ORIGINAL

Decision No. 439.

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BEFORE THE RAILROAD COMMISSION OF THE STATE OF CALIFORNIA.

- - - -

In the matter of the application of United Railroads of San Francisco for permission to issue and sell $2,350,000 six per cent 5-year notes, the proceeds from the sale of which are to be applied toward the payment and discharge of $3,000,000 of the 6 per cent bonds of the Market Street Cable Railway Company and $350,000 of the 6 per cent bonds of the Park and Cliff House Railway Company, both bond issues maturing January 1, 1913.	Application No. 283.

Wm. M. Abbott for United Railroads.
Goodfellow, Eels and Orrick for Rollins and Sons.
E. P. E. Troy for Public Ownership Association.

BY THE COMMISSION.

O P I N I O N.

This is an application for an order authorizing United Railroads of San Francisco to issue and sell $2,350,000 face value 5 year promissory notes, bearing interest at the rate of 6 per cent per annum.

Applicant operates a total single track mileage of 267 miles of street car lines in the City of San Francisco and from the City of San Francisco to San Mateo.

Applicant is capitalized as follows:

Bonds of applicant:

Authorized	$35,275,000
Issued	25,334,000

Underlying bonds:

Authorized	24,750,000
Issued	14,591,000

Of the above amount of bonds of applicant, the company states that it has acquired for sinking fund, $1,690,000 face value of bonds.

Capital Stock:

Authorized, common	$18,800,000
Issued	17,948,600
First Preferred	
Authorized	5,000,000
Issued	5,000,000
Preferred	20,000,000
Issued	20,000,000

Total:

Authorized	43,800,000
Issued	42,948,600

In addition to the above funded indebtedness, applicant owes the following:

Equipment notes, 6 per cent due June 15, 1913 to June 15, 1918, secured by 80 cars - - - - - - - - - - - - - - - - -	300,000
Income notes, 6 per cent due July 1, 1912, to July 1, 1913, issued to United Railways Investment Company and deferred to dividends on first preferred stock -	1,229,000
Ten-year gold notes, 5 per cent due February 1, 1916, no security - - - - -	1,000,000
Promissory notes due on July 1,1912, and August 19, 1912. - - - - - - - - - -	293,250
Current liabilities- - - - - - - -	1,266,481
TOTAL - - - - - - - - - - - -	$4,088,731

It was proposed in the application to sell the promissory notes asked to be authorized, for at least 95 per cent of their face and use the proceeds, with the sinking fund added, later agreed to amount to $1,200,000, to pay off $3,000,000 face value of Market Street Cable Railway Company bonds and $350,000 face value of Park and Cliff House Railway Company bonds, all of which bonds were due and payable January 1, 1913. As security for the payment of the above mentioned promissory notes, applicant proposed to pledge $2,150,000 face value of 5 per cent Market Street Railway Company bonds, the consent of the Railroad Commission for such issuance being asked for in Application No. 284, filed and heard with this application, and in addition it was proposed to pledge

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$970,000 face value of San Francisco Electric Railways 5 per cent first mortgage bonds. These latter bonds were issued prior to March 23, 1912, and are in the hands of a representative of the United Railways Investment Company.

In some cases in which the condition of a public utility at and prior to March 23, 1912, has not been such as would have been sanctioned by this Commission had it been empowered to pass upon the utility's securities, the Commission has nevertheless authorized the issue of new securities, but only in cases in which the issue of such new securities will not cast additional burdens upon the utility and in which the utility is not bankrupt. The Commission will not authorize the issue of additional securities in the two exceptions specified, for the reason that it is obvious that to permit the issuance of new securities by a utility which inevitably must be reorganized or go into the hands of a receiver will only result in loss to the people who invest in these securities. Having this policy in view, the Commission insisted upon being fully advised as to the applicant's financial condition. Inasmuch as sufficient information was not produced at the initial hearing, a demand was made for the complete inspection of the books and accounts of the Company. A full inspection of the minutes of the Company was at first refused but later granted, but the only books of account applicant produced were those for the year 1912. It became necessary for the Commission to see the books preceding the year 1912, but the applicant's officials said that these books were at some unknown place in the east. The Commission made demand that these books be produced, but the Company failed to comply with the Commission's order. In lieu of these books the applicant offered statements made by auditors, which statements were alleged to have been compiled from the books but which consisted of totals only and gave no details of how the totals were secured.

The Commission, through its auditing department, has carefully examined the partial information furnished by applicant and not including the original books prior to the year 1912, and from such examination has reached the following conclusions with reference to applicant's financial condition as bearing on this application:

1. That the provisions of applicant's trust deeds with reference to the establishment of sinking fund reserves have not been complied with.

2. That the United Railroads has exchanged with its owners their own promises to pay and has set them up in an account as sinking fund investments.

3. That a fictitious surplus or profit and loss account has been created.

4. That dividends have been paid out of such fictitious surplus to the detriment of the equity supporting the bonds.

5. That instead of setting up a heavy reserve to aid in retiring bonds which it now seems the company will be unable to pay at maturity, the company is continuing to pay out dividends.

It should be understood that the conclusions hereinbefore set out, have been reached on the partial information which has been submitted to the Commission, and that if an examination of the original books which the company has refused to supply should reveal a different condition, the responsibility for these conclusions, which we contend inevitably must be drawn from what evidence is before us, lies with the applicant because of its failure to submit its books for examination by the Commission.

It is an axiom that evidence supressed is deemed to be adverse, and having in mind this axiom certainly the Commission is justified in concluding that the books which the applicant refuses to produce at least would not better its showing.

We have above set out five general conclusions, which, as we have stated, are conclusions drawn from the only source from which the Commission can draw conclusions in this case, namely, from the partial accounting made to this Commission at and subsequent to the hearing by the applicant.

Because of the desire of this Commission that it be made plainly to appear that the failure to grant this application is due entirely to the action of the company and that the conclusions hereinbefore set out are justified, a brief review of the evidence which the applicant has offered should be made.

The following appears from the minute book of applicant, an inspection of which was had:

On December 21, 1908, the common capital stock was reduced in the sum of $1,200,000 and on February 9, 1909, this sum was credited to profit and loss. The common stock at that time had no market value and as a result of this transaction, a false surplus was set up, and if out of this false surplus any part of the regular yearly dividend of $350,000 on the first preferred stock was paid, this was not only improper but illegal.

From the statements submitted by Mr. Calhoun, President of the United Railroads, the item "Cash Invested in Securities for Sinking Funds" in the amount of $4,062,518.30, is credited to profit and loss account, or surplus. This seems to be the regular practice of applicant with regard to its sinking funds, and in essence means that having created a reserve for the sinking funds it was immediately taken out again and put in surplus, and may have been used for purposes foreign to the sinking funds.

The only evidence submitted to the Commission, other than the mere unsigned typewritten statements exhibited but not filed, of the condition of the various sinking funds of applicant, appears in the minute book in an entry dated January 25, 1912, which is a copy of a report made to the Board of Directors of the United Railroads of San Francisco by two of the directors, Charles Holbrook and Thornwell Mullally. In this report appears the following statement of securities found by these directors in the sinking fund:

"$782,241.93 of United Railways Investment Company's 6 per cent Serial notes of 1908, secured by 11,173 shares of first preferred stock of United Railroads of San Francisco with dividend warrant No. 9 and all subsequent warrants attached.

$1,229,000 United Railways Investment Company's 20-year convertible gold debentures, pending printing and delivery of coupon bearing debentures, temporary debentures Nos. 1 to 1229, inclusive, for $1,000 each, held in lieu thereof.

$20,000 five-year 7 per cent promissory notes of Patrick Calhoun, dated May 23, 1911.

This makes a total of $2,031,241.93 in securities of such a character as does not justify their becoming a part of the sinking funds. Such sinking funds should consist either of cash, bonds of the issue for which the fund was established, underlying bonds, or securities of such a character as to put the probability of their being converted into cash at face value beyond reasonable question.

Assuming that promissory notes under any condition are proper sinking fund securities, they can only be proper where they are so thoroughly secured that their permanent value is assured. As to the promissory notes and debentures of the United Railways Investment Company, the [illegible] apparent security behind them is the earnings on the stock of the United Railroads of San Francisco, owned by this Investment Company, and as the Directors of the United Railroads of San Francisco may withhold dividends at their pleasure, it is evident that it is within the power of applicant, at any time, to destroy or impair the security of these notes, and hence their value, unless the investment company has assets or income from other sources ample to give securities to these notes.

As to the income of the Investment Company, other than that derived from the United Railroads of San Francisco, no data has been furnished.

As to the $20,000 promissory note of Mr. Calhoun there does not appear to be any security back of it, except the personal responsibility of the maker, and this, of course, is not a proper security to be found in a sinking fund. It is stated that this note has since been eliminated from the sinking funds.

In addition to the above, we find notes receivable, as shown by a minute entry of January 25, 1912, in a report made by the same directors as above noted, the following:

> "$56,080.26 of United Railways Investment Company's Serial notes, maturing August 15, 1914, and August 15, 1915, respectively, secured by 801 shares of first preferred capital stock of United Railroads of San Francisco, with dividend warrant No. 9, and all subsequent warrants attached.
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> $703,000 promissory notes of San Francisco Railway and Power Company, dated August 24, 1909, payable on demand, interest at 5 per cent per annum (interest paid to June 30, 1911), secured by 970 San Francisco Electric Railway 5 per cent mortgage bonds, of which 804 bonds are rehypothecated."

The San Francisco Railway and Power Company is a subsidiary of the United Railways Investment Company.

There is nothing to show the value of these notes and in view of the close relationship of the makers of these notes and the United Railroads, evidence is necessary to show that they are something more than in effect promises of the gentlemen in control of these companies to pay themselves.

In the minutes of May 25, 1910, it appears that four years' "back salary" was voted to Patrick Calhoun, President of the United Railroads of San Francisco, in the sum of $75,000 a year, or a total of $300,000. No explanation is made of this item, but it at once suggests the necessity of a thorough investigation in order to determine the items claimed by applicant as operating expenses of the United Railroads over a series of years. This investigation is particularly necessary in view of the claims made by the officials of applicant that its net earnings, after deducting operating expenses, have been ample to provide for sinking fund requirements, pay interest on obligations, dividends on the first preferred stock of $350,000 a year, and leave a surplus. Of course, the question of whether or not such a net earning has been made depends, among other things, upon the character of the items going to make up the operating expense account.

In the minutes of May 18, 1910, appears a resolution empowering the United Railroads to purchase from the United Railways Investment Company, $1,229,000 of its 20-year convertible gold debentures and to deliver in payment therefor, the notes of the United Railroads to the total amount of $1,229,000. In this resolution it was provided that the president of the United Railroads, or his assistant, be authorized to sell these debentures of the United Railways Investment Company to the sinking funds of the Market Street Railway Company or its constitutents, the Sutter Street Railway Company, at 95 per cent of their par value.

This is a very dubious transaction. In effect the United Railroads gives its notes in the sum of $1,229,000 to the holder of its stock, the United Railways Investment Company, and the United Railways Investment Company in return gives its notes, or debentures, in the same amount of $1,229,000 to the United

Railroads. The United Railroads then turns these debentures of the United Railways Investment Company into the sinking funds.

The testimony of Mr. Black, given at the hearing to the effect that this $1,229,000 "went into additions and improvements properly chargeable to capital amount stock" is not borne out by the facts, since it appears that instead of going into "additions and improvements" it went in the shape of promissory notes into the sinking fund.

From the minutes of August 16, 1912, it appears that the Railroad and Power Development Company, a subsidiary of the United Railways Investment Company, was indebted to the United Railroads in the sum of $1,725,284.77, and on August 16, a settlement was ratified by which the United Railroads accepted in payment of this sum of $1,725,284.77, five promissory notes, or debentures of the Railroad and Power Development Company, payable 5 years from date, of the aggregate amount of $873,884.77 and 8514 shares of capital stock of the United Railroads of San Francisco. This is a transaction in a large amount, which seriously affects the assets of applicant and requires thorough investigation to determine the result on the financial condition of applicant.

In the minutes of August 16, 1912, appears a resolution declaring dividend No. 10, of $200,000 on the preferred stock of the United Railroads, the dividend to be paid on January 15, 1913. This dividend is in addition to the dividend of $350,000 regularly paid on the first preferred stock. It is the law, and is certainly sound practice, that dividends be only paid out of net surplus earnings, and the propriety of this proposed dividend No. 10, in view of the situation hereinabove presented, is questionable.

In addition to all that has heretofore been stated, applicant is burdened with approximately $40,000,000 of outstanding bonds, and it is conceded that in 1927 when the issue of United Railroads 4 per cent bonds becomes due, there will be approximately

$20,000,000 face value of these bonds which the company will be unable to pay at that time, and in view of the fact that many of the important franchises of applicant will expire at and within a few years after 1929, it cannot be said that the financial condition of applicant is sound, unless it be shown that all of its outstanding obligations not only can, but will be paid at maturity, or at least at the time when many important franchises of applicant expire.

No such showing has been made to the Commission, and as the bondholders must rely upon the sinking fund provided for in the trust deed under which the United Railroads 4 per cent bonds are issued, and whatever physical value of property may exist at the time of the maturity of these bonds, in the judgment of this Commission, these bonds, at this time, are not certain of payment in full.

In order to safeguard the payment of the obligations of applicant when they fall due, a large part of the surplus income of applicant should be diverted to these securities and it appeals to this Commission as proper that the payment of dividends on the large amount of capital stock outstanding should be deferred to the security of these bonds.

The condition of this company affords a striking illustration of the evils of over capitalization. With a gross revenue of $8,173,113.91 per annum and a net operating revenue of $3,916,374.55 per annum, this company apparently is unable to make much needed extensions and to maintain its service in first class condition. This is so because there is absorbed out of its earnings interest on its bonded and other indebtedness of $1,999,893.86 per annum, and $350,000 dividends on its first preferred stock. If this company were conservatively capitalized, there would be ample funds derived from earnings to put the entire property in first class condition, make all needed extensions, pay all fixed charges and dividends on a reasonable amount of capital stock.

Upon the failure of applicant to produce the books, as requested, it was announced that no order would be made granting this application, and in view of the fact that these books have not been produced, although ample time has been given, it is the conclusion of this Commission that this application should be denied and that it be understood that no favorable action will be taken by this Commission on any application presented by the United Railroads, or its subsidiaries, until the information demanded by the Commission has been furnished.

O R D E R

Application having been made to the Railroad Commission of the State of California by United Railroads of San Francisco, for an order authorizing the issue by said company of $2,350,000 face value of 5-year promissory notes bearing interest at the rate of 6 per cent per annum,

And a hearing having been duly held and it appearing to the Commission that for the reasons set out in the foregoing opinion said application should be denied,

IT IS HEREBY ORDERED that the Railroad Commission of the State of California does hereby deny said application.

The foregoing opinion and order are hereby approved and ordered filed as the opinion and order of the Railroad Commission of the State of California.

Dated at San Francisco, California, this 4th day of February, 1913.

John M. Eshleman
H. D. Loveland
Alex Gordon
Max Thelen
Edwin O. Edgerton

Commissioners.