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CHICAGO, MILWAUKEE, ST. PAUL & PACIFIC RAILROAD

Statement of Fairman R. Dick at the Hearing before the Interstate Commerce Commission on September 20, 1937 in regard to the reorganization of the Chicago, Milwaukee, St. Paul & Pacific Railroad.

During the last month, the Special Committee of the Board to deal with reorganization problems has reconsidered the question: what, if any, modifications of the 1935 Plan may properly and intelligently be suggested by the Debtor at this time? The risks of the 1935 Plan in respect of the two points mentioned during the June, 1937, hearing have been increased rather than diminished since that hearing. The Committee was unanimously of the view, and that view was unanimously concurred in by the full Board, that no Plan of reorganization of this property can be predicated upon today's earnings without doing such violence to all classes of the Debtor's securities, from the General Mortgage Bonds down to the stock, as to indicate a degree of hopelessness as to the railroad situation which would, apart from its effect on private rights, disastrously affect railroad credit. Any such Plan would, it is believed, ultimately prove to have been grossly unfair to all classes of the Debtor's security holders, for neither the Special Committee nor the full Board can believe that the Commission expects that the railroads shall bear the increasing burdens which have recently been imposed upon them, without being provided in some manner by compensating revenues. On the other hand, it would be both rash and unintelligent to attempt to predicate a Plan at this time upon that belief, for firm as its belief is, the Special Committee has had no assurance that such additional revenues will be provided, or if so, to what degree.

Until the answer to this problem is given, or at least indicated, any Plan of reorganization for the Debtor will either be purely guesswork or violent destruction of security values. For these reasons, the Board of Directors directed the filing of the application for an adjournment of this proceeding, which the Commission had denied. Meantime, the Special Committee has requested the Chairman of the Institutional Bondholders' Committee to meet with it to discuss modifications to meet the two particular problems which have heretofore been indicated. The Chairman of the Bondholders' Committee has stated the willingness of that Committee to enter into such conferences with the Special Committee of the Board, and it is hoped that they can promptly be arranged.

I would be lacking in candor if I did not state to the Commission here that if reorganization is to be forced at this time, the effect upon the General Mortgage Bonds of any solution of the first problem which will even have a superficial appearance of being satisfactory will be so drastic that the Debtor's

Board has been unwilling even to suggest it. On any such hypothesis the problem is the problem of the bondholders and not of the Debtor's stockholders, and the Special Committee believes that any suggestion as to its solution must come from the bondholders themselves as the parties most immediately concerned.

Furthermore, I would also be lacking in candor if I did not state here that from my own study of the situation I am convinced that a reorganization at this time sufficiently drastic to create even a superficial appearance of restoration of the Debtor's credit will, in fact, destroy rather than restore railroad credit.

Reorganization of a railroad is undertaken to lift the bankruptcy and restore its credit. The purpose of restoring credit is to assure the maintenance of an adequate transportation system. This was never more clearly stated than by the Commission in the O'Fallon case decision as follows:

"The end in view, as we have stated is the maintenance of an adequate national railway transportation system. Such a system, so long as it is privately owned, obviously cannot be provided and maintained without a continuous inflow of capital. Obviously, also, such an inflow of capital can only be assured by treatment of capital already invested which will invite and encourage further investment."

A continuous inflow of new capital can only be obtained, in the last analysis, by a level of earnings which will attract capital. This does not mean that earnings must be adequate every year. Earning power always varies between periods of prosperity and periods of depression, but to the extent that earnings during depression fall below the required level, then to this extent they must be made up during the following period of prosperity. The greater the deficiency during depressions the greater must be the earning power during prosperity, and where earnings are highly volatile, the sum total must be greater than where earning power is more stable. This is for the reason that if continuity of income return is jeopardized, the expectation of total return must be greater. If, for example, the Milwaukee cannot service its present general mortgage during depressions, then it is obvious that if the investor is to be induced to purchase additional bonds of this mortgage in the future, a materially higher coupon will be necessary. The same principle follows through the balance of the capital structure. On the assumption that present earning power would be a characteristic of all future depressions, satisfactory sales of junior securities would necessitate a fantastic level of earnings during periods of prosperity.

Similarly, adequate earnings are the only foundation for such treatment of capital already invested as will invite and encourage further investment. It may sometimes be possible to obtain a new supply of capital under adverse conditions by scaling or displacing existing debt to the point at which new capital appears to have adequate security through its lien on both the old plant and the new additions. Unless earnings are adequate, however, such a device has but a limited application and cannot assure a railroad of a continuous inflow of capital. Of course, if earnings are adequate no such device is needed. The reason that such a device will not work in the face of inadequate earnings, except on a limited

scale and for a limited time, is that with inadequate earnings the time gradually grows nearer when the combination of both old and new capital will fail to develop earnings sufficient to pay interest even on the new capital.

This process is vividly illustrated by the history of the Western Pacific Railroad which is now unable to pay interest on the bonds sold to provide money for improvements since 1916, in spite of the fact that the \$60,000,000 in improvements from the sale of those bonds was supplemented by \$100,000,000 in property previously provided, for which, under the 1916 Reorganization, no fixed interest securities were issued. When, under an inadequate level of earnings, the point is reached where the earnings on both new and old capital are insufficient to pay interest on the bonds sold to provide new money, another receivership becomes necessary and the so-called new capital must be relegated to the old capital position and, in turn, subordinated to bonds to be sold in the future for additional improvements. This is precisely what has happened in the case of the Western Pacific.

Even before the point is actually reached where earnings are insufficient to pay interest, a continuous flow of new capital cannot be obtained by an increase in the debt ratio because when the debt ratio is continually increasing a time arrives when it is impossible to effect further sales of bonds. Then another scaling is necessary so as to bring about a condition where debt ratio can again be increased. During such periods of capital readjustment, the flow of new money necessarily must cease and the supply of money for improvements cannot be continuous.

The truth of this principle and the accuracy of this logic would seem so obvious as not to be subject to challenge, and the conclusion, therefore, would seem to be that a sound reorganization plan, not only for the Milwaukee, but for any railroad, cannot be based on such methods for assuring a continuous flow of new capital. The basic fallacy underlying many of the present proposals to restore railroad credit would seem to be a failure to fully appreciate that a continuous flow of new capital requires adequate earnings, and no sound methods for obtaining new capital can be based on an assumption that earnings in the long run will be inadequate.

The cynical suggestion is sometimes made that if the scaling of present debt is sufficiently radical, if, for example, all debt is translated into stock, at least the day of reckoning will be long postponed. It is unthinkable that such a procedure could have been the purpose of Congress when it enacted Section 77 of the Bankruptcy Act. Even if any such purpose could be attributed to Congress, that purpose would not be effected. It would gradually be realized, and, indeed, it may be realized today, that the pledge of the old investment with the new investment does not, in fact, insure permanent safety since the time inevitably approaches when what is called the new capital will be relegated to the position of old capital.

During the period when Jay Gould was juggling capital structures at the expense of investors, many conservative investors would not purchase even the senior securities of any Gould road. The adoption of any policy of confiscating old capital in order to make it possible to raise new capital for similar confiscation in the future would unquestionably lead to the adoption by investors of a similar attitude toward railroad securities in general. It should be further noted that even if such plans actually deceived investors and were followed by

satisfactory distribution of bonds sold for improvements, the duration of this temporary and illusory period would undoubtedly be far less than indicated by a computation of the trend of rising fixed charges in relation to net. This point was clearly demonstrated in the Western Trunk Line territory during the years prior to the present depression. The record in rate cases before the Commission showed gradually mounting debt and a gradual reduction in stock protection. For example, in Exhibit #89 in Rate Structure Investigation, Part II, Ex Parte 87, at Omaha, Nebraska, in January, 1927, it was shown that from 1912 to 1926 bonded debt had increased from \$1,514,694,000 to \$1,971,289,000 and the stock protection had declined from a market value of \$1,231,968,000 to \$631,557,000. The extension of the trend lines of this Exhibit would have prophesied the era of receiverships as occurring ten to twenty years in the future, whereas, in fact, these receiverships were precipitated by the depression well in advance of the theoretical time. The reason for this is that low and decreasing margins between expenses and revenues render the net exceptionally vulnerable to changes in the volume of traffic brought about by depressions. In this connection, it should be pointed out that in 1936 the margin between total expenses and gross revenues of the Milwaukee was 8.7%. As has been previously pointed out, the increased expenses in the immediate future are a substantial percentage of the total present margin.

A study of the record in the Milwaukee case reveals clearly that any basis for reorganization which would assure the Milwaukee of even a limited amount of funds for improvement would do the utmost violence to the present security holders, and obviously would run counter to the sound principles stated by the Commission in the O'Fallon case quoted above.

There is no intention here to interpret the principle stated in the O'Fallon case as one insuring all security holders against losses. On the contrary, while it is a fact that the common stock of the Milwaukee represents \$100 a share paid by stockholders, it would be unduly stretching this principle to assume that these stockholders could expect to be protected from serious losses in view of the nature of the present depression. Losses in a depression are a characteristic of all equity securities. If, however, the present capitalization of the Milwaukee is studied further, it will be found that the Adjustment 5s represent the old re-funding issue, legal for savings banks originally and held today by many savings banks. Not only that, but the Fifty-Year 5s represent in part the new money supplied by stockholders in the last receivership. It is apparent, therefore, that severe treatment of the latter securities might well be considered to be in violation of the Commission's principles as laid down in the O'Fallon case. But, assuming that these securities could justifiably be deprived of their present position, there would seem to be no argument which would justify a dilution or displacement of the old first mortgage, held for many years by the most conservative institutions and regarded in the past as riskless investments. And yet, as has been pointed out, under present conditions a displacement or dilution of this mortgage is necessary if the capital structure is to be so constituted as to attract new money to the property, even temporarily. That such a process will continue to attract that continuous flow of capital necessary to supply the transportation needs of the territory served is unthinkable in the light of either logic or experience.

Proposals to scale the fixed debt of the Milwaukee to a degree that in the past has never taken place or even been suggested, are based on the argument

that the road's territory is over-built with railroads and that traffic has declined relatively. This line of argument is based on an erroneous assumption as to the facts. Whatever view may be taken of the earning power of the Puget Sound Extension, 75% of the mileage of the Milwaukee is in Western Trunk Line territory and since 1906, when the prosperity of these roads was indicated by a price of 193 for St. Paul common stock and 240 for Northwestern common, practically no new mileage has been constructed in that territory. More exactly, the increase in the railroad mileage in states wholly within this territory since 1906 has been 4 per cent and in the states partially in this territory one per cent. Because these arguments are based on an error of fact they do not merely advocate reducing debt in proportion to a lower volume of traffic but advocate reducing debt to a point where the traffic volume per dollar of debt is far in excess of other sections of the country. The fixed debt of the Milwaukee today, with 30 ton-miles per dollar, is the same in relation to traffic volume as the average of all steam railroads. If the Fifty-Year 5s are eliminated, ton-mile protection is 45 ton-miles per dollar of debt and if, in addition, underlying debt is cut in half, ton-miles per dollar of debt become 90, three times that of the average for the whole country. Such proposals, then, are not to restore the debt of the Milwaukee to a level which is sound in relation to the service performed but to reduce that debt to a point where the service performed in relation to debt is three times that of the country as a whole. The measure of future capital needs is the service performed; not an arbitrary scaling of present debt. If the Milwaukee must have three times the ton-miles per dollar of debt necessary for the rest of the country, and this condition is to be maintained in the future, it means that every dollar spent by the Milwaukee in the future must be protected by an increase in traffic volume three times that necessary for the rest of the country.

The ultimate objective of railroad regulation by the Interstate Commerce Commission is to supply the country with the most efficient form of transportation at the lowest possible cost. Attainment of this objective requires the maintenance of healthy credit conditions. This, in turn, requires keeping open the large reservoir of low cost money owned by savings banks, life insurance companies and other conservative investors. Sound credit conditions cannot be restored by a slap-dash scaling of fixed charges and capital structures which makes no sufficient provision for raising new money in the future or which assumes a fatalistic attitude in regard to future earnings of the industry. Credit is the state of mind of investors, and the ultimate problem faced by the Commission in its supervision of reorganizations under Section 77 is to provide a cure for the financial weakness which has destroyed investor confidence in the past. Wholesale conversion of bonds which have been regarded in the past as the highest type of security possible to buy into junior type securities or stock in the hope of being able temporarily to raise a limited amount of money is not a solution of this problem.

Any adjustment in capitalization necessary to create a sound credit structure must do some violence to present security holders. If the standard set up for the future is ultra-conservative, the degree of violence may be very great. Unfortunate as this may be, and regardless of the apparent violation of the Commission's principles, it is sound public policy to require security holders to con-

sent to whatever readjustments are necessary to bring about sound credit conditions in the future. What must be avoided, as contrary to the public interest, is a readjustment for the purpose not of creating a sound capital structure for the future but merely in order that new bonds may replace old bonds. It is one thing to ask a bondholder to release his lien in order to secure a continuous flow of future capital in the right form; it is quite another thing to ask him to release his lien in conformity with a plan for raising future capital in the wrong form, thus repeating the mistakes of the past which are responsible for the present bankruptcy and inviting another bankruptcy.

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September 22, 1937