

SURFACE TRANSPORTATION BOARD

DECISION

STB Finance Docket No. 32760 (Sub-No. 23)

UNION PACIFIC CORPORATION, UNION PACIFIC RAILROAD COMPANY,
AND MISSOURI PACIFIC RAILROAD COMPANY--CONTROL AND MERGER--
SOUTHERN PACIFIC RAIL CORPORATION, SOUTHERN PACIFIC
TRANSPORTATION COMPANY, ST. LOUIS SOUTHWESTERN RAILWAY
COMPANY, SPCSL CORP., AND THE DENVER AND RIO GRANDE
WESTERN RAILROAD COMPANY

Decided: September 26, 1997

This decision addresses whether the terms of the proposed merger of St. Louis Southwestern Railway Company (SSW) into SSW Merger Corp., including without limitation the \$6,800 per share price to be paid to the four minority shareholders who own the 61 shares of SSW's common stock that are publicly held, are just and reasonable.

BACKGROUND

In Union Pacific Corporation, Union Pacific Railroad Company, and Missouri Pacific Railroad Company--Control and Merger--Southern Pacific Rail Corporation, Southern Pacific Transportation Company, St. Louis Southwestern Railway Company, SPCSL Corp., and The Denver and Rio Grande Western Railroad Company, Finance Docket No. 32760, Decision No. 44 (STB served Aug. 12, 1996) (UP/SP Dec. No. 44), we approved the common control and merger of the rail carriers controlled by Union Pacific Corporation (Union Pacific Railroad Company and Missouri Pacific Railroad Company) and the rail carriers controlled by Southern Pacific Rail Corporation (Southern Pacific Transportation Company, St. Louis Southwestern Railway Company, SPCSL Corp., and The Denver and Rio Grande Western Railroad Company).¹

The common control authorized in UP/SP Dec. No. 44 was consummated on September 11, 1996, with the merger of SPR with and into UP Holding Company, Inc., a direct wholly owned subsidiary of UPC.

In the application filed on November 30, 1995, applicants had noted, among other things, that, in effectuating UP/SP common control, they intended to merge SPT, SSW, SPCSL, and DRGW into UPRR, although they added that these companies might retain their separate existence for some time. See UP/SP Dec. No. 44, slip op. at 8. With respect to SSW, applicants had specifically noted that, although SSW had a small number of minority equity holders and although the Federal Railroad Administration (FRA) held certain SSW redeemable preference shares, the application did not include a request for a Schwabacher determination² with respect to the compensation that might be paid to SSW security holders in connection with a merger of SSW into UPRR. Applicants added, however, that, if they later determined to carry out such a merger, they

¹ In UP/SP Dec. No. 44: Union Pacific Corporation was referred to as UPC; Union Pacific Railroad Company was referred to as UPRR; Missouri Pacific Railroad Company was referred to as MPRR; UPRR and MPRR were referred to collectively as UP; Southern Pacific Rail Corporation was referred to as SPR; Southern Pacific Transportation Company was referred to as SPT; St. Louis Southwestern Railway Company was referred to as SSW; SPCSL Corp. was referred to as SPCSL; The Denver and Rio Grande Western Railroad Company was referred to as DRGW; SPT, SSW, SPCSL, and DRGW were referred to collectively as SP; UPC, UP, SPR, and SP were referred to collectively as "applicants"; and the application that had been filed by applicants on November 30, 1995, was variously referred to as "the application" and "the primary application."

² The reference is to Schwabacher v. United States, 334 U.S. 192 (1948).

would request either a Schwabacher determination respecting the terms of the merger or a declaratory order that no such determination was required. See UP/SP Dec. No. 44, slip op. at 8 n.6 (second paragraph).

By petition (designated UP/SP-306) filed July 17, 1997, the remaining applicants (UPC, UPRR, SPR, SPT, and SSW, hereinafter referred to simply as "applicants") indicate: that MPRR was merged into UPRR on January 1, 1997; that SPCSL and DRGW were merged into UPRR on June 30, 1997; that the corporate restructuring of the UP/SP system will be completed in February 1998 with the merger of SPT into UPRR; and that, prior to and in anticipation of the merger of SPT into UPRR, SSW (more than 99.96% of the common stock of which is owned by SPT)³ is to be merged into SSW Merger Corp. (100% of the common stock of which is owned by SPT), and SSW Merger Corp. is then to be merged into UPRR. Applicants have requested, in the UP/SP-306 petition, that we issue a determination that the terms of the proposed merger of SSW into SSW Merger Corp. (in particular, the \$6,800 per share price to be paid to the four shareholders who own the 61 shares of SSW's common stock that are publicly held) are just and reasonable.⁴ Applicants seek this determination (1) because they believe the Board is required by Schwabacher to make such a determination to protect minority shareholders, and (2) in order to immunize the merger of SSW into SSW Merger Corp. from the otherwise applicable state law rights, particularly the otherwise applicable state law appraisal rights, of the four remaining public shareholders. 49 U.S.C. 11321(a).

Our statutory mandate, 49 U.S.C. 11324(c), requires, among other things, that we determine, in appropriate cases, that the terms and conditions of certain transactions affecting stockholders are just and reasonable. See, e.g., UP/SP Dec. No. 44, slip op. at 177; Union Pacific Corp. et al.--Cont.--MO-KS-TX Co. et al., 4 I.C.C.2d 409, 515 (1988) ("In appraising this transaction affecting the rights of stockholders, it is incumbent upon us to see that the interests of minority stockholders are protected and that the overall proposal is just and reasonable to those stockholders. Schwabacher v. United States, 344 U.S. 182, 198, 201 (1948)."). Acting in compliance with this statutory mandate, we announced, in a decision served July 29, 1997, and published that day in the Federal Register at 62 FR 40566, that we had been asked to issue a finding that, and we were therefore soliciting comments from all interested persons respecting whether, the terms and conditions of the proposed merger of SSW into SSW Merger Corp. were just and reasonable. We requested that any comments be filed by August 28, 1997.

By decisions served August 20, 1997, and September 5, 1997, the due date for filing comments was extended, first to September 8, 1997, and then to September 11, 1997.

Comments objecting to the determination sought in the UP/SP-306 petition have been filed by the four public shareholders: Benjamin Zatz, Donald Zatz, Joseph S. Guzman, and Homer Henry.⁵

³ SPT owns 173,239 of the 173,300 shares of SSW common stock.

⁴ Applicants indicate that, prior to and independent of the merger, the shares of SSW preferred stock that are publicly held will be redeemed at par value pursuant to their terms. See UP/SP-306 at 1 n.2. Applicants further indicate that they have reached an agreement with FRA regarding the treatment of the FRA preference shares, which will remain in existence as obligations of the merged company (i.e., UPRR). See UP/SP-306 at 3 n.4.

⁵ Of the 61 publicly held shares: the Zatzes own 55; Mr. Guzman owns 5; and Mr. Henry owns 1.

DISCUSSION AND CONCLUSIONS

In developing the \$6,800 per share price, applicants received the advice of, and a written valuation from, Credit Suisse First Boston (CSFB), an investment banking firm with both extensive expertise in the area of railroad securities and an in-depth knowledge of UP/SP operations. CSFB considered, in arriving at its valuation of SSW stock, a range of pertinent factors, including: SSW financial and operating data as compared with financial, operating, and stock market information for other companies in the railroad industry; financial terms of certain other recently effected or proposed railroad transactions; projected SSW cash flow, taking account of the forecast synergies of the UP/SP merger; and other relevant information, financial studies, and analyses. CSFB also considered the compensation SSW shareholders have received in exchange for their shares in several older sale transactions. The factors that CSFB considered are factors that we have found to be acceptable in determining whether the securities terms of a transaction are, or are not, just and reasonable. See, e.g., UP/SP Dec. No. 44, slip op. at 177-78; Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company--Control--Chicago and North Western Transportation Company and Chicago and North Western Railway Company, Finance Docket No. 32133, Decision No. 28, slip op. at 3 (ICC served June 22, 1995).

CSFB, in arriving at the \$6,800 per share valuation, used three different valuation analyses: a comparable company analysis; a discounted cash flow analysis; and a comparable acquisition analysis. Each of these methods produced a different range of values per share, ranging from a low of \$4,155 per share to a high of \$6,809 per share. The comparable company analysis, which compared financial and operating data for SSW with similar data for major Class I and Class II railroads, resulted in an SSW equity value range of approximately \$4,155 to \$4,905 per share. The discounted cash flow analysis, which used various discount rates and cash flow projections, resulted in an SSW equity value range of approximately \$6,030 to \$6,694 per share. The comparable acquisition analysis, which compared purchase prices and multiples paid or proposed to be paid in selected railroad acquisitions, resulted in an SSW equity value range of approximately \$5,655 to \$6,809 per share.

Because the CSFB appraisal considered factors that we have found to be acceptable, because the calculations contained therein appear to be correct, and because the \$6,800 per share valuation urged by applicants is at the top end of the range of SSW's common equity value as calculated by CSFB, we find that the \$6,800 per share valuation is just and reasonable.

The four public shareholders have challenged the \$6,800 per share valuation, but their arguments are not persuasive.

(1) It is argued that the \$6,800 per share valuation fails to reflect the \$1.9 billion SSW purchase "offer" made by Consolidated Rail Corporation (Conrail) during the course of the UP/SP control proceeding, see UP/SP Dec. No. 44, slip op. at 26 n.36. Mr. Henry contends that the \$1.9 billion "offer" translates into a \$10,900 per share valuation. The Zatzes contend that this "offer" translates into a \$13,209 per share valuation.⁶

The \$10,900 and \$13,209 calculations are flawed in two distinct and significant ways. First, the \$1.9 billion "offer" was not firm, and thus could not be relied on by UPC, since Conrail explained that its proposed purchase price was based on its estimate of the operating cash flow of the properties to be acquired, and that the offer would be adjusted accordingly if the estimate proved not

⁶ The \$10,900 calculation appears to have been arrived at by dividing \$1.9 billion by the 173,300 SSW shares, and then rounding off the \$10,963 quotient. The \$13,209 calculation, which is premised upon the notion that the \$1.9 billion "offer" was for only 83% of the SSW, was arrived at: (a) by dividing \$1.9 billion by 83%, which works out to a \$2,289,156,627 "offer" for 100% of the SSW; and then (b) by dividing \$2,289,156,627 by the 173,300 SSW shares, which works out to \$13,209 per share.

to be correct.⁷ Further, only a part of the "offer" represented cash that would be available for equity shareholders, with the remainder an undisclosed amount of assumed debt.

Second, the \$10,900 and \$13,209 calculations, by making no adjustment for the fact that the Conrail "offer" encompassed a large part of SPCSL and important pieces of SPT, significantly overstate the portion of the "offer" that reflected SSW properties. The \$1.9 billion "offer" was not for SSW as such, but rather was for a collection of assets that Conrail referred to as the "SP East," by which was meant SP's properties in Texas, Louisiana, and Arkansas, SP's eastern main line in Missouri and Illinois, all access rights associated with these lines, and all other assets held by SP or its affiliates and used or useful for the maintenance and operation of these lines.⁸ The SSW, however, constituted only a portion of the SP East.⁹ Further, the "offer" also included "an appropriate number" of locomotives, rolling stock, and other equipment, which, as applicants have explained, was not limited to SSW equipment. Even assuming that the \$1.9 billion "offer" was firm, there is really no way to determine what, if anything, Conrail would have offered for the SSW alone, or even for that part of the SSW that was embraced within the SP East. All that can be said with certainty is that any such offer would have been for substantially less than \$1.9 billion.

(2) It is argued, in essence, that the \$1,178,440,000 total valuation proposed by applicants¹⁰ reflects the past but makes no allowance for the future. The value of the SSW franchise, this argument runs, may be on the verge of a dramatic increase, in view of the proposed acquisition of Conrail by CSX Corporation (CSX) and Norfolk Southern Corporation (NS). See CSX Corporation and CSX Transportation, Inc., Norfolk Southern Corporation and Norfolk Southern Railway Company--Control and Operating Leases/Agreements--Conrail Inc. and Consolidated Rail Corporation, STB Finance Docket No. 33388, Decision No. 12 (STB served July 23, 1997, and published that day in the Federal Register at 62 FR 39577). It may well be, this argument

⁷ Applicants have explained that this valuation method, which Conrail never applied to actual SP data, appears very similar to the unrebutted "discounted cash flow" analysis that CSFB performed with respect to SSW, and which, after taking into account the forecast synergies of the UP/SP merger, produced an estimated per share value range of \$6,030 to \$6,694.

⁸ To be precise, the term "SP East" was intended to encompass: (1) SP's lines from Chicago and St. Louis to Galveston, TX, and Brownsville, TX, and from New Orleans to Spofford, TX, Eagle Pass, TX, and El Paso, TX, including all connecting trackage and spur lines serving Alton, IL, New Madrid, MO, Memphis, TN, Little Rock, AR, Indiana, AR, Breaux Bridge, LA, and all intermediate Texas points; (2) all trackage, haulage, and access rights associated with these lines and SP's ownership of, and rights in, the jointly used UP-SP line extending from East St. Louis to Jonesboro, AR; (3) SP's interest in the Alton & Southern Railway Company and the Terminal Railroad Association of St. Louis, and any other terminal railroad serving traffic originating/terminating on the acquired lines; (4) SP's interest in various bridge companies necessary to the effective operation of the acquired lines; and (5) all other assets (including yards, storage facilities, and sidings), options for same, or other facilities used or held by SP or its affiliates for the maintenance, operation, and efficient use of the acquired lines and assets. See UP/SP Dec. No. 44, slip op. at 23.

⁹ See UP/SP Dec. No. 44, slip op. at 15: "SSW operates approximately 2,200 miles of main line and branch line in the Central United States. SSW's main line runs from Santa Rosa, NM, to Kansas City and St. Louis. Operations between Topeka, KS, and St. Louis are over trackage rights on UP. SSW main lines extend from St. Louis south to Shreveport, LA, and Corsicana, TX."

¹⁰ This figure is derived by multiplying the \$6,800 per share valuation by the 173,300 shares.

continues, that SSW someday will be worth much more to, and therefore might be subject to acquisition by, either a post-merger CSX/Conrail or a post-merger NS/Conrail.¹¹

This approach, which is premised upon the notion that certain traffic realignments might be expected to follow in the wake of the proposed division of Conrail by and between CSX and NS, is totally speculative in that it is entirely directed to SSW's future valuation (under an as yet undetermined future rail realignment) and not to SSW's present valuation. The unusual and speculative nature of this approach is highlighted by the Zatzes' witness, Mr. Grocki, who states that "if the [CSX-NS-Conrail] merger is approved, the value of the SSW could be substantially greater than its value today." John J. Grocki statement dated September 10, 1997, at 4 (emphasis added).¹² The recently filed Conrail merger application is now pending before us, and our final written decision on the merits of that application will not be issued until June 8, 1998. It suffices to say that even if (a) the Conrail merger application is ultimately approved, and (b) the UP/SP oversight process ultimately results in the forced divestiture of the SSW lines, any sale of those lines will not occur in the reasonably foreseeable future, and the purchaser of SSW will not necessarily be either a post-merger CSX/Conrail or a post-merger NS/Conrail. The crucial issue we must resolve now, however, is what SSW is worth today, not what SSW might be worth at some uncertain time in the future.¹³

(3) It is argued, in essence, that, in requiring that comments be filed no later than September 11, we have not accorded the four public shareholders, who are not skilled in matters of railroad finance, sufficient time to participate effectively in this proceeding, and have thereby violated the most basic principles of due process.

This argument fails both because the four public shareholders have been afforded sufficient time to participate effectively in this proceeding¹⁴ and also because there is no reason to believe that they could participate any more effectively no matter how much more time they were allowed. There are essentially only two approaches (one financial, the other econometric) that could be taken in seeking a valuation higher than \$6,800 per share, and there is no reason to believe that the results of either such approach might cause us to conclude that the \$6,800 per share valuation is too low. The financial approach would entail an analysis of the CSFB appraisal and/or the preparation of a similar appraisal (with a higher per share bottom line). However, in our opinion, the CSFB

¹¹ There is no reason to think that UP would willingly sell off SSW, but, in at least one conceivable circumstance, such a sale could occur without UP's concurrence. See UP/SP Dec. No. 44, slip op. at 146 (emphasis in original): "We impose as a condition to approval of this merger oversight for 5 years to examine whether the conditions we have imposed have effectively addressed the competitive issues they were intended to remedy. We retain jurisdiction to impose additional remedial conditions if, and to the extent, we determine that the conditions already imposed have *not* effectively addressed the competitive harms caused by the merger." Divestiture is one of the additional remedial conditions we can impose. See UP/SP Dec. No. 44, slip op. at 231, ordering paragraph 6.

¹² This statement is attached to the statement of Benjamin Zatz and Donald Zatz, filed September 11, 1997.

¹³ The same result holds even if it is assumed that the Conrail merger application will ultimately be denied, and that the UP/SP oversight process will ultimately result in the acquisition of the SSW lines by a still independent Conrail. Any such acquisition will not occur in the reasonably foreseeable future.

¹⁴ The four public shareholders could have sought counsel at any time after receiving their copies of the UP/SP-306 petition (which, applicants state, were served on the four public shareholders on July 14, 1997), and they are now represented by counsel. They have had eight full weeks (from July 14 to September 11) to analyze, or to have others skilled in railroad finance analyze, the matters addressed in the UP/SP-306 petition.

appraisal is entirely persuasive, and thus another financial analysis would not lead to a different result. The econometric approach, which might be based upon an analysis of the Carload Waybill Statistics database, would focus upon the traffic realignments that might be expected to occur if and when Conrail is divided by and between CSX and NS. The econometric approach also would fail because, as noted above, that approach addresses the future, not the present.¹⁵

(4) It is argued by Mr. Henry that the merger of SSW into SSW Merger Corp. will itself have anticompetitive effects, and will not be in the public interest, in that this merger (and, more broadly, the merger of all of the SP railroads into UPRR) will give UP/SP increased routing power and will allow it to downgrade, and perhaps to abandon, certain lines. It is therefore requested that the UP/SP-306 petition be held in abeyance until the end of the oversight period.

This argument fails because it amounts to a collateral attack upon UP/SP Dec. No. 44; it was that decision, not the decision issued today, that allowed applicants to merge SSW (indeed, all of the SP railroads) into UPRR. Moreover, UP/SP cannot, by downgrading or abandoning certain lines, undermine our oversight jurisdiction, and any future abandonments remain subject to our prior approval.

Finding. We find, based upon the evidence of record in this proceeding, that the terms of the proposed merger of SSW into SSW Merger Corp., including without limitation the \$6,800 per share price to be paid to the four minority shareholders, are just and reasonable.

This action will not significantly affect either the quality of the human environment or the conservation of energy resources.

It is ordered:

1. This proceeding is discontinued.
2. This decision is effective on the date of service.

By the Board, Chairman Morgan and Vice Chairman Owen.

Vernon A. Williams
Secretary

¹⁵ The due process argument is accompanied by an argument to the effect that a delay in issuing a final decision in this proceeding would not harm any of applicants' legitimate interests. We reject this argument because we agree with applicants: that the merger of SSW into SSW Merger Corp. is an intermediate step in the process of merging all of the SP railroads into UPRR, with the ultimate merger of SPT into UPRR now scheduled to occur in February 1998; that the merger of all of the SP railroads into UPRR will facilitate the achievement of the benefits of the UP/SP merger by allowing UP/SP customers to enjoy the full benefits of single-line and single-system service, and by allowing UP/SP to take advantage of the administrative efficiencies of operating as a single company; that, with the merger of all of the SP railroads into UPRR, UP/SP will no longer be required to maintain the recordkeeping systems necessary to record costs and revenues associated with each separate company; and that, if the merger of SSW into SSW Merger Corp., and the subsequent merger of SSW Merger Corp. into UPRR, cannot be completed before the end of the fiscal third quarter on September 30, 1997, UP/SP will be required to incur considerable expenses in connection with the preparation of separate SSW financial statements.