GAO

Report to the Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives

February 1987

CONRAIL SALE

DOT's Selection of Investment Banks to Underwrite the Sale of Conrail

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

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February 17, 1987

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

As requested in your November 24, 1986, letter, and as agreed to in subsequent discussions with your office, we are providing you with the results of our review of the Department of Transportation's (DOT) selection of six investment banks to serve as co-lead managers for the sale of the government's interest in the Consolidated Rail Corporation (Conrail). You raised a series of questions that encompassed two broad areas: (1) was DOT's selection in compliance with the Conrail Privatization Act, particularly section 4011(a)(2); and (2) was DOT's selection process fair and otherwise proper? We agreed with your staff to complete our audit work by January 5, 1987. On that date we briefed the majority and minority staff on the results of our work.

On the basis of our review of the law, examination of the documents DOT produced, and our interviews, we believe DOT's selection of the six co-lead managers, including one "book-runner"[1] to manage the sale, complied with the act. Although we did identify some discussions about Conrail between DOT and investment banks or their agents which occurred outside the formal selection process adopted by DOT, we do not believe these discussions affected the selection of the six co-lead managers or the book-runner. We conclude, therefore, that the selection process was fair and proper

To perform our review, we examined the act and its legislative history, applicable securities law, federal conflicts of interest statutes, and the American Bar Association (ABA) Code of Professional Responsibility and Rules of Professional Conduct, which for the most part govern attorneys' ethical duties to their clients. We reviewed the documents the Department produced for your Subcommittee and additional documents that we requested. Finally, we interviewed 17 people involved in the

[1]The "book-runner" is the co-lead manager that, pursuant to section 4011(a)(1) of the act, shall be designated by the Secretary to coordinate and administer the public offering of Conrail

Conrail sale (see app. I) and obtained written answers to the questions we asked the Secretary of Transportation.

Your questions about the selection of co-lead managers for the Conrail sale are addressed in detail in the following sections.

The Selection Process

The Northeast Rail Service Act of 1981 required the Secretary of Transportation to engage the services of an investment banking firm to sell the government's common stock in Conrail. In 1982, pursuant to this statutory mandate, DOT engaged Goldman, Sachs & Co. (Goldman Sachs) to provide financial advice and assistance regarding the sale of Conrail.

In September 1986, the Congress was completing work on legislation that would require the sale of Conrail through a public offering. Under the terms of Goldman Sachs' agreement with DOT, the investment bank could not continue to be DOT's adviser if it chose to participate in a public offering. Since Goldman Sachs wanted to participate in the public offering, DOT would lose both its investment adviser and the legal advice it had obtained through Goldman Sachs' law firm, Hughes Hubbard & Reed.

Faced with the loss of its financial adviser and without sufficient expertise in large-scale public offerings, DOT decided to retain independent counsel. Spurring the decision to seek this legal expertise was a provision in the draft legislation that required DOT to choose four to six co-lead managers within 30 days after the privatization act became law.

In mid-October, after DOT interviewed three law firms, Skadden, Arps, Slate, Meagher & Flom (Skadden) was chosen to advise DOT on the Conrail sale. The law firm was charged with providing legal and technical expertise to DOT. According to DOT officials and Skadden attorneys, the law firm was not expected to provide recommendations in favor of or against any of the investment banking firms that might seek to be co-lead managers to underwrite the sale of Conrail common stock. Further, although Skadden was to provide legal and technical expertise, all legal decisions were to be made by DOT attorneys.

Criteria Used in the Selection Process

After the privatization act became law on October 21, 1986, DOT established a two-round process for selecting between four and six investment banks. DOT published a notice in the Federal Register (51 Federal Register 37,813 (1986)) announcing the selection process and setting

forth the criteria by which the investment banks would be judged. These included the requirement of section 4011(a)(2) of the privatization act that DOT consider each firm's institutional and retail distribution capabilities, financial strength, knowledge of the railroad industry, experience in large-scale public offerings, research capabilities, reputation, and contributions in demonstrating and promoting the long-term financial viability of Conrail.

In response to this notice, 25 investment banks filed written applications with DOT. (See app. II.) On November 6 and 7, 24 of the applicants made presentations before a panel that included the Federal Railroad Administration's (FRA) Deputy Administrator, FRA's Special Counsel, DOT's Associate General Counsel, Conrail's Chairman of the Board, Treasury's Assistant Secretary for Domestic Finance, and Skadden attorneys. On the basis of applicants' written and oral presentations, DOT personnel developed a memorandum for the Secretary of Transportation that analyzed each investment bank in terms of the statutory criteria and separated the investment banks into three categories: those that should be invited back for the second round, those that should not be invited back, and those that were not clearly in either category. The recommendations of DOT's staff, Conrail, and Treasury were conveyed to the Secretary of Transportation. The Secretary then selected 12 investment banks to move forward to the second round of the selection process.

On November 13 and 14, the 12 finalists made their presentations before a panel that included DOT's Chief of Staff, FRA's Administrator, Conrail's Chairman of the Board, Treasury's Assistant Secretary for Domestic Finance, and Skadden attorneys. Transcripts were made of the second-round presentations at the Secretary of Transportation's request. DOT staff's, Treasury's, and Conrail's recommendations for the six co-lead managers and book-runner were given to the Secretary, along with a list of each finalist's strengths and weaknesses On November 20, the Secretary of Transportation selected Goldman Sachs, The First Boston Corporation, Merrill Lynch, Morgan Stanley & Co Incorporated, Salomon Brothers Inc , and Shearson Lehman Brothers as co-lead managers for the Conrail public offering. Goldman Sachs was chosen as the book-runner.

The Selection Complied With The Privatization Act

The privatization act directs the sale of Conrail by means of a public offering. The Secretary of Transportation, in consultation with Treasury and Conrail, was to choose four to six investment banks, including one book-runner, to underwrite a public offering of Conrail common stock within 30 days of the effective date of the act (by Nov 21, 1986) As indicated above, the Secretary was to consider or recognize seven criteria set forth in section 4011(a)(2) of the privatization act Further, section 4012(f) required the Secretary to ensure the opportunity for significant minority firm participation in the sale.

On the basis of interviews with DOT, Conrail, and Treasury participants in the selection process and a review of pertinent documents, we believe that the selection complied with the privatization act because, within the period of time mandated by the privatization act, the Secretary selected the co-lead managers after considering the criteria and consulting with Conrail and Treasury.

The First-Round Selection Complied With the Act

The statutory criteria were considered during the first round of the selection process. Specifically, DOT's Federal Register notice set forth the statutory criteria The investment banks addressed these statutory criteria in their written and oral presentations Finally, DOT's Associate General Counsel, FRA's Deputy Administrator, and FRA's Special Counsel produced a memorandum for the Secretary that analyzed each investment bank's strengths and weaknesses in light of the statutory criteria

While no priority was assigned to any of the criteria in section 4011(a)(2) during the first round, DOT officials, and Conrail's and Treasury's representatives all wanted a combination of retail and institutional banks that would obtain the highest price for Conrail Thus, the investment banks were separated into two groups consisting of retail investment banks that would sell stock primarily to individuals and institutional investment banks that would sell primarily to institutions These banks were considered within their respective groups Finally, DOT's Associate General Counsel, FRA's Deputy Administrator, and FRA's Special Counsel said they sought to obtain significant participation of minority firms in the sale

The Treasury and Conrail participants told us that DOT had adequately consulted them The Treasury representative told us he believed the statutory criteria had been used in selecting the investment banks.

The Act's Criteria Were Followed in the Second Round

Before the second round began, each of the 12 finalists received a series of questions to be answered in the second round oral presentations. Each investment bank was asked to relate the statutory criteria to its proposals for the public offering of Conrail common stock For example, applicants were to state what the appropriate domestic and/or geographic distribution should be for the shares of Conrail stock. This would require an applicant to draw upon its experience in large-scale public offerings, as well as its knowledge of the railroad industry. Our examination of the transcripts indicated that when an investment bank's oral presentation did not address one of the listed questions, a panel member asked a question soliciting the information

Our discussions with FRA's Administrator, DOT's Chief of Staff, and Conrail's and Treasury's participants indicated that in the second round they considered the statutory criteria in arriving at their recommendations to the Secretary of Transportation. FRA's Administrator and DOT's Chief of Staff prepared a memorandum which analyzed, in matrix format, each of the remaining investment bank's strengths and weaknesses in light of the statutory criteria. As in the first round, no priority was assigned to any of the criteria in section 4011(a)(2).

The Secretary of Transportation stated that she made her second-round decision on the basis of her own reading of the transcripts, discussion with her staff, consultation with Conrail and Treasury, and statistical data provided by Skadden. Our discussions with DOT staff indicate that the Secretary was especially interested in ensuring that the underwriting group have the proper mix of retail and institutional sales capabilities and significant minority participation in the final sale

Both Treasury's and Conrail's representatives told us that the Secretary of Transportation called them after the second round. They said that they had been adequately consulted

The Selection Process Was Fair and Proper

The privatization act did not require the Secretary to use any particular "process" to select the co-lead managers for the Conrail sale. We believe it is in the public's best interests to make such decisions only after giving notice to interested parties and providing all an equal opportunity to be heard. DOT did establish such a process, which we thus believe was fair and proper

We sought to assure ourselves that the selection process adopted by the Secretary was actually followed. Any attempt by an investment bank, or

its agents, to gain an advantage over its competitors outside of the established process would, we believe, not be in the public interest and would thus be improper. In the course of our review, we identified three areas in which parties with a financial interest in the selection might have had the opportunity to improperly influence that selection outside the formal process.

- Skadden could use its position as independent adviser to DOT to favor a particular investment bank whose interests it represented in other contexts.
- Goldman Sachs could take advantage of its earlier relationship with DOT as independent investment adviser to improperly influence the selection
- Other interested parties could have contacted DOT, Conrail, or Treasury participants outside DOT's selection process in an attempt to improperly influence the selection.

On the basis of our review of the documents supplied by DOT, our interviews, and the written responses to questions we asked the Secretary of Transportation, we do not believe the Secretary's selection of the six co-lead managers or the book-runner was influenced by any contacts listed above with interested parties outside the formal selection process adopted by DOT.

Skadden's Role As Investment Adviser

Skadden has at different times and in differing capacities represented nearly all of the investment banks applying for the co-lead manager position. Based on our review of the law, the American Bar Association Code of Professional Responsibility and Rules of Professional Conduct (Code), examination of the documents produced by DOT, and our interviews, Skadden did not exert improper influence on the selection process because (1) the law firm was not retained to recommend investment banks and did not do so and (2) it disclosed its representations as needed.

Skadden Provided Technical Advice

Skadden's role was limited to providing technical assistance to DOT Specifically, Skadden provided statistical information on each of the banking firms Skadden representatives sat in on both rounds of the selection process and asked questions of the investment banks, intending to draw out technical and complete information Finally, Skadden analyzed the co-lead manager agreements submitted by the investment banks and drafted the final agreements, which DOT revised before using.

At the end of the first round selection process, all the DOT participants who would make recommendations met to discuss who they would recommend that the Secretary select for the second round. After extensive discussion of the merits of all of the investment banks, each of the DOT employees responsible for making recommendations provided the FRA Administrator with a list of candidates for the second round Once this process was complete, FRA's Administrator asked a Skadden attorney, as an informed observer, whom he would have chosen According to the Skadden attorneys; FRA's Administrator, Deputy Administrator, and Special Counsel, and DOT's Associate General Counsel, this was understood to be the attorney's personal views, not a recommendation The FRA Administrator told us that the attorney's list was similar to the list of investment banks already chosen by the DOT staff

Skadden Disclosed Potential Conflicts

Despite the limited nature of Skadden's role, DOT was aware that Skadden's active representation of the competing investment banks in individual transactions, raised a potential conflict-of-interest question. Could Skadden provide the Secretary with dependable, unbiased advice with regard to the selection of six investment banks to underwrite the sale of Conrail common stock? A law firm's representation of a client is impaired if other representations preclude the law firm from considering or recommending an appropriate course of action to that client. The Code requires that the law firm adequately disclose the other representations that could create a potential conflict of interest so that the client can choose to waive the conflict or sever its relationship with the law firm

According to DOT officials and Skadden attorneys, the law firm disclosed throughout the process the nature and extent of its representations of the investment banking firms There have been four such disclosures; FRA's Special Counsel said each disclosure presented enough information for DOT to waive any potential conflict, and DOT has done so.

- At the time Skadden was first contacted by DOT officials, it disclosed that it actively represented many of the large investment banks which could be expected to compete to be co-lead managers Skadden told DOT officials that the law firm represented investment banks only for the duration of individual transactions.
- When Skadden knew which investment banks had applied to be co-lead manager, Skadden attorneys told FRA's Special Counsel that the law firm from time to time represented 22 of the 25 banks and that these representations were for individual transactions

- At the end of the first round presentations, Skadden disclosed to DOT's Associate General Counsel and FRA's Administrator, Deputy Administrator and Special Counsel the extent and nature of its representations of each investment bank under consideration.
- After the selection of the co-lead managers, Skadden again disclosed to FRA's Special Counsel the nature and relative amount of business generated by its representations of each of the co-lead managers.

The Department has an explicit oral understanding with Skadden that the law firm will notify DOT as potential conflicts arise due to any changes in Skadden's relationships with any of the co-lead managers. On the basis of our review of the Code, the disclosures and waivers are sufficient to avoid any ethical problems at this time.

Goldman Sachs' Contacts With DOT

The second area of potential impropriety involved the transition of Goldman Sachs from financial adviser to the Department to an applicant for the position of co-lead manager. DOT contracted with Goldman Sachs in 1982 to provide investment advice on the sale of Conrail The documents we reviewed indicate that the contract was terminated, effective October 19, 1986. Between the termination of the contract and the end of the selection process, we were able to identify several instances in which a DOT employee or agent contacted a Goldman Sachs employee or agent about the Conrail sale outside the formal process

The first such meeting between DOT personnel and Goldman Sachs employees occurred on October 20, 1986. The notes of the meeting indicate, and the FRA Administrator confirmed, that the discussion was focused primarily on technical securities issues and did not touch on the relative merits of any investment bank. For example, DOT asked Goldman Sachs what fees were typical in large public offerings

The second contact was a letter that Skadden sent to Goldman Sachs' law firm, Hughes Hubbard & Reed, on October 22, 1986 In that letter, Skadden asked Goldman Sachs to provide it with factual information relating to the securities industry. According to a handwritten memorandum from one Skadden associate, the firm was aware of the potential conflicts created by this request and therefore verified all of the information provided by Goldman Sachs before it was sent to DOT

According to DOT's Associate Deputy Secretary, after Goldman Sachs' contract with DOT had been terminated and before the beginning of the second round, she initiated two or three phone conversations and one

meeting with Goldman Sachs' legal representative. A former DOT Chief of Staff, the legal representative had been involved with the sale of Conrail during his tenure at the Department After the legal representative left his position at DOT in 1985, and until October 19, 1986, he served as special counsel to the Department in the Conrail sale. In this capacity, he said he assisted in drafting the privatization act.

At the beginning of each of their conversations, the Associate Deputy Secretary and Goldman Sachs' legal representative agreed not to discuss anything involving the selection of any investment bank They discussed potential problems DOT might face because of ambiguities in the privatization act For example, how would authority to manage the underwriting be allocated among six co-lead managers when the custom in the industry was to give such authority to the book-runner? Although the notes we obtained from the Associate Deputy Secretary raised some questions about what was discussed, both participants told us that Goldman Sachs' legal representative only pointed out these ambiguities; he did not discuss possible ways to deal with them

Finally, between the first and second rounds of the selection process, the same Goldman Sachs' legal representative had two conversations about Conrail with the Secretary of Transportation The Secretary stated that she met with him because she wanted the benefit of his recollection and understanding of congressional intent with respect to ambiguities in the privatization act. These were the same ambiguities he had discussed earlier with the Deputy Associate Secretary. The Secretary also stated that at the beginning of their conversation, she insisted that there be no discussion of anything involving the selection of any investment bank or how to resolve the ambiguities. Goldman Sachs' legal representative confirmed both this agreement and that the conversation stayed within the bounds set by the Secretary In the second conversation, the Secretary of Transportation stated that she sought advice on a potential event involving the payment by Conrail to the government of $200 million as mandated by the privatization act

Each of these contacts involved Conrail and was initiated by DOT However, the parties involved stated that the conversations were not intended to and did not affect the selection of the co-lead managers or the book-runner. Further, there were no discussions of any investment banks.

Other Contacts Outside the Formal Selection Process

The third area involving potential impropriety concerned attempts by interested parties to contact key decision-makers outside the process For example, representatives of several investment banks sought appointments with those who would be making recommendations on the selection to the Secretary of Transportation. DOT, Treasury, and Conrail officials who participated in the decision-making process told us that when confronted with these contacts, they told the interested party that all information should be presented during the selection process identified in the Federal Register These responses are consistent with agency directives regarding contacts from interested parties outside the selection process.

Responses to Additional Questions From the Chairman

In addition to the two major areas discussed above, we agreed to address three other questions which you posed. These questions and our responses follow

1. Was the selection of Shearson Lehman Brothers based in any way whatsoever upon an intention of the Department, Shearson, or both that Norfolk Southern Corporation be given an opportunity to purchase the maximum permissible amount of stock in the initial public offering, and is there any evidence, express or implied, to suggest that such an intention exists or existed?

We did not find any evidence to suggest that the selection of Shearson Lehman Brothers as co-lead manager reflected an intention that Norfolk Southern Corporation be given any special opportunity to purchase shares of Conrail common stock during the initial public offering

2. Will the selection of Goldman Sachs and Shearson Lehman Brothers trigger any disclosure requirements in the registration statement that may have an adverse effect on the marketability or price of the government's shares in Conrail, in light of those firms' statements before committees of the House and Senate that a public offering of Conrail's stock was inadvisable, infeasible, or otherwise not in the public interest?

If statements made by an investment bank, before a congressional committee are material to a potential investor, those statements would have to be included in the prospectus regardless of whether or not the investment bank making the statement was chosen as co-lead manager. The questions of materiality are being considered by the parties to the underwriting

3. Do the Department's contracts with the co-lead managers include provisions that will ensure the opportunity for significant minority participation and GAO review?

DOT's contracts with the co-lead managers include provisions that will ensure the opportunity for significant minority participation and GAO review

Our review was performed in accordance with generally accepted government auditing standards. As requested by your office, we did not obtain official agency comments We did, however, discuss the results of our review with senior agency officials and have included their comments where appropriate.

As agreed with your office, unless you publicly announce its contents earlier, we will make this report available to other Members of Congress, the Secretary of Transportation, and other interested parties 30 days after the date of this letter.

This work was performed under the direction of Kenneth M. Mead, Associate Director. Other major contributors are listed in appendix III.

Sincerely yours,

J. Dexter Peach

J Dexter Peach
Assistant Comptroller General

List of Interviews Conducted

James Burnley	Deputy Secretary, DOT
Jennifer Dorn	Associate Deputy Secretary, DOT
Wayne Vance	Chief of Staff, DOT
James Marquez	General Counsel, DOT
Rosalind Knapp	Deputy General Counsel, DOT
Gregory Dole	Associate General Counsel, DOT
Marc Owen	Attorney-Adviser, DOT
John Riley	Administrator, FRA
J Christopher Rooney	Deputy Administrator, FRA
Mark Lindsey	Special Counsel, FRA
Charles Sethness	Assistant Secretary for Domestic Finance, Department of the Treasury
L Stanley Crane	Chairman of the Board, Conrail
H William Brown	General Counsel, Conrail
Bruce Wilson	Chief Financial Officer, Conrail
Matthew Mallow	Skadden, Arps, Slate, Meagher & Flom
Neal McCoy	Skadden, Arps, Slate, Meagher & Flom
Robert P Davis	Anderson, Hibey, Nauheim & Blair

List of 25 Investment Banks That Applied To Co-Lead Manage the Public Offering of Conrail

Alex Brown & Sons Incorporated
Allen & Company Incorporated
Bear, Stearns & Co Inc
Dean Witter Reynolds Inc
Dillon, Read & Co Inc
Donaldson, Lufkin & Jenrette Securities Corporation
E F Hutton
The First Boston Corporation
Goldman, Sachs & Co
Grigsby, Brandford & Co , Inc
Kidder, Peabody & Co Incorporated
L F Rothschild, Unterberg, Towbin, Inc
Lazard Freres & Co
Merrill Lynch
Morgan Stanley & Co Incorporated
PaineWebber Incorporated
Prudential-Bache Securities Inc
Pryor, Govan, Counts & Co Inc
S G Warburg & Co Inc
Salomon Brothers Inc
J Henry Schroder Wagg & Co Limited / Wertheim & Co Inc
Shearson Lehman Brothers
Smith Barney Harris Upham & Co Inc
Swiss Bank Corporation International Securities Inc
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