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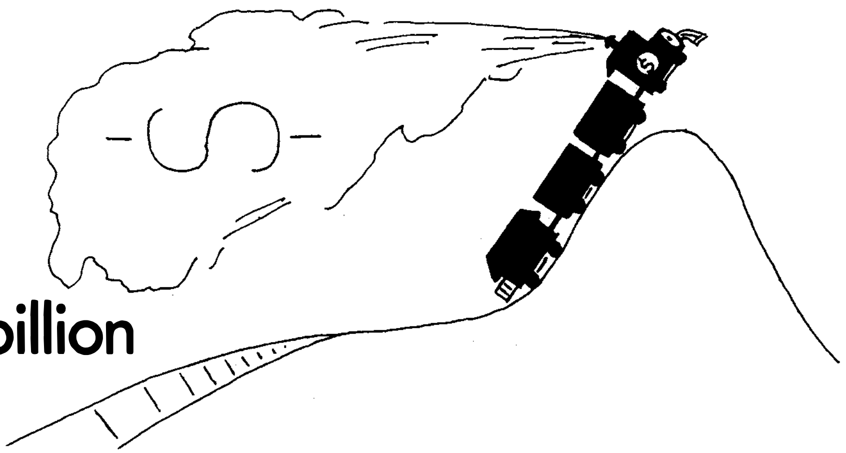

How to make $8 billion off a bankruptcy

In just under a decade the Penn Central, the nation's largest railroad and most spectacular bankruptcy case has parlayed $4 billion in debts, a yearly operating deficit approaching $200 million, and a railroad valued by the Federal government at $600 million in scrap, into a high-flying conglomerate whose total realized value by 1985 will amount to nearly $8 billion.

The means by which such things are accomplished, dubbed a "Well Managed Bankruptcy," are by no means limited to Penn Central. Experts consider railroads among the best vehicles for a Well Managed Bankruptcy (WMB), since railroads are largely a real estate operation to begin with. The transformation into a real estate or raw materials conglomerate using accumulated, carry forward tax losses is relatively simple. Railroads are such a necessary part of the nation's and localities' economic life that all levels of government, shippers, and even employees will cooperate with the bankruptcy managers to keep the operating company, the railroad, alive while the real assets are preserved.

Otherwise, a Well Managed Bankruptcy, whose basis is the skillful use of the tax law, and creation of an atmosphere of crisis and uncertainty to produce the most advantageous financial result, depends on the cooperation of political authorities, financial personnel, and the court system. Few Well Managed Bankruptcies have been accomplished without the guiding hand of top level real estate and insurance technicians who have both expertise and myriad personal contacts in their respective fields.

There are four basic phases of a WMB: preparation for bankruptcy, declaration of bankruptcy, internal reorganization, and final disposition or realization.

Many American railroads are today prepared for the first phase of WMB. With very small or negative operating earnings, long-deferred maintenance, nonexistent capitalization programs, and heavy indebtedness, bankruptcy is an entirely plausible occurence and will not be seen as "insider manipulation." At the point of bankruptcy there should be few operating assets left, both to avoid turning assets over to the eventual receiver—be it government, shippers, or even employees—and to allow the bankruptcy judge to legitimately claim that the bankruptcy was insoluble, thus preparing for disposal of the operating company.

It was not the enormous $189 million 1969 operating loss of the Penn Central that doomed the line a short two years after its birth in the New York Central-Pennsylvania merger. Rather, it was the elaborate system of leaseholds underlying the trackage, tunnels, equipment, land and other improvements that in fact produced these and other "losses."

The railroad itself is at the top of a pyramid from which cash flows down into leaseholds beneath.

A trip from Boston to Philadelphia before bankruptcy would have taken the passenger over the routes of the Boston Terminal Corp., the New York, New Haven and Hartford Railroad and its subsidiaries, including the Boston and Providence which sat in bankruptcy for forty years, the New York Connecting Railroad, the Pennsylvania Tunnel and TerminalhRailroad, the Philadelphia and Trenton Railroad and eventually on to the trackage of the Philadelphia, Baltimore and Washington Railroad: four of these leased trackage to the Penn Central. Such leaseholds, like the Philadelphia and Trenton's 999-year lease of 7 miles between Morrisville and Frankfort, Pennsylvania at ten percent per year of the value of the outstanding securities of the Philadelphia and Trenton, absorbed the cash of the operating company.

The Penn Central's underlying leaseholds were so intricate that while Moody's Transportation Manual gives most major companies two to four pages, description of the Penn Central and its subsidiaries required 66 pages of this 1974 edition.

Just before bankruptcy, the large inside investors may pull out; Goldman Sachs advised key Penn Central investors in the spring of 1970 to dump nearly a billion in securities months before bankruptcy. While this may be highly profitable, it is illegal—Goldman Sachs was subsequently judicially punished—and the validity of the bankruptcy was tarnished. Since such dumping is not essential to a Well Managed Bankruptcy, and may result in unfavorable court proceedings or adverse public opinion, competent WMB managers shun this operation. In the $8 billion value we project by 1985 for Penn Central WMB profits, this value item has been left out.

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The second act of a WMB is the actual bankruptcy, usually prompted by failure to float short-term bonds. In the case of the Penn Central, former chairman Stuart T. Saunders found himself unable to cover $200 million in short term commercial paper maturing over the summer of 1970, even if he was willing to issue obligations one percentage point above market rates.

In the immediate wake of the announcement of financial trouble, stories appeared in the press of the railroad running out of cash "next Thursday," with reports such as "payrolls will be met this week, but next week...." Both the unwillingness of money sources to lend and the imminent choking off of the operating company's cash flow appeared entirely reasonable given the actual condition of the railroad, which certain newspapers took care to paint very darkly.

Bankruptcy immediately reshuffles the cash flow. State and local governments receive no taxes, dividends are eliminated, the value of stocks and bonds plummets, judgments, fringe benefits and even wage payouts are halted or cut, and vendors are left holding their breath. Equipment leasors, often large commercial banks like Chase Manhattan or Irving Trust, usually get paid, the reasoning being that otherwise they would repossess the equipment.

The longest phase of the WMB is the internal reconstruction period in which the bankruptcy is developed, usually by a team that meets once a week to assess the next move. The optimizing principle here is to harbor from the bankruptcy proceeding the real assets of the corporation, the real estate, hotels, and other assets, so that the carry-forward tax loss from the years of bankruptcy can be applied to shelter income from these assets once the bankruptcy is ended. It is here that top real estate and insurance men are engaged.

Richard Dicker, former vice president and assistant general counsel of the Equitable Life Assurance Society of America, was one of the key architects of the internal reconstruction period. Dicker, who saw service in corporation liquidations under Jesse Jones of the Roosevelt Administration's Reconstruction Finance Corporation, put together "the Friday group," a body of fifteen major creditors and three court-appointed trustees so named for their weekly planning meetings.

Dicker is now the chairman of the new post-bankruptcy Penn Central. He recently told a financial journal, "I think we're going to do a helluva job turning Penn Central into a dynamic growth company.' It was Dicker that brought in Victor Palmieri, a professional realtor from Philadelphia, to sell off parts of the company's real estate. Both Palmieri and recently retired Penn Central chairman Frank E. Loy came from O'Melveny & Myers, the Los Angeles law firm that specializes in asset-stripping.

In 1973, Palmieri was offered, and accepted, a contract to sell real estate for the monthly fee of $52,000 plus 1 percent commission on the sale price.

Recently, Palmieri agreed to limit his total remuneration from the Penn Central to $26 million.

WMB managers must have a certain flair for showmanship. The early period of Penn Central internal reorganization was, as Dicker explained, "a time of physical and financial pandemonium, and the first year of trusteeship was agony." Bond holders and particularly leasor obligation holders must be convinced that the trustees are doing their best to resolve the bankruptcy, but that they should also be prepared to take what they get. This will discourage stockholder committees and stockholder suits that could affect the WMB timetable and produce courtroom revelations.

In this period, there will be any number of mini-crises, flareups, disputes, harsh language and admonitions to "get back and work together." Especially in the case of the Penn Central, the drama was heightened not only by the sword of abandonment hanging over the heads of shippers and localities but also the very real day-to-day disruption of the railroad system.

On May 17, 1974, a forest fire confined to an area just under the Penn Central bridge over the Hudson River at Poughkeepsie, New York, burned the bridge pilings, causing the railroad to embargo the bridge. Being bankrupt, the railroad said it had no funds to rebuild the pilings and freight was—and still is—rerouted to the Selkirk Bridge, just south of Albany, New York. That is, 100 miles to the north. As a result freight traffic from New Haven to the Allentown, Pennsylvania yards which took between two and two and a half days, now takes six to seven days, or nearly two weeks round trip. Not only are numerous shippers cut off, but freight car use-efficiency over that stretch has been cut by two-thirds.

At the Allentown yards, the major interchange between the Jersey Central and Reading railroads, two trainmasters with 20 years experience each were replaced by seven business school graduates, each of whom had the right to issue train orders after one week of training at the Penn Central training center in Selkirk. The confusion at Allentown is echoed at the New York end, where lighterage across New York Bay has been discontinued, forcing New York and Long Island bound goods on a three day journey north to the Selkirk bridge, thence back south to New York City.

Generally speaking, there is an advantage to this absurd state of affairs. Increasing operating losses will encourage pessimism among users and creditors and also enlarge carry forward tax losses to be used after bankruptcy terminates.

The exact course of the bankruptcy cannot be predicted. There are two alternatives from which various "mixes" can result: either a government-created operating company—run "for profit" if that pleases legislators—or at the other extreme, large-scale abandon-

The Penn Central profit picture

ASSETS	
Current Assets Real estate, wax museums, amusement parks, coal, oil, oil equipment, not including assets subject to Assets Disposition Program	**$1.0 billion**
Carry Forward Tax Loss Shelter All estimated future income through 1985 included under this category	**$1.5 billion**
Assets Disposition Program Hotel and other properties to be sold under court bankruptcy plan	**$0.7 billion**
Valuation Case Proceeds Proceeds of sale of railroad to Conrail (now in litigation): $3 billion anticipated compromise between Penn Central demand of $7 billion and government offer of $.6 billion ($0.9 billion subbtracted for debt payment).	**$2.1 billion**
SAVINGS	
Conrail and Amtrack Expenditures Government-adopted expenses of Penn Central and 15 subsidiaries plus estimated local subsidies (not including outlays beyond October, 1978)	**$2 billion**
Unpaid or Reduced Taxes	**$0.5 billion**
TOTAL REALIZED FROM BANKRUPTCY	**$7.8 billion**

ment and route redivision among remaining railroads.

The first is exemplified by the creation of Conrail, which took over Penn Central railroad operations on April 1, 1976. Conrail, after pouring in $3.2 billion to keep the system operating, is threatening both to close down 6,000 miles of track and to lose another $1.4 billion through the year 1983. These expenditures are a major saving to the bankrupt railroad.

The second route is exemplified by the Rock Island Railroad. In this case, the Rock Island is to be liquidated, its most profitable lines bought by other railroads for nickels and dimes, and the rest abandoned. The Rock's major shareholder and bondholder, Henry Crown, will walk away with millions in carry-forward tax losses to shelter the enormous gains he expects from the merger of his St. Louis-San Francisco line with the Burlington Northern.

Since an inflow of funds is required regardless of eventual disposition, the threat of selling the operating company for scrap or abandoning overwhelming portions of track must be convincingly made. Legislators are moved by the prospect of having major local industries left without transportation, or mountains of grain filling the main street of farm towns. Usually the first time that this threat becomes real is when the bankruptcy judge finds that the railroad cannot be organized out of bankruptcy in its present form.

When Philadelphis U.S. District Court Judge John P. Fullam made such a finding in the Penn Central case, Congress was galvanized to produce a handout several billions larger than the one that Nixon correctly assumed they would have spurned two years earlier.

WMB managers are responsible for working directly with the judge, offering full cooperation and needed documentation and pointing out to the press that it is not they, the managers, but the judge who deserves credit for a successful bankruptcy.

The fundamental success of a WMB is tested in this period, with the court playing a major role; it depends ultimately on producing a scenario so large and so complicated that even if small creditors, local legislators, or suppliers perceive certain elements of the scenario, no one will discover the whole thing. Some may complain that Victor Palmieri is making too much on his real estate sales, that the railroad is being mismanaged in one locality or another, that Goldman Sachs broke the law, or that former Penn Central chiefs "mismanaged" the line, but no one should ever piece these parts together.

It is now that the new reorganized company is ready to emerge. The fourth phase of a WMB is realization, when sheltered assets like the Penn Central's Edgington Oil Company, Buckeye Pipeline, Arvida Corporation (real estate), Great Southwest Corporation (real estate and amusement parks) and other Pennco entities and new acquisitions like the Marathon Manufacturing Co., are matched with the carry-forward tax losses. When Penn Central stock went on sale following its October 28, 1978 emergence from bankruptcy, *Dun's Review* commented, "Spurred by investment dollars from abroad, the action in Penn Central stock was brisk;" market analysts estimate the greatest problem facing Penn Central CEO Richard Dicker is using up his full $1.5 billion in carry forward tax losses before they expire in the coming years. In any case, the nearest thing to a railroad the Penn Central now operates is a roller coaster.

— *Leif Johnson*