

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

The agreement, as originally structured, provided for a 25 percent interest to the PRR subsidiary and 75 percent to the Garden subsidiary. Because of difficulties in obtaining needed financing, this was later renegotiated, with PRR receiving an increased participation in return for an agreement to provide financing.
Pursuant to an agreement dated December 18, 1968 Garden acquired as of December 31, 1968, Penn Central's interests in Center and PTRE. In addition certain indebtedness owed Penn Central in connection with the office building project was forgiven. In exchange, Penn Central received 1,168,664 unregistered shares of Garden's common stock and 100,000 shares of Garden's participating preferred stock. Contingent upon approval of Garden's stockholders, it was agreed that the participating preferred would be exchanged for 1,151,000 shares of common. This approval was obtained on April 9, 1969 and the exchange made about 10 days later.

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

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

Penn Central indicated that the reason for the transaction was as follows:

Penn Central's interest was to concentrate and unify Penn Central's interests in

\[ \text{Penn Central Transportation Company (Railroad)} \]

\[ \text{Pennsylvania Terminal Real Estate Corporation - 100% owned by Penn} \]

\[ \text{Other wholly owned subsidiaries of Madison Square Garden Corporation:} \]

- Holiday on Ice Productions, Inc.
- Madison Square Garden Attractions, Inc.
- Madison Square Garden Realty, Inc.
- Graham Paige Realty Corp.

\[ \text{Two Pennsylvania Plaza, Inc. 100% owned by MSG Corporation} \]

\[ \text{Joint Venture - 29 Story Office} \]

\[ \text{Bridge, "Penn Plaza Venture"} \]

\[ \text{Tishman Plaza, Inc.} \]
the new Madison Square Garden Center and the office building at Two Pennsyl-
vania Plaza through the ownership of a substantial equity interest in Madison
Square which will be the beneficial owner and operator of those facilities. Thus,
Penn Central as owner of the underlying properties will continue to receive fixed
rentals from these facilities and will in addition have a significant single equity
interest in the profit from their operation.

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

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

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

Received by Penn Central:

| Shares of Garden common stock                     | 1,168,664 |
| Shares of Garden common stock which were represented by the convertible preferred | 1,151,000 |
| **Total**                                            | **2,319,664** |

| Multiplied by per share market price of Garden stock | 11.078 |
| **Total market value of shares received**            | 25,697,238 |

Given up by Penn Central:

| 225 shares of Center                                | $1 |
| 100 shares of PTRE                                  | 100 |
| **Indebtedness forgiven**                           | 4,697,232 |
| **Total given up**                                  | 4,697,333 |

**Net gain on exchange**                              20,999,905

---

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

2 Source: Item 4 of Schedule 13D, filed on Apr. 1, 1969.

3 This increase was attributable mainly to purchases under the stock purchase agreement entered into
December 1968, which was previously described.

4 Because of the early stage of operations the contribution to earnings is difficult to assess. However, of
total investments and advances to subsidiaries of $24,800,000 Garden's books, $17,000,000 was invested in
Center, $5,500,000 in the office project, and $1,300,000 in the lesser subsidiaries. The other significant asset
on Garden's books was the old Garden facility which has been cleared and is currently being used as a
parking lot.

5 This figure represents a 25-percent interest, rather than a 23-percent interest in these assets.

6 As abstracted from accounting workpaper included in the files of Peat, Marwick.
The impact on the 1968 financial statements was as follows:

<table>
<thead>
<tr>
<th></th>
<th>Consolidated</th>
<th>Company-only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings (loss) from ordinary operations</td>
<td>$87,789,000.00</td>
<td>($5,155,000)</td>
</tr>
<tr>
<td>Earnings (loss) absent recognition of gain</td>
<td>66,789,095.00</td>
<td>($26,154,905)</td>
</tr>
</tbody>
</table>

Per share difference:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>As reported</td>
<td>3.80</td>
<td></td>
</tr>
<tr>
<td>Absent recognition of gain</td>
<td>2.89</td>
<td></td>
</tr>
<tr>
<td>Difference</td>
<td>.91</td>
<td></td>
</tr>
</tbody>
</table>

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

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

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

ACCOUNTING—TRUCKING COMPANY DIVIDENDS

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

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

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

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

Hill testified that some people within Penn Central thought that maybe "you could just make marks in a book" that would effect the dividend, but that he objected to taking the dividend income "unless something of value flowed between the parties."
Special Dividend Income Recorded by the Transportation Company in 1969.—New York Central Transport Co. declared the following dividends payable to the transportation company: 91

<table>
<thead>
<tr>
<th>Date</th>
<th>Dividend Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apr. 15, 1969</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>July 15, 1969</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>Dec. 31, 1969</td>
<td>$2,500,000</td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

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

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

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

92 Indeed, Cole has testified that New York Central Transport is currently protesting the transaction and asking for cancellation of the debt incurred.
Conclusion.—The 1969 “company-only” (railroad) financial statements included the sum of $66,324,000 as dividend and interest income. Of this amount, $63,838,000 was from dividends of which $14 million discussed herein, or 22 percent, is included. The loss from ordinary operations of $56,328,000, as shown in the 1969 operating statement, was understated by this $14 million (25 percent of $56,328,000).

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

ACCOUNTING—WASHINGTON TERMINAL CO.

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

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

<table>
<thead>
<tr>
<th>The Baltimore and Ohio Railroad Company (B&amp;O)</th>
<th>Philadelphia, Baltimore and Washington Railroad Company (PB&amp;W)</th>
</tr>
</thead>
<tbody>
<tr>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Transportation Company</td>
<td>THE WASHINGTON TERMINAL COMPANY (WTC)</td>
</tr>
<tr>
<td>100%</td>
<td>Full ownership of &quot;National Visitor Center Property&quot;</td>
</tr>
<tr>
<td>$12,000,000</td>
<td>$14,000,000</td>
</tr>
</tbody>
</table>

New York Central Transport Co.  
Merchants Trucking Co.  
Penntrucking Co.  

Total: $14,000,000
On September 13, 1968, the board of directors of WTC adopted a resolution with respect to the transfer of title to the National Visitor Center property to the owners of WTC. It was the intent to convey undivided one-half interests in the property to two companies to be formed by WTC. The dividend-in-kind would then be accomplished by conveying 100 percent of the common stock of one such company to B&O and 100 percent of the common stock of the other company to the Transportation Co. This was accomplished on or about September 30, 1968, when 100 percent of the stock of Terminal Realty Penn Co. was transferred to the Transportation Co. as a dividend.

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

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

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

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

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

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

The substance of the December 18, 1968, agreement was a promise
on the part of the U.S. Government to purchase certain property after significant construction and alternations had been made to transform such property into a National Visitor Center. Recognition of income under such circumstances was inappropriate until the seller had substantially performed its obligations.

ACCOUNTING—LEHIGH VALLEY RAILROAD CO.

Background.—Prior to 1962 the then PRR, through subsidiaries, owned 44.4 percent of the outstanding shares of Lehigh Valley Railroad Co. As a result of an exchange offer, PRR on February 28, 1963, became the record or beneficial owner of 89.9 percent of the stock and this was increased to 97.3 percent in 1964. The Lehigh Valley’s position was considered in the PRR-New York Central merger hearings before the ICC. The hearing examiner found that the merger could be anticipated to have a detrimental effect on Lehigh Valley and that specific protective provisions should be provided. It would either have to find affiliation with the Norfolk & Western (N&W) or Chesapeake & Ohio/Baltimore & Ohio (C&O/B&O) systems or be merged into PRR. Until this matter was resolved PRR would be required to keep Lehigh Valley operational. The following conditions were imposed by the ICC in its decision dated April 6, 1966, approving the Penn Central merger:

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

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

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

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

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

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

97 The company has been unable, by a large margin, to even operate within its depreciation.
Unconsolidated subsidiary:

<table>
<thead>
<tr>
<th>Stock, 1,475,579 shares</th>
<th>1,475,579</th>
<th>$23.0</th>
<th>$23.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>4.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds, notes and advances</td>
<td>26.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (in millions of dollars)</td>
<td>1,475,579</td>
<td>$27.1</td>
<td>$49.5</td>
</tr>
</tbody>
</table>

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

No dividends were paid in either year.98

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

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

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

In this instance, despite the merger conditions, it appears unlikely that control would be temporary. There were no contacts between Penn Central and C&O/B&O that related in any way to the acquisition of Lehigh Valley in the period from 1966-1969. It seems safe to presume that if Penn Central had thought there was any possibility of interest on the part of C&O/B&O, it would have explored the matter, but C&O/B&O was involved in its own merger plans at the time, plans which would clearly not have included Lehigh Valley.99 Furthermore, even absent the merger factor, the company was not attractive.

The senior vice-president and the chief counsel of C&O/B&O were emphatic in their testimony: at no time from 1965 to date would Lehigh Valley have had any strategic value to their road. Indeed, the C&O/B&O would have to be paid to take it, because of the obligations and liabilities involved. Its attitude toward that road was completely negative.

98 No dividends had been paid since 1957.
99 Not only was it required to do so under the terms of the merger, but it would certainly have jumped at the chance to get rid of this subsidiary.
100 The Erie-Lackawanna Railroad offered in effect the same benefits as the Lehigh Valley, and was considered more attractive. N&W, which was the potential merger partner of C&O/B&O, absorbed the Erie-Lackawanna in early 1968.
In response to a staff inquiry to the N&W regarding its possible interest in Lehigh Valley, that road's vice president-finance replied:

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

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

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

Question. Well, why didn't you get rid of Ann Arbor or Lehigh?
Answer. We tried to get rid of Lehigh Valley, we offered it to Norfolk and Western Railroad and to the C. & O. They wouldn't touch it, nobody would.

Question. Well, wouldn't they take it out of [sic] of book value?
Answer. They wouldn't give you a penny for it, that's my judgment. It's not worth anything.

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

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

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

The stock was listed on Penn Central's books at a value of about $15 per share, whereas the price range in 1969 was $6\[\frac{1}{4}-4.\[102\] In addition, beginning in 1968, Lehigh Valley required significant infusions of capital from Penn Central.\[103\] The operating history of Lehigh Valley for the decade prior to 1970 clearly indicated that the Penn Central could not expect repayment of advances\[104\] and any benefit from share ownership. All evidence points to a situation for permanent impairment in Penn Central's investment.

---

101 It might be noted that the Wabash Railroad Co. was also an unconsolidated, majority owned company but, as discussed previously, in that case the temporary nature of the control was obvious. See page 55.
102 The market was, of course, limited considering Penn Central's 97 percent ownership. The price might reflect this factor to some degree.
103 As noted previously, Penn Central itself initially classified the advances as "accounts doubtful of collection." Although this was later reclassified into the investments category.
104 Prior to that time, Lehigh Valley had relied largely on proceeds of the sale of capital surp (largely second track that they took up) for additional capital.
The audit workpapers of Peat, Marwick for 1969 illustrate their awareness of the problem. They stated, “Lehigh Valley—to be written down or reasons must be supplied.”

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

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

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

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

ACCOUNTING—MERGER RESERVE: SEPARATION OF MAIL AND BAGGAGE HANDLERS

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

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

<table>
<thead>
<tr>
<th>Adjustment of assets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Obsolescence of materials and supplies</td>
<td>$6,013,000</td>
</tr>
<tr>
<td>Impairment in value of properties</td>
<td>125,859,313</td>
</tr>
<tr>
<td>Total</td>
<td>131,872,313</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Provisions for Liabilities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment in value of leased property</td>
<td>335,461</td>
</tr>
<tr>
<td>Cost to demolish obsolete properties</td>
<td>26,236,211</td>
</tr>
<tr>
<td>Cost of recalled employees</td>
<td>116,928,000</td>
</tr>
<tr>
<td>Liabilities incurred upon merger</td>
<td>143,549,672</td>
</tr>
</tbody>
</table>

| Total costs and losses incurred upon merger| 275,421,985 |

In 1968 and 1969, charges of $17,225,000 and $7,216,000, respectively, were made to the provisions other than those for recalled employees. The charges to the merger loss provisions relating to recall of surplus furloughed employees totaled $22,459,000 and $15,250,000 for the 2 years, respectively.

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

105 While shareholders equity was still $67 million at the end of 1969, there is no indication that this figure had any meaningful relationship to liquidating value. Indeed the figure had been declining from year to year and was down from nearly $100 million at the time when PRR acquired control in 1963.
problem is to make sure that all charges against an appropriately established reserve are reasonable and proper.

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

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

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

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

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

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

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

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

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

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

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

We understand that you intend to petition the Interstate Commerce Commission to review the facts concerning the separation of the mail and baggage handlers and to rule on the question of whether such separations are, in fact, merger-related. We have reviewed the letter addressed to the Commission by Mr. Saunders. Under the circumstance, if the Commission in its judgment deems the separations to be merger-related and the costs incident thereto chargeable against the reserve, we would no longer have a basis for objection to a charge against the Merger Reserve for this purpose.
Henry Quinn, the writer of the January 23, 1969, Peat, Marwick letter, testified that he may have been expressing his own personal opinion in such letter. He explained by saying that the Peat, Marwick staff had discussed the matter and several felt that the $4,672,000 was an appropriate charge to the "merger reserve." He stated further that his opinion was not whether the charge was in accordance with generally accepted accounting principles but was whether the charge was in accordance with the criteria initially approved by the ICC. Accordingly, it was Peat, Marwick's position that if the ICC said that the $4,672,000 charge was appropriate then Peat, Marwick would not object.

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

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

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

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

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

107 Division 2 is the three Commissioner panel responsible for hearing appeals in ICC accounting matters.
ACCOUNTING—EXECUTIVE JET AVIATION

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

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

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

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

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

---

108 The advances were as follows:
Through 1966. $13,804,877
1967. 2,441,000
1968. 2,714,000
1969. 2,000,000
Total. 21,019,877

109 PRR had been aware of this problem earlier and taken steps to obscure its effective control.
110 This was later withdrawn.
entered into a memorandum of understanding whereby they would purchase Penn Central’s equity and debt interest in EJA, subject to EJA’s receiving CAB approval to acquire Johnson Flying Service. However, Burlington withdrew from the agreement in December 1968 and U.S. Steel followed. Other attempts by Penn Central to dispose of its interest in EJA proved unsuccessful.

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

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

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

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

111 If EJA was successful, Penn Central would realize a small profit; if it were liquidated, it would incur a small loss.
112 The order directed Penn Central to place all debt and equity interests in EJA into an irrevocable liquidating trust and to divest all of its interest no later than Mar. 1, 1970.
113 1965 loss, $992,000; 1966 loss, $2,214,000; 1967 loss, $2,214,000; 1968 loss, $3,830,000; 1969 loss, $4,101,000.
plans and further meant that the company had substantial equipment which it could not operate. EJA was forced to search for purchasers for the large jet aircraft and allied equipment it had acquired. The company was obviously in extremely serious difficulty, since this would undoubtedly result in additional severe losses, on top of the already unsatisfactory results. Indeed, because of this and other matters, Lybrand wrote to O. F. Lassiter, EJA's chairman in February 1969, outlining to him four major areas that would have to be resolved before they could complete their audit for 1968. No audited financial statements were issued for 1968 or 1969 until after Penn Central's bankruptcy. At that point the auditors disclaimed an opinion on the statements.116

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

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

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

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

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

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

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

It might be noted also that EJA had a reported capital deficit of $13,400,000 as of the end of 1969 and
This letter was dated March 12, 1970, a few days after the Cole and First National City Bank memoranda.

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

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

EJA addendum: The $10 million Liechtenstein account

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

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

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

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

The first affected by the Rosenbaums involved the obtaining of financing through a Rosenbaum family partnership, American Investors Co., for the purchase and lease of automobile racks used by the company in transporting automobiles. The second transaction involved a $12 million equipment-rehabilitation loan from the Berliner Bank, Berlin, Germany, in mid 1969. Thereafter in August of 1969, the Rosenbaums again through the Berliner Bank arranged for another equipment loan of some $10 million to be secured by a conditional sales
agreement between the company and American Contract Co., a wholly-owned subsidiary of the company. Funds were to be drawn down as “groups” of the equipment were completed and a schedule of equipment which had been rehabilitated was submitted to the lender.

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

(a) The closing

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

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

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

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

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

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

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

In 1967, Fidel Goetz, a German financier, was introduced to the top management of the company by Charles Hodge of Glore Forgan, Wm. R. Staats, Inc., who had also introduced Joseph Rosenbaum to the company. According to Bevan, when Goetz first met him,
Goetz expressed an interest in loaning money to American companies and investing funds in foreign airlines. Goetz was apparently aware of the company's interest in EJA, and of EJA's plan to acquire interests in foreign air carriers.

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

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

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

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

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

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

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

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

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

THE ROLE OF THE INDEPENDENT AUDITOR

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

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

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

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

EXHIBIT IB-1—DIARY OF DAVID C. BEVAN

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

1. About a month ago, at a Budget Meeting S. T. S. stated he thought we should deliberately underestimate our per diem charges until such time as we received a rate increase in order to help out in the income account. I ignored this statement and changed the subject to another area. After the meeting Tom Schaeckel came up to me very much disturbed and shocked and asked me if S. T. S. meant this since I had specifically instructed him after we got out of some trouble when
the per diem was handled in the Operating Department that under no circumstances was there ever to be any juggling in this account. I told Schaekel to ignore the entire thing and proceed in accordance with instructions and accrue per diem as accurately as possible regardless of anyone and I would stand back of him.

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

August 22, 1967

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

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

Wednesday, August 23, 1967

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

Friday, August 25, 1967

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

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

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

Wednesday, August 30, 1967

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

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

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

Monday, November 6, 1967

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

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

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

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

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

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

S. T. S. also complained bitterly over the fact that profit on sale of real estate in the third quarter on the UNJRR went to the UNJRR and could not be included in the account of PRR itself but only in the
consolidated statement and at the same time the capital gains tax had to be charged to PRR. He wanted to know who wrote the lease and wanted to see a copy of it. It was explained to him the lease was made over 100 years ago. He also said it was unfair the other stockholders should get a windfall with PRR paying all the tax. It was explained to him that one factor in the annual rental paid by the PRR is the income tax of UNJRR and that the tax is increased by gains and decreased by losses and in our consolidated return we get all the benefit of the gains and that the other stockholders of the UNJRR get no windfall since they are paid an agreed upon fixed rate of return out of the rental.

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

Tuesday, November 7, 1967

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

Thursday, November 9, 1967

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

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

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

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

[c. May 1, 1968]

At the Budget Meeting on April 22, 1968, S. T. S. suggested that
Grant and McTiernan replied that we “could not hope to get away with it. This reserve account will be closely audited by our own CPAs and the ICC.” S. T. S. tried to insist that all they could do in the last analysis would be to criticize us and this did not bother him. He dropped the matter for the time being.

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

\textit{Monday, May 20, 1968}

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

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

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

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

\textit{Tuesday, May 21, 1968—Budget Meeting}

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

\textit{Wednesday, May 22, 1968}

Today, while W. R. G. and I were in New York, W. R. G. received an urgent call from Verlander stating that he had been instructed by McCrone, Treasurer in New York, to cancel a lease that the Financial Department had authorized by the Board of Directors.
volving some racks for piggyback cars. McCrone also said that he should order some additional racks and pay for them in cash and not finance. He said these instructions had come from Walter Grant. On my advice W. R. G. advised Verlander to take no action until he had an opportunity to investigate what was going on.

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

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

* * * *

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

**EXHIBIT 1B-2**

![Diagram of PENN CENTRAL CO. and related companies]
### EXHIBIT 18-3
#### PENN CENTRAL—QUARTERLY RESULTS (PUBLICLY REPORTED ORDINARY INCOME)

[Dollars in millions]

<table>
<thead>
<tr>
<th>Year</th>
<th>1st quarter</th>
<th>2nd quarter</th>
<th>3rd quarter</th>
<th>4th quarter</th>
<th>1st quarter</th>
<th>2nd quarter</th>
<th>3rd quarter</th>
<th>4th quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>1968</td>
<td>$382.2</td>
<td>$382.1</td>
<td>$372.1</td>
<td>$359.3</td>
<td>$406.0</td>
<td>$417.9</td>
<td>$384.8</td>
<td>$429.7</td>
</tr>
<tr>
<td>1969</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### TRANSPORTATION COMPANY

**Rail:**
- Revenues: $382.2, $382.1, $372.1, $359.3, $406.0, $417.9, $384.8, $429.7
- Costs: 387.1, 388.9, 386.2, 397.6, 420.3, 431.5, 423.9, 439.2
- Fixed charges: 22.9, 24.1, 25.7, 26.1, 27.7, 30.6, 34.1, 35.5

**Rail earnings:** (27.8) (20.9) (42.4) (42.0) (44.2) (53.6) (50.0)

#### Real estate:
- Operations: 5.3, 5.3, 6.4, 7.7, 7.5, 8.4, 6.6, 9.0
- Sales: 8.4, 2.4, 0.9, 2.5, 1.3, 1.0, 2.2, 7.4

**Real estate earnings:** 13.7, 7.7, 7.3, 10.2, 8.8, 9.4, 8.8, 16.4

#### Financial:
- From subsidiaries:
  - Dividends: 10.9, 7.6, 7.9, 11.0, 14.8, 19.0, 19.3, 10.1
  - Tax payments: 2.0, 3.9, 7.3, 6.0, 4.2, 6.1, 10.7
  - Securities transactions: 1.1, 1.2, 1.3, 2.5, 3.0, 6.0, 6.8

**Financial earnings:** 15.1, 15.3, 31.1, 41.6, 20.4, 26.6, 31.6, 12.5

**Net company earnings:** 1.0, 2.1 (3.8), (2.6), (12.8), (8.2) (18.2), (16.1)

#### SUBSIDIARIES NET CONTRIBUTIONS

<table>
<thead>
<tr>
<th>Year</th>
<th>1st quarter</th>
<th>2nd quarter</th>
<th>3rd quarter</th>
<th>4th quarter</th>
<th>1st quarter</th>
<th>2nd quarter</th>
<th>3rd quarter</th>
<th>4th quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>1968</td>
<td>12.4</td>
<td>21.5</td>
<td>19.0</td>
<td>39.5</td>
<td>17.4</td>
<td>30.1</td>
<td>10.3</td>
<td>2.9</td>
</tr>
<tr>
<td>1969</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Consolidated earnings:** 13.4, 23.6, 15.2, 36.9, 4.6, 21.9 (8.9), (13.2)

#### SIGNIFICANT ITEMS

**Transportation Company, rail:**
- New Haven losses: 6.5, 4.9, 6.4, 4.5, 4.0, 4.0, 4.0
- Passenger depreciation reversal: 4.8, 5.5, 5.7, 6.0
- New Haven capitalization: 4.8, 5.5, 5.7, 6.0
- Per diem time/mileage: 6.5
- Northeast corridor A/C 80 charges: 1.1, 1.2, 1.3, 2.5, 3.0, 6.0, 6.8
- IBM program capitalization: 2.2, 5.5, 5.7, 6.0
- Net income: 13.6, 13.8, 34.1, 54.7, 17.6, 18.0, 25.8, 32.6

**Transportation Company, nonrail:**
- Sale: Albany Stations, New York: 3.5
- Dover station yard, Boston: 4.0
- Special dividends:
  - Washington Terminal sale: 13.5 (1.8)
  - N.Y.C. Transport: 1.6, 6.0, 6.0
  - Merchants Despatch Transport: 1.5
  - Despatch Shops: 1.0
  - Strick Holding: 5.6
  - Manor Real Estate: 2.6
- Sale Madison Square Garden securities: 21.0
- Profit-Company bonds reacquired: 1.1, 1.2, 1.3, 4.9, 3.1, 1.1

**Total Transportation Co. significant items:** 13.6, 13.8, 34.1, 54.7, 17.6, 18.0, 25.8, 32.6

**Subsidiaries:**
- Great Southwest—Sale:
  - Bryant Ranch: 9.8
  - Atlanta & Irving Sck: 6.7
  - Six Flags Over Texas: 17.5
- P.L.E. Pennsylvania capital stock tax refund: 1.0
- Manis Lke. Sup.—Prt. prop. liquid: 1.0
- Manor Real Estate—Prt. Prop. sales: 2.0
- Pennsylvania Co.—Gain on sale of N.W. investment: 2.4, 2.3, 2.4, 12.6, 5.9, 5.2, 8.1, 3.6

**Total subsidiaries' significant items:** 2.4, 4.3, 4.4, 29.1, 5.9, 22.7, 8.1, 3.6

**Grand total significant items:** 16.0, 18.1, 38.5, 83.8, 23.5, 40.7, 33.9, 36.2

Note: Transportation Company earnings also reflect Subsidiaries, significant items to the extent received as dividends and tax payments.  
1 Included in above results.
I-C. FINANCES

CASH FLOW VERSUS "EARNINGS"

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

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

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

\(^{117}\) For Penn Central’s earnings see following table:

<table>
<thead>
<tr>
<th>Month</th>
<th>Penn Central consolidated earnings</th>
<th>Penn Central Transportation Co. only (which includes railroad)</th>
</tr>
</thead>
<tbody>
<tr>
<td>January–March 1970</td>
<td>($17,229,000)</td>
<td>($52,709,000)</td>
</tr>
<tr>
<td>1969</td>
<td>4,388,000</td>
<td>(56,398,000)</td>
</tr>
<tr>
<td>1968</td>
<td>87,689,000</td>
<td>(5,155,000)</td>
</tr>
<tr>
<td>1967</td>
<td>65,319,000</td>
<td>9,055,000</td>
</tr>
<tr>
<td>1966</td>
<td>147,304,000</td>
<td>85,156,000</td>
</tr>
<tr>
<td>1965</td>
<td>121,872,000</td>
<td>72,422,000</td>
</tr>
<tr>
<td>1964</td>
<td>89,458,000</td>
<td>49,830,000</td>
</tr>
</tbody>
</table>

\(^{1}\) Excluding extraordinary items.

\(^{118}\) See Income Management section of this report for further explanation.

\(^{119}\) Management has argued that accounting practices required for reporting to the ICC mandated this presentation. Even if ICC accounting were required for ICC regulation purposes, management was not prevented from supplying additional earnings information to the public.

\(^{120}\) These figures do not include expenditures for equipment which is customarily financed by conditional sales agreements or equipment trust certificates which require little or no cash outlay by the company. Under these financings, the loans are directly secured by the equipment being acquired.
The public was unaware of the magnitude of the cash drain. This cash drain was particularly important information about the condition of the company and the direction in which it was headed. The drain cut through the optimistic statements and the inflated earnings because it was a reality which could not be denied even by management. The cash drain also indicated at a very early date that Penn Central was a likely prospect for bankruptcy. Penn Central's ability to borrow was very limited despite its huge corporate size. It could not raise money through long-term debt because most of its property was already encumbered by debt and Penn Central's poor earnings would assure poor reception for long-term debt in the financial markets. Penn Central could meet its cash drain only by short-term borrowing or by a liquidation of assets and these two courses were restricted in their own right. There were few assets that could be liquidated. The real estate holdings in New York City, formerly owned by the New York Central, were heavily mortgaged and would not produce much cash upon sale. The other likely area for salable assets would be the Pennsylvania company, but many of these assets were pledged, and some, like Great Southwest Corp. and Maccio Corp., were not what they appeared to be on the surface.

Faced with these problems and the poor image that would be created by trying to liquidate, Penn Central decided to use some of these assets indirectly by pledging them as collateral for short-term loans. The short-term borrowing had severe limitations, however. The money market was tight and interest rates were high even for a large "blue chip" such as Penn Central. Then, too, the pledging of assets in connection with borrowings, such as the revolving credit,
quickly narrowed any future possibility for financing while the use of unsecured financing such as the commercial paper put out by the Transportation Co. exposed the railroad to an immediate runoff if adverse information about the company became public. Penn Central very quickly painted itself into a corner from which there was no escape short of a very dramatic and immediate reversal in the direction of the railroad earnings. Indeed, such a reversal would be needed simply to meet the interest charges. As described elsewhere, there existed fundamental problems in the merger and in management's ability which precluded such a reversal. The cash drain then, and not the publicly reported earnings, foretold the destination of the merged railroads.

**Some Causes of the Cash Loss**

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

**Operations Losses**

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

\[
\text{(Loss) on rail operations} \\
\text{January to March 1970. ($101,600,000)} \quad 1966 \quad 2,559,000 \\
1969 \quad (193,215,000) \quad 1965 \quad (548,000) \\
1968 \quad (142,367,000) \quad 1964 \quad (15,636,000) \\
1967 \quad (85,747,000) \\
\]

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

It should be noted that most of the cash drain in railroad operations was a drain from the day-to-day operation of the railroad and not, as management implied in its public statements, expenses associated with improving the road's facilities. The growing cash outflow, therefore, did not principally represent expenditures being incurred for the development of a better railroad in the future; it represented drains
caused by the poor operations of the railroad. In fact, while capital needs were very great in the postmerger period, the funds available were limited and expenditures were fairly constant.\textsuperscript{121}

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

\textsuperscript{121}Penn Central Transportation Co. (includes P.R.R., Central, and N.Y., N.H. & Hartford) capital expenditures for road and equipment 1964-70.

\begin{tabular}{|c|c|c|c|c|c|c|}
\hline
\hline
Road & $26,158 & $37,709 & $32,302 & $36,720 & $50,193 & $65,507 & $21,637 \\
Equipment (financed) & 80,549 & 160,546 & 148,982 & 81,092 & 76,382 & 80,042 & 13,620 \\
Total & 152,338 & 255,994 & 216,381 & 137,162 & 146,410 & 151,547 & 61,330 \\
\hline
\end{tabular}

\textsuperscript{122}Passenger results, 1964-1970:

\begin{tabular}{|c|c|c|}
\hline
 & Solely related & Fully allocated \\
\hline
1964: & & \\
New York Central & $7,887,396 & ($21,651,885) \\
Pennsylvania Railroad & (2,491,494) & (32,401,279) \\
New Haven & 11,820,339 & (22,829,852) \\
1965: & & \\
New York Central & 5,577,655 & (16,176,207) \\
Pennsylvania Railroad & (11,761,570) & (41,708,640) \\
New Haven & 12,971,936 & (9,656,852) \\
1966: & & \\
New York Central & 4,965,956 & (16,023,304) \\
Pennsylvania Railroad & (15,603,156) & (45,381,248) \\
New Haven & 14,332,014 & (5,636,552) \\
1967: & & \\
New York Central & 7,110,120 & (27,129,186) \\
Pennsylvania Railroad & (27,088,263) & (65,277,416) \\
New Haven & 15,153,631 & (10,281,467) \\
1968: & & \\
Penn Central Transportation Co. & (44,806,190) & (100,237,980) \\
New Haven & 11,603,908 & (12,583,243) \\
1969: & & \\
Penn Central Transportation Co. & (45,811,445) & (104,784,219) \\
1970: & & \\
Penn Central Transportation Co. & (73,853,718) & (132,482,305) \\
\hline
\end{tabular}

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

\textsuperscript{124}An example from Dec. 1, 1969, letter to shareholders explaining the cancellation of the dividend:

"In this same period [first 9 months of 1969], our railroad had a passenger deficit of $73,000,000 on the basis of fully allocated costs or approximately $47,000,000 in direct costs. But for this, the railroad would have been in the black." [The loss from rail operations exceeded $133,000,000 for all of 1969.]
Management used two devices to achieve its goals in setting forth passenger service losses. First, it tended to emphasize the "fully allocated" losses rather than the lower "solely related" costs or the "avoidable" costs. The fully allocated costs include costs shared with freight service. Many of these costs would continue even if passenger service were abandoned. Solely related costs are the costs assigned by accounting to running the passenger service. Avoidable costs are costs which would be avoided by the discontinuance of passenger service. When used in the context of savings that might be achieved by relief from passenger service, the fully allocated figures conveyed an inaccurate picture. The second device used by management was to avoid comparing passenger losses with overall railroad operation losses. Such a comparison would have shown that the direct losses on passenger service were only a relatively minor portion of the overall operations losses. These were losses which would still be incurred even if Penn Central was relieved of all passenger service and they were losses largely related to mismanagement and not Government fiat.

DIVIDENDS

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

1 Avoidable costs were only computed when Penn Central petitioned for abandonment of a passenger service.
2 See pp. 86 and 87 for loss figures.
3 The rise in passenger service losses themselves was probably caused in part by the same problems affecting freight losses.
4 For a description of the decision to abandon the dividend see the section of this report on the role of the directors.
5 Dividend record of Penn Central and predecessors:

<table>
<thead>
<tr>
<th>Year</th>
<th>Penn Central</th>
<th>PRR</th>
<th>NYC</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rate</td>
<td>Annual total</td>
<td>Rate</td>
</tr>
<tr>
<td>1968-69</td>
<td>$0.25</td>
<td>$28,974</td>
<td>$1.25</td>
</tr>
<tr>
<td>1962</td>
<td>.25</td>
<td>$28,974</td>
<td>.25</td>
</tr>
<tr>
<td>1963</td>
<td>.50</td>
<td>55,946</td>
<td>2.30</td>
</tr>
<tr>
<td>1964</td>
<td>1.25</td>
<td>53,051</td>
<td>2.40</td>
</tr>
<tr>
<td>1965</td>
<td>2.00</td>
<td>53,051</td>
<td>2.40</td>
</tr>
<tr>
<td>1966</td>
<td>2.30</td>
<td>55,051</td>
<td>2.40</td>
</tr>
<tr>
<td>1967</td>
<td>2.40</td>
<td>55,051</td>
<td>2.40</td>
</tr>
<tr>
<td>1968</td>
<td>2.40</td>
<td>55,051</td>
<td>2.40</td>
</tr>
<tr>
<td>1969</td>
<td>2.40</td>
<td>42,396</td>
<td>2.40</td>
</tr>
</tbody>
</table>

1 Annual totals in thousands of dollars.
Before extraordinary items.

1968 ______________________ _
1969 ______________________ _

Before extraordinary items.

<table>
<thead>
<tr>
<th></th>
<th>Consolidated earnings (loss) 1 2</th>
<th>Transportation Co. earnings 3 4</th>
<th>Loss from railroad operations</th>
<th>Additional net borrowings, cash loss</th>
<th>Cash dividend paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>1968</td>
<td>$87,789</td>
<td>($5,155)</td>
<td>($142,367)</td>
<td>($172,200)</td>
<td>$55,400</td>
</tr>
<tr>
<td>1969</td>
<td>4,388</td>
<td>(56,328)</td>
<td>(193,215)</td>
<td>(273,000)</td>
<td>43,396</td>
</tr>
</tbody>
</table>

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

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

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

INTEREST COSTS

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Interest Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>$80,723,000</td>
</tr>
<tr>
<td>1966</td>
<td>86,229,000</td>
</tr>
<tr>
<td>1967</td>
<td>90,771,000</td>
</tr>
<tr>
<td>1968</td>
<td>102,206,000</td>
</tr>
<tr>
<td>1969</td>
<td>137,018,000</td>
</tr>
</tbody>
</table>

The additional borrowing by the Penn Central from merger date through the end of 1969 (after deducting debt repayment) was $405 million. The interest costs of these additional borrowings was in excess of $40 million at an annual rate by the end of 1969.130 These interest payments were, of course, cash payments. It can be said that the additional borrowings were the prime cause of the rise in the interest burden during the postmerger period, because the borrowings in this period were made at interest rates at or above the prime rate 131 while the interest burden on most of the existing long-term debt was at fixed lower interest rates from earlier periods.

130 The company was required to keep compensating balances of between 15 and 20 percent of funds borrowed, thereby effectively increasing the interest rate.
131 Some investors may have believed that the short-term debt was being increased to avoid rolling over long-term debt at the prevailing high interest rates. In fact, most of the borrowing was being consumed by operations losses.
CASH RELATIONSHIP OF PENN CENTRAL TO GREAT SOUTHWEST, MACCO AND EXECUTIVE JET AVIATION

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Contribution (Thousands of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1967</td>
<td>$11,408,000</td>
</tr>
<tr>
<td>1968</td>
<td>32,961,000</td>
</tr>
<tr>
<td>1969</td>
<td>51,543,000</td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>WABASH AND NORFOLK &amp; WESTERN DIVIDENDS RECEIVED BY PENNCO</th>
</tr>
</thead>
<tbody>
<tr>
<td>[Thousands of dollars]</td>
</tr>
<tr>
<td>Year</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>1965</td>
</tr>
<tr>
<td>1966</td>
</tr>
<tr>
<td>1967</td>
</tr>
<tr>
<td>1968</td>
</tr>
<tr>
<td>1969</td>
</tr>
</tbody>
</table>

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

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

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

\(^{134}\) For details of the relationship between Penn Central and GSC, see section of this report on Great Southwest Corp.

\(^{135}\) Pennco dividends to Transportation Co.: 1965………………………………………………………….. $23,000,000 1966……………………………………………………………………………….. 24,000,000 1967……………………………………………………………………………….. 25,600,000 1968……………………………………………………………………………….. 24,000,000 1969……………………………………………………………………………….. 24,000,000
simply a 6 percent return on the initial investment of approximately $100 million. From the other diversification subsidiaries (Arvida, Great Southwest and Macco) no significant cash return on the investment was received and, in the case of Macco and Great Southwest, substantial cash advances were passed down after the initial investment. Worse than the poor performance of the diversification program was the use of the program to pass inflated earnings to the parent and the associated touting of the “performance” of the subsidiaries and the “value” of the holdings of the stock of these subsidiaries in Pennco’s portfolio.

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

Management’s Vantage Point

(1) Cash Situation at Time of Merger (February 1968)

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

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

---

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

137 See further discussion at page 74.
indicated that the cash loss for 1967 would be $50 million. He stated: "this preliminary forecast definitely indicates that we will be in a cash bind by the end of the first quarter of the next year and something will have to be done to generate cash."

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

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

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

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

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

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

By early November the railroad was considering requesting an increase of $75 million in the debt allowable under the merger agreement with the New York Central. By mid-November of 1967, however, when it became apparent that the merger might take place as early as January 1, 1968, the Pennsylvania Railroad began rethinking its financing needs since it would have to survive only until January under the existing debt ceiling. The revised plans called for a "floater debenture" on Norfolk & Western stock owned by Pennco to produce over $8 million; a drawdown under a revolving credit agreement of approximately $10 million; and a sale to banks of dividends from the N. & W. stock expected to produce another $10 million after the beginning of 1968.
As described above, the cash situation of the merged railroad at the time of merger was bleak. In the postmerger period chaotic operations and the resulting deterioration of service quickly put an additional strain on the cash situation. The Penn Central, however, managed to paint an almost flattering picture of its financial posture. In a news release dated August 7, 1968, the Penn Central reported on the sales of commercial paper and on its overall financing program. With reference to the $100 million of commercial paper that had been authorized by the Interstate Commerce Commission on July 29, 1968, the release stated:

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

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

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

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

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

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

"In connection with the revenue reductions, we are advised of a reduction of $15 million made by the Revenue Forecast Committee on July 12 and an additional $4 million reduction on July 16. This difficult situation has been further compounded by the not unexpected request from the New Haven for additional $4 million on August 1. ... We are preparing further more detailed estimates based on the information presently available, but it now appears that at the end of this year we will have exhausted the $100 million revolving credit and the $100 million commercial paper program and that we will still have a need for somewhere, depending on future circumstances, between $125 million and $150 million. This is without giving further affect to what would be required in the event of a steel strike. When this is coupled with the fact that we almost invariably lose cash for the first 8 months of the year, I believe it is necessary for us to take all possible steps at this time to conserve cash and work toward a very minimum capital budget for 1969."

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

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

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

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

(3) THE CRISIS GROWS (END 1968–FALL 1969)

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

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

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

A particular problem at that time was the limit on bank borrowings and the problems of the additional restrictions that such borrowings would impose. Garstproper was aware that borrowing limits were
Question. Were you involved in discussions to increase the revolving credit to $300 million?
Answer. Yes.

Question. Did you believe at that time it would be possible to borrow any additional amounts [from] banks of the revolving [credit group] above the $300 million?
Answer. I think the reverse. When I told Mr. Saunders of my reason for leaving, I [told him] I would not take part in borrowing any more money than that. I thought we had reached the limit of our credit.

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

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

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

Question. Was this [in] any particular context? For instance did you ever have a session where you sat down and discussed this?
Answer. Yes; I had a session with George Woods, who is Chairman of the World Bank, I guess, or Monetary Fund or something, and who had previously been the head of First Boston. And Mr. Bevan took me with him, after saying he had gotten Mr. Saunders' approval to go talk with George Woods, and he told George Woods of his concerns and wondered if he had any suggestions as to why it might be—as to what might be done, and my understanding is, and my recollection is, although I'm not positive of it, that as a result of that discussion George Woods talked to Mr. Saunders and indicated to Mr. Saunders that the $300 million was the limit and should be the last borrowing that the company could make unless the cash flow or the operations could be turned around.149

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

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

Question. Was that ever discussed at the budget committee meetings, [attended by operating officers as well as finance officers] particularly in the context "We're coming to some limit and we're getting blocked in by restrictions," and things of that sort?
Answer. I don't recall there was. There were discussions at the budget committee where we would have before us one of Mr. Shaffer's forecasts of cash loss in which it would say "Here is another $40 million loss, and we can't put up with this, we just can't lose a million dollars a day as we are doing," but there never was a sophisticated type of discussion that I recall.

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

149 Bevan first spoke with Woods on Jan. 7, 1969. Woods advised Bevan on efforts to increase the revolving credit to $300 million. In May, Bevan sent Woods an unsolicited payment of $25,000. Woods continued in an informal advisory capacity until the bankruptcy.
141 A First National vice-president and the officer servicing the Penn Central commercial account.
1975 along with other information. The information was never supplied.

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

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

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

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

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

142 It should be noted that our investigation has uncovered no indication of any activity with relation to the blanket mortgage after some initial activity in the early fall of 1968. The market for such an issue was poor, formidable legal and mechanical problems existed, and investors would not purchase such bonds from a company with the negative cash flow being experienced by Penn Central.
borrowings would be needed by the end of the year. This program al-
lowed for a strict road capital program not exceeding $50 million for
1969.

By this time it had become apparent that the additional financings
themselves were producing serious cash burdens on the railroad. In
addition to the need to keep extensive compensating balances against
the bank loans as required by banking practice, the interest payments
were becoming large. With $250 million of revolving credit and $150
million of commercial paper and with the Pennsylvania Co. borro-
wings, the interest costs were approaching a rate of $50 million a year.

In September of 1969 Bevan met with First National City Bank
officials to obtain their approval of an increase in commercial paper by
$50 million to a total of $200 million. Under the terms of the re-
volving credit agreement, the debt of the railroad outside of the re-
volving credit could not exceed $150 million which was the existing
amount of commercial paper. The railroad had drawn down an addi-
tional $25 million on the revolving credit on August 18, 1969, and was
drawing down an additional $25 million on September 3, 1969,
bringing the total to $250 million. Bevan pointed out that he could
draw down the last $50 million of the revolving credit and leave the
commercial paper at $150 million, but that he would prefer to obtain
the last $50 million by commercial paper. He agreed not to draw down
the last $50 million of revolving credit until commercial paper had
been paid off in an amount equal to the final revolving credit draw-
down. First National City Bank obtained the approval of other
banks for this change in the agreement. The effect was to decrease the
backup lines for the commercial paper while allowing Penn Central to
increase its borrowings. Prior to this time the $150 million of commer-
cial paper had been backed by a $50 million bank line and the last
$50 million of the revolving credit, providing a 66% percent coverage.
With the commercial paper increased to $200 million the backup was
reduced to only 50 percent. Prior to an attempt to get additional
security in early 1970, it appears that the banks, through their agent
First National City Bank, never seriously doubted the financial
ability of Penn Central to pay off its loans. They continued to rely on
the issuance of a blanket mortgage bond and on the earnings of the
real estate subsidiaries in addition to a hoped-for turnaround in the
performance of the railroad.

On September 8, 1969, Saunders wrote to Bevan asking for a
program to meet capital needs for the next year and for the 2 years
thereafter. Bevan responded with a memorandum to Saunders on
September 10, 1969, in which he pointed out the continuing financing
strains from the operations of the railroad. In light of the cash situa-
tion, Bevan observed:

Therefore, in my judgment, extraordinary efforts must be made to preserve
every dollar possible. We will be coming up with additional suggestions in this
regard shortly, but I think an immediate stop must be put on capital expenditures.\(^143\)

In view of the current cash situation, it seems to me that every project should
be stopped immediately until each one can be analyzed individually to see whether
or not it is absolutely necessary that it be progressed at this time or done at all
this year.

\(^{143}\) It should be noted that capital expenditures were not greatly larger than they had been in the pre-
I realize that there are problems incident to labor and overhead involved in stopping these projects but I think that a very complete analysis should be made immediately so that every possible cent of cash will be saved and I am particularly interested in what can be saved in the next 30 days. Where we have outside contractors obviously holding up the work or postponement of the work is easier than where we are doing it with our own labor.

I requested an intensive program to reduce accounts receivables but because of the nature of the program I am not optimistic of a material gain this year, although it could bear some near-term results. I do think, however, that a very drastic cut in inventories should be instituted immediately even to the extent of selling in the open market any excess items we may have on hand.

Saunders responded on September 12, 1969, in a letter to Bevan in which Saunders described efforts he had made to convey Bevan’s requests:

With regard to your letter of September 10, I enclose a copy of [a] letter which I have written to Mr. Perlman today with copy to Mr. Flannery. I have also talked with them personally about this and impressed upon them the necessity of immediate action.

I have also talked with Malcolm Richards with regard to curtailing at every possible point and making no further purchases, except where absolutely necessary, until our situation improves.

At the budget meeting this morning, I asked Mr. O’Herron and Mr. Hill to work with Peat, Marwick on a study of our billing and accounts receivable situation to the end that recommendations can be brought forward for improvement.

On October 29, 1969 the Penn Central received ICC authority to issue an additional $50 million of commercial paper, bringing the total to $200 million. At this point the company had effectively exhausted all loans and all commercial paper possibilities. Most banks were at or near their legal or practical lending limits and were looking towards a paydown of these loans rather than increases. Goldman, Sachs, Penn Central’s commercial paper dealer, was already indicating to management that it was difficult to keep out the $200 million and that any adverse information might cause a run on the commercial paper.

It was also in October of 1969 that Penn Central learned that it would not be possible to market Great Southwest stock (which would have included a Pennsylvania Co. secondary offering). This offering would have produced approximately $45 million for the Penn Central complex. As indicated elsewhere in this report the idea of the Great Southwest offering apparently originated with the Penn Central management. The cash needs of Great Southwest, however, were enormous and pressing and Pennsylvania Co. was no longer capable of supplying it with cash. The desperate financial activities in late 1969 and early 1970 by Great Southwest are detailed elsewhere in this report, including a last minute effort in 1969 to have the three principal officers of Great Southwest purchase $40 million worth of Great Southwest stock as a substitute for sales to the public or to private investors.


By October 1969 the prospects for improvement were bleak. A cash estimate from the financial department on a receipts and disbursements basis dated October 9, 1969, indicated a cash deficit of $338 million for 1970. In November of 1969 Penn Central’s commercial paper dealer began becoming more concerned about the condition of Penn Central.\textsuperscript{144} The desperate condition of the railroad would first

\textsuperscript{144} For a detailed treatment of commercial paper sales and the role of Goldman, Sachs, see section III-A.
affect commercial paper because there was a continuing need to resell the short-term paper as it became due and because it was an unsecured financing. Robert T. Wilson, the head of the Goldman, Sachs commercial paper department, spoke with Jonathan O'Herron, who had replaced Gerstnecker, on November 10, 1969, and indicated that a New York Times article which quoted Penn Central's counsel as having told the ICC that the Penn Central is having a rough time with the merger could be harmful to the sale of commercial paper. Wilson suggested an additional $50 million of standby bank lines. On December 1, 1969, Wilson called O'Herron to indicate that with $200 million worth of commercial paper outstanding the adverse information concerning Penn Central would require that $15 million of the $50 million standby bank lines be converted to "swing" lines which could be drawn down on very short notice in case of difficulties in reselling the paper as it became due. Wilson again made reference to the level of backup bank lines. At a meeting on December 9 between George Van Cleave of Goldman, Sachs and members of the finance department of Penn Central (not including O'Herron, who was out of town), Van Cleave pointed out that Goldman, Sachs was currently holding $16 million of Penn Central notes in inventory, the largest position in Penn Central notes that they ever had. Goldman, Sachs suggested additional bank lines on a swing line basis to enable Goldman, Sachs to reduce its inventory. Goldman, Sachs cited "their now being at the $200 million level, a tight market and adverse publicity" as figuring in its desire to reduce inventory.

As the bank lines and the commercial paper reached their limits, the Pennsylvania Co. became the last remaining vehicle for additional financing. The Pennsylvania Co. made a $35 million private placement of collateral trust bonds in the summer of 1969 and then issued $50 million in debentures in December 1969 in a public offering. The proceeds of both sales were supplied to the Transportation Co. Each step of additional financing, however, restricted the range of options to the company. The stock of Pennsylvania Co. had been pledged to the revolving credit. Both the $35 million trust bonds and the $50 million debenture offering in December would have precedence for security purposes over any subsequent financings. This would make potential additional lenders on Pennco's credit more cautious. In addition, the principal asset of the Pennsylvania Co., the stock of the Great Southwest Corp., was very rapidly declining in price. It was clear to the Penn Central management that there was little hope of reversing this decline in the value of Great Southwest stock because the earnings of Great Southwest had been paper earnings and a Great Southwest stock issuance had already been canceled for fear of the impact on the market price from the disclosure of adverse information.

On January 27, 1970 Bevan and O'Herron once again approached officials of First National Bank for additional funds. Bevan indicated that Penn Central would have to raise $165 million to cover capital expenditures and operating losses and to replenish working capital in 1970 despite a projected decrease in capital expenditures to $150

143 These debentures were convertible into Norfolk and Western which gave the issue value aside from the assets of Penn Central. The sale can be looked on as a liquidating of some of Pennco's most valuable assets.
million from the $350 million for each of the preceding 2 years.\(^{146}\) Bevan asked the First National City Bank to act as a lead bank on a $50 million "bridge" loan to the Pennsylvania Co. to be repaid upon the sale of $100 million of debentures by the Pennsylvania Co. Bevan also indicated that the company was discussing a $15 million to $30 million long-term European financing and $20 million to $40 million in commercial paper in European currencies, all of which was to be debt of the holding company.

Since banks normally have limited control over their outstanding loans except when the loans are in default or when other restrictive provisions become activated by circumstances, the First National City Bank decided to use this request for an additional loan to try to strengthen the security position of the $300 million revolving credit. A January 29, 1970 internal bank memorandum by Bowditch observed that the $165 million additional borrowings for 1970 anticipated a loss in the operations of the railroad of about the same size as that in 1969. He stated:

\[\text{It is not possible for us to judge how long this cash drain will continue. Therefore, it appears necessary that we regularize through security and covenants our...[loans].}\]

* * * * * * * * * * * * * *

This is a condition precedent to our considering a new $50 million loan (our share $10 million-$15 million) to the Pennsylvania Co. If Bevan is unwilling to do this, I feel we must decline additional advances and proceed to foreclose on our EJA equipment.\(^{147}\) Our primary effort, however, should be to improve our present credit exposure.\(^{148}\)

The First National City Bank informed Penn Central that it wanted a dollar limit on the amount to be borrowed by the Pennsylvania Co.; a secondary pledge of the Pennsylvania Co. stock on the existing $50 million Eurodollar loan and on a $30,400,000 working capital loan; a negative pledge with the right to take security on the proposed $50 million bridge loan; and other changes in the credit covenants to restrict Penn Central. This was communicated to an officer in the Penn Central finance department on February 9, 1970. A First National memorandum also indicates that Morgan Guaranty had indicated to First National that it would not participate in the bridge loan without security.\(^{149}\)

Bevan was not daunted in his efforts to avoid any further restrictions. He turned to the Chemical Bank which agreed to act as the lead bank in the unsecured $50 million bridge loan to Pennsylvania Co. At that time, the Chemical Bank had a participation in the $300 million revolving credit line and thus Chemical deprived itself of additional security on that loan as well as foregoing security on the additional loan. Although the First National City Bank shortly learned of the Chemical loan and although Chemical was aware of the absence of First National from the $50 million group of banks, neither bank spoke to the other about this loan or about the loss of the opportunity to obtain additional security on the revolving credit.

\(^{146}\) Bevan's figures on capital expenditures for 1968 and 1969 appear to be greatly exaggerated even when equipment financing is included.

\(^{147}\) EJA had loans from First National City Bank which were in default. It avoided foreclosure; however upon Bevan's guarantee in the spring of 1970 that the railroad would make good any losses to First National. The bank was aware that EJA was bankrupt and that foreclosure would require an embarrassing writeoff, in Penn Central's first quarter.

\(^{148}\) First National Bank internal memorandum by Bowditch 1-29-70.

\(^{149}\) Penn Central directors Perkins and Dorrance were also directors of Morgan Guaranty but both deny any involvement in relations between Penn Central and Morgan Guaranty.
While Bevan was sidestepping a confrontation with Penn Central’s banks he was beginning to feel increasing concern and pressure from Goldman, Sachs, its commercial paper dealer. On February 5, 1970, upon the announcement of the 1969 loss of $56 million for the Transportation Co., Wilson contacted O’Herron. Wilson asked about the cash picture for the first 6 months of 1970 and O’Herron indicated that “it is very tight.” Wilson told him that it was Goldman, Sachs’ judgment “that this news [the 1969 loss] would have an adverse effect on their sale of c/p and we may not be able to keep out $200 mm of their notes.” Wilson emphasized again the need for an additional $100 million in standby lines to back up the commercial paper. O’Herron stated that he did not think it would be possible to get an additional $100 million in standby lines. Wilson indicated that procedures would probably have to be set up so that Goldman, Sachs would not have to inventory the $15 million of notes it was carrying (thereby diminishing the direct risk to Goldman, Sachs). On the next day, February 6, 1970, Gustave Levy, Goldman, Sachs’ senior partner, and Wilson met with Bevan, O’Herron and Robert Loder of Penn Central to review the threats to the commercial paper situation. Bevan succeeded in explaining away the 1969 performance and in projecting an optimistic 1970, including having the railroad break even in the fourth quarter of the year. Goldman, Sachs again asked for an additional $100 million in backup lines, suggesting the use of Eurodollar backup lines. They also requested provisions to make the existing backup lines more readily available, including availability to reduce Goldman, Sachs’ inventory from $15 million to no more than $5 million. On February 12, 1970, Penn Central bought back $10 million in notes that were in Goldman, Sachs’ inventory. Penn Central never obtained additional backup lines.

As the lines of credit with domestic banks began running out for the company, it began looking toward Europe. In the fall of 1969, Penn Central engaged in some equipment financing through a German bank, with the assistance of Joseph Rosenbaum. At a later time, portions of this borrowing disappeared, apparently having been diverted to the European associates of Executive Jet Aviation. Penn Central was looking for additional foreign financing, particularly general corporate financing. William Strub of Pressprich & Co. arranged through Joseph Rosenbaum to have Penn Central officials meet with officials of the Dresdner Bank of Germany. This meeting took place on November 19, 1969, in the Penn Central’s New York offices. Bevan was present at this meeting. A subsequent meeting took place on January 22, 1970, again in Penn Central’s New York offices. This meeting was attended by Bevan, O’Herron, Charles Hodge, Joseph Rosenbaum, and Strub, among others. A representative of the Dresdner Bank indicated that German Government restrictions would make a public deutschmark offering unlikely, but that the bank would like to do a Eurodollar offering in the amount of about $20 million. This information did not satisfy Penn Central which wanted quick action and preferred much larger amounts than Dresdner could supply. After the Dresdner officials left, Strub indicated that he might be able to arrange a short-term Eurodollar financing of $15 to $20 million.

101 This matter has been previously discussed at p. 74.
Strub was authorized to proceed and he then contacted Ufitec, a group of European lenders based in Switzerland. O’Herron instructed Strub that the borrowing would be made through the holding company, which had no debt or restrictions. Ufitec advised Penn Central to set up a subsidiary in Curacao for tax purposes. On February 2, Ufitec indicated that it would be able to lend 50 million Swiss francs. On February 5, Strub called Joseph Rosenbaum from Switzerland to tell him that Ufitec could raise up to 150 million Swiss francs. He received word from Rosenbaum that Penn Central would take 120 million Swiss francs (approximately $30 million) at 10.5 percent. Meanwhile, Hans Muntinga of the European underwriting firm of Pierson, Heldring & Pierson called Strub on February 10, 1970, to say that he wanted to do a Eurodollar financing for Penn Central. Muntinga had heard of Penn Central’s interest in European financing because the Penn Central International subsidiary in Curacao was being managed by an affiliate of Pierson, Heldring & Pierson. O’Herron met with Muntinga in mid-February 1970 and they discussed a $20 million offering. The offering was to have been done in conjunction with First Boston Corp. The holding company, Penn Central Co., would have been the issuer (debt restrictions may have prohibited such borrowings through the railroad).

After the first Ufitec offering was completed, Strub was asked by Ufitec to see if Penn Central would take an additional 35 million Swiss francs. This loan was completed in early March. On April 22 and 23 an additional 100 million Swiss francs were placed. In all these financings, Pressprich and Rosenbaum split the finder’s fee. These Swiss loans were first disclosed in the offering circular for the proposed $100 million Pennco debenture offering. The European short-term money markets were Penn Central’s last resource. Because it could be done through the holding company it avoided the restrictions under the revolving credit, and other agreements. No security was required (none was available) and the European lenders were relatively unsophisticated about Penn Central.

After the $50 million Pennco debenture offering, which presented few investment problems because the debentures were convertible into Norfolk & Western shares, Penn Central had little or no financing ability left. The company had found accommodating Swiss lenders (at high rates) and did manage to play Chemical Bank off against First National on the bridge loan, but the commercial paper borrowings were threatening to come apart. The situation was clearly terminal. The Pennsylvania Co. $100 million debenture offering was the last hope for even temporary financial survival. The proposed Pennco offering was fraught with difficulties and doomed from the outset. The proposal of such an offering, however, did give management an opportunity to maneuver a while longer. The difficulties with the debenture offering and the discoveries being made by counsel for the

---

12 Ufitec was already involved in some loans to Great Southwest. In the loans to GSC and Penn Central, Ufitec apparently felt it was lending to a blue chip company. The loans, however, were made at high interest rates.

13 This financing was seriously considered, but was postponed pending developments with the troublesome $100,000,000 Pennco debenture. Both issues would have been offered publicly and presented disclosure problems.

14 In U.S. dollars, Penn Central International borrowed the following amounts from Ufitec:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Feb. 24, 1972</td>
<td>$27,000,000</td>
</tr>
<tr>
<td>Mar. 12, 1972</td>
<td>8,100,000</td>
</tr>
<tr>
<td>Apr. 22, 1972</td>
<td>11,600,000</td>
</tr>
<tr>
<td>Apr. 23, 1972</td>
<td>11,600,000</td>
</tr>
</tbody>
</table>
underwriters are very significant. Because of its importance the offering is treated separately in the next section. The two sections must be read together, however, for a full description of the financial affairs of the company during this period.

By April 22, the final phase of the slide to bankruptcy began. On that day the company announced disastrous first quarter results, including a &dollar;63 million loss in the Transportation Co. The announcement sealed the fate of the debenture offering and started a run on the commercial paper. Goldman, Sachs redoubled its sales efforts but could resell little of the paper coming due. Because most of Penn Central’s paper was of short duration, the runoff was rapid as sizable amounts of the unsaleable paper matured. Part of the &dollar;50 million standby line had already been drawn down to reduce Goldman, Sachs’ inventory. By the end of April, &dollar;37 million of the backup line had been drawn down. A few banks balked on their commitments and by May 11, 1970, the final drawdown of the &dollar;46.5 million available took place. Now only the last &dollar;50 million of the &dollar;300 million revolving credit remained to pay off approximately &dollar;150 million of commercial paper which was by then virtually unsaleable.

Under the terms of the credit agreement Bevan could draw down the last &dollar;50 million as the commercial paper was reduced but the revolving credit bankers would want some explanations about what was happening to determine whether the provisions of the agreement had been met. Also, alerted by O’Herron’s warnings that things were worse than Saunders or Bevan had admitted, Secretary Volpe had arranged for Saunders to see Treasury Secretary Kennedy over the weekend of May 9 and 10 at Hot Springs, Va., about emergency Government assistance. In public statements Bevan and Saunders continued to assure the public that the ship was still on course.

By May 21, 1970, Penn Central could no longer avoid drawing down the last &dollar;50 million of the revolving credit. Bevan invited First National City Bank and Chemical Bank to a meeting in his New York office in the late morning. He told them that the debenture offering had been abandoned and that Penn Central was drawing down the last &dollar;50 million of the revolving credit. He also asked them to join in an additional loan that would be guaranteed by the Government. This was the first knowledge the banks had that a terminal crisis existed. They told Bevan that they would hold up further drawdowns until the other banks could be informed and could indicate their approval because First National and Chemical feared they might be held liable for letting a drawdown occur under the circumstances. The bankers left to consult with their lawyers.155

Bevan then summoned the managing underwriters to a late afternoon meeting in his office.156 It had been pretty well understood that the offering would not be completed.157 Bevan now told them that the offering had been terminated but that they should keep this information confidential because of confidential negotiations taking place with the Government.

On Monday, May 25, management again met in Washington with Government officials including Secretary Kennedy, Peter Flanigan,

154 Further detail on matters relating to the banks is given in section II-A dealing with sales of Penn Central stock by banks who were in the lending group.
155 Representatives of Salomon Bros. and Glore, Forgan were present. First Boston was unable to attend that meeting. It received the information the next morning.
156 See section on Public Offerings.
and Arthur Burns. On Tuesday, management met again with First National and Chemical in New York. The bankers had decided that a meeting of all the bankers should be held at which time Bevan could explain the situation and prospects. Invitations were issued to all creditor banks for a meeting at First National on the morning of May 28.

On the 27th, management asked the Penn Central directors for what was, in effect, unlimited authority to pledge assets and to enter into financing agreements. When a few directors balked, management reluctantly told them what was taking place with the bankers and the Government. The board gave the requested authority.

The Wall Street Journal on May 27, 1970, contained an article highlighting the commercial paper runoff which was disclosed in a textual portion of the revised Pennco prospectus dated May 12, 1970. This appears to be the first revelation in the press of the financial crisis. Copies of both circulars had been distributed to the press but the format of the prospectus did not highlight the significant problem. A Wall Street Journal writer had attempted to learn about the commercial paper problem from Penn Central and from Goldman, Sachs on May 13, before the revised circular with the commercial paper runoff information was issued. Penn Central and Goldman Sachs had both refused to comment.188

At a meeting with the bankers on May 28, Bevan made some explanation of Penn Central’s problems and announced the abandonment of the debenture offering. He also asked the banks to join in a Government-guaranteed loan. After the meeting, a steering group of banks was formed and representatives of First National City Bank flew to Washington to talk with Government officials. Early in the afternoon of May 28, Penn Central issued a release announcing the “postponement” of the debenture sale and indicating that the company was “working on alternate methods of financing.”

Penn Central was now solely dependent on the Government loan. The success of this undertaking was largely a matter of the negotiation of terms between the bankers and the Government. One of these terms was the removal of Bevan and Saunders. The removal was accomplished on June 8. A major problem was the priority of security. The banks wanted to keep their existing security. In negotiations with the Government, flexibility to the extent of some sharing was possible. However, Congressman Patman, who was not involved in the negotiations but whose approval of additional lending legislation was needed, wanted the Government to have first priority. Finally on June 19 the Government withdrew the proposed guarantee and on June 21, 1970, the Penn Central Transportation Co. filed a petition for reorganization.

Postscript

A CASE STUDY OF MANAGEMENT INDIFFERENCE TO OBLIGATIONS TO THE INVESTORS: DILUTION AFFECTING PENNCO PREFERRED SHAREHOLDERS

Throughout Penn Central’s decline, management demonstrated indifference to its obligations to provide shareholders with adequate and accurate information about Penn Central’s affairs and about the
conduct of management. A relatively minor, but clearly delineated, obligation provides an example of that indifference. It also demonstrates that Penn Central's financial problems and restrictions were such that even minor financial demands were more that Penn Central cared to acknowledge. This particular example is the dilution of the value of stock of the Norfolk & Western Railway Co. (N. & W.) into which Pennco preferred stock was convertible. Under the terms of the preferred stock agreement, Pennco was obligated to increase the exchange rate whenever a dilution occurred in N. & W. stock. Penn Central senior management failed to follow the terms of the agreement, despite repeated warnings from subordinates that management was falling in its obligations. 159

**Background.**—On July 24, 1964, pursuant to a merger agreement with Buckeye Pipe Line Co., Pennco, a wholly owned subsidiary of Penn Central Transportation Co., issued 699,123 shares of preferred stock convertible into N.&W. stock at any time after July 1, 1967. The optional redemption price was $137, subject to adjustments if additional shares of N.&W. common stock (other than shares issued for reasons stated in the agreement) were issued at anytime after February 6, 1964. Pursuant to proceedings relating to the merger of N.&W. and the New York, Chicago & St. Louis Railroad Co. (the “Nickel Plate”), the ICC required N. & W. to acquire the Delaware & Hudson Railroad (D. & H.) and the Erie Lackawanna Railway (ELR). N. & W. organized Dereco under the laws of Delaware as a holding company to acquire the D. & H. and the ELR. N. & W issued to Dereco 412,627 shares of its $25 par value common stock to effect the D. & H. acquisition. N. & W. also issued to Dereco a right for it to require the issuance of not exceeding 821,280 shares of N. & W. common stock to Dereco in exchange for Dereco preferred stock issued to acquire ELR. The question whether the issuance of additional N. & W. shares had caused a dilution which required Pennco to place in escrow more N. & W. shares to be available in case of conversion by its preferred shareholders was considered at Penn Central with the knowledge that the Pennco preferred agreement specifically required prompt notice to shareholders in the event of any dilution. 160

**Action by the Pennsylvania Co.:**

On December 27, 1968, Hill (Comptroller of Penn Central Co.) wrote a confidential memo to David Wilson of the legal staff of Penn Central stating that “[w]e have interpreted the N. & W. issue of stock rights for Dereco (Erie-Lackawanna) and their issue of common stock for Dereco (Delaware & Hudson) to cause price adjustment under our [Pennco] preferred requirements.” He went on to say he felt the adjustment would result in a reduction in the redemption price from $137 to $130 per share or a loss to Pennco of over $3,500,000. Because Pennco’s holdings of N. & W. stock were pledged or otherwise restricted, Pennco would probably have had to purchase the stock on the open market to satisfy the escrow requirements. Hill asked Wilson to review the 1964 agreement “to determine if our interpretations are legally correct, and whether there are loopholes we might beneficially apply.”

---

159 On June 6, 1972, the board of directors of Pennco announced that the exchange ratio for the convertible preferred was being adjusted to reflect the 1968 issuances of N. & W. stock. Their knowledge of the existence of this problem arose out of inquiries made by the staff in the course of the investigation.

160 Penn Central officers handled the matter because Pennco did not have its own officers except for sur-
On January 6, 1969, Wilson replied to Hill pointing out “that the terms contemplate that the optional redemption price must ‘immediately’ be adjusted whenever N. & W. issued any additional shares of stock other than so-called “excluded shares.”” “It is furthermore required that upon any such required immediate adjustment the corporation is obligated ‘forthwith’ to file a formal statement of the adjustment with the escrow agent and give prompt written notice by mail to all holders of record of the preferred stock. It would appear that Pennsylvania Co. is rather seriously in default in these obligations.”

On January 15, 1969, Wilson wrote to David F. Anderson of the law firm of Potter, Anderson & Corroon of Wilmington, Del., the general counsel of Pennco, stating that he felt that the optional redemption price should be adjusted and asking Anderson for his thoughts. On January 20, 1969, Anderson replied to Wilson stating that he agreed with him, “[h]owever, I do not have an expertise in interpreting this provision of the merger agreement, and your judgment is as good as mine.”

On January 22, 1969, C. L. Rugart, Jr., the secretary-treasurer and comptroller of Pennco, sent a memorandum to Gerstnecker who at the time was a financial officer of Penn Central but was neither an officer nor director of Pennco. The memorandum stated that Chemical Bank was holding 39 shares for conversion and that other preferred holders were considering converting. Advice was requested concerning revision of the conversion ratio. Rugart also cited the provision which states that if N. & W. takes any action with respect to its capital stock which is not adequately covered by the express provisions on dilution and which might materially dilute the right of any holder of preferred stock, the board of directors of Pennco must appoint a firm of independent certified public accountants to get an opinion as to the adjustment.

During the latter part of January, Wilson, at the suggestion of Gerstnecker, forwarded to Robert Rosenman of the law firm of Cravath, Swaine & Moore, documents relating to the several transactions. Rosenman was asked to form tentative conclusions to be given informally. Sometime prior to February 18, 1969, Wilson and Rosenman conversed. On February 18, 1969, Wilson wrote a memorandum to Gerstnecker stating that the preliminary view of the Cravath firm was that the transactions did constitute the events of dilution requiring an alteration of the conversion ratio and the deposit of additional N. & W. stock with the escrow agent. The memorandum stated that Wilson had told Rosenman that Gerstnecker felt no dilution had occurred. In response, Rosenman had indicated that a change in their preliminary opinion would require additional facts, assuming that such facts existed. The memorandum closed with a request to Gerstnecker to consider the urgency of the situation.

On April 3, 1969, Wilson wrote separate memorandums to Rugart, Edward Kaier, general counsel of Penn Central, and Cole, assistant to Saunders. In the memoranda Wilson indicated that nothing had been done since his February 18, 1969, memorandum and that while he realized that Gerstnecker did not agree with his opinion Wilson felt that very serious consequences could result if the company continued to be derelict in its duties to the stockholders. Cole testified that he recalled receiving Wilson’s memorandum and having had some discussions with Wilson on the matter. Cole also stated that he
never discussed the area of dilution with Saunders and that he was not aware of whether Saunders was familiar with the area of not.

On May 5, 1969, Wilson wrote a memorandum to the files concerning a conversation with Rugart on May 1, 1969, in which Wilson was informed that Chemical Bank had asked what the reason was for the delay in converting 39 shares. Wilson told Rugart that he could approve only two courses of action: either (1) convert and inform the stockholder that a change in ratio was being worked out; or (2) convert without giving the shareholder any notice, and send the additional shares in a week to ten days. Wilson stated that he could not approve any course of action which complied with the redemption request on the old basis without any intention to get in touch with the stockholder in the future or to take any required action to change the ratio. On May 5, 1969, Wilson was informed that the alternative adopted was the one he had not approved of. Wilson was involved in no further communication until after the bankruptcy.

In testimony Gerstnecker stated that he was aware that there was a question of dilution, and that he and Bevan had conferred about the matter. He recalled that both Wilson and Taylor had indicated to him that a dilution had occurred, but that he had felt that the question was one that should be resolved by the legal department.\textsuperscript{161} He also stated that he did not attempt to interpret the sections of 1964 agreement or to indicate his views concerning the intent of the agreement but that he was aware that Cravath, Swaine & Moore had indicated that dilution had occurred and that there was no reason for him to think that there was not a dilution. He stated that if he or Bevan had been told of the need for action, some action would have been taken. Gerstnecker, however, acknowledged having received and read Wilson's memorandum which emphasized the duty specified in the agreement to notify shareholders immediately. Despite this requirement of immediate action, nothing was done during the period of a year and a half until the bankruptcy. The matter was never brought to the attention of the Pennco board.

It is clear that Bevan and Gerstnecker knew that dilution had occurred and knew that Pennco had an obligation immediately to notify shareholders upon such occurrence. Their failure even to raise the issue with the board or to take any of the required steps such as notifying the shareholders resulted from their unwillingness to have to face the problem of finding N. & W. shares. All of Pennco's N. & W. stock had been pledged or escrowed or otherwise restricted. Pennco probably would have been required to purchase the N.& W. stock in the market for cash and management was unwilling to face another cash drain in light of the other financial problems being encountered. Their failure to resolve the problem also contributed to the inaccuracy of statements concerning Pennco's assets. Although the amount of money involved was relatively small, management refused to take even minimal steps to meet its obligations to shareholders.

\textsuperscript{161} His recollection differs from that of Taylor. Taylor recalled that he was summoned by Gerstnecker and Bevan and told that they were of the opinion that no dilution had occurred despite the opinion of Wilson and others. Taylor stated that with this in mind he looked into the matter and concurred. He did not put his views in writing and never spoke with Wilson despite his possession of Wilson's memorandums and despite the fact that Wilson's office was next to his.