Memorandum

To: Chairman and Commissioners

Date: December 3, 2001
Item: PTC Agenda 1a
Action

Diane C Eidam
From: Diane C. Eidam

Ref: Report on NCRA Operator's (Railways, Inc.) Bankruptcy and Potential Impact on State Grant

ISSUE:

The North Coast Railroad Authority (NCRA) is currently eligible for several State and Federal grants for the rehabilitation and update of the rail line from Lombard to Eureka. To facilitate this reopening process, the NCRA entered into an interim operating agreement with Rail-Ways, Inc. and then a permanent operating agreement with the Northwestern Pacific Railway Company (NWPY)-LLC. In April 2001, the Rail-Ways, Inc. filed for bankruptcy. The same individual has represented both companies during public transactions on various NCRA related issues. For this reason, the California Transportation Commission (Commission) requested staff and the Department of Transportation (Department) to provide a legal opinion and report on the following questions related to the bankruptcy of Rail-Ways, Inc:

1. What, if any, is the relationship between Rail-Ways, Inc. and the operating company, NWPY-LLC?

2. Does NCRA's existing contractual relationship with the NWPY-LLC have any direct or indirect impacts on the grants the Department administers to the NCRA?

3. Can any of these grant funds, particularly the Traffic Congestion Relief (TCR) funds, somehow be impacted by the bankruptcy filing of Rail-Ways, Inc.?

RECOMMENDATION:

It is recommended that the Commission and Department continue to monitor events for potential impacts to current and future funding allocated to the NCRA. In addition, it is recommended that all future funding agreements with the NCRA contain language clearly identifying a specific project or tasks to support the allocation. Department staff will consult with legal counsel to develop additional standard language for inclusion into funding agreements with the NCRA.

BACKGROUND:

In 1998, the NCRA contracted with Rail-Ways, Inc, a private company, to serve as interim operator on its rail line and later contracted with the NWPY-LLC to serve as permanent operator. In late April 2001, Rail-Ways, Inc. filed bankruptcy. At this time, the Department raised several concerns to the NCRA regarding its operating agreements. These concerns included the fact that NCRA's operator has used several different company names during agreement negotiations and the performance of tasks related to the agreement. Due to questions surrounding the relationships between the different companies, Department staff was not able to determine the validity of NCRA's operating agreement or subsequent amendments or the impacts of the filing of bankruptcy by Rail-Ways, Inc. on current or future fund allocations to the NCRA.

While the Commission and the Department are not directly involved in funding the operation of rail service provided by the NCRA, the end product of the rail rehabilitation and upgrade project is the continued operation of rail services on the north coast. The Department serves as grants manager over several State and Federal funding sources designated to the NCRA for use on this project. Approximately 62 percent of the overall funding of NCRA's $112 million dollar rail rehabilitation and upgrade project is funds administered by the Department. For this reason, the Commission directed staff and the Department, during its May 2001 meeting, to seek legal advice on the above issues.

ANALYSIS:

To answer the above questions, Department staff forwarded copies of agreements for the operation of rail services (as provided by the NCRA) and other related documents to our legal counsel for review and analysis. In addition, legal counsel consulted with the Department's Audits and Investigations staff regarding information discovered during their most recent audit of Section 130 funds provided to the NWPY-LLC. Below is a summary of counsel's findings:

1. What, if any is the relationship between Rail-Ways, Inc. and the operating company, NWPY-LLC?

   Counsel is of the opinion that Rail-Ways, Inc. and the NWPY-LLC are interrelated and that no pretrial legal distinction should be made with respect to their alleged legal separateness. This is based on several findings including the fact that both companies have commingled funds and assets and staff from each company has managed the affairs of the other.

2. Does NCRA's existing contractual relationship with the NWPY-LLC have any direct or indirect impacts on the grants the Department administers to the NCRA?

   Counsel has determined that NCRA's lease and operating agreement with NWPY does not require the NCRA to pay for services of the NWPY. Therefore, future grants administered by the Department and allocated to the NCRA for improvements to the railroad should not be impacted.

3. Can any of these grant funds, particularly the TCR, somehow be impacted by the bankruptcy filing of Rail-Ways, Inc.?

   Counsel's opinion is that grant funds administered by the Department will not be impacted by the bankruptcy filing of Rail-Ways, Inc., even though the company claimed an accounts receivable of $2 million (in its bankruptcy documents) owed by the NCRA to Rail-Ways, Inc. (Note: Neither the NCRA, nor the Department have any knowledge regarding the nature of this obligation. Additionally, Rail-Ways, Inc. signed an agreement on February 21, 2001 releasing the NCRA from any liability for debt prior to the signing of the agreement.)

   Counsel's opinion is also based on the rationale that, NCRA as a local agency, is covered by Government Code section 970.4 which states, in part, that a local public entity shall pay, to the extent funds are available any judgment out of unappropriated funds <u>unless the funds are restricted by law or contract for other purposes</u>. (Note: Departmental funding agreements require the applicant to provide a clearly defined scope of work for each allocation.)