EMPLOYER STATUS DETERMINATION
Livingston Rebuild Center, Inc.

This is the determination of the Railroad Retirement Board concerning the status of Livingston Rebuild Center, Inc. (LRC) as an employer under the Railroad Retirement Act (45 U.S.C. §231 et seq.) (RRA) and the Railroad Unemployment Insurance Act (45 U.S.C. §351 et seq.) (RUIA). In 1992, the United States Court of Appeals for the Seventh Circuit upheld the Board's determination that LRC has been an employer under the Acts, with service creditable from June 1, 1988 (Livingston Rebuild Center, Inc. v. Railroad Retirement Board, 970 F.2d 295 (7th Cir. 1992)). The Court found that LRC's business of rebuilding and repairing railroad cars constituted service in connection with railroad transportation. Because LRC was under common control with a rail carrier employer, Montana Rail Link, Inc. (MRL) (BA No.3658), it fell within the definition of employer under both the RRA and the RUIA (45 U.S.C. §§231(a)(1)(ii) and 351(a)). LRC has now changed its ownership, as described in more detail below, and has requested the Board to issue a determination that its employer status terminated upon the closing of the sale of a majority interest in the company.

Background Information and Sale[1]

LRC was formed in 1988 by Dennis Washington and a group of investors who purchased the former Burlington Northern Railroad shop facility in Livingston, Montana. Mr. Washington owned approximately 80 percent of the stock of LRC, and the remaining 20 percent was held by 29 other investors. Mr. Washington and the other LRC investors are also the owners of MRL.[2] Mr. Washington has been the Chairman of the Board of both LRC and MRL, and both companies have had two directors in common, Dorn Parkinson and Milt Datsopoulos. LRC has at no time during the prior proceedings before the Board or before the United States Court of Appeals for the Seventh Circuit disputed the finding that Mr. Washington controlled both MRL and LRC.

LRC's directors and officers concluded that LRC could not compete in the equipment repair business with a labor cost structure that was higher by some $3 to $4 an hour per employee than that of other shops that bid for the same work. They indicated that the choices which the company faced were to shut down operations or to

[1]Unless otherwise noted, this information is taken from LRC's Petition for expedited determination of its employer status filed in February 1993. The terms of the sale on May 17, 1993 remained essentially the same as they were described by LRC in the documents submitted in February 1993.

[2]Mr. Washington and the 29 investors in MRL owned identical percentages of the stock of LRC as they own of MRL stock. Thus, Mr. Washington owns approximately 80 percent of MRL.

restructure LRC in a way so as to terminate its coverage under the RRA and the RUIA. The Board of Directors, at the urging of local and state officials, worked to identify a purchaser for the company that would be unaffiliated with any railroad carrier. LRC stated in its Petition that many of its likely prospective buyers, i.e., its existing competitors, were facing financial difficulties and were not in a position to acquire the company. Other prospective buyers declined to pursue the opportunity due to the remote location of LRC in Livingston, Montana. LRC stated in its Petition that although it entered into negotiations with potential buyers of the whole company, none of those negotiations was fruitful. Accordingly, LRC determined that "the only prospect for continued operation of the company" would be to sell a controlling interest in it to an entrepreneur with experience in equipment rebuilding and with ties to the local area.

LRC reached an agreement with Randolph V. Peterson, a Missoula, Montana-based entrepreneur with extensive experience in managing equipment sales and repair operations. Under that agreement, on May 17, 1993, the shareholders of LRC sold 55 percent of their shares of LRC on a prorata basis to Mr. Peterson. Mr. Peterson is the brother of the wife of Dennis Washington, but has no professional or business relationship with Mr. Washington or any of the companies controlled by Mr. Washington.

The transfer of a controlling interest to Mr. Peterson was preceded by an amendment to LRC's Articles of Incorporation in order to recapitalize LRC's single class of 100 shares of common stock into two classes, Class A and Class B. The Class A and Class B shares are identical in all respects, except that the holders of the Class A shares have the right, by vote of a majority of the Class A shares, to elect two of LRC's directors and also have the right to remove and replace such directors, while the Class B shares have the right, by vote of a majority of the Class B shareholders, to elect, remove and replace one director on the LRC board. The shareholders delivered their 100 shares of "old" common stock to LRC in exchange for 55 shares of "new" Class A common stock and 45 shares of "new" Class B common stock.

The shareholders, including Mr. Washington, entered into a Purchase Agreement with Mr. Peterson pursuant to which the shareholders sold the 55 shares of Class A common stock of LRC to Mr. Peterson. The shareholders retained the 45 shares of Class B common stock. Thus, following the sale, Mr. Peterson now owns 55 percent of the issued and outstanding shares of LRC and will be able to elect two out of LRC's three directors. The former members of the LRC Board were to resign, and Mr. Peterson was to vote his Class A shares to elect himself and another person not associated with any Washington-affiliated companies, as directors of LRC. LRC's Petition stated that it was anticipated that Mr. Leroy Wilkes would be elected as the third director of LRC by the holders of the Class B shares.

At the closing of the sale, Mr. Peterson entered into an Employment Agreement with LRC under which LRC appointed Mr. Peterson its Chief Executive Officer for a three-year term, at an annual salary of $100,000 per year, together with the normal benefits provided to other employees of LRC.

The purchase price for the Class A shares was $2,090,000. At the closing, pursuant to the Purchase Agreement, Mr. Peterson was to pay $200,000 in cash to the existing shareholders as a downpayment or in the alternative was to deliver his down payment note in that amount, secured by the sale proceeds of his Missoula residence. The remainder of the purchase price was to be paid by Mr. Peterson's issuance of a nonrecourse promissory note (the "Stock Purchase Note") in the amount of $1,890,000, which obligation is secured by the Class A shares. The Stock Purchase Note is payable as follows: Interest, computed at Harris Bank of Chicago prime rate, shall accrue for three years and be added to the principal. Thereafter, the principal and accrued interest will be amortized and paid ratably over a five-year period, together with interest at Harris Bank prime rate.

In addition to purchasing the Class A shares, Mr. Peterson also purchased 55 percent of the approximately $2.99 million of promissory notes issued by LRC to the current shareholders (the "Company Notes"). Mr. Peterson issued his own note for the Company Notes (the "Debt Purchase Note"). The Debt Purchase Note is payable on demand, but Mr. Peterson may "pay" any such demand by returning an equal amount of Company Notes. LRC's Petition stated that the purchase of Company Notes was recommended by its tax advisors, who believe that Mr. Peterson should own 55 percent of LRC's stock and shareholder debt in order to maintain LRC's status as a "Subchapter S" corporation under the Internal Revenue Code.

LRC, the shareholders, and Mr. Peterson entered into a Shareholders Agreement providing for the following:

(a) A mandatory distribution of cash flow to pay taxes on the Company's profits. Since LRC is a "Subchapter S" corporation, it does not pay taxes, but its shareholders pay taxes for it. The Shareholders Agreement provides a mechanism to allow the shareholders to obtain sufficient cash to pay the taxes due and owing on LRC's profits. The Shareholders Agreement provides that the tax distributions shall be made prior to any payment of LRC's bank debt, shareholders' debt, or other dividends, unless the failure to pay the other amount will cause a default.

(b) Restrictions on the transferability of LRC's stock, and in particular, restrictions on the ability of any shareholder to revoke LRC's existing "Subchapter S" election.

(c) LRC's Petition stated that because the Class A shares

are in control of LRC, it is reasonable to expect that any purchaser will pay a premium for the acquisition of Class A shares. Accordingly, the Shareholders Agreement provides that in the event that Mr. Peterson decides to sell his Class A shares, he is obligated to include the Class B shareholders in such sale prorata, so that the Class B shareholders can share in the premium purchase price.

(d) The Shareholders Agreement allows the Class B shareholders to negotiate a sale of their entire stockholding in LRC, either through a sale of Class B shares to Mr. Peterson at a designated price, or through a sale of the entire company to a third party at that price.

LRC's Petition stated that the provisions of the Shareholders Agreement were deemed necessary by the parties in order to maintain LRC's status as a "Subchapter S" corporation; to provide a mechanism for paying the Federal and State taxes attributable to LRC's profits; and to provide the Class B shareholders with a manner of disposing of their shares (which, in the absence of a mechanism such as that in the Shareholders Agreement, can be impossible for the holders of a minority interest in a close corporation). LRC's Petition stated that none of those provisions will affect the day-to-day operations of LRC or its "overall" policies.

LRC's Petition stated that the parties would also amend LRC's Bylaws to provide that 75 percent, rather than a majority, vote will be required to approve certain specified actions that are not in general related to the ordinary course of LRC's business. That amendment has the effect of giving the Class B shareholders, acting through their elected director, a veto power over certain Board actions. LRC's Petition stated that the Class B shareholders requested those protections, which they believe are ordinarily granted to minority investors in transactions of the magnitude of this one. The amendment to the Bylaws does not give the Class B director the power to affirmatively direct any action by LRC.

The types of actions which will require the approval of the Class B director are as follows:

(a) Self-Dealing Transactions. Since Mr. Peterson will be the President of LRC and will also control the LRC Board of Directors, the Class B shareholders, acting through their elected director, would have the right to scrutinize and approve any transaction that he enters into with LRC, directly or indirectly, and to approve any changes in his compensation.

(b) Fundamental Corporate Changes. The Class B director will have the right to consent to fundamental changes in LRC's corporate structure or its business, such as any amendments to LRC's corporate charter and Bylaws; the sale of substantially

all of its assets; the issuance of new debt or equity securities; the declaration of dividends; the redemption of LRC stock and any mergers. All of those are transactions that are outside the ordinary course of business for LRC.

(c) Large Expenditures and/or Commitments. "Non-ordinary course capital" expenditures and borrowing, as well as capital expenditures and borrowing in excess of $250,000, are subject to approval by the Class B director. In addition, although the President and the Board of Directors will ordinarily be able to establish an annual budget, such budget must be approved by the Class B director if there are "large swings," i.e., a 20 percent increase or decrease in projected operating expenses. The Class B director would also have to approve the Company's adoption of any long-term employee benefit plan or a law suit settlement in excess of $100,000.

(d) Administrative Actions. Under the Bylaws, LRC's books and records will be audited by a national (i.e., "Big Six") accounting firm. The Class B director would have to approve a change to a local or regional accounting firm. Similarly, since LRC's insurance coverage will affect the investment of each shareholder in the event of a catastrophe, the Class B director will be allowed to approve any change in insurance. The Class B director would also be allowed to approve any changes in the Company's environmental procedures, since there are several instances where a company's environmental liabilities are imposed directly on the shareholders.

Applicable Law and Regulations

Section 1 of the RRA defines "employer" to include:

> (i) any express company, sleeping car company, and carrier by railroad, subject to subchapter I of chapter 105 of Title 49 [the Interstate Commerce Act];
>
> (ii) any company which is directly or indirectly owned or controlled by, or under common control with, one or more employers as defined in paragraph (i) of this subdivision, and which operates any equipment or facility or performs any service (except trucking service, casual service, and the casual operation of equipment or facilities) in connection with the transportation of passengers or property by railroad, or the receipt, delivery, elevation, transfer in transit, refrigeration or icing, storage, or handling of property transported by railroad; (45 U.S.C. §231(a)(1)(i) and (ii)).

Section 1 of the RUIA (45 U.S.C. §351) contains essentially the same definition.

The Board's regulations define "control" as follows:

> A company or person is controlled by one or more carriers, whenever there exists in one or more such carriers the right or power by any means, method or circumstance, irrespective of stock ownership to direct, either directly or indirectly, the policies and business of such a company or person and in any case in which a carrier is in fact exercising direction of the policies and business of such a company or person. 20 CFR §202.4.

Section 202.5 of the Board's regulations provides that:

> A company or person is under common control with a carrier, whenever the control (as the term is used in §202.4) of such company or person is in the same person, persons, or company as that by which such carrier is controlled. 20 CFR §202.5.

The sole issue involved in LRC's Petition is whether the sale described above divested Dennis Washington of control of LRC so that it is no longer under common control with a rail carrier employer and is thus no longer a covered employer under the RRA and the RUIA. For the reasons discussed below, the Board determines that upon the closing of the sale as described in detail in LRC's Petition and as summarized above, LRC ceased to be under common control with a rail carrier employer and ceased to be a covered employer under the RRA and the RUIA.

First, upon closing of the sale, Randolph Peterson owned a fifty-five percent interest in LRC. Dennis Washington, who did own approximately 80 percent of the stock of LRC and of MRL, now owns only 80 percent of the remaining 45 shares, or approximately, 36 shares of LRC. Mr. Peterson therefore owns a majority interest in the company.

In addition to owning the largest single interest in the company, Mr. Peterson became the President of LRC and therefore has the right to direct the day-to-day operations of the company. Further, since Mr. Peterson has the right to select two of LRC's three directors, he also has the right to direct the policies of the company. Mr. Washington has no involvement in LRC, either as a director or as an officer, and is involved in the company only as an investor.

Neither the Shareholders Agreement and amendment of LRC's Bylaws which require a 75% vote on certain matters nor the fact that Mr. Peterson is Mr. Washington's brother-in-law indicate that "control," as defined by the Board's regulations, remains with Mr. Washington.

The provisions of the Shareholders Agreement do not affect the day-

to-day operations of LRC or its overall policies. Rather, that Agreement provides a mechanism for paying the federal and state taxes attributable to LRC's profits and provides the Class B shareholders of this closely held corporation with a manner of disposing of their shares. The provisions of the Shareholders Agreement are designed to maintain LRC's status as a "Subchapter S" corporation and to protect the minority shareholders.

The amendment of LRC's Bylaws gives the Class B shareholders, acting through their elected director, the right to consent to (1) self-dealing by the controlling shareholder; (2) fundamental changes in LRC's corporate structure or business; (3) capital expenditures and borrowings which either are not in the ordinary course of business or are large, i.e., in excess of $250,000; and (4) certain administrative actions that the company might take that might impact on the personal liability of the shareholders. It is evident from the nature of the matters which require a 75% vote that the amendment of LRC's Bylaws is intended to protect the Class B shareholders' remaining investment of approximately $1.7 million. The amendment to the Bylaws does not allow Mr. Washington to direct either the day-to-day business of LRC or its policies. Rather, Mr. Washington and the other Class B shareholders have a veto with respect to certain matters outside the ordinary course of LRC's business or which would fundamentally change the nature of LRC.

Finally, the fact that Mr. Peterson is the brother of Dennis Washington's wife does not mean that Mr. Washington retained a controlling interest in LRC after Mr. Peterson purchased a 55 percent interest in the company. The RRA and the RUIA do not address the issue of whether, for purposes of determining "common control," the shares of individuals should be aggregated based on familial relationships. It would appear, however, that neither the Internal Revenue Service nor the Interstate Commerce Commission would aggregate shares based solely upon the existence of an in-law relationship.

Section 318 of the Internal Revenue Code (26 U.S.C. §318) sets out rules concerning the constructive ownership of stock and provides in part that:

> **(1) Members of family.**
>
> (A) In general. An individual shall be considered as owning the stock owned, directly or indirectly, by or for --
>
> (i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and
>
> (ii) his children, grandchildren, and parents. (26 U.S.C. §318(a)(1)(A)).

Section 318(b) of the Internal Revenue Code lists eight sections of the Code to which the rules contained in section 318(a) apply, including the redemption of stock, net operating loss carryovers, and rules relating to foreign corporations. In one of the situations to which section 318(a) applies, the IRS will consider that a taxpayer owns stock which is owned by the taxpayer's spouse, children, grandchildren, and parents. Once there has been an attribution of ownership to a taxpayer, section 318(a)(5)(B) expressly prohibits reattribution of the same stock so as to make another taxpayer the constructive owner of the same shares (26 U.S.C. §318(a)(5)(B)).

Thus, for example, applying the rules of section 318 to LRC's proposed sale, Mr. Washington would be considered to be the constructive owner of stock owned by his wife. His wife, however, would not be considered to be a constructive owner of stock owned by her brother, Mr. Peterson. Further, even if siblings were included in the list of family members so that Mrs. Washington could be found to be the constructive owner of stock owned by Mr. Peterson, that same stock could not then be reattributed to Mr. Washington.

Section 544 of the Internal Revenue Code, which sets forth rules of constructive ownership for purposes of determining whether a corporation is a personal holding company, provides that an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. The term "family" includes the individual's brothers and sisters, but does not include inlaws. Moreover, section 544(a)(5) contains the same type of provision as does section 318(a)(5)(B) so that once there has been an attribution of ownership to a taxpayer, section 544(a)(5) prohibits reattribution of the same stock so as to make another taxpayer the constructive owner of the same shares (26 U.S.C. §544(a)(5)).

The Interstate Commerce Commission (ICC) considers "control" when it approves transactions involving the control of a common carrier (49 U.S.C. §11343(a)). The Interstate Commerce Act provides that "control":

> When referring to a relationship between persons, includes actual control, legal control, and the power to exercise control, through or by (A) common directors, officers, stockholders, a voting trust, or a holding or investment company, or (B) any other means. 49 U.S.C. §10102(7).

In ICC Finance Docket No. 31802 (Sub-No. 1), South Kansas and Oklahoma Railroad, Inc. -- Acquisition and Operation Exemption -- The Atchison, Topeka and Santa Fe Railway Company -- Petition to Revoke, served November 27, 1992, the ICC rejected an argument that two railroads, one owned by a brother and sister and the other

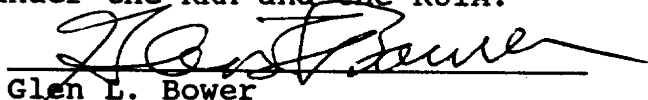
owned by their parents, were in fact a single railroad because of the family relationship. The ICC wrote that:

> There is simply no merit to Rail Labor's argument that a presumption of control arises where a family relationship alone exists among the owners of the involved carriers. Accordingly, we will apply our traditional indicia of independence test (without that presumption) and consider the evidence of the family relationship existing among SKO, SEK and Watco along with the evidence of other factors relevant to determining whether SKO is sufficiently independent for the transaction to properly come under section 10901 rather than section 11343. (ICC Finance Docket No. 31802 (Sub-No. 1), p.4).

The ICC described the "indicia of independence test" as a test of the particular facts involved in a given case.[3] Thus, the mere existence of a family relationship would not be a sufficient basis on which the ICC would base a finding of control. (Cf. Gilbertville Trucking Co. v. United States, 371 U.S. 115, 83 S.Ct. 217, 9 L.Ed.2d 177, 185 (1962)).

Conclusion

For the reasons discussed above, it is determined that upon the closing of the sale of a 55% interest in LRC to Mr. Peterson on May 17, 1993, in accordance with the terms discussed in LRC's Petition, LRC ceased to be under common control with Montana Rail Link, Inc. and ceased to be an employer under the RRA and the RUIA.



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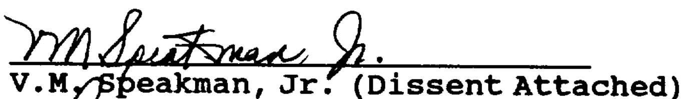
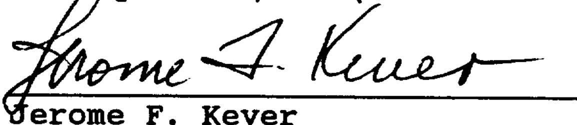


V.M. Speakman, Jr. (Dissent Attached)



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[3] "Indicia of independence include: whether the new entity was formed for legitimate and substantial business reasons unrelated to the labor issue; whether the new entity has its own employees, management and equipment, publishes its own tariffs and operates under its own name; and whether it is responsible for its own financial and contractual obligations." ICC Finance Docket No. 31802 (Sub-No. 1), p.3.

DISSENT OF V. M. SPEAKMAN, JR.
ON THE LIVINGSTON REBUILD CENTER

I vigorously dissent from the majority decision that Livingston Rebuild Center is no longer an employer under the Railroad Retirement Act. The Board's decision in this case is a bad interpretation of the law, makes a travesty of the Board's fiduciary responsibilities, represents incredibly bad public policy, and is certain to subject the Board to ridicule.

Under the law, a company which is owned or controlled by a railroad, directly or indirectly, or is under common control with a carrier, and which is performing railroad service, is a rail employer under the Railroad Retirement Act. Livingston Rebuild Center met that test and was determined by the Board to be a covered employer. The Board's determination was affirmed by the Seventh Circuit Court of Appeals in Livingston Rebuild Center v. Railroad Retirement Board 970 F. 2d 295 (7th Cir. 1992). The Court agreed with the Board that Livingston was under common control with Montana Rail Link, a railroad, because both companies were owned by the same individual. To sever that common control link, that individual sold 55 percent of Livingston to a member of his own family, his brother-in-law. Furthermore, the condition of the sale transaction includes a provision that if the Board does not conclude that Livingston is no longer an employer, the sale will be cancelled.

Now, the Board has ruled that Livingston Rebuild Center is no longer under the common control of the same individual as Montana Rail Link as a result of this dubious and most transparent transaction.

The Board's decision in this case is bad law. The element of control is not defined in the law. Nowhere is it specified that less than fifty percent ownership cannot be controlling under the right circumstances. The issue of control is an area which requires careful case-by-case analysis. There are certainly situations where a powerful and dominant individual or company has sufficient leverage to control an enterprise even though owning only a minority share of that enterprise. This is especially true where such enterprise is inextricably linked to another company of which such minority owner has full and uncontestant control. In the situation at hand, an individual who previously owned the majority of both Montana Rail Link and Livingston Rebuild Center has sold shares of stock to a relative while keeping sufficient control to abort the sale on his terms if he cannot slip through the target loophole. When this case is examined in its entirety, there is absolutely no doubt that Livingston Rebuild Center is still completely under common control with Montana Rail Link in every sense. Livingston should continue to be a covered employer as a result of that control.

The Board has a fiduciary responsibility for the Railroad Retirement and Unemployment Insurance Systems. We make a mockery of that responsibility when we so readily accept such an absurd proposition as is being advanced in this case. We all have constituencies which expect us to protect the Railroad Retirement and Unemployment Insurance Systems from this kind of attack. Coverage is the single most critical factor in the solvency of these programs. Our

constituencies pay the price, in the form of higher payroll taxes and possibly even future benefit reductions, when we allow entities to escape coverage not because they have fundamentally altered their very nature and are no longer a part of rail transportation, but rather, because they have made flimsy, transparent, cosmetic changes. Clearly here, before and after the sale, the same people are in control of the same operation which is still engaging in the same services in connection with transportation by rail.

The Board's decision represents bad public policy. It virtually rewards a blatant attempt to circumvent the law. In this case, the laws are specific mandates which apply to those participating in rail transportation. The public policy is that if you participate in rail transportation, you must honor those mandates. The Board has, in a fashion completely inappropriate for an administering agency, laid out a blueprint for participating in rail transportation while ignoring the mandates. This violates the very public policy the Board is supposed to be implementing.

There is no doubt in my mind that this decision will open the Board to ridicule. It should. It will be characterized as a sham transaction -- a sale to a relative -- to circumvent the law, and the Board bought it. Everyone knows that similar transactions under other laws are subject to scrutiny under a powerful microscope. The Internal Revenue Service would suspect such a transaction and look to determine whether it were an "arms length" transaction. We should do no less. For the Board's constituents, this is a far more important issue than it is for IRS.

I again vigorously dissent. We are setting bad precedent here, both for legal interpretation and for standard of decision-making. I implore my fellow Board Members to reconsider their decision.

V. M. Speakman, Jr

OCT 22 1993

Date