

SURFACE TRANSPORTATION BOARD

DECISION

Docket No. FD 36514

CANADIAN NATIONAL RAILWAY COMPANY,
GRAND TRUNK CORPORATION, AND CN'S RAIL OPERATING SUBSIDIARIES
—CONTROL—
KANSAS CITY SOUTHERN, THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
GATEWAY EASTERN RAILWAY COMPANY, AND
THE TEXAS MEXICAN RAILWAY COMPANY

Digest:¹ The Board determines that this proposed transaction will be subject to the agency's current merger regulations and denies a motion to approve a proposed voting trust agreement, without prejudice, as incomplete.

Decision No. 3

Decided: May 17, 2021

Canadian National Railway Company (CNR), Grand Trunk Corporation (GTC), and their rail operating subsidiaries (collectively, with CNR and GTC, CN)² have notified the Surface Transportation Board (Board) of their intent to file an application seeking authority for the acquisition of control by CNR, through its wholly owned subsidiary Brooklyn Merger Sub, Inc. (Brooklyn Merger Sub), of Kansas City Southern, and through it, of The Kansas City Southern Railway Company (KCSR), Gateway Eastern Railway Company, and The Texas Mexican Railway Company (collectively, KCS), in the event that Kansas City Southern accepts

¹ The digest constitutes no part of the decision of the Board but has been prepared for the convenience of the reader. It may not be cited to or relied upon as precedent. See Pol'y Statement on Plain Language Digs. in Decisions, EP 696 (STB served Sept. 2, 2010).

² CN's rail operating subsidiaries in the United States include Illinois Central Railroad Company; Wisconsin Central Ltd.; Grand Trunk Western Railroad Company; Bessemer and Lake Erie Railroad Company; Chicago, Central & Pacific Railroad Company; Cedar River Railroad Company; The Pittsburgh & Conneaut Dock Company; Sault. Ste Marie Bridge Company; Waterloo Railway Company; and Wisconsin Chicago Link Ltd. CN's rail operating subsidiaries in Canada include Algoma Central Railway, Inc., Quebec and Lake Saint John Railway Company, Canadian Northern Quebec Railway Company, Canada Southern Railway Company, and BC Rail Partnership.

an acquisition proposal that CN conveyed to Kansas City Southern's Board of Directors on April 20, 2021 (CN Proposal).³

Under the terms of the CN Proposal, CNR, through its subsidiary Brooklyn Merger Sub, would acquire all of the capital stock of Kansas City Southern. (Notice of Intent 4.) Specifically, upon receipt of approval by the shareholders of Kansas City Southern and the satisfaction of other customary closing conditions, Brooklyn Merger Sub would merge with and into Kansas City Southern (the Merger), with Kansas City Southern surviving the Merger. (*Id.*) Upon completion of the Merger, holders of Kansas City Southern's common stock would become entitled to receive a combination of CNR common shares and cash in exchange for their common stock, and holders of Kansas City Southern's preferred stock would become entitled to receive cash in exchange for their preferred shares. (*Id.* at 4-5.) Immediately following completion of the Merger, CNR's voting interest in Kansas City Southern acquired in the Merger would be placed into an independent voting trust pending review and approval of the control transaction by the Board. (*Id.* at 5.) CN states that, should the Board take final and favorable action on the application, which would be filed pursuant to 49 U.S.C. §§ 11323-11325, only then would the voting trust be terminated and CNR assume control of Kansas City Southern and its railroad affiliates. (Notice of Intent 1, 5.)

The Board's regulation at 49 C.F.R. § 1180.0(b) provides, in pertinent part, that the Board "will waive application of the regulations contained in this subpart for a consolidation involving [KCS] and another Class I railroad and instead will apply the regulations in this subpart A in effect before July 11, 2001 . . . unless [the Board is] shown why such a waiver should not be allowed." CN states that the Board's current merger regulations contained in 49 C.F.R. part 1180 should apply in this proceeding. (Notice of Intent 3-4; CN Comment 2, Apr. 26, 2021; CN Reply 1, May 3, 2021.)⁴ Comments on the waiver provision have been filed by American Chemistry Council, the Corn Refiners Association, The Fertilizer Institute, the National Grain and Feed Association, The National Industrial Transportation League, and US Wheat Associates (collectively, ACC, et al.); Canadian Pacific Railway Limited and its U.S. rail

³ On May 13, 2021, KCS announced that it received a revised acquisition proposal from CN, which the KCS board of directors has determined constitutes a "Company Superior Proposal" as defined in KCS's merger agreement with Canadian Pacific Railway Limited. For further details, see Press Release, KCS, Kansas City Southern Receives Revised Proposal from Canadian National Railway That Board of Directors Determines is a "Company Superior Proposal" (May 13, 2021), <https://www.kcsouthern.com/media/news/news-releases/kansas-city-southern-receives-revised-proposal-from-canadian-national-railway-that-board-of-directors-determines-is-a-company-superior-proposal>.

⁴ The Notice of Intent stated that, while CN believes that "the current major merger rules should be applied to a transaction involving KCS," a decision that the transaction proposed in Canadian Pacific Railway Limited—Control—Kansas City Southern, Docket No. FD 36500, should receive a waiver from the current merger rules should "apply equally" to the proposed CN-KCS transaction in this docket. (Notice of Intent 4 n.5.) On April 26, 2021, CN filed a comment disagreeing with the decision to apply the waiver in Docket No. FD 36500, but stating that CN would submit an application that complies with the current major merger rules. (CN Comment 1-2, Apr. 26, 2021.)

carrier subsidiaries (collectively, CP); the City of Quitman, Miss.;⁵ CSX Transportation, Inc. (CSXT); Freight Rail Customer Alliance, National Coal Transportation Association, and Private Railcar Food and Beverage Association, Inc. (collectively, FRCA, et al.); North Dakota Grain Dealers Association (NDGDA); and Union Pacific Railroad Company (UP). CN filed a reply on May 3, 2021. For the reasons discussed below, the Board finds that its current merger regulations will apply in this proceeding and that the 49 C.F.R. § 1180.0(b) waiver for major transactions involving KCS has been shown not to be warranted here.

On April 26, 2021, CN filed a motion to approve a proposed voting trust agreement.⁶ However, as discussed below, the voting trust agreement attached to CN's motion for approval is incomplete, and the motion will therefore be denied without prejudice.

DISCUSSION AND CONCLUSIONS

Waiver Provision. In 2001, the Board revised its regulations governing proposals for major rail consolidations, in response to concerns regarding continued consolidation in the rail industry. Major Rail Consolidation Procs., 5 S.T.B. 539, 545 (2001). The new rules, which are codified at 49 C.F.R. part 1180, subpart A, reflected the Board's concerns about what an appropriate rail merger policy should be in light of the declining number of Class I railroads, the elimination of the industry's excess capacity, and the serious transitional service problems that had accompanied recent major rail consolidations. Major Rail Consolidation Procs., 5 S.T.B. at 546. Among other things, the new rules placed a heavier burden on merger applicants to show that a major rail combination is consistent with the public interest, reflecting a shift in the Board's policy that places a greater emphasis in the public interest assessment on enhancing competition while ensuring a stable and balanced rail transportation system. Id.

The Board found, however, that the new rules would not apply to proposed consolidations between KCS and another Class I railroad "unless [the Board is] persuaded otherwise." Id. at 552-53, 587; see also 49 C.F.R. § 1180.0(b). The Board projected that, as a general matter, "a potential transaction involving KCS and another Class I carrier would not necessarily raise the same concerns and risk as other potential mergers between Class I railroads," given KCS's size relative to the other Class I railroads. Major Rail Consolidation Procs., 5 S.T.B. at 552-53. While the Board noted that "a potential merger between [KCS] and a Class I carrier would not necessarily have the same impact as other major mergers," the Board recognized that it could not "assess in the abstract the effect of every potential merger proposal involving KCS" and established a process for interested parties to contest application of the waiver in future consolidation proceedings involving KCS. Id. at 553.

⁵ Objections to the waiver provision were due April 30, 2021 (10 days after the notice of intent was filed). See 49 C.F.R. § 1180.0(b). The Board will accept the City of Quitman's late-filed comment.

⁶ On April 27, 2021, CN filed a corrected voting trust agreement, explaining that the version submitted on April 26, 2021, inadvertently omitted the proposed trustee's name.

CN states that the current major merger rules should be applied to the proposed transaction and that it intends to submit an application under those rules. (Notice of Intent 4; CN Comment 2, Apr. 26, 2021 (expressing disagreement with waiver application to the CP transaction and stating that CN application would be submitted under the current rules); see also CN Reply 1, May 3, 2021 (reiterating CN’s commitment to file an application that includes all elements required by the current merger rules).) Several commenters also assert that the current merger rules should apply, given the characteristics of a potential CN-KCS merger, and oppose applying the waiver provision. (See ACC, et al., Comment 1-3, Apr. 30, 2021; City of Quitman Comment 1-2, May 3, 2021; CP Comment 3-4, 6-14, Apr. 30, 2021; FRCA, et al., Comment 2-3, Apr. 30, 2021; NDGDA Comment 1, Apr. 30, 2021; and UP Comment 1, Apr. 30, 2021.) By contrast, CSXT argues that the regulations in effect before July 11, 2001, are sufficient to permit the Board to review the proposed transaction and assess whether it would be consistent with the public interest. (CSXT Comment 1, Apr. 30, 2021.)

The Board concurs with CN’s commitment to file an application under the current regulations set forth at 49 C.F.R. part 1180 and finds that application of the current merger rules is appropriate for the proposed transaction. Indeed, the proposed transaction poses issues that the current merger rules were designed to address, namely the potential competitive impacts of a merged entity with some degree of overlapping routes and presently existing direct competition—characteristics that would appear to pertain to the CN and KCS systems.⁷ See Major Rail Consolidation Procs., 5 S.T.B. at 556 (noting the potential loss of indirect competition with the merger of two Class I rail carriers whose systems overlap); see also, e.g., 49 C.F.R. § 1180.1(c)(2)(i) (requiring applicants to propose remedies to mitigate and offset competitive harms, including elimination of shippers’ build-out, transloading, plant siting, and production shifting choices when two railroads serving overlapping areas merge); cf. Canadian Pac. Ry.—Control—Kan. City S., FD 36500, slip op. at 2 (STB served Apr. 23, 2021) (finding application of the waiver provision appropriate for an end-to-end transaction involving KCS and CP and noting the systems had “the fewest overlapping routes when compared to a merger between KCS and any other Class I carrier”) (with Board Member Primus dissenting).

Voting Trust Agreement. Under 49 C.F.R. § 1180.4(b)(4)(iv), applicants contemplating the use of a voting trust in a major transaction must explain how the trust would insulate them from an unlawful control violation and why their proposed use of the trust, in the context of their impending control application, would be consistent with the public interest. Following “a brief period of public comment and replies by applicants,” the Board will issue a decision determining whether applicants may establish and use the trust. Id.

As noted above, CN has filed a motion to approve a proposed voting trust agreement which, according to CN, would enable CN to close the proposed transaction with KCS into trust later this year while ensuring that KCS is independently managed pending completion of the Board’s review of the proposed transaction. (CN Mot. 1, Apr. 26, 2021.) CN asserts that the

⁷ (See NDGDA Comment 1, Apr. 30, 2021 (noting the multiple points of overlap of the CN and KCS systems); FRCA, et al., Comment 2, Apr. 30, 2021 (noting that CN and KCS have parallel north-south lines that intersect and overlap at some locations); Notice of Intent 2 (acknowledging “minimal” overlap of the CN and KCS systems).)

proposed voting trust agreement satisfies the guidelines adopted in 49 C.F.R. part 1013 pertaining to “independence” and “irrevocability” and conforms with Board precedent for ensuring that voting trusts do not create a control violation. (CN Mot. 3, 5-7, Apr. 26, 2021.) CN also argues that the use of a voting trust is “plainly in the public interest” and that, if not permitted, the Board effectively would be blocking its ability to consider the potential benefits of a transaction that CN characterizes as end-to-end. (Id. at 2-3, 12.)

Specifically, CN contends that the public interest would be served because a voting trust would provide certainty to KCS shareholders and ensure a level playing field between potential railroad acquirers and purely financial acquirers of KCS. (Id. at 8-9 (stating that disallowing use of a trust here would “create a substantial barrier to any potential competition-enhancing end-to-end mergers” while “leav[ing] the door wide open for non-railroad takeovers that are not subject to Section 11323 review”), id. at 10 (stating that only an end-to-end merger can generate benefits such as extended single-system service and a stronger competitive alternative to trucking).) Conversely, CN contends, there is “no cause for [the] concern” identified in Major Rail Consolidation Procedures about potential harms to “the financial integrity of the applicant carriers” who might “risk having to sell [the railroad in trust] at a greatly reduced price” if a divestiture were required. (CN Mot. 10, Apr. 26, 2021 (quoting Major Rail Consolidation Procs., 5 S.T.B. at 567).) In particular, CN asserts that the recent interest in KCS from both the private equity sector and rail carriers is “powerful evidence that KCS could be successfully sold out of trust at a reasonable price if that were necessary.” (CN Mot. 11, Apr. 26, 2021.) Furthermore, according to CN, there is no reason to believe that a sale out of trust “would harm CN’s financial integrity.” (Id. at 10-11 (stating that CN has fully committed financing in place for a potential combination with KCS, that CN expects to maintain a strong balance sheet and its investment grade rating throughout the trust period and beyond, and that CN has announced that it will pause share repurchases in the short term and use free cash flow to pay down debt).)

Finally, CN contends that the comments submitted by the U.S. Department of Justice (DOJ) in Canadian Pacific Railway Limited—Control—Kansas City Southern, Docket No. FD 36500,⁸ in which DOJ “reiterated its longstanding opposition to the use of voting trusts in virtually all circumstances,” do not justify disallowing the use of a voting trust here.⁹ (CN Mot. 12, Apr. 26, 2021.) Specifically, CN takes exception to DOJ’s argument that voting trusts create a disincentive for competition. (Id. (citing DOJ Comment 3-4, Apr. 12, 2021, Canadian Pac. Ry.—Control—Kan. City S. Ry., FD 36500).) Characterizing its proposed transaction as part of a category of potentially procompetitive end-to-end transactions, CN contends that the competitive concerns raised by DOJ are not a function of the voting trust and that, more fundamentally, DOJ’s “academic concerns” about competition incentives being altered “have little application to a proposed end-to-end rail merger” such as the proposed CN-KCS combination. (CN Mot. 12, Apr. 26, 2021 (citing DOJ Comment 3, Apr. 12, 2021, Canadian Pac. Ry.—Control—Kan. City S. Ry., FD 36500).) Similarly, CN argues, DOJ’s concern about

⁸ See DOJ Comment, Apr. 12, 2021, Canadian Pac. Ry.—Control—Kan. City S. Ry., FD 36500.

⁹ On May 14, 2021, DOJ filed a comment in opposition to CN’s proposed use of a voting trust, asserting, among other things, that “threats to competition would be present immediately after the CN voting trust is consummated.” (DOJ Comment 2, May 14, 2021.)

a railroad in trust engaging in “long-lasting actions that can make it significantly less competitive” is not supported by any persuasive examples of irreversible actions that could be taken by KCS while in trust. (CN Mot. 13, Apr. 26, 2021 (quoting DOJ Comment 5, Apr. 12, 2021, Canadian Pac. Ry.—Control—Kan. City S. Ry., FD 36500).) CN also argues that DOJ’s concerns about hypothetical risks posed by divestiture are not warranted in this case, (CN Mot. 13-14, Apr. 26, 2021), and that DOJ’s suggestion that voting trusts could be replaced with alternative mechanisms to allocate regulatory risk would be ill-suited and contrary to the public interest in the context of major rail mergers, which require more comprehensive regulatory review and a longer review period, (*id.* at 15-16).

CN’s arguments that it would “not [be] consistent with the public interest or the statutory scheme for the Board to change its settled precedent on voting trusts,” (CN Mot. 3-4, Apr. 26, 2021), and that the agency “codified” its analysis for particular past Class I mergers to apply to all Class I mergers, (CN Letter. 3, Apr. 29, 2021), are misplaced. The rule promulgated in 2001 did not codify a previous approach; rather, the Board stated that it was adopting a “much more cautious approach to future voting trusts in order to preserve our ability to carry out our statutory responsibilities.” Major Rail Consolidation Procs., 5 S.T.B. at 567. In discussing its “modified” approach to voting trusts under the new regulation (set forth at 49 C.F.R. § 1180.4(b)(4)(iv)), the Board noted that, under 49 U.S.C. § 11323, it has plenary authority over the consolidation, merger, or common control of railroads. Major Rail Consolidation Procs., 5 S.T.B. at 566-67.

The Board also noted its particular obligation under 49 U.S.C. § 11324(b)(3) to consider the total fixed charges resulting from a transaction, and concluded that the Board is thus “responsible for ascertaining whether a proposed transaction would undermine the financial integrity of the applicant carriers.” Major Rail Consolidation Procs., 5 S.T.B. at 567. Subsection (b)(3) is one of five factors, at a minimum, that the agency is required to consider when determining whether a transaction is “consistent with the public interest.” 49 U.S.C. § 11324(b). Here, while CN contends that there is “no cause for concern” as to whether a sale out of divestiture would “harm CN’s financial integrity,” the level of debt being utilized by CN to fund the proposed merger, as well as the substantial premium CN has offered for KCS, call this assumption into question,¹⁰ and under both 49 U.S.C. § 11324(b) and 49 C.F.R. § 1180.4(b)(4)(iv), the Board must carefully weigh potential consequences to CN and the rail network in the event of a divestiture. Further, while Major Rail Consolidation Procedures specifically referenced the third factor listed under 49 U.S.C. § 11324(b) and the financial integrity of the applicant carriers, the Board added a broad “consistent with the public interest” standard in the new voting trust regulation adopted at 49 C.F.R. § 1180.4(b)(4)(iv).

¹⁰ According to statements made by CN at the time it announced its proposed transaction, CN intends to raise “approximately \$19.3 billion of new debt” to finance its proposed merger with KCS. CN, Foreign Issuer Report (Form 6-K) (Apr. 20, 2021), Ex. 1. CN further stated that its proposal represents “an implied premium of 45% when compared to KCS’ unaffected closing stock price on March 19, 2021 and a 21% improvement over the current value of KCS’ agreement with Canadian Pacific Railway Limited,” and “greater than two-times more cash consideration.” *Id.*; see also CN, Foreign Issuer Report (Form 6-K) (May 14, 2021), Ex. 1 (reiterating that, as revised, CN’s proposal continues to represent “an implied premium of 45% when compared to KCS’ unaffected closing stock price on March 19, 2021”).

In addition, the Board stated in Major Rail Consolidation Procedures that, among other things, “to gain approval for the use of a voting trust, applicants would have to demonstrate either that any harm to the public interest associated with the divestiture process would be relatively small or that some countervailing public benefit would be associated with their proposed use of a voting trust that would outweigh this risk.” Major Rail Consolidation Procs., 5 S.T.B. at 568. The Board noted 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,” id. at 568 n.29, that “use of a voting trust is a privilege, not a right, and that [prospective applicants] may not employ a voting trust until we have authorized its use,” id. at 568. As such, the Board expects to take a more cautious approach to a voting trust here, and its consideration of whether the proposed use of a voting trust in a potential CN-KCS transaction is “consistent with the public interest” would be informed by argument on both the potential benefits and costs of such use.

The voting trust agreement attached to CN’s motion for approval is incomplete, insofar as it identifies (as “Exhibit A to Voting Trust Agreement”) and includes multiple references to a merger agreement, which is not attached. As a result, the Board declines to establish a comment period and review the proposal pursuant to the process prescribed in 49 C.F.R. § 1180.4(b)(4)(iv). CN’s motion for approval of its voting trust agreement is denied, without prejudice, as incomplete.

It is ordered:

1. This transaction is subject to the current regulations set forth at 49 C.F.R. part 1180, as adopted in Major Rail Consolidation Procedures, 5 S.T.B. 539 (2001).
2. CN’s motion for approval of its voting trust agreement is denied, without prejudice, as incomplete.
3. This decision is effective on its service date.

By the Board, Board Members Begeman, Fuchs, Oberman, Primus, and Schultz.