

BEFORE THE RAILROAD COMMISSION OF THE STATE OF CALIFORNIA.

In the matter of the application
of SOUTHWESTERN HOME TELEPHONE
COMPANY for authority to issue
stock, bonds and notes.

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Application No. 871.

Charles A. Rolfe and J. J. Prendergast,
for applicant.

GORDON, Commissioner.

O P I N I O N

Southwestern Home Telephone Company operates telephone exchange systems at Redlands, in San Bernardino county, and Banning, Beaumont, Elsinore, Perris, San Jacinto, Hemet and Temecula, in Riverside county. The toll service connecting these points is operated by The Pacific Telephone and Telegraph Company. The two companies have a contract providing for joint service, and under the terms of this contract the Southwestern Company receives 20 per cent of the toll charges it collects for the Pacific Company. Under this arrangement the exchange and toll services in this territory are distinct and the two corporations are not in competition at any point.

On December 6, 1913, Southwestern Home Telephone Company filed the application under consideration with the Commission in which it asks for authority to issue stock, bonds and notes. This application may be segregated as follows:-

1. Application to renew promissory notes in the sum of \$101,300.00. These notes comprise the following:-

<u>Date</u>	<u>Term</u>	<u>Payee</u>		<u>Amount</u>
April 30, 1910	2 years	Mrs. Mary J. Webster	8%	\$10,000.
June 3, 1910	5 "	C. E. Rohrer	7½%	4,250.
May 15, 1910	1 "	Mrs. Mary A. Prendergast	8%	8,000.
Octo. 31, 1910	2 "	Mrs. Mary Gill Prendergast	8%	1,500.
March 11, 1911	3 "	E. J. Woolverton	7%	3,000.
Amount carried forward.....				\$26,750.

<u>Date</u>	<u>Term</u>	<u>Payee</u>	<u>Amount</u>
Amount brought forward...			\$ 26,750.
Aug. 5, 1911	3 years	S.H. & F.J. Burchell	7% 4,500.
Aug. 30, 1911	2 "	E.M. Izard	7% 4,500.
Oct. 1, 1911	1 "	Mrs. Mary A. Prendergast	8% 10,000.
Oct. 3, 1911	1 "	Mrs. Mary A. Prendergast	7% 3,000.
Jan. 21, 1912	2 "	Joseph S. Hale	7% 3,000.
March 17, 1912	3 "	Mrs. Mary S. Sargent	7% 7,000.
May 12, 1912	1 "	Mrs. Ellen A. Lewis	8% 2,000.
April 4, 1912	3 "	C. B. Hoadley	7% 3,000.
Sept. 23, 1912	demand	First National Bank of Redlands	7% 10,000.
Oct. 2, 1912	1 year	J. S. Luther	8% 2,000.
Oct. 9, 1912	1 "	Mrs. Frances A. L. Smith	8% 1,800.
Nov. 30, 1912	1 "	J. O. Thompson	7% 1,000.
April 25, 1913	3 "	F. E. Wells	8% 10,000.
April 25, 1913	3 "	J. W. Brock	8% 5,000.
June 11, 1913	3 "	Alice P. & Mary Denison	8% 2,250.
June 17, 1913	2 "	Gertrude A. Hayes	8% 3,000.
July 7, 1913	2 "	Mrs. Mary G. Cesselbury	8% 2,500.
			<u>\$101,300.</u>

Request was made to refund these notes as necessity might arise for a maximum period of three years with a maximum interest rate of 8 per cent.

2. Application to pledge as collateral security for the above notes, bonds of Southwestern Home Telephone Company in the ratio of \$2,000.00 face value of bonds for \$1,000.00 face value of notes and \$1,500.00 face value of bonds of Redlands Home Telephone and Telegraph Company for \$1,000.00 face value of notes. More specifically, the applicant requested authority to pledge as collateral security, \$182,000.00 of Southwestern Home Telephone Company bonds and \$15,000.00 of Redlands Home Telephone and Telegraph Company bonds. Bonds in these sums are now pledged as collateral security for the notes and the request is, therefore, to repledge these same bonds.

3. Application for authority to issue 25,000 shares of capital stock at 60 cents per share and to apply the proceeds upon the indebtedness of the applicant and to provide for certain unspecified extensions.

4. Application to sell an unspecified number of applicant's bonds for the purpose of liquidating indebtedness and making

extensions.

5. Application for authority to issue to Mr. Arthur Gregory \$4,500.00 of Southwestern Home Telephone Company first mortgage 5 per cent bonds for 4,500 shares of stock under an arrangement by which the stockholders were given the privilege of surrendering their stock for bonds.

A hearing was held upon this application in Redlands on January 7 and careful investigation was made into the affairs of the applicant.

Following this inquiry Southwestern Home Telephone Company filed an amended application on January 19, 1914, in which it asked for authority merely to refund its promissory notes and to pledge its bonds as collateral security therefor in the ratio of \$2,000.00 in bonds for \$1,000.00 face value of notes.

Under the amended application, therefore, the present findings could be limited to those features of the application embraced under Division Nos. 1 and 2 as heretofore enumerated. A proper consideration of these matters, however, necessitates a brief general review of the affairs of this corporation.

Southwestern Home Telephone Company was organized on February 6, 1905. It took over the Redlands Home Telephone and Telegraph Company in 1906 and gradually extended its lines until it is now serving the sections of San Bernardino and Riverside counties previously mentioned. It was, in the beginning, in competition at all these points with The Pacific Telephone and Telegraph Company. In 1907 it entered into arrangements with The Pacific Telephone and Telegraph Company by which the exchange plants at the points where the two corporations were in competition passed into the hands of the Southwestern Company and the toll lines of the Southwestern Company became the property of the Pacific Company. For the properties thus taken over, the Southwestern Company agreed to pay \$79,845.14. It transferred to the Pacific

Company its toll lines for \$27,967.78 and paid in cash the balance of \$51,877.36.

This amount of \$51,877.36 is at present represented by a portion of the floating indebtedness which applicant now asks authority to refund. Applicant states that the balance of this floating indebtedness has been incurred for other additions and betterments to its plants and facilities.

As a result of the consolidation of these properties the Southwestern Company finds itself with a greater capacity than its business now necessitates. It has 1,800 subscribers in Redlands and a total over its system of 2,800 subscribers. Its representatives assert that it has the facilities to accommodate 4,000 subscribers. A rapid growth is anticipated as unusual conditions have served to retard the corporation's natural expansion during the past two years.

For the purposes of the present inquiry no exhaustive review was made of the physical features of this corporation. Other hearings are pending in which such inquiries will be necessary and to which time they may be deferred. The facts upon which a finding in this case may properly be predicated were developed through an inquiry more particularly into the financial features of this corporation's organization.

The applicant has an authorized issue of stock amounting to \$1,000,000.00, consisting of 1,000,000 shares of the par value of \$1.00 per share. Of this amount it has issued \$405,136.50 par value of stock. This stock is held as follows:-

In the hands of the public.....	\$ 93,269.50
Held by trustee.....	\$ 11,867.00
Contract stock.....	\$300,000.00

The stock held by the trustee, the Southern Trust Company of Los Angeles, is so placed by reason of a provision in applicant's mortgage under the terms of which all its assets must be held by

the trustee. This stock was once issued and later, having been bought back by the company, was deposited with the trustee where it now remains. This stock, so held, can not, of course, affect in any important way the affairs of this corporation, but it should more properly be canceled and I suggest to applicant that it take such steps as may be necessary to have this trustee's stock restored to its treasury and canceled.

The 300,000 shares of contract stock was, according to the explanation of the applicant, given out originally to meet the terms of the statute providing that a corporation must have as much capital stock as bonds. In order to meet this condition, according to the testimony of the applicant, the company issued to one of its projectors and its president, Mr. Carl C. Wells, 300,000 shares of its stock under a contract. This contract stated that 300,000 shares of stock were turned over to Mr. Wells in full payment for his services for three years; that no dividends were to be paid on this stock and that the company was to have the option, within one year after the expiration of ten years from January 1, 1908, of purchasing this stock from Mr. Wells at $1\frac{1}{2}$ cents per share, or a total of \$3,750.00.

Apparently it was the intention to compensate Mr. Wells to the amount of \$3,750.00 for his services in promoting and organizing the company, and the scheme of issuing to him the \$300,000.00 of stock was conceived as a means of complying with the statute providing for an issue of stock equal to the issue of bonds. As will appear later, the company had authorized an issue of \$1,000,000.00 of bonds.

It appears from the testimony that Mr. Wells sold this stock to Mr. Charles A. Rolfe, Vice President and General Manager, and J. J. Prendergast, Secretary and Treasurer, of the Southwestern Home Telephone Company. Mr. Rolfe and Mr. Prendergast have ex-

pressed their desire to turn this stock into the treasury for the amount named, \$3,750.00, or for an amount of stock which at the current quotation would be the equivalent of \$3,750.00 in cash. They state that a present fair price for the stock is 60 cents per share. I suggest to the applicant that it proceed to make such arrangements with Mr. Rolfe and Mr. Prendergast as may be necessary to regain and cancel this block of 300,000 shares of stock.

The applicant has an authorized bonded indebtedness of \$1,000,000.00. It has executed a deed of trust to Southern Trust Company of Los Angeles, dated October 1, 1907, to secure its issue of bonds. These bonds mature in 1937 and carry an interest rate of 5 per cent per annum.

Redlands Home Telephone and Telegraph Company, the stock of which is owned by Southwestern Home Telephone Company, has an authorized bond issue of \$100,000.00 secured by trust deed to Title Insurance and Trust Company of Los Angeles, dated September 1, 1903. The bonds mature on September 1, 1933 and carry an interest rate of 5 per cent per annum.

The bonds of these two corporations are located as follows:-

Southwestern Home Telephone Company

Held in treasury.....	\$500,000.00	
Pledged as collateral.....	\$182,000.00	
Held by public.....		\$318,000.00

Redlands Home Telephone and Telegraph Company

Pledged as collateral.....	15,000.00	
Held by public.....		76,800.00
In treasury of Southwestern Home Telephone Company.....	8,200.00	
Total pledged as collateral.....	\$197,000.00	
Held by the public.....		\$394,800.00 (fwd)

Amount brought forward.....\$394,800.00

The applicant has submitted to the Commission its list of notes payable in the sum of..... 101,300.00 Its indebtedness, therefore, represented by bonds and notes amounts to.....\$496,100.00

At the hearing, Mr. Rolfe submitted an appraisal of the properties of Southwestern Home Telephone Company compiled on April 1, 1908, showing a value, according to his figures at that time, of.....\$562,574.08 To this Mr. Rolfe added the cost of additions..... 25,762.56, making a total of.....\$588,336.64

Mr. Rolfe stated that this was reproduction value "new" with no allowance for depreciation. The company's total charge for depreciation from July, 1909, a period of 4½ years, amounts to \$24,360.74. The company has written the appraisal figure into its books and has no account to show an accumulated surplus, if such has been earned. Obviously the inventory figure of \$588,336.64 is subject to revision. Parts of this plant were constructed in 1905 and other portions, purchased from The Pacific Telephone and Telegraph Company, were built as early as 1891. It is hardly necessary to demonstrate by actual examination that, if Mr. Rolfe's inventory is entirely accurate, the accumulated depreciation would so reduce the value of this company's property as to make it, at most, little more than equal to the outstanding indebtedness and, in fact, there is much reason to believe that it might not even equal this sum.

I have chosen rather to determine, as far as is possible, the actual cost of these properties and by this process I am led to believe that at least the original cost of these properties was not more than the present debt standing against them.

A complete record has not been submitted showing the original cost of the properties of the Redlands Home Telephone and Telegraph Company. This corporation was organized with a capital stock of 1,000 shares of the par value of \$100.00 per share, and with an outstanding indebtedness of \$100,000.00 of bonds. The bonds were taken at a low figure by a construction company and the stock was given as a bonus with the bonds. Thereafter assessments were levied upon the stock, which, according to the evidence, amounted to \$30.00 per share.

In the transaction by which Southwestern Home Telephone Company took over the Redlands Home Telephone and Telegraph Company, the Southwestern Company issued its stock on the basis of par, taking up the Redlands stock on the basis of \$50.00 per share. It required, therefore, 49,750 shares of Southwestern Company's stock to take up the 995 shares of the Redland Company's stock. This 49,750 shares of Southwestern stock, therefore, was issued as against a payment of \$30,000.00, or on the basis of 60 cents per share.

Subsequent to this amalgamation, Southwestern Home Telephone Company indulged in a species of finance, for which it is difficult to find any logical explanation. It may be passed over without special criticism at this time for the reason that the evil attendant upon it has already been wrought. It will suffice for this Commission to address itself to remedial considerations. It appears that in the fall of 1907 the Southwestern Home Telephone Company had stock outstanding to the amount of \$286,711.00 per value. Of this, \$49,750.00 had been issued in exchange for the Redlands Company's stock and the balance had been sold either for cash or in exchange for property on a basis of 75 cents per share. Such stock as was actually sold for cash brought 75 cents per share and such exchange as was made was fixed on a basis of 75 cents per share. In October, 1907, the southwestern Home

Telephone Company presented to its stockholders a plan by which they were given the right to convert their stock into first mortgage 5 per cent bonds at par, on condition that they would subscribe, in addition, for 25 per cent of their stock holdings at par. They were given the privilege further of converting this additional 25 per cent of stock into bonds at par. It is in evidence that holders of 195,500 shares of stock elected to convert their stock and that through the privilege of subscribing for 25 per cent in stock and again converting this stock into bonds; a total of 244,000 shares of stock was eventually converted into bonds. This left the corporation with 91,200 shares of stock outstanding and an issue of \$244,000.00 of bonds, in addition to the underlying issue of \$100,000.00 of the Redlands Company bonds. Since that time additional stock has been issued to bring the total to \$93,269.50. An additional \$74,000.00 of Southwestern Company bonds have been issued; approximately \$29,000.00 at 85 for the purpose of retiring \$23,000.00 of Redlands bonds at 105, and the balance at prices ranging as low as 60 per cent of face value for additions and betterments. Additional money has been secured through issues of notes.

If we assume, therefore, that the \$93,269.50 of outstanding stock brought 75 cents per share, which is the maximum it could have brought, the company received from this source a total of \$69,952.13, or in round numbers approximately \$70,000.00. On the other hand, if it is figured that 195,500 shares of stock which cost 75 cents were converted into bonds at par, there is evidence of a discount of approximately \$49,000.00. In addition, the 5 per cent premium on \$23,000.00 of Redlands bonds and the 15 per cent discount on the \$29,000.00 of bonds sold to refund these Redlands bonds, amount to \$5,500.00. If we assume a discount of only

25 per cent on the remaining \$45,000.00 of bonds, we have an additional \$11,250.00, or a total in discounts and premiums of \$65,750.00. To this must be added the discounts on the Redlands Company bonds. This sum more than offsets the amount received from stock.

There is no evidence of a surplus reinvested and I believe it is thus very clearly established that this property stands today with an indebtedness in excess of its original cost.

I believe that any appreciation of these properties has at least been offset by the depreciation that has occurred. For this reason I believe it is not imperative at this time that the Commission go to the company's inventory to determine its general financial condition.

The applicant submits a statement of earnings and dividends which it presents as evidence of its financial ability to pay interest and eventually to meet the principal of its bonded debt. For the year 1913 it submits an earnings statement as follows:-

Operating Income:

Operating Revenues (Schedule A).....	\$75,354.85
Operating Expenses (Schedule B).....	<u>36,767.15</u>
Net Operating Revenue.....	\$38,587.70

Non-Operating Revenue:

Interest on Bonds Owned.....	\$ 175.00
Interest on Notes Receivable.....	<u>329.53</u>

Total Non- Operating Revenue.....	<u>504.53</u>
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Gross Corporate Income\$39,092.23 (2nd.)

Amount brought forward.....\$ 39,092.23

Deductions from Gross
Corporate Income:

Interest Accrued on
Funded Debt.....\$15,900.00
Other Interest..... 8,074.87
Doubtful Accounts
Charged off..... 229.72
Lease of Redlands
Home Telephone and
Telegraph Co..... 4,015.00

Total Deductions
from Gross Cor-
porate Income..... 28,219.59

Net Corporate Income for Year.....\$ 10,872.64

(Deduct) Dividends 3 per cent,
Common Stock..... 2,798.05
Balance set aside for
Depreciation.....\$ 8,074.59

For the year 1912, the company presents the following
statement of earnings:-

Gross earnings from tele-
phone operations.....\$ 77,145.08
Interest received..... 541.00
Misc..... 33.66

Total earnings.....\$ 77,719.74

Operating and maintenance
expenses.....\$34,652.78
Interest on Southwestern
bonds..... 15,900.00
Interest on notes, etc... 8,129.63
Int. on bonds of Redlands
Home Tel. Co..... 4,015.00
Taxes..... 3,376.76 \$ 66,074.17

Balance.....\$ 11,645.57

Credited to Depreciation
account..... 6,049.47
Dividend 6% on 93,269½
shares.....\$ 5,596.10

The company presents the following statement of dividends:-

Jan. 31, 1910, 1½ per cent on 80,827 shares, \$1,212.32
July 31, 1910, 1½ per cent on 83,130 shares, 1,246.95
Jan. 31, 1911, 3 per cent on 25,840 shares, 2,575.21

Amount carried forward.....\$ 5,034.48

	Amount brought forward.....	\$ 5,034.48
July 31, 1911,	3 per cent on 89,251 shares,	2,677.54
Jan. 31, 1912,	3 per cent on 93,268 shares,	2,798.04
July 31, 1912,	3 per cent on 93,268 shares,	2,798.05
Jan. 31, 1913,	3 per cent on 93,268 shares,	<u>2,798.05</u>
	Total dividends since	
	Jan. 31, 1910.....	<u>\$16,106.16</u>

I do not believe it is necessary to go into extended details to indicate wherein applicant has pursued an unfortunate policy in maintaining its dividends in the face of a large floating indebtedness on top of an already heavy bonded indebtedness.

Viewing this application from the strict limits of its amended form, I am not willing at this time to recommend that this Commission in any degree sponsor the situation as it now exists. An analysis of the note indebtedness shows that there have been issued for refunding purposes, without the approval of this Commission, notes in the sum of \$35,750.00 and that notes are overdue in the sum of \$38,050.00. As to these overdue notes, of course applicant can probably make such arrangements as may be necessary to leave them in their present condition. Some definite arrangement, however, will have to be made by the applicant in regard to those notes in the sum of \$35,750.00 which have been issued for refunding purposes without this Commission's approval. These are the notes given since March 23, 1912 to refund other notes wherein the total period of credit exceeds one year. The applicant may, of course, allow its bonds previously and legally pledged as collateral security so to remain, but it will be necessary for it to make such arrangement as may be required as to those bonds pledged for notes which have been refunded without the approval of the Commission and for which the approval of the Commission is necessary.

This company should take steps to place itself in a position so that the Commission may, with propriety, authorize it to issue such stocks, bonds or notes as may be desirable for its proper

financing. The Commission is not passing in this application on the corporation's original petition to issue bonds and stock, but I believe enough has been said to indicate that some readjustment must precede any authorization of the securities.

I believe that as its first step to place itself upon a basis where it can make a satisfactory showing to this Commission, this company should call upon its stockholders for the restoration of the dividends paid during the past few years. This money should originally have been used to reduce the company's floating indebtedness and should now be regained and so employed. When this has been accomplished, I suggest that the applicant next endeavor to correct, so far as may be possible, the condition created by the transaction under which the large block of stock was converted into bonds. This transaction saddled upon this corporation fixed burdens which it should not be expected to carry. It is in evidence that many of this company's stockholders are also its bondholders, and I believe the applicant herein may be able to arrange for the reconversion of a portion of its bonds into stock.

There is one other matter to which I desire to allude. In its original application the Southwestern Company asked for authority to issue \$4,500.00 of its first mortgage 5 per cent bonds to Mr. Arthur Gregory for 4,500 shares of stock held by him. It was stated that Mr. Gregory had originally elected to convert his stock into bonds under the plan of October, 1907, but that his bonds had never been delivered to him. Request was made to complete this transaction. The Commission informed the applicant that it would consider this feature of the application when proper evidence was submitted that Mr. Gregory had in good faith taken the necessary steps to make such conversion at the time of the original offer in 1907, and further that no other

stock had any right to claim the conversion privilege. This information has not been presented to the Commission, and as applicant makes no reference to this matter in its amended application, I assume that it desires this feature of its petition left in abeyance for the present.

Nothing herein said should be construed as prejudicing the right of the applicant to reapply for authority to issue the \$4,500.00 of bonds to Mr. Gregory.

I shall not at this time recommend that the application of Southwestern Home Telephone Company be either granted or denied. I recommend that it be held in suspense pending such action as the applicant herein may take following suggestions which I shall here outline. I will submit suggestions for the company to follow rather than an Order, feeling that the applicant herein will take the view that the suggestions are meant in its own interests as well as in the public interest. If an Order along these lines becomes necessary, however, it may be issued at any time the Commission may believe it desirable.

I, therefore, recommend that the application herein be held in abeyance until July 1, 1914, and that the applicant herein by that time present to this Commission for its approval a general plan which shall embrace the following:-

1. Reduction of applicant's bonded indebtedness by the conversion of a portion of this indebtedness into stock or by some method equally satisfactory.
2. Reduction of applicant's floating indebtedness by the amount paid out in dividends during the past three or four years and by such other means as shall serve to reduce this indebtedness to a conservative basis.
3. Cancellation, if possible, of stock now held by the trustee under applicant's bond issue.

4. Restoration to applicant's treasury and cancellation of block of 300,000 shares of "contract" stock through an arrangement to be effected between the company and Mr. Charles A. Rolfe and Mr. J. J. Prendergast.

I properly leave the details of these plans to be worked out by the applicant. I suggest further that the applicant notify this Commission formally by letter on the twenty-fifth day of each month outlining what has been done up to that time toward meeting the suggestions of the Commission herein outlined.

The foregoing Opinion is hereby approved and ordered filed as the Opinion of the Railroad Commission of the State of California.

Dated at San Francisco, California, this 24th day of February, 1914.

A. D. Villard
W. C. Gordon
Max Thelen
Edwin O. Edgerton
Commissioners.