

1st MONDAY 3rd MONDAY

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October 1, 1979

Managers and Supervisors:

Judge McMillen's ruling that "an embargo should be directed on a substantial portion of the Trustee's railroad at an early date, followed by a request for directed service, and that the Trustee should be authorized to issue a certificate for the expenditure of the funds requested" is of course the decision we were hoping for. But at this point, further steps are necessary before an embargo may take place. Moreover, there will be efforts made to forestall the embargo and the \$15 million borrowing.

Judge McMillen first issued a "minute order" on September 26. In it he indicated that he was accepting in substance the recommendations of Master Gray. The following day, Thursday, the Court's written opinion became available. It was, in effect, that and that alone: an opinion. It needs to be implemented by two orders of the Court which are yet to come. First, at the direction of the Court, attorneys for the Trustee are to prepare for the Court an order which sets in motion certain actions outlined in the Court's opinion. Then, later, the Court will enter a second order which, most importantly, will define the portions of the Milwaukee which are to be embargoed.

You will recall that, last June 1, Judge McMillen denied the Trustee's request for an embargo because, in effect, the Trustee could not prove that the railroad was "cashless" in view of the potential availability of ERSA loans. Now, he says, circumstances are different -- and the principal change is the position of the DOT:

"This position in substance is that the FRA will not lend any further funds to the Trustee, even on a priority basis, if they are going to be used in connection with the entire Milwaukee system. Instead, federal loans will be limited to those portions of the system which the DOT believes can become economically 'self-sustaining.'

"In other words, the federal authorities are convinced that the present Milwaukee system can never operate profitably, and they are no longer willing to spend any money on portions of the railroad which neither the government nor the Trustee believes can be reorganized to operate in one way or another. This is not only a perfectly justifiable and logical position for the federal government to take but also one over which we have no control."

Judge McMillen pointed out that although projections introduced in Court differed, "all parties seem to agree and certainly the record reflects that the Milwaukee Railroad as it now exists is a seriously and permanently deficit operation." On his own analysis, he found that beginning September 1, 1979, if no embargo or other suspension of service were to occur, operating losses would be \$1,750,000 per week. Cashlessness, he said, would occur on or quite soon after November 1. "Instead of waiting for the fatal day of cashlessness to arrive, we believe that the evidence clearly supports a specific finding that it will arrive on November 1, 1979."

Judge McMillen said: "We will enter an order which will authorize the Trustee to discontinue service on certain portions of its main system and branches

because its cash position will make the continuing operation of these segments impossible as a practical matter at a date on or closely following November 1, 1979."

Just which lines are to be embargoed isn't yet clear, however. Judge McMillen pointed out that, during the hearings in September, attorneys for the Trustee indicated that outside financial assistance would, in his words, "avoid cashlessness" of the Ontonagon, Mason City, Richland Center and Bayport lines. The DOT hadn't decided "whether it would support an embargo of certain branch lines 'within the Milwaukee II core territory' in Wisconsin, Minnesota, Illinois and Iowa, and did not specify which branches this involved," he wrote. Master Gray's recommendation for the embargo excluded branch lines which hadn't been included in the original embargo request and on which the DOT hadn't taken a position.

"There is no question but that the DOT will not lend funds to operate the entire system, that this applies to all of the lines west of Miles City, Montana, and that it has withheld a decision with respect to financing branch lines within the 'Milwaukee II' except those which can be operated on a self-sustaining basis by private funds. This is the portion of the system which the Trustee submits is reorganizable as an operating, ultimately profitable, entity," in Judge McMillen's opinion.

Judge McMillen asked the DOT to "conclude its remaining studies and decide which, if any, lines outside of 'Milwaukee II' it will assist financially. We will then enter an order specifying the exact portions on which transportation must be discontinued, based upon the Secretary of Transportation's refusal to fund the operation of those lines.

"If they all fall outside of 'Milwaukee II,' this will achieve the additional result of giving a fair test to the Trustee's abandonment and reorganization proposals for up to 240 days, in order to allow the ICC to make a specific ruling on abandonments. If the Trustee is unable to obtain a timely agreement with the Secretary of Transportation, then the order should provide for an embargo of all lines not in 'Milwaukee II' and not sustainable by nonfederal funds.

"All of this of course is based on the finding that the DOT will not fund the embargoed portions of the Milwaukee Road, and that they thereby become in fact cashless unless Congress changes that situation, but that the portions which the DOT or other sources will fund will not be cashless."

The Court overruled most of the objections which had been filed to the Special Master's report. In his opinion, Judge McMillen commented on the objections of the Railway Employees Department and the Railway Labor Executives Association. The RED had taken the position that jobs couldn't be abolished at the time of the embargo because the union hadn't received the 60-day notice it was due under its agreement with the railroad. The RLEA argued along the same lines, basing its case on the Interstate Commerce Act.

As to the RED's position, Judge McMillen said, "We do not intend to abrogate the terms of this collective-bargaining agreement, but on the other hand we find and conclude that it does not preclude the application of (the directed-service statute). We note also that there will be some period of time, certainly more than 60 days from the date when the Trustee filed his petition for an embargo on August 13, 1979, before any working conditions are changed pursuant

to his petition, and this filing has constituted notice to the union. . . .
"The provisions of Section 4 of the labor agreement have not yet been violated, may never be violated in most instances, and will not deprive any party of its remedy of arbitration."

As to the RLEA position, the Court responded, "As a matter of law, an embargo cannot be a violation of that statute (the Interstate Commerce Act) if it is carried out under the provisions of Section 11125 and of Section 77 of the Bankruptcy Act. If and when an actual, statutory abandonment occurs, it will be done by due process, pursuant to the Trustee's applications and reorganization plan filed with the ICC."

Speaking generally to other objections which contended that the concepts of "partial cashlessness" or "partial reorganization" are untenable, Judge McMillen declared that if this were so, "then what we and the Trustee are attempting to do in this case is an act of futility. The railroad in the foreseeable future will run out of cash and cease to operate. This is what the indenture trustees seek for their clients, but in our opinion this is not in the best interest of the creditors and the public, at least until a fair opportunity has been given to the Trustee's reorganization plan. We confidently expect this to occur during the 240 or less days following November 1, 1979, and by that time the railroad will be found to be either operable in part or it will go out of business entirely."

Judge McMillen approved the draw-down of \$15 million in property-sale proceeds and Milwaukee Land Company dividends -- but only to the extent that the funds are actually on deposit in the escrow account. He indicated that the use of such funds does undermine the security of the indenture trustees, but he said he continues to believe that the Bankruptcy Act permits the borrowing.

"The Trustee's position is stronger today than it was when we last acted upon such a petition, because he now has filed a proposed plan of reorganization which has been at least implicitly and tentatively favored by an Acting Secretary of Transportation and which, if approved, would permit the reorganization of the railroad. . . . It would be folly to require the Trustee to file a plan of reorganization and then to deprive him of any readily available funds to continue the railroad's operation until the plan can be acted upon by the ICC and the court. . . ."

Should the Trustee spend \$1.7 million on the main line west of Miles City and elsewhere to return the lines at least to minimum FRA track standards? That was the third issue before the court.

"To expend funds on lines which the Trustee and the DOT believe are not reorganizable is to fly in the face of our finding that these portions of the line are cashless," Judge McMillen wrote. "Therefore, we deny the request for the expenditure of funds on the maintenance of lines outside 'Milwaukee II' or on the other portions of the Milwaukee Railroad which the DOT will not fund. . . . The only obligation which we find the Milwaukee Road has is to prevent the lines over which service is to be directed from becoming impassable and to attempt to obtain waivers." The court pointed out that the directed-service statute offers a possible way that the directed carriers may spend, and be reimbursed for, the necessary work.

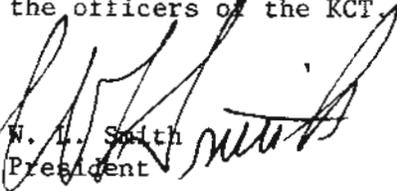
Efforts are under way in Congress to forestall the embargo and, in one or another form, to provide funds to keep the entire Milwaukee operating for the term of the postponement. One version of pending legislation would provide

time for proponents of an Employee Stock Ownership Plan to seek the approval of the ICC and the reorganization court for their plan and to implement the plan. It's premature to speculate on what Congress ultimately will do, if anything. We don't expect any definitive action until next week at the earliest.

On the other hand, opponents to the Trustee's position in the Court proceeding have moved quickly to forestall the implementation of Judge McMillen's September 27 decision. The next day, one of the indenture trustees indicated that it would seek a stay pending the outcome of the appeal from Judge McMillen's earlier denial of an embargo and his granting the Trustee the authority to seek further loans. It's likely that other court challenges to the embargo, and to incurring further debt, will take place. We'll keep you posted.

While we are operating, the Rock Island is not. As you doubtless know, the Kansas City Terminal has been designated by the ICC as the "directed rail carrier" to operate the Rock Island under the same provision of the Interstate Commerce Act that, ultimately, we expect to see applied to portions of our embargoed lines. The KCT is preparing to put what it can of the Rock back to work, once the pickets are removed. The ICC's order emphasizes two areas of Rock Island service which it deems vital: The Chicago commuter service and the movement of grain.

Since the Milwaukee is one of the KCT's owners, we are involved in the Rock Island directed service. But it's important to keep in mind that we ourselves are not going to operate any portion of the Rock Island, nor is any railroad other than the KCT. We do have several officers assigned to the KCT "management team" for its Rock Island directed service. Bill Cruickshank is the team's expert on locomotives and cars. Steve Barry is the team's expert on commuter service. Fritz Miller will be helping with accounting matters. But when Rock Island trains begin moving, they'll be operated by Rock Island employees working for Rock Island supervisors who will be taking their direction from the officers of the KCT.


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