The Strange Career of Independent Voting Trusts in U.S. Rail Mergers

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Abstract

Voting trust arrangements have a long history at both the Interstate Commerce Commission and the Surface Transportation Board as devices to protect the incentives of acquiring firms and maintain the independence of acquiring and target firms during the pendency of regulatory investigation of the merger proposal. However, they are not without problems. The STB argued in 2001 that as Class I railroads have become fewer and larger, it may be difficult to find alternative purchasers for the target firm if the STB turns down the proposal. The Antitrust Division argued in 2016 that joint stock ownership creates anticompetitive and/or otherwise undesirable incentives, even if the independence of the voting trustee is complete. On the other hand, the functions served by voting trusts in railroad mergers are served by merger termination fees and other contractual "lockup" mechanisms in other parts of the economy, without the same incentive problems as voting trusts. Thus voting trusts may no longer serve a useful function in railroad merger deliberations.

Keywords: railroads, mergers, voting trusts, merger termination fees, merger lockup provisions

JEL codes: L92, G34, D82, K23, N72

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Introduction

In November 2015, the Canadian Pacific Railway Company (CP) made an unsolicited bid to acquire the Norfolk Southern Railway Company (NS). This was the first merger proposal among Class I railroads since the imposition by the Surface Transportation Board (STB) of increased scrutiny for such mergers announced in its *Major Rail Consolidation Procedures* decision of June 2001.[1] Over almost a century it had become standard practice in the U.S. railroad merger process for the acquiring company to be permitted to purchase the shares of the target upon announcement of the deal and then to place the shares in an independent voting trust during the pendency of the investigation of the proposal by the Interstate Commerce Commission (ICC) or STB. CP proposed a variant of this arrangement: rather than CP buying the shares of NS and placing them in an independent voting trust, CP would buy the shares of NS but then a) place *its own shares* in an independent voting trust, and b) immediately replace the CEO of NS with the CEO of CP.

The proposal quickly stirred up controversy in the railroad industry. In its *Major Rail Consolidation Procedures* decision, the STB had noted the increased concentration of the U.S. rail sector at the national level and expressed concerns both about further

[1] STB Ex Parte No. 482 (Sub-No. 1), decided June 7, 2001, decision service date June 11, 2001. The STB classifies railroads as Class I, II, or III according to their revenues; a railroad is defined as a Class I railroad if it has annual carrier operating revenues of $250 million or more in 1991 dollars. Currently there are seven North American class I railroads: Burlington Northern Santa Fe, Canadian National, Canadian Pacific, CSX, Kansas City Southern, Norfolk Southern, and Union Pacific. *See* U.S. Surface Transportation Board, *FY 2015 Annual Report*, https://www.stb.dot.gov/stb/docs/AnnualReports/Annual%20Report%202015.pdf, and U.S. Surface Transportation Board, *Reporting Requirements for Positive Train Control Expenses and Investments*, Docket No. EP 706, August 13, 2013, https://www.stb.dot.gov/decisions/readingroom.nsf/fc695db5bc7ebe2c852572b80040c45f/9e3bab823b70ef9385257bc7004e9fad?OpenDocument.

mergers among class I railroads and about the use of independent voting trusts in such deals:

> [W]e believe that, with only a limited number of major railroads remaining, we must take a much more cautious approach to future voting trusts in order to preserve our ability to carry out our statutory responsibilities.[2]

NS declined to accept the CP merger offer and released a white paper from two former STB commissioners arguing that the STB would be unlikely to approve either this unusual voting trust arrangement or the merger transaction itself.[3] Two of the largest Class I railroads, the Burlington Northern Santa Fe (BNSF) and the Union Pacific (UP), stated their opposition to the merger, arguing that, if approved, it would lead to further industry consolidation into a very small number of transcontinental railroads.[4] When CP proceeded to file at the STB in March 2016 requesting approval of the proposed voting trust arrangement, the Antitrust Division of the Justice Department filed its own statement of opposition, as did many shippers and shippers' groups.[5] Finally, in the face

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[2] The Board also noted that "This approach is consistent with the view expressed by CSX at oral argument that, while voting trusts can serve some public purpose, they should not be used routinely, but rather should be available only for those rare occasions when their use would be beneficial." *Major Rail Consolidation Procedures* at 19 and 240.

[3] Norfolk Southern Corporation, "Norfolk Southern Releases White Paper from Former Surface Transportation Board Commissioners: Former Commissioners Francis Mulvey and Charles Nottingham Agree with the Norfolk Southern Board of Directors that the STB Would Be Highly Unlikely to Approve a Voting Trust or the Transaction Proposed by Canadian Pacific," December 7, 2015, http://www.nscorp.com/content/nscorp/en/news/norfolk-southernreleaseswhitepaperfromformersurfacetransportatio.html.

[4] Reynolds Hutchins, *CP-NS merger would fuel biggest rail industry shake-up since Staggers Act*, J. of COMMERCE, January 26, 2016, http://www.joc.com/rail-intermodal/class-i-railroads/canadian-pacific-railway/cp-ns-merger-would-fuel-biggest-rail-industry-shake-staggers-act_20160126.html.

[5] "Reply of the United States Department of Justice" before the Surface Transportation Board, Canadian Pacific Railway Limited – Petition for Expedited Declaratory Order, Finance Docket No. 36004, April 8, 2016, https://www.justice.gov/atr/file/839531/download.

of a wall of opposition, CP abandoned the proposal, seeing "no clear path to a friendly merger" with "the political and economic environment … against us."[6]

A substantive investigation of the proposed merger by the STB would likely have led to multiple interesting and important debates. The combination would have been largely an "end-to-end" merger (where one merging railroad carries traffic from A to B, while the other railroad carries traffic from B to C) rather than a "parallel" merger (where both railroads carry traffic between A and B, though perhaps over very different routings and distances). The ICC and its successor the STB have traditionally found little likely harm to competition in end-to-end rail mergers.[7] This is despite the well established empirical finding that connecting railroads – that is, the partners in end-to-end mergers – often compete with each other for traffic traveling to or from their points of intersection. Two well documented examples are U.S. railroads competing to carry grain originating at common origins in the plains states to different domestic destinations for export and Mexican railroads competing to carry freight in both directions between Mexico City and different port cities.[8]

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[6] Jacquie McNish and Laura Stevens, *Canadian Pacific Drops Efforts to Merger With Norfolk Southern*, WALL ST. J., April 11, 2016, http://www.wsj.com/articles/canadian-pacific-drops-efforts-to-merge-with-norfolk-southern-1460375864.

[7] See, for example, Russell Pittman, *Railroads and Competition: The Santa Fe/Southern Pacific Merger Proposal*, 39 J. INDUSTRIAL ECON. 25 (1990) and John E. Kwoka, Jr., and Lawrence J. White, *Manifest Destiny? The Union Pacific and Southern Pacific Railroad Merger*, in Kwoka and White, eds., THE ANTITRUST REVOLUTION: ECONOMICS, COMPETITION, AND POLICY (4th ed., 2004).

[8] James M. MacDonald, *Competition and Rail Rates for the Shipment of Corn, Soybeans, and Wheat*, 18 RAND J. ECON. 151 (1987); MacDonald, *Railroad Deregulation, Innovation, and Competition: Effects of the Staggers Act on Grain Transportation*, 37 J. LAW & ECON.63 (1989), 63-95; J. Campos, *Lessons from railway reforms in Brazil and Mexico*, 8 TRANSPORT POL. 85 (2001); Stephen Roop, Jeffery Warner, Felipe Zambrano, Roubabah Ismailova, and Dong-Hun Kang, THE IMPACT OF MEXICAN RAIL PRIVATIZATION ON THE TEXAS TRANSPORTATION SYSTEM (Texas Transportation Institute, February 2001), http://d2dtl5nnlpfr0r.cloudfront.net/tti.tamu.edu/documents/2128-2.pdf; International Transport Forum, PEER REVIEW OF RAILWAY FREIGHT DEVELOPMENT IN MEXICO (February 2014); Russell Pittman, *Railways Restructuring and Ukrainian Economic Reform*, 2 MAN & THE ECONOMY 87 (2015).

In addition, there were as noted already concerns expressed about the increased concentration in the U.S. freight rail sector at the national level – from over two dozen Class I railroads in 1980 to fourteen in 1991 to seven today – and any further reduction was likely to raise policy issues in a number of areas beyond that of the loss of competition to existing shippers, including fears of the loss of competition for locating new industrial plants, the reduced number of firms engaged in innovation and experimentation, and the "too big to fail" phenomenon more often applied to financial markets.[9]

What was somewhat remarkable about this episode, however, was the attention devoted and controversy sparked by the independent voting trust proposal itself. As the CP noted and argued, independent voting trusts had been a standard part of U.S. freight railroad mergers for decades – CP calculated that the ICC and STB combined had accepted 144 out of the 144 proposed voting trust proposals placed before them between 1980 and 2016.[10] On the other hand, there had been no mergers among Class I railroads proposed – and thus no independent voting trusts between two Class I railroads created – since the strengthening of the scrutiny of such arrangements announced by the STB in 2001. Furthermore, the novel aspects of this particular proposal – in particular the plan to immediately replace the CEO of the target with the incumbent CEO of the acquirer – raised concerns about the independence of NS during the pendency of an STB review.[11]

[9] See, for example, Russell Pittman, *The Economics of Railroad "Captive Shipper" Legislation*, 62 ADMIN. LAW REV. 919, 934 (2010).
[10] Canadian Pacific Railway, "CP-NS: A Comprehensive Approach to Regulatory Approval," February 2016, http://www.cpr.ca/en/investors-site/Documents/Comprehensive-Approach-to-Regulatory-Approval.pdf.
[11] Bill Stephens, *Freight alliance questions CP's voting trust proposal*, TRAINS MAGAZINE, March 31, 2016, http://trn.trains.com/news/news-wire/2016/03/31--cp-voting-trust.

More important, as it turned out, may have been the specific concerns brought to bear by the STB itself and the Antitrust Division of the Justice Department. The STB's cautionary language in the *Major Rail Consolidation Procedures* decision laid particular emphasis not so much on general worries about railroad firm size and industry concentration as on the very concrete issue of the ability to find an alternative purchaser for a very large railroad enterprise if and when the STB turned down a rail merger proposal after the target's shares had been placed in a voting trust.

The Antitrust Division, on the other hand, attacked the fundamental incentive structures created by the very nature of independent voting trusts. The Division applied the logic of the analysis of partial ownership of one competitor by another to argue that, like such partial ownership arrangements in general, the use of an independent voting trust during the pendency of STB investigation of a merger proposal created incentives for the softening of competition between the two firms – even if the day-to-day management of one of the firms was shielded from direct influence by the existence of the trust. The Division further argued that even if the relationship between the firms was more vertical than horizontal – in this case, more end-to-end than parallel – the voting trust arrangement would provide incentives for relationship-specific investments in capital that would remain in place long after a possible negative regulatory decision. The arguments expressed by the Division were new ones in the context of STB merger proceedings, and may have been decisive in convincing CP not to proceed.

This paper examines the history of the institution of independent voting trusts in the US rail industry, addressing the seeming puzzle of their widespread and historic use in the rail industry vis-à-vis their general absence in the context of mergers in other industries. I argue that independent voting trusts raise issues of potentially anticompetitive (or otherwise welfare harming) incentives during the pendency of regulatory review that seem not to be raised by alternative contractual mechanisms that acquirers and targets in other industries rely on to deal with the same issues of risk and incentives addressed by independent voting trusts in railroads. I conclude that independent voting trusts have probably outlived their usefulness in the STB merger review context.

Independent voting trusts and U.S. railroads

The voting trust – the formal delegation by shareholders of control of a corporation to a separate group of trustees, independent in various ways of day-to-day influence by those shareholders – has a long history in the area of corporate control in the United States, especially but not exclusively in the railroad industry.[12] In the second half of the nineteenth century, voting trusts were often set up as a tool of reorganization in connection with the bankruptcy of a railroad company, in order to assure debtors that the quality of management would be maintained during the recovery process. Two well documented early examples were the reorganization of the Pittsburgh, Fort Wayne and Chicago Railroad in 1859-62[13] and the reorganization of the Philadelphia and Reading

[12] Much of the historical discussion here is derived from Simeon E. Baldwin, *Voting-Trusts*, 1 YALE L.J. 1 (1891); Edward Sherwood Meade, *The Reorganization of Railroads*, 17 ANNALS AMER. ACAD. POL. AND SOCIAL SCIENCE 25 (1901); Stuart Daggett, RAILROAD REORGANIZATION (Harvard Economic Studies, v. iv) (1908, repr. 1967); Harry A. Cushing, VOTING TRUSTS: A CHAPTER IN RECENT CORPORATE HISTORY (1916); John Anton Leavitt, THE VOTING TRUST: A DEVICE FOR CORPORATE CONTROL (1941); James B. Eckert, *Review* of Leavitt, THE VOTING TRUST, 32 AMER. ECON. REV. 387 (1942); and John Warren Giles, *Is the Voting Trust Agreement a "Dangerous Instrumentality"?*, 3 CATHOLIC U. L. REV. 81 (1953).

[13] *See* J.F.D. Lanier, *Winslow, Lanier and Company*, SKETCH LIFE OF J.F.D. LANIER (1870), excerpted in Alfred D. Chandler, Jr., THE RAILROADS: THE NATION'S FIRST BIG BUSINESS (1965*). See also* PENNSYLVANIA COMPANY: CORPORATE HISTORY OF THE PITTSBURGH, FORT WAYNE AND CHICAGO RAILWAY COMPANY (1875), http://books.googleusercontent.com/books/content?req=AKW5QacOt9RbVxqTSl4KV4fuRH-K7-qcp48HYgcwW2HOH6YSGR6qUVFWQNKyQ13loFho_0dlaONe_YWxI2XztvsL6ddsmqOhCSGjyYXkkBRUeOqi

Railway in 1887 and again in 1897.[14] Eventually the voting trust became a standard component of the many railroad reorganizations undertaken by J.P. Morgan and others following the panic of 1893.[15]

There were critics, including most famously Adolf Berle and Gardiner Means, who expressed concern that voting trusts could be used by unscrupulous managers to insulate themselves from shareholder control – one example out of many business and financial arrangements that those authors believed separated ownership from control, to the detriment of management accountability and firm performance.[16] Simeon Baldwin noted early on that there might be limits on the completeness with which shareholders should or legally could sign away their own rights of control.[17] However, John Warren Giles noted that the ICC did not seem to share the concerns of either commentators or the Securities and Exchange Commission (SEC) about the loss of shareholder control, at least when trusts were utilized under carefully specified circumstances and for limited durations.[18]

Early in the twentieth century, voting trusts began to be used, particularly in the railroad industry, for a new purpose: as a device for creating or maintaining the

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[14] *See* Jules Irwin Bogen, THE ANTHRACITE RAILROADS: A STUDY IN AMERICAN RAILROAD ENTERPRISE (1927), at 251, and N.S.B. Gras and Henrietta M. Larson, *J. Pierpont Morgan*, in CASEBOOK IN AMERICAN BUSINESS HISTORY (1939), excerpted in Chandler, *ibid.*

[15] Charles H. Burr, Jr., *The Validity of Voting Trust Provisions in Recent Railroad Reorganizations*, 35 AMER. L. REG. AND REV. 413 (n.s., 1896); Arthur S. Dewing, *The Purposes Achieved by Railroad Reorganization*, 9 AMER. ECON. REV. 277 (1919); Gras and Larson, *ibid.*; E.G. Campbell, THE REORGANIZATION OF THE AMERICAN RAILROAD SYSTEM, 1893-1900 (1938); Herbert E. Dougall, *Review* of Campbell (1938), 46 J. POLITICAL ECON. 420 (1938).

[16] Adolf A. Berle, Jr., and Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[17] Baldwin, *supra* note 12. The issue was also raised by Charles Burr, *supra* note 15, and Harry Cushing, *supra* note 12.

[18] Giles, *supra* note 12.

independence of two companies either until their independent ownership could be effected or during the pendency of regulatory review of a merger proposal. This regulatory application was presaged in one of the first major cases brought under Section 2 of the Sherman Act[19] – the section that prohibits the monopolization or attempted monopolization of a market – when the Department of Justice, in the person of Louis Brandeis, forced the J.P. Morgan interests that controlled the New York, New Haven & Hartford Railroad to divest themselves of the shares of both the Boston & Maine Railroad and of various local trolley companies in Connecticut and Rhode Island, in both instances requiring the creation of independent trusts to manage the operations of the companies until the eventual disposition of their shares.[20]

The earliest use of independent voting trusts by the ICC as a way to separate the control of multiple railways during the pendency of a regulatory review seems to have been two cases involving the acquisition by the Baltimore and Ohio Railway Company (B&O) of the shares of its competitors. In 1929 the ICC found that the B&O's acquisition of the stock of the Wheeling & Lake Erie Railway violated Section 7 of the Clayton Act[21] – the section that addresses anticompetitive mergers and acquisitions – and ordered the B&O to divest itself of the stock. B&O's sale of the stock to an independent trustee for purposes of eventual disposition on the stock market was found to resolve the problem:

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[19] 15 U.S.C. §2.

[20] See, for example, William Z. Ripley, RAILROADS: FINANCE & ORGANIZATION (1915), at 571-74; Leavitt, *supra* note 12, at 93; John L. Weller, THE NEW HAVEN RAILROAD: ITS RISE AND FALL (1969), at 161-195; Thomas A. Barnaco, *Brandeis, Choate and the Boston & Maine Merger Battle, 1908-1914*, 3 MASS. LEGAL HIST. 125 (1997); and *New Haven Road to Be Dissolved: Railroad's Representatives Accept Arrangements Suggested by Attorney General McReynolds*, SPARTANBURG HERALD, March 22, 1914, https://news.google.com/newspapers?nid=1876&dat=19140322&id=0k0sAAAAIBAJ&sjid=4skEAAAAIBAJ&pg=6938,3824235&hl=en.

[21] 15 U.S.C. §18.

> The substantial effect of this trust agreement is to vest the title of the interdicted stock and the power of voting it in a person as trustee, independent of the present holders of the stock and of the other defendants, thus, in effect, accomplishing the result sought in the Clayton Act proceedings.[22]

In the following year the B&O was found by the ICC to have again violated the Clayton Act by acquiring the stock of the Western Maryland Railway Company – in this case the focus was on the fact that they had done so without seeking advance approval from the ICC – and once again the placement of the shares in an independent voting trust was found to resolve the issue.[23]

At about the same time, the ICC began to address its mandate from the Transportation Act of 1920 to develop a "master plan" for the consolidation of U.S. railroads into a financially sound and competitive system.[24] The ICC duly commissioned and published a proposed national railway system plan constructed by Harvard economics professor William Ripley and began holding hearings on its implementation. In its first extensive decision discussing implementation, the Commission referred several times, at worst neutrally and at least once seemingly approvingly, to the use of independent voting trusts as a device to maintain managerial and operational

[22] *Interstate Commerce Commission v. Baltimore & Ohio Railroad Company*, No. 21012, 152 I. C. C. 721 (1929), 156 I. C. C. 607, 609 (1929).

[23] *Interstate Commerce Commission v. Baltimore & Ohio Railroad Company*, No. 21032, 160 I. C. C. 785 (1930), 183 I. C. C. 165 (1932).

[24] See, e.g., Edgar J. Rich, *The Transportation Act of 1920*, 10 AMER. ECON. REV. 507 (1920); Lewis H. Haney, THE BUSINESS OF RAILWAY TRANSPORTATION (1924), Bliss Ansnes, *Federal Regulation of Railroad Holding Companies*, 32 COLUMBIA L. REV. 999 (1932); William Norris Leonard, RAILROAD CONSOLIDATION UNDER THE TRANSPORTATION ACT OF 1920 (1946, repr. 1968); Carl Helmetag, Jr., *Railroad Mergers: The Accommodation of the Interstate Commerce Act and Antitrust Policies*, 54 VIRGINIA L. REV. 1493 (1968); James C. Johnson and Terry C. Whiteside, *Professor Ripley Revisited: A Current Analysis of Railroad Mergers*, 42 ICC PRACTITIONER'S J. 419 (1975); and Michael R. Crum and Benjamin Allen, *U.S. Transportation Merger Policy: Evolution, Current Status, and Antitrust Considerations*, 13 INT'L J. OF TRANSPORT ECON. 41 (1986).

independence among railroad companies with (for a time) common ownership. For example:

> We cannot, therefore, give our approval to any application of the Pennsylvania Railroad Company designed and seeking to carry into effect any portion of so much of the proposed four-system plan [for New England] … unless and until that railroad company either has divested itself of all stock held by it both directly in the New Haven and indirectly … in the New Haven and the Boston & Maine, or has placed all such stock in the hands of independent trustees approved by us as in the public interest….[25]

At the same time, the Commission and Congress considered legislation that would have allowed the Commission to order divestitures of railroads controlled by railroad holding companies whose combinations of railroads was inconsistent with the Ripley plan, with the shares of divested roads to be placed in voting trusts to allow for their gradual sale into the depressed stock market.[26]

Broadly similar proposals for the use of independent voting trusts to maintain the independence of two railroad companies temporarily held in common ownership continued to be accepted or even ordered by the ICC in the forties,[27] fifties,[28] and

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[25] *Consolidation of Railroads: In the Matter of Consolidation of the Railway Properties of the United States into a Limited Number of Systems*, No. 12964, 185 I. C. C. 403, 414 (1932).
[26] *Regulation of Railroad Holding Companies*, Hearings on H.R. 9059 to amend section 5 of the Interstate Commerce Act, House Committee on Interstate and Foreign Commerce, February and March 1932.
[27] *Wabash Railroad Company Control*, Finance Docket No. 13235, 247 I. C. C. 365 (1941*); Chesapeake & Ohio Railway Company Purchase Etc.*, Finance Docket No. 14692, 261 I. C. C. 239 (1945).
[28] *Central of Georgia Railway Company Control*, Finance Docket No. 19159, 295 I. C. C. 563 (1957); *New York, Chicago & St. Louis Railroad Company Control*, Finance Docket No. 17883, 295 I. C. C. 703 (1958).

sixties.[29] By the late fifties the Commission was treating such arrangements as standard operating procedure:

> Voting-trust agreements have long been accepted by the Commission as a means of effecting compliance with the law in connection with holdings of stock in one railroad by another and without which the continued ownership of the stock might be considered unlawful and contrary to the public interest.[30]

Similarly:

> [This] trust agreement was drafted in terms obviously designed to meet the requirements for independent voting trusts heretofore approved and/or prescribed by the Commission in a number of proceedings involving the question of one carrier's control of another where the object of the trust was to bar the beneficial owner of the securities from participation in the control, management, and operation of the issuing carrier.[31]

When put to the test, the use of independent voting trusts for such purposes by the Commission – and later by the Surface Transportation Board – was upheld by the courts.[32]

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[29] *Pennsylvania Railroad Company – Control – Lehigh Valley Railroad Company*, Finance Docket No. 21459, 317 I. C. C. 139 (1962); *Norfolk and Western Railway Company and New York, Chicago and St. Louis Railroad Company – Merger, Etc.*, Finance Docket No. 21510, 324 I. C. C. 1 (1964*); Chesapeake & Ohio Railway Company and Baltimore & Ohio Railroad Company – Control – Western Maryland Railway Company*, Finance Docket No. 23178, 328 I. C. C. 684 (1967).

[30] *New York, Chicago & St. Louis Railroad Company Control*, Finance Docket No. 17883, 295 I. C. C. 703, 715 (1958).

[31] *Missouri Pacific Railroad Company – Control – Chicago & Eastern Illinois Railroad Company*, Finance Docket No. 21755, 327 I. C. C. 279, 319-20 (1965).

[32] *Illinois Central Railroad v. United States*, 263 F.Supp. 421 (1967); *B.F. Goodrich Company v. Northwest Industries and Interstate Commerce Commission*, 303 F.Supp. 53 (1969); City of Ottumwa v. Surface Transportation Board, 153 F.3d 879 (1998).

What's wrong with independent voting trusts?

Figure 1 shows a schematic diagram of the voting trust arrangement proposed by CP in its bid to purchase NS. As is clear from the diagram, under such an arrangement a single "holding company" owns all the shares of both Company A and Company B but "controls" only Company B – Company A is controlled by the Independent Trustee.

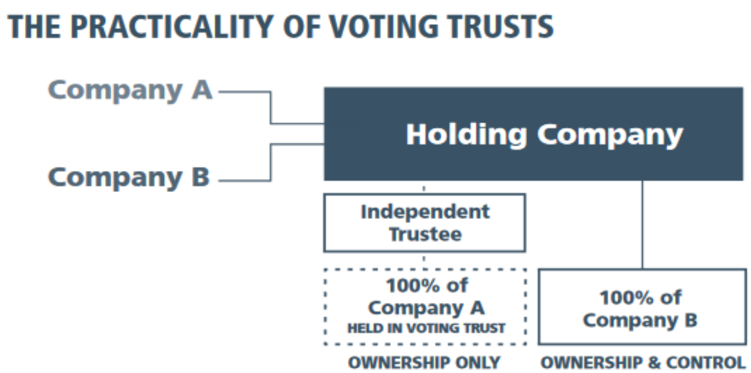

Figure 1. The Voting Trust. Source: Canadian Pacific Railway, "CP-NS: A Comprehensive Approach to Regulatory Approval," February 2016.

In the many decades of ICC and STB consideration of proposals for the creation of independent voting trusts to maintain the independent management and operation of two railroads whose shares had been placed in common ownership, the lion's share of the attention by all participants was devoted to discussion of the precise terms of the contracts that set up the trusts: regulators and courts sought assurances that the trustees would be in fact independent of control or even influence from the acquiring company and its shareholders. For example:

> The creation of voting trusts as a means of satisfying the provisions of section 5 cannot be effective for that purpose unless and until we are satisfied that the trusts constitute an actual divestiture of control.[33]

As noted above, in its *Major Rail Consolidation Procedures* decision of 2001, the STB expressed a newly heightened level of concern about the use of voting trusts in merger proceedings involving the class I railroads. However, the Board's stated principal concern was not trustee independence but rather the ability of the acquiring firm to find an alternative buyer of the target firm assets in the event of eventual STB denial of the merger application:

> [I]t is precisely the divestiture process that now concerns us. When the ICC denied the application in SF/SP, at least two Class I railroads – the Denver and Rio Grand Western Railroad and KCS – were actively involved in bidding for SP when it had to be divested from the voting trust into which its stock had been placed pending the application. In contrast, today there would likely be cases where there would be *no* remaining railroad bidders acceptable to us to buy the shares held in a voting trust if we were to deny a major control transaction or impose conditions that the applicants choose not to accept.[34]

In this paper I focus on a different issue – as the Antitrust Division did in its filing before the STB in the CP/NS proceeding. Even assuming the effectiveness of the voting trust contract in effecting the complete independence of Company A from control or influence by Company B and its shareholders, under the voting trust arrangement

[33] *Central of Georgia Railway Company Control*, 295 I. C. C. 563, 576 (1957). *See also Voting Trust Rules*, 44 FED. REG. 202, October 17, 1979, concerning the investigation by ICC staff as to "whether the voting trust effectively insulates the [applicant] from any violation of Commission policy against unauthorized acquisition of control of a regulated carrier."

[34] *Major Rail Consolidation Procedures* at 19, footnote omitted, emphasis in original.

outlined in Figure 1 Company B is controlled by shareholders who also own the shares of Company A. This raises competitive concerns that are quite familiar from the literature addressing the acquisition by a firm of shares of its competitor, sometimes termed "horizontal shareholding".[35]

In particular, using standard railroad industry analysis, there are two broad ways in which the CP and the NS likely currently compete for traffic. The most obvious is what is called in the railroad industry "source competition": competition for traffic originating and terminating at the points of intersection of the two railroads in and around Kansas City, Chicago, Detroit, Buffalo, and Albany. (See Figure 2.) CP and NS compete for traffic both originating at those points of intersection and terminating elsewhere (for example, grain headed out from Kansas City for export), and originating elsewhere and terminating at those points of intersection (for example, animal feed from a variety of origins competing for buyers in Kansas City). In addition, CP and NS compete with each other via "parallel competition" as parts of moves with different interline partners: traffic between Minneapolis and Atlanta, for example, could move via a CP/CSX routing or a BNSF/NS routing.

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[35] See, for example, Robert J. Reynolds and Bruce R. Snapp, *The Competitive Effects of Partial Equity Interests and Joint Ventures*, 4 INT'L J. OF INDUSTRIAL ORG. 141 (1986); Joseph Farrell and Carl Shapiro, *Asset ownership and market structure in oligopoly*, 21 RAND J. OF ECON. 275 (1990); Einer Elhauge, *Horizontal Shareholding*, 129 HARVARD L. REV. 1267 (2016); Amrita Nain and Yan Wang, *The Product Market Impact of Minority Stake Acquisitions*, 62 MANAGEMENT SCI. (2016), forthcoming; and Miguel Antón, Florian Ederer, Mireia Giné, and Martin Schmalz, *Common Ownership, Competition, and Top Management Incentives*, working paper, July 1, 2016 (finding that "executives are paid less for own performance and more for rivals' performance when the industry is more commonly owned").

Figure 2. The CP and NS railroad systems.

As is well demonstrated in the literature examining the impact of the ownership of an equity interest in one firm by a firm with which it competes, if and when Company A and Company B are competing for the same business, the shareholders to whom Company B managers report will not want Company B to behave too aggressively vis-à-vis Company A, because Company A's losses are their losses too.

But a corresponding logic applies to firms with vertical relationships. If and when Company A and Company B are cooperating for the same business – when traffic originating on the NS in Atlanta is traveling to a destination like Minneapolis that is served by CP but also by other railroads – the shareholders to whom Company B managers report will want the organization of interchange traffic to favor Company A rather than its competitors, all else equal, even if company A is not the most efficient partner for the traffic, because Company A's gains are their gains too. These factors are especially important in an industry like railroads where investments may be both relationship-specific (that is, productive only in the context of cooperation between those two railroads) and extremely long lived, so that improvements in infrastructure that favor interlining between Company A and Company B will survive long past a possible regulatory decision that prohibits the merger and returns the two companies to independent ownership.[36]

Thus regardless of the effectiveness of the voting trust contract in insuring the independence of the management of the firm in the trust, the very fact of the purchase of that company's stock and the combined ownership of the stock of the two firms creates incentives for behavior that may be anticompetitive or otherwise welfare-harming in the event of a decision to prohibit the merger.

What happens in other industries?

There is not a great deal of discussion in the historical record of the reasons behind the ICC's apparent favoring of the voting trust mechanism beyond the simple and straightforward statements in the decisions quoted from above. Giles notes that

> Quite in contrast with the extended expressions of opinion by Judges and text writers and members of the Securities and Exchange Commission as to the merits or dangers of voting trusts, we find a number of decisions by the Interstate Commerce Commission which either approve or disapprove of the employment of voting-trusts, but those decisions contain little editorial comment.[37]

[36] On relationship-specific investments in the railroad industry, see Russell Pittman, *Specific Investments, Contracts, and Opportunism: The Evolution of Railroad Sidetrack Agreements*, 34 J. LAW & ECON. 565 (1991).
[37] Giles, *supra* note 12.

As noted above, one rationale for the use of voting trusts in proposals to restructure the U.S. railroad system in the early 1930's was the depressed nature of the stock market at the time, and the associated fear of the consequences of placing a large number of shares of particular railroads on the stock exchange at a single point in time.[38] With regard to railroad merger proceedings at the ICC, the closest we seem to get to a positive rationale for the use of voting trusts must be inferred from the language in a dissenting opinion from Commissioner Farrell in 1930:

> In my opinion, … [section 7 of the Clayton Act] should be so construed as to permit one carrier to purchase a controlling interest in the stock of another carrier and hold the stock as an investment with the hope and expectation that such investment may be used later for consolidation purposes if the consolidation is approved by us. If such a purchase can not be made until after the intent to purchase has been advertised by an application made to us, it seems to me that it can not be made at all as a practical matter, because such advertisement would result in such an increase in the price demanded for the stock to be purchased that the purchase would not be in the public interest.[39]

Commissioner Farrell refers to issues that are by now well addressed in the broader finance literature. In the context of a potential merger, the potential acquiring firm expends resources as it searches for possible targets and investigates both the internal workings of those firms and the potential synergies of combining itself with them. When the potential acquirer announces its plan, it reveals information to the market that it has acquired from the expenditure of these resources. Other investors may

[38] *See Regulation of Railroad Holding Companies*, Hearings, *supra* note 26.
[39] *Interstate Commerce Commission v. Baltimore & Ohio Railroad Company*, No. 21032, 160 I. C. C. 785, 793 (1930), dissent of Commissioner Farrell.

free ride on this information to bid up the value of the stock of a target firm, and other potential acquirers may free ride on this information to make their own, competing merger proposals.[40]

One possible short-term outcome is the "winner's curse": the firm making the original announcement may win the bidding contest only if it is bidding more than the target is worth.[41] One possible longer-term outcome is that mergers that would have created synergies and so improved economic welfare do not take place, because the incentives for potential acquiring firms to expend the resources to find and merge with targets are reduced or eliminated by this free riding.

But this is not the only risk facing potential acquirers. There are a number of reasons that merger proposals may fail, including not only the appearance on the scene of competing acquirers but also rejection by boards of directors; delays, costs, and adverse decisions by antitrust or regulatory bodies; protectionist, uncooperative behavior by target firm management; and so on. Some of these are risks also faced by target firms as they consider and then enter into contracts with acquirers, and target firms face their own set of risks, including the loss of customers and employees following the merger announcement and, if a deal falls through, the market inference that the firm seeking to be the acquirer unearthed unfavorable information – what might be termed the "Miss Havisham effect".[42] None of these risks are unique to the railroad industry. How are they addressed in industries that do not utilize independent voting trusts?

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[40] *See* Richard S. Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. FIN. ECON. 141 (1983) and Heath Price Tarbert, *Merger Breakup Fees: A Critical Challenge to Anglo-American Corporate Law*, 34 LAW & POLICY IN INTL. BUSINESS 627 (2003).
[41] *See generally* R. Preston McAfee and John McMillan, *Auctions and Bidding*, 25 J. ECON. LIT. 699 (1987) and Richard H. Thaler, *Anomalies: The Winner's Curse*, 2 J. ECON. PERSPECTIVES 191 (1988).
[42] In a nod to the character who is left at the altar in Charles Dickens, GREAT EXPECTATIONS (1861).

In fact there are many contractual mechanisms designed exactly to address the allocation of these risks among the parties to a merger agreement. They include the following:

- On the acquiring firm side, the inclusion of break-up fees to be paid by the target firm if it accepts an alternative bid has become a standard component of merger agreements, arguably required by fiduciary rules in order to maintain the option of the target firm's directors and board to find the best deal for shareholders.[43]
- But break-up fees are not the only risk-allocation device available to acquiring firms. Other options – though apparently less frequently used – include stock lockups (giving the acquirer a call option on a specified number of shares in the target at a specified strike price), asset lockups (giving the acquirer a call option on certain assets of the target at a specified price), and, where permitted, no-shop provisions.[44]
- On the target firm side, the inclusion of break-up fees to be paid by the acquirer to the target in case the deal fails to go through – so-called "reverse termination fees" – has become increasingly common in recent years. These seem to have been mostly associated at first with private equity deals and the accompanying uncertainty regarding the ability of the acquirer to line up financing, but they have lately spread to the mainstream and arguably become more complex in structure

[43] See, e.g., John C. Coates, IV, and Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STANFORD L. REV. 307 (2000); Thomas W. Bates and Michael L. Lemmon, *Breaking up is hard to do? An analysis of termination fee provisions and merger outcomes*, 69 J. OF FINANCIAL ECON. 469 (2003); Micah S. Officer, *Termination fees in mergers and acquisition*, 69 J. OF FINANCIAL ECON. 431 (2003); and Brian J.M. Quinn, *Optionality in Merger Agreements*, 35 DELAWARE J. OF CORP. L. 789 (2010).

[44] See, e.g., Coates and Subramanian, supra note 29, and Wolfgang Bessler, Colin Schneck, and Jan Zimmermann, *Bidder contests in international mergers and acquisitions: The impact of toeholds, preemptive bidding, and termination fees*, 42 INT'L. REV. OF FINANCIAL ANAL. 4 (2015).

as well.[45] A notable recent example was the unsuccessful attempt by AT&T to purchase T-Mobile USA, which resulted in the payment by AT&T of a break-up fee to Deutsche Telekom, the parent firm of T-Mobile USA, of $3 billion in cash and a volume of cellular spectrum valued at at least $1 billion.[46]

- But reverse termination fees are not the only risk-allocation device available to target firms. Other options include "best efforts" and "hell or high water" clauses, obligations to litigate, specified divestiture obligations, "ticking fees" (increasing payments due to the target firm if closing recedes past a specified date), and termination dates.[47]

As a group, these tools are designed to allocate risks between acquirers and targets, in part in recognition of the sometimes lengthy time requirements imposed by deliberations of antitrust investigators, regulatory agencies, and courts. The use of investment voting trusts in the context of merger investigations at the ICC and STB was likely at least in part a response to the traditionally extended nature of such investigations and proceedings, but there are now statutory limitations on their duration.[48] In any case,

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[45] See, e.g., Elizabeth Nowicki, *Reverse Termination Fee Provisions in Acquisition Agreements*, paper presented at the 3rd Annual Conference on Empirical Legal Studies, Cornell University (2008); Afra Afsharipour, *Transforming the Allocation of Deal Risk Through Reverse Termination Fees*, 63 VANDERBILT L. REV. 1161 (2010). (May 2016); and Steven Epstein, *Mergers and Heightened Regulatory Risk*, Harvard Law School Forum on Corporate Governance and Financial Regulation, May 5, 2016.

[46] Michael J. de la Merced, *T-Mobile and AT&T: What's $2 Billion Among Friends?*, N.Y. TIMES, December 20, 2011, http://dealbook.nytimes.com/2011/12/20/att-and-t-mobile-whats-2-billion-among-friends/?_r=0.

[47] See, e.g., Darren S. Tucker and Kevin L. Yingling, *Keeping the Engagement Ring: Apportioning Antitrust Risk with Reverse Breakup Fees*, 22 ANTITRUST 70 (2008); Brian Burke and John Fedele, *Think Again – Allocating Antitrust Risk in a Climate of Protracted Investigations*, CPI ANTITRUST CHRON., May 2016 ; and Steven Epstein, *Mergers and Heightened Regulatory Risk*, Harvard Law School Forum on Corporate Governance and Financial Regulation, May 5, 2016.

[48] With regard to a proposed merger between two Class I railroads, the STB is required to publish a notice of the opening of an investigation in the *Federal Register* within thirty days of the parties' filing, to complete evidentiary proceedings within one year of the publication of the *Federal Register* notice, and to issue a decision within ninety days of the completion of evidentiary proceedings. 49 U.S.C. §11325.

investigations by the Antitrust Division, the Federal Trade Commission, the Federal Communications Commission, the Federal Energy Regulatory Commission, and the banking regulators – not to mention possible litigation – may be equally or even more time-consuming. It is not at all clear why contractual provisions that have become standard in merger contracts throughout the economy cannot perform the same risk allocation function in the railroad industry.

Conclusion

Voting trust arrangements have a long history at both the ICC and the STB as devices to protect the incentives of acquiring firms and to maintain the independence of acquiring and target firms during the pendency of Commission or Board investigation of the merits of the merger proposal. However, they are not without problems. As noted by the STB in 2001, as Class I railroads have become fewer and larger, it may be difficult to find alternative purchasers for the target firm if the STB turns down the proposal. As noted by the Antitrust Division in 2016, joint stock ownership creates anticompetitive and/or otherwise undesirable incentives, even if the independence of the voting trustee is complete.

On the other hand, whatever legitimate functions voting trusts serve in railroad mergers are served by simple lockup agreements and other contractual provisions in other parts of the economy, without the same incentive problems as voting trusts. It is thus not clear that voting trusts still serve a useful function in the context of railroad merger deliberations.